The Do’s and Don’ts of Monetary Policy

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What should monetary policy try to do?

- Some obvious candidates:
  - (1) Stabilize prices
  - (2) Stabilize output and employment
  - (3) Maintain full employment
  - (4) Preserve financial stability
  - (5) Peg the exchange rate
  - (6) Maintain balance of payment equilibrium
- Why not try to do it all?

Preamble to the Bank of Canada Act

“Whereas it is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and mitigate by its influence fluctuations in the general production level, trade, prices and employment, [so far as may be possible within the scope of monetary action, and generally promote the economic and financial welfare of Canada].

- Tinbergen and the concept of one tool – one target
- Can’t we hit two birds with one stone – “the divine coincidence”?
- Why not different targets at different times?

Some important considerations

- What criteria should guide our decision?
  - (1) Feasibility
  - (2) Comparative advantage
  - (3) Consistency
  - (4) Simplicity
  - (5) Clarity
  - (6) Predictability
- What does the public want us to deliver?

Narrowing the options

- What has been tried in the past? – Almost everything
- Inflation targeting as a high bar for change
- What are some possible replacements?
    (1) Price level targeting
    (2) Nominal GDP level targeting
    (3) Fixing the exchange rate (Really?)
- What are some of the possible modifications?
    (1) Raising the target rate of inflation
    (2) Leaning if necessary
    (3) Income inequality concerns

Raising the inflation target - Is higher better?

- Three reasons why we might want to raise the inflation target:

  (1) Declining natural rate of interest

  (2) More volatile domestic and global economies

[In other words, more encounters with the Lower-Effective-Bound]

  (3) Discouraging the search for yield

- Is monetary policy a victim of its own success?
- Is low, stable and predictable inflation inimical to financial stability?

Why low(er) inflation is probably better

- Six reasons why raising the inflation target would be a bad idea:
  - (1) Revised (lower) estimates of the ELB
  - (2) Evidence unconventional monetary policy works
  - (3) Uncertainty about the long-run natural rate of interest
  - (4) Fiscal policy can play a supporting role
  - (5) Monetary policy effectiveness and efficiency can be improved
  - (6) Raising the target undermines the goal of price stability
- Strong reason to believe the benefits of price stability are significant

Pitfalls of “leaning” as a financial stability tool

- Why leaning should be unnecessary and why it is likely unhelpful
- Three important concerns:
  - (1) Uncertain dosage – How high do interest rates have to go?
  - (2) Collateral damage – Bad real effects and perverse dynamics
  - (3) Uncertain timing – When and in what direction to lean?
- Moral hazard and lost central bank independence
- Comparative advantage – There are better ways of dealing with this (micro- and macro prudential tools)

The “inequality trap”

[With apologies to William Watson]

- Why we shouldn’t go there:
  - (1) How could the central bank decide what is fair?
  - (2) Who are the winners and losers? - ambiguous evidence
  - (3) Isn’t this a fiscal issue?
  - (4) Aren’t there better ways to achieve the desired distribution?
  - (5) Canadian exceptionalism (Gini Curve flat-lining)
- Not clear that monetary policy has a useful role to play

Price level targeting – a worthwhile idea

- Greater certainty about long-run prices (and reduced volatility)
- Stronger stabilizing expectations effects
- Misplaced concerns about communication and commitment
- Three counters to the commitment concerns:
  - (1) Price level targeting with a slope
  - (2) More gradual return to target
  - (3) Encouraging empirical evidence
- Supply shocks as a potential Achilles heal

Nominal GDP Level Targeting

- Clear focus on the two principal concerns of the public
- Better response to supply shocks
- Some supposed disadvantages:
    - (1) Quarterly frequency
    - (2) Numerous revisions
    - (3) Political economy considerations
    - (4) Shifting estimates of potential growth
- Why these might not be as serious as advertised

My bottom-line

- What not to do:
  - (1) Don’t lean
  - (2) Don’t peg
  - (3) Don’t be a social planner
  - (4) Don’t be an inflation booster
- What to do:
  - (1) Reconsider merits of price level and GDP level targeting
- Mysteriously ignored in the 2016 renewal process