Can We Do Better Than Flexible Inflation Targeting?

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I. Introduction

Overview

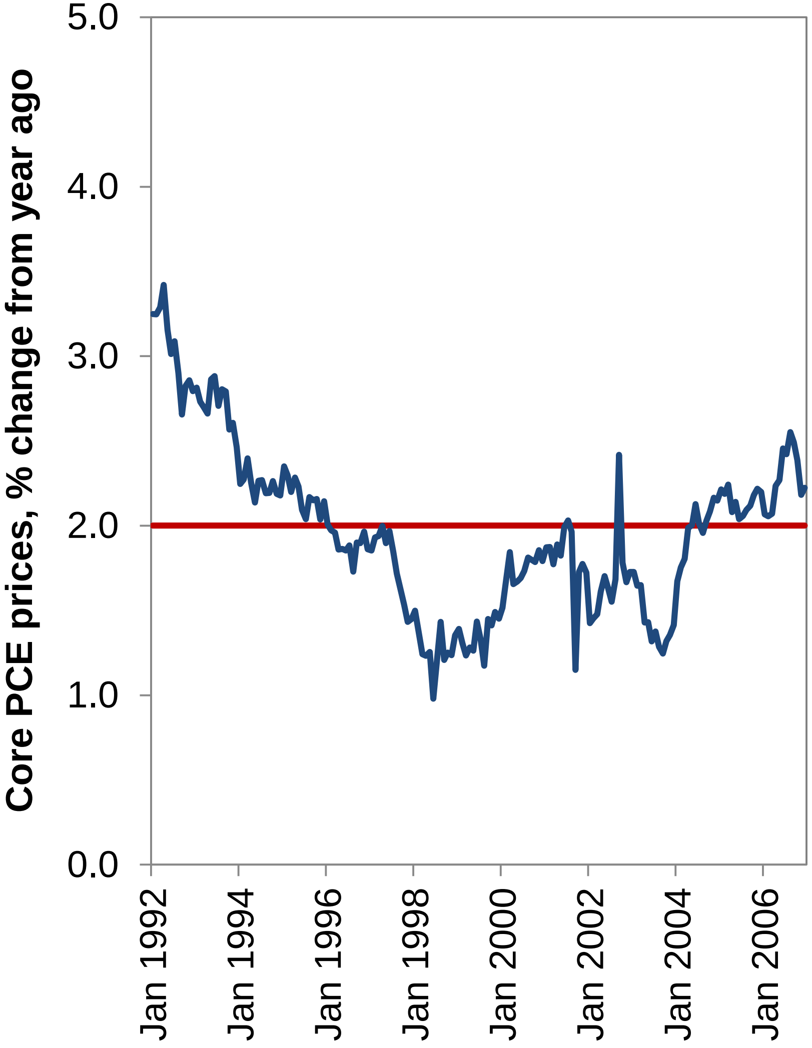
- Theme: It takes a framework to beat a framework.
- I won't focus on a single alternative to flexible inflation targeting.
- Instead:
  - Make the case that this is an important time to be considering alternative frameworks.
  - Discuss what I see as the main candidates.
  - Present some evidence about one of them.

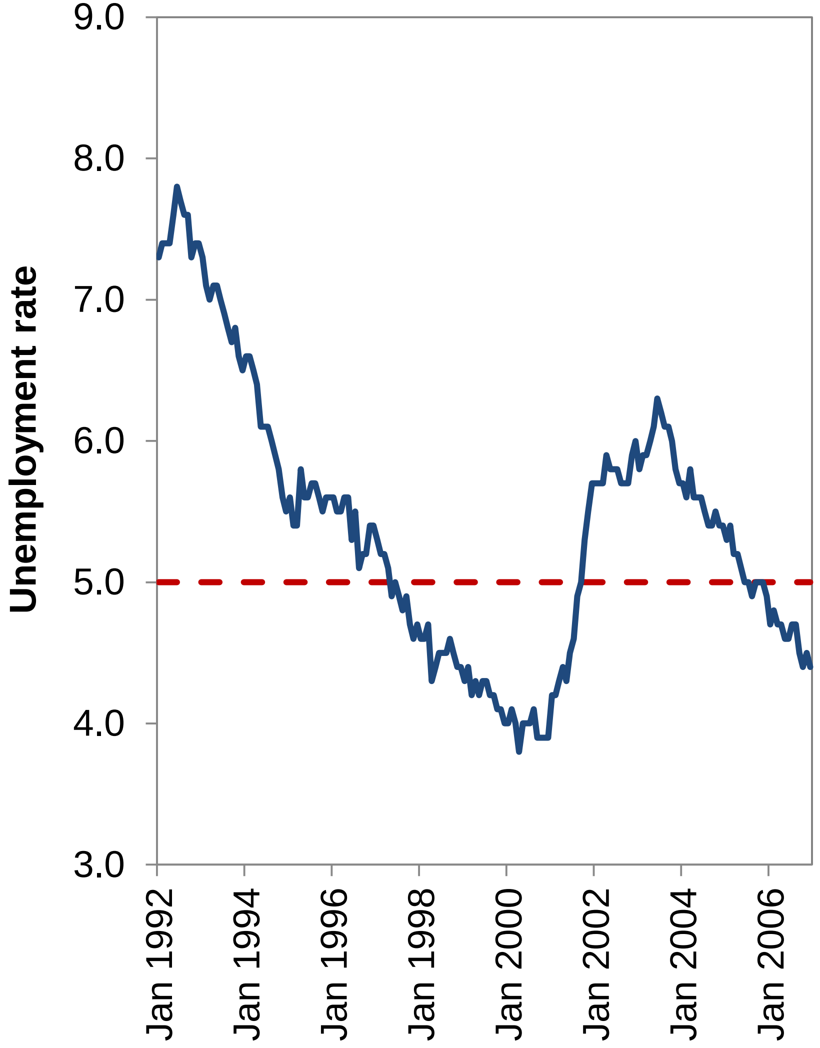
II. The Case for Flexible Inflation Targeting Is No Longer Clear-Cut

Background

- The primary role of monetary policy is to manage aggregate demand.
- c. 2006, flexible inflation targeting had done that very successfully in a wide range of countries for 10–20 years.

Inflation and Unemployment in the U.S., 1992–2006

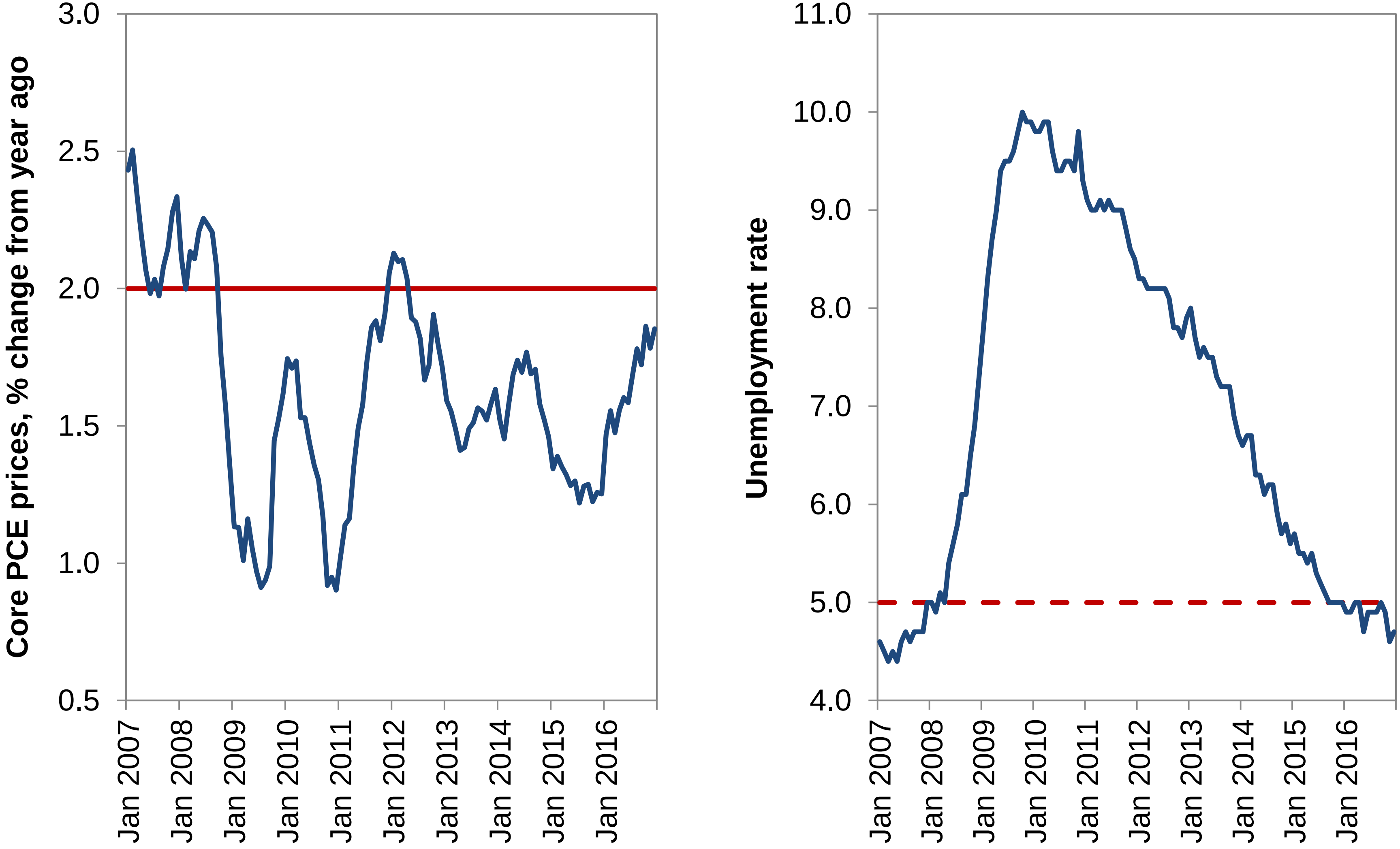




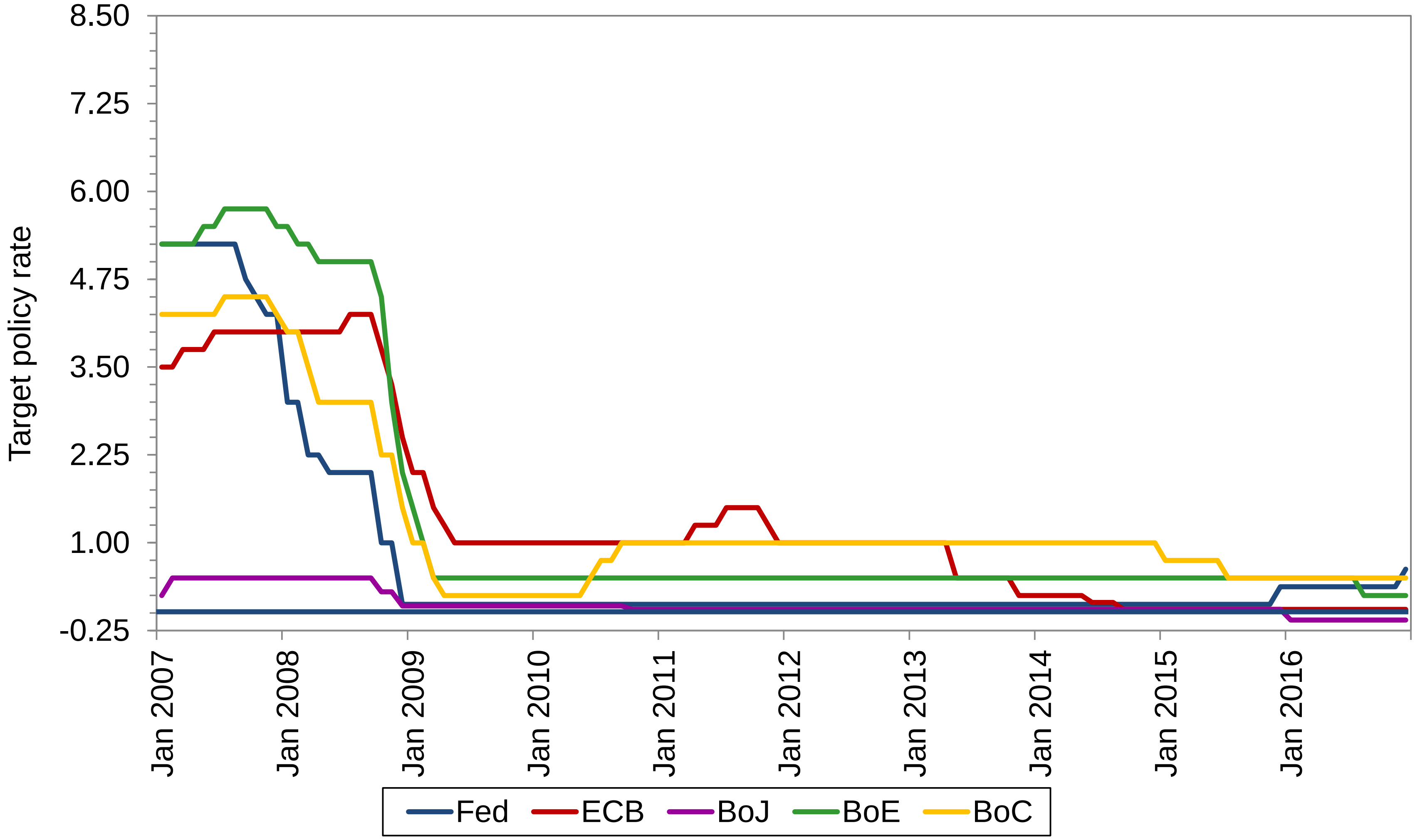
The Great Recession and Its Aftermath

- In the recession, monetary policy fell far short of offsetting the shocks to aggregate demand.
- Aggregate demand remained deficient for years following the recession.

Inflation and Unemployment in the U.S., 2007–2016



Monetary Policymakers Were Constrained in Their Ability to Lower Their Target Interest Rates



Going Forward

- The lower bound on interest rates is likely to continue to be important.
- The burden of keeping the economy stable is likely to fall even more heavily on monetary policy than it did in the Great Recession.

III. What Are the Alternatives?

Alternatives That Differ from Current Flexible Inflation Targeting at All Times, Not Just at the Lower Bound

- A higher inflation target.
- Targeting a price level path.
- Targeting a nominal GDP path.
- Exotic possibilities: abolishing or taxing currency, or a varying exchange rate between currency and the unit of account.

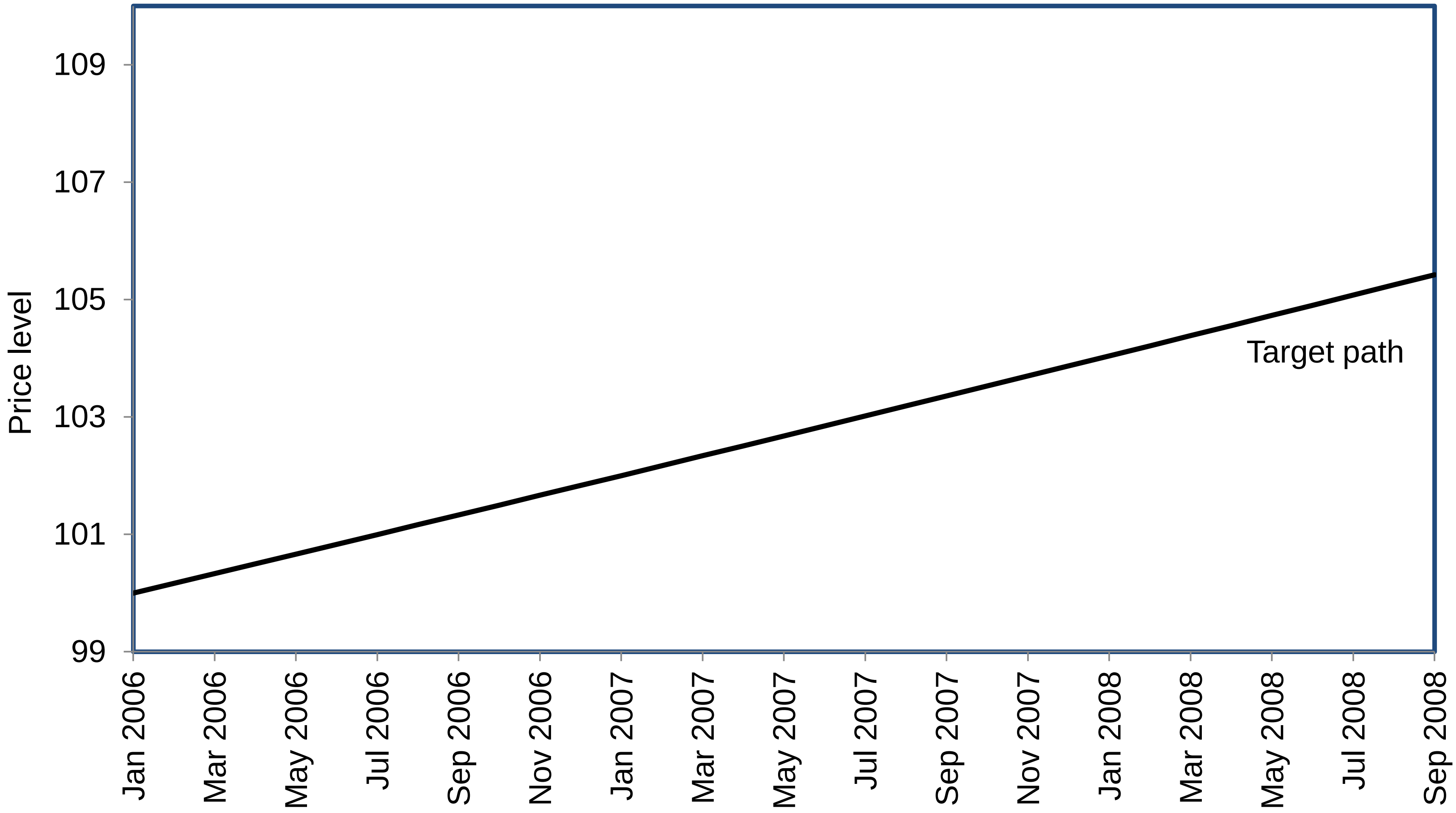
Two General Comments about These Alternatives

- They would have the advantage of providing a unified framework for monetary policy at all times.
- They would have the disadvantage of not using the current flexible inflation targeting regime in normal times, where it has been quite successful.

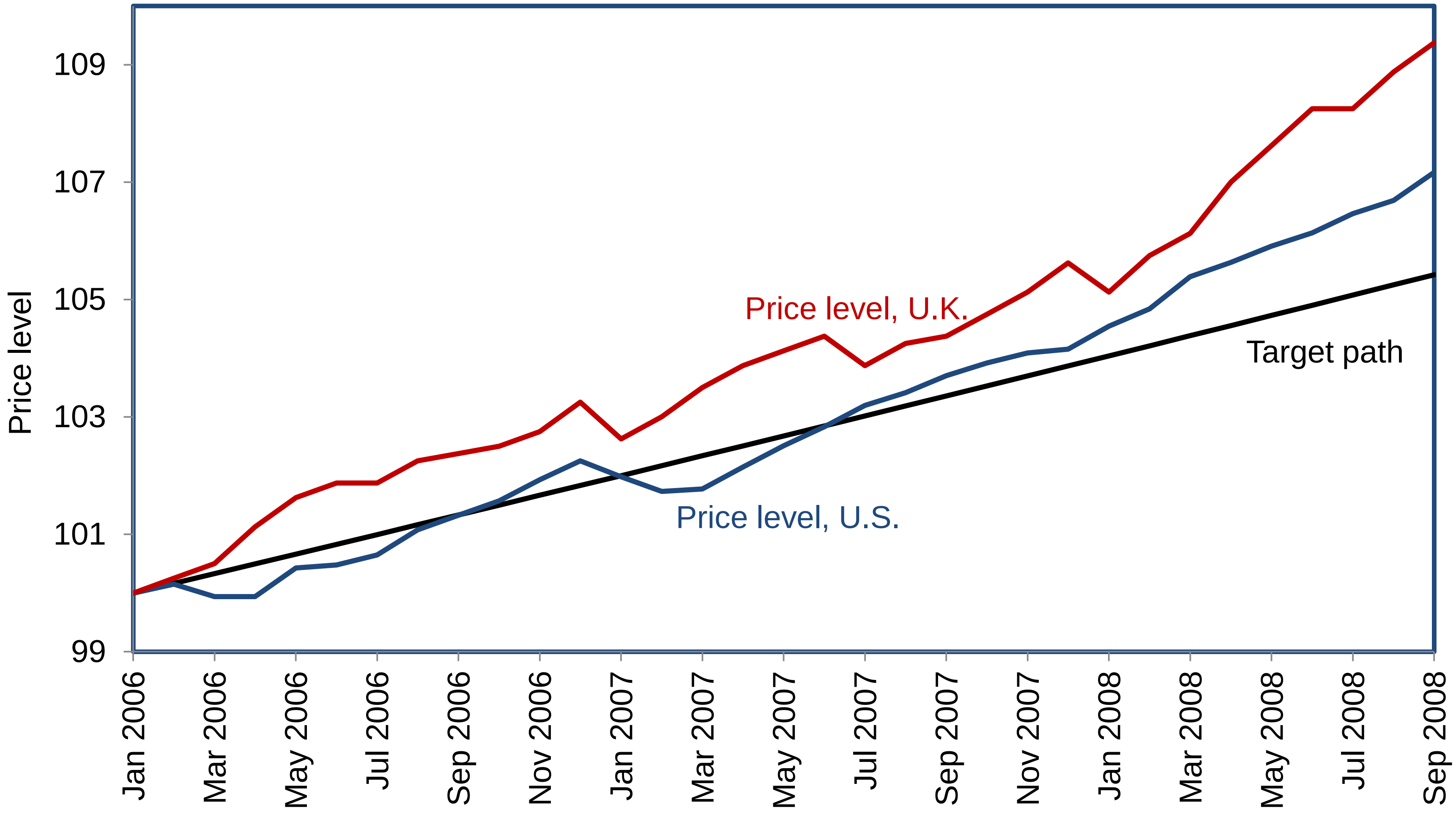
Some Specific Comments about These Alternatives

- My view is that the exotic regimes are (and should be) a nonstarter.
- I also think that raising the inflation target is (and should be) a nonstarter—at least for now.
- The alternatives involving a price level path or nominal GDP path have the advantage of being self-correcting.
- The price level can be a poor guide to policy.

A Price Level Target Path, Jan. 2006–Sept. 2008



A Price Level Target Path, Jan. 2006–Sept. 2008



Alternatives That Depart from Current Flexible Inflation Targeting Only at the Lower Bound

Possible Monetary Policy Tools When the Policy Interest Rate Is Near Zero

- Purchases of long-term government debt.
- Purchases of other assets.
- Forward guidance.
- Targeting long-term interest rates.
- Mildly negative nominal interest rates.
- Funding for credit.
- Direct interventions in credit markets.
- Saying a little more than usual about the exchange rate.

A Key Point

- The fact that monetary policymakers have many tools available to them shouldn’t make us sanguine.

Possibilities for Embedding the Tools in a Broader Framework—Moderate Departures from Flexible Inflation Targeting

- Unconventional monetary policy meets forecast targeting.
- “Whatever it takes”.

Possibilities for Embedding the Tools in a Broader Framework—Larger Departures from Flexible Inflation Targeting

- These approaches would involve a temporary overshooting of the usual inflation target.
  - A temporarily higher inflation target.
  - Temporary price level path targeting.
  - Temporary nominal GDP path targeting.

Regime Shifts at the Lower Bound

- Switching from flexible inflation targeting in normal times to a different framework at the lower bound could have important effects on expectations.
- The effects could be positive …
- or negative.

Two Conjectures about Optimal Rules for When to Switch Out of “Business as Usual” Policy

- Err on the side of switching too soon.
- Err on the side of starting by doing too much.

What Have We Learned from Abenomics?

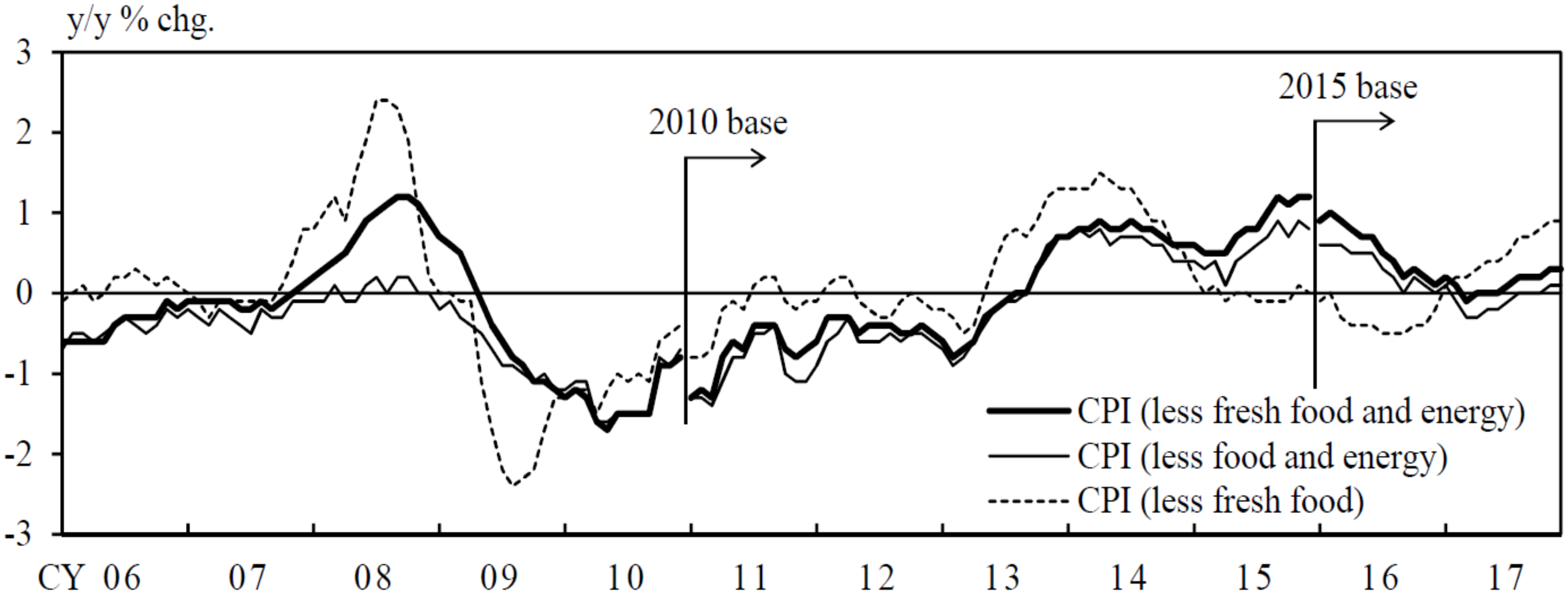
- The Bank of Japan has made enormous efforts to raise inflation.
- But it has stopped short of “Whatever it takes”, and even of forecast targeting (and it has only dipped a toe into overshooting the inflation target).

Lessons from Abenomics

- Generating desired aggregate demand when the policy rate is at the lower bound is hard.
- But attempting to do so has benefits.

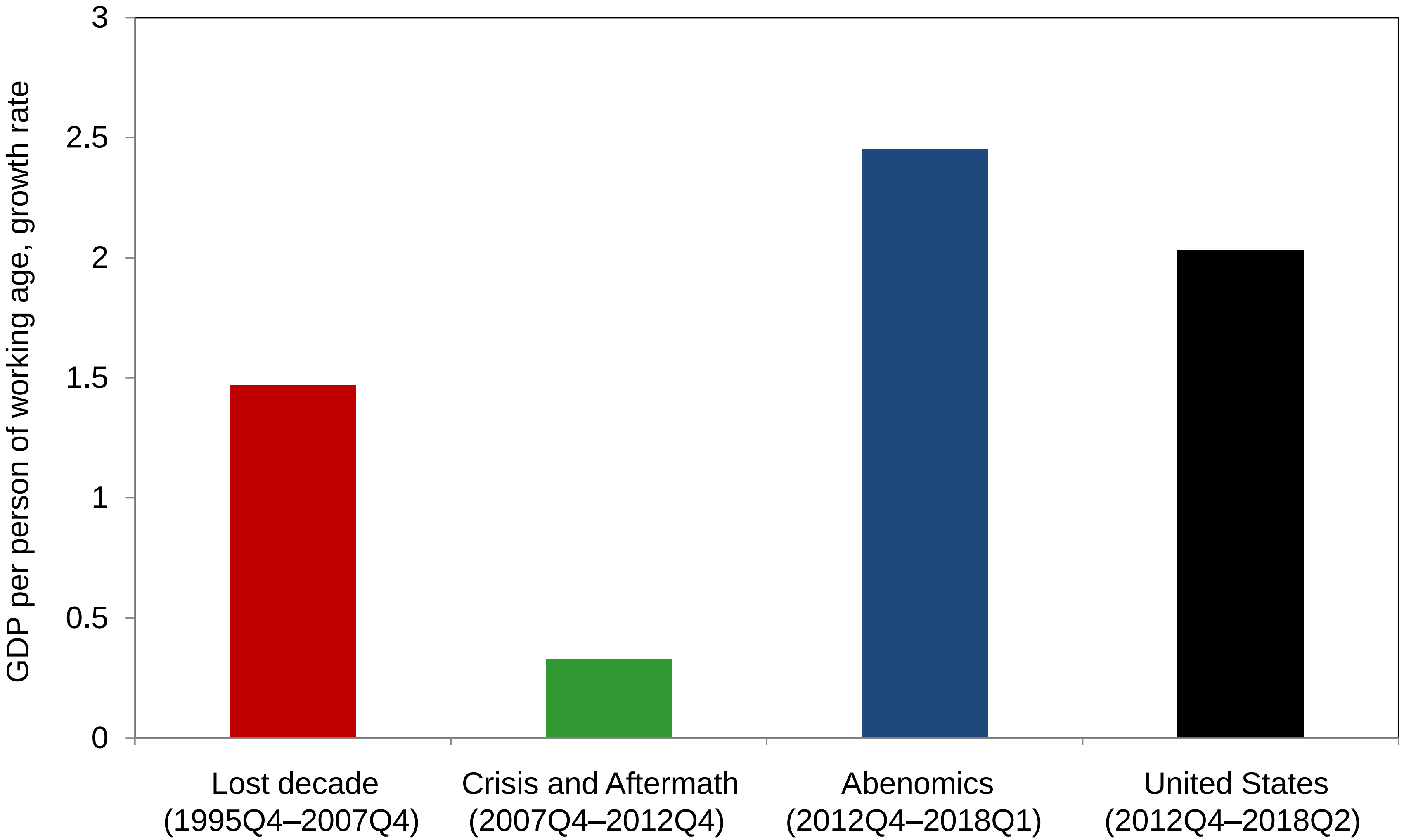
Measures of Underlying Inflation

(1) All Items (Less Fresh Food and Energy) and All Items (Less Food and Energy)



Note: Figures are adjusted for changes in the consumption tax rate. The same applies to the charts below.

Source: Bank of Japan.



Source: Hausman and Wieland (2014) and author’s calculations.

IV. Some Evidence on the Possible Performance of Targeting a Path for Nominal GDP

Targeting a Path of Nominal GDP

- The central bank chooses a desired growth rate of nominal GDP and a base period. Together, these imply a target path.
- The central bank then conducts policy to try to keep nominal GDP close to the target path.
- A key feature: Forces policymakers to respond to past misses—a period of below-normal growth in nominal GDP needs to be followed by a period of above-normal growth.
- As a result, it could have desirable expectations effects.

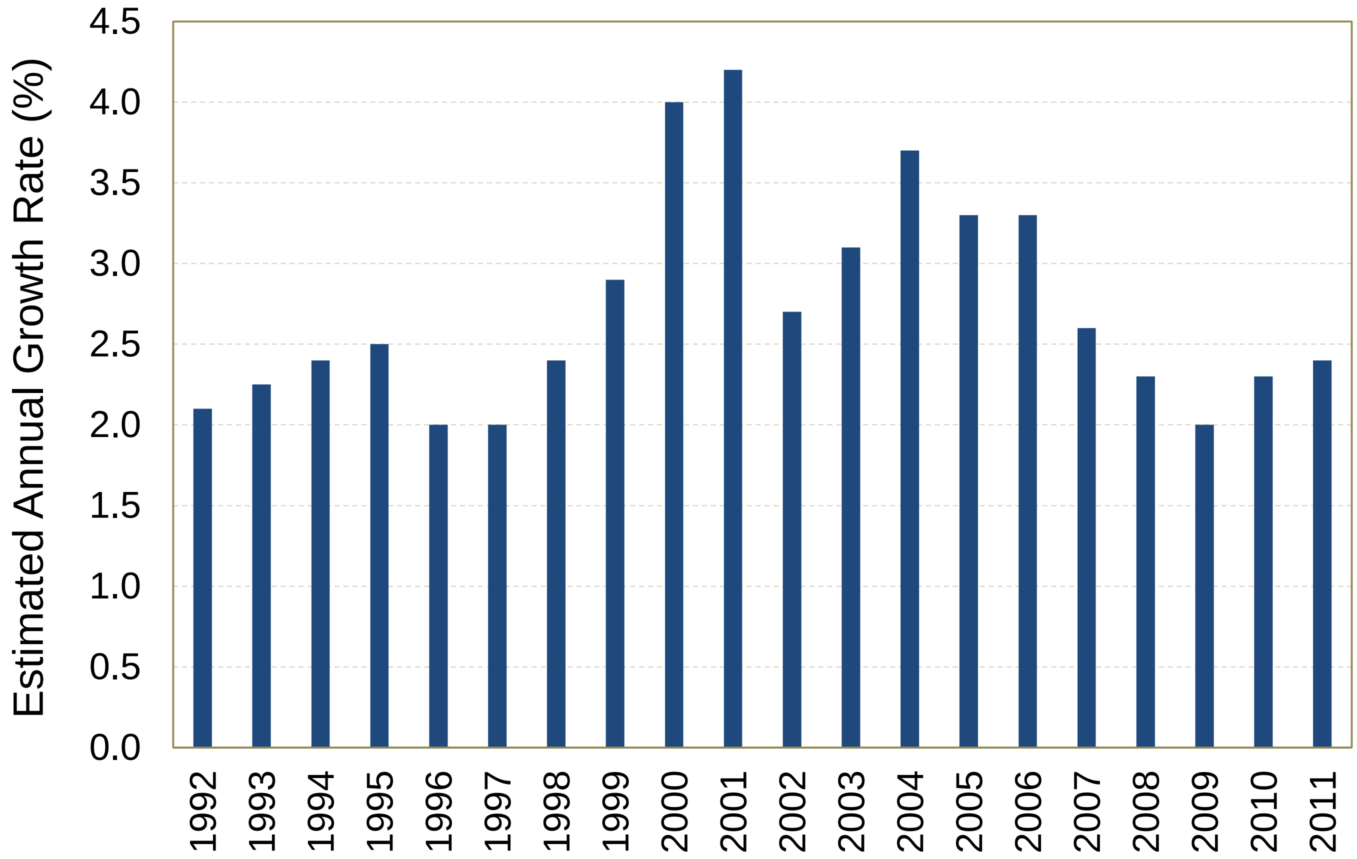
Our Approach

- Providing evidence about expectations effects is difficult.
- We do something more limited:
  - Simulate implementing a target path for nominal GDP starting at various dates given real-time data and forecasts.
  - Forces us to think about the practical issues.
  - Look at what such rules would have told policymakers to do.

Findings about Practical Issues

- Not adjusting the target path in response to revisions to older data would force nontrivial policy changes for reasons unrelated to the outlook for output and inflation.
- Policy based only on actual data (rather than forecasts) would often be very slow to respond to economic developments.
- Not adjusting the target path in response to changes in the growth rate of potential output could lead to large swings in inflation.

Federal Reserve Staff Estimates of the Growth Rate of Potential Output



Source: Board of Governors, Greenbooks or Tealbooks.

Some Evidence about How a Rule Might Perform in Practice

- We consider the Fed adopting a practical nominal GDP target path as of various dates.
- Then ask: What would the rule have told the Fed to do over the next few years, relative to what it actually did?
- As noted above, a limited evaluation.

Major Episodes of Policy Tightening and Loosening, 1993–2011

Period	Direction	What would a nominal GDP rule have told the Fed to do?	Outcomes
Feb. 1993–Feb. 1995	Tightening	Slightly more tightening	Output close to potential; inflation close to 2%
June 1999–May 2000	Tightening	Substantially more tightening	Output well above potential through mid-2001; inflation slightly under 2%; dot-com bubble
Jan. 2001–Dec. 2001	Loosening	Much more loosening	Recession, slow recovery, output persistently below potential; inflation slightly under 2%
June 2004–June 2006	Tightening	Slightly more tightening	Output above trend; inflation slightly over 2%; housing bubble
Sept. 2007–Dec. 2008	Loosening	Much more loosening	Great Recession, slow recovery, output far below potential; inflation persistently below 2%

V. CONCLUSION