Inflation Targets: Practice Ahead of Theory

By Lord Mervyn King

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Charles L Evans
Former President, FRB Chicago

Monetary Policy under Radical Uncertainty

- Q: What is the theory relating changes in instruments to changes in the objective?
  - It is highly desirable to have empirical and theoretical frameworks that include ALL variables relevant for inflation determination
  - Money, credit, banks, finance seem missing but should be important for *nominal economy*.

- Radical uncertainty is a game-changer
  - Previous optimal policies will give way to new policies
  - Missing economic features require attention
  - Forward guidance is problematic? Confidence: Delphic? Odyssean?

Addressing Radical Uncertainty

- Anchored Expectations are a crucial inflation ingredient for strategic frameworks (inflation targeting) and tactical considerations.

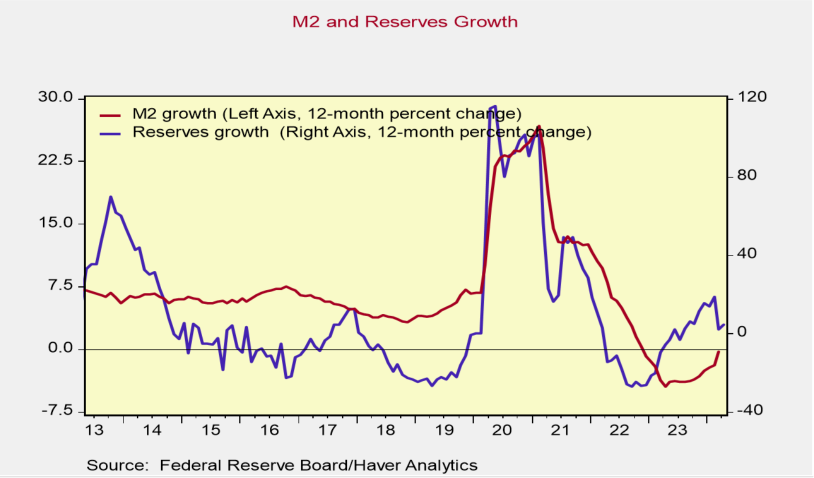
- Money growth and inflation… chart
  - Inflation has surprised central banks around the world
  - Bernanke-Blanchard find that *shortages* account for the initial 2021-22 inflation
  - Global common factor for inflation (CEPR 2024)

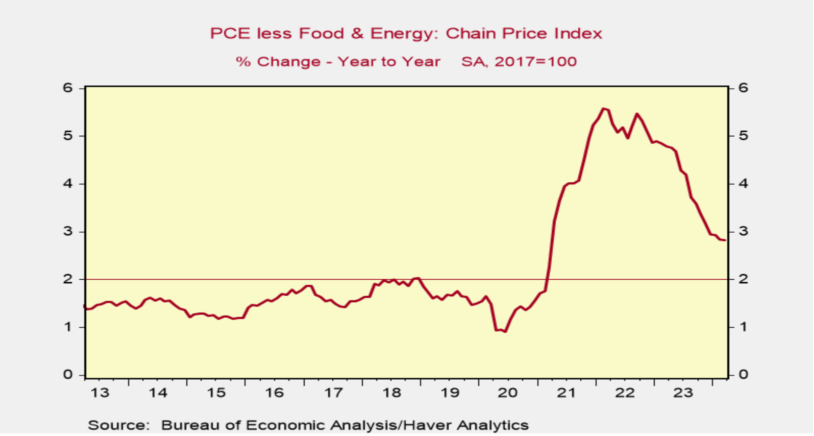
- Fed Tealbook alternative scenarios have been around for quite some time. Excellent example: March 2011.
  - Central bank models are not locked into delivering target inflation if inflation expectations become unmoored.
  - Bernanke Bank of England worthy?

- Reifschneider (2023) counterfactual simulation for early Fed tightening in mid-2021.

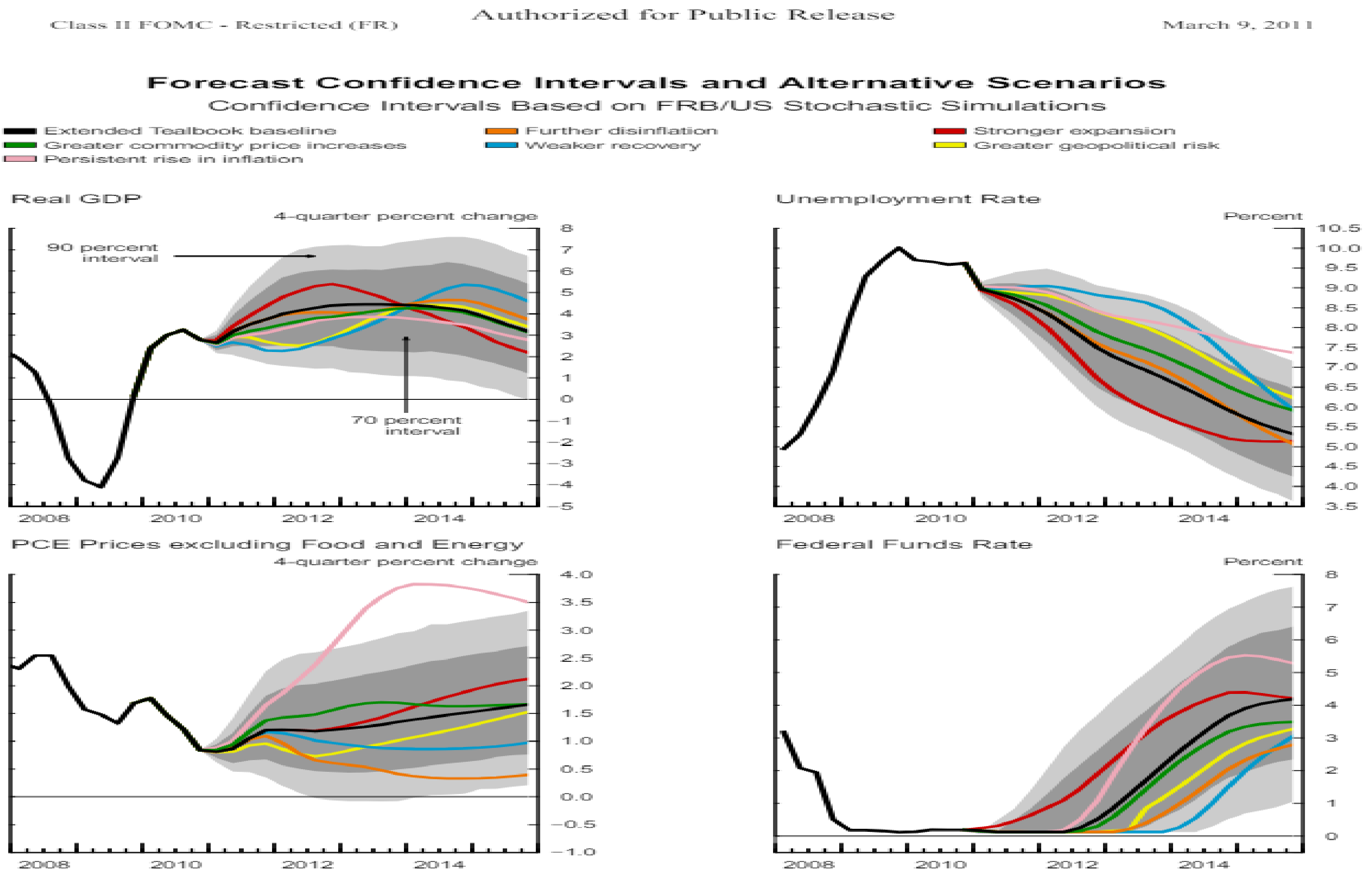
Radical Uncertainty? Money growth?

- Much of M2 growth is driven by Repo and QE in 2019-21.
  - U.S. centric? Global inflation
- Did money growth lead and cause inflation?
  - If so, the quick fall in inflation without expectations becoming unanchored has also been a Fed success.
- Paraphrasing Greenspan, how do we know when radical monetary exuberance has unduly escalated inflation?
  - Not in 2013-14.



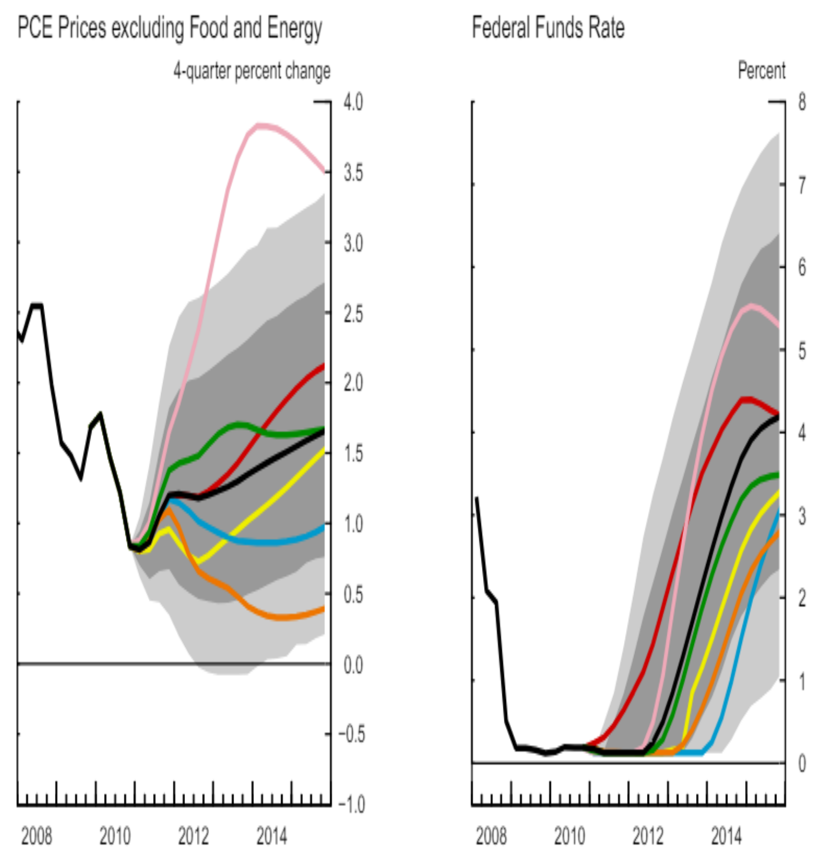


Can inflation be a sufficient indicator?



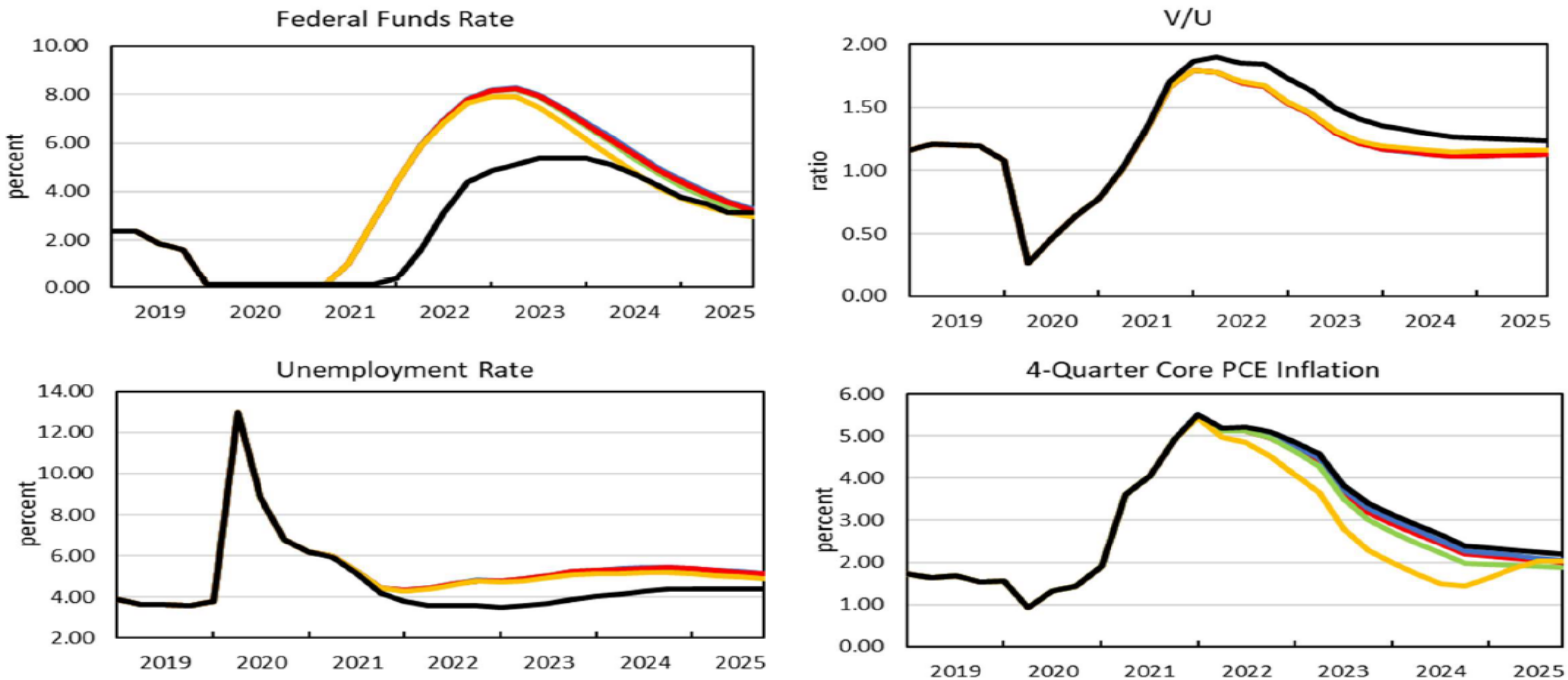
FOMC Alt. Scenarios, March 2011

- Persistent Rise in Inflation
  - Rising Commodity Prices
  - Higher NAIRU (1 ppt)
  - Bottlenecks from accelerating activity
  - Long-run inflation expectations are more sensitive to persistent movements in headline inflation.
- Bernanke-worthy?
- Pushing core PCE inflation outside 90 percentile bands requires a lot of creativity.



Earlier start, V/U, Steeper PC
Reifschneider (2023, PIIE)

Figure 13. Economic Effects of the Counterfactual Monetary Policy: FRB/US Simulations Assuming Well-Informed Financial Market Participants Using Different Specifications of the Phillips Curve (PC)
(Black -- actual and SPD projected, Red -- PC #1, Blue -- PC #2, Green -- PC #3, Yellow -- PC #4)



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, Federal Reserve Bank of New York, Federal Reserve Board, and author's calculations.

FRB/US simulations are run with its wage and price equations based on: (1) standard FRB/US model; (2) Bernanke and Blanchard; (3) Cechetti and others (hot/cold model); and (4) Gagnon and Collins (low inflation bend model). Under the counterfactual policy, in early 2021 the FOMC announces that it will sfollow the prescriptions of the V/U version of the BA rule and will begin normalizing the size of the SOMA portfolio. In response, financial markets revise their expectations as predicted by the model but do not have perfect foresight about future shocks to real activity and inflation. Other agents are less informed and revise their expectations in line with the predictions of a small VAR model.

Source: Reifschneider 2023, Peterson Institute for International Economics

Final Thoughts for Fed policy (1)

- Anchored inflation expectations are a big deal.
  - Central bank models **do not automatically return inflation to 2 percent** if inflation expectations become unmoored.
- Raising FF worked to contain high inflation pressures
  - Implementing restrictive monetary policies remains feasible
  - Providing accommodation at the ELB is more difficult
- The tactics of Sept 2020 FAIT implementation could be improved
  - A tactical threshold escape clause could help, like Evans 2012.
  - A strategic commitment to symmetry is valuable

Final Thoughts for Fed policy (2)

- Much follows from selecting pi*=2.
  - ELB risk depends on pi*
  - The need for QE and its scale depends on pi*
  - At minimum, central banks should make an affirmative case for their selection of 2 percent

- Public dislikes high inflation
  - Maintaining anchored inflation expectations is a big deal.