Commentary on Optimal Contracts and Inflation Targeting Revisited by Persson and Tabellini

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Overview

- Important contribution on critical issue of designing monetary policy strategies and commitment for a wide variety of circumstances
  - In last 15 years central banks have struggled both to raise inflation to target and then to get it back down after it had spiked to well over target
    - More credibility for the latter than the former, judging from expectations
    - Fed, others, have grappled with adjusting strategies to deal with potential ZLB episodes
  - Going forward unclear what circumstances will prevail
    - Possible upward pressures on costs, prices, and interest rates, with political unease as rates respond
    - But can't rule out further episodes at ZLB
  - Strategy and commitment don't guarantee success (Japan), but "plan beats no plan."
- Focus commentary on four "lessons" of paper, in part through the lens of the Fed's 2019-20 framework review and 2024-25 revisit

Lesson 1: Contract and IT regime should condition on being at the ZLB or out of it

- Agree: Constraints of the ZLB will tilt policy toward missing both inflation and output targets on the low side over time and require offsetting strategies when stuck there
  - Fed 2020 framework did this in flexible average inflation targeting, which called for aiming for inflation "moderately above target for some time" after persistently below target results—presumably because of the ZLB (TPLT), but no make up for overshoots
  - But also included another asymmetry: policy taking into account assessments of shortfalls from "maximum employment" but not overshoots, that applied <u>all the time</u>.
    - Arguably contributed to delayed response in 2021-22, especially as implemented in forward guidance, and seems to undermine pre-emptive policy to forestall inflation increases (e.g. 1994-95)
    - Seemed to elevate employment goal relative to price stability, taking more risks with P than U
- For 2024-25 review, strategy needs to be robust under a variety of circumstances, treat price stability as at least an equal goal, get back to pre-emption

Lesson 2: The target should be raised to deal with the ZLB

- Open issue: A common, logical, argument for dealing with the ZLB, but inflation has costs, including some that may not be captured by models
  - People dislike inflation
    - See wage gains as earned by their hard work, but price gains as imposed and eroding the purchasing power of their wage gains
  - Inflation makes market signals hard to interpret and demands attention on how to adapt
    - Greenspan: price stability when households and businesses don’t have to pay attention to inflation. Price stability promotes productivity b/c businesses focus on cost cutting
    - Volcker: 2 is too high and too precise
  - 2024-25 framework review should justify target, not take 2 as given.
    - Consider a range?

Lesson 3: Expand central bank monetary policy mandate to encompass financial stability

- Disagree, but….
  - CBs already have financial stability mandate using discount window and, for many, bank supervision
- Applied to monetary policy, false positives could prevail, resulting in systematic undershooting of inflation and output targets.
  - Much better would be development of macropru tools, though hard for NBFI
- But QE is a second tool and might be tailored to respond to FS threats exacerbated by low long-term rates, with only modest effects on price or output goals
  - E.g. Fed should have trimmed purchases of MBS in 2021 to lean against hot housing market

Lesson 3: Expand central bank monetary policy mandate to encompass financial stability

- Fed 2024-25 framework review should include tools, as well as strategy—especially unconventional tools used at the ZLB.
  - Does possible intersection of QE with financial stability and with fiscal risk change the QE calculus (as suggested by P&T)?
  - What was learned from the experience with forward guidance in 2021-22
    - A forceful implementation of the 2020 framework that delayed lift off

Lesson 4: Accountability should be modified to reflect altered strategies

- Agree: but, as P&T note, not clear how
  - The five-year review should start with lessons learned
    - Ideally by external reviewers, as in the Swedish model and the recent Bernanke report on the BOE MPC
    - But at a minimum with a public internally-produced report
  - Education of the public and the legislature is key to effective accountability when the main accountability instruments are hearings, appointments and the judgment of history, not contracts
    - Expand communication beyond the focus on educating financial markets, which, to be sure, are important to influence the financial conditions channels of policy transmission