Discussion of “Inflation Targets: Practice Ahead of Theory”*

THE QUEST FOR NOMINAL STABILITY:

LESSONS FROM THREE DECADES WITH INFLATION TARGETING

CONFERENCE HELD BY THE RIKSBANK,

STOCKHOLM, SWEDEN

23-24 MAY 2024

CAROLYN A. WILKINS,

SENIOR RESEARCH SCHOLAR, GRISWOLD CENTER,

PRINCETON UNIVERSITY

Princeton University
Department of Economics

* Views expressed here are my own and do not necessarily reflect those of my Financial Policy Committee or other Bank of England colleagues

Outline

Two areas of general alignment with King (2024):

i. limitations of the models used

ii. preference for transparency regarding the reaction function rather than strong forms of forward guidance.

Two issues that require more attention (monetary policy doesn't operate alone):

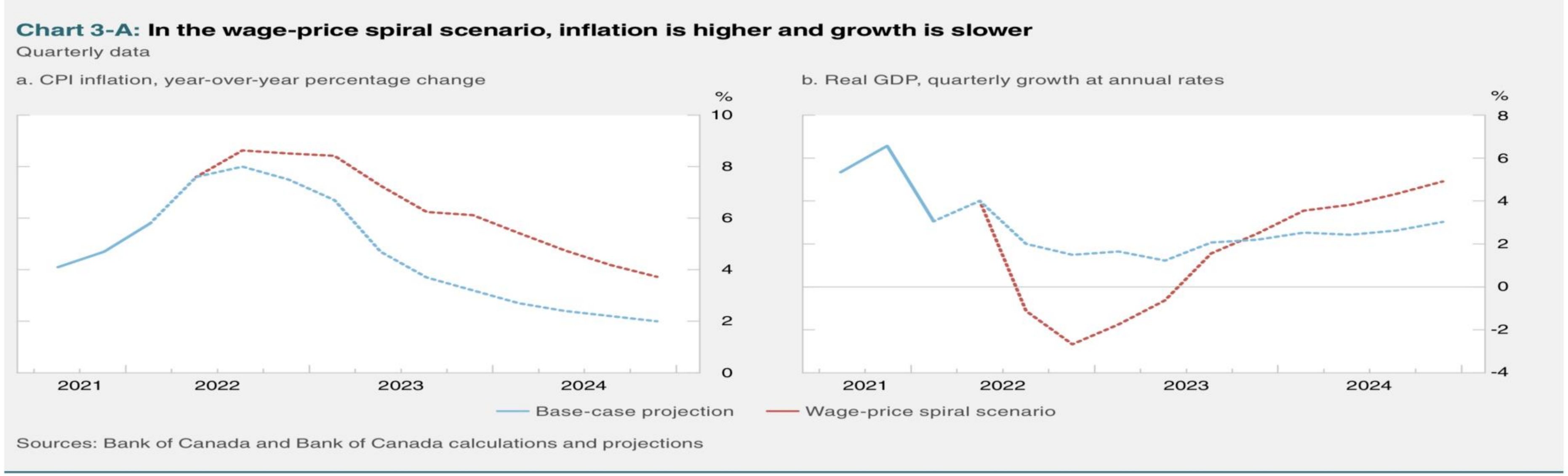
i. financial stability tools as a complement to monetary policy

ii. optimal mix of monetary and fiscal policies

Over reliance on small set of models

Major limitation with of work horse model: inflation is <u>not</u> "always and everywhere a transitory phenomenon"

- Yes, should explore models with endogenous π^e more regularly; CBs *were* concerned about inflation expectations post COVID (e.g., BoC July 2022, Mann 2022)



Over reliance on small set of models

Major limitation with of work horse model: inflation is <u>not</u> "always and everywhere a transitory phenomenon"

- Yes, should explore models with endogenous π^e more regularly; CBs *were* concerned about inflation expectations post COVID (eg, BoC July 2022, Mann 2022)
- Work also needed to improve suite of forecasting models along other lines; unanchoring of π^e can be spurred by significant forecasting errors (not just from a perceived change in π regime)
  - For instance, need better articulated supply side since that was the major source of inflation (Bernanke and Blanchard 2024), among other (Bernanke 2024, RBA Review 2023)
- Idea of multiple paradigms compelling, and may be unexploited value in monetary aggregates
  - Need a new and reliable way to extract value from the data if we want people to put weight on it -- already a start (e.g. Borio 2023, Schnabel 2023 among others)

Transparency about reaction function is best form of forward guidance

Compelling case that "strong" forms of forward guidance court danger

- confounds the forecast with the reaction function and distracts decision makers from the immediate policy decision. It also can be damaging to the CB's reputation (King 2024)
- similar arguments in the RBA Review 2023 that led us to recommend avoiding such strong forms of forward guidance

Communicating reaction function (RF) preferable, yet not an easy task

- central bank may have as many RFs as members of the policy committee
- RF changes over time, at times because of how uncertainty is dealt with in different circumstances; e.g. "whatever it takes" in face of ZLB vs. "wait and see" to reduce risk of policy reversal (Mendes et al 2017)
- 3 recommendations from RBA review that might help:
  - i. explain why and how flexibility is being used (e.g., what trade offs are being made and cost benefit)
  - ii. publish full forecasts with a lag so that researchers can study the reaction function and its evolution
  - iii. inform policy discussions with scenario analysis (including challenging key assumptions (e.g. oil prices BoC 2015) and communicate how different scenarios might change policy decisions

Financial stability policy can support monetary policy objectives

Monetary policy should keep eye on the ball

- "Leaning" to avoid build up in financial vulnerabilities generally found in literature to be costly (e.g., Svensson 2017), and may not be effective (e.g., strong house price growth can also reflect tax policy, supply constraints, immigration policy)

Other tools, while imperfect, can help reduce the build up of some important financial vulnerabilities (and related amplification channels)

- micro prudential regulation (e.g., higher capital and liquidity requirements)
- macro prudential tools (e.g., housing finance rules, CCyB)

Big challenge still in NBFI and fast-moving innovations that need to be addressed (FPC 2024)

- Gaps in NBFI regulation to close (leakage)
- Need to further develop CB tools designed to support FS as distinct from mp tools to achieve inflation target (e.g., current BoE work on liquidity tools for NBFIs)
  - LDI intervention example of intervention that supported monetary policy objectives– temporary, targeted, backstop pricing, prompt exit and follow up to reduce vulnerability (Wilkins 2024, Hauser 2022)
- Need institutional arrangements to support this (e.g., BoE's MPC/FPC model)

Monetary policy is not and should not be the only game in town

King (2024) focuses on CB tools that can be and should used to achieve monetary policy objectives and those that should not

- e.g., interest rates, QE when needed, avoiding strong forms of forward guidance

Monetary and fiscal policy mix issues merit more attention

- "coordination" options difficult to operationalize given the desire to respect independence of respective authorities

Avenues to pursue that don't necessarily threaten independence (RBA Review 2023):

- think through the cost/benefit of QE vs possible fiscal responses, including those to financial stability and distribution (e.g., McKay and Wolf 2023)
- exchange information regularly to be aware of situations in which government policies may be a better solution than tighter mp, particularly to address supply issues (e.g., by reducing frictions, investing in capacity)
- develop models of fiscal/monetary policy interactions and optimal policy mix