Summary of Audience Q&A
Session #5: "Monetary Policy Strategies"

Date: June 5, 2019

Moderator: Adam Posen (Peterson Institute for International Economics)

Presenter: Lars Svensson (Stockholm School of Economics)

Discussant: Sharon Kozicki (Bank of Canada)

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Following the presentation of "Monetary Policy Strategies for the Federal Reserve" by Lars Svensson, and the discussion by Sharon Kozicki, moderator Adam Posen asked the presenter and discussant if there was anything policymakers could do to bolster inflation expectations in the shorter run in order to bring them up to the rate consistent with policymakers' goals. Professor Svensson suggested that announcing a policy of average inflation targeting might not have an appreciable initial effect on inflation expectations, particularly if this announcement came after a period in which inflation had been running below policymakers' target rate, and that actual policy moves might be needed to lift inflation expectations. Professor Svensson also noted that a policy of targeting average inflation would accustom the private sector to periods in which actual inflation was both above and below the objective; short-run inflation expectations would move around a bit but longer-run inflation expectations would then become more stable and better anchored in the face of such variations. In the current framework, Svensson suggested that inflation expectations might pick up if FOMC participants indicated in their Summary of Economic Projections submissions that they expected an ultimately temporary, but multi-year, overshoot of the 2 percent longer-term inflation objective. Ms. Kozicki suggested that the choice of monetary policy strategy affected the degree to which policy was stabilizing, and this choice had a bearing on how much movements in longer-term interest rates reinforced the actions that the authorities took on the policy interest rate. However, she noted that longer-term inflation expectations tended to follow macroeconomic developments with a lag, and that a rise in these expectations might occur once nominal wage growth picked up further in response to labor market strength.

In addressing Ms. Kozicki's discussion of his paper, Professor Svensson noted that they were in agreement that it would be desirable for variations in the private sector's short-run expectations of inflation to play a more active role in returning inflation to policymakers' target rate. Svensson reiterated that a regime of average inflation targeting would be helpful here, as it was straightforward in such a regime to communicate—and therefore easier for the private sector to understand—the idea that a prolonged period in which inflation exceeded the longer-term objective would likely be followed by a prolonged period of below-target inflation. Svensson also indicated that in periods when unemployment was elevated, it would be less urgent to bring inflation down to its longer-term target.

Ethan Harris (Bank of America) suggested that a simpler alternative monetary policy strategy could be one that delivered low inflation early in an economic expansion and higher inflation later in the expansion when the economy reached a state closer to full employment. However, Professor Svensson argued that it might be more stabilizing for economic activity if inflation had a decidedly countercyclical pattern. Ms. Kozicki suggested that aiming to achieve the inflation rate over the business cycle was consistent with the policy of the Reserve Bank of Australia, which emphasized a target range rather than a point target. Both Ms. Kozicki and Professor Svensson noted that even in the case of a target range, it was desirable for inflation expectations to be focused on a single value (the midpoint of the range).

Mickey Levy (Berenberg Capital Markets, LLC) suggested that it might not be a hindrance to economic stability if inflation was below 2 percent for stretches of time, provided that inflation was expected to return eventually to 2 percent. Professor Svensson, however, expressed concerns that inflation would then average below 2 percent, and that longer-term inflation expectations would likely decline. This would likely be problematic for economic performance, especially in the presence of the effective lower bound on short-term interest rates.

A number of conference participants suggested that a monetary policy strategy of nominal income targeting might have better properties than suggested by the analysis in Professor Svensson's paper. Eric Sims (University of Notre Dame) argued that nominal income targeting delivered favorable outcomes in models that incorporated both wage stickiness and price stickiness. Evan Koenig (Federal Reserve Bank of Dallas) agreed with this assessment. He also cited the fact that households facing a stream of fixed nominal debt payments might find it desirable to be in an environment in which they were likely to receive steady nominal income flows. James Bullard (President, Federal Reserve Bank of St. Louis) argued that a policy of nominal income targeting delivered the countercyclical property of inflation that Professor Svensson had earlier cited as being desirable. He noted that Professor Sims and Mr. Koenig had already provided counterexamples to Svensson's position that nominal income targeting could not be found to be optimal in economic models. President Bullard also indicated that, in the model he had used in his recent research—which emphasized nominal contracting frictions rather than price stickiness—nominal income targeting was the first-best monetary policy.

In reply, Professor Svensson said he would expand his coverage of nominal income targeting in his paper but that he continued to doubt that this policy strategy adequately embedded the Federal Reserve's mandate of full employment and price stability (and in particular, the appropriate short-run balancing of the two objectives). As an example, Professor Svensson pointed to the case in which the nominal income target was being achieved but both real economic activity and inflation were away from policymakers' objectives. He also felt that a practical objection to nominal income targeting was the problem of measuring nominal income accurately and promptly. In addition, Professor Svensson argued that issues related to household debt were best addressed using macroprudential policy instead of monetary policy. Ms. Kozicki said that nominal income targeting had been studied in research at the Bank of Canada dating back to the 1980s and that it had been found to have desirable policies. However, she argued that inflation targeting involved fewer communications challenges than nominal income targeting.

President Bullard also expressed concern that Professor Svensson's emphasis on forecast targeting as a way of incorporating judgment into monetary policy formulation could become a back-door way of introducing excessive discretion into policymaking, a situation that might lead to an unmooring of inflation expectations. Ms. Kozicki noted that discretion was already part of monetary policy in practice and that Professor Svensson's forecast-targeting apparatus could be seen as a way of formalizing such judgmental aspects of policymaking. Professor Svensson argued that judgment was essential for policymaking because any one model took into account only a few of the factors relevant for practical monetary policy decisions. He suggested that a commitment by policymakers to their macroeconomic objectives provided a means by which to avoid excessively discretionary policymaking while still exercising judgment in policy decisions.

Finally, Charles Evans (President, Federal Reserve Bank of Chicago) stressed the need to investigate strategies in which monetary policy was credible over time in the sense that the private sector's expectations of future FOMC decisions coincided with the policy choices most appropriate for achieving the dual mandate.