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Monetary Policy: amid debates

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INFLATION TARGETING VS. NGDP TARGETING

The pandemic has put a strain on central banks, which have had to react quickly and have seen their independence diminish as monetary and fiscal policy have moved closer together. In this scenario, central banks' own monetary policy once again became the focus of a debate that never ended. Since the early 1990s, the dominant view among central banks and economists has been that the best target is inflation. A more widely held view today is that central banks should target debt growth or a range of asset prices, such as house or share prices. Moreover, it was in this context that the Inflation Targeting vs. NGDP debate was reopened, mainly by the economists Scott Sumner and David Beckworth, a former international economist at the US Treasury Department. The issue is not new on the economic scene, which, especially in the aftermath of the 2008 financial crisis, has seen supporters of both monetary policy proposals take sides. But why did this debate arise and what are the points sustained by the supporters of NGDP targeting?

THE MAIN ADVANTAGES OF NGDP TARGETING

Advocates of NGDP as a reasonable substitute for Inflation Targeting, such as Sumner, Professor Jeffrey Frankel and Christina Romer, stress how NGDP could help stabilize output fluctuations and the entire business cycle. We will analyse the main advantages of this alternative targeting sustained by its proponents.

Response to supply shock: the first objective of the supporters of this monetary policy is to respond to the criticism commonly raised: Inflation and NGDP Targeting lead to the same results in terms of the level of inflation and the response of the money supply. According to its advocates, it is exactly the response to the supply shock the key factor that differentiates the two strategies. We will try to clarify this point with a simple example. Let us assume that an oil embargo in the Middle East reduces a country's oil imports by 10% while boosting the price of oil by 60%. If the Central Bank targets inflation, policymakers must tighten money enough to deflate all non-oil prices to keep the overall Consumer Price Index (CPI) on target. Nominal wages, however, are sticky or slow to adjust, so a sudden fall in the prices of goods produced within the country, would sharply increase unemployment. Indeed, a fall in NGDP causes a decrease in profits and employment, but in the short run the biggest burden is on the workers. On the contrary, if the central bank targeted the Nominal GDP, it would not have to implement a restrictive policy and, in this way, it could stabilize employment. The main reason for this, is that the ability of employers to meet their wage bill depends more on NGDP growth than on the rate of inflation. The period between the end of 2007 and the beginning of 2008 can be used as evidence for this phenomenon: those years were influenced by a rapid increase in prices. However, as NGDP growth was slow, wages also grew slowly (Sumner, 2014). In the occurrence of an adverse supply shock, Nominal GDP Targeting manages to divide the consequences of the shift of the AS curve into a loss of price stability and a loss on the output objective.

Communication with the public: one of the main pillars for the success of a monetary policy is its credibility towards the public. NGDP Targeting is considered to lead to less confusion about the roles of monetary and fiscal policy. In fact, with Inflation Targeting, there is a general view that monetary policy deals with inflation while fiscal policy with output losses. The reality is that both have a direct impact on aggregate demand, but only an indirect effect on prices and output. On the contrary, under NGDP targeting, the monetary authority has sole responsibility for maintaining stable growth in aggregate spending (Sumner and Roberts, 2018).

In addition, it would help to depoliticize monetary policy, especially as it will not have a dual mandate, whose presence ensures that each of the parties to a given government can point to one of the mandates and argue that the policy has been successful or failed. On the contrary, the unique mandate will mitigate the political pressures monetary policy faces (Sumner, 2014).

Unexpected and unfair wealth transfers between creditors and borrowers is a key point in our discussion between the two monetary policy

Note: NGDP stands for Nominal Gross Domestic Product

targets. George Selgin, Economics professor at University of Georgia, has shown that Inflation Targeting can only avoid such transfers if the economy's productivity is not also changing. On the contrary, under NGDP targeting, even in the case of an unexpected productivity shock, such an event will not occur because the productivity shock would be offset by a reverse change in the inflation rate. But let us now try to understand this better by way of an example. Let us consider a specific country, whose central bank follows NGDP targeting, characterized by the following data:

Country data for specific year

Nominal interest rates	5%
Expected nominal GDP growth	5%
Expected real GDP growth	3%
Inflation rate	2%

Suddenly, there is an unexpected negative supply shock that boosts inflation to 5%, forcing real GDP growth down to 0%. In this scenario, lenders end up earning a real rate of return of zero, but they are in a difficult situation as everyone else. Consequently, with real GDP growth of zero, there is no additional income to be shared between lenders and borrowers. Conversely, under Inflation Targeting, if inflation were being targeted at 2%, NGDP growth would be reduced and this would make it difficult, if not impossible, for many borrowers to repay their debts, putting them in a more difficult situation than lenders (Sumner, 2014).

The advocates of NGDP Targeting do not all agree on one important question of the proposal: in particular, which part of it should we target?
For instance, many argue that monetary policy should target the level, not the growth rate to prevent sharp fluctuations. From this point of view, if NGDP growth begins to dip below the assigned trajectory, people would expect faster growth in output to compensate, and "those expectations would boost current aggregate demand" (Sumner, 2014).
At the same time, many researchers prefer a growth path target rather than a growth rate target because the former allows the economy to counterbalance past misses. In fact, as can be seen in the table below, assuming a NGDP level target at 4% growth, if it grows below 4% in the following year, the missed growth is compensated in the next two years by registering NGDP grow lower than 4%. Conversely, when the NGDP grows above 4%, in the next two years it will grow lower than 4%. Moreover, if the target is well understood by the public and it is credible, it would create expectations of stable money spending growth (Beckworth, 2019).

A GENERAL LAYOUT OF THE PRINCIPAL CONS OF NGDP TARGETING

The decision of many central banks to adopt Inflation Targeting policy is the result of careful and prudent analysis. As underlined above, there is a clear evidence of its benefit in the economy. Therefore, there are some disadvantages of NGDP Targeting that led policymakers not to embrace it.

First, one problem is connected to the greater inflation volatility that it produces. In fact, even if a NGDP Targeting would stabilise output, it does so at the cost of allowing greater inflation variability, as we have seen above, in the presence of a supply shock.

Secondly, the alternative policy reflects government spending: it would fully offset the impact of fiscal policy on Aggregate Demand (AD). Suppose a country whose government is committed to a strong fiscal stimulus (e.g., a tax cut); the AD-AS model would envisage a shift in aggregate demand towards a higher output level. However, the Bank of England, being below the NGDP Targeting, should undertake a corresponding reduction in AD to leave GDP growth at its previous level.

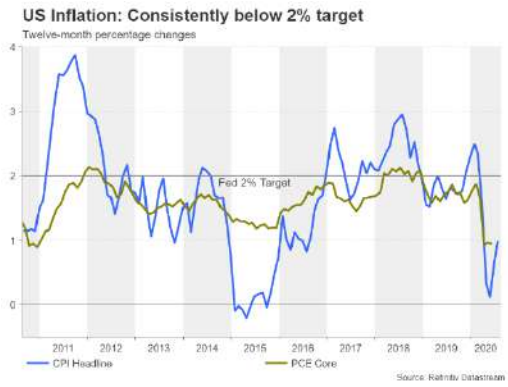
Thirdly, a significant problem is easily guessed: if, for example, next year NGDP target will be 4-5% and the non-compressible inflation is high, nominal

spending will consist exclusively of price variation rather than economic growth.
Furthermore, one of the main criticisms of NGDP Targeting, however, is the reliability of GDP figures. Whilst CPI is produced monthly, GDP comes out quarterly, and it often gets heavily revised. For instance, in August 2008 economists believed that real GDP would grow at 0.6% the next year; it fell by 3.7%. It is also important to notice that, once the target is set, there may be different combinations of real growth and inflation, but with different levels of desirability. For example, 4% real growth and 1% inflation are more desirable than 1% real growth and 4% inflation.

FED'S NEW POLICY: AVERAGE INFLATION TARGETING

Looking at how the USA, and its monetary policymaker, the Fed, have behaved in the recent period. It's possible to say that since the middle of the 90's of the past century the Fed has been (not explicitly) targeting a rate for inflation close to 2%. This undeclared objective became eventually declared in 2012, when former Chairman Ben Bernanke expressly assessed the intention of the American monetary policy to be aligned to that of the major central banks of the rest of the world, i.e., to keep the inflation rate as close as possible to 2%, as previously anticipated.
Moving on in time, we can finally focus on the latest evolution of monetary policy as announced by current Chairman Jay Powell, with particular focus on the long-run policy framework. During the first-ever online Jackson Hole conference, the Chair announced the re-framing of the monetary goal towards an average inflation target (AIT) of 2% for the long-run window. Within this framework, the Fed will tolerate periods of inflation that exceed the targeted one as well as periods where inflation rate will persist below the 2% benchmark, as long as these opposed trends will offset each other under a long-run valuation.

Besides the crucial innovation that AIT represents, we can add some observations in the light of the recent history of inflation.
First, the past years showed an asymmetric pattern of preferred inflation around the 2% goal, with



periods of inflation below the target substantially dominating over periods of inflation above it. This was most likely given by a bigger tolerance towards low inflation as opposed to high inflation. With AIT, the Fed introduces a symmetric target for inflation, which represents a substantial change in how the Fed will behave from now on. Indeed, it is likely that raises in interest rates whenever inflation exceeds the target will be much less frequent than before and the American central bank will start to tolerate much longer periods of high inflation.

This change is a major acknowledgement of the failure of recent monetary policy to prompt economic recovery after the major crises that were suffered worldwide in the last 15 years. Keith Wade, Schroders Chief Economist said "Although widely anticipated, the Fed's move is significant. It is an implicit acknowledgement that policy has been too tight and inflation too low for too long. This is an attempt to correct that. [...] The change in the Fed's target may well push inflation expectations up, prompting workers to push for higher wages, which would potentially shift inflation too. At present though, the ability of workers to do this is low."
Wade also adds comments on the viability of the new approach in the near-term, particularly referring to the capability of the monetary policy to raise inflation in a several year-long low-inflation setting. According to the economist, as seen before the Covid-19 pandemic and the consequent economic crisis, even under all-time low unemployment rates it was difficult to reach the 2% target. This could be potentially justified by the flattening of the Philips curve (that expresses the relation between unemployment and inflation),

according to which low unemployment has not been able to push an increase in wages and, consequently, in price inflation.

Finally, it is useful to make some considerations regarding the recent change in the lead of the US government with the election of the Democrat Joe Biden, after four years with the Republican representative Donald Trump. Biden's so-called "stimulus checks" to relaunch the American economy are part of the American Rescue Plan worth roughly 1.9 trillion dollars. This amount includes direct liquidity injections in the private accounts of American citizens as well as tax credits and student loans, for example. Of course, such a huge budget package raised concerns regarding increased debt levels and, unsurprisingly, inflation. Lawrence Summers, former economic advisor to President Obama and treasury secretary for Bill Clinton, was among the first to warn on the catastrophic consequences that this relief package might have on price levels. Olivier Blanchard agrees with the former.

However, despite a quick increase in treasury bills at the end of February, in the weeks following the announcement, experts now mostly agree that inflation risk will be limited and will be kept under control. Indeed, despite the concerns, it looks like the Federal Reserve's new monetary policy will suit particularly well in this context, since a period of higher inflation is more likely to be tolerated, as we have previously seen, and will likely be offset by other lower inflation periods

CONCLUSION

The monetary policy of every central bank in every country must face an intrinsic network of exogenous and endogenous forces that undermine its success. It is therefore natural that economists constantly ask themselves what the best path to follow is. When we start thinking about moving to NGDP Targeting, we should be very cautious. It has taken a long time to adopt Inflation Targeting and this framework has promoted economic growth over the last two decades. Moreover, while NGDP shows a more robust response to supply shocks, it is also true that central banks could not rely on a complete trustworthiness of its figures and it is also characterized by the fact that it produces greater inflation volatility. A switch to NGDP targeting may lead to a loss of credibility of monetary policy, the results of which are difficult to predict, especially as its arguments are based on laboratory data. It is therefore not obvious that the adoption of the NGDP Targeting will simulate the same documented successes with the introduction of the inflation target.