Comments on: Changing Central Bank Pressures and Inflation

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Overview

- Interesting, thought-provoking paper, raising important issues for central banks.
- Three topics for discussion
  - Challenges relating the model to lived policymaking
  - The implications of the evolving macroeconomic landscape for pressures on central bank price stability mandates
  - How the Fed’s 5-year policy strategy framework review should respond to these potential pressures

Challenges relating the model to policymaking

- Model results—slopes to LRAD and LRAS-- hinge on distortions from imperfectly competitive firms facing Calvo pricing constraints
  - Monetary policy making in the model focuses on the intersection of labor share, degree of distortion, and resulting price dispersion.
- Most policymaking focuses on cyclical issues, in context of hitting price stability and, in US, maximum employment long-run goals
  - Model suggests tradeoff between inflation target and labor share/monopolistic distortions
  - Central banks consider addressing those distortions to be the province of the fiscal and competition authorities

Challenges relating the model to policymaking-2

- LRAD downward slope has echoes in rationale for price stability mandate
  - Inflation makes relative price signals harder to read for both HH and businesses, leading to inefficiencies.
    - AG definition of price stability as when general changes in the price level do not affect business and household decisionmaking.
- But, consequently, no ambiguity: going from higher to lower inflation boosts output over time. Price stability is the route to maximum employment and output (abstracting from ELB issues).
  - AG (1999): Price stability promotes productivity.
    - Because neither business firms nor their competitors can currently count any longer on a general inflationary tendency to validate decisions to raise their own prices, each company feels compelled to concentrate on efforts to hold down costs. The availability of new technology to each company and its rivals affords both the opportunity and the competitive necessity of taking steps to boost productivity. This contrasts with our experiences through the 1970s and 1980s, when firms apparently found it easier and more profitable to seek relief from rising nominal labor costs through price increases than through cost-reducing capital investments.
- LRAS upward slope hard to relate to.
- What do the authors want the central banks to take from the model?
  - In the context of the model, setting the inflation target involves weighing costs to inflation that aren’t in the model against changing competitive distortions
  - It’s about the dynamics of adverse supply shocks—overshooting and the pressures on price stability objectives

Changing economic landscape and political pressures on price stability mandates

- Disinflation from the 1980s into the early 2000s reflected many favorable developments, facilitating the support for new CB governance and price stability mandates.
  - Positive Supply developments
    - Expansion of the global trading system bringing greater competition to bear on labor and capital
    - Privatization and deregulation
    - Technological change driving higher productivity growth
  - Demand side
    - Unwinding of cold war defense spending; US budget surplus crowding in investment
- Unlikely to be repeated and could go into reverse.
  - Tariffs, “friendshoring”, industrial policies to discourage trade in key products increase investment and raise costs
  - Rapid increases in government debt-to-income add to demand and could crowd out investment with narrowing r-g
    - Increases in defense spending; subsidies for decarbonization; demographics raise transfers to lower-saving households

Changing economic landscape and political pressures on price stability mandates-2

- How important?
  - r* dominated by productivity and demographics
    - WEO 4/23: return to low r*, with caveats about deficits and financial fragmentation
  - globalization peaked around 2008, but 20teens…
  - “latent inflationary bias” of politicians potentially constrained by public’s intense dislike of inflation
- But
  - Market expects real r* in US near 2
  - Cost pressures imply trade-offs unlikely to be as favorable as before, implying the possibility of higher U*
  - Higher interest costs will contribute to burgeoning deficits and political discomfort
  - One presidential candidate has demonstrated a predilection for Fed bashing

Strengthening the commitment to and understanding of price stability: The Fed framework review

- The model does help to underscore the dynamics between the changing landscape and pressures on price stability mandates.
- Laws to strengthen central bank independence in the US are highly unlikely, but the Fed can take steps in its framework review to strengthen its commitment to price stability and the public's understanding.
  - Set the stage by:
    - Looking at the lessons learned from 2021-22 experience
    - Analyzing the forces, like those in the paper, that might be acting on interest rates and price pressures over coming years. Show that the Fed has considered alternative macro environments that might call for alterations to the 2020 strategy.
  - Reinforce the price stability target
    - Don't take the 2 percent target as given, examine and justify it or another target.
    - Explicitly define maximum employment as the highest level consistent with price stability.
      - Not about correcting for imperfect competition or the experience of income or demographic groups.

Strengthening the commitment to an understanding of price stability: The Fed framework review-2

- Structure the strategies to sustain price stability and maximum employment under alternative macroeconomic circumstances.
  - Retain the ability to deal with low inflation, low r*, but address more fully the strategy for dealing with actual or prospective inflation overshoots.
    - Do the benefits of an asymmetric approach to labor markets-–respond more to shortfalls than to estimated overshoots—outweigh the costs, including less pre-emption?
    - Does the strategy need two asymmetries—one-sided FAIT and asymmetric labor market responses to address ZLB issues?
- What lessons can be drawn from the 2021-22 experience for the tools of unconventional policy-–QE and forward guidance?