Wrap-up Panel Discussion

The final part of the conference was a panel discussion focused on central bank frameworks and reflecting on 25 years of flexible inflation targeting. The discussion was moderated by Jessica Irvine, senior economics journalist at *The Sydney Morning Herald* and *The Age*, and included the following panellists:

- Philip Lowe, Governor of the Reserve Bank of Australia (RBA)
- Adam Posen, President of the Peterson Institute for International Economics
- Sayuri Shirai, Professor of Economics at Keio University

Conference participants also joined the discussion at various points. As the conference and panel were conducted under the Chatham House Rule, no individuals' comments are attributed.

1. Introduction

The session opened with a brief discussion where it was noted that it had been interesting to reflect on how the inflation-targeting framework had evolved over the past 25 years and to consider what the challenges over the next 25 years may be. It was agreed that it was useful to consider alternatives to the current framework, although participants did not seem to be suggesting any changes to the framework in practice. The moderator opened the discussion by asking panellists what lessons they drew from the conference overall. Panellists then discussed the features of the current Australian framework and what had worked well, before the discussion turned to how that framework had evolved and how it may continue to evolve in the future in response to potential challenges and risks.

2. Areas of Broad Agreement

One panellist noted that, despite some disagreement, there was quite a lot of agreement throughout the conference about the current framework – flexible inflation targeting. The panellist identified five areas of agreement in particular.

1. *Monetary policy regimes matter.* A view repeated many times during the conference was that the shift to inflation targeting appears to have been associated with low and stable inflation, less macroeconomic variability, well-anchored inflation expectations and a greater public understanding of the way monetary policy operates. This has delivered substantial benefits to the public, especially when compared with earlier monetary policy regimes.
2. *Flexibility in the framework is beneficial.* The conference discussions highlighted a clear preference among participants and countries, through their choice of regimes, for flexible rather than strict inflation targeting. When inflation targeting was first introduced, some

countries required strict adherence to the target in an attempt to build credibility. Flexible inflation targeting has, however, built the same credibility through results rather than design. As such, flexible inflation targeting appears to have delivered better outcomes in terms of output variability and financial stability without, perhaps surprisingly, any decline in the control of inflation.

3. *Political systems in most countries support flexible inflation targeting*. There is broad acceptance at a high level in countries around the world that flexible inflation targeting is the right monetary policy framework.
4. *Transparency is important*. Transparency is important for accountability and it makes the monetary policy transmission mechanism work better. The panellist noted that central banks correctly place a higher priority on communication now. However, central banks may currently focus too much on communicating with the market and this probably causes the communication to become too technical. Simpler communication is better when speaking to the community because it improves understanding and transparency.
5. *Committees bring benefits to decision-making*. Monetary policy decisions should be made by committees rather than an individual decision-maker. Diversity on boards is important to bring in a mix of perspectives and people with business backgrounds bring experience in making decisions under uncertainty.

3. The Current Framework in Australia

Discussion then turned to a review of the past 25 years and, in particular, the features of the current Australian system that had contributed to its success. One panellist noted that there has been relatively little change in the inflation-targeting framework in Australia since it was introduced 25 years ago. This is in contrast to a reasonable amount of change in central bank frameworks in other countries. There was a discussion about the effect of change on outcomes. It was noted that some minor changes, such as between a point or a band target or changes in the size of the band, appear to have been relatively easy to implement and created few difficulties in other countries. Notwithstanding this, there was a concern that changing too frequently could undermine the independence of the central bank given an increasingly politicised environment.

The stability in the RBA's mandates was also remarked upon. The *Reserve Bank Act* was enacted in 1959 with a triple mandate of stability of the currency (low and stable inflation), full employment and the welfare of the people. It was noted that even dual mandates were unfashionable in the 1990s because it wasn't 'serious inflation targeting'. The RBA's third mandate, the welfare of the people, was then discussed. Panellists noted that the third mandate changes the focus of policymakers and holds them accountable to the people of Australia, rather than the financial sector, academics or other central banks. Panellists noted that the RBA's communication with the public in 2017 to explain why interest rates were not being lowered made reference to this leg of the mandate. It was noted that the third mandate allows a considerable degree of flexibility to address broader macroeconomic concerns than even a dual mandate. While the current concern in Australia and other countries is financial stability, the factors that could weigh on social welfare may change over time.

Multiple participants noted that anchoring inflation expectations has been an important aspect of flexible inflation targeting. A panellist observed that this has turned out to be easier than expected for Australia, and contrasts with the Japanese experience where it has been difficult to raise inflation expectations towards the Bank of Japan's 2 per cent target. The panellist also noted that inflation expectations have turned out to be sticky because inflation targeting works, leading to rational inattention by the public about the current inflation rate. However, another participant, also citing the Japanese experience, noted that households continue to expect price rises despite effectively zero inflation and, therefore, haven't put off purchases despite deflationary periods. In such an environment, public communication was required to explain why inflation needed to be raised. The participant concluded that central banks must pay attention to the mindset of households.

The question from Guy Debelle's paper over whether central banks are fighting the last war or defending security with regards to high inflation was noted. A panellist opined that while central banks should be cautious about losing gains, high-inflation periods might be an anomaly and inflation expectations have proven to be very sticky recently. Another panellist stated that we do not know enough about the formation of inflation expectations, so we should not assume they will remain anchored if the regime is changed.

4. Evolution in a Changing Environment

While it was agreed that the Australian framework had been comparatively stable, the environment it operated in has not. A panellist observed that the currently accepted framework of inflation targeting was a product of evolution, with no single overwhelming pressure having led to any revolutions in the framework. This evolution has been in the context of many other changes in the policy and economic environment, with panellists noting factors such as changes to central bank independence, a decline in bond yields, an acceleration in productivity growth in the 1990s, US debt consolidation, and China and eastern Europe joining the world market. A panellist noted that Australia, Canada and New Zealand had adopted inflation targeting to lock in low inflation. However, it is difficult to assess the effectiveness of the inflation-targeting framework as these environmental factors may have contributed to the positive macroeconomic outcomes.

A panellist opined that Australia's inflation-targeting framework has been a case of niche evolution. In particular, the liberality of government in Australia and the development of the Pacific and China, which was said to have benefited the labour market, have ultimately worked well for Australia and thus the inflation-targeting regime. However, the panellist noted that Australia has an open economy and may therefore be more susceptible to future changes in the economic environment, which may require adaptations in the monetary policy framework. In addition, the RBA was identified as more independent than most central banks but not immune to peer pressure and market pressures that have led to some changes in frameworks overseas.

Participants questioned whether some of the recent developments in the macroeconomy represent temporary forces or structural shocks. This was said to matter for how policy responds and possibly how the framework evolves.

5. Challenges and Future Risks

The panellists discussed the nature of the possible shocks that the macroeconomy may face and whether these represent threats to the current framework. One panellist noted that no monetary policy regime lasts forever and questioned whether future stresses will cause a break in regimes or gradual evolution. The panel discussed four potential challenges in more detail.

The first was that it may be difficult to raise the rate of inflation back to the target range because of structural reasons. Structural factors could include globalisation, competition, productivity, labour bargaining power or a flatter Phillips curve. It was noted that monetary policy at present may be having less of an effect on inflation than previously. Very low interest rates may also cause distortions and reduce social welfare. Returning inflation to its target under these circumstances may cause community support for the regime to break down, especially if it required higher borrowing. More broadly, it was noted that it may be harder to control the inflation rate when it is low, as the consumer price index may largely reflect relative price changes and structural factors that cannot be controlled.

The lower rates of wages growth observed across the developed world were discussed in some detail as a potential structural change that may keep the rate of inflation lower. Reasons for this may include lower bargaining power of labour, a sustained slowdown in productivity growth or a lower-than-expected NAIRU (non-accelerating inflation rate of unemployment). One participant noted that inflation stayed lower for longer in Japan and Germany because the NAIRU turned out to be lower than previously estimated. Economists were said to be divided on developments in the shape of the Phillips curve. Some were said to believe in a kink in the Phillips curve and that the United States is almost at that kink, such that inflation would soon pick up. But those that believe that structural changes had occurred thought that the unemployment rate would need to fall a lot further to generate an increase in inflation. Similar debates are taking place in countries around the world, including Australia.

The second risk discussed was that low and stable inflation may not maximise social welfare if it raises financial stability concerns. A panellist opined that a relatively new orthodoxy states that these concerns could be solved through the use of macroprudential tools. However, the panellist was sceptical of their usage as macroprudential tools may cause distortions, such as those observed in the 1970s and 1980s, and also do not have as broad-reaching effects as interest rates. Macroprudential tools were also said to not fix high leverage. Social welfare was said to depend on price stability, macro stability and financial stability, which may become more difficult to balance.

A third potential challenge was the possible increase in the prevalence of supply shocks which would put strict inflation targeting, but also possibly flexible inflation targeting, under pressure. Nominal income targeting was raised as a possible solution. See Section 6 for more detail.

Finally, a participant raised the risk that the national currency may be replaced with other means of payment, such as electronic tokens. This was identified as a very unlikely but plausible scenario. Nonetheless, if it occurred central banks would need to rethink how monetary policy operated and its effects.

Many of these issues were said to raise the question of how much flexibility should be built into the framework. One participant opined that the answer to this question is 'quite a lot' and that inflation should be allowed to remain below the target for a while, provided that it returns to target eventually. A couple of participants asked 'what is so wrong with inflation a bit below 2 per cent?' when balanced against risks on the financial side. Another participant asked whether this would damage credibility. One panellist argued that it would not, provided that progress was being made and that the public saw that progress was being made.

6. Alternative Frameworks

Multiple participants noted that what the public care about is rising income, and that it is easier to talk to people about income than inflation. This may lend itself to a nominal income target. Several issues were raised. First, nominal income can be difficult to measure and forecast, and a nominal income target may instead be approximated by flexible inflation targeting. Second, finding a mechanism to deliver stronger income growth was noted to be difficult and generated much discussion. In Australia, many politicians and businesses have started to talk about wages growth, but it is not happening due to coordination failure, which nominal income targeting is unlikely to fix. It is possible that recent lower income growth globally may have been structural, making it difficult for monetary policy to address.

A panellist stated that it was constructive and brave to rethink the framework from a position of strength, which is consistent with the mindset of practical flexibility displayed in Australia's current framework. Participants reflected on the session discussing alternative frameworks, concluding that while inflation targeting may have some issues, so do the alternatives. In considering nominal income targeting, a participant noted that flexible inflation targeting can approximate the nominal income targeting's policy responses without the accompanying issues and while retaining the benefits of inflation targeting.