RESERVE BANK OF AUSTRALIA

Discussion of “Monetary Policy Frameworks away from the Effective Lower Bound”

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*Views are my own and not necessarily those of the RBA.

High level observations

- A paper about monetary policy strategy
- Timely and thought-provoking
- Each question a research agenda in its own right. Too soon to draw firm conclusions
- Average inflation targeting (AIT) as defined in this paper is not equivalent to the Federal Reserve’s Flexible Average Inflation Targeting (FAIT) strategy or the RBA’s flexible inflation target

Did the new frameworks keep inflation expectations anchored?

What does it mean for inflation expectations to be ‘anchored’?

- ‘*long-run inflation expectations are ‘relatively insensitive to incoming data*’ - Bernanke (2007)
- ‘*agents hold beliefs that are consistent with the policy strategy of the central bank*’ - Carvalho, Eusepi, Moench and Preston (2023)

Whose inflation expectations matter for inflation outcomes?

- Households and businesses: direct impacts on price and wage outcomes
- Financial market participants: financial conditions faced by households and businesses
- Unions: wage outcomes
- Professional forecasters: ??

Did the new frameworks keep inflation expectations anchored?

New frameworks performed well

- Focus is professional forecasters – link to inflation outcomes unclear
- Too early to tell? If inflation does not decline as expected, longer-run expectations may rise
- Factors other than changed monetary policy frameworks might have altered the relationship between longer run inflation expectations and inflation
- Better methods available for estimating the response of inflation expectations to news. E.g. Beechey, Johannsen, and Levin (2011).

Would averaging inflation targeting or strict inflation targeting performed better during the inflation surge?

Neither would have stopped inflation rising.Tightening was key

- Simulations based on rational expectations

- Conclusions could be sensitive to alternative assumptions, especially if expectations are backward looking

    - Mann (2023), Brassil et al. (2023), Jaaskela (2005)

Welfare benefits of alternative monetary policy strategies when the Phillips curve is steep/flat or r* is high/low

Welfare benefits from dual mandate arise when Phillips curve is flat.

With low r*, welfare gains from average inflation targeting are larger.

- Assumptions about expectations formation likely important
- Is it appropriate to treat welfare losses to society from high unemployment the same as low unemployment?

Where to from here?

Pressing question for policy makers is monetary policy strategy when there is uncertainty about r* and the slope of the Phillips curve

The paper provides a research agenda for the next round of monetary policy strategy reviews

Macro models need strong micro foundations – collaboration between theoretical and applied empirical researchers will be needed

- Need to better understand the mechanics of price and wage setting at the micro level, including how expectations are formed and how that feeds through to inflation

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