BLOG

On fireside chats and optimal monetary policy

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The ECB is currently reviewing its monetary policy strategy. The work will continue and is due to be completed by September 2021. The Covid-19 pandemic first caused a delay in the schedule, but its more fundamental impact has been to add exceptional timeliness to the challenges of the exercise.

On 24 November, Bank of Finland hosted a webinar focusing on monetary policy challenges both in the euro area and in the United States. It is not too late to follow the interesting presentations and subsequent discussions via a link.

The webinar brought key elements of optimal monetary policy to the table.

The first keynote speech by Isabel Schnabel, member of the ECB Executive Board, served as a reminder that the pandemic has indeed not made the ECB's monetary policy strategy review any less important. On the contrary, the pandemic has reinforced many of the prevailing structural trends that had been identified already earlier in the review process. 'Central banks may have to change how they pursue their mandates in the face of evolving consumer preferences and changing technologies,' Isabel Schnabel pointed out. 'But central banks cannot fundamentally change the long-run course of our economies. But they can, and should, make sure that the operationalization of their mandates – the way they define and pursue price stability – leaves no doubt that too low inflation is as much a concern to society as too high inflation.'

In his presentation, Juha Kilponen, head of department at the Bank of Finland, followed up the theme of price stability by taking the practice of ECB monetary policy under scrutiny. He and his co-authors have delved into past monetary policy-making in the euro area with the help of modern text analysis methods applied to ECB's introductory statements. Their researches point to two possible interpretations of the ECB's policy objectives: the ECB has been either more averse to inflation above 2% or the de facto inflation aim of the ECB has been well below 2%. Their work thus suggests that low inflation bias in policy can be costly in the current low rates environment.

We then also had the pleasure to learn about the interaction between monetary and fiscal policy from Professor Eric Leeper who has developed many of the key concepts and ideas in this field of study. Eric Leeper provided interesting historical account of the economic recovery of 1933 in the U.S., where both monetary and fiscal policies played a key role.

Eric Leeper's presentation showed that the reflation of the Roosevelt period carries also two important lessons for policymakers today. Firstly, rather than relying on a joint monetary-fiscal attack on the problem, as Roosevelt did at the time, many countries are currently leaning entirely on monetary policy, with not so good results.

A second lesson from the Roosevelt era and his policies according to Eric Leeper is that communication about fiscal policy goals is important in order to anchor fiscal expectations. He provided an example by saying that if the objectives bounce between stimulus and consolidation, this can damage the effectiveness of fiscal stimulus when the economy has been hit by extraordinary shocks.

So this made us wonder if central bankers should adopt FDR-style fireside chats? We didn't get deep into that question, but the importance of clear and simple communication on the objectives of monetary policy is thought to be probably even more important in molding inflation expectations than communication on the specifics of its instruments, according to recent studies.

The fact that the monetary-fiscal policy interaction is a fascinating area was also evident in a presentation of Nigel McClung, researcher at the Bank of Finland. He discussed the performance of simple interest rate rules in various fiscal policy regimes. Both Eric Leeper and Nigel McClung emphasized that monetary policy does not necessarily achieve its goals if fiscal policy is not supportive.

The event concluded with a session on the new monetary policy strategy of the Federal Reserve, through a presentation by James 'Jim' Bullard, President of the Federal Reserve Bank of St Louis. He based his presentation on his recent research on monetary policy and inequality, which was motivated by the increase in income, financial wealth and consumption inequality in the past decade.

In his paper 'Optimal Monetary Policy for the Masses' he asks whether monetary policy can be conducted in a way that benefits all households even in a world of substantial heterogeneity – not 'opium' but 'optimal monetary policy for the masses'. According to his paper, the answer is 'yes.' Monetary policy can repair allocative distortions caused by credit market frictions, and can thereby alleviate inequality. This was among the issues which received attention in the Fed's own monetary policy strategy review, the outcome of which the Fed announced in August.

As a result of its strategy review, the Fed adopted average inflation targeting, a form of what are known as the make-up strategies of monetary policy. One finding in Jim Bullard's paper is that another form of make-up strategy, nominal GDP targeting, can be optimal even when there is massive heterogeneity. Upon my follow-up question on that, Jim Bullard elaborated that models for him are very useful to organize his thinking, but policy-makers need both models and judgement to draw conclusions. The Fed’s new policy framework has nevertheless taken steps toward nominal GDP and price level targeting, allowing in some circumstances more inflation.

During just a few hours, communicating across the Atlantic, and vigorously with the participants increased our understanding of optimal monetary policy. I am grateful for all presenters and our web audience for taking part to the webinar.

As I said in conclusion at the event: ‘In a world of pervasive uncertainty, we must try to find certainty and stability in the areas that are still under our control. This applies to monetary policy, too, and that is why we are here today: we are here to discuss what the monetary policy landscape could look like in the coming decade, and how we can best operate in it with the aim of bringing stability and certainty to the hundreds of millions of people that our decisions affect, thus supporting sustainable growth and job creation.’ I believe we moved an inch to that direction.

Tags

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