Panel on “Post–Pandemic Monetary Policy and the Effective Lower Bound”

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Post–Pandemic Monetary Policy: What are the Challenges?

- Persistent decline in r*
  - less monetary policy space

- Flattening of the Phillips curve
  - loss of inflation control

- Impact of the Pandemic
  - need for *more* monetary policy space in the near term
  - fears of recurrence → further decline in r*
Adjusting to a lower $r^*$: Three alternatives

- Unchanged framework + ad-hoc UMPs
- New strategy (with unchanged 2% target)
- Higher inflation target (with unchanged strategy)
Unchanged framework + ad-hoc UMPs when binding ELB

Have UMPs been sufficiently effective?

- Evidence of “ZLB irrelevance” (Swanson-Williams, Debortoli et al.). Focus on responses to “news” or “shocks”.

- Was the reduction in relevant market rates commensurate to the decline in economic activity over the downturn as a whole?
Normalized interest rate adjustment over three U.S. recessions

- Early 1990s
- Early 2000s
- Financial Crisis

dffr/du
Normalized interest rate adjustment over three U.S. recessions
Normalized interest rate adjustments over three U.S. recessions

Early 1990s
Early 2000s
Financial Crisis

-2.50
-2.00
-1.50
-1.00
-0.50
0.00
-0.50
-1.00
-1.50
-2.00
-2.50

dffr/du
dgb2/du
dgb10/du
Normalized interest rate adjustments over three U.S. recessions
Adjusting to a lower $r^*$: Alternative 2

- New strategy (with unchanged 2% target)
  - Key ingredient: Commitment to make up in the future for current deviations from inflation target
  - Anticipation $\rightarrow$ enhanced stability $\rightarrow$ less monetary policy space needed
  - Example: ZLB-contingent, limited memory, price level targeting (Bernanke–Kiley–Roberts)
  - Interpretation: *systematic* forward guidance (vs. ad-hoc)
  - Requirements:
    - credibility (willingness to overshoot!)
    - ability to fine-tune price level movements (harder with flat PC)
Higher inflation target (with unchanged strategy)

- Additional “conventional” monetary policy space, without the need for an enhanced role of expectations

- Costs of higher inflation? Negligible at the margin → *one-for-one rule* (Andrade et al. (2020))

- Transition: gradualism + opportunism
r* and the Optimal Inflation Target

Source: Andrade, Galí, le Bihan and Matheron)}
The decline in $r^*$ calls for a change in the MP framework

A prudent two-handed approach: combination of a (moderate) higher inflation target (3%?) and (moderate) adjustment of the strategy (BKR)

In addition: greater role for countercyclical fiscal policy, with continued monetary policy support