Will new monetary policy frameworks succeed in achieving inflation targets?

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Monetary policy has been successful in influencing financial markets, the first stage of monetary policy pass-through to demand and inflation. But over the past two decades, core inflation in advanced economies has rarely risen above targets. Recently discussed and implemented changes to monetary policy frameworks, which all depend crucially on the inflation expectations channel, could help improve the effectiveness of monetary policy and achieve stable and higher inflation. However, challenges with controlling inflation expectations, the uncertainty surrounding their effect on demand, along with continued structural changes holding down inflation all point to caution (OECD, 2020).

Monetary policy reviews

A combination of deep structural changes and unexpected shocks has challenged the way monetary policy is conducted in many advanced countries. The secular decline in productivity growth and inflation, along with the reduction in the so-called neutral interest rates, which balance aggregate demand and supply, have significantly increased the risk that policy rates hit the zero lower bound. The global financial crisis and the COVID-19 pandemic, both of which prompted very accommodative policy and an enlargement of monetary policy tools, including purchases of public and private assets, forward guidance and negative policy interest rates, further highlighted the limits of conventional monetary policy measures.

In this context, radical and comprehensive alternatives to current frameworks have been discussed in both academic and policy circles and several central banks in advanced economies have embarked on formal monetary policy reviews. The alternatives include raising the inflation target and one of the so-called make-up strategies, like targeting an explicit price (or nominal GDP) level, where past misses of the target should be compensated in the future. Their efficacy crucially hinges on the population's understanding of, and reaction to, monetary policy commitments and strong effects of demand-supply imbalances on inflation – i.e. a steep Phillips curve. The Bank of Japan's "inflation-overshooting commitment" announced in September 2016 can be regarded as a form of a make-up strategy. Similarly, the switch to a flexible form of average inflation targeting (FAIT) will take the US Federal Reserve closer to a price-level targeting, since the FOMC will de facto aim to make up for past inflation misses. The ECB is in the process of reviewing its framework.

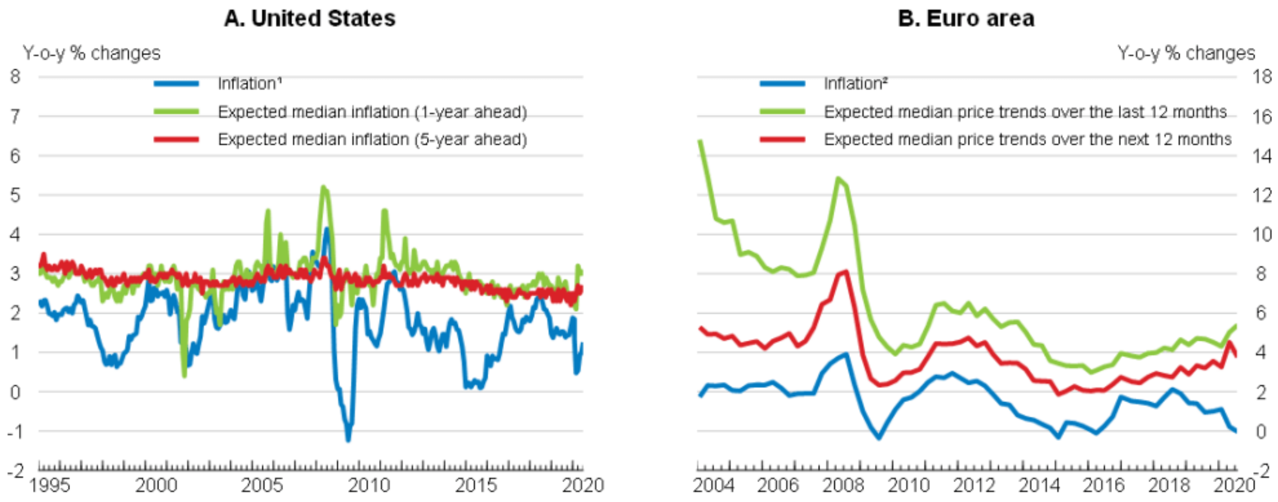
Inflation expectations

When interest rates are low and close to the ZLB, the scope to stimulate demand through yield curve changes, and in turn inflation, is limited. In this case, inflation expectations become the main available channel to boost inflation, as assumed by many make-up strategies. However, three challenges may reduce the effectiveness of inflation expectations as a practical policy channel.

- Although firms set prices of most goods and services, little is known about their inflation expectations. Surveys of firms' aggregate inflation expectations are rare and of limited quality, in contrast to surveys of households' expectations (Coibion et al., 2020a).
- Both households and businesses are generally poorly informed about realised and expected inflation, or inflation targets, and their expectations have been

persistently above targets (figure below). Households have a limited understanding of monetary policy announcements and expectations of neither households nor firms seem to respond much to such communications (Coibion et al., 2020a; Coibion et al., 2020b).

Household inflation expectations tend to exceed realised inflation and targets



1. Personal consumption expenditure deflator, including food and energy prices.
2. Harmonised index of consumer prices, including food and energy prices.
Source: Bureau of Economic Analysis; Eurostat; European Commission; Refinitiv; and OECD calculations.

- Evidence is mixed about the impact of inflation expectations on households' consumption. Under some circumstances, households' expectations about future price changes can have a powerful impact on their consumption decisions (like for VAT rate increases). However, a durable boost to household consumption due to monetary policy forward-guidance, even when well understood by consumers, may be less certain. Higher expected inflation may not stimulate aggregate consumption durably if real income is expected to decline or stagnate. With constant nominal income, higher inflation could just shift demand from non-essential goods and services to necessities. Higher inflation may also increase perceived uncertainty and result in higher household saving. Moreover, the effects of monetary policy are uncertain and refer to a distant future, which may be discounted by households and businesses in their consumption and investment decisions.

Structural shifts in supply and demand

Over the past three decades, a combination of structural changes in advanced economies, which are largely beyond monetary policy decisions and communications, have aggravated the challenge for central banks in attaining their inflation targets.

- ***Globalisation, technological progress and market concentration***: The integration of low-wage emerging-market economies, in particular China, into global value chains (GVCs) combined with trade liberalisation over the past three decades has led to a substantial decline in production costs, expanded supply massively and increased import competition, putting a downward pressure on domestic producer goods prices. Globalisation has also coincided with a rapid technological progress in the production of many goods or their components, including electronics, adding to downward price pressures. The ensuing stronger import competition and rising market concentration can reduce the pass-through from wages to prices in goods-producing sectors.
- ***Retail sector and network industries***: In the United States, over the past three decades, the retail sector has changed from one with many small firms to one dominated by large firms, with large retailers increasingly sourcing from China (Smith, 2019). The rise of general merchandisers selling goods from different industries could have led to reduced margins on some goods to attract clients as profits are maximised at the chain level and not for individual goods. The past decades have also witnessed a global rise of e-commerce, which could have damped prices by increasing price

transparency and eroding profit margins, notably in some traditionally face-to-face businesses. A growing importance of network industries in services (like communication, TV and music streaming services, air transport) has also likely contributed to muted inflation developments. Maximisation of their profits depends on market share gains, limiting possibilities to increase prices persistently.

- ***Weakening demand and large supply***: Limited price pressures resulting from globalisation and technological progress may have been weakened further by the relative saturation of demand for many durable goods compared with ample production capacities. When a new product is developed, demand for it grows very fast and income elasticity of demand is high, stimulating production capacity and technological progress and leading over time to lower prices. When the desired level of possession of the product has been attained, “new demand” for buying the good for the first time vanishes and demand is driven by replacement or renewal motives only. As this phenomenon may affect many durable household products in advanced economies (cars, home appliances, etc.), the scope to increase prices for such goods, that still account for a considerable part of the consumption basket, may be limited by the fear of a fall in demand.

If the above structural trends persist in advanced economies, central banks may continue to struggle to achieve persistently higher inflation in the future. There is, however, large uncertainty about future structural developments, partly related to uncertain long-term impacts of the COVID-19 crisis.

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