

Discussion on  
“Monetary Policy in the New Mediocre”  
by Al-Mashat, Clinton, Hunt,  
Laxton, Wang, and Yao

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# Main Points

- Mediocre as A New Economic Environment:
  - Declined trend growth/natural rate of interest
  - Low inflation environment
  - Higher risk for hitting ELB
- Monetary Policy Implications:
  - Importance of risk-avoidance strategy for MP
    - IFT / Loss-minimization / Conventional FG
  - Financial stability consideration
    - Macroprudential policy tools

# Major Comments

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1. Understanding of Inflation-Forecast Targeting (IFT) Framework
2. Anchoring Long-term Inflation Expectations
3. Risk-Avoidance Strategy & Unconventional Policy Measures
4. Financial Stability Consideration

# Flexible Inflation Targeting

Medium- to Long-term:  
Strong Commitment to P-stability

+

Short-term:  
Flexible Response to Shocks



Measures to Improve Transparency


Anchoring Long-term Inflation-expectations

# Full-Fledged IFT Framework

- Flexible Inflation Targeting (IT) as Best Practice of Monetary Policy:
  - Constrained discretion
  - Not rule but framework
  - Systematic, but flexible and high accountability
- Current Practice: Flexible IT = (Implicit) IFT?
- Difference b/w Explicit / Implicit IFT?

# Transparency in Theory

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- Standard Macroeconomic Model:
  - Economic structure → Common knowledge
  - Policy objectives → Common knowledge
  - Shocks to the economy → Immediate detection
- Fully Transparent w/o Communication:
  - All the economic agents instantaneously project the future path of optimal policy rate as well as macroeconomic variables.

# Two Definitions of Price Stability

- Measured Price Stability:
  - To focus on maintaining a specific rate of inflation measured by a specific price index at a particular point in time
- Sustainable Price Stability:
  - To focus on the consistency with medium to long-term sustainable growth
  - To pay more attention to financial and macroeconomic risk management
- Balancing the Two Definitions in Practice

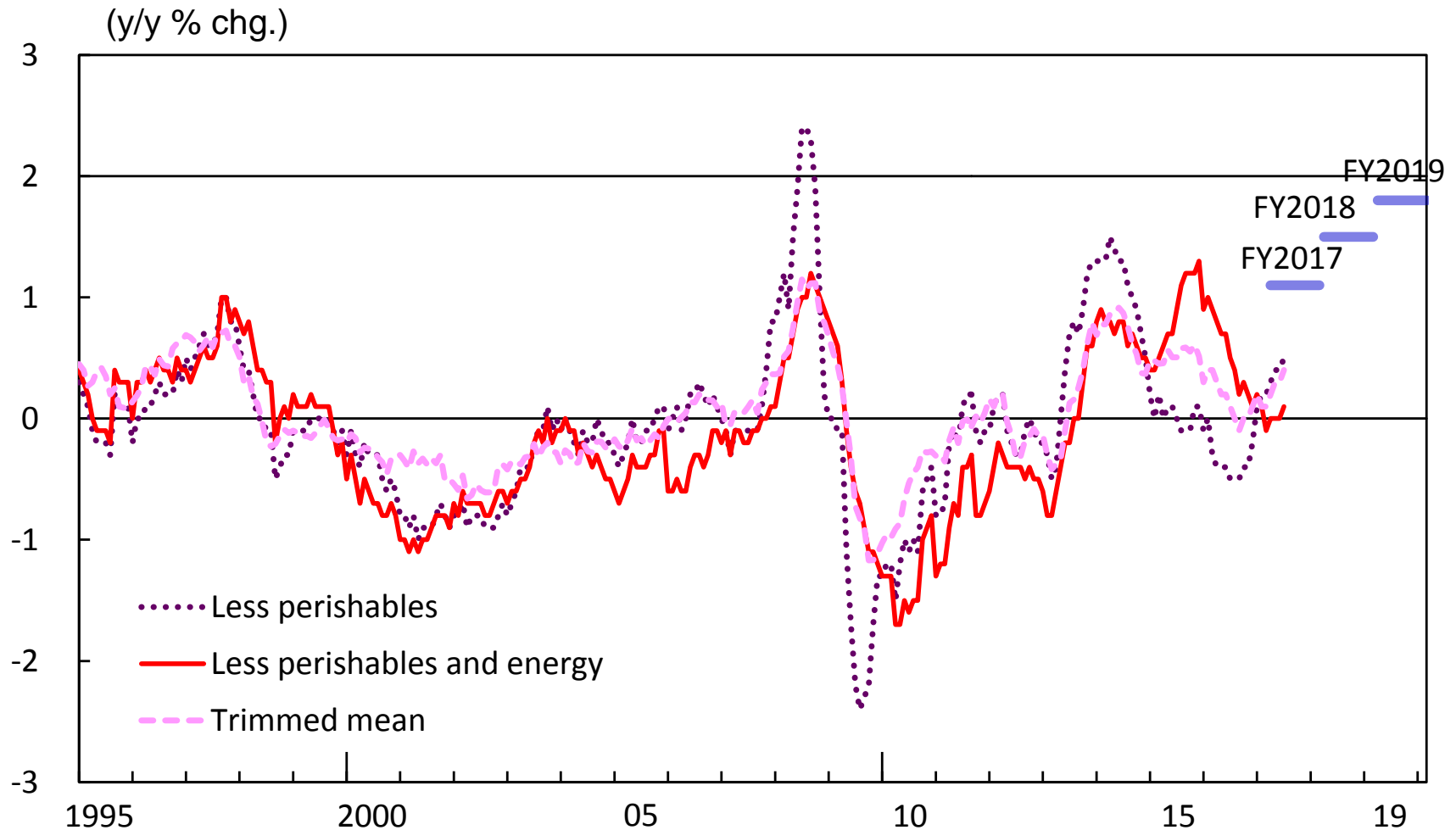
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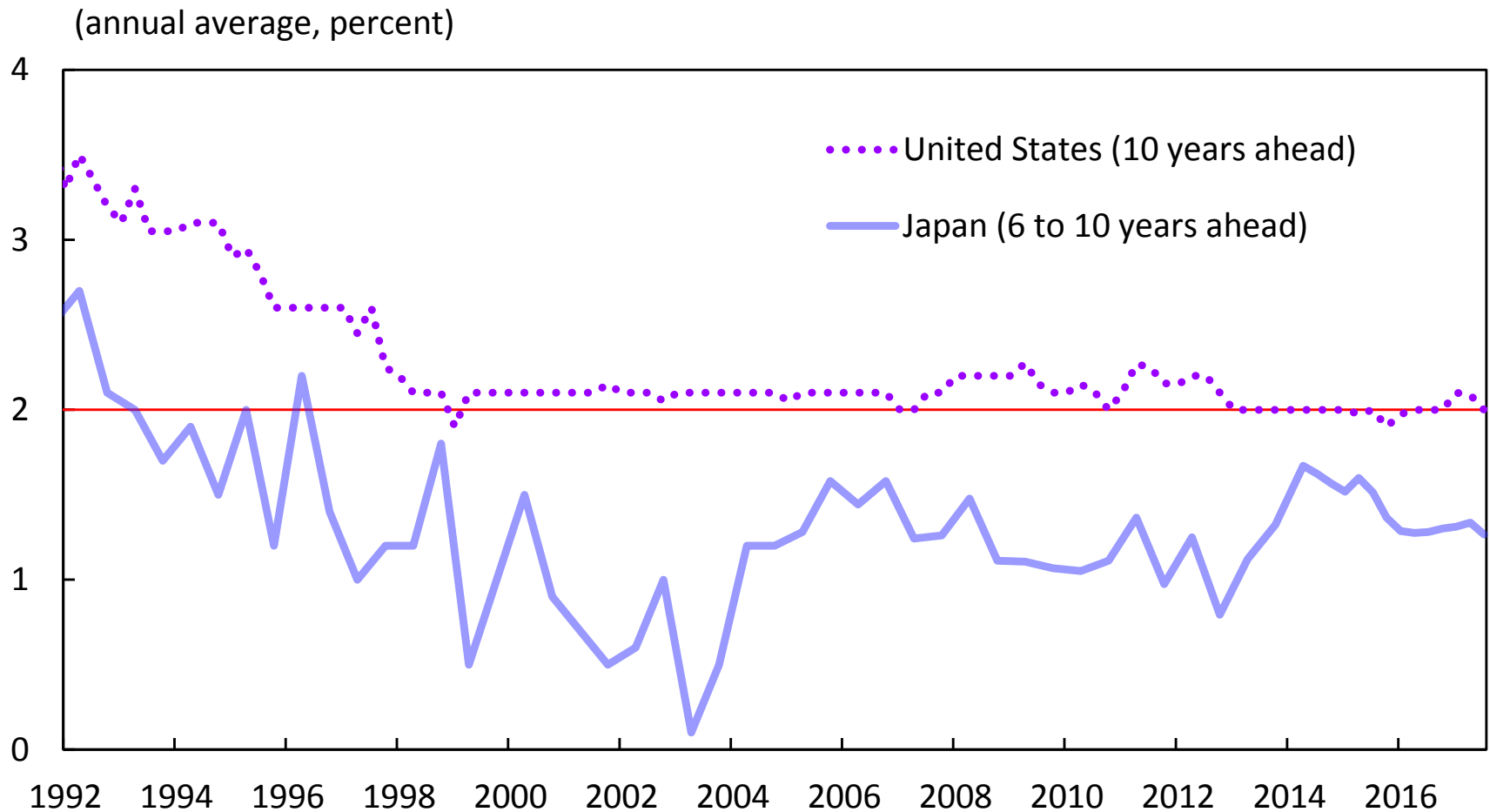


# Core CPI



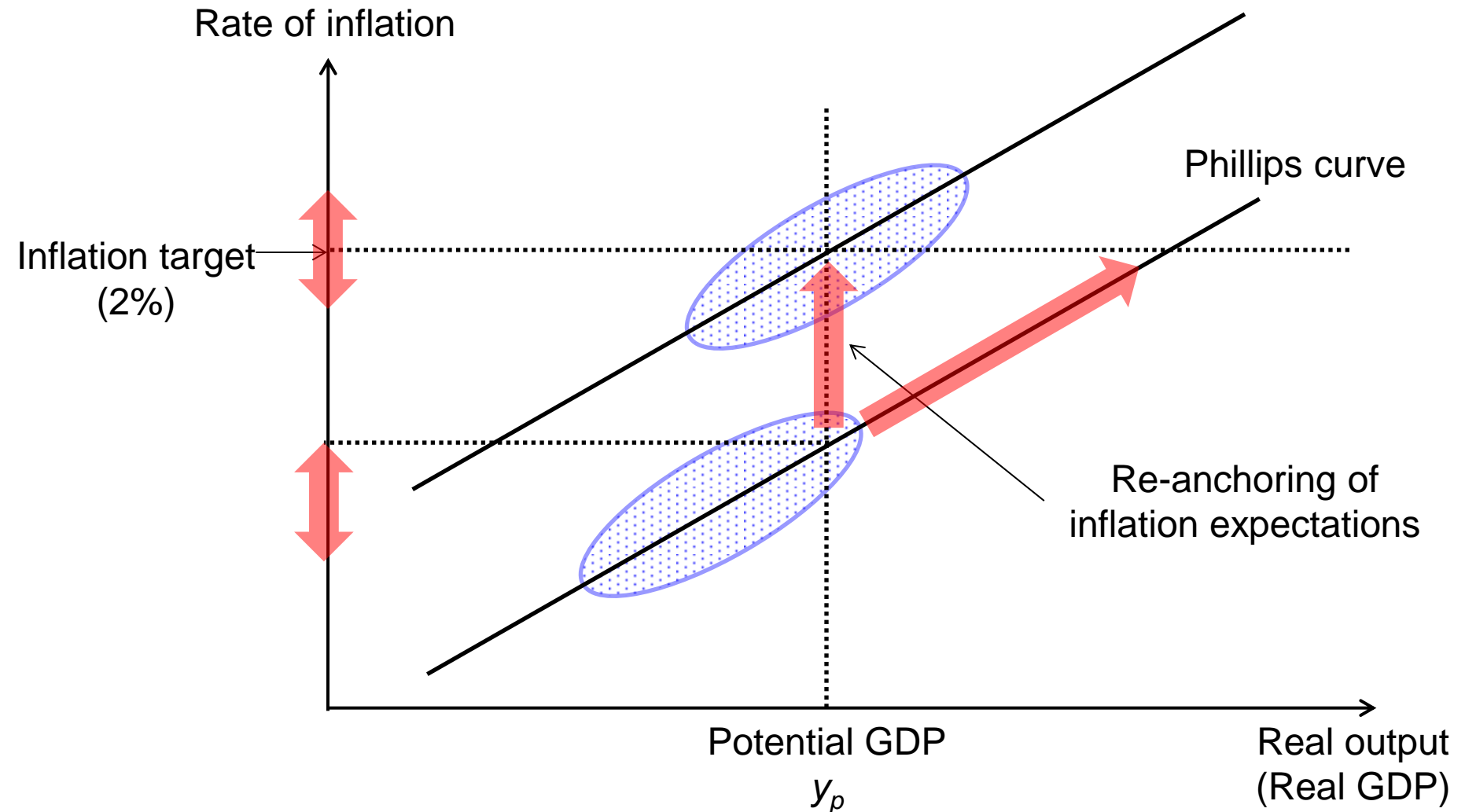
Source: Ministry of Internal Affairs and Communications, *Consumer Price Index*; Bank of Japan.

# Long-term Inflation Expectations



Sources: Consensus Economics Inc., Federal Reserve Bank of Philadelphia.

# Escaping from Deflation



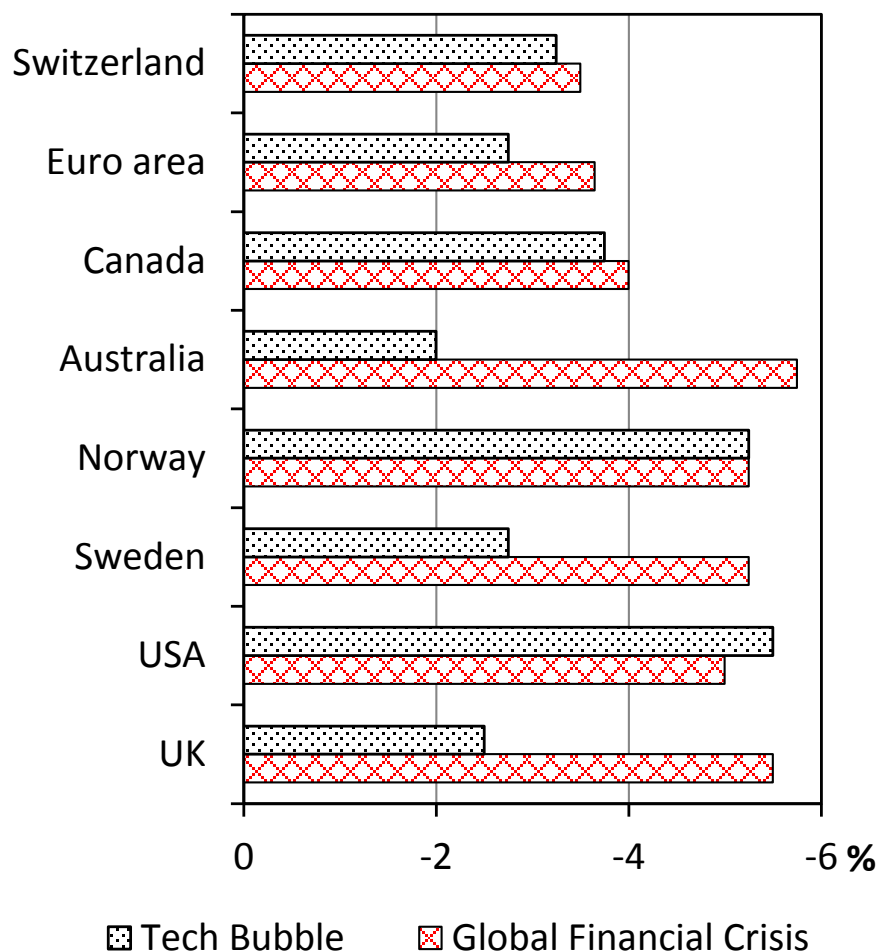
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# Margins to Reduce Policy Rates

Policy Rate Reductions

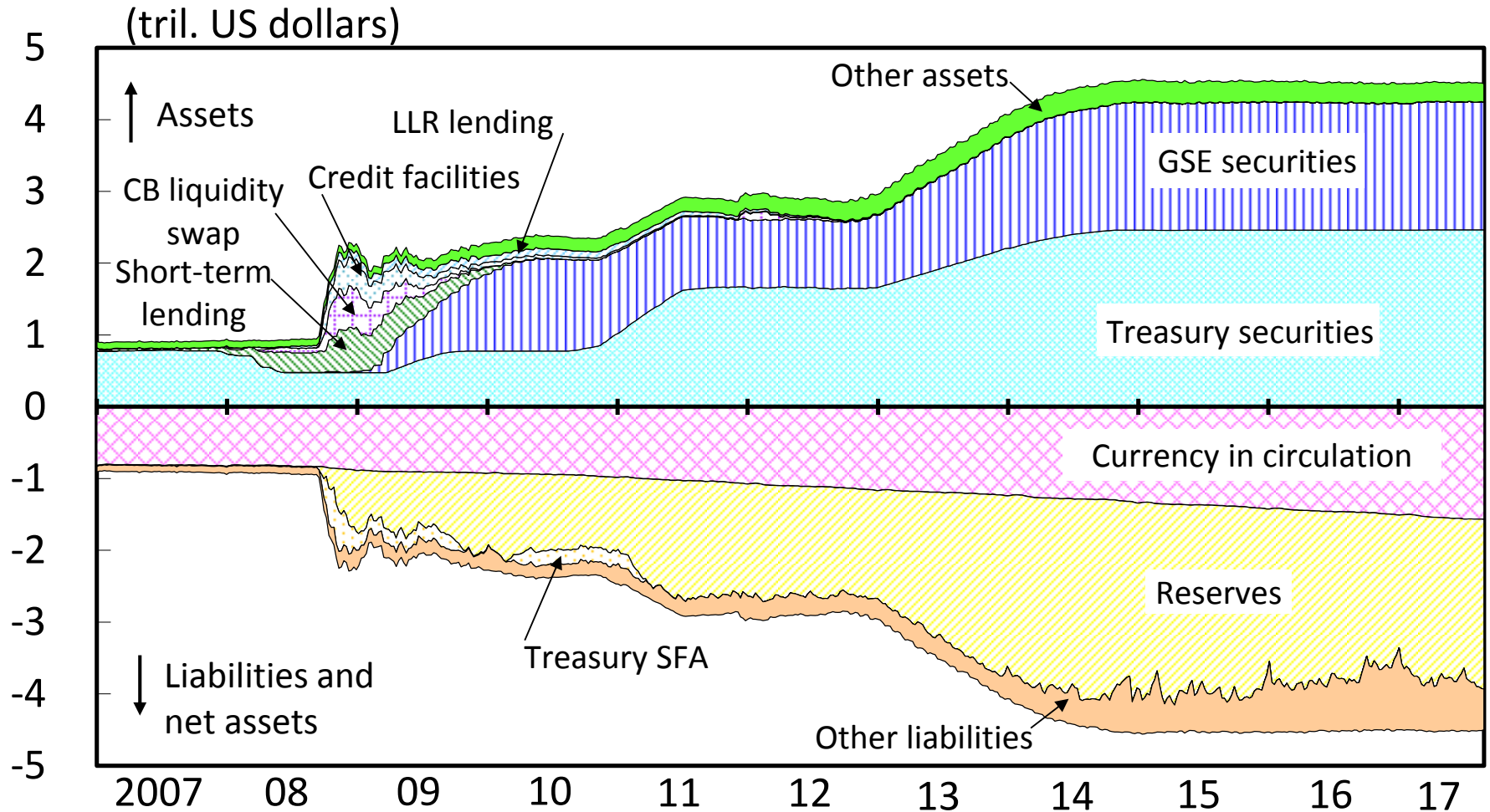


Policy responses  
 in the future  
 Large-scale asset  
 purchase  
 or  
 Negative interest rates  
 Different policy  
 management from  
 conventional MP

# Unconventional Policy Measures

- Policy Effectiveness:
  - Financial system rescue operation vs. macroeconomic stabilization policy
  - Combinations of unconventional tools, given economic, social, and political environments
  - Policy rule?: predictability vs. surprises
- Policy Implications:
  - Evolving nature
  - Border w/ fiscal policy

# Fed's Balance Sheet



Source: Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances*.

# Conventional vs. Unconventional

	Conventional	Unconventional	
Policy tools	O/N rate control	FG, LSAPs, NIRs	
Determinants of CB B/S size	Debt side (demand for CB money) → No excess reserves	Asset side (quantity & variety of unconventional asset purchases) → Massive excess reserves	
Interbank transactions	Scarce reserves	Arbitrage	
Intervention to resource allocations	Remain neutral	Pre crisis	After crisis
		Limited: market distortions, impaired MP transmission channels	Intentional & massive interventions
Policy management	Gradualism → High predictability	Gradualism (learning by doing)	Predictability vs Surprises



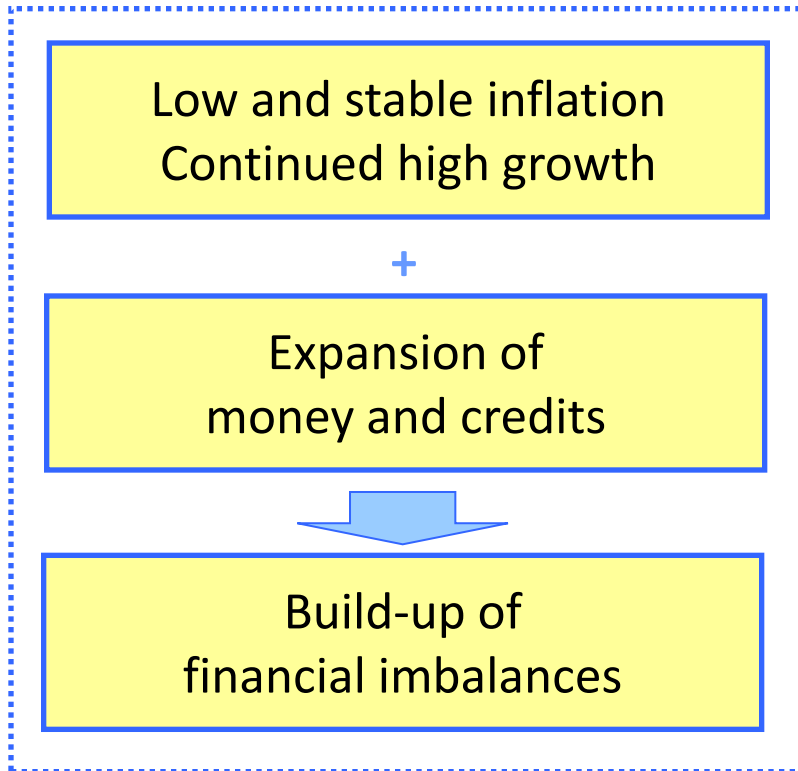
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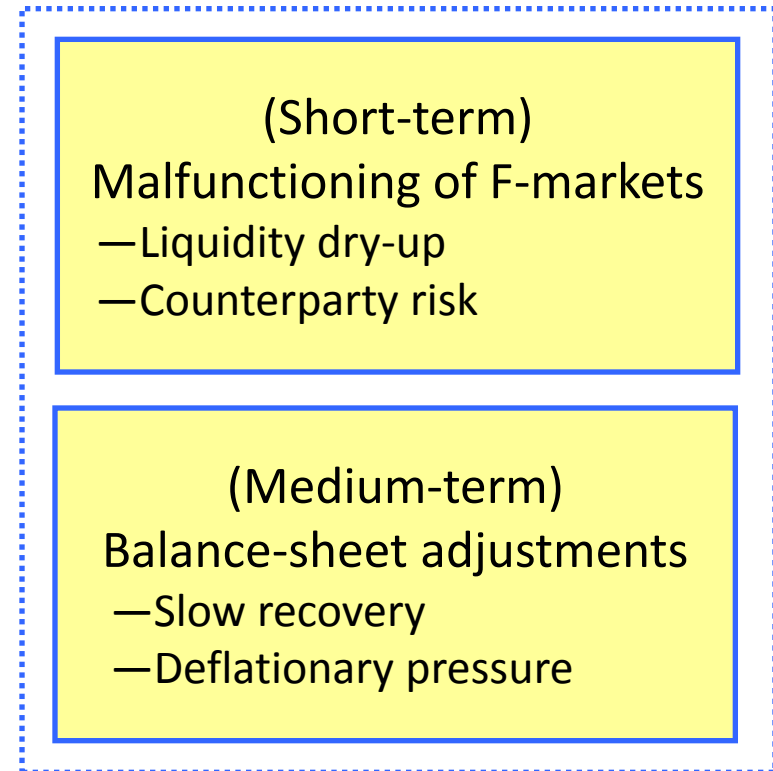
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# Assessment on Financial Stability

## Benign environment



## Materialization of F-imbalances



**Tough Challenge:** Risk assessment under a benign economic and financial environment in a real time basis.

# Macroprudential Policy Framework

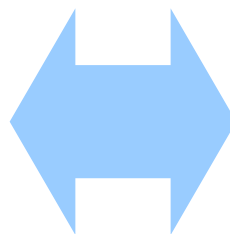
- Need to Address to Build-up of F-imbbalances:
  - Assessment from system-wide & longer-term perspectives
  - Policy Effectiveness: depend crucially on financial environments
- Sustained Stability in Monetary Conditions:
  - Achieving stability both in prices and financial system in a consistent and sustainable manner
  - Comprehensive policy framework for monetary and macroprudential policies

# Central Bank Mandates

## Price stability

A state where various economic agents are able to make economic decisions without being concerned about the fluctuations in the general price level.

Short-term  
conflict

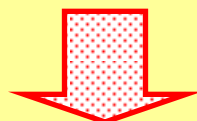


Long term  
comple-  
mentarity

## Financial stability

A state where various economic agents are able to make economic decisions without being **constrained by** the state of the financial system.

Simultaneous achievement of two stabilities in a sustainable manner



Maintenance of economic and financial environment that is consistent with promoting efficient resource allocation in the economy in the long term

# Minor Comments

$$\begin{aligned} i_t = & 0.7i_{t-1} \\ & + (1 - 0.7) \left[ \bar{r}_t + \pi 4_{t+4}^{Core} \right. \\ & \left. + 1.2 \left( \pi 4_{t+4}^{Headline} - \pi^* \right) + 0.4y_t \right] \\ & + \varepsilon_t^i \end{aligned}$$

- Some Questions on Specification for IF-based Policy Reaction Function:
  - Inflation indicators: core vs headline
  - Timing of data observation

# Headline vs Core Inflations

- Definition of Core Inflation Indicators:

$$\pi_t^{Headline} = \pi_t^{Core} + \varepsilon_t$$

- Inflation Indicators:
  - Target (long term): headline
  - Assessment & projection (short term): core
- But
  - “core inflation is a systematically downward-biased indicator of headline inflation” (p.24)

# Timing of Data Observation

$$\pi^4_{t+4} = (\pi_{t+4} + \pi_{t+3} + \pi_{t+2} + \pi_{t+1}) / 4$$

$\left. \begin{array}{l} \pi_{t+4} \\ \pi_{t+3} \end{array} \right\}$  Model forecast

$\left. \begin{array}{l} \pi_{t+2} \\ \pi_{t+1} \end{array} \right\}$  Partly observable / monitored  
 $\rightarrow$  Unobservable in a real time basis?

$y_t \rightarrow$  Unobservable in a real time basis?