Average Inflation Targeting

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Economic Background

After years of unsuccessful inflation target policy, the Fed announced a drastic change to its policy on the 27th August 2020: The average inflation targeting. In contrast to inflation targeting, this policy measure allows inflation to run higher than the 2% target, having further effects on future expectations and unemployment levels. In the New Keynesian model this mandate would increase welfare, given that agents form their expectations based on rationale. Generally, the U.S. Federal Reserve's (Fed) primary objectives are to maintain price stability, which is defined as inflation at 2% and maximum sustainable employment. With this new strategy called "flexible form of average inflation targeting" (AIT), it can theoretically be ensured that the Fed's inflation objective of 2% is obtained on average. This change in policy is primarily driven by failed attempts to achieve inflation at 2%. On average, the inflation over the last decade has been at 1.7%, only rarely reaching levels above 2%. Furthermore, also the low interest rate environment has limited the room for standard monetary policy instruments to be fruitful. Hence, alternative measures needed to be found, such as forward guidance, quantitative easing and now another strategy: Average inflation targeting. Together with the inflation rate, also the natural interest rate has fallen in the last decades, which aggravates to the limitation for monetary policy, because of the zero lower bound.

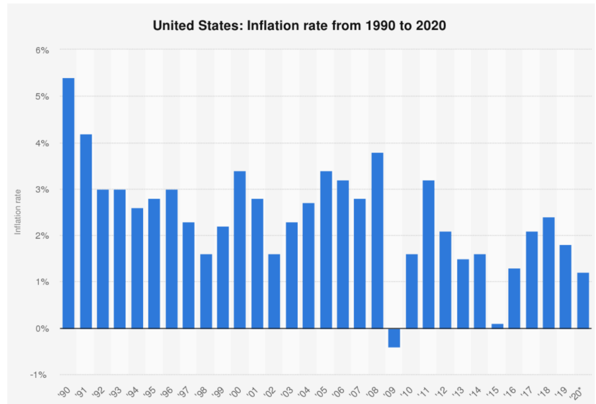

Figure 1: Source: Statista.

Average Inflation Targeting in Detail

Comparing the average inflation targeting to its predecessor, the inflation targeting, one might not see a clear difference. However, the main difference to traditional inflation targeting is the fact that AIT takes into account the past and the future. Traditionally inflation should move according to its target, regardless of how long it had been deviating from it. Now, a period of below-target inflation should be followed by a period, in which inflation is above target.As an example, one could take a closer look at the inflation rate in the U.S for the past decade. Despite, the inflation rate being below 2%, the target average inflation was unchanged. If it were using the new strategy, the forward-looking target would have risen to offset this shortfall. Expectations play a key role in determining the effectiveness of the AIT strategy. When the welfare effects of AIT are examined, two forms of expectations are distinguished: Rational expectations and boundedly-rational expectations, hence including constraints of incomplete or imperfect information and ability. As research suggests, the benefits of AIT are less effective with boundedly-rational expectations than with rational expectations. Under the assumption of rational expectations, the optimal averaging window is infinitely long and welfare gains can even be achieved. However, if cognitive limitations are particularly strong, and resultingly the expectations are bounded, the optimal averaging window will become finite and the effectiveness becomes limited (Budianto et al., 2020)[1]. This insight is essential, because in order to be fruitful AIT requires the profound understanding of future macroeconomic outcomes.

Impact on Economy and Population

The AIT has an impactful effect on markets, population and unemployment. Due to the fact that the real interest rate is close to the zero lower bound, the central bank has little room to manoeuvre in times of crisis like now. If the Fed considers inflation expectations, and expectations are "well- anchored", it can do a better job steering the economy, since now inflation can go above target and nominal interest rates can be reduced further without reducing the real interest rate. As an effect of the rising inflation, also unemployment sinks, which is in turn beneficial for the population. Naturally, this is only beneficial to a certain extent, since low unemployment increases the output gap, over-utilising the economy's resources without being efficient. Ben-

[1] Budianto, F., Nakata, T., Schmidt, S. (2020). Average inflation targeting and the interest rate lower bound.

efiting from the low interest environment are also financial markets. With more flexibility in recession times such as now, the low interest rate could increase government spending, which could again create demand and lead to increased output. Hence, if economic growth and inflation rise is expected, this would indicated that long term maturity bonds could rise more than short-term maturity bonds.

Is This Policy Instrument Fruitful?

In theory, the new average inflation targeting policy sound promising. Yet, this is strongly based on the assumption that expectations are going to adjust following this policy shift. Given the history of struggle to achieve the 2% target, it will be difficult to change expectations in this regard. Additionally, following a period of above target inflation, the Fed could have to raise interest rate in order to slow prices from rising too rapidly. This rise in interest rate would naturally reduce economic growth and increase unemployment.

The Reaction to the Policy Shift

Following Jerome Powell's announcement, the question remains if other central banks, like the European Central Bank (ECB) will adopt a similar strategy in the near future. While, according to Lagarde , the tendency is strong to follow the Fed, because "such a strategy can strengthen the capacity of monetary policy to stabilise the economy when faced with the lower bound" (Budianto et al., 2020), several policymakers warn about the emerging risks. One major criticism point is the confined flexibility, which could suffer from an average target. Diverging situations would have to be judged on its own and policymakers warn about financial markets developing expectations that could potentially not be fulfilled. In the long-run, central banks need to find an effective path to achieve a 2% inflation rate. Under rational expectations, the monetary policy strategy of average inflation targeting improves outcomes and welfare, compared to period-by-period inflation rate targeting. However, considering the cognitive limitations, the optimal averaging window would be finite, thus limiting the effectiveness of the average inflation targeting strategy.