New Consensus Macroeconomics and Inflation Targeting Relevance to CAREC Countries

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Introduction

- We focus on the New Consensus Macroeconomics (NCM) and its policy implications, i.e. Inflation Targeting (IT);
- Examine the NCM theoretical framework and the policy implications;
- Assess it in relation to the CAREC region;
- Summarize and conclude.

The Economics of the New Consensus Macroeconomics

Aggregate demand equation

$$Y_t^g = \alpha_0 + \alpha_1 \cdot Y_{t-1}^g + \alpha_2 \cdot E_t\left[Y_{t+1}^g\right] + \alpha_3 \cdot \left(R_t - E_t\left[p_{t+1}\right]\right) + \alpha_4 \cdot \left(rer\right)_t + s_1;$$

Phillips curve

$$p_t = \beta_1 \cdot Y_t^g + \beta_2 \cdot p_{t-1} + \beta_3 \cdot E_t\left[p_{t+1}\right] + \beta_4 \cdot \left\{E_t\left[p_{W,t+1}\right] - E_t\left[\Delta er_t\right]\right\} + s_2;$$

Monetary policy rule

$$R_t = \left(1 - \gamma_3\right) \cdot \left[RR^* + E_t\left[p_{t+1}\right] + \gamma_1 \cdot Y_{t-1}^g + \gamma_2\left(p_{t-1} - p^T\right)\right] + \gamma_3 \cdot R_{t-1} + s_3;$$

The Economics of the New Consensus Macroeconomics

Real Exchange rate equation

$$rer_t = \delta_0 + \delta_1 \cdot \{(R_t - E_t[p_{t+1}]) - (R_{W,t} - E_t[p_{W,t+1}])\} + \delta_2 \cdot CA_t + \delta_3 \cdot E_t[rer_{t+1}] + s_4;$$

Current account equation

$$CA_t = \lambda_0 + \lambda_1 \cdot rer_t + \lambda_2 \cdot Y_t^g + \lambda_3 \cdot Y_{W,t}^g + s_5;$$

Nominal Exchange rate equation

$$er_t = rer_t + P_{W,t} - P_t \; ;$$

The Economics of the New Consensus Macroeconomics

- Six equations and six unknowns: output, inflation, interest rate, current account, nominal and real exchange rate;
- Basic assumption: intertemporal optimization of a utility function that reflects optimal consumption smoothing;
- Based on the transversality condition, meaning:
- All debts are ultimately paid in full: economic agents are credit worthy;
- All IOUs are perfectly acceptable in exchange; nobody is liquidity constrained;

The Economics of the New Consensus Macroeconomics

- It is a non-monetary model: no private banks or monetary variables.
- Objective: price stability; inflation is a monetary phenomenon;
- Inflation is controlled directly via changes in the rate of interest (not through money stock);
- Fiscal policy should not be used for short-term objectives; only for medium- to long–term ones;

The Economics of the New Consensus Macroeconomics

- Changes in the nominal rate of interest change the real rate of interest (price and wage rigidity is assumed);
- Changes in the rate of interest can only affect aggregate demand in the short run;
- Importance of expectations in the Phillips Curve should be emphasised;
- Phillips curve is vertical in the long run at NAIRU;
- NAIRU is a supply-side variable;

Economic Policy of the New Consensus

- Inflation Targeting (IT) is embedded in equations 1-3;
- IT is a monetary policy framework whereby public announcement of official inflation target is undertaken;
- Equations 2 and 3 entail an important role for ‘expected inflation’;
- Credibility attained through pre-commitment to the inflation target without government interference;

Economic Policy of the New Consensus

- Transparency of inflation forecasts is a paramount element of the policy, and it enhances credibility; but…
- The centrality of inflation forecasts and the margin of errors represent a major challenge to this framework;
- This aspect may be particularly relevant to the CAREC region in particular;

Relevance of the New Consensus Macroeconomics to CAREC

- This section discusses the relevance of the IT type of economic policy to the CAREC group; a very relevant topic for a number of reasons:
- IT has become the dominant monetary policy prescription for developing countries;
- Developing countries are increasingly under pressure to follow IT as part of their IMF-inspired stabilization packages - augmented Washington consensus;
- IT has become an important input to the routine rating procedures of the international financial institutions;

Relevance of the New Consensus Macroeconomics to CAREC

- We suggest that there may be problems with this approach;
- We focus on problems that arise in the application of this paradigm in the case of the CAREC group;
- We distinguish between theory and policy.

Relevance of the New Consensus Macroeconomics to CAREC

- Main Problems (Theory):
- Liquidity Preference is Absent:
- Due to transversality condition;
- Central Bank changes the rate of interest and influences the term structure in a stable fashion;
- But the term structure of interest rates is influenced by a host of other factors, most importantly the market power of the banking sector, i.e. liquidity preference;
- No monetary aggregates;

Relevance of the New Consensus Macroeconomics to CAREC

- No Banks, implying serious problems;
- Banks and their decisions play a significant role in the transmission mechanism of monetary policy;
- Banks play a major role in the expansion of the economy;
- Failure of banks to supply credit would imply that expansion of expenditure cannot occur;
- This is particularly relevant to the CAREC group where the bank-based system is more prominent.

Relevance of the New Consensus Macroeconomics to CAREC

- Vertical Phillips Curve (evidence?);
- NAIRU is a supply-side variable, unaffected by aggregate demand/policy (evidence?);
- But evidence to the contrary does exist: NAIRU is a function of capital stock;
- NAIRU affected by flexible markets, especially labour markets (evidence);
- RR* in equation 3 is problematic.

Relevance of the New Consensus Macroeconomics to CAREC

- Price stability has been associated with benefits to the economies pursuing it; but there are problems:
- Price stability might not be sufficient to avoid serious macroeconomic downturns;
- History is replete with relevant examples;
- Not to mention the experience since August 2007;
- Output and employment stabilisation become important;

Relevance of the New Consensus Macroeconomics to CAREC

- Main Problems (Policy)
- IT is designed to fight demand shocks;
- Supply shocks cannot be handled, as current experience shows;
- Can be accommodated;
- Supply shocks come and go – and on average are zero;
- They have no impact on the expected rate of inflation;
- CAREC group is exposed to supply shocks;

Relevance of the New Consensus Macroeconomics to CAREC

- Insufficient attention paid to exchange rate;
- Exchange rate is not included in equation (3);
- There is the danger of a combination of internal price stability and exchange rate instability;
- Should include exchange rate in equation (3), especially so for the CAREC region if IT were implemented;
- Direct intervention in the foreign exchange market by central banks is necessary;

Relevance of the New Consensus Macroeconomics to CAREC

- Countries that do not pursue IT type of policies have done as well as those who do;
- Monetary policy used for short-term stabilization purposes but not fiscal policy (due to crowding-out);
- Does IT work in practice as the theoretical framework suggest?
- Is monetary policy so effective and fiscal policy so ineffective?

Summary and Conclusions

- We have highlighted the theoretical framework and the policy implications, IT, of the New Consensus Macroeconomics;
- We have also provided a comprehensive coverage of the problematic nature of the NCM paradigm and IT to developing countries and CAREC in particular;
- More thought and research should be channelled into the problems raised above before IT is contemplated in the case of the CAREC region.