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On the performance of nominal income targeting as a strategy for monetary policy in a small open economy

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Abstract

There is a great deal of support for nominal income targeting in the literature on strategies for monetary policy in a closed economy framework. Is nominal income targeting equally attractive in a small open economy? This paper compares nominal income targeting to alternative monetary policy rules in a stochastic macro model for a small open economy. We find that both the weighting in the overall price level of the exchange rate and foreign prices and the elasticity of output supplied with respect to the real exchange rate are important factors in assessing the attractiveness of nominal income targeting. In a small open economy where the size of both parameters is not negligible, a rule targeting the overall price level may actually be preferred to nominal income targeting.

JEL classification: E52; F41

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1. Introduction

The adoption of inflation targets by a number of central banks during the past decade seemed to run counter to the policy advice spelled out in the literature on

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monetary policy strategies in the 1980s and early 1990s. There appeared to be a reasonably strong consensus in the literature then that favored nominal income targeting as the most suitable monetary policy strategy.[1] Thus, the decision by countries like Canada, New Zealand, Sweden, the United Kingdom and others to target inflation directly came somewhat as a surprise. In addition, the long-standing implicit form of inflation targeting pursued by Germany, Switzerland, Japan, and arguably the United States, appeared to be at odds with conventional wisdom.

The divergence between what the literature hailed as the most suitable object of monetary policy and actual practice highlights the need for reassessing the argument for nominal income targeting. Much of the existing literature has focused on relatively closed economies.[2] However, all of the economies that have adopted an explicit inflation target are relatively small open economies. There is thus reason to believe that the attractiveness of nominal income targeting in a closed economy may not carry over in full force to a small open economy.

The evaluation of policy rules for closed economies has mainly focused on the attainment of domestic price and output stability. A small open economy has additional considerations. The stability of the exchange rate is important. Instability in the exchange rate leads to undesirable fluctuations in the pertinent price level, usually represented by a measure of prices of both domestic and foreign goods such as the Consumer Price Index. In addition, the degree of import penetration or openness is another factor that influences the choice of a strategy for monetary policy in a small open economy.

[1] Meade (1978) and Tobin (1980) are two early proponents of nominal income targeting. Hall and Mankiw (1994, p. 77) go as far as arguing that there exists a professional consensus that nominal income is the most suitable object of monetary policy. This consensus was perhaps more evident in the United States, where the economy is rather closed, than in other parts of the world.

[2] This is particularly true for papers that offered an empirical evaluation of nominal income targeting. For example, Taylor (1985), McCallum (1988), Hall and Mankiw (1994). For more recent, somewhat less favorable, assessments see Fair and Howrey (1996) and Rudebusch (2000). The theoretical literature has been generally in favor of nominal income targeting, although different model specifications have provided different degrees of support. The degree of support has been closely linked with a particular model's specification of aggregate supply or the Phillips Curve, as demonstrated by Bean (1983), West (1986), Jansen and Sun (1993), Svensson (1999a) and Ball (2000). Jansen and Sun (1993) and Ball (2000) aver that nominal income targeting may in fact be destabilizing, not stabilizing. Svensson (1999a) is also critical of nominal income targeting in a dynamic backward-looking framework. In contrast, McCallum (1997) stresses that nominal income targeting is a well-defined policy strategy for a number of different specifications of the Phillips Curve. Guender (2001) and Jenssen (2002) argue that under plausible conditions nominal income growth targeting is preferable to inflation targeting in models that emphasize forward-looking behavior by economic agents.