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# Monetary policy for inattentive economies<sup>☆</sup>

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## Abstract

We offer a contribution to the analysis of optimal monetary policy. We begin with a critical assessment of the existing literature, arguing that most work is based on implausible models of inflation–output dynamics. We then suggest that this problem may be solved with some recent behavioral models, which assume that price setters are slow to incorporate macroeconomic information into the prices they set. A specific such model is developed and used to derive optimal policy. In response to shocks to productivity and aggregate demand, optimal policy is price level targeting. Base drift in the price level, which is implicit in the inflation targeting regimes currently used in many central banks, is not desirable in this model. When shocks to desired markups are added, optimal policy is flexible targeting of the price level. That is, the central bank should allow the price level to deviate from its target for a while in response to these supply shocks, but it should eventually return the price level to its target path. Optimal policy can also be described as an elastic price standard: the central bank allows the price level to deviate from its target when output is expected to deviate from its natural rate.

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## 1. Introduction

What policy rule should a central bank follow? Recent years have seen a resurgence of theoretical research on this classic question. Most of this work has built on “new Keynesian” models of the output–inflation trade-off derived from forward-looking models of staggered price adjustment. Unfortunately, these models make implausible predictions about the effects of monetary policy: for example, they imply that a policy change that gradually reduces inflation causes an output boom. There is therefore good reason to be skeptical about what the literature tells us about the effects of alternative policies.

This article tries to make progress toward determining which policies are optimal by studying this question in a model that more closely fits the facts about monetary policy. In particular, we draw on recent behavioral models of the output–inflation trade-off based on the assumption that agents are slow to incorporate information about macroeconomic conditions, even if the information is publicly available. Recent work has shown that such models capture the inertia that is central to inflation dynamics in modern economies. These models should provide more reliable insights into the policy choices facing central banks.

Section 2 briefly reviews the two literatures on which our work builds, the work on optimal monetary policy and the work on behavioral macroeconomics. Section 3 presents a specific model, which builds on the “sticky information” model of [Mankiw and Reis \(2002\)](#), and Section 4 discusses the determinants of welfare in this model. Sections 5–7 derive the optimal policy rules in the model. Section 8 compares our results with those obtained from the standard new Keynesian Phillips curve. Section 9 concludes.

Our central result is that price level targeting is the optimal policy in the model. Inflation targeting—the currently popular policy of allowing base drift in the price level—is suboptimal. When the economy is hit by shocks to aggregate demand or productivity, strict price level targeting is optimal: policymakers should return the price level to a pre-determined path as quickly as possible. However, if there are persistent shocks to firms’ markups, the optimal rule allows temporary deviations from the long-run price target. In this way, the prescriptions of our model are similar to the practice of many central banks, which allow temporary deviations from policy rules in response to “supply shocks.” One can also describe optimal policy as the elastic price standard proposed by [Hall \(1984\)](#). Under this policy, the price level can deviate from target as long as output is expected to deviate from its natural rate.

## 2. Motivation

This research arises from two recent literatures—one on optimal rules for monetary policy and one on behavioral approaches to the Phillips curve. We believe that the second may hold the hope of remedying some deficiencies in the first. The natural place to start our analysis is with a brief overview of these two broad literatures.

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