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The credibility of the monetary policy "free lunch"

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Abstract

Price level targeting has been proposed as an alternative to inflation targeting that may confer benefits if a central bank sets policy under discretion, even if society's loss function is specified in terms of inflation (instead of price level) volatility. This paper demonstrates the sensitivity of this argument. If even a small portion of agents use a rule-of-thumb to form inflation expectations, or does not fully understand the nature of the target, price level targeting may in fact impose costs on society rather than benefits.

JEL classification: E52

Keywords: Price level targeting; Inflation targeting; Credibility; Free lunch; Discretion

1. Introduction

In recent times, a growing number of central banks have commenced explicitly targeting inflation as a means to improving economic performance. Associated with this has been growing central bank credibility, as explicit targets have been achieved,

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Nomenclature

π_t	inflation rate
β	discount rate
x_t	output gap
u_t	cost-push shock
π^*	inflation target
λ	weight on output objective in central bank loss function
κ	slope of Phillips curve

and deviations from the targets have been clearly articulated (see Bernanke et al. (1999) and Johnson (1998) for evidence of this).

Some have argued that central banks should go further. One characteristic of an inflation target is that past mistakes are ignored: if inflation lies above or below the target one period, the inflation target for the following period does not change. In a world in which there are nominal rigidities, optimal policy will generally include some degree of history dependence, so that current policy should condition on past mistakes.

One special case of a history dependent monetary policy that has received particular attention is price level targeting. Several recent papers have focused on the potential benefits of the central bank targeting the price level when the central bank operates under discretion, even if society's loss function is specified in terms of inflation variability. Svensson (1999), using a Neo Classical Phillips curve, argued that there is an advantage to doing so provided the output gap is sufficiently persistent, and labeled this a "free lunch". Others have found even stronger support for price level targeting when agents are forward looking. These papers utilize variants of the New Keynesian framework, outlined in Roberts (1995) and Clarida et al. (1999). This framework assumes that changing prices is costly, so prices that are set today reflect future expectations of inflation. For example, Dittmar and Gavin (2000) find that the inflation-output variability trade-off is better with a price level target than an inflation target. They argue that adding a price level target with a small weight has little cost in terms of the real side of the economy yet is beneficial in reducing inflation volatility.

Vestin (2000), using a similar framework, finds that price level targeting under discretion outperforms inflation targeting under discretion. In some cases, he finds that price level targeting under discretion can result in the same outcome as inflation targeting under commitment, provided the parameters of the loss function are suitably adjusted. In a related paper, Barnett and Engineer (2001) provide a summary of the literature and consider a hybrid New Keynesian–Neo Classical Phillips curve. They argue that optimal monetary policy precludes long-run price-level drift if inflation expectations are sufficiently forward looking, among other contexts.

The existing literature has assumed that agents are fully rational and that the central bank enjoys perfect credibility. Therefore whether a central bank has an inflation