

Price stability through price-level targeting or inflation targeting? A tale of two experiments

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Abstract

Price stability can be attained through price-level or inflation targeting. This paper compares the two monetary policy strategies from both a historical and a theoretical perspective. The Swedish experiment with price-level targeting in the 1930 occurred within a framework that lacked the accountability characteristic of New Zealand's current policy framework for inflation-targeting. Using a simple forward-looking rational expectations framework, we show that price-level targeting offers a better output-inflation variability tradeoff than inflation targeting in the forward-looking New Keynesian framework.

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Broadly defined, inflation targeting is a monetary policy strategy whose chief objective is to maintain inflation at a constant level or within a band. The era of formal inflation targeting began in 1989 when legislation in New Zealand declared price stability to be the overriding goal of monetary policy. There has been widespread support in academic circles for inflation targeting as a monetary policy regime over the past decade (Leiderman & Svensson, 1995, Bernanke et al., 1999). It has won acclaim as the best-practice strategy for monetary policy in a large number of countries around the globe. Every country that followed New Zealand's example and adopted formal inflation targets in the early 1990s – Australia, Canada, New Zealand, Sweden, and the United Kingdom – has since then enjoyed price stability and satisfactory real growth records. As a result, none of the inflation-targeting countries has seen fit to abandon its current monetary policy strategy for any other.

A conceivable alternative to inflation targeting is price-level targeting. Historical evidence on the performance of price level targeting is scant. Indeed the Swedish experiment of targeting the CPI during the 1930s remains the only attempt at targeting the price level over a prolonged

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period of time. From an academic perspective, support for price-level targeting was particularly strong at the beginning and early part of the 20th century. [Wicksell \(1965\)](#) was an early proponent of price-level targeting. Yet in practice, monetary policy in the industrialized world was geared towards maintaining some semblance of a pegged exchange rate system that gave way only with the collapse of the Bretton Woods agreement in the spring of 1973. Skepticism about the effectiveness of pegged exchange rate arrangements had led to calls for basing the conduct of monetary policy on an alternative nominal anchor long before the abandonment of the Bretton Woods agreement. Most analysts would probably concur with the view that the post-World War II literature on monetary policy recommended targeting monetary aggregates over alternative strategies such as price-level targeting. A forceful statement of this policy prescription can be found in [Friedman \(1969\)](#): “Attempting to control directly the price level is therefore likely to make monetary policy itself a source of economic disturbances because of false stops and starts.”¹ More than 25 years later, [Fischer \(1995\)](#) is equally critical of price-level targeting. He goes as far as claiming that conventional wisdom cast aside price-level targeting because of its potential for causing unnecessary variability in the output gap.

A few recent papers challenge the notion that price-level targeting delivers poor stabilization results. [Svensson \(1999\)](#) and [Vestin \(2000\)](#) argue that price-level targeting delivers better results for price stability than inflation targeting. Indeed, price level targeting dominates inflation targeting as the former yields a better output-inflation variability trade-off. Svensson’s comparison of the two alternative strategies is based on a Lucas-type Phillips Curve that allows for substantial persistence in output. In contrast, Vestin analyzes the merits of price-level versus inflation targeting in the context of the New Keynesian framework.²

In this paper, we follow Vestin’s example and carry out the exercise by employing the forward-looking model. However, we use a somewhat different approach, one that dispenses with an intertemporal optimization framework. Our analysis of price-level and inflation targeting is grounded in a standard rational expectations framework where the policymaker follows a simple linear policy rule and minimizes an expected loss function that consists of the unconditional variances of the target variables. The examination of price-level targeting in this simple set-up yields the same powerful insight as the more complex intertemporal approach. Three different approaches to modeling discretionary price-level targeting are compared in the appendix, each generating a better output-inflation variability tradeoff than inflation targeting.

We believe that our approach yields more intuitive results to show why price-level targeting in the forward-looking model is such an attractive monetary policy strategy compared to inflation targeting. In particular, we show how the process of forming rational expectations depends critically on the current price level under price-level targeting. As economic agents are forward-looking, they base their current expectations of future endogenous variables on current information. As a consequence, these expectations depend on the current price level which in turn responds to contemporaneous policy action. Thus, current policy action in response to a cost-push shock affects not only the current price level but also the current expectation of next period’s price level.

¹ p.108.

² [Dittmar and Gavin \(2000\)](#) compare and contrast the output-inflation variability trade-off in models featuring variants of the expectations-augmented and the New Keynesian Phillips Curves. According to their findings, the degree of persistence of real output in the Phillips Curve does not matter in the assessment of the output-inflation variability tradeoff under price level targeting as opposed to inflation targeting in the New Keynesian model. They concur with [Svensson \(1999\)](#) that persistence matters if an expectations-augmented Phillips Curve forms the basis for the comparison of the two targeting strategies.

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