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Price-level versus inflation targeting

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Abstract

This paper shows that price-level targeting outperforms inflation targeting in the standard New-Keynesian model, under the assumption that the central bank is forced to operate in an environment characterized by discretion. In the benchmark case, with no persistence in the shocks, the commitment solution can be fully replicated. Intuitively, price-level targeting introduces history dependence and a stationary level of prices, both of which are prominent features of the commitment solution.
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1. Introduction

Several central banks use inflation targeting as their monetary policy strategy.[2] Since inflation is equal to the change in the price level, it is natural to consider an explicit

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[2]Examples are Bank of England, Bank of Canada and Sveriges Riksbank.

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price-level target as an alternative. Although similar in spirit, this alternative has only been pursued in Sweden in the thirties.[3] Common arguments for inflation targeting apply equally well, or better, to price-level targeting. For example, it is argued that inflation targeting reduces uncertainty about future price developments, which is beneficial to consumers and firms when planning purchases and investments. This uncertainty, however, is reduced even further with a price-level target.[4]

This paper will take a slightly different but complementary approach, in that it will argue that even if society is concerned about inflation (and output), it might still beneficial to delegate a price-level target to the central bank.

The conventional wisdom emerging from the discussion about price-level targeting seems to be that price-level targeting should be avoided because it generates unnecessary variability in the output-gap. In some recent papers, the relative merits of inflation targeting and price-level targeting have been debated, and some results cast doubts on this conventional wisdom. Svensson (1999) found that price-level targeting delivers a better outcome (lower variability of inflation) than inflation targeting, when the central bank acts under discretion. This result is shown for a Lucas-type Phillips curve and requires some output-gap persistence. Woodford (1999) found that for an inflation targeting central bank, the optimal policy under commitment is characterized by a significant degree of interest rate inertia. His results suggest that given a central bank with no commitment, assigning a loss-function with the interest rate as an explicit argument induces the central bank to partly mimic the commitment solution, since there is an explicit reason for smoothing interest rates under the new loss-function. Jensen (2002) finds that in some instances, nominal income growth targeting can dominate inflation targeting for the same reason as pointed out by Woodford; that is by creating inertial behaviour of interest rates, which is a feature of the commitment solution.

The fact that both Clarida et al. (1999) and Woodford (1999) find the price level to be stationary under inflation targeting with commitment is interesting, in that it directs attention to the possibility of an explicit price-level target being preferable when the central bank acts under discretion (since the price level is stationary when there is a price-level target). This paper, therefore, compares price-level targeting and inflation targeting under discretion, and finds that the outcome of the discretionary inflation targeting case can be improved by assigning a price-level target to the central bank. Thus, the question is the same as in Svensson (1999), but posed in a model where forward-looking behaviour is emphasized. The emphasis on forward-looking elements will turn out to play an important role when considering price-level targeting.

Recently, Clarida et al. (1999) have stressed that in forward-looking models, gains from commitment are possible also when the central bank aims at the natural rate of unemployment. One way to interpret this paper is that it makes an attempt to see whether a price-level target can act as a committing device to achieve those gains.

The main result is that price-level targeting delivers a more favourable trade-off between inflation and output-gap variability than does inflation targeting. With no (exogenous) persistence in the inflation process the commitment solution can always be fully implemented through an appropriate price-level targeting regime.

[3]For a description of this episode, see Berg and Jonung (1999).

[4]For a thorough discussion about pros and cons of price-level targeting, see Duguay (1994).

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