FLEXIBLE INFLATION TARGETING AND ALTERNATIVE MONETARY POLICY TARGETS – WHAT DOES RESEARCH TELL US?

ØISTEIN RØISLAND
Disclaimer

Views and conclusions expressed in this presentation are my own should not be taken to represent the views of Norges Bank.
Flexible Inflation targeting (FIT)

- **Theory:** Welfare-maximizing monetary policy can be implemented through FIT
  - Woodford
  \[
  L_t = (\pi_t - \pi^*)^2 + \lambda y_t^2 + \ldots
  \]

- **Caveat 1:** Welfare-maximizing monetary policy imply stabilizing a large number of variables

- **Caveat 2:** FIT might require considerable flexibility to implement welfare-optimizing policy
  - “Divine coincidence” only in very simple, unrealistic models
Alternatives to FIT

- Price-level targeting
  - Or a less extreme variant: average inflation targeting

- Nominal GDP targeting
  - Level
  - Growth
Price-level targeting

Inflation

Price level

Inflation Targeting

Price-Level Targeting

shock
Price-level targeting

Advantages

- Resembles optimal policy under commitment
  - History-dependence

- Easier to escape a liquidity trap
  - Expectations of expansionary future monetary policy

- Less uncertainty about the future price level
  - Smaller unexpected changes in real value of debt
Price-level targeting
Disadvantages

- Can lead to large fluctuations output (and inflation) if
  - expectations are not forward-looking, or
  - price-level target not credible
- More difficult to understand for the public
- Has not (really) been tested in practice
Nominal GDP targeting

Advantages

- Hard-wires a balance between price stability and output stability
  - \( PY = \text{target} \)

- Resembles optimal policy under commitment
  - History-dependence

- Easier to escape a liquidity trap

- Reduces financial risk
  - Debt contracts based on fixed nominal repayments

- Good properties for small open economies hit by ToT shocks
  - Difference between GDP deflator and CPI

- Correlated with house prices and credit
  - Less need for “leaning against the wind”
Nominal GDP targeting

Disadvantages

- More difficult than IT to explain to the public
- Large revisions in NGDP data
- NGDP-level targeting has same problems as price-level targeting if expectations are non-rational or limited credibility
NGDP and CPI tell different stories about nominal stability

Annual change. Percent

Sources: Statistics Norway and Norges Bank
Positively correlated with terms of trade shocks
Annual change. Percent

Source: Statistics Norway
...and credit growth

Four-quarter change. Percent

Source: Statistics Norway
ReFIT research

- Difficult to beat **flexible** inflation targeting
- Trade-off between flexibility and credibility/accountability
- **Research question:** Could an alternative target (e.g. NGDP) provide sufficient real and financial **stability** without requiring too much **flexibility**?
Welfare loss under FIT and NGDP targeting for various degrees of flexibility
Brubakk and Røisland (2017)

- NEMO

- Welfare depends on stability in CPI inflation, output gap and house prices (small weight)
  (+ interest rate smoothing)

- Foreign and domestic shocks
Welfare loss under FIT and NGDP targeting for various degrees of flexibility

Bergholt (2017)

- Three-sector model
  - Commodity (oil)
  - Manufacturing
  - Service

- Welfare depends on stability in CPI inflation and output gap (+ interest rate smoothing)

- International shocks only
Conclusions

- Welfare-optimal monetary policy can in principle be implemented through FIT
  - But needs to be **flexible**

- Trade-off between flexibility and credibility/accountability

- Price-level targeting and NGDP targeting have some nice properties in theory
  - But has some practical problems

- Relatively strict NGDP targeting could come quite close to «optimal» FIT for Norway
  - Correlated with house prices and credit: less need for “leaning”
  - Implies appropriate monetary policy responses to ToT shocks
  - NGDP as a cross-check on nominal stability?
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ØISTEIN RØISLAND
NORGES BANK
Extra
NGDP and house prices

Sources: Statistics Norway and Norges Bank
Price-level targeting
No weight on stabilizing house prices
Equal weight on inflation and house prices
Three-sector model (Bergholt)