BEYOND INFLATION TARGETING: SHOULD CENTRAL BANKS TARGET THE PRICE LEVEL?

Over the last 20 years, many central banks have adopted formal inflation targets to guide the conduct of monetary policy. While this strategy has resulted in relatively low and stable inflation in many countries, considerable uncertainty may remain about the level of prices over the long run. Moreover, the severity of the recent global recession may raise the question of whether, going forward, policymakers might want to consider alternative policy strategies.

In the article, “Beyond Inflation Targeting: Should Central Banks Target the Price Level?” George A. Kahn, vice president and economist at the Federal Reserve Bank of Kansas City, discusses the use of a price-level target, under which a central bank would adjust its policy instrument—typically a short-term interest rate—in order to achieve a pre-announced level of a specific price index over the medium term. The article appears in the third quarter edition of the Bank’s Economic Review.

This approach could potentially result in more stable output and inflation, Kahn writes. In the current low-inflation environment with short-term interest rates near zero, price-level targeting might support positive inflation expectations, leading to negative real interest rates, which would stimulate interest-sensitive spending and contribute to the economic recovery.

But, Kahn cautions that the benefits of price-level targeting may be small and uncertain. Furthermore, the challenges of communicating this untested approach to the public means central banks are not likely to adopt price-level targeting without further research or a dramatic economic deterioration that leads policymakers to fundamentally re-think how they conduct monetary policy.

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