

Comments on

Vojtěch Molnar, Price Level Targeting
with Imperfect Rationality

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Introduction

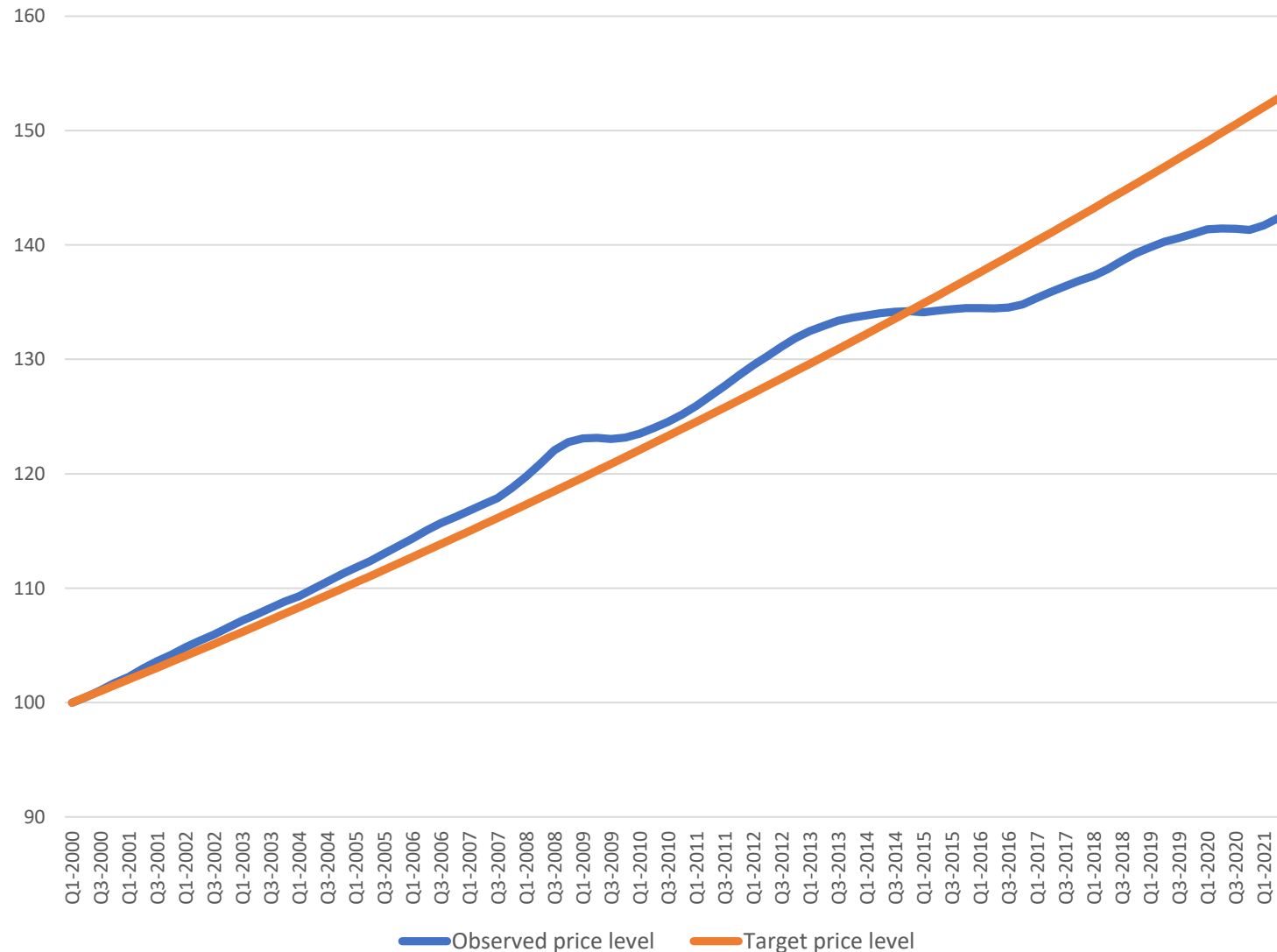
- This is a very interesting and original piece of research
- One of the problems of mainstream macroeconomics is that many of its practitioners construct models based on the central idea that individuals **should** have rational expectations (RE).
- In other words: instead of asking the question of how agents **actually behave**, they impose the condition that agents **should be** rational.
- Making assumptions that deviate from this dogma is deemed to be ad-hoc and therefore not interesting.
- It is refreshing to read a paper that is not ashamed of departing from RE
- and of using a model that comes closer to what agents actually do

Price level targeting (PLT)

- PLT has been advocated by many macroeconomists
- It has been shown that in the context of RE-models PLT has a number of attractive features
- In general it leads to more long term stability of the price level
- This should increase welfare.

- It is useful to look at the data first
- And to ask the question what if..
- What if the central bank (I'll choose the ECB) followed the PLT strategy today and was confronted with a sudden surge of inflation as it does today
- See next chart

Observed and target price level in Eurozone



7.5%

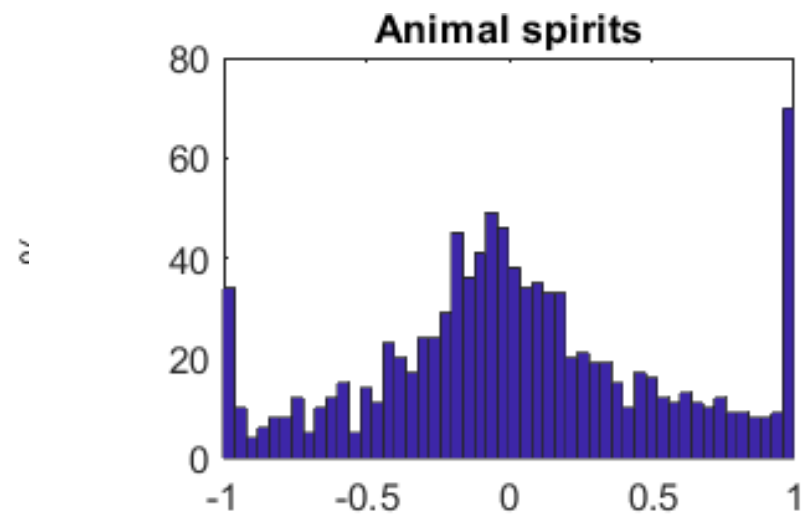
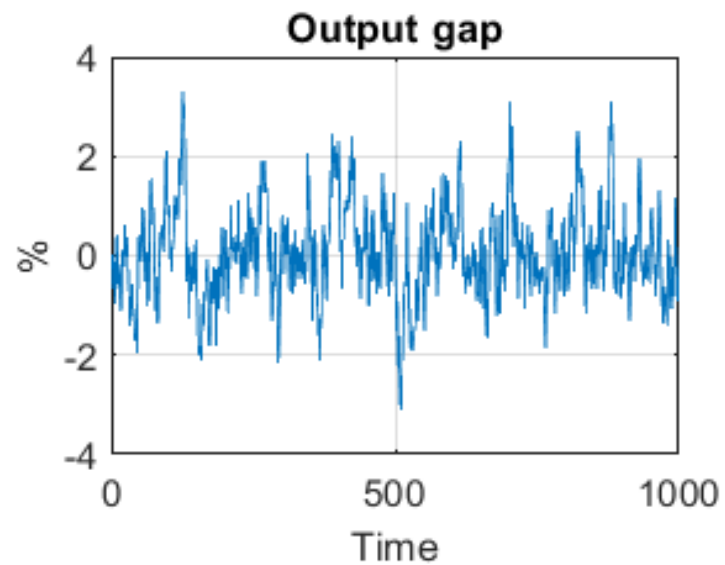
- ECB would come to judgment today that the sudden surge of inflation is welcome
- It brings us very close to the PLT
- Not much should be done
- Would agents understand this strategy?
- Would that be a credible strategy?
- These are the questions analysed by Vojtěch

Source: Eurozone
 Note: PLT assumes target inflation = 2%

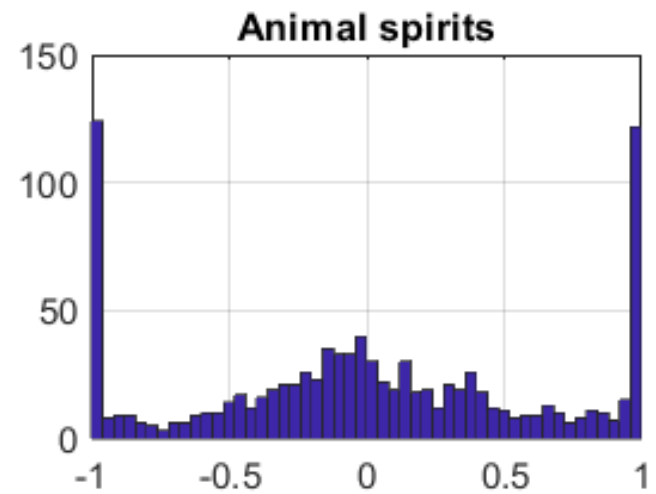
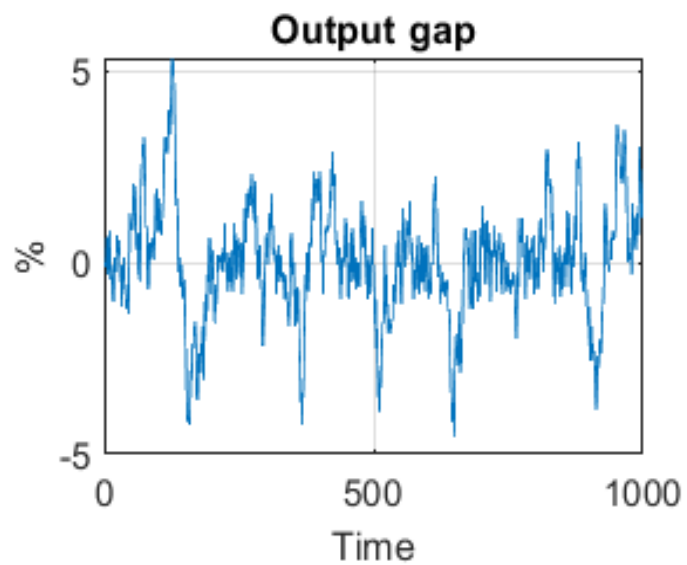
Main results of the paper

- In normal times and assuming agents understand the nature of the targeting rule: PLT leads to less volatility of output and prices
- And thus increases welfare relative to inflation targeting
- But even then there is a significant tail risk:
 - The model predicts divergence in about 20% of the cases
 - Actually this should be called an unstable outcome (rather than divergent)

Price level targeting



Inflation targeting



- If agents do not understand the nature of the regime and continue to forecast inflation, PLT leads to unstable outcomes.
- The reason is that the disconnect between what central bank does (PLT) and what agents do leads to a loss of credibility of the central bank
- In that case, which is the realistic one, PLT leads to more turbulence of output and inflation and is clearly inferior to inflation targeting

- This is a powerful result
- It may explain why PLT has not been observed much in actual policymaking
 - although the Fed came closest to announcing “average inflation targeting”
 - but since the inflation surge has clearly abandoned it.
- This is quite paradoxical: mainstream models using RE usually find that PLT is superior to inflation targeting
- Yet policymakers seem to distrust this result
- They rightly distrust this result as it is based on an implausible rationality assumption.
- Vojtěch’s research confirms that policy-makers should distrust this result

Some additional comments

1. It is unclear to what extent the results of this model depend on the particular numerical values of the parameters used in the simulation exercises

- What is lacking is a sensitivity analysis
- This is necessary to gain insight in the robustness of the results
- Example: higher values of the output parameter in the Taylor rule typically reduce the boom bust nature of business cycle
- A higher value may eliminate the explosive character of the PLT regime
- Suggestion: perform a sensitivity analysis for the key parameters of the model

2. Is this the right model?

- There may be many alternative behavioural models
- What is the empirical evidence?
 - Negative: Liu and Minford(2014)
 - Positive: Jang and Sacht (2016) and Kukacka et al.(2018)
- The jury is still out
- But behavioural macro is the future
- Where is the key of the house?

Le meilleur est l'ennemi du bien

(the best is the enemy of the good)

- Mainstream models tell us that **in ideal conditions**
 - where ideal = agents have RE and thus understand the rulethe PLT rule leads to the best possible outcome
- But this rule will not work well when conditions are not ideal,
 - that is when agents have **cognitive limitations**
- Under non-ideal conditions it is not right to use a rule that can only function under ideal conditions.
- Persisting in this ambition leads to outcome that is inferior to a rule that recognizes the cognitive limitations of agents