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Macroeconomic stability of price level targeting in a model of heterogeneous expectations

Abstract:

This study focuses on the efficacy of Price Level Targeting (PLT) under the Heuristic Switching Model (HSM). PLT has been considered as an alternative to the traditional inflation targeting in the aftermath of the 2008 Great Recession. However, this policy was not thoroughly tested in real life, whereas the experimental evidence remains contradictory. This study contributes to the discussion by extending the HSM by Hommes and Lustenhouwer (2019) with the PLT Taylor rule.

The properties of the PLT rule under the behavioral expectations are mixed. On the one hand, the fundamental steady state becomes the unique fixed point of the system in this setup. However, the stability of this fixed point is highly sensitive to the calibration of the underlying New Keynesian economy, and the exact specification of the HSM. As a result, policy makers can use this policy only if they understand well the way in which the economic agents form their expectations.