

Flexible targeting and its alternatives

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Abstract

Flexible inflation targeting as a loss function, and the makeup strategies proposed for the lower bound: price-level targeting, average inflation targeting, nominal GDP targeting.

“Inflation targeting” as practised is *flexible*: the central bank cares about inflation and about the real economy, and it trades the two off over a horizon. The alternatives proposed since 2008 are mostly ways of making the framework do better at the lower bound, by promising to make up for misses.

Flexible inflation targeting as a loss function

Svensson’s formulation is standard (Svensson, 2010). The central bank minimises

$$L_t = \sum_{k=0}^{\infty} \delta^k \mathbb{E}_t [(\pi_{t+k} - \pi^*)^2 + \lambda x_{t+k}^2], \quad (1)$$

with $\lambda > 0$ the weight on the output gap. Strict targeting is $\lambda = 0$. Under flexible targeting a supply shock that raises inflation and lowers output is met with a *gradual* return of inflation to target, because rushing it would require a large negative gap. The horizon over which the forecast returns to target is the operational expression of λ : two to three years at most inflation-targeting central banks.

Definition 1 (Inflation-forecast targeting). Setting the instrument so that the central bank’s own conditional forecast of inflation returns to the target over the policy horizon while the output gap closes. The forecast is the intermediate target; the decision rule is “adjust until the forecast looks right”.

Flexible targeting has a property that becomes a problem at the lower bound: it is *bygones-are-bygones*. A period of inflation below target is not made up; the target for next year is 2 percent regardless of last year. That means expected future inflation does not rise after a shortfall, and the real-rate stimulus that The effective lower bound needs does not appear. Every alternative below fixes this by making the future target depend on the past.

Price-level targeting

Under price-level targeting the central bank aims at a path for the price level rising at 2 percent a year. After a shortfall, inflation must run *above* 2 percent until the level is back on the path. Svensson showed that in a model with forward-looking expectations this delivers lower inflation *variability* as well as a determinate price level, which he called a “free lunch” (Svensson, 1999). At the lower bound it is exactly the Eggertsson–Woodford commitment: the promise of above-target inflation later lowers real rates now. The obstacles are communication (households do not think in levels) and asymmetric application (making up for overshoots requires deliberate disinflation, which no central bank wants to promise).

Average inflation targeting

The Federal Reserve’s 2020 framework was a bounded version: after periods of below-2-percent inflation, policy would aim for inflation “moderately above 2 percent for some time” so that inflation averages 2

percent (Federal Open Market Committee, 2020). The averaging window and the size of the overshoot were unspecified, which preserved discretion and weakened the commitment. The framework was designed for the 2010s problem of persistent shortfalls and was tested by the 2021 problem of an overshoot, for which it had no provision; the 2025 revision dropped the averaging language, as The 2021–2023 test discusses.

Nominal GDP targeting

Targeting the level of nominal GDP combines the makeup property of price-level targeting with automatic accommodation of supply shocks: when real output falls, the framework tolerates higher inflation without a change in the target. Woodford argued at Jackson Hole in 2012 that a nominal GDP level target was the most credible way to implement the commitment the lower bound calls for, because it is a single number that summarises both goals and does not require the central bank to promise inflation as such (Woodford, 2012). The objections are that nominal GDP is revised heavily and published late, and that the public has no intuition for it. No central bank has adopted it.

Comparing the options

Framework	Makes up for shortfalls?	Handles supply shocks?	Communication burden
Flexible inflation targeting	No	Yes, gradually	Low
Price-level targeting	Yes, fully	Poorly	High
Average inflation targeting	Partly, at discretion	As FIT	Medium; ambiguity is the cost
Nominal GDP level targeting	Yes	Yes, automatically	High

The trade-off is between the strength of the commitment and the ease of explaining it. Frameworks that would work best in the model are the ones the public understands least, which, given Communication, is not a small objection.

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