"The gains from delegation revisited: price-level targeting, speed-limit and interest rate smoothing policies" by Andrew P. Blake, Tatiana Kirsanova and Tony Yates (BKY)

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Research Question in BKY

- Classical question: desirability of discretion versus commitment in the conduct monetary policy?

- This paper asks how the conventional wisdom on the answer to that question is changed in the presence of endogenous capital accumulation.

Historical Conventional Wisdom

- In the context of the (static) **Barro-Gordon** model gains from commitment result from a mandate for the CB to push output beyond its natural level. (Possible reason for such a mandate: **imperfect competition**.) Without commitment a suboptimal equilibrium emerges in which inflation is persistently above target, without any gain in terms of output.

- **Intuition**: Perceptive private sector forms expectations taking into account how the central bank adjusts policy, given that the CB is free to reoptimize every period. The REE thus has the property that the CB has **no incentive** to change its plans in an unexpected way, even though it has the discretion to do so. (This policy is **time consistent**.)

Discretion in the New Keynesian Model

- "**Lean against the wind policy**" is optimal.

- Whenever inflation is above target, the CB contracts demand below capacity (by raising the interest rate) and vice versa when it is below target.

- **Intuition**: The CB's cost function is **convex** in its two arguments. Avoiding extreme values is therefore optimal.

Commitment in the New Keynesian Model

- In the context of the (dynamic) **New-Keynesian model** gains from commitment emerge even in the absence of a mandate for the CB to push output beyond its natural level.

- **Intuition**: (i) Commitment allows the central bank to smooth deviations from target over time. (ii) In this way the inflation/output gap trade-off becomes also more favorable for the CB.

- **Note**: It is important to note, however, that the optimal policy under commitment is **not** time consistent.

Main Results in BKY

- In the presence of capital accumulation the equilibrium under discretion is **not** unique.

- This lack of uniqueness is a **robust** result which obatins for many different specifications of the central bank objective (including those specifications which have been advocated in the literature in order to reduce the welfare losses under discretion with respect to the commitment solution)

- Taken together the results in the present paper show that capital accumulation **matters** for the analysis of the desirability of alternative arrangements for the conduct of monetary policy.

Comment 1

- The welfare criterion is ad hoc, as the authors acknowledge. Analyzing a simple targeting rule is definitely interesting. However, an obvious question is whether or not multiplicity would also obtain if the chosen welfare criterion would correspond to the socially desirable one. This is a concern because the presence of capital accumulation implies important changes in the **welfare criterion**, as Edge (2003) shows in the context of a rental market model. Firm-specific capital accumulation implies additional terms in the welfare criterion.

- A related issue is the definition of **output gap**. Neiss and Nelson (2003) and Woodford (2003, Ch. 5) have proposed alternative definitions in the context of models featuring endogenous capital acumulation. Which one is used in the analysis?

Comment 2

- The explanation for the lack of uniqueness of equilibrium under discretion is a bit vague (economy adjusts "slowly" or "quickly").

- I am puzzled by the "wet" equilibrium.

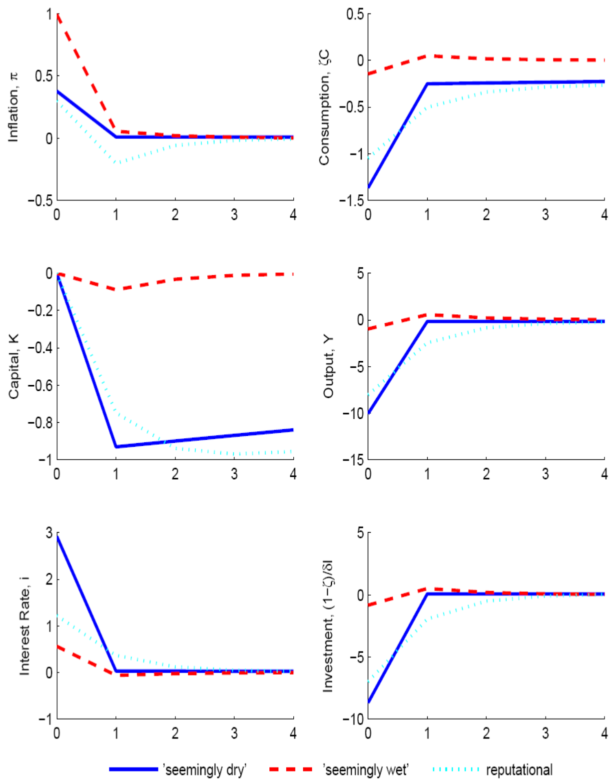

Figure 1: Impulse responses to a unit cost-push shock under three different regimes.

Comment 3

- The social loss associated with the rules considered is stated relative to the commitment solution. But how large are the losses in terms of steady state consumption?

- What are the corresponding social losses if capital is held constant?

- The fact that the "dry" equilibrium under strict price level targeting replicates the commitment equilibrium nearly perfectly deserves a more prominent place in the text, I think.

Conclusion

- This paper is part of an interesting and important research agenda.

- So far, capital has been modeled in a way that brushes away the micro evidence on investment at the plant level.

- Many things remain to be done before we understand the role of capital accumulation for monetary policy design.