

V. Conclusion

What insights does the FTPL provide into the two questions about price stability we posed at the beginning of this review? That is, how can price stability be achieved? And, how much price stability is desirable? Conventional wisdom holds that if there is no doubt about the central bank's commitment to low and stable inflation, then low and stable inflation is exactly what will happen.⁶⁹ According to the FTPL, however, this overstates the central bank's power. Still, it remains an open question just how severe the limitations on central banks' powers are. These limitations may not be very great for modern, developed economies. In the FTPL models that we have studied, the central bank can determine the *average* rate of inflation. However, it cannot perfectly control the variance of inflation because it cannot eliminate the impact of shocks to fiscal policy on the price level. But in a modern Western economy, the stock of outstanding nominal government liabilities is quite large—Judd's (1989) estimate for the United States puts it at one year's GDP. Therefore, a relatively small change in the price level can absorb a fairly large fiscal policy shock.⁷⁰ In practice, then, the conventional answer to the first question may be roughly the right one, even under the FTPL.

Regarding the second question, Sims (1999) has stressed the potential benefits of price volatility.⁷¹ Variations in the price level in response to fiscal shocks have the effect of taxing and subsidizing holders of nominal government liabilities. Under certain circumstances, this can enhance the overall efficiency of government fiscal and monetary policy. But this result also raises questions, because it is obtained in an environment with few of the frictions observed in actual economies that make price volatility costly. Whether the result would survive the introduction of a realistic set of frictions—and a realistic set of alternative methods for dealing with fiscal shocks—is unclear at this time.

■ 69 See Sargent and Wallace (1981), last paragraph.

■ 70 Sims (1999) also stresses this point.

■ 71 Woodford (1998a) has made a similar suggestion. The result has also been obtained in Chari, Christiano, and Kehoe (1991).