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Durable Goods and Monetary Policy: What Should become the central bank's target?

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Abstract

What inflation rate should be the target of the central bank? We address this issue with the two-sector model economy in the existence of the durable good. Different from recent studies of monetary policy with durable goods that only demonstrate the production sector, our model introduces the service market so that the traditional usercost equation can be endogenously derived. There are four implications from the results of our model. First, from the usercost equation we find the aggregate price index in the goods market and utility-based aggregate price index are different. Secondly, when there exists nominal rigidity in both service and good market, sector inflation targeting cannot eliminate the whole distortion. Thirdly, the central bank should stabilize the relative price when the degrees of price stickiness across sectors are different. Fourthly, if there is price stickiness in the durable good market, the central bank should stabilize not only current inflation rate but also the expectation of the future inflation.

Keywords: durable goods; usercost; monetary policy