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Endogenous objectives and the evaluation of targeting rules for monetary policy[☆]

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Abstract

Recent research in monetary economics has followed the advice of McCallum [1988. Robustness properties of a rule for monetary policy. Carnegie-Rochester Conference Series on Public Policy 29, 173–203] and investigated the robustness properties of monetary policy rules by evaluating them in a variety of models. Evaluation across models is typically based on an exogenously specified loss function. However, the theory on which many recent monetary policy models are based implies that changes in the structure of the model also have consequences for the policy objectives the central bank should pursue. Objectives are endogenous, not exogenous to the model. In this paper, I investigate the impact of endogenous objectives on the evaluation of targeting rules for monetary policy.

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1. Introduction

There is a fundamental dichotomy that underlies most monetary policy analysis. On the one hand, there is the model of the economy, consisting of a set of structural equations that characterize the private sector's behavior. On the other hand, there are the preferences of the policy maker. This dichotomy allows economists to provide the policy maker with a menu of alternative choices, leaving it to the policy maker to choose from among the available options. This view is reflected in a recent paper by McCallum and Nelson:

Accordingly, it can be useful to explore the way in which difference properties of a modelled economy—e.g., the variances of the endogenous variables—are related to policy rule parameters, leaving it to actual policy makers to assign the relevant weights [to policy objectives]. McCallum and Nelson (2004b, p. 5).

Recent work in macro, most prominently by Woodford (2003), calls into question this dichotomy between economic structure and policy objectives. He shows that the standard quadratic loss function that has been a common component of much of the monetary policy literature can be, under certain conditions, interpreted as a second-order approximation to the welfare of the representative agent. But critically, this interpretation of the loss function breaks the dichotomy between economic structure and objectives; the relative weights on the variables appearing in the loss function, and even the list of variables that should appear, depend on the structure of the economic model.¹ The policy maker cannot find the marginal rate of substitution between the target variables in a manner that is independent of the transmission mechanism that governs the marginal rate of transformation between them. Even the definition of the target variables will depend on the policy maker's views of the transmission mechanism.

This has two important implications. First, it will rarely be appropriate to combine the same loss function with different structural models of the economy. Different models will imply different loss functions. Second, in assessing model and parameter uncertainty, uncertainty about key structural parameters will also imply uncertainty about the correct loss function.²

At a practical level, the endogeneity of objectives has implications for the assessment of policy robustness. It may, for example, be inappropriate to take a rule designed to minimize a loss function in one model and evaluate its performance in a different model using the original loss function. The objective function appropriate for one model cannot be used directly to evaluate outcomes in a different model. Thus, McCallum's influential recommendation to use multiple models to explore the robustness of policy rules (McCallum, 1988, 1999) may be less straightforward than it appears.

There is another implication of the dependence of objectives on structure. Just as one could follow McCallum and evaluate the consequences of using a rule optimized

¹See, for example, Erceg et al. (2000), Steinsson (2003), and Amato and Laubach (2003).

²See Levin and Williams (2003b) and Kimura and Kurozumi (2003).

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