

Opportunistic monetary policy: An alternative rationalization

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Abstract

This paper offers an alternative rationalization for opportunistic behaviour, i.e., a gradual disinflation strategy where policymakers react asymmetrically to supply shocks, opting to disinflate only in recessionary period. Specifically, we show that adaptive expectations combined with asymmetry in the Phillips curve of a specific sort together provide an optimizing justification for opportunism. However, the empirical basis for these conditions to be satisfied in the current low-inflation context of most OECD countries remains however to be established.

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1. Introduction

During the 1990s many central banks pursued monetary policies committed to keeping inflation at or close to a target, with a secondary objective of stabilising output. Under rational expectations with a standard Phillips curve, such policies can be shown to be optimal. This principle has been challenged in the 1990s, somewhat surprisingly, by senior policymakers at the Fed, who have argued for ‘opportunism’ in monetary policy and have opposed the setting of a single central inflation target.¹ Their argument is that the Fed should move towards its long-run ambitions for inflation gradually and exploit opportunities for inflation reductions as they occur, for example through favourable supply shocks.

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¹ For academic literature see Orphanides and Wilcox (2002) and Bomfim and Rudebusch (2000).

The ‘opportunistic’ approach to monetary policy can be neatly divided into two halves. First and foremost, there is the idea of delay: one should not pursue a target for inflation that is too ambitious in the short run—it is ‘impractical’. Rather one should pursue a practical target for inflation that is within grasp in the short term—an interim target. Secondly, there is the idea of asymmetry: one acts to reduce inflation when the economy is already producing lower inflation via a favourable burst of circumstances (a ‘good supply shock’).² One does not try to reduce inflation when inflation is strengthening; rather one aims to dampen it then—to ‘hold the fort’ as it were.³

For the process of disinflation from high (double digit) initial levels of inflation such ideas have been widely defended. However, in the conditions of the 1990s when inflation was already well within single digits, they seem rather surprising. Yet in the not so distant past, the late 1990s, there has been a recrudescence of these ideas in Federal Reserve pronouncements (see Meyer (1996) and Blinder (1997)). These ideas do seem incongruous in the light of optimising agents using information efficiently and a social objective function derived from these agents’ utility. Nevertheless, it is only right to examine such claims carefully when they emanate from the world’s most powerful central bank.

This paper offers an alternative rationalization for opportunistic behaviour—alternative, that is, to the one given by Orphanides and Wilcox (2002).⁴ Specifically, we show that adaptive expectations combined with asymmetry in the Phillips curve of a specific sort (i.e., a nonlinear effect of the shock on the position of the Phillips curve trade-off) together provide an optimizing justification for opportunism. Here adaptive inflation expectations provides the justification for delay in asserting the ultimate inflation target, i.e., it acts as a proxy for market participants’ learning in a context of uncertainty regarding policymakers’ tastes and objectives. Nevertheless, the empirical basis for these conditions in the current low-inflation context of most OECD countries remains to be established. To anticipate our main conclusions, we find that rigorous defence of the opportunistic strategy can be mounted even if its empirical foundations may not obviously be robust. In Section 2 we derive an optimal inflation response when the policymaker is opportunistic. The implications of opportunism are also explored. Section 3 seeks a set of sufficient conditions under which the opportunistic strategy is *optimal* for a central bank maximising the preferences of the representative agent.⁵ Section 4 provides concluding remarks.

2. Opportunistic inflation response

The treatment of inflation targeting under commitment follows Svensson (1997). The short-run Phillips curve is

$$y_t = \rho y_{t-1} + \alpha(\pi_t - \pi_t^e) + u_t, \quad (2.1)$$

² We abstract from demand shocks because both the opportunistic and deliberate policymaker will fully neutralise the influence of those shocks. Thus, excluding demand shocks does not alter our results; their introduction is an uninteresting complication in the model.

³ These ideas have a long history in central banking practice and advice to central banks. For example the first was espoused by the Bundesbank in the 1980s in its idea of ‘avoidable inflation’ while the second similarly has deep roots in central banking tactics.

⁴ Orphanides and Wilcox (2002) specify a loss function for the policymaker that can be thought of as incurring a first-order loss from output deviation, and yet only a second-order loss from inflation deviations when inflation is close to its target. Hence when inflation is moderate policymakers refrain from inducing the loss in output but rather wait for favourable exogenous shocks to bring inflation down towards their long-term target.

⁵ Plainly these are ad hoc set-ups under which opportunism may be justified. However we believe it is of some interest to see whether opportunism can be justified under the demanding requirements of optimality.

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