A quantitative exploration of the opportunistic approach to disinflation

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Abstract

Under a conventional policy rule, a central bank adjusts its policy rate linearly according to the gap between inflation and its target, and the gap between output and its potential. Under ''the opportunistic approach to disinflation'' a central bank controls inflation aggressively when inflation is far from its target, but concentrates more on output stabilization when inflation is close to its target, allowing supply shocks and unforeseen fluctuations in aggregate demand to move inflation within a certain band. We use stochastic simulations of a small-scale rational expectations model to contrast the behavior of output and inflation under opportunistic and linear rules.
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1. Introduction

The conventional view regarding the appropriate conduct of monetary policy holds that a central bank should balance the objective of achieving and maintaining low inflation against the objective of stabilizing real activity around its sustainable level, and that the marginal tradeoff between the two objectives should be roughly linear. Such an approach to monetary policy is consistent with a loss function that penalizes squared deviations of inflation from the central bank's long-run target and squared deviations of output from its natural level; this type of loss function has been studied extensively (see for example the studies in Taylor, 1999). Furthermore, this loss function coincides with a quadratic approximation of the welfare of the representative household in a simple New–Keynesian model as discussed by Rotemberg and Woodford (1997) and Goodfriend and King (1997).

This paper contrasts the conventional linear approach to monetary policy with an alternative approach known as the ''opportunistic approach to disinflation.'' Proponents of this approach argue that when inflation is moderate but still above the long-run objective, the central bank should abstain from policy actions directed at fighting inflation and should instead wait for exogenous circumstances—such as favorable supply shocks and unforeseen recessions—to deliver the desired reduction in inflation.[1] While waiting for such circumstances, the central bank should focus on stabilizing output and employment and, if necessary, take action to avoid incipient increases in inflation. Once disinflation has occurred due to exogenous events, the central bank should consolidate the gains and stay ready to counteract the return of inflation to past levels.[2]

Recently, Orphanides and Wilcox (2002) have developed a theoretical foundation for the opportunistic approach to monetary policy. Using a simple two-equation model with adaptive expectations, they show that the opportunistic approach is optimal under a loss function that penalizes squared deviations of inflation from a history-dependent intermediate target and absolute deviations of output from its natural level. Balancing squared deviations of inflation against absolute deviations of output on the margin motivates the nonlinear response to inflation implied by the opportunistic approach to disinflation. The history-dependent intermediate target introduces a path-dependence of responses to inflation. Orphanides and Wilcox derive optimal interest rate rules under the opportunistic and the conventional loss functions. In their model, the optimal linear policy is of the same form as Taylor's (1993a) rule.

In this paper, we contrast the quantitative implications of opportunistic and conventional policy rules in an empirical model of the U.S. economy with rational expectations and nominal rigidities due to staggered wage contracts. First, we compute

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[1]Arguments in favor of the opportunistic approach to monetary policy have been presented by former policymakers, including the former President of the Philadelphia Federal Reserve Bank, Edward Boehne, the former Vice-Chair of the Board of Governors, Alan Blinder and former Governor Lawrence Meyer. This approach has never been adopted as an official strategy of the Federal Open Market Committee (FOMC), but the Committee members have discussed their views regarding it at FOMC meetings. (See, in particular, the discussions at the December 1995, July 1996 and July 1997 meetings. Transcripts of these meetings are in the public domain, Federal Reserve Board (1995, 1996, 1997).) See also Orphanides and Wilcox (2002) for additional references to policy discussions on this issue.

[2]See Kohn (1996) for a discussion of the U.S. disinflation experience since 1979 along these lines. These features of the opportunistic approach also led observers during the mid-1990s to remark that the U.S. economy was ''one recession away'' from price stability (e.g. Meyer, 1996; Blinder, 1997).