

Comments on: “Should uncertain monetary policymakers do less”

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The analysis of how parameter uncertainty affects optimal policy making, which origins from the seminal paper of Brainard (1967), has gained renewed interest recently, (Blinder (1995) and Svensson (1997)). From the point of view of policy analysis I regard this area as highly relevant and I find it encouraging that the Bank of England has undertaken research in this direction.

My impression is, however, that the theoretical complexities that parameter uncertainty introduces in the analysis deserve more attention. For instance, inspection of expressions [7] and [8] in the paper reveals that a covariance, ρ_{be} , between the instrument parameter (b) and the error term (ϵ) gives rise to an inflation bias.¹

$$\text{inflation bias} = \frac{-\bar{b}\rho_{be}}{(1-\bar{a})\sigma_b + \bar{b}^2} \quad (1)$$

as well as an instrument bias,

$$\text{instrument bias} = \frac{(1-\bar{a}\rho_{be})}{(1-\bar{a})\sigma_b + \bar{b}^2} \quad (2)$$

The possibility of an inflation bias when the instrument parameter is correlated with the error term is noted by Svensson (1997). However, a more serious effect is the instrument bias. Under reasonable assumptions it goes in the opposite direction implying a real instrument bias. This challenges the view that monetary policy has no long-run real effects.²

The example above is one of many that illustrate that the empirical model examined in the second half of the paper is far more complex than the theoretical model, which weakens the relation between the theoretical and empirical analysis. Another example is that the empirical model assumes that policymakers have other objectives than the stabilisation of inflation.

¹ I have simplified expressions (1) and (2) by assuming that the covariance (ρ_{ab}) between the autoregressive parameter (a) in the inflation process and the instrument parameter (b) is zero. For further analysis of the implication of allowing ρ_{be} to be non-zero, see Martin (1998).

² There is no real inflation bias in the model analysed by Svensson (1998).

In accordance with the reflections above, I tend to favour an empirical analysis with a rather simple structure (with the same set of restrictions) that can more easily be related to the theoretical model analysed in first part of the paper. The structure should capture the most basic features of an inflation-targeting regime and when the sample size becomes large enough, an analysis focusing solely on the current British inflation targeting regime would be highly interesting. The acknowledged problem of formulating a reasonable empirical model when reality exhibits complex features, such as monetary policy regime shifts, is handled in a way that is unavoidably controversial but in my view is not totally unreasonable.

Despite some critical remarks, I found the paper interesting. The paper demonstrates that model uncertainty, which is an important aspect of monetary policy decision making, has implications for the policy response function that reduces the discrepancy between actual and model based behaviour, especially in the inflation targeting period. In particular, the finding that the model with multiplicative uncertainty, in comparison with the model with only additive uncertainty, gives rise to a smoother-and therefore a more realistic-path for the optimal interest rate supports my impression that the paper contributes to our understanding of monetary policy making.

References

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