Inflation Target Uncertainty and Monetary Policy

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Abstract

I develop an extension of the standard New Keynesian model to monetary policy regime switching to study the impact of future uncertainty around the future inflation target. First, I fully characterize how the responses of current inflation and output to inflation target uncertainty depend on the monetary policy rule. If monetary policy is passive, inflation may increase far beyond the anticipated increase in the inflation target, while a strong monetary response to expected inflation results in a decline in inflation. Next, I derive the optimal response of the central bank, which can be achieved by adjusting the current inflation target. A central bank unwilling to adjust the inflation target can optimally adjust other policy rule parameters and can often obtains comparatively similar welfare benefits. Finally, I examine how an anticipated increase in the inflation target should be implemented, and I find that introducing uncertainty around the timing of the inflation target change results in more stable transition paths and often higher welfare.