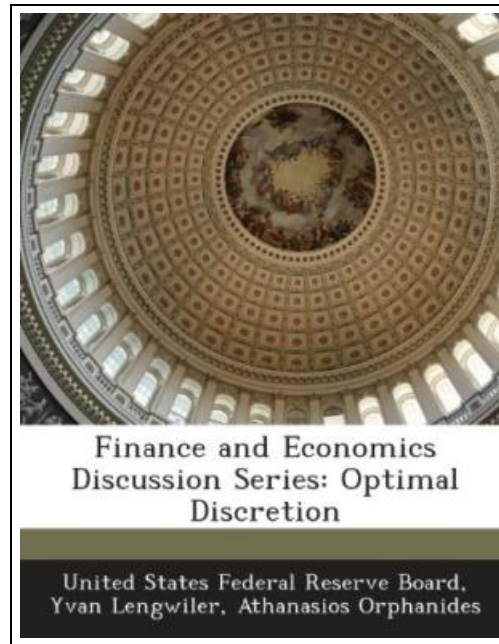


## Finance and Economics Discussion Series: Optimal Discretion



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Bibliogov, United States, 2013. Paperback. Book Condition: New. 246 x 189 mm. Language: English . Brand New Book \*\*\*\*\* Print on Demand \*\*\*\*\*.This paper investigates the desirability of adopting a rule in favor of discretionary monetary policy in a model exhibiting Kydland and Prescott's dynamic inconsistency problem. We deviate from earlier work by adopting assumptions regarding policymaker preferences and inflation dynamics that are compatible with empirically motivated models used for macroeconomic policy evaluation. In particular, we dispense with the notion of a fundamental incompatibility between the policymaker's price stability and full employment objectives and allow for stickiness in the determination of inflation. In this setting, we show that if discretion provides a policy flexibility benefit, adoption of a rule remains optimal but only under certain circumstances. If the central bank's preference to contain inflation is fully credible, then a rule is optimal only when inflation exceeds an endogenously determined threshold. This setup gives rise to a discretionary policy zone for inflation with the central bank taking more drastic action towards stabilizing inflation when inflation veers outside the zone. We also examine optimal policy when the central bank's inflation fighting determination is not fully credible. Then, adopting a rule becomes optimal even when inflation is lower. This result provides a reconciliation of the theory regarding the optimality of adopting a rule with the empirical observation that policymakers appear more willing to abandon discretion when facing either low credibility or high inflation but are less inclined to do so otherwise.



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