Research Working Papers

Optimal Monetary Policy Regime Switches

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How should monetary policy rules respond to shifts in the economy?

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Given regime switches in the economy's growth rate, optimal monetary policy rules may respond by switching policy parameters. These optimized parameters differ across regimes and from the optimal choice under fixed regimes, particularly in the inflation target and interest rate inertia. Optimal switching rules produce welfare gains relative to constant rules, with switches in the implicit real interest rate used for policy and the degree of interest rate inertia producing the largest gains. However, gains from switching rules decrease if the monetary authority trades-off the probability of low rates, or if it may misidentify the regime.

JEL Classification: C63, E31, E52

Article Citations

- Choi, Jason, and Andrew Foerster. "Optimal Monetary Policy Regime Switches," Federal Reserve Bank of Kansas City working paper no. 16-07, August, available at https://doi.org/10.18651/RWP2016-07

Related Research

- Coibion, O., Y. Gorodnichenko, and J. Wieland (2012). The Optimal Inflation Rate in New Keynesian Models: Should Central Banks Raise Their Inflation Targets in Light of the Zero Lower Bound? Review of Economic Studies 79(4), 1371-1406.
- Foerster, A. (2016). Monetary Policy Regime Switches and Macroeconomic Dynamics. International Economic Review 57(1), 211-230.
- Schmitt-Grohe, S. and M. Uribe (2007). Optimal Simple and Implementable Monetary and Fiscal Rules. Journal of Monetary Economics 54(6), 1702-1725.
