Optimal Monetary Policy Under Bounded Rationality*

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Abstract

We build a behavioral New Keynesian model that emphasizes different forms of myopia for households and firms. By examining the optimal monetary policy within this model, we find four main results. First, in a framework where myopia distorts agents’ inflation expectations, the optimal monetary policy entails implementing inflation targeting. Second, price level targeting emerges as the optimal policy under output gap, revenue, or interest rate myopia. Given that bygones are not bygones under price level targeting, rational inflation expectations are a minimal condition for optimality in a behavioral world. Third, we show that there are no feasible instrument rules for implementing the optimal monetary policy, casting doubt on the ability of simple Taylor rules to assist in the setting of monetary policy. Fourth, bounded rationality may be associated with welfare gains.

Keywords: monetary policy, myopia, commitment, discretion, optimal simple rules.

JEL Classification: C53, E37, E52, D01, D11.

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