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July 2008

Working Paper 2008-5

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Imperfect Knowledge and the Pitfalls of Optimal Control Monetary Policy

Athanasios Orphanides* and John C. Williams**

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Abstract

This paper examines the robustness characteristics of optimal control policies derived under the assumption of rational expectations to alternative models of expectations formation and uncertainty about the natural rates of interest and unemployment. We assume that agents have imperfect knowledge about the precise structure of the economy and form expectations using a forecasting model that they continuously update based on incoming data. We also allow for central bank uncertainty regarding the natural rates of interest and unemployment. We find that the optimal control policy derived under the assumption of perfect knowledge about the structure of the economy can perform poorly when knowledge is imperfect. These problems are exacerbated by natural rate uncertainty, even when the central bank's estimates of natural rates are efficient. We show that the optimal control approach can be made more robust to the presence of imperfect knowledge by deemphasizing the stabilization of real economic activity and interest rates relative to inflation in the central bank loss function. That is, robustness to the presence of imperfect knowledge about the economy provides an incentive to employ a "conservative" central banker. We then examine two types of simple monetary policy rules from the literature that have been found to be robust to model misspecification in other contexts. We find that these policies are robust to the alternative models of learning that we study and natural rate uncertainty and outperform the optimal control policy and generally perform as well as the robust optimal control policy that places less weight on stabilizing economic activity and interest rates.

Keywords: Rational expectations, robust control, model uncertainty, natural rate of unemployment, natural rate of interest.

JEL Classification: E52.

* Central Bank of Cyprus ** Federal Reserve Bank of San Francisco. We thank Jim Bullard, Richard Dennis, Bob Hall, Sheryl Kennedy, Andy Levin, Julio Rotemberg, Klaus Schmidt-Hebbel, David Stockman, Carl Walsh, Volker Wieland, Mike Woodford, Hakan Yilmazkuday, and participants at the Central Bank of Chile Conference on "Monetary Policy Under Uncertainty and Learning" for helpful comments and suggestions. The opinions expressed are those of the authors and do not necessarily reflect views of the Central Bank of Cyprus, the Governing Council of the European Central Bank, the management of the Federal Reserve Bank of San Francisco, or the Board of Governors of the Federal Reserve System.

1 Introduction

Sixty years ago, Milton Friedman questioned the usefulness of the optimal control approach because of policymakers' imperfect knowledge of the economy (1947) and favored instead a simple rule approach to monetary policy (1948). Today, these are still live issues, despite the development of powerful techniques to derive and analyze optimal control policies, which central banks use in their large-scale models (see Svensson and Woodford 2003, Svensson 2002, Woodford 2003, Giannoni and Woodford 2005, and Svensson and Tetlow 2005). Although the optimal control approach provides valuable insights, it also presents problems. In particular, because it assumes a single correctly specified reference model, it ignores important sources of uncertainty about the economy that monetary policymakers face. Robust control methods of the type analyzed by Hansen and Sargent (2007) extend the standard optimal control approach to allow for unspecified model uncertainty; however, these methods are designed for relatively modest deviations from the reference model.¹ In practice, policymakers are concerned with more fundamental sources of model uncertainty, and the robustness of monetary policy strategies to uncertainty is generally viewed as important (McCallum 1988, and Taylor 1993). Thus, a key question is whether our understanding of the macroeconomic environment has improved enough to make the optimal control approach to monetary policy preferable to well-designed simple rules.

There has been relatively little research to date on the robustness properties of optimal control policies to moderate or large degrees of model misspecification.² Giannoni and Woodford (2005) show that optimal control policies are robust to misspecification of the shock processes as long as the central bank forecasts are optimal. In contrast, Levin and Williams (2003) show that optimal control policies can perform very poorly if the structural equations of the central bank's reference model are badly misspecified. Orphanides and Williams (2008) examine the robustness of optimal control policies if the reference

¹Svensson and Williams (2007) propose a method to compute optimal policy under model uncertainty using a Markov-switching framework. Computing optimal policies under model uncertainty with this method is extremely computationally intensive, and its application to real-world problems remains infeasible.

²In contrast, there has been considerable research on the robustness of simple monetary policy rules to model uncertainty, including Taylor (1999), Levin, Wieland, and Williams (1999, 2003), Orphanides and Williams (2002, 2007), and Brock, Durlauf, and West (2007), and references therein.

model misspecifies the way private agents form expectations. That paper, henceforth referred to as “OW,” finds that if private agents are uncertain of the true model and form expectations based on an estimated forecasting model, optimal control policies designed under the assumption of rational expectations can perform poorly. OW also shows that optimal control policies can be made more robust to this type of model uncertainty by placing less weight on stabilizing economic activity and interest rates in the central bank objective used in deriving the optimal control policy.

This paper extends the analysis in OW to include uncertainty about the natural rates of interest and unemployment. We allow for exogenous time variation in the natural rates of interest and unemployment that the central bank may measure with error. There is considerable evidence of significant time variation in these natural rates and the difficulties of their real-time estimation (see, for example, Staiger, Stock, and Watson 1997, Laubach 2001, Orphanides and Williams 2002, Laubach and Williams 2003, and references therein).³ We assume that the central bank has a good understanding of the process describing the evolution of these natural rates, but may not observe them directly, in which case it must estimate the natural rates using available data. We consider both the case where the central bank uses the optimal statistical filter—the Kalman filter in the model of this paper—to estimate the natural rates, and the case where the central bank estimate of the key gain parameter of the filter is misspecified. Laubach and Williams (2003) and Clark and Kozicki (2005) document the imprecision in estimates of the gain parameter in the Kalman filter, making uncertainty about this key parameter a real-world problem for central bank estimates of natural rates.

We find that the optimal control policy derived assuming rational expectations and known natural rates performs relatively poorly in our estimated model of the U.S. economy when agents have imperfect knowledge of the structure of the economy, but instead must learn and the central bank must estimate movements in natural rates. The key shortcoming

³The natural rate of output is prone to considerable real-time mismeasurement, causing problems for monetary policy similar to the mismeasurement of the natural rate of unemployment, as discussed in Orphanides et al (2000), Orphanides and van Norden (2002), and Cukierman and Lippi (2005).

of the optimal control policy derived under the assumption of perfect knowledge is that it is overly fine-tuned to the assumptions in the benchmark model. As a result, the optimal control policy works extremely well when private and central bank knowledge are perfect. But, when agents learn and the central bank may mistakes due to misperceptions of natural rates, expectations can deviate from those implied under perfect knowledge, and the finely-tuned optimal control policy can go awry. In particular, by implicitly assuming that inflation expectations are always well anchored, the optimal control policy responds insufficiently strongly to movements in inflation, which results in excessive variability of inflation.

We then seek to construct policies that take advantage of the optimal control approach, but are robust to the forms of imperfect knowledge that we study.⁴ Specifically, following the approach in OW, we look for weights in the central bank objective function such that an optimal control policy derived using these “biased” weights performs well under imperfect knowledge about the structure of the economy. We find that optimal policies derived assuming much lower weights on stabilizing economic activity and interest rates than in the true central bank objective perform well in the presence of both private agent learning and natural rate uncertainty. Relative to the results in OW, the incorporation of natural rate uncertainty further reduces the optimal weights on economic activity and interest rates in the objective function used in deriving optimal policies that are robust to imperfect knowledge.

Finally, we compare the performance of optimal control policies to two types of simple monetary policy rules that have been found to be robust to model uncertainty of various types in the literature. The first is a forward-looking version of a Taylor-type policy rule, of the type that Levin, Wieland, and Williams (2003) found to perform very well in a number of estimated rational expectations models of the U.S. economy. The second is the rule proposed by Orphanides and Williams (2007) that differs from the first rule in that policy responds to the change in the measure of economic activity, rather than the level. This type

⁴An alternative approach, followed by Gaspar, Smets, and Vestin (2006), is to derive optimal monetary policy under learning. Because the model with learning is nonlinear, they apply dynamic programming techniques that are infeasible for the type of models studied in this paper and used in central banks for monetary policy analysis.

of rule has been shown to be robust to mismeasurement of natural rates in the economy (Orphanides and Williams, 2002, 2007) and found to perform very well in a counterfactual analysis of monetary policy during 1996–2003 undertaken by Tetlow (2006). Under rational expectations, these rules perform somewhat worse than the optimal control policy.

The two simple monetary policy rules perform very well under learning and with natural rate mismeasurement. These rules clearly outperform the optimal control policy when knowledge is imperfect and generally perform about as well as the optimal control policies derived to be robust to imperfect knowledge by using a biased objective function. The relatively small advantage that the optimal control policy has over these robust rules when the model is correctly specified implies that the “insurance” payment required to gain the sizable robustness benefits found here is quite small.

The remainder of the paper is organized as follows. Section 2 describes the model and its estimation. Section 3 describes the central bank objective and the optimal control policy. Section 4 describes the models of expectations formation and the simulation methods. Section 5 examines the performance of the optimal control policy under imperfect knowledge. Section 6 analyzes the optimal weights in the central bank objective that yield “robust” optimal control policies that perform well under imperfect knowledge. Section 7 compares the performance of the simple rules to optimal control policies. Section 8 concludes.

2 An Estimated Model of the U.S. Economy

Our analysis is conducted using an estimated quarterly model of the U.S. economy. The basic structure of the model is the same as in OW, but is extended to incorporate time variation in the natural rates of interest and unemployment. The model consists of equations that describe the dynamic behavior of the unemployment rate and the inflation rate and equations describing the natural rates of interest and unemployment and the shocks. To close the model, the short-term interest rate is set by the central bank, as described in the next section.

2.1 The Model

The “IS curve” equation is motivated by the Euler equation for consumption with adjustment costs or habit:

$$u_t = \phi_u u_{t+1}^e + (1 - \phi_u)u_{t-1} + \alpha_u (i_t^e - \pi_{t+1}^e - r_t^*) + v_t, \quad (1)$$

$$v_t = \rho_v v_{t-1} + e_{v,t}, \quad e_v \sim N(0, \sigma_{e_v}^2). \quad (2)$$

We specify the IS equation in terms of the unemployment rate rather than output to facilitate the estimation of the equation using real-time data. This equation relates the unemployment rate, u_t , to the unemployment rate expected in the next period, one lag of the unemployment rate, and the difference between the expected ex ante real interest rate—equal to the difference between the nominal short-term interest rate, i_t , and the expected inflation rate in the following period, π_{t+1} —and the natural rate of interest, r_t^* . The unemployment rate is subject to a shock, v_t , that is assumed to follow an AR(1) process with innovation variance $\sigma_{e_v}^2$. The AR(1) specification for the shocks is based on the evidence of serial correlation in the residuals of the estimated unemployment equation, as discussed below.

The “Phillips curve” equation is motivated by the New Keynesian Phillips curve with indexation:

$$\pi_t = \phi_\pi \pi_{t+1}^e + (1 - \phi_\pi)\pi_{t-1} + \alpha_\pi (u_t - u_t^*) + e_{\pi,t}, \quad e_\pi \sim N(0, \sigma_{e_\pi}^2). \quad (3)$$

It relates inflation, π_t , (measured as the annualized percent change in the GNP or GDP price index, depending on the period) during quarter t to lagged inflation, expected future inflation, denoted by π_{t+1}^e , and the difference between the unemployment rate, u_t , and the natural rate of unemployment, u_t^* , in the current quarter. The parameter ϕ_π measures the importance of expected inflation on the determination of inflation, while $(1 - \phi_\pi)$ captures the effects of inflation indexation. The “mark-up” shock, $e_{\pi,t}$, is assumed to be a white noise disturbance with variance $\sigma_{e_\pi}^2$.

We model the low frequency behavior of the natural rates of unemployment and interest

as exogenous AR(1) processes independent of all other variables:

$$u_t^* = (1 - \rho_{u^*})\bar{u}^* + \rho_{r^*}u_{t-1}^* + e_{u^*,t}, \quad e_{u^*} \sim N(0, \sigma_{e_u^*}^2), \quad (4)$$

$$r_t^* = (1 - \rho_{r^*})\bar{r}^* + \rho_{u^*}r_{t-1}^* + e_{r^*,t}, \quad e_{r^*} \sim N(0, \sigma_{e_r^*}^2). \quad (5)$$

We assume these processes are stationary based on the finding using the standard ADF test that one can reject the null of nonstationarity of both the unemployment rate and real federal funds rate over 1950–2003 at the 5 percent level. The unconditional mean values of the natural rates are irrelevant to the policy analysis and so we set them both to zero.⁵

2.2 Model Estimation and Calibration

The details of the estimation method for the equations for inflation and the unemployment rate are described in OW. The estimation results are reported below, with standard errors indicated in parentheses.

Unrestricted estimation of the IS curve equation yields a point estimate for ϕ_u of 0.39, with a standard error of 0.15. This estimate is below the lower bound of 0.5 implied by theory; however, the null hypothesis of a value of 0.5 is not rejected by the data.⁶ We therefore impose $\phi_u = 0.5$ in estimating the remaining parameters of the equation. Note that the estimated equation also includes a constant term (not shown) that provides an estimate of the natural real interest rate, which is assumed to constant for the purpose of estimating this equation.

$$u_t = 0.5 u_{t+1}^e + 0.5 u_{t-1} + 0.056 (\tilde{r}_t^e - r^*) + v_t, \quad (6)$$

(0.022)

$$v_t = 0.513 v_{t-1} + e_{v,t}, \quad \hat{\sigma}_{e_v} = 0.30, \quad (7)$$

(0.085)

$$\pi_t = 0.5 \pi_{t+1}^e + 0.5 \pi_{t-1} - 0.294 (u_t^e - u_t^*) + e_{\pi,t}, \quad \hat{\sigma}_{e_\pi} = 1.35, \quad (8)$$

(0.087)

⁵Because we ignore the zero lower bound on nominal interest rates as well as any other potential source of nonlinear behavior in the structural model, the unconditional means of variables are irrelevant. Inclusion of the zero bound would severely complicate the analysis and is left for future work.

⁶This finding is consistent with the results reported in Giannoni and Woodford (2005), who in a similar model, find that the corresponding coefficient is constrained to be at its theoretical lower bound.

Unrestricted estimation of the Phillips curve equation yields a point estimate for ϕ_π of 0.51, just barely above the lower bound implied by theory.⁷ For symmetry with our treatment of the IS curve, we impose the $\phi_\pi = 0.5$ and estimated the remaining parameters using OLS. The estimated residuals for this equation show no signs of serial correlation in the price equation (DW = 2.09), consistent with the assumption of the model.

There is considerable uncertainty regarding the magnitude and persistence of low-frequency fluctuations in the natural rates of unemployment and interest (see Staiger, Stock, and Watson 1997, Laubach 2001, Orphanides and Williams 2002, Laubach and Williams 2003, and Clark and Kozicki 2005.) We do not estimate a model of natural rates; instead, we calibrate the parameters of the AR(1) processes based on estimates found elsewhere in the literature. To capture the highly persistent movements in natural rates we set the autocorrelation parameters, ρ_{u^*} and ρ_{r^*} , to 0.99. In our benchmark calibration, we set the innovation standard deviation of the natural rate of unemployment to 0.07 and that of the natural rate of interest to 0.085. These values imply an unconditional standard deviation of the natural rate of unemployment (interest) of 0.50 (0.60), in the low end of the range of standard deviations of smoothed estimates of these natural rates suggested by various estimation methods. We also consider an alternative calibration where the standard deviations of the the natural rate innovations are twice as large, consistent with the upper end of the range of estimates of natural rate variation.

3 Optimal Control Monetary Policy

In this section, we describe the optimal control monetary policy. The policy instrument is the nominal short-term interest rate. We assume that the central bank observes all variables from previous periods when making the current-period policy decision. We further assume that the central bank has access to a commitment technology; that is, we study policy under commitment.

The central bank's objective is to minimize a loss equal to the weighted sum of the

⁷For comparison, Giannoni and Woodford (2005) find that the corresponding coefficient is constrained to be at its theoretical lower bound of 0.5.

unconditional variances of the inflation rate, the difference between the unemployment rate and the natural rate of unemployment, and the first-difference of the nominal federal funds rate:

$$\mathcal{L} = Var(\pi - \pi^*) + \lambda Var(u - u^*) + \nu Var(\Delta(i)), \quad (9)$$

where $Var(x)$ denotes the unconditional variance of variable x . We assume an inflation target of zero percent. As a benchmark for our analysis, we assume $\lambda = 4$ and $\nu = 1$. Based on an Okun's Law type relationship, the variance of the unemployment gap is about 1/4 that of the output gap, so this choice of λ corresponds to equal weights on inflation and output gap variability.

The optimal control monetary policy is that which minimizes the loss subject to the equations describing the economy. We construct the optimal control policy, as is typical in the literature, assuming that the policymaker knows the true parameters of the structural model and assumes all agents use rational expectations and the central bank's knows the natural rates of unemployment and interest.⁸ Note that for the optimal control policy, as well as the simple monetary policy rules described below, we use lagged information in the determination of the interest rate, reflecting the lag in data releases. The optimal control policy is described by set of equations that describe the first-order optimality condition for policy and the behavior of the Lagrange multipliers associated with the constraints on the optimization problem implied by the structural equations of the model economy.

Because we are interested in describing the setting of interest rates in a potentially misspecified model, it is useful to represent the optimal control policy in an equation that relates the policy instrument to macroeconomic variables, rather than in terms of Lagrange multipliers that depend on the model. There are infinitely many such representations. In the following, we focus on one representation, which we denote "OC," of the optimal control policy. In the OC policy, the current interest rate depends on three lags of: the inflation rate, the difference between the unemployment rate and the central bank's estimate of the natural rate of unemployment, and the difference between the nominal interest rate and the

⁸See, for example, Sargent's (2007) description of the optimal policy approach.

estimate of the natural rate of interest. The OC representation yields a determinate rational expectations equilibrium. We find that including three lags of these variables is sufficient to very closely mimic the optimal control outcome assuming the central bank observes natural rates.

3.1 Central Bank Estimation of Natural Rates

As noted above, we compute the OC policy assuming the central bank observes the true values of the natural rates of interest and unemployment. In our policy evaluation exercises, we consider the possibility that the central bank must estimate natural rates in real time. In such cases, we assume that the central bank knows the true structure of the model, including the model parameters (including the unconditional means of the natural rates), and observes all other variables including private forecasts, but does not observe the shocks directly. Given our model, the Kalman filter is the optimal method to estimate the natural rates and we assume that the central bank uses the appropriate specification of the Kalman filters to estimate natural rates. These assumptions represent a best case for the central bank with respect its ability to estimate natural rates. In other work, we examine the implications of model uncertainty regarding the data generating processes for natural rates (Orphanides and Williams 2005, 2007).

The central bank’s real-time estimate of the natural rate of unemployment, \hat{u}_t^* , is given by:

$$\hat{u}_t^* = a_1 \hat{u}_{t-1}^* + a_2 (u_t^* - e_{\pi,t} / \alpha_\pi) \quad (10)$$

where a_1 and a_2 are the Kalman gain parameters and the term within the parenthesis is the current-period “shock” to inflation that incorporates the effects of the transitory inflation disturbance and the deviation of the natural rate of unemployment rate from its unconditional mean, scaled in units of the unemployment rate. Note that the central bank only observes this “surprise” and not the decomposition into its two components.

The central bank estimate of the natural rate of interest, \hat{r}_t^* , is given by:

$$\hat{r}_t^* = b_1 \hat{r}_{t-1}^* + b_2 (r_t^* - v_t / \alpha_u) + b_3 (r_{t-1}^* - v_{t-1} / \alpha_u), \quad (11)$$

where the first term in the parenthesis is the current-period unemployment rate “shock” and the final term is the lagged “shock.” The final term appears in the equation due to the assumption of AR(1) process for the shocks to the unemployment rate equation.

The optimal values of the gain parameters depend on the variances of the four shocks. In our policy evaluation exercises, we consider alternative assumptions regarding the parameter values that the central bank uses in implementing the Kalman filters. In one case, we assume that the central bank uses the optimal values implied by the variances in our baseline calibration of the model. These values are: $a_1 = 0.982, a_2 = 0.008, b_1 = 0.987, b_2 = 0.006, b_3 = -0.003$. As noted above, there is a great deal of uncertainty regarding the values of the gain parameters and real-world estimates tend to be very imprecise. We therefore examine two cases where the central bank uses incorrect gain parameters. In one, the central bank assumes that the natural rates are constant, so the gain parameters are zero. In the other, we assume that the central bank uses the appropriate gain parameters for our baseline model calibration, but in fact the standard deviations of the natural rate shocks are twice as large as in the baseline calibration.

4 Expectations and Simulation Methods

As noted above, we are interested in studying the performance of the optimal control monetary policy is derived under a misspecified model of expectations formation. We assume that private agents and, in some cases, the central bank, form expectations using an estimated reduced-form forecasting model. Specifically, following Orphanides and Williams (2005), we posit that private agents engage in perpetual learning, that is, they reestimate their forecasting model using a constant-gain least squares algorithm that weights recent data more heavily than past data. See Sargent (1999), Cogley and Sargent (2001), and Evans and Honkapohja (2001) for related treatments of learning. This approach to modeling learning allows for the possible presence of time variation in the economy, including the natural rates of interest and unemployment. It also implies that agents’ estimates are always subject to sampling variation, that is, the estimates do not eventually converge to

fixed values.

We assume private agents forecast inflation, the unemployment rate, and the short-term interest rate using a unrestricted vector autoregression model (VAR) containing three lags of these three variables and a constant. Note that we assume that private agents do not observe or estimate the natural rates of unemployment and interest directly in forming expectations. The effects of time variation in natural rates on forecasts are reflected in the forecasting VAR by the lags of the interest rate, inflation rate, and unemployment rate. First, variants of VARs are commonly used in real-world macroeconomic forecasting, making this a reasonable choice on realism grounds. Second, the rational expectations equilibrium of our model with known natural rates is very well approximated by a VAR of this form. As discussed in OW, this VAR forecasting model provides accurate forecasts in model simulations.

At the end of each period, agents update their estimates of their forecasting model using data through the current period. To fix notation, let Y_t denote the 1×3 vector consisting of the inflation rate, the unemployment rate, and the interest rate, each measured at time t : $Y_t = (\pi_t, u_t, i_t)$. Let X_t be the 10×1 vector of regressors in the forecast model: $X_t = (1, \pi_{t-1}, u_{t-1}, i_{t-1}, \dots, \pi_{t-3}, u_{t-3}, i_{t-3})$. Let c_t be the 10×3 vector of coefficients of the forecasting model. Using data through period t , the coefficients of the forecasting model can be written in recursive form:

$$c_t = c_{t-1} + \kappa R_t^{-1} X_t (Y_t - X_t' c_{t-1}), \quad (12)$$

$$R_t = R_{t-1} + \kappa (X_t X_t' - R_{t-1}), \quad (13)$$

where κ is the gain. Agents construct the multi-period forecasts that appear in the inflation and unemployment equations in the model using the estimated VAR.

For some specifications of the VAR, the matrix R_t may not be full rank. To circumvent this problem, in each period of the model simulations, we check the rank of R_t . If it is less than full rank, we assume that agents apply a standard Ridge regression (Hoerl and Kennard, 1970), where R_t is replaced by $R_t + 0.00001 * I(10)$, where $I(10)$ is a 10×10 identity matrix

4.1 Calibrating the Learning Rate

A key parameter in the learning model is the private agent updating parameter, κ . Estimates of this parameter tend to be imprecise and sensitive to model specification, but tend to lie between 0 and 0.04.⁹ We take 0.02 to be a reasonable benchmark value for κ , a value that implies that the mean age of the weighted sample is about the same as for standard least squares with a sample of 25 years. Given the uncertainty about this parameter, we report results for values of κ between 0.01 (equivalent in mean sample age to a sample of about 50 years) to 0.03 (equivalent in mean sample age to a sample of about 16 years).

4.2 Simulation Methods

In the case of rational expectations with constant and known natural rates, we compute model unconditional moments numerically as described in Levin, Wieland, and Williams (1999). In the case of learning, we compute approximations of the unconditional moments using stochastic simulations of the model.

For the stochastic simulations, we initialize all model variables to their respective steady-state values, which we assume to be zero. The initial conditions of C and R are set to the steady-state values implied by the forecasting PLM in the rational expectations equilibrium with known natural rates. Each period, innovations are generated from independent Gaussian distributions with variances reported above. The private agent's forecasting model is updated each period and a new set of forecasts computed, as are the central bank's natural rate estimates. We simulate the model for 44,000 periods and discard the first 4000 periods to eliminate the effects of initial conditions. We compute the unconditional moments from the remaining 40,000 periods (10,000 years) of simulated data.

Learning introduces nonlinear dynamics into the model that may cause the model display explosive behavior in a simulation. In simulations where the model is beginning to display signs of explosive behavior, we follow Marcet and Sargent (1989) and stipulate modifications to the model that curtail the explosive behavior. One potential source of explosive behavior is that the forecasting model itself may become explosive. We take the view that in practice

⁹See Sheridan (2003), Orphanides and Williams (2005), Branch and Evans (2006), and Milani (2007).

private forecasters reject explosive models. Therefore, in each period of the simulation, we compute the maximum root of the forecasting VAR (excluding the constants). If this root falls below the critical value of 1, the forecast model is updated as described above; if not, we assume that the forecast model is not updated and the matrices C and R are held at their respective values from the previous period.¹⁰ This constraint is encountered relatively rarely with the policies analyzed in this paper.

This constraint on the forecasting model is insufficient to assure that the model economy does not exhibit explosive behavior in all simulations. For this reason, we impose a second condition that eliminates explosive behavior. In particular, the inflation rate, nominal interest rate, and the unemployment gap are not allowed to exceed in absolute value six times their respective unconditional standard deviations (computed under the assumption of rational expectations and known natural rates) from their respective steady-state values. This constraint on the model is invoked extremely rarely in the simulations.

5 Performance of the Optimal Control Policy

In this section we examine the performance of the optimal control policy derived under the assumption of rational expectations and known natural rates to deviations from this reference model. We start by considering the case where private agents learn and natural rates are known by the central bank. We then turn to the case of natural rate uncertainty.

5.1 Known Natural Rates

The OC policy, derived for $\lambda = 4$ and $\nu = 1$, is given by the following equation:

$$\begin{aligned}
 i_t = & 1.13(i_{t-1} - \hat{r}_{t-1}^*) + 0.02(i_{t-2} - \hat{r}_{t-1}^*) - 0.26(i_{t-3} - \hat{r}_{t-1}^*) \\
 & + 0.18\pi_{t-1} + 0.03\pi_{t-2} + 0.04\pi_{t-3} \\
 & - 2.48(u_{t-1} - \hat{u}_{t-1}^*) + 2.03(u_{t-2} - \hat{u}_{t-1}^*) - 0.34(u_{t-3} - \hat{u}_{t-1}^*).
 \end{aligned} \tag{14}$$

¹⁰We chose this critical value so that the test would have a small effect on model simulation behavior while eliminating explosive behavior in the forecasting model.

The first line of Table 1 reports the outcomes for the OC policy under rational expectations and known natural rates. These outcomes serve as a benchmark against which the results under imperfect knowledge can be compared. The OC policy is characterized by a high degree of policy inertia, as measured by the sum of the coefficients on the lagged interest rates of 0.89. The sum of the coefficients on lagged inflation equals 0.25 and that on the lagged differences between the unemployment equals -0.89. As discussed in OW, the optimal control policy is characterized by a muted interest rate response to deviations of inflation from target. Following a shock to inflation, the OC policy only gradually brings inflation back to target and thus restrains the magnitude of deviations of unemployment from its natural rate and that of changes in the interest rate.

Macroeconomic performance under the OC policy deteriorates under private agent learning, with the magnitude in fluctuations in all three objective variables increasing in the updating rate, κ . The upper panel of Table 2 reports the results where private agents learn assuming constant natural rates. These results are very similar to those reported in OW, where natural rates are assumed to be constant and known. Thus, the incorporation of know time-varying natural rates does not have notable additional implications for the design of optimal monetary policy under imperfect knowledge. With learning, agents are never certain of the structure of the economy or the behavior of the central bank. As discussed in Orphanides and Williams (2005), particularly large shocks or a “bad run” of one one-sided shocks can be misinterpreted by agents as reflecting a monetary policy regime that places less weight on inflation stabilization or has a different long-run inflation target than is actually the case. This confusion adds persistent noise to the economy, which worsens macroeconomic performance relative to the rational expectations benchmark.

5.2 Estimated Natural Rates

We now analyze the performance of the OC policy designed assuming rational expectations and known natural rates when in fact private agents learn and natural rates are not directly observable. The middle section of Table 2 reports the results assuming that the central bank uses the optimal Kalman filters to estimate both natural rates. As noted above, this

case assumes that the central bank has precise knowledge of the structure of the IS and Phillips curve equations, observes private expectations that appear in those equations, and knows the covariance matrix of the shocks (which is used in determining the coefficients of the Kalman filter).

If expectations are close to the rational expectations benchmark and the central bank efficiently estimates natural rates, then natural rate uncertainty by itself has little additional effect on macroeconomic performance under the OC policy. For example, in the case of $\kappa = 0.01$, the standard deviations of inflation and the first-difference of interest rates is about the same whether natural rates are known or optimally estimated. Not surprisingly, the standard deviation of the difference between the unemployment rate from its natural rate is somewhat higher if natural rates are not directly observed since in that case the central bank will from time to time aim for the “wrong” unemployment rate target. But, these errors do not spill over into greater variability of other variables.

If the learning rate is 0.02 or above, the interaction of natural rate misperceptions and learning leads to a much greater deterioration of macroeconomic performance. Natural rate misperceptions introduce serially correlated errors into monetary policy. When agents are learning, these policy errors interfere with the public’s understanding of the monetary policy rule. As a result, the variability of all three target variables increases. If the central bank uses the incorrect gains in the Kalman filters, macroeconomic performance worsens even further. The effects of using the wrong Kalman gain are illustrated in the lower panel of Table 1. In this example, the central bank incorrectly assumes that Kalman gains of zero in estimating natural rates (that is, it assumes that the variances of the shocks to the natural rates are zero). The resulting outcomes under the OC policy are significantly worse for all three learning rates shown in the table. The deterioration in performance is primarily due to a rise in the variability of inflation. Evidently, the combination of private agent learning and policy mistakes associated with poor measurement of natural rates significantly worsens the anchoring of inflation expectations and stabilization of inflation.

6 Robust Optimal Control Policies

The preceding analysis shows that the optimal control policy derived under rational expectations and known natural rates may not be robust to imperfect knowledge. We now consider an approach to deriving policies that take advantage of the optimal control methodology but are robust to imperfect knowledge. Specifically, following OW, we search for the “biased” central bank loss function for which the implied OC policy derived assuming rational expectations and known natural rates performs best under imperfect knowledge for the true social loss function. This approach applies existing methods of computing optimal policies under rational expectations and is therefore feasible in practice.

For a given value of κ and assumption regarding natural rates and natural rate measurement, we search for the values $\tilde{\lambda}$ and $\tilde{\nu}$ such that the OC policy derived using the loss $\tilde{\mathcal{L}} = Var(\pi - \pi^*) + \tilde{\lambda}Var(u - u^*) + \tilde{\nu}Var(\Delta(i))$ minimizes the true social loss (which is assumed to be given by the benchmark values of $\lambda = 4$ and $\nu = 1$).¹¹ We use a grid search to find the optimal weights (up to one decimal place) for the “biased” central bank loss and refer to the resulting policy as the “robust optimal control,” or ROC, policy.

6.1 Known Natural Rates

With known natural rates, the optimal weights for the central bank loss on unemployment and interest rate variability are significantly smaller than the true weights in the social loss and this downward bias is increasing in the learning rate κ . The results from this exercise are reported in the upper panel of Table 3, which considers the same set of assumptions regarding natural rate measurement as in Table 2. For comparison, the losses under the OC policy, denoted by \mathcal{L}^* , are reported in the final column of the table. The results with known natural rates are similar to that in OW, where natural rates are assumed to be constant. The presence of learning makes it optimal to assign the central bank a loss that places much greater relative weight on inflation stabilization than the true social loss, that

¹¹Note that this approach can be generalized to allow the inclusion of additional variables in the loss function. We leave this to future research.

is, to employ a “conservative” central banker in the terminology of Rogoff (1985).¹² The ROC policies yield losses significantly lower than those under the OC policy.

6.2 Estimated Natural Rates

With estimated natural rates, the optimal weights for the central bank loss on unemployment and interest rate variability are generally smaller than in the case of known natural rates. Thus, the combination of learning and natural rate mismeasurement strengthens the case for placing much greater relative weight on inflation stabilization than the true social loss. For example, in the case of $\kappa = 0.02$ and optimally estimated natural rates, the optimal central bank objective weights are about one half as large as in the case of known natural rates. In that case, the ROC policy for $\kappa = 0.02$ and optimally estimated natural rates is given by the following equation:

$$\begin{aligned}
 i_t = & 1.11(i_{t-1} - \hat{r}_{t-1}^*) - 0.12(i_{t-2} - \hat{r}_{t-1}^*) - 0.15(i_{t-3} - \hat{r}_{t-1}^*) \\
 & + 0.51\pi_{t-1} + 0.28\pi_{t-2} + 0.00\pi_{t-3} \\
 & - 3.32(u_{t-1} - \hat{u}_{t-1}^*) + 2.40(u_{t-2} - \hat{u}_{t-1}^*) - 0.43(u_{t-3} - \hat{u}_{t-1}^*).
 \end{aligned} \tag{15}$$

Note that this ROC policy is characterized by a much larger large direct response to the inflation rate compared to the OC policy derived for the benchmark loss (and reported in equation 14), reflecting the greater relative weight on inflation stabilization for the biased central bank loss. The ROC policy responds somewhat more to lags of the difference between the unemployment rate and the perceived natural rate of interest, with a sum of coefficients of -1.35 vs. -0.89 in the OC policy, and exhibits less intrinsic policy inertia, with the sum of the coefficients on the lagged interest rate of 0.84 (compared to 0.89 in the OC policy), reflecting the much smaller weight on interest rate variability underlying the ROC policy.

When the central bank incorrectly assumes that natural rates are constant, the optimal weights for the central bank loss on unemployment and on interest rate variability are at most one fifth as large as the true values. The differences in the losses under the OC and

¹²Orphanides and Williams (2005), using a very simple theoretical model, similarly found that a central bank loss function biased toward stabilizing inflation (relative to output) was optimal when private agents learn.

ROC policies are much larger than in the case of known natural rates. The central bank loss under imperfect knowledge tends to be relatively insensitive to small differences in the weights used in deriving the robust optimal policies. As a result, the precise choice of optimal weights is not crucial. What is crucial is that the weights on unemployment and the change in interest rates are small relative to that on inflation.

6.3 Greater Natural Rate Variability

Up to this point we have assumed a relatively low degree of natural rate variability. We now explore the implications if natural rates exhibit greater variability, consistent with some estimates in the literature. (The case of zero variability of natural rates is analyzed in OW, so we do not revisit this case here.) In the following, we assume that the standard deviation of the natural rate innovations is twice that assumed in our benchmark calibration. The results for these experiments are reported in Table 5. The final column of the table reports the loss, denoted by \mathcal{L}^* , under the standard OC policy derived assuming rational expectations and known natural rates with the benchmark calibration of innovation variances.

If the central bank is assumed to observe the true values of the natural rates, then the greater degree of natural rate variability does not significantly affect the optimal choices of weights in the objective function used to derive the ROC policy. Comparing the upper panels of Table 3 and 5 shows that the optimal values of $\tilde{\lambda}$ and $\tilde{n}u$ are similar for the two calibrations of natural rate variability. The losses associated with the OC policy are much larger when natural rates are more highly variable. In contrast, the losses under the appropriate ROC policies are not that different in the two cases.

If, however, the central bank underestimates the degree of natural rate variability in estimating natural rates, the optimal values of $\tilde{\lambda}$ and $\tilde{n}u$ are very small, implying that the central bank should focus almost entirely on inflation stabilization in deriving optimal control policies. The lower panel of the table reports outcomes when the central bank uses the Kalman filter gains appropriate for the benchmark calibration of natural rate variability, but in fact the natural rates are twice as variable (in terms of standard deviations). In this case, the OC policy performs very badly, and the benefits of following the ROC policy

rather than the OC are dramatic.

7 Simple Rules

We now compare the performance of two alternative monetary policies that have been recommended in the literature for being robust to various forms of model uncertainty to the optimal control policies analyzed above. The first rule is a version of the forecast-based policy rule proposed by Levin, Wieland, and Williams (2003). We refer to this as the “LWW” type of policy rule; according to this rule, the short-term interest rate is determined as follows:

$$i_t = i_{t-1} + \theta_\pi(\bar{\pi}_{t+3}^e - \pi^*) + \theta_u(u_{t-1} - \hat{u}_{t-1}^*), \quad (16)$$

where $\bar{\pi}_{t+3}^e$ is the forecast of the four-quarter change in the price level and u^* is the natural rate of unemployment which we take to be constant and known. Because this policy rule features characterizes policy in terms of the first-difference of the interest rate, it does not rely on estimates of the natural rate of interest, as does the standard Taylor Rule (1993). The second rule we consider is that proposed by Orphanides and Williams (2007) for its robustness properties in the face of natural rate uncertainty.

$$i_t = i_{t-1} + \theta_\pi(\bar{\pi}_{t+3}^e - \pi^*) + \theta_{\Delta u}(u_{t-1} - u_{t-2}). \quad (17)$$

A key feature of this policy is the absence of any measures of natural rates in the determination of policy.¹³

We choose the parameters of these simple rules to minimize the loss under rational expectations and constant natural rates using a hill-climbing routine.¹⁴ The resulting optimized LWW rule is given by:

$$i_t = i_{t-1} + 1.05 (\bar{\pi}_{t+3}^e - \pi^*) - 1.39 (u_{t-1} - \hat{u}_t^*). \quad (18)$$

¹³This policy rule is related to the elastic price standard proposed by Hall (1984), whereby the central bank aims to maintain a stipulated relationship between the forecast of the unemployment rate and the price level. It is also closely related to the first difference of a modified Taylor-type policy rule in which the forecast of the price level is substituted for the forecast of the inflation rate.

¹⁴If we allow for time-varying natural rates that are *known by all agents*, the optimized parameters of the LWW and OW rules under rational expectations are nearly unchanged. The relative performance of the different policies is also unaffected.

The optimized OW rule is given by:

$$i_t = i_{t-1} + 1.74 (\bar{\pi}_{t+3}^e - \pi^*) - 1.19 (u_{t-1} - u_{t-2}). \quad (19)$$

In the following, we refer to these specific parameterizations of these two rules simply as the “LWW” and “OW” rules.¹⁵

The lower part of Table 1 reports the outcomes for the LWW rule and the OW rule under rational expectations and known natural rates. Note that under rational expectations and known natural rates, the OC policy yield a loss modestly lower than that under the LWW and OW rules, a result consistent with the findings in Williams (2003) and Levin and Williams (2003) about the relative performance of simple rules. for other models.

In contrast to the OC policy, the LWW and OW rules perform very well under imperfect knowledge. Table 5 compares the performance of these rules to that of the OC policy derived under the true central bank loss and the ROC policies. (Note that because the OW rule does not respond to natural rate estimates, outcomes are invariant to the assumption regarding central bank natural rate estimation.) In all cases reported in the table, the LWW rule performs as well as or better than the OC policy, with the performance advantage larger the higher the learning rate and the greater the degree of natural rate misperceptions. As discussed in detail on OW, the LWW rule consistently brings inflation back to target quickly following a shock to inflation and contains the response of inflation to the unemployment shock. The OW rule does even better at containing the inflation responses to shocks than the LWW rule, but at the cost of greater variability of the difference between the unemployment rate and its natural rate and the change in the interest rate. As a result, the LWW rule performs somewhat better than the OW rule in terms for the stipulated central bank loss for all the cases that we consider here.

The outcomes under the LWW and OW rules are generally similar to those under the ROC policies. The first column of Table 5 reports the losses under the ROC policies (repeated from Table 3). The LWW rule does slightly worse than the ROC policy in the cases closest to the perfect knowledge benchmark (low κ and modest natural rate misperceptions)

¹⁵These are identically the same rules as analyzed in Orphanides and Williams (2008).

and performs better as the degree of model misspecification increases. The OW policy performs about the same or slightly worse than the ROC policies, except in the case of known natural rates where the ROC policy performs much better. Evidently, the extra fine-tuning in the ROC policy compared to the simple rules is of little value in an environment characterized by learning and natural rate misperceptions. The results are qualitatively similar with greater natural rate variability, as seen in Table 6. In this case, however, if the central bank uses the Kalman gains based on the benchmark calibration, the OW rule outperforms the ROC policies.

The strong performance of the LWW and OW rules in the presence of natural rate mismeasurement reflects the fact that these rules do not rely on natural rate estimates as much as the OC policy. Indeed, the OW rule does not respond to natural rates at all, while the LWW rule responds only to estimates of the natural rate of unemployment. Importantly, these rules respond aggressively to movements in inflation. In the case of the LWW rule, policy errors due to misperceptions of the natural rate of unemployment cause some deterioration in macroeconomic performance, but the consequences of these errors are limited by the countervailing effect of the strong response to resulting deviations of inflation from target.

8 Conclusion

Current methods of deriving optimal control policies ignore important sources of model uncertainty. This paper has examined the robustness of optimal control policies to uncertainty regarding the formation of expectations and natural rates and analyzed monetary policy strategies designed to be robust to these sources of imperfect knowledge. Our analysis shows that standard approaches to optimal policy yield policies are not robust to imperfect knowledge. More positively, this analysis helps us identify and highlight key features of policies that are robust to these sources of model uncertainty.

The main finding is that a reorientation of policy towards stabilizing inflation relative to economic activity and interest rates is crucial for good economic performance in the

presence of imperfect knowledge. Indeed, focusing on price stability in this manner is the policy that should be pursued even when the central bank in fact cares greatly about stabilization of economic activity and interest rates. Although following policies that place greater weight on economic stability may appear desirable in an environment of perfect knowledge, doing so is counterproductive and leads to greater instability when knowledge is in fact imperfect. Moreover, in an environment of imperfect knowledge, well-designed robust simple rules perform about as well as optimal control policies designed to be robust to imperfect knowledge. This raises further doubts about the wisdom of relying on the optimal control approach over simple rules for policy design. Of course, there are many other sources of model uncertainty and further research should be directed at analyzing robust monetary policy with a full array of sources of model uncertainty.

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Table 1
Performance of Alternative Monetary Policies
under Rational Expectations and Known Natural Rates
 $(\lambda = 4, \nu = 1)$

Policy	Standard Deviation			Loss
	π	$u - u^*$	Δi	\mathcal{L}
OC	1.83	0.68	1.20	6.64
LWW	1.87	0.70	1.24	6.98
OW	1.83	0.73	1.39	7.45

Table 2
Performance of OC Policy under Learning and Time-Varying Natural Rates
 $(\lambda = 4, \nu = 1)$

κ	Standard Deviation			Loss
	π	$u - u^*$	Δi	\mathcal{L}
<i>Known NR</i>				
0.01	2.28	0.80	1.33	9.52
0.02	2.77	0.93	1.55	13.59
0.03	3.23	1.09	1.80	18.46
<i>Optimal KF NR estimates</i>				
0.01	2.26	0.88	1.33	9.99
0.02	3.16	1.10	1.82	17.79
0.03	3.59	1.23	1.99	22.94
<i>NR assumed constant</i>				
0.01	2.81	0.92	1.44	13.39
0.02	3.68	1.12	1.82	21.89
0.03	4.11	1.25	2.09	27.53

Table 3
Optimal Weights in Central Bank Loss under Imperfect Knowledge
 $(\lambda = 4, \nu = 1)$

κ	Weights		Standard Deviation			Loss	
	$\tilde{\lambda}$	$\tilde{\nu}$	π	$u - u^*$	Δi	$\tilde{\mathcal{L}}$	\mathcal{L}^*
<i>Known NR</i>							
0.01	1.4	0.3	1.95	0.80	1.55	8.76	9.52
0.02	1.2	0.2	2.14	0.89	1.85	11.13	13.59
0.03	0.2	0.1	2.03	1.04	2.20	13.31	18.46
<i>Optimal KF NR estimates</i>							
0.01	1.2	0.4	1.95	0.91	1.45	9.29	9.99
0.02	0.5	0.1	2.06	1.03	1.80	11.70	17.79
0.03	0.4	0.2	2.10	1.06	2.23	13.85	22.94
<i>NR assumed constant</i>							
0.01	0.5	0.2	1.97	0.91	1.64	9.90	13.39
0.02	0.5	0.2	2.22	0.98	1.78	11.97	21.89
0.03	0.2	0.1	2.18	1.07	2.21	14.18	27.53

Notes: \mathcal{L}^* denotes the loss under the OC policy derived for $\lambda = 4$ and $\nu = 1$. $\tilde{\mathcal{L}}$ denotes the loss under the OC policy under the optimized values of $\tilde{\lambda}$ and $\tilde{\nu}$, evaluated using $\lambda = 4$ and $\nu = 1$.

Table 4
**Optimal Weights in Central Bank Loss under Imperfect Knowledge
and High Natural Rate Variability**

	Weights		Standard Deviation			Loss	
κ	$\tilde{\lambda}$	$\tilde{\nu}$	π	$u - u^*$	Δi	$\tilde{\mathcal{L}}$	\mathcal{L}^*
<i>Known NR</i>							
0.01	1.1	0.3	1.96	0.85	1.53	9.06	10.26
0.02	0.9	0.2	2.16	0.94	1.81	11.49	15.38
0.03	0.4	0.1	2.13	1.05	2.22	13.89	20.93
<i>Baseline KF NR estimates</i>							
0.01	0.1	0.2	2.14	1.12	1.66	12.31	24.18
0.02	0.1	0.1	2.18	1.18	2.11	14.74	36.34
0.03	0.1	0.1	2.32	1.25	2.27	16.81	53.36

Notes: \mathcal{L}^* denotes the loss under the OC policy derived for $\lambda = 4$ and $\nu = 1$. $\tilde{\mathcal{L}}$ denotes the loss under the OC policy under the optimized values of $\tilde{\lambda}$ and $\tilde{\nu}$, evaluated using $\lambda = 4$ and $\nu = 1$.

Table 5
Performance of Simple Rules under Imperfect Knowledge
 $(\lambda = 4, \nu = 1)$

κ	OC Policies		LWW Rule				OW Rule			
	Loss		Standard Deviation			Loss	Standard Deviation			Loss
	$\tilde{\mathcal{L}}$	\mathcal{L}^*	π	$u - u^*$	Δi	\mathcal{L}	π	$u - u^*$	Δi	\mathcal{L}
<i>Known NR</i>										
0.01	8.76	9.52	1.94	0.86	1.39	8.68	1.93	0.98	1.60	10.16
0.02	11.13	13.59	2.00	0.99	1.57	10.39	1.99	1.08	1.78	11.84
0.03	13.31	18.46	2.09	1.10	1.80	12.43	2.09	1.18	2.03	14.03
<i>Optimal KF NR estimation</i>										
0.01	9.29	9.99	1.94	0.93	1.41	9.17	1.93	0.98	1.60	10.16
0.02	11.70	17.79	2.00	1.03	1.57	10.65	1.99	1.08	1.78	11.84
0.03	13.85	22.94	2.07	1.12	1.78	12.47	2.09	1.18	2.03	14.03
<i>NR assumed constant</i>										
0.01	9.90	13.39	2.03	0.94	1.44	9.72	1.93	0.98	1.60	10.16
0.02	11.97	21.89	2.08	1.01	1.60	10.98	1.99	1.08	1.78	11.84
0.03	14.18	27.53	2.17	1.12	1.86	13.18	2.09	1.18	2.03	14.03

Notes: \mathcal{L}^* denotes the loss under the OC policy derived for $\lambda = 4$ and $\nu = 1$. $\tilde{\mathcal{L}}$ denotes the loss under the OC policy under the optimized values of $\tilde{\lambda}$ and $\tilde{\nu}$, evaluated using $\lambda = 4$ and $\nu = 1$.

Table 6
**Performance of Simple Rules under Imperfect Knowledge
and High Natural Rate Variability**

	OC Policies		LWW Rule				OW Rule			
	Loss		Standard Deviation			Loss	Standard Deviation			Loss
κ	$\tilde{\mathcal{L}}$	\mathcal{L}^*	π	$u - u^*$	Δi	\mathcal{L}	π	$u - u^*$	Δi	\mathcal{L}
<i>Known NR</i>										
0.01	9.06	10.26	1.94	0.90	1.42	9.00	1.99	1.17	1.65	12.17
0.02	11.49	15.38	2.00	1.03	1.57	10.73	2.06	1.28	1.86	14.23
0.03	13.89	20.93	2.09	1.18	1.81	13.23	2.13	1.36	2.07	16.19
<i>Baseline KF NR estimation</i>										
0.01	12.31	24.18	2.09	1.12	1.48	11.57	1.99	1.17	1.65	12.17
0.02	14.74	36.34	2.14	1.20	1.64	12.99	2.06	1.28	1.86	14.23
0.03	16.81	53.36	2.24	1.33	1.91	15.70	2.13	1.36	2.07	16.19

Notes: \mathcal{L}^* denotes the loss under the OC policy derived for $\lambda = 4$ and $\nu = 1$. $\tilde{\mathcal{L}}$ denotes the loss under the OC policy under the optimized values of $\tilde{\lambda}$ and $\tilde{\nu}$, evaluated using $\lambda = 4$ and $\nu = 1$.