

Optimal Monetary Policy with Discretion in a New Keynesian Model with Inertia

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Abstract

This paper analyzes the relationship between the optimal weight on output gap in the central bank's loss function and the degree of inertia in a hybrid version of New Keynesian model with a pure discretionary inflation targeting. We present a policy recommendation as to the weight on output gap that is different from the case without endogenous persistence in inflation dynamics. Additionally, we present a new concept of weighted average inflation targeting and demonstrate that it performs better than the existing inflation targeting regimes.

JEL classification numbers: E52, E58, E61

Key words: hybrid New Keynesian model, policy objective, inflation targeting

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