AMBIGUITY, MONETARY POLICY AND TREND INFLATION

Riccardo M. Masolo  
Bank of England and CfM

Francesca Monti  
King’s Business School and CfM

Abstract
Allowing for ambiguity about the behavior of the policymaker in a simple New-Keynesian model gives rise to wedges between long-run inflation expectations, trend inflation, and the inflation target. The degree of ambiguity we measure in Blue Chip survey data helps explain the dynamics of long-run inflation expectations and the inflation trend measured in the US data. Ambiguity also has implications for monetary policy. We show that it is optimal for policymakers to lean against the households’ pessimistic expectations, but also document the limits to the extent the adverse effects of ambiguity can be undone. (JEL: D84, E31, E43, E52, E58)

The editor in charge of this paper was Claudio Michelacci.

Acknowledgments: We are grateful to the editor, our two referees, and our discussants J. Costain, C. Ilut, P. Karadi, A. Karantounias and A. Sbordone; to G. Ascarì, C. Carvalho, F. De Graeve, W. Den Haan, F. Di Pace, J. Fernandez-Villaverde, R. Harrison, R. Meeks, R. Reis and P. Santos Monteiro for insightful comments and suggestions; and to Alexander Wolman for kindly sharing his notes. We would also like to thank seminar participants at Oxford University, Bank of Finland, ECB-WGEM, Bank of Korea, Bank of England, Bank of Canada, University of York, King’s College London, and Queen Mary, as well as participants at the 2015 North American Winter Meeting of the Econometric Society, the 2015 Barcelona GSE Summer Forum, the Cleveland Fed 2016 Inflation: Drivers and Dynamics Conference, and the 2016 Mid-Year NBER EFSF group Workshop at the Chicago Fed. Any views expressed are solely those of the authors and so cannot be taken to represent those of the Bank of England or to state Bank of England policy.

E-mail: riccardo.masolo@bankofengland.co.uk (Masolo); francesca.monti@kcl.ac.uk (Monti)

Journal of the European Economic Association
Preprint prepared on 30 March 2020 using jeea.cls v1.0.