

Fundamental uncertainty about the natural rate of interest: Info-gap as guide for monetary policy

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Abstract

In this paper we assume that the natural rate of interest is fundamentally uncertain. Info-gap theory is used to rank different monetary policy strategies in terms of their robustness against this uncertainty. Applied to the euro area we find that a more aggressive response by the central bank to deviations from price stability and financial stability, is more robust against natural rate uncertainty than a traditional Taylor rule and a less aggressive policy stance. An inert or low-for-long strategy is least robust. The policy strategy preference is symmetric, implying that natural rate uncertainty calls for a more vigorous adjustment of monetary policy in a downturn as well as in an upturn. In addition, our analysis presents a methodology that is applicable in a wide range of policy analyses under deep uncertainty.

Keywords: Monetary Policy, Monetary Strategy, Knightian uncertainty, info-gaps, satisficing

JEL classifications: E42, E47, E52

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