Optimal Response to Unemployment Fluctuations

Pascal Michaillat
https://www.pascalmichaillat.org/t5.html

Optimal nominal interest rate i^*

$$i^* = i - \frac{[u - u^*]}{du/di}$$

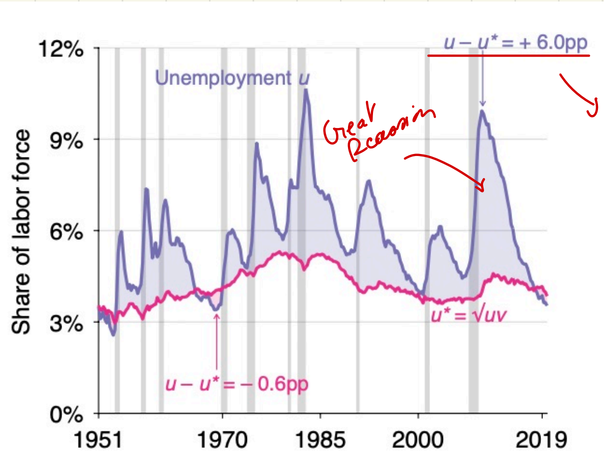
Midrange estimate of monetary multiplier. $du/di = 0.5$

$$\boxed{i^* = i - 2 \times (u - u^*)}$$

↳ for any unemployment gap (pp), the optimal response of monetary policy is $\boxed{2x \text{ gap}}$

↳ ex: if unemployment gap is −1pp, FFR should ~~drop~~ increase by 2 pp

US



FFR should drop by 6×2 = 12 pp. But FFR = 5% in 2008 ⇒ FFR should be < 0 ⇒ ZLB is binding