Comments on Discretion vs. Commitment

Some of you asked why there is no expectation operator on the FOC for the loss function under discretion with shocks (see slide 11 from the review session)

A math equations on a white background

Description automatically generated

Under discretion, the central bank tries to minimize its loss in each period given the realization of the shock. The solution to this problem determines how households set their expectation for inflation. Solving the household expectation allows you to solve prevailing rate of inflation . When we are in the position of the policy maker trying to choose between the two rules, then we solve the loss in expectation using and as inputs. So we (i) solve for the inflation households will expect (they expect the central bank to optimize each period), then (ii) the prevailing rate of inflation (based on ), then (iii) we can use these values to solve for the expected loss to compare the two policies (discretion vs. commitment).