Expectations and the Neutrality of Interest Rates

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Lucas (1972) is the pathbreaking analysis of the neutrality and temporary non-neutrality of money. But our central banks set interest rate targets, and do not even pretend to control money supplies. How is inflation determined under an interest rate target?

We finally have a complete theory of inflation under interest rate targets, that mirrors the long-run neutrality and frictionless limit of monetary theory: Inflation can be stable and determinate under interest rate targets, including a k percent rule, i.e. a peg. The zero bound era is confirmatory evidence. Uncomfortably, long-run neutrality means that higher interest rates eventually produce higher inflation, other things (and fiscal policy in particular) constant.

With a Phillips curve, we have some non-neutrality as well: Higher nominal interest rates raise real rates and lower output. A good model in which higher interest rates temporarily lower inflation is a harder task. I exhibit one such model. It has the Lucas property that only unexpected interest rate rises can lower inflation. A better model, and empirical understanding, is as crucial to today's agenda as Lucas (1972) was in its day.

Much of this is contentious. The issues are crucial for policy: Can the Fed contain inflation without dramatically raising interest rates? Given the state of knowledge, a bit of humility is in order.