BOSTON COLLEGE

Laura Veronika Gati <gati@bc.edu>

# Request for quick turnaround

12 messages

**Ryan Chahrour** <ryan.chahrour@bc.edu> Wed, Sep 30, 2020 at 5:55 PM
To: Laura Veronika Gati <gati@bc.edu>

Hi Laura, in about 10 min I am about to send you three paragraphs summarizing your paper. Can you see if you agree with the summary, take issues with any of the claims, or spot any typos?

Thanks
Ryan

**Laura Veronika Gati** <gati@bc.edu> Wed, Sep 30, 2020 at 5:55 PM
To: Ryan Chahrour <ryan.chahrour@bc.edu>

Hi Ryan,

Sure!!!!
Laura

[Quoted text hidden]

**Ryan Chahrour** <ryan.chahrour@bc.edu> Wed, Sep 30, 2020 at 5:59 PM
To: Laura Veronika Gati <gati@bc.edu>

Ok, more than 3 paragraphs:

Laura's job market paper, entitled ``Monetary Policy and Anchored Expectations: An Endogenous Gain Learning Model" fill an important opening in the macroeconomic literature on the effects of expectations. Although monetary policy makers have long discussed the need for markets and individuals to have ``anchored" inflation expectations, they have lacked a clear model of what anchoring of expectations really means. The primary goal of Laura's paper is to provide a plausible, tractable, and policy-relevant notion of expectations anchoring, to analysis how policy can be designed to account for this important channel.

Laura's paper builds on new work by \cite{CEMP2020}, who propose a model in which people learn about long run inflation using a statistical ``least-squares" learning rule, with weights on new information that depend on the size of past expectations errors. Laura's project pushes this innovative work further, and makes at least three important contributions to the literature on inflation expectations.

First, Laura embeds a time-varying updating mechanism similar to \cite{CEMP2020} within a standard general equilibrium new-Keynesian model. This step is very important to her objectives, because this is the model that policy makers most often use as a baseline when thinking about their policy choices, making this extension crucial for addressing questions related to interest rate policy.

Second, Laura generalizes the nature of the time-varying updating mechanism to allow for smooth, rather than discrete, changes in people's responsiveness to new information. This makes the model better-behaved and allows her to address the positive empirical question of what this updating function looks like. In the paper, Laura use an intuitive moment-based estimation strategy to estimate a non-parametric functional form for the function, which turns out to have intuitive properties. For example, people become more response to new information if they have made large mistakes in the past, but especially responsive after having made large negative forecast errors.

Third, Laura uses her model to examine the features of optimal policy and (nearly optimal) simple rules for the setting of interest rates. Laura shows how to derive an analytical ``target criterion'' for policy, then shows what this criterion means for the setting interest rates. In terms of implementation, optimal policy implies the central bank should be relatively ``dovish'' so long as inflation expectations remain anchored, but should become rather aggressive in the event that people begin to update their beliefs well away from the target level of inflation. This result sounds a great deal like the current conversation going on in policy circles, and no doubt will be useful for informing these conversation as continue.

Laura concludes the paper by showing the, even though the model calls for aggressive responses when expectations become unanchored, simple Taylor rules without this sort of complex state-dependence can do a fairly good minimizing social welfare loss from inflation. Indeed, over all, the the optimal simple Taylor rule requires a smaller coefficient on inflation than the the one implied by the same model with rational expectations. In short, the historical rule used in the US has been, if anything, closer to optimal than one would conclude using the rational expectations version of her model.

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**Ryan Chahrour** <ryan.chahrour@bc.edu> Wed, Sep 30, 2020 at 6:07 PM
To: Laura Veronika Gati <gati@bc.edu>

Lots of typos! Sorry.

On Sep 30, 2020, at 5:55 PM, Laura Veronika Gati <gati@bc.edu> wrote:

[Quoted text hidden]

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**Laura Veronika Gati** <gati@bc.edu> Wed, Sep 30, 2020 at 6:07 PM
To: Ryan Chahrour <ryan.chahrour@bc.edu>

Should I point them out?
Laura

[Quoted text hidden]

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**Ryan Chahrour** <ryan.chahrour@bc.edu> Wed, Sep 30, 2020 at 6:09 PM
To: Laura Veronika Gati <gati@bc.edu>

Sure, for double check. But big picture more important
[Quoted text hidden]

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**Laura Veronika Gati** <gati@bc.edu> Wed, Sep 30, 2020 at 6:11 PM
To: Ryan Chahrour <ryan.chahrour@bc.edu>

Ok I'm on it!
Laura

[Quoted text hidden]

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**Ryan Chahrour** <ryan.chahrour@bc.edu> Wed, Sep 30, 2020 at 6:12 PM
To: Laura Veronika Gati <gati@bc.edu>

If just starting use this:

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Third, Laura uses her model to examine the features of optimal policy and (nearly optimal) simple rules for the setting of interest rates. Laura shows how to derive an analytical ``target criterion'' for policy, then shows what this criterion means for the setting of interest rates. In terms of implementation, optimal policy implies the central bank should be relatively ``dovish'' so long as inflation expectations remain anchored, but should become rather aggressive in the event that people begin to update their beliefs well away from the target level of inflation. This result sounds a great deal like the current conversation going on in policy circles, and no doubt will be useful for informing these conversations as they continue.

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**Laura Veronika Gati** <gati@bc.edu> Wed, Sep 30, 2020 at 6:39 PM
To: Ryan Chahrour <ryan.chahrour@bc.edu>

Hi Ryan,

Wow.

**Content:**

4th paragraph: ``This makes the model better behaved ..." and empirical stuff. I wonder if it is worthwhile emphasizing that smoothness is a necessary condition for the policy problem to be dealt with. I know you don't want to go into detail, but the primary motivation of the smooth anchoring function was initially to be able to take derivatives for the analytical results.
Also, I need to think about whether the property you mention as an example, "people become more responsive to new information if they have made large mistakes in the past," is indeed a property of the estimated anchoring function. My inclination is to say no, because the estimation output suggests that a forecast error of a particular magnitude is associated with a particular gain - I think this relationship is static. Maybe you're thinking of the general specification I started out with, where the gain is a function of forecast errors and its own past value, which I think would lead to this property. Man - I wish I could say that such a property was implied! It would be stronger. But, alas, I don't think it is.

Last paragraph: "the historical rule used in the US has been, if anything, closer to optimal than one would conclude using the rational expectations version". Interesting point!

**Typos: (marked in red)**

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Third, Laura uses her model to examine the features of optimal policy and (nearly optimal) simple rules for the setting of interest rates. Laura shows how to derive an analytical ``target criterion" for policy, then shows (repetition, maybe instead: illustrates, demonstrates?) what this criterion means for the setting of interest rates. In terms of implementation, optimal policy implies the central bank should be relatively ``dovish" so long as inflation expectations remain anchored, but should become rather aggressive in the event that people begin to update their beliefs well away from the target level of inflation. This result sounds a great deal like the current conversation going on in policy circles, and no doubt will be useful for informing these conversations as they continue.

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Thank you, Ryan. That's all I have. Let me know if anything is unclear or you need anything else from me.
Laura

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**Ryan Chahrour** <chahrour@bc.edu> Wed, Sep 30, 2020 at 6:46 PM
To: Laura Veronika Gati <gati@bc.edu>

That's it, thank you Laura!
Ryan

Sent from my phone
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**Ryan Chahrour** <ryan.chahrour@bc.edu> Wed, Sep 30, 2020 at 9:44 PM
To: Laura Veronika Gati <gati@bc.edu>

Just a final comment, I think I stick to my description about the timing of mistakes. The timing is:

Yesterday, I made a big mistake. So my kappa went up yesterday. So I adjust my perception of the equilibrium mapping more, which becomes relevant for the forecasts I make today.

Right?
[Quoted text hidden]

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**Laura Veronika Gati** <gati@bc.edu> Wed, Sep 30, 2020 at 9:53 PM
To: Ryan Chahrour <ryan.chahrour@bc.edu>

Oh that's right. The timing is right. Oh, now I really understand how you meant that sentence. Yes, that way it's all correct. I understood it previously to say something a little different.

So yes, right!
[Quoted text hidden]
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Laura