

# Monetary Policy & Anchored Expectations An Endogenous Gain Learning Model

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# Anchoring

“Essential to anchor inflation expectations at some low level.”

“We don’t see a de-anchoring.”



“Failure of the Fed to stably achieve its 2 percent target could de-anchor inflation expectations.”

“Long-run inflation expectations [...] are not perfectly anchored in real economies; moreover, the extent to which they are anchored can change.”

# This paper

1. A model of expectations:  
    ↪ *unanchored expectations*: sensitivity of long-run expectations to short-run fluctuations
2. Estimate how unanchoring takes place in data  
    ↪ quantify novel anchoring channel
3. Analyze monetary policy  
    ↪ analytically and numerically using novel model disciplined by data
4. Key takeaway  
    ↪ monetary policy anchors expectations to inflation target by not tolerating deviations in long-run expectations from target

# Related literature

- **Optimal monetary policy in the New Keynesian model**

Clarida, Gali & Gertler (1999), Woodford (2003)

- **Adaptive learning**

Evans & Honkapohja (2001, 2006), Sargent (1999), Primiceri (2006), Lubik & Matthes (2018), Bullard & Mitra (2002), Preston (2005, 2008), Ferrero (2007), Molnár & Santoro (2014), Mele et al (2019), Eusepi & Preston (2011), Milani (2007, 2014), Marcet & Nicolini (2003)

- **Anchoring and the Phillips curve**

Goodfriend (1993), Svensson (2015), Hooper et al (2019), Afrouzi & Yang (2020), Reis (2020), Hebden et al 2020, Gobbi et al (2019), Carvalho et al (2019)

# Model overview

- New Keynesian core: standard IS and Phillips curves

► Microfoundations

$$x_t = -\sigma i_t + \hat{\mathbb{E}}_t \sum_{T=t}^{\infty} \beta^{T-t} \left( (1-\beta)x_{T+1} - \sigma(\beta i_{T+1} - \pi_{T+1}) + \sigma r_T^n \right) \quad (1)$$

$$\pi_t = \kappa x_t + \hat{\mathbb{E}}_t \sum_{T=t}^{\infty} (\alpha\beta)^{T-t} \left( \kappa\alpha\beta x_{T+1} + (1-\alpha)\beta\pi_{T+1} + u_T \right) \quad (2)$$

Observables:  $(\pi, x, i)$  inflation, output gap, interest rate

Exogenous states:  $(r^n, u)$  natural rate and cost-push shock

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Observables:  $(\pi, x, i)$  inflation, output gap, interest rate

Exogenous states:  $(r^n, u)$  natural rate and cost-push shock

- Novelty of the paper:** inflation expectations process

$$\hat{\mathbb{E}}_t \pi_{t+1} = \bar{\pi}_t + \mathbb{E}_t \pi_{t+1} \quad (3)$$

$\mathbb{E}$ : rational (model-consistent) expectations

$\hat{\mathbb{E}}$ : nonrational expectations  $\rightarrow$  long-run inflation expectations  $\bar{\pi}_{t-1}$

# Evolution of long-run inflation expectations

One-period ahead inflation forecast:

$$\hat{\mathbb{E}}_{t-1} \pi_t = \bar{\pi}_{t-1} + \mathbb{E}_{t-1} \pi_t \quad (4)$$

# Evolution of long-run inflation expectations

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One-period ahead inflation forecast error:

$$f_{t|t-1} = \pi_t - \hat{\mathbb{E}}_{t-1} \pi_t \quad (5)$$



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→ Update for long-run inflation expectations:

$$\bar{\pi}_t = \bar{\pi}_{t-1} + k_t f_{t|t-1} \quad (6)$$

$k_t \in (0, 1)$  learning gain

# Alternatives for the gain

1. Decreasing gain:

$$\bar{\pi}_t = \bar{\pi}_{t-1} + \frac{1}{t} f_{t|t-1} \quad (7)$$

2. Constant gain:

$$\bar{\pi}_t = \bar{\pi}_{t-1} + k f_{t|t-1} \quad (8)$$

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3. Endogenous gain:

$$\bar{\pi}_t = \bar{\pi}_{t-1} + \mathbf{g}(f_{t|t-1}) f_{t|t-1} \quad (9)$$

► Assumptions on  $\mathbf{g}(\cdot)$

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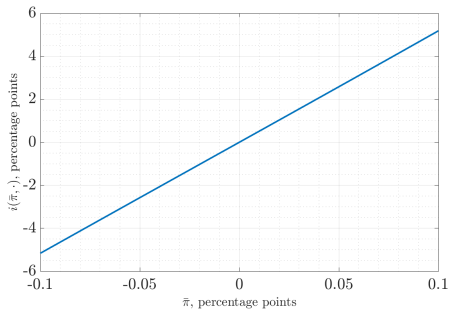
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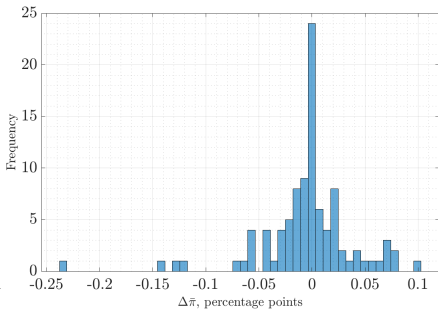
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Optimal monetary policy: -

# Optimal policy - responding to unanchoring



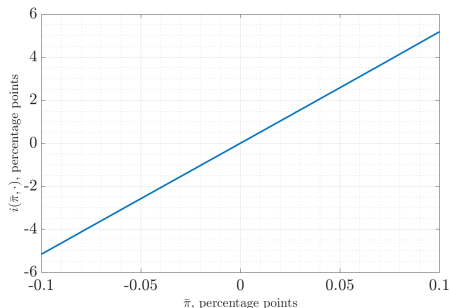
$i(\bar{\pi}, \text{all other states at their means})$



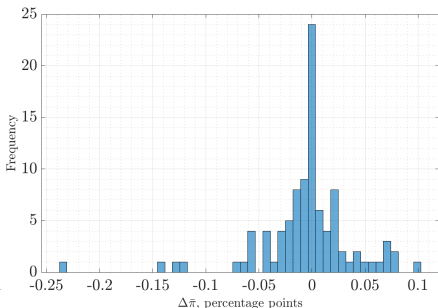
Stabilizing  $\bar{\pi}$

5 bp movement in  $\bar{\pi} \rightarrow 250$  bp movement in  $i$

# Optimal policy - responding to unanchoring



$i(\bar{\pi}, \text{all other states at their means})$



Stabilizing  $\bar{\pi}$

5 bp movement in  $\bar{\pi} \rightarrow 250$  bp movement in  $i$

Mode: 0.3 bp movement in  $\bar{\pi}$



# Unanchoring causes volatility

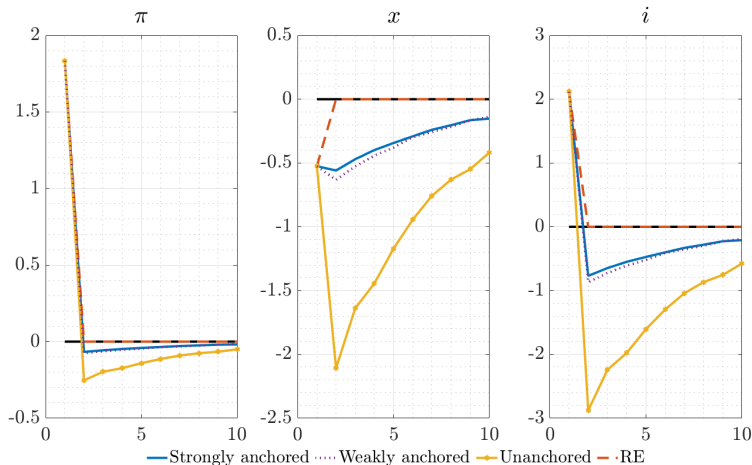


Figure: Impulse responses after a cost-push shock when policy follows a Taylor rule

► Why oscillatory?

# Conclusion

First theory of monetary policy for potentially unanchored expectations

Estimation of novel unanchoring channel

- Expectations process nonlinear

Monetary policy

- **Key:** Optimal policy aggressive when unanchored, accommodates otherwise
- Degree of expectations unanchoring determines extent of smoothing shocks
- Taylor rule less aggressive than under rational expectations

Future work

- ↪ How to anchor at zero-lower bound?
- ↪ Other applications: currency crises

## Appendix

# Long-run expectations: responsive to short-run conditions?

Individual-level Survey of Professional Forecasters (SPF): for 1991-Q4 onward, estimate rolling regression

$$\Delta \bar{\pi}_t = \beta_0 + \beta_1^w f_{t|t-1} + \epsilon_t \quad (10)$$

$\bar{\pi}_t$  10-year ahead inflation expectation

$f_{t|t-1} \equiv \pi_t - \mathbb{E}_{t-1} \pi_t$  individual one-year-ahead forecast error

$w$  indexes windows of 20 quarters

# Time-varying responsiveness

$$\Delta \bar{\pi}_t = \beta_0 + \beta_1^w f_{t|t-1} + \epsilon_t \quad (1)$$

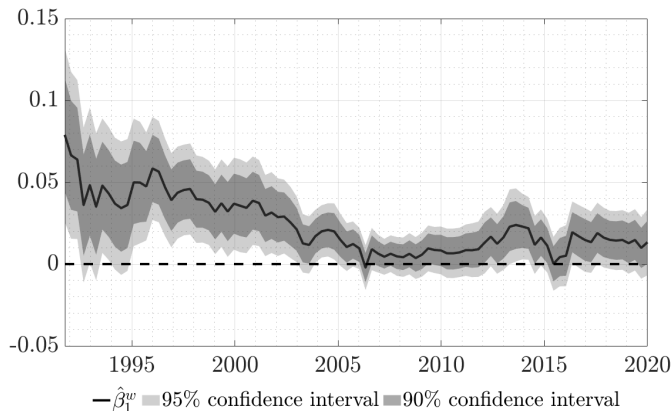


Figure: Time series of  $\hat{\beta}_1^w$

# Breakeven inflation



Figure: Market-based inflation expectations, various horizons, %

# Correcting the TIPS from liquidity risk

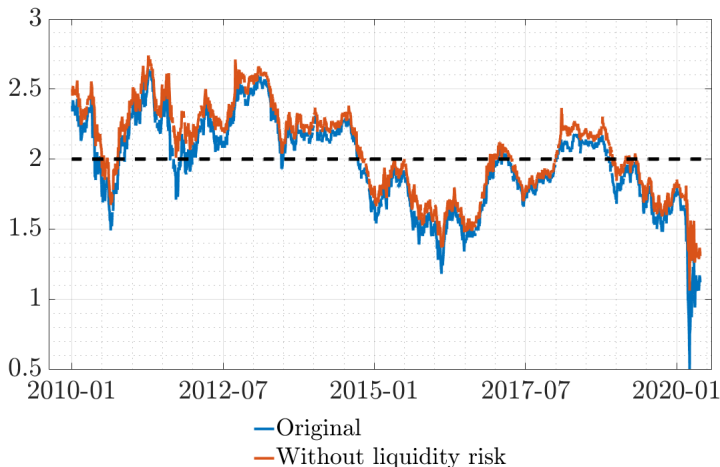


Figure: Market-based inflation expectations, 10 year, %

# Robustness checks

$$\Delta \bar{\pi}_t = \beta_0 + \beta_1^w \pi_t + \epsilon_t \quad (1)$$

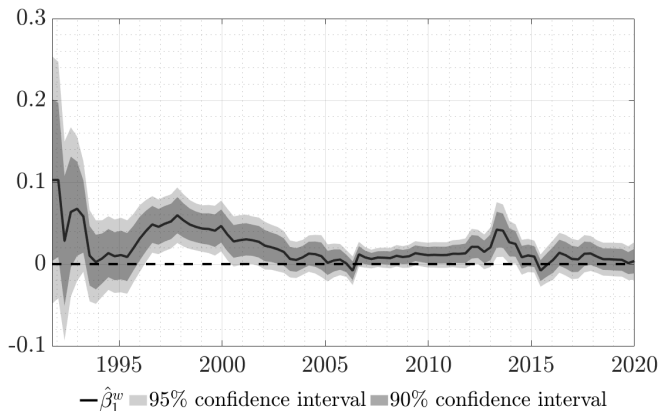


Figure: Time series of  $\hat{\beta}_1^w$



# Robustness checks - PCE core

$$\Delta \bar{\pi}_t = \beta_0^w + \beta_1^w f_{t|t-1} + \epsilon_t \quad (1)$$

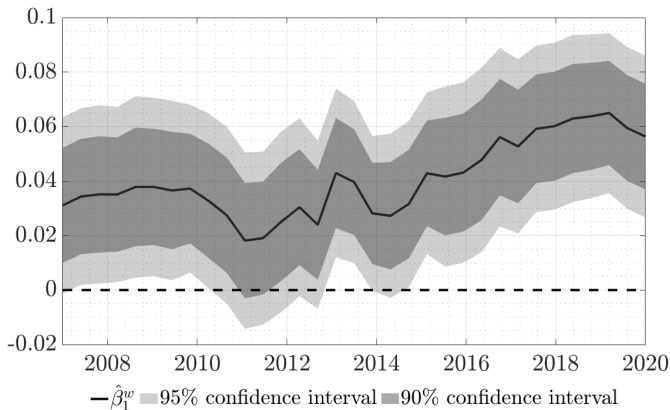


Figure: Time series of  $\hat{\beta}_1^w$

# Robustness checks - controlling for inflation levels

$$\Delta \bar{\pi}_t = \beta_0^w + \beta_1^w f_{t|t-1} + \beta_2^w \pi_t + \epsilon_t \quad (1)$$

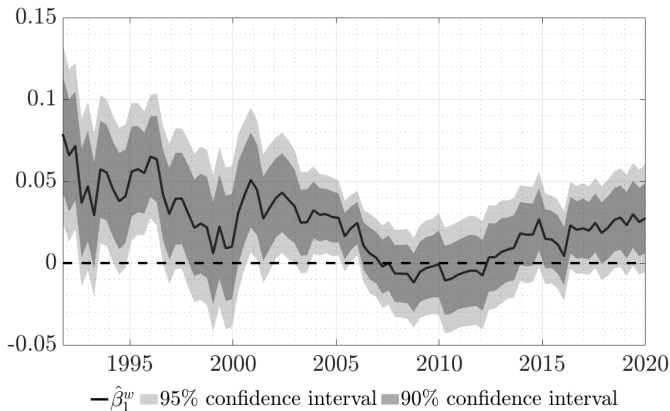


Figure: Time series of  $\hat{\beta}_1^w$

# Further evidence: disagreement

Figure: Livingston Survey of Firms:  
Interquartile range of 10-year ahead inflation expectations

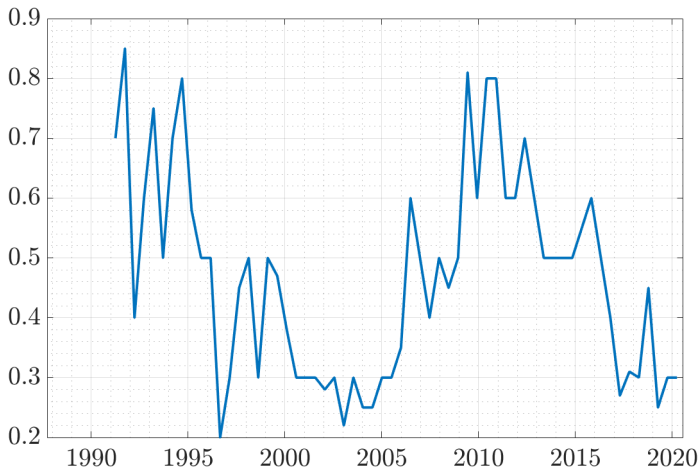
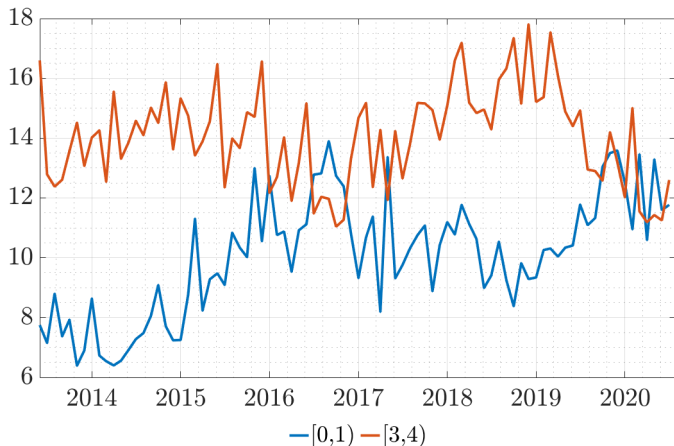
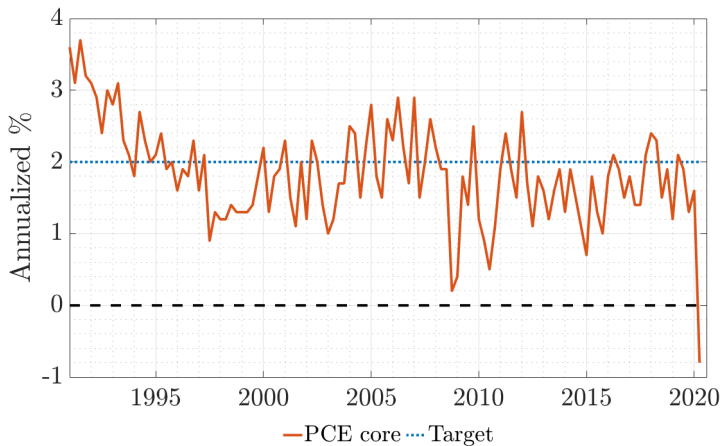


Figure: New York Fed Survey of Consumers:  
Percent of respondents indicating 3-year ahead inflation will be in a particular range



# Further evidence: introspection

Figure: PCE core inflation against the Fed's target



# Households: standard up to $\hat{\mathbb{E}}$

Maximize lifetime expected utility

$$\hat{\mathbb{E}}_t^i \sum_{T=t}^{\infty} \beta^{T-t} \left[ U(C_T^i) - \int_0^1 v(h_T^i(j)) dj \right] \quad (11)$$

Budget constraint

$$B_t^i \leq (1 + i_{t-1})B_{t-1}^i + \int_0^1 w_t(j)h_t^i(j)dj + \Pi_t^i(j)dj - T_t - P_t C_t^i \quad (12)$$

# Firms: standard up to $\hat{\mathbb{E}}$

Maximize present value of profits

$$\hat{\mathbb{E}}_t^j \sum_{T=t}^{\infty} \alpha^{T-t} Q_{t,T} \left[ \Pi_t^j(p_t(j)) \right] \quad (13)$$

subject to demand

$$y_t(j) = Y_t \left( \frac{p_t(j)}{P_t} \right)^{-\theta} \quad (14)$$

# Oscillatory dynamics in adaptive learning

Consider a stylized adaptive learning model in two equations:

$$\pi_t = \beta f_t + u_t \quad (15)$$

$$f_t = f_{t-1} + k(\pi_t - f_{t-1}) \quad (16)$$

Solve for the time series of expectations  $f_t$

$$f_t = \underbrace{\frac{1 - k^{-1}}{1 - k^{-1}\beta}}_{\approx 1} f_{t-1} + \frac{k^{-1}}{1 - k^{-1}\beta} u_t \quad (17)$$

Solve for forecast error  $f_t \equiv \pi_t - f_{t-1}$ :

$$f_t = - \underbrace{\frac{1 - \beta}{1 - k\beta}}_{\lim_{k \rightarrow 1} = -1} f_{t-1} + \frac{1}{1 - k\beta} u_t \quad (18)$$



# Functional forms for $g$ in the literature

- Smooth anchoring function (Gobbi et al, 2019)

$$p = h(y_{t-1}) = A + \frac{BCe^{-Dy_{t-1}}}{(Ce^{-Dy_{t-1}} + 1)^2} \quad (19)$$

$p \equiv \text{Prob}(\text{liquidity trap regime})$   
 $y_{t-1}$  output gap

- Kinked anchoring function (Carvalho et al, 2019)

$$k_t = \begin{cases} \frac{1}{t} & \text{when } \theta_t < \bar{\theta} \\ k & \text{otherwise.} \end{cases} \quad (20)$$

$\theta_t$  criterion,  $\bar{\theta}$  threshold value

# Choices for criterion $\theta_t$

- Carvalho et al. (2019)'s criterion

$$\theta_t^{CEMP} = \max |\Sigma^{-1}(\phi_{t-1} - T(\phi_{t-1}))| \quad (21)$$

$\Sigma$  variance-covariance matrix of shocks

$T(\phi)$  mapping from PLM to ALM

- CUSUM-criterion

$$\omega_t = \omega_{t-1} + \kappa k_{t-1} (f_{t|t-1} f'_{t|t-1} - \omega_{t-1}) \quad (22)$$

$$\theta_t^{CUSUM} = \theta_{t-1} + \kappa k_{t-1} (f'_{t|t-1} \omega_t^{-1} f_{t|t-1} - \theta_{t-1}) \quad (23)$$

$\omega_t$  estimated forecast-error variance

# General updating algorithm

$$\phi_t = \left( \phi'_{t-1} + k_t R_t^{-1} \begin{bmatrix} 1 \\ s_{t-1} \end{bmatrix} \left( y_t - \phi_{t-1} \begin{bmatrix} 1 \\ s_{t-1} \end{bmatrix} \right) \right)' \quad (24)$$

$$R_t = R_{t-1} + k_t \left( \begin{bmatrix} 1 \\ s_{t-1} \end{bmatrix} [1 \quad s_{t-1}] - R_{t-1} \right) \quad (25)$$

# Assumptions on $\mathbf{g}(\cdot)$

$$\mathbf{g}_{ff} \geq 0 \quad (26)$$

$\mathbf{g}(\cdot)$  convex in forecast errors.

# Estimating form of gain function

- Calibrate parameters of New Keynesian core to literature
- Estimate flexible form of expectations process via simulated method of moments  
(Duffie & Singleton 1990, Lee & Ingram 1991, Smith 1993)

$$\bar{\pi}_t = \bar{\pi}_{t-1} + \mathbf{g}(f_{t|t-1}) f_{t|t-1} \quad (18)$$

- Moments: autocovariances of inflation, output gap, federal funds rate and 1-year ahead Survey of Professional Forecasters (SPF) inflation expectations at lags  $0, \dots, 4$

# Estimated expectations process

$$\bar{\pi}_t - \bar{\pi}_{t-1} = \mathbf{g}(f_{t|t-1}) f_{t|t-1} \quad (18)$$

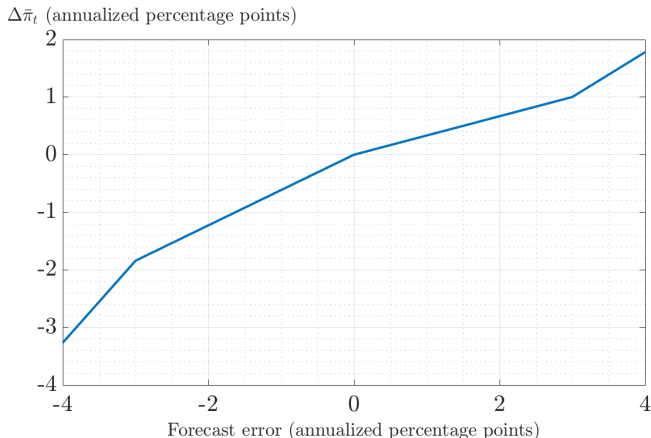


Figure: Changes in long-run inflation expectations as a function of forecast errors

# Details on households and firms

Consumption:

$$C_t^i = \left[ \int_0^1 c_t^i(j)^{\frac{\theta-1}{\theta}} dj \right]^{\frac{\theta}{\theta-1}} \quad (27)$$

$\theta > 1$ : elasticity of substitution between varieties

Aggregate price level:

$$P_t = \left[ \int_0^1 p_t(j)^{1-\theta} dj \right]^{\frac{1}{\theta-1}} \quad (28)$$

Profits:

$$\Pi_t^j = p_t(j)y_t(j) - w_t(j)f^{-1}(y_t(j)/A_t) \quad (29)$$

Stochastic discount factor

$$Q_{t,T} = \beta^{T-t} \frac{P_t U_c(C_T)}{P_T U_c(C_t)} \quad (30)$$

# Derivations

## Household FOCs

$$\hat{C}_t^i = \hat{\mathbb{E}}_t^i \hat{C}_{t+1}^i - \sigma(\hat{i}_t - \hat{\mathbb{E}}_t^i \hat{\pi}_{t+1}) \quad (31)$$

$$\hat{\mathbb{E}}_t^i \sum_{s=0}^{\infty} \beta^s \hat{C}_t^i = \omega_t^i + \hat{\mathbb{E}}_t^i \sum_{s=0}^{\infty} \beta^s \hat{Y}_t^i \quad (32)$$

where ‘hats’ denote log-linear approximation and  $\omega_t^i \equiv \frac{(1+i_{t-1})B_{t-1}^i}{P_t Y^*}$ .

1. Solve (31) backward to some date  $t$ , take expectations at  $t$
  2. Sub in (32)
  3. Aggregate over households  $i$
- Obtain (1)



# Actual laws of motion

$$y_t = A_1 f_{a,t} + A_2 f_{b,t} + A_3 s_t \quad (33)$$

$$s_t = h s_{t-1} + \epsilon_t \quad (34)$$

where

$$y_t \equiv \begin{pmatrix} \pi_t \\ x_t \\ i_t \end{pmatrix} \quad s_t \equiv \begin{pmatrix} r_t^n \\ u_t \end{pmatrix} \quad (35)$$

and

$$f_{a,t} \equiv \hat{\mathbb{E}}_t \sum_{T=t}^{\infty} (\alpha \beta)^{T-t} y_{T+1} \quad f_{b,t} \equiv \hat{\mathbb{E}}_t \sum_{T=t}^{\infty} (\beta)^{T-t} y_{T+1} \quad (36)$$

# Piecewise linear approximation to gain function

$$\mathbf{g}(f_{t|t-1}) = \sum_i \gamma_i b_i(f_{t|t-1}) \quad (37)$$

- $b_i(f_{t|t-1})$  = piecewise linear basis
- $\gamma_i$  = approximating coefficient at node  $i$

↪ Estimate  $\hat{\gamma}$  via simulated method of moments

# The expectation process over time

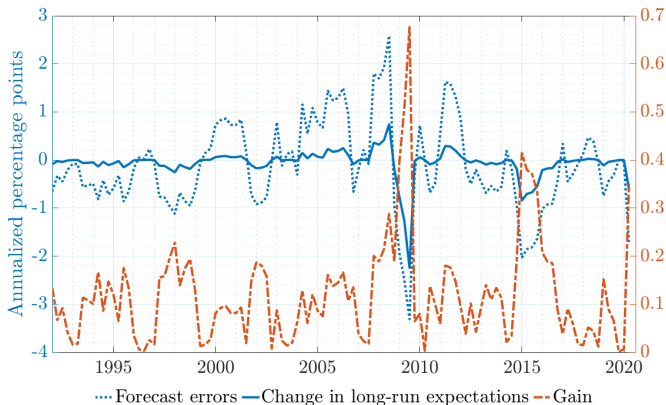


Figure: Time series of forecast errors, changes in long-run expectations and gain

# Target criterion

## Proposition

*Let  $\mathbf{g}_{z,t} \equiv \frac{\partial \mathbf{g}}{\partial z}$  at  $t$ . Then monetary policy optimally brings about the following target relationship between inflation and the output gap*

$$\pi_t = -\frac{\lambda_x}{\kappa} x_t$$

RE (discretion): move  $\pi_t$  and  $x_t$  to offset cost-push shocks

# Target criterion

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Let  $\mathbf{g}_{z,t} \equiv \frac{\partial \mathbf{g}}{\partial \mathbf{z}}$  at  $t$ . Then monetary policy optimally brings about the following target relationship between inflation and the output gap

$$\pi_t - \Gamma(k) \mathbb{E}_t \sum_{i=1}^{\infty} x_{t+i} = -\frac{\lambda_x}{\kappa} x_t$$

Adaptive learning: can move  $\mathbb{E}_t x_{t+i}$  too if  $k > 0$

►  $\Gamma(k)$

# Target criterion

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$$\pi_t - \Omega \left( k_{t+f_t|t-1} \mathbf{g}_{\pi,t} \right) \left( \mathbb{E}_t \sum_{i=1}^{\infty} x_{t+i} \prod_{j=0}^{i-1} (1 - k_{t+1+j} - f_{t+1+j|t+j} \mathbf{g}_{\pi,t+j}) \right) = -\frac{\lambda_x}{\kappa} x_t$$

Endogenous gain: ability to move  $\mathbb{E}_t x_{t+i}$  depends on present and future degree of unanchoring

► Full expression,  $\Omega$

► No commitment

## Lemma

*The discretion and commitment solutions of the Ramsey problem coincide.*

► Why no commitment?

## Corollary

*Optimal policy under adaptive learning is time-consistent.*

# No commitment - no lagged multipliers

Simplified version of the model: planner chooses  $\{\pi_t, x_t, f_t, k_t\}_{t=t_0}^{\infty}$  to minimize

$$\mathcal{L} = \mathbb{E}_{t_0} \sum_{t=t_0}^{\infty} \beta^{t-t_0} \left\{ \pi_t^2 + \lambda x_t^2 + \varphi_{1,t}(\pi_t - \kappa x_t - \beta f_t + u_t) \right. \\ \left. + \varphi_{2,t}(f_t - f_{t-1} - k_t(\pi_t - f_{t-1})) + \varphi_{3,t}(k_t - \mathbf{g}(\pi_t - f_{t-1})) \right\}$$

$$2\pi_t + 2\frac{\lambda}{\kappa}x_t - \varphi_{2,t}(k_t + \mathbf{g}_{\pi}(\pi_t - f_{t-1})) = 0 \quad (38)$$

$$-2\beta\frac{\lambda}{\kappa}x_t + \varphi_{2,t} - \varphi_{2,t+1}(1 - k_{t+1} - \mathbf{g}_f(\pi_{t+1} - f_t)) = 0 \quad (39)$$



# Target criterion system for anchoring function as changes of the gain

$$\begin{aligned} \varphi_{6,t} = & -cf_{t|t-1}x_{t+1} + \left(1 + \frac{f_{t|t-1}}{f_{t+1|t}}(1 - k_{t+1}) - f_{t|t-1}\mathbf{g}_{\pi,t}\right)\varphi_{6,t+1} \\ & - \frac{f_{t|t-1}}{f_{t+1|t}}(1 - k_{t+1})\varphi_{6,t+2} \end{aligned} \quad (40)$$

$$0 = 2\pi_t + 2\frac{\lambda_x}{\kappa}x_t - \left(\frac{k_t}{f_{t|t-1}} + \mathbf{g}_{\pi,t}\right)\varphi_{6,t} + \frac{k_t}{f_{t|t-1}}\varphi_{6,t+1} \quad (41)$$

$\varphi_{6,t}$  Lagrange multiplier on anchoring function

The solution to (41) is given by:

$$\varphi_{6,t} = -2\mathbb{E}_t \sum_{i=0}^{\infty} \left(\pi_{t+i} + \frac{\lambda_x}{\kappa}x_{t+i}\right) \prod_{j=0}^{i-1} \frac{\frac{k_{t+j}}{f_{t+j|t+j-1}}}{\frac{k_{t+j}}{f_{t+j|t+j-1}} + \mathbf{g}_{\pi,t+j}} \quad (42)$$

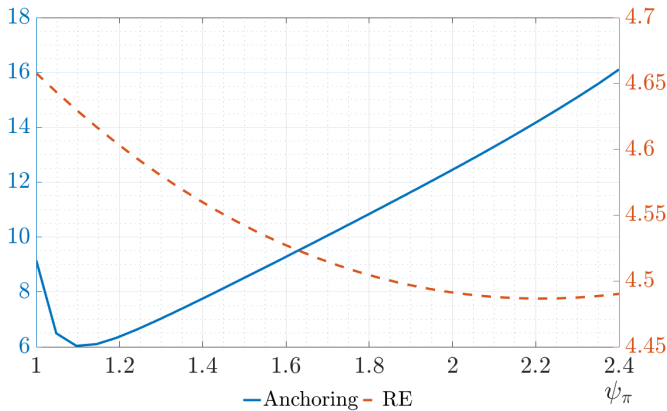
# Optimal Taylor-coefficient on inflation

$$i_t = \psi_\pi \pi_t + \psi_x x_t \quad (43)$$

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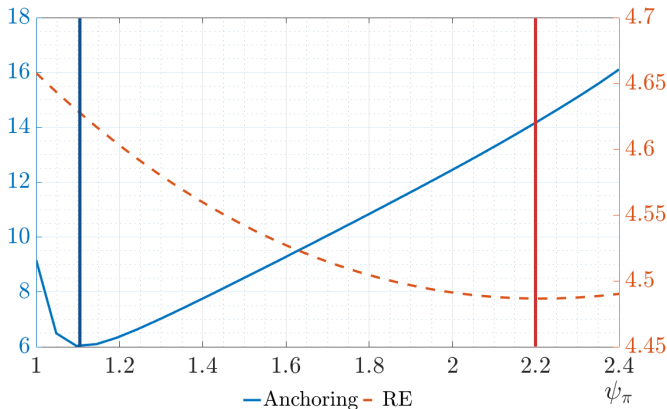
Figure: Central bank loss as a function of  $\psi_\pi$



# Optimal Taylor-coefficient on inflation

$$i_t = \psi_\pi \pi_t + \psi_x x_t \quad (43)$$

Figure: Central bank loss as a function of  $\psi_\pi$



Anchoring-optimal coefficient:  $\psi_\pi^A = 1.1$

RE-optimal coefficient:  $\psi_\pi^{RE} = 2.2$

# Why less aggressive? Future interest rate expectations

IS curve:

$$x_t = -\sigma i_t + \hat{\mathbb{E}}_t \sum_{T=t}^{\infty} \beta^{T-t} ((1-\beta)x_{T+1} - \sigma(\beta i_{T+1} - \pi_{T+1}) + \sigma r_T^n)$$

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- Taylor rule implies interest rate expectation

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- If private sector understands and believes Taylor rule, expected future interest rates additional channel of policy (Eusepi, Giannoni & Preston 2018)

# Respond but not too much

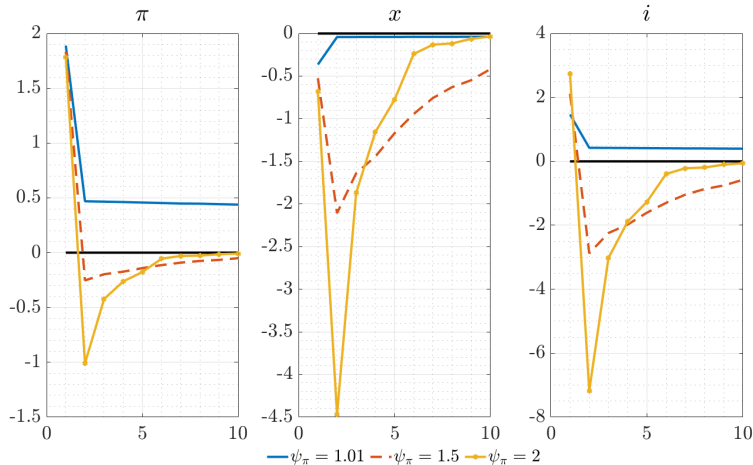


Figure: Impulse responses for unanchored expectations for various values of  $\psi_\pi$