Monetary Policy & Anchored Expectations
Why should we care?

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In the transition to RE, dynamics deviate from RE

1. Once expectations have converged to RE, no difference between RE and AM

$\rightarrow$ The difference is in the transition. Can't assume transition away because that = assuming that all agents are born with knowledge of the model

2. What's happening in the transition and why do we care?
   - In NK model, current variables depend on expectations of future variables (self-referentiality)
   - In transition, AM expectations do not coincide with RE expectations

$\Rightarrow$ Law of motion of endogenous variables will be different!

Monetary policy based on RE gets things wrong

Monetary policy based on the RE model will in the transition

1. Have the wrong expectations
2. Conduct policy based on the wrong model of the endogenous variables (wrong law of motion)

More concretely, it will

1. respond to shocks according to Taylor-rule and states of the RE model (none in NK)
2. will therefore ignore that the economy's law of motion is characterized by a novel state variable: expectations
3. and use the wrong optimal Taylor-rule parameters (CGG parameters optimal for RE law of motion)

$\Rightarrow$ smooth the wrong output gap, unemployment, inflation

Concrete example

Uncertainty shock: $x \downarrow$, econ otherwise in a boom

1. If state variable beliefs is anchored (at Fed's target) and it's been there for a while with no sign of moving
   $\rightarrow$ RE NK dynamics is a good model, Fed can base decision of whether to lower $i \downarrow$ on business cycle indicators (u, π).
   Assume: no need to lower interest rates.

2. If beliefs far below target consistently for a while, then that will amplify $x \downarrow$ (self-referentiality)
   $\rightarrow$ need to $i \downarrow$ a lot

3. Key: if expectations anchored, but drifting down, then even though the RE dynamics is a good description, Fed still needs to make sure that it stays that way:
   $i \downarrow$ **only to keep expectations anchored**