

Materials 25 - Preparing macro lunch

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$$A_a = \begin{pmatrix} -\frac{(\alpha-1)\beta(\delta\sigma+1)}{\delta\sigma+\kappa\psi\sigma+1} & \frac{\alpha\beta\kappa(\delta\sigma+1)}{\delta\sigma+\kappa\psi\sigma+1} & 0 \\ \frac{(\alpha-1)\beta\sigma\psi}{\delta\sigma+\kappa\psi\sigma+1} & -\frac{\alpha\beta\kappa\sigma\psi}{\delta\sigma+\kappa\psi\sigma+1} & 0 \\ -\frac{(\alpha-1)\beta\psi}{\delta\sigma+\kappa\psi\sigma+1} & \frac{\alpha\beta\kappa\psi}{\delta\sigma+\kappa\psi\sigma+1} & 0 \end{pmatrix}$$

$$A_b = \begin{pmatrix} \frac{\kappa\sigma(1-\beta\psi)}{\delta\sigma+\kappa\psi\sigma+1} & -\frac{\kappa(\delta\sigma\beta+\beta-1)}{\delta\sigma+\kappa\psi\sigma+1} & 0 \\ \frac{\sigma-\beta\sigma\psi}{\delta\sigma+\kappa\psi\sigma+1} & -\frac{\delta\sigma\beta+\beta-1}{\delta\sigma+\kappa\psi\sigma+1} & 0 \\ -\frac{\sigma(\beta\psi-1)(\delta+\kappa\psi)}{\delta\sigma+\kappa\psi\sigma+1} & -\frac{(\delta\sigma\beta+\beta-1)(\delta+\kappa\psi)}{\delta\sigma+\kappa\psi\sigma+1} & 0 \end{pmatrix}$$

$$A_s = \begin{pmatrix} \frac{(\delta\sigma+1)\text{ia}(3,1)+\kappa\sigma(\text{ib}(1,1)-\text{ib}(2,1))}{\delta\sigma+\kappa\psi\sigma+1} & \frac{(\delta\sigma+1)\text{ia}(3,2)+\kappa\sigma(\text{ib}(1,2)-\text{ib}(2,2))}{\delta\sigma+\kappa\psi\sigma+1} & \frac{(\delta\sigma+1)\text{ia}(3,3)-\delta\sigma}{\delta\sigma+\kappa\psi\sigma+1} \\ -\frac{\sigma(\psi\text{ia}(3,1)-\text{ib}(1,1)+\text{ib}(2,1))}{\delta\sigma+\kappa\psi\sigma+1} & -\frac{\sigma(\psi\text{ia}(3,2)-\text{ib}(1,2)+\text{ib}(2,2))}{\delta\sigma+\kappa\psi\sigma+1} & -\frac{\sigma(\psi\text{ia}(3,3)-\delta\sigma)}{\delta\sigma+\kappa\psi\sigma+1} \\ \frac{\psi\text{ia}(3,1)+\delta\sigma\text{ib}(1,1)+\kappa\sigma\psi\text{ib}(1,1)-\sigma(\delta+\kappa\psi)\text{ib}(2,1)}{\delta\sigma+\kappa\psi\sigma+1} & \frac{\psi\text{ia}(3,2)+\delta\sigma(\text{ib}(1,2)-\text{ib}(2,2)+1)+\kappa\sigma\psi(\text{ib}(1,2)-\text{ib}(2,2)+1)+1}{\delta\sigma+\kappa\psi\sigma+1} & \frac{\psi\text{ia}(3,3)+\delta\sigma\text{ib}(1,3)+\delta\sigma}{\delta\sigma+\kappa\psi\sigma+1} \end{pmatrix}$$

If shocks are iid, ia and ib are identity matrices, and so A_s becomes:

$$A_s = \begin{pmatrix} \frac{\kappa\sigma}{\delta\sigma+\kappa\psi\sigma+1} & -\frac{\kappa\sigma}{\delta\sigma+\kappa\psi\sigma+1} & \frac{\delta\sigma+1}{\delta\sigma+\kappa\psi\sigma+1} \\ \frac{\sigma}{\delta\sigma+\kappa\psi\sigma+1} & -\frac{\sigma}{\delta\sigma+\kappa\psi\sigma+1} & -\frac{\sigma\psi}{\delta\sigma+\kappa\psi\sigma+1} \\ \frac{\kappa\psi\sigma+\sigma\delta}{\delta\sigma+\kappa\psi\sigma+1} & \frac{1}{\delta\sigma+\kappa\psi\sigma+1} & \frac{\psi}{\delta\sigma+\kappa\psi\sigma+1} \end{pmatrix}$$

A Model summary

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

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

$$i_t = \psi_\pi \pi_t + \psi_x x_t + \bar{i}_t \quad (\text{if imposed}) \quad (\text{A.3})$$

$$\text{PLM:} \quad \hat{\mathbb{E}}_t z_{t+h} = a_{t-1} + b h_x^{h-1} s_t \quad \forall h \geq 1 \quad b = g_x h_x \quad (\text{A.4})$$

$$\text{Updating:} \quad a_t = a_{t-1} + k_t^{-1} (z_t - (a_{t-1} + b s_{t-1})) \quad (\text{A.5})$$

$$\text{Anchoring function:} \quad k_t = k_{t-1} + \mathbf{g}(f e_{t-1}^2) \quad (\text{A.6})$$

$$\text{Forecast error:} \quad f e_{t-1} = z_t - (a_{t-1} + b s_{t-1}) \quad (\text{A.7})$$

$$\text{LH expectations:} \quad f_a(t) = \frac{1}{1-\alpha\beta} a_{t-1} + b(\mathbb{I}_{nx} - \alpha\beta h)^{-1} s_t \quad f_b(t) = \frac{1}{1-\beta} a_{t-1} + b(\mathbb{I}_{nx} - \beta h)^{-1} s_t \quad (\text{A.8})$$

This notation captures vector learning (z learned) for intercept only. For scalar learning, $a_t = (\bar{\pi}_t \ 0 \ 0)'$ and b_1 designates the first row of b . The observables (π, x) are determined as:

$$x_t = -\sigma i_t + \begin{bmatrix} \sigma & 1-\beta & -\sigma\beta \end{bmatrix} f_b + \sigma \begin{bmatrix} 1 & 0 & 0 \end{bmatrix} (\mathbb{I}_{nx} - \beta h_x)^{-1} s_t \quad (\text{A.9})$$

$$\pi_t = \kappa x_t + \begin{bmatrix} (1-\alpha)\beta & \kappa\alpha\beta & 0 \end{bmatrix} f_a + \begin{bmatrix} 0 & 0 & 1 \end{bmatrix} (\mathbb{I}_{nx} - \alpha\beta h_x)^{-1} s_t \quad (\text{A.10})$$

B Target criterion

The target criterion in the simplified model (scalar learning of inflation intercept only, $k_t^{-1} = \mathbf{g}(f e_{t-1})$):

$$\pi_t = -\frac{\lambda_x}{\kappa} \left\{ x_t - \frac{(1-\alpha)\beta}{1-\alpha\beta} \left(k_t^{-1} + ((\pi_t - \bar{\pi}_{t-1} - b_1 s_{t-1})) \mathbf{g}_\pi(t) \right) \right. \\ \left. \left(\mathbb{E}_t \sum_{i=1}^{\infty} x_{t+i} \prod_{j=0}^{i-1} (1 - k_{t+1+j}^{-1} - (\pi_{t+1+j} - \bar{\pi}_{t+j} - b_1 s_{t+j}) \mathbf{g}_{\bar{\pi}}(t+j)) \right) \right\} \quad (\text{B.1})$$

where I'm using the notation that $\prod_{j=0}^0 \equiv 1$. For interpretation purposes, let me rewrite this as follows:

$$\pi_t = -\frac{\lambda_x}{\kappa} x_t + \frac{\lambda_x}{\kappa} \frac{(1-\alpha)\beta}{1-\alpha\beta} \left(k_t^{-1} + f e_{t|t-1}^{eve} \mathbf{g}_\pi(t) \right) \mathbb{E}_t \sum_{i=1}^{\infty} x_{t+i} \\ - \frac{\lambda_x}{\kappa} \frac{(1-\alpha)\beta}{1-\alpha\beta} \left(k_t^{-1} + f e_{t|t-1}^{eve} \mathbf{g}_\pi(t) \right) \left(\mathbb{E}_t \sum_{i=1}^{\infty} x_{t+i} \prod_{j=0}^{i-1} (k_{t+1+j}^{-1} + f e_{t+1+j|t+j}^{eve} \mathbf{g}_{\bar{\pi}}(t+j)) \right) \quad (\text{B.2})$$

Interpretation: **tradeoffs from discretion in RE** + **effect of current level and change of the gain on future tradeoffs** + **effect of future expected levels and changes of the gain on future tradeoffs**

C A target criterion system for an anchoring function specified for gain changes

$$k_t = k_{t-1} + \mathbf{g}(fe_{t|t-1}) \quad (\text{C.1})$$

Turns out the k_{t-1} adds one $\varphi_{6,t+1}$ too many which makes the target criterion unwieldy. The FOCs of the Ramsey problem are

$$2\pi_t + 2\frac{\lambda}{\kappa}x_t - k_t^{-1}\varphi_{5,t} - \mathbf{g}_\pi(t)\varphi_{6,t} = 0 \quad (\text{C.2})$$

$$cx_{t+1} + \varphi_{5,t} - (1 - k_t^{-1})\varphi_{5,t+1} + \mathbf{g}_{\bar{\pi}}(t)\varphi_{6,t+1} = 0 \quad (\text{C.3})$$

$$\varphi_{6,t} + \varphi_{6,t+1} = fe_t\varphi_{5,t} \quad (\text{C.4})$$

where the red multiplier is the new element vis-a-vis the case where the anchoring function is specified in levels ($k_t^{-1} = \mathbf{g}(fe_{t-1})$), as in App. B), and I'm using the shorthand notation

$$c = -\frac{2(1-\alpha)\beta}{1-\alpha\beta} \frac{\lambda}{\kappa} \quad (\text{C.5})$$

$$fe_t = \pi_t - \bar{\pi}_{t-1} - bs_{t-1} \quad (\text{C.6})$$

(C.2) says that in anchoring, the discretion tradeoff is complemented with tradeoffs coming from learning ($\varphi_{5,t}$), which are more binding when expectations are unanchored (k_t^{-1} high). Moreover, the change in the anchoring of expectations imposes an additional constraint ($\varphi_{6,t}$), which is more strongly binding if the gain responds strongly to inflation ($\mathbf{g}_\pi(t)$). One can simplify this three-equation-system to:

$$\varphi_{6,t} = -cfe_tx_{t+1} + \left(1 + \frac{fe_t}{fe_{t+1}}(1 - k_{t+1}^{-1}) - fe_t\mathbf{g}_{\bar{\pi}}(t)\right)\varphi_{6,t+1} - \frac{fe_t}{fe_{t+1}}(1 - k_{t+1}^{-1})\varphi_{6,t+2} \quad (\text{C.7})$$

$$0 = 2\pi_t + 2\frac{\lambda}{\kappa}x_t - \left(\frac{k_t^{-1}}{fe_t} + \mathbf{g}_\pi(t)\right)\varphi_{6,t} + \frac{k_t^{-1}}{fe_t}\varphi_{6,t+1} \quad (\text{C.8})$$

Unfortunately, I haven't been able to solve (C.7) for $\varphi_{6,t}$ and therefore I can't express the target criterion so nicely as before. The only thing I can say is to direct the targeting rule-following central bank to compute $\varphi_{6,t}$ as the solution to (C.8), and then evaluate (C.7) as a target criterion. The solution to (C.8) is given by:

$$\varphi_{6,t} = -2\mathbb{E}_t \sum_{i=0}^{\infty} \left(\pi_{t+i} + \frac{\lambda_x}{\kappa}x_{t+i}\right) \prod_{j=0}^{i-1} \frac{\frac{k_{t+j}^{-1}}{fe_{t+j}}}{\frac{k_{t+j}^{-1}}{fe_{t+j}} + \mathbf{g}_\pi(t+j)} \quad (\text{C.9})$$

Interpretation: the anchoring constraint is not binding ($\varphi_{6,t} = 0$) if the CB always hits the target ($\pi_{t+i} + \frac{\lambda_x}{\kappa}x_{t+i} = 0 \quad \forall i$); or expectations are always anchored ($k_{t+j}^{-1} = 0 \quad \forall j$).