Materials 26 - Implementation of target criterion - Documentation of code

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1 Summary of codes

Two main simulation codes:

1. `sim_learnLH_clean.m`: simulate model

   $\hookrightarrow$ uses `ALM.m`: if the LOM (equation A.1-A.3) of observables is written

$$\underbrace{\begin{pmatrix} 0 & 1 & \sigma \\ 1 & -\kappa & 0 \\ -\psi_\pi & -\psi_x & 1 \end{pmatrix}}_{\equiv A} \underbrace{\begin{bmatrix} \pi_t \\ x_t \\ i_t \end{bmatrix}}_{\equiv y_t} = \underbrace{\begin{pmatrix} s_1 f_b + s_2 s_t \\ s_3 f_a + s_4 s_t \\ s_5 s_t \end{pmatrix}}_{\equiv B} \quad \text{where} \quad s_t = \begin{bmatrix} r_t^n \\ \bar{i}_t \\ u_t \end{bmatrix} \tag{1}$$

where s_i are generated by `smat.m` and are given by

$$s_1 = \begin{bmatrix} \sigma & 1-\beta & -\sigma\beta \end{bmatrix} \qquad s_2 = \sigma \begin{bmatrix} 1 & 0 & 0 \end{bmatrix} (\mathbb{I}_{nx} - \beta h_x)^{-1} \tag{2}$$

$$s_3 = \begin{bmatrix} (1-\alpha)\beta & \kappa\alpha\beta & 0 \end{bmatrix} \quad s_4 = \begin{bmatrix} 0 & 0 & 1 \end{bmatrix} (\mathbb{I}_{nx} - \beta h_x)^{-1} \tag{3}$$

$$s_5 = \begin{bmatrix} 0 & 0 & 0 \end{bmatrix} \text{ or if you include a mon pol shock } \begin{bmatrix} 0 & 1 & 0 \end{bmatrix} \tag{4}$$

`ALM.m` computes $y_t = A^{-1}B$.

Note: To impose that agents form interest-rate expectations according to the Taylor rule (which

I refer to agents "knowing the Taylor rule"), I replace s_1 in `smat.m` by

$$s_1^{old} = \begin{bmatrix} \sigma - \sigma\beta\psi_\pi & 1 - \beta - \sigma\beta\psi_x & 0 \end{bmatrix} \tag{5}$$

2. `sim_learnLH_clean_given_seq.m` simulate model given exogenous input sequence(s)

$\hookrightarrow$ uses `A9A10.m`: This code first determines how many sequences are input, and then uses equations A.9 and A.10 to compute the rest of the observables as

$$x_t = -\sigma i_t + s_1 f_b + s_2 s_t \tag{A9}$$

$$\pi_t = \kappa x_t + s_3 f_a + s_4 s_t \tag{A10}$$

where s_i are again computed by `smat.m`. Of course, you can again tell `smat.m` whether you want agents to know the Taylor rule or not.

A Model summary

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

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

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

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

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

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

$$\text{Forecast error:} \qquad fe_{t-1} = z_t - (a_{t-1} + b s_{t-1}) \tag{A.7}$$

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

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

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

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

B Target criterion

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

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

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

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

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

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

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

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

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

$$\varphi_{6,t} + \varphi_{6,t+1} = fe_t\varphi_{5,t} \tag{C.4}$$

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

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

$$fe_t = \pi_t - \bar{\pi}_{t-1} - bs_{t-1} \tag{C.6}$$

(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:

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

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

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:

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

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 ($k_{t+j}^{-1} = 0 \quad \forall j$).