

Robust Real Rate Rules

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Paper and slides available at <https://www.tholden.org/>.

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Motivation: Fragility of the Taylor principle

- The Taylor principle requires the response of nominal rates to inflation to be greater than one.
 - Sufficient for determinacy in simple models. (Guarantees no belief-driven fluctuations / sunspots.)
- Insufficient if there is e.g.:
 - A fraction of hand-to-mouth households (Gali, Lopez-Salido & Valles 2004).
 - Firm-specific capital (Sveen & Weinke 2005).
 - High government spending (Natvik 2009).
 - A positive inflation target (Ascari & Ropele 2009),
 - ...particularly with trend growth + sticky wages (Khan, Phaneuf & Victor 2019).
- Inverts if there are e.g.:
 - Enough hand-to-mouth households (Bilbiie 2008).
 - Certain financial frictions (Manea 2019).
 - Non-rational expectations (Branch & McGough 2010; 2018).
 - Active fiscal policy (Leeper & Leith 2016; Cochrane 2022).

This paper

- Monetary rules with a unit response to real rates guarantee determinate inflation under the weakest possible assumptions on the rest of the economy.
 - Robust to household heterogeneity, non-rational households/firms, active fiscal policy, missing transversality conditions, existence/slope of the Phillips curve, etc.
- With a time-varying inflation target: enable the determinate robust implementation of an arbitrary path for inflation.
 - So can match observed inflation dynamics, or any model's optimal policy.
- Easy to implement in practice. Use TIPS to infer real rates. Works with bonds of any maturity.
- Reveal: Fisher equation is key to monetary transmission.

A first example

- Nominal bond: \$1 bond purchased at t returns $$(1 + i_t)$ at $t + 1$.$
- Real bond (e.g., TIPS): \$1 bond purchased at t returns $$(1 + r_t + \pi_{t+1})$ at $t + 1$.$
- Arbitrage \Rightarrow the Fisher equation:

$$i_t = r_t + \mathbb{E}_t \pi_{t+1}$$

- Abstracting from inflation risk / term / liquidity premia for now.

- Central bank uses the “real rate rule”:

$$i_t = r_t + \phi \pi_t$$

- With $\phi > 1$. Then:

$$\mathbb{E}_t \pi_{t+1} = \phi \pi_t$$

- Unique non-explosive solution, $\pi_t = 0$. Determinate inflation!

Why is this robust? No need for Euler equation!

- Does not require an aggregate Euler equation to hold.
 - Robust to household heterogeneity and hand-to-mouth agents.
 - Robust to non-rational household expectations.
- For the Fisher equation to hold just need either:
 - Two deep pocketed, fully informed, rational agents in the economy, OR,
 - ...a large market of rational agents with dispersed information (Hellwig 1980; Lou et al. 2019).
- Much more plausible financial market participants have rational expectations than households.
 - Can even partially relax the rationality requirement for financial market participants.
 - E.g.: Global convergence under learning from arbitrary initial beliefs.

Why is this robust? No need for Phillips curve!

- Does not require an aggregate Phillips curve to hold.
 - Robust to slope of the Phillips curve (if it exists).
 - Robust to forward/backward looking degree of Phillips curve equation.
 - Robust to non-rational firm expectations.
- If CB is unconcerned with output and unemployment, they do not need to care about the Phillips curve or its slope.
 - Under this monetary rule, the Phillips curve is irrelevant for inflation dynamics.
 - The Phillips curve (if it exists) determines the output gap, given inflation.
- Only require that at least some prices are adjusted each period using current information.

Implications for monetary economics

- Which model features lead to amplification or dampening of monetary shocks?
- Under a real rate rule: no change in the model can amplify/dampen monetary shocks other than changing rule.
 - Prior amplification/dampening results were sensitive to the monetary rule. May reverse with a response to r_t of > 1 .
- Which shocks drive inflation?
- Under a real rate rule: only monetary policy shocks or shocks to the Fisher equation.
- CB has ultimate responsibility for inflation.

Real rate rules elsewhere in the literature

- Papers with rules responding to real rates, for analytic convenience e.g.:
 - Adão, Correia & Teles (2011), Holden (2019), Lubik, Matthes & Mertens (2019).
- Closest prior work: Cochrane (2017; 2018; 2022) on spread targeting.
 - Cochrane briefly considers a rule of the form $i_t = r_t + \phi\pi_t$ before setting $\phi = 0$.
 - Determinacy in Cochrane's world comes from the Fiscal Theory of the Price Level.
- Other related work:
 - Hetzel (1990) proposes using nominal bond, real bond spread to guide policy.
 - Dowd (1994) proposes targeting the price of price level futures contracts.
 - Hall & Reis (2016) propose making interest on reserves a function of price level deviations from target, e.g. nominal return from \$1 of $\$(1 + r_t) \frac{p_{t+1}}{p_t^*}$ or $\$(1 + i_t) \frac{p_t}{p_t^*}$.
- Large literature on rules tracking efficient (“natural”) real interest rate.
 - E.g., Cúrdia et al. (2015). Very different idea.

Generalizations and generality

Monetary policy shocks

- Suppose the CB uses the rule:

$$i_t = r_t + \phi\pi_t + \zeta_t$$

- with $\phi > 1$, and ζ_t drawn from an AR(1) process with persistence ρ .

- Then from the Fisher equation:

$$\mathbb{E}_t \pi_{t+1} = \phi\pi_t + \zeta_t \quad \Rightarrow \quad \pi_t = -\frac{1}{\phi - \rho} \zeta_t.$$

- Contractionary (positive) monetary policy shocks reduce inflation.
- If the CB is more aggressive (ϕ is larger) inflation is less volatile.
- Can understand inflation dynamics without knowing the rest of the economy.

Explaining observed inflation dynamics

- Large literature finds no role for the Phillips curve in forecasting inflation.
 - Post-1984: IMA(1,1) model beats Phillips curve based forecasts (conditionally & unconditionally) (Dotsey, Fujita & Stark 2018).
 - +: Atkeson & Ohanian (2001), Ang, Bekaert & Wei (2007), Stock & Watson (2009). One explanation: McLeay & Tenreyro (2019).
- Also: Miranda-Agrippino & Ricco (2021):
 - Contractionary monetary policy shock causes immediate fall in the price level.
 - Delayed impact on unemployment.
- All supportive of models in which causation in PC only runs in one direction: *from inflation to the output gap*.
 - As under a real rate rule!

Output dynamics in 3 equation NK model

- As before: CB sets $i_t = r_t + \phi\pi_t + \zeta_t$, so $\pi_t = -\frac{1}{\phi-\rho}\zeta_t$.

- Rest of model 1: Phillips curve (PC), with mark-up shock ω_t :

$$\pi_t = \beta\mathbb{E}_t\pi_{t+1} + \kappa x_t + \kappa\omega_t$$

- Rest of model 2: Discounted/compounded Euler equation (EE) (Bilbiie 2019), n_t exogenous natural rate ($\delta = 1$, $\varsigma =$ EIS recovers standard Euler equation):

$$x_t = \delta\mathbb{E}_tx_{t+1} - \varsigma(r_t - n_t)$$

- PC implies: $x_t = -\frac{1}{\kappa}\frac{1-\beta\rho}{\phi-\rho}\zeta_t - \omega_t$. x_t does not help forecast inflation as $\mathbb{E}_t\pi_{t+1} = \rho\pi_t$.

- Once you know π_t , there is no extra useful information in x_t .

Real rate dynamics in 3 equation NK model

- In the model of the last slide, if ω_t is IID, EE implies:

$$r_t = n_t + \frac{1}{\varsigma} \left[\frac{1}{\kappa} \frac{(1 - \beta\rho)(1 - \delta\rho)}{\phi - \rho} \zeta_t + \omega_t \right]$$

- Derived without solving EE forward!
 - Implies degree of discounting/compounding (δ) has no impact on determinacy.
 - Also implies robustness to missing transversality conditions.
 - Contrasts with Bilbiie (2019): if $\varsigma > 0$, $\beta \leq 1$, with a standard Taylor rule, $\phi > 1$ is only sufficient for determinacy if $\delta \leq 1$.
 - Contrasts with Bilbiie (2008): if $\delta = 1$, $\varsigma < 0$, with a standard Taylor rule, $\phi > 1$ is neither necessary nor sufficient for determinacy.
- Under real rate rule, $\phi > 1$ is always necessary and sufficient! (Given $\phi \geq 0$.)
 - Robust to lags in EE and PC. (PC lag may reduce persistence of effect of monetary shocks on x_t !)

Responding to other endogenous variables

- In the model:

$$i_t = r_t + \phi_\pi \pi_t + \phi_x x_t + \zeta_t$$

$$\pi_t = \tilde{\beta}(1 - \varrho_\pi) \mathbb{E}_t \pi_{t+1} + \tilde{\beta} \varrho_\pi \pi_{t-1} + \kappa x_t + \kappa \omega_t, \quad x_t = \tilde{\delta}(1 - \varrho_x) \mathbb{E}_t x_{t+1} + \tilde{\delta} \varrho_x x_{t-1} - \varsigma(r_t - n_t)$$

- If $\kappa > 0$, $\phi_x \geq 0$ and $\tilde{\beta} \in [0,1]$, then $\phi_\pi > 1$ is sufficient for determinacy!
- Real rate rule still helps robustness as it disconnects EE from prices.
- In any model: $\phi_\pi > 1$ sufficient for determinacy if responses to other endogenous variables are small enough.
 - Implies robustness to non-unit responses to real rates. Other variables (e.g., output growth) may proxy real rates.
- For greater robustness: Replace other endogenous vars in rule with structural shocks.
 - If structural shocks not observed, can infer from structural equations.
 - If equation parameters not known, can learn in real time, still with determinacy!

Implementing arbitrary inflation dynamics

- Suppose CB uses the rule:

$$i_t = r_t + \mathbb{E}_t \pi_{t+1}^* + \phi(\pi_t - \pi_t^*)$$

- π_t^* : an arbitrary stochastic process, possibly a function of economy's other endogenous variables and shocks.
- From the Fisher equation: $\mathbb{E}_t(\pi_{t+1} - \pi_{t+1}^*) = \phi(\pi_t - \pi_t^*)$. With $\phi > 1$, unique, determinate solution: $\pi_t = \pi_t^*$.
- The CB can hit an arbitrary path for inflation!
 - E.g., optimal policy. So real rate rules can attain highest possible welfare.
 - And real rate rules can explain any observed inflation dynamics.
- Related literature on implementation of optimal policy:
 - Svensson & Woodford (2003), Dotsey & Hornstein (2006), Evans & Honkapohja (2006), Evans & McGough (2010).

Interest rate smoothing

- A fully smoothed real rate rule with time-varying target:

$$i_t - r_t = i_{t-1} - r_{t-1} + \mathbb{E}_t \pi_{t+1}^* - \mathbb{E}_{t-1} \pi_t^* + \theta(\pi_t - \pi_t^*)$$

- From the Fisher equation:

$$\theta(\pi_t - \pi_t^*) = \mathbb{E}_t(\pi_{t+1} - \pi_{t+1}^*) - \mathbb{E}_{t-1}(\pi_t - \pi_t^*).$$

- Define: $p_t := \sum_{s=1}^t (\pi_s - \pi_s^*)$ and $\hat{p}_t := p_t + \frac{1}{\theta} \mathbb{E}_0 p_1$. Then summing over time gives:

$$(1 + \theta)\hat{p}_t = \mathbb{E}_t \hat{p}_{t+1}$$

- With $\theta > 0$: Unique equilibrium $\hat{p}_t = 0$, so $\pi_t = \pi_t^*$.

- Produces the same π_t as unsmoothed rule.

- Difference: Only need $\theta > 0$, not $\phi > 1$.

- Likely much easier for CB to convince agents of the former than of the latter.

Challenges to real rate rules

Real rate rules in non-linear models

- Nominal and real bond pricing:

$$I_t \mathbb{E}_t \frac{\Xi_{t+1}}{\Pi_{t+1}} = 1, \quad R_t \mathbb{E}_t \Xi_{t+1} = 1$$

- Non-linear real rate rule:

$$I_t = R_t \Pi^* \left(\frac{\Pi_t}{\Pi^*} \right)^\phi$$

- So:

$$\mathbb{E}_t \frac{\Xi_{t+1}}{\mathbb{E}_t \Xi_{t+1}} \frac{\Pi^*}{\Pi_{t+1}} = \left(\frac{\Pi^*}{\Pi_t} \right)^\phi$$

- $\Pi_t = \Pi^*$ is always one solution of this equation! Always locally unique.
- (Approximately) Globally unique under weak assumptions:
 - There exists $\bar{Z} \geq 1$ such that for all sufficiently high ϕ , $1 \leq \frac{\Pi}{\Pi_t} \leq \bar{Z}^{\frac{1}{\phi-1}} \rightarrow 1$ as $\phi \rightarrow \infty$. So, for large ϕ , $\Pi_t \approx \Pi^*$.
 - Under slightly stronger restrictions on the SDF, $\Pi_t = \Pi$ is globally unique solution for all sufficiently high ϕ .

Wedges in the Fisher equation

- Many potential sources of a Fisher equation wedge:
 - Liquidity premia on nominal bonds (Fleckenstein, Longstaff & Lustig 2014). Deflation protection on real bonds.
 - Risk premia (already considered). Non-rational expectations. Etc.

- Generalized Fisher equation (ν_t : stationary endogenous wedge):

$$i_t = r_t + \mathbb{E}_t \pi_{t+1} + \nu_t$$

- Assume: Exist $\bar{\mu}_0, \bar{\mu}_1, \bar{\mu}_2, \bar{\gamma}_0, \bar{\gamma}_1, \bar{\gamma}_2 \geq 0$ such that for any stationary solution for π_t :

$$|\mathbb{E} \nu_t| \leq \bar{\mu}_0 + \bar{\mu}_1 |\mathbb{E} \pi_t| + \bar{\mu}_2 \text{Var } \pi_t, \quad \text{Var } \nu_t \leq \bar{\gamma}_0 + \bar{\gamma}_1 |\mathbb{E} \pi_t| + \bar{\gamma}_2 \text{Var } \pi_t$$

- Then under a real rate rule: $|\mathbb{E} \pi_t| = O\left(\frac{1}{\phi}\right)$ and $\text{Var } \pi_t = O\left(\frac{1}{\phi^2}\right)$ as $\phi \rightarrow \infty$. Wedges are not a problem with large ϕ !
- If liquidity premia are the main distortion, may be better for CB to intervene in inflation swap market.

Fiscal Theory of the Price Level and “over determinacy”

- If price level is determinate independent of MP, then $\phi > 1$ can mean explosive π_t .
 - E.g., true if fiscal policy is active (real surpluses do not respond to debt).
 - With one period debt, active fiscal policy & flexible prices: $\pi_t - \mathbb{E}_{t-1}\pi_t = -\varepsilon_{s,t}$.
 - Inconsistent with standard real rate rule solution: $\pi_t = -\frac{1}{\phi}\varepsilon_{\zeta,t}$ (IID monetary shock) as long as $\varepsilon_{\zeta,t} \neq \phi\varepsilon_{s,t}$.
 - Only explosive solution remains under real rate rule: $\pi_t = \phi\pi_{t-1} + \varepsilon_{\zeta,t-1} - \varepsilon_{s,t}$.
- This is a knife edge result! With multi-period (geometric coupon) debt: stable π_t solution under a real rate rule.
 - Still consistent with transversality even with active fiscal, active monetary!
 - \uparrow bubble in debt price balanced by \downarrow quantity. Initial debt price jumps. “Fiscal theory of the debt price”.
 - With passive MP this implies multiplicity, so FTPL does not guarantee uniqueness.
- General result: Always a stable solution under a real rate rule if plausible condition satisfied:
 - Potentially explosive variables (e.g., bond prices) must not feed back to the real economy, and are not too forward looking.

Setting nominal rates out of equilibrium

- Apparent issue: If for $t > 0$, $i_t = r_t + \phi\pi_t$, then $\pi_t = 0$ for $t > 0$, so by Fisher $i_0 = r_0$. CB cannot set $i_0 \neq r_0$!
- Resolution: $\pi_t = 0$ iff $\pi_s = 0$ for all $s \in \{0, 1, \dots, t-1\}$, else $\pi_t = \phi\pi_{t-1}$. If $\pi_0 \neq 0$, Fisher states $i_0 - r_0 = \phi\pi_0$.
- May reappear under bounded rationality. Suppose agents have learned $\pi_t = 0$, then $i_t = r_t$ even out of equilibrium.
- One fix: Modified real rate rule:

$$i_t = r_t + \phi\pi_t + \psi\pi_{t-1}$$

- ψ small. Determinate if $\phi > |1 - \psi|$. Solution: $\pi_t = \varrho\pi_{t-1}$, where $\varrho = \frac{\phi - \sqrt{\phi^2 + 4\psi}}{2} \in (-1, 1)$. Agents learn $\pi_t \approx \varrho\pi_{t-1}$.
- Alternative fix: Price level real rate rule rules.

Practical implementation of real rate rules

Practical implementation: Set-up

- Markets in short maturity TIPS may be illiquid, unavailable or unreliable. So, use longer maturity bonds.
 - But: Long maturities may have substantial risk/term/liquidity premia.
 - Extra complications: Inflation may be observed with a lag. 1 month for US CPI. TIPS may have indexation lag. 3 months in US.
- Notation:
 - S : information lag. Market participants use the $t - S$ information set in period t .
 - L : indexation lag in return of inflation protected bonds.
 - $i_{t|t-S}$: nominal yield per period on a T -period nominal bond at t .
 - $r_{t|t-S}$: real yield per period on a T -period inflation protected bond at t .
 - $\nu_{t|t-S}$ Fisher equation wedge (risk premia etc.) for T -period nominal bonds relative to T -period real bonds at t .
 - $\bar{\nu}_{t|t-S}$ central bank's period t belief about level of $\nu_{t|t-S}$ (possibly correlated with $\nu_{t|t-S}$).

Practical implementation: Fisher equation and rule

- Fisher equation (need $T - L \geq 0$):

$$i_{t|t-S} - r_{t|t-S} = v_{t|t-S} + \mathbb{E}_{t-S} \frac{1}{T} \sum_{k=1}^T \pi_{t+k-L}$$

- Monetary rule:

$$i_{t|t-S} - r_{t|t-S} = \bar{v}_{t|t-S} + \mathbb{E}_{t-S} \frac{1}{T} \sum_{k=1}^T \pi_{t+k-L}^* + \phi(\pi_{t-S} - \pi_{t-S}^*)$$

- Combining implies:

$$\mathbb{E}_t \frac{1}{T} \sum_{k=1}^T (\pi_{t+k+S-L} - \pi_{t+k+S-L}^*) + (v_{t+S|t} - \bar{v}_{t+S|t}) = \phi(\pi_t - \pi_t^*)$$

- Solution (A_j unique for $\phi > 1$):

$$\pi_t = \pi_t^* + \mathbb{E}_t \sum_{j=-\infty}^{\infty} A_j (v_{t+j+S|t+j} - \bar{v}_{t+j+S|t+j})$$

Practical implementation: Discussion

- CB's inflation error $\pi_t - \pi_t^*$ is stationary as long as $\nu_{t+S|t} - \bar{\nu}_{t+S|t}$ is stationary.
- If ϕ is large enough, $\pi_t \approx \pi_t^*$ (under the same assumptions as in previous discussion of Fisher wedges).
- If aggressive enough, endogenous wedges, indexation & information lags do not matter!
- Note: CB's trading desk should hold $i_t - r_t$ constant between meetings.
 - This requires i_t to move between meetings, in response to observed changes in r_t .
 - No reason this should be significantly harder than holding i_t fixed.
- CB could also offer to exchange \$1 face value of real debt for $\$(1 + i_t - r_t)$ face value of nominal, as proposed by Cochrane (2017; 2018).
- Or to buy/sell portfolios with +\$1 nominal debt, -\$1 real debt for $\$(i_t - r_t)$.
- Or trade inflation swaps (which pay $\Pi_{t+1} - K_t$ at $t + 1$, with no payments at t).

The zero lower bound

Problems caused by the ZLB

- With the ZLB, simplest real rate rule means:

$$\max\{0, r_t + \phi\pi_t\} = i_t = r_t + \mathbb{E}_t\pi_{t+1}$$

- So:

$$\mathbb{E}_t\pi_{t+1} = \max\{-r_t, \phi\pi_t\}$$

- Real rates no longer cancel out completely! Euler equation still matters for π_t .
- Extra steady state with $\pi = -r$ (Benhabib, Schmitt-Grohé & Uribe 2001).
- Still multiplicity and/or non-existence conditional on convergence to the standard steady state (Holden 2021).
 - E.g., suppose r_t exogenous, $r_t = 0$ for $t \neq 1$, and we assume that $\pi_t \rightarrow 0$ as $t \rightarrow \infty$.
 - Multiple solutions if $r_1 = 0$. No solution if $r_1 < 0$. General problem in NK models.

Modified inflation targets

- Non-existence comes from implicitly targeting an infeasibly low level of inflation.

- Easy to fix. Use the rule:

$$i_t = \max\{0, r_t + \mathbb{E}_t \tilde{\pi}_{t+1}^* + \phi(\pi_t - \tilde{\pi}_t^*)\}, \quad \tilde{\pi}_t^* := \max\{-r_{t-1} + \epsilon, \pi_t^*\}$$

- π_t^* is the original inflation target. $\tilde{\pi}_t^*$ is the modified target. $\epsilon > 0$ is a small constant.

- With modified rule: $\pi_t = \tilde{\pi}_t^*$ for all t is an equilibrium. Locally determinate.

- Closed form solution (rare with ZLB!) makes coordination easy.
- No deflationary bias as $\pi_t > -r_{t-1}$. Instead: small inflationary bias as $\mathbb{E}\pi_t \geq \mathbb{E}\pi_t^*$.

- Solution is unique conditional on $\tilde{\pi}_t^*$ and on a terminal condition ruling out explosions or permanent ZLB traps.

- Multiple solutions for $\tilde{\pi}_t^*$ do not occur for standard NK models.

Equilibrium selection with perpetuities: Idea

- Cochrane (2011) argues no reason to rule out explosive NK equilibria.
- Suppose geometric coupon bonds (GCBs) are traded in the economy. (Later specialise to perpetuities.)
 - Could be approximated by portfolio of different maturity debt. Long-term government contracts (defence,...) also perpetuity like.
- 1 unit of period t GCB bought at t returns \$1 at $t + 1$, along with $\omega \in (0,1]$ units of period $t + 1$ GCB.
 - Suppose stock: $B_t \geq \underline{B}\omega^t$. Then transversality implies GCB price: $Q_t = \mathbb{E}_t \sum_{s=0}^{\infty} \left[\prod_{k=0}^s \frac{1}{I_{t+k}} \right] \omega^s$.
 - If $I_{t+k} = 1$ for high k , then $Q_{t+k} = \frac{1}{1-\omega}$ for high k . Transversality then requires $0 = \lim_{s \rightarrow \infty} \frac{\omega^s}{1-\omega}$, i.e., $|\omega| < 1$. Violated with $\omega = 1$!
- Permanent ZLB \Rightarrow Infinite perpetuity price \Rightarrow Infinite nominal wealth \Rightarrow Infinite inflation \Rightarrow Physically impossible.

Equilibrium selection with perpetuities: Use

- With sticky prices, explosions are generally ruled out.
 - Standard sticky prices specifications imply Π_t is bounded above. + Real costs of inflation explode as inflation explodes.
 - Prices may become more flexible as $\Pi_t \uparrow$, but seems plausible there is a limit on how often prices can be changed.
- So, under sticky prices the previous rule produces uniqueness if households hold perpetuities.
- Non-linear version (with a target known one period in advance, $\mathcal{E} := \exp \epsilon > 1$):

$$I_t = \max \left\{ 1, R_t \tilde{\Pi}_t^* \left(\frac{\Pi_t}{\tilde{\Pi}_{t-1}^*} \right)^\phi \right\}, \quad \tilde{\Pi}_t^* := \max \left\{ \frac{\mathcal{E}}{R_t}, \Pi_t^* \right\}$$

- Without sticky prices, have to send deviations to the ZLB. E.g., with following ($\bar{I} > 1$, $\phi > 1$ and $\mathcal{E} \in (1, \sqrt{\bar{I}})$):

$$I_t = \begin{cases} \max \left\{ 1, R_t \tilde{\Pi}_t^* \left(\frac{\Pi_t}{\tilde{\Pi}_{t-1}^*} \right)^\phi \right\}, & \text{if } I_{t-1} \in (1, \bar{I}), \\ 1, & \text{otherwise} \end{cases}, \quad \tilde{\Pi}_t^* := \max \left\{ \frac{\mathcal{E}}{R_t}, \min \left\{ \frac{\bar{I}}{\mathcal{E} R_t}, \Pi_t^* \right\} \right\}$$

Conclusion

- The Taylor principle does not guarantee determinacy with standard monetary rules.
- Real rate rules ensure determinacy no matter the rest of the economy & give CB almost perfect control of inflation.
- They can be easily implemented using pre-existing assets (nominal and real bonds, or inflation swaps).
- Under a real rate rule:
 - Monetary policy works in spite of, not because of, real rate movements.
 - Causation in the Phillips curve runs exclusively from inflation to the output gap.
 - Household and firm decisions, constraints and inflation expectations are irrelevant for inflation dynamics.
 - Only changes in the rule can amplify the impact of shocks on inflation.
- With a time-varying target, real rate rules can implement optimal monetary policy, or match observed dynamics.
- Real rate rules continue to work in the presence of the ZLB, wedges in the Fisher equation, or active fiscal policy.

Extra slides

Welfare

- Recap: Real rate rules can determinately implement an arbitrary path for inflation, including optimal policy. Automatic that they can attain high welfare!
- Makes sense to limit to “simple” real rate rules though.
 - “Simple” here means simple dynamics of targeted inflation.
 - Claim: Looking for optimal simple inflation dynamics is a useful approach to policy.
- Two exercises follow:
 - MA(0), MA(1) and ARMA(1,1) inflation policy in a simple NK model. Latter is sufficient to attain unconditional optimal.
 - Examination of optimal policy in the Justiniano, Primiceri & Tambalotti (2013) model. Multiple shock ARMA(1,2) inflation policy is very close to fully optimal.

A simple NK model for policy analysis

- Look at welfare in a simple model with the Phillips curve (ω_t IID):

$$\pi_t = \beta \mathbb{E}_t \pi_{t+1} + \kappa x_t + \kappa \omega_t$$

- And the policy objective to minimise:

$$(1 - \beta) \mathbb{E} \sum_{k=0}^{\infty} \beta^k (\pi_{t+k}^2 + \lambda x_{t+k}^2) = \mathbb{E} (\pi_t^2 + \lambda x_t^2)$$

- Equality under the constraint that policy must be time-invariant.

- Optimal policy must have an $\text{MA}(\infty)$ representation ($\theta_1, \theta_2, \dots$ TBD):

$$\pi_t = \kappa \sum_{k=0}^{\infty} \theta_k \omega_{t-k}$$

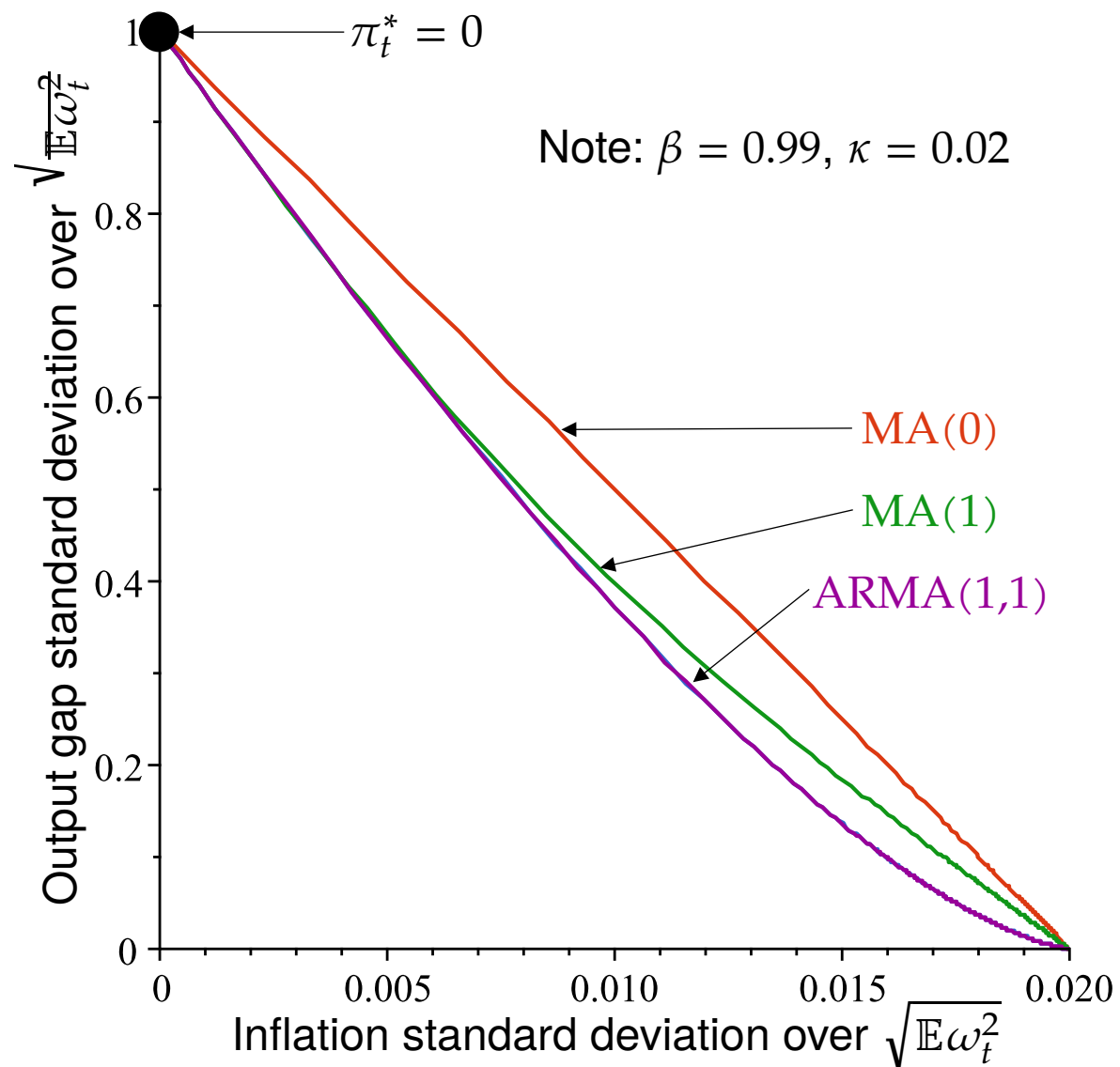
- Implies objective is:

$$\mathbb{E} (\pi_t^2 + \lambda x_t^2) = \mathbb{E} [\omega_t^2] \sum_{k=0}^{\infty} [\kappa^2 \theta_k^2 + \lambda (\theta_k - \beta \theta_{k+1} - \mathbb{1}[k=0])^2]$$

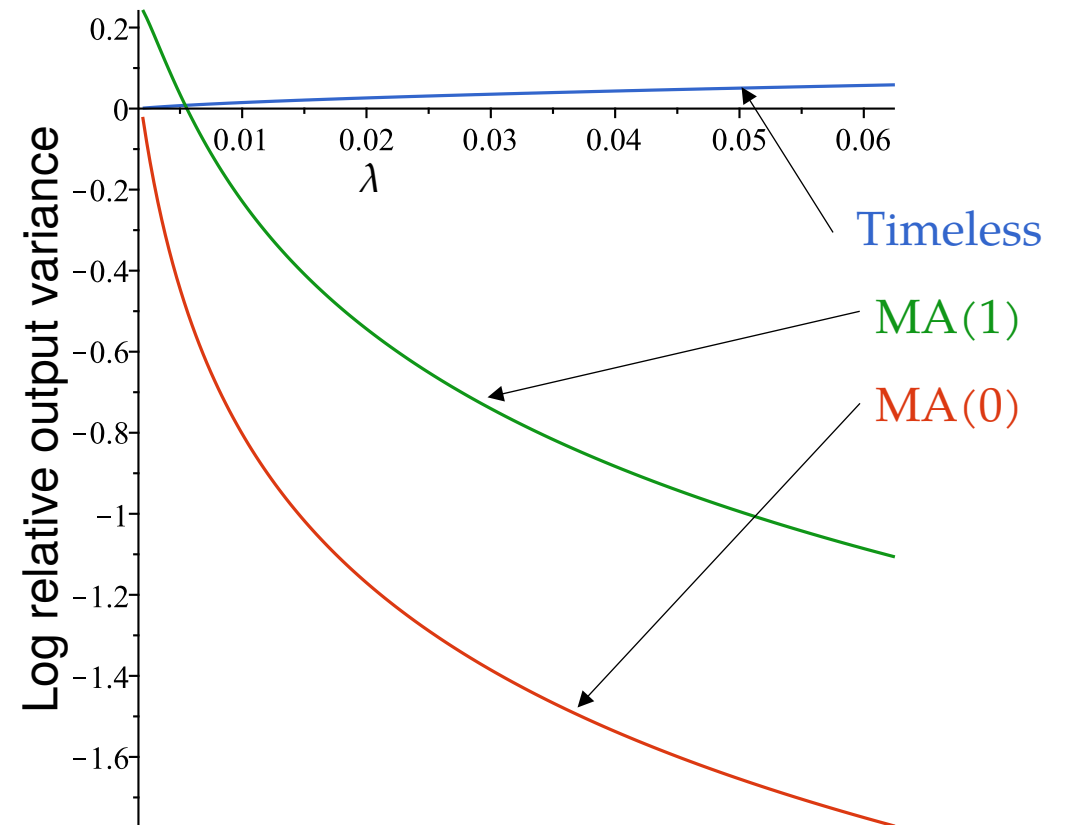
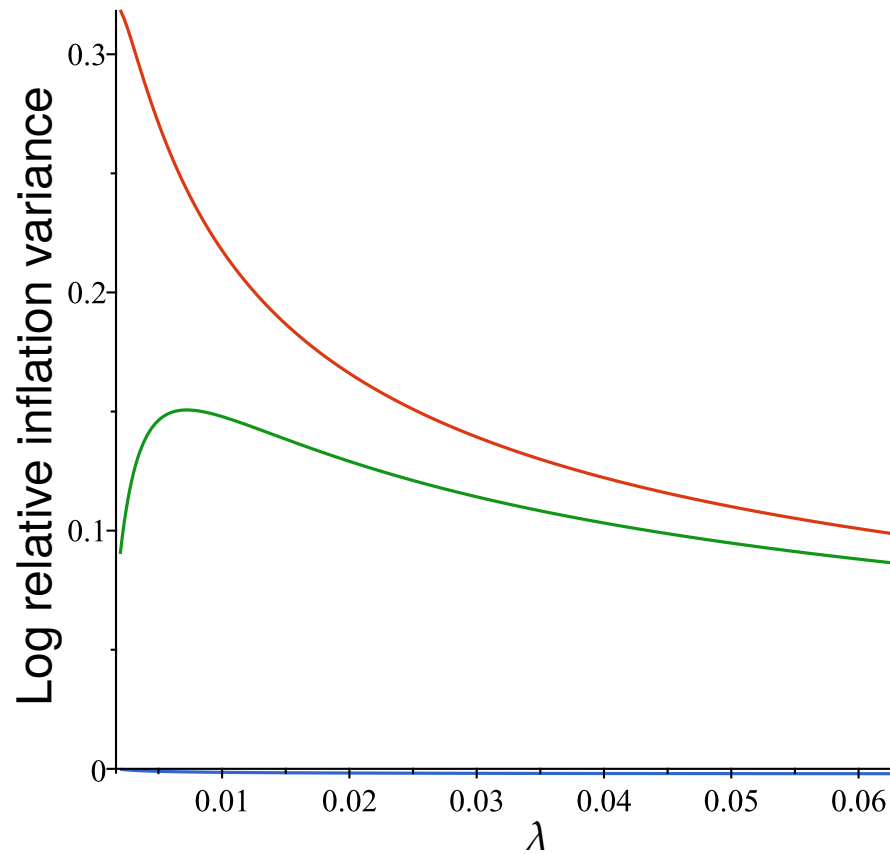
Welfare of real rate rules in a simple model

- Optimising subject to $\pi_t = \pi_t^*$ being MA(0) gives the discretionary optimum with $\pi_t = \kappa \frac{\lambda}{\lambda + \kappa^2} \omega_t$ and $\pi_t + \frac{\lambda}{\kappa} x_t = 0$.
- Optimising subject to $\pi_t = \pi_t^*$ being an MA(1) gives a solution with $\pi_t = \kappa \theta_0 \omega_t + \kappa \theta_1 \omega_{t-1}$ where $\theta_0 \geq 0$ and $\theta_1 \leq 0$.
 - Thus ω_t increases π_t while reducing $\mathbb{E}_t \pi_{t+1}$, lessening output gap movements.
- Optimising subject to $\pi_t = \pi_t^*$ being an ARMA(1,1) give the unconditionally optimal solution from the prior literature (e.g. Damjanovic, Damjanovic & Nolan (2008)) with $\pi_t + \frac{\lambda}{\kappa} (x_t - \beta x_{t-1}) = 0$.
 - Optimal MA coefficient equals $-\beta \approx -0.99$. Close to the IMA(1,1) processes estimated by Dotsey, Fujita & Stark (2018) for the post-1984 period.

Policy frontiers (varying λ)



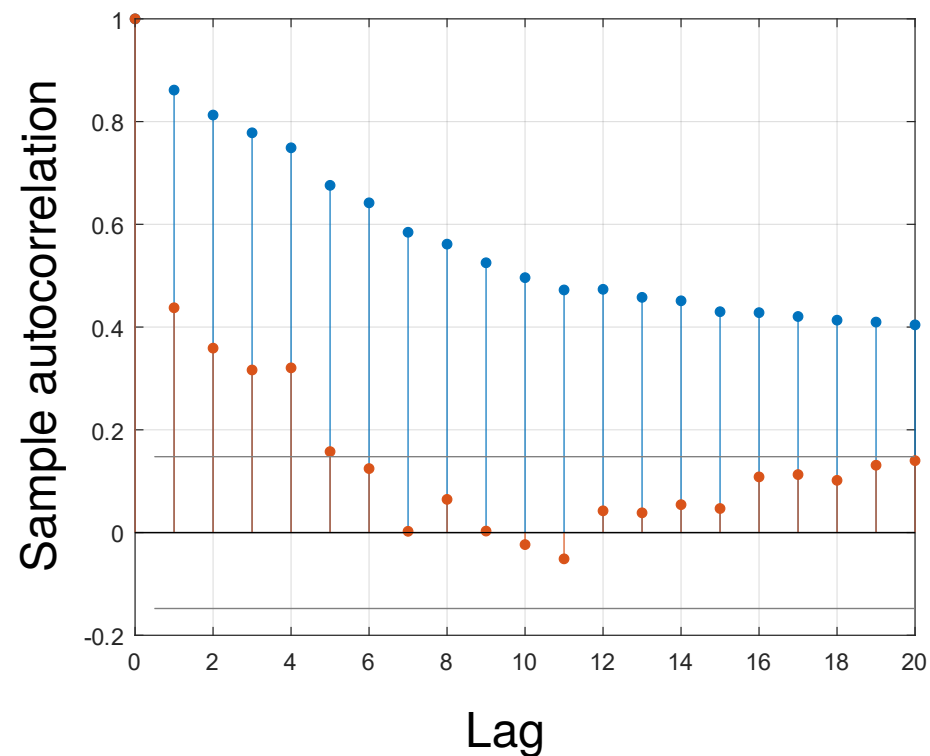
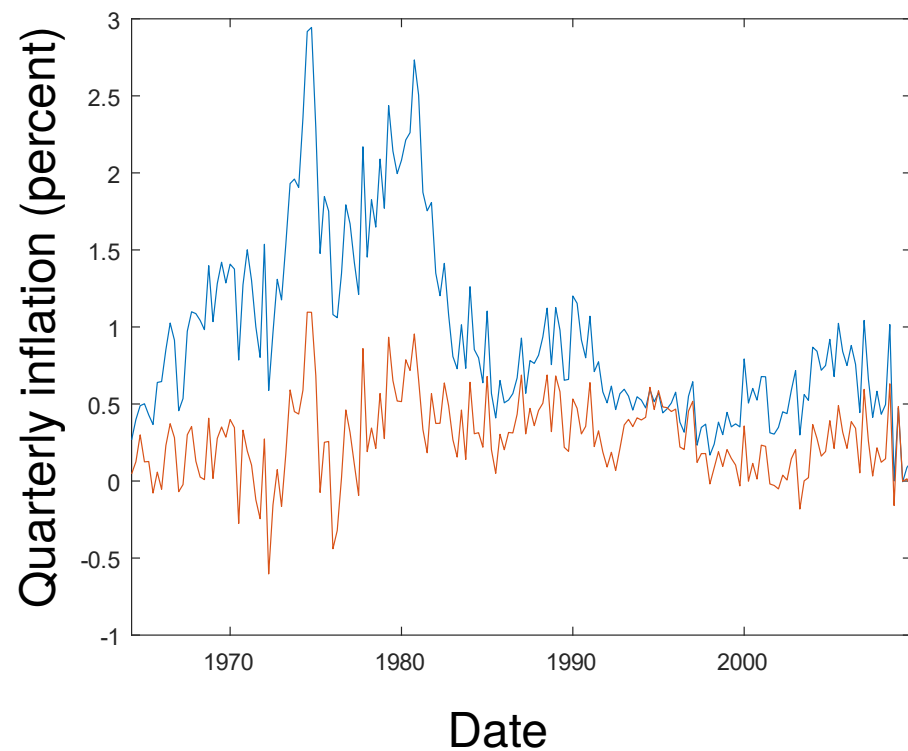
Log relative variances to ARMA(1,1) policy



Note: $\beta = 0.99$, $\kappa = 0.02$.

MA(0) and MA(1) policies generate too much inflation variance.

Optimal inflation dynamics in a richer model



Using the Justiniano, Primiceri & Tambalotti (2013) model and replication files.

Blue: actual US inflation dynamics.

Red: inflation dynamics under optimal policy and US historical shocks. Less persistent!

Simple approximation to optimal policy 1/2

- For any $\rho \in (-1,1)$, the solution for optimal inflation has a multiple shock, ARMA(1, ∞) representation:

$$\pi_t - \pi = \rho(\pi_{t-1} - \pi) + \sum_{k=0}^{\infty} \sum_{n=1}^N \theta_{n,k}^{(\rho)} \varepsilon_{n,t-k}$$

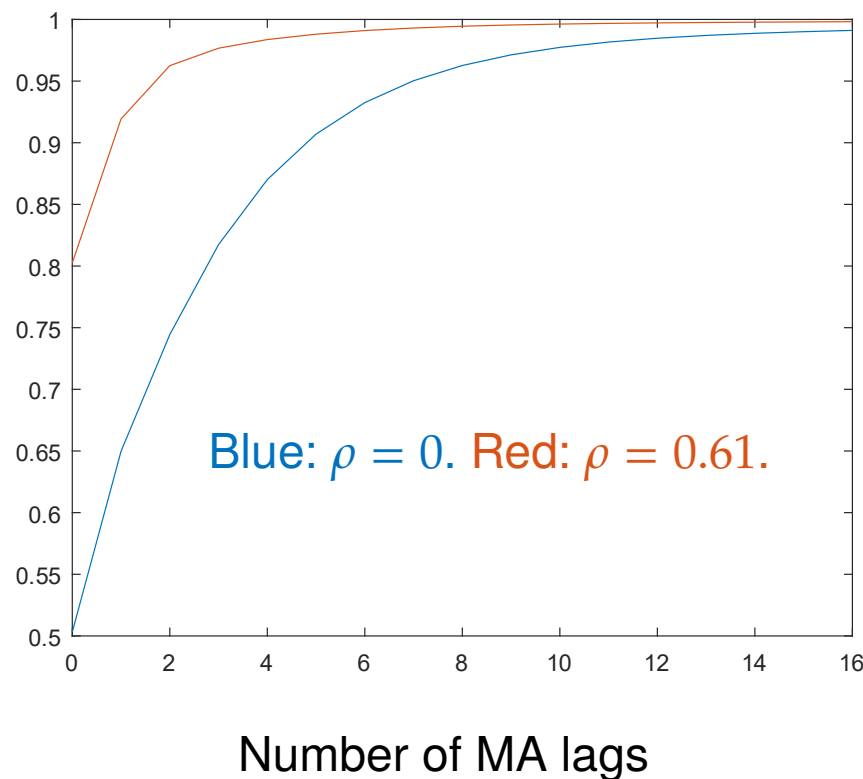
- $\varepsilon_{1,t}, \dots, \varepsilon_{N,t}$ are the model's structural shocks.

- Approximate by truncating MA terms at some point: E.g. multiple shock ARMA(1, K):

$$\pi_t^{(K)} - \pi = \rho(\pi_{t-1}^{(K)} - \pi) + \sum_{k=0}^K \sum_{n=1}^N \theta_{n,k}^{(\rho)} \varepsilon_{n,t-k}$$

- Henceforth: “multiple shock ARMA” = “MSARMA”.

Simple approximation to optimal policy 2/2



Proportion of the variance of optimal inflation in the Justiniano, Primiceri & Tambalotti (2013) model explained by truncating the number of MA lags.

MSARMA(1,1) explains $> 90\%$ of optimal inflation variance, MSARMA(1,2) $> 95\%$!

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