

Central Bank Information or Neo-Fisher Effect?

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Disclaimer: The views expressed herein are mine and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System

Outline

- ▷ Context and summary
- ▷ Identification
- ▷ Some thoughts on optimal monetary policy
- ▷ Conclusion

Summary

- Huge literature on monetary policy shocks and their impact on the economy
- This paper focuses on two types of shocks
 - Neo Fisherian (NF) shocks
 - Central Bank Information (CBI) shocks
- These shocks share the feature that increases in the policy rate don't lower (they might actually increase) economic activity and inflation

Strategy

- Write down a simple closed economy model with both shocks (and other standard shocks)
- Estimate the model (bayesian methods)
- Recover the contribution of each shock to key economic outcomes

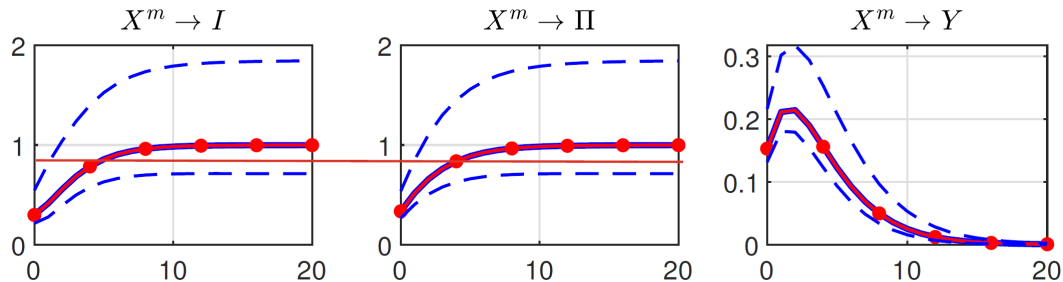
Neo Fisherian shocks

- ▷ Permanent shocks to the nominal interest rate, which engender a corresponding increase in the (de facto) inflation target

Central Bank Information shocks

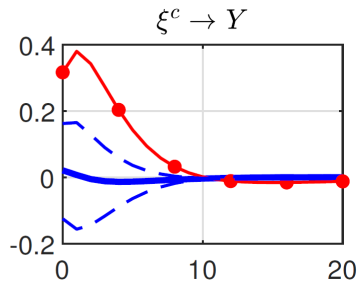
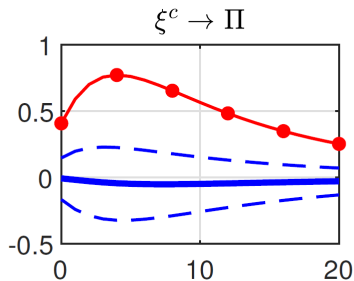
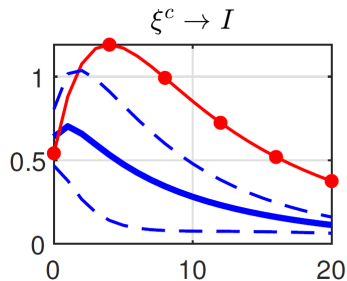
- Shock to current utility from consumption (and leisure), observed by CB
- CB is assumed to respond to it directly
- In a more general set-up CBI shocks are shocks to short run r^* observed by the CB

Impulse responses to a NF shock



- In response to a NF shock, inflation increase almost in lockstep
- On impact actually inflation increases more than nominal i as firms frontload price increase anticipating higher future inflation
- This implies modest decline in real i rate and so modest increase in output

Impulse responses to CBI shock



- In response to a CBI shock CB raises nominal rate immediately (blue line), increases in rates curbs demand, so inflation and output stable.
- Preference shock raise short run r^* and CB raise nominal rate to target it
- If CBI does not respond directly, inflation and output burst, which requires a much larger future responses in nominal rates (red circled lines)

Results

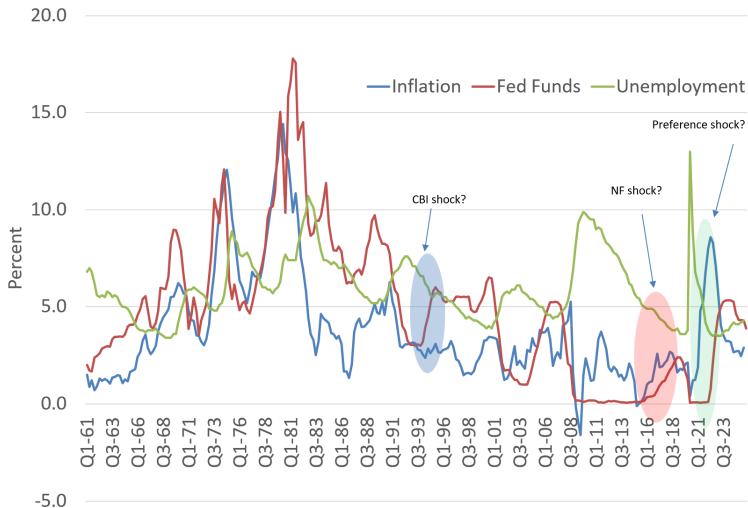
	ΔI	$\Delta \pi$	ΔY
NF shock	6	33	2
CBI shock, ξ^c	53	7	2
Preference shock, ξ^h	25	44	26
Perm. TFP shock	3	4	68

- NF shocks: drive significant fraction of inflation dynamics
- CBI shocks: drive significant part of nominal rate dynamics
- Preference shocks to which the CB does not respond (ξ^h): drive significant part of nominal rate, inflation and output dynamics
- Permanent productivity shocks: drive large fraction of output dynamics

Identification of shocks

- ▷ Bayesian estimation of macro models is a powerful tool
- ▷ However at times it feels black-boxy
- ▷ Which features of the US data drive the results?

Identification of shocks: my guess



▷ Periods in which raise in interest rates are followed by stable output and inflation call for CBI shock

▷ Periods in which inflation and nominal rates go in lock-step without much changes in output call for NF shocks

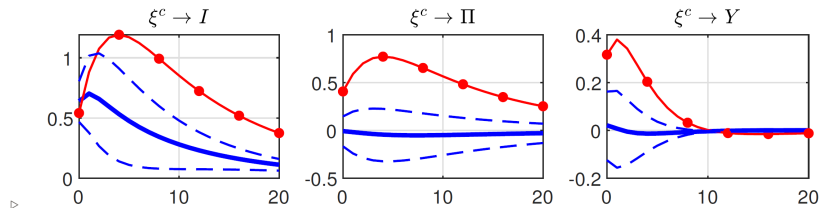
▷ Periods in which output and inflation increase are followed by rates increase call for preference shocks not responded to (ζ^h)

Identification of shocks: suggestion

- A very useful by-product of Bayesian estimation are the actual series for the shocks
- Plotting them along with data will make it much clearer which feature of the data call for what shock

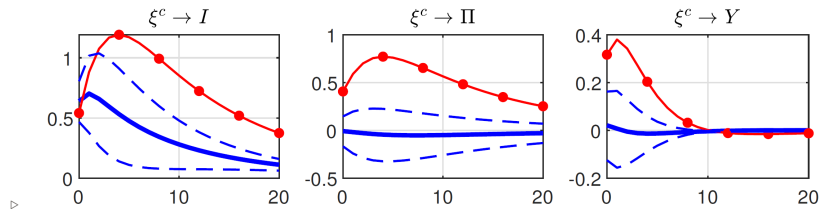
Demand Shocks, CBI and optimal monetary policy, 1

- ▷ Model includes two types of demand shocks ξ^c and ξ^h . CB responds to ξ^c directly, but not to ξ^h
- ▷ Two shocks have very different impacts on the economy
- ▷ ξ^c : interest rate up, fully stable inflation and output (because of CB response, blue lines)
- ▷ ξ^h : interest rates, inflation and output all up (because of CB lack of response, red lines)



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- ▷ Should the CB respond to preference shocks or not?

Demand Shocks, CBI and optimal monetary policy, 2

- Whether CB should respond or not depends on details of the model
- In the set-up of the paper CB should respond to all preference shocks. Why?
- In the flex price equilibrium allocations are independent of preference shocks, preference shocks only change real rates
- When preference shocks hit monetary policy increases real rate so that allocations are unchanged (and sticky price equilibrium mimic flex price)

Demand Shocks, CBI and optimal monetary policy, 3

▷ Consider three (reasonable) modifications to the set-up

- ① Open economy
- ② Capital and investment
- ③ Preference shock involves utility of consumption and not of leisure

$$e^{\tilde{\zeta}} U(c, l) \text{ v/s } e^{\tilde{\zeta}} U(c) + U(l)$$

- ▷ In these cases preference shocks do change allocations (when $\tilde{\zeta} \uparrow$ efficient consumption $\uparrow$)
- ▷ not obvious that CB should always increase rate in response to preference shock
- ▷ In practice: was the COVID inflation a mistake, or was it needed to increase the production of goods at the time they were badly needed?

Conclusions

- Interesting and very policy relevant paper
- Informs policy makers on non conventional consequences of monetary policy
- Raises interesting issues on how monetary policy should respond to demand shocks