Looking Through Supply Shocks versus Controlling Inflation Expectations: Understanding the Central Bank Dilemma

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Summary

This paper: standard New Keynesian model except

- Prices adjust faster than wages in response to supply shocks. One period ahead wage and price setting.
  → Focus on cross-sectional interdependence of wages and prices.

- Agents follow level-k thinking
  → Attenuate general equilibrium (GE) effects in response to shocks.

Results:

- Optimal monetary policy looks through supply-driven inflation at first, then pivots.

- Strong monetary policy tightening can be compatible with a soft landing.

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Relax FI, keep RE
- Relax common knowledge of shocks
- Best suited for studying "normal" business cycles and "systematic" policy rules
- Morris and Shin (2002); Woodford (2003); Nimark (2008); Angeletos and Lian (2018)

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Relaxing either FI or RE
- Dampens the GE effects of shocks
- Optimal monetary policy should therefore take into account how agents form expectations

What is k intended to capture?
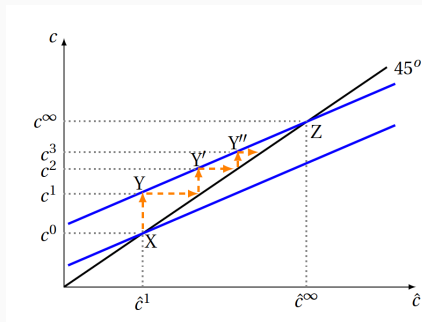
- Is k high or low in the current environment? What does it depend on?
- **Why is k important?** High k implies that a risky soft landing should be less of an issue.

Comment 2: Oil price shocks as productivity shocks

Traditional view, but

- Large fluctuations in real output difficult to square quantitatively with small cost share of oil in domestic output

- Not much empirical evidence for alternate transmission channels related to productivity (i.e., decline in capital stock)

- (Kim and Loungani, 1992; Backus and Crucini, 2000).

Alternate view: oil price shocks affect the economy primarily through consumer and firm expenditures

- Generates larger effects than would be expected based on the small share of energy in consumption

- Demand channel (sectoral shifts) can also rationalise asymmetric responses to oil price increases versus decreases

- (Barsky and Kilian, 2004; Hamilton, 2008).

$\rightarrow$ If an oil price shock cannot be modeled purely as a productivity shock, what does this imply for the optimal pivot point?

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- Results are more generalisable, applicable even when energy is not a large part of the consumption basket
  (Känzig, 2021; Chan, Diz and Kanngiesser, 2022; Del Canto et al., 2023).

- Reflective equilibrium may improve tractability, perhaps also sharpen intuition for the optimal policy results
  (Angeletos and Lian, 2017; García-Schmidt and Woodford, 2019; Angeletos and Sastry, 2021).

- Can the framework be extended to understand when tightening cycles should end?

- Do the findings extend to strategic price setters?

- Very insightful paper, on a highly topical issue
- Offers conditions for the optimality of reversals, when we usually emphasise the costs
- Provides a rich framework to understand a lot of the issues policymakers have been thinking about in the past year

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