Three Issues in Learning and Monetary Policy

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Learning and Macroeconomic Policy
University of Cambridge, UK

Views expressed do not necessarily reflect official positions of the FOMC or the Federal Reserve System.

LEARNING AND MONETARY POLICY

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- Issue three: optimal policy in an economy with non-fundamental equilibria.

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    - The role for learning: filtering.
- Issue two: systemic risk.
    - The role for learning: information revelation.
- Issue three: optimal policy in an economy with non-fundamental equilibria.
    - The role for learning: coordination on preferred equilibria.

WHY THESE THREE ISSUES?

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- Welfare consequences in principle could be large.
- An opening for good research to impact economic outcomes.

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- Now I think the tide has turned and we need to think harder.

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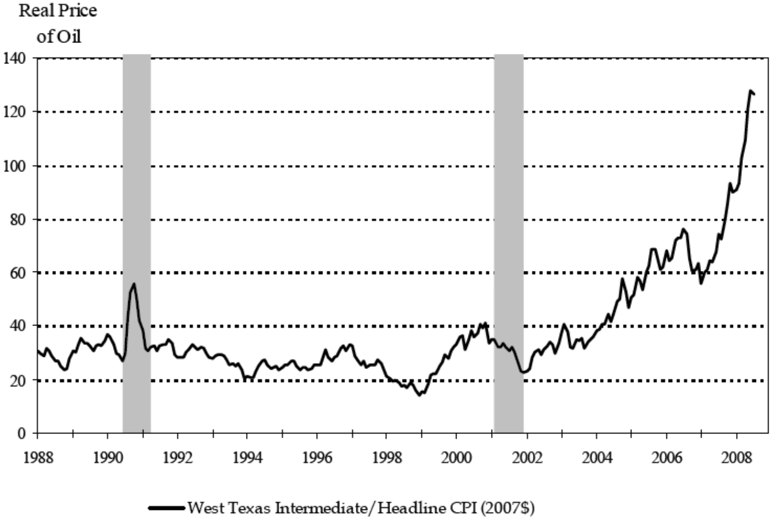
- This is the conventional wisdom echoed at the FOMC.


Real Price of Oil
140
120
100
80
60
40
20
0
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
West Texas Intermediate/Headline CPI (2007$)

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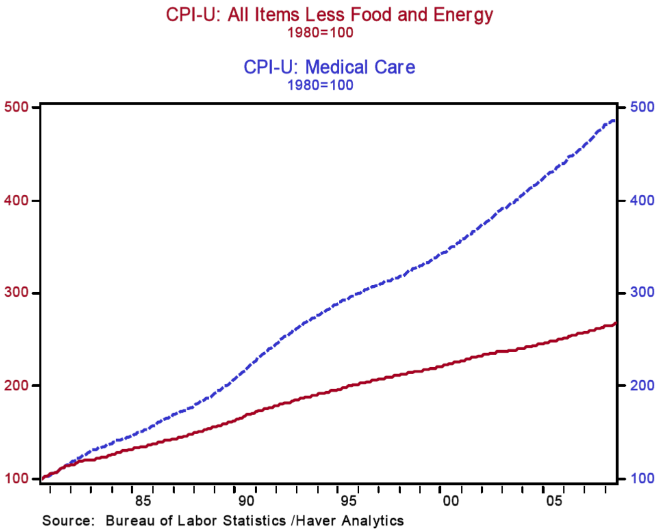
  - This may not work with the most recent data.


CPI-U: All Items Less Food and Energy
1980=100
CPI-U: Medical Care
1980=100
500
400
300
200
100
85
90
95
00
05
Source: Bureau of Labor Statistics /Haver Analytics

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- This would itself influence the equilibrium.

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- This gives the main result.

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- "Degrees of price stickiness" would suggest optimal filtering in this setting.
- Also, the final goods price contains the weighted energy input price.

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- Rising or falling systemic risk is pushed into the stochastic terms.

A SLIPPERY CONCEPT

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- Many genuinely believe it.

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- Of course, there is the Great Depression.
  - Interested listeners might consult Gary Richardson and William Troost, "Monetary Intervention Mitigated Banking Panics During the Depression."

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    - Requires a notion of what drives the dynamics around each steady state.

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- They also understand the sequence of events if there is a default.
    - The endogenous debt constraints literature emphasizes that the penalty for default influences the equilibrium level of credit.

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- Interested listeners might check Franklin Allen’s overview at Jackson Hole, “Understanding Financial Crises.”

Economists versus the world

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- What should policymakers do?

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- It is not clear that this is the best policy.

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- And, actual policymakers may be more circumscribed in what can be done.

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- Commentators were talking about housing bubbles for years before prices began falling. Similarly with recent commodity price increases.

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- All of these topics are part of the current policy debate.