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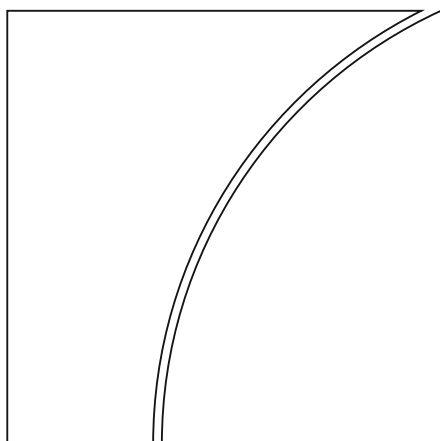
## No 1136

### Expectations and the neutrality of interest rates

by John Cochrane

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## Foreword

The 22nd BIS Annual Conference took place in Basel, Switzerland, on 23 June 2023. The event brought together a distinguished group of central bank Governors, leading academics and former public officials to exchange views on the topic “Central banks, macro-financial stability and the future of the financial system”. The papers presented at the conference are released as BIS Working Papers, nos 1136, 1137 and 1138.

BIS Paper no 140 contains keynote speeches on “Monetary policy and financial stability: A US perspective” by Esther L George (Former President and CEO, Federal Reserve Bank of Kansas City) and on “Power and progress: Our thousand-year struggle over technology and prosperity” by Daron Acemoğlu (Institute Professor, Massachusetts Institute of Technology). It also contains remarks from two panel discussions. In the first panel, the topic of the “Future of crypto” is debated by Hilary J Allen (Professor of Law and the Associate Dean for Scholarship, American University Washington College of Law), Jón Daniélsson (Director of the Systemic Risk Centre, London School of Economics and Political Science) and Fabio Panetta (Member of the Executive Board, European Central Bank). In the closing panel, the question of “What is the remit of central banks?” is addressed by Ida Wolden Bache (Governor and Chair of the Executive Board, Central Bank of Norway), Shaktikanta Das (Governor, Reserve Bank of India) and Tiff Macklem (Governor, Bank of Canada).



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# Expectations and the Neutrality of Interest Rates

John H. Cochrane\*

July 25, 2023

## Abstract

Our central banks set interest rate targets, and do not even pretend to control money supplies. How do interest rates affect inflation? We finally have a complete theory of inflation under interest rate targets and unconstrained liquidity. Its long-run properties mirror those of monetary theory: Inflation can be stable and determinate under interest rate targets, including a peg, analogous to a k-percent rule. The zero bound era is confirmatory evidence. Uncomfortably, stability means that higher interest rates eventually raise inflation, just as higher money growth eventually raises inflation. Sticky prices generate some short-run non-neutrality as well: Higher nominal interest rates can raise real rates and lower output. A model in which higher nominal interest rates temporarily lower inflation, without a change in fiscal policy, is a harder task. I exhibit one such model, but it paints a much more limited picture than standard beliefs. We either need a model with a stronger effect, or to accept that higher interest rates have quite limited power to lower inflation. Empirical understanding of how interest rates affect inflation without fiscal help is also a wide-open question.

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\*Hoover Institution, Stanford University and NBER. john.cochrane@stanford.edu, <https://www.johnhcochrane.com>. This paper stems from a talk given at the Foundations of Monetary Policy Conference celebrating 50 years since the publication of Lucas (1972a) "Expectations and the Neutrality of Money," Federal Reserve Bank of Minneapolis, September 2022. I thank Ed Nelson, Greg Kaplan, Christopher Sims, and anonymous referees for helpful suggestions.

## 1 Introduction

51 years ago, Bob Lucas (1972a) published the watershed “Expectations and the Neutrality of Money.” Lucas studied expectations and the neutrality—and temporary non-neutrality—of, as the title says, *money*. But our central banks set *interest rates*. The Federal Reserve does not even pretend to control money supply, especially inside money. There are no reserve requirements. Super-abundant reserves pay the same or more interest as short-term treasuries and overnight money markets. The Fed controls interest rates by changing the interest it offers on abundant reserves, not by rationing scarce zero-interest reserves. Other central banks follow similar policies. The quantity of M2 is whatever people feel like holding in that form.

We need an analogous theory of inflation under *interest rate targets*. Ideally, the theory should likewise be based on robust and clean economics, starting with a well described frictionless and neutral benchmark, and adding minimal frictions to describe temporary non-neutrality. The theory should be consistent with current institutions, including an interest rate target, ample reserves, and no control of inside money. Its basic mechanisms and signs should be explainable to undergraduates, central bankers, and intelligent laypeople.

I argue that by integrating monetary and fiscal policy we have at last such a theory. The theory describes inflation that is stable and determinate under an interest rate peg, analogous to monetarist analysis of a  $k\%$  money growth rule. The theory starts with a frictionless and neutral benchmark, and it remains approximately long-run neutral with sticky prices. But even these statements are controversial, as is the fiscal underpinning necessary to complete the theory. Moreover, stability under an interest rate peg and approximate long-run neutrality inexorably imply that higher nominal interest rates eventually produce *higher* inflation.

The final piece, a theory of temporary non-neutrality, the central contribution of Lucas (1972a), is unfinished. It is not settled whether and how by raising interest rates, without a change in fiscal policy, the central bank can temporarily lower inflation. In a range of contemporary models, higher interest rates only lower inflation if they are accompanied by tighter fiscal policy, at least to pay higher interest costs of the debt and to repay bondholders in more valuable dollars. The best known model of a temporary negative effect without contemporaneous fiscal tightening includes long-term debt, and temporarily lowers inflation only by raising later inflation in a form of unpleasant arithmetic. This effect is weaker than most economists and central bankers believe, and it is based on a completely different mechanism. We also lack ro-



bust empirical understanding of the effect of interest rate changes, not accompanied by fiscal tightening, on inflation. The hoped-for negative effect may not be there, and experience may have reflected fiscal policy movements.

Ignorance is great news for researchers. The 1970s were a golden decade for macroeconomic research, as much as they were a miserable decade for the economy. The 2020s may well repeat both features.

These questions are also crucial for current policy. Must central banks dramatically raise nominal rates above current inflation, as the Taylor Rule recommends and as we observed in the early 1980s, in order to control inflation? Or can inflation remain contained without such high nominal interest rates, as stability implies? How much does monetary policy depend on fiscal policy? For example, if the central bank raises interest rates, and fiscal policy does not tighten to pay higher interest costs on the debt, does the interest rate rise still lower inflation?

This paper is a synthetic review. I do not present new models. I simplify and connect the dots of existing models, and I present some novel calculations with those models. The contemporary monetary economics literature is full of models that add a bewildering range of ingredients. My aim here is to simplify and start to see which ingredients are really necessary to the basic properties of monetary policy. Some of these points are made at longer length with slightly more complex models in Cochrane (2023), Ch. 5, 12, 16, 17, 20, and Cochrane (2022b).

## 2 Theories of Inflation Under Interest Rate Targets

What is the dynamic effect of *interest rates*—not money—on inflation? I use a very simple standard model to think about this question, and the historical development of our answers to it,

$$x_t = E_t x_{t+1} - \sigma(i_t - \pi_t^e) \quad (1)$$

$$\pi_t = \pi_t^e + \kappa x_t, \quad (2)$$

where  $x$  = output gap,  $\pi$  = inflation,  $\pi^e$  = expected inflation, and  $i$  = interest rate. Variables are all deviations from steady state.

Equation (1) is the first-order condition for consumption or dynamic IS curve, in an economy without capital so that output equals consumption. Equation (2) is the Phillips curve.

Lucas's central innovation was, of course, to specify how expectations enter the Phillips curve so that output variation comes from *unexpected* inflation. Lucas paired that Phillips curve with, essentially,  $MV = PY$  and constant  $V$ , which determines the price level. With this structure, Lucas already had in hand a theory of price level determination, and needed only to extend that theory to describe non-neutrality. Our challenge is to develop a theory of price level determination based on interest rates. We have to work to get to Lucas's launch pad. A little historical tour substantiates my claim that until recently we really hadn't got there, but now, with the addition of fiscal underpinnings, we have.

I hesitate to write down such a model without preferences, technology, market structure, definition of equilibrium, and recursive statement. Lucas' most important contribution may have been methodological, to express a monetary economics question with a completely articulated general equilibrium model. But this is well-trod ground and it is well known how to provide those foundations. See, for example, Woodford (2003).

I simplify further by dropping  $E_t x_{t+1}$  on the right hand side of (1), leaving a simple statement that higher real interest rates depress output,

$$x_t = -\sigma(i_t - \pi_t^e). \quad (3)$$

This simplification turns out not to make any difference for the points I make, and leaving it out allows me to do everything with transparent algebra. Equation (1) iterates forward to

$$x_t = -\sigma E_t \sum_{j=0}^{\infty} (i_{t+j} - \pi_{t+j}^e) + \lim_{T \rightarrow \infty} E_t x_{t+T},$$

so my static version is the same as the dynamic version when the current real interest rate is a sufficient statistic for the expected sum of future real rates, and output is expected to return to steady state. The parameter  $\sigma$  in the simplified model is then larger than the intertemporal elasticity of substitution, as it includes how long the high rates last. Using this static IS curve makes a second point: The troubles I document cannot be fixed just by attenuating the forward-looking part of the IS curve. (For example, Gabaix (2020).)

Substituting output out of (2)-(3), we obtain a relationship between interest rates and inflation:

$$\pi_t = (1 + \sigma\kappa)\pi_t^e - \sigma\kappa i_t. \quad (4)$$

The dynamic response of inflation to interest rates now depends on how expectations are formed.

## 2.1 Expectations, Stability, Determinacy, and Neutrality, and Sign

Table 1 summarizes the steady forward march of expectations in the Phillips curve. Each equation is simplified to be emblematic of an era. Actual Phillips curves also include disturbances. While the table is in chronological order, my discussion will skip around to emphasize the theoretical points.

Author	Phillips curve	Expectations
Phillips (1958)	$\pi_t = \pi_0 + \kappa x_t$	Absent
Dynamic empirical (1960s)	$\pi_t = \alpha \pi_{t-1} + \kappa x_t, \alpha < 1$	Adaptive
Friedman (1968); ISLM AS/AD(1970s)	$\pi_t = \pi_{t-1} + \kappa x_t$	Adaptive
Lucas (1972)	$\pi_t = E_{t-1} \pi_t + \kappa x_t$	Rational
Calvo (1983), Rotemberg (1982); NK (1990s)	$\pi_t = \beta E_t \pi_{t+1} + \kappa x_t$	Rational

Table 1: The steady forward march of expectations in the Phillips curve

Phillips didn't have any expectations or other variables to shift the Phillips curve, nor did the Keynesian advocates of inflation in the early 1960s such as Samuelson and Solow (1960). (See Nelson (2020) Ch. 13.)

Dynamic estimates of the Phillips curve in the 1960s and 1970s added lags of unemployment or inflation, depending which variable one put on the right-hand side of the regression. These specifications retained a long-run inflation-output tradeoff,  $\alpha < 1$  here, and when thinking theoretically, adaptive expectations.<sup>1</sup>

### 2.1.1 Adaptive Expectations

Friedman's (1968) address was fundamentally about neutrality. He proclaimed two things that monetary policy *cannot* do. First, he proclaimed that the Phillips curve would shift once people come to expect inflation, so the central bank cannot permanently lower unemployment. The long-run Phillips curve is vertical. But on the way there, he described explicitly adaptive expectations: "This price expectation effect is slow to develop and also slow to disappear." Phelps

<sup>1</sup>Among many others, Lipsey (1960), Gordon (1970). Gordon (1976) p. 192–193 provides a nice summary of the era. Sargent (1971) and Lucas (1972b) also summarize insightfully.

(1967) also writes “a sort of Phillips Curve ... that shifts one-for-one with variations in the expected rate of inflation; ... the expected inflation rate adjusts gradually over time to the actual inflation rate.”

Second, Friedman proclaimed that the central bank cannot peg the nominal interest rate. We can see this result in our little model. Let expectations be adaptive,  $\pi_t^e = \pi_{t-1}$ . Then from (4) inflation and interest rates are related by

$$\pi_t = (1 + \sigma\kappa)\pi_{t-1} - \sigma\kappa i_t. \quad (5)$$

Inflation is now *unstable* under an interest rate peg, since  $(1 + \sigma\kappa) > 1$ . In Friedman’s description, the central bank needs to print more and more money to keep the interest rate down. The ISLM AS/AD tradition of the 1970s adopted the same adaptive-expectations Phillips curve, in models without money. In that description, a too-low nominal interest rate lowers the real rate, which boosts demand, which boosts inflation, and around we go. The left panel of Figure 1 illustrates instability and the inflation or deflation spirals that break out under an interest rate peg.

The last term of Equation (5) also shows the conventional sign: Higher interest rates lower inflation. Indeed, higher interest rates set off an unstable deflationary spiral. Friedman said so (in the opposite, inflationary, direction), though quickly adding that the central bank would soon give up and raise interest rates (lower money growth) to stop the spiraling inflation.

Thus began the long tradition that views an interest rate target as a fundamentally incomplete price-level anchor.

The Taylor rule repairs Friedman’s critique of interest rate targets.<sup>2</sup> Let the central bank systematically respond to inflation with higher interest rates,

$$i_t = \phi\pi_t + u_t$$

with  $\phi > 1$ . Substituting for  $i_t$  in (5), inflation dynamics become

$$\pi_t = \frac{1 + \sigma\kappa}{1 + \sigma\kappa\phi}\pi_{t-1} - \frac{\sigma\kappa}{1 + \sigma\kappa\phi}u_t. \quad (6)$$

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<sup>2</sup>McCallum (1981) is the first formal statement that the  $\phi > 1$  principle resolves indeterminacy with rational expectations. Taylor (1999) shows how a Taylor rule resolves instability with adaptive expectations. Taylor (1993) is the most influential statement of the rule and its practical implementation. Wicksell (1898), (1965) proposed verbally that a central bank could stabilize the price level by raising and lowering an interest rate target. In the 19th century, the Bank of England systematically raised and lowered the discount rate to defend the gold standard, in part in response to inflation and vice versa.

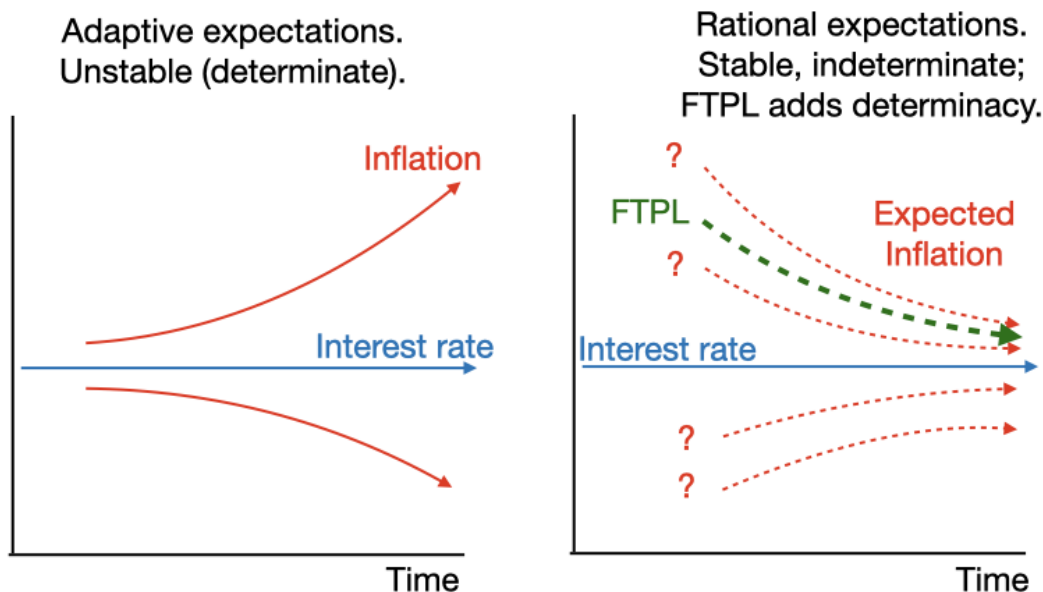


Figure 1: Adaptive vs. Rational Expectations Dynamics

Now inflation is stable under an interest rate target. Sensibly, the central bank's interest rate policies act to *stabilize* the economy. But the economy itself remains fundamentally unstable, with that instability only tamed if the central bank reacts swiftly and more than one for one to inflation, like a seal balancing a ball on its nose. A peg would swiftly unravel.

With this modification, higher interest rates still lower inflation.<sup>3</sup> Figure 5 below plots a simulation.

Adaptive expectations may seem attractive. This model captures policy maker's world view, and it easily generates the conventional view that higher interest rates lower inflation. However, the adaptive expectations model is an unsatisfactory foundational theory of inflation under interest rate targets, certainly as compared to Lucas (1972a) for monetary targets. Irrationality and sticky prices are *necessary* ingredients here, for us to say anything about the price level. The model does not have a frictionless limit or limit point; as prices become less sticky  $\kappa \rightarrow \infty$ , it blows up. We would like to start with a benchmark in which prices are flexible prices, people are rational, and the Lucas (1976) critique holds; and then see just how far we must modify that benchmark to capture realistic dynamics. If there is no such benchmark, monetary economics

<sup>3</sup>In the period of an unexpected shock  $u_1 = \varepsilon_1$  we have  $\pi_1 = -\sigma\kappa/(1 + \sigma\kappa\phi)\varepsilon_1$  and  $i_1 = 1/(1 + \sigma\kappa\phi)\varepsilon_1$  so  $\pi_1 = -\sigma\kappa i_1$ . Interest rates rise and inflation falls. This is important to check, as a positive shock  $u_1$  can lead to negative interest rates  $i_1$  in new-Keynesian models, and then interest rates and inflation go in the same direction.

is on pretty shaky ground. Maybe this is where we end up, but it's at least worth considering if another path is possible.

### 2.1.2 Rational Expectations and New-Keynesian Models

New-Keynesian models use rational expectations, and consciously play by the Lucas rules of how to write and solve intertemporal general equilibrium macroeconomic models. With price adjustment costs, the standard new-Keynesian model bases the Phillips curve on inflation relative to rationally expected future inflation,  $\pi_t^e = \beta E_t \pi_{t+1}$  (Calvo (1983), Rotemberg (1982)). For simplicity, I use  $\beta = 1$  here. I show below that  $\beta < 1$  makes no important difference to my points.

Now from (4) the dynamic response of inflation to interest rates is

$$E_t \pi_{t+1} = \frac{1}{1 + \sigma\kappa} \pi_t + \frac{\sigma\kappa}{1 + \sigma\kappa} i_t. \quad (7)$$

Inflation is *stable* since  $1/(1 + \sigma\kappa) < 1$ . Unlike the adaptive expectations model, this rational expectations model has a sensible frictionless  $\kappa \rightarrow \infty$  limit and limit point:

$$E_t \pi_{t+1} = i_t. \quad (8)$$

Price stickiness draws out dynamics.

But this model so far only ties down expected inflation. Unexpected inflation  $\pi_{t+1} - E_t \pi_{t+1}$  can be anything, or wander up and down following sunspots. Using rational expectations in a related model, Sargent and Wallace (1975) modified Friedman's doctrine: Inflation is *indeterminate* under an interest rate peg. Moreover, neither this model nor the adaptive expectations model determines the price *level*, the nominal anchor, as opposed to the rate of inflation. The sense continued that we don't have a model of inflation under interest rate targets.

Rational vs. adaptive expectations fundamentally change the stability and determinacy properties of the model. The right hand panel of Figure 1 illustrates, with the question mark indicating all the many equilibria that could break out at that point.

Friedman's unstable (and determinate) is different from Sargent and Wallace's stable and indeterminate. They are frequently confused. Both models suggest volatile inflation. But spiraling away on a determinate path is different from batting up and down unpredictably around the peg.

The sign on the last term in (7) has also changed. Now higher nominal interest rates *raise* expected inflation, as they do in the flexible price model (8).

New-Keynesian modelers resolve indeterminacy with a novel application of the Taylor principle. If we add  $i_t = \phi\pi_t + u_t$  in this case, inflation dynamics (7) become

$$E_t\pi_{t+1} = \frac{1 + \sigma\kappa\phi}{1 + \sigma\kappa}\pi_t + \frac{\sigma\kappa}{1 + \sigma\kappa}u_t. \quad (9)$$

With  $\phi > 1$ , dynamics are now *unstable*. Adding a rule against nominal explosions, new-Keynesian modelers can now choose the unique initial value of inflation that precludes an explosion, and thus produce determinate inflation;  $\pi_t = 0$  with no shocks, and

$$\pi_t = -E_t \sum_{j=0}^{\infty} \left( \frac{\sigma\kappa}{1 + \sigma\kappa} \right)^j u_{t+j}$$

with shocks  $u_t$ .

The central bank is imagined in this vision to deliberately *destabilize* an economy which is already stable on its own, exactly the opposite of the Taylor rule in an adaptive expectations economy which *stabilizes* an otherwise unstable economy. The central bank threatens hyperinflation or hyperdeflation in order to select or “coordinate expectations” on the equilibrium it likes.

Indeed, the central bank may simply announce its inflation target, announce this threat, and inflation jumps to whatever value the central bank desires. The Taylor Principle in a new-Keynesian model is an *equilibrium-selection* policy not a *stabilization* policy.

This statement is easiest to see in the  $\kappa = \infty$  case of flexible prices, in which the interest rate directly sets expected inflation (8). Write the policy rule equivalently as

$$i_t = \phi\pi_t + u_t = i_t^* + \phi(\pi_t - \pi_t^*) = E_t\pi_{t+1}^* + \phi(\pi_t - \pi_t^*). \quad (10)$$

Here, we may interpret  $\{\pi_t^*\}$  as the central bank’s stochastic inflation target, the value of inflation it wishes to produce in each date and state, and  $\{i_t^*\}$  as the interest rate target it will use to implement the inflation target. The second and third equalities define  $i_t^*$  and translate between the  $u_t$  and  $i_t^*$ ,  $\pi_t^*$  notation for the monetary policy disturbance. (King (2000) invented this clever

notation.) Eliminating  $i_t$  from (8)-(10), the model's equilibrium condition is

$$E_t(\pi_{t+1} - \pi_{t+1}^*) = \phi(\pi_t - \pi_t^*).$$

With  $\phi > 1$ , the unique bounded equilibrium is  $\pi_t = \pi_t^*$ ,  $i_t = i_t^*$ .

The central bank chooses the inflation it wishes to see  $\{\pi_t^*\}$ . It obtains this value by an interest rate policy  $i_t^*$ , which sets the equilibrium observed interest rate to equal the expected value of the inflation target, and a *separate* equilibrium-selection policy, threatening to produce an expected hyperinflation or deflation should unexpected inflation come out against its desires. For example, if  $\pi_t^*$  is i.i.d., observed interest rates never move. The central bank simply announces each period what inflation it would like to see, and that inflation occurs.

To see the same point in our little sticky price model, again write the policy rule as

$$i_t = \phi\pi_t + u_t = i_t^* + \phi(\pi_t - \pi_t^*), \quad (11)$$

where now

$$i_t^* \equiv \frac{1 + \sigma\kappa}{\sigma\kappa} E_t\pi_{t+1}^* - \frac{1}{\sigma\kappa} \pi_t^*. \quad (12)$$

Equation (12) applies (7) to the starred variables. If we want to think in terms of an interest rate target and an inflation target, those targets must be compatible with private sector equilibrium conditions. With this policy rule, the equilibrium condition (7) becomes

$$E_t(\pi_{t+1} - \pi_{t+1}^*) = \frac{1 + \phi\sigma\kappa}{1 + \sigma\kappa} (\pi_t - \pi_t^*). \quad (13)$$

Again, with  $\phi > 1$  the central bank destabilizes an economy that is stable on its own. By doing so, it repairs indeterminacy:  $\pi_t = \pi_t^*$  and  $i_t = i_t^*$  is the unique locally bounded equilibrium.

New-Keynesian modelers can produce lower inflation when interest rates rise, overcoming the positive signs in (7), (8), and (9), by such equilibrium-selection choices. Suppose that coincident with an unexpected rise in interest rates at time  $t$ , the central bank also announces a lower stochastic inflation target  $\pi_t^*$ . Now current inflation  $\pi_t$  jumps down. If  $\pi_t$  jumps down enough, then  $E_t\pi_{t+1}$ , though still higher than  $\pi_t$ , can also fall relative to what was expected at time  $t - 1$ . Translate back to  $\{u_t\}$  and you have the conventional new-Keynesian model. However, as you can see by this rewriting, the higher interest rate has nothing to do with the lower initial inflation. The central bank could just as easily lower initial inflation without a higher interest rate.



In reality, central banks do not have equilibrium-selection policies. They do not threaten hyperinflation or deflation if inflation comes out against their desires. Such threats being contrary to their objectives, nobody would believe them if they tried. Central banks do not intentionally de-stabilize economies that are stable on their own. Ask central banks. Look at central bank websites. They loudly announce that they they *stabilize* economies; no matter what inflation does, they promise to act resolutely to bring it back.

As I rejected the beautiful  $MV = PY$  because central banks set interest rates, do not limit money supply, and because reserves pay the same interest as bonds, I argue that we should also reject the new-Keynesian solution, because our monetary institutions simply do not remotely behave as this model specifies.

The new-Keynesian theory also requires an extra rule against non locally bounded equilibria, not a part of the standard definition of Walrasian equilibrium (Cochrane (2011)). And yet we see hyperinflations. Also, in the new-Keynesian model, the central bank completely controls inflation, expected and unexpected, and can move inflation with speeches alone and no observed action. Real central banks seem not to have such power. (For all these points, see Cochrane (2011).)

### 2.1.3 Fiscal Theory

The fiscal theory of the price level adds an equilibrium condition, or rather recognizes one that was there all along and has been left out so far. The real value of nominal government debt  $v_t$  evolves as

$$\rho v_{t+1} = v_t + i_t - \pi_{t+1} - \tilde{s}_{t+1} \quad (14)$$

where  $\rho < 1$  and  $\tilde{s}_{t+1}$  is the real primary surplus scaled by the steady state value of debt. I use here the simple case of one-period debt and no economic growth; I generalize to long-term debt below. This equation is also linearized. See Cochrane (2023) Ch. 3.5 for a derivation. The consumer's transversality condition also requires

$$\lim_{T \rightarrow \infty} E_t \rho^T v_T = 0. \quad (15)$$

We can add these conditions to the VAR(1) statement of the model. But in this simple case, we can solve the model analytically by iterating (14) forward to

$$v_t = E_t \sum_{j=0}^{\infty} \rho^j [\tilde{s}_{t+1+j} - (i_{t+j} - \pi_{t+1+j})]. \quad (16)$$

The real value of debt is the discounted present value of future surpluses. Taking innovations  $\Delta E_{t+1} \equiv E_{t+1} - E_t$  of both sides of (16), we obtain.

$$\Delta E_{t+1} \pi_{t+1} = -\Delta E_{t+1} \sum_{j=0}^{\infty} \rho^j \tilde{s}_{t+1+j} + \Delta E_{t+1} \sum_{j=1}^{\infty} \rho^j (i_{t+j} - \pi_{t+j+1}). \quad (17)$$

Unexpected inflation devalues outstanding debt. Thus, unexpected inflation corresponds to the revision in the present value of future primary surpluses. In the second term, higher discount rates lower the value of debt and cause inflation. Equivalently, if interest costs on the debt rise, but current or future surpluses do not rise to pay them, then the resources must come by inflating away outstanding bonds.

Since the rational expectations model left an indeterminacy indexed by unexpected inflation  $\Delta E_{t+1} \pi_{t+1}$ , (17) clearly steps in to restore that determinacy, in place of central bank equilibrium-selection rules.

The point is also easiest to see in the simplest case of flexible prices. Then, (7) and (17) boil down to

$$i_t = E_t \pi_{t+1} \quad (18)$$

$$\Delta E_{t+1} \pi_{t+1} = -\Delta E_{t+1} \sum_{j=0}^{\infty} \rho^j \tilde{s}_{t+1+j}. \quad (19)$$

The interest rate target sets expected inflation; fiscal policy determines unexpected inflation and picks one equilibrium.

With sticky prices, we have the pair (7)-(17), which I repeat for convenience,

$$E_t \pi_{t+1} = \frac{1}{1 + \sigma \kappa} \pi_t + \frac{\sigma \kappa}{1 + \sigma \kappa} i_t \quad (20)$$

$$\Delta E_{t+1} \pi_{t+1} = -\Delta E_{t+1} \sum_{j=0}^{\infty} \rho^j \tilde{s}_{t+1+j} + \Delta E_{t+1} \sum_{j=1}^{\infty} \rho^j (i_{t+j} - \pi_{t+j+1}). \quad (21)$$

Now (20) picks a set of paths for expected inflation, and (21) selects which one is the unique equilibrium. The right hand panel of Figure 1 illustrates this option as well. Fiscal policy determines one of the many possible equilibria. It's straightforward to add policy rules in which surpluses and interest rates respond to inflation and output, and all the other complications of DSGE models.

In sum, with the combination (20) and (21) to choose unexpected inflation, inflation is stable *and determinate* at an interest rate peg (or Taylor coefficients  $\phi < 1$ ), overcoming Sargent and Wallace's contrary doctrine.<sup>4</sup>

How *volatile* inflation is depends on the size of fiscal or discount rates shocks. But economics picks one value for inflation. In addition, we now have a model of the price *level*, a nominal anchor, rather than simply a model of the inflation *rate* at any level. In (16),  $v_t$  is the ratio of nominal debt to the price level. The price level adjusts so that (16) holds.

Monetarists, ISLM-AS/AD or adaptive-expectations Keynesians, Sargent and Wallace, and new-Keynesians make explicit assumptions to wipe out fiscal theory. Careful versions of these theories include the government debt equilibrium condition, but they assume that fiscal authorities “passively” adjust surpluses as needed to validate inflation determined elsewhere. In (21), the central bank picks  $\Delta E_{t+1}\pi_{t+1}$ , and then fiscal authorities supply whatever surpluses  $\tilde{s}_{t+1}$  are necessary to satisfy (16) or (17), often via lump-sum taxes. (Leeper (1991), Woodford (2003) section 4.4.)

Since the equilibrium conditions are the same, the fiscal and new-Keynesian theories make predictions for equilibrium time series that are formally observationally equivalent, at least without further assumptions. (See Cochrane (1998), Cochrane (2023) Ch. 17, 22.) Thus, for the purposes of everything that follows, you may think in terms of the new-Keynesian rather than fiscal-theory version of equilibrium formation, if you disagree with my argument. However, new-Keynesian modelers typically do not examine what the required surpluses are. For a full evaluation of the theory, we must examine them.

For example, in the standard new-Keynesian policy experiment, a monetary policy shock that lowers inflation comes with a “passive” fiscal tightening to pay higher interest costs on the debt and a windfall to bondholders. In the flexible price model, using (19), a surprise decline in initial inflation  $\Delta E_1\pi_1$  *must* come with a rise in primary surpluses. Fiscal theory calls this

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<sup>4</sup>Woodford (1994), Woodford (1995) show that with fiscal theory, an interest rate peg is determinate and stable. Moreover, these results hold even at a zero rate peg, allowing the economy to be satiated in liquidity.

rise a “fiscal shock” coincident with the interest-rate increase. New-Keynesian theory calls it an induced fiscal policy response to the equilibrium-selection part of the central bank’s monetary policy. By either name, however, surpluses must rise, or inflation cannot fall. An interest rate rise without such fiscal backing has different effects, even in totally standard new-Keynesian analysis. So, you can interpret my equations as exploring fiscal underpinnings of conventional new-Keynesian models. In the sticky price case, (21) tells us that an unexpected inflation  $\Delta E_1 \pi_1$  can also come from higher real interest rates, i.e. higher real interest costs on the debt. The sign is “wrong” compared to intuition that higher rates lower inflation, and requires some more powerful ingredient to push the “right” way if we wish that result.

More generally, (19) gives a general preview why we find it so hard for higher interest rates to lower inflation. If the path of real interest rates is on average positive, and with no change in fiscal policy, initial inflation  $\Delta E_1 \pi_1$  must be positive, not negative. With no change in inflation on the date of the shock,  $\Delta E_1 \pi_1 = 0$  (this term is absent in continuous time with sticky prices), the average real interest rate must be zero; we pick an inflation path that on average is equal to the nominal interest rate path. The conventional view of a purely positive real interest rate path pushing down inflation necessarily requires a fiscal contraction to pay net positive interest costs, and is impossible without that contraction.

We should not overstate observational equivalence. For example, in the fiscal theory model, a fiscal shock (a decline in the present value of surpluses) results in inflation to devalue debt that the central bank cannot completely avoid by any path of interest rates. In the new-Keynesian model, the central bank fully controls inflation, expected and unexpected. Fiscal shocks are ruled out: If the central bank does not choose inflation, deficits are always repaid in full. Whether the central bank alone can or cannot fully control inflation is a pretty important policy and doctrinal issue. Did we suffer inflation in 2021-2022 because of a fiscal shock, or because the Fed failed to announce appropriate equilibrium-selection threats to support its 2% inflation target? And knowledge of how our institutions work—that central banks simply do not make explosive equilibrium-selection threats—is information beyond the stochastic properties of equilibrium time series that help to distinguish theories.

Fiscal theory does not have to be married to with rational expectations. I investigate fiscal foundations of adaptive expectations models below.

## 2.2 Lucas's Phillips Curve

In my little Phillips curve history (Table 1), I skipped over Lucas. Lucas (1972a) first made Phillips-curve expectations rational. His Phillips curve relates output to unexpected inflation only, first moving forward the time subscript in the Phillips curve, from  $\pi_t^e = \pi_{t-1}$  to  $\pi_t^e = E_{t-1}\pi_t$ . In the spirit of rational expectations, it makes most sense to pair Lucas' Phillips curve with rational expectations in the bond market and consumption. So let's use Lucas' Phillips curve in an interest-rate model by writing

$$x_t = -\sigma(i_t - E_t\pi_{t+1}) \quad (22)$$

$$\pi_t = E_{t-1}\pi_t + \kappa x_t. \quad (23)$$

Eliminating  $x_t$ , inflation dynamics (4) are now

$$E_t\pi_{t+1} = i_t + \frac{1}{\kappa\sigma}(\pi_t - E_{t-1}\pi_t). \quad (24)$$

Iterating forward,

$$E_t\pi_{t+2} = E_t i_{t+1}.$$

Lucas' specification of the rational expectations Phillips curve, along with our IS curve, passive fiscal policy, and an interest rate target, leads to an economy that is stable and indeterminate, like the new-Keynesian model. Relative to the flexible-price model  $i_t = E_t\pi_{t+1}$ , Lucas's Phillips curve gives one period of additional inflation after a shock, which then reverts to the frictionless value. Adding fiscal theory to this model we again restore determinacy, and name the unexpected inflation shock. One could also add new-Keynesian equilibrium selection.

(Mankiw and Reis (2002) explore an attractive generalization of Lucas' Phillips curve. They relate output to current inflation relative to a distributed lag of expected inflation. Their attractive specification hasn't been widely followed.)

## 3 Long-Run Properties: Neutrality, Stability, and Fisherism

In sum, combining fiscal theory and rational expectations, we have, finally, a complete economic (rational agents, Walrasian equilibrium) theory of inflation under interest rate targets, compatible with what we know about how central banks behave. In it, and like monetarist theory, the

economy is *determinate, stable*, starts from a *neutral* benchmark, displays (potentially approximate) long-run neutrality, and offers a foundation for models with frictions that create short-run non-neutralities.

These properties are on full display with flexible prices,

$$i_t = E_t \pi_{t+1}$$

$$\Delta E_{t+1} \pi_{t+1} = \Delta E_{t+1} \sum_{j=0}^{\infty} \rho^j \tilde{s}_{t+1+j}.$$

There is only one equilibrium value of inflation. The central bank can follow a peg, analogous to a k% rule, and inflation will neither spiral away nor suffer multiple-equilibrium volatility. (Like a k% rule, a peg may not be optimal, but it is possible.) A one percentage point higher interest rate with no change in fiscal policy produces a one percentage point higher inflation, with no change in real rate or output.

The sticky-price version of the model also offers a first step of explicitly modeled short-run non-neutrality, keeping the frictionless model's properties in the long run, again similarly to standard monetary theory. The model remains determinate and stable: Inflation slowly converges to the interest rate. Output and real interest rates vary, but that variation dies away in the long run. A one percentage point higher interest rate leads eventually to one percentage point higher inflation, but not right away.

*Higher interest rates raise inflation?* Even if qualified by “in the long run,” this “Fisherian” property is so contrary to standard doctrine that one looks up in disbelief from the screaming lessons of equations. Really?

*Stability* is the central property behind the Fisherian result. If inflation is stable under an interest rate peg, it follows that raising the peg must eventually raise inflation. The adaptive expectations model is long-run neutral, in that steady states with higher inflation have higher interest rates. But it is unstable, so raising the interest rate from such a steady state lowers inflation.

The equations are clear, but just how do higher interest rates produce higher inflation? What about standard intuition that higher interest rates depress aggregate demand, so should *reduce* inflation?<sup>5</sup>

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<sup>5</sup>Here, I acknowledge conversations with a few prominent economists who pushed me hard to explain intuition despite the simplicity of the equations.

First, consider the full consumer first-order condition  $x_t = E_t x_{t+1} - \sigma(i_t - E_t \pi_{t+1})$  with no pricing frictions. Raise the nominal interest rate  $i_t$ . Before prices change, a higher nominal interest rate is a higher real rate, and induces people to demand less today  $x_t$  and more next period  $x_{t+1}$ . That change in demand pushes down the price level today  $p_t$  and hence current inflation  $\pi_t = p_t - p_{t-1}$ , and it pushes up the expected price level next period  $p_{t+1}$  and thus expected future inflation  $\pi_{t+1} = p_{t+1} - p_t$ . So, standard intuition is correct, and refers to a force that can lower *current* inflation. Fisherian intuition is correct too, and refers to a natural force that can raise *expected future* inflation.

But which is it, lower  $p_t$  or higher  $p_{t+1}$ ? This consumer first-order condition, capturing an “intertemporal substitution” effect, or telling us the slope of the price level over time, cannot tell us. Unexpected inflation and the overall price level is determined by a “wealth effect,” by the overall level of prices, by the “nominal anchor.” If we pair the higher interest rate with no change in surpluses, and thus no wealth effect, then the initial price level  $p_t$  does not change and the entire effect of higher interest rates is a rise in  $p_{t+1}$ . If instead there is a positive “wealth effect,” a concurrent rise in the present value of expected surpluses, then we have a lower price level  $p_t$  and less current inflation  $\pi_t$ . Thus in this context standard intuition also implicitly assumes that fiscal policy acts in concert with monetary policy.

Second, consider the Phillips curve. Suppose a higher nominal rate means a higher real rate in the IS curve and pushes output down, as it does in classic static ISLM thinking and in my simplified model. Lower output  $x_t$  in the Phillips curve,

$$\pi_t = \pi_t^e + \kappa x_t$$

means lower inflation  $\pi_t$ , yes, but *relative* to expected inflation. With adaptive expectations,  $\pi_t^e = \pi_{t-1}$ , lower inflation  $\pi_t$  means that inflation *decreases* over time. But with rational expectations,  $\pi_t^e = E_t \pi_{t+1}$ , lower inflation means that inflation *increases* over time. So we might again be talking to cross-purposes, confusing current inflation that is lower relative to expected inflation with inflation that decreases over time. And lower inflation relative to expected inflation may not mean lower inflation, as expected inflation may rise so much that both current and expected inflation are higher than otherwise, as happens in this case.

Third, verbal intuition may also confuse adjustment to equilibrium with the movement of inflation over time in equilibrium. Hold fixed expected inflation, i.e. assume it is “anchored” as Fed discussions often posit. Then higher real interest rates and lower output lower inflation  $\pi_t$ .

But that means lower inflation *today*, right away, than otherwise would have occurred. It does not mean that higher interest rates today provoke lower output in the near future, and slowly drive inflation down in the further future, as most policy discussion describes. These equations do not have “long and variable lags.” So part of the contrast with standard intuition may come from confusing the process of adjustment to equilibrium with the evolution of equilibrium over time.

(Since Ball (1994), the fact that the standard new-Keynesian Phillips curve relates high output to *decreasing* inflation has been a persistent problem, attracting a wide variety of additional ingredients or a return to adaptive expectations. The point here is not to pursue this issue, but to understand the intuition of the new-Keynesian result.)

Stability is a natural and robust consequence of forward-looking or rational expectations, while instability is a natural consequence of backward-looking expectations. If you drive a car looking through the rear view mirror, you will veer off the road. If you drive looking forward the car will stably follow the road.

If intuition still rebels, keep in mind that stability and a Fisherian response may take a long time to take hold, and keep in mind the experiment: permanently higher interest rates with no change in fiscal policy. Central bankers seldom abstain from moving interest rates for very long, monetary and fiscal policy both respond to events, monetary policy induces fiscal responses, and lies in the shadow of fiscal events which push inflation around. We do not obviously have a lot of experience that bears on the Fisherian proposition.

Exchange rate pegs and purchasing power parity are a good analogy. If a country wishes a lower nominal exchange rate, a less valuable currency, it can do so by pegging at that rate and waiting long enough. Any peg also requires fiscal backing, the ability to get as much foreign exchange or the will to print as much domestic currency or debt as needed to enforce the peg. Pegs fail when governments give up on those fiscal requirements. And one may have to wait a very long time for purchasing power parity and a long slow inflation to kick in. Nonetheless, the proposition that an exchange rate peg is eventually neutral, that relative price levels eventually adjust, if a government can stick to that peg long enough, is intuitively clear, as are the limitations of that proposition for policy and historical analysis. The proposition that higher interest rates lead eventually to higher inflation is analogous. One pegs a cross-sectional nominal price and waits for real prices to return to normal. The other pegs an intertemporal nominal price and waits for real prices to return to normal. Standard intuition holds that an exchange rate peg with



adequate fiscal backing is stable, just as it holds that a money growth peg with adequate fiscal backing is stable. We just extend those ideas to a nominal interest rate peg.

In sum, stability and consequent view that higher interest rates eventually raise inflation are logically linked, explainable by simple intuition, and a robust result of forward-looking expectations. They are hard to avoid. They are also not novel. The proposition that persistently higher interest rates raise inflation has been clear in new-Keynesian writing since the 1990s. It's interesting that it only became controversial more recently.

### 3.1 Stability

Here I clarify the meaning of "stability."

I implicitly defined stability by looking at system dynamics, and then wrote that if a model is stable, expected inflation converges under an interest rate peg. We could use the latter as a defining property. Generalizations beckon. One could state that if interest rates follow a stationary process, so does inflation; or if interest rates are bounded so is inflation. Nonlinear models can have different local and global stability properties. These generalizations are not important for the models I consider here, so I do not belabor the point.

Stability is a property of the whole model. A stable model may contain both stable and unstable eigenvalues. Some equations of the model only describe expectations, as the standard IS and Phillips curve equations (1)–(2) only describe expected output and inflation given their current values and structural shocks. With either a transversality condition or a rule against explosive solutions, though, we can solve explosive eigenvalues forward to determine expectational errors, leaving a stable model. When the number of explosive eigenvalues is equal to the number of expectational equations, the model is stable and determinate. When the number of explosive eigenvalues is less than the number of expectational equations, the model is stable but indeterminate. When the number of explosive eigenvalues is greater than the number of expectational equations, the model is unstable. (These are Blanchard and Kahn (1980) conditions.)

For example, in the full model with  $E_t x_{t+1}$  on the right hand side of the IS equation, the difference equation linking inflation to interest rates generalizing (7) has a root greater than one and a root less than one. (See (26) below.) We can, however, solve the unstable root forward and the model remains stable. Under an interest rate peg, expected inflation converges toward that peg. (See Cochrane (2023) section 5.1.) Likewise,  $p_t = E_t[(p_{t+1} + d_{t+1})/R]$  has an explosive eigen-

value, but we solve forward so the asset price is stable when the transversality condition is satisfied: Prices converge towards a constant dividend, and prices do not explode away from stochastic dividends. By contrast, though the adaptive expectations model  $\pi_t = (1 + \sigma\kappa)\pi_{t-1} - \sigma\kappa i_t$  has an explosive eigenvalue, we still solve it backward, not forward, and we describe explosive dynamics. There is no free unexpected inflation, no free initial condition, no jump variable which can move to offset an explosion.

As above, the policy rule can repair instability or indeterminacy by changing the number of explosive roots. I refer to the “stability” of the underlying economy, with fixed or stochastically varying interest rates, or rates that follow a rule that does not change the stability and determinacy properties of the model.

Traditional monetary doctrine does not much worry about stability: the possibility that there are steady states with higher money growth and proportionally higher inflation, but raising money growth would send prices off on a downward spiral. However, when money demand is sensitive to interest rates—it is—that proposition is not so obvious either. Such models can have multiple unstable equilibria. For example, if velocity rises with the interest rate, so log money, price, and output obey<sup>6</sup>

$$m_t + \alpha(p_{t+1} - p_t) = p_t + y_t$$

and with constant output  $y$ , then inflation  $\pi_{t+1} = p_{t+1} - p_t$  follows

$$\pi_{t+1} = \left(1 + \frac{1}{\alpha}\right)\pi_t - \frac{1}{\alpha}(m_t - m_{t-1}).$$

Steady states with higher money growth have higher inflation, but they are unstable. From a steady state, raising money growth leads to spiraling deflation. This issue is usually glossed over in standard monetarist doctrine, with talk about the “stability” of velocity, where the issue is more contentious in today’s debates about interest rate targets. Again, central banks don’t target money supplies, and reserves pay market interest, so there is not much point in reviving this controversy.

### 3.2 Stability Versus Neutrality

*Stability* is the central question for the possibility of an interest-rate peg and the sign of inflation’s long-run response to interest rates. Exact long-run neutrality is not important. If a one

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<sup>6</sup>This is the Sargent and Wallace (1973) rational expectations version of the Cagan (1956) hyperinflation model.

percentage point interest rate rise leads to 0.9 or 1.1 percentage point higher inflation rather than 1.0 higher inflation, no important conclusion has changed. If that rise leads to an 0.1 percentage point permanent output rise or fall, even less has changed. It would take a mighty non-neutrality for steady state inflation to *decrease* when steady state interest rates rise. Similarly, standard monetary theory is little affected by small non-neutralities, say that inflation goes up 0.9 percentage points when money growth rises one percentage point. It would take a huge non-neutrality for higher money growth to lower inflation.

With a standard new-Keynesian Phillips curve,

$$\pi_t = \beta E_t \pi_{t+1} + \kappa x_t$$

the sticky-price model is not exactly long-run neutral. Real variables are eventually independent of the price *level*, which is one definition of neutrality, but steady states

$$x = (1 - \beta)/\kappa\pi, \tag{25}$$

with a higher inflation *rate* have higher output, which violates a more stringent definition of long-run neutrality. Since  $\beta$  is close to one, however, this is a small effect.

This effect is contentious, with several attempts to fix it and critiques of those attempts. Its presence is not a central part of new-Keynesian doctrine, which unlike 1960s Keynesianism does not argue for higher steady state inflation to produce higher steady state employment. Moreover, it is only one of many peculiarities of the Calvo (1983) and related pricing models (Auclert et al. (2022)), that are not meant to be taken to extremes. For example, a fixed rate of price setting opportunities breaks down as inflation is larger. The Calvo fairy visits more frequently in Argentina. And microeconomic evidence on prices does not fit the model well (Steinsson and Nakamura (2013)).

To the central point,  $\beta < 1$  does not change the sign of the effect of interest rates on inflation, it does not change determinacy or stability properties, and it does not much change dynamics. In this simple model, with  $\beta < 1$  in the Phillips curve, inflation dynamics become

$$E_t \pi_{t+1} = \frac{1}{\beta + \kappa\sigma} \pi_t + \frac{\kappa\sigma}{\beta + \kappa\sigma} i_t.$$

The last coefficient on the interest rate is positive for any  $\beta > 0$ . With  $\beta < 1$ , a tiny  $\kappa\sigma$  can produce an unstable leading term, i.e., greater than one. But this possibility does not exist in the

full model, with  $E_t x_{t+1}$  in the IS curve. In that case, inflation is a two-sided moving average of the nominal interest rate,

$$E_t [(1 - \lambda_1^{-1}L)(1 - \lambda_2 L^{-1})\pi_{t+1}] = \sigma\kappa\lambda_1^{-1}i_t. \quad (26)$$

where

$$\lambda_{1,2} = \frac{(1 + \beta + \sigma\kappa) \pm \sqrt{(1 + \beta + \sigma\kappa)^2 - 4\beta}}{2}.$$

(Again, see Cochrane (2023) section 5.1. Seeing this formula may also motivate exposition with the much simpler model of this paper.) Here  $\lambda_1 > 1$  and  $\lambda_2 < 1$  if  $\sigma\kappa > 0$  and for any  $\beta \in [0, 1]$ . Lowering  $\beta$  cannot change the stability or determinacy of the model.

More importantly, from the IS equation

$$x_t = E_t x_{t+1} - \sigma(i_t - E_t \pi_{t+1}), \quad (27)$$

inflation and interest rates remain long-run neutral even with  $\beta < 1$  and a non-neutral output  $x$ : A 1.0 percentage point higher nominal interest rate still eventually produces a 1.0 percentage point higher inflation. The permanent output effect has no impact on the central relation between nominal interest rates and inflation.

The relationship between interest rates and inflation could also display small non-neutralities. Since nominal interest is taxed, at least one of pre-tax or after-tax nominal interest rates does not move exactly one for one with steady state inflation. Even steady inflation generates distortions via the tax code, and changes the distribution of prices among the monopolistically competitive producers of new-Keynesian models. But these considerations do not affect the *stability*, *determinacy* or the *sign* of the long-run response of inflation to interest rates.

## 4 Can Higher Interest Rates Temporarily Lower Inflation?

Stability and determinacy mean that higher interest rates eventually raise inflation. Experience suggests, and it is widely believed, that higher interest rates can lower inflation. There is nothing in what we have done so far that rules out a *temporary* negative sign. At a minimum we want a model that can express that belief, and see if the required ingredients and other predictions of such a model make sense.

If that were true, then the central bank could do some good by raising rates. We could then also understand central bankers' and policy commentators' belief in a uniformly negative effect, as well as the absence of a well-documented long-run positive effect in most econometric estimates. Central banks seldom leave rates alone long enough, with a background of stable fiscal policy and no other shocks, to see the positive long-run effect.

We are, in short, finally where Lucas started. Lucas's central contribution was to build on a theory of neutral money, to describe the short-run *non-neutrality* of money.

Here are the rules of the game: We want a model in which the central bank operates via an interest rate target, does not limit money supply, and pays full interest on abundant reserves. We want a higher interest rate, with no change in fiscal policy, to lower inflation, at least for a while. The model should follow the usual rules of economics, including rational expectations. The model should build on the frictionless model with well-described frictions. That is likely to leave the frictionless model predictions in the long run, but not necessarily so.

I emphasize the novel qualifier, "with no change in fiscal policy." Monetary policy can appear to have an effect if it comes with or induces a change in fiscal policy. Fiscal policy might react to the same events as monetary policy reacts to. An interest rate rise leads to higher interest costs on the debt, which might induce a fiscal tightening. The interest rate rise might lead to a recession, which leads to stimulus, bank and business bailouts, and automatic stabilizers. Or, inflation induced by monetary policy might lead to austerity and fiscal retrenchment. For evaluating history or for predicting the likely course of the economy following a monetary policy shock, we want to include such contemporaneous and induced fiscal responses. But our question is a theoretical one: What can monetary policy do all by itself? If monetary policy only reduces inflation by inducing a fiscal contraction, that's news for economic theory, and practitioners must recognize that monetary policy by itself is not effective.

There might be no such model. But knowing that fact is important. A search that establishes no such model exists, that standard beliefs require induced fiscal policy responses, irrational people, or an inherently unstable or non-neutral foundation is just as important as a search that finds a model to confirm standard beliefs.

You might think it's easy. Just add some sticky prices. That turns out not to be the case. You might think that standard models in use for decades satisfy this desire. That also turns out not to be the case. Both standard new-Keynesian and adaptive expectations models produce a negative effect by positing a fiscal contraction coincident with the interest rate rise. Without that

contraction, they don't produce a negative sign either.

#### 4.1 A Failure in Simple Sticky Price Models

Figure 2 plots the response of my simplified rational expectations model (20)-(21) to an unexpected permanent interest rate rise. The “sticky price” line gives the main message of this section: Inflation rises, even in the short run. The real interest rate rises (interest rate higher than following inflation), so output declines (not shown). But sticky prices only draw out the positive response of inflation to interest rates. We maintain long-run neutrality: The inflation rate eventually rises to match the interest rate.

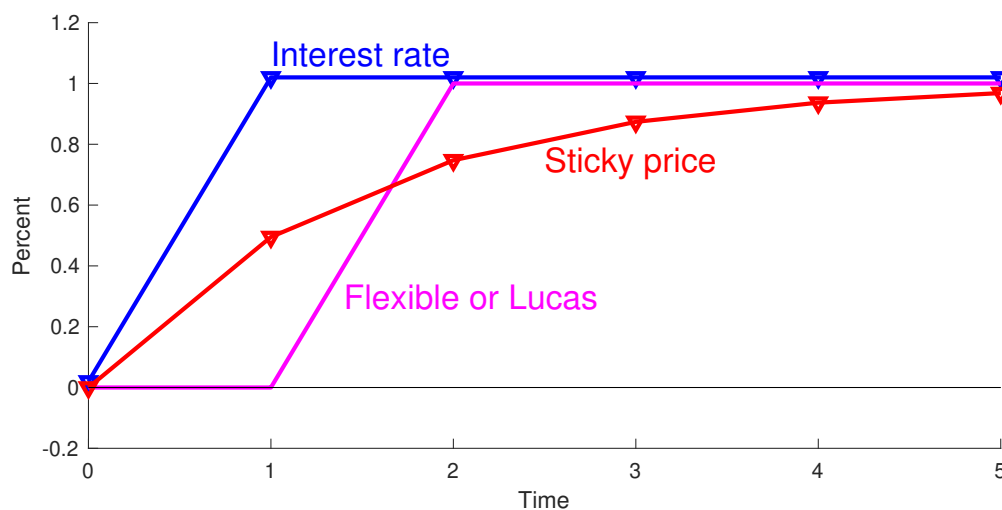


Figure 2: Inflation response to a 1% permanent rise in the interest rate with no change in fiscal policy. Rational expectations model. Parameters  $\sigma\kappa = 1$ .

Now, in detail. Start with the “flexible or Lucas” line. The flexible price model is (18)–(19). The responses solve

$$E_t\pi_{t+1} = i_t \quad (28)$$

$$\Delta E_{t+1}\pi_{t+1} = 0. \quad (29)$$

The response starts with all variables 0 at time 0. We want the response to a permanent unexpected interest rate rise to  $i_t = i_1$ ,  $t = 1, 2, \dots$  at time 1, with no change in fiscal surpluses. The first, surplus, term in the general unexpected inflation equation (17) is zero. By (28), the discount rate or interest cost term is zero as well. Hence, as in (29) and as shown in Figure 2, there is no

change in inflation on the day the interest rate rises, but inflation fully follows the interest rate with a one-period lag.

The Lucas Phillips curve in this model gives dynamics (24). The surplus innovation term in the unexpected inflation equation (17) is again zero, but now there are potentially interest costs to pay. The impulse-response solves

$$E_t \pi_{t+1} = i_t + \frac{1}{\kappa \sigma} \Delta E_t \pi_t \quad (30)$$

$$\Delta E_{t+1} \pi_{t+1} = \Delta E_{t+1} \sum_{j=1}^{\infty} \rho^j (i_{t+j} - \pi_{t+j+1}). \quad (31)$$

With only one unexpected movement at time 1 ( $t = 0$  in the equation), so  $\pi_2 = E_1 \pi_2$  and so forth, (30) leaves  $\pi_1$  arbitrary but then  $\pi_2 = i_1 + \pi_1 / (\kappa \sigma)$ ,  $\pi_3 = i_1$ ,  $\pi_4 = i_1$ , etc. Now, use (31) to find  $\pi_1$  and the unique path. (31) reduces to  $\pi_1 = i_1 - \pi_2 = -\pi_1 / (\kappa \sigma)$ . The unique solution is  $\pi_1 = 0$ , and thus  $\pi_2 = i_1$ ,  $\pi_3 = i_1$ , and so forth. You can verify that this path solves both (30) and (31). Despite the non-neutrality in the Phillips curve, which produces a one-period rise in output (not shown), inflation follows the flexible-price path, and does not decline.

The “sticky price” line uses the forward-looking new-Keynesian Phillips curve. The response function solves (20)-(21):

$$E_t \pi_{t+1} = \frac{1}{1 + \sigma \kappa} \pi_t + \frac{\sigma \kappa}{1 + \sigma \kappa} i_t \quad (32)$$

$$\Delta E_{t+1} \pi_{t+1} = \Delta E_{t+1} \sum_{j=1}^{\infty} \rho^j (i_{t+j} - \pi_{t+j+1}). \quad (33)$$

Again, surpluses are zero in (33) as that is the question we are asking. In response to the interest rate shock, there is a family of solutions to (32) which we can index by  $\pi_1$ ,

$$\pi_{t+1} = i_1 + \frac{1}{(1 + \sigma \kappa)^t} (\pi_1 - i_1). \quad (34)$$

Now, we use (33) at time  $t = 0$  to determine  $\pi_1$ :

$$\pi_1 = \sum_{j=1}^{\infty} \rho^j (i_1 - \pi_{j+1}). \quad (35)$$

Substituting from (34) and simplifying,

$$\pi_1 = \frac{\rho}{1 + \sigma\kappa} i_1 \quad (36)$$

and the full unique solution is

$$\pi_{t+1} = \left[ 1 - \frac{1 + \sigma\kappa - \rho}{(1 + \sigma\kappa)^{t+1}} \right] i_1. \quad (37)$$

The real interest rate rises and output declines. If your objective is only to produce a model in which the central bank can cool economic activity in the short run with interest rate rises, you have it. You might stop here and say that we have indeed redone Lucas (1972a) with interest rate targets, since his purpose was to understand how money growth affects the real economy.

But inflation still rises uniformly after the interest rate rise. Indeed, in period 1, inflation is *greater* than the (zero) value of the frictionless model. Why? With sticky prices, higher nominal interest rates lead to higher real interest rates. Higher real interest rates mean greater unfunded (by assumption of no change in fiscal policy) interest costs on the debt. With no change in surplus, these higher interest costs must come from a higher unexpected period 1 inflation, which devalues outstanding debt.

Indeed, as prices become stickier,  $\kappa \rightarrow 0$ ,  $\pi_1 \rightarrow \rho$  (see (36)) which is just barely less than one. Stickier prices lead to *more* period 1 inflation, since they lengthen the period of high real interest costs.

How is it that inflation jumps up in a most non-sticky way, in the limit that prices become stickier? Sticky *prices* do not imply sticky *inflation*. The few firms which can change price at any instant raise their prices a lot. Much verbal intuition describes sticky *inflation* or inflation momentum, but that needs a different set of costs than those specified by current sticky *price* models. (Lagged inflation in the Phillips curve would add some inflation stickiness; I investigate below and it does not solve the puzzle.)

The fiscal underpinnings matter crucially. If we said that fiscal surpluses would rise to pay higher interest costs on the debt, then we would obtain at least  $\pi_1 (= \Delta E_1 \pi_1) = 0$ , no immediate rise. If we could pair the interest rate rise with even higher surpluses, for example if future inflation led to future fiscal austerity, we could predict lower current inflation,  $\pi_1 < 0$ . But the question we want to ask is, what can higher interest rates do to lower inflation *without* fiscal



support? The answer is, so far, higher interest rates can produce a recession, but they raise inflation.

And even this much non-neutrality is fragile, really the result of one-period rather than instantaneous debt. In the continuous-time version of this response, with instantaneous debt, inflation instantly tracks the interest rate, for any price stickiness. Intuitively, the  $\Delta E_1 \pi_1$  term on the left-hand side of the unexpected inflation identity (33) is absent in continuous time with sticky prices, because prices do not jump, so the discounted sum (integral) of interest costs must be zero. With AR(1) dynamics that cannot overshoot and return, that means inflation must jump instantly to match the interest rate and the real interest rate does not move at all. Sticky prices really do not imply sticky inflation! The Appendix says this with equations.

Appealing to the new-Keynesian model will not help. This *is* the new-Keynesian model. Solving the model in new-Keynesian style, the central bank can produce any value of first-period inflation  $\pi_1 = \pi_1^*$  it wishes, by following an interest rate policy  $i_1 = i_1^* + \phi(\pi_1 - \pi_1^*)$ , where  $i_1^* = 1$ , the first point on the desired interest rate path, and  $\pi_1^*$  is the desired, possibly negative, first-period inflation. Write it up as  $i_t = \phi\pi_t + u_t$  with  $u_t = i_t^* - \phi\pi_t^*$ . But any inflation path other than the one we have already plotted requires a change in surplus, and lower initial inflation requires positive surpluses. If we phrase the question of a new-Keynesian ( $\phi > 1$ , passive fiscal policy) model, “What is the response of inflation to a monetary policy disturbance  $\{u_t\}$  that produces an unexpected permanent rise in the interest rate, and the associated passive fiscal policy requires no change in surpluses?” we have just calculated the unique answer.<sup>7</sup>

## 4.2 A Negative Effect From a Transitory Interest Rate?

The essential failure of the rational expectations sticky price model to produce a negative inflation effect is not tied to the permanent interest rate increase shown in Figure 2. I only graph permanent interest rate changes so that we can see long-run properties.

However, transitory interest rate paths can give a misleading appearance of such an effect. These statements are also important to check as experience with the standard new-Keynesian

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<sup>7</sup>Bianchi and Melosi (2019) study a related question. They also study interest rate increases with no fiscal policy reaction, in a more elaborate sticky-price model. They imagine a central bank that goes one step further, following an “active” Taylor rule that reacts to current inflation with coefficient greater than one. Now, higher interest rates raise interest costs on the debt, which leads as here to greater inflation. Their central bank raises interest rates even further, which if left alone leads to explosive inflation. The possibility of a Markov switch back to a coordinated regime saves this asymptotic possibility. Since on the path, future inflation is higher than current inflation, output falls.

model and AR(1) disturbances has led to the impression that permanent shocks raise inflation, but transitory shocks lower inflation. That conclusion is an artifact of the restriction to AR(1) shocks, but it motivates a look at transitory shocks here. (Explicit calculations in Cochrane (2023) Section 17.3.1).

To illustrate this point, Figure 3 plots the response of the simplified rational expectations model to a transitory interest rate movement, with  $i_t = 0.7i_{t-1} + \varepsilon_t$ . Inflation still rises uniformly. The only difference is that one doesn't notice long-run neutrality with a transitory shock. Again, inflation rises in the short run, even with a transitory interest rate rise.

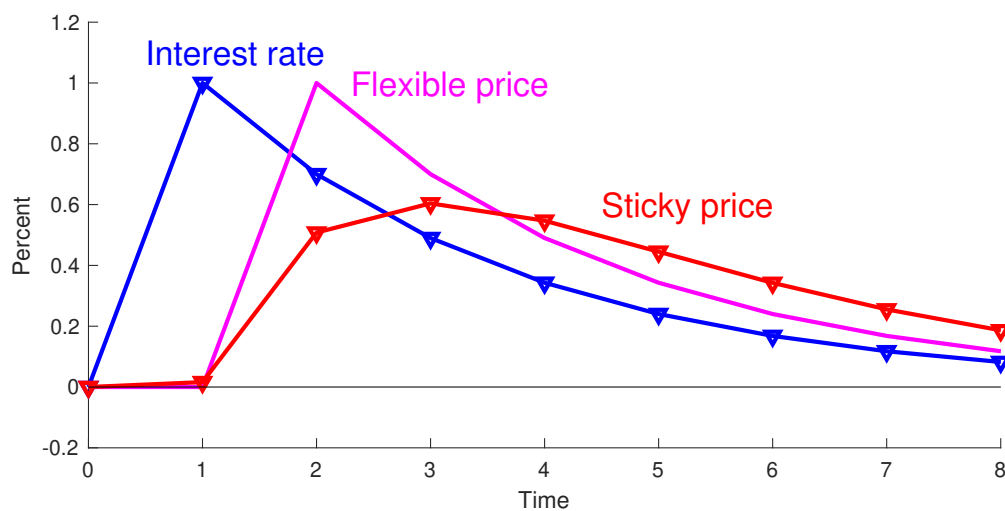


Figure 3: Response of the simple rational expectations sticky price model to a transitory interest rate path, with no change in fiscal policy. Parameters  $\sigma\kappa = 1$ ,  $\rho = 0.99$ , and  $i_t = 0.7i_{t-1} + \varepsilon_t$ .

The standard new-Keynesian specification produces a negative inflation response to an AR(1) monetary policy shock. But it does so by supposing a contemporaneous fiscal tightening (a “passive” response to the central bank’s equilibrium-selection policy). Interest rates rise, inflation falls, so there is a period of higher real interest costs on the debt. The initial disinflation is also a windfall to bondholders. Surpluses rise to pay these costs. Even looked at in standard new-Keynesian way, Figure 3 shows the unique equilibrium inflation path that has no change in fiscal surpluses and is consistent with the plotted interest rate path.

At the cost of some algebra, relegated to the Appendix, we can find the response of the rational-expectations sticky-price model (32)-(33) to an arbitrary interest rate path  $\{i_t\}$ , an-

nounced at period 1, with no change in fiscal surplus:

$$\pi_{t+1} = \frac{1 - \rho}{(1 + \sigma\kappa)^{t+1}} \sum_{j=1}^{\infty} \rho^j i_j + \frac{\sigma\kappa}{1 + \sigma\kappa} \sum_{j=1}^t \frac{1}{(1 + \sigma\kappa)^{t-j}} i_j \quad (38)$$

and in particular

$$\pi_1 = \frac{1 - \rho}{1 + \sigma\kappa} \sum_{j=1}^{\infty} \rho^j i_j. \quad (39)$$

The sum in the first term of equation (38) is common to inflation at all dates, and the coefficient in front of the sum decays at a rate determined by the price-stickiness parameters  $\sigma\kappa$ . This term captures the present value of all future interest costs. In the second term, inflation is a backward-looking moving average. It captures the smoothed version of  $E_t \pi_{t+1} = i_t$ .

In (38), all the coefficients are positive. Hence, *any sequence of positive interest rates*  $\{i_t\}$  *generates uniformly positive inflation response*  $\{\pi_t\}$ . In this sense, the positive response of the rational expectations sticky price model is general and does not depend on the time-series process of the interest rates.

We can generate the appearance of a negative effect of interest rates on inflation, however. If interest rates were to rise in the short run, and then turn towards a long-lasting negative value, we could have a few positive interest rates  $i_t$ , despite a negative value of  $\sum_{j=1}^{\infty} \rho^j i_j$  which drives a negative overall inflation response.

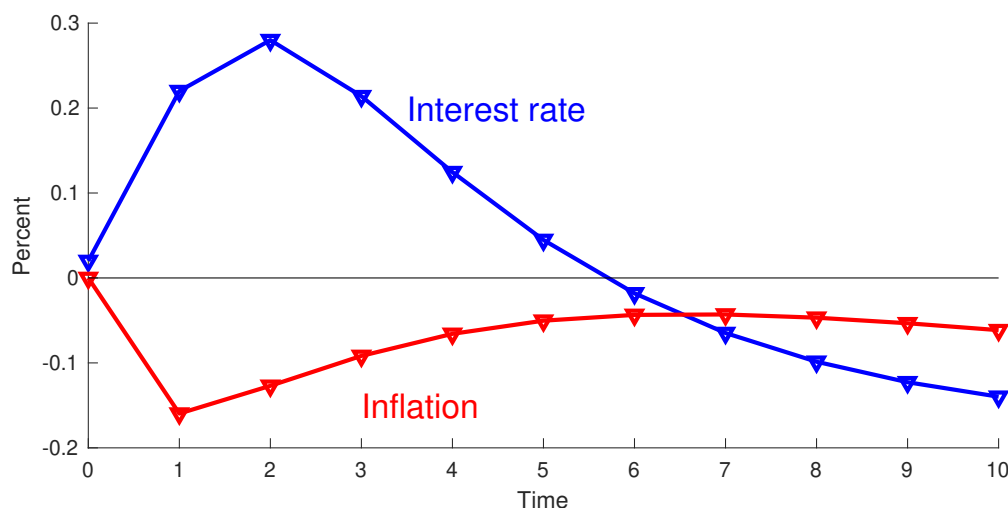


Figure 4: Inflation response to a transitory rise in the interest rate. Parameters  $\sigma\kappa = 0.1$ .

Figure 4 presents an example. As in all figures, this is the response of inflation to the indi-

cated interest rate path, with no change in fiscal surpluses. I create an interest rate path with a hump shape rather than an AR(1) shape to make the graph prettier, and to resemble paths often seen in VARs. I specify  $i_t = 0.7^{(t-1)} - 0.6 \times 0.4^{(t-1)} - 0.2$ . The long-run interest rate response is thus  $-0.2$ . I then calculate the inflation path from (38). For an AR(1)  $i_t = \eta i_{t-1} + \varepsilon_{i,t}$ , (38) becomes

$$\pi_{t+1} = \left\{ \left( \frac{1-\rho}{1+\sigma\kappa} \frac{\rho}{1-\rho\eta} \right) \frac{1}{(1+\sigma\kappa)^t} + \frac{\sigma\kappa}{1-\eta(1+\sigma\kappa)} \left[ \frac{1}{(1+\sigma\kappa)^t} - \eta^t \right] \right\} i_1$$

Then, such solutions add for the three AR(1)s that generate the interest rate path.

Figure 4 looks initially appealing. A higher interest rate lowers inflation! In the very long run, of course, both interest rate and inflation end up at  $-0.2\%$ . But even that is not so unrealistic. We don't often see the long run; and when we do, both interest rates and inflation decline after a successful stabilization such as the 1980s. The plot looks superficially like the standard adaptive expectations model account of that episode (Figure 5 below). The long period in which the interest rate has a slightly greater negative response than inflation on the right-hand side would be easy to miss.

But this reading is profoundly misleading. Inflation declines initially because interest rates decline in the far future, *despite*, not because of, the short-term interest-rate rise. Indeed, the positive interest rates drag inflation up from even more negative values. If you want less inflation in this model, lowering interest rates immediately—the negative of Figure 2—is an even more powerful tool. There is nothing in the mechanics of this model that resembles standard intuition, that high real interest rates drive inflation down. Beware causal readings of impulse-response functions!

If we want a negative effect of interest rates on inflation, without a contemporaneous fiscal shock that's really doing the work, then, we will need to add ingredients beyond sticky prices.

### 4.3 Fiscal Requirements for the Adaptive Expectations Model

The adaptive expectations model (5),

$$\pi_t = (1 + \sigma\kappa)\pi_{t-1} - \sigma\kappa i_t. \quad (40)$$

produces standard intuition. Higher nominal interest rates lower inflation. Debt still accumulates by (14),

$$\rho v_{t+1} = v_t + i_t - \pi_{t+1} - \tilde{s}_{t+1}. \quad (41)$$

This is an identity, unaffected by expectations. Higher ex-post real interest rates  $i_t - \pi_{t+1}$  with no change in surplus lead debt to spiral upward, violating the transversality condition or any other bounds on debt that define an equilibrium.

If we ask the adaptive expectations model, “What is the response of inflation to a permanent unexpected rise in the interest rate, *with no change in fiscal surpluses*,” the downward spiral does not answer that question. Since the model is determinate, there is no answer to that question—the central bank cannot permanently raise interest rates without fiscal support.

Central banks eventually give in and abandon pegs if a spiral emerges. Friedman (1968), describing a reduction in interest rates, wrote that the central bank would eventually give in out of distaste for exploding inflation. Here, it is forced to give in by exploding debt and deficits.

Pegs and spirals obviously don’t work with adaptive expectations. The most standard model that produces a disinflation from a higher interest rate combines adaptive expectations with a Taylor rule. A positive shock to the Taylor rule starts an inflation decline, and then the Taylor rule automatically lowers the interest rate to steady the incipient spiral. However, this model also requires tighter fiscal policy to pay higher interest costs on the debt. Without such support, the disinflation does not occur.

It is easiest to exhibit this behavior in the continuous time version of the model, which avoids timing issues of inflation. Uniting the continuous time versions of (40) and (41) with a Taylor rule,

$$d\pi_t/dt = \sigma\kappa(i_t - \pi_t) \quad (42)$$

$$dv_t/dt = rv_t + i_t - \pi_t \quad (43)$$

$$i_t = \phi\pi_t + u_t. \quad (44)$$

(The Appendix develops the continuous time model more fully. I retain for now the assumption of short-term debt.) At time 0, the monetary policy shock  $u_t$  rises suddenly and unexpectedly from 0 and stays at the constant value  $u_t = u_0$ . Substituting (44) in (42), inflation dynamics become

$$\frac{d\pi_t}{dt} = -\sigma\kappa(\phi - 1)\pi_t - \sigma\kappa u_0.$$

The solution is

$$\begin{aligned}\pi_t &= -\frac{1}{\phi - 1} \left[ 1 - e^{-\sigma\kappa(\phi-1)t} \right] u_0 \\ i_t &= -\frac{1}{\phi - 1} \left[ 1 - \phi e^{-\sigma\kappa(\phi-1)t} \right] u_0 \\ r_t &= e^{-\sigma\kappa(\phi-1)t} u_0 \\ e^{-rt} v_t &= \frac{e^{-[r+\sigma\kappa(\phi-1)]t} - 1}{r + \sigma\kappa(\phi - 1)}.\end{aligned}$$

Figure 5 presents this result. The nominal and hence real interest rate rises, and inflation starts on its downward spiral. Following the Taylor rule, the interest rate swiftly follows inflation down, and the economy trends to the new lower inflation rate. This is a standard story of the 1980s, for example.

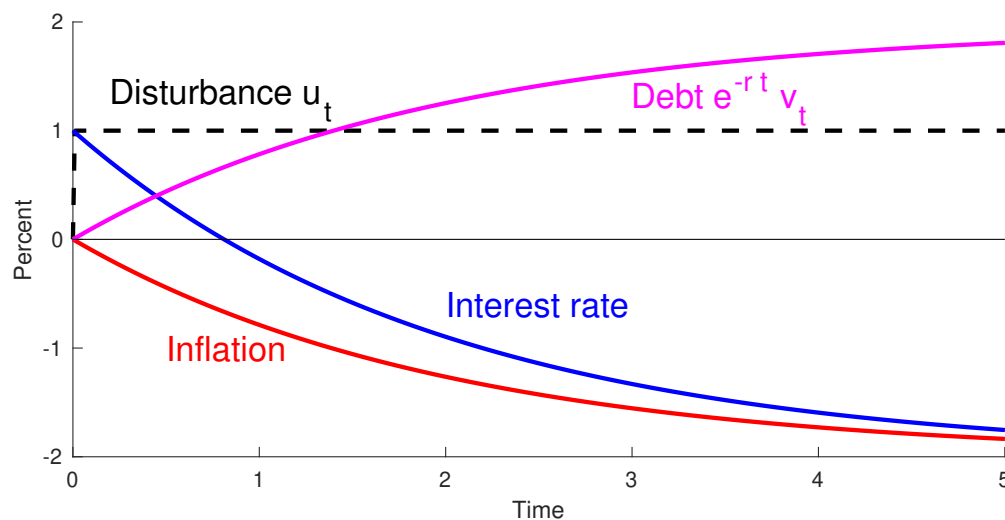


Figure 5: Response to a 1% permanent monetary policy shock in the adaptive expectations model with a Taylor rule. Parameters  $\sigma\kappa = 1$ ,  $\phi = 1.5$ ,  $\rho = 0.01$ .

However, the real interest rate is positive throughout the episode. Thus, with no greater surpluses, the greater interest costs on the debt are simply rolled over, and debt increases without bound. The transversality condition  $\lim_{T \rightarrow \infty} e^{-rT} v_T = 0$  is violated.

Therefore, this simulation does not answer the question, what can the central bank do by itself, without fiscal support? To achieve this outcome, fiscal policy must increase surpluses to pay the interest costs, and keep debt from exploding. If this is the story of the 1980s, the story is a joint monetary-fiscal stabilization, with surpluses rising (as they did) to pay the higher interest

costs of the debt, not a story of monetary policy acting alone.

#### 4.4 Adaptive Expectations With a Fiscal Constraint

In response to our question, the effect of interest rates on inflation *holding fiscal policy constant*, the adaptive expectations model cannot realistically produce a permanent inflation change, by any path of interest rates .

This point is again easier to see in the continuous time version of the model, because the timing of interest rate relative to inflation collapses to  $i_t = \pi_t$ . Denoting  $r_t \equiv i_t - \pi_t$ , (42)-(43) and the transversality condition are

$$d\pi_t/dt = -\sigma\kappa r_t \quad (45)$$

$$dv_t/dt = rv_t + r_t \quad (46)$$

$$\lim_{T \rightarrow \infty} E_t e^{-rT} v_T = 0. \quad (47)$$

The symbol  $r$  without subscript represents the steady state real interest rate, and point of linearization. The symbol  $r_t$  represents variation of the real interest rate around this steady state value. Normally the surplus  $\tilde{s}_t$  appears on the right hand side of (46) but I omit it as the exercise holds fiscal policy constant.

Given a real interest rate path, the solutions to (45)-(46) are

$$\pi_t = -\sigma\kappa \int_0^t r_j dj \quad (48)$$

$$e^{-rt} v_t = \int_0^t e^{-rj} r_j dj. \quad (49)$$

Imposing the transversality condition (47), the discounted sum of interest costs on the debt must be zero, which is a constraint on the real rate path  $\{r_j\}$ ,

$$0 = \int_0^\infty e^{-rj} r_j dj. \quad (50)$$

Define the long-run inflation rate  $\pi_\infty \equiv \lim_{T \rightarrow \infty} \pi_t$ , so

$$\pi_\infty = -\sigma\kappa \int_0^\infty r_j dj. \quad (51)$$

To lower long-run inflation in (51), then, pick a real rate path  $\{r_t\}$ , subject to the fiscal constraint (50), which states that the present value of interest costs is zero, i.e. unchanged. Once we pick the real rate path, and solve for inflation from (48), we can find the nominal rate from  $i_t = r_t + \pi_t$ . One can also express the  $\{\pi_t, v_t\}$  solution directly in terms of the nominal interest rate, but the resulting expressions are not so simple and transparent.

We see right away that *in the limit*  $r \rightarrow 0$ , *the adaptive expectations model cannot produce any permanent inflation or disinflation—a value of  $\pi_\infty$  other than zero—in the absence of a change in fiscal policy.* The right hand sides of (51) and (50) are the same. Positive real interest rates that push down inflation also build up the debt. They must be balanced by negative real rates to bring down the debt, but those real rates raise inflation right back to where it was.

A positive steady state real rate  $r > 0$  offers an apparent avenue for permanent disinflation. But, since  $r$  is small, this result is fragile, and the resulting policies are unrealistic. The present value in (50) downweights real rates in the future. So, to lower inflation, the central bank must first *lower* real interest rates, building up inflation, to produce a period of low interest costs, which lowers the debt. Then the central bank turns around and raises real interest rates, driving inflation down, using the accumulated savings on the debt to pay the higher interest costs. The unweighted integral in (51) allows a longer period of future high interest rates than the initial period of low interest rates, and overall to drive inflation down relative to its initial value.

But with small  $r$ , the opportunity requires large swings in rates and inflation to produce a small permanent reduction in inflation. Moreover, the period of low rates and high inflation must come first, before the final period of high rates and lower inflation. Imagine a central banker announcing that the plan for combatting inflation is first to make inflation worse, do drive down the debt, and only then turn around to cure the initial inflation plus the deliberate addition to inflation. This is highly unrealistic, and not at all consistent with the classic intuition we are trying to rescue.

When we pose the question as, “Can higher interest rates lower inflation, *without a change in fiscal policy*,” not even the most classic adaptive expectations model, which fits the narratives of central bankers and the policy world, can do it.



## 4.5 The Standard Model with Lagged Inflation in the Phillips Curve

Here I verify that with short-term debt and no change in fiscal policy, a higher interest rate does not raise inflation, even in the standard new-Keynesian model, and even extending that model to include lagged inflation in the Phillips curve. The model is

$$x_t = E_t x_{t+1} - \sigma(i_t - E_t \pi_{t+1}) \quad (52)$$

$$\pi_t = (1 - \alpha)E_t \pi_{t+1} + \alpha \pi_{t-1} + \kappa x_t \quad (53)$$

$$\rho v_{t+1} = v_t + i_t - \pi_{t+1} \quad (54)$$

$$i_{t+1} = \eta i_t + \varepsilon_{i,t+1}. \quad (55)$$

Equation (52) includes the forward-looking output term. Equation (53) allows for lagged inflation in the Phillips curve, a common ingredient. Perhaps we can get some of the adaptive expectations dynamics? Alas no, as we shall see. Equation (54) specifies short-term debt and no change in surplus.

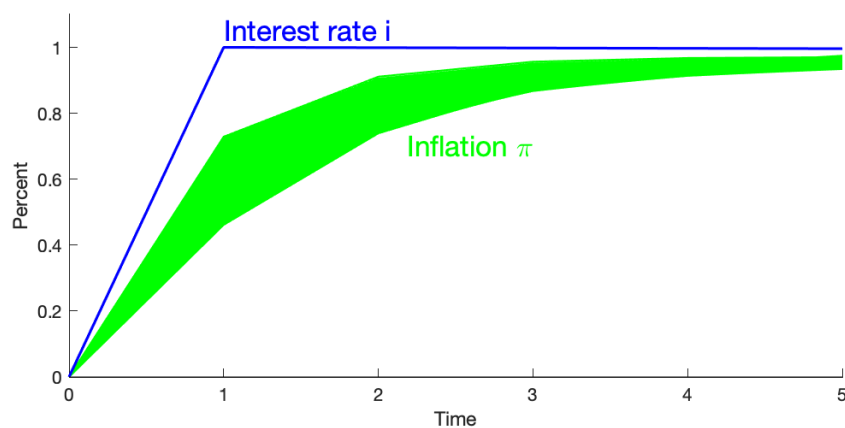


Figure 6: Inflation response to a permanent interest rate rise, with no change in fiscal policy. Full model with forward-looking IS curve and a lag in the Phillips curve. The shaded area shows impulse response functions with all parameters  $\alpha$ ,  $\sigma$ ,  $\kappa$  that produce real eigenvalues.

Figure 6 presents the response of this model to a permanent interest rate rise. I solve the model numerically. The shaded area gives all possible impulse responses, calculated by evaluating the response function for a grid of parameter values. I include all values of  $\alpha \in [0, 1]$ . I restrict parameters to those that produce real eigenvalues, however. Sawtooth or sine-wave responses induced by complex eigenvalues enlarge the possibilities and can produce some tem-

porarily negative inflation responses, but are clearly unrealistic. As the figure shows, for all such parameter values, this generalized model produces a steady rise in inflation. The static IS curve did capture the results of this more complex model.

#### 4.6 A Model with Long-Term Debt that Produces a Negative Effect

Figure 7 offers a simulation of the only current model I know of in which higher interest rates with no change in fiscal policy produce a negative short-run inflation effect.

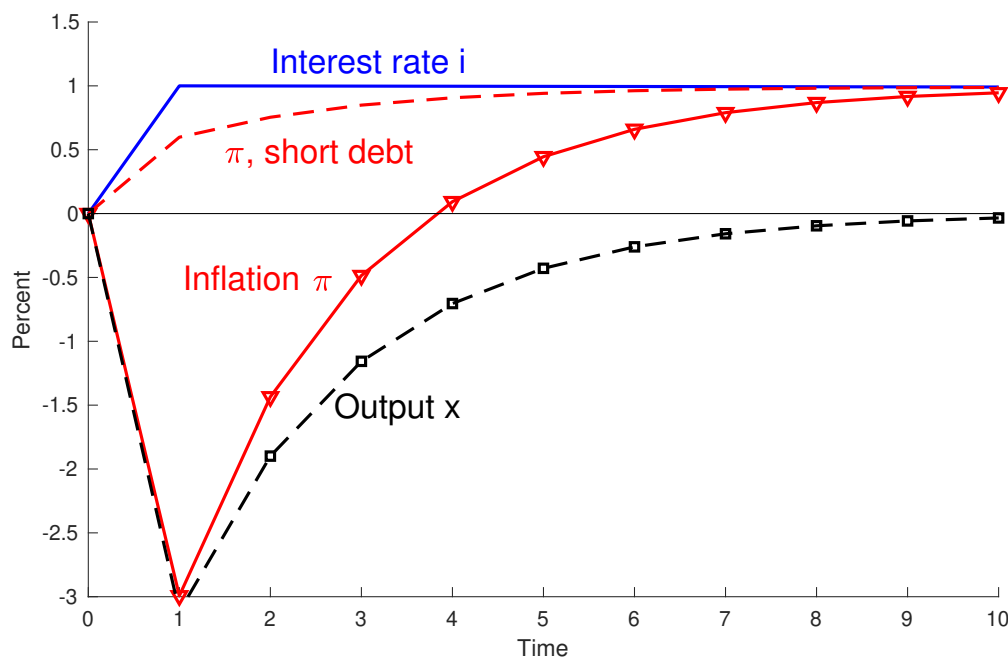


Figure 7: Response of inflation to an interest rate shock, and no change in fiscal policy, with long term debt. In the base case, debt has a geometric maturity structure, decaying at rate  $0.9^t$  with  $t =$  maturity. The short-term debt case is one-period debt only.

The model is

$$x_t = E_t x_{t+1} - 0.5(i_t - E_t \pi_{t+1}) \quad (56)$$

$$\pi_t = E_t \pi_{t+1} + 0.5x_t \quad (57)$$

$$\dot{i}_t = i_{t-1} + \varepsilon_{i,t} \quad (58)$$

$$\rho v_{t+1} = v_t + r_{t+1}^n - \pi_{t+1} - \tilde{s}_{t+1} \quad (59)$$

$$E_t r_{t+1}^n = i_t \quad (60)$$

$$r_{t+1}^n = 0.9q_{t+1} - q_t. \quad (61)$$

Here I use the full rational-expectations model, i.e. including the  $E_t x_{t+1}$  term in (56), as analytic solutions are not insightful. I include long-term debt with a geometric maturity structure. The face value of zero coupon bonds of maturity  $j$ ,  $B_t^{(j)} = \omega^j B_t$  declines at rate  $\omega = 0.9$ . The symbol  $r_{t+1}^n$  represents the ex-post nominal return on the portfolio of government debt. Equation (60) prices long-term bonds with the expectations hypothesis. Equation (61) links the log price  $q_t$  of the government bond portfolio to its rate of return. This is a simplified version of the model in Cochrane (2021), which in turn simplifies Sims (2011).

Again, I raise interest rates, I leave fiscal surpluses unchanged, and I calculate the inflation and output responses. Inflation declines temporarily! Inflation then rises in the long run, fulfilling long-run neutrality. This is the pattern we have been seeking.

Long-term debt is the crucial innovation relative to the simple models of previous figures, and its inclusion produces the negative sign. With long-term debt, but no ability to change surpluses, the central bank can lower inflation now, but by raising inflation later. Raising long-run interest rates, and thus long-run inflation, devalues long-run debt. Since surpluses haven't gone *down* either, that action raises the value of short-term debt. But short-term debt can only become more valuable via a lower price level.

Sims (2011) calls the pattern of Figure 7 “stepping on a rake” and offers it as a parable of the 1970s inflation cycles, in which higher interest rates temporarily lowered inflation, but inflation came back larger. We can call the pattern “unpleasant interest-rate arithmetic,” a successor to Sargent and Wallace (1981) unpleasant monetarist arithmetic. (Sargent and Wallace focus on seignorage in a model with real debt, in which the central bank controls money supply. In this model, there is no seignorage or money, government debt is nominal, and the central bank follows an interest rate target.) Unpleasant interest-rate arithmetic is here a negative sum, or inequality proposition: The central bank gets more long-run inflation than it saves in short-run inflation. (Woodford (2001) has the first statement of this effect.)

Generalizing the unexpected inflation decomposition (17) to long-term debt, we have

$$\sum_{j=0}^{\infty} \omega^j \Delta E_{t+1} \pi_{t+1+j} = -\Delta E_{t+1} \sum_{j=0}^{\infty} \rho^j \tilde{s}_{t+1+j} + \Delta E_{t+1} \sum_{j=1}^{\infty} \rho^j (i_{t+j} - \pi_{t+j+1}), \quad (62)$$

(Cochrane (2023) section 3.5.) By assumption, surpluses on the right hand side do not change. With no change in real interest rates either, as occurs in the flexible price model, the right hand side is zero. In this case, (62) offers the central bank a menu: reduce inflation at one date, in

exchange for more inflation at a different date. Devalue bonds at the later date to repay bondholders at the earlier date with more valuable dollars. This is simple “unpleasant arithmetic.” Higher real interest rates on the right hand side are higher interest costs on the debt, and make the tradeoff *worse*. Inflation must rise more on some dates.

You can see the mechanism directly with flexible prices. Let the real interest rate be constant  $r$ , and imagine a geometric maturity structure in which debt of maturity  $j$  has face value  $Be^{-\varphi j}$  ( $e^{-\varphi} = \omega$ ). Imagine a constant nominal interest rate  $i$ . The government debt valuation equation, stating that the market value of debt equals the present value of surpluses, reads

$$\frac{\int_{j=0}^{\infty} e^{-ij} e^{-\varphi j} B}{P} = \frac{1}{i + \varphi} \frac{B}{P} = E_t \int_{j=0}^{\infty} e^{-rj} s_{t+j}.$$

Imagine an unexpected permanent rise of the nominal interest rate from  $i$  to  $i'$ . The price level then jumps by

$$\frac{P'}{P} = \frac{i + \varphi}{i' + \varphi}$$

With perpetuities,  $\varphi = 0$ , this is a powerful effect. A rise from  $i = 1\%$  (0.01) to  $i = 2\%$  (0.02) cuts the price level in half. A 1% larger inflation then starts right away. Shorter debt gives a smaller response. For example, if debt has a 4 year half life (the face value of debt declines to  $e^{-1}$  by a 4 year maturity), then  $\varphi = 0.25$ , so a rise from 1% to 2% nominal rate implies  $0.26/0.27 \approx 10\%$  price level drop. That is still a large cumulative inflation from a 1% interest rate rise.

As with the short-term debt case, there is nothing essential about a permanent interest rate shock to generating this example. Any persistent shock will also lower long-term bond prices and raise long-term inflation, raising the value of short-term bonds. The initial disinflation is smaller, but still present.

A Taylor-type rule, in which the interest rate reacts to inflation, adds this sort of response to the inflationary effect of fiscal or other shocks. In this way, a Taylor-type rule spreads the inflation of such shocks forward, reducing their immediate impact. With the forward-looking Phillips curve, random walk inflation has no output effect, so by smoothing inflation forward such a rule reduces output volatility. In this model, the Taylor-rule coefficient must be less or equal to one, however.

Taylor emphasizes that his rule works well in a variety of models, and that robustness rather than strict optimality in a particular model is its virtue. Raising interest rates in response to inflation can eliminate the instability of the adaptive expectations model; it can eliminate the

indeterminacy of the rational expectations model; and it can reduce volatility in the rational-expectations fiscal-theory model.

The graph is attractive, but this mechanism is more limited than conventional intuition about monetary policy. If the world matches this model, monetary policy is a lot weaker than most people think, it is conditioned on variables including the persistence of interest rate changes and the maturity structure of debt that are not part of conventional intuition, and its basic mechanism is utterly different from standard intuition.

This negative effect of interest rates on inflation in this model only holds for *unexpected* interest rate rises. Lower inflation breaks out when a higher interest rate is announced, not when it happens. Thus, we have a lovely continuation of our list by which interest rates inherit many Lucas (1972a) properties of money growth. But maybe interest rates also lower inflation when they actually rise, not just when they are announced. If so, we need a different model.

Since the negative effect depends on long-term debt, the effect vanishes when governments borrow short term (one period), as illustrated by Figure 7 in the line marked “ $\pi$ , short debt.” More generally, the size of the negative effect depends on the maturity structure of debt. US government debt is relatively short-term, and has been shorter in the past. Whether debt maturity is long enough to produce quantitatively important effects, and whether the effect of interest rates on inflation varies with the maturity structure of the debt as the model predicts are important unanswered questions.

The negative effect requires long-lasting interest rate increases, that raise long-term nominal bond yields. This is an attractive proposition, as it accords with common intuition and contradicts the new-Keynesian opposite view. But we should check that higher interest rates lower inflation more when they are persistent, and only when they propagate to the long-term yield curve.

As above, price stickiness *reduces* the strength of the negative effect of interest rates on inflation. With sticky prices, the higher real interest rates add interest costs of the debt, an inflationary force. (See 62.) The negative effect of interest rates on inflation is strongest in the flexible price case, when real interest costs do not move. In this model there is no connection at all between sticky prices and the central non-neutrality that drives inflation down, completely contradicting standard intuition in which sticky prices are the central non-neutrality that gives monetary policy its power.

This response function also lowers inflation immediately, where the common intuition lowers inflation gradually. As with the above Phillips curve discussion, do not confuse a response that lowers today's inflation over what it otherwise would have been with a response that gradually brings equilibrium inflation down over time. Perhaps further frictions can produce such a response, but that also needs to be shown.

These features are not necessarily counterfactual. They are unknown, and not part of conventional wisdom. This model is new. Nobody has looked to see if the negative effect of interest rates on inflation is quantitatively linked to announcement, maturity, persistence, price stickiness, and fiscal events as the model predicts. Looking would be a valuable empirical project, though not an easy one.

I suspect the final conclusion may be that this mechanism works; that with long-term debt, persistently higher interest rates can lower inflation at the cost of higher future inflation. It may or may not be quantitatively important. But it does not revive standard beliefs about the power of higher interest rates to mechanically lower inflation. Thus, standard beliefs are either wrong, or require powerful new frictions.

Even if it can quantitatively replicate the result of standard beliefs, i.e. the impulse-response function, the long-term debt mechanism has nothing to do with standard intuition, that higher real interest rates depress demand, and then work through a Phillips curve to lower inflation. It describes only an unpleasant arithmetic, shifting inflation between time periods without changing the overall value of the government bond portfolio.

Clearly, this model does not give an always and everywhere, mechanical connection between higher rates and lower inflation, Lucas holy water sprinkled on IS-LM thinking. It does not produce something like the adaptive-expectations dynamics in the short run, which then turn around and become stable when some suitable friction or information problem is resolved. And it will be a long time before we write opeds, Fed chairs explain, and we teach to undergraduates that the central mechanism by which the Fed can temporarily lower inflation is to rearrange the real payoffs to different maturities of nominal government debt!

## 5 Evidence and Experience

Stability and determinacy under an interest rate peg challenges conventional doctrine, but it is not obviously contrary to historical experience. We have just seen something close to an interest rate peg. From 2008 to 2016 in the US, from 2008 to 2022 in Europe, and from 1995 to 2022 in Japan, interest rates were effectively stuck at zero. They could not move much in the downward direction, they did not move in the upward direction. Central bankers gave “forward guidance” that interest rates would not move, at least not promptly and more than one for one with observed inflation.

When these countries hit the zero bound, many economists, commenters, central banks, and international monetary institutions predicted a “deflation spiral” as depicted in the left-hand panel of Figure 1. They continued to worry that a spiral would break out during the decades of zero interest rates. New-Keynesians had a different worry. They had warned for 20 years that a zero bound would lead to volatile multiple-equilibrium inflation as depicted in the right-hand panel of Figure 1. Yet neither unstable spirals nor additional inflation volatility broke out. Inflation just batted around 1-2% the whole time.<sup>8</sup>

The widespread view that by reacting slowly to inflation in 2022 the Fed made inflation worse, and that only a sustained dose of interest rates higher than current and past inflation can bring inflation down, reflects the same beliefs, captured by unstable adaptive-expectations dynamics. (See, for example, most of Bordo, Cochrane, and Taylor (2022).) Yet, from 2022 to summer 2023, inflation declined with interest rates still below current inflation, as it did previously in 1948, 1951, and 1975. The outbreak of inflation following a huge \$5 trillion fiscal stimulus, and its gentle decline afterwards mirrors the simplest fiscal-theory response to a fiscal shock.<sup>9</sup>

But if we accept this evidence that inflation is stable around a zero peg, we have to accept its uncomfortable long-run Fisherian implication that inflation will still be stable around a higher peg, and raising the peg will eventually raise inflation.

What about historical pegs that preceded inflation? These episodes are central to Friedman’s (1968) argument that pegs are unstable. Well, quiet (the opposite of volatile) inflation also requires no fiscal news in (17). Most governments with interest rate pegs and spiraling inflation use the peg to hold down interest costs of the debt in a time of fiscal stress. One can read such

<sup>8</sup>I summarize here much longer analysis in Cochrane (2017), Cochrane (2018), and Cochrane (2023) Ch. 20.

<sup>9</sup>Cochrane (2022a) presents this simple calculation.

pegs as part of a financial repression regime designed to boost demand for government debt, not a market interest rate with solvent fiscal policy. The US interest rate peg of the 1940s and early 1950s was explicit in that aim. And even so, that peg lasted remarkably long, relative to models that predict instability or indeterminacy. The peg lasted through nearly 20% inflation in 1947, which did not set off a spiral.

One might object to a fiscal explanation for inflation under interest rate pegs, as in the theory only unexpected fiscal events can spark inflation. But sticky prices draw out the response to such events. And if you pick episodes *ex-post* with large inflation, you also are likely to pick episodes that had several bad fiscal news shocks, or episodes like our own from 2010 to 2022 in which a peg was followed by a fiscal shock.

In the zero bound era, real interest rates and interest costs on the debt fell, and unexpectedly relative to long-term bond prices in 2007. Low interest costs on the debt act like surpluses (see (17)). Long-run fiscal policy was not in great shape, but there wasn't much bad *news* during the quiet 2010s.

Econometric analysis gives weak evidence that higher interest rates lower inflation. When monetary policy shocks reduce inflation at all, such reductions are delayed more than a year and then are small and marginally statistically significant or insignificant. Ramey (2016) provides a comprehensive review and update. See especially Figures 1, 2, and 3, with small, sometimes positive, delayed, and insignificant inflation effects, and note the disappearance of any effect after 1983. Romer and Romer (2023) Figure 5 and Figure 7 summarize the results of the narrative approach. After a higher interest rate or monetary tightening, inflation rises slightly for a year, then gently declines, but just about two standard errors below zero. Moreover, these estimates include credit and quantitative shocks in the 1950s and 60s, and the last shocks are in 1981 and 1988 (Table 2). The “price puzzle” that higher interest rates want to raise inflation dogged VAR analysis for decades, requiring careful orthogonalization to produce even this mild inflation reduction. It may have been trying to tell us something.

The empirical evidence that higher interest rates lower output and employment is much stronger. The question is only whether they lower *inflation*. The Phillips curve is the obvious weak point in our understanding.

Several other considerations weaken even this much evidence. Most of all, none of these estimates tries to orthogonalize monetary to fiscal policy, and so do not answer our basic question. That omission is natural, as without a fiscal theory in mind, nobody thought that it was



important to do so. It is plausible that fiscal contractions accompany monetary contractions, if nothing else to pay higher interest on the debt, but also as a coordinated anti-inflation policy response. Fiscal authorities also do what they can to tame inflation. Even the early 1980s included a social security reform, large tax reforms, and deregulation. Sharply rising primary surpluses in the late 1980s and 1990 paid higher interest costs on the debt and paid for a bondholder windfall in the 1980s (Cochrane (2022a)). Conversely, failed stabilizations around the world often include an attempted monetary tightening that is not accompanied by fiscal and microeconomic reform.

Nakamura and Steinsson (2018) eloquently summarize the hard identification and computation troubles of contemporary empirical work. To identify an interest-rate shock, as opposed to an endogenous response, we must assume that regressions control for all variables that the central bank sees and responds to. But central banks watch more variables than we can ever include. Nakamura and Steinsson use 9/11 as a clear example: The Fed lowered interest rates after the terrorist attack, likely reacting to its consequences for output and inflation. But VARs, even those that include interest rates to capture market expectations, register the event as an exogenous shock.

Nakamura and Steinsson also emphasize the oft-forgotten lesson of 1980s time-series econometrics, that estimating 10-year responses from quarterly VARs raised to the 40th power, or monthly VARs raised to the 120th power, is dangerous. Such responses rely crucially on one having in hand the persistent state variables, and accurately measuring their dynamics. Long run dynamics are driven by the largest eigenvalue of the system, which is typically near one. Direct regressions (“local projections”) of variables of interest on shocks are more reliable but less parsimonious. They force one to recognize just how few non-overlapping samples we have at the horizons of interest.

Is there even such a thing as an exogenous policy shock? The Fed always says it is reacting to something. At best, the Fed might react to something that has no effect on inflation or (separately) output, and such reactions would qualify as exogenous for measuring the latter responses. But nobody has taken this old suggestion seriously, preferring to try to find ephemeral shocks that are orthogonal to everything. (It is neither necessary nor sufficient for an interest rate shock to be unexpected by asset market participants in order to identify the output and inflation response.)

Either VAR or local projection responses to shocks completely miss the central ingredient

of an intervention such as the early 1980s. By design, “shocks” are deviations from a rule, not changes in rule or “regime” itself that may durably change expectations. If the art of reducing inflation is to convince people that a new regime has arrived, then the response to any monetary policy “shock” orthogonal to a stable “rule” completely misses that policy. Clarida, Galí, and Gertler (2000) famously attribute the end of 1970s inflation to a change in the rule, a change in  $\phi_\pi$  in  $i_t = \phi_\pi \pi_t + \phi_x x_t + u_t$ , not a big shock  $u_t$ .

The vast majority of current estimates also find that identified monetary policy shocks lead to short-lived interest rate responses. They therefore do not measure the effect of the persistent interest rate movements that we need to evaluate the long-term debt mechanism, or to examine the long-run Fisher prediction that inflation should eventually rise. They do not measure the effect of the persistent high real interest rates of the one great episode, the early 1980s.

Uribe (2022) addresses persistence. He evaluates the “neo-Fisherian” hypothesis that higher interest rates raise inflation via an identified VAR. He identifies a permanent shock as one that increases both the nominal interest rate and inflation in the long run. He finds that shock *raises* inflation and nominal interest rates even in the short run. Similarly, Schmitt-Grohé and Uribe (2022) find that permanent interest rate shocks *depreciate* the currency. In both papers, transitory interest rate movements lead to the standard disinflation and appreciation.

Their results are good news for Figure 2, in which a persistent interest rate rise raises inflation even in the short run. But they are bad news for Figure 3 in which a transitory rate rise also raises inflation, and Figure 7 in which a permanent interest rate rise lowers short-run inflation with long-term debt. They are also bad news for the view that the 1980s succeeded via a highly persistent monetary policy shock. However, Schmitt-Grohé and Uribe also did not attempt to find monetary policy shocks orthogonal to fiscal policy changes, so their results do not directly bear on our question.

In sum, the empirical literature evaluating whether higher interest rates lower inflation is tenuous despite enormous effort, and is not addressed at our central questions. Thus, current empirical work leaves open a possibility: The widespread faith that higher interest rates reliably lower inflation, without fiscal help, may simply not be true.

## 6 Paths to Follow

So, despite 50 years of modern intertemporal general equilibrium macroeconomics since Lucas (1972a), we still don't have a solid well-agreed on theoretical or empirical answer to the basic questions: Can higher interest rates, without concurrent or induced changes in fiscal policy, lower inflation, even temporarily? If higher interest rates can temporarily lower inflation, by what economic mechanism do they do so?

One may be tempted to return to adaptive expectations, or add complex learning and expectation formation schemes (Gabaix (2020), García-Schmidt and Woodford (2019), or Bianchi-Vimercati, Eichenbaum, and Guerreiro (2022)) to similar effect. There was a widespread hope that the new-Keynesian enterprise would put rational expectations and Lucas general equilibrium foundations under classic intuition, finally answering the call for Keynesian “microfoundations.” Forty years on, as this little review emphasizes, we realize that the rational expectations, market clearing, and forward-looking sticky-price models produce something utterly different from the classic intuition reflected in my adaptive expectations model. It's clearer now that if you want to rescue classic intuition, you pretty much have to go back to classic models.

But my little tour should make us even more hesitant to follow this approach. Now we understand just how far away the adaptive expectations model that produces conventional intuition is from the rational benchmark. Adaptive expectations produces the desired short-run sign by changing the basic stability and determinacy properties of the economy, including the long-run sign. It does not produce a transitory negative effect but preserve long-run neutrality.

Somewhat irrational expectations or learning are often important ingredients for matching dynamics and episodes, on top of basic models.<sup>10</sup> But that does not make it desirable to place adaptive or irrational expectations as a *necessary*, always-and-everywhere feature to talk about inflation and monetary policy at all, not just a *sufficient* friction to match dynamics on top of a simple economic benchmark. We would have to say that there *is no* simple model like  $MV = PY$  that explains the basic ideas of price level determination under interest rate targets, which we modify with more complex expectation formation. Icing should not be the cake.

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<sup>10</sup>A taste: Marcet and Nicolini (2003) study recurrent hyperinflations with learning. They explain why bouts of hyperinflation break out in the context of large and stable inflation, with no large changes in seigniorage. Orphanides and Williams (2005) present a model in which constant learning contributes to inflation dynamics, and allows private sector inflation expectations to provide useful information to the central bank. Williams (2006) shows how learning can undermine the desirable properties of a price-level target, that people expect a period of inflation to follow deflation. Bullard and Mitra (2002) show that learning changes the optimal policy rule. Sargent (2001) “Conquest of American Inflation” is a classic example in which learning by the Fed takes center stage.

More deeply, a model like the simple adaptive expectations model here, that reverts to traditional intuition about the sign and stability of interest rate targets, is necessarily bounded away from the frictionless rational benchmark. Sign and stability properties only change when an eigenvalue crosses one. Thus, small changes around the frictionless rational benchmark won't do, and the basic sign and stability of the adaptive expectations model must change along the way back to that benchmark. The frictionless rational benchmark or anything local to it cannot describe the central properties of such a model. (See Cochrane (2016) for a concrete example.)

We would also need to face the failures of the adaptive expectations / unstable approach during the zero bound era, in 1970s stagflation, in the relatively rapid end of inflation in 1982, in the success of 1990s inflation targets, in the ends of hyperinflations (Sargent (1982)) in which inflation fell with no monetary stringency or output consequence, and, as of mid-2023, in the failure of inflation to spiral upwards despite interest rates well below inflation, among other episodes.

Whether people are truly “rational,” and what that term even means, is a contentious philosophical debate, but the issue for us is really just whether expectations are model-consistent. The expectations *of* the adaptive-expectations model can be systematically different from expectations *in* the model. (Lucas (1991) refers to rational expectations as a “consistency condition.”) People in the adaptive-expectations model never catch on, no matter how many times they see inflation rise and fall. Again, that's ok for an episode or transitory phenomena, but should that be a necessary ingredient of our most basic model of inflation?

Expectations may seem adaptive. Expectations must be, in equilibrium, functions of variables that people observe, and likely weighted to past inflation. The point of “rational expectations” is that those forecasting rules are likely to change as soon as a policy maker changes policy rules, as Lucas (1976) famously pointed out<sup>11</sup> in his “critique.” Adaptive expectations may even be model-consistent, until you change the model.

That observation is important in the current policy debate. The proposition that interest rates must be higher than current inflation in order to lower inflation assumes that expected inflation equals current inflation – the simple one-period lagged adaptive expectations that I have specified here. Through 2021-2022, market and survey expectations were much lower than current (year on year) inflation. Perhaps that means that markets and surveys have rational expect-

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<sup>11</sup>Sargent (1971) and Lucas (1972b) made the point earlier in the Phillips curve context. They showed that in a  $\pi_t = \alpha\pi_{t-1} + \kappa x_t + u_t$  regression,  $\alpha < 1$  coefficients can easily occur even when the true Phillips curve has rational expectations. The coefficient  $\alpha$  shifts if the monetary policy process shifts.

tations: Output is temporarily higher than the somewhat reduced post-pandemic potential, so inflation is higher than expected future inflation ( $\pi_t = E_t\pi_{t+1} + \kappa x_t$ ). But that observation could also mean that inflation expectations are a long slow-moving average of lagged inflation, just as Friedman speculated in 1968 ( $\pi_t^e = \sum_{j=1}^{\infty} \alpha_j \pi_{t-j}$ ). In either case, expected inflation is much lower than current inflation. Tests are hard, and you can't just look at in-sample expectations to proclaim them rational or not.

Of course, “rational” or “model consistent” do not mean “clairvoyant,” or even particularly good. Rational people may be quite bad at forecasting inflation. With noisy signals, rational forecast errors can be serially correlated (Coibon and Gorodnichenko (2012)). Inflation, like stocks, may simply be hard to forecast. The Fed and sophisticated market participants are pretty bad at forecasting inflation too.

Much policy discussion recognizes the importance of expectations, treats the Phillips curve  $\pi_t = \pi_t^e + \kappa x_t$  as a causal relation, and thinks of expectations as a free variable. Expectations can be influenced by speeches and “anchoring,” a generic faith that somehow inflation will return to 2%, but expectations are not tied systematically to experience of how the Fed and fiscal policy behave in similar circumstances. Most of all, expectations do not react to a current policy action; people do not worry that a different action may imply a new regime. Higher interest rates reduce output, and holding expectations fixed, lower output lowers inflation. The key assumption in this train of thought is not so much *adaptive* expectations, but exogenous expectations. The central feature of the rational expectations model is that policy actions or rules change expectations.

Most of all, ignoring all these philosophical troubles, the adaptive expectations model I pursued here *cannot* lower inflation without a fiscal tightening to pay the higher interest costs on the debt. In response to the question, how can higher interest rates *by themselves* lower inflation, even the adaptive expectations model comes up empty. Rescuing adaptive expectations to justify powerful monetary policy must somehow overcome its reliance on a fiscal tightening.

You may wish to put money back in the model. Raising interest rates means printing less money  $M$ , which lowers nominal income  $PY$  and eventually the price level  $P$ . (Alvarez, Atkeson, and Edmond (2009) is a good example.) But it's not so easy as a matter of theory, and as in the first paragraph of this essay, our central banks simply do not control money supplies. They change interest rates by changing the rate paid on superabundant reserves, not by rationing low-interest reserves. Adding liquidity effects in government bonds or other financial assets to the model is

an attractive generalization, but the central bank must control the supply of such liquidity just like money for this avenue to produce a basic model of the price level.

You might say that the Fed *should* go back to controlling the money supply, and start cracking down on inside liquid money substitutes. But we need some advice for central banks in the meantime, and at least we should understand how our current system based on interest rate targets works, or doesn't. From 1982 to February 2021 it looked like a pretty good system. Inflation is *something* while central banks control interest rates and provide and allow ample liquidity. We need a theory of what that something is.

One is drawn to add model ingredients. Surely in the DSGE smorgasbord there are enough ingredients to come up with a temporary negative sign. That is, I think, the right answer. My point is, it has not yet been done—and especially, it has not been done with the kind of clarity, simplicity, economic rigor, transparency, and tractability that Lucas brought to the non-neutrality of money. Many model-implied monetary-policy response functions have been computed of course, but not many yet hold fiscal policy constant in an interesting way, and few look into the footnote about lump-sum taxes to see just what those are and to what extent inflation reduction comes from an implicit fiscal contraction. The literature that puts fiscal theory in explicit DSGE models is an exception; see for example most recently Bianchi and Melosi (2022), Chen, Leeper, and Leith (2021), and Leeper (2021). This literature is explicit about fiscal-monetary coordination. However, it has focused on switching between active-fiscal and active-money regimes, and so far has not addressed the question in this paper, whether higher interest rates can lower inflation with no change in fiscal policy.

One easily jumps to capital with adjustment costs, financial frictions, credit constraints, portfolio adjustment costs, liquidity effects, additional price and wage-setting frictions, strategic complementarities, individual heterogeneity, or other model complications. But the negative response of inflation to interest rates should be a robust and deeply rooted phenomenon, one that will not vanish if, for example, the US changes working capital financing traditions or the downpayment rules on mortgages. In his Nobel Lecture, Lucas (1996) cites David Hume for understanding the neutrality and non-neutrality of money in 1752. Velde (2009) documents a beautiful non-neutrality episode in 1724 France, with a monetary and financial system utterly unlike our own.

It is likely to be possible to find in this soup *sufficient* conditions to deliver the negative sign, with enough model complications. Our goal though is the minimum *necessary* conditions, that

apply most broadly and robustly, that we can put at the basis of any good theory of inflation and monetary policy under interest rate targets. That is a harder goal. Again, Lucas (1972a) is a great example. In his economy, the flexible price version leads to super-neutrality: An increase in money just raises the price level. Bob put in *one* “friction,” imperfect information about aggregates, leading to a confusion between relative and aggregate price movements.

Adding to the difficulty, standard new-Keynesian models have struggled to produce the kind of response one sees in VAR estimates, and that represent traditional beliefs, even allowing a contemporaneous “passive” fiscal response. In the estimates and common beliefs, inflation either rises or stays constant for a year, and then falls over time. Interest rates, like money, act with long and variable lags. In the theory, inflation jumps down, and rises over time (Ball (1994) first drew attention to this contrast. The Phillips curve is  $\pi_t = \beta E_t \pi_{t+1} + \kappa x_t$ . Higher interest rates lower  $x_t$ , which lowers  $\pi_t$  *relative* to  $E_t \pi_{t+1}$ . Equilibrium selection chooses a  $\pi_t$  lower than it otherwise would have been, but inflation rises over time.) As we have seen, this is an essential feature of the simple model. Only the drop in current inflation by equilibrium-selection policy overcomes the Fisherian force of the model. Even my long-term debt fiscal theory model produces lower inflation immediately.

Current new-Keynesian models that reproduce something like the classic beliefs and impulse responses do so with a smorgasbord of extra ingredients. Christiano, Eichenbaum, and Evans (2005), Christiano, Eichenbaum, and Trabandt (2016), Christiano, Eichenbaum, and Trabandt (2018), and Smets and Wouters (2007), are classics, which produce VAR-like inflation responses. But they include a long list of additional ingredients, many of which are quite different from standard microeconomic views and thus raise doubts whether the specifications really are policy invariant. Some of the ingredients which seem crucial to producing the inflation response include the following: 1) A strong one-period habit in utility, which essentially adds a time derivative on the relation between consumption growth and interest rates. 2) Sticky wages, driven by labor *monopoly* power, in contrast to the usual microeconomic worry about labor monopsony. 3) Firms must borrow money to pay the next period’s wage bill in advance. That change crucially means that higher interest rates raise marginal costs in the Phillips curve, detaching marginal costs from output and employment. Then higher interest rates raise inflation now  $\pi_t$  relative to expected future inflation  $\beta E_t \pi_{t+1}$ , but with equilibrium selection and timing rules holding  $\pi_t$  from moving, that means  $\beta E_t \pi_{t+1}$  falls. 4) Capital with adjustment costs that depend on investment growth, not the investment to capital ratio as in most microeconomic and asset pricing literature. 5) Wages and prices are indexed, so that those who cannot adjust

nonetheless react to inflation. This modification puts lagged inflation in the Phillips curve, but few prices and wages in the US are actually indexed. More recent literature that matches impulse response functions, for example, Auclert, Rognlie, and Straub (2020), adds still more ingredients, in this case heterogeneous agents. Are all these ingredients *necessary* for the basic sign and pattern of monetary policy in standard New-Keynesian models? And what will we need when we separate monetary and fiscal policy?

(Mankiw and Reis (2002), (2006), (2007) pursue a “sticky information” Phillips curve. It is particularly attractive in this context since it is motivated to reverse the Ball (1994) puzzle and produce inflation that rises over time when output is high. In addition, it is essentially a generalization of the Lucas (1972a) model, in which price-setters take more than a period to learn the aggregate price level, and thus solves the problem of the latter model that only produces a one-period output movement. However, Mankiw and Reis (2002) merges their Phillips curve with money supply control; Mankiw and Reis (2006) doesn’t present any results; and Mankiw and Reis (2007), which merges their Phillips curve with an interest rate rule, doesn’t actually produce the desired result. Inflation and output move essentially together, and inflation is high and declining when the level of output is high. Perhaps this attractive ingredient will in the future produce the desired sign and pattern of the inflation response, but it does not yet do so.)

This train of thought brings us back to the Phillips curve. In my little models, the Phillips curve is the central source of inflation dynamics. Yet the Phillips curve has not achieved great theoretical and empirical clarity, despite decades of dedicated work by top macroeconomists. It may make sense that firms sell more when output prices are high, or that workers work harder when wages are high. But these are relative prices, where the Phillips curve states that output and employment increase when all prices and wages rise together. So, any Phillips curve theory needs some confusion or correlation of relative prices with the overall price level.

In addition to wondering what ingredients to put in, then, perhaps this is one we should take out. Perhaps we can start to study the dynamic relationship between inflation and nominal interest rates apart from the Phillips curve.

Our goal is to understand  $\pi_t = a(L)i_t$ , the dynamic relationship between interest rates and inflation. The Phillips curve came from thinking about output and employment *effects* of inflation. That’s the central point of Lucas (1972a). Lucas had a perfectly good theory of inflation,  $MV = PY$ , but he wanted a theory to describe how inflation affects output. We are reversing the causal logic. We use the IS equation to describe how interest rates lower output, and then



the Phillips curve to describe how output affects inflation. (With the usual caveats for causal readings of equilibrium conditions.) The Phillips curve wasn't designed to be the central mechanism for nominal dynamics. We will of course still want to understand how inflation affects output and employment, and surely that understanding will feed back on inflation dynamics. But in the spirit of adding ingredients and frictions one at a time, perhaps price dynamics even without output effects should come before the Phillips curve.

A disaggregated production approach could be one example of an approach to inflation dynamics that abstract from an aggregate Phillips curve. In 2021-2022 much commentary centered on “supply chain” shocks and relative price movements as both underlying cause and key variables for the dynamics of inflation. Lane (2022) is a good example. In this view, large good- or sector-specific shocks move relative prices. Prices are more sticky downward than upward, so inflation rises. Guerrieri et al. (2021) argue that some inflation is optimal when there are reallocation shocks and downward nominal stickiness. However, this view requires either a compliant or absent nominal anchor, enough money or overvalued government debt for people to pay the higher overall prices, rather than eventually force down prices of goods not in short supply. “Supply” shocks give a transitory price *level* response, not a transitory inflation *rate* response. In this view, relative prices – average vs. marginal rents, house prices vs. rents, core vs. full CPI, etc.—are key state variables that forecast future inflation. The old Phillips curve, with a single output gap or unemployment rate capturing the entire effect of the real economy on inflation, is a dramatic simplification that misses these dynamics. Related, there is new interest in describing inflation dynamics in production networks, for example Minton and Wheaton (2022), Rubbo (2022), and La'O and Tahbaz-Salehi (2023). Perhaps reallocations, networks, supply and demand shocks interacted with sticky prices and wages, will take over from the IS and Phillips curve as our basic model of inflation dynamics, on top of our view—fiscal theory in mine—of a nominal anchor. Or, perhaps these are another in my long list of elaborations which we should hope are not *necessary* minimal ingredients to understand the basic sign and patterns of inflation determination with interest rate targets.

On the other hand, recognize how high the hill is that we have to climb. First, if we wish to produce the usual view, that higher interest rates lower *future* inflation relative to today's inflation (rather than force today's inflation to jump down), then a 1% higher nominal interest rates must lower the real interest rate by more than 1% to lower expected inflation. A small effect of nominal rates on real rates will not do.

Second, the basic logic of the fiscal identity (17) stating that the change in future surpluses

and any net interest costs of the debt must come out of the pockets of initial bondholders via inflation,

$$\Delta E_{t+1} \pi_{t+1} = -\Delta E_{t+1} \sum_{j=0}^{\infty} \rho^j \tilde{s}_{t+1+j} + \Delta E_{t+1} \sum_{j=1}^{\infty} \rho^j (i_{t+j} - \pi_{t+j+1}), \quad (63)$$

poses a robust constraint. With no change in surpluses, the first term on the right hand side is zero. In continuous time with sticky prices and short-term debt, the term on the left is also zero, as the price level cannot jump—we cannot devalue instantaneous debt. What’s left simply says that the long-run average of real interest rates must be zero. Inflation must adjust to the path that gives no long-run average interest costs – and therefore, in these models, no long-run average real interest rate. This is what made the adaptive expectation model incapable of lowering inflation without fiscal help. It’s going to be hard to get *any* model to lower inflation by higher interest rates when any period of high real interest rates must be matched by a period of lower real interest rates. Perhaps financial frictions that drive a wedge between real interest rates that bring down inflation and the government’s real interest costs will help, but again one hesitates for such a friction to be a *necessary* bedrock ingredient for the basic proposition that higher interest rates lower inflation.

There is again another possibility: It might not be true. The long-term debt model, with unpleasant interest-rate arithmetic or “stepping on a rake” may be as close as we come to standard intuition. Otherwise, nominal interest rate rises, *with no change in fiscal policy*, may not lower inflation even in the short run.

## 7 Conclusion

What is the dynamic effect of *interest rates* on inflation,  $\pi_t = a(L)i_t$ , in our world of abundant reserves, in which central banks set nominal interest rates, do not control money supplies, do not make equilibrium-selection threats, and cannot directly change fiscal policy? And, of course, after that, how do interest rates then affect output, employment, and other variables?

I have followed one line of thought on these questions to its logically inevitable conclusion: Rational expectations and fiscal underpinnings of monetary policy imply that inflation is stable and determinate in the long run. Those features imply that pegs are possible, and that higher interest rates, without a change in fiscal policy, eventually raise inflation. There may well be a short-run negative effect of interest rates on inflation. I show one suggestive model, but we

need to know if there are better models of that effect. Or, we need to accept the limited power of this model, and that outside its narrow scope come to believe that higher nominal interest rates without changes in fiscal policy *raise* inflation.

Thus, as I see it, we have made a lot of progress. We're finally at the launch pad, and we have some promising ideas, but we're still waiting for a new Lucas – and then, perhaps a new Sims on the empirical side – to finish the project.

If this path succeeds, we will still be left with an understanding that central banks are less powerful than we thought. First, fiscal policy remains a central determinant of inflation. When a fiscal shock occurs, when people do not expect debt to be fully repaid, and absent explicit default, inflation must rise to devalue the debt. The central bank can choose when and how abruptly that inflation will occur, but inflation is no longer always and everywhere controlled by monetary policy alone. Second, the central bank's ability to lower inflation by higher interest rates, provoking a little bit of recession, remains contingent on the frictions of the model that produces a temporary negative effect. The central bank still fully controls the long-run price level, however, by its ability to drag expected inflation to wherever it sets the nominal interest rate. Third, the simple static story that higher rates lower demand which lowers inflation via a Phillips curve does not even vaguely describe these models.

All this is controversial. Much of the point of this essay is to proclaim and explain the frictionless benchmark for inflation under interest rate targets, which is otherwise not obvious in the equations of new-Keynesian and fiscal theory models. Most academic literature still uses new-Keynesian equilibrium-selection threats and ignores fiscal underpinnings of monetary policy, even just to pay interest costs on the debt. The stability, approximate long-run neutrality, and long-run positive sign of that model is not widely recognized. Most of the policy world uses a muddle with somewhat adaptive expectations, or expectations as an independent force.

At a minimum, basic questions are still up for grabs. In the long run, is inflation stable or unstable, determinate or indeterminate under a peg? If the central bank raises rates persistently, and there is no fiscal news or other shocks, does inflation rise or decline in the long run? If not this, what is the neutral, frictionless benchmark on which we build a theory of inflation under interest rate targets?

The short run effects of higher interest rates have more consensus of opinion behind them, but even less well-accepted theory and empirical work behind that opinion. If the central bank raises interest rates, does inflation temporarily decline? If so, by what mechanism, and under

what preconditions? To what extent is an induced or contemporaneous (present value) fiscal tightening important to that result? And even though most economists seem to believe in the sign of the effect, the all important magnitude is still contentious. Must the central bank raise interest rates by more than the current rate of inflation, following the Taylor Principle, in order to lower inflation at all? Or will the substantially lower interest rate rises that central banks followed in 2023 be sufficient for inflation to fade away, at least until the next big shock? Are transitory or persistent interest rate increases more effective at lowering inflation?

The question I have posed—what is the effect of interest rates on inflation, with no change in fiscal surpluses—is important for understanding monetary economics. But it is an unlikely scenario with which to understand history, and it is not the right question to ask if one wants to forecast the effects of policy. Monetary and fiscal policies change together in response to events, and fiscal policy responds to economic changes brought about by monetary policy. The right interpretation of leaving fiscal policy unchanged depends on context too. For example, if the tax rate and automatic stabilizer laws are unchanged, and higher interest rates cool the economy, then they will lead to deficits, which can further raise inflation. To forecast the effects of an interest rate rise, allowing such responses might be a better definition of unchanged fiscal policy. One define a monetary policy shock as one that leaves the fiscal rule unchanged but has no disturbance to that rule. Cochrane (2021) and the above-cited fiscal theory literature include such fiscal policy rules, responding to output and inflation. Ask interesting questions and be clear what question you're asking.

How is it that we have been investigating interest-rate based models for at least 40 years, yet such basic questions are still unsettled? As I look at monetary models based on interest rate targets, I think we have been guilty of playing with too-complex models when we don't really understand basics, such as stability, determinacy, and the frictionless limit. But ideas in economics and sciences always start complex, and simplicity only emerges after much hard work.

This is all great news for young researchers. These are the good old days. Low-hanging fruit abounds. We're really at the beginning stages where simple models need exploration, not, as it appears, in a mature stage where essentials are settled and all there is to do is to add to the immense stock of complicated epicycles.

However, given the state of actual agreed-on knowledge, central banks' proclamations of detailed technocratic ability to manipulate delicate frictions is really not justified.<sup>12</sup>

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<sup>12</sup>For a lovely example, see the chart at <https://www.ecb.europa.eu/mopo/intro/transmission/html/index.en>.

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## Online Appendix

### A1 Solving the Model for Arbitrary Interest Rates

The model is

$$x_t = -\sigma(i_t - E_t\pi_{t+1}) \quad (\text{A1})$$

$$\pi_t = E_t\pi_{t+1} + \kappa x_t \quad (\text{A2})$$

$$\rho v_{t+1} = v_t + i_t - \pi_{t+1} - \tilde{s}_{t+1} \quad (\text{A3})$$

$$\lim_{T \rightarrow \infty} \rho^T v_T = 0 \quad (\text{A4})$$

We want to calculate the impulse-response function for a generic path  $\{i_t\}$ . All variables are zero until time 1. At time 1 we set off a sequence  $\{i_1, i_2, \dots\}$ . There is no change to surpluses, so  $\tilde{s}_t = 0$ . Given  $\pi_1$ , the other  $\pi_t$  follow since there is no more uncertainty. Equations (A1)-(A2) give us a set of possible paths of inflation indexed by  $\pi_1$ . We use (A3) and (A4) to choose  $\pi_1$ .

This section establishes the following results for this impulse-response function. For an arbitrary sequence  $\{i_1, i_2, \dots\}$ ,

$$\pi_{t+1} = \frac{1}{(1 + \sigma\kappa)^{t+1}} (1 - \rho) \sum_{j=1}^{\infty} \rho^j i_j + \frac{\sigma\kappa}{1 + \sigma\kappa} \sum_{j=1}^t \frac{1}{(1 + \sigma\kappa)^{t-j}} i_j.$$

For an AR(1)  $i_t = \eta i_{t-1} + \varepsilon_t$ ,

$$\pi_{t+1} = \left[ \left( \frac{(1 - \rho)}{(1 + \sigma\kappa)} \frac{\rho}{(1 - \rho\eta)} + \frac{\sigma\kappa}{1 - \eta(1 + \sigma\kappa)} \right) \frac{1}{(1 + \sigma\kappa)^t} - \frac{\sigma\kappa}{1 - \eta(1 + \sigma\kappa)} \eta^t \right] i_1.$$

For  $\eta = 1$ , i.e. a one-time permanent increase in the interest rate,

$$\pi_{t+1} = \left[ 1 - \frac{(1 + \sigma\kappa - \rho)}{(1 + \sigma\kappa)^{t+1}} \right] i_1$$

Now, to derive these results. Eliminating output from (A1)-(A2),

$$E_t\pi_{t+1} = \frac{1}{1 + \sigma\kappa} \pi_t + \frac{\sigma\kappa}{1 + \sigma\kappa} i_t. \quad (\text{A5})$$

$$(\text{A6})$$

Iterating forward (A5), after the shock at time 1, (for  $t \geq 1$ ),

$$\pi_{t+1} = \frac{1}{(1 + \sigma\kappa)^t} \pi_1 + \frac{\sigma\kappa}{1 + \sigma\kappa} \sum_{j=1}^t \frac{1}{(1 + \sigma\kappa)^{t-j}} i_j. \quad (\text{A7})$$

In the case of AR(1),  $i_t = \eta i_{t-1} + \varepsilon_t$ , we have the not very elegant expression

$$\begin{aligned} \pi_{t+1} &= \frac{1}{(1 + \sigma\kappa)^t} \pi_1 + \frac{\sigma\kappa}{1 + \sigma\kappa} \sum_{j=1}^t \frac{\eta^{j-1}}{(1 + \sigma\kappa)^{t-j}} i_1 \\ \pi_{t+1} &= \frac{1}{(1 + \sigma\kappa)^t} \pi_1 + \frac{\frac{1}{(1 + \sigma\kappa)^t} - \eta^t}{\frac{1}{(1 + \sigma\kappa)} - \eta} \frac{\sigma\kappa}{1 + \sigma\kappa} i_1 \end{aligned}$$

If  $\eta = 1$ , so  $\pi_t = \pi_1$ ,  $t > 1$ , this reduces to

$$\pi_{t+1} = i_1 + \frac{1}{(1 + \sigma\kappa)^t} (\pi_1 - i_1).$$

Now, we need to find  $\pi_1$ . Iterating (A3) forward,

$$\rho^t v_t = (0 - \pi_1) + \rho(i_1 - \pi_2) + \rho^2(i_2 - \pi_3) + \rho^3(i_3 - \pi_4) + \dots$$

Thus, the condition  $\rho^t v_t \rightarrow 0$  is

$$\pi_1 = \sum_{j=1}^{\infty} \rho^j (i_j - \pi_{j+1}).$$

Debt is devauled to pay the higher interest costs that result from higher real interest rates. Now plug inflation from (A7),

$$\begin{aligned} \pi_1 &= \sum_{j=1}^{\infty} \rho^j \left( i_j - \left( \frac{1}{(1 + \sigma\kappa)^j} \pi_1 + \frac{\sigma\kappa}{1 + \sigma\kappa} \sum_{k=1}^j \frac{1}{(1 + \sigma\kappa)^{j-k}} i_k \right) \right) \\ \pi_1 &= - \sum_{j=1}^{\infty} \rho^j \frac{1}{(1 + \sigma\kappa)^j} \pi_1 + \sum_{j=1}^{\infty} \rho^j i_j - \frac{\sigma\kappa}{1 + \sigma\kappa} \sum_{j=1}^{\infty} \rho^j \sum_{k=1}^j \frac{1}{(1 + \sigma\kappa)^{j-k}} i_k \\ \pi_1 &= - \sum_{j=1}^{\infty} \rho^j \frac{1}{(1 + \sigma\kappa)^j} \pi_1 + \sum_{j=1}^{\infty} \rho^j i_j - \frac{\sigma\kappa}{1 + \sigma\kappa} \sum_{k=1}^{\infty} \sum_{j=k}^{\infty} \rho^j \frac{1}{(1 + \sigma\kappa)^{j-k}} i_k \\ \pi_1 &= - \sum_{j=1}^{\infty} \rho^j \frac{1}{(1 + \sigma\kappa)^j} \pi_1 + \sum_{j=1}^{\infty} \rho^j i_j - \frac{\sigma\kappa}{1 + \sigma\kappa} \sum_{k=1}^{\infty} \rho^k \left( \frac{1}{1 - \frac{\rho}{1 + \sigma\kappa}} \right) i_k \end{aligned}$$

$$\begin{aligned}
\pi_1 &= -\frac{\frac{\rho}{(1+\sigma\kappa)}}{1 - \frac{\rho}{(1+\sigma\kappa)}}\pi_1 + \left(1 - \frac{\sigma\kappa}{1 + \sigma\kappa} \left(\frac{1}{1 - \frac{\rho}{1+\sigma\kappa}}\right)\right) \sum_{j=1}^{\infty} \rho^j i_j \\
\pi_1 &= -\frac{\rho}{1 + \sigma\kappa - \rho}\pi_1 + \frac{1 - \rho}{1 + \sigma\kappa - \rho} \sum_{j=1}^{\infty} \rho^j i_j \\
(1 + \sigma\kappa - \rho)\pi_1 &= -\rho\pi_1 + (1 - \rho) \sum_{j=1}^{\infty} \rho^j i_j \\
\pi_1 &= \frac{1 - \rho}{1 + \sigma\kappa} \sum_{j=1}^{\infty} \rho^j i_j. \tag{A8}
\end{aligned}$$

For an AR(1)

$$\pi_1 = \frac{1 - \rho}{1 + \sigma\kappa} \sum_{j=1}^{\infty} \rho^j \eta^{j-1} i_1 = \frac{\rho}{1 + \sigma\kappa} \frac{1 - \rho}{1 - \rho\eta} i_1.$$

For  $\eta = 1$

$$\pi_1 = \frac{\rho}{1 + \sigma\kappa} i_1.$$

With  $\pi_1$ , we now have the general solution. Using (A8) in (A7),

$$\pi_{t+1} = \frac{1}{(1 + \sigma\kappa)^{t+1}} (1 - \rho) \sum_{j=1}^{\infty} \rho^j i_j + \frac{\sigma\kappa}{1 + \sigma\kappa} \sum_{j=1}^t \frac{1}{(1 + \sigma\kappa)^{t-j}} i_j.$$

For the AR(1)

$$\begin{aligned}
\pi_{t+1} &= \frac{1}{(1 + \sigma\kappa)^t} \left( \frac{1 - \rho}{1 + \sigma\kappa} \frac{\rho}{1 - \rho\eta} i_1 \right) + \frac{\sigma\kappa}{1 + \sigma\kappa} \sum_{j=1}^t \frac{\eta^{j-1}}{(1 + \sigma\kappa)^{t-j}} i_1 \\
\pi_{t+1} &= \left( \frac{1 - \rho}{1 + \sigma\kappa} \frac{\rho}{1 - \rho\eta} i_1 \right) \frac{1}{(1 + \sigma\kappa)^t} + \frac{\sigma\kappa}{1 + \sigma\kappa} \frac{\frac{1}{(1 + \sigma\kappa)^t} - \eta^t}{\frac{1}{1 + \sigma\kappa} - \eta} i_1 \\
\pi_{t+1} &= \left[ \left( \frac{(1 - \rho)}{(1 + \sigma\kappa)} \frac{\rho}{(1 - \rho\eta)} + \frac{\sigma\kappa}{1 - \eta(1 + \sigma\kappa)} \right) \frac{1}{(1 + \sigma\kappa)^t} - \frac{\sigma\kappa}{1 - \eta(1 + \sigma\kappa)} \eta^t \right] i_1
\end{aligned}$$

For  $\eta = 1$ ,

$$\pi_{t+1} = \left[ 1 - \frac{(1 + \sigma\kappa - \rho)}{(1 + \sigma\kappa)^{t+1}} \right] i_1.$$

## A2 Continuous Time

Here I develop the simple model in continuous time. This is a clearer though less familiar way to see the main points. In particular, we can see here that the central question is really the sign of output in the Phillips curve: Is output high when inflation is *increasing* or *decreasing*? In continuous time, some of the timing conventions that obscure the analysis vanish. In particular, we see that rational expectations in the IS curve are not an issue. Continuous time with sticky prices emphasizes a fundamentally different reinterpretation of the model: The government debt valuation equation does not adjust via price-level jumps on the date of a shock, but by choosing a whole path of inflation that adjusts the discount rate applied to future surpluses, or equivalently adjusts the interest costs on the debt.

Write the standard model (1)-(2)

$$E_t(x_{t+\Delta} - x_t) = \sigma(i_t - E_t\pi_{t+\Delta})\Delta \quad (\text{A9})$$

$$E_t(\pi_{t+\Delta} - \pi_t) = -\kappa x_t \Delta. \quad (\text{A10})$$

This standard model in continuous time is thus

$$E_t dx_t = \sigma(i_t - \pi_t) dt \quad (\text{A11})$$

$$E_t d\pi_t = -\kappa x_t dt. \quad (\text{A12})$$

Normally a term  $-\rho\pi_t dt$  appears on the right of (A12). As I simplified the discrete time Phillips curve from  $\pi_t = \beta E_t \pi_{t+1} + \kappa x_t$  with  $\beta = 1$ , I simplify here with  $\rho = 0$ ; the Phillips curve is centered on expected future inflation, and permanent inflation is fully neutral. Nothing important hinges on this simplification.

The price level is continuous and differentiable, and cannot jump or diffuse. In an instant  $dt$  only a fraction  $\lambda dt$  of producers may change prices. The inflation rate may have jumps or diffusions. But  $E_t \pi_{t+\Delta} - \pi_t$  is still of order  $\Delta$ , so the relevant inflation in the consumer's first order condition (A11) is  $\pi_t$ . The issue whether inflation in that condition should be rationally anticipated or adaptive disappears. This is a useful clarification of continuous time. Expectations in the Phillips curve are the central issue.

Equations (A10) and (A12) express the standard rational-expectations Phillips curve. The

adaptive-expectations analogue is

$$\pi_t - \pi_{t-\Delta} = \kappa x_t \Delta \quad (\text{A13})$$

$$d\pi_t = \kappa x_t dt. \quad (\text{A14})$$

Thus, adaptive and rational expectations differ by whether higher output corresponds to increasing (A14) or decreasing (A12) inflation; by inflation greater than future or past inflation. Essentially, they differ by the sign of  $\kappa$ . Adaptive expectations also produce a differentiable inflation, with neither jumps nor diffusion terms.

Again I simplify the model so we can see the main points without algebra, by using a static version of the consumption equation,

$$x_t = -\sigma(i_t - \pi_t). \quad (\text{A15})$$

Eliminating output from the Phillips curve, we have the dynamic relation between interest rates and inflation. With rational expectations

$$E_t d\pi_t = -\sigma \kappa \pi_t dt + \sigma \kappa i_t dt, \quad (\text{A16})$$

while with adaptive expectations

$$d\pi_t = \sigma \kappa \pi_t dt - \sigma \kappa i_t dt. \quad (\text{A17})$$

We have immediately the results of the discrete-time model: Inflation is stable but indeterminate under rational expectations; while inflation is unstable but determinate under adaptive expectations. “Stable” means that the coefficient in front of  $\pi_t$  on the right hand side is negative. “Indeterminate” means that we do not fully determine inflation. We can write (A16)

$$d\pi_t = -\sigma \kappa \pi_t dt + \sigma \kappa i_t dt + d\delta_t \quad (\text{A18})$$

where

$$d\delta_t = d\pi_t - E_t d\pi_t$$

is an arbitrary random variable (compensated jump or diffusion) with  $E_t d\delta_t = 0$ . The solutions

of (A18) are

$$\pi_t = \sigma\kappa \int_{\tau=0}^t e^{-\sigma\kappa\tau} i_{t-\tau} d\tau + e^{-\sigma\kappa t} \pi_0 + \int_{\tau=0}^t e^{-\sigma\kappa\tau} d\delta_{t-\tau}. \quad (\text{A19})$$

“Stability” means that the influence of past interest rates disappears over time, while “indeterminacy” means that the expectational errors  $d\delta_t$  appear.

For adaptive expectations, “unstable” means that the coefficient in front of  $\pi_t$  on the right hand side is negative. It is “determinate” since  $d\pi_t$  not  $E_t d\pi_t$  appears on the left. The solutions of (A17) are

$$\pi_t = \sigma\kappa \int_{\tau=0}^t e^{\sigma\kappa\tau} i_{t-\tau} d\tau + e^{\sigma\kappa t} \pi_0.$$

“Unstable” means that interest rates and initial conditions further in the past have larger effects today. Despite the  $\sigma\kappa\pi_t dt$  on the right hand side of (A17), we solve the model backward, because there is no jump or diffusion in inflation. If we try to solve forward,

$$\pi_t = \sigma\kappa \int_{\tau=0}^{\infty} e^{-\sigma\kappa\tau} i_{t+\tau} d\tau,$$

the right hand side can require a jump or diffusion that the model rules out. Inflation is predetermined. “Instability” means that for all but one special  $\pi_0$ , inflation or deflation spirals. But  $\pi_0$  is just as predetermined as at other dates, and in particular cannot react to the future realizations of the interest rate.

In the case of a peg,  $i_t = i$ , for rational expectations (A19) becomes

$$\pi_t = (1 - e^{-\sigma\kappa t})i + e^{-\sigma\kappa t} \pi_0 + \int_{\tau=0}^t e^{-\sigma\kappa\tau} d\delta_{t-\tau}. \quad (\text{A20})$$

For adaptive expectations, a peg leads to

$$\pi_t = i + e^{\sigma\kappa t} (\pi_0 - i). \quad (\text{A21})$$

The peg is generically unstable.

As in discrete time, a Taylor rule stabilizes the unstable adaptive expectations model. Adding

$$i_t = \phi\pi_t + u_{i,t}$$



the adaptive-expectations dynamics (A17) become

$$\frac{d\pi_t}{dt} = \sigma\kappa(1 - \phi)\pi_t - \sigma\kappa u_{i,t}$$

With  $\phi > 1$ , dynamics are now stable and determinate. A monetary policy shock  $u_{i,t}$  raises the interest rate and lowers inflation. See Figure 5.

In the rational expectations model with Taylor rule, in the new-Keynesian tradition, rational-expectations dynamics (A17) become

$$E_t d\pi_t = \sigma\kappa(\phi - 1)\pi_t dt - \sigma\kappa u_{i,t} dt.$$

Now  $\phi > 1$  induces instability. This time instability means we can solve the integral forward, and with a rule against nominal explosions recover determinacy,

$$\pi_t = -\sigma\kappa E_t \int_{\tau=0}^{\infty} e^{-\sigma\kappa(\phi-1)\tau} u_{i,t+\tau} d\tau.$$

Define an inflation target  $\{\pi_t^*\}$  and define  $i_t^*$  by

$$E_t d\pi_t^* = -\sigma\kappa\pi_t^* dt + \sigma\kappa i_t^* dt$$

In words,  $i_t^*$  is the interest rate target that implements  $\{\pi_t^*\}$  as an equilibrium. Now write the policy rule as

$$i_t = i_t^* + \phi(\pi_t - \pi_t^*)$$

With this notation, we can write rational-expectations dynamics (A17) as

$$E_t d(\pi_t - \pi_t^*) = \sigma\kappa[-(\pi_t - \pi_t^*) + (i_t - i_t^*)]dt$$

$$E_t d(\pi_t - \pi_t^*) = \sigma\kappa(\phi - 1)(\pi_t - \pi_t^*)dt.$$

Monetary policy has two parts, an interest rate policy  $i_t^*$  which generates the desired path of expected inflation, and an equilibrium-selection policy  $\phi(\pi_t - \pi_t^*)$  which generates explosions unless  $d\pi_t - E_t d\pi_t = d\pi_t^* - E_t d\pi_t^*$ .

Fiscal theory offers an alternative route to determinacy in the rational expectations model. Include the linearized evolution of real government debt, with instantaneous debt and differen-

tiable prices

$$dv_t = (rv_t + i_t - \pi_t - \tilde{s}_t)dt.$$

Integrating forward, taking expectations, and imposing the transversality condition, the real value of debt equals the present value of surpluses.

$$v_t = E_t \int_{\tau=0}^{\infty} e^{-r\tau} [\tilde{s}_{t+\tau} - (i_{t+\tau} - \pi_{t+\tau})] d\tau. \quad (\text{A22})$$

To use this equation in the rational-expectations dynamics (A18) as above, let  $\Delta_t v_t$  isolate the compensated jump or diffusion component of a process. In this case, and unlike discrete time,  $\Delta_t v_t = 0$ . Corresponding to (17),

$$0 = \Delta_t \int_{\tau=0}^{\infty} e^{-r\tau} [\tilde{s}_{t+\tau} - (i_{t+\tau} - \pi_{t+\tau})] d\tau. \quad (\text{A23})$$

Short-term nominal debt is predetermined, and since prices cannot jump or diffuse, the value of debt cannot jump or diffuse. Rather than shock the initial value of debt at all, of the multiple equilibria, we pick the inflation *path* in which the discount rate/interest cost effect, the second term, exactly balances any change in surplus, the first term. In the absence of a surplus change, such as a pure monetary policy shock, we pick the inflation path so that the integral of the discount rate term is zero.

$$0 = \Delta_t \int_{\tau=0}^{\infty} e^{-r\tau} [(i_{t+\tau} - \pi_{t+\tau})] d\tau$$

Continuous time fundamentally changes how we think of the model at high frequency. With flexible prices, a decline in surpluses must be met by a price-level jump which devalues outstanding debt. The discrete-time unexpected inflation equation (17) included some of that intuition along with a discount rate / interest cost effect. Now the latter is everything. In essence, the left-hand side of (17),  $\Delta E_{t+1} \pi_{t+1}$ , is always zero. Now in (A22) a decline in surpluses (first term on the right of (17)) is met by a period of inflation higher than nominal interest rates (second term) which slowly devalues debt. Bondholders lose by a long period of inflation above the nominal interest rate, not by a price-level jump. Monetary policy changes in the path of nominal interest rates generate an inflation path in which the present value of interest costs is zero.

Next, I find the response of inflation to an interest rate shock, Figure 2 in discrete time. We see that with instantaneous debt, even the slow rise of inflation shown in that figure disappears. It was a feature of one-year debt.

We can compute this impulse-response function by supposing there is a shock at time 0, and all variables represent how their expected values respond to that shock. From (A19), for a generic interest rate path  $\{i_t\}$ , the response function

$$\pi_t = \kappa\sigma \int_{\tau=0}^t e^{-\sigma\kappa\tau} i_{t-\tau} d\tau + e^{-\sigma\kappa t} \pi_0 \quad (\text{A24})$$

gives us a family of inflation paths indexed by  $\pi_0$ . Only one of these paths satisfies the valuation equation (A22), which is in this case

$$0 = \int_{t=0}^{\infty} e^{-rt} [\tilde{s}_t - (i_t - \pi_t)] dt. \quad (\text{A25})$$

In the simple case that the interest rate rises at time 0 from 0 to a new value  $i$ , then (A24) reduces to

$$\pi_t = (1 - e^{-\sigma\kappa t})i + e^{-\sigma\kappa t} \pi_0. \quad (\text{A26})$$

Plugging this into the valuation equation (A25) with  $\tilde{s}_t = 0$  to determine  $\pi_0$ ,

$$0 = \frac{i}{r} - \int_{t=0}^{\infty} e^{-rt} [(1 - e^{-\sigma\kappa t})i + e^{-\sigma\kappa t} \pi_0] dt \quad (\text{A27})$$

$$\pi_0 = i. \quad (\text{A28})$$

Despite sticky prices, we pick the equilibrium in which inflation moves instantly to match the interest rate.

## Discussion of John Cochrane

Lucrezia Reichlin  
London Business School

John Cochrane's paper and presentation are a dense summary of the arguments developed over the years in several papers and then in his recent book "The fiscal theory of the price level" (Cochrane, 2023).

He discussed three different topics. The first is purely theoretical and it is about the limitations of the standard New-Keynesian model as a basis for the practice of monetary policy. The second is about the role of fiscal and monetary policy in determining the price level and, finally, he has provided an assessment of the current policy regime in the US.

My discussion is structured accordingly.

### 1. Monetary and fiscal policy in the New Keynesian (NK) model

In the standard NK, John argues, implementing higher interest rate by the central bank cannot lower inflation without a change in fiscal policy. This implies that there is not much that central banks can do on their own. The model does not provide a coherent monetary theory of inflation.

While the first part of this statement is true, the implication that the model does not provide a coherent monetary theory of inflation does not follow. It does only if we are willing to make to odd assumptions.

First, that "interest-rate policy" consists in fixing a target path for a nominal interest rate that is independent of what happens to endogenous variables (including the inflation rate). But this implies that means that something like a Taylor rule doesn't count as "interest-rate policy" !

Second, that fiscal policy should determine a path for the real primary surplus that is independent of what happens to endogenous variables (including the path of government debt and the amount of interest that must be paid on that debt) so that "unchanged fiscal policy" is taken to require that there be no change in the path of the real primary surplus. But this means that continuing to follow a fiscal rule that keeps the debt/GDP level below some upper bound doesn't count as an example of "unchanged fiscal policy" after a change in interest-rate policy!

Of course, it is legitimate to ask, as John does, what should happen under a policy regime that has both properties. But neither of these properties correspond to the conventional understanding of how monetary and fiscal policy typically work. A more interesting question is to ask what kind of monetary and fiscal policy regimes will deliver price stability, what kind of fiscal and monetary rules or guidance for fiscal-monetary coordination. This is indeed an important policy topic and one that can be analyzed through the standard NK model (e.g. Woodford, 1996).

The stylized version of the model has three equations (the IS curve, the Phillips curve and a monetary policy rule) plus a log linear equation for the dynamic of the government budget constraint. It implies that monetary policy has fiscal effects because it affects the real value of outstanding government debt and real debt servicing costs and that fiscal policy matters for inflation since fiscal shocks affect the private sector budget constraint and therefore aggregate demand.

This is the case even when the monetary policy rule does not involve any explicit dependence on fiscal policy. The effects disappear only if the primary surplus adjusts in ways that neutralize any sequence of such shocks.

The implication, according to the standard NK model, is that the Taylor rule is not sufficient to ensure a stable and low equilibrium rate of inflation. Nothing in the model suggests that fiscal and monetary policy are independent.

On the contrary, the model can be used to study alternative policy regimes characterized by different monetary and fiscal rules. Many examples have been discussed in the literature. The point of these examples is that there are many ways to design monetary and fiscal rules, including non-Ricardian fiscal rules, so as to achieve a low and stable inflation equilibrium.

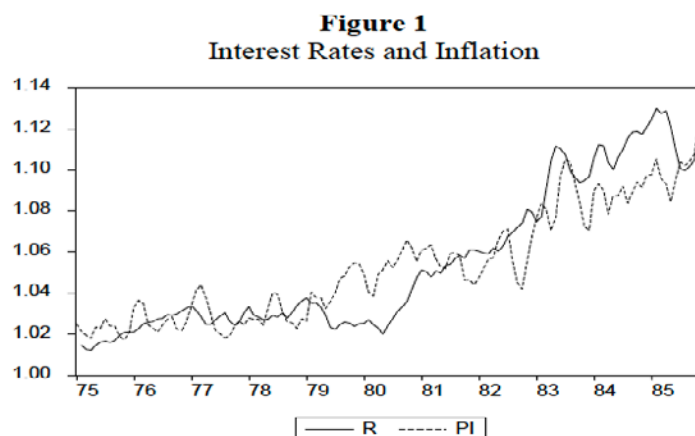
## 2. Monetary and fiscal regimes – examples

*Example 1. Brazil in the 1980s: RE equilibrium exists but involves explosive path for inflation despite Taylor principle (Loyo, 1997)*

Loyo, 1997 analyses, through the lenses of the NK model, inflation in Brazil in the 1970s and 1980s and the causes of its degeneration in hyperinflation by 1985.

Loyo argues that Brazil experienced two different equilibria. The first – in the 1970s and before the hyperinflation of the mid-1980s – was stable. Fiscal expectations were non-Ricardian and monetary policy was accommodating it. This was a case of fiscal dominance. In the 1980s fiscal expectations did not change but monetary policy shifted, and the central bank started applying the “Taylor principle”, responding to inflation with a more than proportional increase in interest rate. Given non-Ricardian fiscal expectations, this was destabilizing. Brazil fell into an unstable equilibrium. Figure 1 shows inflation (PI) and the interest rate (R) from the original paper.

Figure 1

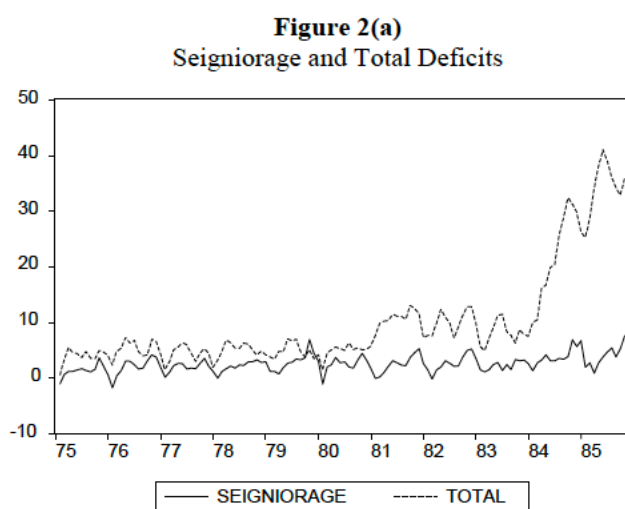


Source: Loyo (1997).

The mechanism in the model is as follows. In the unstable regime, higher interest rate translates into higher nominal financial wealth via the household budget constraint (or higher expected fiscal transfers). Households regards government debt as wealth since Ricardian equivalence is violated. Inflation then needs to go up or otherwise (by the intertemporal government budget constraint) the real value of debt would increase and households would consume more relatively to the endowment

It is important to notice that the mechanism described has nothing to do with an increase in seigniorage. Indeed Figure 2 (Figure (2a) in Loyo’s paper) shows that in the unstable regime the fiscal deficit increases but seigniorage remains constant.

Figure 2



Source: Loyo (1997)

*Example 2. US Interest rate peg 1940s – another example of a stable violation of the Taylor rule (discussed in several Woodford’s papers in the 1990s)*

This is the bond-price support policy that the Fed followed in the 1940s. In such policy regime, the government set taxes regardless of the level of government debt until extreme regions of the state space are reached. Inflation is stable as long as fiscal expectations are stable.

This is an example of a determinate equilibrium which violates the Taylor principle. The equilibrium can last (it did last in the late 1940s) but it is precarious since it breaks down when expectations on future primary surplus change. In this historical case, it happened when, as a consequence of the Korean war, the expected primary surplus declined, and expectations shifted. The regime became inflationary. Indeed in 1951 the monetary-fiscal regime changed with the famous Fed Accord which established the independence of the Federal Reserve from Treasury.

One can build on this example to analyze several interesting cases of war economies or even post-war financial repression.

These cases may become relevant today with wars and various disruptions calling for an exceptional policy mix. The problem with such policy experiments is that even if the fiscal surplus process is chosen in a way to be consistent with price stability, in practice inflation maybe unstable because

the equilibrium depends on long-run fiscal expectations which are difficult to manage by a fiscal authority.

### *Example 3. The EU fiscal rules.*

The EU fiscal rules can be understood as an operationalization of Ricardian fiscal policy leading to an implicit coordination between active monetary policy and Ricardian (passive) fiscal commitment by all member states.

In a paper presented at this conference two years ago (Reichlin et al, 2023), we use this framework to evaluate the effective monetary-fiscal stance in such situation and the implications for the price level. The idea was to study the channels of adjustment to monetary policy shocks given the constraints of the expected present value of the budget of the general government. We did it for the euro area using both national and aggregate data.

Our finding was that in the pre-QE sample (1991-2014) the fiscal surplus declined in the aggregate as a response to conventional interest rate easing in both the short and long-run with the consequence of a small increase in the price level in the long-run. Conversely, during the QE sample, the response to of the cumulated aggregate primary surplus to a monetary policy easing was positive in the long run due to the idiosyncratic behaviour of Germany. As a consequence, the cumulative response of inflation was twice smaller than in the pre-QE sample.

This study points to the importance of the monetary-fiscal interaction for the price level. More empirical work on the topic is needed.

### *3. The current monetary-fiscal regime in the US*

Cochrane offers his story of current inflation in the US. The origin of inflation is fiscal and fiscal policy is non-Ricardian. The NK model, if we abstract from the fiscal equation, predicts that after the Fed's increase in the nominal interest rate, inflation must increase. In other words, inflation cannot fall unless there is a change in fiscal policy. Cochrane's conclusion is that the NK model has no explanation of inflation.

But using the same NK framework, an alternative but equally plausible explanation can be provided. Let us assume, unlike Cochrane, that fiscal policy is Ricardian. As the Fed raises interest rates (and there is an expectation that real rates will be higher for a time as a result), people should expect an eventual increase in the primary budget surplus, to finance the increased cost of servicing the public debt. As a consequence, inflation declines. This is the result of monetary policy applying the Taylor rule and fiscal adjusting passively in a Ricardian way.

At the end the question is an empirical one. Is policy non-Ricardian? Unfortunately, this is difficult to establish empirically. Assuming non-Ricardian policy means assuming that people expect a specific forward path for the real primary government budget surplus, and that in the absence of any "change in fiscal policy" they must continue to expect exactly that same path, regardless of any change in monetary policy. There is no need of an announcement of a "change in fiscal policy" ; what matters are the beliefs about fiscal policy.

Data on long-term expectations on primary surplus are unfortunately not available. Charts 3 and 4 below report one-year ahead expectations on government debt growth and change in taxes as poor proxies for what we are interested in. The charts indicate that these variables are quite stable which suggests that agents may be Ricardian after all.

Figure 3

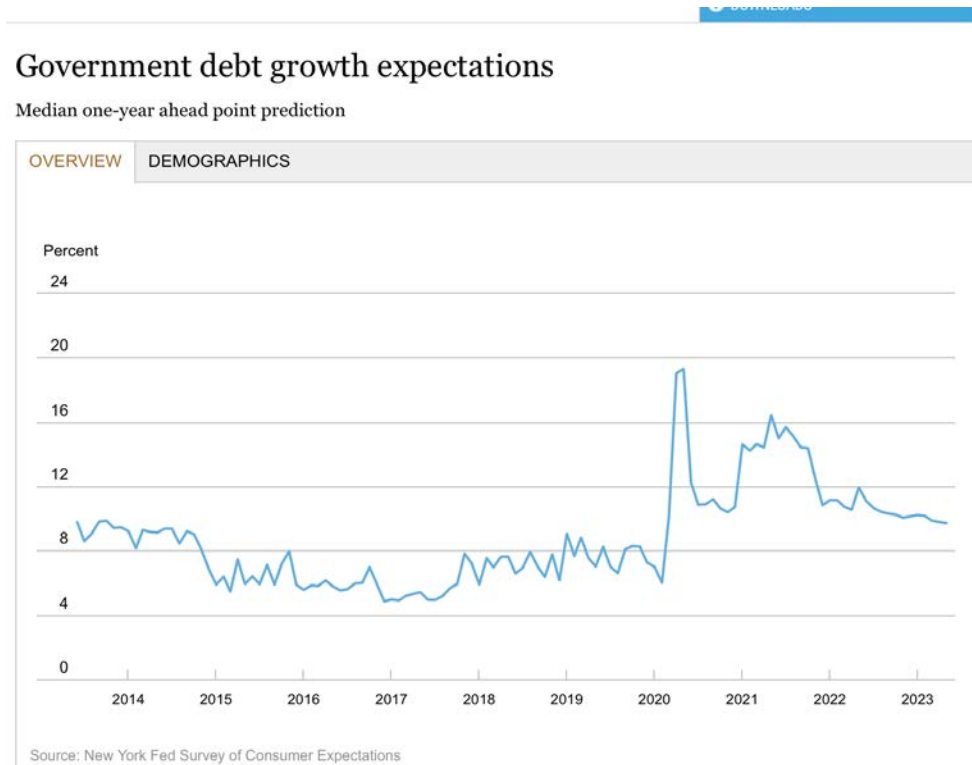
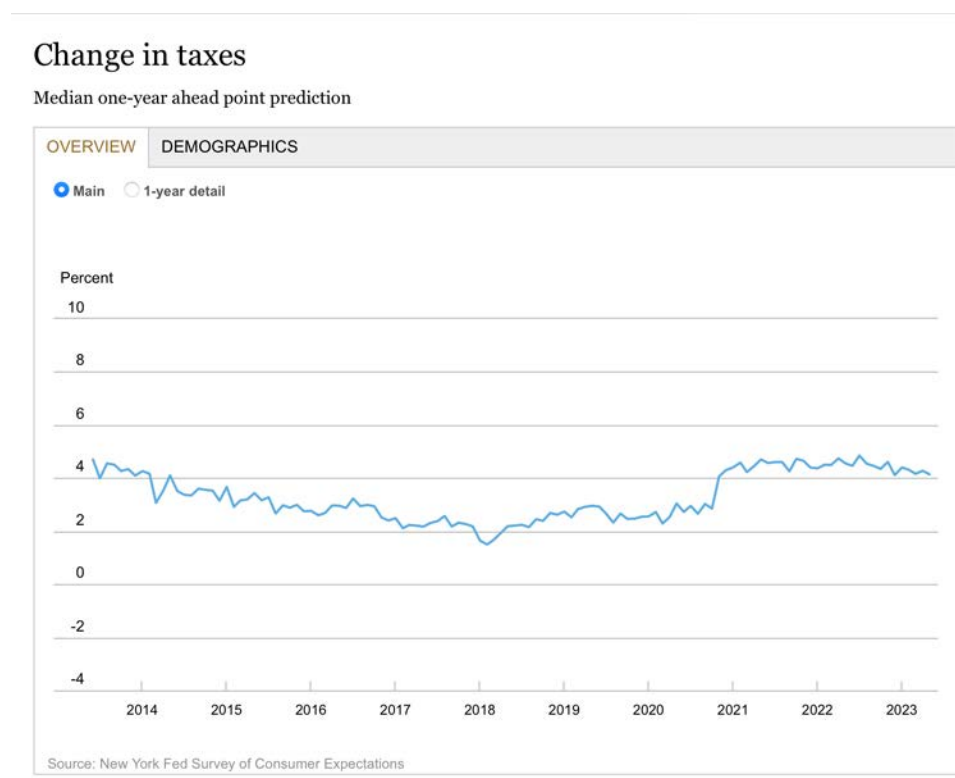




Figure 4



Today's discussion on whether inflation is driven by fiscal or monetary policy is similar to that on Volcker's disinflation. There are two stories. John's story is that the disinflation of the 1980s was due to fiscal policy: a large increase in the equilibrium value of the public debt and an increase in the expected value of primary surpluses. The alternative story is Ricardian: exogenous monetary tightening under Volcker (a shift to the Taylor rule) resulted in a windfall for bondholders which in turn required an increase in expected surpluses to pay for the increased debt services in order to satisfy the government budget constraint.

These are two equally plausible stories. It is an empirical matter to find out which one is true. Today, it is definitely relevant to ask whether agents are Ricardian. Why should people be confident that there is still a commitment to Ricardian fiscal policy, given the behaviour of the US government in recent decades? It is a puzzle that the public seems to be remarkably complacent about the issue of the sustainability of US fiscal policy. However, unless one thinks that it has already been established that US fiscal policy is non-Ricardian, one can't say that the recent events pose some new puzzle for macro theory.

### Conclusions

My discussion can be summarized in three points:

1. In the standard NK model both monetary and fiscal policy matter for inflation. The contrary is true only if we assume that these policies do not respond to endogenous variables.
2. Many stable monetary-fiscal regimes are possible, both Ricardian and non-Ricardian. Historical examples (and theory) show that monetary policy rules may have different consequences on inflation depending on the fiscal regime. In some cases, explicit coordination may be desirable for price stability. Designing adequate monetary and fiscal rules is an alternative to coordination. This discussion has implications for the governance of central banks since it points to the need to coordination between monetary and fiscal policy either formally, informally or through rules, a topic that would require a separate discussion.
3. Today's inflation and disinflation may be consistent with either a Ricardian or a non-Ricardian fiscal regime. More work on fiscal expectations is needed.

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Comments on

# “Expectations and the Neutrality of Money”\*

by John Cochrane

**Pablo Andrés Neumeyer**  
Universidad Torcuato Di Tella

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John Cochrane’s “Expectations and the Neutrality of Interest Rates” is part of a decades-long research program on the determinants of the price level—see [Cochrane \(2023\)](#). My aim in these comments is to put John Cochrane’s research in context, discuss the relation between interest rates and inflation in [Cochrane \(2022\)](#) and pose some further questions on the fiscal theory of the price level (FTPL). To this end, first, I discuss my perception of how many central bankers think monetary policy in inflation-targeting countries works. Then, I illustrate the theoretical weakness of the dominant monetary model used by central banks, i.e. the new Keynesian model (NKM) and how the FTPL addresses this weakness. I conclude with some open research questions.

**Central Banker’s Wisdom.** At the risk of oversimplifying and overgeneralizing, I will state, for the sake of this discussion, five principles that I believe many decision-makers in inflation-targeting central banks share. (i) The best practice to conduct monetary policy is to use a short-term interest rate as the monetary instrument, allowing liquidity to be endogenous. (ii) Inflation is stable in the sense that small deviations from the inflation target do not lead to hyperinflation or deflation. (iii) The rate of inflation is determined by fundamentals, and it does not jump around erratically because of sunspots. (iv) Central banks control inflation by changing interest rates, setting a neutral policy interest rate when inflation is at the target, increasing interest rates to lower inflation when it is above the target, and vice versa when it is below the target. (v) Interest rates control inflation through aggregate demand management and by anchoring expectations<sup>1</sup>.

The fiscal theory of the price level proposed by Cochrane aims to solve the problem

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\*I am grateful to John Cochrane and Juan Pablo Nicolini for very helpful conversations.

<sup>1</sup>See [Werning \(2022\)](#) and the discussion in [Neumeyer \(2023\)](#) for an analysis of the passthrough on inflation expectations onto prices.

of nominal indeterminacy, a fundamental weakness of monetary theory when the monetary policy instrument is the control of an interest rate.

I illustrate the indeterminacy problem with a simple monetary model anchored in two pillars of monetary theory with ample empirical support<sup>2</sup>: the quantity theory of money and the Fisher equation, i.e.

$$\frac{M_t}{P_t} = \ell(i_t)y \tag{1}$$

$$R_t = (1 + i_t) E_t \left[ \frac{P_t}{P_{t+1}} \right], \tag{2}$$

where  $M_t$  denotes the nominal money supply,  $i_t$  the nominal interest rate and  $R_t$  the risk-free real rate between  $t$  and  $t + 1$ ,  $y$  output,  $P_t$  the price level and  $\ell(i_t)$  is a decreasing function representing the inverse of money's velocity.

The system of [equations \(1\) and \(2\)](#) reduces to a difference equation in  $P_t$  which does not have a natural boundary condition. This has been the source of a large literature on the determinacy of prices.

### Determinacy of the price level with monetary targets.

When the monetary authority controls the money supply, there are good reasons to think the price level is determined through an ad-hoc boundary condition. [Equation \(3\)](#) is useful to illustrate the issues. Under perfect foresight, a price sequence that solves

$$P_t \ell \left( \frac{P_{t+1}}{P_t} \right) = M_t \tag{3}$$

is a solution to [equations \(1\) and \(2\)](#). For simplicity, I assumed output and real interest rates are exogenous, constant, and equal to one; that is,  $R_t = y = 1$ . As there is no boundary condition, there are a continuum of solutions. For example, when  $M_t$  is constant, the natural equilibrium supported by the data is a constant price level. However, [equation \(3\)](#) admits solutions in which prices and inflation grow without bound and real money balances converge to zero. The response to this problem has been to find economic environments that rule out this “bubble” like equilibria. For example, [Obstfeld and Rogoff \(1986\)](#) and [Nicolini \(1996\)](#). Their argument for ruling out speculative hyperinflations is to assume a partial backing for the currency that acts as a boundary condition. In [Appendix A](#), I provide an example from [Sargent and Wallace \(1973\)](#) that expresses the equilibrium price level as a function of current and future money supplies by imposing an ad-hoc boundary condition.

Assuming perfect foresight, an exogenous bounded sequence for  $\{M_t\}$ , and a transversality condition that rules out speculative hyperinflations, [equations \(1\) and \(2\)](#) are a complete theory of prices and interest rates<sup>3</sup>.

This theory of prices and interest rates, however, is not helpful for inflation-targeting central banks that use the interest rate as their monetary policy instrument.

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<sup>2</sup>See, for example, [Benati et al. \(2021\)](#), [Gao, Kulish, and Nicolini \(2021\)](#), [Uribe \(2022\)](#)

<sup>3</sup>See [Sargent and Wallace \(1973\)](#) [Obstfeld and Rogoff \(1986\)](#) [Nicolini \(1996\)](#), [Ljungqvist and Sargent \(2012\)](#)

## Indeterminacy of the price level with interest rate targets.

The problem of indeterminacy is more serious when the monetary authority targets the interest rate, allowing liquidity to be endogenous (Sargent and Wallace, 1975). Under this monetary framework, given the policy rate  $i_t$ , the central bank accommodates any  $P_t$  by providing the liquidity  $M_t = P_t \ell(i_t) y$ . Thus, equation (1) does not play a role in determining prices. As the demand for money does not play a role in determining equilibria, much of the literature has focused on cashless economies. The only restriction on the price level is equation (2), which again has no boundary condition. There is a continuum of initial price levels consistent with the Fisher equation (2).

The conventional central bank model, the NKM, proposes to solve the indeterminacy problem by assuming an interest rate rule that satisfies the Taylor principle and imposing ad-hoc restrictions on the set of admissible equilibrium inflation (Woodford, 2003). Cochrane (2011) and Neumeyer and Nicolini (2022) argue that these restrictions on the set of equilibria are unreasonable.

To see why the equilibrium selection assumptions in the NKM are unreasonable, consider the Taylor type interest rate rule

$$1 + i_t = \max \{ R[(1 + \bar{\pi}) + \phi(\pi_t - \bar{\pi})], 1 \}, \quad (4)$$

where  $\bar{\pi}$  is the inflation target,  $\pi_t = P_t/P_{t-1} - 1$  is the inflation rate, and  $\phi$  is a parameter. The Taylor principle is to assume  $\phi > 1$ . If the nominal interest rate hits the zero lower bound at some  $\bar{t}$ , then  $i_t = 0$  and  $\pi_t = 1 - R$  for all  $t \geq \bar{t}$ . Monetary authorities follow the Taylor rule in equation (4) away from the zero lower bound for interest rates.

Under the Taylor rule, equation (4), the Fisher equation (2) implies that equilibrium inflation satisfies

$$\begin{aligned} \pi_{t+1} - \bar{\pi} &= \phi(\pi_t - \bar{\pi}) \\ &= \phi^t(\pi_0 - \bar{\pi}) \end{aligned} \quad (5)$$

for  $t = 0, 1, \dots$ . Any sequence of inflation rates (prices) that satisfy equation (5) is an equilibrium indexed by a positive price level on date 0,  $\pi_0$ .

The equilibrium is unique if, and only if, the Taylor principle holds,  $\phi > 1$ , and the inflation sequences are bounded, and locally unique (Neumeyer and Nicolini, 2022).

Cochrane (2011) challenges this equilibrium concept on the ground that there is no reason to bound inflation in order to rule out hyperinflationary equilibria. In contrast to the case where the central bank chooses  $\{M_t\}$ , where I argued that ruling out hyperinflations is reasonable, in this case the hyperinflation is the direct result of government policy. The hyperinflation is not a pathological solution to equation (3) but a direct result of following the Taylor rule, equation (4) when  $\pi_0 > \bar{\pi}$  and  $\phi > 1$ . The monetary authority engineers the hyperinflation by ever-rising policy interest rates and then accommodating the money supply to the money demand in equation (1). Neumeyer and Nicolini (2022) argue that it is not reasonable to believe that the monetary authority will actually follow a Taylor rule that satisfies the Taylor principle. We show that this policy is strongly time-inconsistent in the sense that almost any monetary policy is better than one that generates hyperinflation. See also, Afrouzi et al. (2023). In summary, an interest rate feedback rule that satisfies the

Taylor principle does not provide a reasonable boundary condition for [equation \(2\)](#). The problem of indeterminacy posed in [Sargent and Wallace \(1975\)](#) persists.

[Sargent and Wallace \(1975\)](#) call our attention to the fact that the initial price level’s indeterminacy is amplified by “sunspot” equilibria as, for each  $P_t$ , there are many values of  $P_{t+1}$  that satisfy [equation \(2\)](#).

The equilibrium price sequences under the Taylor rule are inconsistent with the second principle of central bank wisdom. Central banks do not engineer hyperinflation when they miss their inflation target. The indeterminacy resulting from the fact that the central bank will not pursue a policy that follows the Taylor principle allows for “sunspot” equilibria that violate the third principle of central bank wisdom. Prices do not jump around erratically.

It is worth noticing that in the NKM, a pure monetary shock, say, an increase in interest rates, increases inflation, contradicting the central banker’s fourth principle. For higher interests to lower inflation, the NKM implicitly assumes a fiscal contraction to pay the additional interest on the public debt ([Caramp and Silva, 2023](#)). This result holds in models with a Phillips curve and is a consequence of the Fisher [equation \(2\)](#).

### The Fiscal Theory of the Price Level

The FTPL addresses the indeterminacy of the price level in monetary models where the monetary policy instrument is the nominal interest rate. This theory treats the determination of the price level as a valuation problem, which is the missing boundary condition in the Fisher [equation \(2\)](#).

Consider a cashless economy with a constant endowment and assume a constant interest rate  $R = \beta^{-1}$ , where  $\beta$  is the households’ intertemporal discount factor. Assume an institutional setting in which fiscal policy determines real primary surpluses  $\{s_t\}$  and monetary policy determines interest rates  $\{i_t\}$ <sup>4</sup>.

The government’s nominal debt valuation equation

$$\frac{B_{t-1}}{P_t} = E_t \sum_{j=0}^{\infty} \beta^j s_{t+j} \quad \text{for all } t \geq 0 \quad (6)$$

is the boundary condition for [equation \(2\)](#), and thus the price level is determinate.

The essential difference between the FTPL and the models sketched before is the assumption underlying how the government’s budget constraint is satisfied. In the previous models, fiscal policy  $\{s_t\}$  adjusts to satisfy the budget constraint in [equation \(6\)](#) for **any** value of  $P_t$ . As a result, it plays no role in the determination of equilibrium. The FTPL assumes that the stream of surpluses  $\{s_t\}$  does not fully adjust to changes in the price levels  $P_t$ . The government’s budget constraint needs to be satisfied only at the equilibrium price level. In an economy where the interest rate is the policy instrument, and there is price level indeterminacy, the FTPL’s approach makes more sense than requiring the government to adjust surpluses for all  $P_t$ . This is because requiring budget balance for low/high values of  $P_t$  entails a considerable redistribution of wealth towards/from bondholders. Indeterminacy of the price level makes fiscal policy indeterminate<sup>5</sup>.

<sup>4</sup>In a monetary economy, the surpluses  $s_t$  also include the revenues from money creation.

<sup>5</sup>In an economy where the money supply is the monetary policy instrument, the quantity of money can

The FTPL is a complete theory of prices and interest rates with desirable properties. (i) Equilibria are determinate. (ii) Equilibria are stable in the sense that the instability inherent to the Taylor principle is not necessary. (iii) Central banks control expected inflation by controlling interest rates.

### Interest and prices in the fiscal theory of the price level

[Cochrane \(2022\)](#) focuses on how inflation responds to changes in interest rates in the FTPL. This section illustrates the forces at play in a simple frictionless setting.

Consider a transitory increase in interest rates assuming that fiscal policy is constant. The Fisher [equation \(2\)](#) implies that inflation will increase (even with a Phillips Curve). This is at odds with the fourth principle of central bank wisdom.

The FTPL can reconcile a fall in inflation with a transitory increase in the short-term interest rate through a revaluation effect on long-term public debt. A higher short-term interest rate reduces the nominal value of debt and, with a constant fiscal policy, the valuation [equation \(6\)](#) reduces the price level. Inflation between  $t - 1$  and  $t$  falls, but inflation between  $t$  and  $t + 1$  rises.

To illustrate the forces at work, let the price of a unit of nominal debt at  $t$  that matures at  $t + j$  be  $Q_t^{t+j} = \prod_{s=1}^j \frac{1}{1+i_{t+s}}$  with  $Q_t^t = 1$ . The nominal debt issued at  $t$  and due at  $t + j$  is denoted by  $B_t^{t+j}$ . For simplicity, assume that primary fiscal surpluses are constant at  $s$ . Consider the effect of an unanticipated transitory increase in the short-term nominal interest rate by considering a fall in  $Q_t^{t+1}$  while interest rates after  $t$  remain unchanged so that the bond prices  $Q_{t+1}^{t+1+j}$  for all  $j \geq 0$  are unchanged. The prices at  $t$  for debt maturing after  $t + 1$  and those claims' prices at  $t + 1$  are the same.

[Equation \(7\)](#) is useful to explain the effect of a transitory increase in the short-term interest rate on current and future prices. [Equation \(7a\)](#), is the valuation equation at  $t$ , [equation \(7b\)](#) is the debt rollover at  $t$ , and [equation \(7c\)](#) is the valuation equation at  $t + 1$ .

$$\frac{B_{t-1}^t + Q_t^{t+1} \sum_{j=1}^{\infty} Q_{t+1}^{t+j} B_{t-1}^{t+j}}{P_t} = \frac{s}{1 - \beta} \quad (7a)$$

$$\frac{Q_t^{t+1} \sum_{j=0}^{\infty} Q_{t+1}^{t+1+j} B_t^{t+j}}{P_t} = \frac{B_{t-1}^t + Q_t^{t+1} \sum_{j=1}^{\infty} Q_{t+1}^{t+j} B_{t-1}^{t+j}}{P_t} - s = \frac{\beta}{1 - \beta} s \quad (7b)$$

$$\frac{\sum_{j=0}^{\infty} Q_{t+1}^{t+1+j} B_t^{t+j}}{P_{t+1}} = \frac{s}{1 - \beta} \quad (7c)$$

I analyze the effect of reducing  $Q_t^{t+1}$  on the price level at  $t$  and  $t + 1$ .

In the absence of long-term debt,  $\sum_{j=1}^{\infty} Q_{t+1}^{t+j} B_{t-1}^{t+j} = 0$ , and interest rates have no effect on the current price level. The only effect of the fall in  $Q_t^{t+1}$  is an increase in  $P_{t+1}$  consistent with [equation \(2\)](#). This is also consistent with [equation \(7c\)](#) because  $B_t^{t+1} > B_{t-1}^t$  as a result of the government rolling over debt at  $t$  at a lower price—[equation \(7b\)](#). The rise in the price level at  $t + 1$  is akin to the fall of a stock price after a stock split.

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adjust so that the budget constraint in [equation \(6\)](#) holds. Let  $s_t = \tilde{s}_t + \frac{M_t - M_{t-1}}{P_t}$ , where  $\tilde{s}_t$  is the real primary surplus and  $\frac{M_t - M_{t-1}}{P_t}$  are the revenues from money creation. Assuming (i) a transversality condition for  $P_t$  that rules out speculative hyperinflations and (ii) that for a given sequence  $\{\tilde{s}_t\}$ ,  $\{M_t\}$  adjusts to balance the budget, the equilibrium conditions in [equations \(1\)](#), [\(2\)](#) and [\(6\)](#) determines the price level. See, [Sargent and Wallace \(1981\)](#) and [Ljungqvist and Sargent \(2012\)](#). Under an interest rate target, this is no longer the case.

When long-term debt is positive, reducing  $Q_t^{t+1}$  reduces the nominal value of debt, and the price level has to fall for [equation \(7a\)](#) to hold. The fall in prices is

$$\frac{\Delta P_t}{P_t} = \frac{Q_t^{t+1} \sum_{j=1}^{\infty} Q_{t+1}^{t+j} B_{t-1}^{t+j}}{B_{t-1}^t + Q_t^{t+1} \sum_{j=1}^{\infty} Q_{t+1}^{t+j} B_{t-1}^{t+j}} \frac{\Delta Q_t^{t+1}}{Q_t^{t+1}} \quad (8)$$

Inflation between  $t$  and  $t + 1$  is the same as in the case with no long-term debt so the price level at  $t + 1$  is lower than in that case<sup>6</sup>.

**A neutrality proposition for interest rates.** A one-period unexpected rise in the short-term interest rate increases inflation between  $t$  and  $t + 1$  due to the Fisher effect. Its effect on current prices depends on the maturity structure of government debt as illustrated in [equation \(8\)](#).

It’s worth re-emphasizing that the exercise supposes no fiscal shock, whereas conventional models implicitly pair fiscal and monetary tightening.

The contractionary effect on current prices of a temporary increase in short-term rates is somehow consistent with the fourth principle of central bank wisdom, although through a different transmission mechanism. The price level falls due to a wealth effect on nominal private assets reminiscent of [Patinkin \(1956\)](#). The subsequent increase in inflation is inconsistent with the fourth principle of central bankers’ wisdom.

### Summary, questions, and further research

At the beginning of this discussion, I laid out my perception of how central bankers think about monetary policy. Then, I discussed how it clashes with the mainstream monetary model used in central banks in which the price level is indeterminate. The FTPL is a coherent theory that improves on these models as its equilibrium is stable and determinate. [Cochrane \(2022\)](#) addresses some tension between the central bankers’ tenet that they can stabilize inflation by controlling the short-term interest rate and the predictions of the FTPL where an increase in interest rates increases the inflation rate.

When I think about the FTPL I am also curious about how it works in environments with a lack of commitment. How does the price level behave when the government can default, and the prices of sovereign debt are subject to multiple equilibria as suggested by [Calvo \(1988\)](#)? If the government chooses interest rates sequentially, can there be self-fulfilling prophecies in which an increase in expected inflation lowers the price of debt, forcing the issuance of more debt and inflation?

Much research work remains to be done on a theory of inflation under interest rate targets. In John Cochrane’s words ([Cochrane, 2022](#)) “Thus, basic questions are still up for grabs. In the long run, is inflation stable or unstable, determinate or indeterminate under a peg? If the central bank raises rates persistently, and there is no fiscal news or other shocks, does inflation rise or decline in the long run? If not this, what is the neutral, frictionless benchmark

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<sup>6</sup>[Equation \(7b\)](#) shows the amount of debt rolled over in period  $t$ . The value of the new debt is the difference between the real value of the debt due at  $t$  and the primary surplus at  $t$ , which has a value of  $\frac{\beta}{1-\beta}s$ . This implies that if  $Q_t^{t+1}$  falls, the outstanding face value of the new issuance of nominal bonds has to be larger. Debt is diluted like shares in a stock split. Finally, the valuation [equation \(6\)](#) at  $t + 1$  implies an increase in the price level at  $t + 1$  because the face value of the nominal debt is higher while its prices are constant.



on which we build a theory of inflation under interest rate targets? This is all great news for young researchers. These are the good old days. Low-hanging fruit abounds. We're really at the beginning stages where simple models need exploration, not, as it appears, in a mature stage where essentials are settled and all there is to do is to add to the immense stock of complicated epicycles."

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## A Price level determinacy under money rules

If the monetary instrument is a monetary aggregate, assuming rational perfect foresight and some conditions on prices and money supplies, equations (1) and (2) are a complete theory of interest and prices. We illustrate this with Sargent and Wallace (1973)'s example with a Cagan money demand function. Assuming  $y = 1$ , equations (1) and (2) can be written as the difference equation

$$\frac{M_t}{P_t} = e^{-\alpha(1+r)\frac{P_{t+1}}{P_t}}.$$

Its solution is

$$\ln P_t = \alpha r + \frac{1}{1+\alpha} \sum_{s=0}^{\infty} \left(\frac{\alpha}{1+\alpha}\right)^s \ln M_{t+s} + \lim_{s \rightarrow \infty} \left(\frac{\alpha}{1+\alpha}\right)^s \ln P_{t+s}.$$

A bound on  $M$  or on its growth rate is necessary for the solution to the second term to exist. The last term, the speculative hyperinflation, is hard to rule out. Hyperdeflations can be ruled out through transversality conditions on wealth, but hyperdeflations cannot. Obstfeld and Rogoff (1986) propose a partial backing of the currency. I personally find that somehow ruling out speculative hyperinflations as an equilibrium outcome when the money supply is constant is reasonable.

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