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Some Implications of Learning for Price Stability*

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Abstract

Survey data on expectations of a range of macroeconomic variables exhibit low-frequency drift. In a New Keynesian model consistent with these empirical properties, optimal policy in general delivers a positive inflation rate in the long run. Two special cases deliver classic outcomes under rational expectations: as the degree of low-frequency variation in beliefs goes to zero, the long-run inflation rate coincides with the inflation bias under optimal discretion; for non-zero low-frequency drift in beliefs, as households become highly patient valuing utility in any period equally, the optimal long-run inflation rate coincides with optimal commitment — price stability is optimal. The optimal state-contingent response to cost-push disturbances similarly reflects properties of optimal discretion and optimal commitment, depending on the degree of low-frequency variation in beliefs. When beliefs exhibit substantial variation in response to short-run forecast errors, optimal policy is closer to commitment.

JEL Classifications: E32, D83, D84

Keywords: Optimal monetary policy, Learning dynamics, Price stability

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