

# Central Bank Communication and Expectations Stabilization\*

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## Abstract

The value of communication is analysed in a model in which agents' expectations need not be consistent with central bank policy. Without communication, the Taylor principle is not sufficient for macroeconomic stability: self-fulfilling expectations are possible. Three communication strategies are contemplated to ensure consistency between private forecasts and monetary policy strategy: i) communicating the precise details of policy; ii) communicating only the variables on which policy decisions are conditioned; and iii) communicating the inflation target. The former strategies restore the Taylor principle as a sufficient condition for anchoring expectations. The latter strategy, in general, fails to protect against expectations-driven fluctuations.

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A central bank that is inscrutable gives the markets little or no way to ground these perceptions [about monetary policy] in any underlying reality — thereby opening the door to expectational bubbles that can make the effects of its policies hard to predict. (Blinder, 1999)

## 1 Introduction

Since the 1990's, central banking practice has shifted from secrecy and opaqueness towards greater transparency about monetary policy strategy and objectives. At the same time, an increasing number of central banks have adopted an inflation targeting framework for monetary policy. One potential benefit from successful implementation of inflation targeting is the anchoring of expectations, with its stabilizing effect on macroeconomic activity. Failing to anchor expectations might result in undesired fluctuations and economic instability.

Given the role of expectations, a central bank's communication strategy is a crucial ingredient of inflation targeting. Yet despite its importance, relatively little formal analysis in the context of dynamic stochastic general equilibrium models has been done on the mechanisms by which communication might prove beneficial. The analysis here addresses this hiatus. Using a simple model of output gap and inflation determination, a number of communication strategies are considered which vary the kinds of information the central bank communicates about its monetary policy deliberations. This inquiry has relevance for recent debate in the U.S., elucidating and assisting evaluation of the Federal Reserve's evolving communication strategy in the implementation of monetary policy — see Bernanke (2007).

Motivated by Friedman (1947, 1968), a model is developed in which monetary policy stabilization is conducted in the presence of two informational frictions. First, the central bank has imperfect information about the current state of the economy and must forecast the current inflation rate and output gap when setting the nominal interest rate in any period. Because of this observation lag the central bank responds to information and the state of the economy with a delay.<sup>1</sup> Second, households and firms have an incomplete model of the macroeconomy, knowing only their own objectives, constraints and beliefs. Consequently,

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<sup>1</sup>Policy is implementable in the sense of McCallum (1999).

they do not have a model of how aggregate state variables, including nominal interest rates, are determined. They forecast exogenous variables relevant to their decision problems by extrapolating from historical patterns in observed data.

This specification of subjective beliefs, which can differ from the objective probabilities implied by the economic model, permits defining meaningfully the notion of anchored expectations as those beliefs consistent with the monetary policy strategy of the central bank. The possibility of beliefs being inconsistent with monetary policy strategy and, therefore, unanchored, presents a challenge for stabilization policy and permits examination of the role of communication in policy design.<sup>2</sup> This contrasts with a rational expectations analysis in which expectations are anchored by construction. Beliefs must be consistent with monetary policy regardless of whether policy induces a determinate or indeterminate rational expectations equilibrium.

Communication is modeled as providing agents with certain types of information about how the central bank determines its nominal interest rate setting. This information serves to simplify agents' forecasting problem and to coordinate expectations about various macroeconomic variables in a desirable way. Worth underscoring is that uncertainty about the path of nominal interest rates is only one of several sources of uncertainty present in this economy. Indeed, households and firms are similarly unsure about how aggregate output and inflation are determined. The central question is whether uncertainty about the determination of interest rates is an especially important source of uncertainty and whether additional knowledge about the future path of nominal interest rates helps anchor expectations, assisting macroeconomic stabilization.<sup>3</sup>

Three communication strategies are considered. In the benchmark strategy the central bank discloses, under full credibility, the policy rule employed to set nominal interest rates. Agents therefore know which variables appear in the policy rule and the precise restriction

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<sup>2</sup>These frictions also formed the basis of Friedman's (1968) critique of nominal interest rate rules as a means to implement monetary policy. The analysis here evaluates the verity of this claim, building on the seminal analysis of Howitt (1992), and explores the value of communication in macroeconomic stabilization policy.

<sup>3</sup>On a technical level, the analysis is concerned with the question of whether communication assists convergence to the underlying rational expectations equilibrium of the model.

that holds among these endogenous variables at all points in time in the forecast horizon. An alternative interpretation of this communication strategy is that the bank discloses its forecasts of the entire future path of its policy instrument. A consequence of knowing the policy rule is that agents need not independently forecast the path of nominal interest rates: it is sufficient to forecast the set of variables upon which nominal interest rates depend — expectations are anchored. Because this relation is one of the many equilibrium restrictions agents are attempting to learn, by imposing this restriction on their regression model, a more efficient forecast obtains.

The second communication strategy makes available less information. Rather than conveying the precise policy rule, the central bank only announces the set of variables upon which nominal interest rates are conditioned. This strategy might reflect partial central bank credibility or the inability to accurately communicate the complexities of the decision making process: market participants use available data and the information about the policy rule to verify the reaction function used to set the nominal interest rate — see Mishkin (2004).

Finally, motivated by the inflation targeting literature, which emphasizes the potential benefits of announcing an inflation target for anchoring inflation expectations, we explore the advantages of communicating only the central bank's desired average outcomes for inflation, nominal interest rates and the output gap. Here the only information that is communicated is the central bank's commitment to conduct policy in such a way as to achieve the target for inflation on average. No information on how the central bank will achieve this objective is given.

The central results are as follows. In the case of no communication, policy rules that implement optimal policy under rational expectations fail to anchor expectations and frequently lead to self-fulfilling expectations. In contrast to a rational expectations analysis, an aggressive response to inflation expectations, as adherence to the Taylor principle prescribes, does not guarantee stability. Indeed, it is likely to further destabilize expectations. Instability arises because expectations are inconsistent with the monetary policy strategy of the central bank — and therefore unanchored — and aggressive policy leads to greater macroeconomic uncertainty. A central bank that does not communicate can only stabilize expectations by

aggressively responding to the output gap. But this may have deleterious consequences for welfare. These findings resonate with practical policy experience. For instance, Goodfriend (1993), in discussing the Volker disinflation, notes:

The public found it increasingly difficult to discern the Fed's policy intentions, and the Fed found it increasingly difficult to gauge the state of the economy and how the economy would respond to its policy actions. The opportunity for policy mistakes was enlarged. In short, there was a breakdown in mutual understanding between the public and the Fed.

In contrast, by communicating the entire policy decision process — that is, the relevant conditioning variables and policy coefficients — the central bank mitigates instability and allows successful implementation of optimal policy by stabilizing expectations. Communicating accurate information about the systematic component of current and future monetary policy decisions anchors expectations and promotes macroeconomic stability by ensuring subjective beliefs of agents are consistent with monetary policy strategy. These stabilization benefits can also be fully captured by a communication strategy that only conveys the set of endogenous variables on which monetary policy decisions are conditioned, as proposed by the second communication strategy. This information, combined with knowledge that nominal interest rates are a linear function of these objects, delivers convergence to rational expectations equilibrium and protects against expectations-driven instability.

Finally, communication strategies that only announce an inflation target and the associated average long-run values of the nominal interest rate and output gap frequently lead to expectations-driven instability. In an economy with persistent shocks, the conditions for convergence are identical to those for the benchmark no communication case where these quantities must be learned. Hence, in such economies, communicating the inflation target does little to help stabilize expectations.

Communication helps by providing information about the systematic component of policy and importantly by giving information on how the central bank intends to achieve its announced objectives. Credibility about the future conduct of policy matters not only because

of the stabilization bias that emerges from a rational expectations equilibrium analysis, as is well known from Kydland and Prescott (1977), but also because it anchors expectations thereby protecting against departures from rational expectations equilibrium that arise from small expectational errors on the part of households and firms.

**Related literature:** The analysis builds on an earlier literature commencing with Cukierman and Meltzer (1986) and more recently Faust and Svensson (2001, 2002). These papers consider models in which the central bank has an idiosyncratic employment target which is imperfectly observed by the public. Fluctuations in this target lead to central bank temptation to deviate from pre-announced inflation goals. In this framework, transparency entails costs and benefits. In Cukierman and Meltzer (1986) and Faust and Svensson (2002), when a central bank has a low average inflation bias, lack of transparency helps surprise the public, making monetary policy more effective in stabilizing output fluctuations. The central bank fully understands the private sector's expectations formation mechanism and can exploit it to stabilize output. However, if the central bank has a high inflation bias, increased transparency allows the private sector to observe the employment target with greater precision and raises the costs to the central bank of deviating from its announced objectives. Transparency is desirable as it provides a commitment mechanism.<sup>4</sup>

This literature assumes rational expectations on the part of the central bank and the public. Here we assume that the central bank does not have complete information on private sector expectations formation and cannot manipulate agents' beliefs to its own advantage. We therefore exclude strategic interaction between the central bank and the private sector. Furthermore, in our model, agents have *incomplete information about the policy reaction function*, unlike the papers above where agents have imperfect information about specific variables that appear in the reaction function.

More recently, a literature has emerged focusing on the question of whether transparency of central bank forecasts of exogenous state variables is desirable. In these models, the pub-

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<sup>4</sup>Svensson (1999) further argues on the ground of this result that for inflation targeting central banks it is generally desirable to publish detailed information on policy objectives, including forecasts. Such transparency enhances the public's understanding of the monetary policy process and raises the cost to a central bank from deviating from its stated objectives.

lic correctly understands central bank preferences but has imperfect information about the central bank's forecast of the aggregate state. Building on Morris and Shin (2002), Amato and Shin (2003), Hellwig (2002) and Walsh (2006), among others, show that full transparency about the central bank forecast is not always desirable because private agents may overreact to noisy public signals and under react to more accurate private information. More generally, Geraats (2002) argues that models based on diverse private information often have the property that pronouncements by the central bank may lead to frequent shifts in expectations leading to increased economic volatility. In contrast, Roca (2006) shows that some of these conclusions depend on the postulated objectives of the central bank. Similarly, Svensson (2006) and Woodford (2005) argue that the conclusions of Morris and Shin (2002) depend on implausible parameter assumptions.<sup>5</sup>

Our analysis departs from this literature by analyzing the value of communicating information about current and future nominal interest rate decisions of the central bank. Like Walsh (2006), the present analysis considers a theory of price setting that is consistent with recent New Keynesian analyses of monetary policy. Unlike Walsh, we propose a fully articulated dynamic stochastic general equilibrium model, and, rather than assuming that the central bank and private agents have asymmetric information about the kinds of disturbances that affect the economy, we consider a framework in which these actors have symmetric information about shocks. The asymmetry instead lies in knowledge about how nominal interest rates are determined — that is, monetary policy strategy. This permits a tractable analysis of communication about endogenous decision variables of the central bank — the sequence of choices about the path of nominal interest rates — rather than announcements about exogenous state variables.<sup>6</sup>

Finally, the paper is related to Orphanides and Williams (2005) which presents a reduced form model in which announcing the inflation target achieves a better inflation-output trade-

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<sup>5</sup>See also Woodford (2005) and Geraats (2002) for a review of the benefits of central bank communication and transparency.

<sup>6</sup>Rudebusch and Williams (forthcoming) present an analysis that is similar in spirit, but in which expectations are anchored by assumption, analyzing the consequences of asymmetric information about future policy actions. One of the contributions of our paper is to build on their analysis by developing microfoundations which imply asymmetric information about the economy.

off. Because it reduces the amplitude of macroeconomic fluctuations the announcement of the inflation target is welfare enhancing. However, in their model, regardless of whether or not the inflation target is announced, expectations are well anchored: self-fulfilling expectations cannot arise. The improvement in welfare results from agents having a more accurate forecast of future policy decisions. Moreover, learning about the monetary policy reaction function is not explicitly modeled. In contrast, this paper presents a model in which self-fulfilling expectations emerge even if the inflation target is announced and credible, and, in which, knowledge about the central bank's policy rule proves crucial for expectations stabilization.

The paper proceeds as follows. Section 2 delineates a simple model of the macroeconomy. Section 3 details private agents' expectations formation and the adopted criterion to assess macroeconomic stability. Section 4 provides foundational results. Section 5 explores the role of communication in stabilization policy. Section 6 provides graphical analysis of the dynamics of expectations under communication and provides some extensions to the core analytical results. Section 7 concludes.

## 2 A Simple Model

The following section describes a model similar in spirit to Goodfriend and King (1997), Rotemberg and Woodford (1999) and Svensson and Woodford (2005). A continuum of households faces a canonical consumption allocation problem and decides how much to consume of available differentiated goods and how much labor to supply to firms for the production of such goods. A continuum of monopolistically competitive firms produces differentiated goods using labor as the only input and faces a price-setting problem of the kind proposed by Rotemberg (1982).<sup>7</sup> The major difference is the incorporation of non-rational beliefs, delivering an anticipated utility model. The analysis follows Marcet and Sargent (1989a) and Preston (2005), solving for optimal decisions conditional on current beliefs. Details of the assumed microfoundations, derivations and log-linear approximation are provided in a technical appendix.

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<sup>7</sup>An analysis of price setting of the kind proposed by Calvo (1983), as implemented by Yun (1996), would lead to similar conclusions.

Various mechanisms of persistence, such as habit formation, price indexation and inertial monetary policy are abstracted from. This provides sharp, perspicuous analytical results.<sup>8</sup> An earlier version of this paper, Eusepi and Preston (2007), demonstrates that our conclusions regarding the value of communication in policy design remain pertinent in models with such modifications.

## 2.1 Aggregate Implications

Aggregation of optimal decisions by firms and households provides

$$x_t = \hat{E}_{t-1} \sum_{T=t}^{\infty} \beta^{T-t} [(1 - \beta)x_T - \beta(i_T - \pi_{T+1}) + \beta r_t^e] \quad (1)$$

and

$$\pi_t = \frac{\gamma_1 \xi}{(1 - \gamma_1 \beta)} \hat{E}_{t-1} \sum_{T=t}^{\infty} (\gamma_1 \beta)^{T-t} [(1 - \gamma_1 \beta)(x_T + \hat{\mu}_T) + \pi_T] \quad (2)$$

where  $x_t$  is the output gap,  $\pi_t$  the inflation rate,  $i_t$  the nominal interest rate and both  $r_t^e$  and  $\hat{\mu}_t$  are exogenous disturbance terms, with all variables being properly interpreted as log-deviations from steady state values. The household's discount factor satisfies  $0 < \beta < 1$  and the remaining parameters satisfy  $\xi > 0$  and  $0 < \gamma_1 < 1$ , and are described in a technical appendix. Finally,  $\hat{E}_t$  denotes the assumption of non-rational expectations (to be discussed) and represents the aggregation of household beliefs. Because households and firms in the underlying microfoundations only know their own objectives, constraints and beliefs they cannot compute aggregate probability laws. As a result,  $\hat{E}_t$  does not satisfy the law of iterated expectations.  $E_t$  denotes rational expectations.

The first equation represents the aggregation of optimal consumption decisions by households which are implications of their Euler equation and intertemporal budget constraint. It is therefore an aggregate demand relation, specifying that output is determined by the current real rate of interest and long-horizon expectations of the output gap, the real interest rate and exogenous disturbances into the indefinite future. The presence of long-horizon expectations arises from the intertemporal nature of the household's consumption decision: to optimally

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<sup>8</sup>It is also motivated by Milani (2006) and Eusepi and Preston (2008) which suggest that purely forward looking business cycle models with learning dynamics provide a superior characterization of various U.S. macroeconomic time series than do rational expectations models with various persistence mechanisms.

allocate consumption today requires the household to plan its future consumption over time and across states of nature, which in turn requires forecasts of variables such as income and real interest rates.

Relation (2) is derived from the aggregation of the optimal prices chosen by firms to maximize the expected discounted flow of profits under a Rotemberg (1982) price-setting problem. It is therefore a New-Keynesian Phillips curve, specifying current inflation as depending on the contemporaneous output gap and expectations of this variable and inflation into the indefinite future. Here the presence of long-horizon expectations arises due to the pricing frictions induced by Rotemberg pricing. Shifts in the current state lead to gradual shifts in the optimal price because of costly price adjustment, indexed by the parameter  $\xi$ : larger values imply smaller costs of adjustment — prices are more flexible. The firm must therefore concern itself with macroeconomic conditions relevant to marginal costs into the indefinite future when deciding the current price of its output. Future profits are also discounted at the rate  $\beta$  which equals the inverse of the steady-state gross real interest rate. The term  $\hat{\mu}_T$  represents inefficient variations in the markup.

The underlying microfoundations assume that households and firms make decisions about spending and pricing one period in advance. This is because the sequel assumes that the monetary authority must forecast the current inflation rate to implement monetary policy. Hence, all agents make decisions in period  $t$  based on  $t - 1$  information. These timing assumptions can be changed, with only minor modifications to the results. For instance, if all agents based decisions on period  $t$  information, but the central bank must forecast next-period's inflation to implement policy, all results continue to hold.

## 2.2 The Monetary Authority

The monetary authority minimizes a standard quadratic loss function under the assumption that agents have rational expectations. This approach follows a now substantial literature on learning dynamics and monetary policy — see Howitt (1992) for the seminal contribution and Bullard and Mitra (2002), Evans and Honkapohja (2003) and Preston (2006, 2008), *inter alia*, for subsequent contributions — motivated by the question of robustness of standard

policy advice to small deviations from the rational expectations assumption. For alternative treatments of policy design that exploit knowledge of private agent learning see Gaspar, Smets, and Vestin (2005), Molnar and Santoro (2005) and Preston (2006, 2008).

The optimal policy problem is

$$\min E_{t-1} \sum_{T=t}^{\infty} (\pi_T^2 + \lambda_x x_T^2)$$

subject to the constraints

$$x_t = E_{t-1}x_{t+1} - E_{t-1}(i_t - \pi_{t+1} - r_t^e) \quad (3)$$

$$\pi_t = \xi E_{t-1}x_t + \beta E_{t-1}\pi_{t+1} + E_{t-1}\hat{\mu}_t \quad (4)$$

which are the model implied aggregate demand and supply equations under rational expectations.<sup>9</sup> The weight  $\lambda_x > 0$  determines the relative priority given to output gap stabilization. A second-order accurate approximation to household welfare in this model can be shown to imply a specific value for  $\lambda_x$ . Because this is not central to our conclusions, and because this more general notation permits indexing a broader class of policy rules, we adopt this objective function.

The first-order condition under discretion is

$$E_{t-1}\pi_t = -\frac{\lambda_x}{\xi} E_{t-1}x_t. \quad (5)$$

Hence optimal policy dictates interest rates to be adjusted so that predictable movements in inflation are negatively related to those in the output gap.<sup>10</sup> This targeting rule combined with the structural relations (3) and (4) can be shown to determine the rational expectations equilibrium paths  $\{i_t^*, \pi_t^*, x_t^*\}$  as linear functions of the exogenous state variables  $\{r_{t-1}^e, \hat{\mu}_{t-1}\}$ . Without loss of generality, and to make the analysis as simple and transparent as possible,

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<sup>9</sup>These expressions follow directly from (1) and (2) on noting that  $\hat{E}_t$  satisfies the law of iterated expectations under the assumption of rational expectations — households and firms know the objectives, beliefs and constraints of other agents and can therefore determine aggregate probability laws in equilibrium. Also, at the rational expectations equilibrium  $x_t = E_{t-1}x_t$  and  $\pi_t = E_{t-1}\pi_t$ . These equivalences are not true under learning.

<sup>10</sup>Policies under optimal commitment could similarly be analyzed without substantial differences in the conclusions of this paper. However, because such policies introduce history dependence, analytical conditions are somewhat tedious and we therefore take the case of discretion for convenience.

we assume that the exogenous processes are determined by

$$\begin{aligned} r_t^e &= \rho_r r_{t-1}^e + \varepsilon_t^r \\ \hat{\mu}_t &= \rho_\mu \hat{\mu}_{t-1} + \varepsilon_t^\mu \end{aligned}$$

where  $0 < \rho_r, \rho_\mu < 1$  and  $(\varepsilon_t^r, \varepsilon_t^\mu)$  are independently and identically distributed random variables, with autoregressive coefficients known to households and firms.<sup>11</sup> Under these assumptions

$$i_t^* = \rho_r r_{t-1}^e + \phi_\mu \rho_\mu \hat{\mu}_{t-1}$$

where

$$\phi_\mu = \frac{\rho_\mu \lambda_x + (1 - \rho_\mu) \xi}{\xi^2 + \lambda_x (1 - \beta \rho_\mu)}$$

delineates the desired state contingent evolution of nominal interest rates required to implement the optimal equilibrium.

Following Svensson and Woodford (2005), rather than adopting the targeting rule (5) directly as the policy rule, we instead assume the central bank implements policy according to the nominal interest rate rule

$$i_t = i_t^* + \phi \left( \hat{E}_{t-1} \pi_t + \frac{\lambda_x}{\xi} \hat{E}_{t-1} x_t \right) \quad (6)$$

$$= i_t^* + \phi \hat{E}_{t-1} \pi_t + \phi_x \hat{E}_{t-1} x_t \quad (7)$$

where  $\phi > 0$  and  $\phi_x \equiv (\phi \lambda_x / \xi) > 0$ . This serves to limit the information that the central bank requires to implement monetary policy. Moreover, an explicit policy rule can be learned by market participants without them specifying a complete model of the economy. The central bank is assumed to observe private forecasts — through survey data — or to have an identical internal forecasting model. This rule has the property that if beliefs converge to the underlying rational expectations equilibrium then it is consistent with implementing optimal policy under a rational expectations equilibrium. This follows immediately from observing in this case that

$$\hat{E}_{t-1} \pi_t + \frac{\lambda_x}{\xi} \hat{E}_{t-1} x_t = 0$$

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<sup>11</sup>This assumption can be dispensed with without altering results. Because these shocks are exogenous and assumed to be observed by agents, it is immediate that estimating a first order process for each shock will recover the true autoregressive coefficient with probability going to one as the sample size goes to infinity.

which in turn implies  $i_t = i_t^*$  as required for optimality under rational expectations. Note also that it nests an expectations-based Taylor rule as a special case, albeit with a stochastic constant.<sup>12</sup>

Worth emphasizing is that the precise details of the policy rule are not important to the central points of the paper. While policy details will affect the precise conditions for determinacy of equilibrium and stability under learning dynamics, they are less relevant for the question of communication. What matters, given virtually any policy rule that may be chosen, with arbitrary dependence on both past realizations of various macroeconomic variables and expectations of future realizations of the same, is agents' knowledge about this rule. If agents have imperfect knowledge of monetary policy strategy then there will be a role for communication because beliefs are inconsistent with policy objectives out-of-rational-expectations equilibrium. For example, an earlier version of this paper, Eusepi and Preston (2007), demonstrates that conclusions are similar for inertial policy rules and policy rules that respond to expectations of future inflation. For these reasons, and the logic of later analysis, it is conjectured that policy rules that are consistent with implementing the optimal commitment equilibrium under rational expectations, will likely, for virtually all possible representations of such policies, deliver similar broad conclusions as discerned from the study of rules that implement the optimal discretion equilibrium. This is because when agents have imperfect information about the adopted policy rule, expectations are not anchored: they are inconsistent with the monetary policy strategy of the central bank in the sense that expectations about nominal interest rates, inflation and output do not satisfy the equilibrium restriction implied by the policy rule. The analysis shows that communication delivers better control of the macroeconomy.<sup>13</sup>

The only exception to this is when policy is implemented assuming the central bank: i) employs targeting rules of the kind proposed by Giannoni and Woodford (2002); ii) has

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<sup>12</sup>The stochastic constant is largely irrelevant to the stability analysis under learning dynamics. Also, if the assumption of discretionary optimization is unappealing, then a rule of this form with appropriately defined stochastic constant can implement the optimal equilibrium under commitment — see Preston (2006).

<sup>13</sup>Also see Eusepi (2004) for an example of instability when policy responds to inflation and the change in the output gap, which is similar in spirit to optimal policy under commitment given its dependence on the lagged output gap.

complete knowledge of household and firm behavior; and iii) conditions nominal interest rate decisions on all future expectations about output, inflation and nominal interest rates. This approach is detailed in Preston (2008) in a model closely related to that considered here and by Evans and Honkapohja (2003) in a model where on one period ahead forecasts matter for spending and pricing decisions. Such policy strategies have the property that regardless of the expectations held by agents, expectations will be consistent with the monetary policy strategy of the central bank — see Woodford (2005) for further discussion of this approach. Hence, in the terminology of this paper: expectations are anchored; and Preston (2008) shows that such policies ensure determinacy of equilibrium and stability under learning for all parameter values.

Despite these advantages, attention is here given to simple policy rules because central banks are likely to have imperfect information about the structure of the economy and because such rules have been emphasized in the recent literature on monetary policy design and various central bank publications. An emergent lesson is that if central banks choose to cast their public discussion of policy in terms of simple rules, they ought to be very clear about the details of the adopted strategy.

### **3 Learning and Central bank Communication**

This section describes agents' learning behavior and the criterion to assess convergence of beliefs. Agents do not know the true structure of the economic model determining aggregate variables. To forecast state variables relevant to their decision problems, though beyond their control, agents make use of atheoretical regression models. The regression model is assumed to contain the set of variables that appear in the minimum state variable rational expectations solution to the model. Each period, as additional data become available, agents re-estimate the coefficients of their parametric model.

An immediate implication is that model dynamics are self-referential: the evolution of firm and household beliefs influence the realizations of observed macroeconomic variables. In turn, changes in observed data affect agents' belief formation. Learning induces time variation in the data generating process describing inflation, output and nominal interest rates. The central

technical question concerns the conditions under which beliefs converge to those that would obtain in the model under rational expectations, in which case the data generating process characterizing the evolution of macroeconomic variables is time invariant. Convergence is assessed using the notion of expectational stability outlined in Evans and Honkapohja (2001).

A more fundamental implication of this self-referential property is that it permits analyzing the role of communication in stabilizing expectations. In a rational expectations analysis, expectations are pinned down by construction of the equilibrium and are necessarily consistent with the adopted policy rule. By analyzing a model that permits beliefs to become unanchored from rational expectations and possibly be inconsistent with the monetary policy strategy of the central bank, the value of certain types of information regarding the monetary policy process in stabilizing expectations can be clearly and fruitfully evaluated.

### 3.1 Forecasting

This section outlines the beliefs of agents in our benchmark analysis in the case of no communication. As additional information is communicated to households and firms, the structure of beliefs will change accordingly. These modifications will be noted as they arise, with an illustrative example given below. The agents' estimated model at date  $t - 1$  can be expressed as

$$Z_t = \begin{bmatrix} x_t \\ \pi_t \\ i_t \\ \hat{\mu}_t \\ \hat{r}_t^e \end{bmatrix} = \omega_{0,t-1} + \omega_{1,t-1}Z_{t-1} + \bar{e}_t \quad (8)$$

where  $\omega_0$  denotes the constant,  $\omega_1$  is defined as

$$\omega_1 = \begin{bmatrix} \omega_{xx} & \omega_{x\pi} & \omega_{xi} & \omega_{x\mu} & \omega_{xr} \\ \omega_{\pi x} & \omega_{\pi\pi} & \omega_{\pi i} & \omega_{\pi\mu} & \omega_{\pi r} \\ \omega_{ix} & \omega_{i\pi} & \omega_{ii} & \omega_{i\mu} & \omega_{ir} \\ 0 & 0 & 0 & \rho_\mu & 0 \\ 0 & 0 & 0 & 0 & \rho_r \end{bmatrix}$$

and  $\bar{\varepsilon}_t$  represents an i.i.d. estimation error. Agents are assumed to know the autocorrelation coefficients of the shocks but estimate the other parameters (with time subscripts being dropped for convenience). It is immediate that absent knowledge of the monetary policy rule, the forecasts of  $\{x_t, \pi_t, i_t\}$  implied by (8) need not satisfy (6). Note that the analysis permits agents to include a larger set of variables than just those appearing in the minimum state variable solution to the model. This is done for generality – and, moreover, forecasting with a vector autoregression is an highly natural assumption — and largely irrelevant to our results. Whether the economy is stable or not will turn out to be determined by agents’ learning about the coefficients on variables that do appear in the minimum state variable solution.

This paper models communication as information about the dynamics of nominal interest rates. As an example of communication, suppose the central bank credibly announces that monetary policy will be conducted so that inflation, output and nominal interest rates will on average be zero in deviations from steady state. The model implication is that agents know this with certainty and impose this restriction on their regression model. Hence  $\omega_{0,t-1} = 0$  and agents need only learn a subset of coefficients relevant to the reduced form dynamics of macroeconomic aggregates. This captures well the idea that communicating characteristics of the monetary policy strategy is an attempt to manage the evolution of expectations.

At the end of period  $t - 1$  agents form their forecast about the future evolution of the macroeconomic variables given their current beliefs about reduced form dynamics. Given the vector  $Z_{t-1}$ , expectations  $T + 1$  periods ahead are calculated as

$$\hat{E}_{t-1} Z_{T+1} = (I_5 - \omega_{1,t-1})^{-1} (I_5 - \omega_{1,t-1}^{T-t+2}) \omega_{0,t-1} + \omega_{1,t-1}^{T-t+2} Z_{t-1}$$

for each  $T > t - 1$ , where  $I_5$  is a  $(5 \times 5)$  identity matrix.

### 3.2 Expectational Stability

Substituting for the expectations in the equations for the output gap, inflation and the nominal interest rate, permits writing aggregate dynamics of the economy as

$$Z_t = \Gamma_0(\omega_{0,t-1}, \omega_{1,t-1}) + \Gamma_1(\omega_{1,t-1}) Z_{t-1} + \Gamma_2 \bar{\varepsilon}_t \tag{9}$$

with obvious notation and where  $\bar{\varepsilon}_t$  is a  $(5 \times 1)$  vector of zeros with final two elements  $\varepsilon_t^\mu$  and  $\varepsilon_t^r$ . This expression captures the dependency of observed dynamics on agents' beliefs about the future evolution of the economy. Moreover, it implicitly defines the mapping between agents' beliefs and the actual coefficients describing observed dynamics as

$$T(\omega_{0,t-1}, \omega_{1,t-1}) = (\Gamma_0(\omega_{0,t-1}, \omega_{1,t-1}), \Gamma_1(\omega_{1,t-1})). \quad (10)$$

A rational expectations equilibrium is a fixed point of this mapping. For such rational expectations equilibria we are interested in asking under what conditions does an economy with learning dynamics converge to each equilibrium. Using stochastic approximation methods, Marcet and Sargent (1989b) and Evans and Honkapohja (2001) show that conditions for convergence are characterized by the local stability properties of the associated ordinary differential equation

$$\frac{d(\omega_0, \omega_1)}{d\tau} = T(\omega_0, \omega_1) - (\omega_0, \omega_1), \quad (11)$$

where  $\tau$  denotes notional time. The rational expectations equilibrium is said to be expectationally stable, or E-Stable, when agents use recursive least squares if and only if this differential equation is locally stable in the neighborhood of the rational expectations equilibrium.<sup>14</sup>

## 4 Preliminary Foundations

This section provides the benchmark theoretical results of the paper. The model properties under both rational expectations and learning dynamics without communication are stated. The analysis of various communication strategies in the implementation of monetary policy is then explored in Section 5.

### 4.1 Benchmark Properties

To ground the analysis, and provide a well known comparative benchmark, the stability properties of the model under rational expectations can be summarized as follows.

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<sup>14</sup>Standard results for ordinary differential equations imply that a fixed point is locally asymptotically stable if all eigenvalues of the Jacobian matrix  $D[T(\omega_0, \omega_1) - (\omega_0, \omega_1)]$  have negative real parts (where  $D$  denotes the differentiation operator and the Jacobian understood to be evaluated at the relevant rational expectations equilibrium).

**Proposition 1** *Under rational expectations, the model given by equations (1), (2) and (6) has a unique bounded solution if  $\phi > 1$ .*

This is an example of the Taylor principle. If nominal interest rates are adjusted to ensure appropriate variation in the real rate of interest, then determinacy of rational expectations equilibrium obtains. This feature along with other robustness properties noted by Batini and Haldane (1999) and Levin, Wieland, and Williams (2003), have lead to advocacy of forecast-based instrument rules for the implementation of monetary policy. Indeed, such policy rules appear in a number of central bank forecasting models — see, for instance, the Bank of Canada. Furthermore, Clarida, Gali and Gertler (1998, 2000) adduce empirical evidence for interest rate reaction functions that respond to one period ahead forecasts. Under learning dynamics the model has strikingly different predictions for the evolution of household and firm expectations.

**Proposition 2** *Consider the economy under learning dynamics where the central bank does not communicate the policy rule and  $\phi > 1$ .*

1. *The REE is unstable under learning provided*

$$\bar{M}_I \equiv \frac{\beta\phi}{\xi} [\lambda_x - (1 - \gamma_1)\xi] + \beta(1 - \gamma_1) - M(\xi, \beta) < 0$$

*where  $M(\xi, \beta)$  is described in the appendix. Hence:*

2. *If  $\xi \rightarrow \infty$  then the REE is unstable for all parameter values.*
3. *If  $\beta \rightarrow 1$  and  $\lambda_x < (1 - \gamma_1)\xi$ , then the REE is unstable for all parameter values.*
4. *If  $\beta \rightarrow 0$ , then the REE is stable under learning for all parameter values.*

For many reasonable parameter values,  $\bar{M}_I < 0$ , and the optimal policy under rational expectations cannot be implemented with learning and no communication, rendering the economy prone to self-fulfilling expectations. Indeed, standard parameterizations invariably take the household's discount rate to be near unity. High values of  $\beta$  and low weights on the output gap imply instability under learning. Conversely, as  $\beta$  becomes small,  $\bar{M}_I > 0$ , guaranteeing stability of the equilibrium. Intuitively, as  $\beta$  increases, current consumption plans become more sensitive to expectations, and a correct prediction of the future path

of the nominal interest rate, together with predictions about the output gap and inflation, becomes crucial for stability. Analogously, as the degree of nominal rigidity declines, goods prices become more sensitive to expectations about future marginal cost conditions. Indeed, as  $\xi \rightarrow \infty$ , the flexible price limit, instability obtains for all parameter values. Both features emphasize the importance of stabilizing long-term expectations.

To give further insight to this result, consider the evolution of household beliefs in response to an increase in inflation expectations. To characterize beliefs, we study the associated ordinary differential equation of the E-Stability mapping. Figure 1 plots the local dynamics of the agents' estimates of  $\omega_{x,0}$ ,  $\omega_{\pi,0}$  and  $\omega_{i,0}$  — the estimated intercept. Given a sufficiently large sample of data, the evolution of these belief coefficients are arbitrarily well described by the linear ordinary differential equation

$$\dot{\omega}_0 = (J^* - I_3) \omega_0$$

where

$$\omega_0 = \begin{pmatrix} \omega_{x,0} & \omega_{\pi,0} & \omega_{i,0} \end{pmatrix}'$$

and  $J^*$  is the Jacobian of  $T(\omega_0, \omega_1)$ .<sup>15</sup> This represents the first order dynamics of the ODE (11) whose eigenvalues determine E-Stability properties — see the appendix for further details. The economy is assumed to be initially in the deterministic steady state (with no shocks occurring in the simulation). We then perturb the beliefs of private agents, making the initial estimate of the inflation coefficient,  $\omega_{\pi,0}$ , higher than its rational expectations value. This can be interpreted as an increase in inflation expectations or equivalently an expectational error on the part of agents. The model is calibrated with  $\beta = 0.99$ ,  $\xi = 0.06$ ,  $\phi = 2$  and  $\lambda_x = 0.005$ , which implies  $\phi_x = 0.16$ , similar to the output gap coefficient in a Taylor type rule estimated on quarterly non-annualized inflation.<sup>16</sup>

The solid lines represent expectations of each macroeconomic aggregate, while the dotted line gives the level of the nominal interest rate. The expectational shock engenders higher

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<sup>15</sup>As explained in the appendix, the ODE describing the evolution of the intercept is independent of the ODE describing the evolution of the shock coefficients and the coefficients on lagged variables.

<sup>16</sup>Expectations of output, inflation and the nominal interest rate are determined by the agents' model intercept only, since shocks are set to zero in this experiment — and hence independent of  $\rho_\mu$  and  $\rho_r$ .

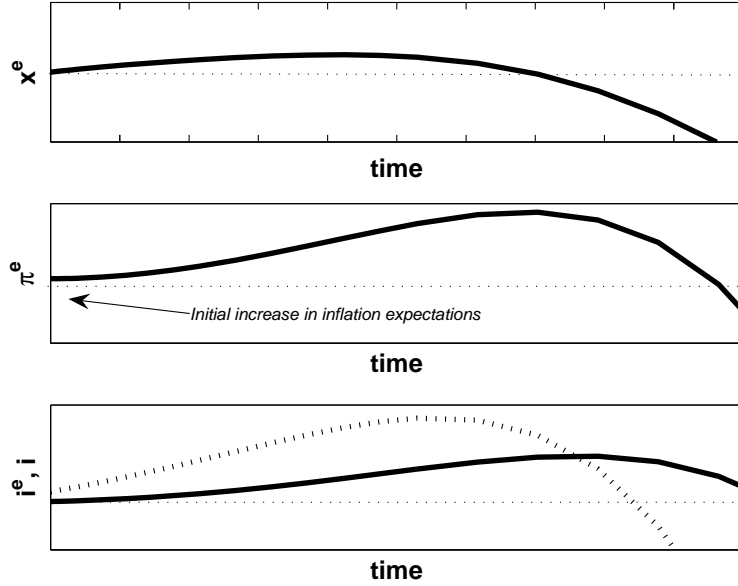


Figure 1: Instability under no communication

output and inflation, and gives rise to higher expectations of both these variables. The central bank's policy response is initially small, strengthening with a delay because of imperfect information about the state of the economy. When an increase in the nominal interest rate does occur, it fails to curb the increase in expected and actual inflation because aggregate demand only depends on predictable changes in nominal interest rates, and it takes time for expectations to adjust. Private agents fail to correctly anticipate the *future* policy stance so that the initial increase in the policy instrument has limited effect on aggregate activity (expected real interest rates decline), validating initial expectations of higher inflation. While not plotted, expectations about inflation, output and nominal interest rates diverge from their rational expectations values with time. Section 5 further explores the dynamics of belief formation under various assumptions about the degree of communication.

Three additional points are worth noting. First, under reasonable parameterizations an increase in  $\phi$  might render the equilibrium less stable — for example if  $\lambda_x < (1 - \gamma_1)\xi$ . This follows immediately from the definition of  $\bar{M}_I$  in Proposition 2. By responding too aggressively, the central bank can lead to households forming conditional forecasts of future nominal interest

rates that promote instability.<sup>17</sup> This finding contrasts with Ferrero (2004) and Orphanides and Williams (2005) which argue that under learning policy should be more aggressive in response to inflation. The difference in conclusion stems from different assumptions about the central bank’s knowledge of the state of the economy and ability to manipulate current demand through appropriate choice of the contemporaneous interest rate. In this model the central bank has incomplete knowledge about the current state of the economy. Moreover, because agents’ decisions are predetermined, current interest rate decisions are less effective in shaping aggregate demand.

Second, a policy rule which responds aggressively to the output gap guarantees the stability of expectations. This result is summarized in the following proposition which considers an economy with arbitrarily small costs of adjusting prices. It can also be shown that the result remains valid for plausible nominal rigidities.

**Proposition 3** *Consider the economy under learning dynamics where the central bank does not communicate the policy rule. Assume an arbitrarily small degree of nominal rigidities so that  $\xi \rightarrow \infty$ . If  $\phi > 0$  and  $\lambda_x$  increases to ensure  $\lambda_x/\xi$  is equal to some constant  $\bar{\lambda}_x = \lambda_x/\xi$ , then there exists  $\bar{\lambda}_x^*$  such that  $\bar{\lambda}_x > \bar{\lambda}_x^*$  implies  $\bar{M} > 0$  guaranteeing E-stability for all parameter values.*

Why is  $\bar{\lambda}_x > 0$  important for expectations stabilization? Recall that prices depend on the expected sequence of output gaps into the indefinite future. As output gap expectations increase, prices move accordingly, affecting *future* inflation expectations. Thus the expected output gap becomes a better indicator of future inflation expectations. By responding to expected output gap the central bank can ‘move ahead’ of inflation expectations, preventing instability. As an example, a policy rule with  $\phi < 1$  but with  $\lambda_x$  and, thus,  $\bar{\lambda}_x$  sufficiently high will yield stability under learning.

Third, and related, a positive response to the output gap has negative welfare consequences. In the case of near price flexibility the optimal response to the output gap is zero. Hence, coordinating expectations comes at a cost of lower welfare. More generally, the observation that policies giving greater weight to output gap stabilization are less likely to be prone

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<sup>17</sup>This observation explains the difference from the stability results for a similar class of policies discussed in Preston (2006).

to instability has relevance for recent debate on the merits of simple policy rules. For example, Schmitt-Grohe and Uribe (2005) demonstrate in a medium-scale model of the kind developed by Smets and Wouters (2003), that optimal monetary policy can be well approximated by a simple nominal interest rate rule that responds to contemporaneous observations of inflation. Policies that respond to output are undesirable, since over-estimating the optimal elasticity by even small amounts can lead to a sharp deterioration in household welfare. What the above result demonstrates is that, in a world characterized by small departures from rational expectations, the policymaker may face a trade-off: strong responses to the output gap may reduce welfare, but they may protect against even more deleterious consequences from self-fulfilling expectations.

## 4.2 Eliminating Policy Delays

This instability result naturally raises the question of how can expectations be managed more effectively in the pursuit of macroeconomic stabilization. The model has two key information frictions. First, the central bank responds to information about the true state of the economy with a delay. This is an implication of the forecast-based monetary policy rule. Second, households and firms have an incomplete model of the macroeconomy and need to learn about the reduced-form dynamics of aggregate prices. It follows that agents are faced with statistical uncertainty about the true data generating process describing the evolution of nominal interest rates. Resolving these informational frictions may mitigate expectations driven instability.

In regards to the policymaker's uncertainty, suppose the central bank has perfect information about current inflation and the output gap. It can then implement the policy rule

$$i_t = i_t^* + \phi \left( \pi_t + \frac{\lambda_x}{\xi} x_t \right) \quad (12)$$

which is closer in spirit to the policy proposed by Taylor (1993). The following result obtains.

**Proposition 4** *Consider the economy under learning dynamics and  $\phi > 1$ . If the central bank implements monetary policy with the rule (12) without communication then expectational stability obtains for all parameter values under maintained assumptions.*

Hence timely information about the state of the economy is invaluable to expectations stabilization. By responding to contemporaneous observations of the inflation rate and the output gap the Taylor principle is restored. Having perfect information about the aggregate state reduces the delay in the adjustment of monetary policy, allowing the central bank to anticipate shifts in expectations. Responding to changes in inflation in a timely fashion prevents large deviations from the rational expectations equilibrium. Comparing this result to proposition 2 underscores that instability stems from the interaction between the two sources of information frictions in the model. Given that central banks are unlikely in practice to have complete information about the current state of the economy, it is worth considering other approaches to effective management of expectations. The remainder of the paper therefore explores the role of communication.

To presage results in the sequel, communication can be an effective stabilization tool. Moreover, give the above proposition, it is precisely when the central bank is uncertain about the state and other features of the structural economy that communication is effective. When the central bank faces a difficult prediction problem regarding the state of the economy, the benefits of communication are high. By announcing the monetary policy strategy, the central bank can better control the economy even though the near-term evolution of the economy is highly uncertain.

## 5 The Value of Communication

Communication is modelled in a very direct and simple way. Under learning dynamics, households and firms are uncertain about the true data generating process characterizing the future path of nominal interest rates, the output gap and inflation. We can therefore ask what kinds of information about the monetary policy strategy assist in reducing the forecast uncertainty that emerges from having a misspecified model. The framework permits a direct analysis of the benefits of communication in managing expectations.

Three communication strategies are considered. First, the central bank announces the precise details of its monetary policy, including both the variables upon which interest rate decisions are conditioned and all relevant policy coefficients. Second, the central bank com-

municates only the variables upon which policy decisions are conditioned. Third, the central bank communicates its inflation target. These strategies successively reduce the information made available to the public and provide insight as to what kinds of information are conducive to macroeconomic stabilization.

## 5.1 Strategy 1

This communication strategy discloses all details of the monetary policy decision process. The central bank announces the precise reaction function used to determine the nominal interest rate path as a function of expectations. Agents know which variables appear in the policy rule and all relevant coefficients. Hence, agents need not forecast the path of nominal interest rates independently — they need only forecast the set of variables upon which nominal interest rates depend. An alternative, but equivalent strategy, is the central bank announces in every policy cycle  $t$  its conditional forecast path for the nominal interest rate,  $\{E_{t-1}i_T\}_{T \geq t}$ . Such a communication strategy might arguably characterize current practice by the Norges Bank and the Reserve Bank of New Zealand — see Norges Bank (2006). These forecasts can be used directly by the private sector in making spending and pricing decisions. Since they are by construction consistent with the adopted policy rule, if agents base decisions directly on these announced forecasts, it must be equivalent to households and firms knowing the policy rule and constructing the forecast path of nominal interest rates independently, subject to the caveats now noted.

To keep the analysis as simple as possible, we assume that the private sector and the central bank share the same expectations about the future evolution of the economy. This assumption is dispensable. Analyzing a model in which the central bank communicates its reaction function but in which there is disagreement about the forecasts is feasible though beyond the scope of this paper.<sup>18</sup>

Regardless of how this communication strategy is implemented, we assume that the central bank is *perfectly credible*, in the sense that the public fully incorporates announced information

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<sup>18</sup>See Honkapohja and Mitra (2005) for an analysis of a New Keynesian model in which only one period ahead forecasts matter and conditions under which heterogeneous forecasts deliver the same stability results. This paper, however, does not study a model which requires agents to forecast nominal interest rates.

in their forecasts without verification. Issues related to cheap talk, as analyzed by Stein (1989) and Moscarini (2007) for example, are not considered. We assume the central bank is able to fully communicate its reaction function without noise so the market fully understands its policy goals and strategy, both in the current period and into the indefinite future.

Imposing knowledge of the policy rule on households' and firms' forecasting models — or knowledge of the central bank's conditional forecast path  $\{E_{t-1}i_T\}_{T \geq t}$  — is equivalent to substituting this equilibrium restriction into the aggregate demand equation to give

$$x_t = \hat{E}_{t-1} \sum_{T=t}^{\infty} \beta^{T-t} \left[ (1 - \beta)x_T - \beta(i_T^* + \phi\pi_T + \phi\frac{\lambda}{\xi}x_T - \pi_{T+1}) + \beta\hat{r}_t^e \right].$$

The remaining model equations are unchanged with the exception of beliefs. Beliefs about the evolution of output and inflation take the form

$$x_t = \omega_{x,0} + \omega_{xx}x_{t-1} + \omega_{x\pi}\pi_{t-1} + \omega_{xi}\dot{i}_{t-1} + \omega_{xr}r_{t-1}^n + \omega_{x\mu}\mu_{t-1} + e_t^x$$

$$\pi_t = \omega_{\pi,0} + \omega_{\pi x}x_{t-1} + \omega_{\pi\pi}\pi_{t-1} + \omega_{\pi i}\dot{i}_{t-1} + \omega_{\pi r}r_{t-1}^n + \omega_{\pi\mu}\mu_{t-1} + e_t^\pi$$

with policy consistent forecasts constructed from knowledge of (6). Compactly, agents' forecasts are determined by

$$\begin{bmatrix} \tilde{Z}_t \\ i_t \end{bmatrix} = \begin{bmatrix} \Omega_0 \\ \Phi\Omega_0 \end{bmatrix} + \begin{bmatrix} \Omega_z & \Omega_i \\ \Phi\Omega_z & \Phi\Omega_i \end{bmatrix} \begin{bmatrix} \tilde{Z}_{t-1} \\ i_{t-1} \end{bmatrix} \quad (13)$$

where

$$\tilde{Z}_t = \begin{bmatrix} x_t & \pi_t & \hat{\mu}_t & \hat{r}_t^e \end{bmatrix}' \text{ and } \Phi = \begin{bmatrix} \phi\lambda/\xi & \phi & \phi_\mu & 1 \end{bmatrix}$$

and  $\Omega_j$  are matrices of estimated coefficients appropriately defined<sup>19</sup> and the statistical properties of  $\{\hat{\mu}_t, \hat{r}_t^e\}$  continue to be known. The second block of the beliefs, describes agents' policy consistent interest rate forecasts, where knowledge of the policy rule (6) is imposed through the coefficient vector  $\Phi$ . This model is then used to generate expectations as in the case of no communication.

Under these assumptions, uncertainty about the model concerns only the laws of motion for inflation and output, which are affected by other factors of the model beyond monetary

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<sup>19</sup>The matrix  $\Omega_z$  is of dimension  $4 \times 4$ , while the matrix  $\Omega_i$  is of dimension  $4 \times 1$ .

policy decisions. Hence perfect knowledge about the central bank’s policy framework does not guarantee that the agents’ learning process converges to the rational expectations equilibrium, since market participants do not fully understand the true model of the economy. However, it does tighten the connection between the projected paths for inflation and nominal interest rates. This property proves fundamental.

**Proposition 5** *Assume the bank communicates under perfect credibility the interest rate forecast  $\{E_{t-1}^{CB}i_T\}_{T=t}^{\infty}$  or, equivalently, the policy rule (6) and  $\phi > 1$ . Then the REE is stable for all parameter values under maintained assumptions.*

Communication of the policy rule completely mitigates instability under learning dynamics — even though the central bank and the private sector have incomplete information about the state of the economy. Indeed, given proposition 4, it is clear that communication has value precisely in circumstances where the central bank is uncertain about the current state. The result shows how communicating the reaction function helps shape beliefs about future policy, making it possible for agents to anticipate future policy. As an example, suppose inflation expectations increase. Under full communication, agents’ conditional forecasts of inflation and nominal interest rates are coordinated according to (6). Agents therefore correctly anticipate that higher inflation leads to a higher path for nominal interest rates — one that is sufficient to raise the projected path of the real interest rate. As a result, output decreases, leading to a decrease in inflation, which in turn mitigates the initial increase in expectations, leading the economy back to equilibrium. In absence of communication, an agents’ conditional forecasts for nominal interest rates and inflation give rise to projected falls in future real interest rates, generating instability by validating the initial increase in inflation expectations. Section 5 discusses further intuition of how communication stabilizes expectations.

## 5.2 Strategy 2

Now suppose the central bank only announces the set of variables relevant to monetary policy deliberations so that agents do not know the precise restriction that holds between nominal interest rates, inflation and the output gap. Furthermore, suppose that while agents do not know the policy coefficients, they do know that nominal interest rates are set according to a

linear function of these variables. By limiting knowledge of private agents about the monetary policy process relative to the benchmark full-information analysis several aspects of central bank communication can be captured. First, uncertainty about parameters and forecasts can be interpreted as a constraint on the communication ability of the central bank. This reflects the fact that the policy decision is the outcome of a complex process, the details of which are often too costly to communicate — see Mishkin (2004). Second, the central bank might face credibility issues, leading the private sector to want to verify announced policies. Third, complete announcement might not be an optimal strategy for a central bank, given the agent’s learning process.<sup>20</sup>

This partial information about the policy process can be incorporated by households and firms in the following two-step forecasting model. First, using the history of available data, agents run a regression of nominal interest rates on expected inflation and the output gap

$$i_t = \psi_{0,t-1} + \psi_{\pi,t-1} \hat{E}_{t-1} \pi_t + \psi_{x,t-1} \hat{E}_{t-1} x_t + e_t.$$

This yields estimates of the coefficients of the policy rule.<sup>21</sup> In the appendix, we consider the more general case where the regression is estimated using a recursive instrumental variable method, allowing for the possibility that private sector and central bank forecasts are different or that the central bank can communicate its expectations with noise.

As a second step, given these estimates, agents proceed in the same manner as strategy 1: they forecast the future paths of the output gap and inflation rate and then use the estimated policy rule to construct a set of nominal interest rate forecasts as described by (13).

**Proposition 6** *If households and firms understand the variables upon which nominal interest rate decisions are conditioned and  $\phi > 1$ , then the REE is stable under learning for all parameter values under maintained assumptions.*

Thus the central bank need not disclose all details of the monetary policy strategy. It is sufficient that information be given regarding the endogenous variables relevant to the deter-

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<sup>20</sup>A discussion of the optimal policy under learning is left for further research.

<sup>21</sup>There is an important subtlety in specifying this regression. We assume that private agents include a fixed constant and do not explicitly allow for a stochastic constant as in (6). Hence the regression is misspecified, though the misspecification vanishes as  $\rho_r, \rho_\mu \rightarrow 0$ . This assumption avoids multicollinearity problems in the case of convergent learning dynamics, given the presence of only two shocks. An alternative approach, that yields that same results, is to add an additional shock to the model and allow for a stochastic constant.

mination of policy and the functional form of the rule — but not its parameterization. Credible public pronouncements of this kind, combined with a sufficient history of data, provide agents with adequate information to verify the implemented rule. And despite the estimation uncertainty attached to the policy coefficients, local to the rational expectations equilibrium of interest, expectations are nonetheless well anchored relative to the no communication case.<sup>22</sup> Indeed, this communication strategy is equally useful in protecting against instability from expectations formation as strategy 1 in which agents know the true policy coefficients. Of course, the out-of-equilibrium dynamics would differ across these two strategies — the estimation uncertainty being relevant to the true data generating process of macroeconomic variables — which in turn has welfare implications. Analyzing such implications is beyond the scope of this paper.

### 5.3 Strategy 3

Over the past two decades numerous countries have adopted inflation targeting as a framework for implementing monetary policy. A central part of this monetary policy strategy has been the clear articulation of a numerical target for inflation. As a final exercise, consider a communication strategy that conveys the desired average outcome for inflation and the associated values for nominal interest rates and the output gap. Given that our analysis is in deviations from steady state, these three values are clearly zero. As discussed in section 3, given this knowledge agents no longer need to estimate a constant in their regression model, leading to more accurate forecasts of the future path of nominal interest rates.

**Proposition 7** *Assume the central bank communicates only the inflation target  $\bar{\pi} = 0$  and the associated values for the output gap and nominal interest rates,  $\bar{x} = \bar{i} = 0$ .*

1. *Define  $\rho \equiv \max(\rho_\mu, \rho_r)$  and let  $\rho \rightarrow 1$ . Then the REE is unstable under learning if condition one of Proposition 2 holds.*
2. *Let  $\xi \rightarrow \infty$ . Then there exists  $\rho^* < 1$  such that if  $\rho \geq \max[0, \rho^*]$  then instability obtains for all parameter values.*

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<sup>22</sup>Formally, this means that agents cannot hold initial beliefs about the policy coefficients that are too different from the true values. Analyzing this possibility would require a global analysis of the model which is well beyond the scope of this paper.

Economies subject to persistent shocks may be prone to expectations driven instability. Indeed, the instability conditions for the no communication case obtain for cost-push or efficient rate disturbance processes having roots near unity. This result nicely demonstrates a fundamental insight of rational expectations analysis: it is not enough to announce an inflation target — one must also announce how one will achieve this target.<sup>23</sup> Only by providing information regarding the systematic component of monetary policy can expectations be effectively managed when shocks are persistent. In contrast, as  $\rho \rightarrow 0$ , so that shocks have no serial correlation, there is similarly no persistence in macroeconomic aggregates. Information about the systematic component is less important as the economy has no intrinsic dynamics, making household and firm forecasting problems less complex. The result also underscores another difference to a rational expectations analysis of the model: the precise details of how exogenous disturbances are specified matters for expectational stability. This is not true for determinacy of rational expectations equilibrium.

To further interpret this condition a graphical analysis is useful. The model is calibrated with  $\beta = 0.99$ ,  $\phi = 2$  and  $\rho_r = 0.2$ . Figure 2 plots three contours demarcating stability and instability regions, above and below respectively, as functions of the parameters  $(\gamma_1, \lambda_x)$ . The parameter  $\gamma_1$  is related to  $\xi$  according to  $\xi = (1 - \gamma_1\beta)(1 - \gamma_1)\gamma_1^{-1}$ . In a model with Calvo price adjustments,  $\gamma_1$  denotes the probability of not re-setting the price. Plotting values of  $\gamma_1$  assists interpretation and comparison with the literature. Each contour is indexed by the maximum autoregressive coefficient, denoted  $\rho_\mu = \rho^M$ . It is immediate that as the maximum eigenvalue increases the set of parameter values for which expectations are stabilized narrows. For a given degree of price stickiness, as the persistence in exogenous disturbance rises a stronger response to the output gap is required. Similarly, for a given weight on output gap stabilization, only in economies with less flexible prices does learnability of rational expectations equilibrium obtain. Hence, the degree of nominal rigidity in price setting has important implications for stabilization policy under learning dynamics. Economies with greater rigidity tend to be conducive to expectations stabilization — current prices are less sensitive to expectations

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<sup>23</sup>Note that if only the inflation target was announced without declaring the associated values of the long-run interest rate and output gap targets, then the stability properties can only be worse since agents must learn a greater number of coefficients.

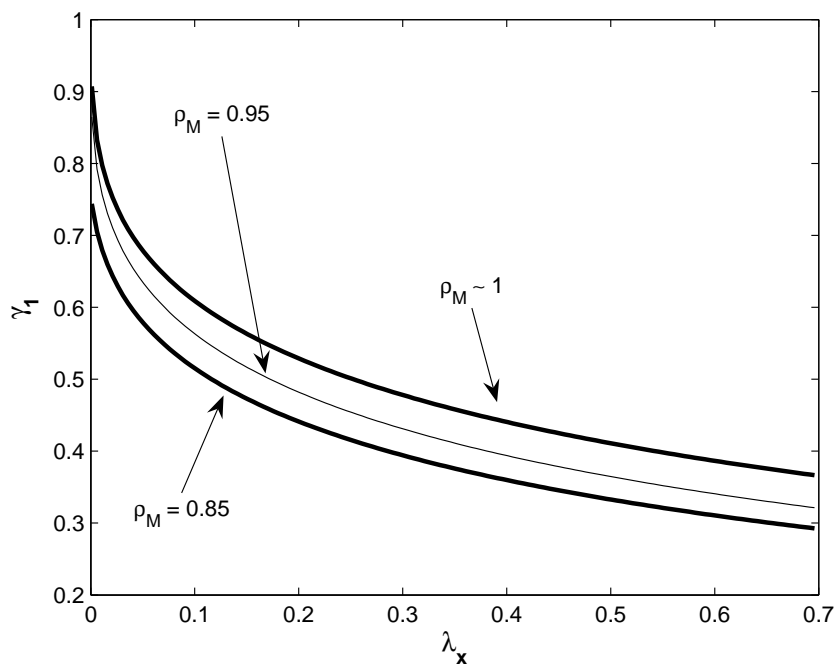


Figure 2: Instability under the announcement of an inflation target

about future macroeconomic conditions. Because prices move little, inflation expectations display low volatility, in turn promoting macroeconomic stability. This is not a property of the model under rational expectations: expectations are well anchored so long as the Taylor principle is satisfied, regardless of the degree of nominal friction.<sup>24</sup>

## 6 The Dynamics of Expectations

So far the analysis has focused on conditions under which expectations are anchored in the long term. The following discussion demonstrates that even when expectations are anchored in the long run, communicating complete details of the monetary policy strategy greatly assists short-run stabilization policy. Hence communication matters not only for expectational stability but macroeconomic stability more generally.

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<sup>24</sup>To quantitatively evaluate the result, keep in mind that even very small values of  $\lambda_x$  might imply large values in terms of the response of output gap in the policy rule,  $\phi_x$ , depending on the degree of nominal rigidity.

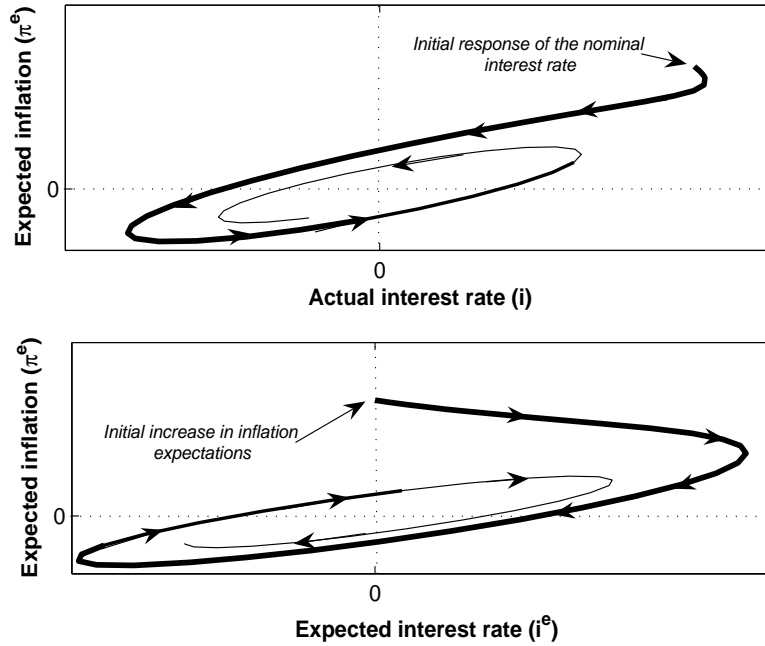


Figure 3: Dynamics under communication of the inflation target

## 6.1 The Efficacy of Short-Run Stabilization Policy

Consider first the strategy in which the central bank announces the inflation target  $\bar{\pi} = 0$  and  $\bar{x} = \bar{i} = 0$ . Furthermore, suppose that exogenous disturbances have sufficiently weak serial correlation, so that monetary policy induces local stability under learning — the case of non-convergence in learning dynamics being clearly undesirable for macroeconomic stabilization. Figure 3 shows the effects of an increase in inflation expectations. The plots are generated as in section 4 by simulating the ODE for the model's shock coefficients. The parameters are  $\beta = 0.99$ ,  $\phi = 2$ ,  $\xi = 0.06$  and  $\lambda_x = 0.005$ . We set the shock coefficients equal to  $\rho_r = \rho_\mu = 0.9$ .

The two panels are distinguished by plotting the level of the nominal interest rate against inflation expectations in the first and expectations of the nominal interest rate and inflation expectations in the second. The interest rate jumps with the rise in inflation expectations, but fails to have a strong initial impact on inflation expectations because of the absence of communication: market participants fail to anticipate correctly the future path of the

policy instrument. The second panel demonstrates why: aggregate demand depends only on expectations of future nominal interest rates and it takes time for these expectations to rise.

Given the weak initial effect on inflation, and therefore on inflation expectations, the central bank keeps increasing the nominal interest rate until inflation expectations start declining. As the response of inflation expectations is inertial, the central bank tends to overtighten. Hence inflation expectations, and as a consequence inflation, keep decreasing until they become negative, overshooting their rational expectations equilibrium values. With low interest rates and low inflation expectations a new cycle starts. The central bank eases its policy stance but expectations react with a delay, leading to excessively low nominal interest rates and high inflation expectations. Agents' beliefs eventually converge though the speed of convergence depends on the chosen parameters. For example, a more aggressive policy towards inflation would magnify the oscillatory convergence back to the equilibrium. The central bank tends to over react to changes in expected inflation, amplifying expansions and recessions.

To summarize the main implications of the model under no communication:

- After an increase in inflation expectations, an aggressive rise in the nominal interest rate does not induce an immediate drop in inflation expectations. On the contrary, inflation expectations may increase even further in the short term;<sup>25</sup>
- Output and inflation expectations display high volatility during the adjustment process. This reflects the excessive tightening and easing described above; and
- A more aggressive response to inflation induces *more* volatility in output and inflation expectations.

These model predictions resonate with actual policymaking experience. In commenting on the Volker disinflation, Goodfriend (2005) remarks:

One might reasonably have expected the aggressive disinflationary policy actions taken in late 1979 to reduce long-term interest rate volatility by quickly stabilizing

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<sup>25</sup>The graph shows that inflation expectations remain constant, even when the interest rate increases. If the central bank does not announce the interest rate (and agents are learning about the model's intercept) inflation expectations actually increase for a period of time, before converging back to equilibrium values.

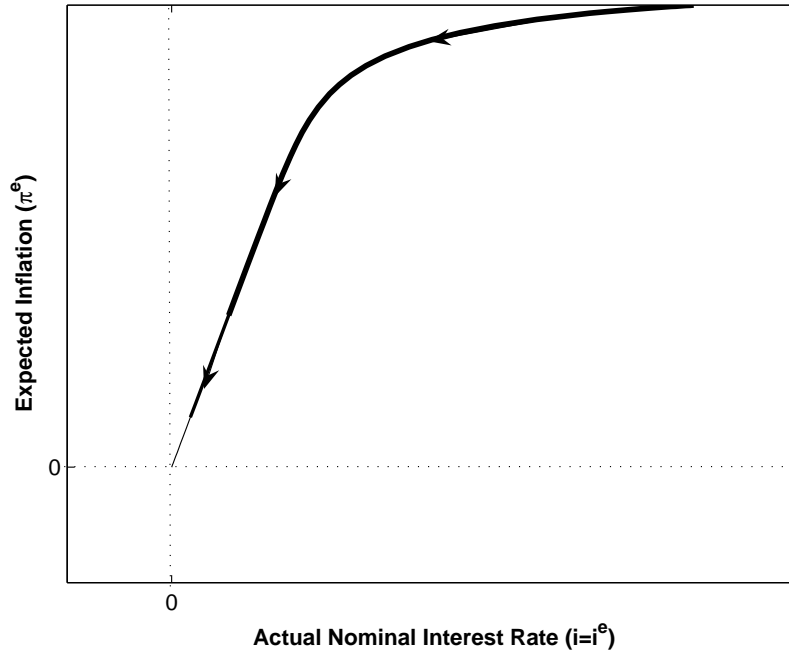


Figure 4: The Benefits of Communication

long-term inflation expectations at a low rate. Yet the reverse was true initially. Long rates turned out to be surprisingly volatile due to a combination of particularly aggressive funds rate movements and inflation scares. Amazingly, it took until 1988 for the unusual long-rate volatility to disappear.

The absence of a *clearly articulated* and credible monetary policy strategy during the Volker period required aggressive adjustments in nominal interest rates that tended to exacerbate uncertainty through higher volatility in inflation and output.

Now consider an identical analysis under full communication where market participants understand the policy rule and can correctly forecast the future path of the policy instrument. In this case, the actual and expected nominal interest rate are identical. Figure 4 shows that expected inflation and the expected interest rate rise and fall together until they converge back to the equilibrium. Convergence in beliefs is monotonic — there are no oscillatory dynamics in expectations. This is explained by market participants correctly anticipating that the interest rate will be higher in the future in response to higher inflation expectations.

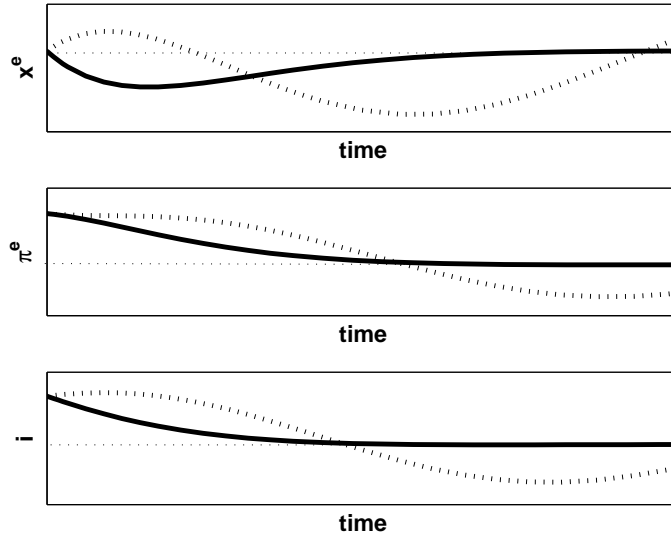


Figure 5: The dotted line shows beliefs dynamics under the no communication regime (solid line for the communication regime)

The anticipated positive response of the nominal interest rate increases the expected real interest rate with a reduction in output that further reduces inflation expectations. This underscores that communicating the reaction function, even in the case of stability under learning dynamics, has stabilization benefits.

To underscore these differences, Figure 5 shows the dynamics of agents beliefs about inflation and output after an increase in inflation expectations.<sup>26</sup> In both cases expectations converge to their rational equilibrium values. It emphasizes the stark difference between the communication and no communication regimes, even if the central bank announces the target. Under no communication expected output actually increases, while inflation expectations remain persistently above equilibrium values. Compared to the communication regime, the interest rate overshoots and stays at high levels for longer, producing a recession where both inflation and output expectations drop below equilibrium values. In the case of full communication, the interest rate increases by less and quickly reverts back to equilibrium, while inflation expectations decrease rapidly towards equilibrium levels. The expected output gap

<sup>26</sup>The dynamics of agents' beliefs are derived using the same parameters.

also converges back to equilibrium after an initial drop. Notice that in this model disinflations *are costly even in the case of full communication* because agents are still learning about output and inflation dynamics. The rational expectations equilibrium would imply all variables remain at steady state values — the incipient increase in inflation expectations would immediately be tamed.

The examples above consider an exogenous shift in beliefs. The same conclusion would follow if we considered the effects a supply shock. In the case of no communication, supply shocks would induce excessive volatility in inflation and output expectations relative to the rational expectations benchmark. But the model predicts that under a regime of communication, expectations would be stable, even if market participants and the central bank still face uncertainty about the effects of supply shocks on the economy.

The central bank can bring about inflation stabilization without excessive volatility of the policy instrument by fully articulating its monetary policy strategy. In the case of no communication, the central bank is more likely to over-react to changing economic conditions with the result of excessively volatile interest rates and potentially destabilizing effects on expectations.

## 7 Conclusion

This paper develops a dynamic stochastic general equilibrium model for the analysis of the role of communication in a central bank's monetary policy strategy. Three communication strategies are considered when the central bank attempts to implement optimal policy. First, the central bank announces the exact details of its monetary policy decision process. This includes both the variables appearing in its policy rule and the relevant policy coefficients. Second, the central bank discloses only the variables appearing in the policy rule. This limits the information households and firms have relative to the full information case, possibly reflecting imperfect credibility of central bank announcements. Third, the central bank announces only its desired inflation target and associated long-run values of the output gap and nominal interest rates.

The central results are as follows. Under no communication the policy rule fails to sta-

bilize macroeconomic dynamics, promoting expectations driven fluctuations — self-fulfilling expectations are possible. However, by announcing the details of the policy process stability is restored. Communication permits households and firms to construct more accurate forecasts of future macroeconomic conditions, engendering greater stability in observed output, inflation and nominal interest rates.

If instead the central bank only discloses the variables upon which interest rate decisions are condition, stability still obtains for all parameter values. Even though this communication strategy imparts less information about the policy process relative to the full communication case, the resulting estimation uncertainty is small. Hence, agents once again can make more accurate forecasts which is conducive to macroeconomic stabilization.

Finally, if the central bank only announces the desired inflation target, economies with persistent shocks will frequently be prone to expectations driven fluctuations. This makes clear that it is not sufficient to announce desired objectives — one must also announce the systematic component of policy which describes how these objective will be achieved.

## A Appendix

### A.1 Some useful properties of $\gamma_1$

Aggregate inflation is determined by

$$\pi_t = \frac{\gamma_1 \xi}{(1 - \gamma_1 \beta)} \hat{E}_{t-1} \pi_t + \frac{\gamma_1 \xi}{(1 - \gamma_1 \beta)} \hat{E}_{t-1} \sum_{T=t}^{\infty} (\gamma_1 \beta)^{T-t} [(1 - \gamma_1 \beta) (\hat{s}_T + \hat{\mu}_T) + \gamma_1 \beta \pi_{T+1}]$$

with the derivation found in the technical appendix to this paper. The parameter  $0 < \gamma_1 < 1$  is an eigenvalue from underlying microfoundations. The following properties of the eigenvalue  $\gamma_1$  in the limit  $\xi \rightarrow \infty$  (which corresponds to the neighborhood of flexible price equilibrium) are used in the proofs. The eigenvalue is given as

$$\gamma_1(\xi) = \frac{1}{2\beta} \left[ \xi + 1 + \beta - \sqrt{(\xi + 1 + \beta)^2 - 4\beta} \right].$$

The following limits are immediate:

1.  $\lim_{\xi \rightarrow \infty} \gamma_1(\xi) = 0$ , where the notation  $\gamma_1(\xi)$  means that  $\gamma_1$  is a function of  $\xi$ . Let

$$\gamma_1 = \frac{1}{2\beta} \frac{\left[ \xi + 1 + \beta - \sqrt{(\xi + 1 + \beta)^2 - 4\beta} \right] \left[ \xi + 1 + \beta + \sqrt{(\xi + 1 + \beta)^2 - 4\beta} \right]}{\left[ \xi + 1 + \beta + \sqrt{(\xi + 1 + \beta)^2 - 4\beta} \right]}$$

which gives

$$\gamma_1 = \frac{1}{2\beta} \frac{4\beta}{\left[ \xi + 1 + \beta + \sqrt{(\xi + 1 + \beta)^2 - 4\beta} \right]}$$

and thus  $\lim_{\xi \rightarrow \infty} \gamma_1(\xi) = 0$ .

2.  $\lim_{\xi \rightarrow \infty} \gamma_1(\xi) \xi = 1$ . We have

$$\begin{aligned} \lim_{\xi \rightarrow \infty} \gamma_1(\xi) \xi &= \frac{1}{2\beta} \frac{4\beta}{\left[ 1 + \xi^{-1} + \xi^{-1}\beta + \sqrt{\xi^{-2} \left( (\xi + 1 + \beta)^2 - 4\beta \right)} \right]} \\ &= \frac{1}{2\beta} \frac{4\beta}{2} = 1. \end{aligned}$$

## A.2 Proof of Proposition 2

Expectational stability is determined by the eigenvalues of the ODE (11). The local dynamics of this system can be decomposed into four independent sub-systems. The first

$$\dot{\omega}_0 = (J_{\omega_0^*} - I_3) \omega_0 \quad (14)$$

characterizes the dynamics of the estimated constants, where  $J_{\omega_0^*}$  is the Jacobian evaluated at the rational expectations equilibrium of interest. The second and the third describe the evolution of the coefficients on the exogenous shocks are given by

$$\dot{\omega}_\mu = (J_{\omega_\mu^*} - I_3) \omega_\mu \quad (15)$$

$$\dot{\omega}_r = (J_{\omega_r^*} - I_3) \omega_r \quad (16)$$

where  $\omega_\mu = \left( \omega_{x\mu} \ \omega_{\pi\mu} \ \omega_{i\mu} \right)'$  and  $\omega_r = \left( \omega_{xr} \ \omega_{\pi r} \ \omega_{ir} \right)'$ . The final subsystem characterizes the coefficients on the endogenous variables and is given by

$$\text{vec}(\dot{\omega}_e) = (J_{\omega_e^*} - I_9) \text{vec}(\omega_e) \quad (17)$$

where  $\omega_e = \begin{pmatrix} \omega_{xx} & \omega_{x\pi} & \omega_{xi} \\ \omega_{\pi x} & \omega_{\pi\pi} & \omega_{\pi i} \\ \omega_{\pi x} & \omega_{\pi\pi} & \omega_{\pi i} \end{pmatrix}$ . Subsequent proofs employ the same structure.

To prove the instability result, we show that the system (14) is locally unstable. The associated Jacobian matrix is

$$(J_{\omega_0^*} - I_3) = \begin{bmatrix} 0 & \beta/(1-\beta) & -\beta/(1-\beta) \\ \gamma_1\xi + \frac{\gamma_1^2\beta\xi}{(1-\gamma_1\beta)} & \frac{\gamma_1\xi}{(1-\gamma_1\beta)} + \frac{\gamma_1^2\beta\xi}{(1-\gamma_1\beta)^2} - 1 & 0 \\ \frac{\phi\lambda_x}{\xi} & \phi & -1 \end{bmatrix}.$$

Necessary and sufficient conditions for stability under learning are

$$\text{Trace}(J_{\omega_0^*} - I_3) < 0 \quad (18)$$

$$\text{Determinant}(J_{\omega_0^*} - I_3) < 0 \quad (19)$$

and

$$\bar{M} = -\text{Sm}(J_{\omega_0^*} - I_3) \cdot \text{Trace}(J_{\omega_0^*} - I_3) + \text{Determinant}(J_{\omega_0^*} - I_3) > 0, \quad (20)$$

where Sm denotes the sum of all principle minors. Satisfaction of these three conditions ensure that all three eigenvalues are negative.

Evaluating the trace gives

$$(1 - \gamma_1\beta)^{-1} \left[ \gamma_1\xi + \frac{\gamma_1^2\beta\xi}{1 - \gamma_1\beta} - 2(1 - \gamma_1\beta) \right]$$

which can be simplified to

$$-2 + \frac{1 - \gamma_1}{1 - \gamma_1\beta} < 0$$

where we use  $\xi = (1 - \gamma_1)(1 - \gamma_1\beta)/\gamma_1$ . The determinant is

$$-\frac{(-\phi\lambda_x\gamma_1\xi + \phi\lambda_x - 2\phi\lambda_x\gamma_1\beta + \phi\lambda_x\gamma_1^2\beta^2 + \gamma_1\xi^2\phi - \gamma_1^2\xi^2\phi\beta - \gamma_1\xi^2 + \gamma_1^2\xi^2\beta)}{\xi(1-\beta)(1-\gamma_1\beta)^2}\beta$$

and can be rearranged to obtain the following condition

$$-\left[ \xi(\phi - 1) + \frac{\phi\lambda_x}{\xi}(1 - \beta) \right] < 0$$

which holds if  $\phi > 1$ . Finally, the third condition is

$$\left\{ -\frac{\gamma_1 \xi}{(1 - \gamma_1 \beta)^2} + 1 + \frac{\beta}{(1 - \beta)} \left[ -(\gamma_1 \xi + \frac{\gamma_1^2 \beta \xi}{(1 - \gamma_1 \beta)}) + \frac{\phi \lambda_x}{\xi} \right] \right\} \left( 2 - \frac{1 - \gamma_1}{(1 - \gamma_1 \beta)} \right) + \frac{-\beta(-\gamma_1 \xi^2 + \gamma_1^2 \xi^2 \beta + \gamma_1 \xi^2 \phi - \gamma_1^2 \xi^2 \phi \beta - \phi \lambda_x \gamma_1 \xi + \phi \lambda_x - 2\phi \lambda_x \gamma_1 \beta + \phi \lambda_x \gamma_1^2 \beta^2)}{\xi(1 - \beta)(1 - \gamma_1 \beta)^2}$$

which on simplification and multiplying by  $(1 - \beta)$  gives

$$\bar{M}_I \equiv \frac{\beta \phi}{\xi} [\lambda_x - (1 - \gamma_1) \xi] + \beta(1 - \gamma_1) - M(\xi, \beta) \quad (21)$$

where

$$M(\xi, \beta) = \left( 2 - \frac{1 - \gamma_1}{(1 - \gamma_1 \beta)} \right) \left( \frac{(1 - \gamma_1)(1 - \beta)}{(1 - \gamma_1 \beta)} - (1 - \beta) + \beta(1 - \gamma_1) \right).$$

$\bar{M}_I$  may be positive or negative. This gives property 1 in the proposition.

In the limit  $\beta \rightarrow 1$  this expression simplifies to

$$\frac{\beta \phi}{\xi} [\lambda_x - (1 - \gamma_1) \xi] + \beta(1 - \gamma_1) = \frac{\phi}{\xi} (\lambda_x - (1 - \gamma_1) \xi).$$

Hence for  $\lambda_x < (1 - \gamma_1) \xi$  instability obtains for all parameter values, establishing property 3 of the proposition. Now consider the limit  $\xi \rightarrow \infty$  which implies  $\gamma_1 \rightarrow 0$ . In this case the condition simplifies to  $-\phi < 0$  for all finite  $\{\phi, \lambda_x\}$ . This establishes property 2 of the proposition. It is also immediate that as  $\beta \rightarrow 0$ ,  $\bar{M}_I = \gamma_1(1 + \gamma_1)$  which guarantees stability (property 4).

### A.3 Proof of Proposition 3

From Proposition 2, for  $\xi \rightarrow \infty$ , and implicitly allowing  $\lambda_x$  to increase to ensure  $\bar{\lambda}_x = \lambda_x/\xi$  is a given constant,

$$\bar{M}_I = \beta [\phi \bar{\lambda}_x - \phi], \quad (22)$$

so that a large enough choice of  $\bar{\lambda}_x$ , say  $\bar{\lambda}_x^I$ , provides  $\bar{M}_I > 0$ , ensuring convergence of the intercept. The stability of the shock coefficients depend on the matrix

$$J_h - I_3 = \begin{bmatrix} \frac{\beta + \beta(1 - \beta)\rho_h}{1 - \beta\rho} & \frac{\beta\rho_h}{1 - \beta\rho_h} & -\beta - \frac{\beta^2\rho_h}{1 - \rho_h} \\ \gamma_1 \xi + \frac{\gamma_1^2 \beta \xi \rho_h}{1 - \gamma_1 \beta \rho_h} & J_1 & 0 \\ J_2 & J_3 & -1 - \frac{\phi \lambda_x}{\xi} \beta - \frac{\phi \lambda_x \beta^2 \rho_h}{\xi(1 - \beta\rho_h)} \end{bmatrix}$$

for  $h = \{r, \mu\}$  where

$$\begin{aligned} J_1 &= -1 + \frac{\gamma_1 \xi}{1 - \gamma_1 \beta} + \frac{\gamma_1^2 \xi \beta \rho_h}{(1 - \gamma_1 \beta)(1 - a\beta \rho_h)} \\ J_2 &= \phi \gamma_1 \xi + \frac{\phi \gamma_1^2 \xi \beta \rho_h}{1 - a\beta \rho_h} + \phi \lambda_x \xi (1 - \beta) + \frac{\phi \lambda_x \beta \xi (1 - \beta) \rho_h}{1 - \beta \rho_h} \\ J_3 &= \frac{\phi \xi \gamma_1}{1 - \gamma_1 \beta} + \frac{\phi \xi \gamma_1^2 \beta \rho_h}{(1 - \gamma_1 \beta)(1 - \gamma_1 \beta \rho_h)} + \frac{\phi \lambda_x \beta \rho_h}{\xi (1 - \beta \rho_h)}. \end{aligned}$$

The trace is

$$\begin{aligned} & \frac{\gamma_1 \xi}{(1 - \gamma_1 \beta)} + \frac{\gamma_1^2 \xi \beta \rho_h}{(1 - \gamma_1 \beta)(1 - \gamma_1 \beta \rho_h)} - \beta - 2 + \frac{\beta(1 - \beta) \rho_h}{(1 - \beta \rho_h)} - \frac{\phi \lambda_x}{\xi} \beta - \frac{\phi \lambda_x \beta^2 \rho_h}{\xi (1 - \beta \rho_h)} \\ \Rightarrow & \frac{\xi \gamma_1}{(\gamma_1 \beta \rho_h - 1)(\gamma_1 \beta - 1)} - \beta - 2 + \frac{\beta(1 - \beta) \rho_h}{(1 - \beta \rho_h)} - \frac{\phi \lambda_x}{\xi} \beta - \frac{\phi \lambda_x \beta^2 \rho_h}{\xi (1 - \beta \rho_h)} \\ \Rightarrow & \frac{(1 - \gamma_1)}{(1 - \gamma_1 \beta \rho_h)} - \beta - 2 + \frac{\beta(1 - \beta) \rho_h}{(1 - \beta \rho_h)} - \frac{\phi \lambda_x}{\xi} \beta - \frac{\phi \lambda_x \beta^2 \rho_h}{\xi (1 - \beta \rho_h)} < 0. \end{aligned}$$

The determinant is

$$\begin{aligned} & \beta \frac{(\xi \gamma_1^2 \beta^2 \rho_r^2 - \xi \gamma_1^2 \beta^2 \rho_r - \phi \lambda_x \gamma_1^2 \beta^2 \rho_r - \gamma_1^2 \xi^2 \beta \rho_r + \phi \gamma_1^2 \xi^2 \beta - \xi \gamma_1 \beta \rho_r^2 + \phi \lambda_x \gamma_1 \beta \rho_r)}{(1 - \gamma_1 \beta) \xi (1 - \beta \rho_r) (1 - \gamma_1 \beta \rho_r)} \\ & + \beta \frac{(\xi \gamma_1 \beta + \beta \phi \lambda_x \gamma_1 - \phi \gamma_1 \xi^2 + \gamma_1 \xi^2 + \phi \lambda_x \gamma_1 \xi + \xi \rho_r - \xi - \phi \lambda_x)}{(1 - \gamma_1 \beta) \xi (1 - \beta \rho_r) (1 - \gamma_1 \beta \rho_r)} \end{aligned}$$

which simplifies to

$$-\beta \left[ \gamma_1 \xi \phi - (\rho_h - \gamma_1) (1 - \gamma_1 \beta \rho_h) + \frac{\phi \lambda_x}{\xi} \gamma_1 (1 - \beta \rho_h) \right] < 0$$

provided the intercept converges. Denote the sum of principle minors as  $\bar{M}(\rho_h)$  and consider

the case where  $\xi \rightarrow \infty$ . Then  $\bar{M}(\rho_h)$  becomes

$$\begin{aligned} & \frac{(3\beta \rho_h^2 - 4\beta \rho_h + \beta - \phi - \rho_h + \phi \beta \rho_h + \phi_x \beta + \phi_x + 1 - 2\phi \bar{\lambda}_x \beta \rho_h)}{(1 - \beta \rho_h)^2} \beta \\ \Rightarrow & \frac{3\beta \rho_h^2 - 4\beta \rho_h + \beta - \phi - \rho_h + \phi \beta \rho_h + \phi \bar{\lambda}_x (1 + \beta - 2\beta \rho_h) + 1}{(1 - \beta \rho_h)^2} \beta \\ \Rightarrow & \frac{3(\rho_h - 1) [\beta \rho_h - \beta (1 - \rho_h) - (1 - \beta \rho_h)] - \phi (1 - \beta \rho_h) + \phi \bar{\lambda}_x [1 - \beta \rho_h + \beta (1 - \rho_h)]}{(1 - \beta \rho_h)^2} \end{aligned} \quad (23)$$

Hence for large enough  $\bar{\lambda}_x$ , say  $\bar{\lambda}_x^S$ , stability of the shock coefficients can always be guaranteed. The local stability of the coefficients on lagged variables are determined by a nine dimensional system. The Jacobian matrix  $(J_e^* - I_9)$  implies that the dynamics of the following coefficients are independent and converge for all parameter values:

$$\begin{aligned}\dot{\omega}_{x\pi} &= -\beta\omega_{x\pi}; & \dot{\omega}_{xi} &= -\beta\omega_{xi}; & \dot{\omega}_{\pi x} &= \left(-\gamma_1 + \frac{\gamma_1(1-\gamma_1)\beta}{(1-\gamma_1\beta)}\right)\omega_{\pi x} \\ \dot{\omega}_{\pi i} &= -\gamma_1\omega_{\pi i}; & \dot{\omega}_{i\pi} &= -\omega_{i\pi}; & \dot{\omega}_{ix} &= -\gamma_1\omega_{ix}.\end{aligned}$$

The remaining parameters evolve according to

$$\begin{bmatrix} \dot{\omega}_{xx} \\ \dot{\omega}_{\pi\pi} \\ \dot{\omega}_{ii} \end{bmatrix} = \begin{bmatrix} -\beta & 0 & -\beta \\ \gamma_1\xi & \frac{\gamma_1\xi}{1-\gamma_1\beta} - 1 & 0 \\ -\lambda_x & \phi & -1 \end{bmatrix}.$$

Again, consider the case where  $\xi \rightarrow \infty$ . In this limit the trace is  $-\beta - 1 < 0$ , and the determinant  $-\beta\phi < 0$ . Finally, the sum of principle minors is  $\beta(-\phi + \phi\bar{\lambda}_x(1 + \beta) + 1 + \beta)$  which is positive for sufficiently high response to the output gap, say  $\bar{\lambda}_x^L$ . We can now define  $\bar{\lambda}_x^* = \max(\bar{\lambda}_x^I, \bar{\lambda}_x^S, \bar{\lambda}_x^L)$  and the proposition is proved.

#### A.4 Proof of Proposition 4

Stability is again determined by four subsystems analogous to (14), (15), (16) and (17). Local stability of the intercept is determined by the Jacobian matrix

$$(J_{\omega_0^*} - I_3) = \begin{bmatrix} 0 & \frac{\beta}{1-\beta} & -\frac{\beta}{1-\beta} \\ \frac{\gamma_1\xi}{1-\gamma_1\beta} & \frac{\gamma_1\xi - 1 + 2\gamma_1\beta - \gamma_1^2\beta^2}{(1-\gamma_1\beta)^2} & 0 \\ -\phi\frac{(-\lambda_x + \lambda_x\gamma_1\beta - \gamma_1\xi^2)}{\xi(1-\gamma_1\beta)} & -\frac{(-\gamma_1\xi^2 + \gamma_1\xi^2\beta - \lambda_x\beta + 2\lambda_x\beta^2\gamma_1 - \lambda_x\beta^3\gamma_1^2)\phi}{\xi(1-\gamma_1\beta)^2(1-\beta)} & -\frac{\phi\lambda_x\beta + \xi - \xi\beta}{\xi(1-\beta)} \end{bmatrix}$$

which can be shown to have one eigenvalue equal to  $-1$ . Noting that  $\omega_{i,0} = \phi\omega_{\pi,0} + \phi\lambda_x/\xi\omega_{x,0}$ , make a change of variables so that local stability can be analyzed by computing the eigenvalues of the two dimensional matrix

$$\tilde{J}_{\omega_0^*} - I_2 = \begin{bmatrix} -\frac{\beta\phi\lambda_x}{\xi}(1-\beta)^{-1} & \beta\frac{\phi-1}{1-\beta} \\ 1-\gamma_1 & \frac{\gamma_1\xi - 1 + 2\beta\gamma_1 - \beta^2\gamma_1^2}{(1-\gamma_1\beta)^2} \end{bmatrix}.$$

Local stability requires that  $\text{trace}(\tilde{J}_{\omega_0^*} - I_2) < 0$  and  $\det(\tilde{J}_{\omega_0^*} - I_2) > 0$ . The trace is

$$-1 + \left( \frac{\gamma_1}{(1 - \gamma_1\beta)} + \frac{\gamma_1^2\beta}{(1 - \gamma_1\beta)^2} \right) \xi - \frac{\beta}{(1 - \beta)} \lambda_x \phi \xi^{-1} = -1 + \frac{(1 - \gamma_1)}{(1 - \gamma_1\beta)} - \frac{\beta}{1 - \beta} \lambda_x \phi \xi^{-1} < 0$$

The determinant is

$$\frac{(-\phi\lambda_x\gamma_1\xi + \phi\lambda_x - 2\phi\lambda_x\gamma_1\beta + \phi\lambda_x\gamma_1^2\beta^2 + \gamma_1\xi^2\phi - \gamma_1^2\xi^2\phi\beta - \gamma_1\xi^2 + \gamma_1^2\xi^2\beta)}{\xi(1 - \beta)(1 - \gamma_1\beta)^2} \beta$$

which on rearranging gives

$$\xi(\phi - 1) + \frac{\phi\lambda_x}{\xi}(1 - \beta) > 0. \quad (24)$$

The Jacobian associated with both (15) and (16) takes the form

$$(J_{\omega_h^*} - I_3) = \begin{bmatrix} -\frac{(1 - \rho_h)\beta}{1 - \beta\rho_h} & \frac{\beta\rho_h}{1 - \beta\rho_h} & -\frac{\beta}{1 - \beta\rho_h} \\ \frac{\gamma_1\xi}{1 - \gamma_1\beta\rho_h} & \frac{\gamma_1\xi}{(1 - \gamma_1\beta\rho_h)(1 - \gamma_1\beta\rho_h)} - 1 & 0 \\ c_1 & c_2 & c_3 - 1 \end{bmatrix}$$

where  $h = \{r, \mu\}$  and  $c_j$  are convolutions of model parameters. Again, one eigenvalue is equal to  $-1$ . A change of variables implies stability depends on the eigenvalues of the two-dimensional matrix

$$\left( \tilde{J}_{\omega_h^*} - I_2 \right) = \begin{bmatrix} -\beta \frac{(1 - \rho_h + \frac{\phi\lambda_x}{\xi})}{1 - \beta\rho_h} & \beta \frac{\phi - \rho_h}{1 - \beta\rho_h} \\ \frac{\gamma_1\xi}{1 - \gamma_1\beta\rho_h} & \frac{\gamma_1\xi - 1 + \beta\gamma_1\rho_h + \beta\gamma_1 - \beta^2\gamma_1^2\rho_h}{(1 - \gamma_1\beta)(1 - \gamma_1\beta\rho_h)} \end{bmatrix}$$

which has trace equal to

$$\begin{aligned} & -\beta - \beta \frac{\phi\lambda_x}{\xi} + (\beta(1 - \beta) - \beta^2 \frac{\phi\lambda_x}{\xi}) \frac{\rho_h}{1 - \beta\rho_h} + \frac{\gamma_1\xi}{(1 - \gamma_1\beta)} + \frac{\gamma_1^2\xi\beta\rho_h}{(1 - \gamma_1\beta)(1 - \gamma_1\beta\rho_h)} - 1 \\ \implies & -1 - \beta + \beta \frac{(1 - \beta)\rho}{1 - \beta\rho} - \frac{\beta}{1 - \beta\rho} \frac{\phi\lambda_x}{\xi} + \frac{1 - \gamma_1}{(1 - \gamma_1\beta\rho)} < 0. \end{aligned}$$

The determinant is

$$\begin{aligned} & \frac{(-\gamma_1\xi^2 + \xi - \xi\gamma_1\beta + \xi\gamma_1^2\beta^2\rho_h - \phi\lambda_x\gamma_1\xi + \phi\lambda_x - \phi\lambda_x\gamma_1\beta\rho_h - \phi\lambda_x\gamma_1\beta + \phi\lambda_x\gamma_1^2\beta^2\rho_h - \rho_h\xi)}{\xi(1 - \beta\rho_h)(1 - \gamma_1\beta)(1 - \gamma_1\beta\rho_h)} \beta \\ & + \frac{(\rho_h^2\xi\gamma_1\beta - \rho_h^2\xi\gamma_1^2\beta^2 + \gamma_1\xi^2\phi - \gamma_1^2\xi^2\phi\beta + \gamma_1^2\xi^2\beta\rho_h)}{\xi(1 - \beta\rho_h)(1 - \gamma_1\beta)(1 - \gamma_1\beta\rho_h)} \beta \end{aligned}$$

which simplifies to

$$\gamma_1\xi\phi - (\rho_h - \gamma_1)(1 - \gamma_1\beta\rho_h) + \frac{\phi\lambda_x}{\xi}\gamma_1(1 - \beta\rho_h). \quad (25)$$

This term is greater than zero if (24) obtains.

Finally, the stability of the coefficients of the lagged variables depends on the matrix (17) which is nine-dimensional. The following six subsystems are independent and it is immediate that the dynamics of these coefficients are stable for all parameter values under maintained assumptions:

$$\begin{aligned}\dot{\omega}_{x\pi} &= -\beta\omega_{x\pi}; & \dot{\omega}_{xi} &= -\beta\omega_{xi}; & \dot{\omega}_{\pi x} &= \left(\frac{1-\gamma_1}{1-\gamma_1\beta} - 1\right)\omega_{\pi x} \\ \dot{\omega}_{\pi i} &= \left(\frac{1-\gamma_1}{1-\gamma_1\beta} - 1\right)\omega_{\pi i}; & \dot{\omega}_{i\pi} &= -\gamma_1\omega_{\pi i}; & \dot{\omega}_{ix} &= -\gamma_1\omega_{ix}.\end{aligned}$$

The final three coefficients have local dynamics described by the system

$$\begin{bmatrix} \dot{\omega}_{xx} \\ \dot{\omega}_{\pi\pi} \\ \dot{\omega}_{ii} \end{bmatrix} = \begin{bmatrix} -\beta & 0 & -\beta \\ \gamma_1\xi & \frac{\gamma_1\xi}{1-\gamma_1\beta} - 1 & 0 \\ c_1 & c_2 & c_3 \end{bmatrix} \begin{bmatrix} \omega_{xx} \\ \omega_{\pi\pi} \\ \omega_{ii} \end{bmatrix}$$

where  $c_j$  for  $j = \{1, 2, 3\}$  is a convolution of model parameters. Again one eigenvalue is equal to  $-1$  so that stability is determined by the two-dimensional matrix

$$\tilde{J} = \begin{bmatrix} -\beta \left(1 + \frac{\phi\lambda_x}{\xi}\right) & -\beta\phi \\ \gamma_1\xi & \frac{\gamma_1\xi}{(1-\gamma_1\beta)} - 1 \end{bmatrix}.$$

The trace of  $\tilde{J}$  is

$$-\beta - \beta\frac{\phi\lambda_x}{\xi} + (1 - \gamma_1) - 1 < 0$$

and the determinant

$$\beta \frac{(-\xi^2\gamma_1 + \xi - \beta\xi\gamma_1 - \phi\lambda_x\gamma_1\xi + \phi\lambda_x - \phi\lambda_x\gamma_1\beta + \phi\gamma_1\xi^2 - \phi\gamma_1^2\xi^2\beta)}{\xi(1-\gamma_1\beta)} = \gamma_1\beta\left(\frac{\phi\lambda_x}{\xi} + \phi\xi + 1\right) > 0.$$

This completes the proof.

## A.5 Proof of Proposition 5

Expectational stability is determined by the eigenvalues of the associated ODE which can again be decomposed into four independent subsystems describing the stability properties of

the constant, efficient rate shock, cost-push shock and lagged coefficient dynamics. Consider the stability of the constant dynamics for output and inflation. The Jacobian matrix

$$J_{\omega_0^*} - I_2 = \begin{bmatrix} -\beta \frac{\phi \lambda_x}{\xi} (1 - \beta)^{-1} & -\beta \frac{(\phi - 1)}{1 - \beta} \\ 1 - \gamma_1 & \frac{\gamma_1 \xi - 1 + 2\beta \gamma_1 - \beta^2 \gamma_1^2}{(1 - \gamma_1 \beta)^2} \end{bmatrix}$$

has trace

$$-1 + \frac{(1 - \gamma_1)}{(1 - \gamma_1 \beta)} - \left(1 + \frac{\beta}{(1 - \beta)}\right) \beta \lambda_x \phi \xi^{-1} < 0$$

and determinant

$$\xi (\phi - 1) + \frac{\phi \lambda_x}{\xi} (1 - \beta) > 0.$$

The shock coefficients have the following Jacobian matrix

$$\left( \tilde{J}_{\omega_h^*} - I_2 \right) = \begin{bmatrix} -\beta \frac{(1 - \rho_h + \frac{\phi \lambda_x}{\xi})}{1 - \beta \rho_h} & \beta \frac{\phi - \rho_h}{1 - \beta \rho_h} \\ \frac{\gamma_1 \xi}{1 - \gamma_1 \beta \rho_h} & \frac{\gamma_1 \xi - 1 + \beta \gamma_1 \rho_h + \beta \gamma_1 - \beta^2 \gamma_1^2 \rho_h}{(1 - \gamma_1 \beta)(1 - \gamma_1 \beta \rho_h)} \end{bmatrix}$$

for  $h = \{r, \mu\}$  which displays trace and determinant as in the previous proposition. For the six coefficients on the endogenous variables, the Jacobian can be expressed as

$$\tilde{J} \otimes I_3 \text{ where } \tilde{J} = \begin{bmatrix} -\beta \left(1 + \frac{\phi \lambda_x}{\xi}\right) & -\beta \phi \\ \gamma_1 \xi & \frac{\gamma_1 \xi}{(1 - a\beta)} - 1 \end{bmatrix}.$$

The trace is

$$-\beta - \beta \frac{\phi \lambda_x}{\xi} + (1 - \gamma_1) - 1 < 0$$

and determinant

$$\beta \frac{(-\xi^2 \gamma_1 + \xi - \beta \xi \gamma_1 - \phi \lambda_x \gamma_1 \xi + \phi \lambda_x - \phi \lambda_x \gamma_1 \beta + \phi \gamma_1 \xi^2 - \phi \gamma_1^2 \xi^2 \beta)}{\xi (1 - \gamma_1 \beta)}$$

which can be rearranged to give

$$\gamma_1 \beta \left( \frac{\phi \lambda_x}{\xi} + \phi \xi + 1 \right) > 0.$$

Hence all six eigenvalues on lagged coefficients are less than zero. This completes the proof.

## A.6 Proof of Proposition 6

Similarly to the previous proposition, the agents' forecasts is determined by :

$$\begin{bmatrix} \tilde{Z}_t \\ i_t \end{bmatrix} = \begin{bmatrix} \Omega_0 \\ \hat{\Psi}\Omega_0 + \hat{\psi}_0 \end{bmatrix} + \begin{bmatrix} \Omega_z & \Omega_i \\ \hat{\Psi}\Omega_z & \hat{\Psi}\Omega_i \end{bmatrix} \begin{bmatrix} \tilde{Z}_{t-1} \\ i_{t-1} \end{bmatrix} \quad (26)$$

where

$$\tilde{Z}_t = \begin{bmatrix} x_t & \pi_t & \hat{\mu}_t & \hat{r}_t^e \end{bmatrix}' \text{ and } \hat{\Psi} = \begin{bmatrix} \hat{\psi}_x & \hat{\psi}_\pi & 0 & 0 \end{bmatrix}.$$

Notice that we consider a policy rule with a fixed constant, to avoid multicollinearity problems.

The evolution of  $\hat{\psi}_t = (\hat{\psi}_{0,t}, \hat{\psi}_{x,t}, \hat{\psi}_{\pi,t})'$  is described by

$$\hat{\psi}_t = \hat{\psi}_{t-1} + \gamma_t \tilde{R}_{t-1}^{-1} \begin{bmatrix} 1 \\ r_{t-1}^n \\ \mu_{t-1} \end{bmatrix} \left( \hat{i}_t - \hat{\psi}'_{t-1} \begin{bmatrix} 1 \\ \hat{E}_{t-1}x_t \\ \hat{E}_{t-1}\pi_t \end{bmatrix} \right)$$

where we assume agents use a Recursive Instrumental Variable estimator, to encompass the case of noise in the announced forecast:<sup>27</sup>

$$\tilde{R}_t = \tilde{R}_{t-1} + \gamma_t \left( \begin{bmatrix} 1 \\ r_{t-1}^n \\ \mu_{t-1} \end{bmatrix} \begin{bmatrix} 1 \\ \hat{E}_{t-1}x_t \\ \hat{E}_{t-1}\pi_t \end{bmatrix}' - \tilde{R}_{t-1} \right)$$

where the instrument is  $\begin{bmatrix} 1 & r_{t-1}^n & \mu_{t-1} \end{bmatrix}$  so we can substitute for the correct coefficients

$$\hat{\psi}_t - \hat{\psi}_{t-1} = \gamma_t \tilde{R}_{t-1}^{-1} \begin{bmatrix} 1 \\ r_{t-1}^n \\ \mu_{t-1} \end{bmatrix} \left( \psi' - \hat{\psi}'_{t-1} \right) \begin{bmatrix} 1 \\ \hat{E}_{t-1}x_t \\ \hat{E}_{t-1}\pi_t \end{bmatrix} = \gamma_t \tilde{R}_{t-1}^{-1} \begin{bmatrix} 1 \\ r_{t-1}^n \\ \mu_{t-1} \end{bmatrix} \begin{bmatrix} 1 \\ \hat{E}_{t-1}x_t \\ \hat{E}_{t-1}\pi_t \end{bmatrix}' \left( \psi - \hat{\psi}_{t-1} \right)$$

where  $\psi = (0, \phi\lambda_x/\xi, \phi)$  and

$$\tilde{R}_t = \tilde{R}_{t-1} + \gamma_t \left( \begin{bmatrix} 1 \\ r_{t-1}^n \\ \mu_{t-1} \end{bmatrix} \begin{bmatrix} 1 \\ \hat{E}_{t-1}x_t \\ \hat{E}_{t-1}\pi_t \end{bmatrix}' - \tilde{R}_{t-1} \right)$$

<sup>27</sup>The gain sequence  $\gamma_t$  has the properties  $0 < \gamma_t < 1$ ,  $\lim_{t \rightarrow \infty} \gamma_t = 0$  and  $\sum_{i=0}^{\infty} \gamma_i = \infty$ . See Evans and Honkapohja (2001).

Taking limits we have

$$\hat{\psi} = \tilde{R}^{-1} M(\Omega, \hat{\psi}) (\psi - \hat{\psi})$$

and

$$\dot{\tilde{R}} = M(\Omega, \hat{\psi}) - \tilde{R}.$$

Given that the rational expectations equilibrium delivers a stationary process, for  $\Omega$  and  $\hat{\psi}$  sufficiently close their rational expectations values, we have that

$$M(\Omega, \hat{\psi}) = E \left( \begin{bmatrix} 1 \\ r_{t-1}^n \\ \mu_{t-1} \end{bmatrix} \begin{bmatrix} 1 \\ \hat{E}_{t-1} x_t \\ \hat{E}_{t-1} \pi_t \end{bmatrix}' \right)$$

is finite, where  $E$  denotes the unconditional expectations operator.<sup>28</sup> Hence:  $\tilde{R} \rightarrow M(\Omega, \hat{\psi})$ , and therefore  $\hat{\psi} \rightarrow \psi$ . The stability conditions are then the same as for the case of full communication.

## A.7 Proof of Proposition 7

Communication implies the constants are known to be zero in rational expectations equilibrium. Therefore, only the stability properties of the efficient rate shock, cost push shock and lagged coefficient dynamics need to be examined. Proposition 3 delivers the conditions for the trace and determinant of the shock matrix. The final condition for stability comes from the sum of principle minors, (20), and delivers a complicated expression of model parameters. Letting  $\bar{M}(\rho_h)$  be the implied expression, it can be shown that  $\lim_{\rho_h \rightarrow 1} (\bar{M}(\rho_h) - \bar{M}_I) = 0$  for  $h = \{r, \mu\}$ . Hence instability arises under the same conditions as in Proposition 2 as asserted in part one of the proposition.

To prove the final part of the proposition, consider  $\xi \rightarrow \infty$ . Moreover, in this case let  $\phi_x \equiv \frac{\phi \lambda_x}{\xi} \rightarrow 0$  as  $\xi$  increases (that is we consider the optimal targeting rule with finite  $\lambda_x$ ). Then  $\bar{M}(\rho_h)$  becomes

$$\frac{3(\rho_h - 1) [\beta \rho_h - \beta(1 - \rho_h) - (1 - \beta \rho_h)] - \phi(1 - \beta \rho_h)}{(1 - \beta \rho_h)^2} \beta. \quad (27)$$

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<sup>28</sup>See Evans and Honkapohja (2001), p.234 for example.

Finally, determine  $0 \leq \rho_h^* \leq 1$  that gives instability. Evaluating the numerator of (27) at  $\rho_h = 1$  we get  $-\beta(\phi - 1)(1 - \beta)^{-1} < 0$ . For  $\rho_h = 0$ ,  $[3(\beta + 1) - \phi]\beta$ . If negative, so that  $\phi > 3(1 + \beta)$ , the proof is complete: there is instability for every  $\rho_h$ . If positive  $\phi < 3(1 + \beta)$  and the derivative of (27) with respect to  $\rho_h$  is  $\beta(\phi\beta - 4\beta + 6\beta\rho_h - 1)$ . Evaluating the slope of the parabola at  $\rho_h = 0$  assuming  $3(\beta + 1) > \phi$  yields a gradient smaller than

$$\beta[3(\beta + 1)\beta - 4\beta - 1] = 3\beta^2 + 3\beta - 4\beta - 1 < 0.$$

Hence, from the numerator of (27) there exists a  $\rho_h^* < 1$  satisfying

$$3\beta^2(\rho_h^*)^2 + \beta(\phi\beta - 1 - 4\beta)\rho_h^* + \beta(\beta - \phi + 1) = 0$$

such that for  $\rho_h > \rho_h^*$  instability occurs. Solving the quadratic equation gives

$$\rho_h^* = \frac{\beta(1 + 4\beta - \phi\beta) - \sqrt{\beta^2(1 + 4\beta - \phi\beta)^2 - 12\beta^3(\beta - \phi + 1)}}{6\beta^2}.$$

This completes the proof of Proposition 7.

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