Inflation – who cares? Monetary Policy in Times of Low Attention

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Introduction

In theory ([3]), *managing inflation expectations* is a powerful tool for monetary policy and especially important if the nominal interest rate is stuck at the zero lower bound.

Recent empirical evidence ([1], [2]) , however, suggests that the general public in advanced economies is *inattentive* to monetary policy and inflation.

This paper addresses two questions:

Q1: How did *attention to inflation* change since the 1970s?

Q2: How does *low attention to inflation* affect optimal monetary policy?

Data and methods

Limited attention model yields a law of motion for inflation expectations $\pi^e_{i,t+1|t}$:

$$\pi^e_{i,t+1|t} = (1-\rho_\pi)\overline{\pi}_i + \rho_\pi \pi^e_{i,t|t-1} + \rho_\pi \boldsymbol{\gamma}\left(\pi_t - \pi^e_{i,t|t-1}\right) + u_{i,t}$$

where $\boldsymbol{\gamma}$ is *attention to inflation* π_t

Data (1968 – 2020, United States):

- Survey of Professional Forecasters, Philadelphia Fed
- Survey of Consumers, University of Michigan

→ estimate $\boldsymbol{\gamma}$ over time

Study Ramsey optimal policy in a New Keynesian Model

+ Zero Lower Bound

+ Limited Attention to Inflation

Results

Empirical Findings:

- Attention to inflation decreased substantially since the 1970s, especially after 2010
- Attention is higher in times of volatile and persistent inflation (consistent with the underlying model of *limited attention*)

Lower attention poses a trade off for monetary policy:

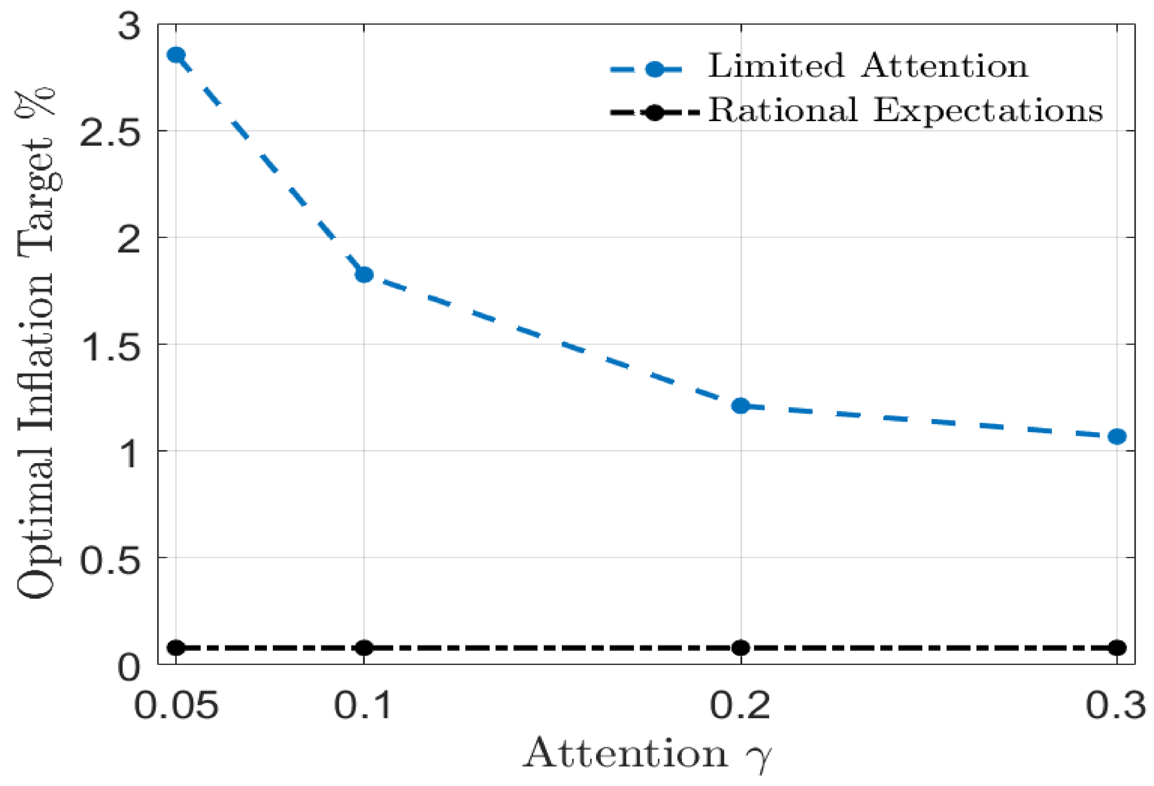
\+ Lower attention reduces inflation and output volatility

\- Conventional (nominal interest rate changes) and unconventional monetary instruments (forward guidance, negative interest rates) become less effective as attention declines

\- Low attention under suboptimal monetary policy can lead to *inflation-attention traps:* long periods of a binding zero lower bound, low inflation and low inflation expectations

→ Underlying reason for trade off: lower attention implies more firmly anchored inflation expectations

→ Optimal policy: *increase the inflation target* as attention declines:



Conclusions

The decline in people's attention to inflation weakens the effectiveness of (conventional and unconventional) monetary policy. This is especially important at the zero lower bound. To deal with this, it is optimal to increase the inflation target, which reduces the likelihood that the zero lower bound is ever attained.

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References

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