Interest Rate Rules, FG Rules and the ZLB on the Nominal Interest Rates in a Cost Channel Economy

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Summary

- Studying economic behaviour in a cost channel economy
  1. Under the ZLB
  2. Under different interest rates rules
  3. Under different FG rules
- Using a three equation NK model
  1. NKPC modified to include a cost channel
  2. Reduced form model
  3. Log-linearized
  4. Nonlinearities arise with ZLB (piecewise)
- Results may differ from a no-cost channel economy
  1. In terms of length of liquidity trap
  2. Risky steady state
  3. Welfare loss
  4. Inflation bias

What I liked in the article

- Interesting topic
- Cost channel is often neglected, while it should not
  - We sterilize supply effects
- ZLB is often neglected, while it should not
  - Nonlinearities rule-out Blanchard and Kahn (1980)
- Article mixes both
- Many insights for further studies

My suggestions and what I would like to see

- Unusual to work with a linearized model in a nonlinear way
  1. Fully microfounded models lead to N.S.D.E.R.E.
  2. We use to log-linearize the model
  3. To make the model linear and solvable
  4. Here nonlinearities are back in the Taylor rule
  5. Implying standard solution methods cannot be used

- Why not using a fully microfounded model?
  - Nonlinearities preserved using same solution methods
  - Possibility to model the cost-channel source
  - Better understanding of which rigidities are modeled

Conclusion

- Interesting paper
- From both economic and computational point of view
- Looking forward to seeing the final version

THANK YOU

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References

Blanchard, O. J. and Kahn, C. M. (1980). The solution of linear difference models under rational expectations. *Econometrica*, 48(5):1305–1311.