

Self-fulfilling Volatility, Risk-Premium, and Business Cycles

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Big Question (Is it possible?)

One monetary tool (i_t) \Rightarrow (i) inflation, (ii) output, and (iii) risk-premium

Macroeconomics: Taylor rules \Rightarrow (i) inflation and (ii) output

Finance: (iii) risk-premium μ volatility² (e.g., Merton (1971))
Usually overlooked in a textbook macroeconomic model

Reason: log-linearized \Rightarrow no price of risk (' risk-premium)

We study these components seriously in monetary frameworks
Need analytical global solutions

Big Finding (Self-fulfilling volatility)

In macroeconomic models with nominal rigidities, \exists global solution where:

Taylor rules (targeting inflation and output) ! \exists rise in volatility and risk-premium

Standard non-linear New-Keynesian model

1. **Show:** proper accounting of a price of risk changes dynamics

Aggregate volatility " () precautionary saving " () aggregate demand#

Conventional Taylor rules => θ new indeterminacy (aggregate volatility)

Equilibrium: θ rise in aggregate volatility in a self-fulfilling way, which drives business cycles

Non-linear New-Keynesian model with a stock market + portfolio

2. **Build** a parsimonious New-Keynesian framework where: [▶ Explain](#)

Stock volatility " () risk-premium " () wealth# () aggregate demand#

Asset price as endogenous shifter in aggregate demand (and vice-versa)

VAR analysis: **financial** vs real volatility [▶ VAR analysis](#)

Isomorphic structure between two frameworks

Conventional Taylor rules \Rightarrow again, equilibria with self-fulfilling volatility (in stock market volatility): (endogenous) stock market volatility and risk-premium driven business cycle

Risk-premium targeting in a specific way \Rightarrow determinacy again

Takeaway (**Ultra-divine coincidence**)

One monetary tool (i_t) \Rightarrow (i) inflation, (ii) output, and (iii) **risk-premium**

- Generalization of the Taylor rule in a risk-centric environment with risk-premium
- Aggregate wealth management of the monetary policy

Remember: no bubble \Rightarrow only fundamental asset pricing [▶ Literature review](#)

A non-linear textbook New-Keynesian model (demand block)

The representative household's problem (given B_0):

$$\max_{\{B_t, C_t, L_t\}} E_0 \int_0^{\infty} e^{-\rho t} \left[\log C_t + \frac{1}{1+h} \frac{L_t^{1+\frac{1}{h}}}{1+\frac{1}{h}} \right] dt \quad \text{s.t.} \quad B_t = i_t B_t - \bar{p} C_t + w_t L_t + D_t$$

where

B_t : nominal bond holding

D_t includes social transfer + profits of the intermediate sector

Rigid price: $p_t = \bar{p}$ for $\forall t$ (demand-determined)

The representative household's problem (given B_0):

$$\max_{\{B_t, C_t, L_t\}} E_0 \int_0^{\infty} e^{-rt} \left[\log C_t + \frac{1}{1+h} \frac{L_t}{1+\frac{1}{h}} \right] dt \quad \text{s.t.} \quad B_t = i_t B_t - \bar{p} C_t + w_t L_t + D_t$$

where

B_t : nominal bond holding

D_t includes social transfer + profits of the intermediate sector

Rigid price: $p_t = \bar{p}$ for $\forall t$ (demand-determined)

A non-linear Euler equation (in contrast to textbook log-linearized one)

$$E_t \frac{dC_t}{C_t} = (i_t - r)dt + \text{Var}_t \frac{dC_t}{C_t}$$

Endogenous drift

(Aggregate) business cycle volatility") precautionary saving") recession now (thus the drift ")

Problem: both variance and drift are endogenous, is monetary policy (Taylor rule) enough for stabilization?

Firm i : face monopolistic competition a la Dixit-Stiglitz with $Y_t^i = A_t L_t^i$ and

$$\frac{dA_t}{A_t} = g dt + \underbrace{\sigma \{Z\}}_{\text{Fundamental risk}} dZ_t$$

dZ_t : aggregate Brownian motion (i.e., only risk source)

(g, s) are exogenous

Flexible price economy as benchmark: the 'natural' output Y_t^n follows

$$\begin{aligned} \frac{dY_t^n}{Y_t^n} &= r^n dt + s^2 dt + s dZ_t \\ &= g dt + s dZ_t = \frac{dA_t}{A_t} \end{aligned}$$

where $r^n = r + g$ s^2 is the 'natural' rate of interest

With

$$\hat{Y}_t = \ln \frac{Y_t}{Y_t^n}, \quad \underbrace{s^2}_{\text{Benchmark volatility}} dt = \text{Var}_t \left\{ \underbrace{z}_{\text{Exogenous}} \frac{dY_t^n}{Y_t^n} \right\}, \quad \underbrace{s + s_t^s}_{\text{Actual volatility}}^2 dt = \text{Var}_t \left\{ \underbrace{z}_{\text{Endogenous}} \frac{dY_t}{Y_t} \right\}$$

With

$$\hat{Y}_t = \ln \frac{Y_t}{Y_t^n}, \quad \underbrace{s^2 dt = \text{Var}_t \frac{dY_t^n}{Y_t^n}}_{\text{Benchmark volatility}} \quad \underbrace{(s + S_t^s)^2 dt = \text{Var}_t \frac{dY_t}{Y_t}}_{\text{Actual volatility}}$$

Exogenous Endogenous

A non-linear IS equation (in contrast to textbook linearized one)

$$d\hat{Y}_t = \underbrace{r^n}_{\text{New terms}} \underbrace{\left\{ \frac{1}{2}(s + S_t^s)^2 + \frac{1}{2}s^2 \right\}}_{\text{New terms}} dt + \underbrace{S_t^s}_{\text{New terms}} dZ_t \quad (1)$$

r_t^T

What is r_t^T ?: a **risk-adjusted** natural rate of interest ($S_t^s =$) r_t^T #)

$$r_t^T = r^n + \frac{1}{2}(s + S_t^s)^2 + \frac{1}{2}s^2$$

Big Question: Taylor rule $i_t = r^n + f_y \hat{Y}_t$ for $f_y > 0$) full stabilization?

Up to a first-order (no volatility feedback): Blanchard and Kahn (1980)

$f_y > 0$: Taylor principle $\Rightarrow \hat{Y}_t = 0$ for δt (unique equilibrium)

Why? (recap): without the volatility feedback:

$$d\hat{Y}_t = (i_t - r^n) dt + s_t^s dZ_t \quad \left\{ \begin{array}{l} \bar{Z} \\ \text{Under} \\ \text{Taylor rule} \end{array} \right. \quad f_y \hat{Y}_t dt + s_t^s dZ_t$$

Then,

$$E_t d\hat{Y}_t = f_y \hat{Y}_t$$

If $\hat{Y}_t \neq 0$, then $E_t \hat{Y}_t$ blows up ! $\hat{Y}_t = 0$ for δt as unique equilibrium

Foundation of modern central banking

Big Question: Taylor rule $i_t = r^n + f_y \hat{Y}_t$ for $f_y > 0$) full stabilization?

Now with the non-linear effects in (1):

Proposition (Fundamental Indeterminacy)

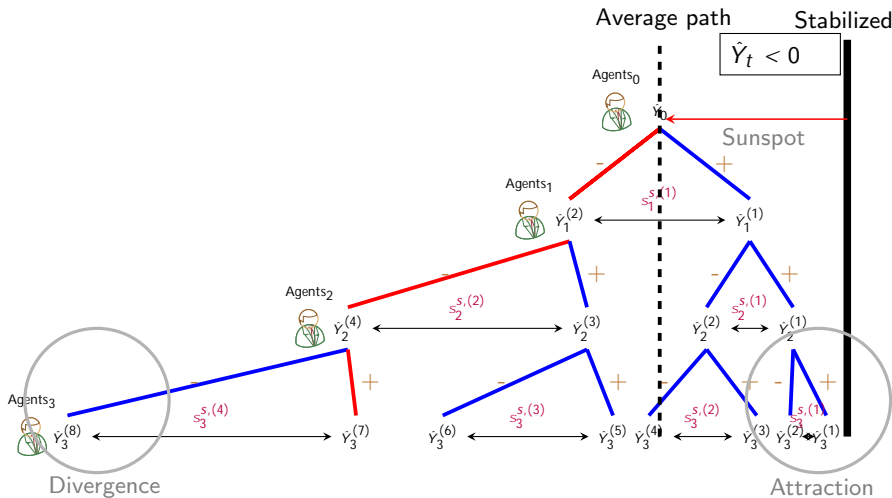
For any $f_y > 0$:

∃ a rational expectations equilibrium that supports a **sunspot** $S_0^s > 0$ satisfying:

- 1 $E_t \hat{Y}_s = \hat{Y}_t$ for $s > t$ (**martingale**)
- 2 $S_t^s \overset{q.s.}{\neq} S_{t+1}^s = 0$ and $\hat{Y}_t \overset{q.s.}{\neq} 0$ (**almost sure stabilization**)
- 3 $E_0(\max_t S_t^s)^2 = \infty$ (**0^+ -possibility divergence**)

Aggregate volatility " possible through the intertemporal coordination of agents

Key: construct a path-dependent intertemporal consumption (demand) strategy



Stabilized as attractor: $s_t^s \overset{q,s}{=} s_{\hat{Y}}^s = 0$ and $\hat{Y}_t \overset{q,s}{=} 0$ but $E_0(\max_t(s_t^s)^2) = \infty$

1. An endogenous aggregate risk arises and drives the business cycle.
2. Sunspots inf s_t^s g act similarly to animal spirit ?
3. New monetary policy

$$i_t = r^n + f_y \hat{Y}_t$$

$$\frac{1}{2} (s + s_t^s)^2 - s^2$$

Aggregate volatility targeting?
Animal spirit targeting?

Restores adeterminacy and stabilization , but what does it mean?

Next: open the stock market, and relate these terms to the risk-premium

The model with a stock market + portfolio decision

Standard demand-determined environment

$s_t^s \Rightarrow$ precautionary saving \Rightarrow consumption (output)#

We can build a theoretical framework with explicit stock markets where

Financial volatility \Rightarrow risk-premium \Rightarrow wealth# \Rightarrow output#

Wealth-dependent aggregate demand

Now, sticky price $sop_t \in 0$: Phillips curve a la Calvo (1983)

▶ Skip the detail

Identical capitalists and hand-to-mouth workers (Two types of agents)

Capitalists: consumption - portfolio decision (between stock and bond)

Workers: supply labor to firms (hand-to-mouth)

Fundamental risk
(Exogenous)

1. Technology

$$\frac{dA_t}{A_t} = \underbrace{g}_{\text{Growth}} dt + \underbrace{s}_{\text{Aggregate shock}} \underbrace{\frac{dZ_t}{Z_t}}_{\text{Aggregate shock}}$$

2. Hand-to-mouth workers : supply labor + solves the following problem

$$\max_{C_t^w, N_t^w} \frac{C_t^w}{A_t} \frac{1}{1+j} \frac{(N_t^w)^{1+c_0}}{1+c_0} \quad \text{s.t.} \quad p_t C_t^w = w_t N_t^w$$

Hand-to-mouth assumption can be relaxed, without changing implications

3. Firms: production using labor + pricing a la **Calvo (1983)**

4. Financial market : zero net-supplied risk-free bond + stock (index) market

Capitalists: standard portfolio and consumption decisions (very simple)

1. Total financial wealth $a_t = p_t A_t Q_t$, where (real) stock price Q_t follows:

$$\frac{dQ_t}{Q_t} = m_t^q dt + s_t^q dZ_t$$

Financial risk
(Endogenous)

m_t^q and s_t^q are both endogenous (to be determined)

2. Each solves the following optimization (standard)

$$\max_{C_t, q_t} E_0 \int_0^{\infty} e^{-rt} \log C_t dt \quad \text{s.t.}$$

$$da_t = (a_t(i_t + q_t(i_t^m - i_t)) - p_t C_t) dt + q_t a_t (s + s_t^q) dZ_t$$

Aggregate consumption of capitalists μ aggregate financial wealth

$$C_t = r A_t Q_t$$

Equilibrium **risk-premium** is determined by the total risk

$$i_t^m - i_t - rp_t = (s + s_t^q)^2$$

Dividend yield: dividend yield = r , as in Caballero and Simsek (2020)

A positive feedback loop between asset price () dividend (output)

Determination of nominal stock return dl_t^m

$$\begin{aligned}
 dl_t^m &= \left[\underbrace{r}_{\text{Dividend yield}} + \underbrace{p_t}_{\text{ln ation}} + g + m_t^q + \underbrace{ss_t^q}_{\text{Covariance}} \right] dt + \underbrace{(s + s_t^q)}_{\text{Risk term}} dz_t \\
 &= \underbrace{i_t^m}_{\text{Drift}} = \underbrace{i_t}_{\text{Monetary policy}} + \underbrace{(s + s_t^q)^2}_{\text{Risk-premium}}
 \end{aligned}$$

Close the model with supply-side (Phillips curve) and $f_t g$ rule

Flexible price economy allocations (benchmark)

$$s_t^{q,n} = 0, Q_t^n, N_{W,t}^n, C_t^n, r^n \text{ (natural rate), } rp_t^n \text{ (natural risk-premium)}$$

Gap economy (log deviation from the flexible price economy)

$$\text{With asset price gap } \hat{Q}_t \quad \ln \frac{Q_t}{Q_t^n} = \hat{C}_t \text{ and } p_t$$

Proposition (Dynamic IS)

A dynamic gap economy can be described with the following equations:

$$1. E_t dp_t = (rp_t - k\hat{Q}_t)dt \text{ with } k > 0$$

$$2. d\hat{Q}_t = (i_t - p_t - \underbrace{r_t^T}_{\substack{\text{red box} \\ \uparrow \\ \text{red arrow}}} })dt + s_t^q dZ_t \text{ where } r_t^T = r^n - \frac{1}{2}(rp_t - rp_t^n) - \frac{1}{2}r^n \hat{r}p_t$$

$$\text{where } rp_t = (s + s_t^q)^2 \text{ and } rp_t^n = s^2 \Rightarrow \hat{r}p_t = rp_t - rp_t^n$$

Now, with asset (stock) price gap \hat{Q}_t :

$$d\hat{Q}_t = i_t p_t \left[\frac{1}{2} (s + s_t^q)^2 + \frac{1}{2} s^2 \right] dt + s_t^q dZ_t \quad (2)$$

Real volatility

Here

$$s_t^q \Rightarrow r_{p_t} \Rightarrow \hat{Q}_t \Rightarrow \hat{Y}_t$$

[More intuitions](#)

Monetary policy: Taylor rule to **Bernanke and Gertler (2000)** rule

$$i_t = r^n + f_p p_t + f_y \hat{y}_t$$

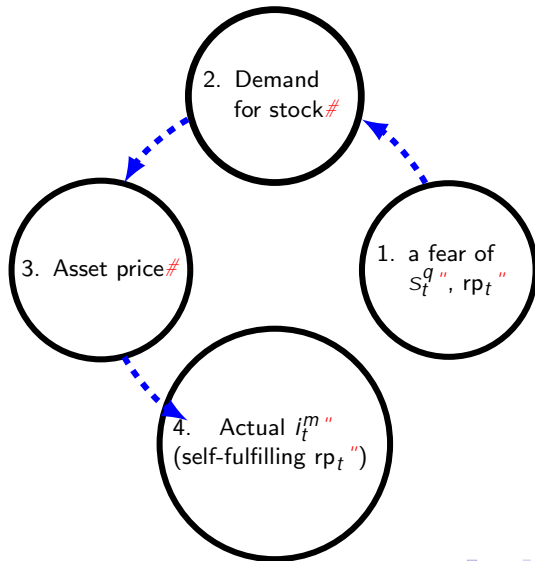
$\hat{y}_t = z \hat{Q}_t$

$$= r^n + f_p p_t + f_q \hat{Q}_t, \quad \text{where } f = f_q + \frac{k(f_p - 1)}{r} > 0$$

Taylor principle

Multiple equilibria (risk-premium sunspot)

How?: **countercyclical** risk-premium with conventional Taylor rules



Assume $\underline{s_0^q} > 0$ for some reason (initial disruption)

The same **martingale equilibrium** [▶ Mathematical explanation](#) [▶ Tree diagram](#)

Assume $s_0^g > 0$ for some reason (initial disruption)

The same **martingale equilibrium** ▶ Mathematical explanation ▶ Tree diagram

Proposition (Fundamental Indeterminacy)

For any $f > 0$:

∃ a rational expectations equilibrium that supports a **sunspot** $s_0^g > 0$ satisfying:

1. $s_t^g \overset{q.s.}{\neq} s_{t-1}^g = 0$, $\hat{Q}_t \overset{q.s.}{\neq} 0$, and $p_t \overset{q.s.}{\neq} 0$ (**almost sure stabilization**)

2. $E_0(\max_t (s_t^g)^2) = \infty$ (**0^+ -possibility divergence**)

(Almost surely) stabilized in the long run after **sunspot** $s_0^g > 0$

Meantime: **crisis** with financial volatility (risk-premium)", asset price#, and business cycle#

$E_0(\max_t (s_t^g)^2) = \infty$: an $e \neq 0$ possibility of ∞ -severity crisis ($s_t^g \neq \infty$)
∃ big crisis that supports $s_0^g > 0$ (e.g., **Martin (2012)** in asset pricing contexts)

(a) With $f_p = 1.5$

(a) With $f_p = 1.5$

(b) With $f_p = 2.5$.

Figure: $f s_t^q, \hat{Q}_t g$ dynamics when $s^{q,n} = 0$ and $s_0^q = 0.9$, with reasonable calibration

As monetary policy responsiveness β

Stabilization speed, β more severe crisis sample path

s_t^q by $s = 2$ 10%# in Q_t (depending on monetary responsiveness)

(a) With $f_p = 1.5$

(b) With $f_p = 2.5$.

Figure: $f(s_t^q, \hat{Q}_t)$ dynamics when $s^{q,n} = 0$ and $s_0^q = 0.9$, with reasonable calibration

As monetary policy responsiveness f_p

Stabilization speed, 9 more severe crisis sample path

s_t^q by $s = 2$ 10%# in Q_t (depending on monetary responsiveness)

Opposite case: with initial sunspot $s_0^q < 0$


Explains boom phase

Financial volatility (risk-premium)#, asset price# and business cycle#

New monetary policy \Rightarrow financial + macro stabilities $\hat{Q}_t = p_t = \hat{r}_t = 0$

New targeting
 $\left. \begin{matrix} z \\ - \end{matrix} \right\} - \{$

$$i_t = r^n + f_p p_t + f_q \hat{Q}_t + \frac{1}{2} \hat{r}_t, \text{ where } f_p + f_q + \frac{k(f_p - 1)}{r} > 0$$


 Sharp

$\left. \begin{matrix} \text{Taylor principle} \\ \hline \{z\} \end{matrix} \right\}$

restores a **determinacy** with:

One monetary tool (i_t) \Rightarrow (i) inflation, (ii) output, and (iii) risk-premium

► Sharpness

Leading to:

$$\begin{aligned}
 & \left[\begin{array}{c} i_t + r p_t \\ - \{ z - \} \\ = i_t^m \end{array} \right] \begin{array}{c} \text{Ito term} \\ \frac{1}{2} r p_t \end{array} = \left[\begin{array}{c} i_t^n + r p_t^n \\ - \{ z - \} \\ = i_t^{m,n} \end{array} \right] \begin{array}{c} \text{Ito term} \\ \frac{1}{2} r p_t^n \end{array} + \left[\begin{array}{c} p p_t + f q \hat{Q}_t \\ - \{ z - \} \end{array} \right] \\
 & \parallel \qquad \qquad \qquad \parallel \qquad \qquad \qquad \text{Business cycle targeting} \\
 & r + \frac{E_t(d \log a_t)}{dt} \qquad \qquad r + \frac{E_t(d \log a_t^n)}{dt}
 \end{aligned}$$

i_t^m , not i_t , follows a Taylor rule?

A % change of (i.e., return on) aggregate wealth not just the policy rate, follows Taylor rules

Why? Because i_t^m , not i_t truly governs intertemporal substitution

My research: other papers

Main theme: modern macroeconomics meets with modern finance

1. Roles of aggregate volatility and risk-premia (or term premia) fluctuations in monetary policy transmission

[A Unified Theory of the Term-Structure and Monetary Stabilization](#) (with Marc Dordal Carreras)

[Active Taylor Rules Still Breed Sunspots: Sunspot Volatility, Risk-Premium, and the Business Cycle](#) (with Marc Dordal Carreras) (Job Market Paper)

[A Higher-Order Forward Guidance](#) (with Marc Dordal Carreras)

2. General New-Keynesian macroeconomics

[A Theory of Keynesian Demand and Supply Interactions under Endogenous Firm Entry](#) (with Marc Dordal Carreras and Zhenghua Qi)

3. Panics and financial frictions in banking

[The Spatial Transmission of US Banking Panics](#) (with Marc Dordal Carreras)

[Risky Growth with Short-Term Debt](#) (with Artur Doshchyn)

Asset pricing from macro intuitions :

Heterogeneous Beliefs, Risk Amplification, and Asset Returns (with Goutham Gopalakrishna and Theofanis Papamichalis)

Contract theory and corporate finance application :

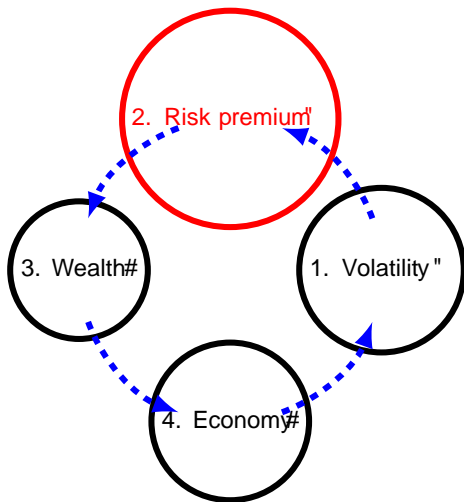
Managerial Incentives, Financial Innovation, and Risk-Management Policies (with Son Ku Kim and Sheridan Titman)

Justifying the First-Order Approach in Agency Frameworks with the Agent's Possibly Non-Concave Value Function (with Jin Yong Jung and Son Ku Kim)

Current debates on wage-price spiral:

Do Cost of Living Shocks Pass Through into Wages? (with Justin Bloesch and Jake Weber)

Thank you very much!
(Appendix)



1 ! 2 comes from "non-linearity (not linearizing)"

2 ! 3 comes from "portfolio decision" of each investor and externality

3 ! 4 comes from the fact wealth drives aggregate demand

4 ! 1 where business cycle has its own volatility (self-sustaining)

(a) Financial Uncertainty series

(b) Financial vs. Real Uncertainty

Figure: Common measures of the financial volatility (left) and real vs. financial uncertainty decomposed by Ludvigson et al. (2015) (right)

The correlation between series is remarkably high and they all display positive spikes at the beginning and/or initial months following NBER-dated recessions

Many of past recessions are, in nature, financial

In a similar manner to Bloom (2009), Ludvigson et al. (2015):

$$\begin{array}{rcc}
 & 2 & 3 \\
 & \log(\text{Industrial Production}) & \\
 \text{VAR-11 order:} & \log(\text{Employment}) & \\
 & \log(\text{Real Consumption}) & \\
 & \log(\text{CPI}) & \\
 & \log(\text{Wages}) & \\
 & \text{Hours} & \\
 & \text{Real Uncertainty (LMN)} & \\
 & \text{Fed Funds Rate} & \\
 & \log(\text{M2}) & \\
 & \log(\text{S\&P-500 Index}) & \\
 & \text{Financial Uncertainty (LMN)} &
 \end{array} \quad (3)$$

Financial uncertainty (LMN) is also replaced by the stock price volatility (following Bloom (2009)) and Baa 10-years bond premia

(a) Response: Industrial Production

(b) Industrial Production

Figure: Impulse-response of IP to one std.dev shock in financial uncertainty measures (left) and the historical decomposition of IP to various attributes (right)

IP falls by 2.5% after one standard deviation spike in the Ludvigson et al. (2015)'s financial uncertainty measure

Financial uncertainty has been important in driving IP boom-bust patterns

Other graphs: IRF and historical decomposition of S&P 500, and FFR (monetary policy), FEVD

(a) Response: S&P-500 Index

(b) S&P-500 Index

(a) Shock: Financial Uncertainty

(b) Shock: Real Uncertainty

With 3 different financial uncertainty measures: Ludvigson et al. (2015), Bloom (2009), Baa 10-years bond premia (left)

(i) Industrial Production

| Horizon | Fin. Uncert. (LMN) | Real Uncert. (LMN) | Stock Vol. (Bloom) | Baa 10-Yr Premia |
|---------|--------------------|--------------------|--------------------|------------------|
| h=1 | 0 | 0.30 | 0.21 | 0.12 |
| h=6 | 1.27 | 3.37 | 2.98 | 1.36 |
| h=12 | 4.28 | 4.38 | 3.16 | 1.94 |
| h=36 | 3.24 | 1.67 | 1.98 | 0.64 |

(ii) S&P-500 Index

| Horizon | Fin. Uncert. (LMN) | Real Uncert. (LMN) | Stock Vol. (Bloom) | Baa 10-Yr Premia |
|---------|--------------------|--------------------|--------------------|------------------|
| h=1 | 0.11 | 0.08 | 0.39 | 0.06 |
| h=6 | 3.30 | 0.25 | 3.26 | 0.62 |
| h=12 | 4.77 | 0.54 | 10.03 | 2.16 |
| h=36 | 6.50 | 0.91 | 12.16 | 2.40 |

(iii) Fed Funds Rate

| Horizon | Fin. Uncert. (LMN) | Real Uncert. (LMN) | Stock Vol. (Bloom) | Baa 10-Yr Premia |
|---------|--------------------|--------------------|--------------------|------------------|
| h=1 | 0.01 | 0.98 | 0 | 0.08 |
| h=6 | 0.42 | 0.84 | 3.11 | 1.66 |
| h=12 | 1.47 | 0.91 | 4.69 | 2.30 |
| h=36 | 2.81 | 2.05 | 5.02 | 3.17 |

Financial uncertainty shocks explain close to:

5% of the fluctuations in both IP and S&P-500 series

Real uncertainty explains:

Additional 2-4% of movements in industrial activity in the medium run

Financial wealth (e.g., risk-intolerance) and aggregate demand: [Mian and Sufi \(2014\)](#), [Caballero and Farhi \(2017\)](#), [Guerrieri and Lacoviello \(2017\)](#), [Caballero and Simsek \(2020a, 2020b\)](#), [Chodorow-Reich et al. \(2021\)](#), [Caballero et al. \(2021\)](#)

Financial disruption (volatility) and macroeconomy: [Gilchrist and Zakrajšek \(2012\)](#), [Brunnermeir and Sannikov \(2014\)](#), [Guerrieri and Lorenzoni \(2017\)](#), [Di Tella and Hall \(2020\)](#)

Our paper: a monetary framework that incorporates financial wealth, aggregate financial volatility, risk-premium, and business cycle (all endogenous)

Monetary policy and financial market disruptions: [Bernanke and Gertler \(2000\)](#), [Nisticò \(2012\)](#), [Stein \(2012\)](#), [Cúrdia and Woodford \(2016\)](#), [Cieslak and Vissing-Jorgensen \(2020\)](#), [Galí \(2021\)](#)

Our paper: a monetary policy's financial targeting (first and second-orders) in the world without bubble + lean against the stock market

Asset pricing and nominal rigidity: [Weber \(2015\)](#), [Gorodnichenko and Weber \(2016\)](#), [Campbell et al. \(2020\)](#)

Time-varying risk-premium in New-Keynesian model: [Laseen et al. \(2015\)](#)

Indeterminacy with an idiosyncratic risk: [Acharya and Dogra \(2020\)](#)

Our paper: an analytical expression of time-varying risk-premium in a monetary model + new indeterminacy in aggregate volatility

Go back

Assume $\underline{s_0^q} > s^{q,n} = 0$ for some reason (initial sunspot)

Blanchard and Kahn (1980) does not apply: we construct a rational expectations equilibrium (REE: not diverging on average) supporting an initial sunspot s_0^q

$$\begin{aligned} d\hat{Q}_t &= i_t - p_t - r_t^n - \frac{1}{2}(r p_t - r p_t^n) dt + s_t^q dZ_t \\ &= \underbrace{(f_p - 1)p_t + f_q \hat{Q}_t + \frac{1}{2}(r p_t - r p_t^n)}_{=0, \quad \delta t} dt + s_t^q dZ_t \end{aligned}$$

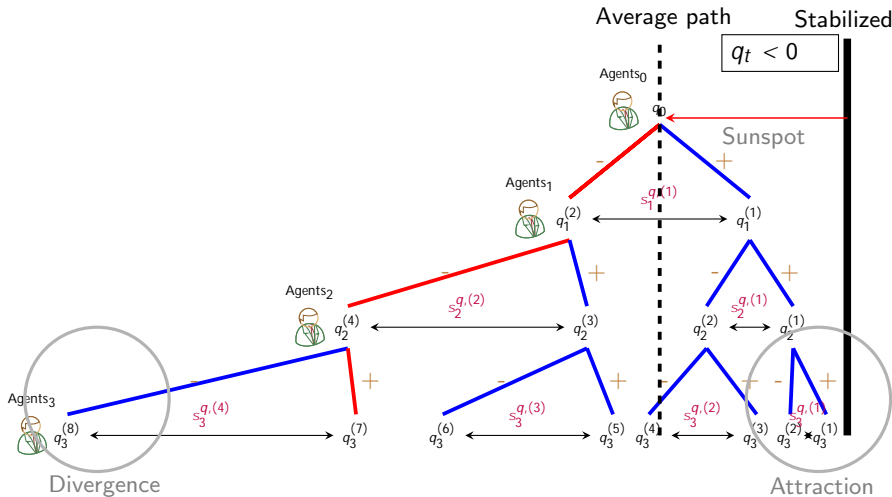
Called the 'martingale equilibrium': supporting an initial sunspot in financial volatility s_0^q

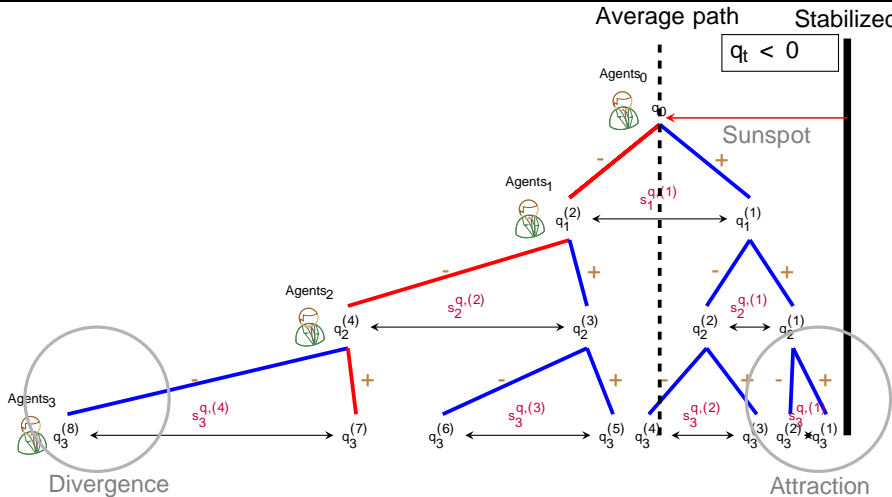
$f s_t^q g$ has its own (endogenous) stochastic process, given initial $s_0^q \notin 0$

$$d s_t^q = \frac{f^2 (s_t^q)^2}{2(s_t + s_t^q)^3} dt + f \frac{s_t^q}{s_t + s_t^q} dZ_t$$

Go back

Again, the same structure





Asset price q_t and the conditional volatility s_t^q are stochastic

Rational expectations equilibrium (REE): no divergence on expectation

As q_t approaches the stabilized path, the s_t^q converges, and more likely stays there:
 convergence $\lim_{t \rightarrow \infty} s_t^q = s^q = 0$

But in the worst scenarios s_t^q diverges (with σ^q -probability)

Go back

What if central bank uses the following alternative rule, where $f_{rp} \in \left(-\frac{1}{2}, 0\right)$?

$$i_t = r_t^n + f_p p_t + f_q \hat{Q}_t + f_{rp} \hat{r}_t^p, \quad \text{where } f_p + f_q + \frac{k(f_p - 1)}{r} > 0$$

Then still a martingale equilibrium supporting sunspots $s_0^q \in (0, 1)$

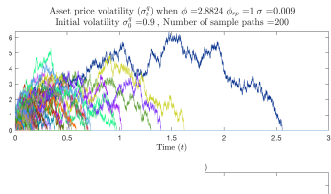
As if $f_{rp} = -\frac{1}{2}$ \Rightarrow (on average) longer time for s_t^q to vanish

Especially, $f_{rp} < 0$ (Real Bills Doctrine) is a bad idea

Summary

Simulation

| | |
|---|---|
| $f_{rp} < 0$ (Real Bills Doctrine) | $0 < f_{rp} < \frac{1}{2}$ |
| (i) With $f_{rp} \neq 0$, convergence speed and less amplified paths | (i) With $f_{rp} > 0$, convergence speed and more amplified paths |
| (ii) $s_t^q > s_t^{q,n} = 0$ means a crisis ($\hat{Q}_t < 0$ and $p_t < 0$) | (ii) $s_t^q > s_t^{q,n} = 0$ means a crisis ($\hat{Q}_t < 0$ and $p_t < 0$) |
| $f_{rp} = \frac{1}{2}$ | $f_{rp} > \frac{1}{2}$ |
| No sunspot (Ultra-divine coincidence) | (i) With $f_{rp} > 0$, convergence speed and less amplified paths |
| | (ii) $s_t^q > s_t^{q,n} = 0$ means a boom ($\hat{Q}_t > 0$ and $p_t > 0$) |
| As $f_{rp} \rightarrow 1$, convergence speed and 9 more amplified paths | |



(a) With $\bar{r}_{rp} = 1$

(b) With $\bar{r}_{rp} = 1.5$.

Figure: $fS_t^q, \hat{Q}_t g$ dynamics when $s^{q,n} = 0$ and $s_0^q = 0.9$, with varying $\bar{r}_{rp} > \frac{1}{2}$