Managing Non-Rational Expectations: A "Monetary Policy" Example

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March, 2016

Abstract

I study a stylized static model of optimal monetary policy in the tradition of Barro and Gordon (1983), which relaxes the conventional assumption that the private sector has rational expectations. Build- ing on the literature on Bayesian networks, I assume that the pri- vate sector forms its inflation forecast by fitting a misspecified causal model - formalized as a direct acyclic graph (DAG) over relevant vari- ables - to the objective steady-state distribution. I characterize the central bank's ex-ante optimal contingent policy for various private- sector DAGs. The classical impossibility of using monetary policy to systematically enhance real activity persists for a large class of DAGs. In these cases, the central bank's optimal policy may display excessive rigidity relative to the rational-expectations benchmark.