Discussion of “Back to the 1980s or Not? The Drivers of Inflation and Real Risks in Treasury Bonds” by Carolin Pflueger

Stefania D'Amico
FRB-Chicago

March 31, 2023
Macroeconomics and Monetary Policy conference

The views expressed here do not necessarily reflect the position of the Federal Reserve Bank of Chicago or the Federal Reserve System.
Summary

- Key novelty: Interaction between macroeconomic shocks and monetary policy is explicitly linked to term/risk premia

- Counterfactual exercises are very interesting and insightful:
  - In the 2000s, supply shocks as volatile as in the 1980s are not sufficient to turn nominal bond risky because of MP

- Post-pandemic out-of-sample exercise is timely and relevant

- Well Done!!!

- But there is still room for improvement
Comments’ overview

- Model’s matching of size and dynamic of term/risk premia is hard to judge based on a few summary statistics

- Model’s simplicity is good but less simplicity might be necessary
  - Time-varying quantity of risk might be playing a very important role
  - Policy rule not adequate to 2001-2019 period and 2020-2022
  - Expectation formation process and its calibration bit puzzling

- Interesting to link risk premia to “deflationary bias” literature (E.g., Adam and Billi, 2007; Nakov, 2008; Mertens and Williams, 2019; Bianchi et al., 2021)
Estimated Size and Dynamic of Risk Premia from DTSM

Figure: Avg RP: 1983-2001, 2y=80bp 10y=190; 2001-2019, 2y=7bp 10y=53bp
IRP Estimated with Time-Varying Inflation Uncertainty

**Figure:** From Breach, D’Amico, and Orphanides (2020)

- ZLB seems important (Gourio and Ngo, 2020; Nakata and Tanaka, 2016)
Model vs DTSM- or Survey-based Risk premia

- Endogenous risk premia focus of this study, hence important to plot them

- Proper comparison to reduced-form alternatives
  - From DTSM (many publicly available)
  - From survey: obtain expectation component using 3-month T-bill forecasts from BCS and subtract it from longer-term yields

- Macro-finance models of Nakata and Tanaka (2016), Gourio and Ngo (2020); Ray (2019); Swanson (2021) show this type of comparisons
Time-Varying Quantity of Risk

- From inflation risk to deflation risk to inflation risk again

- Novel MP tools have compressed rate volatility at the ZLB but increased volatility at turning points: lift-off and tapering

- Changing MP regimes affect macro uncertainty (e.g., David and Veronesi, 2013)
  - Volcker Era
  - Change in Fed communication:
    - E.g., Lunsford (2020) identifies 2003
  - New Long-Run Framework (August 2020)
Changing Inflation Risk

Figure: From D'Amico and Orphanides (2008)

- Break point in early 1990s, possibly more relevant than 2001
Monetary policy rule

- Policy rule not representative of MP in 2001-2019 and post pandemic:
  - 9 years at the ZLB
  -QE very important for risk premia
  - Asymmetric policy rule
  - Average inflation target

- Policymakers have increasingly used forward guidance (FG) to shape interest-rate expectations and provide stimulus
  - This might affect expectation formation
  - Considerable noise in FG signals (D’Amico and King, 2023)

- Partial (vs full) credibility should be relevant for inflation risk premium
Inflation Expectation Formation Process

- Changing expectation formation process across sub-periods adds a confounding factor

- Special weight on asset pricing moments to calibrate $\zeta$ seems arbitrary
  - Should measures of inflation expectations and forecast errors get special weight?

- Does $\zeta = 0.6$, obtained from asset pricing moments, contradict idea that:
  - investors are forward looking?
  - investors are more sophisticated than wage setters?

- Why using only 10-year inflation expectations in calibration?
- Would counterfactual similar to Bianchi, Melosi, Rottner (2021) make risk premia less negative post 2001?
  - Asymmetric policy rule reduces deflationary bias
  - Deflationary bias might cause IRP to be negative (Kitsul and Wright, 2013; Fleckenstein et al, 2017)

- In general, how sensitive are risk premia to different types of policy rule?

- This could be relevant for transmission mechanism of MP to longer-term rates (e.g., in “conundrum period” compressed risk premia delayed transmission of policy rate hikes to longer-term yields)

- Paper so fascinating because can answer many interesting questions!!!