

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

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*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

D'Amico, Kim, Wei (2018)

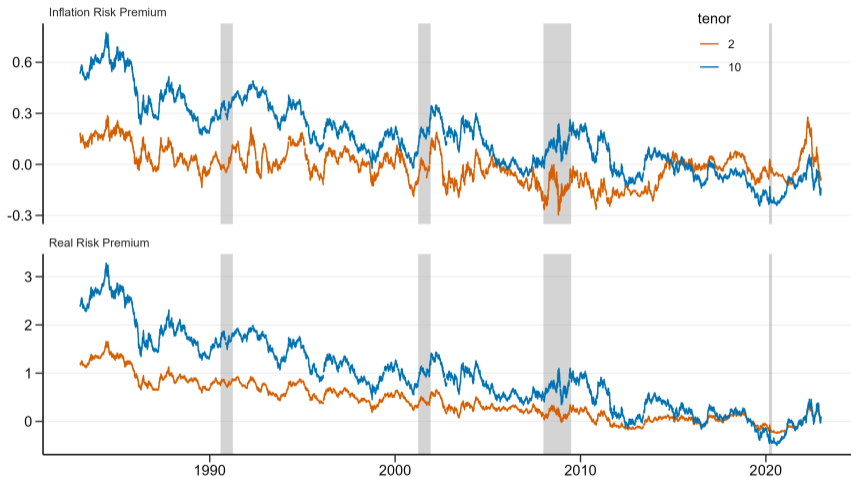


Figure: Avg RP: 1983-2001, 2y=80bp 10y=190; 2001-2019, 2y=7bp 10y=53bp

# IRP Estimated with Time-Varying Inflation Uncertainty

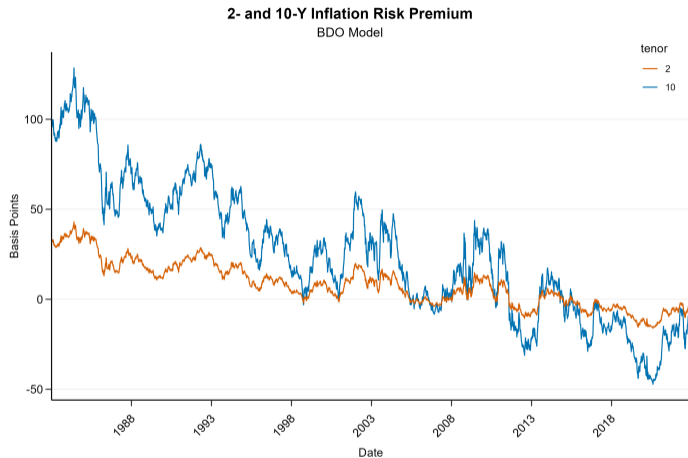


Figure: From Breach, D'Amico, and Orphanides (2020)

- 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

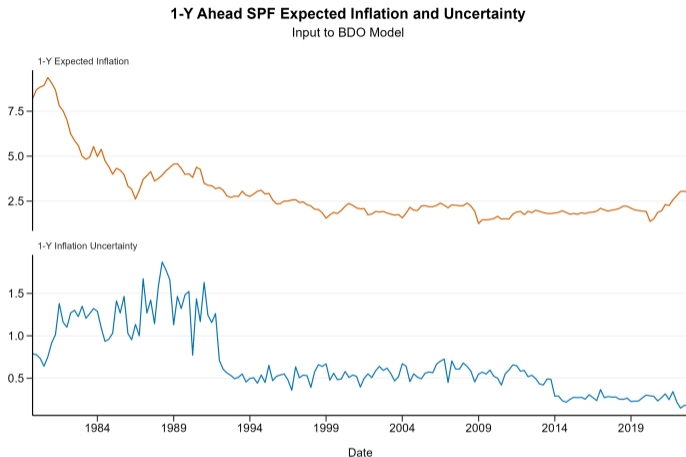


Figure: From D'Amico and Orphanides (2008)

- 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?

## Link to Deflationary Bias Literature

- 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!!!