Discussion of

"Trend Inflation and Asset Pricing in a DSGE Model: Comment"

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Paying attention to "trends" in macroeconomics...

- Recent asset pricing literature suggests that low-frequency movements in inflation are key for describing bond price dynamics in U.S. data.
- Such shifts in "trend" inflation, however, are typically neglected by macro-finance models, and by the monetary policy literature.
- Despite notable exceptions, those models are usually solved around a zero inflation steady state. This is because they are then "easier" to solve, while the results are presumed "robust" to any trends in inflation which are present in the data.

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- It achieves a sizable and variable term premium, while at the same time maintaining a good fit of the macro data, under the assumption of zero trend inflation.
- The authors, thus, introduce into that model a positive trend inflation, and find the "trendy" version is much less practical in explaining both macro and finance data.

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Unreasonable price dispersion implies "excess" volatility...

- In particular, in the RS model with Calvo pricing, a positive trend inflation results in two related "amplification" mechanisms:
  1. *Marginal-cost channel*: firms that cannot reset prices face higher marginal costs.
  2. *Mark-up channel*: firms have an incentive to set even higher prices to account for trend inflation.
- Those two channels lead to "counterfactually" large volatility in the model simulations relative to the data.

...but reasonable changes bring the volatility back in line

- While a positive trend inflation "breaks" the RS model, introducing at the same time "indexation of prices to past inflation" realigns the model's performance with the data.
- The reason is that price indexation, basically, limits the dispersion of prices caused by the trend in inflation.
- Related, how important is the monetary policy regime? What if the central bank stabilized the price level rather than inflation?
- What would "adaptive expectations" imply for the trendy model's performance?

On the perils of following trends

- Shifts in "trend" inflation are important for macro-finance models, and monetary policy analysis.
- The trendy models are practical when prices are anchored or rooted in the past.