Determinacy without the Taylor Principle

Chen Lian (University of California, Berkeley)
George-Marios Angeletos (MIT)

Abstract

A small friction in memory and intertemporal coordination results in a unique bounded equilibrium in the linearized New Keynesian model even when monetary policy does not follow a feedback rule. This leaves no space for equilibrium selection via the Taylor Principle, the Fiscal Theory of the Price Level, or any other off-equilibrium policy threat. It reinforces the logical foundations of the model's conventional solution, also known as the minimum-state-variable solution. And it liberates monetary policy to serve only one function: stabilization.