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INSTRUMENTS VS. TARGETS

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Managing Expectations: Instruments vs. Targets  
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**ABSTRACT**

Should policymakers offer forward guidance in terms of a path for an instrument such as interest rates or a target for an outcome such as unemployment? We study how the optimal approach depends on a departure from rational expectations. People have a limited understanding of the behavior of others and of the general equilibrium (GE) effects of policy. The bite of such bounded rationality on implementability and welfare is minimized by target-based guidance if and only if GE feedbacks are strong enough. This offers a rationale for why central banks should shine the spotlight on unemployment when faced with a prolonged liquidity trap, a steep Keynesian cross, or a large financial accelerator.

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# 1 Introduction

Forward guidance is not comprehensive. Even if a central bank can shape expectations about future interest rates, it remains up to the public to predict the consequences for aggregate employment and income. Under what circumstances is it better to do the opposite, anchoring expectations about the targeted economic outcomes and leaving the public to ponder the supporting policy?

The existing literature on instruments and targets for monetary policy (e.g., [Poole, 1970](#); [Friedman, 1990](#); [Atkeson, Chari and Kehoe, 2007](#)) emphasizes controllability, accountability, and contingency on shocks. We instead focus on the difficulty people may have in reasoning about the economy, especially during unprecedented times like the Great Recession or the Covid-19 crisis.

We model this difficulty as a structured departure from rational expectations equilibrium (REE). People understand the direct, partial equilibrium (PE) effects of policy but not necessarily its indirect, general equilibrium (GE) effects. For example, although people may understand that lower rates mean cheaper credit for themselves, they may incorrectly perceive how others, and hence aggregate demand, may respond to the same policy. Our main result is that, in such circumstances, the optimal communication strategy switches from anchoring expectations of instruments to anchoring expectations of targets like employment or income as Keynesian multipliers, financial accelerators and other GE feedbacks intensify.

This provides a rationale for why experimentations with target-focused communication during the Great Recession, such as the Fed’s “unemployment target” in their December 2012 policy announcement or ECB President Mario Draghi’s famous “whatever it takes” speech, may have been timely—and why similar strategies may be appropriate in the Covid-19 context as all. These two episodes share the following common threads: intensified GE feedbacks and a lack of comparable, prior experiences, which could serve as learning foundations for rational expectations. These are precisely the conditions that, under the lens of our analysis, call for policy commitments that “shine the spotlight on unemployment.”

**Framework.** We use an abstract, minimalistic model to convey the main insights as transparently as possible. Each agent’s optimal action is an increasing function of their expectations of a policy instrument,  $\tau$ , and an economic outcome,  $Y$ . The realized  $Y$ , in turn, depends on the agents’ average action. Together, these relations yield a feedback loop between  $Y$  and the agents’ average action; this stylizes GE feedback. Finally, the policymaker’s objective is to minimize the gaps of  $\tau$  and  $Y$  from their first-best counterparts.

We provide two micro-foundations for this model. The first concerns monetary policy in a New Keynesian economy at the zero lower bound (ZLB). The second concerns taxation in a Neoclassical economy. To fix ideas, let us commit on the first application. In this context,  $\tau$  corresponds to the negative of the interest rate set once the ZLB ceases to bind, or the length of time for which rates will remain low;  $Y$  corresponds to aggregate employment or income; the agents’ relevant action is how much to spend during the liquidity trap; and the dependence of this spending on  $Y$  stylizes the Keynesian cross.

Conventional monetary policy is unavailable because of the ZLB, but the central bank can offer a policy commitment for the future. Such “Odyssean” forward guidance can take one of two forms: instrument communication or target communication. The first strategy anchors expectations of  $\tau$  (“keep rates low until 2014”), the second anchors expectations of (“keep rates low until unemployment is 6.5%”).

**REE and beyond.** Each communication strategy anchors agents' expectations of one object but leaves them to reason the implications for the other object. This is true even when agents are fully rational. But in this fully rational case, agents can flawlessly reason back and forth between  $\tau$  and  $Y$ , or between the extent of monetary loosening and the stimulation of aggregate employment, implying that the policymaker faces no meaningful trade off between the two strategies. Formally, we show that, under rational expectation equilibrium (REE), the implementable combinations of  $\tau$  and  $Y$  are the same under both strategies.<sup>1</sup>

We depart from this benchmark by letting agents have limited depth of knowledge and/or rationality.<sup>2</sup> Such a friction is consistent with the kind of “shallow” higher-order reasoning observed in laboratory experiments (Nagel, 1995; Crawford, Costa-Gomes and Iriberri, 2013). It is also the core common element of a recent theoretical literature upon which we build (Angeletos and Lian, 2018; Farhi and Werning, 2019; Gabaix, 2020; Garcia-Schmidt and Woodford, 2019). But whereas this literature has restricted the policymaker to instrument-based forward guidance, here we study how the policymaker can regulate the bite of the assumed friction on implementability and welfare by switching to target-based forward guidance.

**Main results.** Our main results are stated as Theorems 1 and 2. The first revisits implementability away from the REE benchmark. The second characterizes the optimal communication strategy.

Theorem 1 includes three points. First, the sets of  $\tau$  and  $Y$  that can be implemented differ between the two communication strategies. Second, the distance of either set from the rational-expectations counterpart increases with the shallowness of knowledge and rationality. And third, this distance increases with the GE feedback under instrument communication and decreases with it under target communication.

The first two points formalize the idea that the policymaker's choice of whether to anchor the public's expectations of  $\tau$  or its expectations of  $Y$  becomes consequential once we depart from the REE benchmark, and the more so the larger the departure. The last point highlights the differential effect of the GE feedback and holds the key to Theorem 2. To prove these points, we show how each of the policymaker's strategies induces a different game among the public and study the effect of the belief imperfection in each of them.

Under instrument communication, agents play a game of strategic complements: conditional on an path for interest rates, an agent that expects others to spend more also expects higher aggregate income, so she is willing to spend more herself. The degree of strategic complementarity increases when spending is more sensitive to income, or when the Keynesian cross is steeper.

Under target communication, everything flips. Agents now play a game of strategic substitutability: conditional on a target for aggregate income, an agent that expects others to spend more also expects tighter monetary policy, which reduces the incentive to spend. And because a steeper Keynesian cross maps to a smaller dependence of spending to expectations of interest rates (via which the expectations of others now enter) relative to expectations of income (which are themselves anchored by the policymaker), a steeper Keynesian cross also maps to a lower substitutability in this game.

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<sup>1</sup>This irrelevance result is closely related to the equivalence of primal and dual formulations of policy problems in the Ramsey literature (Chari and Kehoe, 1999; Lucas and Stokey, 1983). And it depends not only on rational expectations but also on the uniqueness of the equilibrium in the game(s) played by the agents. We will clarify this point in Sections 3 and 4.2.

<sup>2</sup>“Depth of knowledge” relates to what agents think others believe (and so on, to higher orders). “Depth of rationality” refers to whether agents think others are rational (and so on, to higher orders). Sections 3.3 and 5.3 cover these issues in detail.

Why are these game-theoretic observations important? For any finite depth of knowledge and rationality, the deviation of actual behavior from its rational-expectations counterpart increases with the absolute magnitude of the strategic interaction: the more agents care about the behavior of others, the larger the footprint on their own behavior of any mistakes in their reasoning about others. The above observations thus translate as follows: a steeper Keynesian cross increases the deviation from rational expectations under instrument communication and decreases it under target communication.

This sums up the logic behind Theorem 1. And along with the assumption that the REE outcome is efficient, it yields Theorem 2: target communication, or “shining the spotlight on unemployment,” is optimal if and only if the Keynesian multiplier or other GE feedback is large enough.

**Robustness.** The aforementioned assumption that the REE outcome is efficient is conceptually appealing because it isolates bounded rationality as the only source of distortion. But it stretches our ZLB application. In that context, it makes more sense to let the REE outcome be inefficiently low. We explain how this enriches the optimal communication strategy without however upsetting our main lesson.

Our (and the related literature’s) preferred departure from REE amounts to having agents systematically under-estimate the responses of others. Assuming the opposite bias, or a form of over-extrapolation, flips the *sign* of the distortion of behavior under both communication strategies. But it does not upset the comparative static of its *magnitude* with respect to the strength of the GE feedback. It follows that Theorem 2 is robust to both kinds of bias. Similarly, a policymaker who suspects that the public “does not fully understand GE” but is not sure of the precise mis-specification thereof could still apply our main lesson.

At the same time, our insights hinge on a departure from full rationality as opposed to pure “noise” or rational inattention. In particular, if we allow agents to observe noisy signals of the policy communications (as, e.g., in Morris and Shin, 2002) but maintain REE, we also maintain the irrelevance of the form of forward guidance for implementability.

Last but not least, our lessons are robust to introducing measurement error, policy trembles, and uncertain fundamentals. These elements, which are the focus of the classics by Poole (1970) and Weitzman (1974), naturally enter the costs and benefits of different policy options. But unlike our approach they do not tie the optimal choice to the relative importance of PE and GE effects.

**Discussion and related literature.** As mentioned in the beginning of the Introduction, the existing literature on the optimal choice of instruments and targets emphasizes three issues: controllability (or tightness); accountability; and state-contingency. The first refers to the minimization of the “trembles” in the policymaker’s hand. The second refers to the alleviation of the type of time-inconsistency problems first highlighted in Kydland and Prescott (1982) and Barro and Gordon (1983). The third refers to the generic necessity of having policy vary with the shocks hitting the economy. See Atkeson, Chari and Kehoe (2007) for a sharp treatment of these issues and Friedman (1990) for an earlier review.

Optimal policy is also generally state-contingent. Insofar as the desirable contingencies can be explicitly articulated (as typically assumed in the Ramsey literature), it suffices for optimality to specify instruments as a functions of exogenous shocks. Otherwise, conditioning instruments on endogenous outcomes may help replicate the missing contingencies. This replication logic, which is the common core of Poole

(1970), [Weitzman \(1974\)](#), and the DSGE literature on optimal policy rules, blurs the distinction between instrument- and target-based policies. But it is orthogonal to the logic behind our own results.

A different argument for making instruments contingent on outcomes is to aid equilibrium selection. This relates to the Taylor principle for monetary policy and to the issues discussed in [Atkeson, Chari and Kehoe \(2010\)](#) and [Bassetto \(2002\)](#). None of these considerations are relevant here because, by design, the equilibrium is unique in our setting under both instrument- and target-based policies.

[Athey, Atkeson and Kehoe \(2005\)](#) shift the focus to a trade off between commitment and flexibility. In their setting, tying the monetary authority's hands avoids the familiar time-inconsistency problem at the expense of preventing it from acting on valuable private information about the economy. The optimal policy turns out to be a cap on inflation, which could be read as a target-based policy.<sup>3</sup> Similar trade offs are studied by [Amador, Werning and Angeletos \(2006\)](#), [Amador and Bagwell \(2013\)](#) and [Halac and Yared \(2018\)](#), albeit in different contexts. The core element of all these papers is the interplay of private information and time inconsistency. That of our paper, instead, is the departure from REE.

Similar points distinguish our paper from the literature on policy communication spurred by [Morris and Shin \(2002\)](#).<sup>4</sup> We share this literature's emphasis on higher-order beliefs but drop rational expectations. We also change the meaning of policy communication, from signaling about exogenous fundamentals to regulation of the private agents' strategic interaction via different policy commitments.<sup>5</sup>

[Caballero and Simsek \(2019\)](#) study an economy where, from the policymaker's perspective, private agents have wrong beliefs about a fundamental but correct beliefs about others' behavior. This precludes the kind of flawed GE reasoning and the trade off between instruments- and target-based policies that our paper focuses on. But it shares the theme of finding a policy that persuades the public to do the right thing despite its wrong beliefs. Similar points apply to [Hansen and Sargent \(2007\)](#) and [Woodford \(2010, 2013\)](#).

Last but not least, our paper adds to the literature on the "forward guidance puzzle."<sup>6</sup> [Del Negro, Giamponi and Patterson \(2015\)](#), [McKay, Nakamura and Steinsson \(2016\)](#) and [Kaplan, Moll and Violante \(2018\)](#) have argued that the puzzle is eased by accommodating finite horizons and liquidity constraints. These works maintain rational expectations and the associated irrelevance of instruments versus targets. But the kind of frictions they emphasize map to stronger GE feedbacks, which under the lens of our analysis can favor target-based guidance. [Angeletos and Lian \(2018\)](#), [Farhi and Werning \(2019\)](#), [Garcia-Schmidt and Woodford \(2019\)](#), [Gabaix \(2020\)](#) and [Wiederholt \(2016\)](#), on the other hand, shift the focus to a belief friction like that captured in our preferred specification. But as previously mentioned, they study only instrument-based guidance. We, instead, highlight that a switch to target-based guidance can ease or even flip the distortion. And we provide a gauge for when such a switch is optimal.

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<sup>3</sup>However, a cap on inflation implements the same outcomes as a cap on the underlying policy instrument (money growth), so the distinction between instrument- and target-based policy is rather tenuous.

<sup>4</sup>See, e.g., [Amador and Weill \(2010\)](#), [Angeletos and Pavan \(2007, 2009\)](#), [Chahrour \(2014\)](#), and [Myatt and Wallace \(2012\)](#).

<sup>5</sup>In this context, three papers deserve special mention. [Angeletos and Pavan \(2009\)](#) allows a policymaker to regulate the agents' strategic interaction but maintain rational expectations and focus, instead, on the use and the aggregation of information. [Corand and Heinemann \(2015\)](#) introduces Level-k Thinking but abstract from policy and focus, instead, on the social value of information. Finally, [Bassetto \(2019\)](#) emphasizes the interaction of signaling with commitment.

<sup>6</sup>This refers to the implausibly large effects that the basic New Keynesian model predicts for forward guidance at the ZLB.

## 2 Model

The economy is populated by a continuum of private agents, indexed by  $i \in [0, 1]$ , and a policymaker. Each private agent chooses an action  $k_i \in \mathbb{R}$ , the average of which is denoted by  $K \equiv \int k_i di$ . The policymaker controls a policy instrument  $\tau \in \mathbb{R}$  and is interested in manipulating an aggregate outcome  $Y \in \mathbb{R}$ .

The workings of the economy are described by two key equations. The first relates the aggregate outcome to the policy instrument and the aggregate behavior of the agents:

$$Y = (1 - \alpha)\tau + \alpha K, \tag{1}$$

where  $\alpha \in (0, 1)$  parameterizes how much of the effect of  $\tau$  on  $Y$  is channeled through the agents' behavior instead of being direct, or mechanical. The second describes the optimal behavior of the typical agent as a function of her expectations of the policy and the outcome:

$$k_i = (1 - \gamma)\mathbb{E}_i[\tau] + \gamma\mathbb{E}_i[Y] \tag{2}$$

where  $\mathbb{E}_i$  denotes the subjective (possibly non-rational) expectation of agent  $i$  and  $\gamma < 1$  parameterizes how much private incentives depend on expectations of the aggregate outcome and thereby on the choices of others. In this sense,  $\gamma$  parameterizes the GE feedback.

**Interpretation.** Our primary application is forward guidance by a central bank during a liquidity trap. In Section 6.1, after presenting our theoretical results, we will spell out the micro-foundations of this application and its mapping to our abstract model. Here, we briefly preview the main ideas to provide context.

Prices are sticky, a shock has pushed the natural rate of interest into negative territory, and the ZLB is binding.  $K$  is aggregate spending during the liquidity trap,  $Y$  is aggregate income during and after the trap, and  $\tau$  is the extent of monetary loosening after the trap. The anticipation of such loosening stimulates spending during the trap through both a partial equilibrium (PE) effect and two general equilibrium (GE) effects. The PE effect captures the impact of lower interest rates on individual spending, holding aggregate income and inflation constant. The two GE effects correspond to the equilibrium response of, respectively, aggregate income and inflation.

Because aggregate income and inflation are tied together via the applicable Philips curve, there is no need to track inflation explicitly. Instead, the combination of the two GE effects can be represented by a positive dependence of  $K$  on  $Y$ , as in equation (2). Accordingly,  $\gamma$  is positively related to the following deep parameters: the marginal propensity to consume (MPC), or the slope of the Keynesian cross; and the degree of price flexibility, or the slope of the Philips curve.

In a second application, described in Appendix B, we consider tax policy in a Neoclassical environment. In this context,  $K$  is aggregate investment today,  $Y$  is aggregate output tomorrow,  $\tau$  is the negative of future taxation, and  $\gamma$  encapsulates two conflicting GE forces: competition for a scarce resource (labor) and a real aggregate-demand externality. This example illustrates how a substantially different, flexible-price mechanism could generate the basic structure of equations (1) and (2). It also allows for the GE feedback to be either positive or negative, depending on which of the aforementioned GE forces dominates.

Both of the above applications center on consumers and firms instead of financial markets. The latter are certainly more attentive to the fine details of policy communications but could still be subject to bounded rationality. In this context,  $K$  could be an aggregate measure of financial trades, or an asset price, which both depends on and feeds into the real economy.<sup>7</sup>

**Parametric restrictions.** The main analysis restricts to  $\gamma > 0$ , or positive GE feedback, which is the relevant case for our ZLB application. But as discussed in Section 5.1, our main result extends to  $\gamma < 0$ . We also require that  $\alpha < \frac{1}{2-\gamma}$ . This restriction guarantees that the equilibrium is unique in our setting, thus bypassing the equilibrium selection issues that relate to the Taylor principle and are the subject of, inter alia, [Atkeson, Chari and Kehoe \(2010\)](#). More fundamentally, this restriction is necessary and sufficient for behavior not to be unduly sensitive to beliefs of *infinite* order. Without it, the model is ill-behaved: the REE cannot be obtained from iteration of best responses, and tiny relaxations in the agents' depth of knowledge or depth rationality can have arbitrarily large effects on their behavior.

**Policy objective.** Let  $\theta \in \mathbb{R}$  be an exogenous random fundamental that determines the policymaker's ideal, or first-best, values for  $\tau$  and  $Y$ . This maps to aggregate TFP in our ZLB application (Section 6), and to the shadow cost of taxation in our Neoclassical variant (Appendix B). More generally,  $\theta$  is a proxy for the kind of state-contingencies that the existing policy literature emphasizes.

The policymaker minimizes the rational expectation of the following quadratic loss function:

$$L(\tau, Y, \theta) \equiv (1 - \chi) (\tau - \tau^*(\theta))^2 + \chi (Y - Y^*(\theta))^2 \quad (3)$$

where  $\tau^*(\theta)$  and  $Y^*(\theta)$  denote the aforementioned ideal values and  $\chi \in (0, 1)$  parametrizes the relative importance of the corresponding gaps. In our ZLB application, these gaps maps to two output gaps (one for the ZLB period and another for the period of subsequent monetary loosening).<sup>8</sup>

For our main analysis, the following assumption is also made:

**Assumption 1.**  $Y^*(\theta) = \tau^*(\theta) = \theta$ .

As we will make clear in the next section, imposing  $Y^*(\theta) = \tau^*(\theta)$  amounts to letting the first best outcome be implementable under rational expectations but not generally otherwise. This restriction therefore allows us to isolate bounded rationality as the only possible source of inefficiency. Conditional on this, the additional restriction  $\tau^*(\theta) = \theta$  is a normalization.<sup>9</sup> Finally, the assumption that  $\theta$  does not appear in equations (1) and (2) is largely a simplification: it herein makes sure that there is no scope or need for informing agents about  $\theta$  per se, but can be relaxed by appropriately redefining  $K$  and  $Y$ , as we indeed do in Section 6.1.

<sup>7</sup>Here we have in mind the financial accelerator in [Bernanke, Gertler and Gilchrist \(1999\)](#) and [Kiyotaki and Moore \(1997\)](#), or the positive feedback loop between household wealth and aggregate demand in [Caballero and Simsek \(2017\)](#). But a negative feedback loop as in [Caballero and Farhi \(2017\)](#) could also be possible.

<sup>8</sup>To be precise, as shown in Section 6.1, the relevant micro-founded gaps map most closely to  $(\tau - \tau^*(\theta))^2$  and  $(K - K^*(\theta))^2$ . But this is inconsequential for our results: as shown in Section 5.2, Theorem 2 readily extends to this case.

<sup>9</sup>In fact, the essential assumption is only that any other distortion is *separable* from that caused by bounded rationality. The logic is similar to that in [Correia, Nicolini and Teles \(2008\)](#) and explain the following subtlety: in the Neoclassical application spelled out in Appendix B,  $\tau^*(\theta)$  and  $Y^*(\theta)$  correspond to a second best à la [Barro \(1979\)](#) and [Lucas and Stokey \(1983\)](#)



**Timing.** Play occurs in the following three stages, indexed by  $t \in \{0, 1, 2\}$ :

0. The policymaker observes  $\theta$  and, conditional on that, chooses whether to engage in “instrument communication,” announcing a commitment to set  $\tau = \hat{\tau}$  for the policy instrument, or “target communication,” announcing a commitment to achieve  $Y = \hat{Y}$  for the outcome.
1. Each agent  $i$  hears the policymaker’s announcement, forms expectations (in one of the various ways described in the next section), and chooses  $k_i$  according to best-response condition (2).
2.  $K$  is publicly observed and the pair  $(\tau, Y)$  is determined as follows. In the case of instrument communication,  $\tau = \hat{\tau}$  and  $Y$  is given by condition (1). In the case of target communication,  $Y = \hat{Y}$  and  $\tau$  is adjusted so that condition (1) holds with  $Y = \hat{Y}$ .

This structure embeds three assumptions, which are worth emphasizing.

First, the policymaker always honors in stage 2 any promise made in stage 0. Forward guidance is thus equated to commitment. The literature has referred to such commitments as “Odyssean” forward guidance (e.g., [Campbell et al., 2012](#)).

Second, the policymaker chooses what to say and do after observing  $\theta$ . This amounts to letting policy be freely contingent on *any* relevant exogenous shock, as in the textbook Ramsey paradigm.<sup>10</sup> It also allows forward guidance to reveal  $\theta$  to the public. But because agents do not care to know  $\theta$  per se, such signaling is irrelevant. There is therefore no room for “Delphic” forward guidance, or for the “information effect” of monetary policy ([Nakamura and Steinsson, 2018](#)).

Finally, we allow the policymaker to announce a value for *either*  $\tau$  or  $Y$ , but not on a pair of values for *both* of them. Such joint commitments do not make sense in the model, but for knife-edge cases, owing to the fact that  $\tau$  and  $Y$  have a fixed relationship at  $t = 2$  once  $K$  is pre-determined. A related rationale, shown in Appendix D, rules out a commitment to a value for  $K$ .<sup>11</sup>

### 3 Rational Expectations and Beyond

This section shows how rational expectations precludes a meaningful trade off between instrument and target communication, recasts this benchmark in terms of infinite depth of knowledge and rationality, and introduces a specific departure from this benchmark, under which we later derive our main results.

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<sup>10</sup>In particular, if some of the relevant shocks are realized after stage 0 but prior to implementing any announced policy commitment, and if this commitment can itself be contingent on such future shocks, then the analysis goes through. One merely has to think of forward guidance as the description of how  $\hat{\tau}$  or  $\hat{Y}$  will vary with the future shocks, as opposed to the announcement of a single value for  $\hat{\tau}$  or  $\hat{Y}$ . If, instead, some of the relevant contingencies are ruled out, then [Poole \(1970\)](#) come into the picture. We abstract from this complication in the main analysis but return to it in Section 5.5.

<sup>11</sup>What remains viable, though, is commitment to a flexible *relation* between  $\tau$  and  $Y$ , namely a function  $f$  such that  $\tau = f(Y; \theta)$ . Appendix H explains why our insights are robust to this possibility.

### 3.1 An Irrelevance Result

Say there is a representative agent, who knows the structure of the economy, observes the policy announcement, and forms rational expectations.<sup>12</sup> In this benchmark,  $\mathbb{E}_i[\cdot] = \mathbb{E}[\cdot|\hat{X}]$  for all  $i$ , where  $\mathbb{E}[\cdot|\hat{X}]$  is the common, rational expectation conditional on announcement  $\hat{X}$ , with  $X \in \{\tau, Y\}$  depending on the form of forward guidance. As a result,  $k_i = K$  for all  $i$  and condition (2) reduces to the following condition:

$$K = (1 - \gamma)\mathbb{E}[\tau|\hat{X}] + \gamma\mathbb{E}[Y|\hat{X}]. \quad (4)$$

A rational expectations equilibrium (REE) is then defined in the usual fashion. In particular,

**Definition 1.** *A quadruple  $(\hat{X}, \tau, K, Y)$  constitutes a REE if and only if it satisfies conditions (1) and (4) along with  $\tau = \hat{X}$  in the case of instrument communication and  $Y = \hat{X}$  in the case of target communication.*

What matters to the policymaker is the set of combinations of  $\tau$  and  $Y$  that can be implemented under each form of forward guidance. We will later explain how implementability changes away from REE. For now, we define and characterize implementability within this benchmark.

**Definition 2.** *A pair  $(\tau, Y)$  is implementable under instrument communication if there is an announcement  $\hat{X}$  for the policymaker and an action  $K$  for the representative agent such that  $(\hat{X}, \tau, K, Y)$  constitutes a REE.*

Denote with  $\mathcal{A}_\tau^*$  and  $\mathcal{A}_Y^*$  the sets of  $(\tau, Y)$  that are implementable under, respectively, instrument and target communication. The policymaker's problem can be expressed as follows:

$$\min_{\mathcal{A} \in \{\mathcal{A}_\tau^*, \mathcal{A}_Y^*\}, (\tau, Y) \in \mathcal{A}} \mathbb{E}[L(\tau, Y, \theta)] \quad (5)$$

The choice  $\mathcal{A} \in \{\mathcal{A}_\tau^*, \mathcal{A}_Y^*\}$  captures the choice of the optimal form of forward guidance (instrument vs target), whereas the choice  $(\tau, Y) \in \mathcal{A}$  captures the optimal pair  $(\tau, Y)$  implemented under the given form of forward guidance. Both of these choices are conditional on  $\theta$ .

We now proceed to show that  $\mathcal{A}_\tau^* = \mathcal{A}_Y^*$ . Using condition (1) to compute  $\mathbb{E}[Y]$  and noting that  $\mathbb{E}[K] = K$  (the representative agent knows his own action), we can restate condition (4) as

$$K = (1 - \alpha\gamma)\mathbb{E}[\tau|\hat{X}] + \alpha\gamma K$$

Since  $\alpha\gamma \neq 1$ , this implies that, in any REE,

$$K = \mathbb{E}[\tau|\hat{X}], \quad Y = (1 - \alpha)\tau + \alpha\mathbb{E}[\tau|\hat{X}] \quad \text{and} \quad \mathbb{E}[Y|\hat{X}] = \mathbb{E}[\tau|\hat{X}] = K$$

These properties hold regardless of the form of forward guidance. With instrument communication, we also have  $\tau = \hat{\tau} = \mathbb{E}[\tau|\hat{X}]$ . It follows that, for any  $\hat{\tau}$ , the REE is unique and satisfies  $K = Y = \tau = \hat{\tau}$ . With target communication, on the other hand, we have  $Y = \hat{Y} = \mathbb{E}[Y|\hat{X}]$ . It follows that, for any  $\hat{Y}$ , the REE is unique and satisfies  $K = Y = \tau = \hat{Y}$ . Combining these facts, we infer that, regardless of the form of forward guidance, a pair  $(\tau, Y)$  is implementable if and only if  $\tau = Y$ . We thus reach the following two results, which serve as benchmarks of comparison for our main analysis.

<sup>12</sup>Under the game representations provided in Lemma 1, this maps to imposing complete information and Nash equilibrium.

**Proposition 1** (Irrelevance under REE). *With rational expectations, the form of forward guidance is irrelevant for implementability:*

$$\mathcal{A}_\tau^* = \mathcal{A}_Y^* = \mathcal{A}^* \equiv \{(\tau, Y) : \tau = Y\}.$$

Combining this result with Assumption 1, we reach the following property, the first part of which verifies the very meaning of this assumption and the second highlights the relevant policy lesson.

**Corollary 1.** *The policymaker’s ideal, or first-best, combination of  $\tau$  and  $Y$  is implementable under rational expectations. Furthermore, the policymaker is indifferent between instrument and target communication: he attains  $\tau = Y = \theta$  (and  $L = 0$ ) by announcing  $\hat{\tau} = \theta$ , as well as by announcing  $\hat{Y} = \theta$ .*

That  $\mathcal{A}^*$  is a linear locus with slope 1 is a simplifying feature of our environment. The relevant point is that implementability is invariant to the form of forward guidance, or to whether the policymaker commits on a value for  $\tau$  or a value for  $Y$ .

### 3.2 Unpacking the Assumptions

The kind of “flawless” GE reasoning alluded to above, and our subsequent relaxation of it, can be formalized by recasting our REE benchmark as the combination of two assumptions. The first regards the agents’ own rationality and awareness, and the second regards the beliefs about *others*.

**Assumption 2.** *Every agent is rational and attentive in the following sense: she is Bayesian, acts according to condition (2), understands that  $Y$  is determined by condition (1) and that the policymaker has full commitment and acts so as to minimize (3), and is aware of any policy communication.*

**Assumption 3.** *The aforementioned facts are common knowledge.*

**Proposition 2.** *The REE benchmark studied in the previous subsection is equivalent to the joint of Assumptions 2 and 3.*

This will become evident in Section 4.2 below, when we show how iteration of best responses converges to the REE under the present assumptions on the agents’ depth of knowledge and rationality but not once we relax them. With this in mind, we next discuss what Assumptions 2 and 3 mean and how they help structure the forms of “bounded rationality” considered in the rest of the paper.

Assumption 2 imposes that, for any  $i$ , agent  $i$ ’s subjective beliefs and behavior satisfy the following three restrictions:

$$\mathbb{E}_i[X] = \hat{X}, \quad \mathbb{E}_i[Y] = (1 - \alpha)\mathbb{E}_i[\tau] + \alpha\mathbb{E}_i[K], \quad \text{and} \quad k_i = (1 - \gamma)\mathbb{E}_i[\tau] + \gamma\mathbb{E}_i[Y], \quad (6)$$

where  $X \in \{\tau, Y\}$  depending on the form of forward guidance. The first restriction follows from the agent’s attentiveness to policy communications and his knowledge of the policymaker’s commitment; the second follows from his knowledge of condition (1); the third repeats the assumed best-response condition (2).

Assumption 3, in turn, imposes that agents can reason, with full confidence and no mistakes, that the above restrictions extend from their own behavior and beliefs to the behavior and the beliefs of others,

to the beliefs of others about the behavior and the beliefs of others, and so on, ad infinitum. It is such *infinite* depth of knowledge and rationality that our REE benchmark and the textbook policy paradigm alike impose—and that we instead relax by modifying Assumption 3 in the subsequent analysis.

### 3.3 Higher-Order Doubts

For our main analysis, we replace Assumption 3 with the following:

**Assumption 4** (“Doubts about Others’ Awareness”). *Every agent believes that all other agents are rational but only a fraction  $\lambda \in [0, 1)$  of them is attentive to or aware of the policy message: every  $i$  believes that, for every  $j \neq i$ ,  $\mathbb{E}_j[X] = \mathbb{E}_i[X] = \hat{X}$  with probability  $\lambda$  and  $\mathbb{E}_j[X] = 0$  with probability  $1 - \lambda$ , where  $X \in \{\tau, Y\}$  depending on the form of forward guidance. This fact and the value of  $\lambda$  are common knowledge.*

Relative to Assumption 3 (which can be nested as  $\lambda = 1$ ), this drops common knowledge of the policy communication and introduces a “crisis of confidence” about whether other agents will respond.

The precise form of Assumption 4 draws from a large literature studying lack of common knowledge in macroeconomics and finance. See [Abreu and Brunnermeier \(2003\)](#), [Morris and Shin \(1998, 2002\)](#), and [Woodford \(2003\)](#) for early contributions and [Angeletos and Lian \(2018\)](#) and [Wiederholt \(2016\)](#) for recent applications to the ZLB context. But whereas most of this literature confounds higher-order doubts with noisy information or rational inattention, Assumption 4 isolates the former friction and equates it with a departure from REE.<sup>13</sup> As further explained in Section 5.4, it is the departure from REE, not noisy information or rational inattention per se, that drives our main result.

In so doing, Assumption 4 admits an immediate re-interpretation in terms of “shallow” reasoning. A large literature documents such a phenomenon in the laboratory and accommodates it by replacing REE with Level-k Thinking.<sup>14</sup> The exact mapping for our setting is spelled out in Appendix C, but the basic idea is quite simple: doubts about others’ rationality (Level-k Thinking) have nearly identical behavioral implications as doubts about others’ awareness (Assumption 4). As explained in Appendix C, the only difference is that our formulation avoids a certain “bug” that emerges when Level-k Thinking is imported from games of strategic complementarity to games of strategic substitutability.

The experimental literature on Level-k Thinking thus provides indirect empirical support for Assumption 4. Additional support can be found in a large psychology literature that documents how people tend to think they are “better than average” in a variety of contexts (see, e.g., [Alicke and Govorun, 2005](#)). The analogue here is that the people think that others are less attentive, or less rational. Assumption 4 is also a close cousin of the form of “cognitive discounting” proposed by [Gabaix \(2020\)](#). Finally, as we will show shortly, Assumption 4 amounts to under-reaction of the average expectations of economic activity ( $K$ ) to

<sup>13</sup>Similar disentanglements of the role of higher-order beliefs from that of noisy information and first-order beliefs have been employed in [Angeletos and La’O \(2009\)](#) and [Angeletos, Collard and Dellas \(2018\)](#), albeit for different purposes.

<sup>14</sup>For the development of this concept and the related experiments, see [Stahl \(1993\)](#), [Nagel \(1995\)](#) and [Crawford, Costa-Gomes and Iriberti \(2013\)](#). This concept has been recently imported to the New Keynesian model by [Garcia-Schmidt and Woodford \(2019\)](#) and [Farhi and Werning \(2019\)](#); see also [Iovino and Sergeyev \(2019\)](#) for an application to Quantitative Easing.

the relevant news (the policy message). Evidence of such under-reaction has been documented by [Coibion and Gorodnichenko \(2012, 2015\)](#).

## 4 Main Results

This section contains our main results. We first show how the allowed departure from rational expectations modifies implementability under each of the two forms of forward guidance, and how it breaks the earlier irrelevance result. We then characterize the optimal communication strategy.

### 4.1 Implementability

With Assumption 4 in place of Assumption 3, we now revisit what pairs of  $(\tau, Y)$  the policymaker can implement. Under rational expectations, these pairs were given by  $\mathcal{A}^* = \{(\tau, Y) : \tau = Y\}$  regardless of the communication choice (Proposition 1). With higher-order doubts, we not only break the equivalence, we also observe several economically interesting properties about the deviation from the rational expectations benchmark. These properties are summarized in the following result, which is proved in detail later.

**Theorem 1** (Implementability). *Let  $\mathcal{A}_\tau$  and  $\mathcal{A}_Y$  denote the sets of the pairs  $(\tau, Y)$  that are implementable under, respectively, instrument and target communication. Then,*

$$\mathcal{A}_\tau = \{(\tau, Y) : \tau = \mu_\tau(\lambda, \gamma)Y\} \quad \text{and} \quad \mathcal{A}_Y = \{(\tau, Y) : \tau = \mu_Y(\lambda, \gamma)Y\},$$

where

$$\mu_\tau(\lambda, \gamma) \equiv \left( (1 - \alpha) + \alpha \frac{1 - \alpha\gamma}{1 - \lambda\alpha\gamma} \right)^{-1} \geq 1 \quad \text{and} \quad \mu_Y(\lambda, \gamma) \equiv \mu_Y = \frac{1 - 2\alpha + \alpha(1 - \gamma)\lambda + \alpha^2\gamma}{(1 - \alpha)(1 - \alpha + \alpha(1 - \gamma)\lambda)} \leq 1$$

Moreover, the following properties hold for  $(\mu_\tau, \mu_Y)$ :

- (i)  $\mu_Y(\lambda, \gamma) < 1 < \mu_\tau(\lambda, \gamma)$  for any  $\lambda < 1$  and  $\gamma \in (0, 1)$ .
- (ii)  $\mu_\tau(\lambda, \gamma)$  increases in  $\lambda$  and  $\mu_Y(\lambda, \gamma)$  decreases in  $\lambda$  for every  $\gamma \in (0, 1)$ .
- (iii)  $|1 - \mu_\tau(\lambda, \gamma)|$  increases with  $\gamma$  and  $|1 - \mu_Y(\lambda, \gamma)|$  decreases with  $\gamma$  for every  $\lambda \in [0, 1]$ .

The frictionless benchmark is nested by  $\lambda = 1$  and results in  $\mu_\tau = 1 = \mu_Y$ . By contrast, for any  $\lambda < 1$  and  $\gamma \notin \{0, 1\}$ , we have  $\mu_Y < 1 < \mu_\tau$  and the two implementable sets cease to be the same. An immediate corollary is the following:

**Corollary 2.** *For any  $\lambda < 1$  and  $\gamma \in (0, 1)$ , the policymaker's first best is not implementable under either mode of communication.*

For generic loss functions, the policymaker will therefore experience a trade-off between the two forms of forward guidance, owing to the different sets of implementable outcomes. The specific trade-off that obtains under the assumed objective 3 and its optimal resolution will be characterized in Section 4.3. But

first, we expand on the economics behind Theorem 1. Because this result regards only implementability, it applies *regardless* of the policy objective or welfare criterion.

A key lesson, described as points (i) and (ii) of Theorem 1, is that the same friction in beliefs has *opposite* effects on implementability under the two strategies. A larger friction *steepens* the implementability constraint under instrument communication (i.e., it raises  $\mu_\tau$ , the marginal change in  $\tau$  needed to implement a marginal change in  $Y$ ) and *flattens* it under target communication (i.e., it lowers  $\mu_Y$ ).

This lesson qualifies the common finding of Angeletos and Lian (2018), Farhi and Werning (2019), Gabaix (2020), Garcia-Schmidt and Woodford (2019) and Wiederholt (2016). These works have argued that essentially the same friction as that studied here arrests the response of aggregate spending to forward guidance at the ZLB (in our language, it steepens implementability). But whereas these works restrict forward guidance to be *instrument-based*, our result clarifies that this prediction can be reversed with *target-based* forward guidance.<sup>15</sup>

However, what will prove important for our take-home message about optimal communication (the upcoming Theorem 2) is not only the sign of the deviation from rational expectations but also its comparative statics with respect to the GE feedback, described as point (iii) of Theorem 1. A higher GE feedback *increases* the distortion of the implementability constraint (i.e., the distance of  $\mu_X$  from its rational-expectation counterpart) under instrument communication and *decreases* it under target communication.

## 4.2 Proof of Theorem 1: Under- vs Over-reaction, and the Role of GE Feedback

The proof of Theorem 1 builds upon several intermediate results, the combination of which comprises this paper’s main economic intuitions. The first, and most primitive, such result is that the form of forward guidance affects the agents’ strategic interaction and hence the type of reasoning they must engage in.

Consider first the case in which the policymaker announces, and commits on, a value  $\hat{\tau}$  for the instrument. This anchors the agents’ beliefs of  $\tau$  but lets them worry what  $Y$  will be. In particular, recall that Assumption 2, which imposes individual rationality and attentiveness but allows arbitrary higher-order beliefs, yields the three restrictions given in condition (6). Now that the policymaker has anchored the agents’ beliefs of  $\tau$ , the first restriction becomes  $\mathbb{E}_i[\tau] = \hat{\tau}$  and the remaining two reduce to

$$k_i = (1 - \gamma)\hat{\tau} + \gamma\mathbb{E}_i[Y] \quad \text{and} \quad \mathbb{E}_i[Y] = (1 - \alpha)\hat{\tau} + \alpha\mathbb{E}_i[K].$$

To determine their best actions, agents therefore need to predict  $Y$ , which is the same as predicting  $K$ , or the response of others. Moreover, for any given  $\hat{\tau}$ , a higher predicted  $K$  means higher predicted  $Y$  and a higher action  $k_i$ . In game-theoretic language, agents’ actions are *strategic complements*. And in the language of our liquidity trap application, a consumer who is pessimistic about aggregate spending wants

<sup>15</sup>The kind of higher-order doubts or bounded rationality we have captured via Assumption 4 is the *sole* friction in Farhi and Werning (2019) and Garcia-Schmidt and Woodford (2019). But this is not the case for Angeletos and Lian (2018), Gabaix (2020) and Wiederholt (2016), which combine the relevant rigidity in higher-order beliefs with a rigidity in first-order beliefs, due the inclusion of noisy information, inattention, or “sparsity.” This additional friction, which we allow for in Section 5.4, contributes toward a less effective forward guidance, or a lower response of  $K$  to  $\hat{X}$ , under *both* communication strategies. But it does not upset our main lessons about their *relative* merits.

to spend *less*, because she understands that, for fixed nominal interest rates, lower aggregate spending translates to lower income, lower inflation, and higher real rates.

Consider next the case in which the policymaker announces, and commits on, a target  $\hat{Y}$  for the outcome. In this case,  $\mathbb{E}_i[Y] = \hat{Y}$  and the remaining two restrictions from condition (6) can be rewritten as

$$k_i = (1 - \gamma)\mathbb{E}_i[\tau] + \gamma\hat{Y} \quad \text{and} \quad \mathbb{E}_i[\tau] = \frac{1}{1-\alpha}\hat{Y} - \frac{\alpha}{1-\alpha}\mathbb{E}_i[K].$$

Agents now know what the outcome will be but have to figure out the policy that will support it. Predicting  $\tau$  under target communication, like predicting  $Y$  in the previous case, also boils down to predicting  $K$ . But the dependence of behavior on the beliefs of  $K$  is the opposite: for any given  $\hat{Y}$ , a higher expectation for  $K$  maps to a lower expectation for the value of  $\tau$  that will be needed to support  $\hat{Y}$ , and hence to a lower action  $k_i$ . In game-theoretic language, agents' actions are *strategic substitutes*. And in the language of the liquidity trap, a consumer who is pessimistic about aggregate spending wants to spend *more*, because she understands that the policymaker's commitment to deliver the announced income or employment target will necessitate a more lax monetary policy, or lower interest rates when others spend less.

The following Lemma summarizes the previous points and spells out the precise form of the game played by the agents under the two forms of forward guidance.

**Lemma 1** (Game representation). *Say the policymaker announces  $X = \hat{X}$  for either  $X \in \{\tau, Y\}$ . Agents' behavior is given by*

$$k_i = (1 - \delta_X)\hat{X} + \delta_X\mathbb{E}_i[K]. \quad (7)$$

where

$$\delta_\tau \equiv \alpha\gamma \in (0, 1) \quad \delta_Y \equiv -(1 - \gamma)\frac{\alpha}{1 - \alpha} \in (-1, 0)$$

*The game induced by instrument communication therefore features strategic complementarity, and the game induced by target communication features strategic substitutability.*

This insight is true, and Lemma 1 holds, with rational expectations as well. But simple algebra in (7) reveals that the exact value of  $\delta_X \in (-1, 1)$  is irrelevant for determining the mapping of  $\hat{X}$  to  $K$  *if and only if* equilibrium expectations are correct or, at least on average,  $\mathbb{E}_i[K] = K$ .<sup>16</sup>

The important deviation in Assumption 4 is to break this irrelevance in a structured way. The following Lemma demonstrates exactly how this assumption functions:

**Lemma 2** (Under-estimating the response of others). *For both modes of communication and for any value  $\hat{X}$  of the policy message,  $\mathbb{E}_i[K] = \tilde{\mathbb{E}}_i[K] = \lambda K$ .*

<sup>16</sup>The restriction  $\delta_X \in (-1, 1)$  means that the equilibrium of both games can be obtained via iteration of best responses for any  $\lambda \leq 1$ , or that beliefs of arbitrarily high order do not have an explosive impact on behavior. Without this restriction, the REE outcome itself is extremely fragile. For instance, Level- $k$  thinking fails to recover it in the limit as  $k \rightarrow \infty$ . This circles back to our discussion of how our framework guarantees, not only a unique equilibrium, but also a vanishing effect of infinite-order beliefs. See also Lemma 8 in the Appendix for the calculation of why  $\delta_Y > -1$  maps to  $\alpha < \frac{1}{2-\gamma}$ .

A heuristic argument is the following. If the typical agent believes that only a fraction  $\lambda$  of the population is aware of the policy message like herself, she also expects the same fraction to respond like herself, and the remaining fraction to stay put. That is,  $\mathbb{E}_i[K] = \lambda k_i$  for the typical agent and therefore also  $\bar{\mathbb{E}}[K] = \lambda K$  in the aggregate. The more precise proof offered in Appendix A demonstrates the formal connection to iteration of higher-order beliefs and makes clearer the intuitive relationship with limited depth of knowledge and rationality.

Combining Lemmas 1 and 2 pins down the behavior of  $K$  under instrument and target communication and gets to the heart of the difference between the two methods:

**Lemma 3** (Under- vs over-reaction, and the effect of  $\gamma$ ). *The realized aggregate action following announcement  $\hat{X}$  is given by*

$$K = \kappa_X \hat{X} \quad \text{with} \quad \kappa_X(\lambda, \gamma) \equiv \frac{1 - \delta_X}{1 - \lambda \delta_X}, \quad (8)$$

where  $X \in \{\tau, Y\}$  depending on the form of forward guidance and  $\kappa_\tau \leq 1 \leq \kappa_Y$ . Moreover, the following properties hold for  $(\kappa_\tau, \kappa_Y)$ :

- (i)  $\kappa_\tau < 1 < \kappa_Y$  for any  $\lambda < 1$  and  $\gamma \in (0, 1)$
- (ii)  $\kappa_\tau(\lambda, \gamma)$  increases and  $\kappa_Y(\lambda, \gamma)$  decreases in  $\lambda$  for every  $\gamma \in (0, 1)$ .
- (iii)  $|1 - \kappa_\tau(\lambda, \gamma)|$  increases with  $\gamma$  and  $|1 - \kappa_Y(\lambda, \gamma)|$  decreases with  $\gamma$  for every  $\lambda \in [0, 1)$ .

This result parallels, and basically proves, Theorem 1. Point (i) shows that instrument and target communication result in *opposite* distortions relative to the rational expectations case: the former leads  $K$  to *under-react* to the announcement, while the latter leads  $K$  to *over-react* to the announcement. This is a direct consequence of the previous discussion of strategic interaction. Point (ii) complements part (i) by showing that a larger friction amplifies the distortion in both cases, increasing under-reaction under instrument communication and increasing over-reaction under target communication. Finally, point (iii) studies how the distortion under each communication method varies with the GE feedback parameter  $\gamma$ . This point, which is crucial for the upcoming characterization of the optimal communication strategy, relates to the mapping from the primitive parameter  $\gamma$  to the strategic interaction parameters  $\{\delta_\tau, \delta_Y\}$  and thereby to the role of higher-order beliefs.

Under instrument communication, a higher  $\gamma$  maps to a larger degree of strategic complementarity, or a more positive value for  $\delta_\tau$ . In the ZLB context, for example, a higher  $\gamma$  may correspond to a steeper Keynesian cross, and hence to a larger feedback from aggregate spending to individual spending for given interest rates, or a higher  $\delta_\tau$ . As this happens, any given under-estimation of the response of others' consumption (and hence of aggregate income) results in a larger reduction in individual spending. This maps to a lower  $\kappa_\tau$ , or equivalently to a larger deviation of  $\kappa_\tau$  from its REE counterpart.

By contrast, with target communication, a higher  $\gamma$  maps to a lower degree of strategic substitutability, or to a less negative value for  $\delta_Y$ . To understand this, recall that under target communication the role of forecasting  $K$  is to forecast the future  $\tau$  that will support the  $Y$  target. As  $\gamma$  increases, expected policy



matters less for decisions, and so does the expected response to forward guidance via  $K$ . As such, there is less opportunity for the friction to bite. That is,  $\kappa_Y$  gets closer to its REE counterpart as  $\gamma$  increases.

Proving Theorem 1 from this point requires only the following few additional lines of algebra. In the case of instrument communication, replacing  $K = \kappa_\tau \hat{\tau}$  in (1) gives  $Y = (1 - \alpha + \alpha\kappa_\tau) \hat{\tau}$ , which together with  $\tau = \hat{\tau}$  yields the implementability constraint  $\tau = \mu_\tau Y$  with  $\mu_\tau = \frac{1}{1 - \alpha + \alpha\kappa_\tau}$ . In the case of target communication, on the other hand, replacing  $K = \kappa_Y \hat{Y}$  in (1) and solving for  $\tau$  gives  $\tau = \frac{1 - \alpha\kappa_Y}{1 - \alpha} \hat{Y}$ , which together with  $Y = \hat{Y}$  yields the implementability constraint  $\tau = \mu_Y Y$  with  $\mu_Y = \frac{1 - \alpha\kappa_Y}{1 - \alpha}$ . The properties of  $(\mu_\tau, \mu_Y)$  then follow directly from the properties of  $(\kappa_\tau, \kappa_Y)$ .

### 4.3 Optimal Policy

We now turn to optimal policy. In particular, we show how the optimal choice between instrument and target communication hinges on  $\gamma$ , or the ferocity of GE feedback. We think of this result as a gauge for when, as a function of economic circumstances proxied by  $\gamma$ , a policymaker should prefer one form of forward guidance to the other.

As a prelude to this result, it is useful to consider two extreme cases:  $\gamma = 0$  and  $\gamma = 1$ . Consider first the case with  $\gamma = 0$ . In this case, condition (2) reduces to  $k_i = \mathbb{E}_i[\tau]$ , which means that agents care to know only  $\tau$ . When the policymaker commits on a value for  $\tau$ , she tells agents everything they need to know, eliminates their need to reason about the behavior of others, and neutralizes the bite of the friction on implementability (formally,  $\mathcal{A}_\tau(0, \lambda) = \mathcal{A}^*$  for all  $\lambda < 1$ ). By contrast, if the policymaker commits on a target for  $Y$ , agents must reason what  $K$  will be in order to figure out the value of  $\tau$  that will support the announced target for  $Y$ , and the mistakes in such reasoning distort implementability (formally,  $\mathcal{A}_Y(0, \lambda) \neq \mathcal{A}^*$  for all  $\lambda < 1$ ). It follows that instrument communication is strictly optimal when  $\gamma = 0$ . Finally, everything flips with  $\gamma = 1$ . In this case, agents only care to know  $Y$  and the only way to insulate the economy from belief friction is to offer target-based forward guidance.

These two cases are knife-edge in the sense that, as anticipated in Corollary 2, the first best is unattainable once  $\gamma \in (0, 1)$ . But they illustrate the basic logic behind our main policy lesson: the optimal form of forward guidance aims at minimizing, as much as possible, the agents' need to reason about the economy. Building on the comparative statics of the implementability constraints with respect to  $\gamma$  documented in Theorem 1, we can indeed show that this logic extends to the general case as follows.

**Theorem 2** (Optimal Forward Guidance). *For any  $\lambda < 1$ , there exists a threshold  $\hat{\gamma} \in (0, 1)$  such that: when  $\gamma \in (0, \hat{\gamma})$ , instrument-based guidance is strictly optimal for all  $\theta$ ; and when  $\gamma \in (\hat{\gamma}, 1)$ , target-based guidance is strictly optimal for all  $\theta$ .*

### 4.4 Proof of Theorem 2

Given  $\theta$ , the policymaker chooses a set  $\mathcal{A} \in \{\mathcal{A}_\tau(\lambda), \mathcal{A}_Y(\lambda)\}$  and a pair  $(\tau, Y) \in \mathcal{A}$  to minimize her loss:

$$\min_{\mathcal{A} \in \{\mathcal{A}_\tau(\lambda), \mathcal{A}_Y(\lambda)\}, (\tau, Y) \in \mathcal{A}} L(\tau, Y, \theta)$$

where  $L(\tau, Y, \theta) = \chi(\tau - \theta)^2 - (1 - \chi)(Y - \theta)^2$ . We focus on  $\lambda < 1$  and  $\gamma \in (0, 1)$ , and let  $(\mathcal{A}^{\text{sb}}, \tau^{\text{sb}}, Y^{\text{sb}})$  be the unique “second-best” triplet that attains the minimum.

Given the specification of  $L$  and the characterization of the implementability sets in Theorem 1, we can restate the choice of the form of forward guidance as the choice of a slope  $\mu \in \{\mu_\tau(\lambda, \gamma), \mu_Y(\lambda, \gamma)\}$  for the equilibrium mapping between  $\tau$  and  $Y$ . Letting  $r \equiv \tau/\theta$  and substituting the implementability constraint, we reach the following simpler representation of the policymaker’s problem:<sup>17</sup>

$$\min_{\mu \in \{\mu_\tau(\lambda, \gamma), \mu_Y(\lambda, \gamma)\}, r \in \mathbb{R}} [(1 - \chi)(r - 1)^2 + \chi(r\mu^{-1} - 1)^2] \quad (9)$$

This makes clear that the optimal form of forward guidance is the same for all realizations of  $\theta$ . It also lets  $r$  identify the optimal covariation of  $\tau$  with  $\theta$ .

It is simple to solve for the optimal  $r$  in closed form and arrive at the following representation of the policymaker’s loss as a function of  $\mu$  alone:

$$\mathcal{L}(\mu) \equiv \min_{r \in \mathbb{R}} [(1 - \chi)(r - 1)^2 + \chi(r\mu^{-1} - 1)^2] = \frac{\chi(1 - \chi)(1 - \mu)^2}{\mu^2(1 - \chi) + \chi},$$

which is a U-shaped function of  $\mu \in (0, \infty)$ , with a minimum equal to 0 and attained at  $\mu = 1$  (the frictionless case).<sup>18</sup> The interpretation of this loss function is simple. The closer  $\mu$  is to 1, the smaller would be the distortion from the frictionless benchmark even if we were to hold  $r$  fixed at 1. The fact that the policymaker can adjust  $r$  as a function of  $\mu$  moderates the distortion but does not upset the property that the loss is smaller the closer  $\mu$  is to 1.

The optimal form of forward guidance can now be found by studying which of the two feasible values of  $\mu$  yields the smallest value for  $\mathcal{L}(\mu)$ . Varying  $\gamma$  changes these two values without affecting the loss incurred from any given  $\mu$ . In particular, raising  $\gamma$  drives  $\mu_\tau$  further way from 1 and brings  $\mu_Y$  closer to 1 (part (iii) of Theorem 1). It follows that  $\mathcal{L}(\mu_\tau)$  is an increasing function of  $\gamma$ , whereas  $\mathcal{L}(\mu_Y)$  is a decreasing function of it.<sup>19</sup> Next, note that both  $\mathcal{L}(\mu_\tau)$  and  $\mathcal{L}(\mu_Y)$  are continuous in  $\gamma$  and recall from our earlier discussion about the extremes  $\gamma = 0$  and  $\gamma = 1$  that the following properties hold:  $\mathcal{L}(\mu_\tau) = 0 < \mathcal{L}(\mu_Y)$  when  $\gamma = 0$ , and  $\mathcal{L}(\mu_\tau) > 0 = \mathcal{L}(\mu_Y)$  when  $\gamma = 1$ . It follows that there exists a threshold  $\hat{\gamma}$  strictly between 0 and 1 such that  $\mathcal{L}(\mu_\tau) < \mathcal{L}(\mu_Y)$  for  $\gamma < \hat{\gamma}$ ,  $\mathcal{L}(\mu_\tau) = \mathcal{L}(\mu_Y)$  for  $\gamma = \hat{\gamma}$ , and  $\mathcal{L}(\mu_\tau) > \mathcal{L}(\mu_Y)$  for  $\gamma > \hat{\gamma}$ .

Figure 1 illustrates this argument in a graph, with the slopes  $(\mu_\tau, \mu_Y)$  in the left panel and the loss functions  $(\mathcal{L}(\mu_\tau), \mathcal{L}(\mu_Y))$  on the right. In a nutshell, because a stronger GE feedback increases the distortion under instrument communication but reduces the distortion under target communication, target communication is optimal if and only if the GE feedback is strong enough.

<sup>17</sup>The expression for the optimal  $r$  is  $r^*(\mu) = \frac{\mu^2(1 - \chi) + \mu\chi}{\mu^2(1 - \chi) + \chi}$ . We can further deduce that, given  $\chi \in (0, 1)$ ,  $r^*/\mu > 1$  for  $\mu \in [0, 1]$ ,  $r^*/\mu < 1$  for  $\mu > 1$ , and  $r^*/\mu = 1$  for  $\mu = 1$ . Further,  $r > 0$  as long as  $\mu > 0$ .

<sup>18</sup>Note that, from the envelope theorem,  $\partial \mathcal{L} / \partial \mu = -2 \cdot \chi \cdot r^* \cdot (r^*/\mu - 1) / \mu^2$ . Combined with the previous footnote’s expression for  $r^*$ , this suggests that  $\partial \mathcal{L} / \partial \mu = 0$  when  $\mu = 1$ ,  $\partial \mathcal{L} / \partial \mu > 0$  when  $\mu > 1$ , and  $\partial \mathcal{L} / \partial \mu < 0$  when  $\mu \in [0, 1]$ . Finally, note that we guarantee  $\mu_Y > 0$  for any possible  $\lambda \leq 1$  given the restriction of  $|\delta_Y| < 1$  or  $\alpha < \frac{1}{2 - \gamma}$ .

<sup>19</sup>This is true strictly away from  $\gamma \in \{0, 1\}$ .

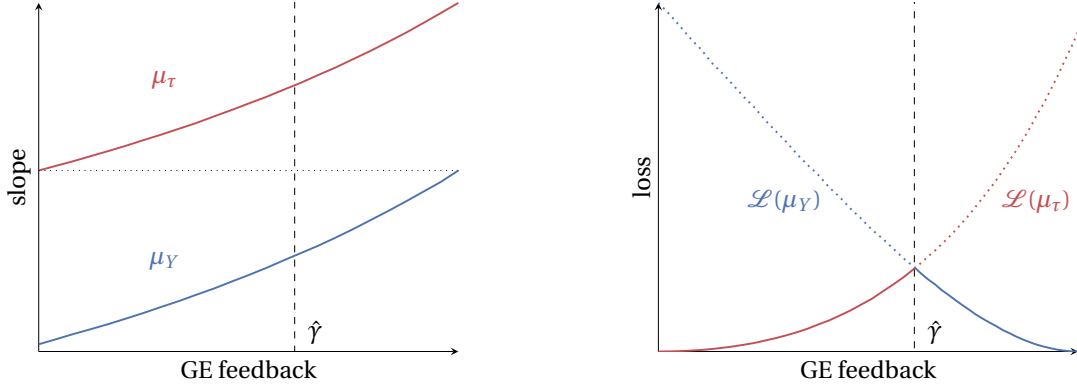


Figure 1: Slope of implementability constraint (left) and welfare loss (right) as function of GE feedback  $\gamma$ .

## 5 Extensions

This section explores the robustness of our results to the following extensions: negative GE feedback, alternative policy objectives, alternative departures from rational expectations, the introduction of inattention, and the introduction of confounding shocks as in [Poole \(1970\)](#). Readers eager to see the application of our theory to the Great Recession are invited to jump to [Sections 6 and 7](#).

### 5.1 Negative GE Feedback

The restriction to positive GE feedback, or  $\gamma > 0$ , is consistent with our main application. But the opposite scenario is possible in other contexts. For instance, in the Neoclassical example of [Appendix B](#),  $\gamma < 0$  is obtained if the wage pressure due to competition for labor overcomes the aggregate demand externality. And in the ZLB context,  $\gamma < 0$  can obtain from competition for another scarce resource, like safe assets as in [Caballero and Farhi \(2017\)](#). [Theorem 2](#) directly extends to such situations. This is readily verified by noting that the proof of [Theorem 2](#) does not actually use  $\gamma > 0$ .<sup>20</sup> We thus have that target communication is optimal if and only if the GE feedback is *both* positive in sign and large enough in magnitude.

### 5.2 Alternative Policy Goals

Our main results focused on implementable pairs of  $(\tau, Y)$ , and their deviations from their first-best counterparts. But what if the policymaker cared also about  $K$  per se? The following result shows how to accommodate this possibility:

**Proposition 3.** *Let the policymaker have the loss function*

$$L = \chi_\tau(\tau - \theta)^2 + \chi_Y(Y - \theta)^2 + \chi_K(K - \theta)^2 \quad (10)$$

for some non-negative weights  $\chi_\tau, \chi_Y, \chi_K$ . The optimal communication strategy has a threshold form for some  $\hat{\gamma} \in (0, 1)$ , as in [Theorem 2](#), if at least two of the three weights are positive.

<sup>20</sup>The proof requires only the weaker restriction  $|\delta_X| < 1$ , which means that beliefs of arbitrarily high order have a vanishing effect on behavior. See [Appendix E](#) for additional details.

Our neoclassical investment example, as shown in Appendix B, maps to  $(\chi_\tau, \chi_Y) > 0$  and  $\chi_K = 0$  and is hence covered directly by Theorem 2. By contrast, our liquidity trap example, as shown in Section 6.1, maps to  $(\chi_\tau, \chi_K) > 0$  and  $\chi_Y = 0$ , hence it requires Proposition 3. Either way, the basic logic is the same. When expectations are rational, the policymaker can close all gaps at once, and can do so with both forms of forward guidance. Otherwise, a trade-off obtains. For instance, the policymaker can close the gap  $\tau - \theta$  by announcing  $\hat{\tau} = \theta$ , but as long as  $\lambda \neq 1$  this leads to *both*  $K \neq \theta$  and  $Y \neq \theta$ . And because this kind of distortion increases with  $\gamma$ , a higher  $\gamma$  favors a switch from instruments to targets.<sup>21</sup>

Things become more tricky only if we relax Assumption 1, that is, if we let the REE benchmark itself deviate from the policymaker’s ideal point. In such circumstances, the logic “the optimal policy aims at minimizing the bite of bounded rationality on implementability and welfare” does not necessarily hold. Instead, the following version of the generic second-best argument applies: if the distortion induced by bounded rationality happens to go in the opposite direction than another distortion, the policymaker may want to leverage on the former to offset the latter.<sup>22</sup>

However, the mere existence of another distortion does not necessarily upset our result. For instance, in our Neoclassical example, the REE outcome is not first-best efficient because lump-sum taxes are unavailable. Still, our result goes through because the tax distortion is invariant to bounded rationality. This guarantees that welfare can still be expressed as in (10), modulo a reinterpretation of the policymaker’s ideal point: instead of representing the unconstrained first best, this point represents the kind of second best characterized in Barro (1979) and Lucas and Stokey (1983). The essence of Assumption 1 is therefore not to rule out all other distortions but rather to abstract from the possibility that the agents’ deviation from full rationality is used by the policymaker as a tool for correcting other problems in the economy (as it is the case, for instance, in Gabaix, 2020, and Farhi and Gabaix, 2020).

### 5.3 Arbitrary Mistakes in Reasoning

Our main specification equated agents’ bounded rationality to lack of common knowledge of others’ awareness and rationality, which amounted to under-estimation of the responses of others. This captures the common core feature of the theoretical literature on which we build (Angeletos and Lian, 2018; Farhi and Werning, 2019; Gabaix, 2020; Garcia-Schmidt and Woodford, 2019). But a policymaker themselves could be forgiven for not having complete confidence that these theories are correct.

Consider the following two alternative stories. The first is that individual agents will be startled and over-estimate the response of the economy to the policy news. The second is that agents’ behavior will be swayed by animal spirits (extrinsic waves of optimism and pessimism about the behavior of others)

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<sup>21</sup>This holds, of course, as long as the policymaker cares about at least two of the gaps seen in (10). Otherwise, there is trivially no trade off and the form of forward guidance is indeterminate.

<sup>22</sup>For instance, suppose that, due to a production externality or some other failure of the first welfare theorem, the rational-expectations equilibrium itself exhibits over-reaction of  $K$  to  $\tau$  relative to the first best, or the policymaker’s ideal point. Then, instrument communication may bring the equilibrium closer to the first best by letting the belief friction induce the opposite distortion. Furthermore, if this consideration happens to be more important when  $\gamma$  is large, this could overturn the comparative statics of the optimal strategy with respect to  $\gamma$ .

or by purely random errors in their reasoning about GE effects (such as, perhaps, those caused by a misspecified belief about the structure of the economy). To capture these possibilities in a structured yet flexible manner, we now consider the following specification of the beliefs about others' behavior:

**Assumption 5** (General distorted reasoning). *Average beliefs satisfy  $\tilde{E}[K] = \lambda K + \sigma \varepsilon$  for some  $\lambda > 0$  (possibly  $\lambda > 1$ ) and  $\sigma \geq 0$ , where  $\varepsilon$  is a unit-variance noise term unknown to the policymaker and independent of the policy announcement.*

Unlike the main analysis, the friction is now introduced directly in the expectations of  $K$  as opposed to in the depth of agents' knowledge and rationality. This shortcut lets us focus on how the friction matters for behavior as opposed to how it is micro-founded. But the missing details can easily be filled in.

For instance, letting  $\lambda > 1$  is akin to modifying the higher-order beliefs in Assumption 4 in the following way: let agents believe that with positive probability others will be "startled" and over-react to the policy message instead of being "sleepy" and under-reactive.<sup>23</sup> Basically the same applies to Level-k Thinking with a level-0 belief of the form  $\eta \hat{X}$ , for some  $\eta > 1$ . And just as  $\lambda < 1$  captures the form of "cognitive discounting" assumed in Gabaix (2020),  $\lambda > 1$  captures the opposite bias, "cognitive hyperopia" or a form of over-extrapolation (Bordalo, Gennaioli and Shleifer, 2017; Bordalo et al., 2018). As for  $\sigma > 0$ , this can be micro-founded by introducing either or shocks to higher-order beliefs (Angeletos and La'O, 2013; Angeletos, Collard and Dellas, 2018) or an "erratic" level-0 belief; and it can be interpreted as random errors in equilibrium reasoning, or as animal spirits operating within a unique equilibrium.

The upshot for implementable sets is the following extension of Theorem 1:

**Proposition 4.** *When Assumption 5 replaces Assumption 3, a pair  $(\tau, Y)$  is implementable if and only if*

$$\tau = \mu_X(\lambda, \gamma)Y + \psi_X(\sigma, \gamma)\varepsilon$$

where  $X \in \{\tau, Y\}$  indexes the form of forward guidance,  $\mu_\tau(\lambda, \gamma)$  and  $\mu_Y(\lambda, \gamma)$  are as in Theorem 1, and

$$\psi_\tau(\sigma, \gamma) \equiv -\sigma \alpha \frac{\alpha \gamma}{1 - \lambda \alpha \gamma + \alpha^2 \gamma (\lambda - 1)} \quad \text{and} \quad \psi_Y(\sigma, \gamma) \equiv -\sigma \frac{\alpha^2 (1 - \gamma)}{(1 - \alpha)((1 - \alpha) + \lambda \alpha (1 - \gamma))}$$

Compared to the case with under-reactive beliefs ( $\lambda < 1$ ), the case with over-reactive beliefs ( $\lambda > 1$ ) flips the *sign* of distortion: implementability is now flattened under instrument communication ( $\mu_\tau < 1$ ) and steepened under target communication ( $\mu_Y > 1$ ). Nevertheless, the comparative statics of the *size* of distortion with respect to the strength of the GE feedback remain the same: as  $\gamma$  increases, the distortion under instrument communication gets larger and that under target communication gets smaller.

The distortions induced by random perturbations ( $\sigma > 0$ ) share this comparative static, too. The common mechanism is that a higher  $\gamma$  increases the dependence of behavior on any mistakes about  $Y$  relative to any mistakes about  $\tau$ . This is true regardless of whether these mistakes are positively correlated, negatively correlated, or uncorrelated with the announcement itself.

Putting these ideas together, it is easy to show that our main policy result and the intuition about minimizing the distortion also remain for any  $\lambda$  and  $\sigma$ .

<sup>23</sup>The only twist is that  $\lambda$  is no more the aforementioned probability, but rather a mixture of this probability and the perceived over-reaction of others.

**Proposition 5.** *When  $\lambda = 1$  and  $\sigma = 0$ , the optimal form of forward guidance is indeterminate. When instead  $\lambda \neq 1$  and/or  $\sigma \neq 0$ , Theorem 2 continues to hold: there exists  $\hat{\gamma} \in (0, 1)$  such that target communication is optimal if and only if  $\gamma > \hat{\gamma}$ .*

The following corollary is then immediate:

**Corollary 3** (Robustness to unknown distortions). *Assume that, from the policymaker’s perspective, the parameters  $(\lambda, \sigma) \in \mathbb{R}_+^2$  are random and drawn from some non-degenerate prior distribution. Then Theorem 2 continues to hold.*

In this sense, a policymaker who suspects that the public has the wrong model of how policy works in GE but is not sure of the precise model thereof could still apply our main result.

## 5.4 Inattention

An important simplification in our model is that agents hear forward guidance perfectly clearly. This contrasts with ample evidence of inattention and compatible theories (Sims, 2003; Gabaix, 2014). We now explain why inattention per se, or noisy information, does not upset the irrelevance of the form of forward guidance that served as our starting point in Section 3—it is only the departure from rational expectations that breaks this irrelevance and that opens the door to the trade off.

Consider the simplest example of rational inattention or noisy information, with Gaussian signals. Let the fundamental  $\theta$  be Gaussian with mean 0 and let the policy announcement  $X$  be linear in  $\theta$ . Next, let each agent receive only a noisy version of  $X$ , given by  $x_i = X + u_i$ , where  $u_i$  is idiosyncratic Gaussian noise. Finally, let  $x_i$  have a fixed signal-to-noise ratio with respect to  $X$ , regardless of the form of forward guidance. This can be justified as the optimal attention choice in a model where the cost of attention is an increasing function of the Shannon mutual information between  $x_i$  and  $X$ .

In this model, which resembles Morris and Shin (2002), Woodford (2003), and the topical applications of Angeletos and Lian (2018) and Wiederholt (2016), the following properties hold under rational expectations. First, the first-order beliefs satisfy  $\bar{\mathbb{E}}[X] = qX$  for some  $q < 1$ , with  $q$  being a positive transformation of the aforementioned signal-to-noise ratio (or of the parameter that regulates the cost of attention). Second, the higher-order beliefs satisfy  $\bar{\mathbb{E}}^h[X] = \lambda^{h-1}\bar{\mathbb{E}}[X]$  for all  $h \geq 2$ , with  $\lambda = q$ . And third, the implementable combinations of  $\tau$  and  $Y$  are *invariant* to the form of forward guidance.

The first two properties are commonplace in the literature. The third, which is central to our purposes and is proved in Appendix G, clarifies that noisy information *alone* does not upset the irrelevance property of the *noiseless* REE benchmark we studied in Section 3. A simple intuition is that, in the new context, which has noisy but still rational expectations,  $\tau$  and  $Y$  are both functions of the same fundamental and these functions are themselves correctly understood by the agents. It follows that a signal of one is just as good as a signal of the other and, as a result, there is still no meaningful trade-off between anchoring the expectations of  $\tau$  and anchoring the expectations of  $Y$ . We summarize this lesson below.

**Proposition 6.** *Insofar as expectations remain rational, the introduction of noisy information or inattention, as modeled above, preserves the irrelevance of the form of forward guidance.*

By the same token, the crucial feature of Assumption 4 was not the rigidity in higher-order beliefs per se (which is present in the above model) but rather the systematic error in equilibrium reasoning (which is absent in the above model). This squares well with the basic premise that our paper is all about systematic errors in equilibrium reasoning, as opposed to mere inattention or rational confusion.

What if inattention coexists with flawed equilibrium reasoning? We study this case in detail in Appendix G. The upshot is the following. If inattention is rational and efficient, in line with the micro-foundations put forward in Sims (2003, 2006) and the Welfare Theorems for inattentive economies proved in Angeletos and Sastry (2019), the errors in equilibrium reasoning remain the only source of inefficiency and our main lessons (Theorem 2, Proposition 5 and Corollary 3) go through. Otherwise, the second-best argument “use one distortion to fight another” may once again become relevant.

### 5.5 A Bridge to Poole (1970): Imperfect Control and Additional Shocks

Much of the contemporary discussion of instrument and targets follows the durable logic of Poole (1970): that the optimal implementation device is the one best hedged against confounding shocks. Such hedging is front-and-center in actual policy design, and while our focus in this paper is transparently different, it is useful to study whether the two justifications conflict with one another.

In Appendix F, we enrich our model with two Poole-like elements. The first is “uncertainty about future fundamentals,” or the existence of an unobserved shock to  $Y$  in (1) on which policy cannot be contingent. Formally, we modify (1) as follows:

$$Y = (1 - \alpha)\tau + \alpha K + u, \quad (11)$$

where  $u$  is Gaussian, orthogonal to  $\theta$ , and unobserved by both the policymaker and the private agents. The second element is “imprecise implementation,” or noisy measurement of  $Y$  or  $\tau$ . Formally, we let the policymaker announce and commit to a value for  $\tilde{\tau}$  or  $\tilde{Y}$  (instead of, respectively,  $\tau$  or  $Y$ ), where

$$\tilde{\tau} = \tau + u_\tau, \quad \tilde{Y} = Y + u_Y, \quad (12)$$

and the  $u$ 's are independent Gaussian shocks, orthogonal to  $\theta$ , and unpredictable by both the policymaker and the private agents. The shock  $u_\tau$  may capture the policymaker's imperfect control over mortgage rates (the kind of interest rates that govern consumer spending), whereas the shock  $u_Y$  may capture measurement error in macroeconomic statistics, or other source of “noise” in the mapping from such statistics to the true outcomes of interest.<sup>24</sup>

Regardless of interpretation, the key assumption here is the lack of sufficiently flexible contingency of the policy on the disturbances  $u$ ,  $u_\tau$  and  $u_Y$ . This assumption is at the heart of Poole (1970): if the policymaker could freely condition the policy on these disturbances, the trade-off studied in that paper would disappear and our own analysis could proceed *as if* these disturbances were absent. It is therefore only the absence of such contingency that gives rise to the considerations articulated in Poole (1970).

<sup>24</sup>As an example, the Fed was very concerned in March 2014 that unemployment figures were falling toward the pre-committed 6.5% threshold for the “bad reason” that individuals were leaving the labor force, while primitive labor market conditions were not improving so much (Blinder et al., 2017).

These considerations may naturally favor one or the other form of forward guidance, regardless of whether expectations are rational or not. For instance, committing on a value for  $\tau$  helps insure against shocks that cause fluctuations in aggregate output but should not influence future interest rates. But, unlike our approach, such considerations do *not* necessarily induce a dependence of the optimal policy on the relative importance of PE and GE considerations, as captured by the structural parameter  $\gamma$ .

**Proposition 7.** *Allow for the Poole-like elements described above. When expectations are rational, the optimal choice between instrument and target communication is invariant to  $\gamma$ . And otherwise, Theorem 2 continues to hold.*

What is more, the logic that the instrument-vs-target choice is irrelevant for implementability in the rational-expectations benchmark (but not away from it) generalizes in the following “average” sense:

**Proposition 8.** *Let  $\mathbb{E}_p[\tau]$  and  $\mathbb{E}_p[Y]$  be the policymaker’s expectation of  $\tau$  and  $Y$  at stage 0, where the expectation is taken over the possible realizations of the future shocks or measurement errors. When  $\lambda = 1$ ,  $\mathbb{E}_p[\tau] = \mathbb{E}_p[Y]$  regardless of the policymaker’s strategy. When instead  $\lambda \neq 1$ ,  $\mathbb{E}_p[\tau] = \mu_\tau \mathbb{E}_p[Y]$  under instrument communication and  $\mathbb{E}_p[\tau] = \mu_Y \mathbb{E}_p[Y]$  under target communication, with  $\mu_\tau \neq \mu_Y$ . Furthermore,  $\mu_\tau$  and  $\mu_Y$  are exactly the same as in our main analysis.*

With rational expectations, and from the policymaker’s perspective at the time she has to choose whether to commit on a value for  $\tau$  or a value for  $Y$ , there continues to exist *no* trade-off in terms of how steep or flat the implementability constraint is. What varies between these two choices is only the extent of insurance provided against future shocks or measurement error. By contrast, with bounded rationality, implementability is fundamentally altered: the average relation between  $\tau$  and  $Y$  depends on the form of forward guidance, and on its interaction with  $\gamma$ , essentially in the same way as in our main analysis.<sup>25</sup>

We close this section with another example of the novel considerations our approach brings to light. In our baseline analysis, we assumed that the policymaker already knew all the shocks upon which the optimal value of  $\tau$  or  $Y$  should be conditioned on; and in the present extension, we relaxed this assumption but, as in [Poole \(1970\)](#), prevented the policymaker from making state-contingent commitments for  $\tau$  or  $Y$ . Suppose now that such state-contingencies are allowed but are also hard to decipher by the agents, in the sense that the inclusion of more contingencies makes agents more prone to mistakes in equilibrium reasoning. Then, announcing and committing to a simple, non-contingent plan could be optimal for the policymaker because it offers more “clarity,” or a smaller departure from rational expectations.

This reasoning favors simple, sharp, communications such as Mario Draghi’s “do whatever it takes” over the kind of more complicated plans, detailed with all kinds of contingencies, found in the typical FOMC announcement. And it provides a novel rationale for curtailing state-contingencies, in addition to previously established results related to time inconsistency ([Athey, Atkeson and Kehoe, 2005](#)). The full exploration of these ideas seems an interesting angle for future research.

<sup>25</sup>A corollary of Proposition 8 is that, when and only when  $\lambda < 1$ , the switch from instrument to target communication is associated with a reduction in the expected value of  $\tau$  needed to achieve the desired target in  $Y$ . This anticipates a point we make in Section 6: the 2012 shift in the Fed’s communication strategy may have, unintentionally but favorably, help shorten the time the economy had to spend at the ZLB.



## 6 Application: Monetary Policy in a Liquidity Trap

In this section, we apply our insights to the main application of interest. We first show how to nest a micro-founded New Keynesian economy at the ZLB in our abstract framework. We then translate our main policy lesson, encapsulated in Theorem 2, into the following more practical lesson: that central banks should switch from talking about interest rates to talking about unemployment when the Keynesian cross is steeper or the deflationary spiral intensifies.

### 6.1 Micro-foundations

**Consumers and Firms.** There are countably infinite periods, indexed by  $t \in \{1, 2, \dots\}$ , and a unit measure of households, or consumers, indexed by  $i \in [0, 1]$ . Household  $i$  consumes  $C_{i,t}$  of the good and works  $N_{i,t}$  hours in period  $t$ . Let  $\beta_t = \exp(-\bar{\rho} - \rho_t)$  be each consumer's subjective discount rate, parametrized by a long-run level  $\bar{\rho} > 0$  and a shock  $\rho_t$ , and let  $\mathbb{E}_{i,t}[\cdot]$  be an individual consumer's subjective expectation operator at  $t$ . Preferences are given by the following:

$$\mathcal{U}_{i,t} = \mathbb{E}_{i,t} \left[ \left( \log C_{i,t} - \frac{1}{2} N_{i,t}^2 \right) + \beta_t \mathcal{U}_{i,t+1} \right] \quad (13)$$

Each consumer also faces the following, standard flow budget constraint:

$$C_{i,t} + B_{i,t} = R_{t-1} \frac{P_{t-1}}{P_t} B_{i,t-1} + Y_{i,t},$$

where  $Y_{i,t}$  is the consumer's income,  $B_{i,t}$  is her savings in a one-period, risk-free bond,  $P_t$  is the price level,  $R_{t-1}$  is the nominal interest rate between  $t-1$  and  $t$ , and  $R_{t-1} \frac{P_{t-1}}{P_t}$  is the corresponding real rate.

There is also a continuum of intermediate goods firms, indexed by  $j \in [0, 1]$ . Each such firm hires  $N_{j,t}$  units of labor and produces quantity  $X_{j,t} = N_{j,t}$ . Aggregate output is produced by a competitive firm with technology  $Y_t = e^{\theta_t} F((X_{j,t})_{j \in [0,1]})$ , where  $\theta_t$  is an aggregate TFP shock and  $F(\cdot)$  is a standard constant-elasticity-of-substitution aggregator. The intermediate-goods firms thus face the same demand and operate the same technology. We let this symmetry extend to prices ( $P_{j,t} = P_t$  for all  $j$ ) but add nominal rigidity by imposing the following, ad hoc, backward-looking Phillips curve:

$$\Pi_t \equiv \frac{P_t}{P_{t-1}} = \left( \frac{Y_{t-1}}{Y_{t-1}^*} \right)^\xi \quad (14)$$

where  $\Pi_t$  is (one plus) the inflation rate,  $Y_t^*$  is the natural or first-best rate of output,  $Y_t/Y_t^*$  is therefore a measure of the output gap, and  $\xi \in [0, 1)$  is a slope parameter. Perfectly rigid prices are nested with  $\xi = 0$ .<sup>26</sup>

**Fundamentals, First-best, and Liquidity Trap.** We assume the following structure for the shocks  $(\rho_t, \theta_t)$ . For all  $t \geq 3$ , both the discount factor and aggregate productivity are at their steady-state values:  $\rho_t = 0$  and  $\theta_t = 0$ . At  $t = 2$ , the discount factor is at its steady state, or  $\rho_2 = 0$ , but productivity is  $\theta_2 = \theta$  for some

<sup>26</sup>This formulation mimics the hybrid Phillips curves that best fit the data (Galí and Gertler, 1999) and that populate the DSGE literature (Christiano, Eichenbaum and Evans, 2005), but simplifies the analysis by abstracting from forward-looking price setting and from the distortionary effect of inflation on the cross-sectional allocation of resources. Also, as it will become clear momentarily, the restriction  $\xi < 1$  is needed in order to make sure that the inflation-spending spiral is not explosive.

random  $\theta$ . At  $t = 1$ , the discount factor is weakly higher than one, or  $\rho_1 = -\bar{\rho} - \Delta$ , for some  $\Delta \geq 0$ , and productivity is the same as in period 2, or  $\theta_2 = \theta_1 = \theta$ .

Given these assumptions, the first-best level of output and the associated natural rate of interest are

$$\log Y_t^* = \begin{cases} \theta & \text{for } t = 1 \\ \theta & \text{for } t = 2 \\ \bar{\rho} & \text{for } t \geq 3 \end{cases} \quad \text{and} \quad \log R_t^* = \begin{cases} -\Delta & \text{for } t = 1 \\ \bar{\rho} - \theta & \text{for } t = 2 \\ \bar{\rho} & \text{for } t \geq 3 \end{cases} \quad (15)$$

The zero-lower-bound (ZLB) constraint, on the other hand, requires  $R_t \geq 1$ . Without the constraint, the first best would be implemented with  $R_t = R_t^*$  and zero inflation. With the constraint, the policy in (15) can still be implemented for  $t \geq 2$ ,<sup>27</sup> but the ZLB necessarily binds at  $t = 1$ , weakly if  $\Delta = 0$  and strictly if  $\Delta > 0$ . This situation defines a liquidity trap and motivates the study of the following policy problem.

**The Policy Problem.** The monetary authority is bound by the ZLB during the trap ( $R_t = 1$  at  $t = 1$ ) and is also committed to replicating flexible-price outcomes in the long run ( $R_t = R_t^*$  and  $Y_t = Y_t^*$  at  $t \geq 3$ ). But it is free to lower  $R_2$  below  $R_2^*$ , and can offer forward guidance about any such plan at  $t = 1$ , in an attempt to stimulate aggregate demand during the trap. Finally, the monetary authority chooses its form of forward guidance—a commitment for  $R_2$  versus a commitment for aggregate employment and output—so as maximize the representative household's welfare.

## 6.2 Mapping to the Abstract Model

Let all lowercase variables be in log deviations from a steady state in which  $\rho_t = \theta_t = 0$ ,  $R_t = \exp(\bar{\rho})$  and  $\Pi_t = 1$ .<sup>28</sup> Similarly to [Angeletos and Lian \(2018\)](#), optimal consumption can be expressed as follows:

$$c_{it} = \mathbb{E}_{it} \left[ (1 - \beta) b_{it} + (1 - \beta) \sum_{k \geq 0} \beta^k y_{t+k} - \sum_{k \geq 0} \beta^k (r_{t+k} - \pi_{t+k+1} - \rho_t) \right] \quad (16)$$

where  $\beta \equiv \exp(-\bar{\rho}) \in (0, 1)$  is the steady-state discount factor. This is the Permanent Income Hypothesis, modified to allow for a time-varying real interest rate and a discount-rate shock. Note in particular that  $\sum_{k \geq 0} \beta^k y_{t+k}$  captures permanent income and  $(1 - \beta)$  captures the marginal propensity to consume (MPC). The following Lemma summarizes how we can use this elementary result along with market clearing and the Philips curve (14) to derive simple expressions for aggregate income (equivalently, aggregate spending) in periods 1 and 2.

**Lemma 4.** *Aggregate income in periods 1 and 2 satisfy*

$$y_1 = \bar{\mathbb{E}} \left[ -\beta^2 r_2 + (1 - \beta + \beta \xi)(y_1 + \beta y_2) + M_1 \right] \quad \text{and} \quad y_2 = -\frac{1}{1 - \xi} r_2 + M_2, \quad (17)$$

*up to constants  $(M_1, M_2)$ , which are functions of  $\theta$ ,  $\bar{\rho}$ , and  $\Delta$  but are invariant to policy.*

<sup>27</sup>For the ZLB not to bind at  $t = 2$ , and otherwise not matter as long as  $\rho_t \equiv 0$ , we assume that  $\theta < \bar{\rho}$  always.

<sup>28</sup>This rule holds with the exception of  $b_{it}$ , which is defined as the simple, linear deviation from steady state, because the steady state value of assets is zero.

The first equation is a modified Keynesian cross: it combines the GE feedback between income and spending with the GE feedback between inflation, real interest rates, and spending. The second equation shows that period 2 income is directly proportional to the policy instrument.

To map to the abstract model, we define  $\tau$  as a rescaling of  $-r_2$ , the degree of policy looseness;  $k_i$  as a rescaling of  $c_{i1}$ , spending during the liquidity trap; and  $Y$  as a rescaling of  $y_1 + \beta y_2$ , the relevant notion of permanent income. We can then derive the following result.

**Lemma 5.** *The the liquidity-trap context described above maps to conditions (1) and (2) with parameters*

$$\gamma = 1 - \beta^2(1 - \xi)^2 \quad \text{and} \quad \alpha = \frac{1}{1 + \beta(1 - \xi)}. \quad (18)$$

*And by implication, the degrees of strategic complementarity and substitutability in the games following instrument and target communication are given by, respectively,*

$$\delta_\tau = 1 - \beta(1 - \xi) \quad \text{and} \quad \delta_Y = -\beta \cdot (1 - \xi). \quad (19)$$

A higher MPC (lower  $\beta$ ) and a steeper Phillips curve (higher  $\xi$ ) thus both map to a more positive  $\delta_\tau$  and a less negative  $\delta_Y$ , which via Lemma 3 translates to the following:

**Lemma 6.** *A higher MPC and/or a steeper Phillips curve raises  $|\kappa_\tau - 1|$ , the distortion in the response of  $K$  to forward guidance under instrument communication, and reduces  $|\kappa_Y - 1|$ , the corresponding distortion under target communication.*

This offers a first clue about how to translate our earlier, abstract insights to the present context. But to complete the translation, we must verify that the applicable policy objective can be represented in the way assumed in our abstract analysis.

The second-order approximation of welfare is

$$\mathcal{W} = \mathcal{W}^* - (y_1 - y_1^*)^2 - \beta(y_2 - y_2^*)^2,$$

where  $\mathcal{W}^*$  is the first-best level and  $y_t - y_t^*$  is the output gap in period  $t$ . Using the fact that  $y_1^* = y_2^* = \theta$  and the applicable transformation of variables, we reach the following result:

**Lemma 7.** *The welfare losses relative to the first best can be represented as*

$$L = (1 - \chi)(K - \theta - (1 - \xi)\Delta)^2 + \chi(\tau - \theta)^2, \quad (20)$$

where  $\chi \equiv \frac{\beta(1-\xi)^2}{1+\beta(1-\xi)^2}$  and where, recall,  $\Delta$  measures the distance of the natural rate of interest at  $t = 1$  from the ZLB.

This helps clarify the following two points. First, the policy objective obtained in (20) is nested in Proposition 3 if and only if  $\Delta = 0$ , or the ZLB is “weakly” binding. This is the analogue of Assumption 1 in the present context and its role is explored in the next subsection. Second, in the model considered thus far, the  $\beta$  behind  $\chi$  is the same as the  $\beta$  that regulates the MPC and enters  $\gamma$  and  $\alpha$ . However, if we consider an overlapping generations (OLG) extension along the lines of [Del Negro, Giannoni and Patterson \(2015\)](#), [Farhi and Werning \(2019\)](#) and in particular [Angeletos and Huo \(2020, Section 7\)](#), we can disentangle the two objects and interpret a high MPC, or a low  $\beta$  in (18) and (19) for given  $\chi$  in (20), as a proxy for liquidity constraints. We adopt this interpretation throughout.

### 6.3 Optimal Forward Guidance at the ZLB

Building on the above results, we reach the following translation of Theorem 2:

**Proposition 9.** *Suppose  $\lambda \neq 1$  and  $\Delta = 0$ , and let  $m$  measure the marginal propensity to consume. There exists a critical threshold  $\hat{m}$  such that target communication is optimal if and only if  $m \geq \hat{m}$ . Furthermore,  $\hat{m}$  decreases in  $\xi$ , the slope of the Phillips curve.*

In other words, “talking about unemployment rather than interest rates” becomes more desirable when the Keynesian cross gets steeper, as in the case of worsening credit conditions, or the deflationary spiral gets stronger. And although our model is too stylized for quantitative purposes, the following back-of-the-envelope exercise offers a useful illustration.

Interpret a period in our model as four years, so that the liquidity trap has a realistic length in light of the Great Recession; let the policymaker weigh equally the output gaps during and after the trap; let  $\lambda = .75$ , which amounts to assuming that 75% of the population are fully rational, level- $\infty$  agents and the remaining are unsophisticated, level-0 agents; and finally let  $\xi = 0$ , which amounts to assuming completely rigid prices and unresponsive inflation. In this case, target-based forward guidance is optimal whenever the annualized MPC exceeds 0.14.

The typical estimate of the average annualized MPC in the US and other advanced countries is close to 0.30 (e.g., [Jappelli and Pistaferri, 2010](#)), suggesting that the condition  $m > \hat{m}$  is likely to be satisfied in practice. What is more, previous work has shown how realistic, joint heterogeneity in the MPC and the business cycle exposure maps to a higher slope of the Keynesian cross ([Patterson, 2019](#)) and how this in turn amplifies the importance of higher-order doubts (Section 7 in [Angeletos and Huo, 2020](#)). In the light of our results, such HANK-like heterogeneity seems likely to favor target-based forward guidance.

The above back-of-the envelope exercise assumed  $\xi = 0$ , or perfectly rigid prices. If instead we set the slope of the Phillips curve to  $\xi = 4 \times 0.1$ , which translates a 1% output shortfall to an annual deflation of merely 0.1%, then the relevant threshold reduces to  $\hat{m} = 0$ : target communication is *always* preferred. This illustrates how target-based forward guidance becomes more desirable as the deflationary spiral kicks in.

Let us now consider the role of  $\Delta$ . The translation of Theorem 2 offered in Proposition 9 relies on  $\Delta = 0$ , which means that the ZLB is weakly binding, or equivalently that Assumption 1 holds. In the more realistic case in which the ZLB is strictly binding ( $\Delta > 0$  and  $R_1^* < 1$ ), Assumption 1 no more holds. This of course does not affect our results about implementability (Theorem 1 and Lemma 6), but enters the policymaker’s calculation as follows:

**Proposition 10.** *For  $\lambda < 1$ , increasing  $\Delta$  marginally from  $\Delta = 0$  favors target communication if  $\theta > 0$  and instrument communication if  $\theta < 0$ . And the opposite is true for  $\lambda > 1$ .*

That is, the influence of  $\Delta > 0$  on the ranking between instruments and targets flips sign with the sign of the productivity shock, as well as with the direction of the departure from rational expectations.

Let us explain why. When  $\Delta > 0$ , the policymaker is combating an inefficient recession at  $t = 1$ , regardless of the value of  $\theta$ . But the value of  $\theta$  influences whether the policymaker would like the public to over- or under-react. When  $\theta > 0$ , the policymaker wants to engineer a boom at  $t = 2$  and therefore has “good

news” to share with the economy. And because such good news can alleviate the inefficient recession at  $t = 1$ , policymaker prefers on the margin that the public *over-react* to it. Target communication, in our main specification of  $\lambda < 1$ , fulfills this role. When instead  $\theta < 0$ , the policymaker would prefer for the “bad news” to not overly affect behavior at  $t = 1$ ; and with  $\lambda < 1$ , this goal is achieved with instrument communication. Finally, with  $\lambda > 1$ , the logic about how the sign of  $\theta$  influences the desirability of over- or under-reaction remains valid, but the means of accomplishing such over- and under-reaction flip.

In short, our take-home lesson remains valid at least “on average” (i.e., across realizations of  $\theta$  or parameterizations of  $\lambda$ ). One way to formalize this idea is the following:

**Corollary 4.** *Suppose that the policymaker is restricted to using the same form of forward guidance across all  $\theta$  and to implementing a linear relation between  $\theta$  and  $\tau$  (or  $Y$ ) Then, Proposition 9 extends to any  $\Delta > 0$ , and the threshold  $\hat{m}$  is invariant to  $\Delta$ .*

The above restriction forces the policymaker to calculate things “on average” (in expectation over realizations of  $\theta$ ), balances the  $\theta$ -dependent effects of  $\Delta > 0$ , and recovers the result for  $\Delta = 0$ . The same applies if we replace this restriction space with appropriate uncertainty about  $\lambda$ , the error in people’s reasoning.

## 6.4 Talking About Inflation or Other Targets

So far we have let the monetary authority communicate a commitment for either  $r_2$ , the post-trap interest rates, or  $y_1 + \beta y_2$ , the cumulative income during and after the trap. This was the most direct mapping between the application and our abstract framework. But the application raises the possibility that the policymaker tries to communicate other kinds of commitments, such as about inflation.

By the Phillips curve (14), a commitment for  $\pi_3$  is the same as a commitment for  $y_2$ ; and by the second part of Lemma 4, this is also the same as a commitment for  $r_2$ . Talking about  $\pi_3$  or  $y_2$  is therefore the same as instrument communication. A commitment for  $\pi_2$ , on the other hand, is the same a commitment for  $y_1$ , or  $K$ . But as noted earlier (and explained in more detail in Appendix D.1), such a commitment is not viable in our model. And a commitment for cumulative inflation,  $\pi_2 + \beta\pi_3$ , is the same as a commitment for  $y_1 + \beta y_2$ , that is, target communication.

We conclude that, at least in the context of our stylized model, there is essentially no room for other forms of forward guidance than those already considered. Reality is of course more complicated and future extensions of our model may help shed further light on the finer details of optimal policy communication. For instance, it seems useful to consider an extension that lets unobserved cost-push or other shocks to drive a wedge between inflation and output gaps. We expect this to favor output or employment targets over inflation targets, at least insofar as such shocks are essentially “noise” from the policymaker’s perspective. This circles back to our discussion of how our insights interact with those of [Poole \(1970\)](#).

Another possibility, close to the spirit of our paper and also broadly consistent with the evidence reviewed in [Candia, Coibion and Gorodnichenko \(2020\)](#), is that people fail to understand the GE mapping from inflation to real interest rates and aggregate demand and, instead, are likely to interpret a commitment for higher inflation merely as bad news about real wages and purchasing power. This, too, seems likely to favor “taking about unemployment” over “talking about inflation.”

## 7 The Fed's Experiment with Target Communication

This paper's analysis is normative rather than positive. Still, it is useful to relate our insights to actual experience so as to further contextualize our results.

The Fed's initial approach to forward guidance during the Great Recession was based on a timeline for interest rates to remain near zero. This is typified in the August 9, 2011, statement that economic conditions merited "exceptionally low levels for the federal funds rate at least through mid-2013." In December 2012, however, the Fed sharply pivoted to a strategy that highlighted a 6.5% unemployment rate as a specific pre-requisite for increasing interest rates.<sup>29</sup>

While the actual statement hedged with goals for inflation and other contingencies, it is not unreasonable to call this, in our language, as a switch from instrument communication to target communication. As [Alan S. Blinder \(2018\)](#) wrote in a retrospective analysis, much of the public seemed only to hear the following:

The Fed would begin to raise rates as soon as the unemployment rate dipped below 6.5 percent. Period.

What is more, this seems to have been largely expected by the Fed, if not fully intended. During the December 2012 FOMC deliberations, San Francisco Fed President [John C. Williams](#) argued:

We should recognize we are shining a very bright spotlight on the unemployment rate. ... When we stated a specific date for lift-off, the spotlight was cast on the calendar, and that's what everyone focused on, for better or for worse. Once we start talking in terms of an unemployment threshold, it will be the unemployment rate that takes center stage, commanding all of the attention of our audience.

Minneapolis Fed President [Narayana Kocherlakota](#) similarly commented that, absent "the perfect description of a reaction function," attempting to describe more complicated contingencies would be "letting the perfect be the enemy of the good."

Our theory offers a new way to think about these issues. The Great Recession was an unusual episode during which two conditions were satisfied. First, GE feedbacks were amplified because of both the ZLB and the credit crunch. Second, economic agents were presumably more likely to make mistakes in reasoning about how the economy works, or how other may respond to policy, simply because this time was unprecedented. Under the lens of [Theorem 2](#), such an episode is exactly the right time to "shine the spotlight on unemployment." And for the reasons alluded to at the end of [Section 5.5](#), the attempt to describe more complicated contingencies could have backfired by confusing people and amplifying the mistakes in their equilibrium reasoning.

The proximate cause of the switch may have been uncertainty about the length and severity of the recession. But it is anyone's guess whether this was merely uncertainty about the economy's hard fundamentals, in the sense that may be best captured by a [Poole \(1970\)](#) model, or also uncertainty about when

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<sup>29</sup>The strategy was popularly dubbed the "Evans rule" in reference to one of its chief proponents, Chicago Fed President Charles Evans. For additional context and retrospective policy analysis, see reviews by [Blinder et al. \(2017\)](#) and [Feroles et al. \(2017\)](#).

and how public confidence would be restored, which is the focus of our own analysis. To the extent that the latter maps in the theory to higher-order beliefs or mistakes in equilibrium reasoning, the actual reasons behind the switch may have been correlated with the issues considered in this paper, even though policymakers at the time may not have reasoned through our theory.

Did the switch work as predicted by our theory? While the data from this one episode is insufficient to test our theory, there are hints of a trade-off between anchoring instrument and target expectations, in line with our theory.

Consider first the Fed's explicit date-based guidance in late 2011 and early 2012. On the one hand, the Fed was able to move expectations about interest rates to an extent that it could not during the previous, weaker regime of communication (see, e.g., Swanson and Williams, 2014; Williams, 2016). On the other hand, Andrade et al. (2019) show in professional forecast data that the same focusing of interest rate expectations coincided with an *increase* in the dispersion of GDP forecasts. This is consistent with our theory's claim that instrument communication is successful in anchoring expectations of interest rates only at the expense of increasing the uncertainty about how the economy would respond to them.<sup>30</sup>

Finally, the December 2012 shift in the Fed's communication strategy coincided with a reduction in GDP forecast dispersion (see again Andrade et al., 2019) at the expense of an increase in interest-rate forecast dispersion. This is again consistent with our theory's proposition that target communication helps anchor expectations of outcomes. And it raises the possibility that the policy shift may have—perhaps unintentionally but favorably—reduced the period of time that the economy had to be stuck at the ZLB.<sup>31</sup>

## 8 Conclusion

Should a policymaker offer clarity about policy instruments, for instance by outlining a time-path for interest rates or a dollar amount for fiscal stimulus, or should she instead shine the spotlight on the relevant outcome, for instance by promising to do whatever it takes to hit a target for unemployment?

We first showed that this choice is irrelevant in a frictionless, Ramsey benchmark where the policymaker has full commitment, the relevant state-contingencies can be fully articulated, and the public is unboundedly rational. We then relaxed the last assumption, allowing people to have a shallow or distorted understanding of others' behavior and of the GE implications of policy. We explained why and how this breaks the aforementioned irrelevance and provided a new gauge for how forward guidance should be conducted in such circumstances. This gauge is summarized below:

*The optimal strategy shifts from instrument-based to target-based forward guidance, or from anchoring expectations of interest rates to anchoring expectations of unemployment and income, as Keynesian multipliers, financial accelerators, and other GE feedbacks get larger.*

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<sup>30</sup>To be precise, the kind of anchoring featured in our theory manifests in the cross section of beliefs as soon as we introduce heterogeneity in  $\lambda$ .

<sup>31</sup>This is the point we anticipated at the end of Section 5.5: the reduction in the expected value of  $\tau$  needed to induce the desired expected value of  $Y$  translates, in the present context, to less monetary loosening needed *after* the economy has exited the liquidity trap, or a faster "lift-off" date, while achieving the same stimulating effect during the trap.

Why? Instrument-focused communication leaves the public to reason about the effect of interest rates on aggregate employment and income. Target-focused communication does the opposite, sacrificing clarity about the policy for more anchoring of the expectations of targeted outcome. A larger GE multiplier makes expectations of aggregate outcomes such as employment and income more essential for private decisions, and any mistakes thereof more detrimental for welfare, which tilts the balance toward target-focused communication.

The irrelevance result that served as our point of departure echo related results from the Ramsey literature about the equivalence of different implementations. From this perspective, a high-level contribution of our paper is to illustrate both how such results hinge on *infinite* depth of knowledge and rationality, and how more “sophisticated” policies can regulate the bite of bounded rationality. Exploring our insights in other contexts, such as Ricardian equivalence (Barro, 1974) or the equivalence of monetary policy and taxation (Correia, Nicolini and Teles, 2008; Correia et al., 2013), is left for future work.

Our analysis focused on “Odyssean” forward guidance: we abstracted from signaling, or the “information effect” of monetary policy, and equated different communication strategies with different commitments. At the same time, our analysis abstracted from commitment problems: forward guidance was fully credible. Commitment problems can exist with rational expectations and have been the topic of a large literature. Perhaps more intriguingly, our analysis has hinted at how the private sector’s bounded rationality could itself be the source of time-inconsistency. The exploration of this issue, too, is left for future work.

Another interesting direction for future research is the application of our insights to the theory of optimal policy rules, and in particular optimal Taylor rules for monetary policy. The conventional approach is based on either the idea of replicating certain state-contingencies or the logic of Poole (1970). Our approach instead highlights how different policy rules can influence the strategic interaction among the private agents and, thereby, the bite of higher-order beliefs and of related forms of bounded rationality.<sup>32</sup>

Finally, our paper has provided a new theoretical context for a growing empirical literature on the effectiveness of central bank communication in moving the beliefs of both experts (Campbell et al., 2012; Ehrmann et al., 2019) and the general public (Coibion, Gorodnichenko and Weber, 2019; Coibion et al., 2019). Most of this literature focuses on information revelation—think, in particular, of the communication of the central bank’s forecasts about future economic conditions. We instead have focused on the commitments embedded in central bank communications and have argued that such commitments may fruitfully manage private sector expectations especially when the latter are not fully rational. We hope this perspective can inform more empirical or experimental work.

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<sup>32</sup>A formal treatment of this idea within our framework is offered in Online Appendix H. The application to richer, dynamic, macroeconomic models remains to be done.



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## A Proofs

### Proposition 1, Corollary 1, Theorem 1, Corollary 2, and Lemma 1

In main text.

### Lemma 2

This proof supplements the simpler argument given in the main text and reveals the role of higher-order beliefs. By iterating the best responses in the representation  $K = (1 - \delta_X)X + \delta_X \bar{\mathbb{E}}[K]$ , provided that  $|\delta_X| < 1$ , we can express the expectation of  $K$  as a weighted average of the higher-order beliefs about  $X$ :

$$\bar{\mathbb{E}}[K] = \bar{\mathbb{E}} \left[ (1 - \delta_X) \sum_{h=1}^{\infty} (\delta_X)^{h-1} \bar{\mathbb{E}}^h[X] \right]. \quad (21)$$

Because we have let the typical agent believe that only a fraction  $\lambda$  of the other agents is aware of the policy message, her second-order beliefs satisfy

$$\mathbb{E}_i [\bar{\mathbb{E}}^1[X]] = \mathbb{E}_i [\mathbb{E}_j[X]] = \lambda \hat{X} + (1 - \lambda)0 = \lambda \hat{X}.$$

By aggregation and induction, for any  $h \geq 1$ ,

$$\bar{\mathbb{E}}^h[X] = \lambda^h \hat{X}. \quad (22)$$

Relative to the frictionless benchmark (nested here with  $\lambda = 1$ ), higher-order beliefs are therefore more rigid (i.e., anchored to 0), and the more so the higher their order.

It follows that  $\bar{\mathbb{E}}[K]$ , a weighted average of higher-order beliefs, is also rigid. By direct calculation, the action  $K$  is

$$\begin{aligned} K &= (1 - \delta_X) \sum_{h=1}^{\infty} (\delta_X)^{h-1} \bar{\mathbb{E}}^h[X] \\ &= (1 - \delta_X) \sum_{h=1}^{\infty} (\delta_X)^{h-1} \lambda^h X \end{aligned} \quad (23)$$

while the expectation thereof is

$$\begin{aligned} K &= \bar{\mathbb{E}} \left[ (1 - \delta_X) \sum_{h=1}^{\infty} (\delta_X)^{h-1} \bar{\mathbb{E}}^h[X] \right] \\ &= (1 - \delta_X) \sum_{h=1}^{\infty} (\delta_X)^{h-1} \lambda^{h+1} X \\ &= \lambda K \end{aligned} \quad (24)$$

The last line is the desired result.

### Lemma 3

By direct calculation, using the best response  $K = (1 - \delta_X)X + \delta_X \bar{\mathbb{E}}[K]$  and the result from Lemma 2 that  $\bar{\mathbb{E}}[K] = \lambda K$ , we compute

$$\kappa_X(\lambda, \gamma) = \frac{1 - \delta_X}{1 - \lambda \delta_X} \quad (25)$$

for each communication method. Observe that:

1. For  $\lambda < 1$ ,  $\kappa_X > 1$  if and only if  $\delta_X < 0$ ; otherwise, if  $\delta_X > 0$ ,  $\kappa_X < 1$ .

2. The derivative of  $\kappa_X$  in  $\lambda$  is

$$\frac{\partial \kappa}{\partial \lambda} = \delta_X \frac{(1 - \delta_X)}{(1 - \lambda \delta_X)^2} \quad (26)$$

which has the same sign as  $\delta_X$  provided that  $\delta_X < 1$ , which is always satisfied.

3. The derivative of  $\kappa_X$  in  $\gamma$  is

$$\begin{aligned} \frac{\partial \kappa}{\partial \gamma} &= \frac{\partial \kappa}{\partial \delta_X} \cdot \frac{\partial \delta_X}{\partial \gamma} \\ &= -\frac{1 - \lambda}{(1 - \lambda \delta_X)^2} \cdot \frac{\partial \delta_X}{\partial \gamma} \end{aligned} \quad (27)$$

which has the opposite sign as  $\frac{\partial \delta_X}{\partial \gamma}$ .

We now review how to apply the previous points to derive each of the results for instrument and target communication.

### Instrument Communication.

1.  $\delta_\tau = \alpha \gamma \in (0, 1)$  provided that  $\alpha \in (0, 1)$  and  $\gamma \in (0, 1)$ . Thus  $\kappa_\tau < 1$ .

2. By the same argument,  $\frac{\partial \kappa}{\partial \lambda} < 0$ .

3.  $\frac{\partial \delta_X}{\partial \gamma} = \alpha > 0$  so  $\frac{\partial \kappa}{\partial \gamma} < 0$ . As  $\kappa_\tau < 1$ , this implies  $|1 - \kappa_\tau|$  increases in  $\gamma$ .

### Target communication.

1.  $\delta_Y = -(1 - \gamma)\alpha / (1 - \alpha) < 0$  for any  $\alpha \in (0, 1)$  and  $\gamma < 1$ . Thus  $\kappa_Y > 1$ .

2. By the same argument,  $\frac{\partial \kappa}{\partial \lambda} > 0$ .

3.  $\frac{\partial \delta_X}{\partial \gamma} = \alpha / (1 - \alpha) > 0$  so  $\frac{\partial \kappa}{\partial \gamma} < 0$ . As  $\kappa_Y > 1$ , this implies  $|1 - \kappa_Y|$  decreases in  $\gamma$ .

### Proposition 3

To prove this proposition, we will directly establish the monotonicity of the loss functions  $\mathcal{L}_\tau(\gamma)$  and  $\mathcal{L}_Y(\gamma)$ , corresponding to the loss under method  $\tau$  or  $Y$ , evaluated at the optimal announcement, as a function of the underlying parameter  $\gamma$  for fixed values of all other parameters.

Let the implementable outcomes under each communication method take the form

$$\mathcal{B}_X = \{(\tau, K, Y) : \tau = r\theta, K = a_X \tau, Y = b_X \tau\} \quad (28)$$

for some  $r \in \mathbb{R}$  and coefficients  $(a_X, b_X)$ . Observe that, based on previous calculations,  $a_\tau = \kappa_\tau < 1$ ,  $b_\tau = \mu_\tau^{-1} < 1$ ,  $a_Y = \kappa_Y \mu_Y^{-1} > 1$ , and  $b_Y = \mu_Y^{-1} > 1$ .

For a given set of coefficients  $(a_X, b_X)$ , the policy problem simplifies to choice of  $r$ :

$$\mathcal{L}_X = \max_r \chi_\tau (r - 1)^2 + \chi_Y (r b_X - 1)^2 + \chi_K (r a_X - 1)^2 \quad (29)$$

The optimal choice of  $r$  solves

$$r^* = \frac{\chi_\tau + \chi_Y b_X + \chi_K a_X}{\chi_\tau + \chi_Y b_X^2 + \chi_K a_X^2} \quad (30)$$

Observe that  $r^* > 1$  for instrument communication, owing to the fact that  $a_\tau < 1$  and  $b_\tau < 1$ , and  $r^* \in (0, 1)$  for target communication, owing to the fact that  $a_Y > 1$  and  $b_Y > 1$ .

The derivative of  $\mathcal{L}_X$  in  $\gamma$  is the following, by the envelope theorem:

$$\frac{\partial \mathcal{L}_X}{\partial \gamma} = 2\chi_Y r(r b_X - 1) \frac{\partial b_X}{\partial \gamma} + 2\chi_K r(r a_X - 1) \frac{\partial a_X}{\partial \gamma} \quad (31)$$

Given that  $r > 0$ , observe that the sign of the above is the same as the sign of

$$\chi_Y(r b_X - 1) \frac{\partial b_X}{\partial \gamma} + \chi_K(r a_X - 1) \frac{\partial a_X}{\partial \gamma} \quad (32)$$

**Instrument communication.** Observe first that  $\mathcal{L}_\tau(0) = 0$  as  $a_\tau = b_\tau = 1$ . It remains to establish  $\frac{\partial \mathcal{L}_\tau}{\partial \gamma} > 0$  for  $\gamma \in (0, 1)$ . This requires showing

$$\chi_Y(r b_\tau - 1) \frac{\partial b_\tau}{\partial \gamma} > -\chi_K(r a_\tau - 1) \frac{\partial a_\tau}{\partial \gamma} \quad (33)$$

Note that  $\frac{\partial a_\tau}{\partial \gamma} = \frac{\partial \kappa_\tau}{\partial \gamma} < 0$ , according to Lemma 3, that  $b_\tau = (1 - \alpha) + \alpha a_\tau > a_\tau$ , and  $0 > \frac{\partial b_\tau}{\partial \gamma} = \alpha \frac{\partial \kappa_\tau}{\partial \gamma} > \frac{\partial a_\tau}{\partial \gamma}$ . Hence the above simplifies to

$$\frac{\chi_K}{\chi_Y} (1 - r a_\tau) > \alpha (r b_\tau - 1) \quad (34)$$

Observe next that, since  $a_\tau < b_\tau$ , it is guaranteed that

$$r a_\tau = \frac{\chi_\tau + \chi_Y a_\tau b_\tau + \chi_K a_\tau^2}{\chi_\tau + \chi_Y b_\tau^2 + \chi_K a_\tau^2} < \frac{\chi_\tau + \chi_Y b_\tau^2 + \chi_K a_\tau^2}{\chi_\tau + \chi_Y b_\tau^2 + \chi_K a_\tau^2} = 1$$

and hence the right condition is

$$\frac{\chi_K}{\chi_Y} > \alpha \frac{r b_\tau - 1}{1 - r a_\tau} \quad (35)$$

An immediate sufficient condition, which helps reveal the economics, is  $r b_\tau < 1$ : as long as the relation between the optimal policy only partially offsets the distortion, so that  $Y$  remains less responsive to  $\theta$  than under REE, the result goes through. Otherwise, the result will still be true provided the relative importance of the output gap is small. Direct calculation shows that (35) is equivalent to

$$(1 - \alpha \lambda \gamma) \chi_\tau + (1 - \alpha)(1 - \alpha \gamma(\lambda + (1 - \lambda)\alpha)) > 0 \quad (36)$$

which is verified in our parameter range.

**Target communication.** The argument for target communication is symmetric. Observe first that  $\mathcal{L}_Y(1) = 0$  as  $a_Y = b_Y = 1$ . It remains to establish  $\frac{\partial \mathcal{L}_Y}{\partial \gamma} < 0$  for  $\gamma \in (0, 1)$ . This requires showing

$$\chi_Y(r b_\tau - 1) \frac{\partial b_\tau}{\partial \gamma} > -\chi_K(r a_\tau - 1) \frac{\partial a_\tau}{\partial \gamma} \quad (37)$$



Note that  $\frac{\partial b_Y}{\partial \gamma} = -\frac{1}{\mu_Y^2} \frac{\partial \mu_Y}{\partial \gamma} > 0$ , by Theorem 1. Next  $a_Y = \kappa_Y \mu_Y^{-1} = \frac{\kappa_Y(1-\alpha)}{1-\alpha\kappa_Y} > 0$ . By direct calculation,

$$\frac{\partial b_Y}{\partial \gamma} = \frac{\alpha(1-\alpha)}{(1-\alpha\kappa_Y)^2} \frac{\partial \kappa_Y}{\partial \gamma} \quad \text{and} \quad \frac{\partial a_Y}{\partial \gamma} = \frac{1-\alpha}{(1-\alpha\kappa_Y)^2} \frac{\partial \kappa_Y}{\partial \gamma} \quad (38)$$

It follows that the relevant condition is

$$\frac{\chi_K}{\chi_Y} (r a_\tau - 1) > \alpha(1 - r b_\tau) \quad (39)$$

Observe next that, since  $a_Y > b_Y$ , it is guaranteed that  $r a_Y > 1$  and hence the right condition is, in direct analogy to (35),

$$\frac{\chi_K}{\chi_Y} > \alpha \frac{r b_Y - 1}{1 - r a_Y} \quad (40)$$

Direct calculation shows that (40) is true if and only if

$$1 + \alpha(-2 + \alpha\gamma + \lambda(1 - \gamma)) > 0 \quad (41)$$

but the above is guaranteed, for all  $\lambda$ , by  $\alpha < 1/(2 - \gamma)$  which was the pre-specified condition for stability.

#### Proposition 4

This is a simple calculation involving the following two steps. First, for each of instrument and target communication, we solve the best-response fixed point

$$K = \kappa_X X + \kappa_X^\varepsilon \varepsilon = (1 - \delta_X) X + \delta_X (\lambda(\kappa_X X + \kappa_X^\varepsilon \varepsilon) + \sigma \varepsilon)$$

where  $\kappa_X$  coincides exactly with the values given in Lemma 3 and  $\kappa_X^\varepsilon$  is a new loading on the belief shock given by

$$\kappa_X^\varepsilon = \frac{\sigma \delta_X}{1 - \lambda \delta_X}$$

Then, to get the implementability constraints, we solve the fixed-point

$$\tau = \mu_X Y + \psi_X \varepsilon = \frac{1}{1-\alpha} (Y - \alpha(\kappa_X X + \kappa_X^\varepsilon \varepsilon))$$

Which has solutions  $\mu_X$  given in Proposition 1 and  $\psi_X$  given by

$$\psi_\tau = -\kappa_\tau^\varepsilon \frac{\alpha}{1 - \alpha + \alpha \kappa_\tau}$$

$$\psi_Y = -\kappa_Y^\varepsilon \frac{\alpha}{1 - \alpha}$$

The expressions given in the text follow from plugging the primitive parameters into the previous expression.

**Proposition 5**

This is a simple extension of the proof of Theorem 2. Let us assume that  $\lambda \in [0, 1 + 1/\alpha)$ . This plays a similar role as the restriction  $\alpha < \frac{2}{1-\gamma}$ : it ensures convergence of iterated best-responses and thereby also that  $(\mu_\tau, \mu_Y) \in \mathbb{R}_+^2$ .

First, note that, using the same expressions from the proof of Proposition 1,  $\mu_\tau$  and  $\mu_Y$  both *decrease* in  $\gamma$  for  $\lambda > 1$ . Importantly, the comparative statics in the distortion  $|\mu_X - 1|$  are the same.

Second, consider the comparative statics for the variance contributions  $(\psi_\tau, \psi_Y)$ . Note that

$$\frac{\partial \psi_\tau}{\partial \gamma} = -\frac{\sigma \alpha^2}{(\alpha^2 \gamma (\lambda - 1) - \alpha \gamma \lambda + 1)^2} < 0$$

and  $\psi_\tau \leq 0$  as long as  $\lambda < 1/\alpha + 1$ . Finally,  $\psi_\tau = 0$  if  $\gamma = 0$ . Next,

$$\frac{\partial \psi_Y}{\partial \gamma} = \frac{\sigma \alpha^2}{(\alpha(1-\gamma)\lambda + 1 - \alpha)^2} > 0$$

and  $\psi_Y \leq 0$  for any value of  $\lambda$ . Finally,  $\psi_Y = 0$  if  $\gamma = 1$ .

Consider now the policy loss function. After substituting in the implementability constraint, the loss function under target communication for a given value of  $\theta$  is given by

$$\mathcal{L}_\tau \equiv \min_{r_\tau \in \mathbb{R}} \left[ \theta^2 (1 - \chi) (r_\tau - 1)^2 + \theta^2 \chi (r_\tau / \mu_\tau - 1)^2 + \chi \psi_\tau^2 \sigma^2 \right]$$

where we suppress the dependence on  $\theta$  for simplicity. The same problem with an unconditional expectation on  $\theta$  (i.e., an ex ante choice of method) would replace  $\theta^2$  with the fundamental's variance  $\sigma_\theta^2$ .

Let us now prove that, for fixed  $(\theta, \lambda, \sigma)$ , optimal policy is characterized by a threshold rule. For target communication, the appropriate translation of the loss function is

$$\mathcal{L}_Y \equiv \min_{r_Y \in \mathbb{R}} \left[ \theta^2 (1 - \chi) (r_Y - 1)^2 + \theta^2 \chi (r_Y / \mu_Y - 1)^2 + (1 - \chi) \psi_Y^2 \sigma^2 \right]$$

where we once again suppress the dependence on  $\theta$ . Via an identical argument to the one pursued in the proof of Theorem 2, each loss function is monotone in  $\gamma$  holding fixed the value of  $\psi_X$ . That is to say, if the loss functions were each re-written in the form  $\mathcal{L}_X = \ell_X(\mu_X, \psi_X)$ , then, for all  $\theta$ ,

$$\frac{\partial \ell_\tau}{\partial \mu_\tau} \frac{\partial \mu_\tau}{\partial \gamma} > 0 \quad \frac{\partial \ell_Y}{\partial \mu_Y} \frac{\partial \mu_Y}{\partial \gamma} < 0 \quad (42)$$

Showing the equivalent monotonicity via the second channel is simple using the previously proven comparative static for the  $\psi_X$ :

$$\frac{\partial \ell_\tau}{\partial \psi_\tau} \frac{\partial \psi_\tau}{\partial \gamma} = 2\chi \sigma^2 \psi_\tau \frac{\partial \psi_\tau}{\partial \gamma} > 0 \quad \frac{\partial \ell_Y}{\partial \psi_Y} \frac{\partial \psi_Y}{\partial \gamma} = 2\chi \sigma^2 \psi_Y \frac{\partial \psi_Y}{\partial \gamma} < 0 \quad (43)$$

and combining (42) and (43) is sufficient to prove

$$\frac{\partial \ell_\tau}{\partial \gamma} > 0 \quad \frac{\partial \ell_Y}{\partial \gamma} < 0$$

Finally, note that previous argument about continuity and extreme values from the proof of Theorem 2 also carries over. In particular, for all  $\theta$ ,

$$\mathcal{L}_\tau|_{\gamma=0} = \mathcal{L}_Y|_{\gamma=1} = 0$$

and

$$\mathcal{L}_\tau|_{\gamma=1} \geq 0 \quad \mathcal{L}_Y|_{\gamma=0} \geq 0$$

with the last two inequalities being strict so long as  $\theta \neq 0$  or  $\sigma > 0$ . Hence, generically speaking (for  $\theta \neq 0$  or  $\sigma > 0$ ), there exists a  $\hat{\gamma} \in (0, 1)$  such that target communication is strictly optimal when  $\gamma \in (\hat{\gamma}, 1]$ , instrument communication is optimal when  $\gamma \in [0, \hat{\gamma})$ , and the policymaker is indifferent at  $\gamma = \hat{\gamma}$ .

### Corollary 3

Let us finally consider the case of uncertain distortions. Note that, for every  $(\lambda, \sigma)$  and every value of  $\theta \neq 0$ ,  $\gamma \mapsto \mathcal{L}_\tau(\cdot; \lambda, \sigma)$  and  $\gamma \mapsto \mathcal{L}_Y(\cdot; \lambda, \sigma)$  have all the relevant monotonicity and limit-value properties because of Proposition 5 (see also the proof thereof). It follows that the average  $\gamma \mapsto \mathbb{E}_{\pi(\lambda, \sigma)}[\mathcal{L}_X(\cdot; \lambda, \sigma)]$ , where the relevant expectation is over possible values of  $(\lambda, \sigma)$  in accordance with prior  $\pi$ , maintains the same properties. Hence these “expected loss functions” must cross at some  $\hat{\gamma} \in (0, 1)$ , completing the proof.

### Proposition 6

See Appendix G.

### Propositions 7 and 8

See Appendix F.

### Lemmas 4, 5, 6, and 7

We prove these results together by detailing the mapping to the abstract model step-by-step.

The average consumption of agents at time  $t$  can be expressed as the following function of current and future real interest rates, income, and discount rate shocks:

$$c_t = (1 - \beta) \sum_{j=0}^{\infty} \beta^j \bar{\mathbb{E}}_t[y_{t+j}] + \beta \sum_{j=0}^{\infty} \beta^j \bar{\mathbb{E}}_t[-(r_{t+j} - \pi_{t+j+1} - \rho_t)] \quad (44)$$

where  $\beta \equiv \exp(-\bar{\rho})$  is the steady-state discount factor. This expression is obtained by substituting the consumer’s Euler equation into his lifetime budget constraint and solving for consumption. It represents the optimal consumption in period  $t$ , as a function of the expected path of income and interest rates, and identifies  $1 - \beta$  with the marginal propensity to consume out of income.

Inflation is

$$\pi_t = \xi(y_{t-1} - \theta_{t-1}) \quad (45)$$

Note that  $y_t = r_t = \pi_{t+1} = 0$  for  $t \geq 3$  as the economy returns to steady state.

Consider first aggregate consumption and income at  $t = 2$ . We assume that, at this point, all agents have the same (rational) expectations. It is simple to apply forward-looking rational expectations in (44) to get

$$c_2 = -\beta r_2 + (1 - \beta + \beta\xi)y_2 - \beta\xi\theta$$

which solves, after imposing market clearing, to

$$c_2 = y_2 = -\frac{1}{1-\xi}(r_2 + \xi\theta) \quad (46)$$

where the last step uses the fact that  $r_s = 0$  for all  $s \geq 3$ .

Next let us solve for individual consumption in period 1. In this case, (44) reduces to the following after substituting out inflation rates as a function of the relevant output gaps:

$$c_{i,1} = \mathbb{E}_i [(1 - \beta)b_{i,1} - \beta^2 r_2 + (1 - \beta + \beta\xi)(y_1 + \beta y_2)] + \beta(\rho + \bar{\rho}) - \beta(1 + \beta)\xi\theta \quad (47)$$

Note that the first term disappears because we assume initial asset positions are symmetric, which along with the fact that aggregate assets are zero gives  $b_{i1} = 0$  for all  $i$ .

We can now derive the mapping to the abstract model. Let

$$\tau \equiv -r_2 \quad (48)$$

be the negative real interest rate at  $t = 2$ . A higher  $\tau$  corresponds to looser monetary policy after the trap. Next, let

$$K \equiv (1 - \xi)^2 c + b_k$$

be a normalized measure of aggregate spending during the crisis, defined up to constant  $b_k = \xi(2 - \xi)\theta - (1 - \xi)(\rho + \bar{\rho})$ . Finally, let

$$Y \equiv \frac{1}{\beta + (1 - \xi)^{-1}}(y_1 + y_2) + \frac{b_k}{\beta(1 - \xi)^2 + (1 - \xi)} \quad (49)$$

be a normalized measure of total output during and right after the liquidity trap.

We can re-write the definition of  $Y$  in the following form:

$$Y = \frac{\beta(1 - \xi)}{1 + \beta(1 - \xi)}\tau + \frac{1}{1 + \beta(1 - \xi)}K, \quad (50)$$

which matches condition (1) in our abstract framework for

$$\alpha = \frac{1}{1 + \beta(1 - \xi)}. \quad (51)$$

Condition (47), on the other hand, can be written as:

$$k_i = \beta^2(1 - \xi)^2 \mathbb{E}_i[\tau] + (1 - \beta^2(1 - \xi)^2) \mathbb{E}_i[Y], \quad (52)$$

which matches condition (2) in our abstract framework for

$$\gamma = 1 - \beta^2(1 - \xi)^2. \quad (53)$$

The expressions for  $\delta_\tau$  and  $\delta_Y$  follow from direct calculation. The implications for  $\kappa_\tau$  and  $\kappa_Y$ , described in Lemma 6, follow from identical logic as the proof of Lemma 3.

The final step is to calculate the welfare objective as in Lemma 7. We approximate the policymaker's utilitarian objective around the case in which the first-best is implemented by a (possibly infeasible) monetary policy. In log deviations, this yields the following loss function, up to rescaling:

$$L = (y_1 - \theta)^2 + \beta(y_2 - \theta)^2. \quad (54)$$

Each quadratic term incorporates both the concavity of the utility function and the disutility of labor. This is because, for given  $\theta$ , labor hours and output have a fixed proportion to one another.

Plugging in our definitions of  $K$  and  $\tau$  yields

$$L = (K - \theta + (1 - \xi)(\rho + \bar{\rho}))^2 + \beta(1 - \xi)^2(\tau - \theta)^2, \quad (55)$$

This is the same as (20), with

$$\chi \equiv \frac{\beta(1 - \xi)^2}{1 + \beta(1 - \xi)^2} \in (0, 1) \quad \text{and} \quad \Delta \equiv -(\rho + \bar{\rho}) \geq 0.$$

### Proposition 9

Observe that

$$\delta_\tau = \alpha\gamma = 1 - \beta(1 - \xi) \quad \delta_Y \equiv -\frac{\alpha}{1 - \alpha}(1 - \gamma) = -\beta(1 - \xi) \quad (56)$$

And since  $\beta \in (0, 1)$  and  $\xi \in (0, 1)$ ,

$$-1 < \delta_Y < 0 < \delta_\tau < 1.$$

As noted in the main text, both  $\delta_\tau$  and  $\delta_Y$  decrease in  $\beta$  and increase in  $\xi$ . Identical arguments to those in Lemma 3, and the proof thereof, show that, under instrument communication,  $K = \kappa_\tau \tau$  where

$$\kappa_\tau(\beta, \xi) = \frac{\beta(1 - \xi)}{1 - \lambda + \lambda\beta(1 - \xi)} \quad (57)$$

obeys the following properties for all  $\lambda \in (0, 1)$ :  $\kappa_\tau < 1$  and  $|1 - \kappa_\tau|$  decreases with  $-\beta$  and  $\xi$ . The implementable sets under instrument communication have the form

$$\mathcal{A}_\tau = \{(\tau, K) : \tau = r\theta, K = a_\tau \tau\} \quad (58)$$

where  $a_\tau = \kappa_\tau$ .

Next, direct calculation shows that the implementable set under target communication is a locus

$$\mathcal{A}_Y = \{(\tau, K) : \tau = r\theta, K = a_Y \tau\} \quad (59)$$

where

$$a_Y(\beta, \xi) = \kappa_Y(\beta, \xi) \cdot \frac{1 - \alpha}{1 - \alpha\kappa_Y(\beta, \xi)} = \frac{1}{\lambda} \quad (60)$$

This slope therefore has no dependence on deep parameters  $(\beta, \xi)$ .

Let us now establish the two desired properties of the optimal communication strategy. Consider first the dependence of optimal communication on the discount rate  $\beta$ . Let  $\ell_\tau(\beta, \xi; \chi)$  denote the policymaker's loss under target communication as a function of  $(\beta, \xi)$ , *holding fixed* the value of  $\chi = \frac{\bar{\beta}(1-\bar{\xi})^2}{1+\bar{\beta}(1-\bar{\xi})^2}$  for some  $\bar{\beta} \in (0, 1)$  and  $\bar{\xi} \in (0, 1)$ . This loss function can be re-written as

$$\ell_\tau(\beta, \xi; \chi) = \min_r [(1-\chi)(r-1)^2 + \chi(a_\tau(\beta, \xi) \cdot r - 1)^2] \quad (61)$$

where  $a_\tau$  depends on  $\beta$  and  $\xi$ . As in the proof of Theorem 2, after establishing that  $a_\tau(\beta, \xi) < 1$  and  $a_\tau(\beta, \xi) \cdot r^* < 1$ , it is straightforward to show that  $\partial \ell_\tau / \partial \beta$  has the same sign as  $\partial a_\tau / \partial \beta$ . The latter is negative so the former is negative: loss decreases as  $\beta$  increases.

The analogous loss function defined for target communication,

$$\ell_Y(\beta, \xi; \chi) = \min_r [(1-\chi)(r-1)^2 + \chi(1/\lambda \cdot r - 1)^2] \quad (62)$$

is invariant as a function of  $\beta$ . Let  $L(\chi)$  denote its level. It follows that a decrease in  $\beta$  strictly increases the difference  $\ell_\tau(\beta; \chi) - \ell_Y(\beta; \chi) = \ell_\tau(\beta; \chi) - L(\chi)$  for any value of  $\chi$ .

Toward showing the desired threshold characterization of the optimal policy, observe there are three possible cases:

1. If  $\ell_\tau(1; \chi) > L(\chi)$ , then  $\ell_\tau(\beta; \chi) > L(\chi)$  for all  $\beta \in (0, 1)$ . Thus target communication is optimal over the entire parameter space, the critical threshold for  $\beta$  is  $\hat{\beta} = 1$ .
2. If  $\ell_\tau(0; \chi) < L(\chi)$ , then  $\ell_\tau(\beta; \chi) < L(\chi)$  for all  $\beta \in (0, 1)$ . Thus instrument communication is optimal over the entire parameter space,  $\hat{\beta} = 0$ .
3. If neither of the previous is true, then  $\ell_\tau(1; \chi) < L < \ell_\tau(0; \chi)$ . Note also that  $\ell_\tau(\beta; \chi)$  is a continuous, increasing function of its first argument. It follows that there exists some threshold  $\hat{\beta} \in (0, 1)$  below which target communication is optimal.

Next, we establish the comparative static in  $\kappa$ . Note first that, for a fixed policy objective, higher  $\kappa$  favors target communication for the exact same reason described above. The log difference between loss with instrument and target communication is

$$\begin{aligned} D &\equiv \log \ell_\tau(\beta, \xi; \chi) - \log \ell_Y(\beta, \xi; \chi) \\ &= 2 \log \left( \frac{1 - a_\tau^{-1}}{1 - a_Y^{-1}} \right) - \log \left( \frac{a_\tau^{-2}(1-\chi) + \chi}{a_Y^{-2}(1-\chi) + \chi} \right) \end{aligned} \quad (63)$$

Only the last term depends on  $\chi$ , and since  $a_\tau < 1$  and  $a_Y > 1$ , then  $\frac{\partial D}{\partial \chi} > 0$ . Finally, observe that  $\frac{\partial \chi}{\partial \xi} > 0$ , so an increase in  $\kappa$  increases  $\Delta$  through its effect on the policy objective holding fixed its effect on  $(a_\tau, a_Y)$ .

Next, observe that  $\ell_\tau(\beta, \xi; \chi)$  is a strictly increasing function of  $\xi$ , holding fixed preferences, according to the same arguments used in the context of  $\beta$ ;  $\ell_Y(\beta, \xi; \chi)$  is invariant in  $\xi$ ; and hence  $\ell_\tau(\beta, \xi; \chi) - \ell_Y(\beta, \xi; \chi)$  strictly increases in  $\xi$ , holding fixed preferences.

The two facts together establish that the preference for target communication increases in  $\kappa$ . Given the previous characterization of optimal policy as a threshold in  $\hat{\beta}$ , it must be the case that the aforementioned threshold is non-increasing in  $\xi$ . Finally, to complete the proof, note that a threshold in  $\hat{\beta}$  can be trivially translated into a threshold in the annualized MPC  $m = (1 - \beta)/T$ , where  $T$  is a period length.

**Proposition 10**

The objective function, up to terms outside the policymaker's control, can be written as

$$L = \min_r [\theta^2(1 - \chi)(r - 1)^2 + \theta^2\chi(a_X r - 1)^2 + 2\chi\theta \cdot \Delta \cdot a_X r] \quad (64)$$

Let  $L_X$  denote be the loss function under strategy  $X$ ,

$$L_X = \theta^2(1 - \chi)(r - 1)^2 + \theta^2\chi(a_X r_X - 1)^2 + 2\chi\theta \cdot \Delta \cdot a_X r_X \quad (65)$$

where  $r_X$  solves the optimization in (64).

By the envelope theorem, the change in objective from a marginal change in  $\Delta$  is

$$\frac{\partial L_X}{\partial \Delta} = 2\chi\theta \cdot a_X r_X \quad (66)$$

Applying the previous,

$$\frac{\partial(L_\tau - L_Y)}{\partial \Delta} = 2\chi\theta(a_\tau r_\tau - a_Y r_Y) \quad (67)$$

As established in the proof of Proposition 9, when  $\Delta = 0$  and  $\lambda < 1$ , we have  $a_\tau r_\tau < 1$  and  $a_Y r_Y > 1$  for any value of  $1 - \beta$  or  $\xi$ , and hence  $\frac{\partial(L_\tau - L_Y)}{\partial \Delta} < 0$ .

This implies that when  $\Delta$  marginally decreases, or  $|\Delta|$  marginally increases, then

1. Losses marginally increase for instrument relative to target communication when  $\theta > 0$ .
2. Losses marginally decrease for instrument relative to target communication when  $\theta < 0$ .

This implies that the region of parameters for which target communication is optimal increases in the first case and the region of parameters for which target communication is optimal decreases in the second case.

Next, consider the case of  $\lambda > 1$ . It is straightforward to extend Lemma 6 and Proposition 9 to show (i)  $a_\tau > 1$  and  $a_\tau r_\tau > 1$  and (ii)  $a_Y < 1$  and  $a_Y r_Y < 1$  in this context. The results follow from reversing the previous logic in this proof to this new case.

**Corollary 4**

Taking into account the implementability constraint, the policymaker's problem can be re-expressed as follows:

$$\min_{r, X \in \{\tau, Y\}} \int [\theta^2(1 - \chi)(r - 1)^2 + \theta^2\chi(a_X r - 1)^2 + 2\chi\theta \cdot \Delta \cdot a_X r] dF(\theta) \quad (68)$$

where  $F(\theta)$  is the distribution from which  $\theta$  is drawn. Given that  $\theta$  has mean 0 and variance  $\sigma_\theta^2$ , this problem reduces to

$$\min_{r, X \in \{\tau, Y\}} \sigma_\theta^2 [\theta^2(1 - \chi)(r - 1)^2 + \theta^2\chi(a_X r - 1)^2] \quad (69)$$

This is identical to the policy problem solved in Proposition 9. Hence all properties of the solution identified in Proposition 9 carry over.

# Online Appendices [not intended for publication]

## B A Neoclassical Application

Our primary application, spelled out in Section 6, concerns monetary policy and output gaps in a Keynesian economy. The micro-foundation offered here differs in its approach (Neoclassical), policy instrument (taxation), and key decision (investment).

### B.1 Primitives

There are three periods,  $t \in \{0, 1, 2\}$ . A continuum of firms or entrepreneurs,  $i \in [0, 1]$ , choose investment at  $t = 1$ . Investment is an intermediate input that enters the production of a final good at  $t = 2$ , along with the labor supply by a representative worker. The first period,  $t = 0$ , identifies only the time of policy announcement. We now review each of these ingredients in turn.

**Final good production at  $t = 2$ .** The final-good firm operates at  $t = 2$ . Define the following constant elasticity of substitution (CES) aggregator of the intermediate goods

$$X \equiv \left( \int x_i^{1-\frac{1}{\varepsilon}} di \right)^{\frac{\varepsilon}{\varepsilon-1}} \quad (70)$$

where  $\varepsilon \in (1, \infty)$  is the inverse elasticity of substitution. The final goods firm operates with a Cobb-Douglas technology over this intermediate and labor with capital share  $\alpha$ :

$$Q = X^\alpha N^{1-\alpha} \quad (71)$$

The firm operates competitively and has the following revenue

$$Q - wN - \int p_i x_i di \quad (72)$$

where  $w$  is the wage and the  $(p_i)_{i \in [0,1]}$  are the prices of the intermediates.

The final goods firm's demand for intermediates is

$$p_i = \alpha Q X^{\frac{1}{\varepsilon}-1} x_i^{-\frac{1}{\varepsilon}} \quad (73)$$

and their demand for labor is

$$w = (1 - \alpha) \frac{Q}{N} \quad (74)$$

**Representative worker.** A representative worker lives only in period  $t = 2$ . They consume at level  $C_w$  and supply  $N$  hours of labor, to maximize their utility, given by

$$\mathcal{U}_w = \log C_w - \frac{1}{1+\phi} N^{1+\phi} \quad (75)$$

where  $\phi > 0$  parameterizes the Frisch elasticity of labor supply. Their income equals the sum of labor earnings, taxed at rate  $z$ , and a transfer  $T$ :



$$C_w \leq w(1-z)N + T$$

The transfer rebates the tax, or  $T = zwN$ . Labor supply has the following simple form:

$$w(1-z) = N^\phi C_w \quad (76)$$

which, combined with (74), fully characterizes the labor market.

**Entrepreneurs and investment at  $t = 1$ .** At  $t = 1$ , the entrepreneur is endowed with one unit of the final good, which they choose how to allocate between current consumption,  $c_{i,1}$ , and investment,  $x_i$ , into the next-period production of an intermediate good. The technology is linear, and the productivity is set to one for simplicity, so the quantity of the intermediate good produced and sold at  $t = 2$  is also  $x_i$ . The entrepreneur's consumption at  $t = 2$  is given by the proceeds of selling the intermediate good, or  $c_{i,2} = p_i x_i$ . His preferences are linear:

$$\mathcal{U}_e = c_i^1 + c_i^2.$$

It follows that

$$\mathcal{U}_e = 1 - x_i + p_i x_i.$$

where  $p_i$  is given by (B). The entrepreneur therefore chooses investment,  $x_i$ , so as to maximize the net payoff  $p_i x_i - x_i$ , subject to (B). This yields the following optimality condition:

$$x_i^{\frac{1}{\varepsilon}} = \alpha(1 - \varepsilon^{-1})\mathbb{E}_i \left[ X^{\alpha + \frac{1}{\varepsilon} - 1} N^{1-\alpha} \right] \quad (77)$$

**Policy preferences.** For simplicity, the policymaker cares only about the representative worker's welfare but cannot directly transfer consumption from the entrepreneurs to the worker. Instead, she must use the single available tax instrument, the proportional tax on the second-period final good, to balance two objectives: encourage investment by the entrepreneurs so as to increase aggregate the consumption of workers; and collect tax revenue so as to pay for a public good.

The policymaker wishes to maximize the utility of the worker, but also has an external value for tax revenues  $rwN$ . Assume that external benefit is linearly separable in the policymaker's preferences, has a log functional form, and has weight  $\xi$  relative to the worker's welfare. The policymaker thus wishes to maximize

$$\mathcal{W} = \log C_w - \frac{N^{1+\phi}}{1+\phi} + \xi \log(rwN). \quad (78)$$

The primitive shock of interest in our model will be  $\xi$ , which is a pure shifter of the policymaker's preferences.

(78) can be justified as follows. Let the underlying government budget constraint take the form  $rwN \geq g$ , where  $g$  is the exogenous and random level of government spending. Provided that  $g$  is bounded away from zero, we can re-write this constraint as  $\log(rwN) \geq \log g$ . This yields (78) as the Lagrangian of this problem, with  $\xi$  being positive and increasing in  $g$ . And since there is a one-to-one mapping between  $g$  and  $\xi$ , we can treat the latter as the "fundamental" for our purposes.

## B.2 Benchmark with REE and Optimal Policy

Assume rational expectations. Let us first characterize implementable equilibria indexed by the tax rate  $r$ . In such an equilibrium, the agent will conjecture that  $x_{-i} = x_i \equiv X$ . Since everything is now known, we can pull  $X$  out of the expectation and solve to get

$$X_i = X = (\alpha(1 - \varepsilon^{-1}))^{\frac{1}{1-\alpha}} N$$

It is immediate that output is linear in labor:

$$Q = X^\eta N^{1-\eta} = (\alpha(1 - \varepsilon^{-1}))^{\frac{\alpha}{1-\alpha}} N$$

and finally note from the worker's budget constraint that consumer income equals consumer spending, or  $C_w = wN = (1 - \alpha)Q$ .

Setting labor supply to labor demand gives

$$N = (1 - z)^{\frac{1}{1+\phi}} \tag{79}$$

which corresponds to output level

$$Q = (\alpha(1 - \varepsilon^{-1}))^{\frac{\alpha}{1-\alpha}} (1 - z)^{\frac{1}{1+\phi}} \tag{80}$$

and investment level

$$X_i = X = (\alpha(1 - \varepsilon^{-1}))^{\frac{1}{1-\alpha}} (1 - z)^{\frac{1}{1+\phi}}$$

The policymaker chooses one of the implementable allocations, as described by (79) and (80), to maximize its objective function (78). We appeal to standard arguments to write the problem in the “dual” form as a function of the policy instrument. Substituting out the production function gives the following representation of the policy problem:

$$\max_r \left\{ (1 + \xi) \log((1 - \alpha)X^\alpha N^{1-\alpha}) - \frac{N^{1+\phi}}{1 + \phi} + \xi \log((1 - \alpha)z) \right\} \tag{81}$$

and further substituting in the implementability constraints for  $(X, N)$  gives the following up to constants:

$$\max_z \{ (1 + \xi) \log(1 - z) + z + \xi(1 + \phi) \log z \} \tag{82}$$

The first-order condition is

$$1 + \frac{\xi(1 + \phi)}{z} = \frac{(1 + \xi)}{1 - z} \tag{83}$$

There are two solutions to this, and the relevant one that corresponds to a minimum of the objective is

$$z^*(\xi) = \frac{1}{2} \left( \sqrt{\xi^2(2 + \phi)^2 + 4(1 + \phi\xi)} - \xi(2 + \phi) \right) \tag{84}$$

which increases in  $\xi$ , the government's preference for raising revenue.

### B.3 Forward Guidance

At  $t = 0$ , the policymaker learns its preference shifter  $\xi$  and decides to levy a tax or subsidy. They have two options. The first is to announce and commit to a fixed level of the tax  $z$  at  $t = 2$ . The second is to commit to a given level of output, and adjust *ex post* the tax such that, for a pre-determined level of the capital stock, the output target is met. Observe that, under rational expectations, the two approaches are equivalent; but under non-rational expectations they may differ.

### B.4 Mapping to the Abstract Behavioral Equations

Now consider a more general model in which agents do not form rational expectations, because of either limited information or various behavioral biases. The fixed-point equation 77 can no longer be solved without expectations. To make progress, we will take log-linear approximations around a case in which the government preference shock is at a steady-state value, or  $\xi = \bar{\xi}$ , and the tax is set at the (rational-expectations-implementation) optimum that achieves the second-best, or  $z = \bar{z} = z^*(\bar{\xi})$ . Let  $(\bar{Q}, \bar{N}, \bar{X})$  denote output, labor, and investment evaluated at this point. Let  $Y = \log Q - \log \bar{Q}$ ,  $k_i = (\log x_i - \log \bar{X})$ ,  $K = \int_i k_i di$ , and  $n = \log N - \log \bar{N}$  be log deviations of the first two quantities. Further, define

$$\tau = \frac{1}{1+\phi} \log \left( \frac{1-z}{1-\bar{z}} \right) \approx -\frac{1}{1+\phi} (z - \bar{z})$$

as a convenient transformation of the tax, which is higher when the tax is relatively low and lower when the tax is relatively high.

Aggregate production is log-linear, or  $Y = (1 - \alpha)n + \alpha K$ . And, up to log deviations, labor is the same as the rescaled tax:  $n = \tau$ . Hence we recover the abstract model's equation

$$Y = (1 - \alpha)\tau + \alpha K \tag{85}$$

in which  $\alpha$  has a structural interpretation as the capital share of income. The direct effect of policy, with weight  $1 - \alpha$ , comes entirely through the expansion of labor demand.

Let us now turn to the investment decision (77). To a log-linear approximation, it is

$$k_i = \varepsilon \mathbb{E}_i[Y] + (1 - \varepsilon) \mathbb{E}_i[K]$$

After substituting in equilibrium  $K$  from the production function, this simplifies to

$$k_i = (1 - \gamma) \mathbb{E}_i[\tau] + \gamma \mathbb{E}[Y] \tag{86}$$

for feedback parameter

$$\gamma \equiv \frac{1}{\alpha} - \varepsilon \left( \frac{1}{\alpha} - 1 \right) \tag{87}$$

This parameter is in the domain  $(-\infty, 1]$ , reaching the latter for  $\varepsilon = 1$ . It is positive if and only if

$$\varepsilon < 1 + \alpha$$

or the aggregate demand externality is sufficiently strong relative a threshold that decreases in the capital share of income. Economically this means that the force of the aggregate demand externality, which works only through the accumulation of capital in the model, offsets the GE force of resource scarcity in the labor market.

## B.5 Policy Objective

We approximate objective (78) around the aforementioned steady-state with the second-best policy. This results in the following loss function:

$$(1 + \xi)(Y - Y^*)^2 + (1 + \phi)^2 (\phi(1 - \bar{r}) + \xi(1 - \bar{r})^2) (\tau - \tau^*)^2 \quad (88)$$

which maps to our abstract problem for target weight

$$\chi \equiv \frac{1 + \xi}{(1 + \phi)^2 (\phi(1 - \bar{r}) + \xi(1 - \bar{r})^2) + 1 + \xi} \quad (89)$$

and ideal points

$$Y^* = \tau^* = \theta \equiv (1 - z^*(\xi))^{\frac{1}{1+\phi}} \quad (90)$$

The policymaker cares both about hitting the second-best level of output and the second-best level of the policy instrument. The former measures the payoffs to the policymaker via both the household's consumption and the additional amount of tax revenue for a fixed tax rate. The latter measures the benefit of setting the right tax and not additionally distorting labor supply relative to the second-best benchmark.

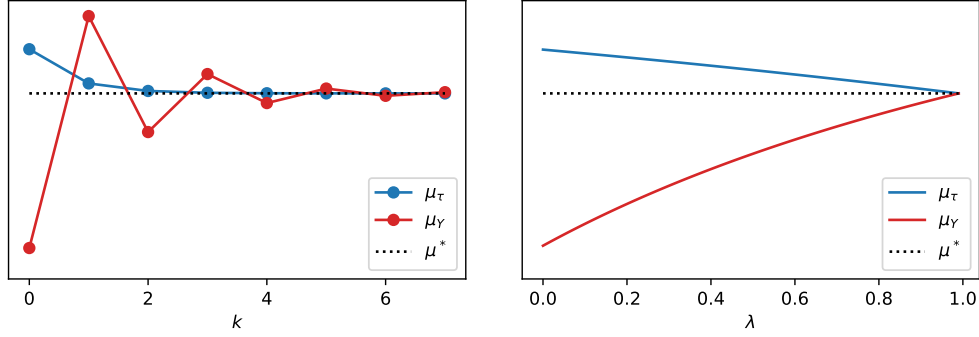


Figure 2: The implementability coefficients  $\mu_\tau$  and  $\mu_Y$  under Level- $k$  Thinking (left) and our main specification (right).

### C Level-k Thinking

The key mechanism in the main analysis is agents’ under-forecasting of others’ responses to the policy message: as demonstrated in Lemma 2,  $\bar{\mathbb{E}}[K]$  moves less than  $K$  in response to variation in  $\hat{X}$ . One could recast this as the consequence of agents’ bounded ability to calculate others’ responses or to comprehend the GE effects of the policy.

A simple formalization of such cognitive or computational bounds is Level- $k$  Thinking. This concept represents a relaxation of the part of Assumption 3 that imposes common knowledge of rationality: agents play rationally themselves, but question the rationality of others. In particular, this concept is defined recursively by letting the level-0 agent make an exogenously specified choice (this is the completely irrational agent), the level-1 agent play optimally given the belief that others are level-0 (this agent is rational but believes that others are irrational), the level-2 agent play optimally given the belief that others are level-1, and so on, up to some finite order  $k$ . Level- $k$  Thinking therefore imposes a pecking order, with every agent believing that others are less sophisticated than herself in the sense that they base their beliefs on fewer iterations of the best responses than she does.

To see the implications of this concept in our context, assume all agents think to the same order  $k \geq 1$  and let the “base case” (level-0 behavior) correspond to  $K = 0$ . Because level- $k$  agents believe that all other agents are of cognitive order  $k - 1$ , the expectation of  $K$  is now given by

$$\bar{\mathbb{E}}[K] = (1 - \delta_X) \sum_{h=0}^{k-1} (\delta_X)^h \hat{X} = (1 - (\delta_X)^k) \hat{X}. \quad (91)$$

For *even*  $k$  and  $\delta_X \in (-1, 1)$ , this always implies a dampened response of beliefs to the fundamental. Outcomes  $K = ((1 - \delta_X) + \delta_X(1 - (\delta_X)^k)) \hat{X}$  have dampened response to  $\hat{X}$  for  $\delta_X > 0$  and amplified response for  $\delta_X < 0$ . These distortions remain monotone in the extent of strategic interaction in either direction,  $|\delta_X|$ . Intuitively, higher  $|\delta_X|$  puts higher weight on agents’ faulty reasoning. As such our core results readily extend to this case.

The equivalence, however, breaks down for any odd number  $k$  because Level- $k$  Thinking displays a

peculiar, “oscillatory” behavior in games of strategic substitutability. In our context, this problem emerges with target communication, precisely because this induces a game of strategic substitutability.

Let us explain. For any given announcement, an agent wants to invest more when he expects others to invest less. Because the level-0 agent is assumed to be completely unresponsive, a level-1 agent expects  $K$  to move *less* than in the frictionless benchmark and thus moves *more* himself. A level-2 agent then expects  $K$  to move *more* than in the frictionless benchmark and therefore chooses to move *less* himself. That is, whereas  $k = 0$  amplifies the actual response of investment relative to rational expectations,  $k = 1$  attenuates it. The left panel of Figure 2 shows that this oscillatory pattern continues for higher  $k$ , and that this oscillation with target communication is the only qualitative difference between the present specification and that studied as our baseline.

We are not aware of any experimental evidence of this oscillatory pattern. We suspect that it is an unintended “bug” of a solution concept that was originally developed and tested in the experimental literature primarily for games of strategic complementarity and may not be applicable to games of strategic substitutability without appropriate modification. Seen from this perspective, the formalization adopted in the main text captures the essence of Level- $k$  Thinking while bypassing its “pathological” feature.

The same goal can be achieved with a “smooth” version of Level- $k$  Thinking along the lines of [Garcia-Schmidt and Woodford \(2019\)](#). The concept of “cognitive discounting” introduced in [Gabaix \(2020\)](#) works in a similar manner, too, because it directly postulates that the subjective expectations of endogenous variables such as  $K$  move less than the rational expectations of it.

## D Communicating Other Objects

Our focus on communicating  $\tau$  or  $Y$  seemed natural for applications. But, for completeness, we discuss here the possibilities of committing to a target for the aggregate action  $K$  or communicating the realized value of  $\theta$  along with (or perhaps instead of) a policy plan.

### D.1 Communicating a target for $K$

Consider the scenario in which the policymaker commits to a target for  $K$ , instead of a value for  $\tau$  or  $Y$ . This option may be impractical if  $K$  stands for a complex set of decisions that is hard to measure. But even abstracting from such measurement issues, this option is not well-posed in our model.

Consider in particular the specification studied in Section 3.3 and let the policymaker announce and commit to a value  $\hat{K}$  for aggregate investment. Assume that first-order beliefs about investment are correct ( $\bar{\mathbb{E}}[K] = \hat{K}$ ) and higher-order beliefs are sticky around zero ( $\bar{\mathbb{E}}^h[K] = \lambda^{h-1} \hat{K}$ ). For the announcement to be fulfilled in equilibrium, it must be the case that

$$\hat{K} = (1 - \delta_X) \bar{\mathbb{E}}[X] + \delta_X \bar{\mathbb{E}}[K] = (1 - \delta_X) \bar{\mathbb{E}}[X] + \delta_X \hat{K}$$

for either fundamental  $X \in \{\tau, Y\}$ . The only first-order beliefs compatible with this announcement, then, are  $\bar{\mathbb{E}}[\tau] = \bar{\mathbb{E}}[Y] = \bar{\mathbb{E}}[K] = \hat{K}$ : on average (and, in fact, uniformly), agents believe that equilibrium will be  $\tau = Y = K$ . This is an ideal scenario for the policymaker.

It turns out, however, that a rational agent who doubts the attentiveness of others will doubt that other agents play the announcement, or that  $K = \hat{K}$ . If a given agent  $i$  thinks that agent  $j$  plays  $k_j = \hat{K}$ , she is implicitly taking a stand on agent  $j$ 's beliefs about  $\tau$  and  $Y$ . Specifically, agent  $i$  believes that agent  $j$  is following her best response (here, written with  $X = \tau$ ), namely

$$\mathbb{E}_i[k_j] = (1 - \delta_\tau) \mathbb{E}_i \mathbb{E}_j[\tau] + \delta_\tau \mathbb{E}_i \mathbb{E}_j[K]$$

We have assumed that  $\mathbb{E}_i[k_j] = \hat{K}$  and  $\mathbb{E}_i \mathbb{E}_j[K] = \lambda \hat{K}$ . This produces the following restriction on second-order beliefs about  $\tau$ :

$$\mathbb{E}_i \mathbb{E}_j[\tau] = \frac{1 - \lambda \delta_\tau}{1 - \delta_\tau} \hat{K}.$$

This has a simple interpretation: to rationalize aggregate investment being  $\hat{K}$  despite the fact that fraction  $(1 - \lambda)$  of agents were inattentive to the announcement, agent  $i$  thinks that a typical other agent has *over*-forecasted the policy instrument  $\tau$ .

At the same time, agent  $i$  knows that, like himself, all attentive agents expect  $\tau$  to coincide with  $\hat{K}$ . And since agent  $i$  believes that the fraction of attentive agents is  $\lambda$ , the following restriction of second-order beliefs also has to hold:

$$\mathbb{E}_i \mathbb{E}_j[\tau] = \lambda \hat{K}.$$

When  $\lambda = 1$  (rational expectations), the above two restrictions are jointly satisfied for any  $\hat{K}$ . When instead  $\lambda < 1$ , this is true only for  $\hat{K} = 0$ . This proves the claim made in the text that, as long as  $\lambda < 1$ , there is no equilibrium in which is infeasible to announce and commit to any  $\hat{K}$  other than 0 (the default point).

In a nutshell, the problem with communicating  $K$  is that the policymaker has no direct control over it. From this perspective, output communication worked precisely because the policymaker had some plausible commitment. Agents could rationalize  $Y = \hat{Y}$  regardless of their beliefs about  $K$  because there always existed some level of  $\tau$  that implemented  $\hat{Y}$ .

## D.2 Expanding the message space

Return to the case in which the policymaker commits to a value for  $\tau$  or  $Y$  (conditional on  $\theta$ ), but allow her to provide an additional message of the form

$$m = a\theta + b\varepsilon$$

where  $a, b \in \mathbb{R}$  and  $\varepsilon$  is an arbitrary random variable. This could capture a perfect or imperfect signal of the fundamental, a “justification for the policy choice,” or some other arbitrary message. Let Assumption 4 apply to the vector  $(\theta, X)$ .

It is obvious that the additional message plays no role in the best response (7) or the expansion (22); does not enter the expression for  $K$ ; and thus does not affect the implementability constraint. Hence the implementable sets are the same as the ones given for instrument and target communication in Proposition 1. The messages provide no extra flexibility.

### D.2.1 Communicating only $\theta$

What about communicating a message *without* a policy plan? In particular, what if the policymaker communicates *only* the value of  $\theta$ ? In general, agents may have no idea what  $\theta$  means, or how to map its announced value to an expectation for  $\tau$  and  $Y$ . So, unless additional assumptions are made, this scenario is ill-posed.

One way to close this scenario is to assume that the agents have knowledge of the policymaker’s *entire* problem, namely her objective as given in (3), her set of options (pick a value for  $\tau$  or one for  $Y$ ), and her beliefs about the structure of the economy. The agents could then use this knowledge along with the announcement of  $\theta$  to figure out the policymaker’s choices. This would only replicate the outcomes of our baseline analysis, in an indirect and uninteresting way.

This is true, of course, insofar as the policymaker’s problem remains the same as in our baseline analysis: the policymaker is still committing to a value for  $\tau$  or  $Y$ , although “secretly” so. If, instead, the policymaker lacks commitment, they will expect her to play a different strategy. This takes us to the territory of Section H, where we explain why commitment is essential for regulating the bite of bounded rationality.



## E Convergent Higher-Order Beliefs

Most of our analysis restricts  $\alpha < \frac{1}{2-\gamma}$  so as to guarantee that  $-1 < \delta_X < 1$  for both form of forward guidance. The following technical lemma states and verifies this claim:

**Lemma 8.** *Let  $\gamma \in (-\infty, 1]$  and  $\alpha \in (0, 1)$ . The following statements are equivalent:  $|\delta_X| < 1$  for  $X \in \{\tau, Y\}$ ;  $\gamma > 2 - 1/\alpha$ ; and  $\alpha < 1/(2 - \gamma)$ .*

*Proof.* This is a very simple calculation. Note that  $\delta_Y < 0$  for any  $\gamma \leq 1$ , so  $\delta_Y < 1$  is guaranteed. The condition  $\delta_Y > -1$  re-arranges to

$$\delta_Y = -(1 - \gamma) \frac{\alpha}{1 - \alpha} > -1$$

This re-arranges to  $1 - \gamma < 1 - \frac{1}{\alpha}$  given  $\alpha \in (0, 1)$  and the previous re-arranges to  $\gamma > 2 - 1/\alpha$ . Finally, solving for  $\alpha$  gives  $\alpha < 1/(2 - \gamma)$ . Thus we have shown that  $|\delta_Y| < 1$ ,  $\gamma > 2 - 1/\alpha$ ; and  $\alpha < 1/(2 - \gamma)$  are interchangeable statements.

Note next that  $\delta_\tau < 1$  is guaranteed by  $\alpha \in (0, 1)$ .  $\delta_\tau > -1$  requires  $\gamma > -1/\alpha$ . But this is implied by  $\gamma > 2 - 1/\alpha$  and hence by  $\delta_Y > -1$ .  $\square$

This allows the characterization of beliefs and behavior by repeated iteration of the best responses. In particular, in Section 3 it guarantees that the joint of Assumptions 2 and 3 replicates the REE benchmark; in Appendix C, it guarantees that the Level- $k$  outcome converges to the REE outcome as agents become “infinitely rational” ( $k \rightarrow \infty$ ); and in Sections 3.3 and 5.3, it guarantees that Assumptions 4 and 5 yield the corresponding PBE outcomes. On a more technical level, restricting to  $\delta_Y > -1$  allows us to maintain  $\mu_Y > 0$ , which is important to the proofs of Theorem 2 and Proposition 3. This is established below:

**Lemma 9** (Sign of  $\mu_Y$ ). *Fix a value for  $\alpha$  and a domain  $\gamma \in G$ , with  $0 \in G$ , such that  $\delta_Y > -1$ . Then  $\mu_Y > 0$  on the same domain for all values of  $\lambda$ .*

*Proof.* Note that  $\mu_Y > 0$  when  $\kappa_Y < 1/\alpha$ . This reduces to to

$$\gamma\alpha(\lambda - \alpha) < 1 - \alpha(2 - \lambda)$$

Let’s consider three cases of this. First, assume that  $\lambda > \alpha$ . Some algebraic manipulation yields the condition

$$\gamma < 1 + \frac{(1 - \alpha)^2}{\alpha(\lambda - \alpha)}$$

which is obviously true for any  $\gamma < 1$ . Thus no more restrictions are required.

Next, consider  $\lambda = \alpha$ . The condition becomes

$$\alpha(2 - \alpha) < 1$$

which is always true for  $\alpha = \lambda \in (0, 1)$ .

Finally, consider  $\lambda < \alpha$ . In this case, the condition is

$$\gamma > \frac{1 + \alpha(\lambda - 2)}{\alpha(\lambda - \alpha)}$$

A strictly tighter condition is the same evaluated at  $\lambda = 0$ , which re-arranges to

$$\gamma > \frac{1}{\alpha} \left( 2 - \frac{1}{\alpha} \right) \quad (92)$$

Note that the restriction that  $\delta_Y > -1$  encodes the following restriction for fixed  $\alpha$  and all  $\gamma \in G$

$$\gamma > 2 - \frac{1}{\alpha} \quad (93)$$

as calculated in Lemma 8.

Evaluating this at  $\gamma = 0$ , which is within the domain  $G$  over which the condition must apply, gives  $\alpha < 1/2$ . When  $\alpha < 1/2$ , the right-hand-side of conditions (92) and (93) are both negative, and (93) implies (92). Clearly, this must apply for all  $\gamma \in G$  and  $\alpha$  such that (93) holds. This completes the proof. □

We think, for all the reasons above, it is most reasonable to restrict to  $|\delta_X| < 1$ . But for completeness we discuss here what happens otherwise. Consider first an “adversarial” selection of outcome in this case. This will only strengthen the case for the main results. For  $-1/\alpha < \gamma < 2 - 1/\alpha$ , we have  $\delta_Y < -1$  and  $\delta_\tau \in (-1, 1)$ . Instrument communication would clearly be preferred to prevent arbitrarily poor outcomes under target communication. To use an analogy which applies directly in our extension that considers policy rules (Section H), this is like picking a policy that obeys the Taylor principle over one that does not. For  $\gamma < -1/\alpha$ , we have both  $\delta_Y < -1$  and  $\delta_\tau < -1$ , so theory lacks a clear prediction under either communication strategy.

## F Connection to [Poole \(1970\)](#)

Our baseline model included exogenous shocks to the preferences of the policymaker but excluded such shocks from conditions (1) and (2). This is without loss of generality if the other shocks are common knowledge and observed by the policymaker. These assumptions are extreme, but common in the Ramsey policy paradigm. In our context, they guarantee that implementability results remain true provided that the quantities  $(\tau, Y)$  are re-defined to be “partialed out” from the extra shocks.

A more plausible scenario, perhaps, is that other shocks are unobserved and the policymaker cannot condition on them. This introduces into our analysis similar considerations as those in [Poole \(1970\)](#). The latter focused on how two different policies—fixing the interest rate or fixing the money supply—differed in their robustness to external shocks. Primitive shocks (to supply and demand) had different effects on the policy objective (output gap) depending on the slope of the model equations and the policy choice. Poole could do comparative statics of optimal policy in these slopes as well as the relative variance of the shocks.

Such “Poole considerations” can be inserted into our framework and will naturally affect the choice between fixing  $\tau$  and fixing  $Y$ . However, such consideration matter even in the REE benchmark and, roughly speaking, are separable from the mechanism we have identified in our paper.

**Shocks to output.** Consider now a model in which output contains a random component:

$$Y = (1 - \alpha)\tau + \alpha K + u,$$

where  $u$  is drawn from a Normal distribution with mean 0 and variance  $\sigma_u^2$ , is orthogonal to  $\theta$ , and is unobserved by both the policymaker and the private agents. In this case, announcing and committing to a value for  $Y$  stabilizes output at the expense of letting the tax distortion fluctuate with  $u$ . Conversely, announcing and committing to a value for  $\tau$  stabilizes the tax distortion at the expense of letting output fluctuate with  $u$ . It follows that, even in the frictionless benchmark ( $\lambda = 1$ ), the policymaker is no more indifferent between the two. In particular, target communication is preferable if and only if the welfare cost of the fluctuations in  $Y$  exceeds that of the fluctuations in  $\tau$ , which is in turn is the case whenever  $\chi$  is high enough.<sup>33</sup>

While these possibilities are interesting on their own right, they are orthogonal to the message of our paper. Indeed, the shock considered above does not affect the strategic interaction of the private agents under either the form of forward guidance: Lemma 1 remains the same. By the same token, when  $\lambda = 1$ , the sets of the implementable  $(\tau, Y)$  pairs remain invariant to  $\gamma$ , even though they now depend on the realization of  $u$ . It then also follows that, as long as  $\lambda = 1$ , the optimal communication strategy does not depend on  $\gamma$ .

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<sup>33</sup>The above scenario has maintained that the ideal level of output is  $Y^{\text{fb}} = \theta$ . What if instead  $Y^{\text{fb}} = \theta + u$ ? This could correspond to a micro-founded business-cycle model in which technology shocks that have symmetric effects on equilibrium and first-best allocations. Under this scenario, it becomes desirable to let output fluctuate with  $u$ , which in turn implies that instrument communication always dominates target communication with rational expectations. A non-trivial trade off between the two could then be recovered by adding unobserved shocks to the tax distortion. The optimal strategy is then determined by the relative variance of the two unobserved shocks and the relative importance of the resulting fluctuations, along the lines of [Poole \(1970\)](#).

As soon as  $\lambda < 1$ , the implementability sets and the optimal communication strategy start depending on  $\gamma$ , for exactly the same reasons as those explained before. To make this more clear, note that the implementable set for instrument communication is

$$\{(\tau, Y) : Y = \mu_\tau^{-1}\tau + u\}$$

which means the policymaker, free to choose announcement  $\tau = r_\tau\theta$ , can implement  $(\tau, Y)$  pairs of the form  $(r_\tau\mu_\tau^{-1}\theta, r_\tau\theta + u)$ .

Consider a policymaker who must commit ex ante, before the realization of  $\theta$ , to either instrument or target communication and a mapping from  $\theta$  to their announcement  $\hat{X}$ . This is a slightly different assumption than our main analysis, but an appropriate translation of the classic Poole problem. We could just as easily have assumed contingency on  $\theta$  but *not*  $u$ , with the minor change that optimal policy now depends on the realization of  $\theta$  in place of its ex ante variance.

The appropriate translation of the loss function is

$$\mathcal{L}_\tau \equiv \min_{r_\tau \in \mathbb{R}} \left[ \sigma_\theta^2 [(1-\chi)(r_\tau - 1)^2 + \chi(r_\tau/\mu_\tau - 1)^2] + \chi\sigma_u^2 \right]$$

where  $(\sigma_u^2, \sigma_\theta^2)$  are the respective variances of  $u$  and  $\theta$ . To re-iterate, were policy contingent on realized  $\theta$ , the same would apply with  $\theta^2$  in place of  $\sigma_\theta^2$ .

For target communication, the implementable set is

$$\left\{ (\tau, Y) : \tau = \mu_Y Y - \frac{u}{1-\alpha} \right\}$$

which means that, for announcement  $Y = r_Y\theta$ , the policymaker can implement  $(\tau, Y)$  pairs of the form  $(r_Y\mu_Y\theta - u/(1-\alpha), r_Y\theta)$ . The appropriate translation of the loss function is

$$\mathcal{L}_Y \equiv \min_{r_Y \in \mathbb{R}} \left[ \sigma_\theta^2 [(1-\chi)(r_Y - 1)^2 + \chi(r_Y/\mu_Y - 1)^2] + \frac{1-\chi}{(1-\alpha)^2} \sigma_u^2 \right]$$

Note that the extra terms that appear in the loss functions for  $\sigma_u^2 > 0$  have no dependence on  $\gamma$ . To map to the loss functions plotted in Figure 1 as a function of  $\gamma$ , each loss function is shifted above, but neither “twists” or loses its monotonicity in  $\gamma$ .

Finally, note that in expectation both implementable sets are the same as the ones that are presented in Theorem 1. This demonstrates Proposition 8. In particular, when  $\lambda = 1$  and  $\mu_\tau = \mu_Y = 1$ , the implementable sets are the same as the rational-expectations ones in Proposition 1. This demonstrates Proposition 7.

**Measurement errors and trembles.** The same logic as above applies if we introduce measurement errors in the policymaker’s observation of  $\tau$  and  $Y$ , or equivalently trembles in her control of these objects. To see this, consider a variant of our framework that lets the policymaker control either  $\tilde{\tau}$  or  $\tilde{Y}$ , where

$$\tilde{\tau} = \tau + u_\tau, \quad \tilde{Y} = Y + u_Y,$$

and the  $u$ 's are independent Gaussian shocks, orthogonal to  $\theta$ , and unpredictable by both the policymaker and the private agents. Instrument communication now amounts to announcing and committing to a value for  $\tilde{\tau}$ , whereas target communication amounts to announcing and committing to a value for  $\tilde{Y}$ .

By combining the above with condition (1), we infer that, under both form of forward guidance, the following restriction has to hold:

$$\tilde{Y} = (1 - \alpha)\tilde{\tau} + \alpha K + \tilde{u},$$

where

$$\tilde{u} \equiv -(1 - \alpha)u_{\tau} + u_Y.$$

At the same time, because the  $u$ 's are unpredictable, the best response of the agents can be restated as

$$k_i = (1 - \gamma)\mathbb{E}_i[\tilde{\tau}] + \gamma\mathbb{E}_i[\tilde{Y}].$$

This maps directly to the version with unobserved shocks just discussed above if we simply reinterpret  $\tilde{\tau}$ ,  $\tilde{Y}$ , and  $\tilde{u}$  as, respectively, the actual tax rate, the actual level of output, and the unobserved output shock.

To sum up, the presence of unobserved shocks and measurement error can tilt the optimal strategy of the policymaker one way or another in manners already studied in the literature that has followed the lead of [Poole \(1970\)](#). This, however, does not interfere with the essence of our paper's main message regarding the choice of a communication strategy as a means for regulating the impact of strategic uncertainty and the bite of the considered forms of bounded rationality.

## G Inattention vs. Distorted Reasoning

Our main analysis allows people to imperfectly reason about equilibrium, which is the friction of interest, but abstracts from the possibility that people are inattentive to forward guidance. In this appendix, we accommodate this possibility and study how it matters, or does not matter, for our paper’s lessons. In particular, we show that our main result (Theorem 2) remains intact if we let people be *rationally* inattentive and maintain our working hypothesis that the policymaker aims at getting the economy as close as possible to the rational-expectations outcome. But we also explore what happens away from this case.

### G.1 Implementability and distortions

We start with a reduced-form specification that let us flexibly incorporate both inattention and imperfect equilibrium reasoning. A specific micro-foundation in terms of information and priors will be provided in the next subsection.

Maintain that higher-order beliefs have the structure from Section 3.3, or

$$\bar{\mathbb{E}}^h[X] = \lambda^{h-1} \bar{\mathbb{E}}[X],$$

for some  $\lambda \in (0, 1]$  and all  $h \geq 2$ . But now let first-order beliefs satisfy

$$\bar{\mathbb{E}}[X] = qX,$$

for some parameter  $q \in (0, 1]$ . Our analysis so far is nested by  $q = 1$ . Inattention, rational or not, is introduced by letting  $q < 1$ . Alternatively,  $q < 1$  can be interpreted as the main specification of “sparsity” employed in Gabaix (2014) and Gabaix (2020).

Behavior is still determined by the solution to the following game:

$$k_i = \mathbb{E}_i [(1 - \delta_X)X + \delta_X K],$$

with  $X \in \{\tau, Y\}$  depending on the form of forward guidance. Aggregating this and replacing  $\bar{\mathbb{E}}[X] = q$ , we get

$$K = (1 - \delta_X)qX + \delta_X \bar{\mathbb{E}}[K],$$

which makes clear that aggregate behavior depends, not only on the average beliefs of  $K$ , but also on the average belief of  $X$ , which now moves less than to one-to-one with  $X$  insofar as  $q < 1$ . That said, the following property still holds:

$$\bar{\mathbb{E}}[K] = \lambda K.$$

This makes clear that  $\lambda$  alone pins down the perceived responsiveness of others relative the truth.

Theorem 1 readily extends modulo the following change in the slopes of the implementability constraints:

$$\mu_\tau = \left(1 - \alpha + \frac{1 - \alpha\gamma}{1 - \alpha\gamma\lambda} \alpha q\right)^{-1} \quad \text{and} \quad \mu_Y = \frac{1 - \alpha + \alpha(1 - \gamma)\lambda - \alpha(1 - \alpha\gamma)q}{(1 - \alpha)(1 - \alpha + \alpha(1 - \gamma)\lambda)}. \quad (94)$$

Instrument communication necessarily produces attenuation, or  $\mu_\tau > 1$ , because both frictions ( $q < 1$  and  $\lambda < 1$ ) work in the same direction. By contrast, the case for target communication is ambiguous ( $\mu_Y \leq 1$ ), because the amplification induced by rigid higher-order beliefs ( $\lambda < 1$ ) opposes the attenuation induced by inattention ( $q < 1$ ). Which effect dominates depends on the belief parameters ( $q, \lambda$ ) and the GE feedback  $\gamma$ , because the last interacts with rigid higher-order beliefs as explained in our main analysis.<sup>34</sup>

Finally, note that  $\mu_\tau = \mu_Y$  if and only if  $q = \lambda$ . In this knife-edge case, agents' perception of *all* variables, communicated directly or not, is uniformly dampened by a single parameter and, as a result, we recover irrelevance of the instrument-versus-target choice. We allude to this fact in our discussion of clarity and confidence in Section 7—a model with “plain” inattention does *not* capture our desired feature of relaxing the most essential property of (full information) rational expectations equilibrium, which is the interchangeability of different objects that appear in the equilibrium allocation.

## G.2 A signal extraction model

To provide a more specific structure for what  $q$  and  $\lambda$  mean as independent parameters, consider the following model of inattention with a behavioral twist. Let the announcement  $X$  be Gaussian with mean 0 and known variance  $\sigma_X^2$ .<sup>35</sup> Each agent, because of their inattention, observes in effect a noisy signal  $s_i = X + u_i$ , where  $u_i$  is idiosyncratic Gaussian noise with mean 0. Agent  $i$  perceives  $u_i$  to have variance  $\omega^2$ ; the noise actually has variance  $\xi^2$ , where  $\xi$  may or may not be the same as  $\omega$  depending on whether the agent has the correct prior about his cognitive capacities. It follows, from simple signal-extraction math, that the agent's own expectation of  $X$  is

$$\mathbb{E}_i[X] = \frac{\sigma_X^2}{\sigma_X^2 + \omega^2} (X + u_i).$$

This expression, averaged and then mapped to the reduced-form model for average expectations introduced in the previous subsection, gives  $\bar{\mathbb{E}}[X] = qX$  with

$$q \equiv \frac{\sigma_X^2}{\sigma_X^2 + \omega^2}.$$

When agents perceive their internal representations to have more noise (i.e.,  $\omega^2$  is higher),  $q$  becomes smaller and first-order beliefs are more attenuated. Note that there is no direct role for the actual noise variance  $\xi^2$  in determining the mean belief, which is sufficient for characterizing implementable allocations. Nonetheless, we can also define a “rational” signal-to-noise ratio, or

$$q^* \equiv \frac{\sigma_X^2}{\sigma_X^2 + \xi^2},$$

<sup>34</sup>Indeed, attenuation is obtained with target communication (i.e.,  $\mu_Y > 1$ ) if and only if  $q < \bar{q}(\lambda, \gamma) \equiv \frac{1-\alpha(1-(1-\gamma)\lambda)}{1-\alpha\gamma}$ . The threshold  $\bar{q}$  is increasing in both  $\lambda$  and  $\gamma$ , always exceeds  $\lambda$ , and reaches 1 when either  $\lambda = 1$  or  $\gamma = 1$ .

<sup>35</sup>This property will be maintained in the policy problem we consider if the underlying shock  $\theta$  is Gaussian with known variance, because  $X$  is itself proportional to  $\theta$  in equilibrium

which is a benchmark to which we can compare the actual outcome whenever subjective perceptions diverge from reality. When agents over-estimate their cognitive capacities or the precision of their information,  $\omega^2 < \xi^2$  and  $q > q^*$ . When they make the opposite mistake,  $\omega^2 > \xi^2$  and  $q < q^*$ .

The above completes the description of how agents think about *themselves*. Let us now turn to how they think about *others*. Agent  $i$  perceives any other agent  $j$  to receive a signal of the form  $X + u_j$ , where  $u_j$  has mean 0 and variance  $\tilde{\omega}^2$ , which again may not equal the true variance  $\xi^2$ . Agent  $i$  believes further that agent  $j$  will associate variance  $\tilde{\omega}^2$  with the signals of agents  $k \neq j$ , and so forth. It is simple to show that second-order beliefs thus satisfy

$$\mathbb{E}_i[\mathbb{E}_j[X]] = \mathbb{E}_i \left[ \frac{v^2}{v^2 + \tilde{\omega}^2} (X + u_j) \right] = \left( \frac{v^2}{v^2 + \tilde{\omega}^2} \right) \mathbb{E}_i[X]$$

Averaging and iterating this argument, we get  $\bar{\mathbb{E}}^h[X] = \lambda^{h-1} \bar{\mathbb{E}}[X]$  with

$$\lambda \equiv \frac{v^2}{v^2 + \tilde{\omega}^2}.$$

This scalar therefore depends exclusively on what each agent perceives to be the quality of *others'* information.

Note now that  $q \in (0, 1)$  and  $\lambda \in (0, 1)$  are guaranteed respectively by  $\omega^2 > 0$  and  $\tilde{\omega}^2 > 0$ , or positive perceived variances. The case  $q > \lambda$  is guaranteed by  $\omega^2 > \tilde{\omega}^2$ , or a given agent believing he is more informed and/or attentive than the average other agent. The opposite case,  $q < \lambda$ , is associated with the opposite, or a given agent's belief that others are more likely to be paying attention.

The canonical noisy rational expectations case is nested for  $\tilde{\omega}^2 = \omega^2 = \xi^2$ , or  $\lambda = q = q^*$ . But  $\omega^2 = \tilde{\omega}^2$ , or  $\lambda = q$ , alone is necessary for a model that, in terms of the equivalence between instrument and target communication irrelevance outcomes, is isomorphic to the noisy rational-expectations model.

Going back to the analysis of the previous subsection, recall that the implementability constraints depend only on  $q$  and  $\lambda$ , not on  $q^*$ . This is because, in a linear model such as ours, the actual level, or the value of  $q^*$ , does not matter at all for the *positive* properties of aggregate behavior; what matters is only people's subjective view of the world. But as we explain below,  $q^*$  matters for judging the *normative* implications of any given behavior.

### G.3 Rational inattention or “one-distortion case”

Our baseline analysis and the loss function (3) compared all allocations to the full-information, rational-expectations allocation. This may not be appropriate in an environment with *rational* inattention, as in [Sims \(2003\)](#) and large follow up literature. [Angeletos and Sastry \(2019\)](#) show that the introduction of such inattention *alone* does not upset the Welfare Theorems: there is no policy that can improve upon market outcomes. .

The basic intuition is that there is no good reason for the policymaker to try to correct people's behavior if any “friction” in it is merely the product of the agents' optimal use of limited information or limited cognitive capacity. To capture this idea in reduced form, we now consider an altered policy problem that



is “re-centered” around the rational expectations equilibrium (i.e., the one with *correct* perceptions of the noise variance).

Let us first consider the simplest such case, in which mis-perception of others’ precision of information is the only behavioral distortion. This means  $q = q^*$ , or agents correctly perceive their own precision, but  $\lambda \neq q = q^*$ , or agents mis-perceive others’ precision. Let  $\mu_{\text{in}}$  be the slope of the implementability constraint in a counterfactual world in which  $\lambda = q = q^*$ . Re-centering the policymaker’s objective around this reference point amounts to the following modification of the loss function:

$$L(\tau, Y, \theta) \equiv (1 - \chi)(\tau - \theta)^2 + \chi(Y - \theta/\mu_{\text{in}})^2. \quad (95)$$

This problem features only one distortion, relative over or under confidence, and thus resembles our baseline policy problem with a new “center point.” Given this adjustment in the relevant benchmark for optimality, we can prove that our main result is once again generic for  $\lambda \neq q$ :

**Proposition 11.** *Assume the combination of first and higher-order uncertainty described above and a policy objective that treats the noisy rational expectations equilibrium as the first-best. For  $q \leq 1$  and  $\lambda \neq q$ , there exists some critical threshold  $\hat{\gamma} \in [0, 1)$  such that target communication is strictly preferred for  $\gamma > \hat{\gamma}$ .*

This result, and all others in this section, are proved in a final subsection. The result intuitively “re-isolates” our main friction of interest as the *only* source of distortion.

#### G.4 Irrational inattention or “two-distortion case”

Let us now consider a situation in which there is a second *competing* distortion induced by irrational inattention or some other “wedge” in first-order beliefs.

A first path forward for evaluating optimal policy is to treat inattention and the behavioral bias as joint sources of inefficiency. This is tantamount to evaluating  $\mu_{\text{in}}$  in (95) with  $q^* = 1$ , or continuing to use the original objective (3). Provided  $\lambda < q$ , the paternalistic planner again uses a threshold strategy:

**Proposition 12.** *Let  $c(\gamma) \equiv \mathbb{1}_{\{\mathcal{A}^* = \mathcal{A}_Y\}}$  be a 0 or 1 indicator for using target communication. For  $\lambda < q \leq q^* = 1$ ,  $c(\gamma)$  weakly increases on the domain  $[0, 1]$ .*

In this case, target communication may be preferred on the entire domain. This has the opposite intuition from the previous result: some over-reaction in GE reasoning helps offset the attenuation from incomplete information.

Note that the previous two propositions do not cover the case of  $q < \lambda < q^* = 1$ , with agents believing they are “worse than average.” In such a case, the considerations of canceling out the friction in higher-order reasoning and “fighting” the wedge in first-order beliefs do not stack with one another. Instead, there is now room for the familiar second-best logic of using one distortion to fight another.

Next, consider the case of  $q^* < 1$  but  $q > q^*$ . There is optimally some inattention, but agents over-perceive the precision of their own signals. As discussed later, the empirical evidence in [Kohlhas and Broer \(2018\)](#) and [Bordalo et al. \(2018\)](#) supports such a case in the data. We now consider a policy problem with

the objective 95, but with  $\mu_{in}$  evaluated at  $q = q^*$  and  $\lambda = q^*$ . In such a case, we can show that if  $\lambda < q$  our result extends in the following sense:

**Proposition 13.** *Let  $c(\gamma) \equiv \mathbb{1}\{\mathcal{A}^* = \mathcal{A}_Y\}$  be a 0 or 1 indicator for using target communication. For  $\lambda < q \leq 1$  and  $q^* < q$ ,  $c(\gamma)$  weakly increases on the domain  $[0, 1]$ .*

**Empirical (and psychological) context.** The combination of the evidence provided in [Bordalo et al. \(2018\)](#), [Coibion and Gorodnichenko \(2012, 2015\)](#), [Coibion et al. \(2018\)](#), [Kohlhas and Broer \(2018\)](#), and [Kohlhas and Walther \(2018\)](#) from various surveys of macroeconomic forecasts rejects the representative-agent, rational-expectations benchmark. Much of this evidence concentrates on professional forecasters, but some of it covers firms and consumers as well. Notwithstanding the difficulty of extrapolating from such broad-scope evidence to the specific counterfactual studied in our paper, we now explain why this evidence points towards the following combination of parameters, which (per Proposition 13) suffices for our main result to survive even when inattention is irrational:

- $q < 1$ , meaning that people are inattentive or imperfectly informed;
- $q^* < q$ , meaning that people over-estimate the precision of their information relative to the truth; and
- $\lambda < q$ , meaning that people under-estimate the precision of others' information relative to their own.

The first property is documented in [Coibion and Gorodnichenko \(2012, 2015\)](#) by showing that average forecasts under-react to news. These papers also offer a structural interpretation of this fact in terms of models with dispersed noisy information and rational expectations, along the lines of [Morris and Shin \(2002\)](#) and [Woodford \(2003\)](#). But they do not contain any evidence that would help support this hypothesis against the richer alternative. That is, they *presume*  $q = \lambda = q^* < 1$ , but the provided evidence actually only proves  $q < 1$  and  $\lambda < 1$ , leaving the  $q - \lambda$  gap and the value of  $q^*$  free. Accordingly, [Gabaix \(2020\)](#) interprets the same fact as evidence of a certain form of *irrational* inattention, or in terms of a model where  $q < 1$  but  $q^* = 1$ .

This ambiguity is resolved by the combination of [Bordalo et al. \(2018\)](#) and [Kohlhas and Broer \(2018\)](#). These papers provide evidence that, whereas forecast errors are positively related to past forecast revisions at the *aggregate* level (as originally shown in [Coibion and Gorodnichenko, 2015](#)), they are negatively related at the *individual* level.

The second fact, by itself, rejects rational expectations: with rational expectations, an individual's forecast error cannot be forecastable by his *own* past information. Furthermore, the sign of the documented bias points towards individual over-reaction to own information. [Kohlhas and Broer \(2018\)](#) attribute such over-reaction to the tendency of an individual to think that his information is more precisely than it actually is ("absolute over-confidence"). In the language of the simple model presented above, this means  $q > q^*$ . [Bordalo et al. \(2018\)](#) propose a variant explanation, based on "representativeness bias," which though works in essentially the same way and, for our purposes, can also be captured by  $q > q^*$ .

To match the first fact, or the under-reaction of the average forecasts, it is then necessary to have dispersed noisy information. To understand why, recall that this fact alone could be explained either by dispersed noisy information, as originally shown by [Coibion and Gorodnichenko \(2012, 2015\)](#) themselves, or by a bias that causes individual beliefs to under-react, as suggested by [Gabaix \(2020\)](#). But we just argued that the bias in individual beliefs, as evidenced in the second fact, is of the opposite kind. The two facts *together* therefore point towards the combination of over-confidence and dispersed noisy information, which in the language of the model presented above means  $q^* < q < 1$ .

Both [Bordalo et al. \(2018\)](#) and [Kohlhas and Broer \(2018\)](#) reach basically the same conclusion. [Angeletos and Huo \(2020\)](#) further clarify why information has to be not only noisy but also dispersed: the aforementioned facts together imply one agent’s forecast error is predictable by the *another* agent’s information. [Angeletos and Huo \(2020\)](#) also develop the precise mapping between these facts and a model that has a similar formal structure as our framework—and that adds various extra features that are needed for quantitative purposes, including richer micro-foundations, long horizons and learning dynamics, but are of course beyond the scope of our paper.

More importantly for the present purposes, [Kohlhas and Broer \(2018\)](#) provide a *third* fact, which points towards  $\lambda < q$ : individual forecasts over-react to consensus forecasts. This is consistent with the hypothesis that the typical individual under-estimates the information of others and is thus “relatively over-confident” in their own assessment. As mentioned in the main text, such a perception in being “better than average” is described by psychologists in various contexts (see, for instance, [Alicke and Govorun, 2005](#)). In our context, it translates into a lack of confidence in other agents’ attentiveness to forward guidance, or  $\lambda < q$ .

Of course, the literature reviewed here may not be the final word on what the best structural interpretation of the available evidence on expectations is. Also, this evidence need not be directly importable to the context of interest. In particular, [Garcia-Schmidt and Woodford \(2019\)](#) and [Farhi and Werning \(2019\)](#) argue that, because this was the first time the United States had hit the ZLB context and nobody could draw from past data to infer the GE effects of the various unconventional policies the Fed had to experiment with, people may have naturally resorted to introspection and deductive (iterative) reasoning, of the kind seen in experiments. If this argument is valid, it offers a more direct justification for our baseline analysis. Still, the evidence discussed above is complementary: not only it rejects the representative-agent, rational-expectations benchmark but also favors, within the extension presented in this appendix, the particular scenario of  $\lambda < q$  and  $q^* < q$ , which in turn suffices for our main policy prescription to continue to hold (Proposition 13) despite the presence of confounding distortions.

## G.5 Proofs

### Proof of Proposition 11

Note first the following properties of  $(\mu_{in}, \mu_{\tau}, \mu_Y)$ , which can be verified by direct calculation:

1.  $\mu_{\tau} = \mu_{in}$  when  $\gamma = 0$ , and  $\mu_{\tau} > \mu_{in}$  when  $\gamma \in (0, 1]$ .

2.  $\mu_Y = \mu_{\text{in}}$  when  $\gamma = 1$ , and  $\mu_Y < \mu_{\text{in}}$  when  $\gamma \in [0, 1)$

Note finally that  $\mu_Y > 0$  if and only if  $\lambda > 1 + q - 1/\alpha$ , which by the same argument provided in Lemma 9 is always true if we have specified  $|\delta_Y| < 1$  for all  $\gamma \in [0, 1]$ . As with the main result, we will focus on such a case in the proof.

Assume that the policymaker's objective function is given by (95), where  $\mu_{\text{in}}$  defines the slope of the implementability constraint in the noisy rational expectations case of a given model (i.e., in which  $\lambda$  is set equal to  $q$ ).

The objective in terms of the message slope  $r$  and the implementability slope  $\mu$  is

$$(1 - \chi)(r - 1)^2 + \chi(r/\mu - 1/\mu_{\text{in}})^2$$

The optimal  $r$  in closed-form, as a function of other parameters, is

$$r(\mu) = \frac{(1 - \chi)\mu^2 + \chi \frac{\mu}{\mu_{\text{in}}}}{(1 - \chi)\mu^2 + \chi}$$

and the new objective function, in terms of  $(\mu, \mu_{\text{in}})$ , is a function  $\ell_0$ :

$$\mathcal{L} = \ell(\mu, \mu_{\text{in}}) \equiv \chi(1 - \chi) \frac{(\mu - \mu_{\text{in}})^2}{\mu_{\text{in}}^2 (\mu^2 (1 - \chi) + \chi)} \quad (96)$$

Note that the derivative of the loss function  $f$  with respect to  $\gamma$  comes through two components, and is

$$\frac{\partial \ell}{\partial \gamma} = \frac{\partial \ell}{\partial \mu} \frac{\partial \mu}{\partial \gamma} + \frac{\partial \ell}{\partial \mu_{\text{in}}} \frac{\partial \mu_{\text{in}}}{\partial \gamma} \quad (97)$$

The two partial derivatives of  $\ell$  are

$$\frac{\partial \ell}{\partial \mu} = 2(1 - \chi)(\chi) \frac{(\mu - \mu_{\text{in}})(\mu \mu_{\text{in}}(1 - \chi) + \chi)}{\mu^2 (\mu^2 (1 - \chi) + \chi)^2}$$

which is positive if and only if  $\mu > \mu_{\text{in}}$ , and

$$\frac{\partial \ell}{\partial \mu_{\text{in}}} = -2(1 - \chi)(\chi) \frac{\mu}{\mu_{\text{in}}} \cdot \frac{(\mu - \mu_{\text{in}})}{\mu_{\text{in}}^2 (\mu^2 (1 - \chi) + \chi)}$$

which is positive if  $\mu < \mu_{\text{in}}$ .

Plugging the previous expressions into (97), we have that  $\partial \ell / \partial \gamma > 0$  is positive if  $\mu > \mu_{\text{in}}$  and

$$\frac{\partial \mu}{\partial \gamma} > \frac{\mu}{\mu_{\text{in}}} \frac{\mu^2 (1 - \chi) + \chi}{\mu \mu_{\text{in}} (1 - \chi) + \chi} \frac{\partial \mu_{\text{in}}}{\partial \gamma} \quad (98)$$

or if  $\mu < \mu_{\text{in}}$  and

$$\frac{\partial \mu}{\partial \gamma} < \frac{\mu}{\mu_{\text{in}}} \frac{\mu^2 (1 - \chi) + \chi}{\mu \mu_{\text{in}} (1 - \chi) + \chi} \frac{\partial \mu_{\text{in}}}{\partial \gamma} \quad (99)$$

Finally, note that the partial derivative of  $\mu_{\text{in}}$  with respect to  $\gamma$  is

$$\frac{\partial \mu_{\text{in}}}{\partial \gamma} = \frac{\alpha^2 (1 - q) \lambda}{(1 - \alpha + \alpha q (1 - q))^2} > 0$$

**Monotonicity of loss with instrument communication.** Note that the derivative of  $\mu_\tau$  in  $\gamma$  is given by

$$\frac{\partial \mu_\tau}{\partial \gamma} = \frac{q\alpha^2(1-\lambda)}{(1-\alpha + q\alpha(1-\alpha\gamma) - \alpha\gamma\lambda(1-\alpha))^2} > 0$$

Consider first this case  $q > \lambda$  which entails  $\mu_\tau > \mu_{\text{in}}$ . A looser version of (98) is

$$\frac{\partial \mu_\tau}{\partial \gamma} > \left(\frac{\mu_\tau}{\mu_{\text{in}}}\right)^2 \frac{\partial \mu_{\text{in}}}{\partial \gamma}$$

and this can be verified by “brute force”: the previous expression is

$$\frac{(1-\lambda)}{(1-q)} > \frac{(1-\lambda\alpha\gamma)^2}{(1-q\alpha\gamma)^2} \quad (100)$$

Note that an upper bound for the right-hand-side is given for  $\gamma = 1$ , or

$$\frac{(1-\lambda)}{(1-q)} > \frac{(1-\lambda\alpha)^2}{(1-q\alpha)^2}$$

But this is guaranteed if we impose  $\alpha < 1/2$ , which was consistent with  $|\delta_Y| > -1$  on the entire domain of study.

Now consider  $q < \lambda$ . The loose version of (99) is

$$\frac{\partial \mu_\tau}{\partial \gamma} < \left(\frac{\mu_\tau}{\mu_{\text{in}}}\right)^2 \frac{\partial \mu_{\text{in}}}{\partial \gamma}$$

because for  $\mu_\tau < \mu_{\text{in}}$  the right-hand-side is a lower bound. From the exact same math of (100), the key condition is now

$$\frac{(1-\lambda)}{(1-q)} < \frac{(1-\lambda\alpha\gamma)^2}{(1-q\alpha\gamma)^2} \quad (101)$$

which is satisfied for the exact same reason.

Together, these arguments suffice to show that in any case,  $\ell(\mu_\tau, \mu_{\text{in}})$  increases in  $\gamma$ . Note finally that this loss function is 0 at  $\gamma = 0$ , where  $\mu_\tau = \mu_{\text{in}}$ , and strictly positive at  $\gamma = 1$ , where  $\mu_\tau \neq \mu_{\text{in}}$ .

**Monotonicity of loss with target communication.** The derivative of  $\mu_Y$  in  $\gamma$  is given by

$$\frac{\partial \mu_Y}{\partial \gamma} = \frac{q\alpha^2(1-\lambda)}{(1-\alpha + \alpha\lambda(1-\gamma))^2} > 0$$

First consider  $q > \lambda$ , which entails  $\mu_Y < \mu_{\text{in}}$ . It is simple to show that (99) is never satisfied because  $\frac{\partial \mu_Y}{\partial \gamma} > \frac{\partial \mu_{\text{in}}}{\partial \gamma}$ , since

$$\frac{\partial \mu_Y}{\partial \gamma} = \frac{(1-\lambda)}{(1-q)} \frac{(1-\alpha + \alpha q(1-\gamma))^2}{(1-\alpha + \alpha\lambda(1-\gamma))^2} \frac{\partial \mu_{\text{in}}}{\partial \gamma} > \frac{\partial \mu_{\text{in}}}{\partial \gamma}$$

Next consider the case  $q < \lambda$ , which entails  $\mu_Y > \mu_{\text{in}}$ . Note that condition (98) is violated because

$$\frac{\partial \mu_Y}{\partial \gamma} = \frac{(1-\lambda)}{(1-q)} \frac{(1-\alpha + \alpha q(1-\gamma))^2}{(1-\alpha + \alpha\lambda(1-\gamma))^2} \frac{\partial \mu_{\text{in}}}{\partial \gamma} < \frac{\partial \mu_{\text{in}}}{\partial \gamma} < \left(\frac{\mu_Y}{\mu_{\text{in}}}\right)^2 \frac{\partial \mu_{\text{in}}}{\partial \gamma}$$

Together, these arguments suffice to show that  $\ell(\mu_Y, \mu_{\text{in}})$  decreases in  $\gamma$ . Note finally that this loss function is 0 at  $\gamma = 1$ , where  $\mu_Y = \mu_{\text{in}}$ , and strictly positive at  $\gamma = 0$ , where  $\mu_Y \neq \mu_{\text{in}}$ .

**Proving the threshold strategy.** Given the monotonicities established above, proving the sought-after result—that target communication is optimal if and only if  $\gamma > \hat{\gamma}$ , for some  $\hat{\gamma} \in (0, 1)$ —requires only using continuity arguments like in the proof of Theorem 2.

**Proof of Proposition 12**

First, we note the monotonicity of  $(\mu_\tau, \mu_Y)$  in  $\gamma$ . The derivative of  $\mu_\tau$  with respect to  $\gamma$  is

$$\frac{\partial \mu_\tau}{\partial \gamma} = \frac{1}{\mu_\tau^2} \frac{\alpha q(1-\lambda)}{(1-\lambda\gamma)^2} > 0$$

and the derivative of  $\mu_Y$  is

$$\frac{\partial \mu_Y}{\partial \gamma} = \frac{1}{\mu_Y^2} \frac{\alpha q(1-\alpha)(1-\lambda)}{(\alpha q(\delta_Y - 1) - \lambda\delta_Y + 1)^2} > 0$$

Next, we want to show that  $\mu_\tau > \mu_Y$ . The correct condition in terms of parameters is

$$\frac{1 + \frac{\lambda\alpha(1-\gamma)}{1-\alpha} - \alpha q \frac{1-\alpha\gamma}{1-\alpha}}{1-\alpha + \lambda\alpha(1-\gamma)} \leq \frac{1-\lambda\alpha\gamma}{(1-\alpha)(1-\lambda\alpha\gamma) + \alpha q(1-\alpha\gamma)}$$

Given that  $\mu_Y > 0$ , which is guaranteed like just as in Lemma 9, the left denominator is positive. The other three terms are necessarily positive. Thus an equivalent statement, after cross-multiplying, is the following:

$$(1-\lambda\alpha\gamma)(1-\alpha + \lambda\alpha(1-\gamma)) \geq \left( (1-\lambda\alpha\gamma) + \frac{\alpha q(1-\alpha\gamma)}{1-\alpha} \right) (1-\alpha + \lambda\alpha(1-\gamma) - \alpha q(1-\alpha\gamma))$$

Subtracting like terms from each side, and dividing by  $\alpha > 0$ , yields the following condition:

$$(q-\lambda)(1-\alpha\gamma) \geq 0$$

Hence  $q > \lambda$  and  $\alpha\gamma < 1$  are a sufficient condition for  $\mu_\tau > \mu_Y$ , and either  $q = \lambda$  or  $\alpha\gamma = 1$  are a sufficient condition for  $\mu_\tau = \mu_Y$ .

Finally, let us return to the proof of optimality. It is straightforward to solve the expression for  $\mu_Y$  for some  $\tilde{\gamma}_Y(\alpha, \lambda, q) \in (0, 1]$  such that  $\mu_Y|_{\gamma=\tilde{\gamma}_Y} = 1$ . One can apply the argument in the proof of Theorem 2 to the loss functions  $\mathcal{L}_\tau(\gamma)$  and  $\mathcal{L}_Y(\gamma)$  on the domain  $[0, \tilde{\gamma}_Y]$ . There is some  $\hat{\gamma} \in [0, \tilde{\gamma}_Y)$  where the functions cross.

For  $\gamma \in (\tilde{\gamma}_Y, 1)$ , we know that (i)  $\mu_Y$  and  $\mu_\tau$  both increase in  $\gamma$  and (ii)  $\mu_\tau > \mu_Y$ . It is straightforward to deduce that  $\mu_\tau > \mu_Y > 1$  for  $\gamma > \tilde{\gamma}_Y$  (and hence  $\mathcal{L}_Y < \mathcal{L}_\tau$ ), which shows the optimality of target communication and completes the proof.

**Proof of Proposition 13**

We proceed with the same parameter restriction assumed in the proof of Proposition 11. Note also that the same expressions for the loss functions, the partial derivatives thereof, and sufficient conditions for monotonicity of the loss function in  $\gamma$  still apply.

Applying arguments from the proof of Proposition 11, it is simple also to show that  $\mu_\tau > \mu_Y$  and  $\mu_{in} > \mu_Y$  on this domain.

**Case 1:**  $q^* \leq \lambda < q$ . In this case,  $\mu_\tau \leq \mu_{\text{in}}$  with equality only for  $q^* = \lambda$  and  $\gamma = 1$ , verified by the direct calculation

$$\frac{1 - \alpha\lambda\gamma}{(1 - \alpha)(1 - \alpha\lambda\gamma) - q\alpha(1 - \alpha\gamma)} \leq \frac{1 - \alpha q^* \gamma}{1 - \alpha - q^* \alpha(1 - \gamma)} \quad (102)$$

In this case, we have  $\mu_Y < \mu_\tau \leq \mu_{\text{in}}$ , and all three increasing in  $\gamma$ . It follows that instrument communication always produces less loss and is preferred on the entire domain  $\gamma \in [0, 1]$ . To see this, note that for  $\mu < \mu_{\text{in}}$ , the loss function is decreasing in  $\mu$ .

**Case 2:**  $\lambda < q^* \leq \frac{q}{1 + \alpha(q - \lambda)} < q$ . Re-arrangement of (102), with this condition, again shows  $\mu_\tau \leq \mu_{\text{in}}$  with equality only at  $\gamma = 1$  and  $q^* = \frac{q}{1 + \alpha(q - \lambda)}$ . Again, instrument communication is preferred on the entire domain.

**Case 3:**  $\frac{q}{1 + \alpha(q - \lambda)} < q^* < q$  and  $\lambda < q^*$ . In this final case, there exists a  $\check{\gamma}$  such that  $\mu_\tau > \mu_{\text{in}}$  for  $\gamma > \check{\gamma}$  and  $\mu_\tau \leq \mu_{\text{in}}$  for  $\gamma \leq \check{\gamma}$ . The previous argument applies to show the optimality for instrument communication for  $\gamma \leq \check{\gamma}$ . For  $\gamma > \check{\gamma}$ , we want to show that the loss for instrument communication strictly increases and the loss from target communication strictly decreases.

From the proof of Proposition (11), a sufficient condition for the first is that

$$\frac{\partial \mu_\tau}{\partial \gamma} > \left( \frac{\mu_\tau}{\mu_{\text{in}}} \right)^2 \frac{\partial \mu_{\text{in}}}{\partial \gamma}$$

This condition simplifies to

$$\frac{q}{q^*} \frac{(1 - \lambda)}{(1 - q^*)} > \frac{(1 - \lambda\alpha\gamma)^2}{(1 - q^* \alpha\gamma)^2}$$

Taking a lower bound on the left (with  $q/q^* \geq 1$ ) and an upper bound on the right (evaluating at  $\gamma = 1$ ) gives

$$\frac{(1 - \lambda)}{(1 - q^*)} > \frac{(1 - \lambda\alpha)^2}{(1 - q^* \alpha)^2}$$

which, as used in the proof of Proposition 11, will always hold for  $\lambda < q^*$  and  $\alpha < 1/2$ . Thus we have shown that  $\mathcal{L}_\tau(\gamma)$ , the loss function associated with instrument communication, strictly increases for  $\gamma > \check{\gamma}$ .

Next, a sufficient condition for  $\mathcal{L}_Y(\gamma)$ , the loss function from target communication, to decrease for  $\gamma > \check{\gamma}$  is  $\frac{\partial \mu_Y}{\partial \gamma} > \frac{\partial \mu_{\text{in}}}{\partial \gamma}$ . By direct calculation,

$$\frac{\partial \mu_Y}{\partial \gamma} = \frac{q}{q^*} \frac{(1 - \lambda)}{(1 - q^*)} \frac{(1 - \alpha + \alpha q^* (1 - \gamma))^2}{(1 - \alpha + \alpha \lambda (1 - \gamma))^2} \frac{\partial \mu_{\text{in}}}{\partial \gamma} > \frac{\partial \mu_{\text{in}}}{\partial \gamma}$$

so this is always true.

We have thus established that the difference in loss between target and instrument communication, or  $\Delta \equiv \mathcal{L}_Y(\tau) - \mathcal{L}_\tau(\tau)$ , decreases in  $\gamma$  for  $\gamma > \check{\gamma}$ .

Let the choice of target communication be a 0 or 1 indicator variable,  $c \equiv \mathbb{1}_{\{\mathcal{A}^* = \mathcal{A}_Y\}} = \mathbb{1}_{\{\Delta < 0\}}$ .  $c$  weakly decreases in  $\Delta$ , so the choice of target communication weakly increases in  $\gamma$  for  $\gamma \in (\check{\gamma}, 1]$ . Because  $c = 0$  for any  $\gamma \in [0, \check{\gamma}]$ , this completes the proof that  $c$  weakly increases in  $\gamma$  in  $[0, 1]$ .

## H Sophisticated Forward Guidance and Policy Rules

### H.1 Set-up

Assume that, after observing  $\theta$ , the policymaker can commit to and communicate a flexible *relation* between the instrument  $\tau$  and the outcome  $Y$ , given by

$$\tau = T(Y; \theta),$$

for some function  $T : \mathbb{R}^2 \rightarrow \mathbb{R}$ .<sup>36</sup> Without serious loss of generality, we restrict attention to linear reaction functions of the form

$$T(Y; \theta) = a + bY, \quad \text{with} \quad a = A(\theta) \quad \text{and} \quad b = B(\theta), \quad (103)$$

for arbitrary  $A(\cdot) : \mathbb{R} \rightarrow \mathbb{R}$  and  $B(\cdot) : \mathbb{R} \rightarrow (\underline{b}, 1)$ , where  $\underline{b} \equiv \frac{1+\alpha\gamma}{1-2\alpha+\alpha\gamma} < -1$ . The bounds on  $b$  are necessary and sufficient for “reasoning to converge,” or for infinite-order beliefs not to have undue influence on behavior.<sup>37</sup> The simpler strategies considered in our baseline analysis are nested with  $b = 0$  and  $a = \hat{\tau}$  for instrument communication, and  $b \rightarrow -\infty$  and  $-a/b \rightarrow \hat{Y}$  for target communication. With the flexibility added here, forward guidance amounts to announcing, conditional on  $\theta$ , a pair of numbers  $(a, b) = (A(\theta), B(\theta))$ , or an intercept and a slope for the reaction function, instead of a single number  $\hat{\tau}$  or  $\hat{Y}$ .<sup>38</sup>

All assumptions about depth of knowledge and rationality now relate to agents’ understanding of the function  $T$ , or the pair  $(a, b)$ . In particular, Assumption 4 is adapted as follows: agents believe that only a fraction  $\lambda \in [0, 1]$  of the others are both rational and aware of the actual  $(a, b)$ , like themselves; the rest are expected to play the “default” action  $k = 0$ , either because of inattention or because of irrationality.<sup>39</sup>

### H.2 Optimal policy

In our main analysis, we contrasted how the choice between instrument and target communication was irrelevant in the rational-expectations benchmark ( $\lambda = 1$ ) to how it became crucial in managing expectations once we accommodated bounded rationality ( $\lambda < 1$ ). The next result generalizes this insight to the richer policy strategy space allowed here.

<sup>36</sup>Clearly, the outcomes implemented with such a policy rule coincide with those implemented with a rule of the form  $\tau = T(K; \theta)$ , since  $Y$  is a (fixed) function of  $\tau$  and  $K$ .

<sup>37</sup>See the proof of Proposition 15 for the details. In the New Keynesian framework, the analogue of  $b < 1$  is the Taylor principle, and the analogue of  $b > \underline{b}$  is the additional bound on the slope of the Taylor rule identified by Guesnerie (2008) as necessary and sufficient for the unique linear REE of that model to be also the unique rationalizable outcome.

<sup>38</sup>This interpretation is under the maintained timing, which has the policymaker choose and communicate the scalars  $(a, b)$  after observing  $\theta$ . But the same outcomes obtain also with an alternative timing that has the policymaker choose and communicate the entire mappings  $(A(\cdot), B(\cdot))$  prior to observing  $\theta$ . The first perspective seems more natural in the context of forward guidance and under the interpretation of  $\theta$  as the policymaker’s current assessment of the best thing to do. The second perspective is more appropriate for connecting to the macroeconomic literature on policy rules and for re-interpreting  $\theta$  as a *future* shock. Finally, note that for now we are allowing *both* the intercept and the slope of the policy rule to vary with  $\theta$ , but below we will show that optimality requires that *only* the intercept varies with  $\theta$ .

<sup>39</sup>This specification imposes  $\lambda \leq 1$ . But the results stated below readily extend to  $\lambda > 1$ , or a situation where agents over-estimate the responses of others and the GE effects of policy, along the lines of Section 5.3.



**Proposition 14.** Consider a reaction function  $T$  and let  $Y(\theta)$  and  $\tau(\theta)$  be, respectively, the induced equilibrium values of the outcomes and the supporting policies (together, “allocations”). Next, consider any other reaction function  $T'$  such that  $T'(Y(\theta), \theta) = T(Y(\theta), \theta)$  for all  $\theta$ .

- (i) When  $\lambda = 1$ ,  $T'$  induces the same equilibrium outcomes and policies as  $T$ .
- (ii) When instead  $\lambda < 1$ ,  $T'$  induces different equilibrium outcomes and policies than  $T$ .

Part (i) is familiar from the existing literature on Ramsey problems, in which there is often a large family of policy rules that implement the same equilibrium allocations and policies. The analogue of this property in the 3-equation New Keynesian model is also well known: there are multiple combinations of a state-contingent intercept and a slope for the Taylor rule that implement the same equilibrium paths for output, inflation, and interest rates.<sup>40</sup>

Part (ii) shows that this kind of irrelevance breaks once we bound agents’ depth of knowledge and rationality. Fix  $T$  and let  $\theta \mapsto (\tau^*(\theta), Y^*(\theta))$  be the equilibrium mapping from states to allocations implemented by  $T$ . Next take any other  $T'$  that satisfies  $T'(Y^*(\theta), \theta) = \tau^*(\theta)$ . This property guarantees that agents find it optimal to play the same action under  $T'$  as under  $T$  insofar as long as they conjecture that  $T'$  continues to induce the same allocations as  $T$ . When  $\lambda = 1$ , one can close the loop to prove this conjecture is self-fulfilling and hence that  $T'$  induces the same behavior as  $T$ . But once  $\lambda < 1$ , agents doubt that *others* make the same conjecture. This causes them to form different expectations about  $K$  under  $T'$  than under  $T$ , which in turn leads them to follow different behavior under  $T'$  than under  $T$ .

In short, the above result generalizes our earlier insights about the role of policy in regulating the error in the public’s reasoning and its footprint on actual behavior. The upshot for optimality is given below:

**Proposition 15.** (i) When  $\lambda = 1$ , the optimal rule is indeterminate and its slope can be anything: the first best is implemented if and only if the intercept satisfies  $a = (1 - b)\theta$ , for an arbitrary (possibly  $\theta$ -contingent) slope  $b$ .

(ii) When instead  $\lambda \neq 1$ , the optimal rule is unique and its slope is inversely related to the GE feedback: the first best is implemented if and only if

$$b = -\frac{\gamma}{1-\gamma} \quad \text{and} \quad a = \frac{1}{1-\gamma}\theta \quad \forall \theta. \quad (104)$$

With rational expectations, optimality requires that  $\tau = Y = \theta$ , but there is a continuum of policy rules that induce this as an equilibrium. The analogue in the New Keynesian model (without a binding ZLB and markup shocks) is that the first best can be implemented with a continuum of Taylor rules, whose state-contingent intercept tracks the natural rate of interest and whose non-contingent slope with respect to inflation or the output gap is indeterminate.

With bounded rationality, this indeterminacy disappears. The slope of the optimal rule is now inversely tied to the strength of the GE feedback, in a way that smooths out our baseline main result (Theorem 2): as

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<sup>40</sup>The most applied segment of the New Keynesian literature (e.g., that on estimated DSGE models) often removes the state-contingency of the intercept of the Taylor rule. We return to this issue at the end of this section.

$\gamma$  increases, the policymaker gives more emphasis on anchoring the public’s expectations of  $Y$  rather than their expectations of  $\tau$ .

To see this more clearly, let us first re-express the optimal rule as follows:

$$\tau - \theta = -\frac{\gamma}{1-\gamma}(Y - \theta).$$

From this perspective, the optimal forward guidance consists of two components: the policymaker’s assessment of the “fundamentals” and of the corresponding “rational” outcome (e.g., the central bank’s forecast about the natural rate of output) in the form of  $\theta$ ; and a commitment about how much she will tolerate a gap in terms of  $\tau$  versus a gap in terms of  $Y$ . Building on our discussion of categorizing policy communication in Appendix XX, the former piece might be reflected in the policymaker’s overall outlook (e.g., as reflected in the Summary of Economic Projections and dot plots), whereas the latter requires an explicit discussion of policy’s contingency on different outcomes. The latter piece, our analysis shows, is *required* to achieve the first best—forecasts, by themselves, cannot do the job.

The next result expands on how policy optimally manages the expectations of interest rates and aggregate employment when both of them are distorted due to bounded rationality:

**Proposition 16.** *Let  $f_\tau(\gamma) \equiv |\tau - \bar{\mathbb{E}}[\tau]|$  and  $f_Y(\gamma) \equiv |Y - \bar{\mathbb{E}}[Y]|$  denote the aggregate errors in the expectations of, respectively, the instrument and the outcome, evaluated at the optimal policy, as functions of  $\gamma$ . Then, for all  $\gamma \in (0, 1)$ : (i)  $f_\tau(\gamma) > 0$  and  $f_Y(\gamma) > 0$ ; (ii)  $f'_\tau(\cdot) > 0$ , and  $f'_Y(\cdot) < 0$ .*

The first property shows that, away from the extreme values of  $\gamma$ , the optimal policy is never completely clear: it does not eliminate the mistakes in either kind of expectations. This might be surprising given the previous discussion of “forecasts plus commitments”—in this interpretation, if the Fed had provided forecasts and a dot plot that described  $\tau = Y = \theta$ , its optimal forward guidance would induce the public to think something else.

The second property shows that policy shifts clarity from  $\tau$  to  $Y$  as the GE feedback increases. This makes even clearer how the optimal policy rule “smooths out” the main insight of Theorem 2 about switching the spotlight from instruments to targets, or from interest rates to unemployment.

Although the optimal rule does not eliminate the mistakes in people’s reasoning about equilibrium, under the assumptions made thus far it insulates their actual behavior from such reasoning and recovers the policymaker’s first best. The intuition is similar to the one developed for the extremes  $\gamma = 0$  and  $\gamma = 1$  in our baseline analysis, except that it now extends to interior  $\gamma$ : the optimal rule zeros out equilibrium reasoning about others’ reactions.<sup>41</sup>

One should not take the present result too literally. First, there may be costs (left outside our analysis) for communicating sophisticated strategies. Second, if the policymaker is uncertain about the precise value of  $\gamma$ , the policymaker implements a “second-best approximation” of the policy described in Proposition 15: the first best is not attainable any more, but the optimal  $b$  increases (in the sense of first-order

<sup>41</sup>In the language of best-response condition (7), the optimal rule ensures a zero slope on  $\mathbb{E}_i[K]$ . This implements the first best without correctly anchoring beliefs about *either* the instrument or target, but instead by making sure that the distortions in those beliefs are exactly irrelevant for choices.

stochastic dominance) in the policymaker's beliefs about  $\gamma$ . We expect a related result to hold in a multi-decision extension with limited policy instruments: the policymaker would try to eliminate the distortion in all decisions, but might succeed in doing so for only some.

But the basic logic is always the same. The optimal policy aims at minimizing the public's need to reason about the economy. And this is achieved by shifting emphasis from anchoring the public's expectations of  $\tau$  ("interest rates") to anchoring the public's expectations of  $Y$  ("unemployment") as the GE feedback increases.

### H.3 Optimal policy without commitment

We now expand on the role played by commitment. In the absence of commitment, the policymaker chooses  $\tau$  in stage 2 so as to minimize  $L$  subject to condition (1), taking  $K$  as given. This gives the following optimality condition, which trades off the marginal effect of the policy on the two "gaps:"

$$(1 - \chi)(\tau - \theta) + \chi(Y - \theta)(1 - \alpha) = 0;$$

Rearranging gives the follow ex post optimal reaction function:

$$\tau = \frac{1 - \alpha \chi}{1 - \chi} \theta - \frac{\chi(1 - \alpha)}{1 - \chi} Y. \quad (105)$$

The coefficients of this reaction function do not depend on the parameter  $\gamma$ , which determined how expectations of  $\tau$  and  $Y$  mapped to  $K$ , because  $K$  itself is already determined. By contrast, the optimal policy rule with commitment, given in (104), depends on  $\gamma$  precisely because it internalizes the effect it has on public reasoning and thereby on  $K$ .

Except for the knife-edge case in which  $\frac{\chi(1 - \alpha)}{1 - \chi} = \frac{\gamma}{1 - \gamma}$ , the two rules are different. Commitment is *necessary* for implementing the first best—but only insofar as there is a distortion in equilibrium reasoning ( $\lambda \neq 1$ ). When instead  $\lambda = 1$ , the following class of rules implements the first best under full commitment and rational expectations:

$$\{\tau = (1 + b) - bY, \text{ for any } b\}$$

But this class now includes the policy rule in (105), which means that commitment is *not* needed under rational expectations.

When the policymaker follows (105) and agents have rational expectations, agents *correctly* expect that all others will play  $K = \theta$  and that this together with (105) will induce  $\tau = Y = \theta$ . But once  $\lambda \neq 1$ , this rule causes agents to believe that  $K \neq \theta$ , which in turn distorts their behavior away from the first best. The only way to fix this distortion is to make sure that agents find it optimal to play the first best action *regardless* of their beliefs of  $K$  (or regardless of their higher-order beliefs), which in turn is possible if and only if the policymaker commits to the rule described in (105).

We summarize these lessons below.

**Proposition 17.** *In the absence of commitment, the unique optimal policy rule is given by*

$$\tau = \frac{1 - \alpha \chi}{1 - \chi} \theta - \frac{\chi(1 - \alpha)}{1 - \chi} Y. \quad (106)$$

This implements the first best when  $\lambda = 1$  but not when  $\lambda \neq 1$  (except for the knife-edge case in which  $\frac{\chi(1-\alpha)}{1-\chi} = \frac{\gamma}{1-\gamma}$  or  $\theta = 0$ ).

**Corollary 5.** *Commitment is valuable only when  $\lambda \neq 1$  (away from rational expectations). In these circumstances, the rule described in (105) is ex ante optimal, even though ex post suboptimal, because and only because the commitment embedded in it helps regulate the distortion in equilibrium reasoning.*

Of course, the property that commitment is useless under rational expectations is special to our model. There is a large literature in macroeconomics studying time-inconsistency issues under rational expectations in the context of both flexible policy rules (Kydland and Prescott, 1977; Barro and Gordon, 1983) and simpler, instruments-versus-targets implementations (Atkeson, Chari and Kehoe, 2007; Halac and Yared, 2018). But by assuming away these familiar considerations, we have illustrated a *new* function that commitment can play away from rational expectations.

Circling back to our baseline analysis, this also makes clear the following point: what was crucial about the two kinds of forward guidance studied there is that they communicated a policy plan (i.e., a commitment to get something done) as opposed to information about fundamentals (e.g., the central bank's forecasts of future fundamentals).

## H.4 Proofs

### Proofs of Propositions 14 and 15

For a policy rule to implement the first best, it is necessary that  $T(\theta, \theta) = \theta$ , which restricts  $a$  and  $b$  as follows:

$$a = (1 - b)\theta.$$

We can henceforth focus on the class of policy rules that satisfy this restriction. This is a one-dimensional class indexed by  $b$ .

Solving (103) and (1) jointly for  $\tau$  and  $Y$ , using  $a = (1 - b)\theta$ , and substituting the solution into (2), we obtain the following game representation for the agents' behavior in stage 1:

$$k_i = (1 - \delta)\theta + \delta \mathbb{E}_i[K] \tag{107}$$

where

$$\delta = \delta(b; \alpha, \gamma) \equiv \frac{\alpha(\gamma + b(1 - \gamma))}{1 - (1 - \alpha)b}.$$

Note that  $\delta \in (-1, +1)$  if and only if  $b \in (\underline{b}, +1)$ , where  $\underline{b} \equiv \frac{1 + \alpha\gamma}{1 - 2\alpha + \alpha\gamma} < -1$ . This explains the assumed bounds imposed on  $b$ : outside these bounds, “reasoning fails to converge” (this is the present analogue of the restriction  $\delta_X \in (-1, +1)$ ,  $X \in \{\tau, Y\}$ , in the baseline analysis).

Consider now the case with rigid beliefs from higher-order doubts, as in Section 3.3. Iterating the best response (107) yields the unique equilibrium average action as

$$K = \sum_{h=1}^{\infty} \delta^{h-1} \lambda^{h-1} \zeta \theta = \frac{1 - \delta}{1 - \lambda\delta} \theta, \tag{108}$$

with  $\delta = \delta(b; \alpha, \gamma)$  defined above. For this to coincide with the first best action, it is therefore necessary and sufficient that

$$\frac{1 - \delta}{1 - \lambda\delta} = 1$$

Clearly, this is automatically satisfied when  $\lambda = 1$  (rational expectations), regardless the value of  $\delta$ , or equivalently of  $b$ . This verifies the indeterminacy of the optimal policy rule under rational expectations. When instead  $\lambda < 1$ , the above is satisfied if and only if  $\delta = 0$ , or equivalently  $b = -\gamma/(1-\gamma)$ . Along with  $a = (1-b)\theta$ , this completes the characterization of the unique policy rule that implements the first best once  $\lambda < 1$ .<sup>42</sup>

### Proof of Proposition 16

Note that  $\bar{\mathbb{E}}[K] = \mathbb{E}_i[K] = \lambda K$  by an argument essentially identical to the one supporting Lemma 2. Evaluated at the equilibrium under optimal policy, this is  $\bar{\mathbb{E}}[K] = \lambda\theta$ . The expected policy instrument and outcome, evaluated at the optimal rule, are

$$\begin{aligned}\bar{\mathbb{E}}[\tau] &= \frac{\theta}{1-\gamma} - \frac{\gamma}{1-\gamma} \bar{\mathbb{E}}[Y] \\ \bar{\mathbb{E}}[Y] &= (1-\alpha)\bar{\mathbb{E}}[\tau] + \alpha\lambda\theta\end{aligned}$$

Solving this system of equations gives

$$\begin{aligned}\bar{\mathbb{E}}[\tau] &= \frac{1 - \lambda\alpha\gamma}{1 - \alpha\gamma} \cdot \theta \\ \bar{\mathbb{E}}[Y] &= \frac{1 - \alpha + \alpha\lambda(1 - \gamma)}{1 - \alpha\gamma} \cdot \theta\end{aligned}$$

Recall also that the equilibrium satisfies  $\tau = Y = \theta$ .

The instrument forecast gap as a function of  $\gamma$  is

$$f_\tau(\gamma) \equiv |\tau - \bar{\mathbb{E}}[\tau]| = \left| \frac{(1-\lambda)}{1-\alpha\gamma} \alpha\gamma \right| \cdot |\theta|$$

which satisfies  $f_\tau(0) = 0$  and  $f'_\tau(\gamma) > 0$  for  $\gamma \in (0, 1)$ . This obviously implies  $f_\tau(\gamma) > 0$  for  $\gamma \in (0, 1)$ . Similarly the target forecast gap is

$$f_Y(\gamma) \equiv |Y - \bar{\mathbb{E}}[Y]| = \left| \frac{(1-\lambda)}{1-\alpha\gamma} \alpha(1-\gamma) \right| \cdot |\theta|$$

which satisfies  $f_Y(1) = 0$  and  $f'_Y(\gamma) < 0$  for  $\gamma \in (0, 1)$ . This obviously implies  $f_Y(\gamma) > 0$  for  $\gamma \in (0, 1)$ .

Finally, going slightly beyond the original statement of the Proposition, it is simple to see that the instrument gap is always smaller for  $\gamma < 0$ :  $f_\tau(\gamma) > f_Y(\gamma)$  since  $|1-\gamma| > |\gamma|$ . This generalizes our results for the optimality of instrument communication with negative GE effects.

<sup>42</sup>Clearly, the argument extends to  $\lambda > 1$ , modulo the re-interpretation of the friction along the lines of Section 5.3.