

The Inflation Target and The Equilibrium Real Rate

Real interest rates have fallen in recent decades. Consequently, monetary policy is more constrained by the effective lower bound. In response, many have suggested raising the inflation target. It is believed that raising the inflation target will not affect the equilibrium real rate. In this case, raising the inflation target by 2p.p. would raise the average nominal interest rate by a corresponding 2p.p. In this paper, I demonstrate that once we incorporate agent heterogeneity into a standard New Keynesian model, raising the inflation target will lower the equilibrium real rate. There are two parts to this channel. The first part is that higher inflation leads to lower firm profitability under standard price rigidities. The second part is that lower firm profitability implies a lower demand for assets. Under agent heterogeneity, a lower demand for assets leads to a fall in the equilibrium real rate. In a calibrated model, I find that a rise in the inflation target of 2p.p. generates a fall of between [0.1]p.p. and [0.8]p.p. in the equilibrium real rate. This implies that a rise in the inflation target will raise the average nominal interest rate by less than 2p.p. and thus reduce the probability of hitting the effective lower bound by less than expected.