Research Working Papers

The Optimal Monetary Policy Response to Belief Distortions: Model-Free Evidence

by: Jonathan J. Adams and Symeon Taipliadis

June 23, 2025

Data suggest that monetary policy should ease to offset inflation over-pessimism among households.

RWP 25-04, June 2025

Households' inflation expectations are often inconsistent with the full information rational expectation. Economic theory predicts that these belief distortions affect the business cycle. How then might monetary policy respond? We investigate with a model-free approach using high-frequency monetary policy shocks and a structural VAR method to identify the effects of shocks to belief distortions. Belief distortion shocks are contractionary; if households become overly pessimistic about inflation, then unemployment and deflation follow. Intuitively, our method implies that the optimal policy response is to ease: a 1 percentage point increase in the belief distortion is optimally offset by a 0.85 percentage point surprise interest rate decrease. Unconventional monetary policy is less effective than using short-run rates in our setting.

JEL Classifications: E52, E30, D84, E70

Article Citations

- Adams, Jonathan J. and Symeon Taipliadis. 2025. "The Optimal Policy Response to Belief Distortions: Model-Free Evidence." Federal Reserve Bank of Kansas City, Research Working Paper no. 25-04, June. Available at https://doi.org/10.18651/RWP2025-04.

Author

Jonathan J. Adams

Senior Economist

Jonathan J. Adams is a Senior Economist in the Economic Research Department. His research studies macroeconomics in general, with a focus on frictions related to expectations. Prior to joining the Federal Reserve, Jonathan was an assistant professor in the University of Florida Economics Department, and earned his PhD from the University of Chicago in 2016.