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# Working Paper Climate actions, market beliefs, and monetary policy

JRC Working Papers in Economics and Finance, No. 2022/14

**Provided in Cooperation with:** Joint Research Centre (JRC), European Commission

*Suggested Citation:* Annicciarico, Barbara; Di Dio, Fabio; Dilusio, Francesca (2022) : Climate actions, market beliefs, and monetary policy, JRC Working Papers in Economics and Finance, No. 2022/14, European Commission, Ispra

This Version is available at: https://hdl.handle.net/10419/283076

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# JRC TECHNICAL REPORT

# Climate Actions, Market Beliefs, and Monetary Policy

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2022

JRC Working Papers in Economics and Finance, 2022/14



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JRC130146

Luxembourg: Publications Office of the European Union  $\ensuremath{\mathbb{C}}$  European Union, 2022



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How to cite this report: Annicchiarico, B., Di Dio, F. and Diluiso, Climate Actions, Market Beliefs, and Monetary Policy, European Commission, 2022, JRC130146

#### Executive summary

The paper highlights the role of expectations in the transmission of climate policies over the business cycle and studies how monetary policy can facilitate the achievement of a predetermined mitigation target while keeping inflation under control.

Since the seminal contributions of Tversky and Kahneman (1974), Grether and Plott (1979), and Thaler (1980), an increasing number of studies have accounted for the fact that agents are not perfectly rational when making their choices and that their actions are subject to errors and cognitive biases. To overcome these cognitive limits and to the extent that economic forecasting is costly, agents, in need of making quick choices, formulate expectations and take decisions based on simple rules, the so-called heuristics or rules of thumb. It is reasonable to deduce that the presence of heterogeneous agents who change the way they formulate expectations and, therefore, their behavior over the business cycle, adds a further complication and an additional layer of uncertainty also when it comes to the macroeconomic impact of carbon pricing policies.

In the context of climate policy, agents already operate under the uncertainty inherent to the selected environmental regulatory instrument. While a carbon tax (i.e., price regulation) entails emission uncertainty, a cap-and-trade mechanism (i.e., quantity regulation) introduces short-term volatility of allowance prices. Climate policy-induced uncertainty directly reflects in output and inflation dynamics.

This paper explicitly contributes to the debate about the role of monetary policy in the face of climate actions when considering (i) short-run uncertainty and (ii) agents that are not-fully rational. Bounded rationality and behavioral biases, coupled with business cycle fluctuations, can prevent agents from fully internalizing the impact of climate policies, conditioning the policy effectiveness and the achievement of climate targets. In this context, an active monetary policy can anchor expectations and support the greening process of the economy. The underlying view of our approach is that it is crucial to understand how the stabilization of the price levels by central banks affects the nature of the business cycle whose fluctuations are dominated by movements of 'animal spirits', and to understand if the stabilization efforts, aimed at reducing the intensity of booms and busts, might be beneficial also in reducing the uncertainty surrounding the underlying climate policy and in mitigating its short-run costs.

Our results show that without the standard assumption of perfect rationality, there is more uncertainty surrounding the time path, the effectiveness, and the impact of climate policies, opening up to a non-trivial interplay between climate and monetary policies. Specifically, our key findings are as follows. First, the presence of market beliefs and behavioral agents drives and amplifies business cycle fluctuations, making the adjustment dynamics during the transition highly unpredictable. Second, under price regulation, the time needed to achieve an emission-reduction target can be longer in a behavioral model, while under a cap-and-trade scheme, there may be a severe threat to price stability. Third, a monetary policy sufficiently reactive to the output gap or inflation can dampen emission volatility, reducing the uncertainty surrounding the achievement of climate targets and stabilizing inflation, thus reducing the pressure on prices introduced by an increasingly stringent climate policy, regardless of the environmental regime adopted. Finally, delays in the implementation of the mitigation plan, lack of credibility regarding the ability of the central bank to keep inflation under control, and the adoption of monetary policy rules reacting to market expectations, rather than to fundamentals, are all factors that may amplify fluctuations and worsen the impact of climate actions on price stability. Overall, our results suggest a critical role for central banks in the fight against climate change within the remit of their mandates.

#### Abstract

This paper studies the role of expectations and monetary policy on the economy's response to climate actions. We show that in a stochastic environment and without the standard assumption of perfect rationality of agents, there is more uncertainty regarding the path and the economic impact of a climate policy, with a potential threat to the ability of central banks to maintain price stability. Market beliefs and behavioral agents increase the trade-offs inherent to the chosen mitigation tool, with a carbon tax entailing more emissions uncertainty than in a rational expectations model and a cap-and-trade scheme implying a more pronounced pressure on allowances prices and inflation. The impact on price stability is worsened by delays in the implementation of stringent climate policies, by the lack of confidence in the ability of central banks to keep inflation under control, and by the adoption of monetary rules tied to expectations rather than current macroeconomic conditions. Central banks can implement successful stabilization policies that reduce the uncertainty surrounding the impact of climate actions and support the greening process while staying within their mandate.

*Keywords*: Monetary policy; climate policy; expectations; inflation; market sentiments; business cycle.

*JEL Codes*: D83, Q50, E32, E71.

# 1 Introduction

In analyzing the economic impact of climate policies in a stochastic environment, the following questions may arise. Suppose that a mitigation plan is implemented through a quantity or a price regulation on emissions. How will the economy's response change if we remove the standard assumption of rational expectations? What is the role of market beliefs in driving or hindering the mitigation process? Finally, on a policy level, can monetary policy tame the irrational exuberance or the doom and gloom of the markets rendering the greening policy put in place more effective, while maintaining price stability?

To address these issues, we start our analysis from the simplest version of the canonical New Keynesian model augmented to include a negative environmental externality and agents who lack the cognitive abilities necessary to form rational expectations. The paper highlights the role of expectations in the transmission of climate policies along the business cycle and studies how monetary policy can facilitate the achievement of a predetermined mitigation target while keeping inflation under control.

According to the standard economic theory, when economic agents make their decisions, they consider all the options available to them, anticipate the possible outcome, and know how the economy works and the probability distributions of future events. Put another way, agents formulate rational expectations. However, do agents do that? Do agents have a sufficient ability to understand economic variables and formulate fully-model consistent expectations? Since the seminal contributions of Tversky and Kahneman (1974), Grether and Plott (1979), and Thaler (1980), an increasing number of studies have accounted for the fact that agents are not perfectly rational when making their choices and that their actions are subject to errors and cognitive biases. Moreover, in a world where knowledge is bounded and time is pressing, the decision process can be extremely complicated and costly.<sup>1</sup> To overcome these cognitive limits and to the extent that economic forecasting is costly, agents, in need of making quick choices, formulate expectations and take decisions based on simple rules, the so-called heuristics or rules of thumb.<sup>2</sup> However, agents using heuristics learn from their mistakes and stand ready to choose the rule that exhibits the best performance, generating endogenous dynamics that, in turn, may give rise to short-term macroeconomic fluctuations.

There is quite an extensive literature, based on survey data, rejecting the rational expectations hypothesis and emphasizing the considerable heterogeneity of private-sector forecasts of macroeconomic variables. For a comprehensive survey, see Pesaran and Weale (2006). Figure 1 shows some evidence of substantial heterogeneity in expectations formation by displaying the dispersion of expected GDP growth and CPI inflation in the US Survey of Professional Fore-

 $<sup>^{1}</sup>$ On this issue see the early paper of Evans and Ramey (1992).

<sup>&</sup>lt;sup>2</sup>Forming rational expectations can be expensive (one needs to do research and be very smart), while observing just current data/variables is cheaper. On the notion of heuristics see e.g. Gigerenzer and Selten (2002) and Gigerenzer and Gaissmaier (2011).

Figure 1: Cross-Sectional Dispersion of Growth and Inflation Expectations



Note: the figure plots the cross-sectional difference between the 75th percentile and the 25th percentile of projections of real GDP growth and CPI inflation against actual data. All variables are expressed in annualized percentage points. Data are from the US Survey of Professional Forecasters for the period 1995Q1-2019Q4.

casters. Data refer to forecasts made in the relevant quarter for the period 1995Q1-2019Q4. The figure documents substantial disagreement among professional economists about both variables. The disagreement tends to be more prominent when the growth and inflation are away from long-run averages.

It is then reasonable to deduce that the presence of heterogeneous agents who change the way they formulate expectations and, therefore, their behavior along the business cycle, adds a further complication and an additional layer of uncertainty also when it comes to the macroeconomic impact of carbon pricing policies.<sup>3</sup> In the context of climate policy, agents already operate under the uncertainty inherent to the selected environmental regulatory instrument. While a carbon tax (i.e., price regulation) entails emission uncertainty, a cap-and-trade mechanism (i.e., quantity regulation) introduces short-term volatility of allowance prices. Climate policy-induced uncertainty directly reflects in output and inflation dynamics. Assuming agents formulate expectations on these two variables we are implicitly considering climate policy uncertainty and how agents react to it.<sup>4</sup> Via the expectation channel, agents shape the dynamics in response to mitigation policies and may play an enabling or a hampering role in the transition process, depending on how they forecast future economic variables.

<sup>&</sup>lt;sup>3</sup>Along this line, see Alessi et al. (2021), who study the reaction of financial investors to the Paris Agreement and then to the subsequent withdrawal of the US from it, finding evidence of a strong heterogeneity of reactions across different categories of investors. In particular, following the US withdrawal the behavior of households is shown to be more sentiment-driven, in contrast to that of regulated financial institutions.

<sup>&</sup>lt;sup>4</sup>Note that in this context formulating expectations directly on emission dynamics or on the time path of the permits price would be redundant.

The economy's response to climate policies and the effects on macroeconomic stability, particularly on inflation dynamics, are at the center of the current policy debate. While there is a broad consensus on the necessity of policy actions to comply with the goals set by the Paris Agreement and meet climate targets (e.g. IPCC, 2018), the short-medium-run macroeconomic implications of climate policies are not yet very well understood. This poses a challenge in particular for the conduct of monetary policy, whose conventional policy horizon is typically from two to three years. The process of reducing emissions is likely to have a significant impact on the economy, with potential repercussions on macroeconomic and price stability, conditioning the environment in which central banks operate and, thus, the conduct of their policies (e.g. NGFS, 2019 and Schoenmaker, 2021).

Several central banks around the world have joined the Network for Greening the Financial System (NGFS) and are currently evaluating how climate policies can influence their mandates and what role they can play in the fight against climate change (e.g. Carney, 2015, Rudebusch et al., 2019, Lagarde, 2021, Villeroy de Galhau, 2021). Last year the European Central Bank presented an action plan to include climate change considerations in its monetary policy strategy (see ECB 2021). We can expect climate and monetary policy to walk closer in the future. Even if governments remain primarily responsible for facilitating an orderly low-carbon transition and undertaking the main policy interventions, there are several areas in which central banks can contribute to support climate actions, simply acting in the perimeter of their mandates.

This paper explicitly contributes to this debate by discussing the role of monetary policy in the face of climate actions when considering (i) short-run uncertainty and (ii) agents that are not-fully rational. This allows us to evaluate the performance of climate policy and its interaction with monetary policy in an economy hit by shocks and subject to market beliefs. Bounded rationality and behavioral biases, coupled with business cycle fluctuations, can prevent agents from fully internalizing the impact of climate policies, conditioning the policy effectiveness and the achievement of climate targets. In this context, an active monetary policy can anchor expectations and support the greening process of the economy.

The underlying view of our approach is that it is crucial to understand how the stabilization of the price levels by central banks affects the nature of the business cycle whose fluctuations are dominated by movements of 'animal spirits', and to understand if the stabilization efforts, aimed at reducing the intensity of booms and busts, might be beneficial also in reducing the uncertainty surrounding the underlying climate policy and in mitigating its short-run costs.

Our results show that without the standard assumption of perfect rationality, there is more uncertainty surrounding the time path, the effectiveness, and the impact of climate policies, opening up to a non-trivial interplay between climate and monetary policies. Specifically, our key findings are as follows. First, the presence of market beliefs and behavioral agents drives and amplifies business cycle fluctuations, making the adjustment dynamics during the transition highly unpredictable. Second, under price regulation, the time needed to achieve an emission-reduction target can be longer in a behavioral model, while under a cap-and-trade scheme, there may be a severe threat to price stability. Third, a monetary policy sufficiently reactive to the output gap or inflation can dampen emission volatility, reducing the uncertainty surrounding the achievement of climate targets and stabilizing inflation, thus reducing the pressure on prices introduced by an increasingly stringent climate policy, regardless of the environmental regime adopted. Fourth, delays in the implementation of the mitigation plan, lack of credibility regarding the ability of the central bank to keep inflation under control, and the adoption of monetary policy rules reacting to market expectations, rather than to fundamentals, are all factors that may amplify fluctuations and worsen the impact of climate actions on price stability. Overall, our results suggest a critical role for central banks in the fight against climate change within the remit of their mandates.

To the best of our knowledge, this paper is the first attempt to study the transmission of climate actions and the role of monetary policy in the low-carbon transition in a behavioral New Keynesian model, where agents are not fully rational and subject to market beliefs. For the formalization of behavioral agents in the context of the canonical New Keynesian model, this work follows quite closely the contributions by De Grauwe (2011, 2012b,a), Kurz et al. (2013), De Grauwe and Macchiarelli (2015), De Grauwe and Gerba (2018), De Grauwe and Ji (2020), Hommes and Lustenhouwer (2019) and Hommes et al. (2019).<sup>5</sup> Several authors have also considered New Keynesian model variants deviating from the rational expectations hypothesis and introducing heterogeneous market beliefs. These include Branch (2009), Branch and McGough (2010), Levine et al. (2012), Kurz et al. (2013), Massaro (2013), and Annicchiarico et al. (2019), among others.<sup>6</sup>

The interactions between monetary and climate policy in New Keynesian models have been explicitly investigated by Annicchiarico and Di Dio (2015, 2017), Economides and Xepapadeas (2018) and Chan (2020) in closed economy, and by Annicchiarico and Diluiso (2019), and Pagliari and Ferrari (2021), in open economy.<sup>7</sup> Recently, in a New Keynesian model with financial frictions Diluiso et al. (2021) explore the monetary policy's role during a credible and gradual medium-term mitigation plan, showing that a monetary policy targeting inflation can limit output losses, while jointly safeguarding financial and price stability. However, in that analysis, the economy is not perturbed by any shocks during the greening process, and agents are assumed to be fully rational. Dietrich et al. (2021) focus on the implications that climate-change-related disaster expectations can have for the conduct of monetary policy and

<sup>&</sup>lt;sup>5</sup>Other variants with non-rational agents include the near rationality hypothesis as in Woodford (2010), the learning mechanism as in Bullard and Mitra (2002) and Evans and Honkapohja (2012), and the approach of Gabaix (2020) who introduces the notion of *cognitive discounting* by which non-rational agents discount future events relatively more than rational agents when the forecasting horizon is more distant in the future.

<sup>&</sup>lt;sup>6</sup>More recently Ferrari and Landi (2022) show that the green transition may be inflationary if agents are not rational or the government is not credible.

<sup>&</sup>lt;sup>7</sup>For an overview of the literature on business cycles and environmental policy, see e.g. Annicchiarico et al. (2021).

the emergence of cyclical fluctuations. Our paper contributes to this literature and provides a different perspective to the heated debate on the role that central banks can play during the transition to a low-carbon economy and the impact that the fight against climate change may have on the price stability objectives (see e.g. NGFS, 2020a,b).

Finally, by explicitly distinguishing between carbon taxes and cap-and-trade schemes, this paper also contributes to the literature on price versus quantity regulations that since the seminal contribution of Weitzman (1974) has animated the debate among economists, policy analysts and practitioners.<sup>8</sup> We show that in the presence of uncertainty and non-rational agents, the close connection between these two modes of environmental control becomes more problematic.

The paper is structured as follows. Section 2 presents the behavioral New Keynesian model with environmental externality. Section 3 describes the baseline parameterization. Section 4 looks at the dynamic response of the economy to a mitigation policy and explores the role of monetary policy during the green transition. Section 5 undertakes some sensitivity analysis to examine the role of market beliefs, considers different hypotheses about how agents form their expectations, and studies the effects of the lack of credibility regarding the ability of the central bank to maintain inflation at its target. Section 6 concludes and draws some implications for monetary policy.

# 2 A Behavioral New Keynesian Environmental Model

We consider a behavioral variant of the prototypical New Keynesian dynamic stochastic general equilibrium model with imperfect price adjustment  $\dot{a}$  la Calvo (1983), including pollutant emissions and climate policy. Private agents formulate expectations by endogenously selecting the forecasting rules based on their relative past performance. In what follows we present our setup where we adapt the microfoundations of the New Keynesian model with heterogeneous expectations of Kurz et al. (2013), also used in Hommes and Lustenhouwer (2019) and Hommes et al. (2019), among others.

The economy is populated by three types of agents: (i) a continuum of households who consume, supply labor, own firms, and formulate expectations according to simple heuristics; (ii) a continuum of monopolistically competitive polluting firms, facing nominal rigidities and using labor and a fossil resource as production inputs; (iii) a public sector conducting monetary policy through an interest rate rule of the Taylor-type and setting climate policy by either controlling the price of carbon or by setting a cap on emissions.

<sup>&</sup>lt;sup>8</sup>See Karp and Traeger (2018) and Stavins (2020) for a comprehensive discussion on this debate and on the related policy implications.

#### 2.1 Households

There is a continuum of mass one of infinitely lived households on the demand side. The representative household of type i has preferences represented by:

$$\tilde{E}_{i,0} \sum_{t=0}^{\infty} (e^{v_t}) \beta^t \left[ \frac{(C_{i,t} - hC_{t-1})^{1-\gamma} - 1}{1-\gamma} - \chi \frac{N_{i,t}^{1+\varphi}}{1+\varphi} - \frac{\varrho}{2} \left(\frac{B_{i,t}}{P_t}\right)^2 \right],\tag{1}$$

where  $\tilde{E}_{i,0}$  denotes the subjective expectation operator in the period 0, the variable  $v_t$  is an exogenous shock distorting the household discount factor (i.e., an intertemporal preference shock),  $\beta \in (0, 1)$  is the discount factor,  $C_{i,t}$  is consumption,  $\gamma > 0$  is the inverse of the intertemporal elasticity of substitution,  $h \in [0, 1)$  measures habit persistence,<sup>9</sup>  $C_{t-1}$  is the lagged value of average aggregate consumption, taken as given by each atomistic household (external habit),  $N_{i,t}$  denotes hours of work,  $\chi$  measures the disutility of labor, and  $\varphi > 0$  is the inverse of the Frisch elasticity of labor supply. Finally,  $P_t$  is the aggregate price level of the economy,  $B_{i,t}$  denotes the quantity of one-period nominal bonds purchased in t and  $\rho > 0$ . As in Kurz et al. (2013) the last term in (1) introduces a penalty on excessive lending at individual levels and replaces transversality conditions.<sup>10</sup> It should be noted that households are heterogeneous since they formulate different expectations about future income and inflation. In Section 2.4. we will see how expectations are formulated and how agents endogenously select their expectation rule.

Each household faces a flow budget constraint of the form:

$$P_t C_{i,t} + B_{i,t} = W_t N_{i,t} + R_{t-1} B_{i,t-1} + D_{i,t},$$
(2)

where  $W_t$  is the nominal wage,  $R_{t-1}$  is the nominal (risk-free) interest factor and  $D_{i,t}$  represents the lump-sum income component, including government transfers and dividends from the ownership of firms. The representative household of type *i* in period *t* chooses  $C_{i,t}$ ,  $B_{i,t}$  and  $N_{i,t}$ , so as to maximize (1), subject to (2).

#### 2.2 Production

As in the baseline New Keynesian model, we assume there is a perfectly competitive final good sector assembling differentiated intermediate goods to produce a single final good,  $Y_t$ , according

<sup>&</sup>lt;sup>9</sup>Habit persistence has been shown to improve the empirical performance of dynamic stochastic general equilibrium models. Habit formation, for instance, helps to match the interest rate dynamics to several features of asset prices (as shown in Christiano et al. 2001) but it is also useful to have an empirical-relevant propagation of monetary shocks into consumption (see Christiano et al. 2005).

<sup>&</sup>lt;sup>10</sup>When the economy is out of its steady state, in fact, heterogeneous agents lend and borrow from each other. See Annicchiarico et al. (2019) where debt and wealth dynamics are made explicit.

to a constant elasticity of substitution (CES) technology:

$$Y_t = \left[ \int_0^1 (Y_{i,t})^{(\sigma-1)/\sigma} \, di \right]^{\sigma/(\sigma-1)},\tag{3}$$

where  $\sigma > 1$  is the elasticity of substitution between intermediate goods and  $Y_{i,t}$  is the intermediate good of generic type *i*. At the optimum, the demand equation for the generic variety *i* is  $Y_{i,t} = (P_{i,t}/P_t)^{-\sigma} Y_t$ , where  $P_t = \int_0^1 (P_{i,t}^{1-\sigma})^{1/(1-\sigma)} di$  is the aggregate price index of the economy, such that  $P_t Y_t = \int_0^1 P_{i,t} Y_{i,t} di$ .

Monopolistic competitive firms produce intermediate goods. Households have equal ownership shares in all firms, but each household is assumed to manage only one firm. Note that we use the same index i used for types of households in indexing producers, given the assumption made regarding the management of firms.

The intermediate good producer *i* uses labor inputs  $N_{i,t}$  and a fossil resource  $Z_{i,t}$  as a polluting source of energy. The production function is a constant return to scale technology of the CES type:

$$Y_{i,t} = \Delta_t \left[ \zeta Z_{i,t}^{\frac{\varkappa - 1}{\varkappa}} + (1 - \zeta) \left( A_t N_{i,t} \right)^{\frac{\varkappa - 1}{\varkappa}} \right]^{\frac{\varkappa}{\varkappa - 1}}, \tag{4}$$

where  $Y_{i,t}$  is production,  $\Delta_t$ , captures a negative environmental externality impacting all producers in the same way,  $A_t$  is an exogenous process measuring labor productivity,  $\zeta \in (0, 1)$ is the energy quasi-share parameter and  $\varkappa > 0$  is the elasticity of substitution between energy and labor inputs. The CES structure of the production function implies that factor cost shares are allowed to vary along the business cycle. We assume  $\varkappa \in (0, 1)$ , so to capture a certain complementarity between the two factor inputs. Let  $P_{Z,t}$  denote the nominal price of the fossil resource, then the real marginal cost of production can be written as:

$$MC_{i,t} = MC_t = \Delta_t^{-1} \left[ \zeta^{\varkappa} \left( \frac{P_{Z,t}}{P_t} \right)^{1-\varkappa} + (1-\zeta)^{\varkappa} A_t^{\varkappa - 1} \left( \frac{W_t}{P_t} \right)^{1-\varkappa} \right]^{\frac{1}{1-\varkappa}},$$
(5)

where we have dropped the i subscript for the marginal costs since they are symmetric across firms.

Following Calvo (1983), each producer may reset its price only with probability  $1 - \varpi$ . The typical firm able to re-optimize in period t will choose the *optimal* price, say  $P_{i,t}^*$ , to maximize the current market value of the expected profits generated while that price will stay put. We further assume that in the periods between price re-optimization, firms will be able to mechanically adjust their prices according to a simple indexation rule:

$$P_{i,t+s} = P_{i,t+s-1} \Pi^{\kappa} \Pi^{\kappa}_{t+s-1}, \qquad s = 1, ..., n,$$
(6)

where  $\Pi_{t+1} = P_{t+1}/P_t$  is the gross inflation rate at the time t+1 and  $\Pi$  is its steady-state value, while  $\kappa \in [0, 1]$  measures the degree of indexation to past inflation. Since there is a continuum of firms of mass one, in each period a fraction  $1 - \varpi$  of firms will be able to re-optimize and a fraction  $\varpi$  will change their price according to the indexation rule (6). The solution to the price-setting problem is deferred to the Appendix.

#### 2.3 Public Sector, Pollution Stock, and Equilibrium

We assume that the polluting energy input is extracted with no cost by the government, which sells it to the intermediate-goods producers and distributes the proceeds as lump-sum transfers to the households. The government's budget is then balanced at all times. We also assume that the emissions flow is equal to  $Z_t$ , so that by either setting the price or the supply of the fossil resource, the government can control emissions.<sup>11</sup> In the first case, the government sets the real price per emissions unit, and this price can be interpreted as a carbon tax; in the second case, the government sets a cap on the overall emissions generated by the economy. We limit our attention to these specific pollution policies since they are two instruments frequently contrasted in the literature and the policy debate.

Following Golosov et al. (2014), the cumulative emissions in the atmosphere,  $M_t$ , evolves as:

$$M_t - \overline{M} = \int_0^1 Z_{i,t} di + (1 - \delta_M) \left( M_{t-1} - \overline{M} \right) + Z_t^{RoW}, \tag{7}$$

where  $\overline{M}$  denotes the pre-industrial concentration of pollutant,  $\delta_M \in (0, 1)$  measures the natural rate at which the atmosphere recovers, and  $Z_t^{RoW}$  is an exogenous process capturing the restof-the-world emissions. In what follows, we will keep  $Z_t^{RoW}$  constant.

Finally, we include a damage channel in the model, namely a level impact channel affecting firms' productivity via the damage factor  $\Delta_t$ . Following Golosov et al. (2014), who simplify the approach of Nordhaus (2008, 2017), the damage evolves as follows:

$$\Delta_t = \exp\left(-\eta \left(M_t - \overline{M}\right)\right),\tag{8}$$

where  $\eta > 0$  is a scaling coefficient measuring the intensity of the negative externality on production.  $1 - \Delta_t$  is then the fraction of output lost due to climate change. This is a parsimonious way of introducing the negative environmental externality by which pollutant concentrations affect productivity.<sup>12</sup> From the climate system's functioning, it is easy to understand how changes in emissions in a limited period and implemented by one and only economy, do not substantially change cumulative emissions in the atmosphere. This implies that the marginal benefits of unilateral mitigation policies are negligible at business cycle frequency, while the

<sup>11</sup>Analogously one could assume that households own the fossil resource and that the public sector levies a tax on its use or imposes quantity restriction as a way to price carbon.

 $<sup>^{12}</sup>$ In fully fledged integrated assessment models carbon concentration affects global mean temperature, and then changes in temperature negatively impact productivity. See Golosov et al. (2014) for a discussion on how the exponential damage function specified here approximates the current state-of-the-art damage function given e.g. by Nordhaus (2007).

marginal costs are substantial.

Monetary policy is set according to a Taylor-type interest rate rule specified as follows:

$$\frac{R_t}{R} = \left(\frac{R_{t-1}}{R}\right)^{\iota_R} \left[ \left(\frac{\Pi_t}{\Pi}\right)^{\iota_\pi} \left(\frac{Y_t}{Y_t^*}\right)^{\iota_y} \right]^{1-\iota_R} \exp u_t,\tag{9}$$

where R denotes the steady-state value of the nominal interest rate,  $\Pi$  is the steady-state inflation,  $Y_t^*$  is the natural level of output (i.e., the output that would prevail if prices were fully flexible),  $\iota_R \in [0, 1)$  is the smoothing parameter, measuring the degree of persistence of the rule,  $\iota_{\pi} > 0$  and  $\iota_y > 0$  capture the responsiveness of nominal interest rate to movements in inflation and output, while  $u_t$  represents an exogenous monetary policy shock.

Finally, since we have assumed that the natural resource is produced at no cost, the resource constraint of the economy is given by:

$$Y_t = \int_0^1 C_{i,t} di.$$
 (10)

### 2.4 The Aggregate Model and Expectations

In this section, we first summarize the aggregate equations of the model described in the previous section and then introduce the modeling of expectations. The equilibrium conditions describing the behavior of heterogeneous agents have been log-linearized around a zero-inflation steady state and then aggregated. The aggregate model is reported in Table 1, where  $y_t$ ,  $m_{c_t}$ ,  $z_t, p_{z,t}, m_t, y_t^*$  and  $\delta_t$  denote output, marginal costs, emissions flow, the relative price of carbon, stock of pollutant, natural output, and environmental damage. All these variables are expressed as natural log deviations from their steady-state values; in contrast the inflation rate,  $\pi_t$ , and the nominal interest rates,  $r_t$ , are expressed in deviations from their respective steady-state levels. In detail, the first equation of Table 1 describes the aggregate demand (IS curve); the second equation determines the time path of the marginal costs, where the last term measures the impact of the environmental damage on production; the third equation describes the dynamic of emissions that are decreasing in the carbon price; the fourth equation is the behavioral analog of the New Keynesian Phillips curve relating inflation to marginal costs and agents' beliefs about future inflation; the fifth equation describes the accumulation of the pollution stock; the sixth equation refers to the environmental damage factor; finally, the last equation is the interest rate rule, where we have set  $\iota_r$  at zero. The equations of the aggregate model will come in handy in interpreting the results of our numerical experiments. For the complete derivation of these equations, see the Appendix.

We are now ready to describe how agents formulate expectations about future variables. As anticipated, agents are assumed to have cognitive limitations, therefore, they use simple rules (i.e., heuristics) to forecast future income and inflation. In the words of Gigerenzer and

Equation	Description
$y_t (1+h) = \tilde{E}_t y_{t+1} + h y_{t-1} - \frac{1-h}{\gamma} \left( r_t - \tilde{E}_t \pi_{t+1} \right) + v_t$	IS
$mc_t = mc_y y_t - mc_\delta \delta_t - mc_z z_t - mc_a a_t - mc_{y-1} y_{t-1}$	Marginal Cost
$z_t = \varkappa mc_t + (\varkappa - 1) \delta_t + y_t - \varkappa p_{Z,t}$	Emissions
$\pi_t = \frac{1 - \varpi\beta}{1 + \beta\kappa} \frac{1 - \varpi}{\varpi} mc_t + \frac{\beta}{1 + \beta\kappa} \tilde{E}_t \pi_{t+1} + \frac{\kappa}{1 + \beta\kappa} \pi_{t-1}$	New Keynesian Phillips Curve
$m_t = \delta_M \frac{Z}{Z + Z^{RoW}} z_t + (1 - \delta_M) m_{t-1} + \delta_M \frac{Z^{RoW}}{Z + Z^{RoW}} z_t^{RoW}$	Pollution Stock
$\delta_t = -\eta \left( M - \overline{M} \right) m_t$	Environmental Damage
$r_t = \iota_\pi \pi_t + \iota_y (y_t - y_t^*) + u_t$	Taylor Rule

Table 1: The Aggregate Log-Linearized Model

Note: the model is log-linearized around a zero steady-state inflation. In the second equation the coefficients are all positive and depend on a complex fashion on the deep parameters of the model. See the Appendix. Variables  $v_t$ ,  $a_t$  and  $u_t$  are exogenous stochastic processes driving economic fluctuations.

Gaissmaier (2011, p. 454), a heuristic is "a strategy that ignores part of the information to make decisions more quickly and frugally than more complex methods". The assumption is that agents adopt precise rules of thumb in their decision-making to overcome their cognitive limitations.

Following the heterogeneous expectations framework of Brock and Hommes (1997), the forecasting rules are described by an endogenous selection mechanism by which agents switch from one rule to another based on their past forecasting performances. For simplicity, we assume only two types of forecasting rules. Consistently with the terminology of De Grauwe (2011, 2012a,b) we consider an 'extrapolative' rule and a 'fundamentalist' rule.

The extrapolative prediction rule, labeled e, is a random walk rule by which agents use the previously observed value of a variable as a forecast. This is a myopic rule according to which agents are insensitive to other information about the functioning of the economy. The fundamentalist rule, labeled f, is more sophisticated. Agents expect future output to be equal to the expected value of its fundamental level, natural output, while next period inflation is simply expected to return to its long-run value target set by the central bank. In formulating their expectation regarding the natural level of output, these agents use all the information set available at the time t, that is, they formulate rational expectations, but on the wrong variable since they neglect imperfect price adjustments. The judgment on future output is also based on the (wrong) belief that monetary policy is neutral. Put another way, fundamentalists expect that the next period's output gap will be equal to zero.

According to these forecasting rules, expectations on output and inflation are such that:

$$\dot{E}_{e,t}(y_{t+1}) = y_{t-1},$$
  $\dot{E}_{e,t}(\pi_{t+1}) = \pi_{t-1},$  (11)

$$\tilde{E}_{f,t}(y_{t+1}) = E_t y_{t+1}^*, \qquad \qquad \tilde{E}_{f,t}(\pi_{t+1}) = 0, \qquad (12)$$

where expectations are formulated at the beginning of the period t before the realization of the shocks. Let  $\alpha_{y,t}^e$  ( $\alpha_{y,t}^f$ ) denote the share of agents opting for an extrapolative (fundamentalist) rule for output forecast, and  $\alpha_{\pi,t}^e$  ( $\alpha_{\pi,t}^f$ ) the share of agents opting for an extrapolative (fundamentalist) rule for inflation forecast, the market forecasting rules for output and inflation immediately follow:

$$\tilde{E}_{t}(y_{t+1}) = \alpha_{y,t}^{f} \tilde{E}_{f,t}(y_{t+1}) + \alpha_{y,t}^{e} \tilde{E}_{e,t}(y_{t+1}),$$
(13)

$$\tilde{E}_t(\pi_{t+1}) = \alpha_{\pi,t}^f \tilde{E}_{f,t}(\pi_{t+1}) + \alpha_{\pi,t}^e \tilde{E}_{e,t}(\pi_{t+1}),$$
(14)

where  $\alpha_{y,t}^f + \alpha_{y,t}^e = 1$  and  $\alpha_{\pi,t}^f + \alpha_{\pi,t}^e = 1$ .

Following Brock and Hommes (1997), agents can switch between these rules on the basis of their forecasting performances. Put it differently, agents are aware that their predictions may be biased, they then deliberately learn from their mistakes and switch to the best performing rule. From this point of view, agents can be seen as *rational* since they continuously evaluate the forecast performance of a given rule.<sup>13</sup>

Let  $U_x^i$  denote the fitness criterion of rule  $i \in \{f, e\}$  for the generic variable  $x \in \{y, \pi\}$ . This criterion of success is simply defined as the negative of the weighted mean squared forecasting errors of the forecasting rule:

$$U_{x,t}^{i} = -\sum_{k=0}^{\infty} \gamma_k \left( x_{t-k-1} - \tilde{E}_{i,t-k-2} x_{t-k-1} \right)^2,$$
(15)

where  $\gamma_k$  denote geometrically declining weights measuring the weight attributed by agents to past forecast errors. We assume that agents tend to forget, so they attach relatively higher importance to recent errors than those made far in the past. To capture this tendency to forget in a parsimonious way, we assume  $\gamma_k = (1 - \rho)\rho^k$  with  $0 \le \rho \le 1$ , then (15) can be re-written as:

$$U_{x,t}^{i} = \rho U_{x,t-1}^{i} - (1-\rho) \left( x_{t-1} - \tilde{E}_{i,t-2} x_{t-1} \right)^{2},$$
(16)

where the parameter  $\rho$  is a measure of agent memory. In particular, when  $\rho = 1$  agents have infinite memory and assign the same weights to all past mistakes; when  $\rho = 0$ , instead, agents have no memory and only the last period forecasting error matters. In the latter case, we will see that the economy is more volatile.

Moreover, agents may be unpredictably affected by their state of mind when choosing between the two rules, or they may face a measurement error in calculating forecast errors. To capture these factors that may affect decisions, we assume that the comparison between the two values of the metrics chosen as fitness criterion of rules  $i \in \{f, e\}$  is based on the following probability P:

$$\alpha_{x,t}^f = P[U_{x,t}^f + \epsilon_{x,t}^f > U_{x,t}^e + \epsilon_{x,t}^e],$$
(17)

 $<sup>^{13}</sup>$ Agents then spend some mental energy in evaluating the performance of a given heuristic.

where now  $\alpha_{x,t}^{f}$  can be interpreted as the probability of opting for a fundamentalist rule, while  $\epsilon_{x,t}^{f}$  and  $\epsilon_{x,t}^{e}$  are random variables catching all the unpredictable factors that may affect agents when choosing between alternatives.

As in the discrete choice model of Brock and Hommes (1997) and hinging on the work of Manski and McFadden (1981) and Anderson et al. (1992), these random variables are assumed to be logistically distributed. Under the assumption that all agents can simultaneously update the forecasting rule they use, then the fraction of agents opting for rule i in each period will be given by:

$$\alpha_{x,t}^{i} = \frac{e^{\theta U_{x,t}^{i}}}{\sum_{i} e^{\theta U_{x,t}^{i}}},\tag{18}$$

where the parameter  $\theta$  referred to as 'learning parameter' or 'intensity of choice', reflects the tendency of agents to select the best-performing rule.<sup>14</sup> The size of this parameter is related to the variance of the random components  $\epsilon_{x,t}^f$  and  $\epsilon_{x,t}^e$  in (17). In particular, if this variance tends to infinity, then  $\theta \to 0$  and agents cannot observe any difference in fitness between the two rules, or simply they do not exhibit any willingness to learn from past mistakes. In this case, agents flip a coin to make their choice, so that  $\alpha_{x,t}^f$  and  $\alpha_{x,t}^e$  will be equal to 0.5. When the variance of the random components tends to zero,  $\theta \to \infty$  and agents select the best-performing rule, the probability of opting for one rule can be either 1 or 0. We will see that for a higher  $\theta$  market beliefs tend to amplify disturbances.

Given these assumptions, the economy features four types of agents according to their way of formulating expectations: (i) agents who formulate expectations according to the extrapolative rule for both output and inflation, (ii) agents who formulate expectations according to the fundamentalist rule for both output and inflation, (iii) agents who opt for the extrapolative rule for output and the fundamentalist rule for inflation, (iv) agents who opt for the extrapolative rule for inflation and the fundamentalist rule for output.

# **3** Parameterization

In this section we describe the parameterization of the model. To this end, we start by assuming that all the exogenous components  $v_t$ ,  $a_t$  and  $u_t$  follow an AR(1) process:

$$v_t = \rho_v v_{t-1} + \xi_{v,t}, \tag{19}$$

$$a_t = \rho_a a_{t-1} + \xi_{a,t},$$
 (20)

$$u_t = \rho_u u_{t-1} + \xi_{u,t}, \tag{21}$$

 $<sup>^{14}</sup>$ According to (18) we are considering the case of synchronous updating, where all agents switch to better rules in each period. We will remove this assumption in Section 5, where will introduce the possibility of asynchronous updating.

where  $\rho_v$ ,  $\rho_a$ ,  $\rho_u \in [0, 1)$  and  $\xi_{v,t}$ ,  $\xi_{a,t}$ ,  $\xi_{u,t}$  are normally and independently distributed innovations with mean zero and standard deviations  $\sigma_v$ ,  $\sigma_a$  and  $\sigma_u$ , respectively.

To parameterize the model we proceed in two steps. First, we fix a set of parameters to match standard macroeconomic and environmental targets in steady state. Second, given the values of those parameters, we choose the remaining ones to match some moments (standard deviation, autocorrelation and kurtosis) in the data. A model period corresponds to one quarter.

Fixed Parameters. Table 2 lists the choice of parameter values that we fix. In particular, the parameters related to the New Keynesian structure of the model are standard and taken from the current literature. Preferences in consumption are assumed to be logarithmic ( $\gamma = 1$ ) and the inverse of the Frisch elasticity  $\varphi$  is set to 1, an intermediate value between micro and macro data estimates. The discount factor  $\beta$  is equal to 0.99, consistent with a real interest rate of 4% per year. The elasticity of substitution between energy and labor inputs,  $\varkappa$ , is fixed at 0.3, implying that the two production factors are imperfect complements. The quasishare parameter measuring the contribution of the polluting input in the CES production,  $\zeta$ , is calibrated starting from the share of income spent on energy in the US that in 2018 was around 6% of GDP according to EIA (2020). The probability that prices stay unchanged in each quarter,  $\varpi$ , is fixed at 0.75. In the baseline calibration, the policy parameters of the Taylor rule are also standard, that is  $\iota_{\pi} = 1.5$ ,  $\iota_{y} = 0.125$  and  $\iota_{r} = 0$ .

To parameterize the environmental part of the model, we proceed as follows. We start by considering the world's total emissions in 2020 according to the business-as-usual scenario of the DICE model, which is 41.685 giga-tons of carbon dioxide per year.<sup>15</sup> The quarterly rate at which the atmosphere recovers,  $\delta_M$ , is 0.0021 consistently with Reilly and Richards (1993), implying a half-life of carbon in the atmosphere of about 83 years. Knowing that the pre-industrial atmospheric concentration of carbon,  $\overline{M}$ , is about 581 giga-tons, we can obtain the steady-state value for M that approximately corresponds to the atmospheric concentration of carbon observed in the DICE model in 2080. According to the DICE simulations, at this pollutant concentration level, the fraction of output lost for the damage is around 0.026. From this assumption, we can retrieve the damage parameter  $\eta$ . Finally, to set the coefficient  $Z/(Z^{RoW} + Z)$  in the pollution stock equation of Table 1, we use World Bank data for 2018 and observe that the share of worldwide GHG emissions ascribed to the US is around 13%.

*Fitted Parameters.* We choose the remaining parameters, listed in Table 3, in order to match the empirical targets in Table 4. Although the model is nonlinear and under-identified, with six moments determining ten parameters, it fits the targets in Table 4 fairly well.

In particular, the parameters measuring habit persistence and past indexation of price settings, h and  $\kappa$ , the parameter capturing the intensity of choice  $\theta$ , the one measuring the memory of agents,  $\rho$ , and the autoregressive coefficients and standard deviations of the three shocks are

<sup>&</sup>lt;sup>15</sup>For details on the DICE model, see Nordhaus (2017, 2018).

Parameter	Value	Description
β	0.99	Discount rate
$\gamma$	1	Risk aversion coefficient
arphi	1	Inverse Frisch elasticity
$\zeta$	0.1724	Energy quasi-share parameter
$\mathcal{H}$	0.3	Elasticity of substitution between energy and labor inputs
$\omega$	0.75	Calvo's price parameter
$\delta_M$	0.0021	Emissions decay rate
$\eta(M-\bar{M})$	0.0263	Impact damage coefficient
$\iota_r$	0	Smoothing parameter of the Taylor rule
$\iota_y$	0.125	Output gap coefficient of the Taylor rule
$\iota_{\pi}$	1.5	Inflation coefficient of the Taylor rule

Table 2: Fixed Parameter Values

set using a simulated minimum distance routine so that, in the baseline parameterization under a constant carbon tax policy, the model can reasonably match the moments of output and inflation observed in the US quarterly data for the period 1990Q1-2019Q4. As shown, the model can also reproduce the excess of kurtosis found in the data, which is evidence of fat tails in the output distribution and inflation.<sup>16</sup>

Parameter	Value	Description
h	0.5	Habit parameter
$\kappa$	0.5	Coefficient of price indexation
$\theta$	3050	Learning or intensity of choice parameter
ho	0.4	Memory of agents
$ ho_a$	0.8	Technology shock persistence
$ ho_v$	0.8	Preference shock persistence
$ ho_u$	0.5	Monetary policy shock persistence
$\sigma_a$	0.009	Standard deviation of the technology shock
$\sigma_v$	0.005	Standard deviation of the preference shock
$\sigma_u$	0.005	Standard deviation of the monetary policy shock

<sup>&</sup>lt;sup>16</sup>It can be shown that under a quantity restriction (i.e., a cap on emissions) output is less volatile, consistently with previous findings (e.g. Fischer and Springborn 2011 and Annicchiarico and Di Dio 2015) and less leptokurtic, while inflation is slightly more volatile than under a tax, because of the uncertainty surrounding emission prices over the business cycle.

Table 4: Moments for Output and Inflation - Data and Model under the Baseline Parameterization

		Standard Deviation	Autocorrelation	Kurtosis
Output a	Data	0.0103	0.8565	3.3057
Output, y	Model	0.0105	0.8863	3.3239
Inflation <i>m</i>	Data	0.1758	0.9668	3.8501
	Model	0.2418	0.8996	4.4822

Note: the table reports moments generated by the model under the baseline parameterization for 100 replications of shock sequences of size 1,000 and those of the US data over the period 1990Q1-2019Q4, retrieved from FRED, Federal Reserve Bank of St.Louis. Series used: Real Gross Domestic Product - GDPC1 (HP Filtered series) and Gross Domestic Product: Implicit Price Deflator (GDPDEF) The standard deviation of (quarterly) inflation is expressed in percentage points.

# 4 Greening the Economy: The Role of Market Beliefs and Monetary Policy

This section shows how expectations and market beliefs interact with different environmental policies, and seeks to understand the role monetary policy could play in reducing the trade-offs at stake, controlling potential inflationary pressures, and helping reach the climate targets. In Section 4.1 we explore the implications of removing the standard assumption of full rationality for the conduct of environmental policy. Section 4.2 analyzes how the presence of behavioral agents and business cycle fluctuations shape the economy's response to price and quantity-based mitigation scenarios and explores what the implications for price stability are. Finally, Section 4.3 studies the role of monetary policy during the greening process under different underlying environmental regimes, different degrees of monetary policy stringency, and different interest-rate rules.

#### 4.1 Market Beliefs and Environmental Policy: A Simple Example

Here we analyze the impact of a mitigation policy under different expectation formations. We solve the model both under the rational expectations hypothesis (the orthodox model) and under the case in which agents are assumed to formulate expectations according to heuristics, as described in the previous sections. To elucidate better the transmission mechanism of environmental policy under different formalizations of the expectations, we start our analysis with an illustrative example. We consider a permanent increase in the carbon price,  $p_z$ , to induce a 1% reduction in emissions. To achieve this target, the carbon price  $p_z$  must increase by 2.9%.

Figure 2 illustrates the dynamic effects of this modest greening policy in the two variants of the model economy (behavioral vs. rational expectations), where we assume that the fraction of agents using an extrapolative rule for both inflation and output is initially equal to 0.5. In this case, the economy's response to this policy shock abstracts from the presence of business cycle fluctuations, that is, we assume that the economy is in steady state when the carbon pricing shock hits it. Figure 2 allows us to clarify the role that expectations play in reaction to mitigation policies along several dimensions: the time needed to meet the target, the interlinkages between macroeconomic and environmental variables, and the interplay between monetary and climate policy.

We observe that under the same policy stringency in the presence of bounded rationality, the time required to achieve the mitigation target almost doubles compared to the rational expectation case. Note that the 1% reduction is reached in period 4 in the rational expectations model and approximately in period 9 in the behavioral model. This delay implies a lower cumulative reduction in emissions of about 2.4% in the latter scenario.

Different assumptions about expectation formation then strongly alter the dynamic behavior of the relevant macro variables. As expected, output decreases in both the model configurations in response to the increase in the carbon price. This is due to the rise in marginal costs driven by the higher price of the energy input. However, under the rational expectations hypothesis, agents can fully internalize the effects of the policy and react immediately, thus reducing emissions and production promptly. In this case, the recessionary effects of the policy fully materialize earlier. Rational-expectations agents are aware that climate policy, by permanently changing the supply-side conditions, will affect their permanent income, therefore, they push down consumption. Conversely, the agents' reaction is more conservative in the behavioral model, implying a slower adjustment of real macroeconomic variables. Nonetheless, the aggregate dynamics mask striking differences in the underlying adjustment between extrapolators and fundamentalists. In particular, fundamentalists expect a return of the economy to its natural level, which is negatively affected by the pollution policy. However, these agents do not account for the short-run deviations of output from its natural level and thus do not have a precise perception of the time path of output during the adjustment process.<sup>17</sup> On the other hand, extrapolators are purely backward-looking and initially perceive the climate action as a temporary shock. As a result, these agents slowly adjust their consumption choices, selfsustaining aggregate demand and production during the mitigation period, slowing down the transition toward a greener economy.

Looking at the behavior of inflation and interest rates, we note what kinds of interaction effects are in place between monetary and climate policies. The carbon pricing policy propagates in the economy as a cost-push shock, creating an upsurge in inflation and a drop of output. The output gap is positive because price rigidity dampens the decrease of output and output decreases less than in the case of a fully-flexible price economy. The increase in inflation leads the central bank to raise the nominal interest rate more than proportionally, to bring inflation

<sup>&</sup>lt;sup>17</sup>Recall that here the output gap is expressed as the difference between the output arising under sticky prices and the natural level of output, meant as the output prevailing in the case of fully flexible prices.



Figure 2: Increase in the Carbon Price under Rational and Behavioral Expectations

Note: the figure plots the response of the economy to a permanent increase in the carbon price aimed at permanently reducing emissions by 1%. Horizontal axis: quarters. Vertical axis: all variables are expressed in percentage deviations from their respective business-as-usual value, with the exceptions of the inflation and the real interest rate, expressed in quarterly basis points (b.p.) deviations, and the shares of extrapolators, expressed in percentage points (p.p.) deviations.

back to its target. The adjustment process is slowed down by non-rational agents, and inflation remains above the target more persistently. In this case, preserving price stability in response to climate action looks more challenging.<sup>18</sup> Hence, compared to the dynamics of the standard New Keynesian model with rational expectations, the presence of agents following different heuristic expectation rules highly affects the effectiveness of policy interventions and the persistence of the adjustment process, especially in the short run.

In this experiment, we do not consider the role of uncertainty in shaping the economy's response to a climate policy. Indeed, there is significant uncertainty about how a greening policy can affect the economy and the conduct of monetary policy, especially during an ambitious mitigation path. This is especially true in behavioral models where the economy's response to policies may entail waves of optimism and pessimism generated by wrong market beliefs and where the results are sensitive to the initial conditions of the economy (i.e., the share of different agents in the economy and the phase of the business cycle).

# 4.2 Market Beliefs and Mitigation Scenarios: Price vs. Quantity Regulations

We are now ready to consider a more ambitious mitigation scenario and analyze the uncertainty surrounding the impact of a greening policy on the main macroeconomic variables in an economy with non-rational agents. Specifically, we start by examining a mitigation policy implemented through a gradual increase in the carbon tax able to generate a reduction of emissions by 20% in 5 years in a deterministic rational expectations economy, where, in each period, agents are assumed to be surprised by the policy shock. This assumption is made to rule out any anticipation effects. The mitigation scenario is in line with the emission reduction targets set by the United States for 2030.<sup>19</sup>

We factor in uncertainty by undertaking two series of simulations based on the behavioral version of the model. The design of the experiment is as follows. In the first baseline simulated series, the economy is hit by exogenous shocks on technology, demand, and interest rate. The length of the series is 300 quarters. In the second simulation series, the economy is hit by the same exogenous shocks as in the first simulation series, but it also entails the introduction of a mitigation plan after 200 periods. To compute the response functions of the economy to a mitigation policy introduced in a business-as-usual scenario, we subtract the first simulated series from the second one. Basically, the economy is away from the steady state when the

<sup>&</sup>lt;sup>18</sup>In the next section we will see how preserving price stability may be even more difficult under a cap policy prescribing a commensurate quantity restriction on the pollutant.

<sup>&</sup>lt;sup>19</sup>The United States has an economy-wide target of reducing its GHG emissions by 50-52% below 2005 levels by 2030. We use the emission data provided by Crippa et al. (2021) to compute the reduction achieved so far and the one still needed to reach the target. Consistently with the short-run analyses presented in the paper and the typical horizon of monetary policy, we present here the first five years of the mitigation plan (20% emission reduction compared to current levels).





Note: the figure plots the mean response of the economy to a gradual increase in the carbon price aimed at permanently reducing emissions by 20%. Dashed lines show  $\pm 2$  standard deviations from the mean. Horizontal axis: quarters. Vertical axis: all variables are expressed in percentage deviations from their respective business-as-usual value, with the exceptions of the inflation and the real interest rate, expressed in quarterly basis points (b.p.) deviations, and the shares of extrapolators, expressed in percentage points (p.p.) deviations.

Timely N	Aitigation	n	Delayed	Mitigation
	Tax	Cap	Tax	Сар
$\sigma_z$	0.1584	0	0.1972	0
$\sigma_{p_z}$	0	0.4774	0	0.6046
$\sigma_{y-y^*}$	0.1001	0.0823	0.1242	0.1038
$\sigma_{\pi}$	2.7081	2.9812	3.2712	3.6587
$E(\pi)$	6.6437	7.7108	8.0425	9.3969
$max(\pi)$	8.1280	9.4923	13.8860	16.172

 Table 5: Macroeconomic Volatility over the Mitigation Path

Note: the table reports the standard deviations of the response for a selection of variables along with mean inflation and its maximum observed value over the mitigation time path;  $\sigma_{p_z}$ ,  $\sigma_z$ ,  $\sigma_{y-y^*}$  are expressed in percentages,  $\sigma_{\pi}$ ,  $E(\pi)$  and  $max(\pi)$  in quarterly basis points.

carbon pricing policy is implemented. We then replicate this experiment considering 1,000 random shocks' realizations,  $\xi_{v,t}$ ,  $\xi_{a,t}$ ,  $\xi_{u,t}$ , and compute the mean response functions and the corresponding standard deviations. In other words, we analyze the effects of carbon pricing conditional on the state of the economy.

Figure 3 illustrates the mean response (solid lines) and a band of significance of  $\pm 2$  standard deviations from the mean (dashed lines). We can observe how expectations and market beliefs can generate large movements in output and inflation through this experiment. Looking closely at the figure, we can see a wide increase in the uncertainty surrounding the short-term effects of the carbon price. The economy's reaction depends on the initial state of the economy that could be in any phase of the business cycle. The range of variation in the dynamic response to the shock is driven endogenously by self-fulfilling movements of optimism and pessimism that amplify fluctuations and affect how the policy shock is transmitted to the economy. By basing their decisions on biased information, non-rational agents make the economy more prone to fluctuations. In addition, the policy shock itself affects market sentiments, which is why it may take longer to adjust to the new long-term equilibrium.<sup>20</sup>

In the context of mitigation policies, this last result is particularly relevant since it brings light on an additional layer of uncertainty surrounding the achievement of climate targets. In a timely and orderly mitigation scenario, as depicted in Figure 3, emissions could follow only slightly different trajectories. We observe that the number of quarters needed to reach the objective by 20% emissions reduction ranges from 20 to 28 quarters. In the case of a disorderly mitigation scenario and/or in the case of a highly perturbed economy, instead, the emission trajectory can be much more unpredictable, making the adjustment process to the target more or less expensive in terms of cumulative emissions.<sup>21</sup> To achieve an equivalent mitigation goal

 $<sup>^{20}\</sup>mathrm{In}$  Appendix we show how the economy evolves under rational expectations.

<sup>&</sup>lt;sup>21</sup>The time path of emissions in a highly perturbed economy is shown in Appendix.

over the same time horizon, but avoid any uncertainty regarding the emission pattern, the government may opt for a quantity-based instrument rather than a price instrument. However, a quantity approach may entail excessive volatility of the emission prices. To understand the uncertainty inherent to the selected instrument, in the first two columns of Table 5, we compare the performance of a carbon tax and an emission cap during the mitigation path considered in Figure 3. We look at the variability of a selection of variables and at the inflation dynamics. By introducing more uncertainty regarding the time path of emission prices, a cap policy delivers more inflation volatility and higher inflation than a tax policy.<sup>22</sup> In this respect, maintaining price stability looks more challenging under a quantity restriction than under a carbon tax. In the third and fourth columns of the same table, we consider a delayed scenario in which the greening policy is introduced one year later. For comparability, we design this scenario so that after 20 quarters the amount of cumulative emission variation is as in the timely case. We can see that whether the regulator chooses a tax or a quantity-based instrument entails a more intense trade-off between emission and inflation stabilization.

To better appreciate the dynamics of the economy in the four scenarios of Table 5 in Figure 4 we show the inflation and the output dynamics, along with their market forecast errors. The forecast errors for both variables are substantially more significant in the delayed scenario, while a cap is clearly more inflationary than a tax overthe adjustment process. Agents tend to undermine inflation and overstate output more intensively under a cap than under a tax, and under a delayed scenario than under a timely mitigation process.<sup>23</sup>

#### 4.3 The Role of Monetary Policy

In this section, we explore the role of monetary policy in shaping the economy's response to climate policy. In particular, we address the following questions. Can monetary policy reduce the uncertainty regarding the economy's response during the transition? Can monetary policy affect the timing by which a specific mitigation objective is reached?

To address these questions, we consider different values for the interest rate rule parameters,  $\iota_y$ ,  $\iota_\pi$  and  $\iota_r$ , and see how monetary policy interacts with the instrument chosen to achieve the mitigation goal. The results are summarized in Table 6. A higher reactivity of the interest rate to the output gap or inflation strongly reduces the average volatility of the economy. This is true independently of the underlying environmental regime adopted. The intuition for this result is that a significant stabilization effort of central banks mitigates the intensity of the waves of optimism and pessimism triggered by (wrong) market beliefs, thus reducing the uncertainty surrounding the mitigation policy. By reacting more to the output gap or

 $<sup>^{22}</sup>$ In a highly perturbed scenario choosing between price and quantity regulations would entail a major policy trade-off between emission certainty and price stability. In Appendix we show the time path of permits price and inflation in a highly perturbed scenario.

<sup>&</sup>lt;sup>23</sup>In Appendix we show that under rational expectations the forecast errors are driven only by the pollution policy that is phased in as a surprise policy shock.



Figure 4: Mitigation Scenarios - Macroeconomic Dynamics and Market Forecast Errors

Note: the figure plots the mean response of the economy to different mitigation scenarios entailing the same cumulative emissions after 20 quarters in the deterministic counterparts. Horizontal axis: quarters. Vertical axis: Inflation and its forecast errors are expressed in quarterly basis points (b.p.) deviations, while output and its forecast errors are in percentage deviations.

			Tax					Cap		
$\iota_y$										
	$\sigma_z$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$	$\sigma_{p_z}$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$
0	0.2097	0.1327	3.6079	7.8440	9.7411	0.6259	0.1080	3.9248	8.9555	11.1760
0.125	0.1584	0.1001	2.7081	6.6437	8.1280	0.4775	0.0823	2.9812	7.7108	9.4923
0.5	0.0778	0.0490	1.3043	4.5251	5.3703	0.2390	0.0410	1.4712	5.4329	6.4966
1.5	0.0210	0.0131	0.3342	2.4704	2.8330	0.0661	0.0112	0.3869	3.0859	3.5594
2	0.0134	0.0083	0.2062	2.0277	2.3086	0.0422	0.0071	0.2391	2.5563	2.9232
3	0.0072	0.0044	0.1018	1.5032	1.6974	0.0224	0.0037	0.1162	1.9159	2.1686
$\iota_{\pi}$										
	$\sigma_z$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$	$\sigma_{p_z}$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$
1.1	0.1998	0.1265	3.4545	7.6721	9.6154	0.6395	0.1104	4.0471	9.1434	11.5907
1.2	0.1882	0.1191	3.2440	7.3882	9.1995	0.5926	0.1023	3.7381	8.7399	10.9906
1.5	0.1584	0.1001	2.7081	6.6437	8.1280	0.4775	0.0823	2.9812	7.7108	9.4923
3	0.0776	0.0487	1.2679	4.3878	5.1074	0.2013	0.0344	1.1845	4.8382	5.5797
4	0.0532	0.0333	0.8435	3.5764	4.0750	0.1302	0.0221	0.7341	3.8862	4.3777
5	0.0386	0.0240	0.5934	3.0223	3.3988	0.0909	0.0153	0.4907	3.2560	3.6094
$\iota_r$										
	$\sigma_z$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$	$\sigma_{p_z}$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$
0	0.1584	0.1001	2.7081	6.6437	8.1280	0.4775	0.0823	2.9812	7.7108	9.4923
0.5	0.2150	0.1358	3.6263	7.4956	9.1287	0.6590	0.1134	4.0268	8.7150	10.4960
0.7	0.3128	0.1980	5.3100	8.9110	11.1092	0.9848	0.1698	6.0158	10.4125	12.7421
0.9	0.9265	0.5900	16.5975	18.2039	24.3147	3.1754	0.5507	20.3834	22.3629	30.1979

Table 6: Macroeconomic Volatility over the Mitigation Path: The Role of Monetary Policy

Note: the table reports the standard deviations of the response for a selection of variables along with mean inflation and its maximum observed value over the mitigation time path;  $\sigma_{p_z}$ ,  $\sigma_z$ ,  $\sigma_{y-y^*}$  are expressed in percentages,  $\sigma_{\pi}$ ,  $E(\pi)$  and  $max(\pi)$  in quarterly basis points.

inflation, monetary policy is more restrictive and induces the economy to converge quickly to its new long-run equilibrium. In this case, the fundamentalist rules, envisaging the return of the economy to its natural level, are validated by monetary policy. Under the central bank's more vigorous stabilization effort, there is no longer any trade-off between inflation control and climate policy: more price stabilization can be achieved without leading to more uncertainty about meeting the climate target.

On the other hand, for an increasing  $\iota_r$ , the Taylor rule becomes less reactive to current variations of the output gap and inflation. Thus we observe that macroeconomic volatility goes up. An excessive degree of inertia delivers higher variability as monetary policy cannot stabilize the economy in reaction to the current economic conditions. More importantly, it can be shown that for  $\iota_r$  set to 0.9, the time needed to reach the mitigation objective ranges from 18 to 38 quarters, so with a potential mitigation delay of more than 4 years.

Overall, from these results, we observe that when the central bank assigns more weight either to inflation or to the output gap, it can align different objectives, namely stabilizing inflation around the inflation target, while facilitating the decarbonization process by avoiding unnecessary volatility and, in the case of the carbon tax, by shortening the time needed to reach a given mitigation target. Put another way, conventional monetary policy can work alongside climate policy, reducing the uncertainty surrounding mitigation strategies and at the same time stabilizing both the output gap and inflation. Central banks can then support climate policies without overstretching their competencies.

#### 4.3.1 Alternative Interest Rate Rules

To further shed light on the role of monetary policy in the mitigation process, we show how our results may change under alternative implementable interest rate rules. In particular, we consider the following forms:

(i) backward-looking interest-rate rule:

$$r_t = \iota_\pi \pi_{t-1} + \iota_y (y_{t-1} - y_{t-1}^*) + u_t, \tag{22}$$

(ii) forward-looking interest-rate rule:

$$r_t = \iota_\pi E_t \pi_{t+1} + \iota_y E_t (y_{t+1} - y_{t+1}^*) + u_t, \tag{23}$$

(iii) market expectations-based interest-rate rule:

$$r_t = \iota_\pi \tilde{E}_t \pi_{t+1} + \iota_y \tilde{E}_t (y_{t+1} - y_{t+1}^*) + u_t, \qquad (24)$$

(iv) interest rate rule reacting to output growth:

$$r_t = \iota_\pi \pi_t + \iota_y (y_t - y_{t-1}) + u_t.$$
(25)

Rules (i) and (ii) belong to the class of monetary-policy rules that are typically analyzed in the monetary policy literature and require no less information on the part of the central bank than the contemporaneous feedback rule based on the current values of inflation and the output gap.<sup>24</sup> Rule (iii) is a simple implementable expectations-based rule. Here the assumption is that policymakers can observe the average forecasts made by heterogeneous agents. The rationale of this rule is that monetary policy should react aggressively to market expectations.<sup>25</sup> Finally, in the feedback rule (iv) the change in interest rate is set as a function of output growth rather than of output gap. This last specification implies that the central bank does not need to know the flexible-price level of aggregate activity. For comparability across monetary rules, we set the policy parameter values as in Table **??**. The results are summarized in Table **7**.

Table 7: Macroeconomic Volatility over the Mitigation Path under Alternative Monetary Rules

	Tax				
	$\sigma_z$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$
$r_t = \iota_\pi \pi_t + \iota_y (y_t - y_t^*)$	0.1584	0.1001	2.7081	6.6437	8.1280
$r_t = \iota_{\pi} \pi_{t-1} + \iota_y (y_{t-1} - y_{t-1}^*)$	0.1885	0.1188	3.1408	7.1380	8.5656
$r_t = \iota_\pi E_t \pi_{t+1} + \iota_y E_t (y_{t+1} - y_{t+1}^*)$	0.1577	0.0998	2.7323	6.8825	8.6229
$r_t = \iota_{\pi} \tilde{E}_t \pi_{t+1} + \iota_y \tilde{E}_t (y_{t+1} - y_{t+1}^*)$	0.2978	0.1886	5.1800	9.9000	12.6396
$r_t = \iota_\pi \pi_t + \iota_y (y_t - y_{t-1})$	0.2156	0.1365	3.7277	8.2961	10.3813
	Cap				
	$\sigma_{p_z}$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$
$r_t = \iota_\pi \pi_t + \iota_y (y_t - y_t^*)$	0.4775	0.0823	2.9812	7.7108	9.4923
$r_t = \iota_{\pi} \pi_{t-1} + \iota_y (y_{t-1} - y_{t-1}^*)$	0.5853	0.1005	3.5268	8.3282	9.9898
$r_t = \iota_\pi E_t \pi_{t+1} + \iota_y E_t (y_{t+1} - y_{t+1}^*)$	0.4720	0.0814	3.0077	8.0467	10.1408
$r_t = \iota_{\pi} \tilde{E}_t \pi_{t+1} + \iota_y \tilde{E}_t (y_{t+1} - y_{t+1}^*)$	1.0218	0.1766	6.5035	12.1937	15.8057
$r_t = \iota_\pi \pi_t + \iota_y (y_t - y_{t-1})$	0.6422	0.1108	4.0555	9.4710	11.8816

Note: the table reports the standard deviations of the response for a selection of variables along with mean inflation and its maximum observed value over the mitigation time path;  $\sigma_{p_z}$ ,  $\sigma_z$ ,  $\sigma_{y-y^*}$  are expressed in percentages,  $\sigma_{\pi}$ ,  $E(\pi)$  and  $max(\pi)$  in quarterly basis points.

Clearly, inflation is more stabilized under the baseline interest rate rule and the forward

<sup>&</sup>lt;sup>24</sup>See e.g. Schmitt-Grohé and Uribe (2007).

<sup>&</sup>lt;sup>25</sup>This rule is used in several papers dealing with non-rational agents. See Evans and McGough (2005), Preston (2006) and Branch and McGough (2010) among others. The market expectation  $\tilde{E}_t y_{t+1}^*$  is introduced in the model as done for inflation and output in Section 2.4, and depends on the expectation formulated by fundamentalists,  $\tilde{E}_{f,t}y_{t+1}^* = E_t y_{t+1}^* = 0$ , and on that formulated by extrapolators,  $\tilde{E}_{e,t}y_{t+1}^* = y_{t-1}^*$ .

interest rule. Under both a backward monetary policy rule and a rule envisaging a reaction to output growth the variability of all variables and average inflation tend to increase. In the former case, this can be explained by the fact that, by changing the nominal interest in reaction to past events, the central bank is less able to limit the current exuberance of the markets. This result is consistent with those observed in Table 6 for positive values of the persistence parameter  $\iota_r$ . In the latter case, the monetary rule becomes less stringent by reacting to output variations that during the greening path are negative. However, the worst-performing rule is the one based on market expectations. When the interest rate changes in response to private-sector expectations, the volatility of all variables is almost two times the one observed under the contemporaneous baseline rule. This is because monetary policy, instead of limiting divergent behavioral dynamics around the mitigation path, somehow validates the 'wrong' expectations that partially ignore the ongoing structural change. This is why an expectationsbased rule is potentially destabilizing. Finally, it can be shown that the uncertainty regarding the time horizon by which the mitigation target is reached slightly changes only in the case of an expectations-based rule, with a time frame ranging from 21 to 30 quarters. Under all the other rules, this time frame stays almost unchanged.

# 5 Sensitivity Analysis and Extensions

In this section, we carry out a series of checks to assess the robustness of the previous results against changes in the values of the behavioral parameters that might be surrounded by uncertainty and might be particularly relevant in shaping the economy's response to a gradual decarbonization process. We also propose a couple of extensions of our analysis, allowing for asynchronous updating of the forecasting rules, trending-based rules, and skepticism about the ability of the central bank to keep inflation at its target during the mitigation path.

#### 5.1 Memory and Willingness to Learn

In this section, we look at the role played by the parameters  $\theta$ , which measures the willingness to learn and  $\rho$ , which measures agents' memory. The results are shown in Table 8.

For small values of the willingness to learn, agents are less sensitive to the performance of their forecasting rule and tend to decide more randomly. As a result, the initial state of the economy is less relevant for the dynamic adjustments of output, emissions, and inflation, and the uncertainty surrounding the greening path is lower.

For large values of  $\theta$  instead, agents learn from their past mistakes and revise how they formulate expectations based on past performances. We observe a more significant variability of the main macroeconomic variables during the greening plan and a more substantial inflationary pressure, especially under a cap policy. Suppose that the mitigation process starts when the

			Tax					Cap		
$\theta$										
	$\sigma_z$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$	$\sigma_{p_z}$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$
500	0.0260	0.0164	0.4440	4.6315	5.5010	0.0783	0.0135	0.4887	5.6256	6.6495
1000	0.0519	0.0328	0.8879	5.0261	6.0161	0.1565	0.0270	0.9774	6.0345	7.2069
2500	0.1299	0.0821	2.2198	6.2097	7.5614	0.3914	0.0674	2.4436	7.2610	8.8791
3050	0.1584	0.1001	2.7081	6.6437	8.1280	0.4775	0.0823	2.9812	7.7108	9.4923
3200	0.1662	0.1051	2.8413	6.7621	8.2826	0.5009	0.0863	3.1278	7.8334	9.6595
$\rho$										
	$\sigma_z$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$	$\sigma_{p_z}$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$
0	0.1737	0.1093	2.9030	6.7951	8.2708	0.5215	0.0894	3.1774	7.8626	9.6561
0.2	0.1678	0.1059	2.8332	6.7384	8.2204	0.5045	0.0867	3.1077	7.8069	9.5989
0.4	0.1584	0.1001	2.7081	6.6437	8.1280	0.4775	0.0823	2.9812	7.7108	9.4923
0.6	0.1417	0.0897	2.4631	6.4746	7.9459	0.4286	0.0740	2.7251	7.5327	9.2794
0.9	0.0744	0.0473	1.3450	5.8345	7.1174	0.2229	0.0387	1.4730	6.8288	8.2953

Table 8: Macroeconomic Volatility over the Mitigation Path: The Role of Willingness to Learn and Memory

Note: the table reports the standard deviations of the response for a selection of variables along with mean inflation and its maximum observed value over the mitigation time path;  $\sigma_{p_z}$ ,  $\sigma_z$ ,  $\sigma_{y-y^*}$  are expressed in percentages,  $\sigma_{\pi}$ ,  $E(\pi)$  and  $max(\pi)$  in quarterly basis points.

economy is in an expansionary phase. In that case more agents expect that income will stay high in the future on the basis of the extrapolative rule. A higher expected income drives current demand upward, validating the initial expectations. In this case, emissions will converge to the new equilibrium following a higher trajectory. On the other hand, if the greening action is taken when the economy is in a recession, the same mechanism will work in the opposite direction. The initial lower level of income implies that more agents expect a lower level of income for the following period, reducing aggregate demand and so the current output. Again expectations are self-validating, and the economy will converge toward the new long-run equilibrium along a lower trajectory.

When  $\rho$  is low, agents learn less from the mistakes made in the past and attach a larger weight to the last period's performance in evaluating a forecasting rule. As a result, the economy is more sensitive to the current state of the economy, and the business cycle has a greater influence on the mitigation process. On the other hand, for values of  $\rho$  closer to 1, agents have more memory and attach a high weight to past mistakes. For this reason, they react relatively less to the last period's forecast error, and there is less uncertainty surrounding the greening process. However, it can be shown that emissions converge slowly to their target. This is because agents do not react promptly to the new economic conditions following the increase in carbon pricing. Since most recent mistakes and events have a relatively marginal role in driving the choice between heuristics, agents do not immediately adjust their forecasting

Table 9: Macroeconomic Volatility over the Mitigation Path: Asynchronous Updating of Expectations

			Tax					Cap		
$\delta_i$										
	$\sigma_z$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$	$\sigma_{z}$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$
0	0.1584	0.1001	2.7081	6.6437	8.1280	0.4775	0.0823	2.9812	7.7108	9.4923
0.2	0.1536	0.0972	2.6413	6.5869	8.0726	0.4635	0.0800	2.9136	7.6531	9.4283
0.4	0.1454	0.0921	2.5236	6.4960	7.9776	0.4401	0.0760	2.7924	7.5583	9.3177
0.6	0.1307	0.0829	2.2970	6.3393	7.8002	0.3966	0.0686	2.5505	7.3903	9.1091
0.8	0.1001	0.0636	1.7939	6.0373	7.4164	0.3033	0.0526	1.9868	7.0568	8.6525
1	0.0000	0.0000	0.0000	4.2370	4.9861	0.0000	0.0000	0.0000	5.2168	6.0923

Note: the table reports the standard deviations of the response for a selection of variables along with mean inflation and its maximum observed value over the mitigation time path;  $\sigma_{p_z}$ ,  $\sigma_z$ ,  $\sigma_{y-y^*}$  are expressed in percentages,  $\sigma_{\pi}$ ,  $E(\pi)$  and  $max(\pi)$  in quarterly basis points.

rule, and the economy will reach the new steady state with some delay.

#### 5.2 Asynchronous Updating

We now introduce the possibility of asynchronous updating by changing how the fraction of agents opting for a specific rule evolves over time.<sup>26</sup> In particular, we now replace equation (18) with the following:

$$\alpha_{x,t}^{i} = \delta_{i} \alpha_{x,t-1}^{i} + (1 - \delta_{i}) \frac{e^{\theta U_{x,t}^{i}}}{\sum_{i} e^{\theta U_{x,t}^{i}}}, \quad 0 \le \delta_{i} \le 1$$

$$(26)$$

where the asynchronous updating parameter  $\delta_i$  captures inertia in the choice of the heuristics. In the extreme case of  $\delta_i = 0$  there is synchronous updating and the economy evolves as in our baseline model, where agents stand ready to opt for the best performing rule, given their state of mind. A the other extreme, for  $\delta_i = 1$ , agents never update their forecasting rule independently of their performance, that is like saying that agents are stubborn. Table 9 shows the economy's volatility for different values of  $\delta_i$ . We observe that when agents are more reluctant to switch from one rule to another on the basis of their forecast errors, the economy is less volatile, and keeping inflation stable becomes less challenging.

#### 5.3 Other Expectation Rules

Our analysis has been conducted using elementary forecasting rules for both variables and under the assumption that only a fraction of agents perceive the central bank's commitment to maintain price stability as entirely credible. However, during a greening transition process

 $<sup>^{26}</sup>$ This is along the lines of Diks and Van Der Weide (2005), Hommes et al. (2005a) and Hommes et al. (2019) and is consistent with the evidence provided by Hommes et al. (2005b).

that is expected to be inflationary, it makes sense to assume that also fundamentalists may cast doubt about the credibility of the inflation-targeting regime, reducing the effectiveness of forward guidance. This may be particularly relevant under a delayed scenario. In addition, one can assume that agents may revise their way of formulating expectations about output and inflation on the basis of a trend-following rule. Again, during a structural change, agents may also account for the information provided by the last observed variation in their forecast variable in developing their expectations.

To address the issue of credibility of the inflation targeting policy, we start by considering two extreme cases. One is to assume that there is 100% skepticism. In this case, all agents are extrapolators when they formulate expectations about inflation. The market inflation expectation is then  $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$ . The other extreme case, i.e., full credibility of the inflation target, assumes that all agents are fundamentalists when forecasting inflation. The market inflation expectation is then  $E_t(\pi_{t+1}) = 0$ . We also allow for a more complex heuristic considering a trend-adjusted rule for inflation so that the private sector inflation expectation is now  $E_t(\pi_{t+1}) = \pi_{t-1} + g_{\pi}(\pi_{t-1} - \pi_{t-2})$  where  $g_{\pi} > 0$  measures the responsiveness of the expected inflation to the last observed inflation variation. As in Hommes et al. (2019), we assign two possible values to  $g_{\pi}$ , namely 0.4 and 1.3, so distinguishing between strong- and weak-trending following rules. Table 10 shows the results. As expected, when all agents maintain skepticism about the credibility of the inflation-targeting policy or adopt trend-following rules to forecast inflation, keeping price stability becomes tougher. For a strong-trend following rule, the task becomes even more arduous. In revising their prices, agents expecting persistent deviations of inflation from its target would set too high or too low prices, thus validating their 'wrong' expectations and destabilizing the real side of the economy. Consequently, emissions are more perturbed along their path than in the baseline case.

Finally, we account for the implications of having a trend-following rule for output by assuming that extrapolators, instead of simply using a random walk rule to predict the next period value of output, formulate their expectations according to a trend-adjusted rule of the form:  $\tilde{E}_{e,t}(y_{t+1}) = y_{t-1} + g_y(y_{t-1} - y_{t-2})$ , with  $g_y > 0$ . Fundamentalists act as in the baseline case since by expecting future output to be equal to its natural counterpart, they already factor in the effects of the ongoing structural change. The last two lines of Table 10 report our findings for the case of weak- and strong-trend following rules for output. When extrapolators react vigorously to the output trend, the inflation rate is strongly stabilized under both regulatory regimes. Under a tax, we note that emissions are much less volatile than in all other cases. Under this rule, extrapolators adjust their expectations for the negative trend, and the economy moves more smoothly towards its new long-run equilibrium. In the case of a weak-trend following rule, instead, results do not seem to change substantially. Table 10: Macroeconomic Volatility over the Mitigation Path: Other Expectation Rules

	Tax				
	$\sigma_z$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$
Baseline	0.1584	0.1001	2.7081	6.6437	8.1280
Inflation targeting skepticism	0 1441	0.0010	6 1445	20.0006	38 2703
$\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$	0.1441	0.0510	0.1440	20.5500	00.2100
Inflation targeting credibility $$	0.1735	0 1098	1 7203	37914	4 3634
$E_t(\pi_{t+1}) = 0$	0.1100	0.1050	1.1200	0.1011	1.0001
Strong-trend following rule for inflation	0.2203	0.1397	28 1793	66 1670	107 1897
$E_t(\pi_{t+1}) = \pi_{t-1} + 1.3(\pi_{t-1} - \pi_{t-2})$	0.2200	0.1001	20.1100	00.1010	101.1001
Weak-trend following rule for inflation $\tilde{\tilde{\sigma}}$	0.1360	0.0859	7.3463	25.6732	45.3238
$E_t(\pi_{t+1}) = \pi_{t-1} + 0.4(\pi_{t-1} - \pi_{t-2})$	0.2000				
Strong-trend following rule for output $\tilde{z}$	0.0788	0.0492	1.1943	2.0836	2.6467
$E_{e,t}(y_{t+1}) = y_{t-1} + 1.3(y_{t-1} - y_{t-2})$					
Weak-trend following rule for output $\tilde{E}_{-}(x) = 0.4(x)$	0.1358	0.0857	2.2868	5.3782	6.3607
$E_{e,t}(y_{t+1}) = y_{t-1} + 0.4(y_{t-1} - y_{t-2})$	0				
	100				
	Сар			$\mathbf{E}(\cdot)$	
	Cap $\sigma_{p_z}$	$\sigma_{y-y^*}$	$\sigma_{\pi}$	$E(\pi)$	$max(\pi)$
Baseline	$Cap \\ \sigma_{p_z} \\ 0.4775$	$\frac{\sigma_{y-y^*}}{0.0823}$	$\frac{\sigma_{\pi}}{2.9812}$	$E(\pi)$ 7.7108	$\frac{max(\pi)}{9.4923}$
Baseline Inflation targeting skepticism $\tilde{\Sigma}$ (	Cap $\sigma_{p_z}$ 0.4775 0.4308	$\sigma_{y-y^*}$ 0.0823 0.0742	$\sigma_{\pi}$ 2.9812 6.2204	$E(\pi)$ 7.7108 23.4153	$max(\pi)$ 9.4923 41.5472
Baseline Inflation targeting skepticism $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$	Cap $\sigma_{p_z}$ 0.4775 0.4308	$\sigma_{y-y^*}$ 0.0823 0.0742	$\sigma_{\pi}$ 2.9812 6.2204	$E(\pi)$ 7.7108 23.4153	$   \begin{array}{r} max(\pi) \\     9.4923 \\     41.5472 \\   \end{array} $
Baseline Inflation targeting skepticism $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$ Inflation targeting credibility	Cap $\sigma_{p_z}$ 0.4775 0.4308 0.5364	$\sigma_{y-y^*}$ 0.0823 0.0742 0.0926	$\sigma_{\pi}$ 2.9812 6.2204 1.8470	$E(\pi)$ 7.7108 23.4153 4.4050	$ \begin{array}{r} max(\pi) \\ 9.4923 \\ 41.5472 \\ 5.1235 \end{array} $
Baseline Inflation targeting skepticism $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$ Inflation targeting credibility $\tilde{E}_t(\pi_{t+1}) = 0$	Cap $\sigma_{p_z}$ 0.4775 0.4308 0.5364	$\sigma_{y-y^*}$ 0.0823 0.0742 0.0926	$\sigma_{\pi}$ 2.9812 6.2204 1.8470	$E(\pi)$ 7.7108 23.4153 4.4050	$   \begin{array}{r} max(\pi) \\     9.4923 \\     41.5472 \\     5.1235 \\   \end{array} $
Baseline Inflation targeting skepticism $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$ Inflation targeting credibility $\tilde{E}_t(\pi_{t+1}) = 0$ Strong-trend following rule for inflation $\tilde{T}(\pi_{t+1}) = 0$	Cap $\sigma_{p_z}$ 0.4775 0.4308 0.5364 0.6790	$\sigma_{y-y^*}$ 0.0823 0.0742 0.0926 0.1174	$\sigma_{\pi}$ 2.9812 6.2204 1.8470 26.1196	$E(\pi)$ 7.7108 23.4153 4.4050 66.6758	$max(\pi)$ 9.4923 41.5472 5.1235 108.5485
Baseline Inflation targeting skepticism $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$ Inflation targeting credibility $\tilde{E}_t(\pi_{t+1}) = 0$ Strong-trend following rule for inflation $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1} + 1.3(\pi_{t-1} - \pi_{t-2})$	Cap $\sigma_{p_z}$ 0.4775 0.4308 0.5364 0.6790	$\sigma_{y-y^*}$ 0.0823 0.0742 0.0926 0.1174	$\sigma_{\pi}$ 2.9812 6.2204 1.8470 26.1196	$E(\pi) 7.7108 23.4153 4.4050 66.6758$	$\begin{array}{c} max(\pi) \\ 9.4923 \\ 41.5472 \\ 5.1235 \\ 108.5485 \end{array}$
Baseline Inflation targeting skepticism $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$ Inflation targeting credibility $\tilde{E}_t(\pi_{t+1}) = 0$ Strong-trend following rule for inflation $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1} + 1.3(\pi_{t-1} - \pi_{t-2})$ Weak-trend following rule for inflation	Cap $\sigma_{p_z}$ 0.4775 0.4308 0.5364 0.6790 0.4043	$\sigma_{y-y^*}$ 0.0823 0.0742 0.0926 0.1174 0.0695	$\sigma_{\pi}$ 2.9812 6.2204 1.8470 26.1196 7.3475	$E(\pi) 7.7108 23.4153 4.4050 66.6758 28.3265$	$\begin{array}{r} max(\pi) \\ 9.4923 \\ 41.5472 \\ 5.1235 \\ 108.5485 \\ 48.2071 \end{array}$
Baseline Inflation targeting skepticism $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$ Inflation targeting credibility $\tilde{E}_t(\pi_{t+1}) = 0$ Strong-trend following rule for inflation $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1} + 1.3(\pi_{t-1} - \pi_{t-2})$ Weak-trend following rule for inflation $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1} + 0.4(\pi_{t-1} - \pi_{t-2})$	$\sigma_{p_z}$ 0.4775           0.4308           0.5364           0.6790           0.4043	$\sigma_{y-y^*}$ 0.0823 0.0742 0.0926 0.1174 0.0695	$\sigma_{\pi}$ 2.9812 6.2204 1.8470 26.1196 7.3475	$E(\pi) 7.7108 23.4153 4.4050 66.6758 28.3265$	$\begin{array}{c} max(\pi) \\ 9.4923 \\ 41.5472 \\ 5.1235 \\ 108.5485 \\ 48.2071 \end{array}$
Baseline Inflation targeting skepticism $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$ Inflation targeting credibility $\tilde{E}_t(\pi_{t+1}) = 0$ Strong-trend following rule for inflation $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1} + 1.3(\pi_{t-1} - \pi_{t-2})$ Weak-trend following rule for inflation $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1} + 0.4(\pi_{t-1} - \pi_{t-2})$ Strong-trend following rule for output $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1} + 1.2(\pi_{t-1} - \pi_{t-2})$	Cap $\sigma_{p_z}$ 0.4775 0.4308 0.5364 0.6790 0.4043 0.2320	$\sigma_{y-y^*}$ 0.0823 0.0742 0.0926 0.1174 0.0695 0.0394	$\sigma_{\pi}$ 2.9812 6.2204 1.8470 26.1196 7.3475 1.2558	$E(\pi)$ 7.7108 23.4153 4.4050 66.6758 28.3265 2.4593	$\begin{array}{r} max(\pi) \\ 9.4923 \\ 41.5472 \\ 5.1235 \\ 108.5485 \\ 48.2071 \\ 3.0899 \end{array}$
Baseline Inflation targeting skepticism $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$ Inflation targeting credibility $\tilde{E}_t(\pi_{t+1}) = 0$ Strong-trend following rule for inflation $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1} + 1.3(\pi_{t-1} - \pi_{t-2})$ Weak-trend following rule for inflation $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1} + 0.4(\pi_{t-1} - \pi_{t-2})$ Strong-trend following rule for output $\tilde{E}_{e,t}(y_{t+1}) = y_{t-1} + 1.3(y_{t-1} - y_{t-2})$ Weak trend following rule for output	$\sigma_{p_z}$ 0.4775         0.4308         0.5364         0.6790         0.4043         0.2320	$\sigma_{y-y^*}$ 0.0823 0.0742 0.0926 0.1174 0.0695 0.0394	$\sigma_{\pi}$ 2.9812 6.2204 1.8470 26.1196 7.3475 1.2558	$E(\pi) 7.7108 23.4153 4.4050 66.6758 28.3265 2.4593$	$\begin{array}{r} max(\pi) \\ 9.4923 \\ 41.5472 \\ 5.1235 \\ 108.5485 \\ 48.2071 \\ 3.0899 \end{array}$
Baseline Inflation targeting skepticism $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1}$ Inflation targeting credibility $\tilde{E}_t(\pi_{t+1}) = 0$ Strong-trend following rule for inflation $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1} + 1.3(\pi_{t-1} - \pi_{t-2})$ Weak-trend following rule for inflation $\tilde{E}_t(\pi_{t+1}) = \pi_{t-1} + 0.4(\pi_{t-1} - \pi_{t-2})$ Strong-trend following rule for output $\tilde{E}_{e,t}(y_{t+1}) = y_{t-1} + 1.3(y_{t-1} - y_{t-2})$ Weak-trend following rule for output $\tilde{E}_{e,t}(y_{t+1}) = y_{t-1} + 1.3(y_{t-1} - y_{t-2})$	$\sigma_{p_z}$ 0.4775         0.4308         0.5364         0.6790         0.4043         0.2320         0.4081	$\sigma_{y-y^*}$ 0.0823 0.0742 0.0926 0.1174 0.0695 0.0394 0.0702	$\sigma_{\pi}$ 2.9812 6.2204 1.8470 26.1196 7.3475 1.2558 2.5039	$E(\pi)$ 7.7108 23.4153 4.4050 66.6758 28.3265 2.4593 6.2443	$\begin{array}{r} max(\pi) \\ 9.4923 \\ 41.5472 \\ 5.1235 \\ 108.5485 \\ 48.2071 \\ 3.0899 \\ 7.4330 \end{array}$

Note: the table reports the standard deviations of the response for a selection of variables along with mean inflation and its maximum observed value over the mitigation time path;  $\sigma_{p_z}$ ,  $\sigma_z$ ,  $\sigma_{y-y^*}$  are expressed in percentages,  $\sigma_{\pi}$ ,  $E(\pi)$  and  $max(\pi)$  in quarterly basis points.

# 6 Conclusions

There is an ongoing debate among economists and policy analysts about the implications of climate change for monetary policy, and many central banks have already included climate change considerations in their assessments of potential economic and financial risks. This paper shows the relevance of market expectations and business cycle fluctuations on the interaction between monetary and climate policy by focusing on two specific aspects of this debate. The first aspect regards the potential implications of different mitigation instruments for the ability of central banks to conduct monetary policy successfully and keep inflation under control. The second aspect concerns the role that central banks themselves can play in supporting the transition process and reducing the macroeconomic uncertainty inherent to the policy tool selected to fight climate change.

The presence of behavioral agents with cognitive limitations amplifies business cycle fluctuations and allows for the emergence of waves of optimism and pessimism overthe mitigation path, injecting further uncertainty regarding the impact and effectiveness of climate policies. In this context, a green transition is found to pose a more significant threat to the ability of central banks to maintain price stability than in the case of an economy with rational agents. Moreover, the trade-offs between cap-and-trade and carbon tax policies are accentuated, with the two instruments delivering different dynamic adjustments. On the one hand, for price regulation, the time needed to achieve an emission-reduction target can be longer than in standard rational expectation models, especially in a highly perturbed economy. On the other hand, while a cap-and-trade scheme allows us to control future emissions levels, it implies significant uncertainty on allowances prices, production costs, and inflation dynamics, posing a major threat to price stability.

Looking at the role of central banks, we find that, under price regulation, a monetary policy more reactive to the output gap or inflation can help stabilize emissions, thus reducing the degree of uncertainty regarding the achievement of climate targets. Under both environmental regimes, a more vigorous response to current fluctuations in macroeconomic variables can help moderate inflation volatility and reduce the pressure on prices due to the more stringent climate policy. Central banks seem then to be able to tame market sentiments and support, in some respect, the green transition.

Delays in the implementation of stringent climate policies, the lack of confidence in the ability of central banks to maintain price stability during the green transition, and the adoption of monetary rules reacting to market expectations, rather than to current macroeconomic variables, are all factors that can magnify the uncertainty overthe mitigation path and worsen the impact on price stability.

The main policy message arising from this paper is that, regardless of the adoption of new instruments targeted to support the low-carbon transition, central banks can contribute to fighting climate change by primarily acting in the perimeter of their mandate. By implementing successful stabilization policies, central banks can highly reduce the uncertainty surrounding the introduction of carbon pricing policies, ensuring better conditions for successful climate actions.

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# Appendix

#### Households

In the period t the typical household i chooses  $C_{i,t}$ ,  $B_{i,t}$  and  $N_{i,t}$ , to maximize (1), subject to (2). At the optimum, the following conditions must hold:

$$1 + \varrho \frac{B_{i,t}}{P_t} \left( C_{i,t} - hC_{t-1} \right)^{\gamma} = \beta R_t \tilde{E}_{i,t} \left\{ \left[ \exp(\mu_{t+1} - \mu_t) \right] \left( \frac{C_{i,t} - hC_{t-1}}{C_{i,t+1} - hC_t} \right)^{\gamma} \frac{1}{\Pi_{t+1}} \right\},$$
(A-1)

$$\chi N_{i,t}^{\varphi} = \frac{W_t}{P_t} \left( C_{i,t} - h C_{t-1} \right)^{-\gamma}, \qquad (A-2)$$

where equation (A-1) describes the time path of consumption of a household of type i, while equation (A-2) is the labor supply.

### Production and Calvo's Pricing Problem with Past Indexation

The typical intermediate-good producer i solves a cost-minimization intratemporal problem given the available technology and taking input prices as given. At the optimum, the demand for labor immediately is

$$\frac{W_t}{P_t} = MC_t \Delta_t^{\frac{\varkappa - 1}{\varkappa}} Y_{i,t}^{\frac{1}{\varkappa}} (1 - \zeta) \left( A_t N_{i,t} \right)^{-\frac{1}{\varkappa}} A_t,$$
(A-3)

while the demand for the energy source is

$$\frac{P_{Z,t}}{P_t} = MC_t \Delta_t^{\frac{\varkappa-1}{\varkappa}} Y_{i,t}^{\frac{1}{\varkappa}} \zeta Z_{i,t}^{-\frac{1}{\varkappa}}.$$
(A-4)

We now solve the price-setting problem. To make the notation more compact, let  $\Psi_t = \Pi_t^{-1} \Pi_{t-1}^{\kappa}$ . Given the price indexation rule, during the time interval in which the typical firm cannot re-set its price, its relative price  $p_{i,t+s} = P_{i,t+s}/P_{t+s}$  evolves as:

$$p_{i,t+s} = \left(\prod_{k=1}^{s} \Psi_{t+k}\right) p_{i,t}^*,\tag{A-5}$$

where  $p_{i,t}^* = P_{i,t}^*/P_t$ . We have made use of the fact that  $\Pi = 1$ . Clearly, for s = 0, we have  $p_{i,t} = p_{i,t}^*$ .

Let  $Y_{i,t+s|t}$  denote the demand in period t+s faced by a firm *i* having reset its price in the period *t*, that is  $Y_{i,t+s|t} = p_{i,t+s}^{-\sigma} Y_{t+s}$ . Using the result in (A-5)  $Y_{i,t+s|t}$  can be expressed as:

$$Y_{i,t+s|t} = \left[ \left( \prod_{k=1}^{s} \Psi_{t+k} \right) p_{i,t}^* \right]^{-\sigma} Y_{t+s}.$$
(A-6)

Now consider the case of the firm able to re-optimize in period t. As mentioned above, the representative firm i will choose the price  $p_{i,t}^*$  to maximize the current market value of the profits generated while that price remains constant. The optimization problem can be written as:

$$\max_{p_{i,t}^*} \tilde{E}_{i,t} \sum_{t=0}^{\infty} \varpi^s \left[ Q_{i,t,t+s} \left( p_{i,t+s} Y_{i,t+s|t} - M C_{t+s} Y_{i,t+s|t} \right) \right],$$
(A-7)

subject to (A-6), where  $Q_{i,t,t+s} = \beta^s \lambda_{i,t+s} / \lambda_{i,t}$  is the real stochastic discount factor with  $\lambda$  denoting the marginal utility of consumption. The first-order condition for the optimal price is then:

$$p_{i,t}^* = \frac{\sigma}{\sigma - 1} \frac{\tilde{E}_{i,t} \sum_{t=0}^{\infty} \varpi^s \beta^s \lambda_{i,t+s} Y_{t+s} \left(\prod_{k=1}^s \Psi_{t+k}\right)^{-\sigma} M C_{t+s}}{\tilde{E}_{i,t} \sum_{t=0}^{\infty} \varpi^s \beta^s \lambda_{i,t+s} Y_{t+s} \left(\prod_{k=1}^s \Psi_{t+k}\right)^{1-\sigma}}.$$
 (A-8)

## Aggregation

In this model agents are heterogeneous because they formulate expectations differently, i.e., they have different market beliefs. To solve the aggregation problem we first need to log-linearize the model around the deterministic steady state.

Equations (A-1) and (A-2) can be easily log-linearized around a zero-inflation steady state to obtain:

$$c_{i,t} = \tilde{E}_{i,t}c_{i,t+1} - h\left(c_t - c_{t-1}\right) - \frac{1-h}{\gamma}\left(r_t - \tilde{E}_{i,t}\pi_{t+1}\right) + (A-9)$$
  
$$-\frac{1-h}{\gamma}\left(\tilde{E}_{i,t}\mu_{t+1} - \mu_t\right) + \bar{\varrho}b_{i,t},$$
  
$$\varphi n_{i,t} = w_t - \frac{\gamma}{1-h}c_{i,t} + \frac{\gamma h}{1-h}c_{t-1}, \qquad (A-10)$$

where  $c_i$  and  $n_i$  denote consumption and labor expressed as natural log deviations from their steady-state values,  $\bar{\varrho} = (1-h)^{1+\gamma} Y^{1+\gamma} \varrho/\gamma$ ,  $b_{i,t} = B_{i,t}/YP_t$ ,  $w_t$  refers to the natural log deviation of the real wage from its steady-state level,  $\pi_t = \Pi_t - 1$  and  $r_t = R_t - R$ .

Equation (A-9) can be re-written as

$$c_{i,t} = \tilde{E}_{i,t}c_{t+1} + \left(\tilde{E}_{i,t}c_{i,t+1} - \tilde{E}_{i,t}c_{t+1}\right) - h\left(c_t - c_{t-1}\right) + (A-11) \\ - \frac{1-h}{\gamma}\left(r_t - \tilde{E}_{i,t}\pi_{t+1}\right) - \frac{1-h}{\gamma}\left(\tilde{E}_{i,t}\mu_{t+1} - \mu_t\right) + \bar{\varrho}b_{i,t},$$

where now  $\tilde{E}_{i,t}c_{t+1}$  is the subjective expectations of aggregate consumption. Let  $c_t = \int_0^1 c_{i,t} di$  denote aggregate consumption, then from the above equation, we have:

$$c_{t} = \tilde{E}_{t}c_{t+1} - \frac{1-h}{\gamma} \left( r_{t} - \tilde{E}_{t}\pi_{t+1} \right) - hc_{t} + hc_{t-1} + \int_{0}^{1} \left( \tilde{E}_{i,t}c_{i,t+1} - \tilde{E}_{i,t}c_{t+1} \right) di + v_{t},$$
(A-12)

where  $\tilde{E}_t c_{t+1}$  and  $\tilde{E}_t \pi_{t+1}$  are the market forecasts for consumption and inflation. Note that we have used the fact that in equilibrium it must be that  $\int_0^1 b_{i,t} di = 0$ . For simplicity, we assume that  $v_t = -\frac{1-h}{\gamma} \left( \int_0^1 \tilde{E}_{i,t} \mu_{t+1} - \mu_t \right)$ , where  $v_t$  follows a first-order autoregressive process.<sup>27</sup> To facilitate aggregation, following Hommes et al. (2019), we further assume the average expectation of individual consumption is equal to the average expectation of aggregate consumption, that is  $\int_0^1 \tilde{E}_{i,t}c_{i,t+1}di = \int_0^1 \tilde{E}_{i,t}c_{t+1}di.$ Aggregate labor supply immediately follows from (A-2):

$$\varphi n_t = w_t - \gamma (1-h)^{-1} c_t + \gamma h (1-h)^{-1} c_{t-1}, \qquad (A-13)$$

where  $w_t$  is the wage rate expressed as natural log deviation from its steady-state value.

Equations (4), (A-3) and (A-4) can be easily log-linearized to obtain:

$$y_t = \delta_t + \epsilon_Z z_t + \epsilon_N \left( a_t + n_t \right), \qquad (A-14)$$

$$w_t = mc_t + \frac{\varkappa - 1}{\varkappa} \delta_t + \frac{1}{\varkappa} \left( y_t - n_t \right) + \left( 1 - \frac{1}{\varkappa} \right) a_t, \tag{A-15}$$

$$p_{Z,t} = mc_t + \frac{\varkappa - 1}{\varkappa} \delta_t + \frac{1}{\varkappa} \left( y_t - z_t \right), \qquad (A-16)$$

where  $\epsilon_N \equiv (\Delta AN/Y)^{\frac{\varkappa-1}{\varkappa}} (1-\zeta), \ \epsilon_Z \equiv (\Delta Z/Y)^{\frac{\varkappa-1}{\varkappa}} \zeta, \ p_{Z,t}$  is the relative price of emissions expressed in log deviation from its steady state level. All the other variables refer to their capital-letter counterparts, always expressed as natural log deviations from their respective steady-state values.

Log-linearizing (A-8) around the zero-inflation steady state delivers:

$$\hat{p}_{i,t}^* = (1 - \varpi\beta) mc_t - \varpi\beta \tilde{E}_{i,t} \psi_{t+1} + \varpi\beta \tilde{E}_{i,t} \hat{p}_{i,t+1}^*,$$
(A-17)

where  $\hat{p}_{i,t}^* = (p_{i,t}^* - p^*)/p^*$  and  $\psi_{t+1} = -\pi_{t+1} + \kappa \pi_t$ . Let  $\hat{p}_t^* = \int_0^1 \hat{p}_{i,t}^* di$ . The pricing equation can then be re-written as:

$$\hat{p}_{i,t}^* = (1 - \varpi\beta) mc_t - \beta \varpi \kappa \pi_t + \varpi \beta \tilde{E}_{i,t} \left( \hat{p}_{t+1}^* + \pi_{t+1} \right) + \varpi \beta \left( \tilde{E}_{i,t} \hat{p}_{i,t+1}^* - \tilde{E}_{i,t} \hat{p}_{t+1}^* \right), \quad (A-18)$$

where we have used the fact that  $\psi_{t+1} = -\pi_{t+1} + \kappa \pi_t$ .

Given the definition of aggregate price index  $P_t = \int_0^1 \left(P_{i,t}^{1-\sigma}\right)^{1/(1-\sigma)} di$ , in the presence of price stickiness and indexation, we have:

$$P_t^{1-\theta} = \int_0^{1-\varpi} \left(P_{i,t}^*\right)^{1-\sigma} di + \int_0^{\varpi} \left(P_{i,t-1}\Pi_{t-1}^{\kappa}\right)^{1-\sigma} di$$
(A-19)

that in log-linear terms can be expressed as:

$$(1-\varpi)\hat{p}_t^* = \varpi \left(\pi_t - \kappa \pi_{t-1}\right). \tag{A-20}$$

Substituting into equation (A-18) gives:

$$\hat{p}_{i,t}^* = (1 - \varpi\beta) mc_t - \varpi\beta\kappa\pi_t - \varpi\beta\frac{\varpi}{1 - \varpi}\kappa\pi_t + \frac{\varpi}{1 - \varpi}\beta\tilde{E}_{i,t}\pi_{t+1} + \varpi\beta\left(\tilde{E}_{i,t}\hat{p}_{i,t+1}^* - \tilde{E}_{i,t}\hat{p}_{t+1}^*\right).$$
(A-21)

<sup>&</sup>lt;sup>27</sup>Alternatively, one can also make explicit the expectation rules on the variable v.

The above equation can be aggregated over all firms re-setting their price to obtain:

$$\pi_t = \frac{1 - \varpi\beta}{1 + \beta\kappa} \frac{1 - \varpi}{\varpi} mc_t + \frac{\beta}{1 + \beta\kappa} \tilde{E}_t \pi_{t+1} + \frac{\kappa}{1 + \beta\kappa} \pi_{t-1} + (1 - \varpi)\beta \int_0^1 \left(\tilde{E}_{i,t} \hat{p}^*_{i,t+1} - \tilde{E}_{i,t} \hat{p}^*_{t+1}\right) di.$$
(A-22)

Now observe that all firms have access to the same technology, have the same marginal costs, and are subject to the same random shocks. As one above, we then assume that the aggregate expectation on the optimal future price set by each firm manager  $\int_0^1 \tilde{E}_{i,t} \hat{p}_{i,t+1}^* di$  is equal to the aggregate expectations on the average optimal price of the economy  $\int_0^1 \tilde{E}_{i,t} \hat{p}_{t+1}^* di$ . It follows that (A-22) can be written as:

$$\pi_t = \frac{1 - \varpi\beta}{1 + \beta\kappa} \frac{1 - \varpi}{\varpi} mc_t + \frac{\beta}{1 + \beta\kappa} \tilde{E}_t \pi_{t+1} + \frac{\kappa}{1 + \beta\kappa} \pi_{t-1}.$$
 (A-23)

The above equation is the New Keynesian Phillips curve with price indexation and non-rational agents.

Finally, the log-linearized versions of equations (7)-(10) immediately follow:

$$m_{t} = \delta_{M} \frac{Z}{Z + Z^{RoW}} z_{t} + (1 - \delta_{M}) m_{t-1} + \delta_{M} \frac{Z^{RoW}}{Z + Z^{RoW}} z_{t}^{RoW}, \qquad (A-24)$$

$$\delta_t = -\eta \left( M - \overline{M} \right) m_t, \tag{A-25}$$

$$r_t = \iota_r r_{t-1} + (1 - \iota_r) [\iota_\pi \pi_t + \iota_y (y_t - y_t^*)] + u_t,$$
(A-26)

$$c_t = y_t, \tag{A-27}$$

where  $m_t$  is the log-deviation of  $M_t - \overline{M}$  from its steady state value.

Using the equilibrium condition (A-27) in the aggregate Euler equation (A-12), we obtain:

$$y_t (1+h) = \tilde{E}_t y_{t+1} + h y_{t-1} - \frac{1-h}{\gamma} \left( r_t - \tilde{E}_t \pi_{t+1} \right) + v_t.$$
 (A-28)

We can then combine (A-13), (A-14), (A-15) with (A-16) to get rid of  $n_t$  and  $w_t$ , and obtain:

$$mc_{t} = \left(\frac{\varphi + \frac{1}{\varkappa}}{\epsilon_{N}} - \frac{1}{\varkappa} + \frac{\gamma}{1-h}\right)y_{t} - \left(\frac{\varphi + \frac{1}{\varkappa}}{\epsilon_{N}} + \frac{\varkappa - 1}{\varkappa}\right)\delta_{t} - \epsilon_{Z}\frac{\varphi + \frac{1}{\varkappa}}{\epsilon_{N}}z_{t} - (1+\varphi)a_{t} - \gamma\frac{h}{1-h}y_{t-1},$$
(A-29)

$$p_{Z,t} = mc_t + \frac{\varkappa - 1}{\varkappa} \delta_t + \frac{1}{\varkappa} \left( y_t - z_t \right).$$
(A-30)

The above two equations, along with (A-23), (A-25)-(A-24) and (A-28) describe the aggregate model summarized in Table 1 where we have assumed that  $z_t^{NI} = 0$  and written the coefficients of equation (A-29) in a compact form.

Under flexible prices, the typical firm *i* will set the price  $P_{i,t}$  to maximize profits given the demand schedule  $Y_{i,t} = (P_{i,t}/P_t)^{-\sigma} Y_t$ . At the optimum  $MC = (\sigma - 1)/\sigma$ , so that in the log-linearized model  $mc_t = 0$ . Combining (A-29) with (A-30) and assuming  $mc_t = 0$ , the natural level of output immediately follows:

$$y_t^* = \frac{\epsilon_N \frac{\varphi+1}{\varphi+\frac{1}{\varkappa}} a_t + \left[1 + \epsilon_N \frac{\frac{\varkappa-1}{\varkappa}}{\varphi+\frac{1}{\varkappa}} + \epsilon_Z \left(\varkappa - 1\right)\right] \delta_t^* - \epsilon_Z \varkappa p_{Z,t}^* + \epsilon_N \frac{\gamma h (1-h)^{-1}}{\varphi+\frac{1}{\varkappa}} y_{t-1}^*}{1 - \epsilon_Z \varkappa - \epsilon_N \frac{\frac{1}{\varkappa} - \gamma (1-h)^{-1}}{\varphi+\frac{1}{\varkappa}}}, \quad (A-31)$$

where  $\delta_t^* = -\eta \left( M - \overline{M} \right) m_t^*$ ,  $m_t^* = \delta_M \frac{Z}{Z + Z^{RoW}} z_t^* + (1 - \delta_M) m_{t-1}^*$  while  $z_t^*$  must satisfy the equation below:

$$p_{Z,t}^* = \frac{\varkappa - 1}{\varkappa} \delta_t^* + \frac{1}{\varkappa} \left( y_t^* - z_t^* \right).$$
 (A-32)

From (A-31) we can see that the natural level of output is decreasing in the policy variable  $p_{Z,t}^*$ . Clearly, if the government sets the price of emissions, then  $p_{Z,t}^* = p_{Z,t}$ , while in the case of a cap control we will have  $z_t^* = z_t$ .

#### **Additional Results**

In this appendix, we report some additional results. Figure A-1 shows the economy's response to a timely mitigation policy under rational and behavioral expectations. It is interesting to see that, in the case of a gradual emission reduction, the time path of emissions does not differ substantially between the two cases, contrary to what happens to inflation and all the other variables.

Figure A-2 is the rational expectations counterpart of Figure 3 of the main text. Here the forecast errors are driven only by the pollution policy phased in as a surprise policy shock.

Figure A-3 plots the response of emissions to a gradual increase in the carbon tax, as in the main scenario of Figure 3, but in a highly perturbed economy, where the standard deviations of shocks driving business cycle fluctuations are three times larger than in the baseline case. In a similar scenario, Figure A-4 shows the response of the emission permits price and the inflation rate to a gradual quantity restrictions of emissions (cap-and-trade scheme). Comparing these two figures makes it clear that the choice between price and quantity regulations poses a significant policy trade-off between emission certainty and price stability in a perturbed economy. Inflation targeting becomes more problematic.





Note: the figure plots the economy's response to a gradual increase in the carbon price aimed at permanently reducing emissions by 20%. Horizontal axis: quarters. Vertical axis: all variables are expressed in percentage deviations from their respective business-as-usual value, with the exceptions of inflation and of the real interest rate that are expressed in quarterly basis points (b.p.) deviations, while the shares of extrapolators are expressed in percentage points (p.p.) deviations.



Figure A-2: Mitigation Scenarios - Macroeconomic Dynamics and Market Forecast Errors under Rational Expectations

Note: the figure plots the mean response of the economy to different mitigation scenarios entailing the same cumulative emissions after 20 quarters in the deterministic counterparts. Horizontal axis: quarters. Vertical axis: inflation and its forecast errors are expressed in quarterly basis points (b.p.) deviations, while output and its forecast errors are in percentage deviations.



Figure A-3: Emission Dynamics in a Highly Perturbed Economy

Note: the figure plots the time path of emissions in a highly perturbed economy. The climate policy consists of a gradual increase in the carbon price aimed at permanently reducing emissions by 20% in a deterministic setting. Cumulative reductions are simply the cumulative variations of emissions. Horizontal axis: quarters.

Figure A-4: Permits Price and Inflation in a Highly Perturbed Economy



Note: the figure plots the time path of permits price and inflation in a highly perturbed economy. The climate policy consists of a gradual emission restriction. Horizontal axis: quarters.

# Declarations of interest

None

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