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INTEREST RATES WITH OPTIMAL INFLATION TAX AVOIDANCE

Abstract:

This paper explains real US short term government bond rates through a general equilibrium monetary economy with optimal inflation tax avoidance. The effective inflation tax adds to the shadow cost of consumption, forms an intertemporal wedge, and explains variation in real bond rates for the US fiat era, post 1970. There is a high correlation between rates computed using the model's asset pricing equation
and those found in the data. Breaking the sample period into pre- and post-2008 subperiods demonstrates how increasing bank productivity pre-2008 helps to better match the level of real rates.

Keywords:

Euler equation, interest rates, bond pricing kernel, inflation, bank productivity, money velocity.