

Expectations, Stagnation and Fiscal Policy

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Discussion by Athanasios Orphanides at the
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Setup and Main Question

- ▶ Study a NK model with learning and possible multiple equilibria when the economy is subject to the ZLB.
- ▶ One steady state reflects the usual “good” outcome.
- ▶ An unintended stagnation equilibrium is also (locally) stable under learning.
- ▶ The risk: A “pessimistic expectations” shock can push the economy to the stagnation equilibrium.
- ▶ The policy question: What is the role of fiscal policy for guarding against the stagnation outcome?

Policy Lessons

- ▶ Fiscal policy has noticeably different properties under learning than under RE.
- ▶ Under learning, effect of fiscal stimulus is front-loaded and in this sense more powerful than it appears under RE.
- ▶ Small fiscal stimulus can fail to avoid the stagnation equilibrium.
- ▶ Sufficiently large stimulus can effectively defend against stagnation.
- ▶ Fiscal policy is most effective when implemented early.

Comments I

- ▶ An important contribution that highlights the potential role of bad policy for the stagnation of the past decade.
- ▶ Nice example of why learning should be at the heart of any model, given implausibility of usual assumptions.
- ▶ Key findings elevate role of fiscal policy as a tool at ZLB. Early lit. relied on fiscal policy only as an escape tool.
- ▶ Particularly important lessons for fiscal policy:
 - ▶ Best to act early to defend against stagnation fears.
 - ▶ Must act decisively, else may be ineffective.

Comments II: A wish list on policy modelling

- ▶ Deviation from the toy RE NK model too small.
- ▶ Cannot expect to capture ZLB policy options in models:
 - ▶ without quantities and portfolio balance effects,
 - ▶ without frictions in financial intermediation and markets,
 - ▶ without imperfect knowledge regarding economy, policy multipliers, expectations formation etc.
- ▶ Should be willing to tolerate more significant deviations from analytical tractability to respect reality.
- ▶ Else, “policy” models will be justifiably sidelined when it matters, leading to less-well informed policy debates.

Comments III: Fiscal or monetary policy?

- ▶ Are the lessons just about fiscal policy?
- ▶ At ZLB, monetary and fiscal policy become blurred.
- ▶ IS curve with balance sheet effects will exhibit qualitatively similar multipliers for balance sheet policies.
- ▶ So analysis can be used to highlight crucial role of balance sheet monetary policy in defending against a stagnation equilibrium.
- ▶ Particularly important lessons for balance sheet policy:
 - ▶ Best to act early to defend against stagnation fears.
 - ▶ Must act decisively, else may be ineffective.

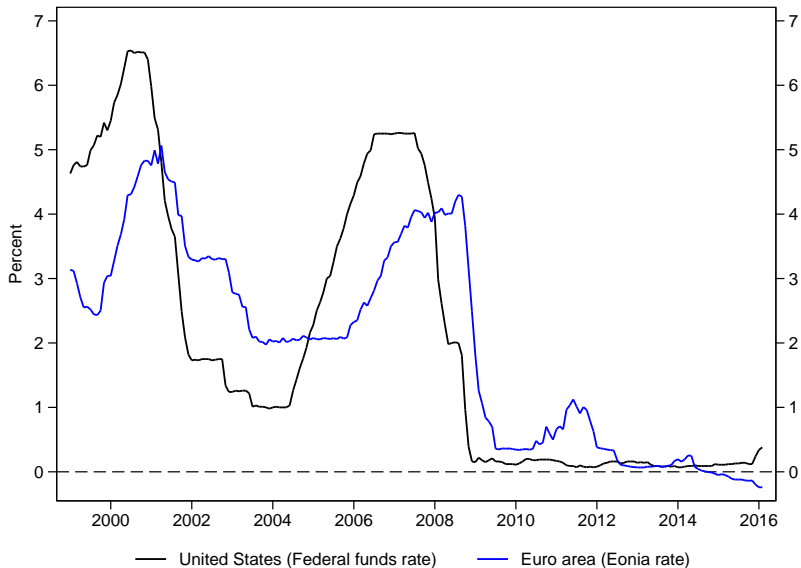
Comments IV: Expanded model

- ▶ Consider monetary policy designed to be robust to ZLB and uncertainty with expanded model and rule.
- ▶ Generalized policy rule:
 - ▶ $\Delta i = \phi_{\pi}(\pi - \pi^*)$, when ZLB does not bind.
 - ▶ $\Delta M = \psi_{\pi}(\pi - \pi^*)$, at the ZLB.
- ▶ For robustness, must be ready to adapt ϕ_{π} and ψ_{π} to incorporate learning about multipliers. (If inflation is not responding as fast as expected, adjust upwards.)

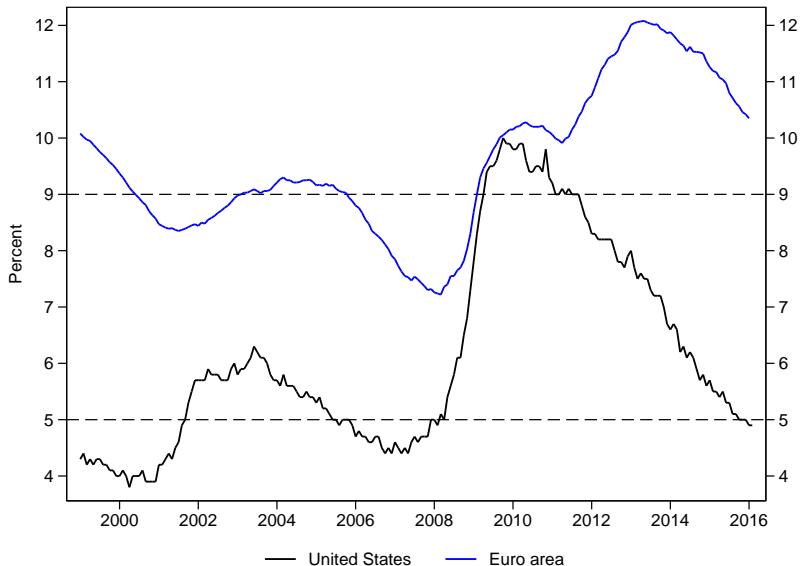
Comments V: Explaining stagnation

- ▶ Expanded model (with balance sheet effects) critical to assess empirical role of monetary (and fiscal) policy over past decade.
- ▶ Absent balance sheet effects, need to confront “permazero” scenaria as possible explanations of Japan/euro area stagnation relative to US.
- ▶ Alternative is to contrast complete policy mix, including:
 - ▶ fiscal policy.
 - ▶ interest rate monetary policy.
 - ▶ balance sheet monetary policy.

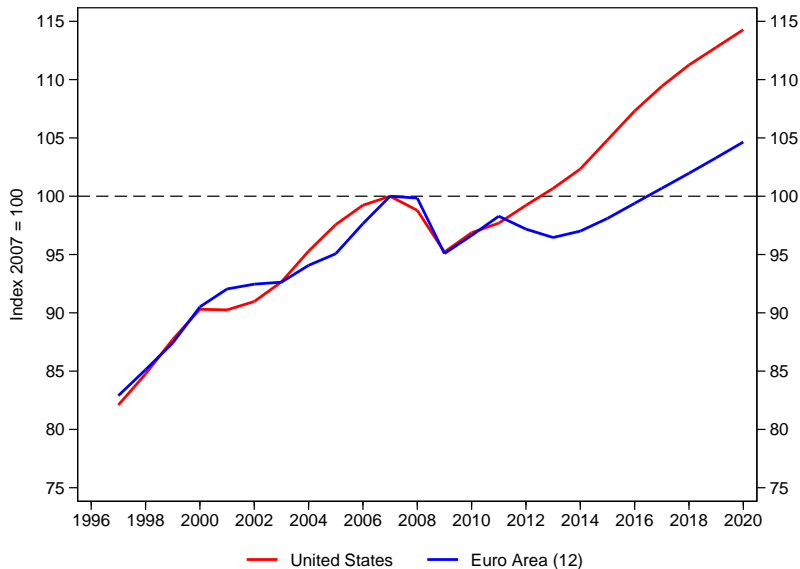
Fed vs ECB: Overnight interest rate



Fed vs ECB: Unemployment

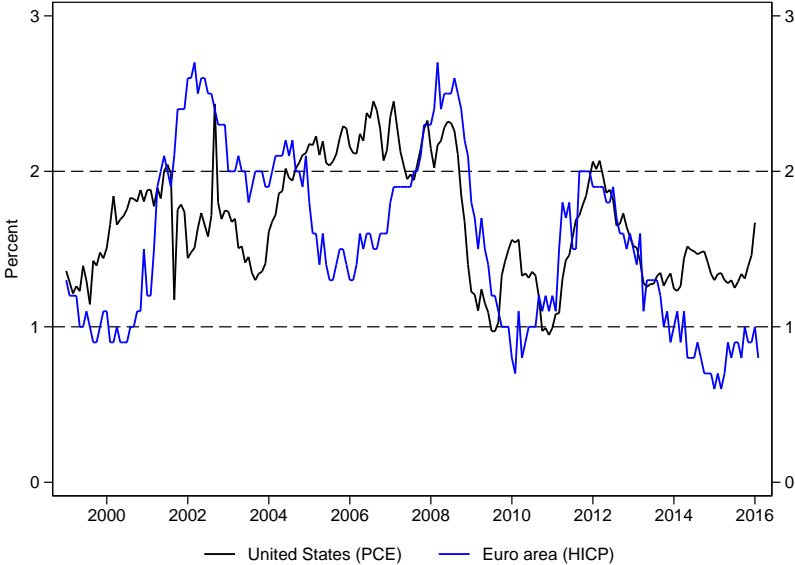


Fed vs ECB: Real GDP per person

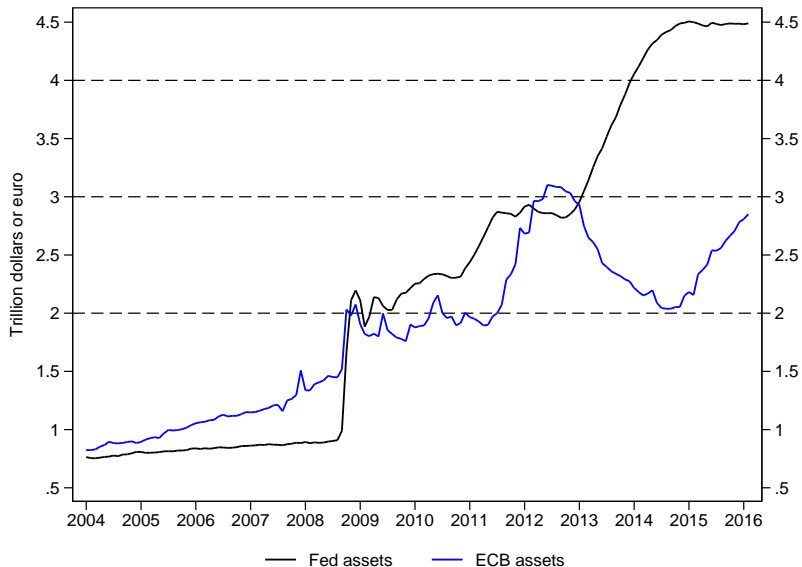


IMF World Economic Outlook data and projections.

Fed vs ECB: Core Inflation



ECB vs Fed policy: A missing couple trillion euro?



Latest ECB move: Towards a correction

- ▶ ECB Governing Council decisions on 10 March 2016 represent an important correction in policy direction.
- ▶ Further expansion of balance sheet through asset purchases, which will now include corporate debt.
- ▶ Further expansion of balance sheet through long-term liquidity provision (4 years) at fixed interest rate which can be zero or below zero.
- ▶ Forward guidance on asset purchases.
- ▶ Forward guidance on policy rates.