Expectations, Deflation traps and Macroeconomic Policy

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- Liquidity trap is a real concern not only under RE but even under learning
  - Evans and Honkapohja 2005 and Evans, Guse, and Honkapohja 2008
- In this paper Evans and Honkapohja analyze the case when long term expectations matter under learning
  - This is motivated by the finding that commitment to future policies can help to fight deflation under RE (Krugman 1998 and Eggertsson and Woodford 2003)
  - Under infinite horizon learning expectations matter more

Main results

- Monetary policy alone is not enough to prevent deflation
- A coordination of monetary and fiscal policy is needed

Very interesting paper with alarming conclusions

- Important to access the robustness of policy recommendations to alternative (and realistic) expectation formations
- Important to analyze global dynamics

Role of monetary policy

Is monetary policy really inefficient alone?

- Nonlinear Taylor rule $R_t = f(\pi^e_{t+1})$
- Would a different monetary policy be able to fight deflation?
  - How would an interest rate rule perform that conditions on all private expectation variables π, y, g
  - Molnar and Santoro 2007
    - When expectations are non-rational they become a natural state variable
    - Optimal policy on these new states implements non-explosive paths

Role of fiscal policy

Fiscal policy seems too efficient in this model

- In the paper the mix of government financing does not influence private consumption behavior
- Lump sum taxes

- Seems that fiscal policy alone would be enough to escape deflation

Role of commitment

The role of commitment under learning

- The paper shows that: committing to a low interest rate rule for a long period does not help much under learning
- Expectations are purely backward looking - influence of commitment is through the actual data path
- A different role of commitment might be through the Lucas critique (endogenous choice of expectation formation Evans and Ramey 2004, Brock and Hommes 1997)

Final comment about modeling

- Agents must **know her own decision problem** (firms, consumers)
- Form **expectations about their individual variables**
  - They do not realize individual variables coincide with aggregate variables, i.e. **they are representative agents**
    - Otherwise infinite horizon expectations do not matter (Preston 2005)
  - There can be **inconsistency between forecasts**.
    For example Phillips curve

$$\pi_t = f(\ \{y^e_{t+s}, g^e_{t+s}\}_{s=1}^{\infty}\ )$$

Forecasts of future π must be also consistent with future output and government spending forecasts through the PC