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## **EXPECTATIONS, STAGNATION AND FISCAL POLICY**

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Mitra

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## Abstract

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JEL Classification: E62, D84, E21, E43

Keywords: Stagnation, Deflation, Expectations, Output Multiplier, New Keynesian Model, Adaptive Learning, Fiscal policy

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# Expectations, Stagnation and Fiscal Policy\*

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27 July 2016

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Stagnation as the new norm and fiscal policy are examined in a New Keynesian model with adaptive learning determining expectations. We impose inflation and consumption lower bounds, which can be relevant when agents are pessimistic. The inflation target is locally stable under learning. Pessimistic initial expectations may sink the economy into steady-state stagnation with deflation. The deflation rate can be near zero for discount factors near one or if credit frictions are present. Following a severe pessimistic expectations shock a large temporary fiscal stimulus is needed to avoid or emerge from stagnation. A modest stimulus is sufficient if implemented early.

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# 1 Introduction

The sluggish macroeconomic performance of advanced market economies in the seven years after the Great Recession has raised interest in the possibility of the economy becoming stuck for long periods in a distinct stagnation state and that this stagnation might be associated with the zero lower bound (ZLB) for the monetary policy interest rate.<sup>1</sup> One possible explanation for the stagnation state is that it is caused by a wide-spread lack of confidence on the part of economic agents. In other words, a stagnation state with deflation and interest rates constrained by the ZLB may be a possible equilibrium of the economy. We develop an extension of a standard new Keynesian (NK) model to account for existence of a stagnation steady state. Our analysis assumes that economic agents make forecasts using adaptive learning (AL) and we impose the requirement that the stagnation steady state be (locally) stable under adaptive learning. Existence of a stagnation steady state is consistent with the observation that under the ZLB constraint, real economic performance of the US, Japanese and the euro area economies appears to be clearly worse than in the earlier period before the ZLB became binding.

Within the context of the standard NK model, the implications of the ZLB have been approached from several angles. First, there is the possibility of exogenous shocks to demand that push the economy to the ZLB. Exogenous discount rate or, more plausibly, credit-spread shocks have been emphasized by Eggertsson and Woodford (2003), Christiano, Eichenbaum, and Rebelo (2011), Corsetti, Kuester, Meier, and Muller (2010) and Woodford (2011). These shocks are often assumed to follow a two-state Markov process in which the credit-spread shock disappears each period with a fixed probability, with aggregate output and inflation recovering as soon as the exogenous shock stops operating.

While this approach has been fruitful in suggesting suitable monetary and fiscal policy responses to such shocks, it has several somewhat unattractive features. It relies heavily on the persistence of a shock that evaporates according to an exogenous process, and recession ends as soon as the exogenous negative shock ends.<sup>2</sup> Furthermore, this approach, which is often

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<sup>1</sup>For different arguments and explanations for long-lasting stagnation see, for example, Summers (2013), Evans (2013), Teulings and Baldwin (2014), Eggertsson and Mehrotra (2014), Benigno and Fornaro (2015) and Schaal and Taschereau-Dumouchel (2015).

<sup>2</sup>There is also an issue with existence of a rational expectations solution when the probability of the shock ending is too small. A related issue for calibrated models is the

developed using a linear approximation around the intended steady state, with the ZLB appended, does not do justice to the issue of inherent multiplicities raised by Benhabib, Schmitt-Grohe, and Uribe (2001b) for the NK model and Reifschneider and Williams (2000) for backward-looking models.

A second approach, emphasized by Benhabib, Schmitt-Grohe, and Uribe (2001b), focuses squarely on the existence of multiple rational expectations equilibria (REE) when the interest-rate rule is subject to the ZLB. In particular, in addition to the intended steady state at the inflation rate targeted by monetary policy, there is a second, unintended steady state at a low inflation or modest deflation rate, as well as perfect foresight paths converging to the unintended steady state. This multiplicity was emphasized in Bullard (2010). Figure 1 gives a scatter plot of core inflation vs. the policy interest rate, as originally done in Bullard (2010) for Japan and US data and subsequently by Honkapohja (2016) using Japan and euro area data. Figure 1 uses monthly data, over 1/2002 to 1/2015 for euro area and US and to 10/2013 for Japan,<sup>3</sup> and combines them in one figure. The illustrated policy rule is drawn with a two-percent inflation target and is merely used to provide a common reference since the two percent target does not exactly match either U.S. or euro area practice.

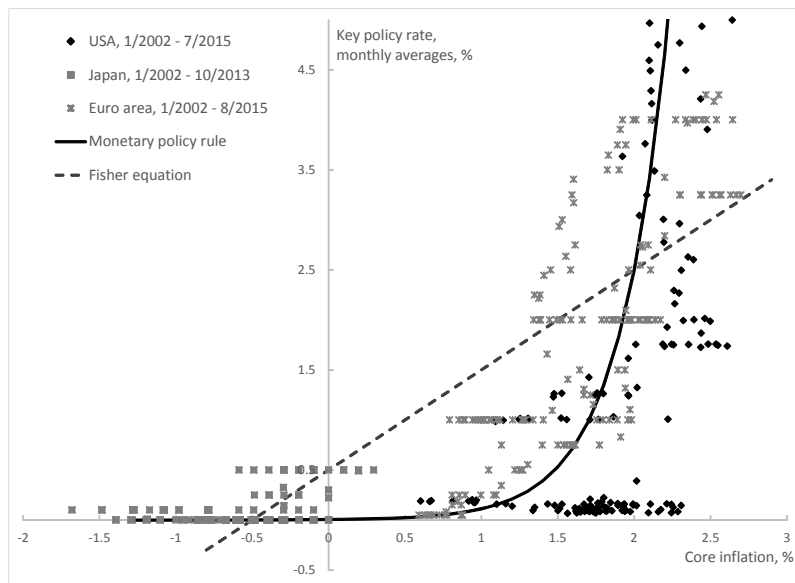


Figure 1: Interest rate vs inflation in Japan, US and euro area

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length of time for which Japan has been at the ZLB.

<sup>3</sup>Japan switched the policy target in 2013 to monetary base.

Inflation and interest rates at the two steady states in Figure 1 correspond to the two intersections of the Fisher equation and the Taylor-type interest rate rule.<sup>4</sup> The Japanese data from this period is essentially entirely within the liquidity trap, while the US and euro area data show a mixture of liquidity-trap and non-liquidity trap periods. Both the US and the euro area had brief periods of deflation during 2009 and the Great Recession, followed by a period of inflation. However more recently, since 2013, inflation in both the euro area and the US has often been below target and sometimes shown signs of decline. Figure 1 thus suggests some possibility of convergence to an unintended low inflation steady state.

A major problem with this second approach is its neglect of the concern that periods of ZLB are associated with periods of recession, low output and stagnation. Although there is a long-run trade-off in the NK model between output and inflation, the extent of this trade-off is quite minor as the discount factor is close to one. It follows that in the unintended low inflation steady state the level of aggregate output is only very slightly below that of the intended steady state in Figure 1. Figures 2a to 2c give real GDP per capita since 2001 for the US, Japan and the euro area.<sup>5</sup>

Figures 2a-c illustrate the point that depressed output levels in Japan, the US and the Euro area have been associated with the ZLB. This is inconsistent with the view of two steady-states in the second approach. Taken together with Figure 1, there appears also to be the possibility of stagnation, i.e. persistently depressed levels of output, at low inflation or deflation steady states. This is discussed further below. Here we note the magnitudes of the drop in (real) GDP per capita.

For the US, the decrease from 2007Q4 to 2009Q2 was about 6.0%. Given an underlying trend growth in the US of real GDP per capita of 2% per year, one would have expected 3% total growth over this period, so one could argue that this corresponds to a 9% GDP gap.<sup>6</sup> For Japan, the decrease in GDP per capita from 1997Q1 to 1999Q1 was 3.5% and from 2008Q1 to 2009Q2

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<sup>4</sup>The interest-rate rule curve takes the form  $R = A * \exp(B\pi)$ , where here  $\pi$  denotes net inflation and here  $R$  denotes the net interest rate.

<sup>5</sup>Data for Figures 2 a-c is from Macrobond data base which in turn utilizes standard data sources. GDP data is volume data with 2010 as reference year and in local currency. GDP data is annualized. This was specifically done for the Euro area by multiplying quarterly data by 4. Population data is total population and it is interpolated for quarters.

<sup>6</sup>This is consistent with the increase in the unemployment rate of about 5 percentage points and an Okun's Law coefficient around 2.

was 7.5%. For the euro area the drop in GDP per capita from 2008Q1 to 2009Q2 was 5.5%. Again, allowing for usual trend growth in GDP per capita, the resulting GDP gaps would be larger.

Another objection to the two-steady state view of recent events is that the unintended low-inflation steady state is not stable under adaptive learning. This point has been emphasized in Evans, Guse, and Honkapohja (2008) and Benhabib, Evans, and Honkapohja (2014). We expand on this point at length below, but the key point is that this makes it implausible that the economy will converge to the unintended steady state. This instability under learning is in contrast to the (local) stability under learning of the targeted steady state in the model of Benhabib, Schmitt-Grohe, and Uribe (2001b).

A third approach relies on sunspot equilibria that can also be shown to exist when there are two steady states. A sunspot is modelled as a two-state Markov process with fixed transition probabilities. This can either be a stationary 2-state sunspot equilibrium, as in Aruoba, Cuba-Borda, and Schorfheide (2014) or a 2-state sunspot equilibrium with an absorbing state at the targeted steady state, as in Mertens and Ravn (2014). In this approach the state corresponding to deflation and recession is not due to a fundamental shock, but to a pure confidence shock.

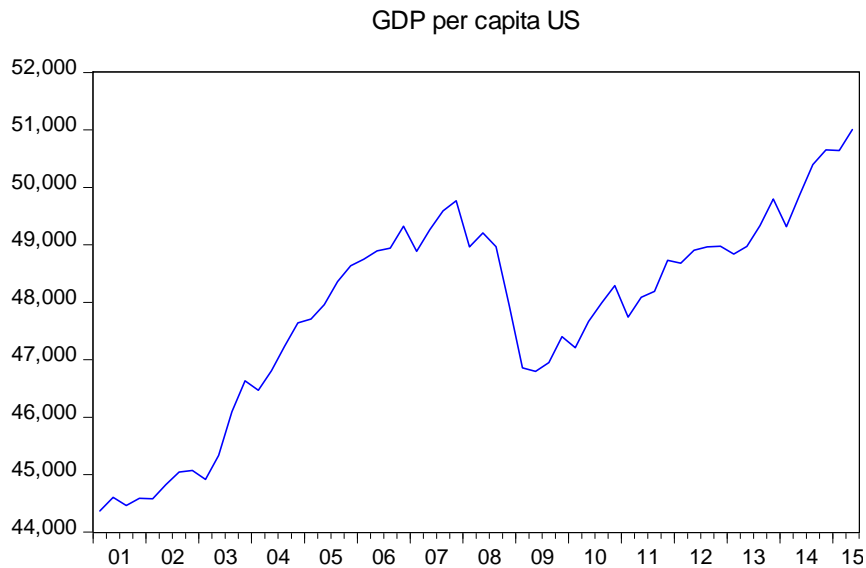


Figure 2a: US real GDP per capita in dollars



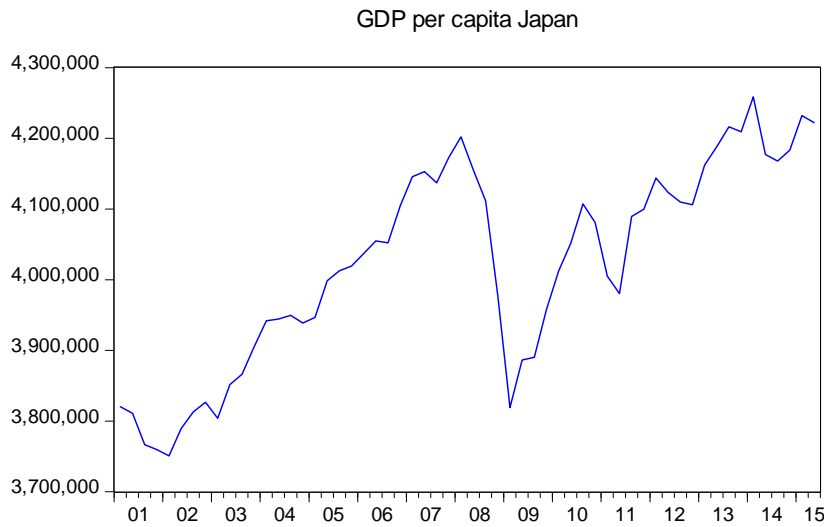


Figure 2b: Japan real GDP per capita in yen

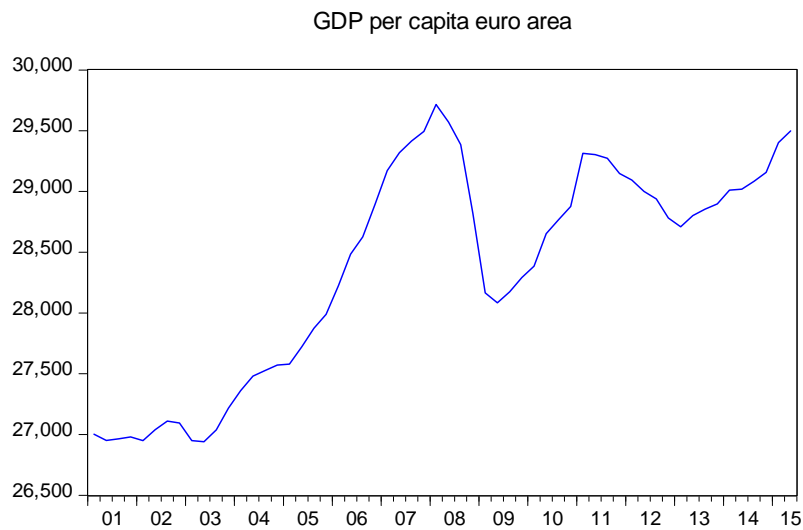


Figure 2c: Euro area real GDP per capita in euros

This approach is attractive in that it gives full weight to the multiple equilibria issue. However it also has disadvantages. As with sunspot equilibria more generally, there is the practical question of what variable is used to coordinate expectations. From our viewpoint there is also the issue of stability under learning: it can be shown that two-state sunspot equilibria are

not locally stable under learning when they are close to two steady states, one of which is not locally stable under learning as in the present case; e.g. see Evans and Honkapohja (2001), Chapter 12.

There is also an issue concerning the relatively small magnitude of recessions on this approach. The size of recessions appears to be greatest in the case of a Markov sunspot equilibrium with an absorbing state. However, even in this case the size of the recession is relatively mild: in the illustrations given in Mertens and Ravn (2014) the impact on output is  $-1.6\%$ . This is more in line with typical recessions and, as seen from the figures given above, this magnitude is well below the levels associated with the Great Recession. This is a reflection of the fact that output levels in the two steady states are nearly equal. We remark that the output drops in the Great Recession are still relatively small compared to the Great Depression, during which there was substantial deflation and the ZLB was eventually also attained. Real GDP figures for the US show a  $26.5\%$  drop between 1929 and 1933. Much of the policy discussion in the US during the Great Recession, in particular the speed with which the policy interest rate was reduced to the ZLB and the various rounds of quantitative easing, was concerned with taking steps to avoid the output drop and unemployment increase magnitudes of the Great Depression.

This discussion motivates the approach that we take in the current paper. In Evans, Guse, and Honkapohja (2008) and Benhabib, Evans, and Honkapohja (2014) adaptive learning was introduced into the NK model with two steady states arising from the ZLB. These papers showed that while the unintended steady state is not locally stable under learning, it is on the edge of a deflation trap region in which inflation and output fall without bound. In the current paper we add lower bounds to inflation and consumption into a NK model. We think such bounds are both plausible and more consistent with observed data. Depending on the magnitude of the inflation lower bound there are then one or three steady states. The critical level is a net deflation rate equal to the net discount rate. If the inflation lower bound is higher than this critical rate then the deflation trap region cannot be reached and the targeted steady state is unique. However, if the inflation bound is below this critical rate, then there are three steady states. We will show that in this case there is a stagnation steady state, at the inflation lower bound, which is locally stable under learning. This stagnation or “trap” steady state can have very low output accompanied by moderate deflation.

When our model has three steady states, these are all rational expecta-

tions (RE) steady states, and from the RE viewpoint the model is therefore indeterminate. However, AL resolves the indeterminacy issue in the sense that, given initial expectations and the learning rule, the time path of the economy is pinned down. AL explains how deep recessions accompanied by deflation can emerge and points to the possibility of deflationary stagnation. We show that the usual targeted steady state is locally stable under learning, i.e. there is convergence to the intended steady state under learning from nearby initial expectations, and indeed the basin (also called domain) of attraction is quite large. In contrast, the unintended steady state emphasized by Benhabib, Schmitt-Grohe, and Uribe (2001b) is not locally stable under learning: for nearby initial expectations there will either be convergence to the intended steady state or expectations will evolve toward lower expected inflation and output. Expectations then are driven down to the stagnation steady state, which is also locally stable under learning.<sup>7</sup>

The key point of the AL literature is that the low output and inflation during the period of exogenous discount rate, credit or other shocks, may have made agents generally more pessimistic about the future, and that these pessimistic expectations may well continue for a time after the exogenous shocks have ceased. In effect expectations have been re-initialized by the severe recession and if these expectations are sufficiently pessimistic then they may have taken the economy out of the basin of attraction of the targeted steady state.

The possibility of a stagnation steady state raises the question of whether policy can return the economy to the better steady state associated with output, inflation and interest rates at their normal levels. In particular, can fiscal policy prevent the economy from converging to stagnation, and if the economy has settled into stagnation, with deflation and interest rates at the ZLB, can fiscal policy dislodge the economy from stagnation and return it to the steady state targeted by monetary policy? To emphasize this issue, when we take up fiscal policy at the ZLB in Section 4.2, we will abstract from

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<sup>7</sup>In his August 13, 2015 conference speech “Neo-Fisherianism” (available on the FRB St. Louis website) at the University of Oregon Conference on “Expectations in Dynamic Macroeconomic Models,” James Bullard suggested that instability of the unintended low steady state under learning goes against the empirical evidence of major developed economies, in recent times, which are close to the ZLB and the unintended inflation steady state. In contrast we find that this instability can lead to convergence to a stagnation steady state at the ZLB with approximately the same inflation rate, but significantly lower output, which better matches the recent experience of major economies.

credit-spread shocks on the assumption that any such shocks have already dissipated.

We study the impact of government spending increases in our extended NK model when agents make forecasts using AL. Earlier work has shown that the fiscal policy effects under AL can sometimes be significantly different from those based on the RE assumption.<sup>8</sup> In undertaking this study it is clearly crucial to take into account both the monetary policy regime and the state of the economy. For example, under RE it has been shown that government spending multipliers are generally much larger when interest rates are fixed, as they are at the ZLB. Furthermore, as noted above the ZLB has arisen primarily in economies that have undergone severe recessions.

The AL approach used in the current paper is implemented as follows. Because we consider temporary changes in fiscal policy, similar to the stimulus measures adopted in practice in recent recessions, we use the general infinite-horizon approach advocated by Preston (2005) and Eusepi and Preston (2010a), but modified for policy changes as discussed in Evans, Honkapohja, and Mitra (2009) and Mitra, Evans, and Honkapohja (2013). Agents are assumed to incorporate the announced path of future government spending and taxes into their intertemporal budget constraint, and thus take into account the known direct impact of the policy. At the same time, agents are assumed not to know the general equilibrium effects of the temporary change in fiscal policy, and to use adaptive learning to forecast future values of output and inflation. Under AL agents update each period their estimates of the coefficients in their forecast model, and the evolution of these parameters over time modulates the impact of fiscal policy under learning vis-a-vis the impacts under rational expectations.

As mentioned above, we also explicitly impose inflation and consumption lower bounds, which can be relevant when expectations are pessimistic. The inflation lower bound is motivated by empirical experience that finds a smaller reduction in inflation rates at very low levels of output than would have been expected from the standard NK Phillips curve. See for example Ball and Mazumder (2011) and IMF (2013). We also introduce a consumption lower bound that would plausibly arise when consumption is substan-

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<sup>8</sup>The Great Recession and the ZLB have led to renewed interest in fiscal policy and a fairly voluminous recent literature in which the discussion has often been conducted in terms of the magnitude of the multiplier; see for instance Hall (2009), Barro and Redlick (2011), Ramey (2011b), Ramey (2011a), Leeper, Traum, and Walker (2011), Coenen et al. (2012), and Ravn, Schmitt-Grohe, and Uribe (2012).

tially below the level corresponding to the usual steady state. Although in normal times the inflation and consumption lower bounds are not relevant, they can play an important role during times of deep recession.

The structure of our paper is as follows. In Section 2 we present the Rotemberg adjustment-cost version of the NK model when the ZLB and other lower bounds are not applicable. In this setting we obtain the household and firm decision rules, the temporary equilibrium equations, and the updating rules for agents' forecast rules. In Section 3 we extend the model to include lower bounds for interest-rates, inflation and consumption. Because monetary policy is assumed transparent, household forecasts of future interest rates must allow for the possibility of the ZLB binding. This Section obtains the key existence and learning stability results for the different steady states, in the model with lower bounds, demonstrating in particular the possibility of a stagnation steady state, with low output and moderate deflation, and showing that it is locally stable under learning.

In Section 4 we compare fiscal policy under RE and AL both in normal times and when the ZLB may be binding. In Section 4.1 we find that the overall size of the output multipliers for government spending under AL and RE are about the same, but the AL multipliers are front-loaded, i.e. the bulk of the impact on output occurs during the early part of the stimulus, whereas under RE the output effect is greater near the end of the stimulus.

Section 4.2 turns to numerical results for fiscal policy when expectations are sufficiently pessimistic that they imply a high likelihood under unchanged policy of the economy converging to stagnation. We examine the impact of a fiscal stimulus, in which government purchases are increased for a temporary stated period of time, and we show that in this situation the impact of fiscal policy is nonlinear. For a given duration, a small stimulus can fail to prevent convergence to the stagnation state, while a sufficiently large temporary stimulus can be very effective in returning the economy to the targeted steady state. In either case the size of the multipliers is large compared to normal times when none of the lower bounds apply, but in these settings a large stimulus can have an extremely large cumulative output multiplier.

These results imply that multipliers are both state-dependent and nonlinear. They are also stochastic. For a given initial state, in which expectations are pessimistic, and a given announced fiscal stimulus, convergence to the targeted steady state will depend on the sequence of stochastic shocks. We give numerical results for the proportion of times stagnation is avoided for different magnitudes and horizons of fiscal stimulus.

Section 5 considers several important extensions. Fiscal policy is most effective when it is implemented early. We also consider worst-case situations in which the economy has converged to and fully adapted to a stagnation steady state. We show numerically that even in this case there are fiscal policies that in most cases will dislodge the economy from the stagnation state and return it over time to the targeted steady state.

Section 5 also discusses the connection between the discount factor and the magnitude of the deflation rate in the stagnation state and consider the implications of financial frictions. While in our benchmark simulations we use a standard calibration of the discount factor, values plausibly closer to one would imply a critical deflation rate that is smaller in magnitude, and this would increase the likelihood of experiencing deep recessions or depressions with mild deflation.

When a credit friction is added to the model this increases further the critical inflation rate. The inflation rate in the stagnation steady state can then be zero or even a low positive rate. This indicates a new reason for concern if inflation and inflation expectations are persistently below the central bank target, especially if they are low and falling. Such circumstances raise the possibility of a path to stagnation and the potential need for aggressive macroeconomic policy.

## 2 New Keynesian Model

We use a NK model with households and firms following the method developed in Eusepi and Preston (2010a) and Evans and Honkapohja (2010). Our version of the NK model uses the Rotemberg adjustment cost version of the pricing friction, which we adopt because of its analytical convenience in looking at global dynamics. We index households by  $i$  and firms by  $j$ , but in the temporary equilibrium dynamics that we study all households and firms will make identical decisions. We start with the households. We assume a cashless limit and that households are Ricardian. In Section 2 it is assumed that the ZLB on interest rates is never binding. The ZLB and other bounds are introduced in Section 3.

The model incorporates random markup and productivity shocks, so our approach is to linearize the model around the targeted steady state, which is the usual procedure for local analysis. In Section 3 we consider more global aspects of the economy. As the model is stochastic, we continue to

use the linearized model in the analysis. An exception is Figure 4 where the global learning dynamics are illustrated. In this figure the quadratic adjustment costs are incorporated in the market clearing equation while agents' decision rules are kept linear. Global nonlinear analysis in the fully nonlinear stochastic setup would be challenging, though approximations based on the assumption of point expectations could be used. See e.g. Evans and Honkapohja (2010) and Benhabib, Evans, and Honkapohja (2014). We remark that our results are consistent with the latter papers, so the qualitative results seem to be robust to this issue.

## 2.1 Households

The objective for agent  $i$  is to maximize expected, discounted utility subject to a standard flow budget constraint:

$$\text{Max } \hat{E}_{0,i} \sum_{t=0}^{\infty} \beta^t U_{t,i}(C_{t,i}, h_{t,i}) \quad (1)$$

$$\text{s.t. } C_{t,i} + b_{t,i} + \Upsilon_{t,i} = R_{t-1} \pi_t^{-1} b_{t-1,i} + Y_{t,i}, \quad (2)$$

where  $C_{t,i}$  is the Dixit-Stiglitz consumption aggregator,  $h_{t,i}$  is the labour input into production,  $b_{t,i}$  denotes the real quantity of risk-free one-period nominal bonds held by the agent at the end of period  $t$ ,  $\Upsilon_{t,i}$  is the lump-sum tax collected by the government,  $R_{t-1}$  is the nominal interest rate factor between periods  $t-1$  and  $t$ ,  $P_t$  is the aggregate price level and the inflation rate is  $\pi_t = P_t/P_{t-1}$ . Consumers' income is denoted by  $Y_{t,i}$  where

$$Y_{t,i} = \frac{W_t}{P_t} h_{t,i} + \Omega_t^i.$$

$W_t$  is the nominal wage and  $\Omega_t^i$  denotes profits from holding shares in equal part of each firm. The subjective discount factor is denoted by  $\beta$ . The utility function has the parametric form

$$U_{t,i} = \log C_{t,i} - \gamma \frac{h_{t,i}^{1+\varepsilon}}{1+\varepsilon},$$

where  $\varepsilon > 0$ . The household decision problem is also subject to the usual 'no Ponzi game' condition.

There is a static FOC for the household concerning labor-leisure choice, which is

$$\frac{W_t}{P_t} = \gamma h_{t,i}^\varepsilon C_{t,i}. \quad (3)$$

To derive the linearized consumption function, we first linearize the Euler equation

$$C_{t,i}^{-1} = \beta R_t \hat{E}_{t,i} (\pi_{t+1}^{-1} C_{t+1,i}^{-1}) \quad (4)$$

to get

$$\tilde{C}_{t,i} = \hat{E}_{t,i} \tilde{C}_{t+1,i} - \beta \bar{C} \hat{E}_{t,i} \tilde{r}_{t+1}, \quad (5)$$

where tilde indicates deviation from the steady state, e.g.  $\tilde{C}_{t,i} = C_{t,i} - \bar{C}$ , and the bar denoting the deterministic steady state. Here

$$r_{t+1} \equiv \frac{R_t}{\pi_{t+1}}.$$

As shown in Appendix 1, the linearized lifetime budget constraint of the household is

$$\sum_{s=0}^{\infty} \beta^s \tilde{C}_{t+s,i} = \sum_{s=0}^{\infty} \beta^s (\tilde{Y}_{t+s,i} - \tilde{G}_{t+s}). \quad (6)$$

Here  $G_t$  is the level of government purchases, assumed exogenous, and we are assuming Ricardian households with identical taxes so that for each agent we may set  $\Upsilon_t = G_t$ .<sup>9</sup>

Iterating the Euler equation gives

$$\hat{C}_{t,i} = \hat{E}_{t,i} \hat{C}_{t+s,i} - \hat{E}_{t,i} \sum_{i=1}^s \hat{r}_{t+i},$$

where we have used  $\beta^{-1} = \bar{r}$  and a hatted variable indicates proportional deviations from its mean. e.g.

$$\hat{C}_{t,i} = \frac{C_{t,i} - \bar{C}}{\bar{C}} \text{ and } \hat{r}_{t+1} = \frac{r_{t+1} - \bar{r}}{\bar{r}}.$$

Combining the lifetime budget constraint and the iterated Euler equation and using the representative agent assumption  $\hat{C}_{t,i} = \hat{C}_t$ ,  $\hat{Y}_{t,i} = \hat{Y}_t$  and  $\hat{E}_{t,i} = \hat{E}_t$

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<sup>9</sup>For explanation of the terms Ricardian and non-Ricardian households see e.g. Benhabib, Evans, and Honkapohja (2014).



yields

$$\begin{aligned} \hat{C}_t = & (1 - \beta) \left[ \frac{\hat{Y}_t}{(\bar{C}/\bar{Y})} - \frac{\hat{G}_t}{(\bar{C}/\bar{G})} + \sum_{s=1}^{\infty} \beta^s \hat{E}_t \left( \frac{\hat{Y}_{t+s}}{(\bar{C}/\bar{Y})} - \frac{\hat{G}_{t+s}}{(\bar{C}/\bar{G})} \right) \right] \\ & - \hat{E}_t \sum_{s=1}^{\infty} \beta^s \hat{r}_{t+s}. \end{aligned} \quad (7)$$

## 2.2 Firms

The production function for each firm, producing good  $j$ , is given by

$$Y_{t,j} = A_t h_{t,j}^\alpha$$

where  $0 < \alpha \leq 1$  and  $A_t$  is a random productivity shock with mean  $\bar{A}$ . Output is differentiated and firms operate under monopolistic competition. Each firm faces a downward-sloping demand curve given by

$$P_{t,j} = \left( \frac{Y_{t,j}}{Y_t} \right)^{-1/\theta_t} P_t. \quad (8)$$

Here  $P_{t,j}$  is the profit maximizing price set by firm  $j$  consistent with its production  $Y_{t,j}$  (this optimization will be done below). The parameter  $\theta_t$  is the elasticity of substitution between two goods and is assumed to be greater than one.  $\theta_t$  is assumed to be a random stationary process with mean  $\theta$ .  $Y_t$  is aggregate output, which is exogenous to the firm. The firms' problem is

$$\text{Max } \hat{E}_{T,j} \sum_{T=t}^{\infty} Q_{t,T} P_T \Omega_{T,j},$$

where, due to log utility,  $Q_{t,T} = \beta^{T-t} \frac{P_t C_t}{P_T C_T}$ , for  $T \geq t$ , where

$$\Omega_{t,j} = (1 - \tau) \frac{P_{t,j}}{P_t} Y_{t,j} - \frac{W_t}{P_t} h_{t,j} - \frac{\psi}{2} \left( \frac{P_{t,j}}{P_{t-1,j}} - \pi^* \right)^2,$$

and where  $\tau$  is the revenue tax rate to eliminate the steady state distortion in output caused by monopolistic competition. Here  $\pi^*$  is the (gross) rate of inflation  $\pi_t = P_t/P_{t-1}$  that is targeted by policymakers. Thus firms view it as costly to change prices by an amount that differs from the monetary

policymaker target  $\pi^*$ . We interpret the quadratic term as reflecting the costs of justifying to consumers price increases at a rate higher than the target rate and the additional marketing costs of making customers aware of price increases below the target rate.<sup>10</sup>

The first-order condition for the firm's choice of  $P_{t,j}$  is given by

$$0 = (1 - \tau)(1 - \theta_t) \left( \frac{P_{t,j}}{P_t} \right)^{-\theta_t} Y_t + S_{t,j} Y_t \theta_t \left( \frac{P_{t,j}}{P_t} \right)^{-\theta_t - 1} - \psi \frac{P_t}{P_{t-1,j}} \left( \frac{P_{t,j}}{P_{t-1,j}} - \pi^* \right) + \hat{E}_{t,j} Q_{t,t+1} \frac{P_t}{P_{t,j}} \psi \frac{P_{t+1,j}}{P_{t,j}} \left( \frac{P_{t+1,j}}{P_{t,j}} - \pi^* \right). \quad (9)$$

Here we use  $Q_{t,t} = 1$  and

$$S_{t,j} = \frac{W_t/P_t}{\partial Y_{t,j}/\partial h_{t,j}} = \frac{W_t/P_t}{\alpha A_t h_{t,j}^{\alpha-1}}. \quad (10)$$

is the real marginal cost. It's useful to define the mark-up  $\mu$  by

$$\mu_t = \frac{\theta_t}{\theta_t - 1}. \quad (11)$$

The steady state at  $\pi^*$  satisfies

$$(1 - \tau)(1 - \theta) + \bar{S}\theta = 0.$$

In the steady state, of course,  $\mu = \theta(\theta - 1)^{-1}$ . From above steady state real marginal cost is

$$\bar{S} = \frac{(\theta - 1)(1 - \tau)}{\theta} = (1 - \tau)\mu^{-1}. \quad (12)$$

We make the assumption that the target inflation rate is  $P_t/P_{t-1} = \pi^* \geq 1$ , i.e. the net inflation rate may be positive. As discussed above, we are making the assumption that price adjustment costs are quadratic in terms of the deviation from the target inflation rate and this is also analytically convenient. The market clearing condition is

$$Y_t = C_t + G_t + \frac{1}{2}\psi(\pi_t - \pi^*)^2. \quad (13)$$

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<sup>10</sup>Benhabib, Schmitt-Grohe, and Uribe (2001b) and Benhabib and Eusepi (2005) use this formulation of price adjustment costs, though they do so in the context of the utility loss of household firms. Eusepi and Preston (2010a) also use this formulation but set  $\pi^* = 1$ .

We need to linearize around the steady state  $\pi^*, \bar{Y}, \bar{S}, \bar{C}, \bar{Q}, \bar{h}$ . Clearly  $\bar{Q} = \beta/\pi^*$  is the steady state value of  $Q_{t,t+1}$  and  $\bar{S}$  is given above. From (13) with  $\pi_t = \pi^*$  we have  $\bar{Y} = \bar{C} + \bar{G}$ . Finally, in a steady state (10) and (3) can be combined to give

$$\bar{S} = \gamma\alpha^{-1}A^{-1}\bar{h}^{1+\varepsilon-\alpha}\bar{C}. \quad (14)$$

Equation (14) together with the steady-state production function  $\bar{Y} = A\bar{h}^\alpha$ , market-clearing  $\bar{Y} = \bar{C} + \bar{G}$  and (12) determines steady values of  $\bar{Y}, \bar{S}, \bar{C}, \bar{h}$  at the targeted steady state  $\pi^*$ .

We assume that firms use a decision-rule for price setting based on a linearization around the targeted steady state. Appendix 1 shows how to obtain the infinite horizon linearized New Keynesian Phillips curve

$$\begin{aligned} (1 - a_1)\hat{\pi}_t - a_2\hat{Y}_t &= a_1 \sum_{s=1}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{\pi}_{t+s} + a_2 \sum_{s=1}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{Y}_{t+s} \\ &\quad - a_3 \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{A}_{t+s} - a_4 \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{G}_{t+s} \\ &\quad + a_5 \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{\mu}_{t+s}, \end{aligned} \quad (15)$$

where the coefficients  $a_1, \dots, a_5$  and  $\gamma_1$  are defined in the Appendix.

The interpretation of equation (15) is as follows. As is standard higher, expected future inflation and higher current and expected future aggregate output lead to higher current inflation. Current inflation is also increased when future monopoly power is expected to be higher. The remaining terms reflect the impact of productivity and government spending on real marginal cost. When expected future productivity is high this lowers expected future marginal costs and hence reduces inflation. Finally, conditional on expected future output, higher current and expected future government spending is associated with lower consumption, higher labor supply (conditional on real wages) and hence lower real wages, which leads to lower inflation.

### 2.3 Temporary equilibrium and learning

We can now define the temporary equilibrium which is given by the Phillips curve (15), the NK IS curve and the interest rate rule. To get the IS curve, we combine the consumption function (7) with the linearized market clearing

condition  $\hat{Y}_t = \frac{\bar{C}}{\bar{Y}}\hat{C}_t + \frac{\bar{G}}{\bar{Y}}\hat{G}_t$ , or

$$\hat{Y}_t = (1 - \bar{g})\hat{C}_t + \bar{g}\hat{G}_t, \quad (16)$$

where  $\bar{g} = \frac{\bar{G}}{\bar{Y}}$ .<sup>11</sup> This yields

$$\hat{Y}_t = \bar{g}\hat{G}_t + (1 - \beta) \left[ \hat{Y}_t - \bar{g}\hat{G}_t + \sum_{s=1}^{\infty} \beta^s \hat{E}_t \left( \hat{Y}_{t+s} - \bar{g}\hat{G}_{t+s} \right) \right] - (1 - \bar{g})\hat{E}_t \sum_{s=1}^{\infty} \beta^s \hat{r}_{t+s}.$$

Note that from  $r_{t+1} \equiv \frac{R_t}{\pi_{t+1}}$  we have

$$\hat{r}_{t+1} = \hat{R}_t - \hat{\pi}_{t+1}. \quad (17)$$

The equation for  $\hat{Y}_t$  can be rewritten as

$$\begin{aligned} \hat{Y}_t &= \bar{g}\hat{G}_t + (1 - \beta)\beta^{-1} \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{Y}_{t+s} - (1 - \beta)\bar{g}\beta^{-1} \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{G}_{t+s} \\ &\quad - (1 - \bar{g})(\hat{R}_t - \hat{E}_t \hat{\pi}_{t+1}) - (1 - \bar{g}) \sum_{s=2}^{\infty} \beta^{s-1} \hat{E}_t \hat{r}_{t+s}. \end{aligned} \quad (18)$$

To complete the model one must specify an interest rate rule, for example,

$$R_t = \beta^{-1} (\pi^* + \chi_{\pi}(\pi_t - \pi^*) + \check{\chi}_Y(Y_t - \bar{Y})),$$

which in log-linearized form becomes

$$\hat{R}_t = \chi_{\pi} \hat{\pi}_t + \chi_Y \hat{Y}_t, \quad (19)$$

where  $\hat{R}_t = (R_t - \bar{R})/\bar{R}$ , and  $\chi_Y = \frac{\check{\chi}_Y \bar{Y}}{\pi^*}$ . We also assume a government fiscal policy in which government spending is financed by lump-sum taxes. Here we are assuming that the ZLB is not violated. In the next section we allow for cases in which the ZLB is binding.

The shocks to  $A_t$  and  $\mu_t$  are assumed to follow exogenous AR(1) processes given by

$$\hat{A}_t = \rho_A \hat{A}_{t-1} + v_{At}, \quad (20)$$

$$\hat{\mu}_t = \rho_{\mu} \hat{\mu}_{t-1} + v_{\mu t}, \quad (21)$$

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<sup>11</sup>As in the Appendix to Eusepi and Preston (2010a), the adjustment costs drop out from the log-linearized market clearing equation.

where  $0 < \rho_A, \rho_\mu < 1$  and the shocks  $v_{At}$  and  $v_{\mu t}$  are iid normal variables with zero mean and constant variances  $\sigma_A^2$  and  $\sigma_\mu^2$ . This completes the description of the model apart from a specification of how expectations are formed.

Under RE the solution technique is standard. See Appendix 1 for details. Under adaptive learning, agents need to form forecasts of future inflation, output and, when a fiscal policy change occurs, of government spending and taxes. We assume that agents know the interest rate rule and that the ZLB is never binding.

Agents are assumed to have perceived laws of motion (PLMs) of the same form as the RE solution of the economy under standard policy. To allow for the indirect general-equilibrium impact of a policy change on future output and inflation, agents use constant-gain learning, as discussed below. There is a stochastic steady state of the form

$$\hat{\pi}_t = f_\pi + d_{\pi A} \hat{A}_t + d_{\pi \mu} \hat{\mu}_t \quad (22)$$

$$\hat{Y}_t = f_Y + d_{Y A} \hat{A}_t + d_{Y \mu} \hat{\mu}_t \quad (23)$$

where  $\hat{A}_t, \hat{\mu}_t$  are observable processes (with known coefficients) given by (20) and (21). Under adaptive learning agents estimate the coefficients of (22)-(23). Given their time  $t$  estimates of the coefficients  $f_\pi, d_{\pi A}, d_{\pi \mu}, f_Y, d_{Y A}, d_{Y \mu}$  forecasts  $\hat{E}_t \hat{\pi}_{t+s}$  and  $\hat{E}_t \hat{Y}_{t+s}$  are given by

$$\begin{aligned} \hat{E}_t \hat{\pi}_{t+s} &= f_\pi + d_{\pi A} \rho_A^s \hat{A}_t + d_{\pi \mu} \rho_\mu^s \hat{\mu}_t, \\ \hat{E}_t \hat{Y}_{t+s} &= f_Y + d_{Y A} \rho_A^s \hat{A}_t + d_{Y \mu} \rho_\mu^s \hat{\mu}_t. \end{aligned}$$

These forecasts can then be inserted into the model (15)-(18), and the infinite series summed, to determine the temporary equilibrium at time  $t$ . When there is no fiscal policy, government spending is constant and  $\hat{G}_t = \hat{E}_t \hat{G}_{t+s} = 0$  and the corresponding terms in (15)-(18) are zero.

Finally we describe the least-squares updating rule for the forecast rule coefficients of  $\hat{\pi}_t$  and  $\hat{Y}_t$ . Agents are assumed to use constant gain recursive least squares (RLS). The parameter estimates based on data through time  $t$  are

$$\phi_{\pi,t} = \begin{pmatrix} f_{\pi,t} \\ d_{\pi A,t} \\ d_{\pi \mu,t} \end{pmatrix}, \phi_{Y,t} = \begin{pmatrix} f_{Y,t} \\ d_{Y A,t} \\ d_{Y \mu,t} \end{pmatrix}, z_t = \begin{pmatrix} 1 \\ \hat{A}_t \\ \hat{\mu}_t \end{pmatrix}.$$

The RLS formulae corresponding to estimates of equations (22)-(23) are

$$\begin{aligned}\phi_{\pi,t} &= \phi_{\pi,t-1} + \kappa \mathcal{R}_t^{-1} z_t (\pi_t - \phi_{\pi,t-1} z_t), \\ \phi_{Y,t} &= \phi_{Y,t-1} + \kappa \mathcal{R}_t^{-1} z_t (Y_t - \phi_{Y,t-1} z_t), \\ \mathcal{R}_t &= \mathcal{R}_{t-1} + \kappa (z_t z_t' - \mathcal{R}_{t-1}).\end{aligned}$$

Here  $0 < \kappa < 1$  is the “gain” parameter that discounts old data at rate  $1 - \kappa$  per period (taken to be one quarter), to allow for adaptation of parameters to structural changes like policy changes. We assume that parameter estimates under learning are updated at the end of the period. Thus in time  $t$ , when expectations are formed, agents observe the current value of the exogenous variables  $\hat{A}_t$  and  $\hat{\mu}_t$  but use estimates  $\phi_{\pi,t-1}$ ,  $\phi_{y,t-1}$  in making forecasts. The initial values of all parameter estimates  $\phi$  and  $\mathcal{R}$  are set to the initial steady state values under RE.

### 3 Model with Lower Bounds

We now extend the temporary equilibrium framework of the model under learning to allow for the ZLB. In this section our focus is on AL when the initial expectations are sufficiently pessimistic that the ZLB is binding or is expected to be binding. We remark that in contrast to much of the literature on the liquidity trap, and in particular most of the literature on fiscal multipliers at the ZLB assuming RE, in our framework the ZLB is primarily driven by a pessimistic expectations shock rather than by fundamental exogenous shocks to preferences (or natural interest rate shocks). Following the seminal paper of Eggertsson and Woodford (2003), much of the literature has assumed that low inflation and output at the ZLB are triggered by an exogenous preference shock that shifts the targeted RE equilibrium in such a way that the ZLB becomes a constraint for that equilibrium.<sup>12</sup> The shock is assumed to vanish according to a Markov process with known transition probability and an absorbing state, leading to a return to the intended steady state. Under RE the path of the economy with and without fiscal policy is largely determined by these exogenous preference shocks.

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<sup>12</sup>In this approach global indeterminacy is ignored even though models describe monetary policy in terms of a Taylor rule subject to the ZLB. For example, see Christiano, Eichenbaum, and Rebelo (2011) and Woodford (2011). Aruoba, Cuba-Borda, and Schorfheide (2014) and Mertens and Ravn (2014) focus attention on sunspot solutions that are constructed using the indeterminacy.

In contrast, the approach followed here focuses directly on a pessimistic shock to expectations. Although in our numerical analysis we do allow for exogenous shocks, as in the first part of the paper, we do not need to introduce an exogenous Markov preference shock or beliefs influenced by a sunspot that drive the recession and its recovery. Instead we assume an initial pessimistic expectations shock that, under learning, has the capacity to drive the economy to low levels of output and inflation and become self-sustaining.<sup>13</sup>

It is known from earlier work on AL in the New Keynesian model that there is the possibility of deflation traps that cannot be overcome by interest rate policy, due to the ZLB, and which push the economy along divergent deflationary trajectories.<sup>14</sup> We think that in these circumstances other bounds may also be important, which will act to stabilize the economy along an otherwise divergent trajectory. We begin with a discussion of these bounds and their implications for the possible steady states in the model.

### 3.1 Lower bounds on $R$ , $\pi$ and $C$

A zero lower bound on net nominal interest rates correspond to a bound on the gross nominal one-period interest rate  $R_t \geq 1$ . Usually, central banks prefer not to reduce net interest rates below a small positive number  $\eta > 0$  and we thus impose the lower bound  $R_t \geq 1 + \eta$ .<sup>15</sup> At the global level we also now introduce two other lower bounds that will plausibly arise in extreme circumstances: an inflation lower bound  $\underline{\pi}$  and a consumption lower bound  $\underline{C}$ . An inflation lower bound was discussed in Benhabib, Evans, and Honkapohja (2014) and Evans (2013). It is empirically appealing because the extent of deflation appears bounded even at very low levels of aggregate output. See for example Ball and Mazumder (2011), IMF (2013), and Coibion and Gorodnichenko (2015). Possible explanations include downward wage rigidity or money illusion, as discussed in Akerlof, Dickens, and Perry (1996), Akerlof, Dickens, and Perry (2000), Akerlof and Dickens (2007) and Akerlof and Shiller (2009)). We capture these factors through the simple device of

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<sup>13</sup>Arias, Erceg, and Trabandt (2016) and Milani (2011) are examples of studies that consider the consequences of expectation shocks.

<sup>14</sup>See Evans, Guse, and Honkapohja (2008), Evans and Honkapohja (2010) and Benhabib, Evans, and Honkapohja (2014). An earlier discussion of deflation traps in a backward-looking model was provided by Reifschneider and Williams (2000).

<sup>15</sup>This is also convenient theoretically because it ensures money demand is finite at the lower bound.

an inflation lower bound  $\underline{\pi}$ , which we usually take to correspond to a modest rate of deflation.<sup>16</sup> The value of  $\underline{\pi}$  may vary over time and across countries.

We assume  $\underline{\pi} < \pi^*$ , where  $\pi^*$  is the inflation rate targeted by monetary policy. A consumption lower bound would plausibly arise when consumption approaches the (perhaps socially determined) subsistence level. Below we assume that the bound  $\underline{C}$  is significantly below the targeted steady state. The spirit of this bound is similar to the subsistence level parameter used in Stone-Geary preferences; see, for example King and Rebelo (1993) and Ravn, Schmitt-Grohe, and Uribe (2008).<sup>17</sup> Although in normal times these bounds would not be apparent, they can play a role in stabilizing the economy at low levels of output at the ZLB.

We begin with a discussion of the steady states that may arise when these lower bounds may be binding. In this section it is convenient to simplify the monetary policy rule, so that the Taylor-type rule responds only to inflation. Together with the interest-rate lower bound we have

$$\begin{aligned} R_t^* &= \beta^{-1}\chi_\pi(\pi_t - \pi^*) + \beta^{-1}\pi^*, \text{ with } \chi_\pi > 1, \text{ and} \\ R_t &= \max(R_t^*, 1 + \eta). \end{aligned}$$

Here the parameterization is consistent with our earlier log linearization  $\hat{R}_t = \chi_\pi \hat{\pi}_t$  at the intended steady state. Throughout this Section it is convenient to abstract from the intrinsic random productivity and mark-up shocks.

To analyze the possible non-stochastic steady states we can focus attention on the Euler equations for consumption and price setting. These will hold with equality unless constrained by the consumption or inflation lower bounds. Setting  $C_t = C_{t+1} = C$  and  $\pi_t = \pi$ , it follows from (4) that the Fisher equation

$$R/\pi = \beta^{-1}$$

holds, unless consumption is at its lower bound. Figure 3, which shows this relationship together with the steady state interest rate rule

$$R = \max(\beta^{-1}\chi_\pi(\pi - \pi^*) + \beta^{-1}\pi^*, 1 + \eta),$$

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<sup>16</sup>As shown in Benhabib, Evans, and Honkapohja (2014), one can justify  $\underline{\pi}$  formally by introducing an asymmetry into the inflation adjustment cost term. If nominal wage rigidity were explicitly modeled, the bound would correspond to an upper bound on the magnitude of wage deflation.

<sup>17</sup>Our procedure for incorporating the consumption lower bound differs somewhat from using Stone-Geary preferences, but is convenient given our treatment of the two other lower bounds. Because the key property is a positive lower bound to consumption, it is clear that changing to Stone-Geary preferences would yield very similar qualitative results.



illustrates the usual indeterminacy result that in addition to the intended steady state at  $\pi = \pi^*$  there is an unintended steady state at  $\pi = \pi_L \equiv \beta(1 + \eta)$ . Figure 3 also shows the additional stagnation steady state that arises when both inflation and consumption are constrained at their lower bounds.

We assume  $0 < \eta < \beta^{-1}\pi^* - 1$  throughout, so that the interest rate lower bound is below the level implied by the Fisher equation at  $\pi^*$  and  $\chi_\pi > 1$  implies the existence of the unintended deflation steady state at  $\pi_L < 1$ . This multiplicity issue was analyzed in detail, under the RE assumption, in Benhabib, Schmitt-Grohe, and Uribe (2001b) and Benhabib, Schmitt-Grohe, and Uribe (2001a). Bullard (2010) gave a forceful argument that the pattern of inflation and interest rates in Japan and the US was cause for concern that the US experience might converge to a Japanese style stagnation with steady mild deflation.

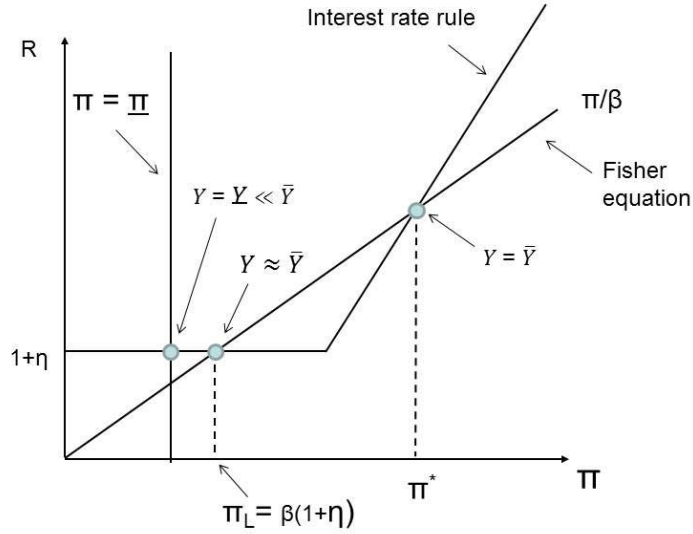


Figure 3: Existence of multiple steady states.

The remaining steady state equation is obtained from the NK Phillips relationship (9), setting  $P_{t,j} = P_t$ ,  $S_{t,j} = S$ ,  $Y_t = Y$ ,  $h_t = h$ ,  $\theta_t = \theta$ ,  $P_{t+1}/P_t = \pi$ ,  $A_t = A$  and  $Q_{t,t+1} = \beta/\pi$ . This gives

$$0 = (1 - \tau)(1 - \theta)Ah^\alpha + SAh^\alpha\theta - \psi\pi(\pi - \pi^*) + \beta\psi\pi(\pi - \pi^*)$$

Using (3) and (10) gives  $S = \alpha^{-1}\gamma A^{-1}h^{1+\varepsilon-\alpha}C$ , which leads to<sup>18</sup>

$$(\pi - \pi^*)\pi(1 - \beta) = \frac{\theta}{\alpha\psi} [C\gamma h^{1+\varepsilon} - \alpha(1 - \tau)(1 - \theta^{-1})Ah^\alpha]. \quad (24)$$

This is the steady-state NK Phillips curve equation, which must hold unless inflation is constrained by its lower bound. We will also need the GDP steady state accounting identity

$$Ah^\alpha = C + G + \frac{\psi}{2}(\pi - \pi^*)^2. \quad (25)$$

As we have noted, the above steady-state Phillips curve and Fisher equations hold unless inflation or consumption are constrained by their lower bounds. The inflation lower bound  $\underline{\pi}$  holds if (24) would otherwise lead to an inflation rate lower than this bound, and similarly the consumption lower bound holds if otherwise we would have  $\beta R > \pi$ . Taking into account these bounds, the Euler equations thus lead to the inequalities

$$R/\pi \geq \beta^{-1} \text{ and } C \geq \underline{C}, \text{ with c.s.}, \quad (26)$$

which one could call the Fisher inequality, and the Phillips curve inequality

$$\begin{aligned} (\pi - \pi^*)\pi(1 - \beta) &\geq \frac{\theta}{\alpha\psi} [C\gamma h^{1+\varepsilon} - \alpha(1 - \tau)(1 - \theta^{-1})Ah^\alpha] \quad (27) \\ \text{and } \pi &\geq \underline{\pi}, \text{ with c.s.} \end{aligned}$$

Here c.s. denotes that these inequalities hold with complementary slackness, i.e. if either inequality holds strictly then the other holds with equality. We can also write the interest-rate rule subject to its lower bound as

$$R \geq \beta^{-1}\chi_\pi(\pi - \pi^*) + \beta^{-1}\pi^* \text{ and } R \geq 1 + \eta, \text{ with c.s.} \quad (28)$$

Using the three inequalities (26), (27), (28) we can examine the possible steady states. We assume throughout that  $G > 0$  and it is convenient to strengthen this slightly and assume that  $G > \underline{G} > 0$  where  $\underline{G}$  is specified below. In addition we assume that the consumption lower bound  $\underline{C}$  is not too large, as further specified below.

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<sup>18</sup>The steady-state Phillips curve equation here differs from the one in Evans, Guse, and Honkapohja (2008). The latter paper uses a representative household-firm in which the price-adjustment costs are quadratic in utility. In the current set-up households and firms are distinct. With utility  $\log(C)$  this leads to a multiplicative factor  $C$  on the right-hand side of (24) not present in Evans, Guse, and Honkapohja (2008).

## 3.2 Steady states

The number of steady states in the economy will depend critically on the inflation lower bound  $\underline{\pi} < \pi^*$ , specifically on whether  $\underline{\pi} < \pi_L$ ,  $\underline{\pi} = \pi_L$  or  $\underline{\pi} > \pi_L$ . Full analytical results are available for cases in which price adjustment costs are small. The steady state results are given in the following proposition:

**Proposition 1** *Suppose that  $\underline{\pi} < \pi_L$ . Then for  $\psi > 0$  sufficiently small, there are exactly three steady states:*

- (i)  $\pi = \pi^*$ , with  $R = \beta^{-1}\pi^*$  and  $C$  uniquely determined by (24) and (25),
- (ii)  $\pi = \pi_L$ , with  $R = 1 + \eta$  and  $C$  uniquely determined by (24) and (25),
- (iii)  $\pi = \underline{\pi}$ , with  $R = 1 + \eta$  and  $C = \underline{C}$ .

*If  $\pi_L < \underline{\pi} < 1$  then there is a unique steady state at  $\pi = \pi^*$ , with  $R = \beta^{-1}\pi^*$  and  $C$  uniquely determined by (24)-(25).*

*If  $\underline{\pi} = \pi_L$  then for  $\psi > 0$  sufficiently small there is a steady state at  $\pi = \pi^*$ , with  $R = \beta^{-1}\pi^*$  and  $C$  uniquely determined by (24)-(25) and a continuum of steady states at  $\pi = \pi_L$ , with  $R = 1 + \eta$  and with  $C$  satisfying  $\underline{C} \leq C \leq C_L$ , where  $C_L$  is uniquely determined by (24)-(25).*

The proofs of all propositions are given in Appendix 2.

## 3.3 Local stability of steady states under learning

We now consider the stability under AL of the steady states just described. As is well known, the local stability of an RE solution under least-squares learning, of the type outlined in Section 2.3 is determined by expectational stability, or “E-stability” conditions, as discussed, for example in Evans and Honkapohja (2001). Although one could allow for the inclusion of exogenous productivity and mark-up shocks in this analysis, local stability in the current setting is governed by the intercepts of the forecast rules. We therefore simplify the theoretical stability results by assuming that the PLM for both output and inflation takes the form of an unknown constant plus a perceived white noise disturbance. Furthermore, for theoretical convenience in this section, we assume a forward-looking interest-rate rule  $\hat{R}_t = \max[\chi_\pi \hat{E}_t \hat{\pi}_{t+1}, 1 + \eta]$  where  $\chi_\pi > 1$ . (Proposition 2 also holds for the case of the analogous contemporaneous-data rule.)

The local stability results are given by the following proposition.

**Proposition 2** *If  $\underline{\pi} < \pi_L$  then the steady state at  $\pi^*$  is locally E-stable and the steady state at  $\underline{\pi}$  is locally E-stable, while the steady state at  $\pi_L$  is locally E-unstable for  $\psi$  sufficiently small. If  $\underline{\pi} > \pi_L$  then the (unique) steady state at  $\pi^*$  is locally E-stable.*

Figure 4 below illustrates the E-stability dynamics that give the mean dynamics under constant gain learning with small constant gain, based on linearized decision rules subject to the lower-bound constraints, but incorporating the nonlinear market clearing condition (25).<sup>19</sup> In this figure we use standard calibrated values for the structural parameters given below in Section 4.1, and we set the interest rate rule parameters at  $\chi_\pi = 1.5, \eta = 0.0001$ . For convenience we set  $\pi^* = 1$ . Finally, we set the lower bound for consumption at 10% below the intended steady state and the lower bound for (net) inflation at  $-1.3\%$ , i.e.  $\hat{\pi} = -0.013$ .

The origin of Figure 4 represents the targeted steady state  $\hat{y} = \hat{\pi} = 0$ , i.e.  $y, \pi$  are in proportional deviation from targeted steady state form. The unintended low steady state has an output level very close to the targeted steady state; specifically, it is only  $-0.00040\%$  below the value of output at the targeted steady state. The corresponding (net) inflation rate at the unintended steady state is  $-0.9901\%$  i.e.  $\hat{\pi}_L = -0.01008$ . Finally the stagnation trap steady state, corresponding to  $\hat{\pi} = -0.013$ , has an output level equal to  $6.93\%$  below the value of output at the targeted steady state.

It can be seen that the intended steady state at  $\hat{\pi} = \hat{c} = 0$  is locally stable under learning (with the dynamics locally cyclical). The unintended steady state created by the ZLB is locally unstable (the dynamics are a saddle) and the stagnation steady state is locally stable.<sup>20</sup> It can be seen that if  $\pi^e$  is sufficiently pessimistic then under learning the economy converges to the trap steady state with low output and mild deflation. The downward sloping (almost straight line) curve through the middle steady state is the line separating the basins of attraction of the target and stagnation steady

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<sup>19</sup>We also impose an upper bound to inflation to ensure existence of a temporary equilibrium. This is not needed in the linearized model with market clearing linearized around the targeted steady state.

<sup>20</sup>Our stability results bear some similarities to other macroeconomic learning models with multiple steady states, e.g. Marcet and Nicolini (2003) and Evans, Honkapohja, and Romer (1998). The former examines policies to avoid hyperinflation in seigniorage models of inflation. The latter demonstrates the possibility of self-fulfilling cycles between high and low growth rates.

states.<sup>21</sup> We will refer to the latter domain as the “stagnation trap” or the “deflation trap” region.<sup>22</sup>

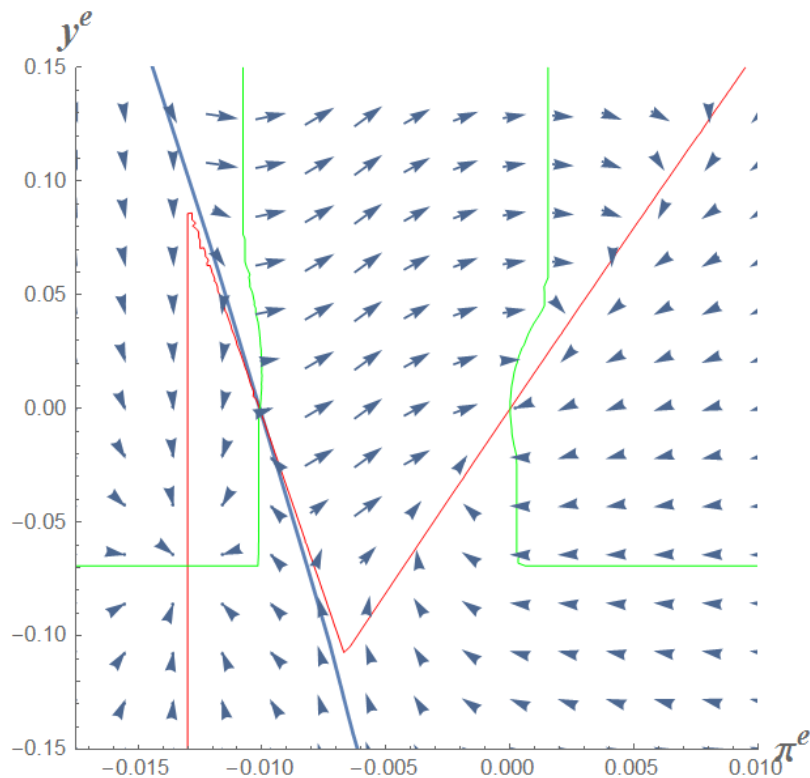


Figure 4: E-stability dynamics with forward looking Taylor rule in the case of three steady states. Here  $y^e$  and  $\pi^e$  denote expectations as proportional deviations from the targeted steady state, i.e.  $\hat{Y}^e$  and  $\hat{\pi}^e$ .

There has been considerable concern among US and European policy-makers about deflation and the possibility of their economies, following the financial crisis of 2007-9, becoming enmeshed in a long period of stagnation with mild deflation, similar to that experienced by Japan since the mid 1990s.

<sup>21</sup>We remark that if random productivity and mark-up shocks are introduced, real-time learning can converge to an ergodic distribution around the two stable steady states. This requires a sufficiently large support for the random shocks. See Sections 14.3.1 - 14.3.2 of Evans and Honkapohja (2001) for this kind of phenomenon in a simple model.

<sup>22</sup>In Benhabib, Evans, and Honkapohja (2014) the basin of attraction of the targeted steady state was called the “corridor of stability” and the complement region containing explosive paths was called the “deflation trap.”

This concern has been a large part of the motivation for setting and keeping policy interest rates near zero, and for innovative monetary policies like “quantitative easing” and “forward guidance.” The above analysis shows that under adaptive learning this concern is acute if the inflation lower bound  $\underline{\pi}$  is below the unintended steady state inflation rate  $\pi_L$ . There is then a stable deflation-trap steady state at  $\pi = \underline{\pi}$  and a low level of output underpinned by the consumption lower bound. Because, in the deflation trap, steady-state interest rates are at the ZLB, conventional monetary policy cannot move the economy back to the targeted steady state. The effectiveness of fiscal policy in this setting is then of particular interest.

In turning to an examination of fiscal policy we do not mean to suggest that monetary policy is not crucial in the face of large pessimistic shocks. For example the speed with which the policy rate is reduced can be critical. In addition, quantitative easing arising from purchases of a broad range of assets can be effective.<sup>23</sup> This affects a spectrum of interest rates. Finally, both forward guidance concerning future interest rates and explicit inflation targets may be important in affecting how household and firm expectations respond to observed data. We study fiscal policy in this setting primarily in order to examine its effectiveness as an alternative or supplement to unconventional monetary and financial policy when conventional monetary policy appears insufficient to guarantee avoiding convergence to stagnation.

## 4 Fiscal Policy

We turn now to fiscal policy. A growing literature has been reconsidering the effects of fiscal policy in light of the relatively large fiscal stimuli adopted in various countries in the aftermath of the Great Recession. For example, Christiano, Eichenbaum, and Rebelo (2011), Corsetti, Kuester, Meier, and Muller (2010) and Woodford (2011) demonstrate the effectiveness of fiscal policy in models with monetary policy when the zero lower bound on nominal interest rate is reached. For a contrary view see Mertens and Ravn (2014). Most of this literature explicitly makes the RE assumption. The AL literature has shown that quite different results can arise both in NK and Real Business Cycle models; see Evans, Guse, and Honkapohja (2008), Benhabib, Evans, and Honkapohja (2014), Mitra, Evans, and Honkapohja (2013), Gasteiger and Zhang (2014) and Mitra, Evans, and Honkapohja (2015).

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<sup>23</sup>See Honkapohja (2016) for an example of this in a variant of the current model.

In this Section we examine fiscal policy under AL, and it is convenient to study its impact first in normal times, when the economy is near the targeted steady state. We then turn to cases in which the economy would otherwise be at risk of falling into the stagnation steady state or even have already converged to the stagnation steady state.

Because we assume Ricardian households, we examine the impact of changes in the level of government purchases, and we focus on temporary increases in the level of government spending on goods and services.<sup>24</sup> When there is a change in fiscal policy, agents will take account of the tax effects of the announced path of policy. Given the Ricardian assumption, we can assume balanced budget increases in spending so that the path of taxes matches the path of government spending. We assume that initially, at  $t = 0$ , we are in the stochastic steady state corresponding to  $G = \bar{G}$ , and that at  $t = 1$  the government announces an increase in government spending for  $T$  periods, i.e.

$$G_t = \tau_t = \begin{cases} \bar{G}', & t = 1, \dots, T \\ \bar{G}, & t \geq T + 1. \end{cases}$$

Thus government spending and taxes are changed in period  $t = 1$  and this change is reversed at a later period  $T + 1$ . We assume that the announcement is fully credible and actually implemented. These assumptions could, of course, be relaxed.

Denoting the change in government spending by  $\Delta G (= \bar{G}' - \bar{G})$  we have

$$\hat{G}_t = \begin{cases} \frac{\Delta G}{\bar{G}}, & t = 1, \dots, T \\ 0, & t \geq T + 1. \end{cases}$$

It is straightforward to compute  $\sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{G}_{t+s}$  and  $\sum_{s=0}^{\infty} \beta^s \hat{E}_t \hat{G}_{t+s}$ , which will depend on calendar time, and include these terms in (15) and (18) when determining the temporary equilibrium.

It is useful to begin with looking at the fiscal multiplier in normal times, when the ZLB does not bind, and then move on to the more general case when the ZLB and the inflation and consumption lower bounds may be binding. In both cases we will provide information on the output multipliers for changes in government spending, and we show both the multiplier viewed as a distributed lag response and the cumulative multiplier over time. The

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<sup>24</sup>In further work it would be of interest to introduce alternative fiscal frameworks with distortionary taxes and/or public debt.

cumulative multipliers are computed as a discounted sum using the discount factor  $\beta$ . Specifically, we compute

$$ym_t = \frac{Y_t - Y_t^{np}}{(\bar{G}' - \bar{G})} \text{ and } ycm_t = \frac{\sum_{i=1}^t \beta^{i-1} (Y_i - Y_i^{np})}{(\bar{G}' - \bar{G}) \sum_{i=1}^T \beta^{i-1}}, \text{ for } t = 1, 2, 3, \dots,$$

Because of discounting the cumulative multiplier will be finite even in those cases considered below in which policy leads to a permanent change in the level of output. In the formula above,  $Y_i^{np}$  denotes the level of output in period  $i$  in the absence of a policy change.

## 4.1 Fiscal policy in normal times

Here we focus on the set-up of Section 2 and compute numerically government spending multipliers during normal times when the ZLB does not bind. In Section 4.2 we extend the analysis to the role of fiscal policy and the size of government spending multipliers when there are large pessimistic shocks.

To illustrate we consider the temporary policy change discussed above with  $T = 10$ . The baseline parameters used in the simulations in both this and the following section are

$$\begin{aligned} \alpha &= 0.66, \beta = 0.99, \theta = 7.67, \tau = 0, \epsilon = 2, \gamma = 1, \psi = 128.8, \\ \bar{G} &= 0.2, \rho_A = \rho_\mu = 0.8, \sigma_A = \sigma_\mu = 0.0033. \end{aligned}$$

$A = 1.085$  is chosen so that output is approximately one; precisely  $Y = 1.0081$ . We interpret the parameters as corresponding to a quarterly calibration. The gain parameter  $\kappa$  of agents in this section is set equal to 0.04. For the inflation target we set  $\pi^* = 1.005$ . For quarterly data this corresponds to an annual rate of inflation of 2% which is a frequently used target for monetary policymakers. The value for  $\psi$  is based on a 15% markup of prices over marginal cost suggested in Leeper, Traum, and Walker (2011) (see their Table 2) and the price adjustment costs estimated from the average frequency of price reoptimization at intervals of 15 months (see Table 1 in Keen and Wang (2007)). We remark that the numerical simulations in this section use the linearized system of equations given in Section 2. It would be possible to combine the linearized decision rules for consumption and price setting with the non-linear equations for market clearing, production, factor prices and



labor supply, but this adds considerable computational complexity.<sup>25</sup>

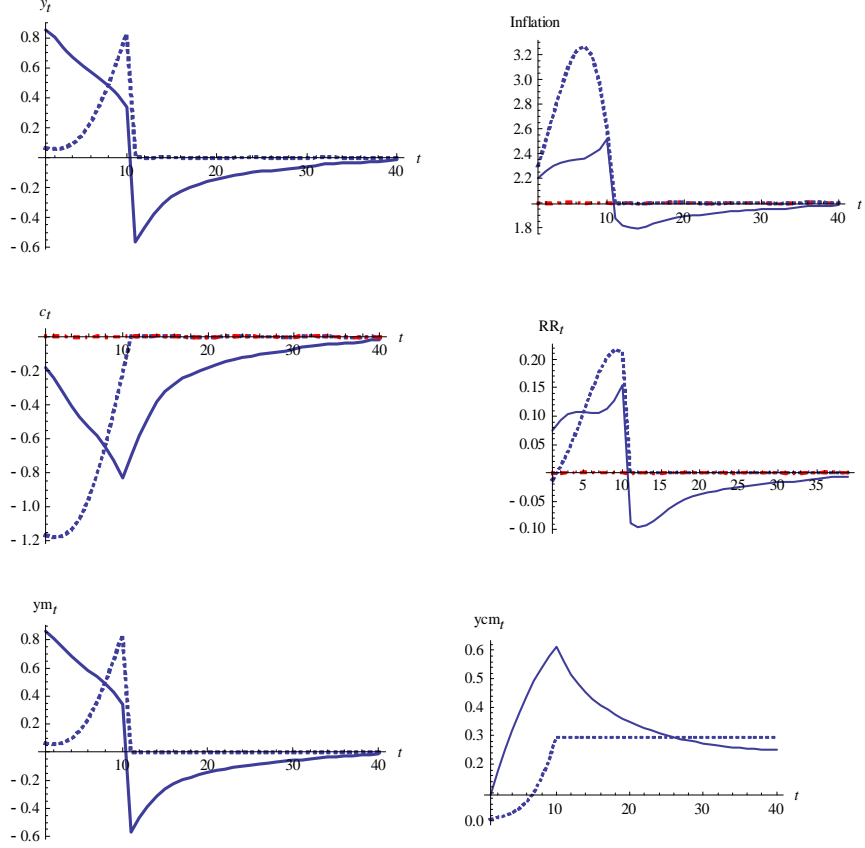


Figure 5: The upper panel shows the output and inflation paths under RE (dotted line), learning (solid line) for a temporary policy change with  $T = 10$  (inflation in this and all subsequent figures is the actual annualized inflation rate). The middle panel shows the paths of the corresponding consumption and *ex ante* one period real rate of interest ( $\hat{R}_t - \hat{E}_t \pi_{t+1}$ ). The lower panel shows the distributed lag and cumulative output multipliers. Here and in subsequent figures  $\hat{y}_t$  is used for  $\hat{Y}_t$ .

In the examples we set  $\chi_Y = 0$  to prevent monetary policy from directly acting against the output effects of fiscal policy. However we set  $\chi_\pi > 1$  in

<sup>25</sup>Mitra, Evans, and Honkapohja (2015) found in an RBC model that including nonlinear temporary equilibrium equations made little difference, even when the shocks were large or steady states were changed. However, the computations were 150 times slower.

line with the Taylor principle, in order to ensure both that the economy is determinate and that it is stable under least-squares learning. We set the values of  $\rho_A, \rho_\mu$  and  $\sigma_A, \sigma_\mu$  so that deflation is a very infrequent phenomenon in normal times and the ZLB is almost never reached. Figure 5 shows the output and inflation paths under learning (solid line) and RE (dotted line) and the output multipliers (impact and cumulative) for a surprise temporary policy change with  $T = 10$ . Initial beliefs of agents and the values of the exogenous variables are at the steady state. For this example we set  $\chi_\pi = 1.5$  and  $\chi_Y = 0$  and consider an increase in  $G$  of 5%. The Figure shows the mean values of percent deviations of inflation and output from the steady state over 10,000 simulations. For this setting the ZLB is never violated.

The most notable results are that the output and multiplier effects are larger under learning in early periods of policy, compared to RE. Under learning the maximum positive output effect is at the beginning of the policy, while under RE the maximum effect is in the last period of policy. Once the policy ends, the output effects are reversed under learning, with negative deviations for several periods after the stimulus ends. This contraction is the result of the higher expected inflation of agents, developed during the policy implementation, which leads agents to anticipate higher future real interest rates in accordance with the active Taylor rule.

To understand these results, we first examine the path under RE, which is fairly complex, and best analyzed starting from the last period of the policy. From  $t = T + 1 = 11$ , because there are no endogenous predetermined state variables in the NK model, the economy will return to the initial RE stochastic steady state. Consider next the economy at  $t = T = 10$ . The extra government spending  $\Delta G$  at  $T = 10$  has an impact on aggregate demand that is much larger than the small reduction in consumption resulting from the corresponding one-period tax increase. Because of consumption smoothing the reduction in consumption at  $T = 10$  turns out to be relatively small. The high level of output and employment at  $t = 10$  leads to higher real wages, and thus higher marginal costs and higher inflation through the Phillips curve. This in turn leads to high nominal and real interest rates through the Taylor rule. Now consider the economy at earlier dates  $t < 10$ . The reduction in consumption is greater in earlier periods and largest at  $t = 1$ . This is because households anticipate both a longer period of higher taxes and a longer period of higher real interest rates. It follows that under RE the increase in output is smallest at  $t = 1$ , due to the crowding out, and also that the impact on inflation is low in early periods. Under RE the largest impact of fiscal policy

is at the *end* of the period of increased government spending.

Consider in contrast the path under learning. This path is best understood beginning with the impact effect at  $t = 1$ . Households reduce consumption because of the foreseen period of temporary tax increases, but they do not foresee the sustained period of high real interest rates. The reduction in consumption is thus much smaller than under RE and there is a large increase in output and employment due to the additional government spending. Through the Phillips curve there is also an increase in inflation and interest rates. At  $t = 2$  expectations of future output and inflation will both be revised upward. Because higher expected inflation translates, into higher expected future nominal and real interest rates (since  $\chi_\pi > 1$  in the Taylor rule), consumption falls. For later periods with  $t < T$  increasing expected inflation and real interest rates leads to further reductions in consumption and output, with continued moderate inflation. Finally, at  $t = 11$ , when the policy ends, there is a substantial drop in output because the reduction in government spending is not offset by an increase in consumption, which remains low due to continued high expected inflation and real interest rates under adaptive learning. The low output levels for  $t > 10$  continue for a period of time until inflation expectations, in response to observed low inflation rates, return to the steady state level. Thus under learning the largest impact of fiscal policy is at the *start* of the policy, and is partially offset following the end of the policy.

Similar results are obtained if, continuing to assume that the exogenous variables are initially at their steady state levels, one now assumes that initial beliefs of inflation and output are lower than steady state values, but not so low that the ZLB will ever be obtained. Simulation results (not reported) show that this alters the path of the economy, both with and without the change in fiscal policy, but the distributed lag and cumulative output multipliers are broadly similar. The cumulative output multipliers are higher under AL than under RE during the policy implementation period, with the impact, relative to RE, concentrated in the early part of the policy. The maximum output effect of the fiscal policy under learning is in the early part of the policy, while the maximum output effect under RE occurs as the policy ends. The additional output increase under learning during the policy period is offset by lower levels of output after the policy ends.

## 4.2 Fiscal policy when the ZLB may be binding

As extensively discussed in the recent literature on fiscal policy in New Keynesian models, the size of the multipliers can be very sensitive to the response of monetary policy: fiscal multipliers are smaller when the induced changes in inflation and output lead to increases in interest rates through the monetary policy rule. A particular case in which the multiplier can be expected to be large is when interest rates are at or near the zero-lower bound (ZLB), so that they are unresponsive to fiscal policy changes.

### 4.2.1 Preliminary considerations

A zero lower bound on net nominal interest rates corresponds to a bound on the gross nominal one-period interest rate  $R_t \geq 1$ . Recall that the steady state real interest rate factor is  $\bar{r} = \beta^{-1}$ . When the target inflation rate is  $\pi^* \geq 1$ , the steady state nominal interest-rate factor is  $\bar{R} = \beta^{-1}\pi^*$ . Because  $\hat{R}_t = (R_t - \bar{R})/\bar{R} = (\beta R_t)/\pi^* - 1$ , it follows that at the ZLB we have  $\hat{R}_t = \beta/\pi^* - 1$ .

In practice, in our numerical simulations, much like the actual monetary policy followed in the US and the UK in the 2008 - 2015 period, we will assume net interest rates are bounded by some small value  $\eta > 0$ . Thus the ZLB is defined by the bound

$$\hat{R}_t \geq \frac{\beta(1 + \eta)}{\pi^*} - 1.$$

We continue to assume that in normal times the interest-rate policy is given by the Taylor rule. With the ZLB added policy takes the form

$$\begin{aligned} \hat{R}_t &= \max \left\{ \hat{R}_t^*, \frac{\beta(1 + \eta)}{\pi^*} - 1 \right\}, \text{ where} \\ \hat{R}_t^* &= \chi_\pi \hat{\pi}_t + \chi_Y \hat{Y}_t. \end{aligned}$$

We first note that the New Keynesian Phillips curve (15) is unaffected because it does not depend on the interest rate. However, the New Keynesian IS equation (18) is altered because expected future interest rates and the current interest rate may be subject to the ZLB.

Whether agents expect the ZLB to bind in the future depends both on the fundamental shocks and the beliefs of agents as measured by their estimates of the parameters of the PLM. There are actually four cases to consider

depending on whether the ZLB is expected to bind in all future periods, no future periods, after a finite number of periods or up to some date. Case 1 corresponds to normal times in which the ZLB is not expected to hold in the future. Case 2 corresponds to very pessimistic inflation expectations, in which the ZLB is expected to hold throughout the future. In Case 3 expectations are pessimistic but offset for an initial period because of current  $A_t, \mu_t$  shocks, and in Case 4 expectations are not too pessimistic but the ZLB is expected to hold for an initial period because of unfavorable current  $A_t, \mu_t$  shocks.<sup>26</sup>

These cases are discussed in detail in Appendix 3. The condition determining the applicable case depends in part on the parameters  $\rho_A$  and  $\rho_\mu$ , and for analytical convenience we restrict attention to the case  $\rho_A = \rho_\mu$ . For each case we must also allow for the possibility of the ZLB binding in the temporary equilibrium. Note that the model of Section 2 corresponds to normal times in which the ZLB never holds either in expectation or in the temporary equilibrium.

In this section we make the additional assumptions that inflation and consumption are also subject to lower bounds, as described in Section 3.1. We normally take  $\underline{\pi}$  to correspond a modest rate of deflation. The lower bounds  $\underline{c}$  and  $\underline{\pi}$  come into play when expectations are very pessimistic and can become binding in the “deflation trap” regions, emphasized by Benhabib, Evans, and Honkapohja (2014), in which adaptive learning can produce otherwise divergent paths with falling inflation and output. In Section 2 we implicitly assumed paths in which the consumption and inflation lower bounds were never violated.

#### 4.2.2 Simulation results

We now use simulations to study the possible paths of the economy, under AL, that can arise from a pessimistic expectation shock, and examine the potential role for fiscal policy to prevent stagnation or ameliorate bad outcomes. We emphasize that these simulation results are designed to be illustrative, i.e. to exhibit the range of possible results that can be obtained in our model. Using the model to fit actual historical episodes is reserved for future research.

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<sup>26</sup>Related ideas have been discussed in Williams (2010) in the context of price-level targeting under imperfect knowledge and learning.

The impact of fiscal policy will depend sensitively on the values of  $\underline{\pi}$  and  $\underline{c}$  and the nonstochastic component of the initial expectations  $\hat{\pi}^e(0) = f_\pi(0)$  and  $\hat{Y}^e(0) = f_Y(0)$ . There are cases in which without policy the economy will converge to a stagnation steady state rather than to the targeted steady state. If initial expectations are close to the edge of the deflation trap region, fiscal policy may be able to shift the path to the targeted steady state. In cases involving possible convergence to the stagnation regime, the impact of fiscal policy may depend critically on the size and length of fiscal policy.

Before turning to simulations, recall that there are three possible steady states when the inflation lower bound  $\underline{\pi}$  is below  $\pi_L = \beta(1 + \eta)$ . In proportional deviation form this corresponds to  $\hat{\underline{\pi}} < \hat{\pi}_L$  where  $\hat{\underline{\pi}} = \underline{\pi}/\pi^* - 1$  and  $\hat{\pi}_L = \beta(1 + \eta)/\pi^* - 1$ . The first steady state is the targeted steady state at  $\pi = \pi^*$  i.e. at  $\hat{\pi} = 0$ . There is a second steady state at  $\hat{\pi} = \hat{\pi}_L$  with  $\hat{c}_L > \hat{c}$ . This steady state, however, is unstable under learning. Finally, there is the stagnation steady state at  $\hat{\pi} = \hat{\underline{\pi}}$  and  $\hat{c} = \hat{c}$ .

If instead  $\hat{\underline{\pi}} > \hat{\pi}_L$  then the usual targeted steady state is the unique steady state, and if  $\hat{\underline{\pi}} = \hat{\pi}_L$  there will also be a continuum of steady states at  $\hat{\pi} = \hat{\underline{\pi}}$  with  $\hat{c} > \hat{c}$ .

For our parameterization with  $\beta = 0.99$  and  $\eta = 0.0001$ , the critical value  $\pi_L$  for the inflation bound is approximately  $-0.0099$ . This is a deflation rate of 0.99% per period, which we take to be a quarter, i.e. just under 4% per annum. In our simulations below we set  $\hat{\underline{\pi}} = -0.017$  or  $\hat{\underline{\pi}} = -0.01475$ . The inflation lower bound  $\hat{\underline{\pi}} = -0.017$ , which corresponds to about  $-1.21\%$  per quarter, leads to three steady states, while the lower bound  $\hat{\underline{\pi}} = -0.01475$ , corresponding to about  $-0.98\%$  per quarter, leads to a unique steady state.

For the consumption lower bound we set  $\hat{c} = -0.3$ , which corresponds to a 30% reduction in consumption from the targeted steady state and which in turn corresponds to a drop of roughly 24% in aggregate output in our model. Thus the level of output in the stagnation state corresponds roughly to the output drop in the Great Depression in the United States in the 1930s.<sup>27</sup> This is a fairly extreme assumption, and it would straightforward to examine calibrations consistent with stagnation steady states more in line with the Great Recession. We choose the setting  $\hat{c} = -0.3$  in order to consider the effectiveness of fiscal policy even in extreme cases in which the economy has

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<sup>27</sup>In our simulations we continue to use the linearized model, for the reasons given earlier, but now the relevant equations are subject to the lower bounds on the interest rate, inflation and consumption.

settled into a persistent stagnation with output far below normal levels.<sup>28</sup>

In this Section we set the benchmark gain to 0.10 because we consider expectations that are sometimes far from rational values. In these circumstances agents have an incentive to adjust expectations relatively quickly to eliminate systematic forecast errors.<sup>29</sup>

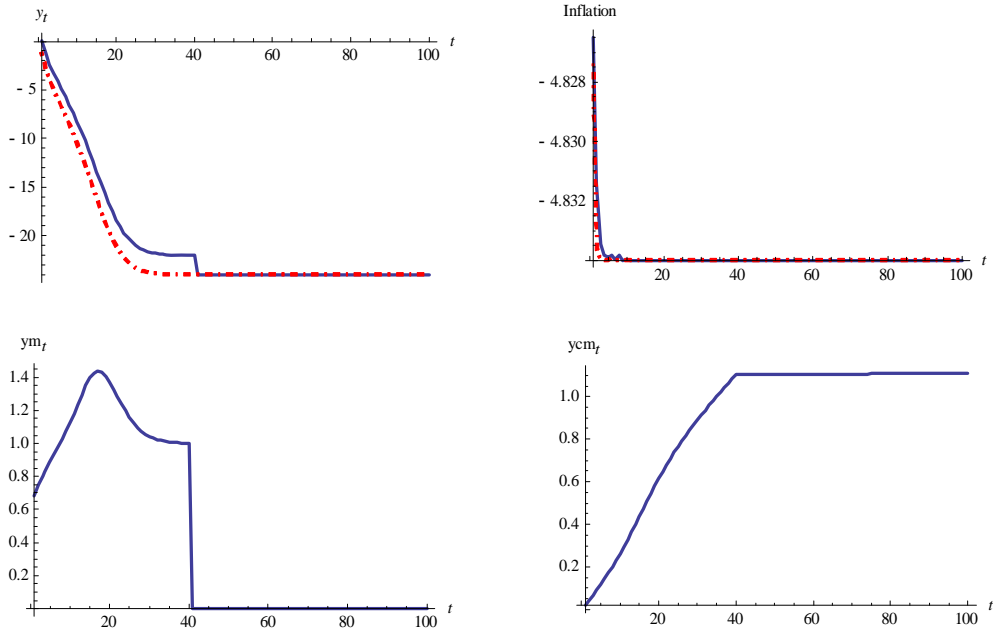


Figure 6: Small policy change. The upper panel shows the output and inflation paths under learning with policy change (solid line) and learning without policy change (dashed line) for a policy change with  $T = 40$ . The lower panel shows the distributed lag and cumulative output multipliers. All except one of the 10,000 replications converge to the stagnation state with policy change (all replications converge to the stagnation state without policy change).

<sup>28</sup>In the US Great Depression, deflation rates of about 10% per year were observed during 1931-2, but from 1933 deflation became less severe or nonexistent. Several explanations are possible. New Deal policies were introduced specifically to limit wage and price decreases. In addition, a version of our model with a lower bound on wage inflation is consistent with temporarily high price deflation rates associated with reductions in aggregate output that ease bottlenecks.

<sup>29</sup>The qualitative features are fairly robust to the value of the learning gain parameter  $\kappa$ , but quantitative results may be affected by  $\kappa$ .

Figure 6 sets  $\hat{\pi} = -0.017$  and shows the results for initial  $f_\pi = -0.0148$  and  $f_Y = -0.015$ . With an annual inflation target of  $\pi^* = 2\%$ , and since steady state output is approximately  $\bar{Y} = 1.0081$ , these values for  $f_\pi$  and  $f_Y$  correspond to initial inflation expectations of just under  $-1.0\%$  per quarter (an annual rate of  $-3.9\%$ ) and output expectations  $1.5\%$  below the level of the targeted steady state (assuming the exogenous shocks are at their mean values). This setting can be thought as follows. At the beginning of time  $t = 0$  the economy suffers a pessimistic expectation shock, which resets mean expectations to levels below the targeted steady state, specifically  $\hat{\pi}^e = -0.0148$  and  $\hat{Y}^e = -0.015$ . We also set the  $t = 0$  values of inflation and output at these same pessimistic values. We then contrast the evolution of the economy under learning when fiscal policy is unchanged with the evolution of the economy under learning when at  $t = 1$  a temporary fiscal stimulus is initiated of known duration. One natural interpretation of the pessimistic expectations at  $t = 0$  is that they arose from the impact of recent adverse discount rate or credit friction shocks that had dissipated by  $t = 1$ .<sup>30</sup>

Without fiscal policy these initial expectations are sufficiently pessimistic so that inflation at  $t = 1$  falls immediately to the lower bound  $\hat{\pi} = -0.017$ . This is accompanied by small reductions in consumption and output, and the interest rate falls to the ZLB. Because of the ZLB, and with inflation at its (negative) lower bound, current and expected future real interest rates are positive and approximately equal to the deflation rate. Using the temporary equilibrium consumption function and market clearing equations, with inflation and expected inflation at the lower bound, it is shown at the end of Appendix 3 that

$$\hat{Y}_t = f_{Y,t} - \Delta, \text{ where } \Delta = \frac{(1 - \bar{g})(\pi_L - \bar{\pi})}{(1 - \beta)\pi^*} > 0,$$

and  $\hat{C}_t = (1 - \bar{g})^{-1}\hat{Y}_t$ . Thus at each time  $t$  output is lower than expected output. This results in expected output falling over time. More specifically, it can be shown that the RLS updating equation for  $f_Y$  in Section 2.3 can be approximated by  $f_{Y,t+1} = f_{Y,t} + \kappa(\hat{Y}_t - f_{Y,t}) = f_{Y,t} - \kappa\Delta$ , with also  $d_{YA,t}, d_{Y\mu,t} \rightarrow 0$ . It follows that  $\hat{E}_t Y_{t+s} = f_{Y,t}, \hat{Y}_t$  and  $\hat{C}_t$  will steadily fall over time until  $\hat{C}_t$  is constrained by the consumption lower bound, at which point

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<sup>30</sup>In order to focus on the impact of pessimistic expectations we have not explicitly included these shocks, but it is clear that introducing them would allow us to generate suitable initial expectations.



the economy reaches and stays in the stagnation steady state. The paths of key variables are illustrated in Figure 6 by the dot-dashed lines. With no fiscal policy change the initial pessimistic expectations lead the economy into a deflation trap at  $\underline{\pi}$  with output approximately 24% below the targeted steady state.

Consider now the effectiveness fiscal policy. Figure 6 shows the impact of a small fiscal stimulus with a duration of  $T = 40$  periods. Under a fiscal policy that increases  $G$  by 10%, from  $G = 0.2$  to  $G = 0.22$ , there are positive multipliers during the policy period, with a cumulative multiplier of around 1.1, after 100 periods, which is mostly reached by period 40. However, the economy sinks back into the deflation trap around period 40.

In contrast, when  $G$  is changed by a sufficiently large amount the economy can be shifted to the targeted steady state. In Figure 7 we start with the same initial beliefs as in Figure 6, but we consider a policy that increases government spending from  $G = 0.2$  to  $G = 0.28$  for a period of  $T = 4$  periods. In approximately 99.61% of the simulations there is convergence to the intended steady state under this fiscal policy. Figure 7 illustrates the results based on 10,000 simulations. The top panel shows the mean paths of output and inflation for the paths for which fiscal policy is effective in the sense that it leads to convergence to the intended steady state. The middle panel shows that in the relatively few simulations (approximately 0.39%) in which the economy fails to avoid convergence to stagnation, fiscal policy still has substantial positive effects on output. In sharp contrast, without policy change, *all* simulations converge to the stagnation state. The bottom panel shows the distributed lag and cumulative output multipliers averaged over all 10,000 simulations. Output and inflation increase monotonically during the period of the stimulus,  $t = 1, \dots, 4$ .

The intuition for the results in which there is convergence to the intended steady state under policy is as follows. In period  $t = 1$  pessimistic expectations for inflation and output are predetermined. The increase in  $G$  has a large effect on output because there is only a small crowding out effect on consumption. Although there is deflation and interest rates are near the ZLB, the high level of output in period  $t = 1$  increases inflation above its expected level. Consequently in the following period inflation and output expectations are both revised upward. The higher inflation and output expectations and continued high  $G$  lead in period  $t = 2$  to even higher output and to inflation close to the target level. Beginning in period  $t = 3$ , inflation has risen above target. The high output and inflation levels in period

$t = 3, 4$ , result in inflation and output expectations being large enough so that when the government stimulus is removed in  $t = 5$ , output falls back close to normal levels, though inflation remains above target for a sustained period of time. Because expectations of inflation are above target levels, it still takes significant time for the economy to converge to the targeted steady state, but expectations are now within the basin of attraction of the targeted steady state and there is asymptotic convergence to the target.

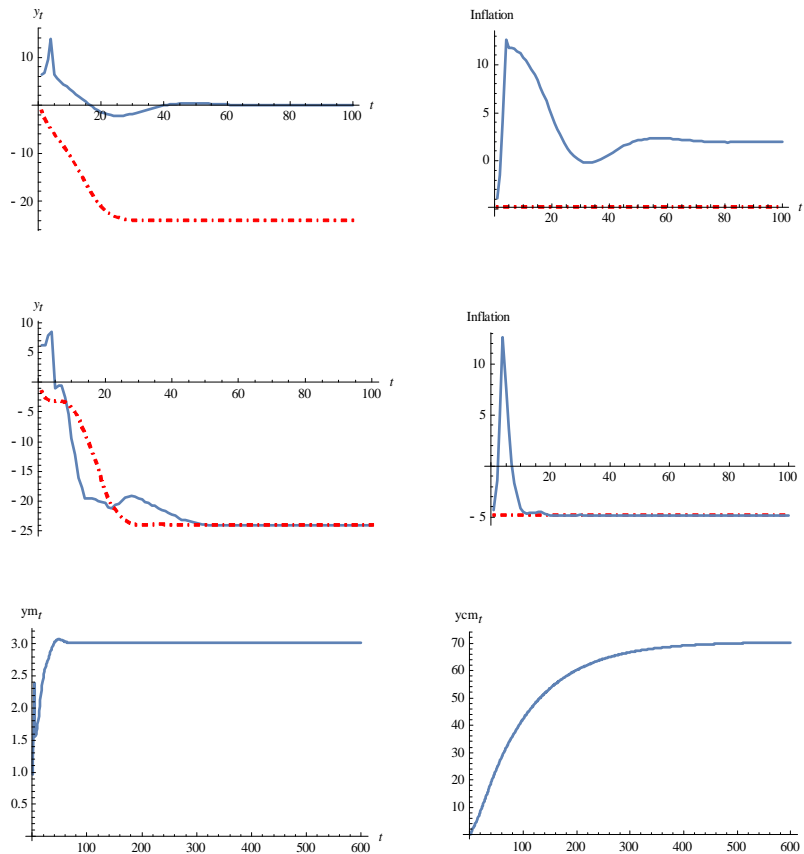


Figure 7: Large policy change. The top two panels show the output and inflation paths under learning with policy change (solid line) and without policy change (dashed line) for  $T = 4$ . Top panel: means of paths with convergence to targeted steady state under policy. Middle panel: means of paths with convergence to deflation trap despite policy. Bottom panel: distributed lag and cumulative output multipliers across all paths.

In summary, temporary increases in  $G$  are effective in raising output. Small temporary increases in  $G$  lead only to temporary increases in  $y$ , but large temporary increases in  $G$  can shift the economy back to the targeted steady state resulting in a permanent increase in output. It is important to note that whether or not the fiscal policy is successful in pushing the economy back to the targeted steady state depends in part on the sequence of stochastic shocks hitting the economy over time.

Tables 1 and 2 show the results for the same initial expectations and for alternative values of  $G$  and  $T$ . Table 1 shows the probability that the fiscal stimulus results in eventual convergence to the targeted steady state, and Table 2 shows the corresponding cumulative multipliers as of  $t = 40$  i.e. 10 years after the policy has been implemented. These results are based on 100 simulations for each cell. The extreme values  $G = 1.0$  and  $2.0$  and extended lengths of  $T = 20$  and  $40$  are included only for purposes of comparison.

It is not surprising that many entries in Table 1 are neither 100 or 0. Starting from the given initial pessimistic expectations, the sequence of serially correlated random productivity and mark-up shocks affect realized inflation and output over time, which under learning affects the expected inflation and output.<sup>31</sup> For a given fiscal policy that is usually successful, a particularly unfavorable sequence of shocks can adversely affect expectations enough to prevent the policy from working. Similarly, under a fiscal policy that will normally be unsuccessful, a particularly favorable sequence of shocks can in some cases be sufficient to lead to convergence to the targeted steady state.

Table 1 shows, however, that for a substantial range of policies, in particular for  $G$  between 0.27 and 0.40 with  $T$  between 2 and 5 quarters, a fiscal stimulus is successful at least 99% of the time. Table 2 shows that in these cases the cumulative multipliers are very large, reflecting the fact that the policies prevent the economy from descending into stagnation and push it back permanently (or almost permanently) to the targeted steady state, even though the fiscal stimulus is temporary.

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<sup>31</sup>We remark that for our calibration of exogenous shocks, with expectations initially at the targeted steady state, deflation is rarely observed – less than once every two hundred periods. Increasing the variances of the shocks, or increasing their serial correlation holding the unconditional variances constant, makes the results more stochastic, e.g. in Table 1 entries of zero become positive and entries of 100 are somewhat reduced.

$G \setminus T$	1	2	3	4	5	10	20	40
0.22	0	0	0	0	0	0	0	0
0.24	2	12	16	22	21	13	3	0
0.25	23	53	64	58	49	32	14	0
0.27	88	100	100	100	99	86	99	10
0.28	98	100	100	100	100	96	70	14
0.30	100	100	100	100	100	100	100	39
0.35	100	100	100	100	100	100	97	99
0.40	100	100	100	100	100	98	92	100
0.50	100	100	100	99	98	86	39	49
0.60	100	100	100	99	95	59	21	2
1.0	100	98	89	56	42	9	2	2
2.0	95	30	7	6	3	2	0	0

Table 1: Percentage of simulations in which fiscal policy successfully results in convergence to the targeted steady state starting from pessimistic expectations. Based on 100 simulations for each cell.

$G \setminus T$	1	2	3	4	5	10	20	40
0.22	4.6	3.1	2.6	2.3	2.2	2.2	1.5	1.1
0.24	12.6	14.6	11.6	11.1	8.4	3.6	1.7	1.1
0.25	36.8	35.9	27.9	19.4	14.0	5.4	2.2	1.1
0.27	76.2	43.1	29.0	21.9	17.5	8.1	17.5	1.3
0.28	73.5	37.8	25.4	19.2	15.4	7.7	3.4	1.4
0.30	59.9	30.2	20.3	15.3	12.4	6.4	3.4	1.5
0.35	40.0	20.2	13.6	10.2	8.3	6.9	2.3	1.6
0.40	30.0	15.1	10.2	7.7	6.2	3.2	1.7	1.3
0.50	20.0	10.1	6.8	5.2	4.0	2.0	1.2	1.0
0.60	15.0	7.6	5.0	3.7	2.9	1.4	1.0	1.0
1.0	7.4	3.5	2.1	1.4	1.1	0.9	0.9	0.9
2.0	2.9	1.0	0.7	0.7	0.8	0.9	0.9	1.0

Table 2: Cumulative multipliers through  $t = 40$  for fiscal policies starting from pessimistic expectations. Based on 100 simulations for each cell.

It can also be seen that in many cases a fiscal stimulus that is too long can be counterproductive. For example, for  $G = 0.28$  the effectiveness of the stimulus decreases if  $T$  is increased to  $T = 10$  quarters or longer. This is a reflection of the negative effect on consumption of the tax burden associated with higher government spending, which we assume is correctly foreseen by households. In particular, in the first period when a fiscal policy of a given magnitude  $\Delta G$ , for  $T$  periods, is initiated, the impact on aggregate output is largest if  $T = 1$ . In this case the present value of the tax burden is simply  $\Delta G$  and the direct impact of this on consumption is  $-(1 - \beta)\Delta G$ , which is very small compared to the increase in aggregate demand for output from government spending  $\Delta G$ . For larger  $T$  the present value of the tax burden is larger; consequently the reduction in consumption in the initial period is greater, leading to a smaller initial increase in aggregate output and inflation. Against this, of course, a larger  $T$  means that the increase in demand continues for a longer period of time, which means under learning that expectations will adjust to a greater extent to the higher values of output and inflation realized during the policy. These offsetting factors account for the complicated patterns seen in Table 1.

In Figure 8 we consider the case in which the inflation lower bound is high enough so that there is a unique steady state. In this case the low level trap does not exist and the targeted steady state is unique. Initial pessimistic expectations can still lead to a very long transition to the targeted steady state and effectiveness of fiscal policy is of interest.

Figure 8 shows the impact on output and inflation of an increase in  $G$  from 0.20 to 0.24 for  $T = 40$  periods where agents continue to use a gain parameter of 10%. For these simulations we set  $\hat{\pi} = -0.01475$ , about 0.98% per quarter, i.e. just above the level needed to avoid the low-level trap. Initial expectations following a large pessimistic shock are set at  $\hat{\pi}^e = -0.0165$  (inflation around  $-1.2\%$  per quarter) and  $\hat{y}^e = -0.01$ . The results are reported on the basis of 6000 simulations. The cumulative multipliers here are smaller than the more dramatic values given in Table 2. However, they are substantially larger than those seen in Figure 5. This is because, although there is a unique steady state, the economy is initially in a liquidity trap. Consequently the multipliers are higher than when fiscal policy is conducted in normal times and lower bounds are not present. The relatively high values for the multipliers also in large part reflect the impact of the fiscal policy on expectations under learning: the sustained increases in output and inflation during the policy implementation period have positive impacts on inflation

and output after the policy has ended due to improved expectations during the policy.

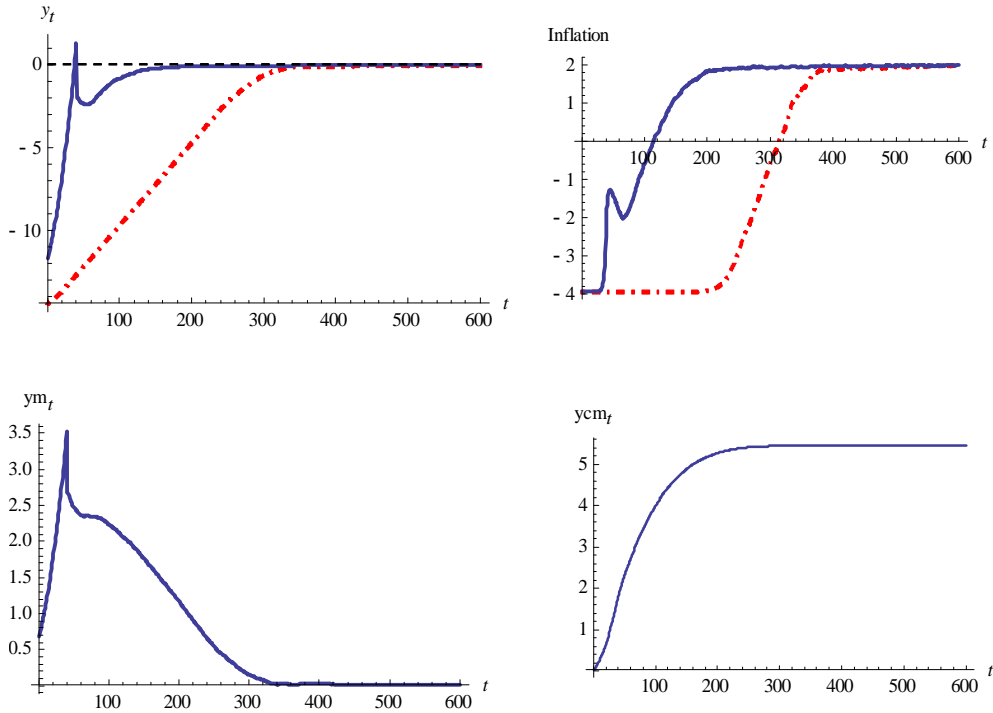


Figure 8: Policy change when there is a unique steady state with learning gain parameter equal to 10%. Top panel: output and inflation paths under learning with policy change (solid line) and without policy change (dashed line) for temporary policy change. Bottom panel: distributed lag and cumulative output multipliers.

This last example shows that even in cases in which there is a unique steady state, fiscal policy can be important when there is a sufficiently large pessimistic expectations shock that drives the economy into recession and deflation and monetary policy to the ZLB. However, the most dramatic results arise when the inflation lower bound is low enough to create the possibility of an additional stagnation steady state.

## 5 Further Results and Discussion

Our results raise two key questions. In the preceding Section we looked at the effectiveness of fiscal policy when expectations were subject to a pessimistic shock that would lead to convergence to the stagnation trap equilibrium in the absence of fiscal policy. Suppose, however, that fiscal policy is not contemplated until the economy has already converged to the trap. Can a fiscal stimulus still be effective in extracting the economy from the stagnation trap and returning it to the targeted steady state? The second question we consider is the size of the critical deflation rate below which a stagnation trap exists. Under our calibration this corresponds to an annual deflation rate of about 4% per year. Are there circumstances in which milder deflation can result in a stagnation trap?

### 5.1 Escape from stagnation

Can a suitable fiscal stimulus return the economy to the targeted steady state if, as a result of a large pessimistic shock it has been allowed to converge to the stagnation steady state? This is clearly a worst-case setting given the parameters since we are assuming that expectations have fully adapted to the stagnation steady state. To examine this question we use numerical simulations, with the calibration of the previous Section, but now set the intercepts of the forecast rules so that mean forecasts correspond to mean inflation and output rates at the stagnation steady states. Table 3 gives the results for 100 simulations. As in Table 1 we consider combinations of increased government spending levels  $G$  and policy length  $T$ .

From Table 3 it can be seen that a fiscal stimulus can be successful in extracting the economy from the stagnation trap even if expectations have settled into levels consistent with the trap. However, the size of the stimulus is now very large – much larger than was required in Tables 1 and 2, when expectations were less pessimistic – and it has a modest chance of full success. The policies with the highest probability of success, between 89% and 91%, are fiscal expansions that are both relatively short and big, e.g. a six-quarter stimulus at  $G = 1.0$ , a five-fold increase in  $G$ . A less huge, but still very large, stimulus of  $G = 0.7$  for twelve quarters, has a 82% chance of success. Table 3 shows a general trade-off between magnitude and duration, with some intriguing nonlinearities that reflect the balance of factors discussed earlier in

connection with Table 1.<sup>32</sup> Of course our numerical results will be sensitive to the parameterization used. For example, a smaller stimulus might have a higher chance of success if the consumption lower bound corresponds to a less drastically reduced level of output in the stagnation steady state.

$G \backslash T$	1	2	3	4	5	6	7	8	12	16	20
0.4	0	0	0	0	0	0	0	0	0	0	0
0.5	0	0	0	0	0	0	0	0	0	3	43
0.7	0	0	0	1	6	19	47	60	82	60	37
0.8	0	0	1	13	53	77	86	89	63	33	25
0.9	0	1	29	68	85	90	88	81	36	17	11
1.0	0	14	66	87	90	91	80	60	20	9	5
1.2	0	73	91	88	79	61	44	31	4	4	3
1.5	58	89	84	62	33	22	11	9	1	2	1
1.7	76	88	72	32	16	10	6	6	2	1	0
2	83	66	30	13	6	5	4	2	3	0	0
2.5	81	33	8	3	1	4	3	4	1	0	0

Table 3: Percentage of simulations in which fiscal policy successfully results in convergence to the targeted steady state starting from stagnation expectations. Based on 100 simulations for each cell.

While we find that a sufficiently large stimulus of appropriate duration can have a high probability of extracting the economy from a stagnation trap, even after expectations have adapted to the trap, an equally important conclusion from these numerical results is that a higher probability of avoiding the stagnation trap can be achieved, with a much smaller stimulus, if the policy is implemented earlier, when expectations are less pessimistic. Following a large adverse shock to expectations, in which there is risk of the economy descending into the stagnation trap, a fiscal stimulus should be implemented as early as possible.

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<sup>32</sup>There is no reason a priori to restrict the fiscal stimulus to be of fixed size over time until termination. We have not investigated other time profiles.



## 5.2 Deflation and calibration of the discount factor

The results of the previous Section emphasize the importance of the level of the inflation lower bound for the existence of a stagnation steady state. This brings us to a delicate issue, which is the appropriate calibration of the discount factor  $\beta$ . Our numerical results have used the standard quarterly calibration of  $\beta = 0.99$ . While this value is fairly standard, there are good reasons to consider alternative, higher, values. The historical average realized net real interest rate on US Treasuries bills is not more than 1% per annum. In an economy without growth this would correspond to a discount factor of about  $\beta = 0.9975$ . Presumably one major reason that the lower discount factor  $\beta = 0.99$  is often used in calibrated models is that the average net real rate of return on equities is much higher (e.g. 7% p.a.). With no consensus on how to resolve the equity premium puzzle, a value of  $\beta = 0.99$  might be viewed as a rough and ready compromise value. However, in the context of liquidity traps, the ZLB and deflation traps with a stagnation steady state, the calibration of  $\beta$  plays an important role and must be faced.

For  $\beta = 0.99$  the critical  $\pi_L$ , when  $\eta = 0$ , corresponds to 1% deflation per quarter, i.e. to 4% per year. Because the magnitude of deflation in Japan and Europe (as well as the US even in 2009-2010) has been below this value, this suggests either that the inflation lower bound  $\underline{\pi}$  is above  $\pi_L$  or that policy has prevented inflation from falling below the critical level. On the other hand if  $\beta = 0.995$  or  $\beta = 0.9975$  is the appropriate value to use in the consumption Euler equation, then the critical deflation rate is only around 2% or 1% per year, in line with values that have occasionally been observed, e.g., in Japan in various periods since the 1990s.<sup>33</sup> The possibility of deflation rates above these levels would appear to be a serious concern, for example, in at least some countries in Europe in 2016.

In Figure 9 we redo the simulations using the higher discount factor of  $\beta = 0.9975$ . We again assume agents use a gain parameter 10%. For these simulations we set  $\hat{\pi} = -0.0085$ , which is somewhat below the critical value, so that there are three steady states including a low-level trap. For this value of  $\hat{\pi}$  steady state quarterly inflation is 0.9964575 which corresponds to a deflation rate of about 1.4% per annum. As in Figures 6 and 7 we set  $\hat{c} = -0.3$  which corresponds to a 30% reduction in consumption from

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<sup>33</sup>We note that Eggertsson (2010) uses a calibration of  $\beta = 0.997$  in a model of the US economy during the Great Depression. During the Great Depression deflation reached 10% per year during the trough.

the targeted steady state. Initial expectations following a presumed large pessimistic shock are set at  $\hat{\pi}^e = -0.0074$  (about  $-1\%$  per annum) and  $\hat{Y}^e = -0.025$ .

From Figure 9 one can see that in the absence of fiscal policy the economy would fall into a stagnation state with deflation. For these parameters a short but very aggressive fiscal stimulus is needed to avoid stagnation. In these simulations we consider an increase in  $G$  from 0.20 to 0.35 for  $T = 2$  periods.

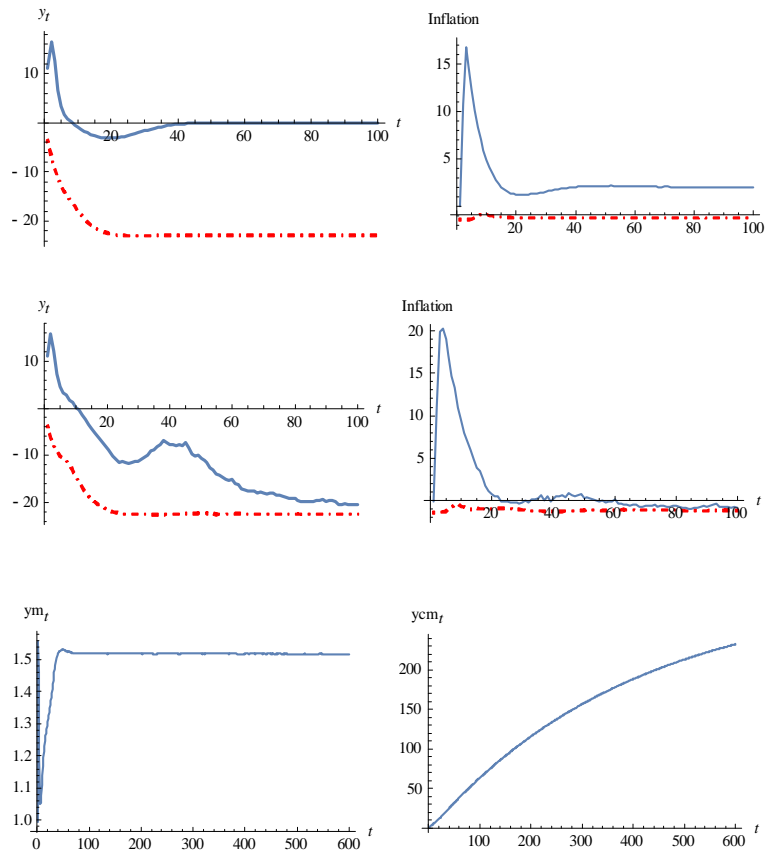


Figure 9: High discount factor,  $\beta = 0.9975$ . The top two panels show paths under learning with policy change (solid line) and without policy change (dashed line). Top panel: means of paths with eventual convergence to targeted steady state under policy. Middle panel: mean paths with eventual convergence to deflation trap despite policy. Bottom panel: distributed lag and cumulative output multipliers across all paths.

Our fiscal policy almost guarantees that the stagnation state will be avoided since for these parameters, based on 10,000 simulations, 98.6% of the with-policy simulations converged to the intended steady state while 1.4% eventually sank to the stagnation steady state. In sharp contrast, without policy change, 95.3% of the simulations sink to the stagnation steady state and only the remaining 4.7% converge to the targeted steady state. In Figure 9 the top panel shows the mean paths of those simulations that under the policy converge to the intended steady state. The middle panel shows the mean paths of those few paths that, despite policy, eventually converge to the stagnation steady state. For these cases we note that the process is typically very slow. The bottom panel shows the multipliers averaged over all simulations. The cumulative multipliers are, of course, very high.

### 5.3 Credit frictions

Another factor that can potentially lead to a higher level of the critical inflation rate, below which stagnation can occur, is the existence of credit frictions. A number of different models have been proposed that generate a spread between different interest rates on loans. A prominent example within a New Keynesian setting is the credit frictions model described in Curdia and Woodford (2010) and developed at length in Curdia and Woodford (2015). Their framework posits a heterogeneous agents set-up with two types of household, at any given time, experiencing different realizations of taste shocks, leading to lending from those agents who are currently more patient to those who are currently more impatient. The model also has a financial intermediation sector, and a central feature of their model is that the borrowing rate is above the lending rate.

Embedding a heterogeneous agents framework into our model is beyond the scope of the current paper. However, it is straightforward and natural to incorporate a shortcut, motivated by Woodford (2011), which is to assume that the interest rate relevant in household Euler equations “for the intertemporal allocation of expenditure is not the same as the central bank’s policy rate” (p. 16). Woodford (2011) and Curdia and Woodford (2015) focus on the implications of the time variation in this spread, which reflects the efficiency of financial intermediation, while for our purposes a key implication is the positive steady state spread  $\varphi = R - i > 0$ , where  $i$  is the policy rate and  $R$  is the interest rate relevant for household decision-making.

Curdia and Woodford (2015) work explicitly through the aggregation

problem and show that the aggregate implications correspond to interpreting  $\varphi$  as the average of  $i$  and the borrowing rate; the shortcut in our representative-agent setting is then simply to directly interpret the market interest rate for households as  $R_t = i_t + \varphi$ , where  $i_t$  is the interest rate set by policymakers. It is, of course, the policy interest rate that is subject to the lower bound. The benchmark calibration in Curdia and Woodford (2015) corresponds to a value  $\varphi = 0.0025$ , i.e. to 1% per annum.

We next discuss the implications of including credit frictions. Incorporating an interest rate spread  $\varphi > 0$  is formally identical to our Section 3.1 model without a credit friction, but in which the central bank places a floor to its policy rate at  $1 + \eta'$  where  $\eta' = \varphi > 0$ . To see this, note first that, in our current setting and with inflation target  $\pi^*$ , the steady state market interest rate  $R$  satisfies  $R = \beta^{-1}\pi^*$  and the corresponding policy rate with credit frictions is  $i = \beta^{-1}\pi^* - \varphi$ . The Taylor rule for the policy rate, subject to the  $1 + \eta$  lower bound, is given by

$$i = \max(\beta^{-1}\chi_\pi(\pi - \pi^*) + \beta^{-1}\pi^* - \varphi, 1 + \eta).$$

Equivalently the market interest rate satisfies

$$R = \max(\beta^{-1}\chi_\pi(\pi - \pi^*) + \beta^{-1}\pi^*, 1 + \eta'),$$

where  $\eta' = \eta + \varphi$ . As in Section 4.2, under learning agents use knowledge of this relationship and forecasts of inflation to forecast future market interest rates. It follows that to capture the impact of a steady state credit friction  $\varphi > 0$  in our model we simply replace  $\eta$  by  $\eta' = \eta + \varphi$ .

Before turning to numerical simulations it is useful to reconsider Figure 3, showing the existence of multiple steady states. The variable  $R$  on the vertical axis has a lower bound of  $1 + \eta'$  and is now interpreted as the market interest rate, not the policy rate. The corresponding unintended steady state is at  $\pi_L = \beta(1 + \eta')$ . Provided the inflation lower bound satisfies  $\underline{\pi} < \pi_L$  there are three steady states as shown in Figure 3. As before the targeted and the stagnation steady states are locally stable under learning. For given  $\underline{\pi}$  an increase in the credit spread  $\varphi$  increases  $\eta'$  leading to an increase in the (locally unstable) unintended steady state associated with  $\pi_L$ . This will increase the basin of attraction of the stagnation steady state and reduce the basin of attraction of the targeted steady state.

A new phenomenon worth noting is that if  $\varphi$  is large enough then both the targeted steady state and the unintended steady state disappear and

only the stagnation steady states remains. Another new result of considerable practical significance arising from credit frictions is that if  $\beta(1 + \eta') > 1$  then it is possible to have  $1 < \underline{\pi} < \pi_L < \pi^*$ . Thus, not only does including a credit friction raise the critical inflation rate to at mild deflation level, but it is also possible for the critical inflation rate to be positive. In this case a stagnation steady state can correspond to a zero or low positive inflation rate.

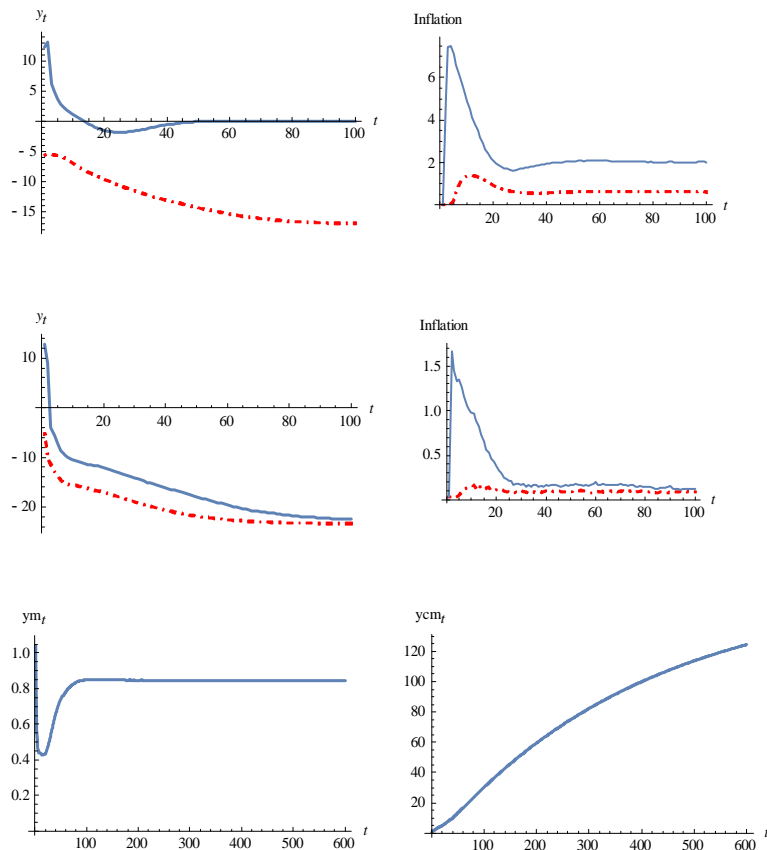


Figure 10: Credit spread case. The top two panels show paths under learning with policy change (solid line) and without policy change (dashed line). Top panel: means of paths with eventual convergence to targeted steady state under policy. Middle panel: mean paths with eventual convergence to deflation trap despite policy. Bottom panel: distributed lag and cumulative output multipliers across all paths.

We now illustrate numerically the implications of adding the credit friction. In Figure 10 we redo the simulations using the higher discount factor of  $\beta = 0.9975$  and adding a credit friction corresponding to 1.08% annually (thus the credit friction is very slightly above the benchmark rate used in Curdia and Woodford (2015)). For these simulations we set  $\hat{\pi} = -0.0049$ , somewhat below the critical value, so that there are three steady states, including a low-level stagnation trap. This value of  $\hat{\pi}$  corresponds to  $\underline{\pi} = 1.000755$ , yielding an inflation lower bound at 0.03% per annum, i.e. very slightly above zero inflation.

For this policy experiment agents are again assumed to use a gain parameter 10% and we continue to set  $\hat{c} = -0.3$ . Initial expectations following a presumed large pessimistic shock are set at  $\hat{\pi}^e = -0.0048$  (a slightly positive expected inflation rate of just under 0.1% per annum) and  $\hat{Y}^e = -0.05$ . For these initial expectations, as noted below, there is a high likelihood of the economy, without a fiscal stimulus, converging to the stagnation steady state. We consider fiscal policies that increase  $G$  from 0.20 to 0.38 for  $T = 2$  periods. This is a very large, albeit short, fiscal stimulus, which appears necessary given the pessimistic initial expectations. Our fiscal policy does not guarantee that the stagnation state will be avoided. However, based on 10,000 simulations, almost 86% of the with-policy simulations converged to the intended steady state, 11% eventually sank to the stagnation steady state, while approximately 3% had not yet converged. In sharp contrast, without policy change, 73.66% of the simulations sink to the stagnation steady state, 25.33% converge to the targeted steady state while the remaining 1.1% had not yet converged.<sup>34</sup> In Figure 10, as usual, the top panel shows the mean paths of those simulations that under the policy converge to the intended steady state. The middle panel shows the mean paths of those paths that eventually under the policy converge to the stagnation steady state. For these cases we note that the process is typically very slow.

The bottom panel shows the multipliers averaged over all simulations. We remark that the cumulative multipliers are very high, even though the policy does not guarantee escape from eventual stagnation and deflation. Finding a mix of policies that maximizes the chance of avoiding the stagnation trap would be useful to consider in future work.

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<sup>34</sup>The smaller difference between  $\pi^*$  and  $\pi_L$ , when  $\beta$  and  $\varphi$  are high, increases the importance of the sequence of random shocks in determining the asymptotic path.

## 5.4 Wage and profit forecasting

We have assumed that households forecast their own income while making future decisions about their consumption as in Eusepi and Preston (2010a) and Eusepi and Preston (2010b). In this approach households directly forecast their period income which is the sum of wage income and profit (dividend) income. Since agents' wage income depends on their own labor supply choice, this approach has agents forecasting variables (income) that depend on endogenous variables like labor supply.<sup>35</sup> However, an advantage of our approach is that it yields a consumption function close to traditional formulations based on the permanent income and life-cycle models.<sup>36</sup>

Preston (2005), on the other hand, assumes that agents only forecast variables that are exogenous to their own decision problem. We now show that our results are robust when agents forecast in this fashion. This alternative approach is implemented by assuming that households forecast wage rates and profits, i.e. only variables that are exogenous to their decision problem (instead of their own income) as in Eusepi and Preston (2012) and Eusepi, Giannoni, and Preston (2012). To operationalize this approach households use a consumption function that depends on forecasts of wages and profits. The details of this approach are given in Appendix 4. Households use PLMs for wages and profits which take the same form as the minimal state variable solution and use constant gain learning of the same form used before. This affects the consumption function (see equation (72) in Appendix 4) and hence the aggregate demand equation of the model.

Firms take aggregate demand as exogenous when choosing their optimal price so their decision problem is unaffected and the Phillips curve stays the same as before. We remark, however, that there are potentially two ways of implementing the firms' forecasting problem. In one approach they are assumed to forecast future inflation, aggregate demand and wages (apart from the exogenous shocks); see equation (40) in Appendix 1.<sup>37</sup> Alternately,

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<sup>35</sup>This issue does not arise in the case of firms forecasting aggregate income since the latter is assumed to be exogenous to the firm's choice of price level while maximizing their own profits. However, see below.

<sup>36</sup>Woodford (2013) also employs a consumption function based on current and expected income net of taxes and real interest rates.

<sup>37</sup>This approach is adopted in Eusepi and Preston (2012) and Eusepi, Giannoni, and Preston (2012). However, since these authors assume constant returns to scale in the production function, firms do not have to forecast future aggregate demand in their analysis. As we assume decreasing returns to scale, firms also have to forecast aggregate demand in

if firms make use of the labor supply schedule, the production function and the market clearing condition (i.e. use the three equations preceding equation (42)) then they only need to forecast future inflation and aggregate demand as in equation (42). We make use of this latter simplifying assumption in what follows.

We consider the case when fiscal policy changes in normal times i.e. in situations when the ZLB does not bind as in Section 4.1. For illustrative purposes we consider the same policy change in Figure 5. We find that the qualitative dynamics illustrated in Figure 5 remain unchanged when households forecast wages and profits instead of income (including the dynamics of the distributed and cumulative lag output multipliers). The quantitative dynamics are also similar and only slightly different, e.g. consumption falls slightly more towards the end of the policy change when households forecast wages and profits compared to the situation in Figure 5 (for brevity, we do not present the figure here). This indicates that our results are robust to the alternative approach in which agents forecast wages and profits.<sup>38</sup>

## 6 Conclusions

Sluggish real economic performance, accompanying long-lasting ZLB monetary policy regimes, has made the possibility of secular stagnation a prominent topic in discussions among economists. Our first objective in this paper was to extend a standard NK model in a way that makes stagnation at the ZLB, with a low level of aggregate output, a possible steady state outcome for the economy. The model can have multiple equilibria, and stagnation arises when economic agents have pessimistic expectations concerning future inflation and aggregate output.<sup>39</sup>

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equation (40).

<sup>38</sup>A similar phenomenon is observed in Kuang and Mitra in the context of the real business cycle model. The statistical results, impulse responses etc are very similar in these two scenarios: compare Kuang and Mitra (2016) and Kuang and Mitra (2015). In the former households forecast wages and interest rates i.e. variables exogenous to the household's problem while in the working paper version it was assumed households forecast their period income which contains their own labor supply choice (which is an endogenous choice variable in their decision problem).

<sup>39</sup>As we have emphasized, our results have been obtained through an extension of the basic standard New Keynesian model; this facilitates understanding of the key forces at work. For serious applied work it would, of course, be important to incorporate many



The dynamics of the economy, including specifically the dynamics of private-sector expectations, are modeled using the AL approach to expectation formation rather than using the standard RE hypothesis. The RE assumption assumes a great deal of knowledge on the part of agents and implicitly also assumes coordination of agents on those expectations. These criticisms of RE are particularly forceful when the economy is in an unusual situation, i.e. outside the usual regime of positive inflation and interest rates. In such circumstances the government may also need to consider policies outside the usual range of experience.

It should be emphasized that the AL approach is consistent with the RE assumption as the steady states are potential fixed points of agents' learning. Existence of multiple RE equilibria is a conundrum for the RE approach and AL can provide a selection criterion among the REE. We impose the stability criterion that steady states of economic interest are locally stable outcomes of the AL dynamics. We show that both the targeted and stagnation steady states meet this requirement. Additionally, AL can provide useful perspectives on the short- and medium run dynamics of the economy.

A second objective of our paper has been to consider the impact of fiscal policy in the extended NK model when expectations are formed using AL. We studied fiscal policy when agents take account of the direct effects of the announced policy, but when RE is replaced by the assumption that agents use AL to forecast future values of endogenous market variables, i.e., future inflation and aggregate output.<sup>40</sup>

Impacts of fiscal policy depend sensitively on whether we are considering fiscal policy in normal times, when the ZLB on interest rates does not bind, or at times of low inflation and output when the ZLB binds. For normal times there are significant but relatively minor differences between AL and RE: under AL the impact of the fiscal policy is front-loaded compared to RE, i.e. the strongest effects are towards the beginning of the policy. Furthermore, the positive effects during the policy implementation period are partially offset by negative output effects when the policy comes to an end.

However, outside normal times, when inflation and output may be very low, the impact of fiscal policy under AL can be dramatic. In addition to incorporating lower bounds on inflation and consumption in our extended

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features found in more elaborate models, including investment and capital, separate wage and price frictions, habit persistence, distortionary taxes, and an explicit financial sector.

<sup>40</sup>This approach was pursued in Evans, Honkapohja, and Mitra (2009).

model, we allow for the possibility that agents anticipate that future interest rates will be at the ZLB. We show that if expectations of inflation and output enter a deflation trap region, then they will tend to converge to the stagnation steady state.

There is thus the possibility that a large pessimistic expectation shock (due, say, to a recent financial crisis) can push the economy to the ZLB and along a path to steady state stagnation and deflation. In this setting a fiscal stimulus can be particularly potent. We have seen that a sufficiently large temporary increase in government spending can increase output and inflation enough to prevent the economy being pulled into deflation and stagnation. The chances of policy success are significantly greater if the policy is implemented early, before expectations deteriorate greatly. However, even if expectations have adapted to the stagnation trap, a large temporary fiscal stimulus can dislodge the economy from a stagnation trap.

The existence of a locally stable stagnation steady state arises if the inflation lower bound is below a critical rate given by the inverse of the discount factor. A common calibration for the discount factor is  $\beta = 0.99$  per quarter. When this is used the critical rate is deflation at 4% per year. However, for a discount factor of 0.9975 the critical rate is deflation at 1% per year, a rate frequently experienced by Japan over the last few decades. A final extension of the paper allows also for credit frictions, which further raises the critical rate and can make it zero or even positive. This suggests that positive but low inflation rates can be a concern if they are persistently below a central bank's target. In this situation, low and declining inflation and inflation expectations raise the possibility of the economy entering a stagnation trap.

Despite the many simplifications of the standard New Keynesian model that formed the basis for our extended model, the framework is quite rich in terms of the possible economic outcomes that can arise when there is a large pessimistic shock to expectations following an event like the financial crisis that pushes policy and the economy to the ZLB. If the inflation lower bound is below the critical rate then, depending on the extent to which expectations have deteriorated, paths under normal policy can either lead back to the targeted steady state or follow a path to stagnation.

If instead the inflation lower bound is just slightly above the critical value, so that there is a unique steady state, a large pessimistic shock can still lead to an extended period of low output and inflation before the economy eventually climbs its way back to the targeted steady state. An extended period of low

output and inflation can also arise in the case of multiple steady states if the initial pessimistic shock places expectations near the unintended locally unstable steady state. In this case expectations will adjust very slowly before eventually “declaring” themselves to be within either the corridor of stability for the targeted steady state or the stagnation trap region.

In addition to the precise level of the inflation lower bound, the magnitudes of initial expectation shocks, and the sequence of random fundamental shocks, the path of the economy will depend on the policy response, including both monetary and fiscal policy. Here we have emphasized the potentially important role for fiscal policy, and we have seen that whether a policy will enable the economy to avoid a stagnation trap, and the speed with which an economy returns to the targeted steady state, can depend on the size and duration of a fiscal stimulus and whether the fiscal stimulus is implemented early or later.

From these observations it can be seen that the framework of this paper can encompass a wide range of outcomes arising from a large pessimistic shock to expectations. Using this framework to explain recent (and future) events for the different major economies in the wake of the 2007-9 financial crisis is reserved for future research.

## Appendix 1: Model details

We develop here the model outlined in Section 2 following the analysis of Eusepi and Preston (2010a).

### Consumers

Next use the flow budget constraint and the NPG (no Ponzi game) condition to obtain an intertemporal budget constraint. Write

$$b_{t,i} = r_t b_{t-1,i} + \zeta_{t,i},$$

where  $r_t = R_{t-1}/\pi_t$ . and

$$\zeta_{t,i} = Y_{t,i} - C_{t,i} - G_{t,i}. \quad (29)$$

In (29) consumers are assumed to know that the government will run a balanced budget policy. Iterating (29) forward and imposing

$$\lim_{s \rightarrow \infty} \hat{E}_{t,i}(D_{t,t+s})^{-1} b_{t+s,i} = 0, \quad (30)$$

where

$$D_{t,t+s} = \prod_{i=1}^s r_{t+i},$$

with  $r_{t+s} = R_{t+s-1}/\pi_{t+s}$ . We obtain the life-time budget constraint of the household

$$0 = \Delta_{t-1,i} + \zeta_{t,i} + \sum_{s=1}^{\infty} \hat{E}_t(D_{t,t+s})^{-1} \zeta_{t+s,i},$$

where  $\Delta_{t-1,i} = r_t b_{t-1,i}$  and

$$\zeta_{t+s,i} = Y_{t+s,i} - C_{t+s,i} - G_{t+s,i}. \quad (31)$$

Because there is zero net government debt and we have representative agents, it follows that  $\Delta_{t-1,i} = b_{t-1,i} = 0$  for all agents. Thus

$$0 = \zeta_{t,i} + \sum_{s=1}^{\infty} \hat{E}_t(D_{t,t+s})^{-1} \zeta_{t+s,i}, \quad (32)$$

Linearizing (32) we have

$$\begin{aligned} 0 &= \tilde{\zeta}_{t,i} + \sum_{s=1}^{\infty} \beta^s \tilde{\zeta}_{t+s,i} - \bar{\zeta} \sum_{s=1}^{\infty} \beta^{s+1} \sum_{i=1}^s \tilde{r}_{t+i}, \\ \tilde{\zeta}_{t+s,i} &= \tilde{Y}_{t+s,i} - \tilde{C}_{t+s,i} - \tilde{G}_{t+s,i}, \end{aligned}$$

where tilde denotes deviation from the non-stochastic steady state for each variable, for example,  $\tilde{Y}_{t+s,i} = Y_{t+s,i} - \bar{Y}$ . Note that here  $\bar{\zeta} = 0$  by market clearing, so that

$$\sum_{s=0}^{\infty} \beta^s \tilde{C}_{t+s,i} = \sum_{s=0}^{\infty} \beta^s (\tilde{Y}_{t+s,i} - \tilde{G}_{t+s,i}).$$

The next step is iterate the linearized Euler equation forward. We have

$$\begin{aligned} \tilde{C}_{t,i} &= \hat{E}_{t,i} \tilde{C}_{t+1,i} - \beta \bar{C} \hat{E}_{t,i} \tilde{r}_{t+1} \text{ and} \\ \tilde{C}_{t,i} &= \hat{E}_{t,i} \tilde{C}_{t+s,i} - \beta \bar{C} \hat{E}_{t,i} \sum_{i=1}^s \tilde{r}_{t+i}, \end{aligned} \tag{33}$$

where  $\tilde{C}_{t,i} = C_{t,i} - \bar{C}$  and  $\tilde{r}_{t+i} = r_{t+i} - \bar{r}$ . This can also be written as

$$\begin{aligned} \hat{C}_{t,i} &= \hat{E}_{t,i} \hat{C}_{t+1,i} - \hat{E}_{t,i} \hat{r}_{t+1}, \text{ where} \\ \hat{C}_{t,i} &= \frac{C_{t,i} - \bar{C}}{\bar{C}} \text{ and } \hat{r}_{t+1} = \frac{r_{t+1} - \bar{r}}{\bar{r}}, \end{aligned}$$

which yields

$$\hat{C}_{t,i} = \hat{E}_{t,i} \hat{C}_{t+s,i} - \hat{E}_{t,i} \sum_{i=1}^s \hat{r}_{t+i},$$

where we have used  $\beta^{-1} = \bar{r}$ .

Combining (33) with the linearized budget constraint in expectational form we get:

$$\begin{aligned} 0 &= \tilde{Y}_{t,i} - \tilde{C}_{t,i} - \tilde{G}_{t,i} + \sum_{s=1}^{\infty} \beta^s \hat{E}_{t,i} (\tilde{Y}_{t+s,i} - \tilde{G}_{t+s,i}) \\ &\quad - \sum_{s=1}^{\infty} \beta^s \tilde{C}_{t,i} - \beta \bar{C} \sum_{s=1}^{\infty} \beta^s \hat{E}_{t,i} \sum_{i=1}^s \tilde{r}_{t+i}. \end{aligned}$$

This yields the consumption function for consumer  $i$

$$\begin{aligned}\tilde{C}_{t,i} &= (1 - \beta)[\tilde{Y}_{t,i} - \tilde{G}_{t,i} + \sum_{s=1}^{\infty} \beta^s \hat{E}_{t,i}(\tilde{Y}_{t+s,i} - \tilde{G}_{t+s,i})] \\ &\quad - \beta \bar{C} \hat{E}_{t,i} \sum_{s=1}^{\infty} \beta^s \tilde{r}_{t+s}.\end{aligned}$$

This can also be written in proportional form yielding

$$\begin{aligned}\hat{C}_t &= (1 - \beta) \left[ \frac{\hat{Y}_t}{(\bar{C}/\bar{Y})} - \frac{\hat{G}_t}{(\bar{C}/\bar{G})} + \sum_{s=1}^{\infty} \beta^s \hat{E}_t \left( \frac{\hat{Y}_{t+s}}{(\bar{C}/\bar{Y})} - \frac{\hat{G}_{t+s}}{(\bar{C}/\bar{G})} \right) \right] \\ &\quad - \hat{E}_t \sum_{s=1}^{\infty} \beta^s \hat{r}_{t+s},\end{aligned}$$

which is (7) making use of the representative agent assumption.

The market clearing condition is

$$Y_t = C_t + G_t + \frac{\psi}{2}(\pi_t - \pi^*)^2$$

which at the targeted steady state  $\pi_t = \pi^*$  is

$$\bar{Y} = \bar{C} + \bar{G}$$

It follows that the linear approximation around the targeted steady state is

$$\begin{aligned}\hat{Y}_t &= (1 - \bar{g})\hat{C}_t + \bar{g}\hat{G}_t, \\ \bar{g} &\equiv \frac{\bar{G}}{\bar{Y}} \text{ and } \frac{\bar{C}}{\bar{Y}} = 1 - \bar{g}.\end{aligned}$$

We thus have

$$\begin{aligned}\hat{C}_t &= (1 - \beta)(1 - \bar{g})^{-1}\hat{Y}_t + (1 - \beta)(1 - \bar{g})^{-1} \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{Y}_{t+s} \\ &\quad - (1 - \beta)\bar{g}(1 - \bar{g})^{-1}\hat{G}_t - (1 - \beta)\bar{g}(1 - \bar{g})^{-1} \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{G}_{t+s} \\ &\quad - \beta \hat{R}_t - \beta \hat{E}_t \sum_{s=1}^{\infty} \beta^s \hat{R}_{t+s} + \hat{E}_t \sum_{s=1}^{\infty} \beta^s \hat{\pi}_{t+s}.\end{aligned}\tag{34}$$

For the contemporaneous interest rate rule  $\hat{R}_t = \chi_\pi \hat{\pi}_t + \chi_Y \hat{Y}_t$  we have

$$\begin{aligned} \hat{C}_t &= ((1 - \beta)(1 - \bar{g})^{-1} - \beta\chi_Y) \hat{Y}_t + ((1 - \beta)(1 - \bar{g})^{-1} - \beta\chi_Y) \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{Y}_{t+s} \\ &\quad - \beta\chi_\pi \hat{\pi}_t + (1 - \beta\chi_\pi) \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{\pi}_{t+s} \\ &\quad - (1 - \beta)\bar{g}(1 - \bar{g})^{-1} \hat{G}_t - (1 - \beta)\bar{g}(1 - \bar{g})^{-1} \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{G}_{t+s} \end{aligned} \quad (35)$$

## Firms

As in the text

$$\begin{aligned} (1 - \tau)(1 - \theta)\bar{Y} + \bar{S}\bar{Y}\theta &= 0, \text{ or} \\ (1 - \tau)(1 - \theta) + \bar{S}\theta &= 0 \end{aligned}$$

We need to linearize around steady state  $\bar{Y}, \bar{S}, \pi^*, \bar{Q}$  where  $\bar{Q}$  is the steady state value of  $Q_{t,t+1}$ . Note that  $\bar{Q} = \beta/\pi^*$ .

It is useful to define the mark-up  $\mu$  by equation (11). In the steady state  $\mu = \theta(\theta - 1)^{-1}$ . Log-linearizing (11) gives

$$\hat{\mu}_t = -(\theta - 1)^{-1} \hat{\theta}_t.$$

From above the mean real marginal cost is

$$\bar{S} = \frac{(\theta - 1)(1 - \tau)}{\theta} = (1 - \tau)\mu^{-1}.$$

Next, we linearize (9) and obtain

$$\begin{aligned} 0 &= (1 - \tau)(1 - \theta)\tilde{Y}_t - (1 - \tau)(1 - \theta)\theta\bar{Y} \left( \frac{P_{t,j}}{P_t} - 1 \right) - (1 - \tau)\bar{Y}\tilde{\theta}_t + \\ &\quad \theta\bar{Y}\tilde{S}_{t,j} + \bar{S}\theta\tilde{Y}_t - \bar{S}\bar{Y}\theta(1 + \theta) \left( \frac{P_{t,j}}{P_t} - 1 \right) + \bar{S}\bar{Y}\tilde{\theta}_t - \\ &\quad \pi^*\psi \left( \frac{P_{t,j}}{P_{t-1,j}} - \pi^* \right) + (\pi^*)^2 \hat{E}_{t,j} \left[ \bar{Q}\psi \left( \frac{P_{t+1,j}}{P_{t,j}} - \pi^* \right) \right]. \end{aligned}$$

where  $\tilde{\theta}_t = \theta_t - \theta$ ,  $\tilde{Y}_t = Y_t - \bar{Y}$ , etc. Also, to the first order

$$\frac{P_{t+1,j}}{P_{t,j}} - 1 = \tilde{p}_{t+1,j} - \tilde{p}_{t,j},$$

where  $\tilde{p}_t \equiv \ln P_t - (\pi^* - 1)t$  and  $\tilde{p}_{t,j} \equiv \ln P_{t,j} - (\pi^* - 1)t$ . Note that  $(1 - \tau)(1 - \theta)\tilde{Y}_t = \bar{S}\tilde{\theta}_t$ , so these terms cancel. We must also take into account that  $S_{t,j}$  depends on endogenous variables. Write (10) in the form

$$\alpha A_t^{1/\alpha} Y_t^{(\alpha-1)/\alpha} \left( \frac{P_{t,j}}{P_t} \right)^{-\theta_t(\alpha-1)/\alpha} S_{t,j} = w_t$$

which is linearized:

$$\begin{aligned} \tilde{w}_t = & \alpha A^{1/\alpha} Y^{(\alpha-1)/\alpha} \tilde{S}_{t,j} + A^{1/\alpha-1} Y^{(\alpha-1)/\alpha} \bar{S} \tilde{A}_t + \alpha A^{1/\alpha} Y^{-1/\alpha} \left( \frac{\alpha-1}{\alpha} \right) \bar{S} \tilde{Y}_t \\ & + \alpha A^{1/\alpha} Y^{(\alpha-1)/\alpha} \bar{S} \left( \frac{-\theta(\alpha-1)}{\alpha} \right) \left( \frac{P_{t,j}}{P_t} - 1 \right). \end{aligned}$$

Solve for  $\tilde{S}_{t,j}$  and use the approximation  $\frac{P_{t,j}}{P_t} - 1 = \tilde{p}_{t,j} - \tilde{p}_t$  from above to get

$$\begin{aligned} \tilde{S}_{t,j} = & \tilde{w}_t / (\alpha A^{1/\alpha} Y^{(\alpha-1)/\alpha}) - A^{-1} \bar{S} \alpha^{-1} \tilde{A}_t - \left( \frac{\alpha-1}{\alpha} \right) \bar{S} Y^{-1} \tilde{Y}_t \quad (36) \\ & - \bar{S} \left( \frac{-\theta(\alpha-1)}{\alpha} \right) (\tilde{p}_{t,j} - \tilde{p}_t). \end{aligned}$$

It follows that

$$\begin{aligned} 0 = & -(1 - \tau)\tilde{\theta}_t + \theta \left[ \bar{S}\tilde{w}_t - \bar{S}\alpha^{-1}\tilde{A}_t - \left( \frac{\alpha-1}{\alpha} \right) \bar{S}\tilde{Y}_t \right] \\ & - \bar{S}\theta \left[ 1 - \frac{\theta(\alpha-1)}{\alpha} \right] (\tilde{p}_{t,j} - \tilde{p}_t) + \bar{S}\tilde{\theta}_t - \\ & \pi^* \bar{Y}^{-1} \psi (\tilde{p}_{t,j} - \tilde{p}_{t-1,j}) + \hat{E}_{t,j} [\bar{Q}\bar{Y}^{-1} (\pi^*)^2 \psi (\tilde{p}_{t+1,j} - \tilde{p}_{t,j})]. \end{aligned}$$

Then combine the terms involving  $\tilde{p}_{t,j} - \tilde{p}_t$  and rearrange the coefficients using the steady state relations. Also combine the terms involving  $\tilde{\theta}_t$  and use the log-linearization between  $\hat{\mu}_t$  and  $\hat{\theta}_t$ . This yields the result

$$\tilde{p}_{t,j} - \tilde{p}_{t-1,j} = \beta \hat{E}_{t,j} (\tilde{p}_{t+1,j} - \tilde{p}_{t,j}) + \frac{\bar{\omega}}{\bar{\psi}} (\tilde{p}_t - \tilde{p}_{t,j}) + \frac{\theta \bar{Y} \bar{S}}{\bar{\psi}} [\hat{\mu}_t - \alpha^{-1} \tilde{A}_t - \left( \frac{\alpha-1}{\alpha} \right) \tilde{Y}_t + \tilde{w}_t]. \quad (37)$$

where  $\bar{\omega} = \theta \bar{Y} \bar{S} (1 - \theta(\alpha-1)/\alpha)$  and  $\bar{\psi} = \psi \pi^*$ .

Here

$$\hat{\mu}_t = \frac{\mu_t - \mu}{\mu}.$$



Next, we use the back-shift operator technique on (37) (see pp. 393-5 of Sargent (1987)).<sup>41</sup> Taking expectations  $\hat{E}_{t,j}$  of (37) and rearranging we get

$$\begin{aligned} & \left[ 1 - \left( 1 + \beta^{-1} + \frac{\bar{\omega}}{\beta\bar{\psi}} \right) B + \beta^{-1}B^2 \right] \hat{E}_{t,j}\tilde{p}_{t+1,j} \\ &= \hat{E}_{t,j} \left[ -\frac{\bar{\omega}}{\beta\bar{\psi}}\tilde{p}_t - \frac{\theta\bar{Y}\bar{S}}{\beta\bar{\psi}}(\hat{\mu}_t - \alpha^{-1}\hat{A}_t - \left(\frac{\alpha-1}{\alpha}\right)\hat{Y}_t + \hat{w}_t) \right]. \end{aligned}$$

The quadratic in  $B$  can be factored into the product  $(1-\gamma_1B)(1-\gamma_2B)$  with roots  $0 < \gamma_1 < 1 < \gamma_2$  satisfying

$$\gamma_1\gamma_2 = \beta^{-1} \text{ and } \gamma_1 + \gamma_2 = \beta^{-1}(1 + \beta + \bar{\omega}\bar{\psi}^{-1}).$$

We write

$$\begin{aligned} & (1-\gamma_1B)(1-\gamma_2B)E_{t,j}\tilde{p}_{t+1,j} \\ &= \hat{E}_{t,j} \left[ -\frac{\bar{\omega}}{\beta\bar{\psi}}\tilde{p}_t - \frac{\theta\bar{Y}\bar{S}}{\beta\bar{\psi}}(\hat{\mu}_t - \alpha^{-1}\hat{A}_t - \left(\frac{\alpha-1}{\alpha}\right)\hat{Y}_t + \hat{w}_t) \right] \end{aligned}$$

or

$$\begin{aligned} & (B^{-1} - \gamma_1)(B^{-1} - \gamma_2)E_{t,j}\tilde{p}_{t-1,j} \\ &= \hat{E}_{t,j} \left[ -\frac{\bar{\omega}}{\beta\bar{\psi}}\tilde{p}_t - \frac{\theta\bar{Y}\bar{S}}{\beta\bar{\psi}}(\hat{\mu}_t - \alpha^{-1}\hat{A}_t - \left(\frac{\alpha-1}{\alpha}\right)\hat{Y}_t + \hat{w}_t) \right]. \end{aligned}$$

Operating on both sides by  $(B^{-1} - \gamma_2)^{-1}$  we get

$$\begin{aligned} & (B^{-1} - \gamma_1)E_{t,j}\tilde{p}_{t-1,j} \\ &= \frac{1}{(B^{-1} - \gamma_2)}\hat{E}_{t,j} \left[ -\frac{\bar{\omega}}{\beta\bar{\psi}}\tilde{p}_t - \frac{\theta\bar{Y}\bar{S}}{\beta\bar{\psi}}(\hat{\mu}_t - \alpha^{-1}\hat{A}_t - \left(\frac{\alpha-1}{\alpha}\right)\hat{Y}_t + \hat{w}_t) \right] \\ &= \frac{\gamma_2^{-1}}{(1 - \gamma_2^{-1}B^{-1})}\hat{E}_{t,j} \left[ \frac{\omega}{\beta\bar{\psi}}\tilde{p}_t + \frac{\theta\bar{Y}\bar{S}}{\beta\bar{\psi}}(\hat{\mu}_t - \alpha^{-1}\hat{A}_t - \left(\frac{\alpha-1}{\alpha}\right)\hat{Y}_t + \hat{w}_t) \right]. \end{aligned}$$

Writing  $(1 - \gamma_2^{-1}B^{-1})^{-1} = 1 + \gamma_2^{-1}B^{-1} + \gamma_2^{-2}B^{-2} + \dots$  and also using  $\gamma_1\gamma_2 = \beta^{-1}$  we obtain

$$\begin{aligned} \tilde{p}_{t,j} &= \gamma_1\tilde{p}_{t-1,j} + \\ & \frac{\gamma_1}{\bar{\psi}} \left( \sum_{s=0}^{\infty} \gamma_2^{-s} \hat{E}_{t,j} \left[ \bar{\omega}\tilde{p}_{t+s} + \theta\bar{Y}\bar{S}(\hat{\mu}_t - \alpha^{-1}\hat{A}_t - \left(\frac{\alpha-1}{\alpha}\right)\hat{Y}_t + \hat{w}_t) \right] \right). \end{aligned} \tag{38}$$

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<sup>41</sup>where  $B^{-1}E_{t-1}x_{t+j} = E_{t-1}x_{t+j+1}$ . As emphasized by Sargent, it is legitimate to operate on both sides of an equation by polynomials involving non-positive powers of  $B$ .

as the evolution of the optimal price of firm  $j$ .

We now define  $\tilde{\pi}_t = \tilde{p}_t - \tilde{p}_{t-1}$ . Note that  $\tilde{\pi}_t$  is the rate of inflation net of the target rate  $\pi^*$ . Using

$$\sum_{s=0}^{\infty} \gamma_2^{-s} \hat{E}_{t,j} \tilde{\pi}_{t+s} = \sum_{s=0}^{\infty} \gamma_2^{-s} \hat{E}_{t,j} \tilde{p}_{t+s} - \sum_{s=0}^{\infty} \gamma_2^{-s} \hat{E}_{t,j} \tilde{p}_{t+s-1}$$

and

$$\sum_{s=0}^{\infty} \gamma_2^{-s} \hat{E}_{t,j} \tilde{p}_{t+s-1} = \tilde{p}_{t-1} + \gamma_2^{-1} \sum_{s=0}^{\infty} \gamma_2^{-s} \hat{E}_{t,j} \tilde{p}_{t+s},$$

we obtain

$$\sum_{s=0}^{\infty} \gamma_2^{-s} \hat{E}_{t,j} \tilde{p}_{t+s} = (1 - \gamma_2^{-1})^{-1} \sum_{s=0}^{\infty} \gamma_2^{-s} \hat{E}_{t,j} \tilde{\pi}_{t+s} + (1 - \gamma_2^{-1})^{-1} \tilde{p}_{t-1}.$$

Plugging into (38) we obtain

$$\begin{aligned} \tilde{p}_{t,j} &= \gamma_1 \tilde{p}_{t-1,j} + \frac{\gamma_1 \bar{\omega}}{\bar{\psi}(1 - \beta\gamma_1)} \tilde{p}_{t-1} + \frac{\gamma_1 \bar{\omega}}{\bar{\psi}(1 - \beta\gamma_1)} \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_{t,j} \tilde{\pi}_{t+s} + \\ &\quad \frac{\gamma_1 \theta \bar{Y} \bar{S}}{\bar{\psi}} \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_{t,j} (\hat{\mu}_{t+s} - \alpha^{-1} \hat{A}_{t+s} - \left(\frac{\alpha-1}{\alpha}\right) \hat{Y}_{t+s} + \hat{w}_{t+s}). \end{aligned}$$

Subtracting  $\tilde{p}_{t-1,j}$  from both sides and collecting terms, and imposing the representative agent assumption, the coefficient of  $\tilde{p}_{t-1,j}$  becomes

$$\begin{aligned} (\gamma_1 - 1) + \frac{\gamma_1 \bar{\omega}}{\bar{\psi}(1 - \beta\gamma_1)} &= \frac{(\gamma_1 - 1)(1 - \beta\gamma_1) + (\bar{\omega}/\bar{\psi})\gamma_1}{1 - \beta\gamma_1} \\ &= \frac{\gamma_1(\bar{\omega}/\bar{\psi} + \beta + 1 - \beta\gamma_1) - 1}{1 - \beta\gamma_1} = \frac{\gamma_1\beta\gamma_2 - 1}{1 - \beta\gamma_1} = 0. \end{aligned}$$

Note that

$$\gamma_1 = 1 - \frac{\gamma_1 \bar{\omega}}{\bar{\psi}(1 - \beta\gamma_1)}. \quad (39)$$

Using the representative agent assumption the resulting equation becomes

$$\begin{aligned} \tilde{\pi}_t &= \frac{\gamma_1 \bar{\omega}}{\bar{\psi}(1 - \beta\gamma_1)} \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t \tilde{\pi}_{t+s} + \\ &\quad \frac{\gamma_1 \theta \bar{Y} \bar{S}}{\bar{\psi}} \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t (\hat{\mu}_{t+s} - \alpha^{-1} \hat{A}_{t+s} - \left(\frac{\alpha-1}{\alpha}\right) \hat{Y}_{t+s} + \hat{w}_{t+s}). \end{aligned} \quad (40)$$

Next use the equation

$$w_t = \gamma \left( \frac{Y_t}{A_t} \right)^{\varepsilon/\alpha} C_t$$

to obtain

$$\hat{w}_t = \frac{\varepsilon}{\alpha} (\hat{Y}_t - \hat{A}_t) + (1 - \bar{g})^{-1} \hat{Y}_t - \frac{\bar{g}}{1 - \bar{g}} \hat{G}_t. \quad (41)$$

At the targeted steady state  $\bar{Y} = \bar{C} + \bar{G}$  has the linear approximation

$$\hat{Y}_t = (1 - \bar{g}) \hat{C}_t + \bar{g} \hat{G}_t,$$

where  $\bar{g} \equiv \frac{\bar{G}}{\bar{Y}}$  and  $\frac{\bar{C}}{\bar{Y}} = 1 - \bar{g}$ . We get

$$\begin{aligned} \tilde{\pi}_t = & \frac{\gamma_1 \bar{\omega}}{\bar{\psi}(1 - \beta\gamma_1)} \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t \tilde{\pi}_{t+s} + \frac{\gamma_1 \theta \bar{Y} \bar{S}}{\bar{\psi}} \left[ \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t [\hat{\mu}_{t+s} + \right. \\ & \left. \left( \frac{-1 - \varepsilon}{\alpha} \right) \hat{A}_{t+s} + \left( \frac{1 - \alpha}{\alpha} + \frac{\varepsilon}{\alpha} + (1 - \bar{g})^{-1} \right) \hat{Y}_{t+s} - \frac{\bar{g}}{1 - \bar{g}} \hat{G}_{t+s} \right]. \end{aligned} \quad (42)$$

Letting  $\hat{\pi}_t \equiv \tilde{\pi}_t / \pi^*$  and substituting into (40) we finally obtain the Phillips curve

$$\begin{aligned} \hat{\pi}_t = & a_1 \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{\pi}_{t+s} + a_2 \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{Y}_{t+s} - a_3 \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{A}_{t+s} \\ & + a_4 \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{G}_{t+s} + a_5 \sum_{s=0}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{\mu}_{t+s}. \end{aligned} \quad (43)$$

where the coefficients  $a_i$  are defined as:

$$\begin{aligned} a_1 &= \frac{\bar{\omega} \gamma_1}{\bar{\psi}(1 - \beta\gamma_1)}; a_2 = \frac{\gamma_1 \theta \bar{Y} \bar{S}}{\bar{\psi} \pi^*} \left( \frac{1 - \alpha}{\alpha} + \frac{\varepsilon}{\alpha} + (1 - \bar{g})^{-1} \right); \\ a_3 &= \frac{-\gamma_1 \theta \bar{Y} \bar{S}}{\bar{\psi} \pi^*} \left( \frac{1 + \varepsilon}{\alpha} \right); a_4 = \frac{-\gamma_1 \theta \bar{Y} \bar{S}}{\bar{\psi} \pi^*} \frac{\bar{g}}{1 - \bar{g}}; a_5 = \frac{\gamma_1 \theta \bar{Y} \bar{S}}{\bar{\psi} \pi^*}. \end{aligned}$$

Note that by (39) we have  $a_1 = 1 - \gamma_1$ . Rearrange the above equation to get (15).

### Temporary equilibrium

The IS curve under the contemporaneous interest-rate rule is obtained from combining the consumption function (35) with the market-clearing equation  $\hat{Y}_t = (1 - \bar{g})\hat{C}_t + \bar{g}\hat{G}_t$ . This yields

$$\begin{aligned}
& \beta(1 - \bar{g})\chi_\pi \hat{\pi}_t + (\beta + \beta(1 - \bar{g})\chi_Y) \hat{Y}_t \\
= & [(1 - \bar{g})(1 - \beta\chi_\pi)] \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{\pi}_{t+s} + [(1 - \beta) - (1 - \bar{g})\beta\chi_Y] \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{Y}_{t+s} \\
& + \bar{g}\hat{G}_t - (1 - \beta)\bar{g} \sum_{s=0}^{\infty} \beta^s \hat{E}_t \hat{G}_{t+s} \tag{44}
\end{aligned}$$

Henceforth, we use the following short-hand notation

$$\begin{aligned}
b_1 & \equiv (1 - \bar{g})(1 - \beta\chi_\pi), \\
b_2 & \equiv (1 - \beta) - (1 - \bar{g})\beta\chi_Y.
\end{aligned}$$

Let us now write the price setting equation (15) and the demand equation (44) (under subjective expectations) in matrix form. Let

$$M = \begin{pmatrix} 1 - a_1 & -a_2 \\ \beta(1 - \bar{g})\chi_\pi & \beta + \beta(1 - \bar{g})\chi_Y \end{pmatrix} \tag{45}$$

Then

$$\begin{aligned}
M \begin{pmatrix} \hat{\pi}_t \\ \hat{Y}_t \end{pmatrix} &= \sum_{s=1}^{\infty} \begin{pmatrix} a_1(\beta\gamma_1)^s & a_2(\beta\gamma_1)^s \\ b_1\beta^s & b_2\beta^s \end{pmatrix} \begin{pmatrix} \hat{E}_t \hat{\pi}_{t+s} \\ \hat{E}_t \hat{Y}_{t+s} \end{pmatrix} + \begin{pmatrix} -a_4 \\ \beta\bar{g} \end{pmatrix} \hat{G}_t + \\
& \sum_{s=0}^{\infty} \begin{pmatrix} -a_3(\beta\gamma_1)^s & a_5(\beta\gamma_1)^s \\ 0 & 0 \end{pmatrix} \begin{pmatrix} \hat{E}_t \hat{A}_{t+s} \\ \hat{E}_t \hat{\mu}_{t+s} \end{pmatrix} + \sum_{s=1}^{\infty} \begin{pmatrix} -a_4(\beta\gamma_1)^s \\ -(1 - \beta)\bar{g}\beta^s \end{pmatrix} \hat{E}_t \hat{G}_{t+s}.
\end{aligned}$$

For the shock terms above we get

$$\begin{aligned}
& \sum_{s=0}^{\infty} \begin{pmatrix} -a_3(\beta\gamma_1)^s & a_5(\beta\gamma_1)^s \\ 0 & 0 \end{pmatrix} \begin{pmatrix} \rho_A^s \hat{A}_t \\ \rho_\mu^s \hat{\mu}_t \end{pmatrix} \\
&= \begin{pmatrix} \sum_{s=0}^{\infty} \left( -a_3(\rho_A\beta\gamma_1)^s \hat{A}_t + a_5(\rho_\mu\beta\gamma_1)^s \hat{\mu}_t \right) \\ 0 \end{pmatrix} \\
&= \begin{pmatrix} \sum_{s=0}^{\infty} \left( -a_3(\rho_A\beta\gamma_1)^s \hat{A}_t + a_5(\rho_\mu\beta\gamma_1)^s \hat{\mu}_t \right) \\ 0 \end{pmatrix} \\
&= \begin{pmatrix} -a_3(1 - \rho_A\beta\gamma_1)^{-1} \hat{A}_t + a_5(1 - \rho_\mu\beta\gamma_1)^{-1} \hat{\mu}_t \\ 0 \end{pmatrix}.
\end{aligned}$$

Consider a change in government spending that is known to be temporary. We assume that initially, at  $t = 0$ , we are in the steady state corresponding to  $G = \bar{G}$ , and consider the following policy experiment, assumed fully credible and announced at the start of period 1:

$$G_t = \tau_t = \begin{cases} \bar{G}', & t = 1, \dots, T \\ \bar{G}, & t \geq T + 1, \end{cases} \quad (46)$$

i.e., government spending and taxes are changed in period  $t = 1$  and this change is reversed at a later period  $T + 1$ . Thus, the experiment is one where the policy change is announced in period 1 to take place in the future for a fixed number  $T$  of periods. Denote the change in government spending by  $\Delta G (= \bar{G}' - \bar{G})$  so that

$$\hat{G}_t = \begin{cases} \frac{\Delta G}{\bar{G}}, & t = 1, \dots, T \\ 0, & t \geq T + 1. \end{cases}$$

We first consider the evolution of the learning economy during the period when the policy increase is in effect i.e. for periods  $t = 1, \dots, T$ . Then we

have

$$\begin{aligned} \sum_{s=1}^{\infty} \begin{pmatrix} -a_4(\beta\gamma_1)^s \\ -(1-\beta)\bar{g}\beta^s \end{pmatrix} \hat{E}_t \hat{G}_{t+s} &= \sum_{s=1}^{T-t} \begin{pmatrix} -a_4(\beta\gamma_1)^s \\ -(1-\beta)\bar{g}\beta^s \end{pmatrix} \frac{\Delta G}{\bar{G}} = \\ & \begin{pmatrix} -a_4 \sum_{s=1}^{T-t} (\beta\gamma_1)^s \\ -(1-\beta)\bar{g} \sum_{s=1}^{T-t} \beta^s \end{pmatrix} \frac{\Delta G}{\bar{G}} = \begin{pmatrix} -a_4\beta\gamma_1 \frac{1-(\beta\gamma_1)^{T-t}}{1-\beta\gamma_1} \\ -\beta(1-\beta)\bar{g} \frac{1-\beta^{T-t}}{1-\beta} \end{pmatrix} \frac{\Delta G}{\bar{G}}. \end{aligned}$$

Write the final form of the model when agents are learning in the following matrix form (which is true for  $1 \leq t \leq T$ )

$$\begin{aligned} M \begin{pmatrix} \hat{\pi}_t \\ \hat{Y}_t \end{pmatrix} &= \sum_{s=1}^{\infty} \begin{pmatrix} a_1(\beta\gamma_1)^s & a_2(\beta\gamma_1)^s \\ b_1\beta^s & b_2\beta^s \end{pmatrix} \begin{pmatrix} \hat{E}_t \hat{\pi}_{t+s} \\ \hat{E}_t \hat{Y}_{t+s} \end{pmatrix} + \\ & \begin{pmatrix} -a_3(1-\rho_A\beta\gamma_1)^{-1}\hat{A}_t + a_5(1-\rho_\mu\beta\gamma_1)^{-1}\hat{\mu}_t \\ 0 \end{pmatrix} + \\ & \begin{pmatrix} -a_4\beta\gamma_1 \frac{1-(\beta\gamma_1)^{T-t}}{1-\beta\gamma_1} \\ -\beta(1-\beta)\bar{g} \frac{1-\beta^{T-t}}{1-\beta} \end{pmatrix} \frac{\Delta G}{\bar{G}} + \begin{pmatrix} -a_4 \\ \beta\bar{g} \end{pmatrix} \frac{\Delta G}{\bar{G}}. \end{aligned} \quad (47)$$

Note that when  $t > T$ , the model evolution under learning is governed by

$$\begin{aligned} M \begin{pmatrix} \hat{\pi}_t \\ \hat{Y}_t \end{pmatrix} &= \sum_{s=1}^{\infty} \begin{pmatrix} a_1(\beta\gamma_1)^s & a_2(\beta\gamma_1)^s \\ b_1\beta^s & b_2\beta^s \end{pmatrix} \begin{pmatrix} \hat{E}_t \hat{\pi}_{t+s} \\ \hat{E}_t \hat{Y}_{t+s} \end{pmatrix} + \\ & \begin{pmatrix} -a_3(1-\rho_A\beta\gamma_1)^{-1}\hat{A}_t + a_5(1-\rho_\mu\beta\gamma_1)^{-1}\hat{\mu}_t \\ 0 \end{pmatrix}. \end{aligned} \quad (48)$$

since  $\hat{G}_t = 0$  when  $t > T$ .

We consider PLMs of the same form as the standard minimal state variable (MSV) solution of the economy. One can solve the model under RE with fixed  $G_t$  to get a stochastic steady state of the form

$$\begin{aligned} \hat{\pi}_t &= f_\pi + d_{\pi A}\hat{A}_t + d_{\pi\mu}\hat{\mu}_t \\ \hat{Y}_t &= f_Y + d_{Y A}\hat{A}_t + d_{Y\mu}\hat{\mu}_t \end{aligned}$$

where  $\hat{A}_t, \hat{\mu}_t$  are observable processes (with known coefficients) given by (20) and (21). These can be used to construct forecasts  $\hat{E}_t \pi_{t+s}$  and  $\hat{E}_t \hat{Y}_{t+s}$  which

are then inserted into the model (47) to govern the evolution of the economy for the first  $T$  periods (and by (48) for periods after  $T$ ).

Using the MSV form of the PLM we get

$$\begin{aligned}\hat{E}_t \hat{\pi}_{t+s} &= f_\pi + d_{\pi A} \hat{E}_t \hat{A}_{t+s} + d_{\pi \mu} \hat{E}_t \hat{\mu}_{t+s} \\ &= f_\pi + d_{\pi A} \rho_A^s \hat{A}_t + d_{\pi \mu} \rho_\mu^s \hat{\mu}_t.\end{aligned}$$

Similarly,

$$\hat{E}_t \hat{Y}_{t+s} = f_Y + d_{YA} \rho_A^s \hat{A}_t + d_{Y\mu} \rho_\mu^s \hat{\mu}_t.$$

Consider the term below that needs to be evaluated in the first row of (47)

$$\begin{aligned}& a_1 \sum_{s=1}^{\infty} (\beta \gamma_1)^s \hat{E}_t \hat{\pi}_{t+s} + a_2 \sum_{s=1}^{\infty} (\beta \gamma_1)^s \hat{E}_t \hat{Y}_{t+s} \\ &= a_1 \sum_{s=1}^{\infty} (\beta \gamma_1)^s (f_\pi + d_{\pi A} \hat{E}_t \hat{A}_{t+s} + d_{\pi \mu} \hat{E}_t \hat{\mu}_{t+s}) \\ & \quad + a_2 \sum_{s=1}^{\infty} (\beta \gamma_1)^s (f_Y + d_{YA} \rho_A^s \hat{A}_t + d_{Y\mu} \rho_\mu^s \hat{\mu}_t) \\ &= (a_1 f_\pi + a_2 f_Y) \frac{\beta \gamma_1}{1 - \beta \gamma_1} + (a_1 d_{\pi A} + a_2 d_{YA}) \frac{\rho_A \beta \gamma_1}{1 - \rho_A \beta \gamma_1} \hat{A}_t \\ & \quad + (a_1 d_{\pi \mu} + a_2 d_{Y\mu}) \frac{\rho_\mu \beta \gamma_1}{1 - \rho_\mu \beta \gamma_1} \hat{\mu}_t.\end{aligned}$$

Similarly consider the term below that is required to be evaluated in the second row of (47)

$$\begin{aligned}& b_1 \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{\pi}_{t+s} + b_2 \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{Y}_{t+s} \\ &= b_1 \sum_{s=1}^{\infty} \beta^s (f_\pi + d_{\pi A} \hat{E}_t \hat{A}_{t+s} + d_{\pi \mu} \hat{E}_t \hat{\mu}_{t+s}) \\ & \quad + a_2 \sum_{s=1}^{\infty} (\beta \gamma_1)^s (f_Y + d_{YA} \rho_A^s \hat{A}_t + d_{Y\mu} \rho_\mu^s \hat{\mu}_t) \\ &= (b_1 f_\pi + b_2 f_Y) \frac{\beta}{1 - \beta} + (b_1 d_{\pi A} + b_2 d_{YA}) \frac{\rho_A \beta}{1 - \rho_A \beta} \hat{A}_t \\ & \quad + (b_1 d_{\pi \mu} + b_2 d_{Y\mu}) \frac{\rho_\mu \beta}{1 - \rho_\mu \beta} \hat{\mu}_t.\end{aligned}$$

We can obtain a mapping from the PLM to the ALM from (47) for the first  $T$  periods (and from (48) for periods after  $T$ ).

We now combine terms of the right hand side of (47). The first row on the right hand side of (47) is given by

$$\begin{aligned} & (a_1 f_\pi + a_2 f_Y) \frac{\beta \gamma_1}{1 - \beta \gamma_1} + (a_1 d_{\pi A} + a_2 d_{Y A}) \frac{\rho_A \beta \gamma_1}{1 - \rho_A \beta \gamma_1} \hat{A}_t \\ & + (a_1 d_{\pi \mu} + a_2 d_{Y \mu}) \frac{\rho_\mu \beta \gamma_1}{1 - \rho_\mu \beta \gamma_1} \hat{\mu}_t - a_3 (1 - \rho_A \beta \gamma_1)^{-1} \hat{A}_t \\ & + a_5 (1 - \rho_\mu \beta \gamma_1)^{-1} \hat{\mu}_t - a_4 (\beta \gamma_1 \frac{1 - (\beta \gamma_1)^{T-t}}{1 - \beta \gamma_1} + 1) \frac{\Delta G}{\bar{G}}. \end{aligned}$$

The second row on the right hand side of (47) is given by

$$\begin{aligned} & (b_1 f_\pi + b_2 f_Y) \frac{\beta}{1 - \beta} + (b_1 d_{\pi A} + b_2 d_{Y A}) \frac{\rho_A \beta}{1 - \rho_A \beta} \hat{A}_t \\ & + (b_1 d_{\pi \mu} + b_2 d_{Y \mu}) \frac{\rho_\mu \beta}{1 - \rho_\mu \beta} \hat{\mu}_t - \beta \bar{g} [(1 - \beta) \frac{1 - \beta^{T-t}}{1 - \beta} - 1] \frac{\Delta G}{\bar{G}}. \end{aligned}$$

This process gives us the mapping for the T-map as below.

We collect the terms for the intercept in preceding two equations. This gives two equations (49) and (50) to solve for the T-map for the intercept terms  $T_\pi, T_Y$  :

$$(1 - a_1) T_\pi - a_2 T_Y = (a_1 f_\pi + a_2 f_Y) \frac{\beta \gamma_1}{1 - \beta \gamma_1} - a_4 (\beta \gamma_1 \frac{1 - (\beta \gamma_1)^{T-t}}{1 - \beta \gamma_1} + 1) \frac{\Delta G}{\bar{G}}, \quad (49)$$

$$\begin{aligned} \beta(1 - \bar{g}) \chi_\pi T_\pi + (\beta + (1 - \bar{g}) \chi_Y) T_Y &= (b_1 f_\pi + b_2 f_Y) \frac{\beta}{1 - \beta} \\ &- \beta \bar{g} [(1 - \beta) \frac{1 - \beta^{T-t}}{1 - \beta} - 1] \frac{\Delta G}{\bar{G}}. \end{aligned} \quad (50)$$

Similarly, consider the terms involving  $\hat{A}_t$

$$(1 - a_1) T_{\pi A} - a_2 T_{Y A} = (a_1 d_{\pi A} + a_2 d_{Y A}) \frac{\rho_A \beta \gamma_1}{1 - \rho_A \beta \gamma_1} - a_3 (1 - \rho_A \beta \gamma_1)^{-1}, \quad (51)$$

$$\beta(1 - \bar{g}) \chi_\pi T_{\pi A} + (\beta + (1 - \bar{g}) \chi_Y) T_{Y A} = (b_1 d_{\pi A} + b_2 d_{Y A}) \frac{\rho_A \beta}{1 - \rho_A \beta}. \quad (52)$$



Equations (51) and (52) are solved for the coefficients  $T_{\pi A}$  and  $T_{YA}$ . Finally, consider terms involving  $\hat{\mu}_t$

$$(1 - a_1)T_{\pi\mu} - a_2T_{Y\mu} = (a_1d_{\pi\mu} + a_2d_{Y\mu})\frac{\rho_\mu\beta\gamma_1}{1 - \rho_\mu\beta\gamma_1} + a_5(1 - \rho_\mu\beta\gamma_1)^{-1}, \quad (53)$$

$$\beta(1 - \bar{g})\chi_\pi T_{\pi\mu} + (\beta + (1 - \bar{g})\chi_Y)T_{Y\mu} = (b_1d_{\pi\mu} + b_2d_{Y\mu})\frac{\rho_\mu\beta}{1 - \rho_\mu\beta}. \quad (54)$$

and equations (53)-(54) are solved for the coefficients  $T_{\pi\mu}$  and  $T_{Y\mu}$ .

These six equations (49), (50), (51), (52), (53), and (54) yield the mapping

$$(f_\pi, f_Y, d_{\pi A}, d_{YA}, d_{\pi\mu}, d_{Y\mu}) \rightarrow (T_\pi, T_Y, T_{\pi A}, T_{YA}, T_{\pi\mu}, T_{Y\mu})$$

from the PLM to the ALM in parameter space and the fixed points of the map correspond to the MSV REE solution. This is the T-mapping for periods  $1, \dots, T$ . For periods  $t > T$  the same equations, together with the requirement  $\Delta G = 0$ , give the T-map.

### RE Solution with policy change

We need to compute the RE solution when the fiscal policy changes. To compute the effect of policy changes under RE, the Euler equation approach seems preferable owing to its simplicity.<sup>42</sup> We, therefore, compute the Euler equations for this framework. We first consider the IS curve equation. Imposing symmetry in equation (5), we obtain

$$\frac{C_t - \bar{C}}{\bar{C}} = E_t\left(\frac{C_{t+1} - \bar{C}}{\bar{C}}\right) - E_t\left(\frac{r_{t+1} - \bar{r}}{\beta^{-1}}\right),$$

or in proportional deviation form

$$\hat{C}_t = E_t\hat{C}_{t+1} - E_t\hat{r}_{t+1}$$

where

$$\hat{r}_{t+1} = \frac{r_{t+1} - \bar{r}}{\bar{r}}; \bar{r} = \beta^{-1}.$$

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<sup>42</sup>Note that the effect of policy changes under RE in the New Keynesian model is easier to work out compared to the RBC model since the baseline New Keynesian framework does not have any lagged endogenous variables.

Then using (16), we obtain

$$\hat{Y}_t = E_t \hat{Y}_{t+1} - \frac{\bar{C}}{\bar{Y}} E_t \hat{r}_{t+1} + \frac{\bar{G}}{\bar{Y}} (\hat{G}_t - E_t \hat{G}_{t+1}) \quad (55)$$

as the IS curve in (proportional) deviation form. If we use the interest rate rule (19) in (55) above we obtain

$$(1 + \frac{\bar{C}}{\bar{Y}} \chi_Y) \hat{Y}_t + \frac{\bar{C}}{\bar{Y}} \chi_\pi \hat{\pi}_t = E_t \hat{Y}_{t+1} + \frac{\bar{C}}{\bar{Y}} E_t \hat{\pi}_{t+1} + \frac{\bar{G}}{\bar{Y}} (\hat{G}_t - E_t \hat{G}_{t+1}) \quad (56)$$

Since

$$\frac{\bar{C}}{\bar{Y}} = 1 - \frac{\bar{G}}{\bar{Y}} \equiv 1 - \bar{g},$$

we can rewrite (56) as

$$(1 + (1 - \bar{g}) \chi_Y) \hat{Y}_t + (1 - \bar{g}) \chi_\pi \hat{\pi}_t = E_t \hat{Y}_{t+1} + (1 - \bar{g}) E_t \hat{\pi}_{t+1} + \bar{g} (\hat{G}_t - E_t \hat{G}_{t+1}) \quad (57)$$

We now compute the one-step forward looking Phillips curve. Imposing symmetry, we obtain from (37)

$$\hat{\pi}_t = \beta E_t \hat{\pi}_{t+1} + \frac{\theta \bar{Y} \bar{S}}{\bar{\psi}} (\hat{\mu}_t - \alpha^{-1} \hat{A}_t - \left( \frac{\alpha - 1}{\alpha} \right) \hat{Y}_t + \hat{w}_t).$$

Substituting in (41)  $\hat{w}_t = \frac{\varepsilon}{\alpha} (\hat{Y}_t - \hat{A}_t) + (1 - \bar{g})^{-1} \hat{Y}_t - \frac{\bar{g}}{1 - \bar{g}} \hat{G}_t$  this becomes

$$\hat{\pi}_t = \beta E_t \hat{\pi}_{t+1} + \frac{\theta \bar{Y} \bar{S}}{\bar{\psi}} \left[ \left( \frac{1 + \varepsilon}{\alpha} + \frac{\bar{g}}{1 - \bar{g}} \right) \hat{Y}_t + (\hat{\mu}_t - \left( \frac{1 + \varepsilon}{\alpha} \right) \hat{A}_t) - \frac{\bar{g}}{1 - \bar{g}} \hat{G}_t \right]. \quad (58)$$

Writing (57) and (58) in matrix form we get<sup>43</sup>

$$\begin{aligned} & \begin{pmatrix} 1 & -\frac{\theta \bar{Y} \bar{S}}{\bar{\psi}} \left( \frac{1 + \varepsilon}{\alpha} + \frac{\bar{g}}{1 - \bar{g}} \right) \\ (1 - \bar{g}) \chi_\pi & 1 + (1 - \bar{g}) \chi_Y \end{pmatrix} \begin{pmatrix} \hat{\pi}_t \\ \hat{Y}_t \end{pmatrix} \\ &= \begin{pmatrix} \beta & 0 \\ 1 - \bar{g} & 1 \end{pmatrix} \begin{pmatrix} E_t \hat{\pi}_{t+1} \\ E_t \hat{Y}_{t+1} \end{pmatrix} + \begin{pmatrix} \frac{\theta \bar{Y} \bar{S}}{\bar{\psi}} & -\frac{(1 + \varepsilon) \theta \bar{Y} \bar{S}}{\alpha \bar{\psi}} \\ 0 & 0 \end{pmatrix} \begin{pmatrix} \hat{\mu}_t \\ \hat{A}_t \end{pmatrix} \\ &+ \begin{pmatrix} -\frac{\theta \bar{Y} \bar{S}}{\bar{\psi}} \frac{\bar{g}}{1 - \bar{g}} \hat{G}_t \\ \bar{g} (\hat{G}_t - E_t \hat{G}_{t+1}) \end{pmatrix}. \end{aligned}$$

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<sup>43</sup>Note that  $\frac{\theta \bar{Y} \bar{S}}{\bar{\psi}} = \frac{(\theta - 1) \bar{Y} (1 - \tau)}{\bar{\psi}}$  which is denoted by  $\xi$  (with  $\tau = 0$ ) in Eusepi-Preston (2010) and is set equal to 0.06 in footnote 11, p. 243, of their paper.

Inverting the matrix on the left hand side of the above system we can obtain the system

$$\begin{pmatrix} \hat{\pi}_t \\ \hat{Y}_t \end{pmatrix} = \Psi \begin{pmatrix} E_t \hat{\pi}_{t+1} \\ E_t \hat{Y}_{t+1} \end{pmatrix} + F \begin{pmatrix} \hat{\mu}_t \\ \hat{A}_t \end{pmatrix} + \Gamma \begin{pmatrix} -\frac{\theta \bar{Y} \bar{S}}{\psi} \frac{\bar{g}}{1-\bar{g}} \hat{G}_t \\ \bar{g} (\hat{G}_t - E_t \hat{G}_{t+1}) \end{pmatrix}, \quad (59)$$

which can be used to compute numerically the RE solution with the fiscal policy change. Thus, (59) gives the system under RE when the Taylor rule (19) is followed. We will be using this system to compute the RE solution when there is a change in government purchases (and a balanced budget).

We get

$$\begin{pmatrix} \hat{\pi}_t \\ \hat{Y}_t \end{pmatrix} = \sum_{i=0}^{\infty} \Psi^i \left( F E_t \begin{pmatrix} \hat{\mu}_{t+i} \\ \hat{A}_{t+i} \end{pmatrix} + \Gamma H_{t+i} \right), \text{ where}$$

$$H_t = \begin{pmatrix} -\frac{\theta \bar{Y} \bar{S}}{\psi} \frac{\bar{g}}{1-\bar{g}} \hat{G}_t \\ \bar{g} (\hat{G}_t - E_t \hat{G}_{t+1}) \end{pmatrix},$$

which can be written as

$$\begin{pmatrix} \hat{\pi}_t \\ \hat{Y}_t \end{pmatrix} = \sum_{i=0}^{\infty} \Psi^i F \begin{pmatrix} \rho_{\mu} & 0 \\ 0 & \rho_A \end{pmatrix}^i \begin{pmatrix} \hat{\mu}_t \\ \hat{A}_t \end{pmatrix} + \sum_{i=0}^{\infty} \Psi^i \Gamma H_{t+i}. \quad (60)$$

The first term on the right-hand side of (60) is the MSV solution when government spending is constant. It takes the form

$$\begin{pmatrix} \hat{\pi}_t \\ \hat{Y}_t \end{pmatrix}_{MSV} = \begin{pmatrix} \bar{d}_{\pi A} \\ \bar{d}_{Y A} \end{pmatrix} \hat{A}_t + \begin{pmatrix} \bar{d}_{\pi \mu} \\ \bar{d}_{Y \mu} \end{pmatrix} \hat{\mu}_t,$$

where

$$\begin{pmatrix} \bar{d}_{\pi A} \\ \bar{d}_{Y A} \end{pmatrix} = (M - N_A)^{-1} cons_A,$$

$$\begin{pmatrix} \bar{d}_{\pi \mu} \\ \bar{d}_{Y \mu} \end{pmatrix} = (M - N_{\mu})^{-1} cons_{\mu},$$

and

$$N_A = \begin{pmatrix} a_1 \frac{\rho_A \beta \gamma_1}{1 - \rho_A \beta \gamma_1} & a_2 \frac{\rho_A \beta \gamma_1}{1 - \rho_A \beta \gamma_1} \\ b_1 \frac{\rho_A \beta}{1 - \rho_A \beta} & b_2 \frac{\rho_A \beta}{1 - \rho_A \beta} \end{pmatrix}, \quad cons_A = \begin{pmatrix} -a_3 (1 - \rho_A \beta \gamma_1)^{-1} \\ 0 \end{pmatrix},$$

$$N_{\mu} = \begin{pmatrix} a_1 \frac{\rho_{\mu} \beta \gamma_1}{1 - \rho_{\mu} \beta \gamma_1} & a_2 \frac{\rho_{\mu} \beta \gamma_1}{1 - \rho_{\mu} \beta \gamma_1} \\ b_1 \frac{\rho_{\mu} \beta}{1 - \rho_{\mu} \beta} & b_2 \frac{\rho_{\mu} \beta}{1 - \rho_{\mu} \beta} \end{pmatrix}, \quad cons_{\mu} = \begin{pmatrix} a_5 (1 - \rho_{\mu} \beta \gamma_1)^{-1} \\ 0 \end{pmatrix}.$$

The second term gives the modification due to changes in government spending and it is calculated as follows. For  $t = 1$  we have

$$\begin{aligned} HRE_1 &\equiv \sum_{s=0}^{\infty} \Psi^s \Gamma H_{1+i} = \sum_{s=0}^{T-2} \Psi^s \Gamma \bar{H}_1 + \Psi^{T-1} \Gamma \bar{H}_2 \\ &= (1 - \Psi^{T-1})(1 - \Psi)^{-1} \bar{H}_1 + \Psi^{T-1} \Gamma \bar{H}_2, \text{ where} \\ \bar{H}_1 &= \begin{pmatrix} -\frac{\theta \bar{Y} \bar{S}}{\psi} \frac{\Delta G}{1-\bar{g}} \\ 0 \end{pmatrix} \text{ and } \bar{H}_2 = \begin{pmatrix} -\frac{\theta \bar{Y} \bar{S}}{\psi} \frac{\Delta G}{1-\bar{g}} \\ -\Delta G \end{pmatrix}. \end{aligned}$$

In general,

$$HRE_t = (1 - \Psi^{T-t})(1 - \Psi)^{-1} \bar{H}_1 + \Psi^{T-t} \Gamma \bar{H}_2$$

for  $t = 1, \dots, T-1$ . For  $t = T$  we have

$$HRE_T = \Gamma \bar{H}_2$$

and

$$HRE_t = \begin{pmatrix} 0 \\ 0 \end{pmatrix}$$

for  $t \geq T+1$ .

In total, the RE solution is the sum of the MSV solution with constant government spending plus the term  $HRE_t$ .

## Appendix 2: Details of model with lower bounds Proofs of Propositions

The proof of the Proposition 1 uses the following result:

**Lemma 3** *Let*

$$\begin{aligned} \xi(C; \pi, \psi, G) &= C\gamma A^{-(1+\varepsilon)/\alpha} \left( C + G + \frac{\psi}{2}(\pi - \pi^*)^2 \right)^{(1+\varepsilon)/\alpha} \\ &\quad - \alpha(1-\tau)(1-\theta^{-1}) \left( C + G + \frac{\psi}{2}(\pi - \pi^*)^2 \right). \end{aligned}$$

Let  $\underline{G} = ((\alpha A/\gamma)(1-\tau)(1-\theta^{-1}))^{\frac{\alpha}{1+\varepsilon}}$ . Then provided  $G > \underline{G}$ , there exists  $\check{\psi} > 0$  such that for all  $0 < \psi < \check{\psi}$  the function  $\xi(C; \pi, \psi, G)$  is strictly monotonically increasing in  $C$  and for given  $\pi, \psi < \check{\psi}$  and  $G > \underline{G}$  we have  $\lim_{C \rightarrow \infty} \xi(C; \pi, \psi, G) = +\infty$ .

**Proof of Lemma 3:** Computing the derivative we have

$$\begin{aligned} \left. \frac{d\xi}{dC} \right|_{\psi=0} &= \gamma C \frac{1+\varepsilon}{\alpha A} (A^{-1}(C+G))^{\frac{1+\varepsilon}{\alpha}-1} + \gamma A^{-1}(C+G)^{\frac{1+\varepsilon}{\alpha}} \\ &\quad - \alpha(1-\tau)(1-\theta^{-1}). \end{aligned}$$

If  $G > \underline{G}$  then  $\left. \frac{d\xi}{dC} \right|_{\psi=0} > 0$  for all  $C \geq 0$ . Since  $d\xi/dC$  is continuous in  $\psi$ , then result follows. ■

**Proof of Proposition 1:** First suppose the inflation lower bound satisfies  $\underline{\pi} < \pi_L$ . (i)  $\pi = \pi^*$ , with  $R = \beta^{-1}\pi^*$  satisfy (26) and (28). From (24) and (25) we have  $0 = \xi(C; \pi^*, \psi, G)$ . We have  $\xi(0; \pi^*, \psi, G) = -\alpha(1-\tau)(1-\theta^{-1})G < 0$ . Since we are assuming  $G > \underline{G}$  it follows from the Lemma that there is a unique  $C = \bar{C}$  that solves (24) and (25).

(ii)  $\pi = \pi_L$ , with  $R = 1 + \eta$  satisfy (26) and (28). From (24) and (25) we have  $(\pi_L - 1)\pi_L(1 - \beta)\alpha\psi\theta^{-1} = \xi(C; \pi_L, \psi, G)$ . For  $\psi$  sufficiently small the term  $(\pi_L - 1)\pi_L(1 - \beta)\alpha\psi\theta^{-1}$  can be made arbitrarily close to zero. Since  $\xi(0; \pi_L, \psi, G) = -\alpha(1-\tau)(1-\theta^{-1}) \left( G + \frac{\psi}{2}(\pi_L - \pi^*)^2 \right) < 0$ , the Lemma again applies and there is a unique  $C = C_L$  that solves (24) and (25).

(iii)  $\pi = \underline{\pi}$  with  $R = 1 + \eta$  satisfy (26) and (28) provided  $C = \underline{C}$ . We thus need to establish that (27) holds with strict inequality, i.e. that

$$(\underline{\pi} - 1)\underline{\pi}(1 - \beta)\alpha\psi\theta^{-1} > \xi(\underline{C}; \underline{\pi}, \psi, G)$$

As in part (ii) the Lemma implies that, given  $G > \underline{G}$  and  $\psi$  sufficiently small, there exists  $\tilde{C} > 0$  such that

$$(\underline{\pi} - 1)\underline{\pi}(1 - \beta)\alpha\psi\theta^{-1} = \xi(\tilde{C}; \underline{\pi}, \psi, G)$$

Thus for consumption lower bound  $\underline{C} < \tilde{C}$  (27) holds with strict inequality.

It is straightforward to see that there is no other steady state. Suppose first that there is a steady state at  $\pi$  with  $\underline{\pi} < \pi < \pi_L$  or  $\pi > \pi^*$ . Then  $R > \beta^{-1}\pi$ . By (26) this implies  $C = \underline{C}$ . But there exists  $C_\pi$  such that (24) is satisfied and since we can assume  $\underline{C} < C_\pi$  it follows from the Lemma that (27) holds with strict inequality. However this implies  $\pi = \underline{\pi}$ , which contradicts our assumption. If instead  $\pi_L < \pi < \pi^*$ . Then  $R < \beta^{-1}\pi$ . But this contradicts (26).

Next, suppose If  $\pi_L < \underline{\pi} < \pi^*$ . By (27) there cannot be a steady state at  $\pi < \underline{\pi}$ . Clearly there is again a steady state at  $\pi = \pi^* \geq 1$ . This is the unique steady state since steady states  $\pi$  with  $\underline{\pi} < \pi < \pi^*$  or  $\pi > \pi^*$  can be ruled out using the above arguments. ■

**Proof of Proposition 2:** For the consumption function we employ equation (34), which with  $G_{t+s}$ , held constant can be written in the form

$$\hat{C}_t = \left( \frac{1 - \beta}{1 - \bar{g}} \right) \left[ \hat{Y}_t + \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{Y}_{t+s} \right] - \left[ \beta \hat{R}_t + \beta \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{R}_{t+s} \right] + \left[ \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{\pi}_{t+s} \right].$$

Assuming steady-state learning, we have  $\hat{E}_t \hat{Y}_{t+s} = f_Y$  and  $\hat{E}_t \hat{\pi}_{t+s} = f_\pi$ . With the forward looking interest rate rule  $\hat{R}_t = \chi_\pi \hat{E}_t \hat{\pi}_{t+1}$  we also have  $\hat{R}_t = \hat{E}_t \hat{R}_{t+s} = \chi_\pi f_\pi$  for all  $s$  locally near the targeted steady state.

$$\hat{C}_t = \left( \frac{1 - \beta}{1 - \bar{g}} \right) \left( \hat{Y}_t + \frac{\beta}{1 - \beta} f_Y \right) - \beta \chi_\pi f_\pi - \frac{\beta^2}{1 - \beta} \chi_\pi f_\pi + \frac{\beta}{1 - \beta} f_\pi. \quad (61)$$

Assuming that government spending and the shocks are constant in equation (15), the Phillips curve is

$$\begin{aligned} (1 - a_1)\hat{\pi}_t - a_2\hat{Y}_t &= a_1 \sum_{s=1}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{\pi}_{t+s} + a_2 \sum_{s=1}^{\infty} (\beta\gamma_1)^s \hat{E}_t \hat{Y}_{t+s} \\ &= a_1 f_\pi \frac{\beta\gamma_1}{1 - \beta\gamma_1} + a_2 f_Y \frac{\beta\gamma_1}{1 - \beta\gamma_1}. \end{aligned}$$

The third equation is the linearized market-clearing condition (16). It can be noted that at the steady state  $a_1 = 1 - \gamma_1$ . For steady state learning, the system giving the temporary equilibrium map  $(\hat{\pi}, \hat{Y}) = T(f_\pi, f_Y)$  takes the linearized form with coefficient matrix  $DT$  at the targeted steady state given by<sup>44</sup>

$$\begin{pmatrix} \hat{\pi}_t \\ \hat{Y}_t \end{pmatrix} = DT \begin{pmatrix} f_\pi \\ f_Y \end{pmatrix}, \text{ where}$$

$$DT = \begin{pmatrix} \frac{\beta(1-\gamma_1)}{1-\beta\gamma_1} + \frac{a_2(\chi_\pi-1)(\bar{g}-1)}{\gamma_1(1-\beta)} & \frac{a_2}{\gamma_1(1-\beta\gamma_1)} \\ \frac{(\chi_\pi-1)(\bar{g}-1)}{1-\beta} & 1 \end{pmatrix}.$$

E-stability is determined by the eigenvalues of  $DT - I$  and holds if these have negative real parts. It is easily verified that  $\text{tr}(DT - I) < 0$  and  $\det(DT - I) > 0$  when  $\chi_\pi > 1$  and  $\bar{g} < 1$ , implying E-stability of the targeted steady state.

Next, consider the steady state  $\pi_L$ . The lower bound on the interest rate is binding locally near  $\pi_L$ , so we impose the constraint  $\hat{R} = 0$  and evaluate the other variables at their low steady state values and impose  $\psi = 0$ . Local stability of the low steady state is determined by the eigenvalues of  $DT$  at the steady state. It can be computed that

$$DT = \begin{pmatrix} \frac{a_2(1-\bar{g})}{(1-\beta)(1-a_1)} + \frac{\beta\gamma_1 a_1}{(1-\beta\gamma_1)(1-a_1)} & \frac{a_2}{(1-\beta\gamma_1)(1-a_1)} \\ \frac{1-\bar{g}}{1-\beta} & 1 \end{pmatrix}$$

and that  $\det(DT - I) < 0$  since  $a_2 > 0$  and  $0 < \beta, a_1, \gamma_1, \bar{g} < 1$ . By continuity of eigenvalues, it follows that the low steady state  $\pi_L$  is unstable also for sufficiently small  $\psi > 0$ .

Next, consider the trap steady state, where the bounds  $\underline{\pi}$  and  $\underline{C}$  are strictly binding as described in part (iii) of Proposition 1. Clearly, from the interest rate rule (see Figure 3)  $\exists \check{\pi}$  such that  $\hat{\pi}_t = \underline{\pi}$  for all  $\underline{\pi} \leq \pi \leq \check{\pi}$ . Now also  $\exists \check{C}$  such that  $\hat{C}_t = \underline{C}$  for  $\underline{C} \leq C \leq \check{C}$  and  $\underline{\pi} \leq \pi \leq \check{\pi}$ . By market clearing,  $\hat{Y}_t = (1 - \bar{g})\underline{C} + (\psi/2)\underline{\pi}^2$  in this region. It follows that  $\partial\hat{\pi}_t/\partial f_\pi = \partial\hat{\pi}_t/\partial f_Y = 0$  and  $\partial\hat{Y}_t/\partial f_\pi = \partial\hat{Y}_t/\partial f_Y = 0$  implying E-stability of the trap steady state. ■

We remark that  $\det(DT - I) < 0$  implies that the  $\pi_L$  steady state has local dynamics under learning that take the form of a saddle.<sup>45</sup>

<sup>44</sup>Mathematica routine for the details is available on request.

<sup>45</sup>Stability of the targeted steady state and instability of the  $\pi_L$  steady state have also

## Construction of Phase Diagram of Global E-stability Dynamics

We here give the additional details for constructing and interpreting Figure 4. In constructing this Figure we ignore the impact of exogenous shocks, so that we set  $\hat{A}_t = \hat{\mu}_t = 0$ . Consequently, the forecast rule coefficients  $\chi_\pi$  and  $\chi_Y$  consist only of the two intercepts  $f_\pi$  and  $f_Y$ , which allows us to illustrate global learning dynamics using a 2-dimensional figure. Under real-time learning the least-square updating equations at the end of Section 2.3 simplify and are replaced by

$$\begin{aligned} f_{\pi,t} &= f_{\pi,t-1} + \kappa (\pi_t - f_{\pi,t-1}) \\ f_{Y,t} &= f_{Y,t-1} + \kappa (Y_t - f_{Y,t-1}). \end{aligned}$$

It is known that these real-time learning dynamics are, for small gains  $\kappa > 0$ , approximated by the E-stability equations given below.

The nonlinear market-clearing equation, where variables are expressed in terms of proportional deviations from the targeted steady state, is given by

$$\hat{Y}_t = (1 - \bar{g})\hat{C}_t + \frac{\psi}{2\bar{Y}}\hat{\pi}_t^2. \quad (62)$$

We use this rather than the linearized market-clearing equation because we are looking at global dynamics that include regions around all three of the steady states. In Figure 4 we set  $\pi^* = 1$  and thus  $\hat{\pi}_t = \pi_t - 1$ . In the absence of lower bound constraints the temporary equilibrium equation for the Phillips curve is given by

$$(1 - a_1)\hat{\pi}_t - a_2\hat{Y}_t = (a_1f_\pi + a_2f_Y)\frac{\beta\gamma_1}{1 - \beta\gamma_1}, \quad (63)$$

where  $\hat{\pi}^e = f_\pi$  and  $\hat{Y}^e = f_Y$ . The temporary equilibrium equation for consumption is given by (61). We modify (61) by incorporating the ZLB and the nonlinear market-clearing equation (62) into it. This gives the aggregate demand function

$$\begin{aligned} \hat{Y}_t &= \frac{\psi}{2\bar{Y}\beta}\hat{\pi}_t^2 + f_Y - \frac{1 - \bar{g}}{1 - \beta}\max[\chi_\pi f_\pi, \beta - 1] + \frac{1 - \bar{g}}{1 - \beta}f_\pi \\ &\equiv \frac{\psi}{2\bar{Y}\beta}\hat{\pi}_t^2 + F(f_Y, f_\pi). \end{aligned} \quad (64)$$

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been observed for the version of the model in which price adjustment costs are formulated in terms of utility losses. See, for example, Benhabib, Evans, and Honkapohja (2014).



The temporary equilibrium for  $(\hat{Y}_t, \hat{\pi}_t)$  is given by equation (63) and (64), where the Phillips curve and the consumption function underlying the aggregate demand curve are interpreted as inequalities subject to lower bound constraints and holding with complementary slackness. That is, (63) holds unless  $\hat{\pi}_t < \underline{\pi}$ , in which case  $\hat{\pi}_t = \underline{\pi}$ , and (64) holds unless  $\hat{C}_t < \underline{C}$ , in which case  $\hat{C}_t = \underline{C}$ .

Substituting (64) into (63) gives

$$\hat{\pi}_t = \gamma_1^{-1} a_2 \left[ \frac{\psi}{2\bar{Y}\beta} \hat{\pi}_t^2 + F(f_Y, f_\pi) \right] + \gamma_1^{-1} G(f_Y, f_\pi),$$

where

$$G(f_Y, f_\pi) = (a_1 f_\pi + a_2 f_Y) \frac{\beta \gamma_1}{1 - \beta \gamma_1}.$$

This can be rearranged to

$$\mathfrak{A} \hat{\pi}_t^2 - \hat{\pi}_t + \gamma_1^{-1} [a_2 F(f_Y, f_\pi) + G(f_Y, f_\pi)] = 0, \quad (65)$$

where

$$\mathfrak{A} = \frac{\gamma_1^{-1} a_2 \psi}{2\bar{Y}\beta}.$$

This shows that for given  $\hat{\pi}^e$  there are two solutions to the quadratic (65), provided  $\hat{Y}^e = f_Y$  is not too large, and we choose the one with the smaller inflation rate, which is the economically relevant solution: this is the solution in which higher  $\hat{Y}^e$  gives higher  $\hat{Y}_t$  and  $\hat{\pi}_t$ . If  $\hat{Y}^e$  is sufficiently large no temporary equilibrium solution exists to our equations.<sup>46</sup> To cover this case we replace (63) with the common real part of the complex roots to (65).<sup>47</sup> This real part is the maximum inflation rate, i.e. an upper bound to inflation in the model.

This procedure defines the temporary equilibrium map

$$\left( \hat{\pi}, \hat{Y} \right) = T \left( \hat{\pi}^e, \hat{Y}^e \right)$$

giving the realized values of  $\hat{\pi}_t$  and  $\hat{Y}_t$  for given expectations  $\hat{\pi}^e$  and  $\hat{Y}^e$ . The three steady states correspond to the fixed points of this map. E-stability

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<sup>46</sup>We omit the formal details concerning existence of temporary equilibrium as they are not central to our analysis.

<sup>47</sup>This procedure means that the vector field in Figure 4 is continuous.

dynamics are given by

$$\frac{d}{d\tau}T(\hat{\pi}^e, \hat{Y}^e) = T(\hat{\pi}^e, \hat{Y}^e) - (\hat{\pi}^e, \hat{Y}^e),$$

where  $\tau$  represents "notional" time, which can, however, be linked to real time  $t$  according to the equation  $\tau \approx \kappa t$ . Figure 4 plots the vector field generated by  $T(\hat{\pi}^e, \hat{Y}^e) - (\hat{\pi}^e, \hat{Y}^e)$ . This vector field shows the paths of expectations  $(\hat{\pi}^e, \hat{Y}^e) = (f_\pi, f_Y)$  under the simple learning rule given above.

To compute the curve separating the basins of attraction of the target and trap steady states one recalls that middle steady state is a saddle point, so that its one-dimensional stable manifold under the E-stability differential equation gives the boundary.

### Appendix 3: Temporary equilibria with lower bounds

We here develop the model details when the economy with exogenous shocks is subject to interest rate, inflation and output lower bounds, and fiscal policy is included. We start by focusing on the interest rate lower bound (ZLB). The Phillips curve is unaffected by the ZLB. Using the calculations after (48) in Appendix 1 we have, using the first row of (47), the Phillips Curve

$$\begin{aligned}
(1 - a_1)\hat{\pi}_t - a_2\hat{Y}_t &= (a_1f_\pi + a_2f_Y)\frac{\beta\gamma_1}{1 - \beta\gamma_1} & (66) \\
&+ \left[ (a_1d_{\pi A} + a_2d_{YA})\frac{\rho_A\beta\gamma_1}{1 - \rho_A\beta\gamma_1} - \frac{a_3}{1 - \rho_A\beta\gamma_1} \right] \hat{A}_t \\
&+ \left[ (a_1d_{\pi\mu} + a_2d_{Y\mu})\frac{\rho_\mu\beta\gamma_1}{1 - \rho_\mu\beta\gamma_1} + \frac{a_5}{1 - \rho_\mu\beta\gamma_1} \right] \hat{\mu}_t \\
&- a_4\left(\beta\gamma_1\frac{1 - (\beta\gamma_1)^{T-t}}{1 - \beta\gamma_1} + 1\right)\frac{\Delta G}{\bar{G}},
\end{aligned}$$

where the term in  $\frac{\Delta G}{\bar{G}}$  is set to zero for  $t > T$ . It is convenient to write this as

$$(1 - a_1)\hat{\pi}_t - a_2\hat{Y}_t = TPCfn(d, f, \hat{A}_t, \hat{\mu}_t, t)$$

where  $d' = (d_{\pi A}, d_{YA}, d_{\pi\mu}, d_{Y\mu})$  and  $f' = (f_\pi, f_Y)$ .

For the IS curve we start by combining (34) with  $\hat{Y}_t = (1 - \bar{g})\hat{C}_t + \bar{g}\hat{G}_t$ , which yields

$$\begin{aligned}
\beta\hat{Y}_t &= \bar{g}\hat{G}_t + (1 - \beta)\sum_{s=1}^{\infty}\beta^s\hat{E}_t\hat{Y}_{t+s} - (1 - \beta)\bar{g}\sum_{s=0}^{\infty}\beta^s\hat{E}_t\hat{G}_{t+s} \\
&- (1 - \bar{g})\sum_{s=1}^{\infty}\beta^s\hat{E}_t(\hat{R}_{t+s-1} - \hat{\pi}_{t+s}).
\end{aligned}$$

We write this as

$$\beta\hat{Y}_t + (1 - \bar{g})\beta\hat{R}_t = ISG_t + ISPY_t + ISR_t \quad (67)$$

where

$$\begin{aligned} ISPY_t &= (1 - \beta) \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{Y}_{t+s} + (1 - \bar{g}) \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{\pi}_{t+s}, \\ ISG_t &= \bar{g} \hat{G}_t - (1 - \beta) \bar{g} \sum_{s=0}^{\infty} \beta^s \hat{E}_t \hat{G}_{t+s}, \\ ISR_t &= -(1 - \bar{g}) \sum_{s=2}^{\infty} \beta^s \hat{E}_t \hat{R}_{t+s-1}. \end{aligned}$$

$ISPY_t$  and  $ISG_t$  are given by

$$\begin{aligned} ISPY_t &= \frac{\beta(1 - \bar{g})}{1 - \beta} f_{\pi} + \beta f_Y + ((1 - \bar{g})d_{\pi A} + (1 - \beta)d_{YA}) \frac{\rho_A \beta}{1 - \rho_A \beta} \hat{A}_t \\ &\quad + ((1 - \bar{g})d_{\pi \mu} + (1 - \beta)d_{Y \mu}) \frac{\rho_{\mu} \beta}{1 - \rho_{\mu} \beta} \hat{\mu}_t \end{aligned}$$

and

$$ISG_t = \begin{cases} \beta \Delta G - \beta(1 - \beta^{T-t}) \Delta G & \text{if } t \leq T \\ 0 & \text{if } t \geq T + 1. \end{cases}$$

For  $ISR_t$  we need to determine when agents expect the ZLB to apply in the future. For simplicity we assume  $\rho_A = \rho_{\mu} = \rho$  and  $0 \leq \rho < 1$ . It then can be shown that there are four cases, depending on  $\hat{A}_t$  and  $\hat{\mu}_t$ . Let

$$\begin{aligned} K &= \hat{A}_t (\chi_{\pi} d_{\pi A} + \chi_Y d_{YA}) + \hat{\mu}_t (\chi_{\pi} d_{\pi \mu} + \chi_Y d_{Y \mu}) \\ L &= \frac{\beta(1 + \eta)}{\pi^*} - 1 - \chi_{\pi} f_{\pi} - \chi_Y f_Y. \end{aligned}$$

Note that  $K$  depends on  $\hat{A}_t$  and  $\hat{\mu}_t$  and that under learning both  $K$  and  $L$  depend on the PLM parameter estimates, which are evolving over time.

The ZLB  $R \geq 1 + \eta$  binds if and only if the forecasted interest rate based on the Taylor rule satisfies

$$\hat{E}_t \hat{R}_{t+s}^* = \chi_{\pi} \hat{E}_t \hat{\pi}_{t+s} + \chi_Y \hat{E}_t \hat{Y}_{t+s} \leq \frac{\beta(1 + \eta)}{\pi^*} - 1.$$

It is then easy to see that this holds when  $K\rho^s \leq L$ . There are four cases:

1. The ZLB never binds (in anticipation) if  $K\rho^s > L$ . This happens when  $K \geq 0, L < 0$  or if  $K, L < 0$  and  $\rho K > L$  or if  $K = 0, L \neq 0$  or if  $K > 0$  and  $L = 0$ .

2. The ZLB holds for all  $s \geq 1$  if  $K \leq 0, L \geq 0$  or  $K, L > 0, \rho K \leq L$ .
3. The ZLB holds for all  $s \geq \hat{s}$ , where  $\hat{s}$  is the smallest integer below  $\hat{s}^* = \ln(L/K)/\ln(\rho)$ , if  $K, L > 0, \rho K > L$ .
4. The ZLB holds for all  $1 \leq s \leq \hat{s}$  if  $K, L < 0, \rho K \leq L$ .

The value of  $ISR_t$  depends on the case. Let

$$ISR_t = -(1 - \bar{g}) \times ISRi_t \text{ in case } i = 1, 2, 3, 4.$$

In case 1 we have

$$\begin{aligned} ISR1_t &= \frac{\beta\rho}{1 - \beta\rho} \left[ \hat{A}_t(\chi_\pi d_{\pi A} + \chi_Y d_{Y A}) + \hat{\mu}_t(\chi_\pi d_{\pi\mu} + \chi_Y d_{Y\mu}) \right] \\ &\quad + (\chi_\pi f_\pi + \chi_Y f_Y) \frac{\beta^2}{1 - \beta}. \end{aligned}$$

In case 2 we have

$$ISR2_t = \frac{\beta^2}{1 - \beta} \left( \beta \frac{(1 + \eta)}{\pi^*} - 1 \right).$$

In case 3 we have

$$\begin{aligned} ISR3_t &= \frac{\beta^2\rho(1 - (\beta\rho)^{\hat{s}-1})}{1 - \beta\rho} \left[ \hat{A}_t(\chi_\pi d_{\pi A} + \chi_Y d_{Y A}) + \hat{\mu}_t(\chi_\pi d_{\pi\mu} + \chi_Y d_{Y\mu}) \right] \\ &\quad + (\chi_\pi f_\pi + \chi_Y f_Y) \frac{\beta(1 - \beta^{\hat{s}-1})}{1 - \beta} + \left( \beta \frac{(1 + \eta)}{\pi^*} - 1 \right) \frac{\beta^{\hat{s}+1}}{1 - \beta}. \end{aligned}$$

In case 4 we have

$$\begin{aligned} ISR4_t &= \frac{\beta(\beta\rho)^{\hat{s}}}{1 - \beta\rho} \left[ \hat{A}_t(\chi_\pi d_{\pi A} + \chi_Y d_{Y A}) + \hat{\mu}_t(\chi_\pi d_{\pi\mu} + \chi_Y d_{Y\mu}) \right] \\ &\quad + (\chi_\pi f_\pi + \chi_Y f_Y) \frac{\beta^{\hat{s}+1}}{1 - \beta} + \frac{\beta^2}{1 - \beta} \left( \beta \frac{(1 + \eta)}{\pi^*} - 1 \right) (1 - \beta^{\hat{s}-1}). \end{aligned}$$

We can now solve for the tentative temporary equilibrium values  $\hat{\pi}_t^{tent}, \hat{Y}_t^{tent}$  for  $\hat{\pi}_t, \hat{Y}_t$  that would obtain if none of the lower bounds at time  $t$  apply. These are given by

$$\begin{aligned} (1 - a_1)\hat{\pi}_t^{tent} - a_2\hat{Y}_t^{tent} &= TPC(d, f, \hat{A}_t, \hat{\mu}_t, t) \\ (1 - \bar{g})\beta\chi_\pi\hat{\pi}_t^{tent} + \beta(1 + \chi_Y(1 - \bar{g}))\hat{Y}_t^{tent} &= TIS(d, f, \hat{A}_t, \hat{\mu}_t, t) \end{aligned}$$

where  $TIS(d, f, \hat{A}_t, \hat{\mu}_t, t) = ISG_t + ISPY_t + ISR_t$  and  $ISR_t = ISRn_t$  for case  $n = 1, 2, 3, 4$ . Under real-time learning we use the time  $t$  estimates of  $d, f$ .

We next need to incorporate the lower bounds on inflation, consumption and interest rate in the time  $t$  temporary equilibrium. The consumption lower bound gives an output lower bound. In proportional terms the lower bound  $\underline{C}$  is  $\hat{C}_{\text{inf}} = \frac{C - \bar{C}}{\bar{C}}$ . From  $\hat{Y} = (1 - \bar{g})\hat{C} + \bar{g}\hat{G}$  this gives the lower bound on  $\hat{Y}$  of

$$\begin{aligned}\underline{\hat{Y}}_t &= (1 - \bar{g})\hat{C}_{\text{inf}} + \bar{g}\hat{G}_t, \text{ or} \\ \underline{\hat{Y}}_t &= (1 - \bar{g})\hat{C}_{\text{inf}} + \frac{G_t - \bar{G}}{\bar{Y}}.\end{aligned}$$

Note that  $\underline{\hat{Y}}_t = (1 - \bar{g})\hat{C}_{\text{inf}}$  after the fiscal policy stimulus has ended.

First we check for the ZLB at time  $t$ . Assuming  $\chi_\pi \hat{\pi}_t^{\text{tent}} + \chi_Y \hat{Y}_t^{\text{tent}} \geq \beta(1 + \eta) - 1$  so that the ZLB at  $t$  does not bind then set  $\pi\pi_t = \hat{\pi}_t^{\text{tent}}$ ,  $YY_t = \hat{Y}_t^{\text{tent}}$  and  $RR_t = \chi_\pi \hat{\pi}_t^{\text{tent}} + \chi_Y \hat{Y}_t^{\text{tent}}$ . If instead  $\chi_\pi \hat{\pi}_t^{\text{tent}} + \chi_Y \hat{Y}_t^{\text{tent}} < \beta(1 + \eta) - 1$  then we set  $RR_t = \beta(1 + \eta) - 1$  and set  $YY_t$  and  $\pi\pi_t$  to solve

$$(1 - a_1)\pi\pi_t - a_2YY_t = TPC(d, f, \hat{A}_t, \hat{\mu}_t, t) \quad (68)$$

$$(1 - \bar{g})\beta(\beta(1 + \eta) - 1) + \beta YY_t = TIS(d, f, \hat{A}_t, \hat{\mu}_t, t). \quad (69)$$

Next, if  $\pi\pi_t < \underline{\pi}$  (“situation 1”) then we calculate  $YY_{\text{new}_t}$  and  $RR_{\text{new}_t}$  by simultaneously solving (67) with  $\hat{Y}_t = YY_{\text{new}_t}$  and  $RR_{\text{new}_t} = \chi_\pi \underline{\pi} + \chi_Y YY_{\text{new}_t}$ . If  $RR_{\text{new}_t} > \beta(1 + \eta) - 1$  then the situation 1 step has ended and we set  $\pi\pi_t = \underline{\pi}$ ,  $YY_t = YY_{\text{new}_t}$  and  $RR_t = RR_{\text{new}_t}$ . If instead  $RR_{\text{new}_t} \leq \beta(1 + \eta) - 1$  then set  $\pi\pi_t = \underline{\pi}$ ,  $YY_t$  is set to solve (69), and  $RR_t = \beta(1 + \eta) - 1$ . If now  $YY_t < \underline{\hat{Y}}_t$  then  $\pi\pi_t = \underline{\pi}$ ,  $YY_t = \underline{\hat{Y}}_t$  and  $RR_t = \max(\chi_\pi \underline{\pi} + \chi_Y \underline{\hat{Y}}_t, \beta(1 + \eta) - 1)$ .

It remains to consider situation 2 in which  $\pi\pi_t \geq \underline{\pi}$  and  $YY_t < \underline{\hat{Y}}_t$ .<sup>48</sup> We set  $YY_t = \underline{\hat{Y}}_t$ ,  $\pi\pi_t$  to solve (68) with  $YY_t = \underline{\hat{Y}}_t$ , and  $RR_t = \max(\chi_\pi \pi\pi_t + \chi_Y \underline{\hat{Y}}_t, \beta(1 + \eta) - 1)$ .

The resulting values for  $YY_t$ ,  $\pi\pi_t$  and  $RR_t$  are the temporary equilibrium values for  $\hat{Y}_t$ ,  $\hat{\pi}_t$  and  $\hat{R}_t$ . We remark that we have not assumed that firms and households restrict forecasts to obey the consumption and inflation lower bounds. This seems natural since households may not be aware of these

<sup>48</sup>It is assumed below that  $a_2 > 0$  and  $0 < a_1 < 1$ . This is satisfied in the calibrated cases and ensures that  $\pi\pi_t > \underline{\pi}$ .

aggregate lower bound constraints. Under adaptive learning expectations of future inflation and output will have to eventually obey these lower bounds.

**Consumption and output at the inflation lower-bound:** If inflation and inflation expectations are at the inflation lower bound, i.e.  $\hat{\pi}_t = \hat{E}_t \hat{\pi}_{t+s} = \underline{\hat{\pi}}$ , where  $\underline{\pi} < \pi_L$ , then interest rates and expected interest rates are also at their lower bound, i.e.  $\hat{R}_t = \hat{E}_t \hat{R}_{t+s} = \frac{\beta(1+\eta)}{\pi^*} - 1 \equiv \hat{R}_{ZLB}$ . Inserting these into the consumption function (34) we obtain

$$(1-g)\hat{C}_t = (1-\beta)\hat{Y}_t + \beta f_{Y,t} - \frac{\beta(1-\bar{g})}{1-\beta}(\hat{R}_{ZLB} - \underline{\hat{\pi}}).$$

Here we have simplified by ignoring the impact on expected output of the exogenous shocks  $\hat{A}_t, \hat{\mu}_t$ , i.e. we are setting  $\hat{E}_t Y_{t+s} = f_{Y,t}$ . This approximation is reasonable since in the temporary equilibrium at the inflation lower bound the shocks do not affect output. Combining this equation with the linearized market-clearing equation  $\hat{Y}_t = (1-\bar{g})\hat{C}_t$  gives

$$\hat{Y}_t = f_{Y,t} - \frac{1-\bar{g}}{1-\beta}(\hat{R}_{ZLB} - \underline{\hat{\pi}}) \text{ where}$$

$$\hat{R}_{ZLB} - \underline{\hat{\pi}} = \frac{\beta(1+\eta) - \underline{\pi}}{\pi^*} = \frac{\pi_L - \underline{\pi}}{\pi^*} > 0$$

since we assume  $\underline{\pi} < \pi_L$ .

## Appendix 4: Model with forecasting of wages and profits

In this appendix we redo the consumption function when households forecast wages and profits. Refer to the linearized Euler equation and the lifetime budget constraint i.e. (5) and (6) and the definition of household period income which is

$$Y_{t,i} = w_t h_{t,i} + \Omega_t^i.$$

In deviation form, the previous equation is

$$\tilde{Y}_{t,i} = \bar{w} \tilde{h}_{t,i} + \tilde{w}_t \bar{h} + \tilde{\Omega}_t^i. \quad (70)$$

Since all households earn the same profits,  $\tilde{\Omega}_t^i = \tilde{\Omega}_t$ , and using the static linearized first order condition of the household i.e.

$$\tilde{w}_t = \frac{\epsilon \bar{w}}{\bar{h}} \tilde{h}_{t,i} + \frac{\bar{w}}{\bar{c}} \tilde{c}_{t,i}$$

we obtain (recall bars over variables indicate their steady state values)

$$\bar{w} \tilde{h}_{t,i} = \bar{h} \epsilon^{-1} \tilde{w}_t - \bar{h} \epsilon^{-1} \bar{w} \bar{c}^{-1} \tilde{c}_{t,i}.$$

Substituting this in (70) we obtain

$$\tilde{Y}_{t,i} = (1 + \epsilon^{-1}) \bar{h} \tilde{w}_t - \bar{h} \bar{w} \epsilon^{-1} \bar{c}^{-1} \tilde{c}_{t,i} + \tilde{\Omega}_t.$$

In turn substituting this equation into the linearized infinite horizon budget constraint we have

$$\sum_{s \geq 0} \beta^s \tilde{G}_{t+s} = \sum_{s \geq 0} \beta^s [(1 + \epsilon^{-1}) \bar{h} \tilde{w}_{t+s} + \tilde{\Omega}_{t+s} - (1 + \bar{h} \epsilon^{-1} \bar{w} \bar{c}^{-1}) \tilde{c}_{t+s,i}]. \quad (71)$$

Defining

$$\begin{aligned} S\tilde{G}_t &= \hat{E}_t \sum_{s=1}^{\infty} \beta^s \tilde{G}_{t+s}, \\ S\tilde{w}_t &= \hat{E}_t \sum_{s=1}^{\infty} \beta^s \tilde{w}_{t+s}, \\ S\tilde{\Omega}_t &= \hat{E}_t \sum_{s=1}^{\infty} \beta^s \tilde{\Omega}_{t+s}. \end{aligned}$$



and taking expectations at time  $t$  of equation (71) we obtain the following

$$\tilde{G}_t + S\tilde{G}_t = (1 + \epsilon^{-1})\bar{h}(\tilde{w}_t + S\tilde{w}_t) + \tilde{\Omega}_t + S\tilde{\Omega}_t - (1 + \bar{h}\bar{w}\epsilon^{-1}\bar{c}^{-1}) \sum_{s=0}^{\infty} \hat{E}_{t,i} \beta^s \tilde{c}_{t+s,i}.$$

Using the one-step ahead consumption Euler equation we then obtain the following

$$(1 + \bar{h}\bar{w}\epsilon^{-1}\bar{c}^{-1})(1 - \beta)^{-1} \tilde{c}_{t,i} = (1 + \epsilon^{-1})\bar{h}(\tilde{w}_t + S\tilde{w}_t) + \tilde{\Omega}_t + S\tilde{\Omega}_t - (1 + \bar{h}\bar{w}\epsilon^{-1}\bar{c}^{-1})\beta\bar{c} \sum_{s=1}^{\infty} \beta^s \sum_{j=1}^s \hat{E}_{t,i} \tilde{r}_{t+j}$$

Using

$$\sum_{s=1}^{\infty} \beta^s \sum_{j=1}^s \hat{E}_{t,i} \tilde{r}_{t+j} = (1 - \beta)^{-1} \sum_{j=1}^{\infty} \beta^j \hat{E}_{t,i} \tilde{r}_{t+j}$$

we get finally

$$\begin{aligned} \tilde{c}_{t,i} &= \frac{(1 - \beta)}{(1 + \bar{h}\bar{w}\epsilon^{-1}\bar{c}^{-1})} [(1 + \epsilon^{-1})\bar{h}(\tilde{w}_t + S\tilde{w}_t) + \tilde{\Omega}_t + S\tilde{\Omega}_t - \tilde{G}_t - S\tilde{G}_t] \\ &\quad - \beta(1 - \beta)\bar{c}(1 - \beta)^{-1} \sum_{j=1}^{\infty} \beta^j \hat{E}_{t,i} \tilde{r}_{t+j} \end{aligned}$$

In proportional deviation form, and dropping  $i$  (by symmetry),

$$\begin{aligned} \hat{c}_t &= \frac{(1 - \beta)}{(\bar{c} + \bar{h}\bar{w}\epsilon^{-1})} [(1 + \epsilon^{-1})\bar{w}\bar{h}(\hat{w}_t + S\hat{w}_t) + \bar{\Omega}(\hat{\Omega}_t + S\hat{\Omega}_t) \\ &\quad - \bar{G}(\hat{G}_t + S\hat{G}_t)] - \hat{E}_t \sum_{j=1}^{\infty} \beta^j \hat{r}_{t+j}; \end{aligned}$$

Here  $\hat{r}_{t+j} = \beta \tilde{r}_{t+j}$ . Finally we obtain the consumption function of the representative household in the case when they forecast future wages and profits

$$\begin{aligned} \hat{c}_t &= \frac{(1 - \beta)}{(\bar{c} + \bar{h}\bar{w}\epsilon^{-1})} [(1 + \epsilon^{-1})\bar{w}\bar{h}(\hat{w}_t + S\hat{w}_t) + \bar{\Omega}(\hat{\Omega}_t + S\hat{\Omega}_t) \\ &\quad - \bar{G}(\hat{G}_t + S\hat{G}_t)] - \beta\hat{R}_t - \beta S\hat{R}_t + S\hat{\pi}_t; \\ S\hat{R}_t &= \hat{E}_t \sum_{s=1}^{\infty} \beta^s \hat{R}_{t+s}; S\hat{\pi}_t = \hat{E}_t \sum_{s=1}^{\infty} \beta^s \hat{\pi}_{t+s}. \end{aligned} \tag{72}$$

Since we only consider the case when the ZLB never binds, the interest rate rule (19) is then plugged into the consumption function.  $\hat{c}_t$  is thus determined based on  $\hat{w}_t, \hat{\Omega}_t, \hat{G}_t, \hat{\pi}_t, \hat{Y}_t$  (if  $\chi_Y \neq 0$ ) and expectations of these variables.

In temporary equilibrium the following also hold

$$\begin{aligned}\hat{w}_t &= \epsilon \hat{h}_t + \hat{c}_t, \\ \hat{Y}_t &= (1 - \bar{g})^{-1} \hat{c}_t + \bar{g} \hat{G}_t, \\ \hat{h}_t &= \alpha^{-1} (\hat{Y}_t - \hat{A}_t), \\ \bar{\Omega} \hat{\Omega}_t &= \bar{Y} \hat{Y}_t - \bar{w} \bar{h} (\hat{h}_t + \hat{w}_t) = \bar{Y} (\hat{Y}_t - (1 - \bar{\Omega}) (\hat{h}_t + \hat{w}_t))\end{aligned}$$

The above equations follow from the first order condition of the household, market clearing condition, the production function and (70) respectively, all in proportional deviation from the targeted steady state. This gives the temporary equilibrium in terms of  $\hat{c}_t$  from (72),  $\hat{w}_t, \hat{Y}_t, \hat{h}_t, \hat{\Omega}_t$  from the previous four equations and  $\hat{\pi}_t$  from the original Phillips curve equation (which remains unchanged in this formulation).

To obtain  $S\hat{w}_t, S\hat{\Omega}_t$  in (72) we assume constant gain learning of  $\hat{\Omega}^e$  and  $\hat{w}^e$  by regression of  $\hat{\Omega}_t$  and  $\hat{w}_t$  on intercepts and on  $\hat{A}_t$  and  $\hat{\mu}_t$ . For our policy change and assumed learning forms, the infinite sums simplify further.  $S\hat{G}_t = 0$  for  $t \geq T$  while for  $1 \leq t \leq T - 1$

$$S\hat{G}_t = \frac{\beta(1 - \beta^{T-t}) \Delta G}{1 - \beta} \frac{1}{\bar{G}}.$$

For  $S\hat{w}_t$  and  $S\hat{\Omega}_t$  we use the PLMs

$$\begin{aligned}\hat{w}_t &= f_w + d_{wA} \hat{A}_t + d_{w\mu} \hat{\mu}_t \\ \hat{\Omega}_t &= f_\Omega + d_{\Omega A} \hat{A}_t + d_{\Omega\mu} \hat{\mu}_t\end{aligned}$$

As before, under adaptive learning, agents estimate the coefficients of the previous equations and given their time  $t$  estimates of the parameter coefficients, the forecasts  $\hat{E}_t \hat{w}_{t+s}$  and  $\hat{E}_t \hat{\Omega}_{t+s}$  are given by

$$\begin{aligned}\hat{E}_t \hat{w}_{t+s} &= f_w + d_{wA} \rho_A^s \hat{A}_t + d_{w\mu} \rho_\mu^s \hat{\mu}_t, \\ \hat{E}_t \hat{\Omega}_{t+s} &= f_\Omega + d_{\Omega A} \rho_A^s \hat{A}_t + d_{\Omega\mu} \rho_\mu^s \hat{\mu}_t.\end{aligned}$$

Using these PLMs and continuing to use the same PLMs for  $\hat{\pi}_t, \hat{Y}_t$  as before we obtain the following (the final line uses knowledge of the Taylor rule on

the part of households)

$$\begin{aligned}
S\hat{w}_t &= \hat{E}_t \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{w}_{t+s} = \frac{\beta}{1-\beta} f_w + d_{wA} \frac{\beta \rho_A}{1-\beta \rho_A} \hat{A}_t + d_{w\mu} \frac{\beta \rho_\mu}{1-\beta \rho_\mu} \hat{\mu}_t, \\
S\hat{\Omega}_t &= \hat{E}_t \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{\Omega}_{t+s} = \frac{\beta}{1-\beta} f_\Omega + d_{\Omega A} \frac{\beta \rho_A}{1-\beta \rho_A} \hat{A}_t + d_{\Omega \mu} \frac{\beta \rho_\mu}{1-\beta \rho_\mu} \hat{\mu}_t, \\
S\hat{\pi}_t &= \hat{E}_t \sum_{s=1}^{\infty} \beta^s \hat{E}_t \hat{\pi}_{t+s} = \frac{\beta}{1-\beta} f_\pi + d_{\pi A} \frac{\beta \rho_A}{1-\beta \rho_A} \hat{A}_t + d_{\pi \mu} \frac{\beta \rho_\mu}{1-\beta \rho_\mu} \hat{\mu}_t, \\
S\hat{Y}_t &= \frac{\beta}{1-\beta} f_Y + d_{\pi A} \frac{\beta \rho_A}{1-\beta \rho_A} \hat{A}_t + d_{\pi \mu} \frac{\beta \rho_\mu}{1-\beta \rho_\mu} \hat{\mu}_t, \\
S\hat{R}_t &= \chi_\pi S\hat{\pi}_t + \chi_Y S\hat{Y}_t.
\end{aligned}$$

The Phillips curve continues to be given by equation (15) where the infinite sums simplify to

$$\begin{aligned}
\sum_{s=1}^{\infty} (\beta \gamma_1)^s \hat{E}_t \hat{\pi}_{t+s} &= \frac{\beta \gamma_1}{1-\beta \gamma_1} f_\pi + d_{\pi A} \frac{\beta \gamma_1 \rho_A}{1-\beta \gamma_1 \rho_A} \hat{A}_t + d_{\pi \mu} \frac{\beta \gamma_1 \rho_\mu}{1-\beta \gamma_1 \rho_\mu} \hat{\mu}_t, \\
\sum_{s=1}^{\infty} (\beta \gamma_1)^s \hat{E}_t \hat{Y}_{t+s} &= \frac{\beta \gamma_1}{1-\beta \gamma_1} f_Y + d_{\pi A} \frac{\beta \gamma_1 \rho_A}{1-\beta \gamma_1 \rho_A} \hat{A}_t + d_{\pi \mu} \frac{\beta \gamma_1 \rho_\mu}{1-\beta \gamma_1 \rho_\mu} \hat{\mu}_t, \\
\sum_{s=0}^{\infty} (\beta \gamma_1)^s \hat{E}_t \hat{A}_{t+s} &= \sum_{s=0}^{\infty} (\beta \gamma_1 \rho_A)^s \hat{A}_t = \frac{1}{1-\beta \gamma_1 \rho_A} \hat{A}_t, \\
\sum_{s=0}^{\infty} (\beta \gamma_1)^s \hat{E}_t \hat{\mu}_{t+s} &= \sum_{s=0}^{\infty} (\beta \gamma_1 \rho_\mu)^s \hat{\mu}_t = \frac{1}{1-\beta \gamma_1 \rho_\mu} \hat{\mu}_t,
\end{aligned}$$

and finally for  $1 \leq t \leq T-1$ ,

$$\sum_{s=0}^{\infty} (\beta \gamma_1)^s \hat{E}_t \hat{G}_{t+s} = \frac{1 - (\beta \gamma_1)^{T-t}}{1 - \beta \gamma_1} \frac{\Delta G}{\bar{G}}$$

and the same sum is zero for  $t \geq T$ .

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