

Discussion of:
“Expectations, Stagnation and Fiscal Policy: a
Nonlinear Analysis”

by George W. Evans, Seppo Honkapohja and Kaushik Mitra

Stefano Eusepi

2021 Bank of Canada Annual Economic Conference”

November 8-10, 2021

Summary

This paper:

- Evaluates effects a 'confidence shock' in an NK economy with multiple equilibria
 - 1 Under 'normal policy' the economy can get trapped into a stagnation equilibrium [low output, deflation and near-zero interest rates]
 - 2 Fiscal and monetary stimulus can steer the economy towards the 'good' equilibrium

Summary

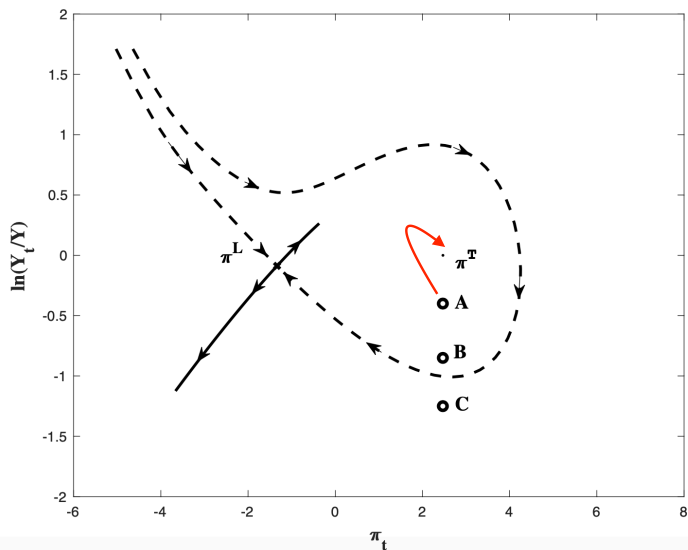
This paper:

- Evaluates effects a 'confidence shock' in an NK economy with multiple equilibria
 - ① Under 'normal policy' the economy can get trapped into a stagnation equilibrium [low output, deflation and near-zero interest rates]
 - ② Fiscal and monetary stimulus can steer the economy towards the 'good' equilibrium

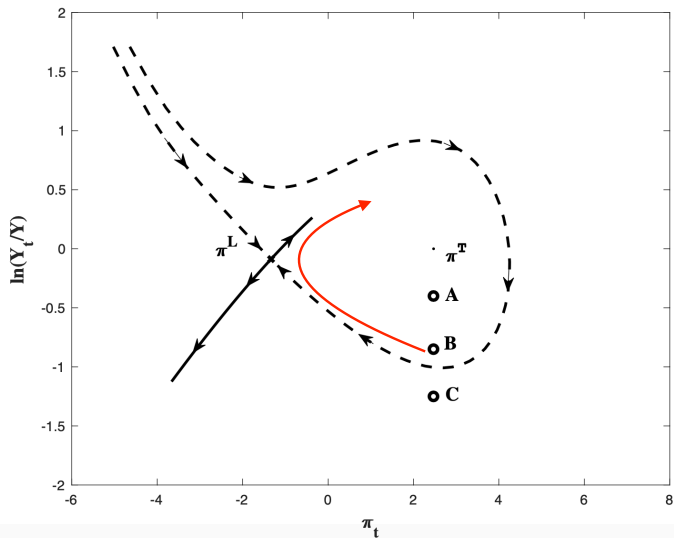
My discussion:

- ① Recap of the mechanism
- ② Comments on the methodology and experiment;
- ③ Self-promotion

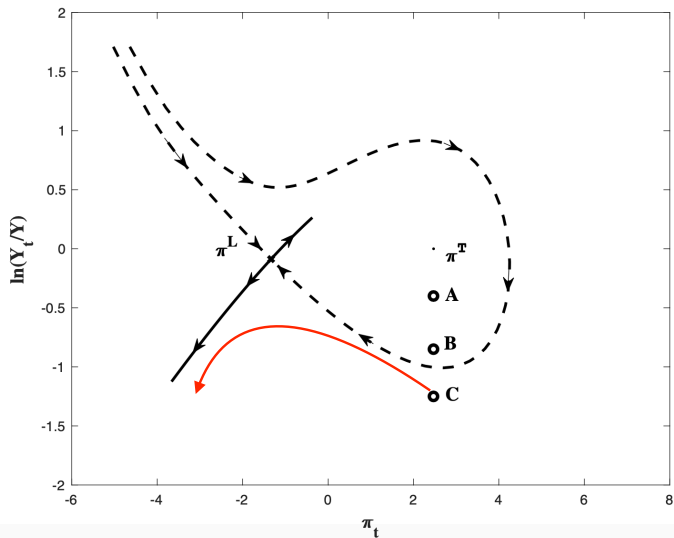
Rings of stability: Normal Times



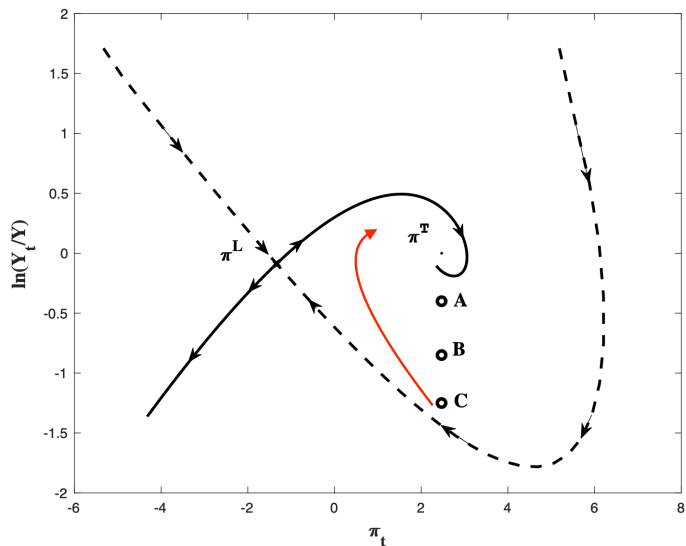
Rings of stability: Sluggish Recovery



Rings of stability: Economic Shutdown



Rings of stability: Policy Stimulus



Methodology

Standard Framework [Eggertsson-Woodford]

- 1 'Linear' setup: ZLB episode as a temporary bad state
- 2 Rational expectations

This paper

- 1 Global analysis: ZLB episode leads to permanent economic stagnation
- 2 Bounded rationality and learning

Policy Implications?

- Clear benefits from dropping (2.): duration of the ZLB is now endogenous → clear implications for policy
- What about (1.)?
 - Costs: *ad hoc* decision rules, beliefs under nonlinearity and uncertainty
 - Benefits?: paper needs more discussion

Alternative Experiment

Current experiment

- Exogenous shift in confidence + stochastic simulations
- **Knife edge**: economy either falls into stagnation or returns to normal [no much role for shocks]

Recurrent ZLB episodes

- Stochastic simulations: can we get endogenous switches between normal and stagnation equilibria?
 - Shocks size and location of the stagnation equilibrium
 - Sensitivity of expectations to forecast errors
- Interesting implications:
 - 1 What kind of policies can be designed to minimize such episodes?
 - 2 What are the policy trade-offs? [i.e. costs of expansionary policies]

ZLB under bounded rationality: policy lessons

Eusepi, Gibbs and Preston (2021). 'Linear' setup + bounded rationality:
Optimal forward-guidance policy

- 1 Large front-loaded stimulus: keeps expectations from falling
- 2 Policy trade-off: excessive stimulus if shock is short-lived but insurance in case of persistent shocks
- 3 Stimulus generally leads to over-shooting [imperfect control of expectations]
- 4 Policy delays are costly

I would expect similar conclusions in [this paper](#):

- (4.): discussed
- (1.): does front-loading matter? how does it depend on the gain?
- (2-3.): what is the transition back to the normal equilibrium?

Conclusions

- Very nice paper!
- Further develop global analysis
- Highlight policy conclusions relative to standard rational expectations advice