Liquidity traps and expectation dynamics: Fiscal stimulus or fiscal austerity?

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Seppo Honkapohja

Bank of Finland, Member of the Board

Seppo Honkapohja is Member of the Board of the Bank of Finland since 1 January 2008, with responsibility for research, investment of financial assets and the administration function.

[Abstract] We examine global dynamics under infinite-horizon learning in New Keynesian models where the interest-rate rule is subject to the zero lower bound. As in Evans, Guse and Honkapohja (2008), the intended steady state is locally but not globally stable. Unstable deflationary paths emerge after large pessimistic shocks to expectations. For large expectation shocks that push interest rates to the zero bound, a temporary fiscal stimulus or a policy of fiscal austerity, appropriately tailored in magnitude and duration, will insulate the economy from deflation traps. However “fiscal switching rules“ that automatically kick in without discretionary fine tuning can be equally effective.