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Economics
Discussion Paper Series
EDP-1220

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September 2012

Economics
School of Social Sciences
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Manchester M13 9PL

Escaping Expectation Traps: How Much Commitment is Required?*

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January 23, 2012

Abstract

In this paper we study the degree of precommitment that is required to eliminate multiplicity of policy equilibria, which arise if the policy maker acts under pure discretion. We apply a framework developed by Schaumburg and Tambalotti (2007) and Debortoli and Nunes (2010) to a standard New Keynesian model with government debt. We demonstrate the existence of expectation traps under limited commitment and identify the minimum degree of commitment which is needed to escape from these traps. We find that the degree of precommitment which is sufficient to generate uniqueness of the Pareto-preferred equilibrium requires the policy maker to stay in office for a period of two to five years. This is consistent with monetary policy arrangements in many developed countries.

Key Words: Limited Commitment, Commitment, Discretion, Multiple Equilibria, Monetary and Fiscal Policy Interactions

JEL References: E31, E52, E58, E61, C61

*We thank Andy Blake, Xiaoshan Chen, Richard Dennis, Campbell Leith, Charles Nolan and all seminar participants in Exeter, St.Andrews, ANU, Bank of England and at the Bundesbank. All errors are ours.

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1 Introduction

In this paper we study the existence and uniqueness properties of monetary policy in a limited commitment framework in the Blanchard and Kahn (1980) class of linear quadratic rational expectation models (LQ RE). This class of models is typically used to study aggregate fluctuations in macroeconomics. Building on research in Schaumburg and Tambalotti (2007) and Debertoli and Nunes (2010) we show the existence of multiple equilibria under limited commitment policy.¹ Similar to the case of pure discretion, under limited commitment policy makers cannot manage private sector expectations which can lead to expectation traps and coordination failures. We investigate the question of how much precommitment is needed to escape such expectation traps and to coordinate on the Pareto-preferred equilibrium. We find that the necessary degree of precommitment to eliminate multiplicity is relatively small – from two to five years - which is consistent with tenure terms of monetary policy makers in many countries.

It is well known that in LQ models with rational expectations policies under commitment and discretion may imply very different dynamics for the economy. With full commitment the policy maker has complete control over the private sector's expectations about future policy and steers them in a way that furthers his stabilization goals. The policy maker can coordinate all future actions of consequent policy makers, which allows him to choose once, and apply indefinitely, an intertemporal contingency plan (Kydland and Prescott (1977)). In linear quadratic models a commitment policy, if it exists, is always unique (Kwakernaak and Sivan (1972), Backus and Driffill (1986)).

With no commitment at all, i.e. under pure discretion, the policy maker does not control the expectations of the private sector and fails to coordinate the actions of consequent policy makers. Under discretion the policy maker optimizes in each period of time and the private sector knows that future policy makers will implement the same decision process in subsequent periods (see e.g. Oudiz and Sachs (1985), Backus and Driffill (1986), Currie and Levine (1993)). However, under pure discretionary policy expectation traps and multiple equilibria can arise because the expectations of the private sector are shaped by anticipations about future policy behavior. Since the policy maker cannot fully control private sector expectations, those expectations may trap the policy maker into implementing a policy that validates them. The trap is closed if it is less costly for the policy maker to validate the private sector beliefs about future policy than to ignore

¹Originally, their framework is based on Roberds (1987). Lohmann (1992) studied limited commitment policies in a one-period setting.

those expectations, see King and Wolman (2004).²

Under limited commitment a new policy maker arrives in offices with an exogenous probability α every period, reneges on the past policy plan of its predecessor and credibly commits to a new policy plan that is optimal at this point in time. Clearly, this framework has elements of both discretion and commitment. However, the policy maker can neither completely control the expectations of the private sector, nor can he coordinate the actions of all future policy makers. Therefore coordination failures between the sequence of policy makers and the private sector can occur and may result in multiple equilibria and expectation traps. Models with expectation traps can help us to explain the observed excess volatility of macroeconomic data.³ These models should also be used to improve macroeconomic policy to avoid such traps.

Our contribution is twofold. First, we demonstrate, by example, that similar to discretion expectation traps also exist under limited commitment.⁴ We use a simple NK model with government debt accumulation which describes an economic behavior that is familiar from the literature on the fiscal theory of the price level (see e.g. Leeper (1991)). Second, we obtain the minimum degree of policy precommitment that is required to select the best equilibrium. We demonstrate that a small degree of precommitment is enough to select the best equilibrium; a tenure of about 2-5 years is sufficient to eliminate all equilibria except the Pareto-preferred.

The paper is organized as follows. In Section 2 we introduce the NK model with debt accumulation. We first review properties of discretion and commitment policies for this model and demonstrate the existence of expectation traps under quasi-commitment. Then we find the minimum length of precommitment that is required to select the best equilibrium in our model. Section 5 concludes. Finally, the Appendix presents a numerical algorithm to find policy with limited commitment.

2 The Model with Government Debt

This section demonstrates the existence of multiple equilibria under limited commitment by example. We present a simple NK model with government debt accumulation in the spirit of

²Dynamic RE models with multiple discretionary equilibria are presented in King and Wolman (2004) and Blake and Kirsanova (2012). Lockwood and Philippopoulos (1994), Albanesi et al. (2003) give examples of multiplicity in models with static expectations.

³Discretionary policy with multiple equilibria generates data series which can be observed as satisfying a Markov-switching regime (Blake and Kirsanova (2012)). There is much empirical evidence on such regimes; for one example which uses a similar model as we study here see Davig and Leeper (2006).

⁴Schaumburg and Tambalotti (2007) term limited commitment ‘quasi-commitment’ and Debertoli and Nunes (2010) use ‘loose commitment’. In this paper we use these terms interchangeably.

Leeper (1991). This model is well suited to use as an example to demonstrate the existence of expectation traps and to study the dynamic properties of an economy under monetary policy with limited commitment. First, unlike the model in Schaumburg and Tambalotti (2007) this model has an endogenous predetermined state variable, government debt, which is affected by policy. The presence of such a variable is crucial to generate multiple equilibria under discretionary policy in LQ RE models (Blake and Kirsanova (2012)). A necessary condition for multiplicity is the existence of strategic complementarities between the decisions of agents. An endogenous state variable ensures that the current policy maker reacts (indirectly) to the past actions of the private sector and his predecessors. Therefore the policy maker can be trapped into implementing an undesired policy, if it is less costly to validate the expectations formed in the past, than sticking to his initial policy plan. Second, the model is simple enough to derive most of our results analytically.⁵

We adopt the model from Benigno and Woodford (2003).⁶ The economy consists of a representative household, a representative firm that produces the final good, a continuum of intermediate goods producing firms and a monetary and fiscal authority. The intermediate goods producing firms act under monopolistic competition and produce according to a production function that depends only on labor. Goods are combined via a Dixit and Stiglitz (1977) technology to produce aggregate output. Firms set their prices subject to a Calvo (1983) price rigidity. Households choose consumption and leisure and can transfer income through time through their holdings of government bonds. All agents can observe and affect the accumulation of real government debt. The accumulation of government debt must depend on a fiscal stance. Hence, in the model there is a non-optimizing fiscal authority facing a stream of exogenous public consumption. These expenditures are financed by levying income taxes and by issuing one-period risk-free nominal bonds. We assume that the fiscal authority imposes a simple proportional rule for the tax rate: if real debt is higher (lower) than in the steady state the tax rate rises (falls). We shall refer to the tax rate as ‘taxes’ and to the parameter of the proportional rule as the ‘fiscal feedback’. The size of this fiscal feedback measures the strength of the fiscal stabilization of debt and, as we shall show, plays an important role in the model. The presence of the non-optimizing fiscal authority in the economy is captured by this single feedback parameter μ .

We assume that all public debt consist of riskless one-period bonds. Accordingly, the nominal

⁵Debertoli and Nunes (2010) use a non-linear model to illustrate a generalization of the quasi-commitment equilibrium concept to a non-linear setting. Their model is not suitable for our analysis because of the assumption of non-linearity.

⁶It was also used in Blake and Kirsanova (2012) to investigate the properties of multiple equilibria under discretionary policy.

value of end-of-period public debt \mathcal{B}_t evolves according to the following law of motion:

$$\mathcal{B}_t = (1 + i_{t-1})\mathcal{B}_{t-1} + P_t G_t - \Upsilon_t P_t Y_t, \quad (1)$$

where Υ_t represents the share of nominal income that the government taxes in period t . G_t denotes government purchases which are exogenously given. The aggregate price level is denoted by P_t and the nominal interest rate of government bonds is denoted by i_t . The national income identity yields

$$Y_t = C_t + G_t, \quad (2)$$

where C_t is private consumption. For analytical convenience, we define $B_t = (1 + i_{t-1})\mathcal{B}_{t-1}/P_{t-1}$ as a measure of real government debt. Because B_t is observed at the beginning of period t , (1) can be rewritten as

$$B_{t+1} = (1 + i_t) \left(B_t \frac{P_{t-1}}{P_t} - \Upsilon_t Y_t + G_t \right). \quad (3)$$

We assume that fiscal policy is conducted according to a simple mechanistic feedback rule that relates the tax rate, Υ_t , to the stock of real debt, B_t

$$\Upsilon_t = \tilde{\Upsilon} \left(\frac{B_t}{\tilde{B}} \right)^{\mu \frac{\tilde{B}}{\tilde{Y}}}. \quad (4)$$

Here and below the tilde denotes the steady-state value of the corresponding variable in the model's zero-inflation non-stochastic steady state.

Log-linearizing (3) and (4) yields

$$b_{t+1} = \frac{\tilde{B}}{\tilde{Y}} \iota_t + \frac{1}{\beta} \left((1 - \mu \tilde{\Upsilon}) b_t - \frac{\tilde{C}}{\tilde{Y}} \tilde{\Upsilon} c_t - \frac{\tilde{B}}{\tilde{Y}} \pi_t \right), \quad (5)$$

where $b_t = \frac{\tilde{B}}{\tilde{Y}} \ln \left(\frac{B_t}{\tilde{B}} \right)$, $c_t = \ln \left(\frac{C_t}{\tilde{C}} \right)$ and $\iota_t = \ln \left(\frac{1+i_t}{1+\tilde{i}} \right)$. The private sector's discount factor, β , satisfies $\beta = 1/(1 + \tilde{i})$. To make the model particularly simple we assume $\tilde{B} = 0$, which eliminates the first-order effect of the interest rate and inflation on debt, and obtain the final version of linearized debt accumulation equation

$$b_{t+1} = \rho b_t - \eta c_t, \quad (6)$$

where the parameter $\rho = (1 - \mu \tilde{\Upsilon})/\beta$ is a function of the tax rate, implying that with stronger fiscal feedback μ the stock of real debt is stabilized more rapidly, and where the parameter $\eta = \tilde{C} \tilde{\Upsilon} / (\beta \tilde{Y})$ describes the sensitivity of debt to the tax base.

The derivation of the appropriate Phillips curve is standard (Benigno and Woodford (2003), Sec. A.5) and real marginal cost is a function of output and taxes. Log-linearizing the price-setting-firms' pricing decision around the zero-inflation non-stochastic steady state yields the following New Keynesian Phillips curve

$$\pi_t = \beta \mathbb{E}_t \pi_{t+1} + \delta \left(\left(\frac{1}{\sigma} + \frac{\theta}{\psi} \right) c_t + \frac{\tilde{\Upsilon}}{(1 - \tilde{\Upsilon})} \tau_t \right) + u_t,$$

where $\delta = \frac{(1-\gamma\beta)(1-\gamma)\psi}{\gamma(\psi+\epsilon)}$ is the slope of Phillips curve, $\tau_t = \ln\left(\frac{\Upsilon_t}{\tilde{\Upsilon}}\right)$, σ is the inverse of the intertemporal elasticity of substitution, ψ is the elasticity of labour supply, $\theta = \tilde{C}/\tilde{Y}$ is the steady state consumption to output ratio and u_t is an AR(1) cost push shock with persistence parameter ρ_u . \mathbb{E}_t is the expectation operator conditional on information available at time t . Substituting the log-linearized equations (2) and (4) into the New Keynesian Phillips curve yields

$$\pi_t = \beta \mathbb{E}_t \pi_{t+1} + \kappa c_t + \nu b_t + u_t, \tag{7}$$

where $\nu = \mu\kappa\tilde{\Upsilon}/(1 - \tilde{\Upsilon})$ and $\kappa = \delta(1/\sigma + \theta/\psi)$.

In summary, the model is described by the debt accumulation equation (6) and the Phillips curve (7). The aggregate agents' decision variable is inflation, π_t , and the initial state, \tilde{b} , is known to all agents. We assume that the policy maker chooses consumption c_t . In contrast to the standard New Keynesian model (used in Schaumburg and Tambalotti (2007)) the predetermined state variable, b_{t+1} , is affected by policy, c_t .

The intertemporal welfare criterion of the policymaker is defined by the following quadratic objective

$$L = \frac{1}{2} \mathbb{E}_t \sum_{t=0}^{\infty} \beta^t (\pi_t^2 + \lambda c_t^2). \tag{8}$$

The criterion is derived under the assumption of a steady state labour subsidy. Parameter λ is a function of model parameters, $\lambda = \theta\kappa/\epsilon$, and ϵ is the elasticity of substitution between any pair of monopolistically produced goods.

The policy maker knows the laws of motion (6)-(7) of the aggregate economy and takes them into account when formulating policy.

3 Preliminaries: Discretion and Commitment

We shall compare the dynamics of the model under quasi-commitment policy with dynamics under the two limiting cases, discretion and commitment.⁷ This Section gives all necessary definitions and presents solutions to these two limiting cases in a comparable form using the model above as an example.

3.1 Discretionary Policy

Under discretion there is a sequence of policy makers: each period a new policy maker arrives in office. The new policy maker chooses the best policy knowing that he stays in office for only one period and the next-period's policy maker will re-optimize again.⁸ The law of motion of the aggregate economy (6)-(7) is known by the policy maker and taken into account when he formulates the optimal policy. Furthermore, the policy maker finds the best action every period and knows that future policy makers have the freedom to change policy, but will apply the same decision process. At every point in time t the decision rules of each agent are linear functions of the current state

$$c_t = c_u u_t + c_b b_t, \quad (9)$$

$$\pi_t = \pi_u u_t + \pi_b b_t. \quad (10)$$

Note that from

$$\pi_{t+1} \stackrel{eq.(10)}{=} \pi_u u_{t+1} + \pi_b b_{t+1} \stackrel{eq.(6)}{=} \pi_u \rho_u u_t + \pi_b (\rho b_t - \eta c_t) \stackrel{eq.(7)}{=} \frac{1}{\beta} \pi_t - \frac{\kappa}{\beta} c_t - \frac{\nu}{\beta} b_t - \frac{1}{\beta} u_t,$$

it follows that the private sector's decision can also be written as

$$\pi_t = (\beta \pi_u \rho_u + 1) u_t + (\beta \rho \pi_b + \nu) b_t + (\kappa - \beta \eta \pi_b) c_t. \quad (11)$$

The policy maker moves first within each period and the private sector observes the action of the policy maker. Thus, the private sector takes into account the 'instantaneous' influence of the policy choice measured by $(\kappa - \beta \eta \pi_b)$.

We can give now a more precise definition of discretionary policy: A policy determined by (9) is *discretionary* if the policy maker *finds it optimal* to follow it in every period $s > t$, given

⁷In this section we largely follow the approach and results in Blake and Kirsanova (2012) and in Kirsanova and Wren-Lewis (2011), but present the results in a form that is more convenient for our purposes.

⁸Our definition of discretionary policy is standard and follows Oudiz and Sachs (1985), Backus and Driffill (1986) and Clarida et al. (1999).

the private sector (i) observes the current policy, (ii) knows that future policy makers re-optimize and use the same decision process, and (iii) expects policy (9) will be implemented in all future periods.

We can write the criterion for optimality as

$$S_{uu}u_t^2 + 2S_{ub}u_t b_t + S_{bb}b_t^2 = \min_{c_t} \left((\pi_t^2 + \lambda c_t^2) + \beta (S_{uu}u_{t+1}^2 + 2S_{ub}u_{t+1}b_{t+1} + S_{bb}b_{t+1}^2) \right), \quad (12)$$

subject to constraints (6) and (11).

One can solve the problem using Lagrange multipliers. The expected Lagrangian can be written as

$$\mathcal{L}_t^d = \frac{1}{2} (\pi_t^2 + \lambda c_t^2) + \beta \frac{1}{2} (S_{uu}\rho_u^2 u_t^2 + 2S_{ub}\rho_u u_t b_{t+1} + S_{bb}b_{t+1}^2) \quad (13)$$

$$+ \xi_{t+1} (\rho b_t - \eta c_t - b_{t+1}) + \phi_{t+1} (\pi_t - \kappa c_t - \nu b_t - u_t - \beta (\pi_u \rho_u u_t + \pi_b b_{t+1})). \quad (14)$$

This approach exploits the intertemporal representation (6)-(7) together with the underlying assumption that the private sector expectations about its own future decisions will be necessarily a function of the future state.

Only current period constraints matter for the policy maker and the first order conditions can be written as

$$0 = \beta S_{bb}b_{t+1} + \beta S_{ub}\rho_u u_t - \xi_{t+1} - \beta \pi_b \phi_{t+1}, \quad (15)$$

$$0 = \pi_t + \phi_{t+1}, \quad (16)$$

$$0 = \lambda c_t - \eta \xi_{t+1} - \kappa \phi_{t+1}, \quad (17)$$

$$0 = \rho b_t - \eta c_t - b_{t+1}, \quad (18)$$

$$0 = \beta \pi_b b_{t+1} + \kappa c_t + \nu b_t - \pi_t + \beta \pi_u \rho_u u_t. \quad (19)$$

The optimal policy response can be written in the form of (9) with

$$c_u = - \frac{((\lambda - \beta \pi_b \eta) (\beta \pi_u \rho_u + 1) - \eta \beta S_{ub} \rho_u)}{(\beta \eta^2 S_{bb} + (\lambda - \beta \pi_b \eta)^2 + \alpha)} \quad (20)$$

$$c_b = - \frac{((\lambda - \beta \pi_b \eta) (\beta \pi_b \rho + \nu) - \eta \beta S_{bb} \rho)}{(\beta \eta^2 S_{bb} + (\lambda - \beta \pi_b \eta)^2 + \alpha)} \quad (21)$$

and so the components of the value function satisfy the following equations

$$S_{uu} = \left(((\beta \pi_u \rho_u + 1) + (\lambda - \beta \pi_b \eta) c_u)^2 + \alpha c_u^2 + \beta (\rho^2 S_{uu} - 2\rho \eta S_{ub} c_u + \eta^2 S_{bb} c_u^2) \right), \quad (22)$$

$$S_{\eta b} = ((\beta \pi_u \rho_u + 1) + (\lambda - \beta \pi_b \eta) c_u) ((\beta \pi_b \rho + \nu) + (\lambda - \beta \pi_b \eta) c_b) + \alpha c_u c_b + \beta S_{ub} \rho_u (\rho - \eta c_b) - \beta S_{bb} \eta c_u (\rho - \eta c_b), \quad (23)$$

$$S_{bb} = ((\beta \pi_b \rho + \nu) + (\lambda - \beta \pi_b \eta) c_b)^2 + \beta S_{bb} (\rho - \eta c_b)^2 + \alpha c_b^2. \quad (24)$$

This yields the following coefficients in (10)

$$\pi_u = \beta\pi_u\rho_u + 1 + (\lambda - \beta\pi_b\eta) c_u, \quad (25)$$

$$\pi_b = \beta\pi_b\rho + \nu + (\lambda - \beta\pi_b\eta) c_b. \quad (26)$$

The solution to (20)-(26) gives the discretionary equilibrium described by the set $\{c_u, c_b, \pi_u, \pi_b, S_{uu}, S_{ub}, S_{bb}\}$. Note that the discretionary equilibrium is fully characterized by the deterministic component of the solution, $\{\pi_b, c_b, S_{bb}\}$. Indeed, we can solve system (20)-(26) in a recursive way. We first solve (21), (24) and (26) for $\{c_b, \pi_b, S_{bb}\}$ and then solve the rest of the system for the stochastic component of the solution. We use this well known fact to find all discretionary equilibria in the following simple and illustrative way.⁹

Suppose the policy maker guesses the response of the private sector to the state, π_b . Then the optimal discretionary policy is given by the pair (21) and (24). We find c_b and therefore the optimal response π_b^* of the private sector is given by (26). Then, for every - not necessarily optimal - π_b we can compute a unique π_b^* and plot the dependence $\pi_b^*(\pi_b)$, see the first panel in Figure 1, Panel I. Clearly, if $\pi_b = \pi_b^*$ we have a solution to the discretionary problem.

For our base line calibration the graph of $\pi_b^*(\pi_b)$ intersects the 45° degree line in three points labelled *A*, *B* and *C*, so we have three discretionary policy equilibria.¹⁰ A moderate inflation, set by the firms in response to a given debt level, π_b , increases the marginal return to a policy decision that increases consumption in response to this level of debt, c_b . Higher consumption raises demand and firms will increase their response to debt, π_b^* . This complementarity ensures the steepness of $\pi_b^*(\pi_b)$ and three equilibria arise.

The three equilibria, whose characteristics are presented in Table 1 result in qualitatively and quantitatively different dynamics of the economy. Figure 2, which shows the responses of key variables to a unit markup shock for equilibria *A* and *C* (as equilibrium *B* is similar to equilibrium *A* for the benchmark calibration) using dotted lines with markers.¹¹ Focusing first on equilibrium *A*, inflation rises following the markup shock and the policy response is to defer consumption (by raising the nominal interest rate sufficiently high, this is implicit in our model). The decline in consumption lowers output and government tax revenues, which leads to a rise in government

⁹See Anderson et al. (1996) on certainty equivalence in this class of models and Blake and Kirsanova (2012) for explicit formulae for stochastic components as functions of deterministic components for discretionary models.

¹⁰The benchmark calibration follows Schaumburg and Tambalotti (2007) and Blake and Kirsanova (2012). The model's frequency is quarterly. The subjective discount rate β is set to 0.99, the government share of total output $1 - \rho$ is 0.25. The elasticity of intertemporal substitution σ is 1/2, the Frisch elasticity of labor supply $\varphi = 1/2$, an elasticity of demand ϵ of 7. The Calvo parameter $\gamma = 0.75$. Fiscal feedback μ is set to 0.05, which guarantees multiplicity of equilibria.

¹¹These impulse responses are identical in each panel.

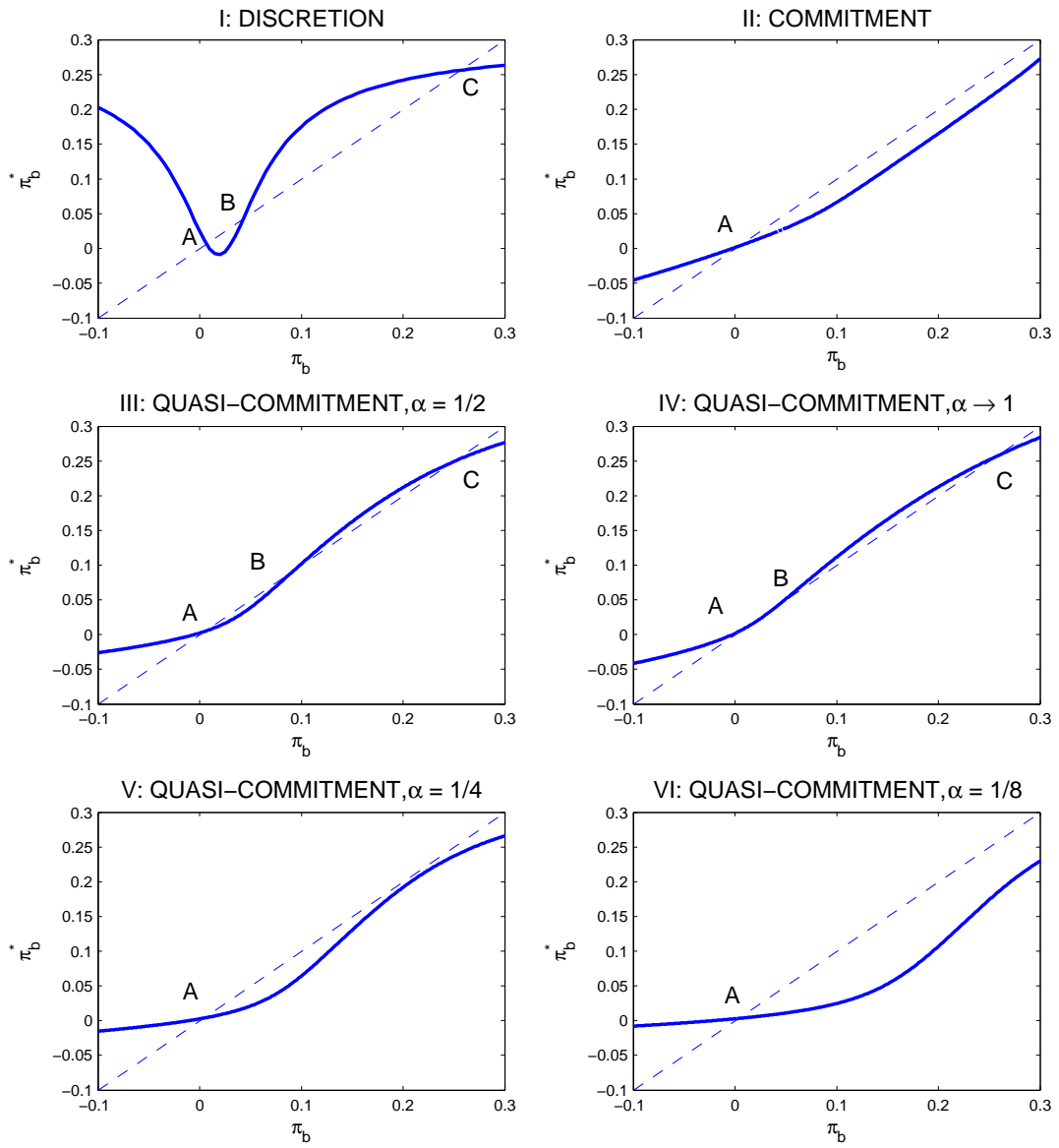


Figure 1: Multiple policy equilibria for different degrees of precommitment

		Eq. A	Eq. B	Eq. C	
<i>Characteristics of Discretionary Policy Equilibria</i>					
(1)	Policy Reaction	$\begin{bmatrix} c_\eta & c_b \end{bmatrix}$	$\begin{bmatrix} -4.8 & -0.02 \end{bmatrix}$	$\begin{bmatrix} -4.5 & -0.01 \end{bmatrix}$	$\begin{bmatrix} -0.4 & 1.9 \end{bmatrix}$
(2)	Private Sector Reaction	$\begin{bmatrix} \pi_\eta & \pi_b \end{bmatrix}$	$\begin{bmatrix} 0.7 & 0.01 \end{bmatrix}$	$\begin{bmatrix} 0.8 & 0.02 \end{bmatrix}$	$\begin{bmatrix} 1.0 & 0.3 \end{bmatrix}$
(3)	Normalized Loss	L	1.3326	1.3872	1.8283
<i>Characteristics of Commitment Policy Equilibrium</i>					
(4)	Policy Reaction	$\begin{bmatrix} c_\eta & c_b & c_\phi \end{bmatrix}$	$\begin{bmatrix} -3.6 & -0.01 & 3.6 \end{bmatrix}$	–	–
(5)	Private Sector Reaction	$\begin{bmatrix} \pi_\eta & \pi_b & \pi_\phi \end{bmatrix}$	$\begin{bmatrix} 0.5 & 0.002 & 0.45 \end{bmatrix}$	–	–
(6)	Normalized Loss	L	1.0	–	–
<i>Degree of Precommitment Required to Select the Best Equilibrium</i>					
(7)	Duration of commitment period to select Eq. A	$1/\alpha,$ quarters	7	–	–

Table 1: Properties of Discretionary Equilibria in the NK Model with Debt Accumulation

debt. In subsequent periods, although interest rates are lowered to stimulate the economy and bring it out of recession, government debt is brought back to baseline predominantly through (primary) fiscal surpluses, rather than through a decline in the cost of financing government debt.

In equilibrium C monetary policy responds to the markup shock by stimulating consumption and output, raises real marginal costs, and causes inflation to rise by more than it otherwise would. This monetary policy causes tax revenues to rise and leads to a decline in government debt. To stabilize government debt, future policy makers raise the cost of financing government debt, which causes consumption, output, and real marginal costs to decline and places downward pressure on inflation. In the spirit of Leeper (1991) monetary policy can be thought of as being active in equilibria A and B and passive in equilibrium C . Table 1 reveals this trade-off between the response to government debt and the response to the markup shock: The more ‘actively’ the policy maker behaves, the stronger is the policy-induced recession in response to the mark-up shock.

3.2 Commitment Policy

Under the full commitment policy the policy maker optimizes only once, in the initial moment. He chooses a contingency plan, which is then applied indefinitely but can be implemented sequentially. If there is a change of policy makers, the subsequent policy maker continues the policy of its predecessor; therefore we can assume that there is only one policy maker which takes office in

period zero and stays infinitely. When optimizing, the policy maker internalizes the effect of its choice on private sector's expectations and solves the following Lagrangian

$$\mathcal{L}^c = \sum_{t=0}^{\infty} \beta^t \left(\frac{1}{2} (\pi_t^2 + \lambda c_t^2) + \xi_{t+1} (\rho b_t - \eta c_t - b_{t+1}) + \phi_{t+1} (\pi_t - \kappa c_t - \nu b_t - u_t - \beta \pi_{t+1}) \right).$$

The corresponding first order conditions are:

$$0 = -\xi_t + \rho \beta \xi_{t+1} - \nu \beta \phi_{t+1}, \quad (27)$$

$$0 = \pi_t + \phi_{t+1} - \phi_t, \quad (28)$$

$$0 = \lambda c_t - \eta \xi_{t+1} - \kappa \phi_{t+1}, \quad (29)$$

$$0 = \rho b_t - \eta c_t - b_{t+1}, \quad (30)$$

$$0 = \beta E_t \pi_{t+1} + \kappa c_t + \nu b_t + u_t - \pi_t, \quad (31)$$

for $t \geq 0$; with initial conditions $b_0 = \bar{b}$ and $\phi_0 = 0$, and the transversality condition $\lim_{t \rightarrow \infty} b_t < \infty$.

The solution to the commitment problem can be written in the following linear form (see Appendix A)

$$\pi_t = \pi_u u_t + \pi_b b_t + \pi_\phi \phi_t, \quad (32)$$

$$c_t = c_u u_t + c_b b_t + c_\phi \phi_t, \quad (33)$$

$$\xi_t = \xi_u u_t + \xi_b b_t + \xi_\phi \phi_t. \quad (34)$$

Writing the solution in this way allows us to compare it with the discretionary solution. Again, suppose the response of the private sector to debt, π_b , is given. We can guess the other feedback coefficients in the system (32)-(34) and iterate the Riccati equation as suggested in Appendix A, but do not update π_b . If the procedure converges, we have obtained the optimal response of the policy maker to the private sector decision, provided that the private sector responds to the Lagrange multiplier (set by the policy maker) in an optimal way. Then, we iterate the Riccati equation once again to obtain π_b^* . A solution to the commitment problem implies $\pi_b^* = \pi_b$. The graph of $\pi_b^*(\pi_b)$ intersects the 45° degree line in one point labelled *A*, see the second panel in Figure 1, and we can verify with standard methods (Söderlind (1999)) that this point is, indeed, a solution. For the base line calibration the economy is stabilized by the policy maker in the unique equilibrium *A*.

Figure 2 reports the responses of all variables to a positive unit cost push shock. Under commitment (the blue dotted line with x-markers) the policy maker engineers a fall in private

consumption, which will dampen marginal costs. Although the dynamics of the economy is very similar to the one in discretionary equilibrium A , in contrast to this discretionary equilibrium, the policy maker keeps consumption below the steady state for several periods. Such a policy allows the policy maker to lower expected future inflation and ensures price stability in the long run. Government debt initially increases due to the fall in consumption, but is brought back to the steady state with higher taxes.

4 Quasi-Commitment Policy

This Section studies monetary policy within a limited commitment framework. We discuss the continuum of intermediate cases between commitment and discretion. We want to understand (i) how a ‘quasi-commitment bridge’ links the economy under commitment and under discretion when multiple equilibria exist, and (ii) how effectively quasi-commitment helps to select the best equilibrium.

4.1 Existence of Multiple Policy Equilibria

A quasi-commitment policy, as introduced in Schaumburg and Tambalotti (2007), also assumes sequential policy making. A new policy maker is appointed with a constant and exogenous probability α every period. When a new policy maker arrives in office, he reneges on the promises of his predecessor and commits to a new policy plan that is optimal at the time of the change. All agents understand the possibility and the nature of this change and form expectations accordingly. The private sector knows that a new policy maker will re-optimize, therefore it doubts the reliability of outstanding promises.

As in Schaumburg and Tambalotti (2007) and Debortoli and Nunes (2010) we assume that the policy maker’s tenure in office depends on a sequence of exogenous i.i.d. Bernoulli signals $\{\Omega_t\}_{t \geq 0}$ with $\mathbb{E}[\Omega_t] = \alpha$. If $\alpha = 1$ the policy authority acts under full discretion and every period a new policy maker arrives in office and re-optimizes the planning problem. If $\alpha = 0$ the policy maker stays in office infinitely long and keeps his promises.

Schaumburg and Tambalotti (2007) and Debortoli and Nunes (2010) demonstrate that the optimization problem under limited commitment can be expressed by the following Lagrangian

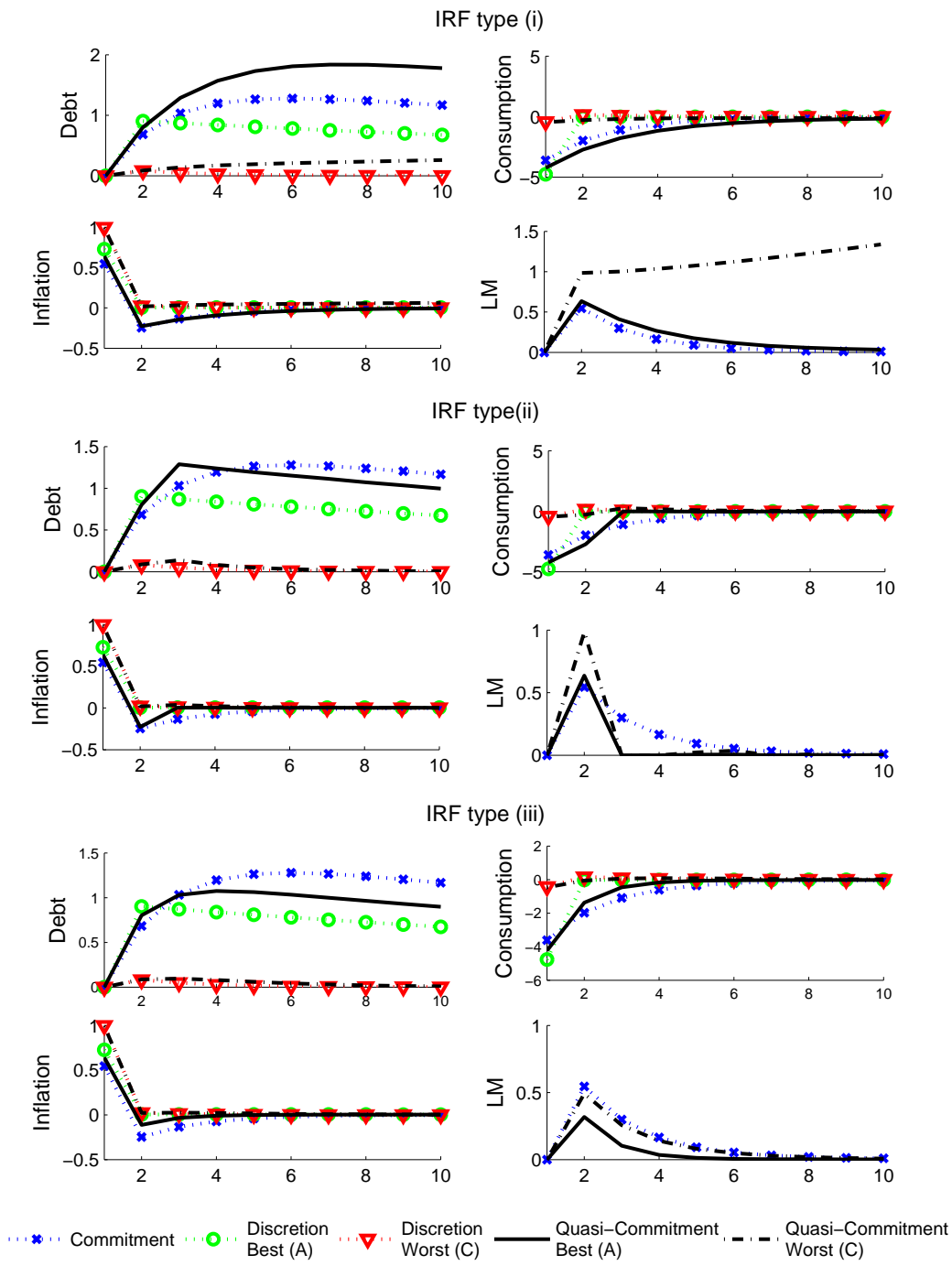


Figure 2: Impulse Responses to a 1% cost push shock in the model with government debt

$$\begin{aligned}
\mathcal{L}^{qc} &= \sum_{t=0}^{\infty} (\beta(1-\alpha))^t \left(\frac{1}{2} (\pi_t^2 + \lambda c_t^2 + \beta\alpha (S_{uu}u_{t+1}^2 + 2S_{ub}u_{t+1}b_{t+1} + S_{bb}b_{t+1}^2)) \right) & (35) \\
&+ \phi_{t+1} (\pi_t - \kappa c_t - \nu b_t - u_t - \beta(1-\alpha)\pi_{t+1} - \beta\alpha\pi_b b_{t+1} - \beta\alpha\pi_u u_{t+1}) \\
&+ \xi_{t+1} (\rho b_t - \eta c_t - b_{t+1})
\end{aligned}$$

for $0 \leq \alpha < 1$. The first order conditions are

$$0 = \beta\alpha S_{ub}u_t + \beta\alpha S_{bb}b_t - \xi_t + \rho\beta(1-\alpha)\xi_{t+1} - \nu\beta(1-\alpha)\phi_{t+1} - \beta\alpha\pi_b\phi_t, \quad (36)$$

$$0 = \pi_t + \phi_{t+1} - \phi_t, \quad (37)$$

$$0 = \lambda c_t - \eta\xi_{t+1} - \kappa\phi_{t+1}, \quad (38)$$

$$0 = \rho b_t - \eta c_t - b_{t+1}, \quad (39)$$

$$0 = \beta(1-\alpha)\pi_{t+1} + \beta\alpha\pi_b b_{t+1} + \kappa c_t + \nu b_t + (\beta\alpha\pi_u \rho_u + 1)u_t - \pi_t, \quad (40)$$

for $t \geq 0$, with initial conditions $b_0 = \bar{b}$ and $\phi_0 = 0$, and the transversality condition $\lim_{t \rightarrow \infty} b_t < \infty$. These first order conditions are similar to those for commitment, but depend additionally on the parameters $\{\pi_b, S_{bb}, S_{ub}\}$.¹²

We can plot the solutions to this system using the same approach as in Section 3.2. The solution to (36)-(40) can be written in form of (32)-(34). The resulting matrix Riccati equation is similar to the one under commitment, but its coefficients depend obviously also on $\{\pi_b, S_{bb}, S_{ub}\}$. We can use a similar solution method to find the number of equilibria: suppose we guess the response of the private sector to the state variable, π_b . Then, we can solve the policy maker's problem and find the 'first guess' of S . In the next step we iterate the Riccati equation, but do not update π_b . If the procedure has converged, we iterate it once to obtain the update π_b^* . Solutions to the system (36)-(40) will be among the points where $\pi_b^* = \pi_b$.

For the base line calibration of $\alpha = 1/2$ (which implies an average regime duration of two quarters) the graph of $\pi_b^*(\pi_b)$ intersects the 45° degree line in three points labelled A , B and C , see the third panel in Figure 1.¹³ Therefore, if we move from pure discretionary policy to a policy maker who stays in office on average for two periods all three equilibria survive.

Proposition 1 *There exists a $0 < \bar{\alpha} < 1$ such that if $\alpha \in [\bar{\alpha}, 1)$ then there are as many quasi-commitment policy equilibria as under pure discretionary policy.*

¹²These parameters will be obtained as the solution of the corresponding Bellman equation (see Appendix C for details).

¹³Again, we can verify with alternative methods that these are indeed solutions to the optimization problem.

Proof. Note that if $\alpha = 1$, the policy maker defaults with certainty every period. Then, the Lagrangian (35) takes the form of (13), which describes the discretionary optimization problem. However, the first order conditions for the limited commitment optimization problem (36)-(40) are left-discontinuous at point $\alpha = 1$. System (36)-(40) does not collapse to (15)-(19), because the past-period constraints still bind for any $\alpha < 1$. Therefore, taking the limit $\alpha \rightarrow 1$ in system (36)-(40) does not eliminate the Lagrange multiplier on the previous-period constraint ϕ_t in equation (37). Because for any $\alpha < 1$ the private sector does not expect the occurrence of default with certainty in the next period, this property holds at the limit and implies discontinuity of the first order conditions.

Suppose $\alpha \rightarrow 1$. After the straightforward substitution of ξ_t , c_t and π_t the first order conditions (36)-(40) collapse to the following system

$$b_{t+1} = \frac{\lambda\rho + (\kappa\rho + \nu\eta)(\kappa - \beta\eta\pi_b)}{(\kappa - \beta\eta\pi_b)^2 + \lambda + S_{bb}\beta\eta^2} b_t - \frac{\eta(\kappa - \beta\eta\pi_b)}{(\kappa - \beta\eta\pi_b)^2 + \lambda + S_{bb}\beta\eta^2} \phi_t + \frac{\eta(\kappa - \beta\eta\pi_b + \beta\rho_u(\kappa\pi_u - \beta\eta\pi_b\pi_u - \eta S_{ub}))}{(\kappa - \beta\eta\pi_b)^2 + \lambda + S_{bb}\beta\eta^2} u_t \quad (41)$$

$$\phi_{t+1} = -\frac{\nu(\lambda + S_{bb}\beta\eta^2) + \beta\rho(\lambda\pi_b + S_{bb}\kappa\eta)}{(\kappa - \beta\eta\pi_b)^2 + \lambda + S_{bb}\beta\eta^2} b_t + \frac{\lambda + S_{bb}\beta\eta^2}{(\kappa - \beta\eta\pi_b)^2 + \lambda + S_{bb}\beta\eta^2} \phi_t - \frac{\lambda + \beta\eta^2 S_{bb} + \beta\rho_u(\pi_u(\lambda + \beta\eta^2 S_{bb}) + \eta S_{ub}(\kappa - \beta\eta\pi_b))}{(\kappa - \beta\eta\pi_b)^2 + \lambda + S_{bb}\beta\eta^2} u_t \quad (42)$$

for $t \geq 0$, where the coefficients depend on the solution to the corresponding discretionary problem, π_b , S_{ub} and S_{bb} .

All variables in system (41)-(42) are predetermined with initial conditions $\phi_0 = 0$ and $b_0 = \bar{b}$. Therefore for a given solution to the discretionary problem $D = \{\pi_b, S_{ub}, S_{bb}\}$ we can construct a unique path $P = \{b_t, \phi_t, u_t | D\}_{t \geq 0}$. The limiting case of first order conditions to the quasi-commitment optimization problem will have as many solutions as the corresponding discretionary optimization problem. Because there are three different discretionary equilibria there are three distinct sets $D^j = \{\pi_b^j, S_{ub}^j, S_{bb}^j\}$, $j = 1, 2, 3$ for the base line calibration. Therefore, three paths $P^j = \{b_t, \phi_t, u_t | D^j\}_{t \geq 0}$ satisfy the system (41)-(42). By continuity there will exist $\bar{\alpha} < 1$ such that these properties will hold for $\alpha \in [\bar{\alpha}, 1)$. ■

We plot the case $\alpha \rightarrow 1$ in the fourth panel in Figure 1. The $\pi_b^*(\pi_b)$ line intersects the 45° degree line in three points, which are the same points as under pure discretion.¹⁴

Note that the system (36)-(40) describes the dynamics of the economy in which, although it

¹⁴The shape of $\pi_b^*(\pi_b)$ is different than in Panel I because we take into account the Lagrange multipliers when computing $\pi_b^*(\pi_b)$.

is expected that new policy makers arrive in office with probability α and renege on the promises of their predecessors, defaults never happen in the realized history and therefore the Lagrange multiplier ϕ_s is never reset to zero for $s > t$. The left-discontinuity of the first order conditions at $\alpha = 1$ arise because for any $\alpha < 1$ the realized reoptimization may never happen, but it happens with certainty for $\alpha = 1$. However, because the consequent policy makers *do* reset ϕ_s to zero with probability α , the dynamic properties of the economy are left-continuous at point $\alpha = 1$.¹⁵

In Figure 2 we show the responses of all variables to a positive 1% cost push shock under a quasi-commitment policy. We set $\alpha = 1/2$, which implies an average regime duration of two quarters. We also demonstrate impulse responses under commitment and discretion (equilibria *A* and *C*).

Panel I of Figure 2 shows the impulse response functions of Type (i).¹⁶ These impulse responses demonstrate the evolution of the economy if no reoptimization happens over the horizon of interest, while the private sector expects them to happen every period with probability 1/2. In this scenario a central banker stays in office unexpectedly long, which becomes more and more unrealistic over time. To generate impulse responses we use the transition matrix given by the conditions (36)-(40). Similar to discretion we plot the two quasi-commitment equilibria *A* and *C*. We use solid and dash-dotted lines correspondingly. Compared to the full commitment policy, quasi-commitment policy in the active monetary policy equilibrium *A* delivers a stronger and longer lasting decrease in consumption. As reoptimizations are expected to happen the price setters expect future policy makers to increase consumption and therefore expect a high inflation in the future. Therefore, if the policy maker wants to exploit private sector expectations he has to pay a higher cost in form of a stronger recession. In the absence of reoptimizations this results in stronger future deflation and higher debt, compared to commitment.

Type (i) impulse responses under quasi-commitment policy in equilibrium *C* are explosive. In this case the ‘passive’ monetary policy is not able to stabilize inflation, while trying to keep debt under control. After the shock occurred the policy maker cannot move consumption by much, since he has to avoid excessive debt accumulation. This is a similar behaviour as in discretionary equilibrium *C*. Because the private sector expects defaults in the future and hence high future inflation, inflation can only be controlled with low demand. However, lower consumption would result in excessive debt accumulation. Therefore the reduction in consumption unwinds the attempt of the central bank to ensure fiscal solvency and the economy exhibits explosive behavior.

¹⁵See Appendix B for details.

¹⁶The categorization of the impulse response functions follows Schaumburg and Tambalotti (2007).

As the fourth chart in the first panel shows, the Lagrange multiplier ϕ_t which measures the shadow price of controlling the private sector inflation expectations is much higher in equilibrium C and explodes with time.¹⁷ The result is not surprising, given that the monetary policy maker has to control debt in the passive equilibrium. This task becomes incompatible with inflation stabilization if expected defaults do not happen.

Impulse responses of Type (ii) in Panel II of Figure 2 characterize a more typical behavior of the economy under quasi-commitment. Suppose reoptimizations happen in periods 2, 3, 6 and 8 after the initial shock. In each of these periods the reoptimizing policy maker reneges on the plan of its predecessor. When the policy maker defaults on the promises of his predecessor, he resets the predetermined Lagrange multiplier to zero. The policy maker takes this opportunity to end the promised recession of his predecessor and raises consumption back to its initial level. The increase in consumption also leads to a faster reduction of government debt.

Type (iii) impulse responses (Panel III in Figure 2) are the ex ante averages of all the possible conditional IRFs integrated over the distribution of the corresponding reoptimization draws. Therefore they demonstrate the expected evolution of the system following the initial shock. Naturally, they are in between the IRF of the respective discretionary equilibria and the IRF under full commitment.

4.2 Equilibrium Selection

Proposition 2 *There exists a $0 < \underline{\alpha} < 1$ such that if (i) $\alpha \in [0, \underline{\alpha})$ and (ii) a quasi-commitment equilibrium exists, then the equilibrium is unique.*

Proof. Under commitment the policy equilibrium in LQ RE models, if it exists, is unique.¹⁸ By continuity there exists a $\underline{\alpha} > 0$ such that if $\alpha \in [0, \underline{\alpha})$ the quasi-commitment solution is unique if it exists. ■

By continuity the selected equilibrium is always Pareto-optimal because the commitment equilibrium, to which the selected equilibrium converges at the limit, delivers the lowest loss. The value of $\underline{\alpha}$ which selects the unique equilibrium can be smaller than the value of $\bar{\alpha}$ which ensures the same number of equilibria as under discretion. How big are these values for our model? In particular, what is the sufficient degree of precommitment $\underline{\alpha}$ such that only one equilibrium survives?

¹⁷This Lagrange multiplier is set on the Phillips curve in the optimization problem of the policy maker.

¹⁸A commitment policy which stabilises the economy may not exist, see Appendix A.

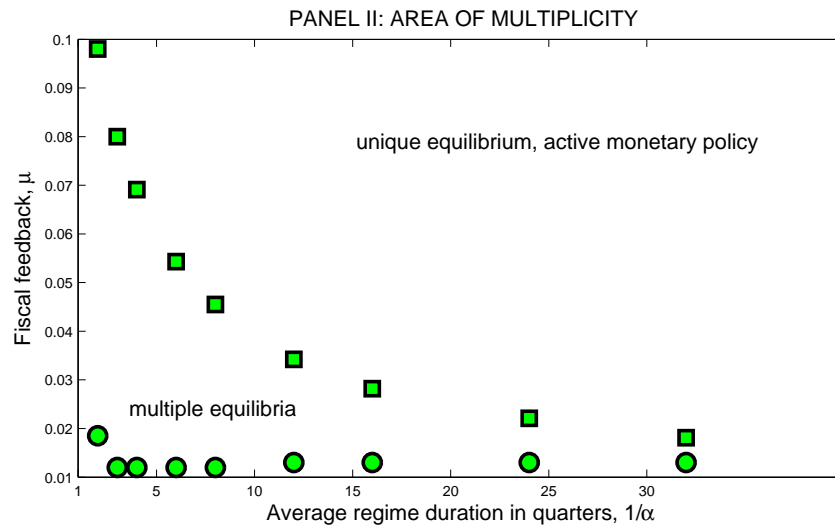
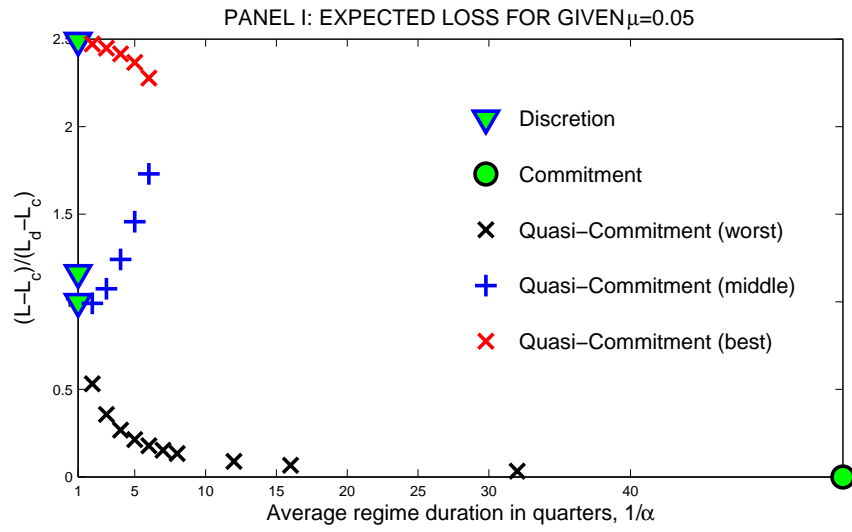


Figure 3: Equilibrium Selection

Panel I in Figure 3 plots the expected welfare loss for each equilibrium as a function of the average duration of the period of precommitment $1/\alpha$ for a given fiscal feedback parameter $\mu = 0.05$. In case of pure discretion ($\alpha = 1$) we have three equilibria denoted by triangular markers. With higher degrees of precommitment all three equilibria survive. The losses in the corresponding equilibria are marked with crosses. Panel I suggests that for the benchmark value of the fiscal feedback parameter the worst and the middle equilibria are eliminated if $\bar{\alpha} = \underline{\alpha} = 1/8$, as we also report in row (7) of Table 1. If the policy maker stays in the office only for two years on average this will guarantee the unique equilibrium under quasi-commitment policy.¹⁹

To summarize, only a relatively small degree of commitment is required to select the best equilibrium. If a limited commitment technology is available, then it is a more powerful selection mechanism than a formation of a coalition of consequent discretionary policy makers, see Dennis and Kirsanova (2009). If consequent policy makers form coalitions and reoptimize under discretion only in the first period of each coalition tenure, sticking to the same time-consistent policy between reoptimizations, it requires a tenure period of three years to select the best equilibrium in this model.²⁰ An access to the limited commitment technology reduces the necessary tenure period which is required to avoid falling into an expectation trap. Panel I in Figure 3 shows that for $\mu = 0.05$ multiplicity is eliminated, if a policy maker can commit on average for 2 years.²¹ Moreover, and more generally, Proposition 2 claims that there is some sufficient degree of commitment which will certainly select the Pareto-preferred equilibrium (if the corresponding commitment equilibrium exists), but no coalition of discretionary policy makers might exist to select it (Dennis and Kirsanova (2009)).

Panel II in Figure 3 investigates the robustness of the above result for different values of the fiscal feedback parameter μ , which is crucial for multiplicity. We concentrate on the range of the fiscal feedback μ which generates multiplicity of quasi-commitment equilibria for a given average regime duration, $1/\alpha$. For every (discrete) regime duration the square marker denotes the minimum level of μ above which there is a unique equilibrium characterized by an ‘active’ monetary policy. Below the round marker there is an area of unique equilibrium characterized by a ‘passive’ monetary policy. In the area between the two markers we observe multiplicity of

¹⁹Panel I in Figure 3 also demonstrates that the welfare loss is quickly reduced for a higher degree of precommitment. The initial gap between the loss in the best discretionary equilibrium A and commitment is nearly halved after one year of precommitment. A further reduction in α demonstrates that the gains from even minimal levels of credibility are substantial.

²⁰For the base line calibration of the model with $\mu = 0.05$.

²¹Our numerical experiments with different (and more complex) models show consistently that the best equilibrium is selected only after a few periods of precommitment.

policy equilibria. Panel II demonstrates that with longer periods of precommitment the area of multiplicity shrinks very quickly: if the average period of precommitment is more than five years then expectation traps only exist for very small and empirically irrelevant values of the fiscal feedback μ .

Parameter μ is crucial for multiplicity, but how realistic is its base-line calibration? The recent empirical evidence suggests that, although the strength of fiscal feedback varies across countries and with time, it is around $\mu = 0.05$. Indeed, tax and spending rules for the post-1960 period in the US were estimated in Leeper et al. (2010) who find a reaction of labour taxes to debt of about 0.05 percentage points.²² Therefore, the range of fiscal feedbacks in Panel II in Figure 3 is empirically relevant. The base-line value of $\mu = 0.05$ creates multiplicity under pure discretionary policy. However, it is enough for a policy maker to stay in the office for two years in order to select the best equilibrium.

Our results are robust to different calibrations of other parameters of the model. Two parameters were found to affect the quantitative results most. More myopic agents (i.e. lower β) put higher relative weight on stabilization of the economy in the first periods after the shock. This eliminates the good equilibrium for low values of the fiscal feedback parameter μ , because in this equilibrium the adjustment is relatively slow. Differently, a higher degree of price stickiness (bigger Calvo parameter γ) slows the adjustment process down and eliminates the bad equilibrium for high values of μ . However, the shape of the curve in Panel I of Figure 3 stays in both cases the same and quantitative differences are not very large.

5 Conclusion

In this paper we study monetary policy in a limited commitment framework using a simple New Keynesian model with government debt. We show by example the existence of multiple equilibria under quasi-commitment policy using a model with government debt accumulation. We demonstrate the existence of expectation traps similar to those under pure discretionary policy. Because the private sector expects eventual re-optimizations to happen the current policy maker formulates its policy based on the forecast of the private sector about future policy makers' behaviour. We find that there can be at least as many limited commitment policy equilibria as in the corresponding discretionary policy problem.

Although the previously developed equilibrium selection mechanism may suggest that eco-

²²See also Coenen and Straub (2005) and Forni et al. (2009) who find a slightly higher response of taxes to debt for the Euro Area.

conomic agents are likely to coordinate on the best equilibrium, our example demonstrates that a limited commitment technology helps the policy maker to avoid falling into an expectation trap even if the degree of precommitment is very small.

In this paper we also provide an algorithm for computing quasi-commitment equilibria in the general class of LQ RE models with endogenous state variables and with exogenous probability of default. We leave the numerical investigation of properties of quasi-commitment policy in a wider class of non-linear dynamic models for future research. This research might investigate how much commitment is required to select the best equilibrium in a King and Wolman (2004) type of model with multiple discretionary equilibria. Once a robust algorithm to solve non-linear models is developed, future research will be able to endogenize the probability of default along the lines suggested in Debortoli and Nunes (2010).

A Commitment FOCs in the Form of a Riccati Equation

When optimizing, the policy maker internalizes the effect of its choice on private sector's expectations and solves the following Lagrangian

$$\mathcal{L}^c = \sum_{t=0}^{\infty} \beta^t \left(\frac{1}{2} (\pi_t^2 + \lambda c_t^2) + \xi_{t+1} (\rho b_t - \eta c_t - b_{t+1}) + \phi_{t+1} (\pi_t - \kappa c_t - \nu b_t - u_t - \beta \pi_{t+1}) \right).$$

The corresponding first order conditions are:

$$0 = -\xi_t + \rho \beta \xi_{t+1} - \nu \beta \phi_{t+1}, \quad (43)$$

$$0 = \pi_t + \phi_{t+1} - \phi_t, \quad (44)$$

$$0 = \lambda c_t - \eta \xi_{t+1} - \kappa \phi_{t+1}, \quad (45)$$

$$0 = \rho b_t - \eta c_t - b_{t+1}, \quad (46)$$

$$0 = \beta E_t \pi_{t+1} + \kappa c_t + \nu b_t + u_t - \pi_t, \quad (47)$$

for $t \geq 0$; with initial conditions $b_0 = \bar{b}$ and $\phi_0 = 0$, and the transversality condition $\lim_{t \rightarrow \infty} b_t < \infty$.

If the system (6)-(7) is controllable, there always exists a unique path $\{c_t, \pi_t, b_t\}_{t \geq 0}$ which (i) satisfies system (43)-(47) and the initial conditions and (ii) all eigenvalues of the resulting transition matrix are less than $1/\sqrt{\beta}$ in modulus (see, e.g. Kwakernaak and Sivan (1972), Backus and Driffill (1986)).²³ For the rest of this paper we use the following definition: The economy is *stabilized* by a policy if all eigenvalues of the transition matrix are inside the unit circle. If the

²³System (6)-(7) is controllable if $\rho \neq 0$ and $\eta \neq 0$.

economy is stabilized by a policy we call such a policy *stabilizing*. In general, because $\beta < 1$ a stabilizing commitment policy may not exist for all problems in the LQ RE class.

One way to solve the system (43)-(47) is to use the Schur decomposition, see e.g. Söderlind (1999). Alternatively, and more convenient for our purpose, we can also solve the system using an iterative scheme.

System (43)-(47) can be written as

$$\begin{bmatrix} 0 & 0 & \eta \\ 0 & \beta & 0 \\ 0 & 0 & \rho\beta \end{bmatrix} \begin{bmatrix} c_{t+1} \\ \pi_{t+1} \\ \xi_{t+1} \end{bmatrix} = \begin{bmatrix} 0 & 0 & -\kappa \\ -1 & -\nu & 0 \\ 0 & 0 & \nu\beta \end{bmatrix} \begin{bmatrix} u_t \\ b_t \\ \phi_t \end{bmatrix} + \begin{bmatrix} \lambda & \kappa & 0 \\ -\kappa & 1 & 0 \\ 0 & -\nu\beta & 1 \end{bmatrix} \begin{bmatrix} c_t \\ \pi_t \\ \xi_t \end{bmatrix} \quad (48)$$

$$\begin{bmatrix} u_{t+1} \\ b_{t+1} \\ \phi_{t+1} \end{bmatrix} = \begin{bmatrix} \rho_u & 0 & 0 \\ 0 & \rho & 0 \\ 0 & 0 & 1 \end{bmatrix} \begin{bmatrix} u_t \\ b_t \\ \phi_t \end{bmatrix} + \begin{bmatrix} 0 & 0 & 0 \\ -\eta & 0 & 0 \\ 0 & -1 & 0 \end{bmatrix} \begin{bmatrix} c_t \\ \pi_t \\ \xi_t \end{bmatrix} \quad (49)$$

Substitute (32)-(34) into both sides of (48) and use (49) to substitute out b_{t+1}, ϕ_{t+1} . We obtain

$$\begin{bmatrix} \lambda + \eta^2 \xi_b & \kappa - \eta \xi_\phi & 0 \\ \beta \eta \pi_b - \kappa & 1 - \beta \pi_\phi & 0 \\ \beta \eta \rho \xi_b & -\beta (\nu + \rho \xi_\phi) & 1 \end{bmatrix} \begin{bmatrix} c_t \\ \pi_t \\ \xi_t \end{bmatrix} = \begin{bmatrix} \eta \xi_u \rho \eta & \eta \rho \xi_b & \kappa - \eta \xi_\phi \\ \beta \rho_u \pi_u + 1 & \nu + \beta \rho \pi_b & -\beta \pi_\phi \\ \beta \rho \xi_u \rho_u & \beta \rho^2 \xi_b & -\beta (\nu + \rho \xi_\phi) \end{bmatrix} \begin{bmatrix} u_t \\ b_t \\ \phi_t \end{bmatrix}$$

Substitution of (32)-(34) yields the following matrix discrete algebraic Riccati equation:

$$\begin{bmatrix} c_u & c_b & c_\phi \\ \pi_u & \pi_b & \pi_\phi \\ \xi_u & \xi_b & \xi_\phi \end{bmatrix} = \begin{bmatrix} \lambda + \eta^2 \xi_b & \kappa - \eta \xi_\phi & 0 \\ \beta \eta \pi_b - \kappa & 1 - \beta \pi_\phi & 0 \\ \beta \eta \rho \xi_b & -\beta (\nu + \rho \xi_\phi) & 1 \end{bmatrix}^{-1} \begin{bmatrix} \eta \xi_u \rho \eta & \eta \rho \xi_b & \kappa - \eta \xi_\phi \\ \beta \rho_u \pi_u + 1 & \nu + \beta \rho \pi_b & -\beta \pi_\phi \\ \beta \rho \xi_u \rho_u & \beta \rho^2 \xi_b & -\beta (\nu + \rho \xi_\phi) \end{bmatrix}$$

We can guess all feedback coefficients in (32)-(34) and thus in the right hand side of the equation above. Then, the Riccati equation gives an update of these coefficients: in the next step we update the right hand side of it and iterate until convergence. The algorithm will converge (Lancaster and Rodman (1995)).

Although the base line calibration delivers a stabilizing solution, note that if the fiscal feedback is weak, $0 < \mu < \mu^*$, where $\mu^* = (1 - \tilde{\Upsilon}) (1 - \beta) \kappa / (\tilde{\Upsilon} ((1 - \tilde{\Upsilon}) \kappa - \zeta \theta \tilde{\Upsilon}))$, the economy is not stabilized by policy. The optimal monetary policy still delivers a finite value of the loss function (8), but all variables exhibit slow explosion with a rate of explosion less than $1/\sqrt{\beta}$. However, this solution should be disregarded as it violates the assumption of a finite working week.²⁴

Finally, note that equation (44) implies price stability: if $\phi_t = 0$ and $\lim_{t \rightarrow \infty} \phi_t = 0$ it follows that $\sum_{t=0}^{\infty} \pi_t = 0$.

²⁴This result was shown in a similar model in Schmitt-Grohe and Uribe (2004) and in Kirsanova and Wren-Lewis (2011).

B Discontinuity of FOCs under Limited Commitment and Stability of Solution

For a given $\alpha < 1$ the probability of the realized history with no default occurring in the past K periods tends to zero with growing K . In this case the stability properties of system (36)-(40) in each quasi-commitment equilibrium are different from the stability properties of the system that describes the expected evolution of the economy in the same equilibrium. In particular, in the limiting case $\alpha \rightarrow 1$ the system (41)-(42) has unstable eigenvalues in two of the three equilibria. However, because the policy maker almost surely resets the Lagrange multiplier ϕ_s to zero in every period $t > 0$, the expected evolution of the economy is described by the following system:

$$\begin{aligned} b_{t+1} &= \frac{\lambda\rho + (\kappa\rho + \nu\eta)(\kappa - \beta\eta\pi_b)}{(\kappa - \beta\eta\pi_b)^2 + \lambda + S_{bb}\beta\eta^2} b_t + \frac{\eta(\kappa - \beta\eta\pi_b + \beta\rho_u((\kappa - \beta\eta\pi_b)\pi_u - \eta S_{ub}))}{(\kappa - \beta\eta\pi_b)^2 + \lambda + S_{bb}\beta\eta^2} u_t \quad (50) \\ \phi_t &= 0. \quad (51) \end{aligned}$$

Equation (50) is the same as under pure discretion and the evolution of the economy is a stationary process in every discretionary equilibrium D^j .

More generally, the expected evolution of the economy following an initial disturbance is obtained by taking averages of all possible evolutions, integrated over the distribution of the corresponding re-optimization draws. The expected evolution of the economy is described by the following transition matrix: $\alpha \begin{bmatrix} M_{yy} & 0 \\ 0 & 0 \end{bmatrix} + (1 - \alpha) M$ in (56), see the Appendix C for details. The stability properties of this transition matrix, which represent the dynamic properties of the economy under a limited commitment policy, are different from the stability properties of the system (41)-(42). This system describes only one of infinitely many possible re-optimization histories.²⁵

This inconsistency between expected and observed paths can destabilize the economy (and ruin the agent's finances). However, this does not happen in all equilibria. If defaults do happen and for every time $t > 0$ there is at least one period $s > t$ when ϕ_s is reset to zero, then there are no issues with dynamic instability of the economy in any equilibrium. These defaults also ensure that if there is less-than-full precommitment, there is no price stability under limited commitment policy.

²⁵Using an analogy with a roulette game, system (41)-(42) describes the history when 'red' never realizes while it is expected – and it is bet on – with probability 1/2.

C Limited Commitment Policy in General LQ RE Framework

We assume a non-singular linear deterministic rational expectations model, augmented by a vector of control instruments. Specifically, the evolution of the economy is explained by the linear system

$$\begin{bmatrix} y_{t+1} \\ \mathbb{E}_t x_{t+1} \end{bmatrix} = \begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix} \begin{bmatrix} y_t \\ x_t \end{bmatrix} + \begin{bmatrix} B_1 \\ B_2 \end{bmatrix} u_t + C \begin{bmatrix} \xi_{t+1} \\ 0 \end{bmatrix}, \quad (52)$$

where y_t is an n_1 -vector of predetermined variables with initial conditions y_0 given, x_t is n_2 -vector of non-predetermined (or jump) variables with $\lim_{t \rightarrow \infty} x_t = 0$, u_t is a k -vector of policy instruments of the policy maker, and ξ_t is a vector of i.i.d. shocks with covariance matrix Σ . For notational convenience we define the n -vector $z_t = (y_t', x_t)'$ where $n = n_1 + n_2$. We assume A_{22} is non-singular.

The inter-temporal policy maker's welfare criterion is defined by the quadratic loss function

$$L_0 = \frac{1}{2} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t g_t' \mathcal{Q} g_t = \frac{1}{2} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^{s-t} (z_t' Q z_t + 2z_t' P u_t + u_t' R u_t). \quad (53)$$

The elements of vector g_s are the goal variables of the policy maker, $g_t = \mathcal{C}(z_t', u_t)'$. Matrix \mathcal{Q} is assumed to be symmetric and positive semi-definite.²⁶

Schaumburg and Tambalotti (2007) and then Debortoli and Nunes (2010) demonstrate that the optimization problem can be written as

$$\min \mathbb{E}_0 \sum_{t=0}^{\infty} (\beta(1-\alpha))^t (z_t' Q z_t + 2z_t' P u_t + u_t' R u_t + \beta \alpha y_{t+1}' S y_{t+1}) \quad (54)$$

subject to

$$\begin{aligned} y_{t+1} &= A_{11} y_t + A_{12} x_t + B_1 u_t + C \xi_{t+1} \\ (1-\alpha) E_t x_{t+1} + \alpha H y_{t+1} &= A_{21} y_t + A_{22} x_t + B_2 u_t \end{aligned}$$

where H and S are components of the solution to the corresponding discretionary problem, $x_t = H y_t$ and the loss is $L_t(y_t) = \frac{1}{2} y_t' S y_t$.

The first order conditions to the appropriate Lagrangian

$$\begin{aligned} \mathcal{L}^{qc} &= \sum_{t=0}^{\infty} (\beta(1-\alpha))^t (z_t' Q z_t + 2z_t' P u_t + u_t' R u_t + \beta \alpha y_{t+1}' S y_{t+1} \\ &\quad + 2\varphi_{t+1}' (A_{21} y_t + A_{22} x_t + B_2 u_t - (1-\alpha) x_{t+1} - \alpha H y_{t+1}) \\ &\quad + 2\psi_{t+1}' (A_{11} y_s + A_{12} x_s + B_1 u_s + \xi_{t+1} - y_{s+1})) \end{aligned}$$

²⁶It is standard to assume that R is symmetric positive definite (see Anderson et al. (1996), for example). However, since many economic applications involve a loss function that places no penalty on the control variables, we note that the requirement of \mathcal{Q} being positive definite can be weakened to \mathcal{Q} being positive semi-definite if additional assumptions about other system matrices are met (Clements and Wimmer (2003)). The analysis in this paper is valid for $R \equiv 0$.

can be written as

$$\begin{aligned}
& \begin{bmatrix} I & 0 & 0 & 0 & 0 \\ 0 & \beta A'_{22} & 0 & 0 & \beta A'_{12} \\ 0 & B'_2 & 0 & 0 & B'_1 \\ \alpha H & 0 & 0 & (1-\alpha)I & 0 \\ 0 & \beta(1-\alpha)A'_{21} & 0 & 0 & \beta(1-\alpha)A'_{11} \end{bmatrix} \begin{bmatrix} y_{t+1} \\ \varphi_{t+1} \\ u_{t+1} \\ x_{t+1} \\ \psi_{t+1} \end{bmatrix} \\
= & \begin{bmatrix} A_{11} & 0 & B_1 & A_{12} & 0 \\ -\beta Q'_{12} & I & -\beta P_2 & -\beta Q_{22} & 0 \\ -P'_1 & 0 & -R & -P'_2 & 0 \\ A_{21} & 0 & B_2 & A_{22} & 0 \\ -\beta((1-\alpha)Q_{11} + \alpha S) & \alpha H' & -\beta(1-\alpha)P_1 & -\beta(1-\alpha)Q_{12} & I \end{bmatrix} \begin{bmatrix} y_t \\ \varphi_t \\ u_t \\ x_t \\ \psi_t \end{bmatrix}
\end{aligned} \tag{55}$$

Solution to this system (using Schur decomposition, for example, or iteration Riccati equation as we do in the text) can be written in the form

$$\begin{aligned}
\begin{bmatrix} u_t \\ x_t \\ \psi_t \end{bmatrix} &= \begin{bmatrix} X_{uy} & X_{u\varphi} \\ X_{xy} & X_{x\varphi} \\ X_{\psi y} & X_{\psi\varphi} \end{bmatrix} \begin{bmatrix} y_t \\ \varphi_t \end{bmatrix}, \quad \begin{bmatrix} y_{t+1} \\ \varphi_{t+1} \end{bmatrix} = \begin{bmatrix} M_{yy} & M_{y\varphi} \\ M_{\varphi y} & M_{\varphi\varphi} \end{bmatrix} \begin{bmatrix} y_t \\ \varphi_t \end{bmatrix}, \\
W_t(y_t, \varphi_t) &= \frac{1}{2} \left(\begin{bmatrix} y_t \\ \varphi_t \end{bmatrix}' \begin{bmatrix} U_{11} & U_{12} \\ U_{21} & U_{22} \end{bmatrix} \begin{bmatrix} y_t \\ \varphi_t \end{bmatrix} \right).
\end{aligned} \tag{56}$$

Equation (54) yields

$$\begin{aligned}
\begin{bmatrix} U_{11} & U_{12} \\ U_{21} & U_{22} \end{bmatrix} &= \begin{bmatrix} I & 0 \\ X_{xy} & X_{x\varphi} \\ X_{uy} & X_{u\varphi} \end{bmatrix}' \begin{bmatrix} Q_{11} & Q_{12} & P_1 \\ Q'_{12} & Q_{22} & P_2 \\ P'_1 & P'_2 & R \end{bmatrix} \begin{bmatrix} I & 0 \\ X_{xy} & X_{x\varphi} \\ X_{uy} & X_{u\varphi} \end{bmatrix} \\
&+ M' \begin{bmatrix} \beta(1-\alpha)U_{11} + \beta\alpha S & \beta(1-\alpha)U_{12} \\ \beta(1-\alpha)U_{21} & \beta(1-\alpha)U_{22} \end{bmatrix} M
\end{aligned} \tag{57}$$

A possible iterative scheme is (different order of updates is possible):

1. Guess M, X, U , as part of them we have $H = X_{xy}, S = U_{11}$
2. Compute an update of U using (57)
3. Solve (55) using Schur decomposition (with stability threshold as $1/\sqrt{\beta(1-\alpha)}$) to find an update for X and M .

Once the procedure has converged, we can find the loss using the standard approach. Assume that the social welfare loss is given by

$$\begin{aligned}
L^S &= \frac{1}{2} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t g_t^S \mathcal{Q}^S g_t = \frac{1}{2} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^{s-t} \begin{bmatrix} y_t \\ x_t \\ u_t \end{bmatrix}' \begin{bmatrix} Q_{11}^S & Q_{12}^S & P_1^S \\ Q_{12}^{S'} & Q_{22}^S & P_2^S \\ P_1^{S'} & P_2^{S'} & R^S \end{bmatrix} \begin{bmatrix} y_t \\ x_t \\ u_t \end{bmatrix} \\
&= \frac{1}{2} \text{trace} \left(\hat{Q}^S \hat{P} \right)
\end{aligned}$$

where

$$\hat{Q}^S = \begin{bmatrix} I & 0 \\ X_{xy} & X_{x\varphi} \\ X_{uy} & X_{u\varphi} \end{bmatrix}' \begin{bmatrix} Q_{11}^S & Q_{12}^S & P_1^S \\ Q_{12}^{S'} & Q_{22}^S & P_2^S \\ P_1^{S'} & P_2^{S'} & R^S \end{bmatrix} \begin{bmatrix} I & 0 \\ X_{xy} & X_{x\varphi} \\ X_{uy} & X_{u\varphi} \end{bmatrix}$$

$$\hat{P} = \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^{s-t} \begin{bmatrix} y_t \\ \varphi_t \end{bmatrix}' \begin{bmatrix} y_t \\ \varphi_t \end{bmatrix}$$

and Q^S is not necessarily the same as Q in (54) because the policy maker's objectives are not necessarily social.²⁷ Matrix \hat{P} can be found from

$$vec(P) = \left(I - \beta (\hat{M} \otimes \hat{M}) \right)^{-1} vec \left(\frac{\beta}{1-\beta} V + Z_0 \right).$$

where $\hat{M} = (1 - \alpha) M + \alpha \begin{bmatrix} M_{yy} & 0 \\ 0 & 0 \end{bmatrix}$, $V = \mathbb{E}_0 \left(\begin{bmatrix} \xi_{t+1} \\ 0 \end{bmatrix} \begin{bmatrix} \xi_{t+1} \\ 0 \end{bmatrix}' \right)$ and $Z_0 = \begin{bmatrix} y_0 \\ \varphi_0 \end{bmatrix} \begin{bmatrix} y_0 \\ \varphi_0 \end{bmatrix}'$.

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²⁷This algorithm is more naturally suited to deal with the case of $Q^S \neq Q$ than the algorithm given in Schaumburg and Tambalotti (2007).

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