Forward Guidance Credibility and Fiscal Policy*

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Abstract

This paper presents a discretionary central bank that implements reputation-based forward guidance within a standard New Keynesian economy subject to repeated liquidity trap episodes featuring recessions. Previous studies show that forward guidance policies can be made credible using reputation. In this model I incorporate a treasury that conducts fiscal stabilization policy, and I explore how this policy impacts on the credibility of reputation-based forward guidance. I numerically show that the central bank has a range of credible forward guidance policies that it can implement even when the treasury uses fiscal policy to mitigate recessions. I also find that an increase in the effectiveness of fiscal stabilization policy reduces the range of credible forward guidance announcements that the central bank can implement. Finally, I explore how fiscal policy responds when forward guidance is in place, and I find that forward guidance can crowd out fiscal effort and result in a loose monetary-tight fiscal policy mix during recessions.

Keywords: Monetary policy, Fiscal policy, Liquidity trap, Forward guidance, Reputation

JEL Codes: E52, E58, E61, E62, E63

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