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The Forward Fiscal Guidance Puzzle and a Resolution*

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Abstract

The forward fiscal guidance puzzle pertains to New Keynesian models when monetary policy is temporarily caught in a liquidity trap: (1) expected future fiscal shocks have an unbelievably large effect on current inflation, and (2) the effect on current inflation is larger the further out is the shock expected to occur. We illustrate the problem analytically. Then, we use Blue Chip inflation forecasts to argue that the effects on inflation expectations should be small. And finally, we analyze two potential resolutions to the puzzle. The first is the Fiscal Theory of the Price Level. In a calibrated model with price inertia, investment, and long term debt, we show that the Fiscal Theory resolves the second aspect of the puzzle, but certainly not the first. In our preferred resolution we return to a Ricardian fiscal policy. And we assume that the probability of a return to the Taylor Rule depends on the rate of inflation. The model's predictions are in line with the evidence from the Blue Chip forecasts.

Keywords: Anticipated Fiscal Policy, Zero Lower Bound, Monetary Policy Normalization

JEL Codes: E52, E62, E63

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