Fiscal and Monetary Policy Interaction under Limited Foresight*

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Abstract

Analyses of the interaction between monetary and fiscal policy often turn crucially on assumptions that are made about outcomes far in the future, sometimes infinitely far. This is a problematic feature of rational-expectations analyses, given the limited basis for assumptions about the distant future. This paper instead considers both short-term effects and long-run consequences of alternative monetary and fiscal policies under an assumption of bounded rationality. In particular, it assumes that explicit forward planning extends only a finite distance into the future, with anticipated situations at that horizon evaluated using a value function learned from past experience. Such an approach makes announcements of future policies relevant, but avoids the debates about equilibrium selection that plague rational-expectations analyses. The combined monetary-fiscal regimes that result in stable long-run dynamics are characterized, and the effectiveness of temporary changes in either type of policy as a source of short-run demand stimulus is analyzed. The effectiveness of a coordinated change in monetary and fiscal policy is shown to be greatest when decision makers' degree of foresight is intermediate in range (average planning horizons on the order of ten years), rather than shorter or longer.

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