DEBT, POLICY UNCERTAINTY AND EXPECTATIONS STABILIZATION

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Abstract
This paper develops a model of policy regime uncertainty and its consequences for stabilizing expectations. Because of learning dynamics, uncertainty about monetary and fiscal policy is shown to restrict, relative to a rational expectations analysis, the set of policies consistent with macroeconomic stability. Anchoring expectations by communicating about monetary and fiscal policy enlarges the set of policies consistent with stability. However, absent anchored fiscal expectations, the advantages from anchoring monetary expectations are smaller the larger is the average level of indebtedness. Finally, even when expectations are stabilized in the long run, the higher are average debt levels the more persistent will be the effects of disturbances out of rational expectations equilibrium. (JEL: E52, D83, D84)