Demand expectations and the timing of stimulus Policies

CFM-DP2015-03

Bernardo Guimaraes[1,2] and Caio Machado[2]

[1]Centre for Macroeconomics; and [2] Sao Paulo School of Economics, Fundação Getúlio Vargas

Pessimistic expectations are often said to play an important role in recessions. This basic idea is that in times of low economic activity, firms face low demand and thus have low incentives for investing. In a dynamic setting, this feedback effect may trap the economy in a regime of low output. One consequence of this view is that in the trough of a recession, policy should be very stimulative in order to get investment going.

This paper provides a framework where one can evaluate the pertinence of this type of argument. We propose a model that captures this dynamic coordination problem arising from demand externalities and fixed costs of investment. A firm's optimal investment decision depends on its expectations about others' actions in the future. Naturally, the optimal policy also depends on those expectations.

The main result of the paper is that this dynamic coordination problem does not imply policies should be more stimulative when the economy is in a trough. Expectations that arise in equilibrium are key to this result: agents' expectations exactly offset the dynamic coordination problem faced by firms.