Doubts about the model and optimal policy

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Anastasios G. Karantounias

Centre For Macroeconomics and University of Surrey

This paper analyzes optimal policy in setups where both the policymaker and the private sector have doubts about the probability model of uncertainty and form endogenous worst-case beliefs. There are two forces that shape optimal policy results: a) the manipulation of the endogenous beliefs of the private sector so that the forward-looking constraints that the policymaker is facing are relaxed, b) the discrepancy (if any) in pessimistic beliefs between a paternalistic policymaker and the private sector, which captures ultimately differences in welfare evaluation. I illustrate the methodology in an optimal fiscal policy problem and show that manipulation of beliefs materializes as an effort to make government debt cheaper through the endogenous beliefs of the household. This force may lead to either mitigation or amplification of the household's pessimism, depending on the problem's parameters. The policymaker's relative pessimism determines whether paternalism reinforces or opposes the price manipulation incentives.