



Maastricht University



UNU  
MERIT

Working Paper Series

#2023-024

**Expectations and the stability of stock-flow consistent models**

**Huub Meijers, Joan Muysken and Giulia Piccillo**

Published 22 June 2023

**Maastricht Economic and social Research institute on Innovation and Technology (UNU-MERIT)**

email: [info@merit.unu.edu](mailto:info@merit.unu.edu) | website: <http://www.merit.unu.edu>

Boschstraat 24, 6211 AX Maastricht, The Netherlands

Tel: (31) (43) 388 44 00

**UNU-MERIT Working Papers**

**ISSN 1871-9872**

**Maastricht Economic and social Research Institute on Innovation and Technology**

**UNU-MERIT | Maastricht University**

UNU-MERIT Working Papers intend to disseminate preliminary results of research carried out at UNU-MERIT to stimulate discussion on the issues raised.



# Expectations and the stability of stock-flow consistent models

Huub Meijers<sup>a</sup>, Joan Muysken<sup>b</sup> and Giulia Piccillo<sup>c</sup>

Maastricht University

<22 June 2023 >

## Abstract

Expectations are usually introduced in macroeconomic stock-flow consistent models (SFC-models from hereon) in an ad hoc way, without much motivation. Moreover, these are usually very simple forms of expectations, and certainly not some form of rational expectations. The implicit assumption is that expectations do not matter very much in these models. However, the way expectations are modelled in SFC-models is very important for two reasons.

The first reason is that expectations are very important in understanding the way the economy reacts to a shock, since the stability of the economy is dependent on the nature of expectations. We show for instance that the more backward-looking expectations are, the more stable the economy tends to become.

The second reason is that expectations themselves can also be a source of shocks. We show how under certain circumstances optimism or pessimism in expectations can lead to self-fulfilling prophecies.

To illustrate the impact of expectations on the stability of an economy we use a simple model, based on the models in Godley & Lavoie, 2007. The model includes a financial sector and government, since we are convinced that the notion of a monetary economy is crucial to understand the impact of expectations on an economy. We also introduce a foreign sector in a very simple way to allow for a better understanding of the multiplier impact of shocks and of foreign reserves on the economy.

First we analyse the stationary state solution and analyse its properties. We show that this model is only stable when either the tax rate or government debt is not too high. We also point out the self-fulfilling properties of optimism and pessimism in expectations in this model. Next to that, we show that under “perfect foresight” the model becomes less stable – more restrictions on taxes and government debt are necessary to guarantee stability of the model. However, under naïve expectations the model becomes more stable – there are less restrictions necessary to guarantee stability of the model (due to path dependency). Finally, we introduce the notion of fundamentalist expectations and show how these affect the stability of the model in an intermediate way.

In order to introduce adaptive expectations, we conclude our model with some simulation results – analytical solutions cannot be found. We show how adaptive expectations also require an intermediate reaction of fiscal policy to keep the economy stable.

JEL Code: E70, B5, E6, F45, F47

Key words: expectations, financialisation, wealth accumulation, stock-flow consistent modelling

---

<sup>a</sup> Department of Economics, SBE, Maastricht University; UNU-MERIT.

[huub.meijers@maastrichtuniversity.nl](mailto:huub.meijers@maastrichtuniversity.nl)

<sup>b</sup> Department of Economics, SBE, Maastricht University; UNU-MERIT, CoffEE-Europe.

[j.muysken@maastrichtuniversity.nl](mailto:j.muysken@maastrichtuniversity.nl)

<sup>c</sup> Department of Economics, SBE, Maastricht University; CES-Ifo, Munich.

[g.piccillo@maastrichtuniversity.nl](mailto:g.piccillo@maastrichtuniversity.nl)

- 1 Introduction
- 2 The model
  - 2.1 A simple model, including a financial sector, government and a foreign sector
  - 2.2 Stock-flow consistency and behavioural assumptions
  - 2.3 The nature of expectations
    - 2.3.1 Stability
    - 2.3.2 SFC with expectations rules
- 3 Solving the model
  - 3.1 The stationary state solution of the model
    - 3.1.1 The full open equilibrium
    - 3.1.2 The moderate open equilibrium
  - 3.2 The impact of optimism and pessimism in expectations
  - 3.2 Stationary state stability conditions
    - 3.2.1 Stability in the full open economy
    - 3.2.2 Stability in the moderate open economy
- 4 The role of expectations in the stability of the moderate open economy model
  - 4.1 More instability under “perfect foresight”
  - 4.2 Less instability under naïve expectations
  - 4.3 Intermediate instability under fundamentalist expectations
  - 4.4 Varying instability under adaptive expectations
  - 4.5 Stability under various expectations compared
- 5 Concluding remarks

## References

- Appendix A The model
- A.1 The model of the full open economy
  - A.2 The (implicit) role of other financial institutions
  - A.3 The model of the moderate open economy
- Appendix B The solution of the model for the moderate economy

## 1 Introduction

Expectations are usually introduced in macroeconomic stock-flow consistent models (SFC-models from hereon) in an ad hoc way, without much motivation. Moreover, very simple forms of expectations are used – the implicit assumption is that expectations do not matter very much in these models. Also, rational expectations in one form or another are not consistent with the post-Keynesian tradition of SFC-models. However, the way expectations are modelled in SFC-models is very important for three reasons.

The first reason is that expectations influence the way the economy reacts to a shock. As we elaborate below, the stability of the economy and the room for stabilising fiscal policy is dependent on the nature of expectations. We show for instance that the more backward-looking expectations are, the more stable the economy tends to become and the larger the room for fiscal policy is.

The second reason is that expectations themselves can also be a source of shocks. We show how optimism or pessimism in expectations can lead to self-fulfilling prophecies. Moreover, one may wonder what happens when persons have different expectations under different circumstances and what causes the transition from one type of expectations to another. Although we do not elaborate that point here, the different types of expectations we explore provide already an interesting insight in the potential implications of this phenomenon.

The third reason to look at expectations in SFC models lies in the nature of these models themselves. The way shocks affect an economy is dependent on the buffers the economy has available to absorb these shocks – this also holds for both expected shocks and shocks in expectations. It has only been recently recognised in macroeconomic modelling that wealth accumulation, together with debt accumulation, plays an important role – sufficient wealth accumulation is required to deal with shocks. As we elaborate below, it is very natural to use SFC-models to study wealth accumulation. These models pay explicit attention to the role of both monetary and fiscal policy, moreover they recognise explicitly the role played by financial institutions. See Godley and Lavoie (2007) for a seminal introduction.

In our analysis we use a simple macro model in the SFC tradition, to keep it analytically tractable. In the tradition of Godley and Lavoie (G&L from hereon), the model is typically Keynesian: product markets clear through quantity adjustments, and the model is demand-led. In spite of its simplicity, we show how introducing different types of expectations in this model leads to new insights in the way expectations affect the stability of the model.

To illustrate the impact of expectations on the stability of an economy we present a simple model in section 2, based on the models in G&L. In order to keep the analysis as simple as possible, we abstain from economic growth and stick to a stationary economy. Next to firms and households, the model includes both government and a foreign sector to allow for a better understanding of the multiplier impact of shocks to the economy and the buffer role played by government bonds and foreign reserves. We also include a banking sector, since this plays an important intermediary role in the accumulation and distribution of financial wealth over buffers. Moreover banks provide an additional buffer to the economy in the form of deposits.

In section 3 we analyse the stationary state of the model and analyse its properties. Moreover, we show that this model is only stable when both taxes and government debt are not too high (and there is a trade-off between both). We also point out the self-fulfilling properties of optimism and pessimism in expectations in this model.

We then analyse the impact of different forms of expectations in section 4. We show that under “perfect foresight” the model becomes less stable – more restrictions on taxes and government debt are necessary to guarantee stability of the model compared to the stationary situation. The intuition is that “perfect foresight” enhances the impact of shocks in the economy, inducing self-fulfilling prophecies. On the other hand, under naïve expectations the model becomes more stable. The intuition is that the path dependency of naïve expectations hampers the adjustments to shocks in the economy and thus mitigates their destabilising impact. We also introduce the notion of fundamentalist expectations and show that these also affect the stability of the model in a positive way, compared to stationary expectations. Finally, we investigate the properties of adaptive expectations and show that these have a similar impact on stability as fundamentalist expectations.

We present our concluding remarks in section 5.

## 2 The model

To illustrate the impact of expectations on the stability of an economy we present a simple model in section 2.1. The model includes a financial sector, government and a foreign sector – each of these sectors provides buffers which help to absorb shocks in an economy. We introduce government in our model, since understanding fiscal policy can be very important to contain instabilities in the model and government bonds provide a relevant buffer through household savings. We also introduce a foreign sector in a very simple way to allow for a better understanding of the multiplier impact of shocks to the economy and to analyse the role of foreign reserves in stabilising the economy. In line with the notion of a monetary economy financial wealth is included in our model, in the form of deposits, loans, government bonds and foreign reserves. For that reason the model also is in the tradition of stock-flow consistent modelling as we elaborate in section 2.2. Finally we discuss in section 2.3 the role of expectations in our model, since these are at the core of our analysis. In order to keep the analysis as simple as possible, we abstain from economic growth and stick to a stationary economy.

### 2.1 A simple model, including a financial sector, government and a foreign sector

The model used in this paper is based on G&L (Ch. 7), to which we add government and a foreign sector.<sup>1</sup>

The economy consists of five sectors households, firms, government, banks and foreign. Output of the economy consists of consumption goods  $C$ , investment goods  $I$  and government goods  $G$ , and net exports  $X - IM$ :

$$Y = C + I + G + X - IM \quad (1)$$

Firms produce this output and borrow the amount of money necessary to finance their net-investments from banks at a rate  $r$ . That is, borrowing by firms implies an additional amount of loans:

$$\Delta L = I - \delta \cdot K_{-1} \quad \delta > 0 \quad (2)$$

---

<sup>1</sup> The full model is presented in the Appendix, with references to the corresponding equations of G&L.

where  $\delta$  is the rate of depreciation of the capital stock  $K$ . Note that we introduce here two stocks in our analysis, the capital stock  $K$  and the amount of loans  $L$ . From equation (2) one observes that in our analysis stocks are measured at the end of the period, and for simplicity we ignore time subscripts  $t$ .<sup>2</sup>

Next to that, firms pay wages to workers such that the wage bill paid by firms is  $WB = W.Y/pr$  – here  $W$  is the endogenous real wage and  $pr$  stands for exogenous labour productivity.

Since there are no credit restrictions and firms can borrow unlimited from banks, we assume that firms do not retain earnings to finance their investment (see also G&L, p.223). Therefore net savings of firms are zero and firm expenditures equal output. That is:

$$Y = WB + r_{-1}.L_{-1} + \delta.K_{-1} \quad (3)$$

Investment behaviour of firms follows from:

$$I = \gamma.(K^e - K_{-1}) + \delta.K_{-1} \quad 0 < \gamma < 1 \quad (4)$$

Here  $K^e$  represents the expected capital stock. With respect to the capital stock we note that capacity output is defined by:<sup>3</sup>

$$Y^* = K/\kappa \quad \kappa > 0 \quad (5)$$

The parameter  $\kappa$  is a constant capital output ratio. The notion of a constant capital output ratio introduces the accelerator in the model as we elaborate below. However, in our stationary economy capacity output does not play a role.

Government levies taxes  $T$  from households proportional to output at a rate  $\tau$  and issues bonds  $B$  to households at a rate  $r$  such that its expenditures are fully covered. Hence does hold:

$$\Delta B = G - T + r.B_{-1} \quad (6)$$

and an increase in debt implies negative government savings.

$$T = \tau.Y \quad 0 < \tau < 1 \quad (7)$$

Government also imposes a debt criterion such that government debt should always be proportional to output at a rate  $\beta$ :

$$B = \beta.Y \quad \beta > 0 \quad (8)$$

As we elaborate below, government expenditures then are endogenous.

Households receive income from wages and wealth. Their savings are used to buy government bonds and are held at banks as deposits  $M$  and abroad as reserves  $R$  at a rate  $r$ . Hence household wealth consists of bonds, deposits and foreign reserves. In the Appendix we provide a further explanation of the reasons that foreign reserves end up in households, with other financial institutions (for instance pension funds) as intermediaries.

Wealth accumulation follows from household savings,  $YD - C$ , where  $YD$  is disposable income:

$$\Delta M + \Delta B + \Delta R = YD - C \quad (9)$$

$$YD = WB + r_{-1}.M_{-1} + r_{-1}.B_{-1} - T \quad (10)$$

<sup>2</sup> That is, we write  $\Delta L = L - L_{-1}$  instead of  $\Delta L_t = L_t - L_{t-1}$  where  $L_t$  is the amount of loans at end of period  $t$ .

<sup>3</sup> See G&L (p. 226, n.4), we normalise the utilisation rate at full capacity to unity.

Household consumption is given by:

$$C = \alpha_1 \cdot YD^e + \alpha_2 \cdot (M_{-1} + B_{-1} + R_{-1}) + C^A \quad \alpha_1 > 0, \alpha_2 > 0 \quad (11)$$

with  $YD^e$  representing expected disposable income. The constant term  $C^A$  represents autonomous consumption.

We assume exports  $X$  to be exogenous at a value  $X^A$  and imports  $IM$  to be proportional to output:

$$IM = \mu \cdot Y \quad \mu > 0 \quad (12)$$

The surplus (deficit) of exports over imports leads to an increase (decrease) of foreign debt in the form of reserves  $R$  held by households at a rate  $r$ . Thus we find:

$$\Delta R = X^A - \mu \cdot Y + r_{-1} \cdot R_{-1} \quad (13)$$

Finally, we include the banking sector: banks provide loans  $L$  to firms and hold deposits  $M$  provided by households. That is, banks accept all demand for deposits by households and provide all loans demanded by firms at the prevailing interest rate  $r$  – this implies that they create money. For simplicity we assume that the interest rate on loans is equal to the interest rate on deposits to households. Since:

$$r_{-1} \cdot L_{-1} = r_{-1} \cdot M_{-1} \quad (14)$$

does hold, bank savings are zero.

We assume the interest rate  $r$  to be exogenous. The price level is constant at a level unity.

The working of the model is explained in more detail below.

## 2.2 Stock-flow consistency and behavioural assumptions

The stock-flow consistent nature of the model implies that all wealth components (stocks) can be identified in the model as assets and liabilities and that all flows in the model should be consistent with changes in wealth.

*Table 1. The balance sheet*

	Households	Firms	Banks	Government	Abroad	Total
Deposits	+M		-M			0
Bonds	+B			-B		0
Loans		-L	L			0
Fixed Capital		+K				+K
Reserves	+R				-R	0
Wealth	-Vh	0	0	-Vg	-Va	-Vh-Vg-Va
Total	0	0	0	0	0	0

From the balance sheet presented in Table 1 one observes that household wealth  $Vh$  consists of deposits, government bonds and foreign reserves. Firm wealth is zero since the only asset, capital, equals the only liability, loans held at banks. For banks, wealth is zero since deposits from households correspond to loans issued to firms. Government wealth  $Vg$  is negative, consisting of government debt



in the form of bonds, held by households. Finally, foreign wealth  $V_a$ , held abroad, consists of reserves only.

Table 2 The accumulation of savings and investment matrix

	Households	Firms	Banks	Gov.	Abroad	Total
Consumption	-C	+C+G		-G		0
Investment		+I				+I
Net Exports		+(X-M)			-(X - M)	0
Wages	WB	-WB				0
Taxes	-T			+T		0
Cons of fixed cap.		- $\delta \cdot K_{-1}$				- $\delta \cdot K_{-1}$
Interest	+ $r_{-1} \cdot B_{-1}$ + $r_{-1} \cdot M_{-1}$ + $r_{-1} \cdot R_{-1}$	- $r_{-1} \cdot L_{-1}$	+ $r_{-1} \cdot L_{-1}$ - $r_{-1} \cdot M_{-1}$	- $r_{-1} \cdot B_{-1}$	- $r_{-1} \cdot R_{-1}$	0
Net savings	Sh	0	0	Sg	Sa	Stot
$\Delta$ Loans		+ $\Delta L$	- $\Delta L$			0
$\Delta$ Deposits	- $\Delta M$		+ $\Delta M$			0
$\Delta$ Bonds	- $\Delta B$			+ $\Delta B$		0
$\Delta$ Reserves	- $\Delta R$				+ $\Delta R$	0
$\Delta$ Capital		- $\Delta K$				- $\Delta K$
Total	0	0	0	0	0	0

The flows and changes in stocks in the model are summarised in Table 2. Consistent with equation (8) savings of households,  $Sh$ , are held either as deposits at banks, as government bonds or as reserves. In line with equation (2) net investments are financed by borrowing from banks, hence consistent with equation (3) net savings of firms  $Sf$  are zero, and the accumulation of capital  $\Delta K$  equals additional borrowing from banks  $\Delta L$ . From equation (14) it follows that banks' savings are zero – these banks ensure that the deposits held by households are equal to the amount of loans provided to firms. The foreign sector (abroad) issues these foreign reserves and these constitute foreign savings. Finally, government savings  $Sg$  are negative, since government accumulates debt by issuing bonds to households.

To understand the working of the model it is useful to explain the behaviour of each sector more in detail. If we ignore both government and the foreign sector, we find that households save enough to finance net investment of firms, with banks as intermediaries. The underlying assumptions are that households consume according to the consumption function (11), which contains the income multiplier next to wealth effects. Firms invest according to the investment function (4), which contains the accelerator.<sup>4</sup> The interaction of multiplier and accelerator then lead to an equilibrium as we analyse below (section 3.1) – this income is stable under certain parameter conditions.

The notion that banks can create money helps us to understand the property of the model that household savings end up in net investment in absence of government and a foreign sector. Important then is the behavioural assumption that banks accept all demand for deposits by households and provide all loans demanded by firms at the prevailing interest rate  $r$ . As G&L (p. 227) emphasise, “the

<sup>4</sup> The notion of the accelerator enters through the specification of the expected capital stock,  $K^e$ , as we elaborate below.

rate of interest on loans can be set by the banking system at the level that it sees fit. The rate of interest on loans is not the result of a market clearing price mechanism".<sup>5</sup>

By introducing government in the model we add two interesting features. On the one hand, we provide an alternative opportunity for households to invest their savings. Although the total amount of savings held in government bonds is implied directly by  $\beta \cdot Y$ , one can argue that these savings are decided upon by choosing the debt-output ratio  $\beta$ . As G&L emphasize (pp. 108-9):

*The crucial assumption which is made here, and which will be used time and time again, is that money balances are the element of flexibility in a monetary system of production. Money balances are the buffer that absorbs unexpected flows of funds...*

The assumption we make is that the entire amount of unexpected saving will be kept in the form of additional cash money balances. Errors in expectations are entirely absorbed by unexpected fluctuations in money balances. Money balances act as a buffer against mistakes in expectations. Any mistake regarding expected disposable income is entirely absorbed by an equivalent unexpected change in money balances.

This implies that, regardless of whether they are realized or not, households actually invest in bills on the basis of their expectations with respect to disposable income that were made at the beginning of the period. This means that the amount of bills held by households at the end of the period is exactly equal to the amount of bills that were demanded by households at the beginning of the period.

On the other hand, one should realise that the choice of a debt-output ratio  $\beta$ , together with choosing a tax rate  $\tau$ , implies that government expenditures are endogenous in the model. We show below that the stationary state government expenditures to output ratio,  $(G/Y)^*$  is given by  $(G/Y)^* = \tau - r \cdot \beta$ . By choosing a higher debt-output ratio at a given tax rate, more money is needed for interest payments and hence less money is available for government expenditures. That is the reason why in the stationary state  $(G/Y)^*$  decreases when  $\beta$  increases. Similarly, since more money is available for government expenditures when the tax rate increases at a given debt-output ratio, in the stationary state  $(G/Y)^*$  increases when  $\tau$  increases. The stationary state budget deficit is  $-r \cdot \beta$ .

Finally, the introduction of the foreign sector mitigates the multiplier working of the model due to import leakages. Next to that, the impact of the accumulation or decumulation of foreign reserves due to current account surpluses or deficits registered in our model, appears from Tables 1 and 2, changes the outcome of the model – we further analyse this in section 3.1.

We show below that introducing government and a foreign sector has an impact on the stationary state conditions of the model and also influences the stability conditions of the model. Moreover, introducing government allows us to intervene in the economy when changes in expectations or shocks force the economy out the stability corridor as we discuss section 3.

### 2.3 The nature of expectations

The role of expectations in macroeconomics has been noted as far back as Keynes (Keynes, 1936). When people take economic actions, their forecasts of the future matter. Keynes famously characterised behaviour as the result of animal spirits, which drive people to act through waves of optimism when facing fundamental uncertainty.<sup>6</sup> These forecasts affect household decisions (how

---

<sup>5</sup> G&L section 7.6 show that the rate of interest affects the real wage in the stationary state, such that a higher rate of interest implies a lower real wage.

<sup>6</sup> "Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits – of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities." (Keynes, 1936)

much to consume today versus save for an uncertain future) and investment decisions (when expecting a growing or slowing economy). With the theory of rational expectations (RE), the literature addressed the issue of model consistency (Muth, 1961; Lucas, 1972). Under RE, economic agents understand how the world works, and they adjust their predictions in real time with all available information. While this approach allowed economists to formalise the key role of expectations in macroeconomic modelling, it became obvious that RE could not realistically describe the dynamics of people's actual expectations (Frankel & Froot, 1987). Agents (even expert agents, like professional forecasters, or econometricians) do not have *perfect foresight* (Wieland & Wolters, 2011). More fundamentally, their errors are not random. Specifically, individuals have several recognizable biases. They make clustered errors, where mistakes in the same direction arise together, and where periods of high error volatility alternate with periods of low error volatility (Milani, 2017). They also update using new information non-linearly, with a systematic early under-reaction to new information, followed by a systematic over-reaction. Therefore, theories of *adaptive learning* (Evans & Honkapohja, 2001) and of behavioural biases, like coordinated *waves of optimism and pessimism* (De Grauwe & Rovira Kaltwasser, 2007; Kurz et al., 2013) are better ways to describe belief dynamics empirically. Additionally, beliefs are also heterogeneous across people (De Grauwe & Ji, 2022; Hommes, 2021). Different people likely use different forecasting rules, whose relative performance varies through time (Brock & Hommes, 1997; Chiarella et al., 2014). In addition to the expectation types mentioned above ("perfect foresight", adaptive learning and optimists/pessimists), the most typical rules studied in the literature are *naïve expectations* (a special case of adaptive expectations), *stationary expectations* (expectations are constant at the steady state) and *fundamentalist expectations* (a more nuanced and time-varying version of stationary expectations). When agents are allowed to switch which expectation rule they use every period according to their past performance, the model often has multiple equilibria and, in a subset of the parameter space, even chaotic dynamics. For chaotic dynamics to arise, it is enough that these agents select between the two rules, one forward looking (fundamentalist expectations) and one backward looking (adaptive expectations). Finally, new studies of survey data show systematic reactions of the individual subjective belief in the face of increasing fundamental uncertainty (Piccillo & Poonpakdee, 2021), closing the circle back to the Keynesian thoughts on the role of expectations.

### 2.3.1 Stability

When applied to macroeconomic models, most boundedly rational expectation rules can impact the steady state and its stability in a variety of ways. Changes to stability arise especially due to the feedback mechanism inherent to the concept of expectations. Expectations are themselves (appropriately) functions of the state variables in the model since, according to the literature above, agents update their beliefs using some mix of current and past information, and then they use this information to make decisions affecting the world today (Lustenhouwer, 2023). For this reason, it is also not unusual for expectations to add new state variables to the dynamic system (Evans & Honkapohja, 2001).

For instance, it is natural that backward looking expectations (like naïve and adaptive expectations) amplify the dynamic model dependence on the past. Often this leads to the stability of the model being affected. In several cases (Hommes, 2021; Kurz et al., 2013) the stability of the bounded rationality system is more constrained compared to the benchmark case of "perfect foresight". In several cases, backward looking expectations are inserted in a model only for a fraction of the agents, and the other fraction may either hold perfect foresight beliefs, with or without costs (Bask & Proaño, 2016; Brock & Hommes, 1997) or moving toward a fundamental value by an arbitrary distance every period, as in the fundamentalist expectation rule (Massaro, 2013). This kind of models displays a rich dynamics, and the global stability of the one steady state is dependent on several conditions (Gomez

& Piccillo, 2019). In the case of dynamic stochastic general equilibrium models, the role of money and of the central bank is crucial to keep the system stable. Most generally, expectations in these models make money non-neutral, without the addition of any other frictions. Therefore the role of monetary policy becomes then to act by ruling on the impact of expectations, rather than the more common for this literature, to react to exogeneous shocks (Kurz et al., 2015)

However, and despite this rich literature, SFC models until now left only a marginal role to the study of how expectation models affect model dynamics. G&L (Ch.3) show that due to the buffer function of money, following from including wealth in the consumption function, their simple model will always tend to a steady state solution (provided the parameter conditions are satisfied), and mistakes in expectations will be corrected eventually.<sup>7</sup> Of course the adjustment path towards the steady state is affected by the mistakes in expectations. They show this for constant and naïve expectations – in the latter case the value of the variable in the previous period is expected also to prevail in the current period.

In their models of Ch. 4 and Ch. 5 G&L also use either constant, or naïve expectations. In Ch.7 they also use expectations in the form of adapting the previous period value to a target value. Only in Ch.9 and the following chapters adaptive expectations are used. Adaptive expectations have been recently used in several SFC models (Burgess et al., 2016; Caiani et al., 2016; Le Heron, 2011; Meijers & Muysken, 2022; Santos & Zezza, 2008). Recently, a study shows that the steady state of SFC models is affected by different specifications of adaptive expectation rules (Kappes & Milan, 2020).

Given this context, there remains a gap in the literature on the impact of the most widely known expectation rules on SFC models. We explore this question and we find that both the steady state and the conditions for its stability can be strongly affected. Below, we show how the system changes with the chosen rules: naïve, stationary expectations, fundamentalist, “perfect foresight”.

### 2.3.2 SFC with expectations rules

In our model we introduce expected disposable income  $YD^e$  in equation (9) and the expected capital stock  $K^e$  in equation (4). It is important to understand that disposable income is a flow and the expected capital stock is a stock. We already mentioned that stocks are measured at the end of the period. That implies that the expected capital stock  $K^e$  is the stock at the end of period  $t$ , with expectations formed at the beginning of period  $t$ . In the same vein, the expected disposable income  $YD^e$ , formed at the beginning of period  $t$ , refers to the income that will be obtained during period  $t$ . It then is consistent, in line with equation (5), to assume with respect to  $K^e$ :

$$K^e = \kappa \cdot Y^e \tag{15}$$

In this way all that agents have to forecast is output for period  $t$ , which will only be known at the end of the period. Having this forecast allows firms and households to form consistent expectations of expected capital and expected disposable income, since they are both functions of the same period output. We elaborate this for the most common rules of expectations we mentioned above, under the representative agent assumption (we discuss heterogeneous expectations towards the end of the paper).

---

<sup>7</sup> An important observations is that “money ... acts as a ‘buffer’ when expectations turn out to be incorrect.” (p. 78). That is, “if realised income is above the expected income, households will hold the difference in the form of larger than expected money balances.”(p. 79).

### *Stationary expectations*

The simplest form of expectations from the point of view of the agents is to hold a stationary expectation. This means that at every period in time the agents will continue to forecast that next period the model consistent steady state will be achieved<sup>8</sup>:

$$Y^e = Y^* \quad (16S)$$

This is a constant expectation which, insofar as the model does achieve steady state, correctly reflects also the nature of expectations and the model parameters. In this sense, the rule is consistent with the model. It is also mean-reverting, since it allows the agents to make decisions that are moving away from any trend that can be originated by exogenous shocks. The rule is however not rational since it is clear that after any shock, if agents forecast the stationary income value, they are going to be wrong for the period of time that the model is out of steady state.

### *Fundamentalist expectations*

We saw an example of fundamentalist rule in the literature review above. When agents hold this rule, they do believe that the system will eventually converge back to its proper, model consistent steady state. However they do not hold stationary expectations since they recognize when the economy is out of steady state. Therefore they forecast that at each period in time the economy will move toward the steady state (or fundamental value, as it is referred to in this literature), by a fixed proportion.

$$Y^e = \theta \cdot Y^* + (1 - \theta) \cdot Y_{-1} \quad (16F)$$

Agents holding this rule are also not rational, since they assume that income will move back to steady state at a fixed, arbitrary rate, rather than through a dynamic path that is model consistent.

### *Naïve expectations*

In the paragraphs above we also referred to backward looking expectations. These are expectations that use past information to forecast unobservable variables. The simplest form of backward looking expectations is given by naïve expectations. Under this rule, income during the current period is expected to be equal to income in last period:<sup>9</sup>

$$Y^e = Y_{-1} \quad (16N)$$

A more complex form of backward looking expectation is the so called adaptive expectation rule. Under this rule, instead of using past income, agents use their own past error in predicting past income, to update their forecast. Since this more complex rule adds one state variable (income in period t-2), we post-pone the study of this rule to the end of the paper.

### *“perfect foresight”*

Finally, as a useful comparison with models which do not describe boundedly rational expectations, we study the case of “perfect foresight”. Under this rule, agents know the one model consistent expectation, given the shock, the form of the model *and* their own expectation, and they correctly forecast income (one period ahead) at every period in time:

---

<sup>8</sup> We add S to the equation number, to indicate we analyse stationary expectations. Other types of expectations will be discussed below and will have different letters: N – naïve; P –perfect foresight; F – fundamentalist.

<sup>9</sup> We add N to the equation number, to indicate we analyse naïve expectations. Other types of expectations will be discussed below and will have different letters: S – stationary; P –perfect foresight; F – fundamentalist.

$$Y^e = Y \tag{16P}$$

In most models, perfect foresight (rational expectations), achieve the widest parameter space where the model is stable. It is easy to see why: when agents have the complete information, they do not waste time and resources into arbitrary errors, but right away re-optimize their decisions, which puts them on the equilibrium path that leads to the stable steady state. This conclusion takes place when the central bank implements a monetary policy which keeps the system stationary in the first place (therefore when the Taylor principle is satisfied, and a heavy enough weight is placed by the central bank on stabilizing inflation). Therefore, macroeconomic models of one stable steady state which already have a stable path to equilibrium, thanks to the agents and the central bank endogenous reaction to exogenous shocks, have the largest stability under perfect foresight. This is logical given the unique key role that monetary policy plays in these models, where flows are not necessarily anchored by the corresponding stocks, and where decision rules are not the result of optimisation. Indeed, we will see that this story is quite different when “perfect foresight” is compared to other expectation rules within the context of SFC models.

#### *Adaptive expectations*

There is evidence (Chiarella et al., 2014; Hommes, 2021) that agents form their beliefs according to some type of extrapolative rule. While naïve expectations are surely the simplest type of backward looking rule, they lack the extrapolative power of adaptive expectations. Agents who adopt this rule not only look at the level of yesterday’s output to forecast today’s level, but they focus on yesterday’s growth level, and they forecast that today’s change is going to be in the same direction as earlier, but proportionally smaller.

$$Y^e = \theta Y_{-1}^e + (1-\theta)Y_{-1} \tag{16A}$$

Adaptive expectations complicate our mathematical system, as these expectations take into consideration multiple preceding years. However this type of rule is also one of the most general versions of learning from past data applied in economics, after the well-known work on learning in (Evans & Honkapohja, 2001).

#### *Summing up*

Given the forms described in equations (16), it is clear that when the model is in the stationary state, all the expectation rules above become equivalent.

Finally, while these are the most widely used expectation rules, there are many other ways of forming expectations. We will elaborate on more complex rules below and show their impact on the stability of the economy. As G&L (p. 109) claim: “the model will easily accommodate any other scheme of expectations formation so long as it is not systematically perverse as would be the case if an error in one period were to be larger and in the same direction in the subsequent period.” However, they also show that in many cases the model then becomes too complicated to be solved analytically. We will also elaborate on this below. In section 3 we show how the model can be solved analytically for several types of expectations. We then introduce in section 4 more elaborate types of expectations in the model.

### 3 Solving the model

To further analyse the model, we look at its reduced form. Since we know that always should hold:  $L = M + R = K$ , the model excluding expectation formation can be reduced to the following four equations:

$$YD^e = (1 - \tau).Y^e - \delta.K_{-1} + r.\beta.Y_{-1} + r.R_{-1} \quad (18)$$

$$(1 + \mu - \tau - \beta).Y = \alpha_1.YD^e + \gamma.k.Y^e + (\alpha_2 - 1 - r).\beta.Y_{-1} + (\alpha_2 - \gamma + \delta).K_{-1} + C^A + X^A + \alpha_2.R_{-1} \quad (19)$$

$$K = \gamma.(k.Y^e - K_{-1}) + K_{-1} \quad (20)$$

$$R = X^A - \mu.Y + (1 + r).R_{-1} \quad (21)$$

Compared to the absence of a foreign sector, we find that households accumulate wealth not only in the form of physical capital  $K$  and bonds issued by government  $B$ , but also in the form of foreign reserves  $R$ . However, for analytical reasons, we distinguish between two situations. First a 'full open economy', where the effects of foreign reserves on household income and wealth are included in the way described above. Second we analyse a 'moderate open economy' in which the foreign reserves that are indirectly accumulated by households and their corresponding income are ignored by households. This moderate open economy bears some similarities to the German and the Dutch situation.<sup>10</sup>

Combining equations (18) and (19), we can reduce the model to the following three equations:

$$\rho.Y = a_1.Y^e - a_2.Y_{-1} - a_3.K_{-1} + a_4.R_{-1} + C^A + X^A \quad (19')$$

$$K = \gamma.k.Y^e + (1 - \gamma).K_{-1} \quad (20')$$

$$R = -\mu/\rho.a_1.Y^e - \mu/\rho.a_2.Y_{-1} - \mu/\rho.a_3.K_{-1} + (1 + r - \mu/\rho.a_4).R_{-1} + (1 - \mu/\rho).X^A - \mu/\rho.C^A \quad (21')$$

With:

$$\rho = (1 + \mu - \tau - \beta) > 0; a_1 = [\alpha_1.(1 - \tau) + \gamma.k] > 0; a_2 = [1 + (1 - \alpha_1).r - \alpha_2].\beta > 0;$$

$$a_3 = [\gamma - \alpha_2 - (1 - \alpha_1).\delta] > 0; a_4 = (\alpha_1.r + \alpha_2) > 0.<sup>11</sup>$$

This is a dynamic system with output  $Y$ , capital  $K$  and reserves  $R$  as variables. We still need to specify the expectations.

We focus on the stationary state – i.e. output and capital do not grow over time. A stationary state solution then can be easily found if we assume expected output and capital to be equal to their stationary values. This solution is presented in section 3.1 for both the full open economy and the moderate open economy, and its properties are discussed. In section 3.2 we point out the self-fulfilling properties of optimism and pessimism in expectations in the model for a moderate open economy.

<sup>10</sup> Both Germany and the Netherlands have a persistent current account surplus, increasing from 4 per cent of GDP on average prior to the financial crisis to 7 per cent of GDP thereafter. Net foreign debt fluctuates around 90 per cent of GDP in recent years. A typical Dutch feature is that, due to the funded pension system a lot of household savings end up in pension funds, who invest strongly abroad. The wealth of pension funds (over 250 per cent of GDP, and owned by households) is traditionally not included in household wealth in the Netherlands, when estimating the consumption function. See also Meijers and Muysken (2022).

<sup>11</sup> In a moderate open economy we find  $a_4 = 0$ . The wealth effect  $\alpha_2$ , the depreciation rate  $\delta$  and the interest rate  $r$  are assumed to be relatively small.

We show in section 3.3 that this model is only stable when taxes and government debt are not too high.

### 3.1 The stationary state solution of the model

To analyse the stability properties of this system, we should first look at the stationary state solution. In stationary equilibrium all three variables  $Y$ ,  $K$  and  $R$ , are constant over time, and expectations are consistent with the stationary state. We elaborate below that in case of a full open economy when the economy has a trade balance surplus in the stationary state ( $\mu \cdot Y^* < X^A$ ), its foreign reserves have to be negative. The reason is that when reserves have to remain constant over time, the trade surplus has to be compensated by negative interest payments on foreign reserves. This observation provides a motivation to look also at the moderate open economy with stationary output. In that situation we assume that foreign reserves, which are indirectly accumulated by households, do not generate returns for households and therefore are also not recognised by households as part of their wealth ( $a_4 = 0$ ). That is, households do only get returns on the deposits held at banks and on bonds, and these deposits and bonds are only included in the wealth accumulation affecting consumption. In that case positive foreign reserves can be consistent with a trade surplus. We elaborate both types of stationary equilibria below.

#### 3.1.1 The full open economy

We assume that all three variables  $Y$ ,  $K$  and  $R$ , are constant over time at  $Y^{**}$ ,  $K^{**}$  and  $R^{**}$ , respectively, and expectations are consistent. We then find:<sup>12</sup>

$$Y^{**} = \frac{C^A + (1 - a_4 \frac{1}{r}) X^A}{\rho - a_1 + a_2 + a_3 \kappa - a_4 \frac{\mu}{r}} = \frac{C^A + (1 - \alpha_1 - \alpha_2 \frac{1}{r}) X^A}{(1 - \alpha_1) \cdot (1 - \tau - \delta \cdot \kappa + r \cdot \beta) - \alpha_2 \cdot (\kappa + \beta) + \mu (1 - \alpha_1 - \alpha_2 \frac{1}{r})} \quad (22)$$

$$K^{**} = \kappa \cdot Y^{**} \quad (23)$$

$$R^{**} = (\mu \cdot Y^{**} - X^A) / r \quad (24)$$

Equation (24) follows from the notion that in order to keep foreign reserves constant, imports should equal exports net of interest payments. This implies that when the economy has a trade balance surplus in the stationary state ( $\mu \cdot Y^{**} < X^A$ ), the reserves have to be negative, i.e. the economy should have a foreign debt position. The reason is that when reserves have to remain constant over time, the trade surplus has to be compensated by interest payments on foreign debt (negative reserves).

According to equation (22) the impact of reserves has a negative impact on both the numerator and the denominator through the coefficient  $a_4$ . The impact on the numerator is stronger, which implies that a higher value of  $a_4$  leads to a lower value of stationary output  $Y^{**}$ . The reason is that reserves  $R^{**}$  are negative, while a higher value of  $a_4$  indicates that the wealth effect of negative reserves is stronger and/or that the interest payments on reserves play a more important negative role in consumption through their influence on disposable income. The other properties of the stationary state will be discussed in the next section, since they also apply to the moderate open economy.

#### 3.2.2 The moderate open economy

In case of a moderate open economy output, capital and reserves are constant over time at  $Y^*$ ,  $K^*$  and  $R^*$ , respectively, and expectations are consistent. We assume that foreign reserves, which are

---

<sup>12</sup> Since  $a_4/r = \alpha_1 + \alpha_2/r > 1$  does probably hold, both the nominator and denominator of  $Y^{**}$  are negative.



indirectly accumulated by households, do not generate returns for households and therefore are also not recognised by households as part of their wealth ( $a_4 = 0$ ). We find as stationary state solution of the model:<sup>13</sup>

$$Y^* = \frac{C^A + X^A}{\rho - a_1 + a_2 + a_3 \kappa} = \frac{C^A + X^A}{(1 - \alpha_1)(1 - \tau - \delta \kappa + r \beta) - \alpha_2(\kappa + \beta) + \mu} \quad (25)$$

$$K^* = \kappa \cdot Y^* \quad (26)$$

$$R^* = (X^A - \mu \cdot Y^*)/r \quad (27)$$

Similar to G&L we assume that the denominator of (25) is positive, i.e. that does hold:<sup>14</sup>

$$1 - \alpha_1 > \frac{\alpha_2(\kappa + \beta) + \mu}{1 - \tau - \delta \kappa + r \beta} \quad \text{and} \quad \tau < 1 - \delta \kappa + r \beta \quad (28)$$

in order to ensure  $Y^* > 0$ .<sup>15</sup>

The properties of the stationary state are discussed extensively in G&L for the situation without government. We therefore, focus here on the impact of introducing government in the model.

First, we observe that government expenditures are endogenous in the model due to the assumption of a limitation on government debt  $\beta \cdot Y$  and endogenous taxes  $\tau \cdot Y$ . Combining (6), (7) and (8) yields the stationary state government expenditures to output ratio,  $(G/Y)^*$ :

$$(G/Y)^* = \tau - r \cdot \beta \quad (29)$$

As we explained above by choosing a higher debt-output ratio at a given tax rate,  $(G/Y)^*$  decreases when  $\beta$  increases. Similarly, when the tax rate increases at a given debt-output ratio,  $(G/Y)^*$  increases when  $\tau$  increases. These observations imply that the impact of increased government expenditures does not follow from increased autonomous expenditures, equivalent to an increase in  $C^A$  in equation (19), but only indirectly through changes in  $\beta$  and  $\tau$ .

A second observation is that the second condition in equation (28) puts a cap on the tax rate, which also puts a cap on government expenditures:

$$(G/Y)^* < 1 - \delta \cdot \kappa \quad (30)$$

However, within the admissible range, we observe that an increase in the tax rate  $\tau$  always leads to an increase in stationary state output  $Y^*$ . This result is consistent with the reasoning behind our finding above that  $(G/Y)^*$  increases when  $\tau$  increases.

Finally, we observe from equation (25) that the impact of an increase in  $\beta$  on output depends on whether

$$\alpha_2 > (1 - \alpha_1) \cdot r \quad (31)$$

holds or not. If (31) does hold, the intuition is that the increase in consumption, due to the income effect of increased interest payments and the wealth effect of additional bonds, should be large enough to offset the increased interest payments by government, leading to an increase in

<sup>13</sup> It can easily be verified, comparing equation (25) with (22) that stationary output in the moderate economy is higher than stationary output in the full open economy ( $Y^* > Y^{**}$ ).

<sup>14</sup> Equation (13) reduces to equation G&L equation (7.30) when we assume  $\beta = \tau = \mu = 0$ .

<sup>15</sup> This is to ensure that 'the model makes sense.' (G&L, p. 229) See also G&L equation (7.31).

government expenditures. However, the negative impact of  $\beta$  on  $(G/Y)^*$  implies that condition (31) should not be taken for granted.

With respect to the foreign sector we find from equation (27) that an increase in exports  $X^A$  increases stationary output. An increase in the propensity to import  $\mu$  leads to a decrease in stationary output. Both results are intuitively plausible.

Again we find that when the economy has a trade balance surplus in the stationary state ( $\mu.Y^* < X^A$ ), the reserves have to be negative, i.e. the economy should have a foreign debt position. However, we show below that in the moderate open economy output and capital can remain at their stationary levels, while the economy has both a trade balance surplus and positive foreign reserves.

### 3.2 The impact of optimism and pessimism in expectations

For a better understanding of the role of expectations in our model we look at the impact of optimistic expectations. Let stationary output systematically be overestimated by  $\Omega$ , that is:

$$Y^e = Y^* + \Omega \quad (16S')$$

whereby  $Y^*$  (or  $Y^{**}$ ) is the stationary output consistent with these expectations. We can derive the impact of optimism for both types of open economies, and  $K^*$  (or  $K^{**}$ ) the corresponding capital stock. As might be expected, the outcomes are different for the full open economy and the moderate one. We analyse first the implications for the moderate open economy and then those for the full open economy.

The model for the moderate open economy is given by equations (19') – (21'), with  $a_4 = 0$ . Substituting equation (16S') and  $Y = Y_{-1} = Y^*$  and  $K = K_{-1} = K^*$  yields as stationary state:

$$Y^* = \frac{C^A + X^A + \{\alpha_1(1 - \tau) + [(1 - \gamma) + \alpha_2 + (1 - \delta)\alpha_1] \cdot \gamma \cdot \kappa\} \cdot \Omega}{(1 - \alpha_1) \cdot (1 - \tau - \delta \cdot \kappa + r \cdot \beta) - \alpha_2 \cdot (\kappa + \beta) + \mu} \quad (33)$$

$$K^* = \kappa \cdot Y^* \quad (34)$$

From equation (33) we see that stationary output increases with  $\Omega$ . In the case of optimistic expectations, overestimating output will result in higher stationary output due increased consumption and investment demand.<sup>16</sup> This illustrates that optimism is a self-fulfilling prophecy in this model. And it is obvious that the same does hold for pessimism.

Similarly we find for the full open economy:

$$Y^{**} = \frac{C^A + (1 - \alpha_1 - \alpha_2 \frac{1}{r}) X^A + [(1 - \gamma) + \alpha_2 + (1 - \delta)\alpha_1] \cdot \gamma \cdot \kappa \cdot \Omega}{(1 - \alpha_1) \cdot (1 - \tau - \delta \cdot \kappa + r \cdot \beta) - \alpha_2 \cdot (\kappa + \beta) + \mu (1 - \alpha_1 - \alpha_2 \frac{1}{r})} \quad (35)$$

And the same holds as for the moderate open economy.

Finally, it is important to note that in this specification, where optimism or pessimism are introduced by adding  $\Omega$  to expected output – cf. equation (16'S) – optimism does not affect the stability of the model. Only the constant terms in equations (19') – (21') change, but this does not appear in the stability condition. That is, the impact of information from the past is not influenced by our specification of optimism or pessimism, and therefore there is no impact on the stability of the model.

<sup>16</sup> If only consumers are optimistic, the term between brackets in the denominator of equation (18') would be equal to  $\alpha_1(1 - \tau)$ . If only firms are optimistic, the term would be equal to  $\gamma \cdot \kappa$ .

Other forms of introducing optimism and pessimism might have an impact on stability, but our main point is that under plausible circumstances optimism and pessimism will have a tendency of self-fulfilling prophecies in the moderate open economy.

### 3.3 Stationary state stability conditions

We can derive the stability conditions for both type of open economies. As expected, these are different for the full open economy and the moderate one. The stability conditions for the full open economy can be derived, but they can only be analysed numerically. We therefore focus on the stability conditions for the moderate open economy, since these can be fully analysed.

#### 3.3.1 Stability in the full open economy

In order to derive the stability conditions, we substitute the expectation equation (16S) in the model of equations (19') – (21'). We then find:

$$\rho.Y = a2.Y_{-1} + a3.K_{-1} + a4.R_{-1} + C^A + X^A + a1.Y^{**} \quad (36)$$

$$K = (1 - \gamma).K_{-1} + \gamma. \kappa.Y^{**} \quad (37)$$

$$R = -\mu/\rho.a2.Y_{-1} - \mu/\rho.a3.K_{-1} + (1 - \mu/\rho.a4).R_{-1} + (1 - \mu/\rho).X^A - \mu/\rho.C^A - \mu/\rho.a1.Y^{**} \quad (38)$$

Stability of the system then requires all eigenvalues of the coefficient matrix are within the unit circle.

After some manipulation, we derive that the three roots are given by:

$$x_1 = B - \left(\frac{X}{Z} + Z\right) \quad (39)$$

$$x_{2,3} = B - \frac{\left(\frac{X}{Z} + Z\right) \pm \sqrt{3} \cdot \left(\frac{X}{Z} - Z\right) \cdot i}{2} \quad (40)$$

As a consequence stability requires that:

$$\max \left[ B - \left(\frac{X}{Z} + Z\right) ; \sqrt{\left[ B - \frac{1}{2} \left(\frac{X}{Z} + Z\right) \right]^2 + \frac{3}{4} \cdot \left[ \left(\frac{X}{Z} - Z\right) \right]^2} \right] < 1 \quad (41)$$

$$A = [a3.\kappa - (1 - \gamma).\rho - a2.(2 - \gamma) + (1 - \gamma).a4.\mu]/(3.\rho)$$

$$B = [a2 + (2 - \gamma).\rho - a4.\mu]/(3.\rho)$$

$$C = (a3.\kappa - a2.(1 - \gamma))/(2.\rho)$$

$$X = A + B^2$$

$$Z = \left\{ \left[ B^3 - C + (2/3).A.B \right]^2 - (A + B^2)^3 \right\}^{(1/2)} + B^3 - C + (2/3).A.B \right\}^{(1/3)}$$

Since this condition is very hard to analyse further, we have to resort to numerical simulations to investigate its properties. For the moment we leave this for further research.

However, if this condition is satisfied, the economy returns to  $Y^{**}$ ,  $K^{**}$  and  $R^{**}$  after a shock. We illustrate this process for the case of a decrease in autonomous consumption. Initially, this leads to lower income: directly because consumption decreases, and indirectly through the multiplier-accelerator process. But lower income also leads to lower imports. Since exports remain at the same level, lower imports imply a decrease in foreign debt (increase in reserves). This leads to an increase in income through wealth and interest income. Both taxes and government expenditures will be lower

because of the initial decrease in income – the latter since the amount of bonds will also decrease initially. However, in the end the total amount of bonds will return to its stationary level  $\beta.Y^{**}$ . But total household wealth will decrease, since accumulated wealth has decreased due to lower savings during the transition period. On the other hand, accumulated foreign debt has decreased (reserves have increased) due to the lower imports during the transition period. Both household wealth and foreign reserves remain constant after the transition period. In the end foreign debt will be lower (reserves will be higher) at a level that compensates through wealth effects and interest income for the loss of income through lower autonomous consumption.

### 3.3.2 Stability in the moderate open economy

In order to derive the stability conditions, we substitute the expectation equation (16S) in the model of equations (19') – (21'), with  $a_4 = 0$ . That is, we assume that foreign reserves, which are indirectly accumulated by households, do not generate returns for households and therefore are also not recognised by households as part of their wealth. The implication is that the development of reserves over time does not affect output and capital accumulation. For that reason we can focus on the latter two variables. That is, we focus on the stability conditions for:

$$Y = - (a_2/\rho).Y_{-1} - (a_3/\rho).K_{-1} + [C^A + X^A + a_1.Y^*]/\rho \quad (42)$$

$$K = (1 - \gamma)K_{-1} + \gamma.K.Y^* \quad (43)$$

Stability of the model then requires that all eigenvalues of the coefficient matrix are within the unit circle, which implies:<sup>17</sup>

$$a_2/\rho < 1 \quad (44)$$

We note that in the stationary solution the capital stock is not affected by past output. That makes the dynamics of the model relatively simple. The stability conditions of other forms of expectations are much more complicated as we elaborate in section 4.

Substitution of  $a_2$  and  $\rho$  in the stability condition (44) yields:

$$[(1 - \alpha_2) + (1 - \alpha_1).r]. \frac{\beta}{(1 + \mu - \tau - \beta)} < 1 \quad (44')$$

A first observation is that this condition does always hold in absence of government. In that case the system is inherently stable, assuming the stationary expectations.

When we introduce government, we note that it is crucial whether  $\beta + \tau - \mu$  is smaller or larger than unity. Now there are two reasons why in the stationary analysis we assume  $\beta + \tau - \mu$  is smaller than unity, i.e.  $\rho > 0$ . First, when one considers the average EMU member state, the target value for  $\beta$  is 0.6, the average tax rate will be around 0.5 and the import quote will be around 0.5. Hence, only when  $\beta$  is considerably larger than 0.6 this condition is violated. However, one should realise that the target value of  $\beta$  is 0.6, is based on a growing economy. In our stationary economy this target value does not hold. If positive at all, it will be much lower – this is the second reason why we assume  $\beta + \tau - \mu$  is smaller than unity.

---

<sup>17</sup> This is a sufficient condition, which should not be confused with the necessary condition that the absolute value of the system's determinant is smaller than unity, which is often used in G&L.

As we mentioned above, the stationary state government expenditures to output ratio is given by equation (29). This equation implies that for positive values of  $\beta$ , the stationary state requires a budget surplus:

$$\tau - (G/Y)^* = r \cdot \beta \quad (29')$$

This surplus is necessary to pay for the interest on government debt implied by the positive value of  $\beta$ .

Since  $\tau < 1 + \mu - \beta$ , we find from (35') as the stability condition:

$$\tau < 1 + \mu - \beta - [(1 - \alpha_2) + (1 - \alpha_1) \cdot r] \cdot \beta \quad (45)$$

Since  $[(1 - \alpha_2) + (1 - \alpha_1) \cdot r] \cdot \beta > 0$ , this condition can be binding.

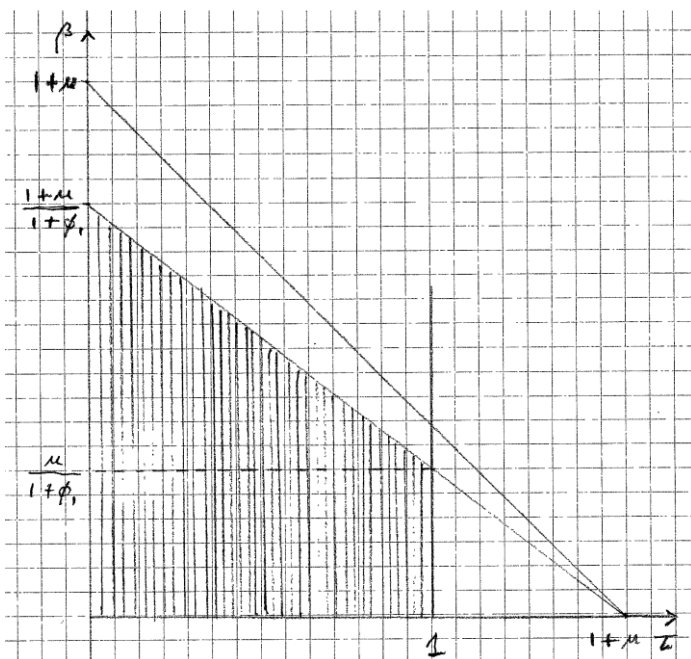
We illustrate this condition in Figure 1, rewriting the borderline case as:

$$\beta = \frac{1 + \mu}{1 + \phi_1} - \frac{\tau}{1 + \phi_1} \quad (46)$$

with  $\phi_1 = [(1 - \alpha_2) + (1 - \alpha_1) \cdot r] > 0$ .

The borderline case is displayed in Figure 1,<sup>18</sup> and the region of stability is displayed by the vertically striped area.

Figure 1 Stability conditions for stationary expectations



In Figure 1 we present at the vertical axis the debt-to-output ratio  $\beta$ , and on the horizontal axis the tax rate  $\tau$ . The region of stability is bounded by a downward sloping line, which implies that at a higher

<sup>18</sup> Here  $\tau = 0$  gives:  $\beta = \frac{1 + \mu}{1 + \phi_1}$ , and  $\tau = 1$  gives:  $\beta = \frac{\mu}{1 + \phi_1}$ . Remember from equation (27) that also should hold:  $\tau < 1 - \delta \cdot \kappa + r \cdot \beta$ , we ignore this in the figure.

debt to output ratio the admissible tax rate to maintain stability is lower. The intuition for this trade-off follows from the binding constraint on government expenditures by the debt-output ratio. This implies a trade-off between the tax rate and debt-output ratio in the multiplier impact of government expenditures (in addition to the impact of the tax rate through disposable income).

Also, the admissible tax rate at a certain debt to output ratio is even lower when  $\mu$  decreases. This follows from the observation that a lower propensity to imports increases the multiplier and hence the impact of shocks to the economy.

Moreover, from the properties of  $\phi_1$  we infer additional properties of the model, which are intuitively plausible. One observes that when adjustment of the capital stock becomes faster, i.e.  $\gamma$  increases, the model becomes more stable since it adjusts faster to the new situation. The same does hold for the wealth effect in consumption – when  $\alpha_2$  increases, the model becomes more stable. This finding is consistent with G&L (p.83).

In summary, we find that under stationary expectations for the moderate open economy the probability of stability increases when: (1) the tax rate is lower; (2) the debt-to-output ratio decreases; (3) the propensity to imports is higher; (4) the adjustment of the capital stock is faster; (5) the wealth effect on consumption is higher; (6) the propensity to consume is higher; and (7) the interest rate is lower.

A final observation is that stability only refers to output and capital. After a shock the economy returns to  $Y^*$  and  $K^*$ . However, it does not return to  $R^*$ . Take for example situation with initially a positive trade balance and corresponding negative reserves in the stationary state. Then we follow the example from the previous section, with a decrease in autonomous consumption. This leads to lower income: directly because consumption decreases, and indirectly through the multiplier-accelerator process. Moreover, the decrease is stronger compared to the full open economy, because there is no countervailing tendency from returns to reserves, and wealth effects. Eventually income and capital will return to their new stationary state levels.

However, reserves will increase consistently and become positive. When  $Y^*$  has reached its new level, reserves will continue to increase according to:

$$R = X^A - \mu \cdot Y^* + (1 + r) \cdot R_{-1} \quad (47)$$

As we explain in the Appendix, this does not affect output and the capital stock, since it will be absorbed by the financial sector. This is consistent with the German and Dutch situation, as we explained above.

#### 4 The role of expectations in the stability of the model

To illustrate the importance of the nature of expectations we analyse now the impact of the various types of expectations introduced in section 2.3 on the stability of the model. We focus on the case of a moderate open economy since this can be fully analysed, as we elaborated in the previous section.

The border lines have been derived using the analytically derived stability conditions, see Appendix B, except for adaptive expectations. Unfortunately the stability conditions are too complex to analyse them in a straight forward way, as we did in section 3.3.2. For that reason we investigate the stability conditions numerically, using plausible parameter values – see Meijers and Muysken (2022). These parameter values are reproduced in Table 3.

*Table 3. Parameter settings for the stationary expectations model simulations*

Imputed values			
$\alpha 1$	0.7	$\mu$	0.5
$\alpha 2$	0.02	$\beta$	0.4
$\gamma$	0.5	$\tau$	0.4
$\delta$	0.08	$X^a$	100
$\kappa$	1	$C^a$	25
$r$	0.01	$\theta$	0.5
Calculated values			
$\rho$	0.7	a2	0.3932
a1	0.92	a3	0.456

When we substitute the expectations equations (16..) in (19') and (20'), the generic reduced form of the moderate economy model is defined by:

$$Y = a.Y_{-1} + b.K_{-1} + e \quad (48)$$

$$K = c.Y_{-1} + d.K_{-1} + f \quad (49)$$

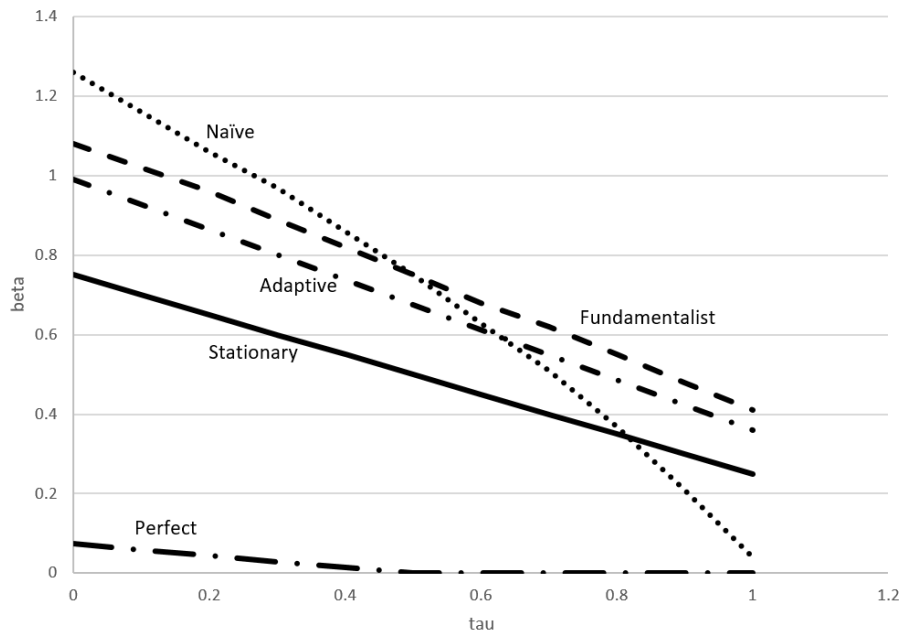
and various forms of expectations define the parameters of that model. These parameters are summarized in Table 4.

*Table 4. Coefficients a, b, c and d for various type of expectations*

	a	b	c	d
Stationary	$-(a2/\rho)$	$-(a3/\rho)$	0	$(1 - \gamma)$
“perfect foresight”	$-a2/(\rho - a1)$	$-a3/(\rho - a1)$	$-a2.\gamma.\kappa/(\rho - a1)$	$(1 - \gamma) - a3.\gamma.\kappa/(\rho - a1)$
Naïve	$(a1 - a2)/\rho$	$-(a3/\rho)$	$\gamma.\kappa$	$(1 - \gamma)$
Fundamentalist	$[a1.(1 - \theta) - a2] / \rho$	$-(a3/\rho)$	$(1 - \theta).\gamma.\kappa$	$(1 - \gamma)$

For each of the expectations forms presented in Table 4 and for adaptive expectations, we then check the values of  $\tau$  and  $\beta$ , for which the model is stable, conditional on all other parameters as presented in Table 3. This enables us to derive the border lines of stability analogous to the border line presented in Figure 1 for the stationary state. The findings are summarised in Figure 2.

Figure 2 Stability conditions for various type of expectations



We take stationary expectations, which we analysed in section 3.2.1 as the benchmark. The stability condition (35') is reproduced in Figure 2, and we add the conditions for “perfect foresight”, naïve expectations, fundamentalist expectations and adaptive expectations.

One observes that the conditions under “perfect foresight” seem more binding, while those for naïve expectations are less binding than stationary expectations. This is not consistent with the findings in the literature as reviewed in section 2.3.

The reason for our findings lies in the demand oriented nature of our model, where a positive shock in output leads to higher output due to the multiplier-accelerator mechanism.

When comparing a positive shock in output under “perfect foresight” to stationary expectations, the shock in output will directly translate in enhancing output under “perfect foresight”, while it will not do so under stationary expectations. Hence the initial impact under “perfect foresight” is larger and will therefore destabilise the model stronger.

On the other hand, under naïve expectations, the shock in output will directly affect lagged output, whereas it will affect output one period later under stationary expectations. Therefore the feedback is stronger under naïve expectations and this explains why the model is more stable.

We look at the impact of expectations more in detail below.

#### 4.1 More instability under “perfect foresight”

With “perfect foresight” the reduced form of the relevant equations (19') and (20') become:

$$Y = -a_2/(\rho - a_1).Y_{-1} - a_3/(\rho - a_1).K_{-1} + (C^A + X^A)/(\rho - a_1) \quad (50)$$

$$K = \gamma.k.Y + (1 - \gamma).K_{-1} \quad (51)$$



An important observation is that shocks in output did not affect the capital stock through past output under stationary expectations. Under “perfect foresight” these shocks have an instantaneous impact on capital and through lagged capital also on output. This implies that a shock in for instance exports  $X^A$  has a direct impact on both output and capital through current output, and then also indirectly through both past output and capital.

In addition, these shocks are amplified through the multiplier-accelerator mechanism (by subtracting  $a_1$  in the denominator). That is, while the direct impact of the shock on output through past output is  $-a_2/\rho$  under stationary expectations, the direct impact of the shock is now  $-a_2/(\rho - a_1)$  under “perfect foresight”.<sup>19</sup> Next to that past output and capital have an impact on current output of  $-a_2/(\rho - a_1)$  and  $-a_3/(\rho - a_1)$ , respectively, compared to  $-a_2/\rho$  and  $-a_3/\rho$ , respectively, under stationary expectations. Finally, current output also has a positive influence on the current capital stock, and therefore additionally influences current output through past values of the capital stock.

This explains why the border of stability under “perfect foresight”, presented by the grey line in Figure 2, is close to the horizontal axis and far below the border of stability for stationary expectations (the red line).

The intuition is that under “perfect foresight” through the multiplier and accelerator mechanisms the adjustment to shocks in the economy is instantaneous. Hence reaction is faster than under stationary expectations. Moreover, it is also stronger because the shock is immediately included in current output. This makes the system less stable.

#### 4.2 Less instability under naïve expectations

With naïve expectations the reduced form of the relevant equations (19') and (20') become:

$$Y = (a_1 - a_2)/\rho \cdot Y_{-1} - a_3/\rho \cdot K_{-1} + (C^A + X^A)/\rho \quad (52)$$

$$K = \gamma \cdot K \cdot Y_{-1} + (1 - \gamma) \cdot K_{-1} \quad (53)$$

An important difference with stationary expectations is that the capital stock is influenced by past output. This creates an additional dynamic loop compared to stationary expectations. That is, past output does not only influence current output directly, but also indirectly through the lagged capital stock. Moreover, past output influences current output with coefficient  $(a_1 - a_2)/\rho$ , compared to  $-a_2/\rho$  under stationary expectations. In that respect the multiplier accelerator mechanism through  $a_1$  plays a stabilising role.<sup>20</sup> In addition, lagged income appears in the system through the interest payments and wealth effects related to government debt. If government debt increases this can lead to a destabilising impact of government debt – this is obvious in the case of stationary expectations as can be seen from Figure 1.<sup>21</sup> In the case of naïve expectations the additional dynamic loop through the capital stock provides a counterbalancing effect, since the influence of lagged capital

<sup>19</sup> Taking into account the definition of  $\rho = (1 + \mu - \tau - \beta)$ , and understanding that a plausible value of  $a_1$  is just below unity, one understands that for low values of  $\tau$  and/or  $\beta$  the coefficient  $1/(\rho - a_1)$  initially is positive, increasing strongly in  $\tau$  and/or  $\beta$  to a very high value. It then switches sign and becomes negative at that very high value, again increases strongly in  $\tau$  and/or  $\beta$ , while remaining negative.

<sup>20</sup> The coefficient  $a_1 = [\alpha_1 \cdot (1 - \tau) + \gamma \cdot \kappa]$  contains both the multiplier and the accelerator.

<sup>21</sup> This effect is found in the coefficient  $a_2 = [1 + (1 - \alpha_1) \cdot r - \alpha_2] \cdot \beta$ .

is negative because of the lagged adjustment of the capital stock to its target value.<sup>22</sup> This enhances the stability of the model.

The borderline for naïve expectations is presented by the dotted line in Figure 2. One observes that under the chosen parameter conditions the model is more stable than under stationary expectations till a high tax rate. The reason for the latter is that for an increasing tax rate the influence of the lagged capital stock becomes increasingly stronger relative to the influence of lagged output, since the multiplier effect decreases. At some level of the tax rate the negative influence of the lagged capital stock then is so dominating that it becomes destabilising.

Hence, under naïve expectations the model becomes more stable – there are less restrictions necessary to guarantee stability of the model. The intuition is that the path dependency of naïve expectations makes the reaction to shocks in the economy smoother.

#### 4.3 Intermediate instability under fundamentalist expectations

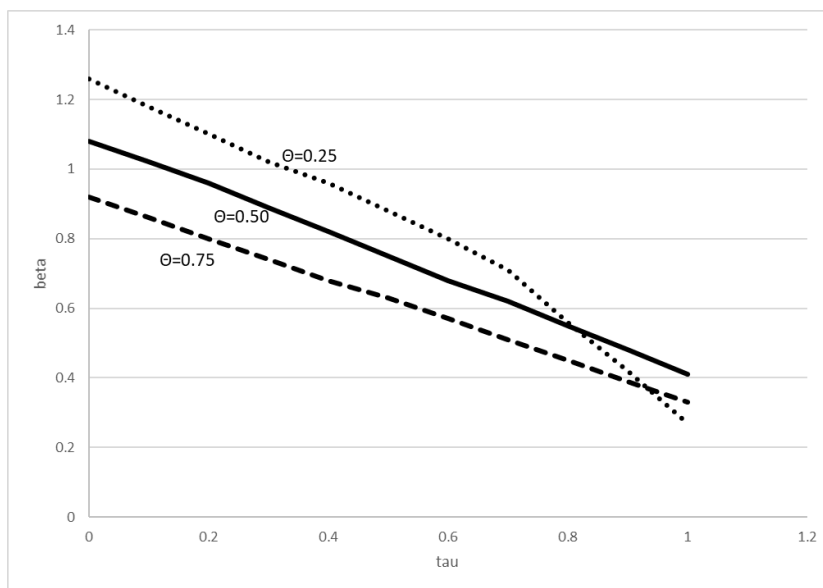
With fundamentalist expectations the reduced form of the relevant equations (19') and (20') become:

$$Y = [a_1(1 - \theta) - a_2]/\rho \cdot Y_{-1} - a_3/\rho \cdot K_{-1} + (C^A + X^A + a_1 \cdot \theta \cdot Y^*)/\rho \quad (54)$$

$$K = (1 - \theta) \cdot \gamma \cdot k \cdot Y_{-1} + (1 - \gamma) \cdot K_{-1} + \gamma \cdot k \cdot \theta \cdot Y^* \quad (55)$$

The borderline for fundamentalist expectations is presented by the dashed line in Figure 2 (for  $\theta = 0.5$ ). Since fundamentalist expectations are a weighted average of stationary and naïve expectations, one would think that the model is more stable than under stationary expectations, but less stable than under naïve expectations. This does hold indeed for lower and intermediate values of the tax rate. However, for higher values of the tax rate fundamentalist expectations become less stable because at a very high tax rate the multiplier becomes ineffective, as we explained for naïve expectations above.

Figure 3 Stability conditions for fundamentalist expectations, different speeds of adjustment



<sup>22</sup> This follows from our assumption that  $a_3 = [\gamma - \alpha_2 - (1 - \alpha_1) \cdot \delta] > 0$ , which implies that we assume a positive speed of adjustment of the capital stock, since should hold  $\gamma > \alpha_2 + (1 - \alpha_1) \cdot \delta > 0$ .

The observation that for a higher speed of adjustment the region of stability decreases is in line with our intuition above that a larger degree of path dependency makes the adjustments to shocks in the economy smoother and hence increases stability. Again, for higher values of the tax rate naïve expectations become less stable because at a very high tax rate the multiplier becomes ineffective, at a low speed of adjustment.

#### 4.4 Varying instability under adaptive expectations

As we mentioned above, the stability conditions for adaptive expectations cannot be solved analytically. That is, we cannot present the reduced form of the relevant equations (19') and (20') with adaptive expectations. The reason is that adaptive expectations include a second dynamic element in the model such that investigating stability requirements include higher-order calculations. Under adaptive expectations, we have for expected output:

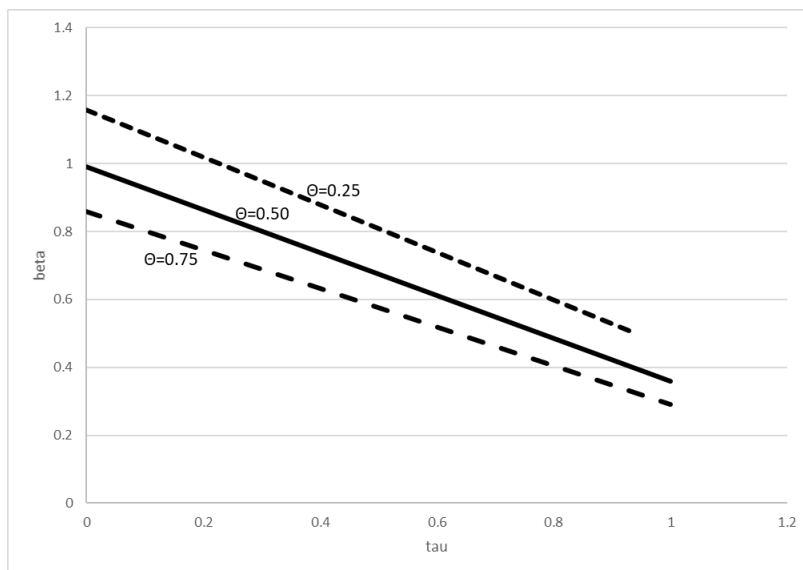
$$y_t^e = \theta y_{t-1}^e + (1 - \theta) \cdot y_{t-1} \stackrel{\text{def}}{=} y_{t-1} + \theta(y_{t-1}^e - y_{t-1}) \quad (16A)$$

And substituting  $y_t^e$  backwards shows that  $y_t^e$  itself depends on the entire history of  $y_t$ .

Given the structure of the model, the stability condition of the model cannot be found analytically and we therefore continue by numerical simulations of the whole model.

We start in the stationary state and simulate the model numerically, using the Eviews software package, where the expected output is equal to output in the stationary state. The model then remains in a stationary state. We shock the model in a single period by increasing the expected output by 10%. The model then either returns to a stationary state after the shock, in which case the model is stable or does not return to a stationary state, in which case the model is unstable. As before, we check the values of  $\tau$  and  $\beta$ , for which the model is stable or unstable, conditional on all other parameters as presented in Table 3. The resulting values of  $\tau$  and  $\beta$  constitute the border of stability represented by the dash-dotted line in Figure 2.

Figure 4 Stability conditions for adaptive expectations, different speeds of adjustment



As we observe from the figure, the region of stability for adaptive expectations is below that of fundamental expectations, implying that the region of stability is somewhat smaller. However, it is

above the region of stability for stationary expectations. That is, expected income adjusts under adaptive expectations between ultimately stationary income and lagged (naïve expected) income.

Finally, as in the case of fundamentalist expectations, we find that for a higher speed of adjustment the region of stability decreases. This is in line with our intuition above that a larger degree of path dependency smoothens the adjustments to shocks in the economy and hence increases stability. Again, for higher values of the tax rate naïve expectations become less stable because at a very high tax rate the multiplier becomes ineffective, at a low speed of adjustment.

#### 4.5 Stability under various expectations compared

Section 4 shows that the stability of the SFC model under different forms of expectations varies greatly. What is more surprising, the qualitative results arising from macroeconomic models with optimising agents do not hold in SFC models. This is because agents in SFC models use thumb rules to take their decisions, instead of re-optimising their actions when they change expectations. Therefore the result that naïve expectations have a wider policy space of stability is due to the fact that as long as agents do not consciously re-optimize their decisions, updating their expectations in real time and aligning them with the “perfect foresight” rule is actually leading the model to stronger reactions to exogenous shocks, and therefore to less stability. On the contrary, naïve expectations, which take a full lag before reacting to shocks, are among the most stable rules, due to this delay.

This result aligns with recent interdisciplinary literature showing that in a complex world which contains fundamental uncertainty and where optimization is not feasible, it is simple thumb rules (also called heuristics, meaning the easy forms listed above, like naïve, fundamentalist, adaptive) that are the closest one can do to get to a better result. In this world without optimisation, perfect foresight is not the first best, but simple thumb rules are (Dosi et al., 2020; Gerd Gigerenzer, n.d.; Gigerenzer & Brighton, 2009). In our paper we show that this intuition is easily carried over into SFC models, given these models' more realistic description of decision making processes. Ultimately, this section shows that the space of feasible rules for fiscal policy (in terms of tax rate and debt level) is larger for heuristics and thumb rules than it is for “perfect foresight”.

## 5 Conclusion

Our analysis above illustrates that in a simple SFC model, the economy under different forms of expectations always converges to the stationary state levels of output and capital if it is stable. However, the stability of the model is highly dependent on the nature of the expectations. While after a shock the economy may be stable under one type of expectations, it can be highly unstable under another type of expectations. This implies that expectations should not be introduced in SFC-models in an ad hoc way, without much motivation, as usually is the case. It is important to understand the nature of expectations and to model these in a proper way.

In this analysis we show how the region of stability for government policy, defined by the combination of tax rate and debt-to-output ratio, is larger, the higher the path dependency in the economy is. We explain that for low and intermediate tax rates naïve expectations, only depending on output in the previous period, lead to the largest region of stability. However, we still need to study the dynamics of the economy in reaction to shocks under different types of expectations. This might give additional insights in the properties of the model under different forms of expectations.

A final point is that our analysis illustrates that when fiscal policy is defined by the combination of tax rate and debt-to-output ratio, as is the case in many Euro countries, severe shocks in the economy will

always lead to instability. To deal with these shocks, this type of fiscal policy is not suitable and 'unconventional measures' have to be taken. In that sense the region of stability in our analysis reminds us of Leyonhufvud's corridor of stability (Leijonhufvud, 1973, 2009).

## References

- Bask, M., & Proaño, C. (2016). Optimal Monetary Policy under Learning and Structural Uncertainty in a New Keynesian Model with a Cost Channel and Inflation Inertia. *Journal of Economic Dynamics and Control*, *69*, 112–126. <https://doi.org/10.1016/j.jedc.2016.05.009>
- Brock, W. A., & Hommes, C. H. (1997). A Rational Route to Randomness. *Econometrica*, *65*(5), 1059–1095. <https://doi.org/10.2307/2171879>
- Burgess, S., Burrows, O., Godin, A., Kinsella, S., & Millard, S. (2016). *A dynamic model of financial balances for the United Kingdom* (Bank of England Working Paper No. 614). Bank of England. <https://econpapers.repec.org/paper/boeboeewp/0614.htm>
- Caiani, A., Godin, A., Caverzasi, E., Gallegati, M., Kinsella, S., & Stiglitz, J. E. (2016). Agent based-stock flow consistent macroeconomics: Towards a benchmark model. *Journal of Economic Dynamics and Control*, *69*, 375–408. <https://doi.org/10.1016/j.jedc.2016.06.001>
- Chiarella, C., He, X.-Z., & Zwinkels, R. C. (2014). Heterogeneous expectations in asset pricing: Empirical evidence from the S&P500. *Journal of Economic Behavior & Organization*, *105*, 1–16.
- De Grauwe, P., & Ji, Y. (2022). *Trust and Monetary Policy* (SSRN Scholarly Paper No. 4069895). <https://papers.ssrn.com/abstract=4069895>
- De Grauwe, P., & Rovira Kaltwasser, P. (2007). *Modeling Optimism and Pessimism in the Foreign Exchange Market* (SSRN Scholarly Paper No. 982787). <https://doi.org/10.2139/ssrn.982787>
- Dosi, G., Napoletano, M., Roventini, A., Stiglitz, J. E., & Treibich, T. (2020). *Rational Heuristics? Expectations and Behaviors in Evolving Economies with Heterogeneous Interacting Agents* (Working Paper No. 26922; Working Paper Series). National Bureau of Economic Research. <https://doi.org/10.3386/w26922>
- Evans, G. W., & Honkapohja, S. (2001). *Learning and Expectations in Macroeconomics*. Princeton University Press. <https://www.jstor.org/stable/j.ctt7s6t9>
- Frankel, J., & Froot, K. A. (1987). Using Survey Data to Test Standard Propositions Regarding Exchange Rate Expectations. *American Economic Review*, *77*(1), 133–153.

- Gerd Gigerenzer. (n.d.). *Bounded Rationality: The adaptive toolbox* | Max Planck Institute for Human Development. Retrieved November 23, 2019, from <https://www.mpib-berlin.mpg.de/en/research/adaptive-behavior-and-cognition/publications/books/bounded-rationality>
- Gigerenzer, G., & Brighton, H. (2009). Homo heuristicus: Why biased minds make better inferences. *Topics in Cognitive Science*, 1(1), 107–143. <https://doi.org/10.1111/j.1756-8765.2008.01006.x>
- Godley, W., & Lavoie, M. (2007). *Monetary Economics: An Integrated Approach to Credit, Money, Income, Production and Wealth*. London: Palgrave Macmillan
- Gomez, T., & Piccillo, G. (2019). *Diverse Risk Preferences and Heterogeneous Expectations in an Asset Pricing Model* (SSRN Scholarly Paper ID 3517050). Social Science Research Network. <https://papers.ssrn.com/abstract=3517050>
- Hommel, C. (2021). Behavioral and Experimental Macroeconomics and Policy Analysis: A Complex Systems Approach. *Journal of Economic Literature*, 59(1), 149–219. <https://doi.org/10.1257/jel.20191434>
- Kappes, S. A., & Milan, M. (2020). Dealing with adaptive expectations in Stock-Flow consistent models. *Journal of Post Keynesian Economics*, 43(1), 76–89. <https://doi.org/10.1080/01603477.2019.1640067>
- Keynes, J. M. (1936). *The General Theory of Employment, Interest and Money* | work by Keynes | *Britannica.com*. <https://www.britannica.com/topic/The-General-Theory-of-Employment-Interest-and-Money>
- Kurz, M., Motolese, M., Piccillo, G., & Wu, H. (2015). *Monetary Policy with Diverse Private Expectations*. <https://www.cesifo.org/en/publications/2015/working-paper/monetary-policy-diverse-private-expectations>
- Kurz, M., Piccillo, G., & Wu, H. (2013). Modeling diverse expectations in an aggregated New Keynesian Model. *Journal of Economic Dynamics and Control*, 37(8), 1403–1433.

- Le Heron, E. (2011). Confidence and financial crisis in a post-Keynesian stock flow consistent model. *European Journal of Economics and Economic Policies: Intervention*, 8(2), 361–387.
- Leijonhufvud, A. (1973). Effective demand failures, *Swedish Economic Journal*, March 1973, 27-48.
- Leijonhufvud, A. (2009). Out of the corridor: Keynes and the crisis. *Cambridge Journal of Economics*, 33(4), 741–757. <https://doi.org/10.1093/cje/bep022>
- Lustenhouwer, J. (2023, March 21). *The role of stickiness, extrapolation and past consensus forecasts in macroeconomic expectations*. <https://www.joeplustenhouwer.com/publication/haglus20/>
- Massaro, D. (2013). Heterogeneous expectations in monetary DSGE models. *Journal of Economic Dynamics and Control*, 37(3), 680–692. <https://doi.org/10.1016/j.jedc.2012.11.001>
- Meijers, H., & Muysken, J. (2022). The macroeconomic implications of financialisation on the wealth distribution - a stock-flow consistent approach, *UNU-MERIT Working Paper series 2022-035*.
- Milani, F. (2017). Sentiment and the U.S. business cycle. *Journal of Economic Dynamics and Control*, 82, 289–311. <https://doi.org/10.1016/j.jedc.2017.07.005>
- Muysken, J., & Meijers, H. (2022). Globalisation and Financialisation in the Netherlands, 1995–2020. In *Macroeconomic Modelling, Economic Policy and Methodology* (pp. 71–88). Routledge.
- Picillo, G., & Poonpakdee, P. (2021). *Effects of Macro Uncertainty on Mean Expectation and Subjective Uncertainty: Evidence from Households and Professional Forecasters* (SSRN Scholarly Paper No. 3998024). <https://doi.org/10.2139/ssrn.3998024>
- Santos, C. H. D., & Zezza, G. (2008). A simplified, 'benchmark', stock-flow consistent post-Keynesian growth model. *Metroeconomica*, 59(3), 441–478.
- Wieland, V., & Wolters, M. H. (2011). The diversity of forecasts from macroeconomic models of the US economy. *Economic Theory*, 47(2), 247–292. <https://doi.org/10.1007/s00199-010-0549-7>



## Appendix The model

### A.1 The model of the full open economy

'Behavioural equations' are ignored. Instead of equations (7.1) – (7.4) we use:

$C_s = C_d = C$ ;  $I_s = I_d = I$ ;  $N_s = N_d = N$ ;  $\Delta L_s = \Delta L_d = \Delta L$  (and ignore further distinctions  $s$  and  $d$ ).

Moreover, we use the balance sheet identities:  $L = M - R = K$

We follow G&L from equation (7.5):<sup>23</sup>

#### Transactions firms

$$Y = C + I + G + X - M \quad (7.5') \quad \text{Gov. exp. } G \text{ and net exports } X - M \text{ added}$$

$$WB = Y - r_{l-1}L_{-1} - DA \quad (7.6)$$

$$\Delta L = I - DA \quad (7.8)$$

#### Transactions households

$$YD = WB + r_{m-1}M_{-1} + r_{r-1}B_{-1} + r_{l-1}R_{-1} - T \quad (7.9) \quad \text{Interest on } B \text{ \& } R, \text{ and taxes added}$$

$$\Delta M + \Delta B + \Delta R = YD - C \quad (7.10') \quad \text{Bond and reserves added}$$

#### Transactions banks

$$\Delta M = \Delta L \quad (7.11)$$

$$r_m = r_l \quad (7.12)$$

#### Transactions government

$$G = \Delta B + T - r_{l-1}B_{-1} \quad (7.13)$$

#### The wage bill

$$N = Y/pr \quad (7.14)$$

$$W = WB/N \quad (7.15)$$

#### Household behaviour

$$C = \alpha_1 YD^e + \alpha_2 (M_{-1} + B_{-1} + R_{-1}) + C^A \quad (7.16') \quad \text{Bonds and reserves added}$$

#### Firm behaviour

$$\Delta K = I - DA \quad (7.17)$$

$$DA = \delta \cdot K_{-1} \quad (7.18)$$

$$KT = \kappa \cdot Y^e \quad (7.19')$$

$$I = \gamma \cdot (KT - K_{-1}) + DA \quad (7.20)$$

New equations:

#### Government behaviour

$$T = \tau \cdot Y \quad (7.G2)$$

$$B = \beta \cdot Y \quad (7.G3)$$

$$r = r_l \quad (7.G4)$$

#### Bank behaviour

$$r_l = r^* \quad (7.21)$$

#### Foreign behaviour

$$X = X^A \quad (7.F1)$$

$$IM = \mu \cdot Y \quad (7.F2)$$

$$\Delta R = X - Im + r_{l-1}R_{-1} \quad (7.F3)$$

We find the model of Ch. 7 when  $X^A = \beta = \tau = \mu = 0$

<sup>23</sup> The equation numbers are consistent with those of G&L, modifications are indicated.

## A.2 The (implicit) role of other financial institutions

As we mentioned in section 2.1, the assumption that foreign reserves are held directly by households is a short-cut to keep the story of the model simple. Actually we assume that households lend  $F$  to other financial institutions, such as pension funds and funds holding non-traded assets, at a rate  $r$ . These financial institutions then hold foreign reserves  $R$ , also at a rate  $r$ . Since the reserves yield a return  $r_{-1}R_{-1}$  and households receive  $r_{-1}F_{-1}$ , savings of financial institutions are zero and households essentially receive  $r_{-1}R_{-1}$ . Hence the short-cut, and Tables 1A and 2A collapse to Tables 1 and 2 in the text.

Table 1A The balance sheet

	Households	Firms	Banks	Fin.Instit.	Government	Abroad	Total
Deposits	+M		-M				0
Bonds	+B				-B		0
Loans		-L	L				0
Fixed Capital		+K					+K
Fin. Ass.	+F			-F			
Reserves				+R		-R	0
Wealth	-Vh	0	0	0 (-Vf)*	-Vg	-Va	-Vh-Vg-Va (-Vf)*
Total	0	0	0	0	0	0	0

Table 2A The accumulation of savings and investment matrix

	Households	Firms	Banks	Fin.Instit.	Gov.	Abroad	Total
Consumption	-C	+C+G			-G		0
Investment		+I					+I
Net Exports		+(X-M)				-(X-M)	0
Wages	WB	-WB					0
Taxes	-T				+T		0
Cons of fixed cap.		$-\delta \cdot K_{-1}$					$-\delta \cdot K_{-1}$
Interest	$+r_{-1}B_{-1}$ $+r_{-1}M_{-1}$ $+r_{-1}F_{-1} (0)^*$	$-r_{-1}L_{-1}$	$+r_{-1}L_{-1}$ $-r_{-1}M_{-1}$	$+r_{-1}R_{-1}$ $-r_{-1}F_{-1} (0)^*$	$-r_{-1}B_{-1}$	$-r_{-1}R_{-1}$	0
Net savings	Sh	0	0	0 (Sfi)	Sg	Sa	Stot
$\Delta$ Loans		$+\Delta L$	$-\Delta L$				0
$\Delta$ Deposits	$-\Delta M$		$+\Delta M$				0
$\Delta$ Bonds	$-\Delta B$				$+\Delta B$		0
$\Delta$ Oth.Fin.Ass	$-\Delta F (0)^*$			$\Delta F (0)^*$			
$\Delta$ Reserves				$-\Delta R$		$+\Delta R$	0
$\Delta$ Capital		$-\Delta K$					$-\Delta K$
Total	0	0	0	0	0	0	0

\* In the moderate economy, the term between brackets does hold

The situation is different in the moderate economy. Here households do no longer receive interest income on their lending to financial institutions and  $F$  is not perceived as wealth in their consumption behaviour. As we explained above, this is quite similar to the German and the Dutch situation.

The consequence is that reserves can accumulate, without affecting output and capital, as we explained above. The reason is that the reserves remain within the financial institutions and increase their wealth position.<sup>24</sup>

### A.3 The model of the moderate open economy

We use the balance sheet identities:  $L = M - F = K; F = R$

#### *Transactions firms*

$$Y = C + I + G + X - M \quad (7.5')$$

$$WB = Y - r_l \cdot L_{-1} - DA \quad (7.6)$$

$$\Delta L = I - DA \quad (7.8)$$

#### *Transactions households*

$$YD = WB + r_m \cdot M_{-1} + r_b \cdot B_{-1} - T \quad (7.9)$$

$$\Delta M + \Delta B = YD - C \quad (7.10')$$

No interest from R

No accumulation of R (or F)

#### *Transactions banks*

$$\Delta M = \Delta L \quad (7.11)$$

$$r_m = r_l \quad (7.12)$$

#### *Transactions government*

$$G = \Delta B + T - r_b \cdot B_{-1} \quad (7.13)$$

#### *The wage bill*

$$N = Y/pr \quad (7.14)$$

$$W = WB/N \quad (7.15)$$

#### *Household behaviour*

$$C = \alpha_1 \cdot YD + \alpha_2 \cdot (M_{-1} + B_{-1}) + C^A \quad (7.16')$$

No impact from R (or F)

#### *Firm behaviour*

$$\Delta K = I - DA \quad (7.17)$$

$$DA = \delta \cdot K_{-1} \quad (7.18)$$

$$KT = \kappa \cdot Y_{-1} \quad (7.19')$$

$$I = \gamma \cdot (KT - K_{-1}) + DA \quad (7.20)$$

New equations:

#### *Government behaviour*

$$T = \tau \cdot Y \quad (7.G2)$$

$$B = \beta \cdot Y \quad (7.G3)$$

$$r = r_l \quad (7.G4)$$

#### *Bank behaviour*

$$r_l = r^* \quad (7.21)$$

#### *Other financial institutions*

<sup>24</sup> A similar phenomenon happened with Dutch pension funds, see Muysken and Meijers (2023).

$$S_{fi} = r_{-1} \cdot R_{-1} \quad (7.B1) \quad \text{Savings of other fin. Instit. added}$$

*Foreign behaviour*

$$X = X^A \quad (7.F1)$$

$$IM = \mu \cdot Y \quad (7.F2)$$

$$\Delta R = X - Im + r_{-1} R_{-1} \quad (7.F3)$$

## Appendix B The solution of the model for the moderate economy

The system of equations (48) – (49) has two eigenvalues and stability requires that the modulus of the eigenvalues are less than unity. Eigenvalues are determined by setting the determinant of the characteristic polynomial equal to zero:

$$\left| \text{Det} \begin{pmatrix} a - \lambda & b \\ c & d - \lambda \end{pmatrix} \right| = 0 \quad (B1)$$

Solving for  $\lambda$  gives:

$$\lambda_{1,2} = \frac{a+d}{2} \pm \sqrt{\left(\frac{a+d}{2}\right)^2 - (ad - cb)} \quad (B2)$$

If the term in the square root is positive, we can solve both eigenvalues using this equation. If the term is negative, one can find the modulus of the complex number.

In the latter case, i.e.  $\left(\frac{a+d}{2}\right)^2 - (ad - cb) < 0$ , we can write the root as a complex number as:

$$\lambda_{1,2} = x + yi = \frac{a+d}{2} \pm \left( \sqrt{ad - cb - \left(\frac{a+d}{2}\right)^2} \right) \cdot i \quad (B3)$$

which implies that the eigenvalue becomes:<sup>25</sup>

$$\lambda = \sqrt{\left(\frac{a+d}{2}\right)^2 + ad - cb - \left(\frac{a+d}{2}\right)^2} = \sqrt{ad - cb} \quad (B4)$$

As a consequence stability requires that:

$$\text{Max} \left[ \sqrt{ad - cb} ; \left| \frac{a+d}{2} \pm \sqrt{\left(\frac{a+d}{2}\right)^2 - (ad - cb)} \right| \right] < 1 \quad (B5)$$

<sup>25</sup> The modulus of a complex number  $x + yi$  is equal to:  $\sqrt{(x^2 + y^2)}$ .

## The UNU-MERIT WORKING Paper Series

- 2023-01 *Can international mobility shape students' attitudes toward inequality? The Brazilian case* by Cintia Denise Granja, Fabiana Visentin and Ana Maria Carneiro
- 2023-02 *Demand-led industrialisation policy in a dual-sector small open economy* by Önder Nomaler, Danilo Spinola and Bart Verspagen
- 2023-03 *Reshoring, nearshoring and developing countries: Readiness and implications for Latin America* by Carlo Pietrobelli and Cecilia Seri
- 2023-04 *The role of product digitization for productivity: Evidence from web-scraping European high-tech company websites* by Torben Schubert, Sajad Ashouri, Matthias Deschryvere, Angela Jäger, Fabiana Visentin, Scott Cunningham, Arash Hajikhani, Lukas Pukelis and Arho Suominen
- 2023-05 *More than a feeling: A global economic valuation of subjective wellbeing damages resulting from rising temperatures* by Stephan Dietrich and Stafford Nichols
- 2023-06 *Was Robert Gibrat right? A test based on the graphical model methodology* by Marco Guerzoni, Luigi Riso and Marco Vivarelli
- 2023-07 *Predicting social assistance beneficiaries: On the social welfare damage of data biases* by Stephan Dietrich, Daniele Malerba and Franziska Gassmann
- 2023-08 *Related or unrelated diversification: What is smart specialization?* By Önder Nomaler and Bart Verspagen
- 2023-09 *Breach of academic values and digital deviant behaviour: The case of Sci-Hub* by Giulia Rossello and Arianna Martinelli
- 2023-10 *The effect of lobbies' narratives on academics' perceptions of scientific publishing: An information provision experiment* by Giulia Rossello and Arianna Martinelli
- 2023-11 *Making impact with agricultural development projects: The use of innovative machine learning methodology to understand the development aid field* by Lindsey Moore, Mindel van de Laar, Pui Hang Wong and Cathal O'Donoghue
- 2023-12 *Green windows of opportunity in the Global South* by Rasmus Lema and Roberta Rabellotti
- 2023-13 *The green and digital transition in manufacturing global value chains in latecomer countries* by Rasmus Lema and Roberta Rabellotti
- 2023-14 *Impact of prestigious-STEM Education of corporate board members on innovation effort: Evidence from India* by Rituparna Kaushik, Sourabh Bikas Paul and Danilo Spinola
- 2023-15 *Reducing environmental impact through shared ownership: A model of consumer behaviour* by Francesco Pasimeni and Tommaso Ciarli
- 2023-16 *Welfare losses, preferences for redistribution, and political participation: Evidence from the United Kingdom's age of austerity* by Patricia Justino, Bruno Martorano and Laura Metzger
- 2023-17 *Inequality, social mobility and redistributive preferences* by Isabel Günther and Bruno Martorano
- 2023-18 *Automation-induced reshoring and potential implications for developing economies* by Hubert Nii-Aponsah, Bart Verspagen and Pierre Mohnen
- 2023-19 *Ethnic spatial dispersion and immigrant identity* by Amelie F. Constant, Simone Schüller and Klaus F. Zimmermann
- 2023-20 *Public R&D and Growth: A dynamic Panel VECM Data Analysis for 14 OECD Countries* by Thomas H.W. Zieseme by r

- 2023-21 *Innovation and the labor market: Theory, evidence and challenges* by Nicoletta Corrocher, Daniele Moschella, Jacopo Staccioli and Marco Vivarelli
- 2023-22 *Revisiting Schumpeter in Europe: Place-based innovation and transformative industrial policy* by Luc Soete and Johan Stierna
- 2023-23 *Identification of Fourth Industrial Revolution technologies using PATSTAT data* by María de las Mercedes Menéndez, Önder Nomaler and Bart Verspagen
- 2023-24 *Expectations and the stability of stock-flow consistent models* by Huub Meijers, Joan Muysken and Giulia Piccillo