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# Gains from Wage Flexibility and the Zero Lower Bound\*

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## Abstract

We analyze the welfare impact of greater wage flexibility while taking into account explicitly the existence of the zero lower bound (ZLB) constraint on the nominal interest rate. We show that the ZLB constraint generally *amplifies* the adverse effects of greater wage flexibility on welfare when the central bank follows a conventional Taylor rule. When demand shocks are the driving force, the presence of the ZLB implies that an increase in wage flexibility reduces welfare even under the optimal monetary policy with commitment.

Keywords: labor market flexibility, nominal rigidities, optimal monetary policy with commitment, Taylor rule, ZLB

JEL: E24, E32, E52

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# 1 Introduction

Most mainstream economists view wage rigidity as an undesirable feature for an economy, one that is likely to hamper macroeconomic stability and cause a higher and volatile unemployment rate. The perceived costs of wage rigidity rely on a logic based on the familiar labor market diagram found in introductory textbooks: a decrease in wages should offset, at least partly, the negative effects on employment (and output) of any adverse aggregate shock that reduces labor demand. If wages are rigid and that adjustment doesn't take place (or it is slow) the negative employment and output effects of adverse shocks are likely to be amplified and unemployment will rise, at least temporarily.<sup>1</sup>

In the *General Theory*, Keynes (1936) already called into question the previous logic, which he associated with "classical" economics, and deemed it irrelevant to understand the workings of modern economies. In his view, the wage level did not have a direct role in the determination of employment. The latter was instead determined by aggregate demand *for goods*. Accordingly, aggregate demand management, rather than wage flexibility, was the key to employment stability.

More recently, Galí (2013) revisited Keynes' argument through the lens of the New Keynesian model, in the *absence* of a zero lower bound (ZLB) constraint on the nominal interest rate. Two results are worth stressing from that analysis. First, the extent to which greater wage flexibility contributes to employment and output gap stability hinges critically on the monetary policy rule in place. More precisely, it is the strength of the central bank's systematic response to inflation that largely determines the response of aggregate demand to changes in wages. Secondly, an increase in wage flexibility tends to raise the volatility of price and wage inflation, both of which are costly since they generate an inefficient allocation of resources in the presence of staggered price and wage setting. Thus, if the central bank follows a rule that calls for a relatively weak response to inflation, the benefits of increased wage flexibility in the form of a more stable output gap and employment will generally be small, and likely more than offset by the welfare losses brought about by the more volatile price and wage inflation. On the other hand, when the Taylor rule calls for a sufficiently aggressive response to inflation, or when the central bank follows the optimal policy (with commitment) an increase in wage flexibility tends to improve welfare, at least for reasonable calibrations of the economy's parameters.

In the present paper we extend the analysis in Galí (2013) to take explicitly into account the

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<sup>1</sup>See e.g. Hall (2005) and Shimer (2005, 2012) for a discussion of the role of wage rigidities in accounting for labor market fluctuations in the context of the search and matching model. Blanchard and Galí (2007, 2010) emphasize the policy tradeoffs generated by the presence of wage rigidities in a New Keynesian model.

ZLB constraint on the nominal interest rate, and study the role of that constraint in determining the gains from greater wage flexibility. The reason for focusing on the interaction between wage flexibility and the ZLB is that the presence of the latter may limit the ability of a central bank to respond to downward pressures on wage and price inflation in the face of a shock triggering such pressures. Accordingly, any potential gains from greater wage flexibility may be hampered by that constraint. Our analysis seeks to assess the extent to which the presence of the ZLB may affect the gains (or losses) from an increase in wage flexibility, under alternative monetary policy regimes (Taylor rule vs optimal policy) and sources of fluctuations (demand vs. technology shocks).

## 1.1 Related Literature

The present paper is related to several branches of the literature. At a more general level, our paper is related to the recent literature that seeks to understand the implications of the ZLB constraint along different dimensions, including the design of optimal monetary policy (e.g. Adam and Billi (2006, 2007), Nakov (2008), Jung et al. (2005)), the role of forward guidance (e.g. Eggertsson and Woodford (2003)), the emergence of multiple steady states (e.g. Benhabib et al. (2001, 2002), Mertens and Ravn (2014), Benigno and Fornaro (2017)), and the effectiveness of fiscal policy (Eggertsson (2011), Christiano et al. (2011), among others).

On the other hand our paper is closely connected to a literature that studies the impact of (changes in) nominal rigidities on macroeconomic stability, without reference to the ZLB constraint. Thus, De Long and Summers (1986) use a model with staggered Taylor contracts to show that an increase in wage flexibility may be destabilizing due to the contractionary impact of *falling* prices, working through the expected real rate. More recently, a number of papers have addressed similar concerns using a New Keynesian model. Thus, Bhattarai et al. (2018) study the conditions under which an increase in price flexibility may have destabilizing effects on output and employment, without considering the case of a binding ZLB constraint. They show that this will be the case if demand shocks are prevailing and interest rates do not respond strongly to inflation. By contrast, when supply shocks are dominant, greater price flexibility is destabilizing only if interest rates respond strongly to inflation. Galí (2013) addresses a similar question with a focus on wage flexibility and its impact on welfare. He shows that an increase in wage flexibility may be welfare reducing if the interest rate is not too responsive to inflation. Galí and Monacelli (2016) revisit the impact of wage flexibility on macro stability and welfare in the context of an open economy, focusing on the role of

the exchange rate regime. They show that a strong concern for exchange rate stability or, in the limit, the adoption of a foreign currency or the membership in a large currency union, make it more likely that welfare is reduced in response to greater wage flexibility.<sup>2</sup>

As discussed in Erceg and Lindé (2012), the constraints on monetary policy imposed by a credible exchange rate peg are related, though not identical, to those implied by a binding ZLB.<sup>3</sup> Several papers have analyzed the interaction between price flexibility and the ZLB. Werning (2011) uses a continuous-time version of the New Keynesian model and shows, among other findings, that when monetary policy lacks commitment and the zero lower bound is binding, the magnitude of the negative output gap and of deflation resulting from an adverse demand shock are exacerbated by price flexibility. Eggertsson and Krugman (2013) argue that an increase in price and or wage rigidity may help offset the adverse effects of deflationary shocks in an environment with a binding ZLB, in which lower prices tend to reduce aggregate demand by raising real interest rates, as well as the real value of (nominal) debt, with the consequent drop in spending by debtors. They refer to that stabilizing property of price rigidities as the "paradox of flexibility."<sup>4</sup> Roulleau-Pasdeloup and Zhutova (2018) use an estimated DSGE model for the U.S. economy during the Great Depression and conclude that the Hoover "high wage" policies helped limit the damage from the adverse negative demand shock and succeeded in delaying the liquidity trap episode. Using a calibrated DSGE model, Coibion et al. (2012) show that the introduction of downward nominal wage rigidities reduces the incidence of ZLB episodes, thus implying a lower optimal inflation rate.

Building on some of the insights of the previous literature, our paper analyzes the impact of the ZLB constraint on the *welfare* effects of greater wage flexibility under alternative specifications of monetary policy, using a standard New Keynesian model for which a second-order approximation to the welfare losses of the representative household can be derived. In particular, we seek to understand how the presence of the ZLB affects the interaction between wage flexibility, welfare and the monetary policy rule in place.

Our paper proceeds as follows. Section 2 contains a description of our baseline model. Section 3 analyzes the effects of an exogenous adjustment in labor costs. Section 4 studies the effect of wage

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<sup>2</sup>Relatedly, Eggertsson et al. (2014) raise a warning on the possible contractionary effects of structural reforms (modelled as favorable supply shocks) in an economy that is part of a larger currency union, due to the increase in real interest rates resulting from the combination of deflationary pressures and an unresponsive nominal rate.

<sup>3</sup>In particular, a binding ZLB does not, *by itself*, constitute an anchor for nominal variables, in contrast with an exchange rate peg.

<sup>4</sup>Eggertsson (2010) provided an early conjecture of that result, focusing exclusively on the expected inflation channel.

flexibility on macro stability and welfare. Section 5 looks at the implications of simultaneous changes in price and wage flexibility. Section 6 concludes.

## 2 Our Baseline Model

We carry out our analysis using a version of the New Keynesian model with staggered price and wage setting à la Calvo, originally developed by Erceg et al. (2000), augmented with a ZLB constraint on the short-term nominal interest rate. In some of the scenarios considered, monetary policy is described by a (truncated) Taylor rule, while in others the central bank is assumed to follow the optimal policy under commitment. We rely on a standard calibration of the model as a baseline for our analysis. Next we introduce briefly the key equations describing the model's equilibrium. The reader can find detailed derivations of those equations as well as a complete analysis of the model in the absence of the ZLB constraint in Galí (2015).<sup>5</sup>

### 2.1 Private Sector

The behavior of the private sector is described by the equilibrium conditions introduced in this section, which correspond to a closed economy version of the New Keynesian model with staggered price and wage setting, without capital accumulation or a fiscal sector. All the equations are log-linearized around a steady state with zero price and wage inflation, and with a wage subsidy that exactly offsets the distortions resulting from price and wage markups. Derivations can be found in Galí (2015, chapter 6).

The supply side of the economy is described by the following three equations representing the dynamics of price and wage inflation,  $\pi_t^p$  and  $\pi_t^w$  :

$$\pi_t^p = \beta E_t \{ \pi_{t+1}^p \} + \varkappa_p \tilde{y}_t + \lambda_p \tilde{\omega}_t \quad (1)$$

$$\pi_t^w = \beta E_t \{ \pi_{t+1}^w \} + \varkappa_w \tilde{y}_t - \lambda_w \tilde{\omega}_t \quad (2)$$

$$\tilde{\omega}_t \equiv \tilde{\omega}_{t-1} + \pi_t^w - \pi_t^p - \Delta \omega_t^n \quad (3)$$

where  $\tilde{y}_t \equiv y_t - y_t^n$  and  $\tilde{\omega}_t \equiv \omega_t - \omega_t^n$  denote, respectively the output and wage *gaps*, with  $y_t^n$  and  $\omega_t^n$

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<sup>5</sup>For convenience we use identical notation to Galí (2015). The only difference with that model lies in the introduction of a wage subsidy. See Galí and Monacelli (2016) for details.



representing the (log) *natural* output and (log) *natural* wage (i.e. their corresponding equilibrium values in the absence of nominal rigidities). In addition, we note that  $\varkappa_p \equiv \frac{\alpha\lambda_p}{1-\alpha}$ ,  $\varkappa_w \equiv \lambda_w \left( \sigma + \frac{\varphi}{1-\alpha} \right)$ ,  $\lambda_p \equiv \frac{(1-\theta_p)(1-\beta\theta_p)}{\theta_p} \frac{1-\alpha}{1-\alpha+\alpha\epsilon_p}$ , and  $\lambda_w \equiv \frac{(1-\theta_w)(1-\beta\theta_w)}{\theta_w(1+\epsilon_w\varphi)}$ , where  $\theta_p \in [0, 1)$  and  $\theta_w \in [0, 1)$  are the Calvo indexes of price and wage rigidities, and  $\epsilon_p > 1$  and  $\epsilon_w > 1$  denote the elasticities of substitution among varieties of goods and labor services, respectively. Parameters  $\sigma$ ,  $\varphi$  and  $\beta$  denote the household's coefficient of relative risk aversion, the curvature of labor disutility and the discount factor, respectively. Parameter  $\alpha$  denotes the degree of decreasing returns to labor in production. As shown in Galí (2015), (1) and (2) can be derived from the aggregation of the price and wage setting decisions of workers and firms, in an environment in which such re-optimization takes place with probabilities  $1 - \theta_p$  and  $1 - \theta_w$ , respectively. Much of the focus of our analysis below is on the consequences of changes in the wage rigidity parameter  $\theta_w$ .

The *natural* output and wage are given by (ignoring constant terms):

$$y_t^n = \psi_{ya} a_t + \psi_{y\tau} \tau_t$$

$$\omega_t^n \equiv \psi_{\omega a} a_t + \psi_{\omega\tau} \tau_t$$

where  $a_t$  is an exogenous technology shifter which follows an exogenous  $AR(1)$  process with autoregressive coefficient  $\rho_a$ . Variable  $\tau_t$  denotes a proportional wage subsidy that subtracts from the labor cost incurred by firms (expressed in deviations from its steady state value). It can be shown that

$$\psi_{ya} \equiv \frac{1+\varphi}{\sigma(1-\alpha)+\varphi+\alpha}, \quad \psi_{y\tau} \equiv \frac{1-\alpha}{\sigma(1-\alpha)+\varphi+\alpha}, \quad \psi_{\omega a} \equiv \frac{\sigma+\varphi}{\sigma(1-\alpha)+\varphi+\alpha} \quad \text{and} \quad \psi_{\omega\tau} \equiv \frac{\sigma(1-\alpha)+\varphi}{\sigma(1-\alpha)+\varphi+\alpha}.$$

The demand side of the economy is described by a dynamic IS equation:

$$\tilde{y}_t = E_t\{\tilde{y}_{t+1}\} - \frac{1}{\sigma} (i_t - E_t\{\pi_{t+1}^p\} - r_t^n) \quad (4)$$

where  $i_t$  is the nominal interest rate, and  $r_t^n$  is the natural rate of interest. Under our assumptions the latter is given by  $r_t^n = \rho + (1 - \rho_z)z_t + \sigma E_t\{\Delta y_{t+1}^n\}$ , where  $\rho \equiv -\log \beta$  is the discount rate and  $z_t$  is a preference shifter (or demand shock) which follows an exogenous  $AR(1)$  process with autoregressive coefficient  $\rho_z$ .

## 2.2 Monetary Policy

In our analysis we consider two alternative monetary policy regimes. The first regime is described by a "truncated" Taylor rule given by:

$$i_t = \max [0, i_t^*] \tag{5}$$

where

$$i_t^* = \phi_i i_{t-1}^* + (1 - \phi_i) (\rho + \phi_p \pi_t^p + \phi_y \tilde{y}_t) \tag{6}$$

The previous rule, which incorporates explicitly the ZLB constraint, can be viewed as capturing in a parsimonious way the behavior of central banks in many advanced economies. Note that  $i_t^*$  can be interpreted as a *shadow* interest rate in that context.<sup>6</sup>

The second regime we consider corresponds to the optimal policy under commitment and subject to a ZLB constraint. That policy is a state contingent plan that maximizes the representative household's welfare, subject to an infinite sequence of private sector constraints given by (4) through (3), and the ZLB constraint,  $i_t \geq 0$ , all for  $t = 0, 1, 2, \dots$ . That optimal policy problem is described formally in Appendix 1 and gives rise to a set of difference equations which, together, with equations (4) through (3) describe the equilibrium under the optimal policy with commitment.

## 2.3 Calibration

Our baseline calibration is quite conventional and largely follows Galí (2015). We set the discount factor  $\beta$  to 0.995 to imply a (annualized) steady-state real interest rate of 2 percent. We set  $\sigma = 1$ ,  $\varphi = 5$  and  $\alpha = 0.25$ . Elasticity of substitution parameters  $\epsilon_p$  and  $\epsilon_w$  are set to 9 and 4.5, respectively. We set  $\theta_p = \theta_w = 0.75$ , consistent with an average duration of price and wage spells of one year. We adopt the interest rate rule coefficients proposed in Taylor (1993), i.e.  $\phi_p = 1.5$  and  $\phi_y = 0.125$ . The smoothing coefficient in the Taylor rule is set to 0.8, close to the estimates in Clarida et al. (2000) and others. The autoregressive coefficient of the driving variables is set to 0.8 to generate sufficient persistence, while the standard deviation of their respective innovation chosen in order to have a ZLB incidence of 5 percent under the Taylor rule, and conditional on each of the shocks (demand

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<sup>6</sup>Our specification of the rule for the shadow rate, which makes the latter a function of its own lag (as opposed to the lag of the actual policy rate) implies a kind of "forward guidance" that may compensate partly for the lost monetary stimulus due to the presence of a ZLB constraint.

or technology) being the only source of fluctuations in the economy. Our baseline calibration is summarized in Table 1.

Next we turn to the analysis of some of the model's predictions regarding the interaction of wage flexibility and the ZLB.<sup>7</sup> We start by studying the impact of the latter on the effectiveness of labor cost reductions.

### 3 The Effects of Labor Cost Reductions in the Presence of the ZLB

The eventual stabilizing role of wage flexibility hinges critically on the influence that adjustments in wages (or other components of labor) may have on output and employment. As argued in Galí (2013), in an economy described by the New Keynesian model, the amount of labor hired is determined, in the short run and for a given technology, not by the prevailing wage but by the quantity of output that firms want to produce which, in turn, is determined by aggregate demand. Thus, the effect of a change in labor costs on employment is transmitted through the impact of the former on marginal costs, inflation and –through the monetary policy rule– on nominal and real interest rates, which finally affect consumption. If the ZLB is binding and, as a result, the change in inflation does not elicit a change in the nominal rate, the previous causal chain in the transmission of labor cost adjustments to employment breaks down. Furthermore, in the face of a constant nominal rate, any reduction in expected inflation caused by a downward adjustment in labor costs will lead to a rise in the real interest rate, and may thus end up having a "perverse" effect on output and employment.

In order to illustrate the role played by the ZLB in determining the effects of labor cost adjustments, we use the model above to analyze the impact of a large, unanticipated, negative demand shock and its interaction with a wage subsidy increase, where the latter is presumably enacted in order to counteract the adverse effects of the shock on output and employment. The shock is assumed to last for 20 quarters and its size is normalized so that the drop of output on impact is 4 percent in the presence of a ZLB constraint and under a constant wage subsidy.

Figure 1 displays the responses of output, inflation, and the nominal and real interest rates to the demand shock just described *and* a simultaneous wage subsidy increase, *in the absence of a ZLB constraint*. We assume that the increase in the wage subsidy lasts for as long as the shock (i.e. 20 quarters) and has an alternative size of 0, 1 or 3 percent, corresponding respectively to the lines

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<sup>7</sup>The model outcomes are obtained with Dynare using an extended-path method. Replication files are available from the authors upon request.

with (black) squares, (blue) circles and (red) diamonds. As Figure 1 makes clear, in the no ZLB environment, the effects of the wage subsidy accord to conventional wisdom: the larger the subsidy increase, the more it stabilizes output in the face of the adverse demand shock. The reason is that a larger subsidy triggers a larger decrease in inflation and hence a stronger monetary policy response in the form of lower nominal and real interest rates, as captured in the bottom panels.

As shown in Figure 2, however, things are considerably different in the presence of the ZLB constraint. Note that the size of the shock is large enough to make the ZLB binding for many periods, independently of the response of the wage subsidy. The latter, however, has a significant impact on the response of output and inflation. Thus, we see that the larger is the increase in the wage subsidy, the weaker is its stabilizing effect (i.e. the deeper is the short run decline in output in response to the adverse demand shock). The fourth panel of Figure 2 displays the response of the real interest rate under the three scenarios considered, and points to the mechanism responsible for the "counterproductive" impact of a larger wage subsidy: the deflationary effects of the latter combined with the binding ZLB lead to a higher real rate, thus amplifying the initial negative effects of the shock on aggregate demand and output.

The previous exercise provides an illustration of the potentially perverse effects that labor cost adjustments may have in combination with a binding ZLB. Needless to say, actual economies are not always against a binding ZLB constraint. But to the extent that ZLB episodes are recurrent, the associated recessions may be deeper and more persistent if they bring about large downward wage adjustments. In that case the presence of the ZLB may reduce or even reverse the sign of the welfare gains that the conventional wisdom associates with greater wage flexibility. The analysis below seeks to evaluate the plausibility of that hypothesis.

## 4 Gains from Wage Flexibility and the Zero Lower Bound

A key objective of our analysis is the evaluation of the impact of changes in the degree of wage rigidity on welfare in the presence of a ZLB constraint. For that purpose, we use as a welfare metric the second order approximation to the average welfare losses experienced by the representative household as a result of fluctuations around an efficient, zero inflation steady state, expressed as a fraction of steady state consumption. Such welfare losses can be written as:<sup>8</sup>

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<sup>8</sup>See Galí (2015) for a derivation.

$$\mathbb{L} = \frac{1}{2} \left[ \left( \sigma + \frac{\varphi + \alpha}{1 - \alpha} \right) \text{var}(\tilde{y}_t) + \frac{\epsilon_p}{\lambda_p} \text{var}(\pi_t^p) + \frac{\epsilon_w(1 - \alpha)}{\lambda_w} \text{var}(\pi_t^w) \right]$$

Note that the welfare loss has three distinct components, respectively associated with the volatilities in the output gap, price inflation, and wage inflation. Parameter  $\theta_w$  enters the welfare loss function through  $\lambda_w$ , to which it is inversely related. Thus, an increase in wage flexibility (i.e. a smaller  $\theta_w$ ) reduces welfare losses, for any *given* volatility of wage inflation. The reason is that, given  $\text{var}(\pi_t^w)$ , more flexible wages are associated with less wage dispersion, and a smaller inefficiency resulting from misallocation of labor. In equilibrium, however, the volatility of wage inflation, price inflation and the output gap is not invariant to a change in  $\theta_w$ . In particular, we expect that greater wage flexibility will be associated with higher volatility of wage inflation and, *ceteris paribus*, of price inflation as well. On the other hand, more flexible wages should make employment (and, thus, output) deviate less from their natural counterparts, thus reducing  $\text{var}(\tilde{y}_t)$ . As a result, the net effect on welfare from a reduction in  $\theta_w$  is generally ambiguous *ex ante*. As emphasized in Galí (2013) (and Galí and Monacelli (2016) in the context of a small open economy), which factor ends up dominating depends to a large extent on the monetary policy regime in place. The latter is, in turn, affected by the presence of a ZLB constraint. Next we describe such effects through a number of simulations.

Figure 3 displays artificial time series for the output gap, price inflation, wage inflation and the nominal rate, generated by the equilibrium of our calibrated model, with the ZLB constraint, and with demand shocks as a source of fluctuations. The two lines correspond to alternative assumptions on the degree of wage rigidity: our baseline assumption ( $\theta_w = 0.75$ ; in blue) and an alternative with more flexible wages ( $\theta_w = 0.25$ ; in red). The simulations reported in the Figure allow us to illustrate visually some of the findings discussed below. As is clear from the top panel, an increase in wage flexibility has only a small effect on output gap volatility: the two lines almost lie on top of each other. This contrasts with the behavior of price and wage inflation, whose volatility is much larger when wages are more flexible. A closer look at the Figure suggests that it is precisely during episodes when the ZLB is binding that the gap in the volatility between the two series is particularly large.

Figure 4 shows the welfare losses as a function of the index of nominal wage rigidities,  $\theta_w$ , with the latter's baseline value (0.75) indicated by a vertical line. Each of the four panels corresponds to a particular combination of monetary policy regime (Taylor rule vs optimal policy) and source

of fluctuations (demand vs technology shocks), and displays the welfare losses with and without a ZLB constraint as lines with red diamonds and blue circles, respectively. Not surprisingly, welfare losses appear to be generally larger with the ZLB constraint. But this is not the focus of our inquiry, which pertains instead to the effect of *changes* in  $\theta_w$  on welfare, i.e. on the *slope* of the welfare loss function, rather than on its relative position.

Our results for the case of no ZLB, represented by the lines with blue circles in Figure 4, replicate the main qualitative findings in Galí (2013). First, and under the calibrated Taylor rule, an increase in wage flexibility (i.e. a decrease in  $\theta_w$ ) leads to higher welfare losses for a large range of initial  $\theta_w$  values (one that includes the baseline setting of 0.75). This is true for both technology and demand shocks. Under the optimal policy, on the other hand, welfare losses are either zero independently of wage rigidity (in the case of demand shocks, which are fully offset by the central bank), or they are decreasing as wages become more flexible (in the case of technology shocks).<sup>9</sup> The previous simulations thus make clear that the existence of welfare gains from greater wage flexibility is not generally true. On the contrary, the sign and extent of the resulting welfare effects depend critically on the monetary policy in place (and the nature of the shock in the case of the optimal policy).

The introduction of a ZLB constraint alters those findings in two ways, as a comparison of the two lines in each panel makes clear. Firstly, under the Taylor rule, the presence of the ZLB *amplifies* the adverse effects of greater wage flexibility on welfare, both for demand and technology shocks, as reflected in a steeper welfare loss function for a broad range of  $\theta_w$  values (including the baseline one). Secondly, under the optimal policy and demand shocks, an increase in wage flexibility raises welfare losses when the ZLB is in place, for a very large range of initial  $\theta_w$  values. Under technology shocks, on the other hand, the introduction of the ZLB raises welfare losses, without affecting significantly the sensitivity of welfare to wage rigidity (though the gains from greater wage flexibility appear to be slightly smaller in the ZLB case).

Next we show that the finding that the presence of a ZLB amplifies the adverse welfare effects of greater wage flexibility is robust to alternative calibrations of the Taylor rule parameters ( $\phi_p$ ,  $\phi_y$ ,  $\phi_i$ ,  $\rho$ ). Figure 5 shows the *ratio* of welfare losses with and without the ZLB constraint, as a function of  $\theta_w$ , and for alternative values of the coefficients in the rule. For concreteness, the figure assumes demand shocks as a source of fluctuations. Several results are worth pointing out. First, we see that

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<sup>9</sup> As discussed in Galí (2013), the finding that welfare losses are an inverse monotonic function of wage rigidity under the optimal policy is not completely general and may be overturned for some extreme calibrations (e.g. extreme price stickiness).

the loss ratio is larger than one in all cases, i.e. the introduction of the ZLB constraint always reduces welfare for any given calibration. Secondly, we see that in response to greater wage flexibility (i.e. a reduction in  $\theta_w$ ), welfare losses increase in a greater proportion when the ZLB constraint is present, as reflected by the negative slope of the loss ratio curves. That impact of the ZLB on the welfare effect of enhanced wage flexibility holds for all the rule coefficients considered, but is particularly strong for large values of  $\phi_p$  and  $\phi_y$ , small values of  $\phi_i$  and  $\rho$ , since in all of those cases the incidence of a binding ZLB is higher. Similar findings to those in Figure 5 obtain when technology shocks are the source of fluctuations (not shown).

We show next how the presence of the ZLB constraint affects the three components of the welfare loss function, associated respectively with the volatility of the output gap, price inflation, and wage inflation. Figures 6 to 9 display welfare losses and its components as a function of  $\theta_w$ , with and without the ZLB. Each figure corresponds to a different monetary policy regime and/or source of fluctuations.<sup>10</sup>

Figure 6 shows the welfare loss and its components under a Taylor rule with demand shocks as the source of fluctuations. Absent a ZLB, an increase in wage flexibility from its baseline value stabilizes the output gap (which reduces welfare losses), but on the other hand increases the volatility in price and wage inflation (which increases welfare losses). The latter effect appears to dominate, except when the initial degree of wage rigidities is very low. Note in particular that the (local) increase in the losses from higher volatility of wage inflation occurs despite the fact that the cost of any given level of such volatility is smaller when wages are more flexible. The presence of the ZLB constraint raises the volatility in the output gap, price inflation, and wage inflation for any given level of  $\theta_w$ , and thus the corresponding welfare losses. More interestingly, we see that the three components play a role in the amplification of the adverse welfare effects of greater wage flexibility that results from the presence of the ZLB constraint. The previous results are qualitatively similar if instead technology shocks are the source of fluctuations, as Figure 7 shows, though with lower magnitudes of amplification.

Figure 8 shows the welfare loss function and its components under the optimal policy with commitment, with and without the ZLB, when demand shocks are the only source of fluctuations. As

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<sup>10</sup>In these figures, there is a non-monotonic effect of wage flexibility on the component of welfare connected to wage inflation (bottom-right panel). The reason for this non-monotonicity is that, as explained earlier, if wages become more flexible, the volatility in wage inflation increases; however, the weight attached to such volatility in the social welfare function decreases. Thus, if wages are very flexible, a further increase in wage flexibility leads to a reduction in the component of welfare connected to wage inflation.

discussed above, absent a ZLB, the optimal policy fully stabilizes the output gap, price inflation and wage inflation, so no losses emerge from any of those components, as captured by the flat lines at zero. The presence of the ZLB makes it impossible for monetary policy to fully offset large adverse demand shocks. As a result, the output gap and price and wage inflation deviate from their first-best values and welfare losses arise. An increase in wage flexibility, starting from the baseline value, partly offsets the larger costs resulting from the ZLB by reducing the volatility of the output gap (see top-right panel). But that beneficial impact of greater wage flexibility is more than offset by the increase in the costs resulting from greater volatility in price and wage inflation, as shown in the two bottom panels, accounting for the net increase in welfare losses.

In the case of an optimal policy under technology shocks our findings are somewhat different, as shown in Figure 9. In this case, and as discussed above, an increase in wage flexibility reduces welfare losses both with and without the ZLB constraint. The main difference with respect to demand shocks is that with technology shocks and increase in wage flexibility reduces the volatility of *price* inflation. In response to a positive technology shock, prices tend to go down, due to a fall in marginal costs, and wages tend to increase. Greater wage flexibility allows for larger wage raises and hence a smaller decline in marginal costs and prices, thus accounting for the smaller price inflation volatility associated with lower  $\theta_w$  values. This effect contributes to the positive relation between wage rigidity and welfare losses. Note also that in the case of total welfare losses, the slope of the two curves is similar with and without the ZLB constraint, suggesting that in this case, and in contrast with the cases considered previously, the presence of the ZLB constrain doesn't alter significantly the welfare impact of a *change* in wage flexibility.

## 5 Price Rigidities, Wage Rigidities, Welfare and the Zero Lower Bound

Next we study the welfare effect of *simultaneous* changes in price and wage flexibility on welfare, and how those effects depend on the monetary policy regime and the presence or not of a ZLB constraint.

Figure 10 shows the welfare loss from fluctuations in the economy, as a function of  $\theta_w$  (line with blue circles) and as a function of  $\theta$  (line with red diamonds). We use  $\theta$  to denote a common value for  $\theta_w$  and  $\theta_p$ . The other parameters are kept at their baseline value.<sup>11</sup> The figure shows outcomes

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<sup>11</sup>As  $\theta_w$  and  $\theta_p$  share the same value in our baseline calibration, the vertical line in the figure indicates the baseline



*without* a ZLB constraint in the model. The top panels show the outcome under a Taylor rule, conditional on demand shocks or technology shocks being the source of fluctuations. As discussed above, in both cases, an increase in wage flexibility leads to a deterioration in welfare for a large range of initial  $\theta_w$  values. On the other hand, and starting from the baseline setting of 0.75 for  $\theta$ , a similar deterioration of welfare obtains *locally* in response to a simultaneous increase in price and wage flexibility (i.e. a decrease in  $\theta$ ). However, as the same plot reveals, the relation between welfare losses and nominal rigidities changes sign at relatively large values of  $\theta$ , implying that a nontrivial *joint* increase in price and wage flexibility from their baseline value would generate a welfare improvement. The bottom-right panel shows the corresponding outcome under the optimal policy when technology shocks are the source of fluctuations.<sup>12</sup> In this case, and as discussed above, an increase in wage flexibility (while keeping  $\theta_p$  constant) is welfare improving. Interestingly, as shown in Figure 10, that improvement vanishes (and becomes a welfare deterioration) when both prices and wages become more flexible (locally) starting from the baseline value for  $\theta$ . The reason for this is that both price and wage inflation become more volatile in that case (with and without the ZLB), offsetting the smaller losses due to a more stable output gap.

Next we show how the presence of a ZLB constraint affects the relation between welfare and nominal rigidities (i.e. price and wage rigidities, jointly). Figure 11 shows the welfare loss as a function of  $\theta$ , with and without a ZLB constraint in the model. As shown in the top two panels, under a Taylor rule and conditional on either demand or technology shocks, the introduction of the ZLB constraint amplifies the increase in welfare losses from a (local) reduction in nominal rigidities. The ZLB constraint is also seen to increase the range of  $\theta$  values for which welfare is reduced in response to a decrease in nominal rigidities, relative to the case without a ZLB constraint. The bottom-left panel shows the outcome under the optimal policy conditional on demand shocks. In contrast with the case of a change in wage flexibility *only*, discussed above in the context of Figure 4, now a welfare gain can be attained with a relatively small increase in *both* price and wage flexibility, starting from their baseline value. This is not the case when we condition on technology shocks (bottom-right panel): in that case, under the optimal policy, a small parallel increase in both wage and price flexibility from the baseline leads to a welfare deterioration, with and without a ZLB constraint.

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value of both these parameters.

<sup>12</sup>Welfare losses are zero with demand shocks as a source of fluctuations and in the absence of the ZLB, as reflected in the bottom-left panel of Figure 10.

Note finally that in the limit, if both prices and wages are fully flexible, the first-best is attained with the resulting welfare losses being zero in all the scenarios considered. Accordingly, a *sufficiently large joint increase* in price and wage flexibility generates a welfare gain, independently of the monetary regime in place and the presence or not of the ZLB constraint (since both become irrelevant for real allocations and welfare in the absence of nominal rigidities).

## 6 Concluding Remarks

We have revisited the analysis in Galí (2013) on the welfare consequences of greater wage flexibility by explicitly taking into account the existence of a ZLB constraint on the nominal interest rate. In a first exercise, we have shown how a downward adjustment in labor costs (implemented through a wage subsidy) in a recessionary environment with a binding ZLB may (unintentionally) deepen the downturn, due to the implied procyclical response of the real interest rate.

We then have studied the impact of an occasionally binding ZLB constraint on the relationship between wage flexibility and the welfare costs of recurrent fluctuations. Several findings have emerged from our analysis. Firstly, and perhaps not surprisingly, the presence of the ZLB increases welfare losses for any calibration of nominal rigidities and/or policy regime. Secondly, the main finding in Galí (2013), namely, that under a (realistic) Taylor rule an increase in wage flexibility is welfare reducing, is robust to the presence of the ZLB constraint. Furthermore, we show that the ZLB constraint generally *amplifies* the adverse effects of greater wage flexibility on welfare. Thirdly, when demand shocks are the driving force, an increase in wage flexibility is associated with larger welfare losses even when the central bank follows an optimal monetary policy. This is not true however for technology shocks. Finally, we have shown that under a Taylor rule and conditional on either demand or technology shocks, the introduction of the ZLB constraint (i) amplifies the increase in welfare losses from a (local) simultaneous reduction in both price and wage rigidities and (ii) increases the range of those rigidities for which welfare losses are decreasing in the degree of nominal rigidities, relative to the case without a ZLB constraint.

To summarize: through the lens of the New Keynesian model the case for greater wage flexibility appears to be weaker than commonly held, and it is only weakened further by the introduction of an explicit ZLB constraint on the nominal interest rate.

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## APPENDIX: Optimal Policy under Commitment with a ZLB Constraint

The problem of optimal policy with commitment is given by

$$\min \frac{1}{2} E_0 \sum_{t=0}^{\infty} \beta^t \left[ \left( \sigma + \frac{\varphi + \alpha}{1 - \alpha} \right) \tilde{y}_t^2 + \frac{\epsilon_p}{\lambda_p} (\pi_t^p)^2 + \frac{\epsilon_w(1 - \alpha)}{\lambda_w} (\pi_t^w)^2 \right]$$

subject to (1)-(4) and  $i_t \geq 0$ .

Write the period Lagrangian

$$\begin{aligned} L_t = & \frac{1}{2} \left[ \left( \sigma + \frac{\varphi + \alpha}{1 - \alpha} \right) \tilde{y}_t^2 + \frac{\epsilon_p}{\lambda_p} (\pi_t^p)^2 + \frac{\epsilon_w(1 - \alpha)}{\lambda_w} (\pi_t^w)^2 \right] + \beta E_t V_{t+1} \\ & + m_{1t} \left[ y_t + \frac{1}{\sigma} (i_t - \rho - (1 - \rho_z) z_t) \right] - \frac{1}{\beta} m_{1t-1} \left( y_t + \frac{1}{\sigma} \pi_t^p \right) \\ & + m_{2t} (\pi_t^p - \varkappa_p \tilde{y}_t - \lambda_p \tilde{\omega}_t) - m_{2t-1} \pi_t^p \\ & + m_{3t} (\pi_t^w - \varkappa_w \tilde{y}_t + \lambda_w \tilde{\omega}_t) - m_{3t-1} \pi_t^w \\ & + m_{4t} (\omega_t - \omega_{t-1} - \pi_t^w + \pi_t^p). \end{aligned}$$

The Kuhn-Tucker conditions are

$$0 = \frac{\partial L_t}{\partial y_t} = \left( \sigma + \frac{\varphi + \alpha}{1 - \alpha} \right) \tilde{y}_t + m_{1t} - \frac{1}{\beta} m_{1t-1} - \varkappa_p m_{2t} - \varkappa_w m_{3t} \quad (7)$$

$$0 = \frac{\partial L_t}{\partial \pi_t^p} = \frac{\epsilon_p}{\lambda_p} \pi_t^p - \frac{1}{\beta \sigma} m_{1t-1} + m_{2t} - m_{2t-1} + m_{4t} \quad (8)$$

$$0 = \frac{\partial L_t}{\partial \pi_t^w} = \frac{\epsilon_w(1 - \alpha)}{\lambda_w} \pi_t^w + m_{3t} - m_{3t-1} - m_{4t} \quad (9)$$

$$0 = \frac{\partial L_t}{\partial \omega_t} = \frac{\partial \beta E_t V_{t+1}}{\partial \omega_t} - \lambda_p m_{2t} + \lambda_w m_{3t} + m_{4t} \quad (10)$$

$$0 = \frac{\partial L_t}{\partial i_t} i_t = \frac{1}{\sigma} m_{1t} i_t, \quad m_{1t} \geq 0 \text{ and } i_t \geq 0, \quad (11)$$

whereas the envelope condition gives

$$\frac{\partial \beta E_t V_{t+1}}{\partial \omega_t} = -\beta E_t m_{4t+1}.$$

The equilibrium conditions under the optimal policy are then given by (1)-(4) and (7)-(11).

Table 1: Baseline calibration

Parameter	Description	Value
$\beta$	Discount factor	0.995
$\sigma$	Curvature of consumption utility	1
$\varphi$	Curvature of labor disutility	5
$\alpha$	Index of decreasing returns to labor	0.25
$\epsilon_p$	Elasticity of substitution of goods	9
$\epsilon_w$	Elasticity of substitution of labor	4.5
$\theta_p$	Calvo index of price rigidities	0.75
$\theta_w$	Calvo index of wage rigidities	0.75
$\phi_i$	Smoothing coefficient in the Taylor rule	0.8
$\phi_p$	Rule coefficient on price inflation	1.5
$\phi_y$	Rule coefficient on output gap	0.125
$\rho_{a,z}$	Persistence of shocks	0.8
$\sigma_a$	Std. deviation of technology shock	0.033
$\sigma_z$	Std. deviation of demand shock	0.044

Note: Values are shown in quarterly rates.

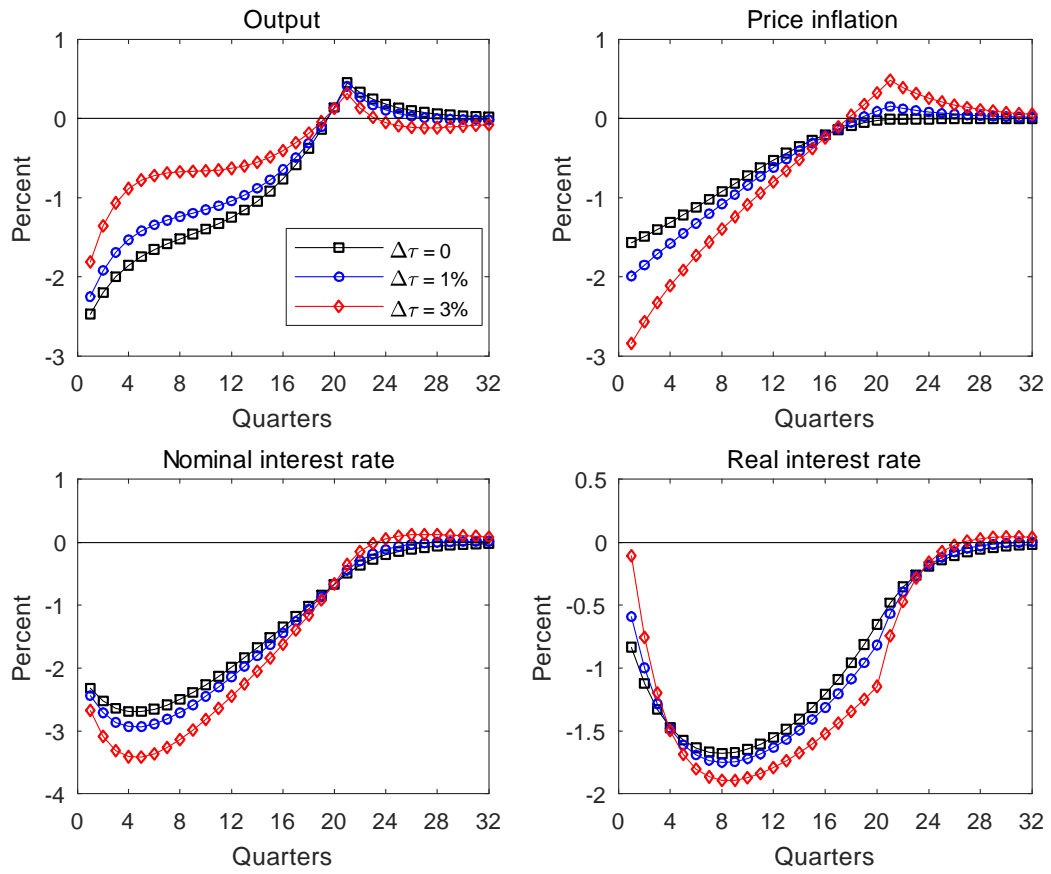


Figure 1: Dynamic responses to a wage subsidy if ZLB absent.



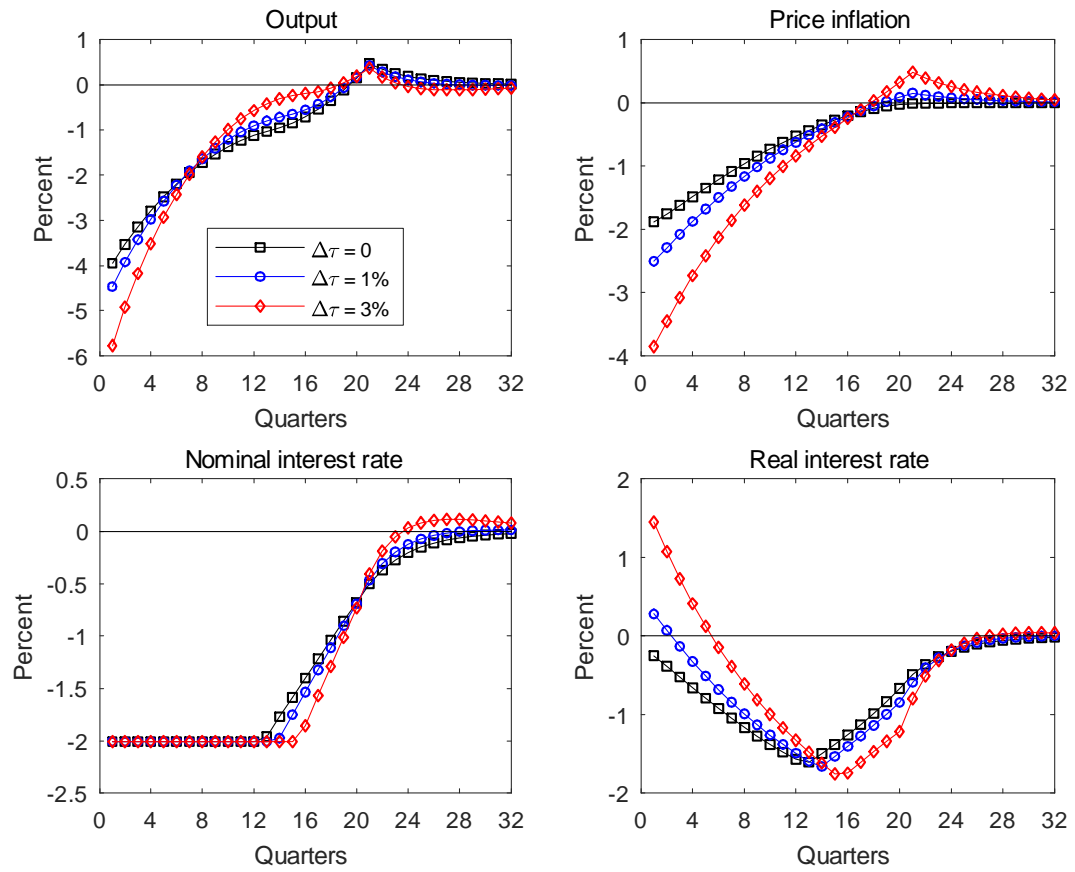


Figure 2: Dynamic responses to a wage subsidy during a ZLB episode.

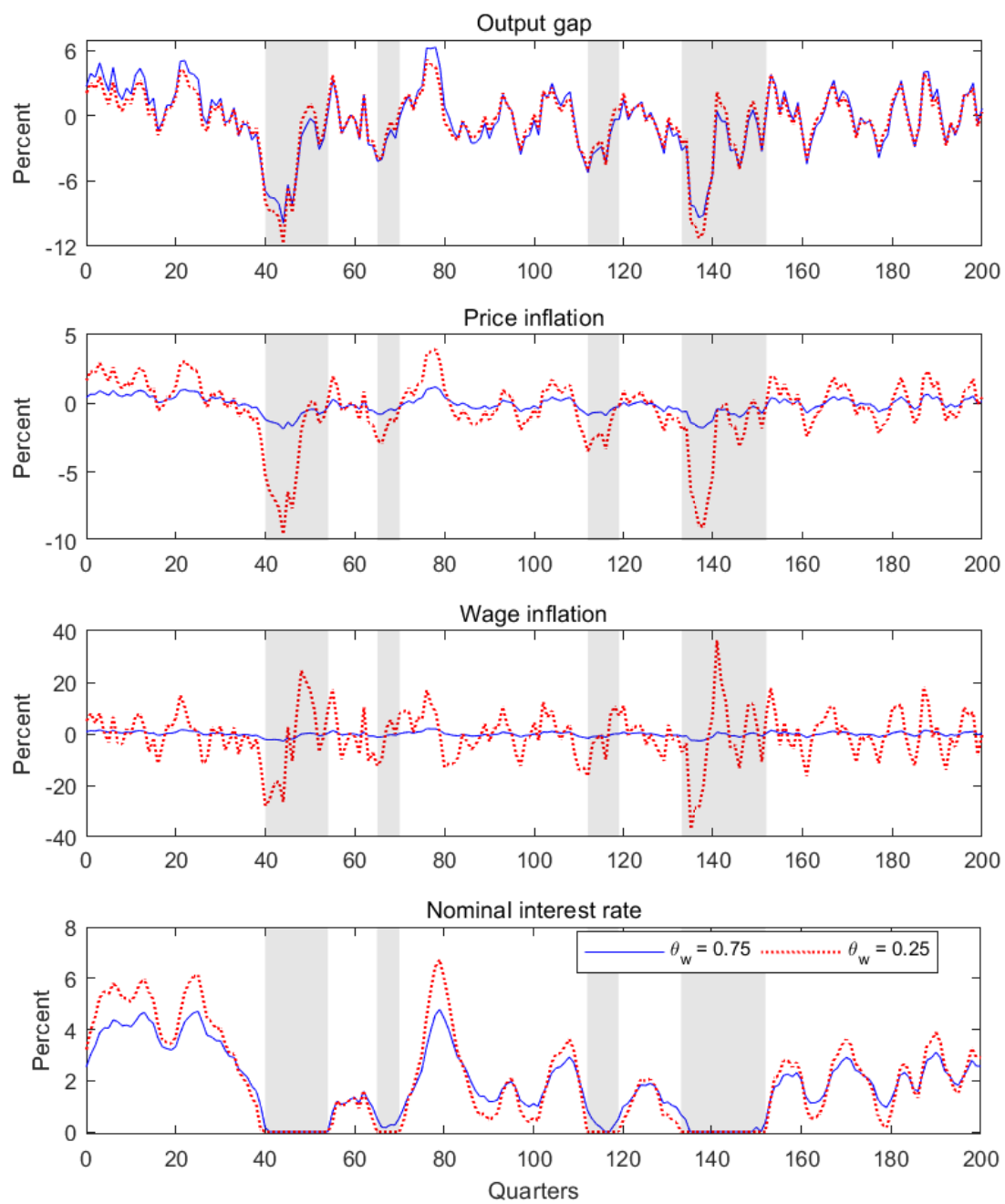


Figure 3: Paths conditional on demand shocks: effect of wage rigidities.

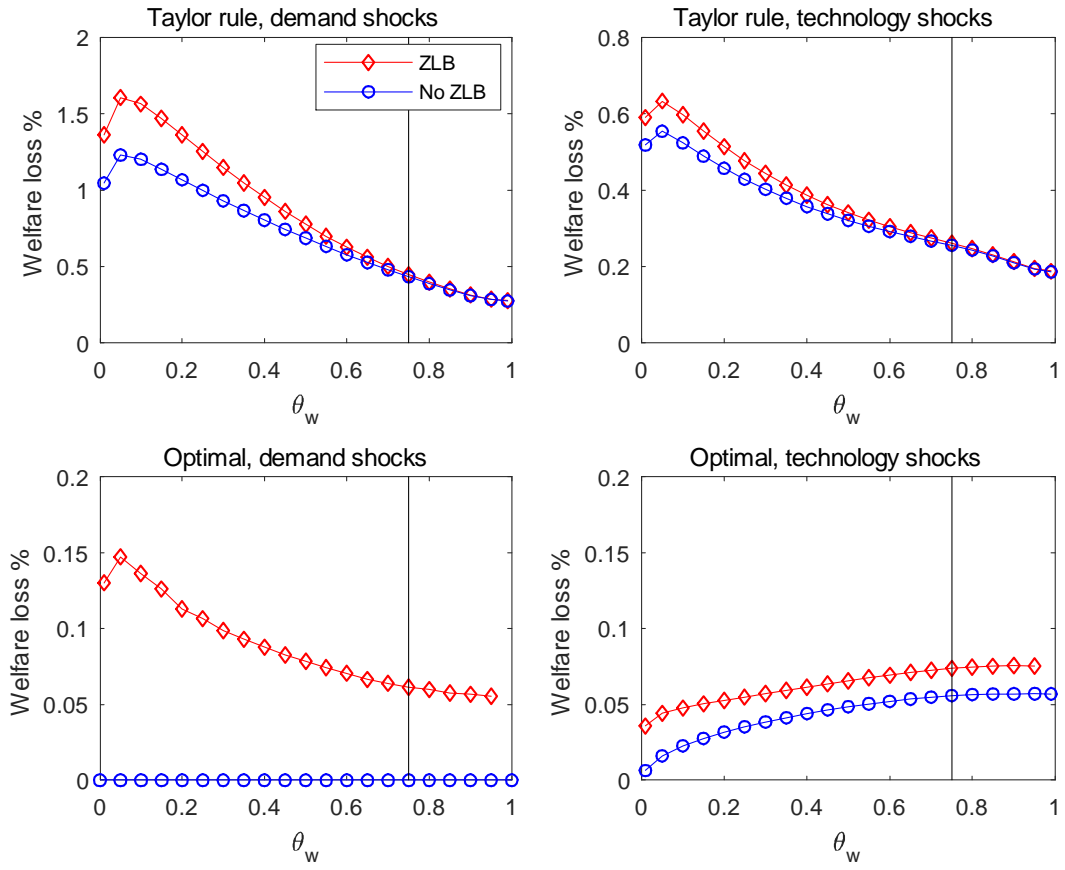


Figure 4: Wage rigidities and welfare: effect of ZLB.

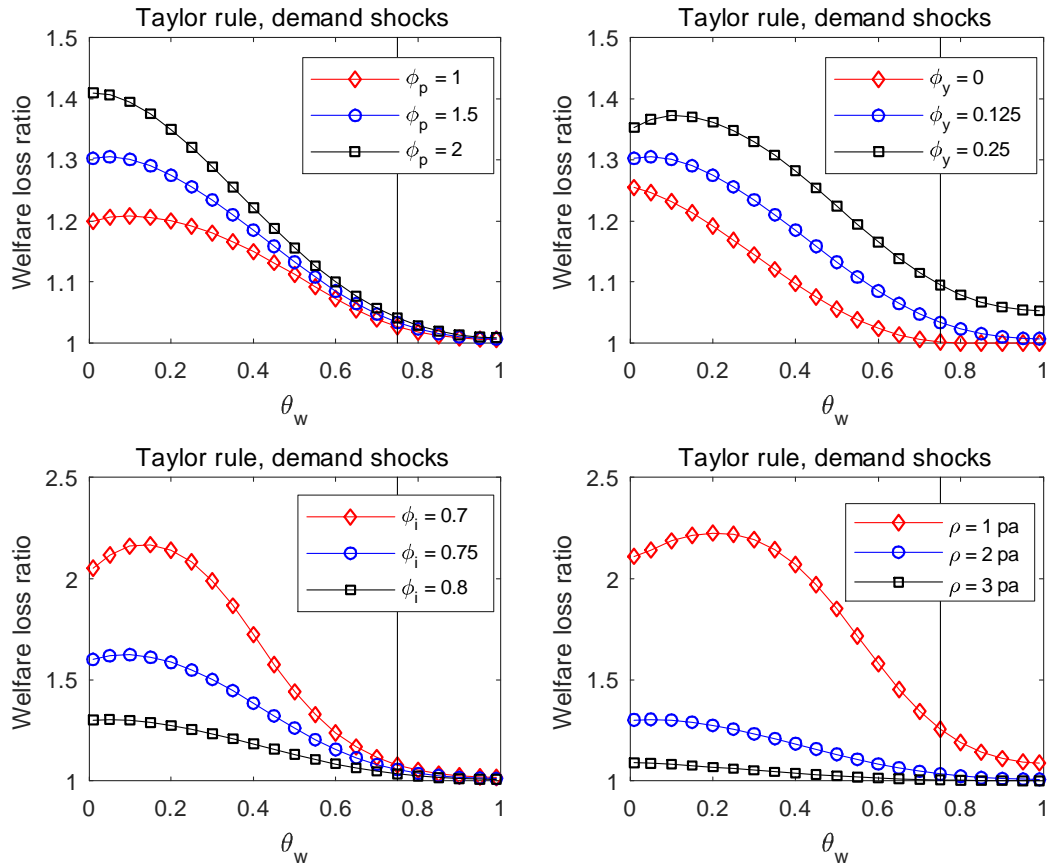


Figure 5: Wage rigidities and welfare loss from ZLB: role of policy responsiveness.

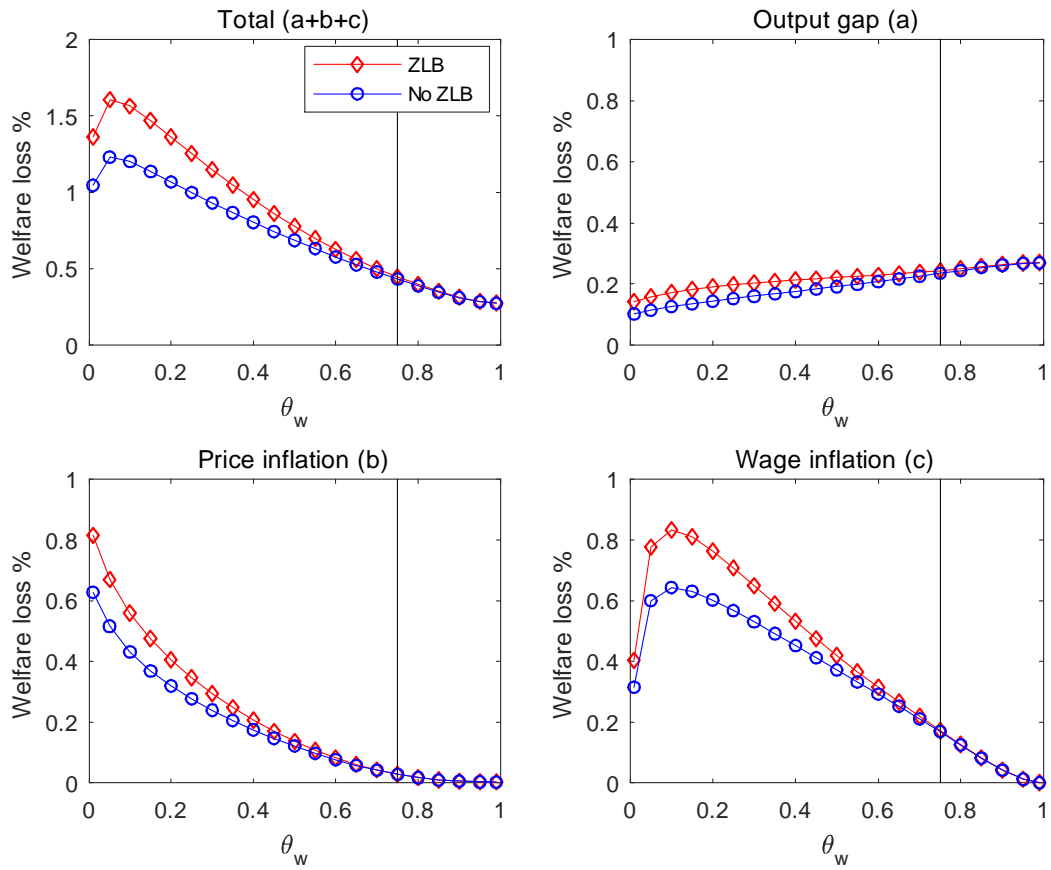


Figure 6: Wage rigidities and welfare components: Taylor rule and demand shocks.

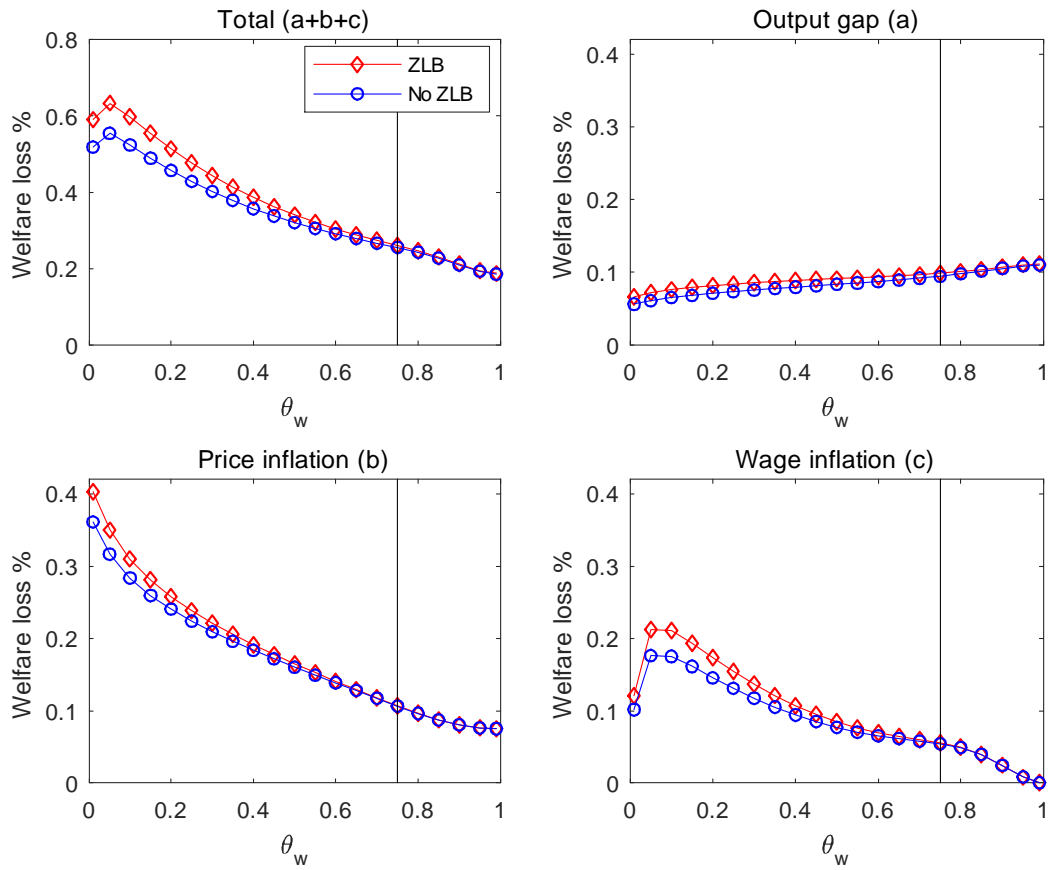


Figure 7: Wage rigidities and welfare components: Taylor rule and technology shocks.

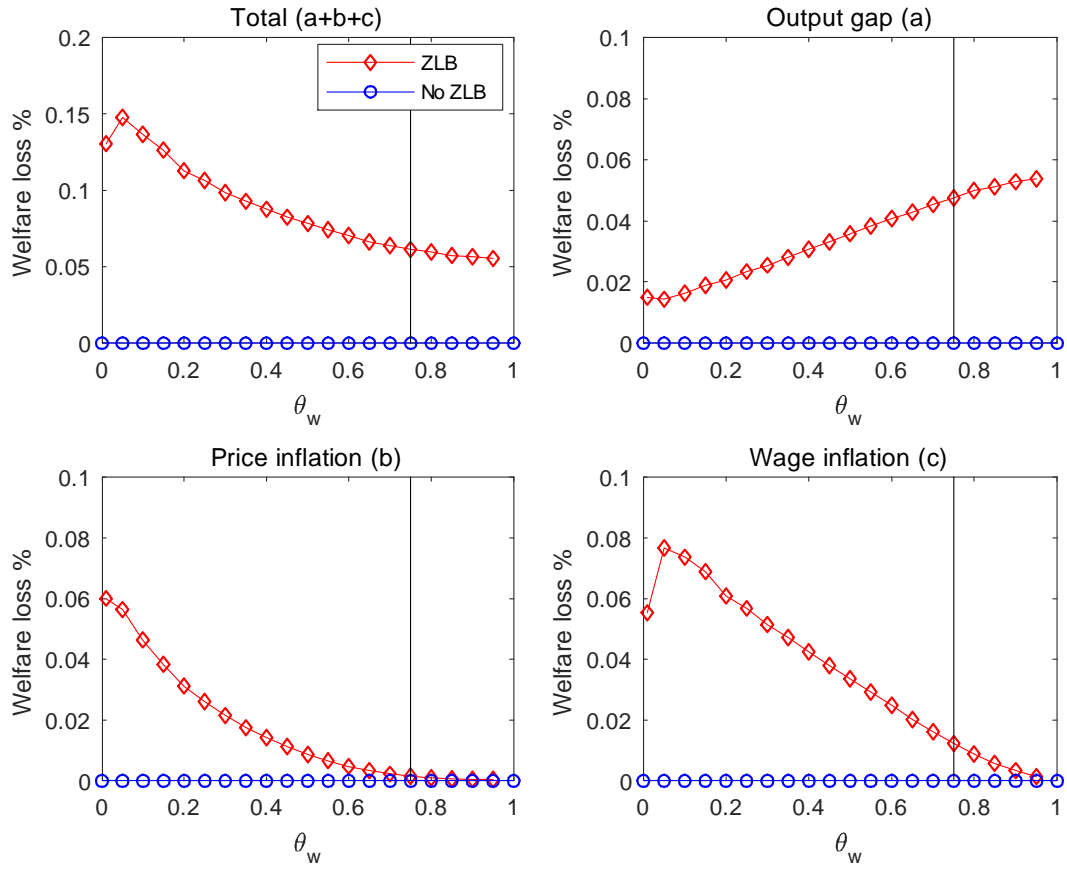


Figure 8: Wage rigidities and welfare components: optimal policy and demand shocks.

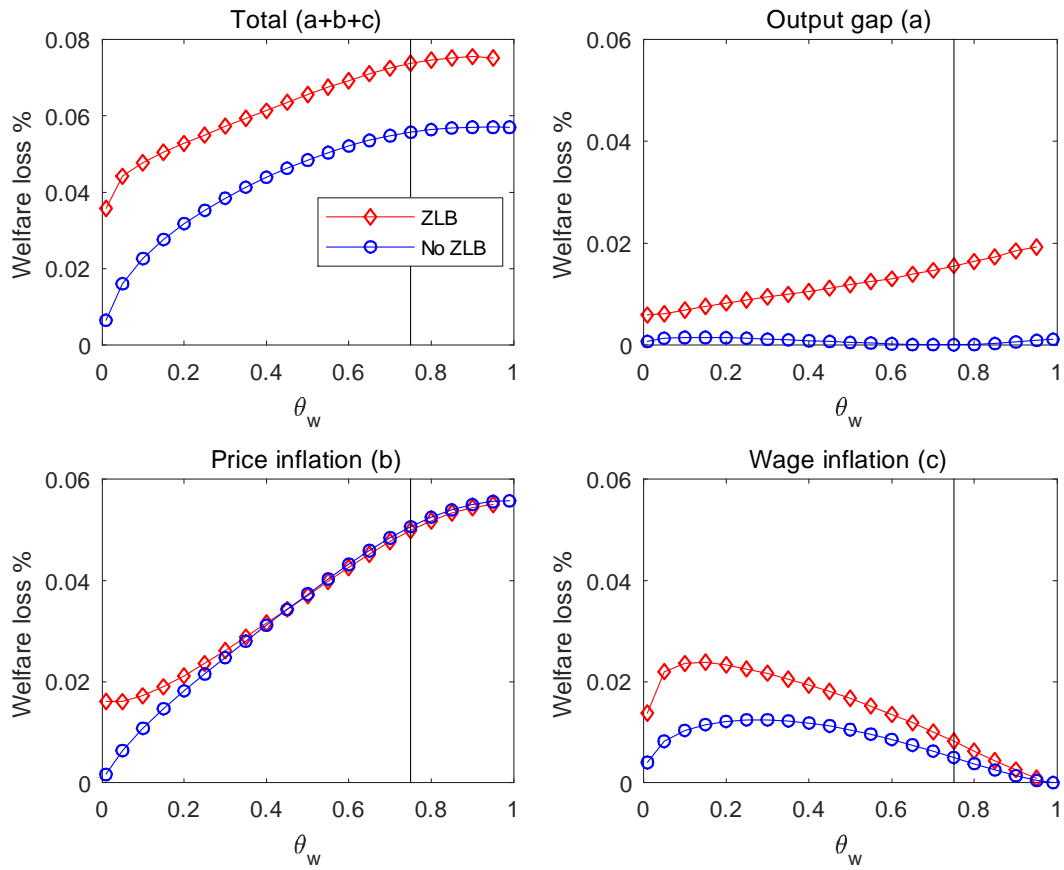


Figure 9: Wage rigidities and welfare components: optimal policy and technology shocks.



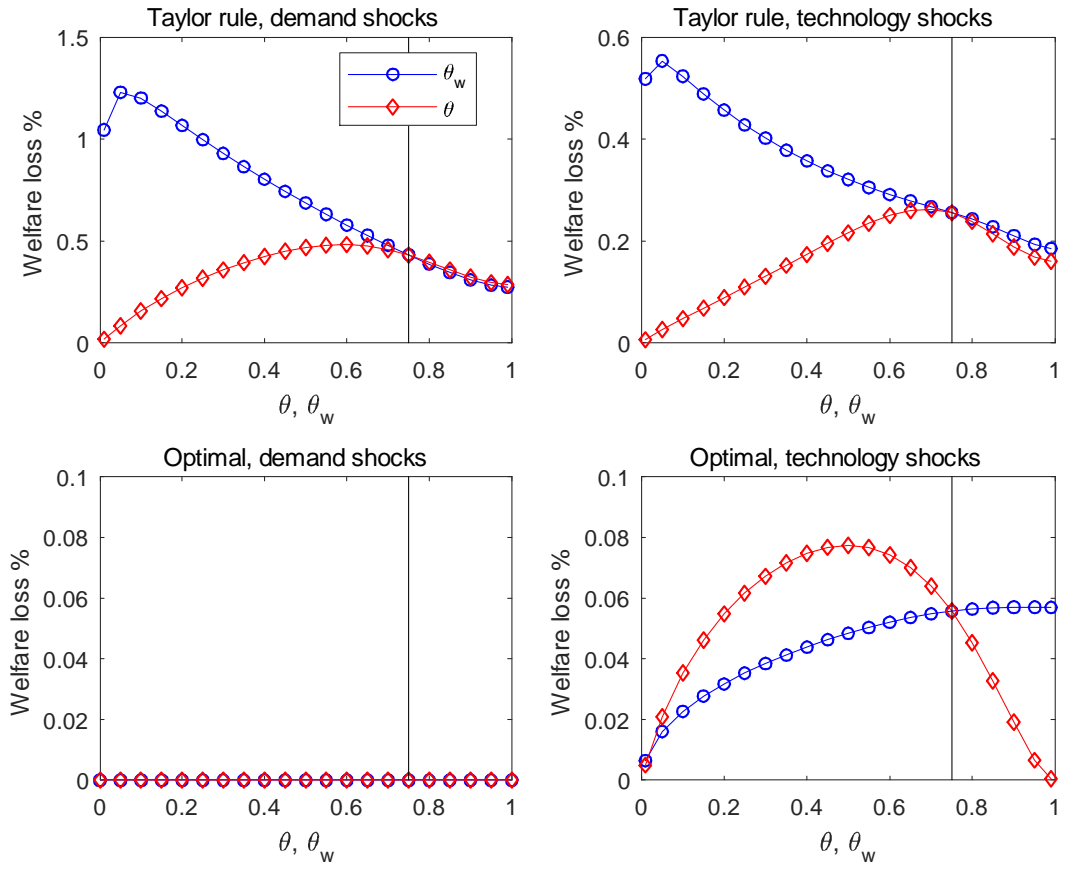


Figure 10: Nominal rigidities and welfare if ZLB absent.

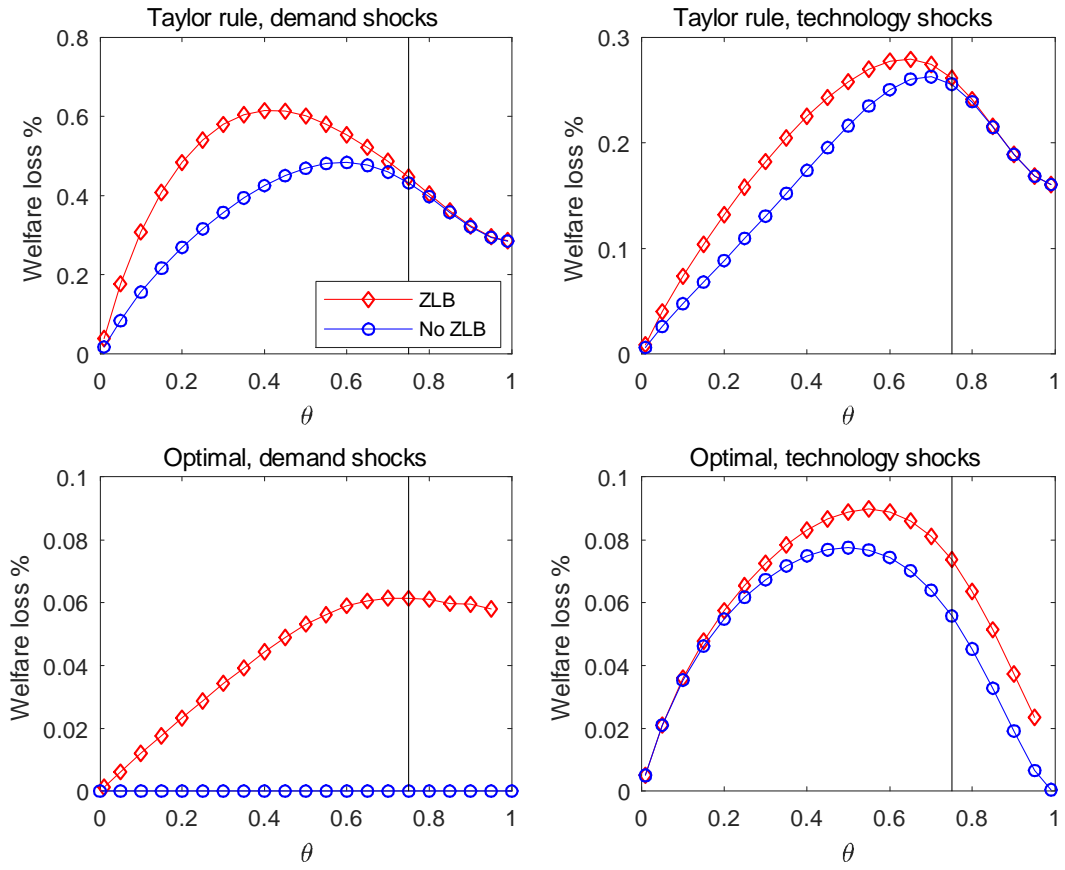


Figure 11: Nominal rigidities and welfare: effect of ZLB.

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Expectation Driven Business Cycles with Limited Enforcement <i>by Karl Walentin</i>	2009:229
Effects of Organizational Change on Firm Productivity <i>by Christina Håkanson</i>	2009:230
Evaluating Microfoundations for Aggregate Price Rigidities: Evidence from Matched Firm-Level Data on Product Prices and Unit Labor Cost <i>by Mikael Carlsson and Oskar Nordström Skans</i>	2009:231
Monetary Policy Trade-Offs in an Estimated Open-Economy DSGE Model <i>by Malin Adolfson, Stefan Laséen, Jesper Lindé and Lars E. O. Svensson</i>	2009:232
Flexible Modeling of Conditional Distributions Using Smooth Mixtures of Asymmetric Student T Densities <i>by Feng Li, Mattias Villani and Robert Kohn</i>	2009:233
Forecasting Macroeconomic Time Series with Locally Adaptive Signal Extraction <i>by Paolo Giordani and Mattias Villani</i>	2009:234
Evaluating Monetary Policy <i>by Lars E. O. Svensson</i>	2009:235
Risk Premiums and Macroeconomic Dynamics in a Heterogeneous Agent Model <i>by Ferre De Graeve, Maarten Dossche, Marina Emiris, Henri Sneessens and Raf Wouters</i>	2010:236
Picking the Brains of MPC Members <i>by Mikael Apel, Carl Andreas Claussen and Petra Lennartsdotter</i>	2010:237
Involuntary Unemployment and the Business Cycle <i>by Lawrence J. Christiano, Mathias Trabandt and Karl Walentin</i>	2010:238
Housing collateral and the monetary transmission mechanism <i>by Karl Walentin and Peter Sellin</i>	2010:239
The Discursive Dilemma in Monetary Policy <i>by Carl Andreas Claussen and Øistein Røisland</i>	2010:240
Monetary Regime Change and Business Cycles <i>by Vasco Cúrdia and Daria Finocchiaro</i>	2010:241
Bayesian Inference in Structural Second-Price common Value Auctions <i>by Bertil Wegmann and Mattias Villani</i>	2010:242
Equilibrium asset prices and the wealth distribution with inattentive consumers <i>by Daria Finocchiaro</i>	2010:243
Identifying VARs through Heterogeneity: An Application to Bank Runs <i>by Ferre De Graeve and Alexei Karas</i>	2010:244
Modeling Conditional Densities Using Finite Smooth Mixtures <i>by Feng Li, Mattias Villani and Robert Kohn</i>	2010:245
The Output Gap, the Labor Wedge, and the Dynamic Behavior of Hours <i>by Luca Sala, Ulf Söderström and Antonella Trigari</i>	2010:246
Density-Conditional Forecasts in Dynamic Multivariate Models <i>by Michael K. Andersson, Stefan Palmqvist and Daniel F. Waggoner</i>	2010:247
Anticipated Alternative Policy-Rate Paths in Policy Simulations <i>by Stefan Laséen and Lars E. O. Svensson</i>	2010:248
MOSES: Model of Swedish Economic Studies <i>by Gunnar Bårdsen, Ard den Reijer, Patrik Jonasson and Ragnar Nymoén</i>	2011:249
The Effects of Endogenous Firm Exit on Business Cycle Dynamics and Optimal Fiscal Policy <i>by Lauri Vilmi</i>	2011:250
Parameter Identification in a Estimated New Keynesian Open Economy Model <i>by Malin Adolfson and Jesper Lindé</i>	2011:251
Up for count? Central bank words and financial stress <i>by Marianna Blix Grimaldi</i>	2011:252
Wage Adjustment and Productivity Shocks <i>by Mikael Carlsson, Julián Messina and Oskar Nordström Skans</i>	2011:253

Stylized (Arte) Facts on Sectoral Inflation <i>by Ferre De Graeve and Karl Walentin</i>	2011:254
Hedging Labor Income Risk <i>by Sebastien Betermier, Thomas Jansson, Christine A. Parlour and Johan Walden</i>	2011:255
Taking the Twists into Account: Predicting Firm Bankruptcy Risk with Splines of Financial Ratios <i>by Paolo Giordani, Tor Jacobson, Erik von Schedvin and Mattias Villani</i>	2011:256
Collateralization, Bank Loan Rates and Monitoring: Evidence from a Natural Experiment <i>by Geraldo Cerqueiro, Steven Ongena and Kasper Roszbach</i>	2012:257
On the Non-Exclusivity of Loan Contracts: An Empirical Investigation <i>by Hans Degryse, Vasso Ioannidou and Erik von Schedvin</i>	2012:258
Labor-Market Frictions and Optimal Inflation <i>by Mikael Carlsson and Andreas Westermark</i>	2012:259
Output Gaps and Robust Monetary Policy Rules <i>by Roberto M. Billi</i>	2012:260
The Information Content of Central Bank Minutes <i>by Mikael Apel and Marianna Blix Grimaldi</i>	2012:261
The Cost of Consumer Payments in Sweden <i>by Björn Segendorf and Thomas Jansson</i>	2012:262
Trade Credit and the Propagation of Corporate Failure: An Empirical Analysis <i>by Tor Jacobson and Erik von Schedvin</i>	2012:263
Structural and Cyclical Forces in the Labor Market During the Great Recession: Cross-Country Evidence <i>by Luca Sala, Ulf Söderström and Antonella Trigari</i>	2012:264
Pension Wealth and Household Savings in Europe: Evidence from SHARELIFE <i>by Rob Alessie, Viola Angelini and Peter van Santen</i>	2013:265
Long-Term Relationship Bargaining <i>by Andreas Westermark</i>	2013:266
Using Financial Markets To Estimate the Macro Effects of Monetary Policy: An Impact-Identified FAVAR* <i>by Stefan Pitschner</i>	2013:267
DYNAMIC MIXTURE-OF-EXPERTS MODELS FOR LONGITUDINAL AND DISCRETE-TIME SURVIVAL DATA <i>by Matias Quiroz and Mattias Villani</i>	2013:268
Conditional euro area sovereign default risk <i>by André Lucas, Bernd Schwaab and Xin Zhang</i>	2013:269
Nominal GDP Targeting and the Zero Lower Bound: Should We Abandon Inflation Targeting?*	2013:270
<i>by Roberto M. Billi</i>	
Un-truncating VARs* <i>by Ferre De Graeve and Andreas Westermark</i>	2013:271
Housing Choices and Labor Income Risk <i>by Thomas Jansson</i>	2013:272
Identifying Fiscal Inflation* <i>by Ferre De Graeve and Virginia Queijo von Heideken</i>	2013:273
On the Redistributive Effects of Inflation: an International Perspective* <i>by Paola Boel</i>	2013:274
Business Cycle Implications of Mortgage Spreads* <i>by Karl Walentin</i>	2013:275
Approximate dynamic programming with post-decision states as a solution method for dynamic economic models <i>by Isaiah Hull</i>	2013:276
A detrimental feedback loop: deleveraging and adverse selection <i>by Christoph Bertsch</i>	2013:277
Distortionary Fiscal Policy and Monetary Policy Goals <i>by Klaus Adam and Roberto M. Billi</i>	2013:278
Predicting the Spread of Financial Innovations: An Epidemiological Approach <i>by Isaiah Hull</i>	2013:279
Firm-Level Evidence of Shifts in the Supply of Credit <i>by Karolina Holmberg</i>	2013:280

Lines of Credit and Investment: Firm-Level Evidence of Real Effects of the Financial Crisis <i>by Karolina Holmberg</i>	2013:281
A wake-up call: information contagion and strategic uncertainty <i>by Toni Ahnert and Christoph Bertsch</i>	2013:282
Debt Dynamics and Monetary Policy: A Note <i>by Stefan Laséen and Ingvar Strid</i>	2013:283
Optimal taxation with home production <i>by Conny Olovsson</i>	2014:284
Incompatible European Partners? Cultural Predispositions and Household Financial Behavior <i>by Michael Haliassos, Thomas Jansson and Yigitcan Karabulut</i>	2014:285
How Subprime Borrowers and Mortgage Brokers Shared the Piecial Behavior <i>by Antje Berndt, Burton Hollifield and Patrik Sandås</i>	2014:286
The Macro-Financial Implications of House Price-Indexed Mortgage Contracts <i>by Isaiah Hull</i>	2014:287
Does Trading Anonymously Enhance Liquidity? <i>by Patrick J. Dennis and Patrik Sandås</i>	2014:288
Systematic bailout guarantees and tacit coordination <i>by Christoph Bertsch, Claudio Calcagno and Mark Le Quement</i>	2014:289
Selection Effects in Producer-Price Setting <i>by Mikael Carlsson</i>	2014:290
Dynamic Demand Adjustment and Exchange Rate Volatility <i>by Vesna Corbo</i>	2014:291
Forward Guidance and Long Term Interest Rates: Inspecting the Mechanism <i>by Ferre De Graeve, Pelin Ilbas &amp; Raf Wouters</i>	2014:292
Firm-Level Shocks and Labor Adjustments <i>by Mikael Carlsson, Julián Messina and Oskar Nordström Skans</i>	2014:293
A wake-up call theory of contagion <i>by Toni Ahnert and Christoph Bertsch</i>	2015:294
Risks in macroeconomic fundamentals and excess bond returns predictability <i>by Rafael B. De Rezende</i>	2015:295
The Importance of Reallocation for Productivity Growth: Evidence from European and US Banking <i>by Jaap W.B. Bos and Peter C. van Santen</i>	2015:296
SPEEDING UP MCMC BY EFFICIENT DATA SUBSAMPLING <i>by Matias Quiroz, Mattias Villani and Robert Kohn</i>	2015:297
Amortization Requirements and Household Indebtedness: An Application to Swedish-Style Mortgages <i>by Isaiah Hull</i>	2015:298
Fuel for Economic Growth? <i>by Johan Gars and Conny Olovsson</i>	2015:299
Searching for Information <i>by Jungsuk Han and Francesco Sangiorgi</i>	2015:300
What Broke First? Characterizing Sources of Structural Change Prior to the Great Recession <i>by Isaiah Hull</i>	2015:301
Price Level Targeting and Risk Management <i>by Roberto Billi</i>	2015:302
Central bank policy paths and market forward rates: A simple model <i>by Ferre De Graeve and Jens Iversen</i>	2015:303
Jump-Starting the Euro Area Recovery: Would a Rise in Core Fiscal Spending Help the Periphery? <i>by Olivier Blanchard, Christopher J. Erceg and Jesper Lindé</i>	2015:304
Bringing Financial Stability into Monetary Policy* <i>by Eric M. Leeper and James M. Nason</i>	2015:305
SCALABLE MCMC FOR LARGE DATA PROBLEMS USING DATA SUBSAMPLING AND THE DIFFERENCE ESTIMATOR <i>by MATIAS QUIROZ, MATTIAS VILLANI AND ROBERT KOHN</i>	2015:306

SPEEDING UP MCMC BY DELAYED ACCEPTANCE AND DATA SUBSAMPLING <i>by MATIAS QUIROZ</i>	2015:307
Modeling financial sector joint tail risk in the euro area <i>by André Lucas, Bernd Schwaab and Xin Zhang</i>	2015:308
Score Driven Exponentially Weighted Moving Averages and Value-at-Risk Forecasting <i>by André Lucas and Xin Zhang</i>	2015:309
On the Theoretical Efficacy of Quantitative Easing at the Zero Lower Bound <i>by Paola Boel and Christopher J. Waller</i>	2015:310
Optimal Inflation with Corporate Taxation and Financial Constraints <i>by Daria Finocchiaro, Giovanni Lombardo, Caterina Mendicino and Philippe Weil</i>	2015:311
Fire Sale Bank Recapitalizations <i>by Christoph Bertsch and Mike Mariathasan</i>	2015:312
Since you're so rich, you must be really smart: Talent and the Finance Wage Premium <i>by Michael Böhm, Daniel Metzger and Per Strömberg</i>	2015:313
Debt, equity and the equity price puzzle <i>by Daria Finocchiaro and Caterina Mendicino</i>	2015:314
Trade Credit: Contract-Level Evidence Contradicts Current Theories <i>by Tore Ellingsen, Tor Jacobson and Erik von Schedvin</i>	2016:315
Double Liability in a Branch Banking System: Historical Evidence from Canada <i>by Anna Grodecka and Antonis Kotidis</i>	2016:316
Subprime Borrowers, Securitization and the Transmission of Business Cycles <i>by Anna Grodecka</i>	2016:317
Real-Time Forecasting for Monetary Policy Analysis: The Case of Sveriges Riksbank <i>by Jens Iversen, Stefan Laséen, Henrik Lundvall and Ulf Söderström</i>	2016:318
Fed Liftoff and Subprime Loan Interest Rates: Evidence from the Peer-to-Peer Lending <i>by Christoph Bertsch, Isaiah Hull and Xin Zhang</i>	2016:319
Curbing Shocks to Corporate Liquidity: The Role of Trade Credit <i>by Niklas Amberg, Tor Jacobson, Erik von Schedvin and Robert Townsend</i>	2016:320
Firms' Strategic Choice of Loan Delinquencies <i>by Paola Morales-Acevedo</i>	2016:321
Fiscal Consolidation Under Imperfect Credibility <i>by Matthieu Lemoine and Jesper Lindé</i>	2016:322
Challenges for Central Banks' Macro Models <i>by Jesper Lindé, Frank Smets and Rafael Wouters</i>	2016:323
The interest rate effects of government bond purchases away from the lower bound <i>by Rafael B. De Rezende</i>	2016:324
COVENANT-LIGHT CONTRACTS AND CREDITOR COORDINATION <i>by Bo Becker and Victoria Ivashina</i>	2016:325
Endogenous Separations, Wage Rigidities and Employment Volatility <i>by Mikael Carlsson and Andreas Westermark</i>	2016:326
Renovatio Monetae: Gesell Taxes in Practice <i>by Roger Svensson and Andreas Westermark</i>	2016:327
Adjusting for Information Content when Comparing Forecast Performance <i>by Michael K. Andersson, Ted Aranki and André Reslow</i>	2016:328
Economic Scarcity and Consumers' Credit Choice <i>by Marieke Bos, Chloé Le Coq and Peter van Santen</i>	2016:329
Uncertain pension income and household saving <i>by Peter van Santen</i>	2016:330
Money, Credit and Banking and the Cost of Financial Activity <i>by Paola Boel and Gabriele Camera</i>	2016:331
Oil prices in a real-business-cycle model with precautionary demand for oil <i>by Conny Olovsson</i>	2016:332
Financial Literacy Externalities <i>by Michael Haliasso, Thomas Jansson and Yigitcan Karabulut</i>	2016:333



The timing of uncertainty shocks in a small open economy <i>by Hanna Armelius, Isaiah Hull and Hanna Stenbacka Köhler</i>	2016:334
Quantitative easing and the price-liquidity trade-off <i>by Marien Ferdinandusse, Maximilian Freier and Annukka Ristiniemi</i>	2017:335
What Broker Charges Reveal about Mortgage Credit Risk <i>by Antje Berndt, Burton Hollifield and Patrik Sandås</i>	2017:336
Asymmetric Macro-Financial Spillovers <i>by Kristina Bluwstein</i>	2017:337
Latency Arbitrage When Markets Become Faster <i>by Burton Hollifield, Patrik Sandås and Andrew Todd</i>	2017:338
How big is the toolbox of a central banker? Managing expectations with policy-rate forecasts: Evidence from Sweden <i>by Magnus Åhl</i>	2017:339
International business cycles: quantifying the effects of a world market for oil <i>by Johan Gars and Conny Olovsson I</i>	2017:340
Systemic Risk: A New Trade-Off for Monetary Policy? <i>by Stefan Laséen, Andrea Pescatori and Jarkko Turunen</i>	2017:341
Household Debt and Monetary Policy: Revealing the Cash-Flow Channel <i>by Martin Flodén, Matilda Kilström, Jósef Sigurdsson and Roine Vestman</i>	2017:342
House Prices, Home Equity, and Personal Debt Composition <i>by Jieying Li and Xin Zhang</i>	2017:343
Identification and Estimation issues in Exponential Smooth Transition Autoregressive Models <i>by Daniel Buncic</i>	2017:344
Domestic and External Sovereign Debt <i>by Paola Di Casola and Spyridon Sichliris</i>	2017:345
The Role of Trust in Online Lending <i>by Christoph Bertsch, Isaiah Hull, Yingjie Qi and Xin Zhang</i>	2017:346
On the effectiveness of loan-to-value regulation in a multiconstraint framework <i>by Anna Grodecka</i>	2017:347
Shock Propagation and Banking Structure <i>by Mariassunta Giannetti and Farzad Saidi</i>	2017:348
The Granular Origins of House Price Volatility <i>by Isaiah Hull, Conny Olovsson, Karl Walentin and Andreas Westermark</i>	2017:349
Should We Use Linearized Models To Calculate Fiscal Multipliers? <i>by Jesper Lindé and Mathias Trabandt</i>	2017:350
The impact of monetary policy on household borrowing – a high-frequency IV identification <i>by Maria Sandström</i>	2018:351
Conditional exchange rate pass-through: evidence from Sweden <i>by Vesna Corbo and Paola Di Casola</i>	2018:352
Learning on the Job and the Cost of Business Cycles <i>by Karl Walentin and Andreas Westermark</i>	2018:353
Trade Credit and Pricing: An Empirical Evaluation <i>by Niklas Amberg, Tor Jacobson and Erik von Schedvin</i>	2018:354
A shadow rate without a lower bound constraint <i>by Rafael B. De Rezende and Annukka Ristiniemi</i>	2018:355
Reduced "Border Effects", FTAs and International Trade <i>by Sebastian Franco and Erik Frohm</i>	2018:356
Spread the Word: International Spillovers from Central Bank Communication <i>by Hanna Armelius, Christoph Bertsch, Isaiah Hull and Xin Zhang</i>	2018:357
Predictors of Bank Distress: The 1907 Crisis in Sweden <i>by Anna Grodecka, Seán Kenny and Anders Ögren</i>	2018:358

Diversification Advantages During the Global Financial Crisis <i>by Mats Levander</i>	2018:359
Towards Technology-News-Driven Business Cycles <i>by Paola Di Casola and Spyridon Sichelmiris</i>	2018:360
The Housing Wealth Effect: Quasi-Experimental Evidence <i>by Dany Kessel, Björn Tyrefors and Roine</i>	2018:361
Identification Versus Misspecification in New Keynesian Monetary Policy Models <i>by Malin Adolfson, Stefan Laseén, Jesper Lindé and Marco Ratto</i>	2018:362
The Macroeconomic Effects of Trade Tariffs: Revisiting the Lerner Symmetry Result <i>by Jesper Lindé and Andrea Pescatori</i>	2019:363
Biased Forecasts to Affect Voting Decisions? The Brexit Case <i>by Davide Cipullo and André Reslow</i>	2019:364
The Interaction Between Fiscal and Monetary Policies: Evidence from Sweden <i>by Sebastian Ankargren and Hovick Shahnazarian</i>	2019:365
Designing a Simple Loss Function for Central Banks: Does a Dual Mandate Make Sense? <i>by Davide Debortoli, Jinill Kim and Jesper Lindé</i>	2019:366



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