Discussion of

The Dire Effects of the Lack of Monetary and Fiscal Coordination

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Disclaimer: The views expressed on the slides are my own and do not necessarily represent those of the ECB.
This paper: Part I

- Inspects economic consequences of a *temporary* monetary-fiscal configuration where
  
  - the monetary authority aims to stabilize inflation by adjusting the policy rate elastically to changes in inflation (‘active MP’)
  
  - the fiscal authority refrains from adjusting the primary surplus sufficiently elastically to changes in government liabilities (‘active FP’)

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- Can be thought of as a ‘lack of monetary-fiscal coordination’, since, if permanent, no *locally-stable* RE equilibrium exists.
What is a desirable monetary-fiscal configuration to deal with large contractionary demand shocks, in particular in the vicinity of the lower bound on nominal interest rates?
Framework

Textbook New Keynesian model of the U.S. economy

- rational expectations, perfect information
- monetary policy governed by interest-rate feedback rule
- fiscal policy governed by feedback rule for *lump-sum taxes*
- exogenous shifts between three monetary-fiscal configurations
- two-state discount factor shock
Possible monetary-fiscal configurations

- Monetary-fiscal coordination

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     → if permanent, fiscal variables irrelevant for inflation determination
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This paper: Exogenous shifts between regimes 1, 2 and 3.
Main results: Part I

- In general, a central bank charged with maintaining price stability must not be indifferent as to how fiscal policy is conducted.

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- Expectations matter
  - Anticipation of possible transition to active MP, active FP regime affects equilibrium dynamics under the two co-ordinated regimes.
  - Equilibrium dynamics under the active MP, active FP regime depend on expectations about how the policy conflict is resolved, i.e. on future regime shifts.
Main results: Part II

- A co-ordinated regime that preserves the active MP, passive FP configuration as a benchmark but allows for short-run switches to the passive MP, active FP regime in case of large contractionary demand shocks can be a useful strategy to deal with liquidity trap events.
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- Specifically, proposed strategy involves commitment to inflate away just the amount of new government debt that results from the large contractionary demand shock.
Comments
Comments on part II: Tracking the shadow economy

- Proposed ‘emergency-budget rule’ requires the policymakers and the private sector to keep track of a shadow economy that abstracts from the large two-state demand shock.

In practice, the shadow economy is unobservable, which complicates communication and implementation of the proposed strategy. Use projections for future gov. debt, output and inflation prior to the materialization of the large contractionary demand shock as a proxy? Only works if projections are not ‘contaminated’ by expectations about possibility of future crisis shock (and regime shifts).
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- Can the ‘temporary overshooting of the inflation target’ promise be made time-consistent?
  
  - Lump-sum taxes not freely adjustable (Eggertsson, 2006; Burgert and Schmidt, 2014)
  
  - Reputational equilibria (Nakata, 2017)
Discretionary monetary-fiscal policymaker aims to maximize welfare
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- Policy instruments: policy rate and government spending; lump-sum and distortionary taxes are fixed
- Optimal policy uses all instruments to stabilize output, inflation and government debt
- Issuing government debt allows discretionary policymaker to influence future fiscal and monetary policy, and thereby private sector expectations (policy becomes ‘history dependent’)
Mechanism in Burgert and Schmidt (2014)

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- Policymaker lowers policy rate to zero and increases government spending (leading to a further increase in gov. debt)
- When demand shock recedes, government debt still above long-run level
- Therefore, policymaker implements interest rate path that remains transitorily below the one that would be warranted by output and inflation stabilization considerations alone
- Economy experiences a transitory upswing in output and inflation above target which attenuates the drop at the outset of the liquidity trap event
Figure: Impulse responses to natural real rate shock

Note: ‘Without government debt’ refers to case of freely adjustable lump-sum taxes. Source: Burgert and Schmidt (2014)
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Remarks on Part I: Policymakers’ motives

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  If the active MP, active FP regime is clearly undesirable why would policymakers ever chose to stay in that regime?

- Difficult to answer in the current setup.

- Doing so would require to explicitly model the policymakers’ preferences, information sets, and their strategic interactions.
Comments on part I: The interest-rate rule

- Implications of (expectations about) regime shifts become even more clear-cut when allowing the interest rate rule to track the natural real rate of interest: \[ \tilde{R}_t = \tilde{RR}_t^n + \psi_\pi \tilde{\pi}_t + \psi_y (\tilde{y}_t - \tilde{y}_t^*) \]

- Under a permanent active MP, passive FP regime, this rule completely isolates the output gap and inflation from the discount factor shock (w/o ZLB)

- Hence any deviation from perfect stabilization driven by expectations about future regime shifts
Comments on part I: Duration of government debt

- Duration of government debt important for equilibrium dynamics when fiscal policy is active

- How would change in duration affect the alternative regime-shift scenarios (Fig. 3-5)?
Conclusion

- Bianchi and Melosi provide concise analysis of the perils of an uncoordinated monetary-fiscal configuration whereby MP aims to stabilize inflation and FP is reluctant to stabilize government debt.

Potential future work: Formally explore why economy could end up in this undesirable configuration (preferences and interactions).

Discuss role of policy credibility.
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  - Discuss role of policy credibility
References


Background slides
The pervasiveness of monetary-fiscal interactions

[With sticky prices and distortionary taxation, we observe revaluation effects and pervasive interactions between monetary and fiscal policy across both the M and F regimes.]

[...] the active/passive rubrics also lose their usefulness once one considers optimal policies. Jointly optimal monetary and fiscal policies generally combine elements of both regimes M and F [...]
Figure: Equilibrium responses to beginning-of-period gov. debt

Source: Burgert and Schmidt (2014)