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')
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  - 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')
- Can be thought of as a 'lack of monetary-fiscal coordination', since, if permanent, no *locally-stable* RE equilibrium exists.

This paper: Part II

- 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

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This paper: Exogenous shifts between regimes 1, 2 and 3.

Main results: Part I

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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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- This policy mitigates decline in output and inflation in the short run by raising expectations about future inflation, much like the optimal Ramsey policy under full commitment does.
- 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.

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- 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)

Burgert and Schmidt (2014)

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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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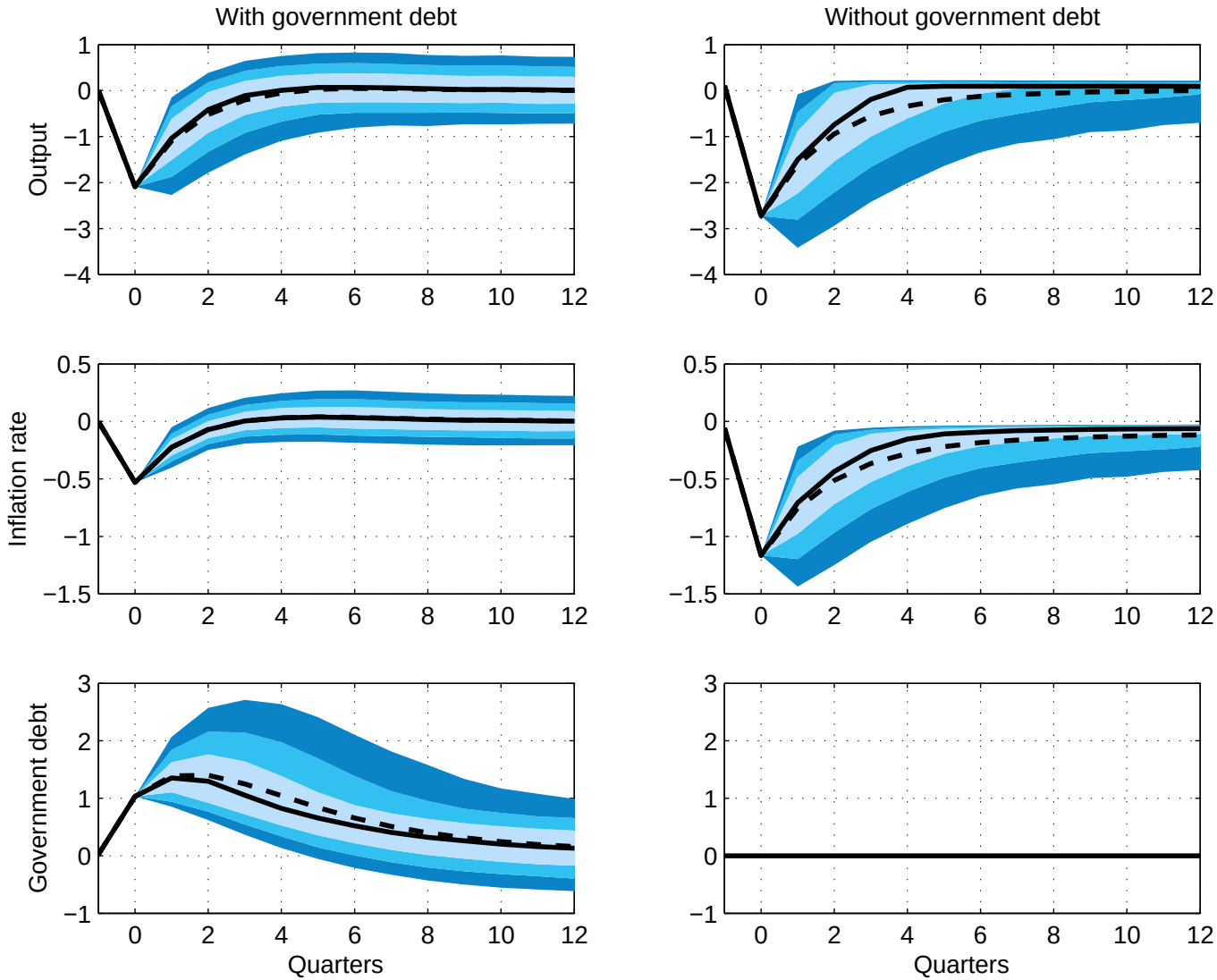
- When demand shock recedes, government debt still above long-run level
- Therefore, policymaker implements interest rate path that remains transitorily *below* the one that would be warranted by output and inflation stabilization considerations alone
- Economy experiences a transitory upswing in output 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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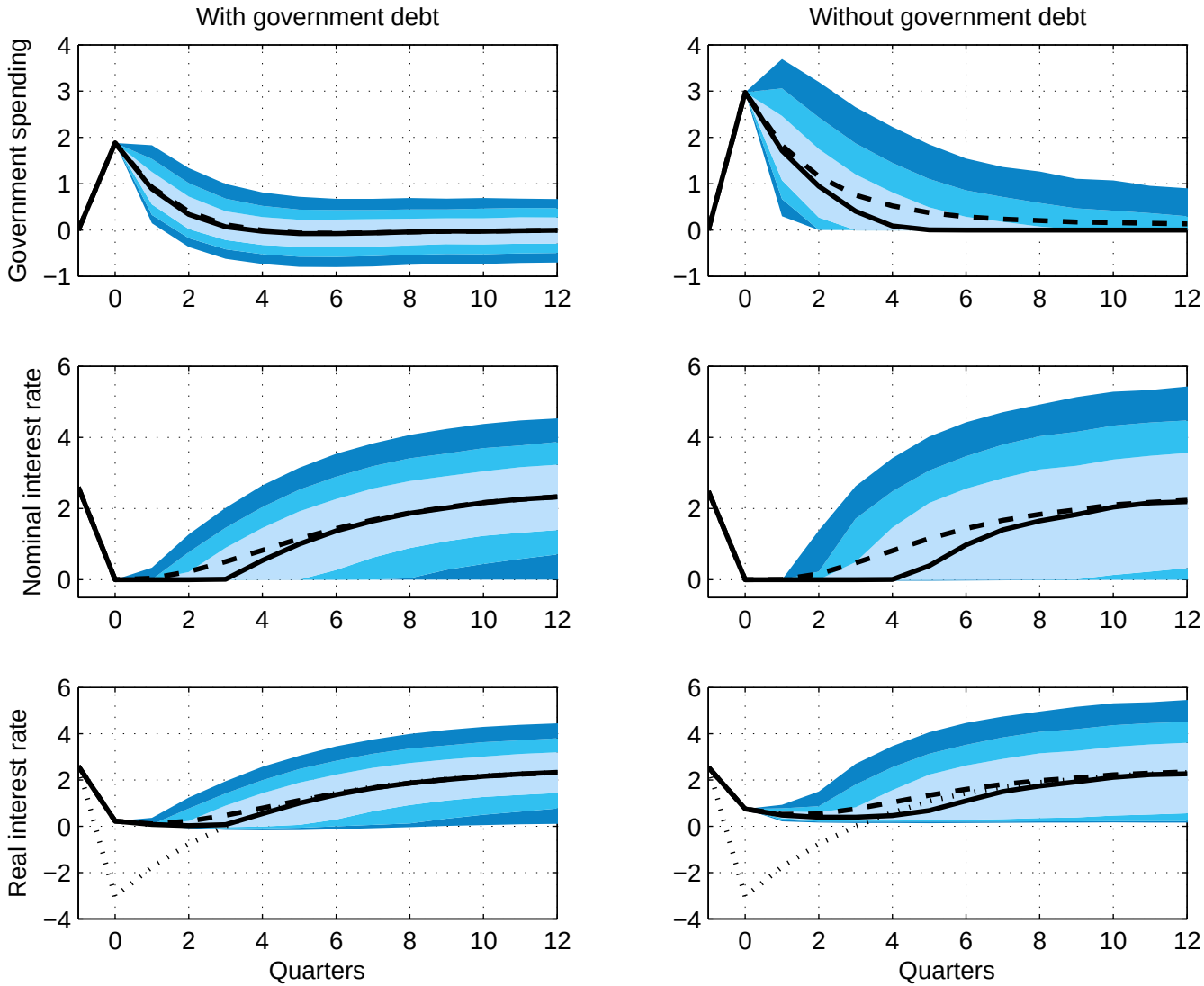

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  If the active MP, active FP regime is clearly undesirable why would policymakers ever chose to stay in that regime?

- 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: $\tilde{R}_t = \widetilde{RR}_t^n + \psi_\pi \tilde{\pi}_t + \psi_y(\tilde{y}_t - \tilde{y}_t^*)$
- 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

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  - Potential future work: Formally explore why economy could end up in this undesirable configuration (preferences and interactions)
- They also propose a way to raise inflation expectations in a liquidity trap by making use of a temporary and partial regime shift
  - Discuss role of policy credibility

References

Burgert, M., and S. Schmidt (2014). Dealing with a liquidity trap when government debt matters: Optimal time-consistent monetary and fiscal policy. Journal of Economic Dynamics and Control, 47, 282-299.

Eggertsson, G. (2006). The deflation bias and committing to being irresponsible. Journal of Money, Credit and Banking, 38, 283-321.

Leeper, E., and C. Leith (2016). Understanding Inflation as a Joint Monetary-Fiscal Phenomenon. Editors: John B. Taylor, Harald Uhlig, In Handbook of Macroeconomics, Elsevier, Volume 2, 2305-2415.

Nakata, T. (2017). Reputation and liquidity traps. Review of Economic Dynamics, forthcoming.

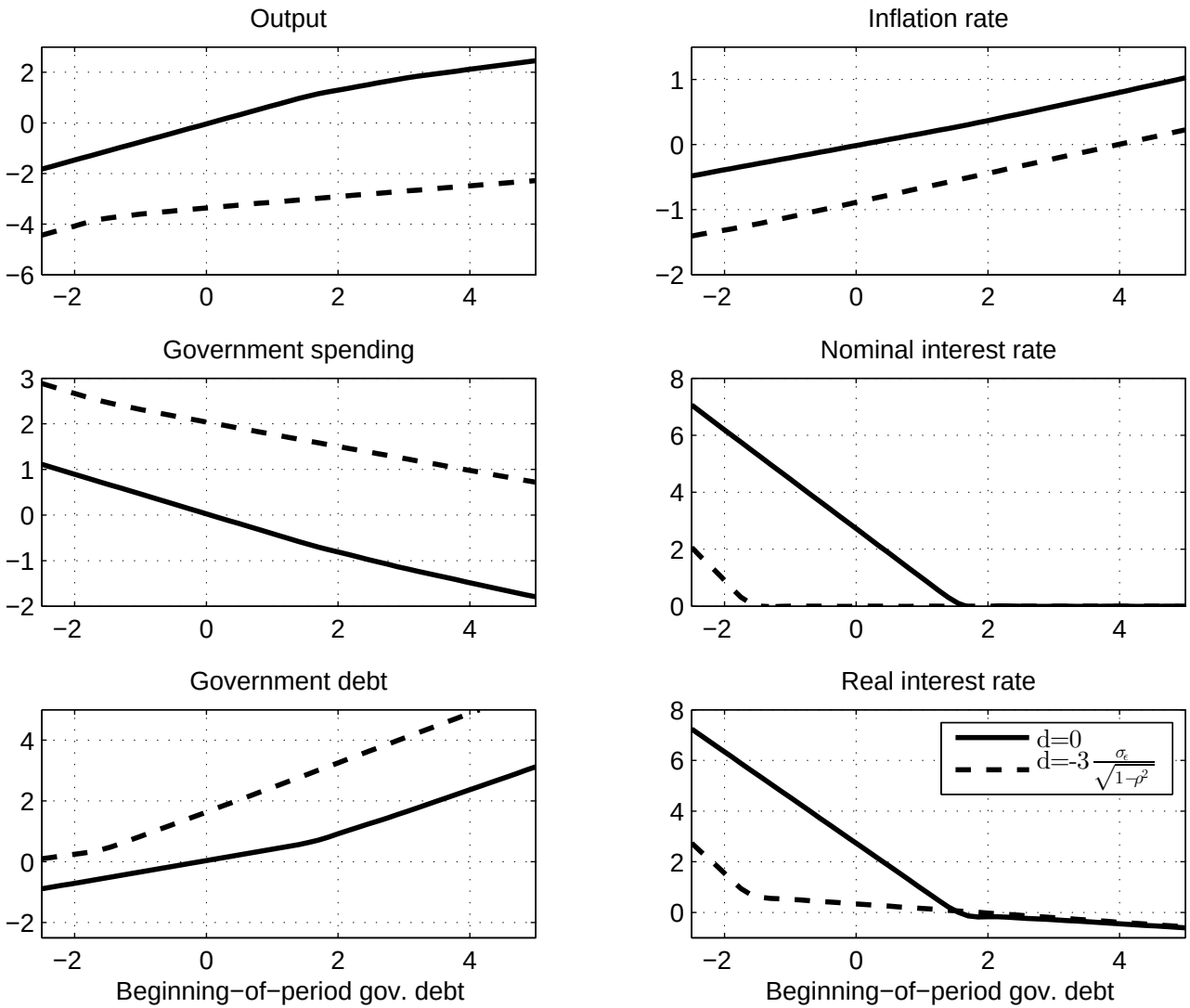
Background slides

The pervasiveness of monetary-fiscal interactions

> *[W]ith 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 [...]*

Leeper and Leith (2016), Handbook of Macroeconomics, Vol. 2B, chapter on 'Understanding Inflation as a Joint Monetary-Fiscal Phenomenon':

Figure: Equilibrium responses to beginning-of-period gov. debt



Source: Burgert and Schmidt (2014)