

MONETARY AND FISCAL POLICY

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Three preliminary points

- We should not make two opposite mistakes: throw away everything we believed in before the crisis or ignore its lessons.
- As economists let's readily admit what we don't know.
- Macro is again great fun because we thought we knew all the answers but we don't. So I will raise lots of questions and provide not many answers

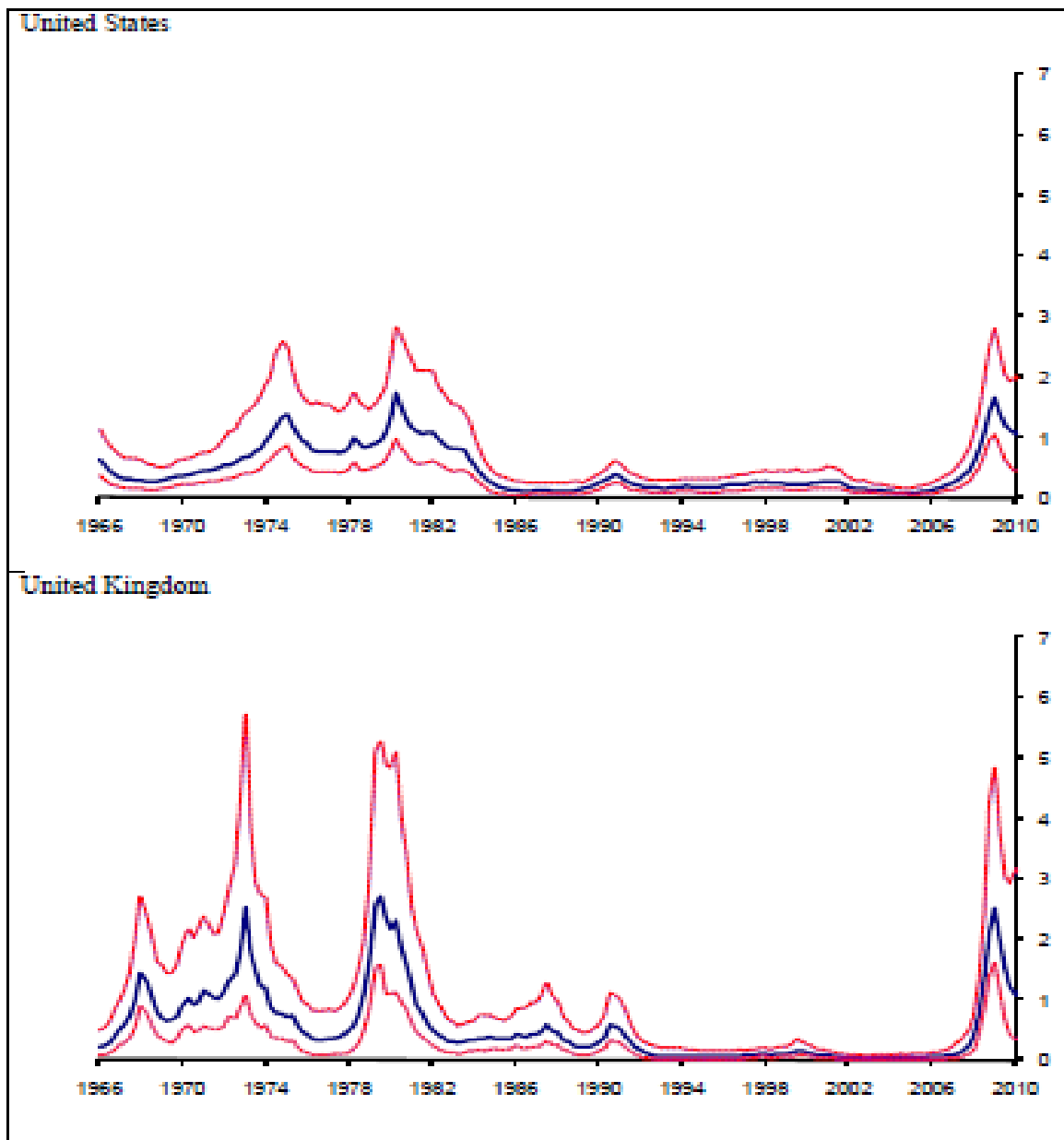
Monetary policy

- Rules versus discretion
- Which rule?
- Regulations of financial markets and monetary policy
- Zero bounds

Rules versus Discretion

- During the Great Moderation we thought we had solved the issue: rules based policies in fact the temptation of deviating from them was not even there any more (Blinder)
- Was Greenspan instead an example of a Barro Gordon type deviation from a credible rule to over stimulate the economy? My answer: yes
- Was the crisis partly due to Greenspan abandoning some sort of Taylor rule? My answer: yes
- Was it a mistake to abandon conventional monetary policy during the crisis? My answer: no

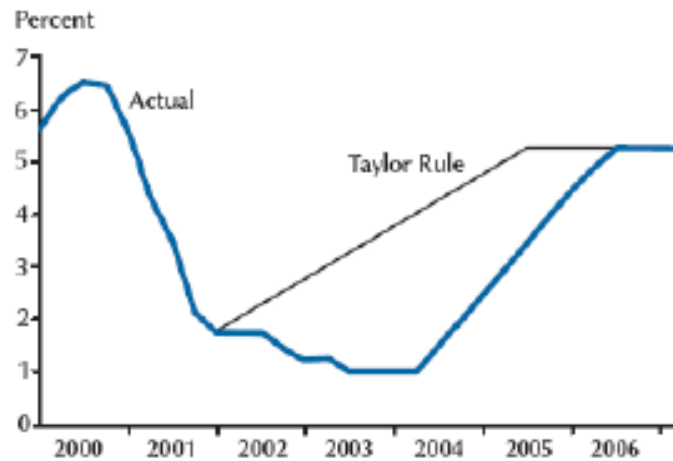
Macroeconomic Volatility Measures



A rule abandoned

Figure 2

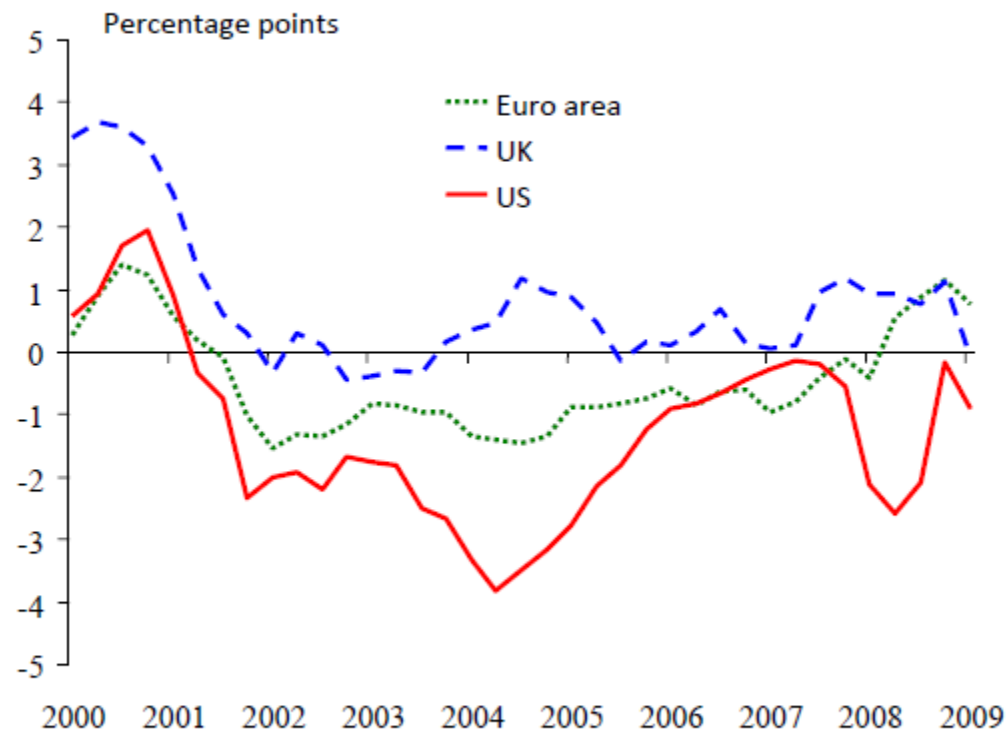
Federal Funds Rate, Actual and Counterfactual



NOTE From Taylor (2007).

The ECB not so tight

Deviation of Policy Rates from Taylor Rule



Source: OECD

Rules versus discretion

- John Taylor makes two points: the deviation from the Taylor rules contributed to create the crisis
- We should not have abandoned a Taylor rule even after the crisis exploded.
- My Take: right on point 1) not on point 2) A Taylor rule in 2008 would have been very tight and would have ignored the looming bank asset problems

Flexible versus simple rules

- If a rule is very simple (rigid inflation targeting) it is easy to verify but may not allow enough room for flexibility (e.g. during a crisis)
- But if a rule is too flexible it becomes indistinguishable from no rule at all since a deviation from the rule cannot be easily verified.

The answer: flexible Inflation targeting?

- “Flexible” inflation targeting can become so “flexible” that just about anything could be described as flexible inflation targeting “rule”.
- Have lost the distinction between rules and discretion?
- Is the question still relevant?
- Yes: Greenspan was a deviation from a rule and created a mess.

Answer: simple rules with escape clauses?

- My take: simple rules in normal times to be abandoned during crises.
- But:
- 1) who defines a crisis? Would this undermine the rule?
- 2) can monetary policy uncertainty exacerbate the crisis?

Asset prices

- Should the Central Bank worry about asset prices?
- Before the crisis the answer believed by most was no.
- Greenspan doctrine: don't worry about possible asset bubbles, clean up when they break

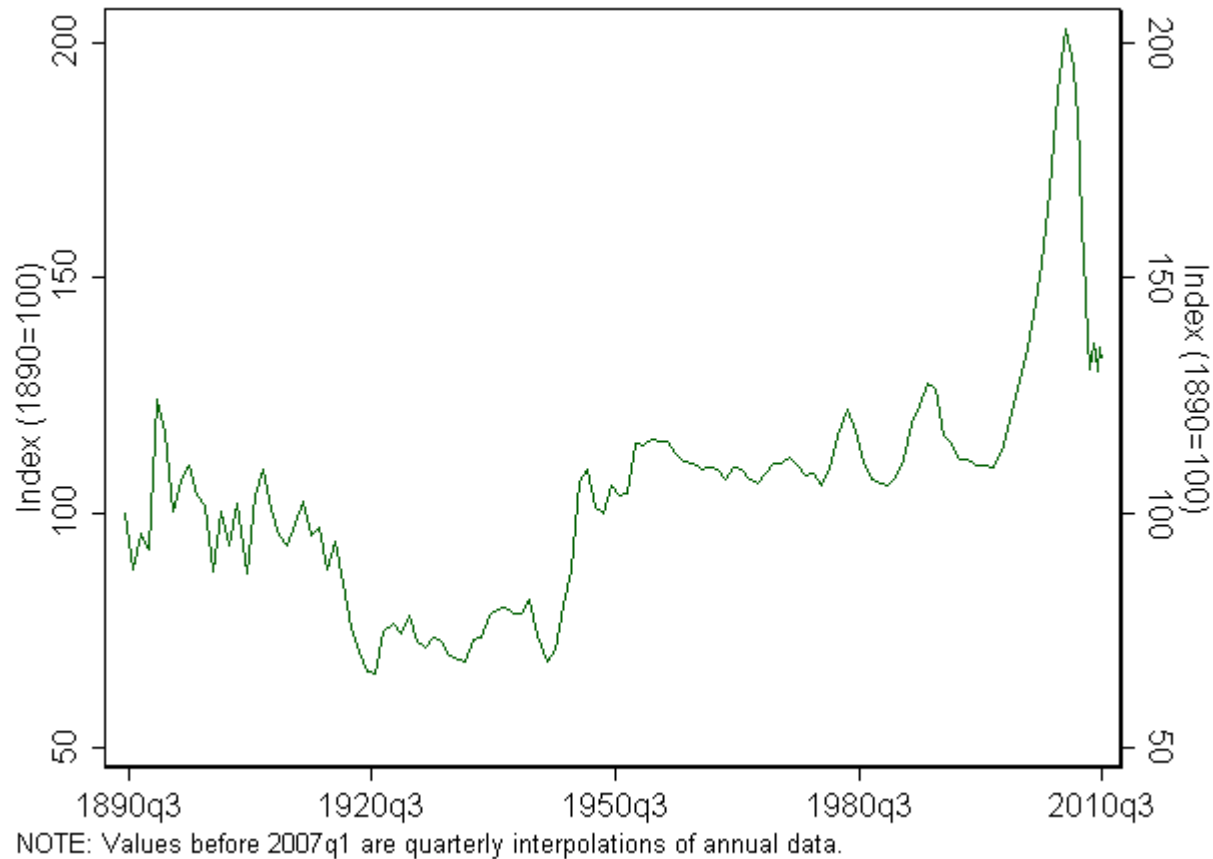
Should we change our view about this?

- Well, cleaning up after this mess has been very costly, even thought to be fair to Greenspan, cleaning up after the internet bubble was not that costly.
- We need some serious rethinking of the Greenspan doctrine but several questions remains

Issues

- How do we recognize a bubble? (Example: US real estate prices)
- Is raising interest rates enough to burst a bubble?
- What if a bubble is on only one class of assets and monetary policy affects all assets?
- Would a policy of targeting assets create confusion in market participants' expectations?

Case Shiller in levels



Case Shiller in logs



Financial regulation

- Extremely complicated issue (at least for me)
- We need to understand much better the connection between monetary policy, interest rates and banks and (non bank intermediaries) balance sheets.
- Probably the crisis will end a literature of monetary policy without credit, money and banks in it, and this is a good thing.
- Many economists at work on financial frictions, banks balance sheets, risk and monetary policy

Institutional question

- Who should be doing the financial regulation?
- One view: The Central Bank (probably the more conventional view)
- An independent agency (probably a minority view but see Zingales)
- Economic efficiency democratic theory and regulatory capture may give different answers.

Issues: efficiency

- Central Bank needs immediate information about bank balance sheets; economic efficiency would suggest that the CB does financial supervision

Issues: democratic theory

- But inflation control and bank supervision may require choices between various trade offs
- Are the voters represented by independent Central Banks (Zingales)? Democratic deficit?
- My belief in the opportunity of having independent central banks is unchanged by the crisis, but when Central banks make fiscal decisions in nature....

Issues: Regulatory Capture

- Which institution is more likely to be captured? An independent agency or the Central Bank?
- In the discussion about regulatory reforms the issue of regulatory capture is not sufficiently prominent

My Take

- On balance I would choose the Central Bank but it is not a slam dunk

Zero bounds

- The Japanese experience and now the financial crisis showed that that the zero bound on nominal interest rates can be a serious problem.
- What to do about it?
- Are non conventional intervention the solution?
- Target 4 per cent rather than 2 per cent inflation rate (Blanchard et al)

Zero bounds

- The benefit of targeting a higher level of inflation has to be judged against the risk that at 4 per cent the slippage to 5, 6 etc. is higher than from 1 to 2.
- How big is this problem?
- How distortionary on market participants is a 4 per cent inflation level?
- Is it politically feasible?

My take

- I would be worried about a 4 per cent inflation target more for practical political economy reasons than for theory

Fiscal Policy: What do we agree upon

- Tax smoothing principle
- Automatic stabilizers have to do their work
- That would imply that balanced budget rules (like the current German one) are a bad idea.
- But...political distortions?
- There are huge issues on the politics of fiscal policy (I will mostly ignore it here but the policy discussions should not)

What we don't agree about

- Discretionary counter cyclical policies when should we use them? Often? Never?
- Taxes or spending: size of multipliers

The old identification problem...

- Co-movements of G , T and GDP . What causes what?
- There are always third factors moving around, so?
- Is G and T a response to movements in Y or vice versa?

...and what do people do to solve it

- Dynamic general equilibrium models
- Vector auto regression analysis (Blanchard Perotti)
- Isolate episodes of exogenous changes in tax rates (Romer and Romer)
- Isolate exogenous and unexpected changes in spending, military spending (Barro Ramey)
- Case studies

The size of multipliers:

Basic Keynesian Ec 101 model

- Spending multiplier (much) bigger than one.
- Spending multiplier bigger than tax multiplier

How does it come out

- Not too well
- Range of spending multiplier estimated from 0.4 to 1.5
- Tax multipliers seem bigger (Romer and Romer up to 3!)

Contentious issues: Spending

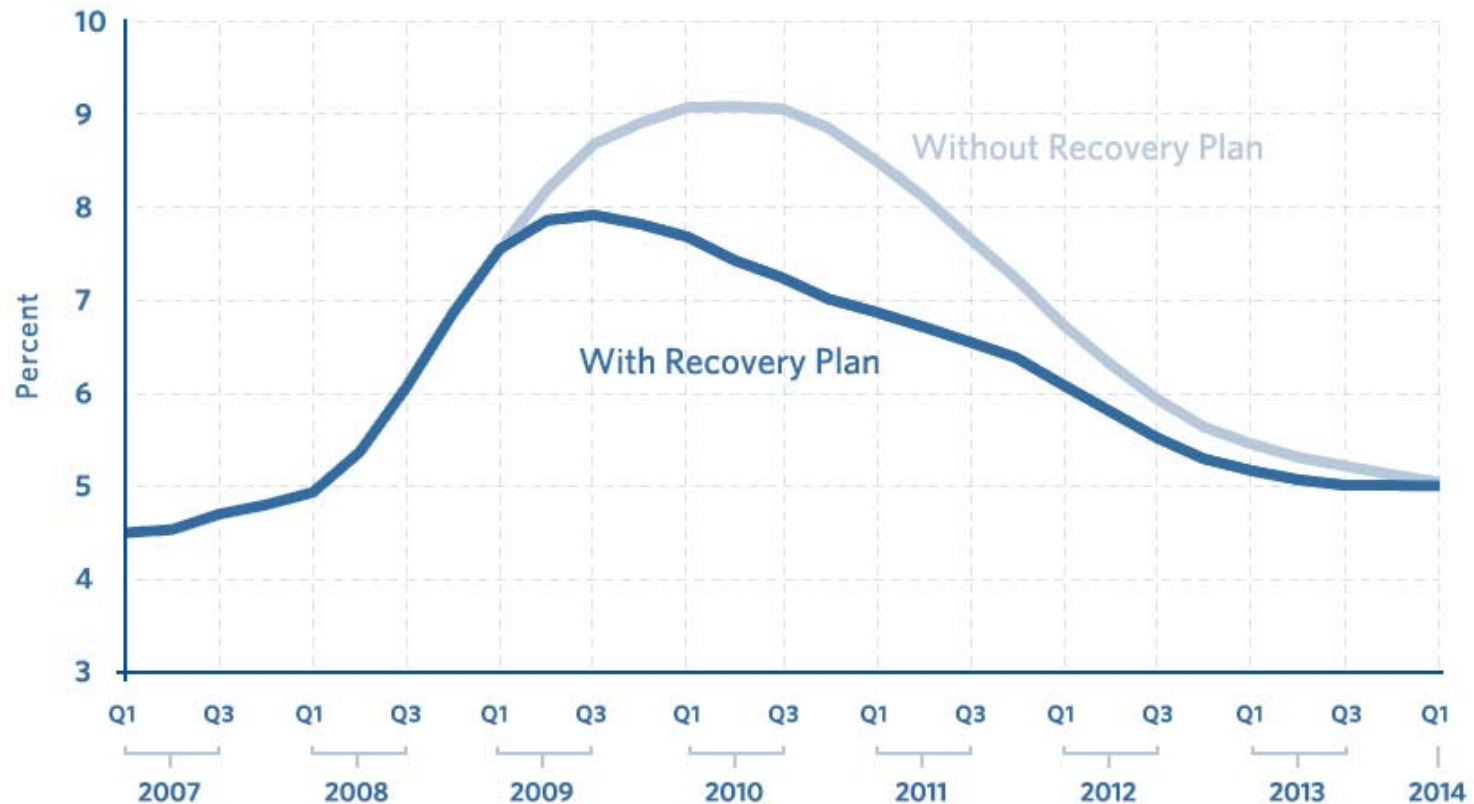
- Hansen and Sargent, Ramey and Barro argue that the VAR analysis of Blanchard and Perotti tend to overestimate spending multipliers
- This is because the methodology does not distinguish between expected and unexpected changes in spending and fails in identification

Contentious issues: spending

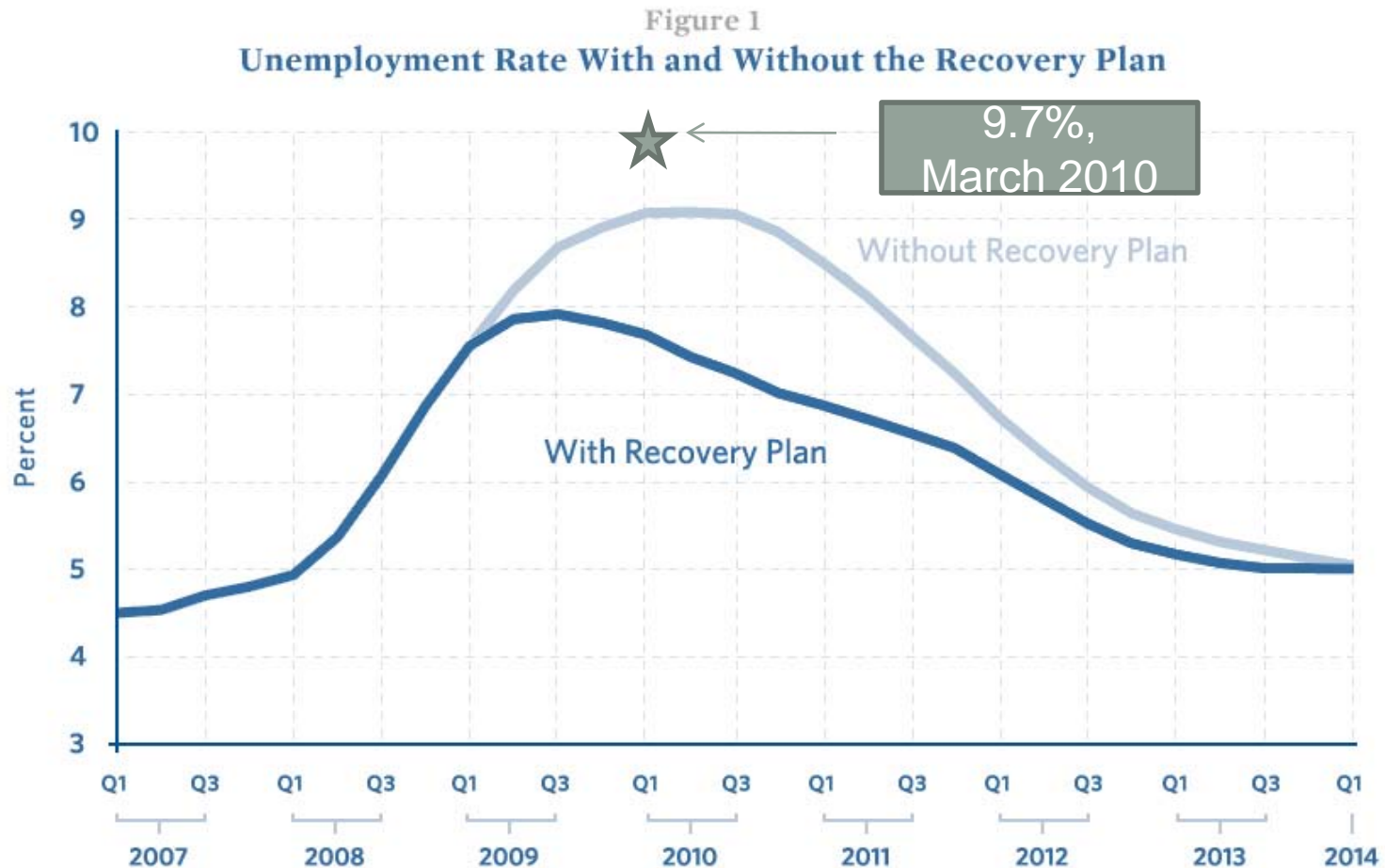
- Barro, Ramey et al uses military spending as source of exogenous episodes.
- Either a “narrative” approach or actual military spending
- Criticism: is there something special about war periods?
- Can we draw conclusion based upon a few years of major wars on everyday fiscal policy?

Administration estimates, Jan 2009

Figure 1
Unemployment Rate With and Without the Recovery Plan

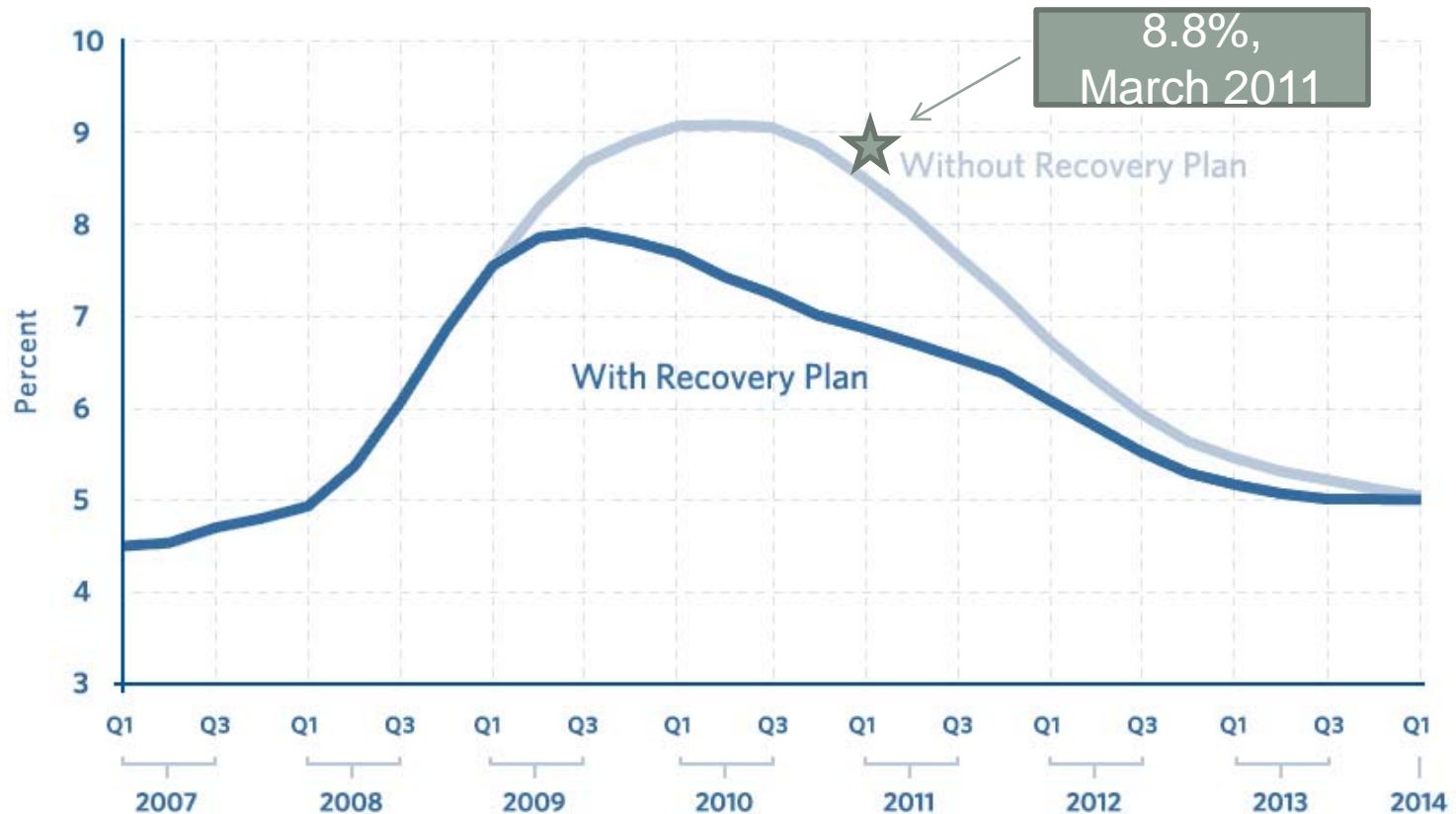


How has it worked out?



How has it worked out?

Figure 1
Unemployment Rate With and Without the Recovery Plan



Contentious issues: Taxes

- Are the Roemer and Romer multipliers “too large”?
- Most likely (recent work by Favero Giavazzi and Perotti)
- Probably smaller but they might be larger than spending multipliers. Why?
- Tax and spending multipliers can be very different in different countries and at different levels of debt (Giavazzi Favero)

Case studies of large fiscal adjustments

- Lively revival of a literature started by Giavazzi and Pagano and Alesina and Perotti in the early nineties about the possibility of expansionary fiscal adjustments.
- Recent papers by Weo, (2010) Alesina Ardagna,(2010) Perotti (2011), IMF volume (2011)

What are the issues?

- Are spending based adjustments less contractionary in the short run than tax based adjustments?
- Some fiscal adjustments have been expansionary even in the short run. Why? What is the channel?

My take

- Spending based adjustments in OECD economies with close to 50 per cent of G/Y are preferable and very likely to be less costly than tax based ones (This may not hold for developing countries)
- A large fiscal consolidation accompanied by appropriate policies (wage moderation, friendly monetary policy, stabilizing inflationary expectations) can be much less costly than we normally think not only in the medium run but also in the short run

Channels

- Interest rates reductions when deficits down. Today they are low (for some countries) but they could go up so the benchmark against which to evaluate fiscal adjustment today is what would happen with raising rates
- Wage effects from public sector wages
- Expected future taxes down if G goes down
- Distortionary cost of taxation

Channels

- Devaluation helps (It does not work today for Euro countries, but will help England)
- Confidence effects on investment, may be important for the US

My take

- There is no alternative to tightening of fiscal policy in many (but not all) OECD countries
- This does NOT mean that the entire world is tightening there is a developing world that can help world demand.

Conclusion

- The crisis was a shock that lead us to rethink and work harder on many policy issues which we thought we had solved.
- For the moment we have more questions than answers
- ..but the macro seminars are again full of students!