Monetary/Fiscal Mix and Agents’ Beliefs

This paper investigates the role of the fiscal/monetary policy mix in explaining the rise and fall of inflation. I make use of a DSGE model in which agents are aware of the possibility of regime changes in the monetary/fiscal policy mix in order to study the potential role of the lack of fiscal discipline in explaining the rise of inflation in the ’70s. The results will then be used to investigate the long-run consequences of the current crisis under different assumptions around what agents expect policy makers will do in the future. Most importantly, I will try to argue that important effects could arise simply from the uncertainty characterizing the behavior of policy makers. In other words, what agents believe is going to happen in the future has an impact on the economy today, independent of the realization of those beliefs. This is related to the core argument of the Fiscal Theory of Price Level (FTPL): Off equilibria behavior is what really matters.

The potential role of fiscal policy in explaining the rise of inflation in the ’70s has been highlighted by [Sims, 2009b] and [Cochrane, 1998], as well as by the current Fed chairman. In a 2003 speech ([Bernanke, 3 Feb 2003]), Bernanke claimed that the role of oil shocks in explaining the rise of inflation has probably been overvalued. In his opinion, a more important role has been played by the lack of fiscal discipline that characterized those years. The first goal of this project is to formally investigate the validity of this hypothesis. The PI plans to estimate a model in which both monetary and fiscal policy can change over time according to a Markov-switching process. Uncertainty around the behavior of policy makers is captured by the probability that agents assign to the different regimes.

Over the past two years the US economy has gone through one of the most severe recessions of its history, possibly the worst one since the Great Depression. In an attempt to mitigate the effects of the recession exceptional measures have been taken by the US Government and the Federal Reserve. The stimulus package has implied a substantial increase in government expenditure and the Federal Reserve has injected a significant amount of liquidity into the market and created an entire set of new tools to conduct monetary policy.
As a result of these important changes the debt-to-gdp ratio is expected to increase to levels that are comparable to the ones inherited after World War II. Furthermore, the relevant changes in the composition of the Fed’s balance sheet has induced some economists and practitioners to wonder if the Fed’s independence is at risk ([Sims, 2009a]). Taken together these facts have potentially important consequences for the Fed’s ability to control inflation. According to the FTPL, the monetary policy authority is able to control inflation only under the assumption that the fiscal authority is committed to move taxes and government expenditure in order to repay the debt. When this commitment is absent, monetary policy can have perverse and surprising effects.

References


