

Comments on

**Monetary and Fiscal Policy Switching**

by **Davig, Leeper and Chung**

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# The standard result with fixed policy regimes

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	Active Monetary Policy	Passive Monetary Policy
Active Fiscal Policy	<u>No equilibrium</u>	<u>Unique</u> <u>NON-RICARDIAN</u> <u>equilibrium</u>
Passive Fiscal Policy	<u>Unique</u> <u>RICARDIAN</u> <u>Equilibrium</u>	<u>Multiple Equilibria</u>

## In this paper:

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- Monetary and Fiscal policy rules are time varying
- Switch randomly between active and passive regimes
- Monetary policy is on average passive
- Fiscal policy is on average active

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- This setup results in a unique NON-RICARDIAN eq.
- Even in the AM-PF regime, fiscal shocks have effects on wealth
- This is not because agents rationality is bounded. Quite the opposite!

# Comments

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- A more general framework
- Exogenous switching assumption in policy

# 1. Independent policy switches

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- Main result generalizes to a model in which policy switches (as in reality) are not synchronized
- Unique determinate eq. even if (temporarily) MP and FP are both active or both passive!
- Important consequences for the historical interpretation of macro policies

## 2. A question

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- An important component of time variation in systematic policy is not exogenous
  - Learning
  - Political pressures etc...
- Modeling assumptions can have implications for the equilibrium

# A simple example

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- Simple endogenously time varying policy rules

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- Monetary policy rule

$$R_t = \alpha_0 + [\alpha_1 + \alpha_2 \cdot (\pi_t - \pi)] \cdot \pi_t + \varepsilon_t^{mp}$$

- Fiscal policy rule

$$\tau_t = \gamma_0 + [\gamma_1 + \gamma_2 \cdot (b_{t-1} - b)] \cdot b_{t-1} + \varepsilon_t^{fp}$$

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- Reaction to inflation and debt proportional to levels

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- When the economy is close to the steady state
  - MP is “passive”
  - FP is “active”
- However, if  $a_2$  and  $\gamma_2$  high enough



Unique RICARDIAN Equilibrium

# Conclusion

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- This paper forces us to think about
  - Monetary fiscal mix
  - How to model time variation in policy rules
  
- What we learn: intertemporal aspects of the monetary-fiscal interactions are crucial