

Policy Options for a Depressed Economy

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Federico Caffè Lectures 2014

Outline of the Lectures

- First Lecture:
 - a) What determines economic activity? Classical vs. Keynesian views
 - b) Policy options (I): Supply-side policies
- Second Lecture:
 - a) Policy options (II): Demand-side policies
 - b) Concluding remarks

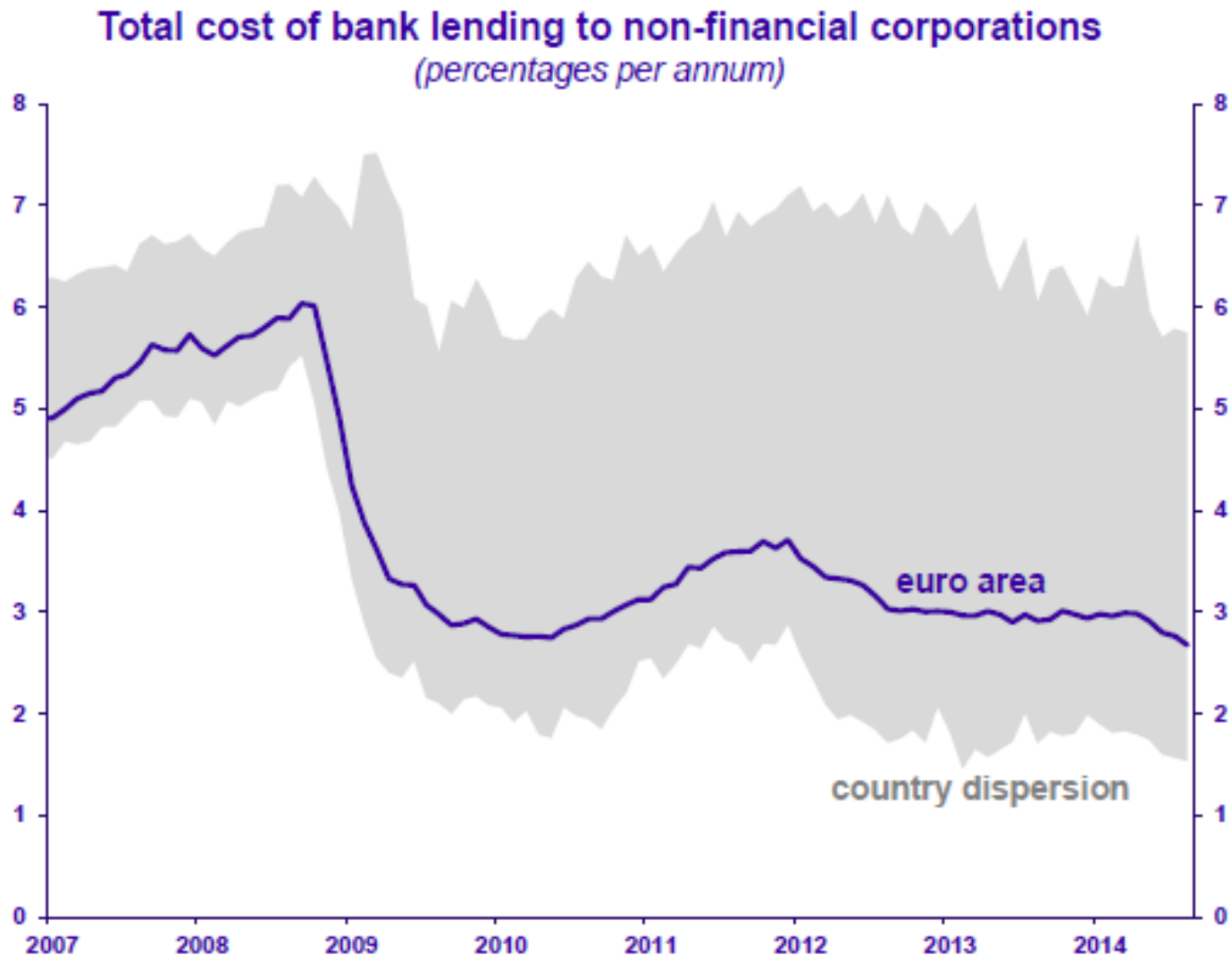
First Lecture: Key Ideas

- Both Classical and Keynesian models are taught and used in economics, but they represent radically different views about the determination of aggregate activity.
- In a Classical world, supply side policies are likely to be very effective in stimulating economic activity.
- In a Keynesian world, supply-side policies may fail to stimulate economic activity unless they are accompanied by sufficiently accommodating monetary policies.
- Monetary policy rules that make interest rates highly responsive to inflation in the face of supply-side stimuli are likely to make the latter more effective.
- Supply-side policies are likely to be the least effective in (small) countries that are part of a currency union (Galí-Monacelli 2014), or facing a binding zero lower bound constraint on the nominal interest rate (Eggertsson-Ferrero-Raffo 2014).

Policy Options (II): Demand-side Policies

- *Wanted*: a policy that stimulates output and employment *without*...
 - ...raising the debt/GDP ratio
 - ...relying on a reduction in the short-term nominal rate
 - ...generating "unacceptable" inflation or deflation
- Failure of existing policies
 - (i) Fiscal policy: consolidations still underway
 - (ii) Monetary policy: forward guidance, QE-type policies

Euro area: Limited effects of forward guidance on loan rates



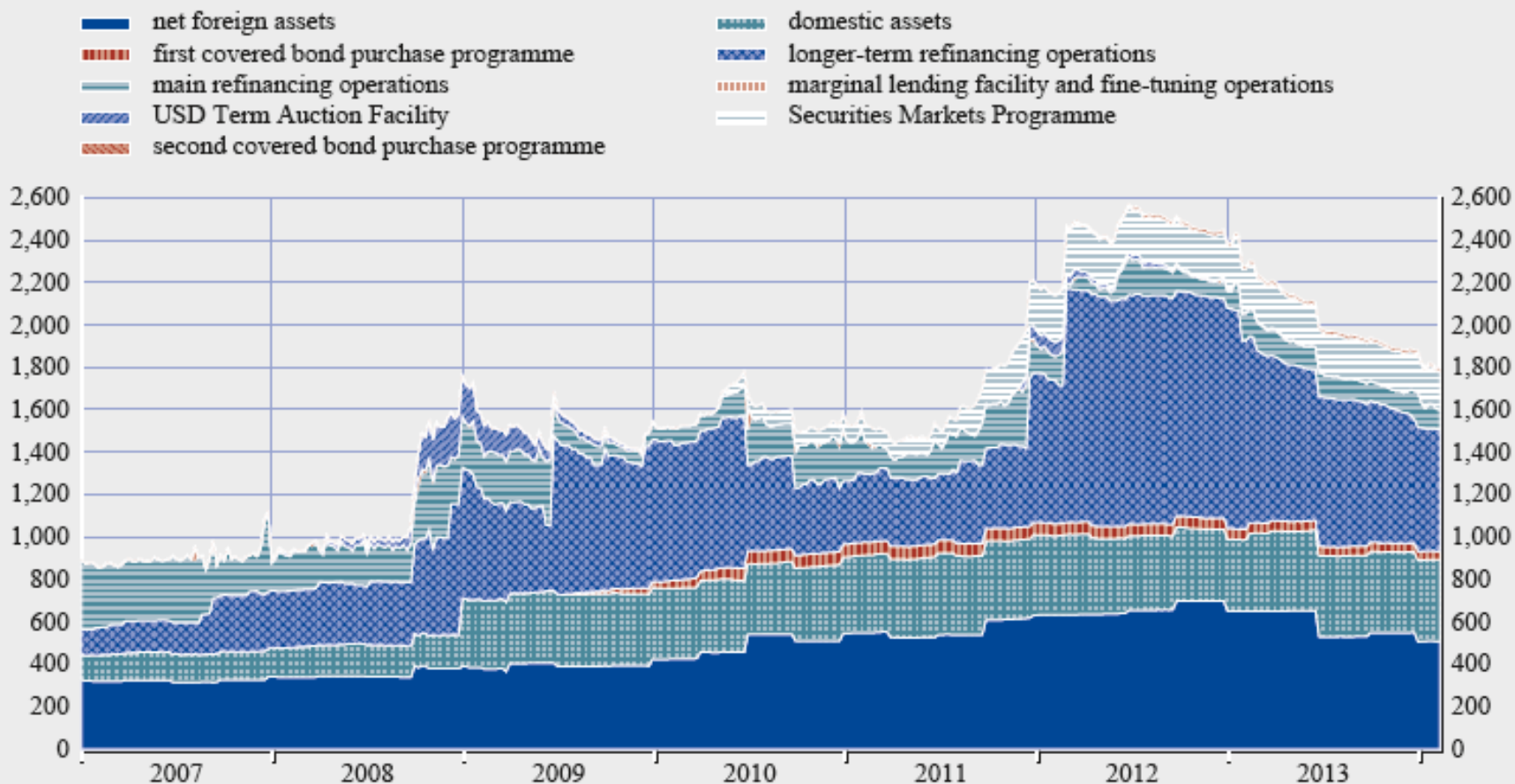
Source: ECB. Latest data: August 2014.

Notes: The country dispersion is calculated as min/max over 18 euro area countries. The indicator is calculated by aggregating short and long-term rates using a 24-month moving average of new business volumes.

ECB: A large increase in the balance sheet....

Chart A Simplified Eurosystem balance sheet: assets

(EUR billions)



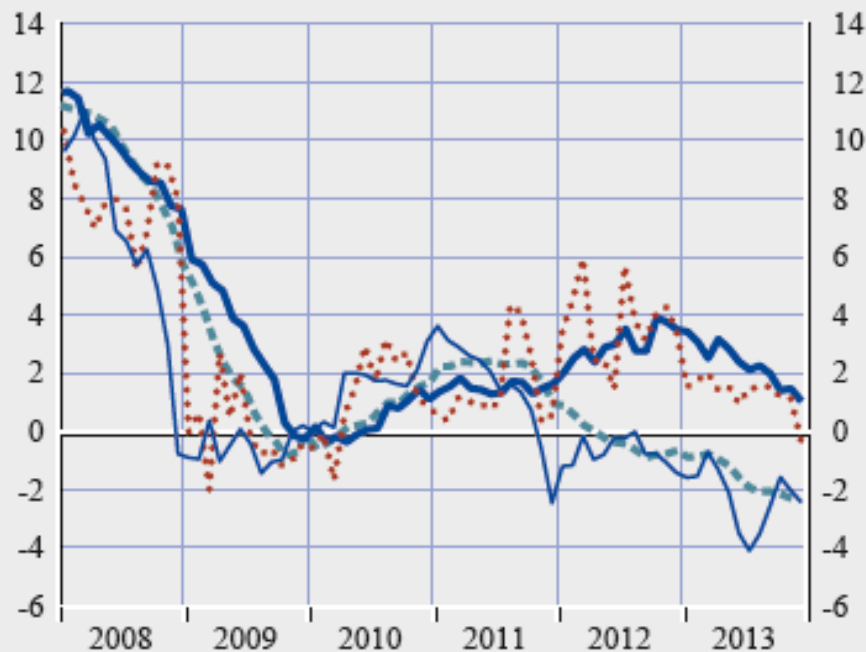
Source: ECB.

...but limited effects on M3 or credit

Chart 6 M3 and loans to the private sector

(annual percentage changes; adjusted for seasonal and calendar effects)

- M3 (annual growth rate)
- M3 (annualised three-month growth rate)
- loans to the private sector (annual growth rate)
- loans to the private sector (annualised three-month growth rate)



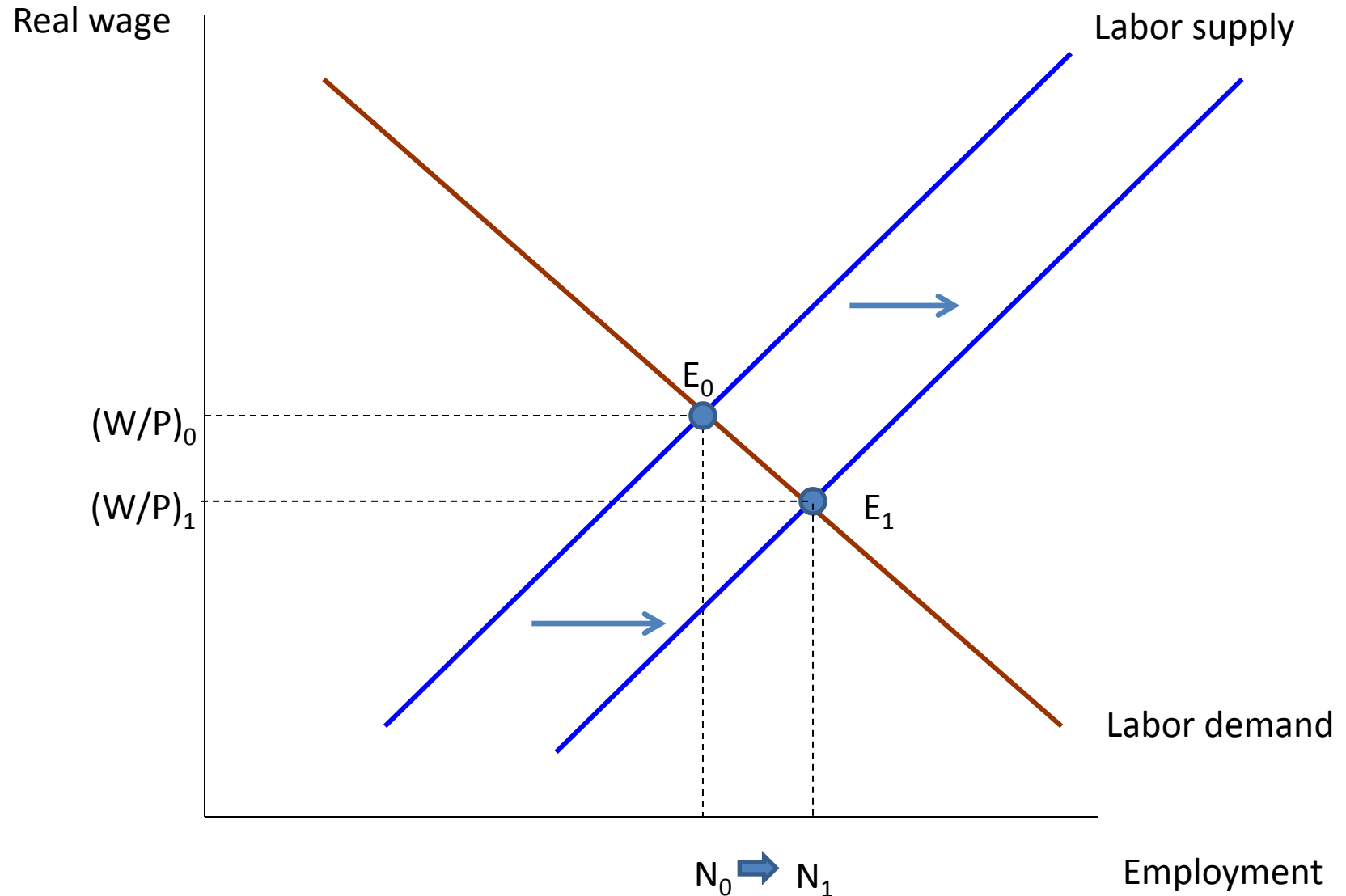
Source: ECB.

Policy Options (II): Demand-side Policies

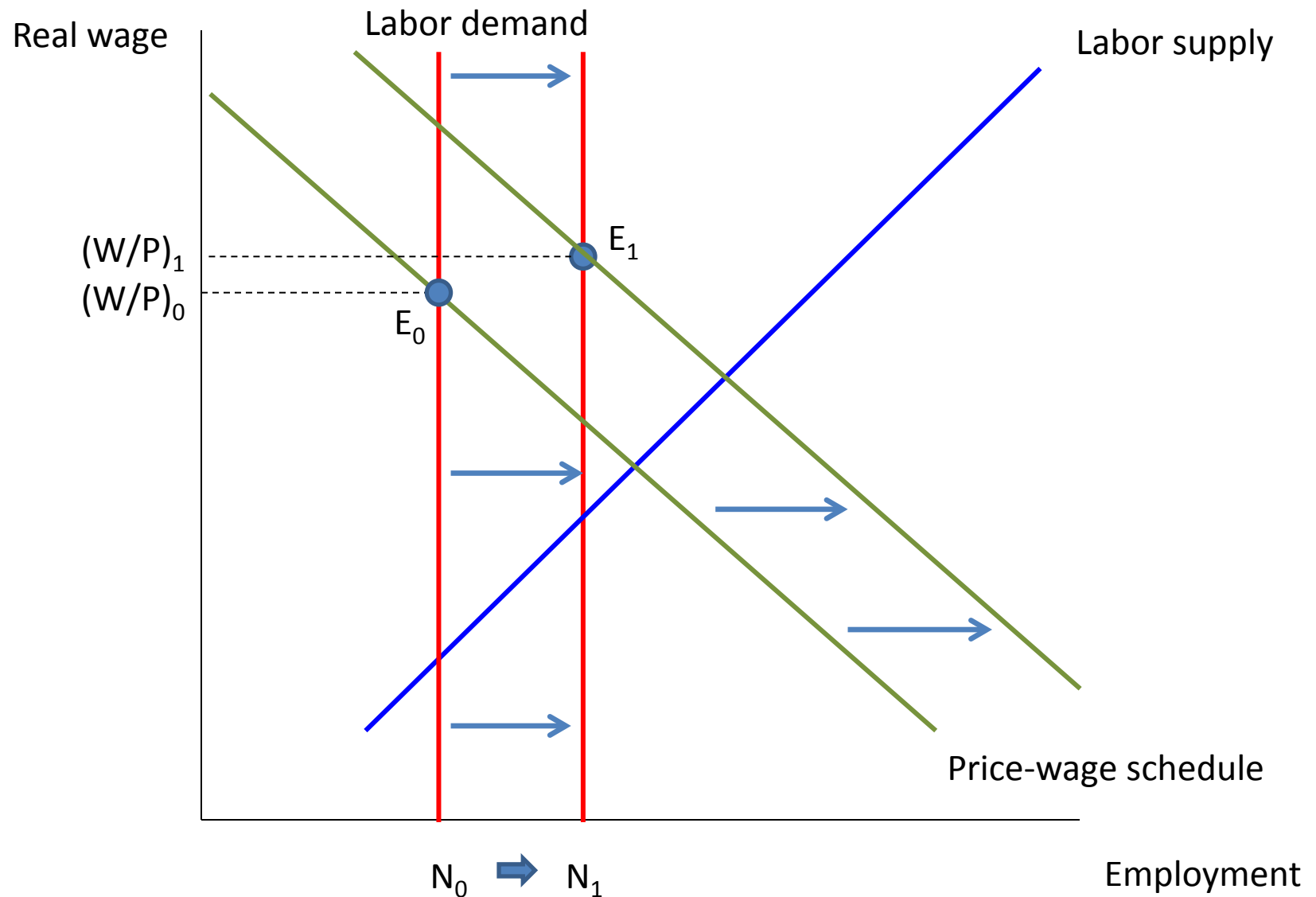
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- *Proposal*: An increase in government purchases financed entirely through money creation (Galí 2014)
- *Evaluation of its effects*:
 - (i) Classical vs. New Keynesian economies
 - (ii) Money vs. debt financing

"The prohibition of money financed deficits has gained within our political economy the status of a taboo, as a policy characterised not merely as [...] undesirable, but as something we should not even think about let alone propose." Lord Turner (2013)

The Effects of a Money-Financed Fiscal Stimulus: The Classical View



The Effects of a Money-Financed Fiscal Stimulus: The Keynesian View



A Monetary and Fiscal Framework

- Government purchases

$$\widehat{g}_t = \rho_g \widehat{g}_{t-1} + \varepsilon_t^g$$

where

$$\widehat{g}_t \equiv \frac{G_t - G}{Y}$$

- Two financing regimes:

(i) monetary-financing:

$$\frac{\Delta M_t}{P_t} = G_t - G$$

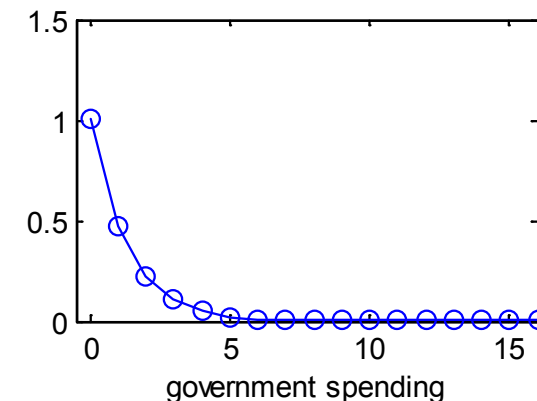
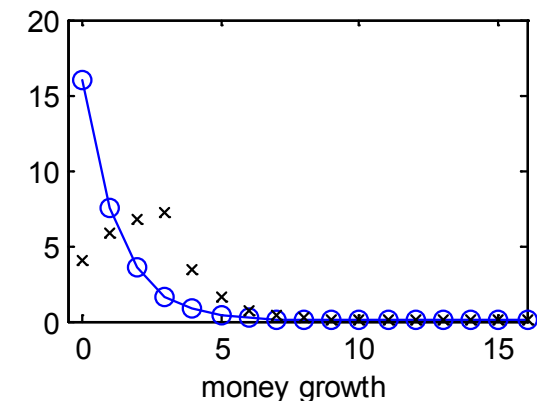
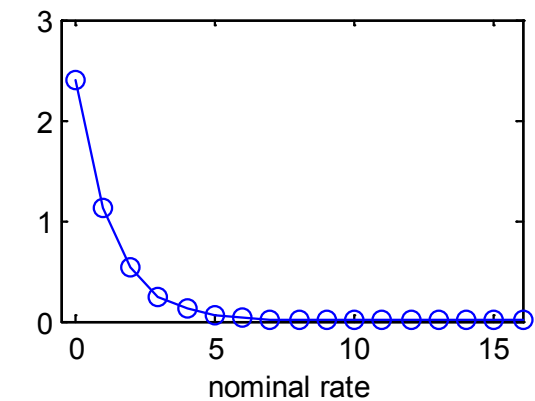
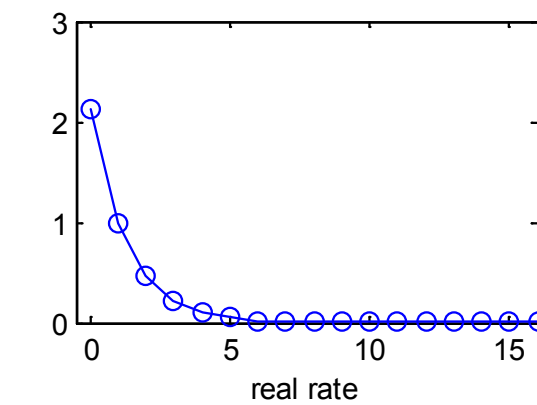
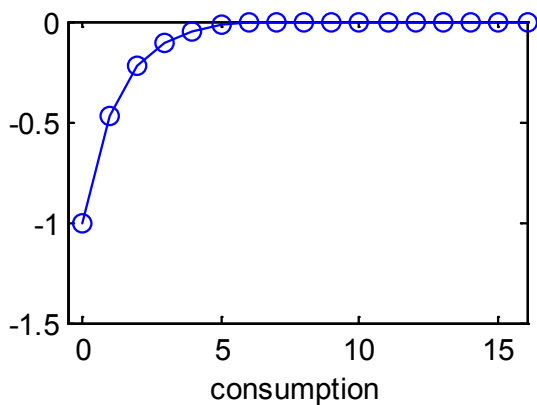
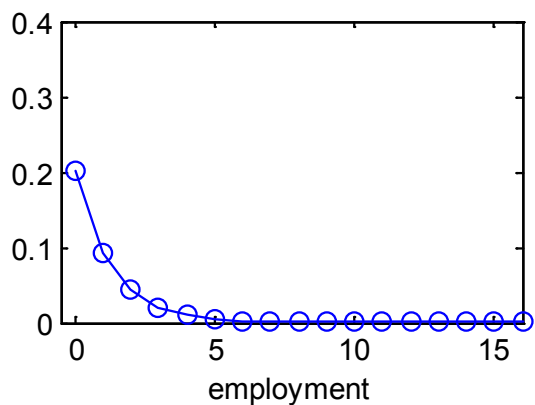
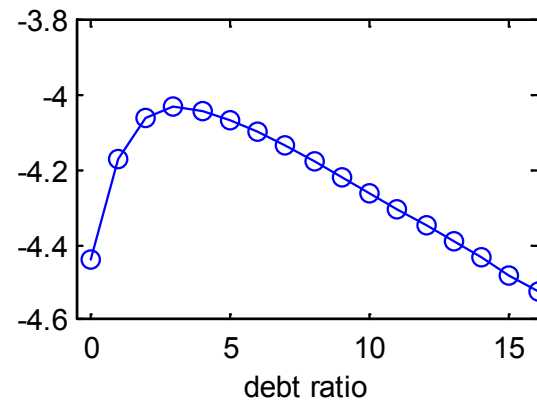
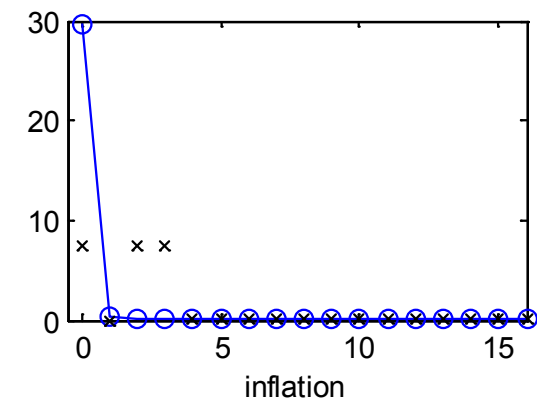
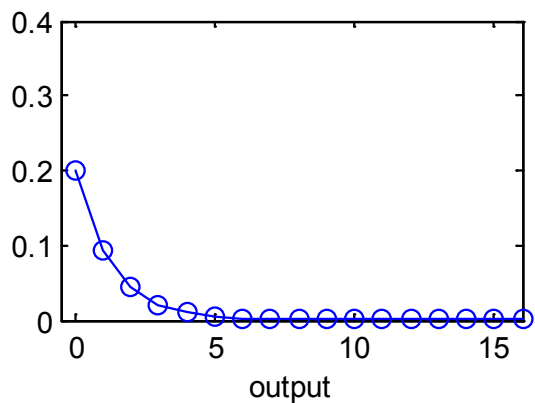
(ii) debt-financing:

$$\mathcal{B}_t^H = \mathcal{B}_{t-1}^H \mathcal{R}_{t-1} + G_t - T - \Delta M_t / P_t$$

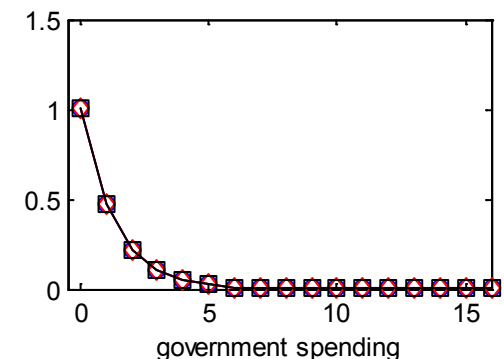
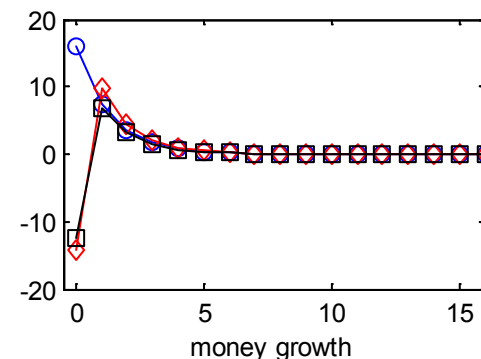
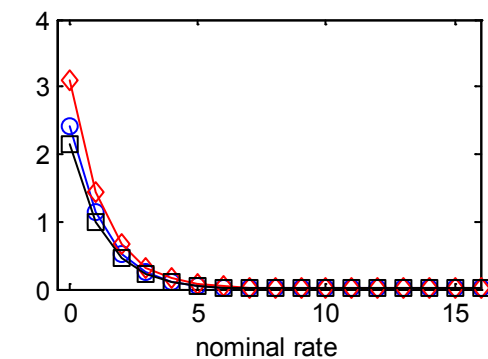
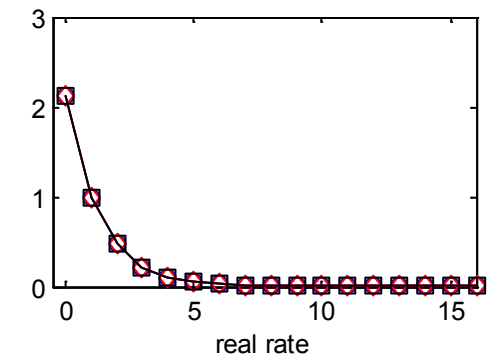
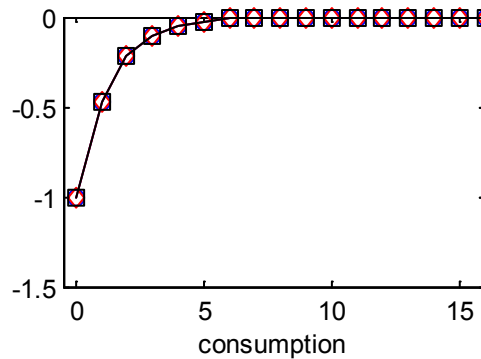
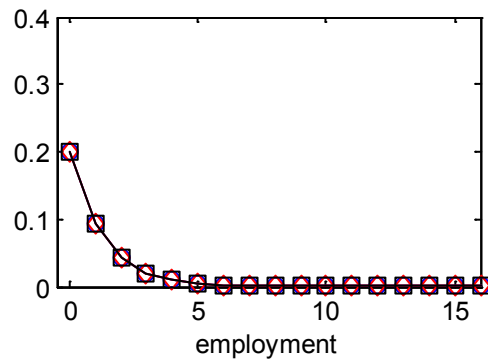
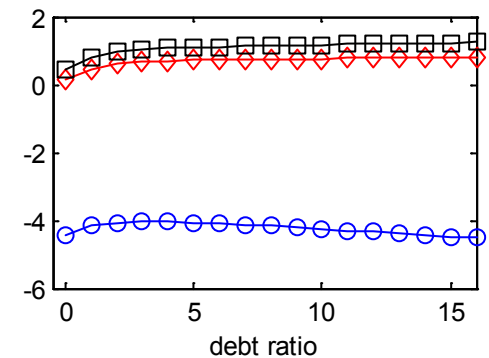
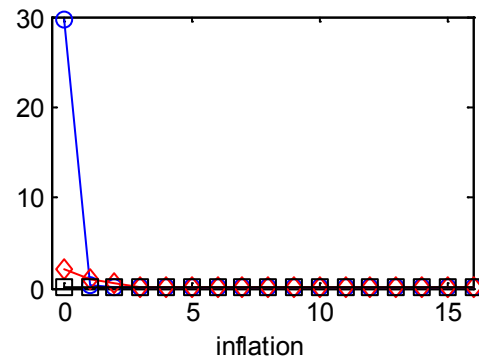
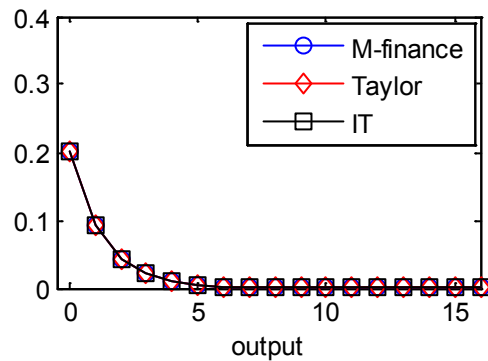
$$i_t = \rho + \phi_p \pi_t^p$$

where $\phi_p = 1.5$ ("Taylor") or $\phi_p = +\infty$ ("inflation targeting")

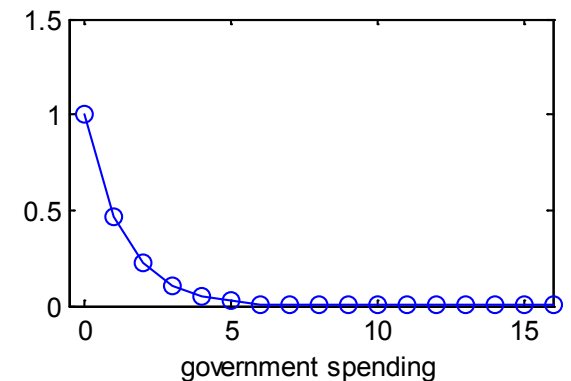
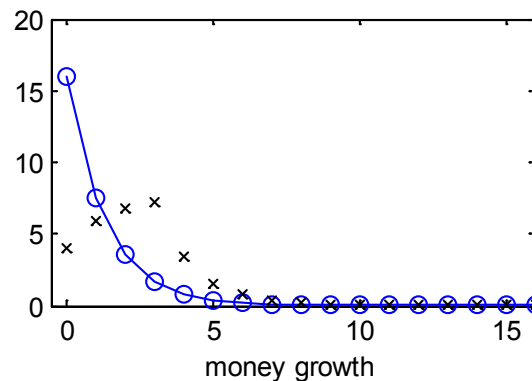
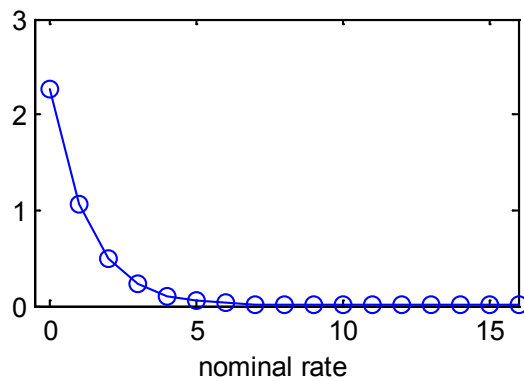
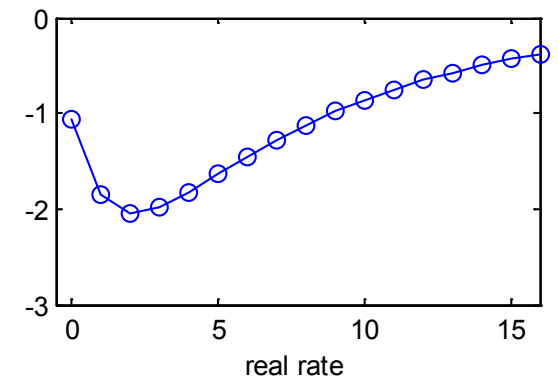
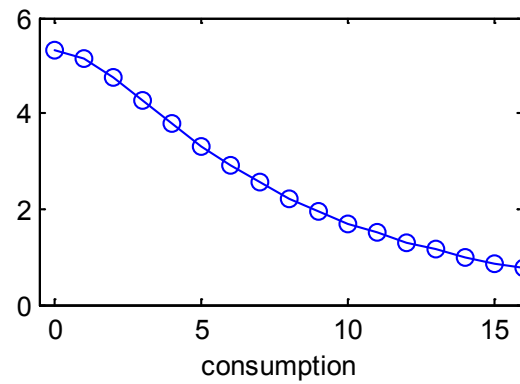
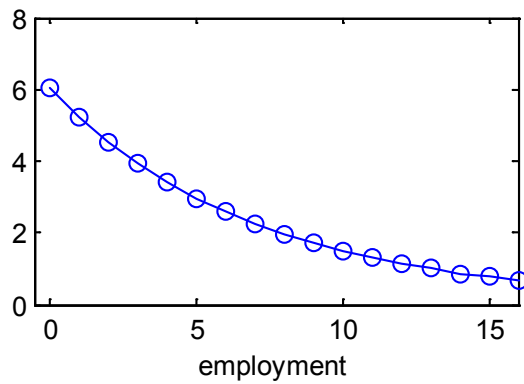
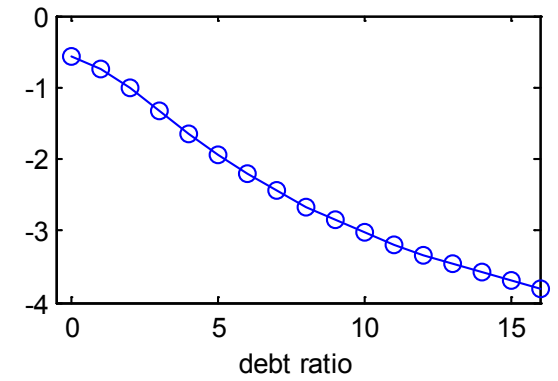
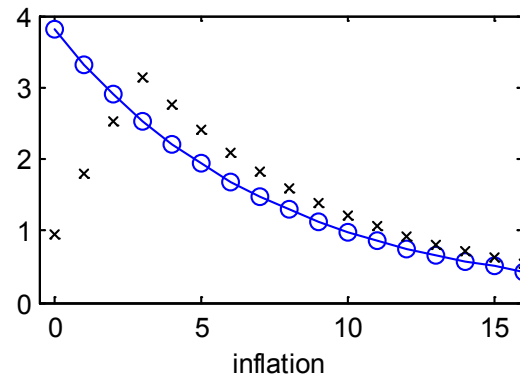
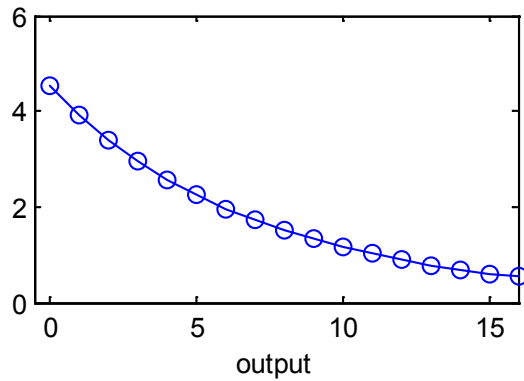
The Effects of a Money-Financed Fiscal Stimulus in a Classical Economy



The Effects of a Fiscal Stimulus in a Classical Economy: Money vs. Debt Financing

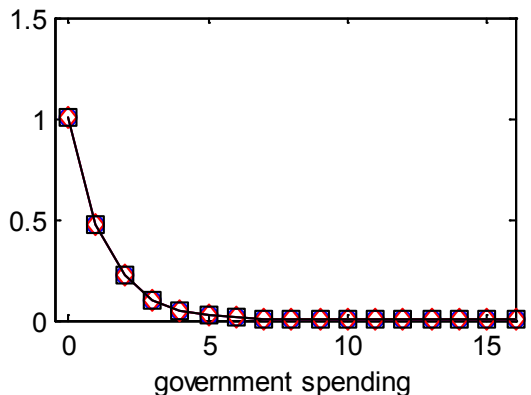
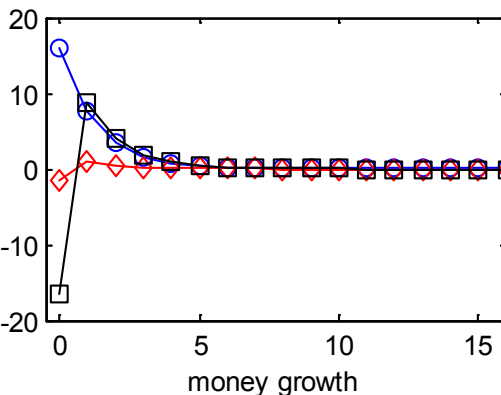
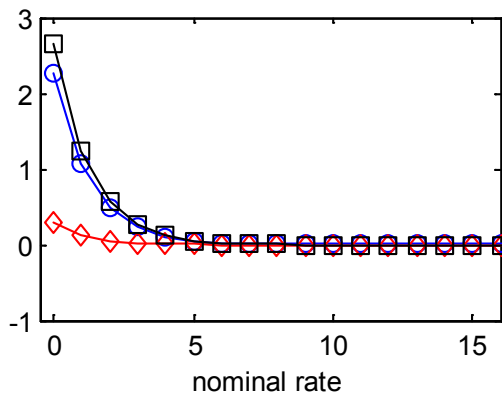
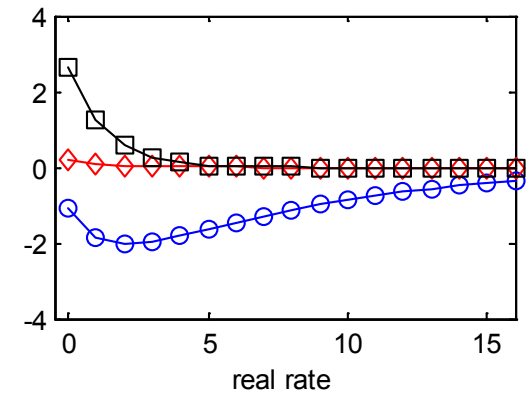
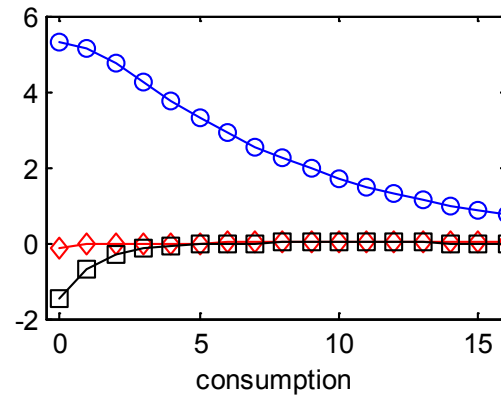
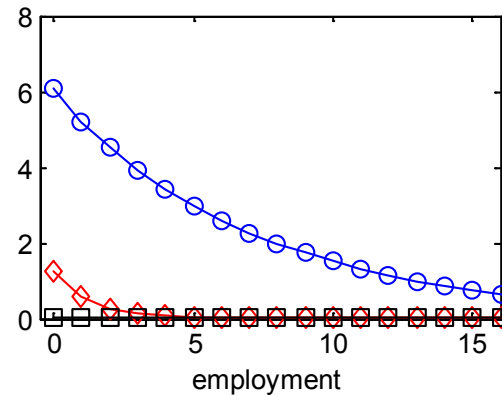
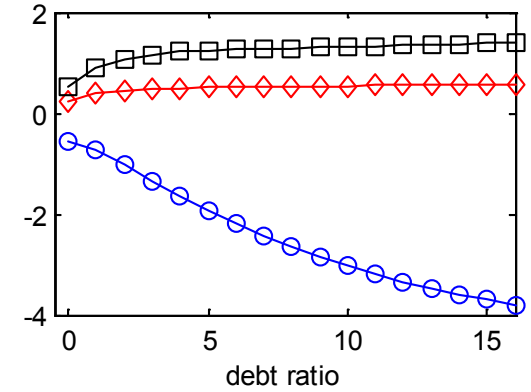
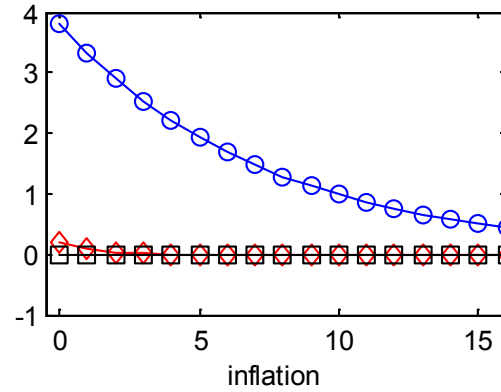
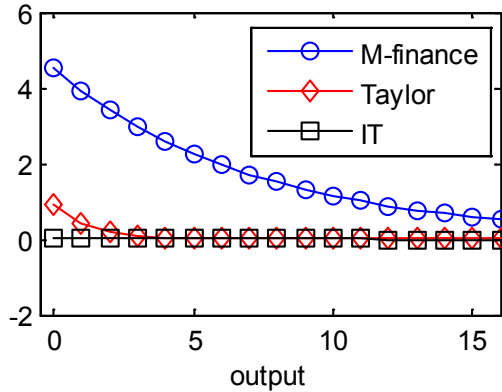


The Effects of a Money-Financed Fiscal Stimulus in a New Keynesian Economy

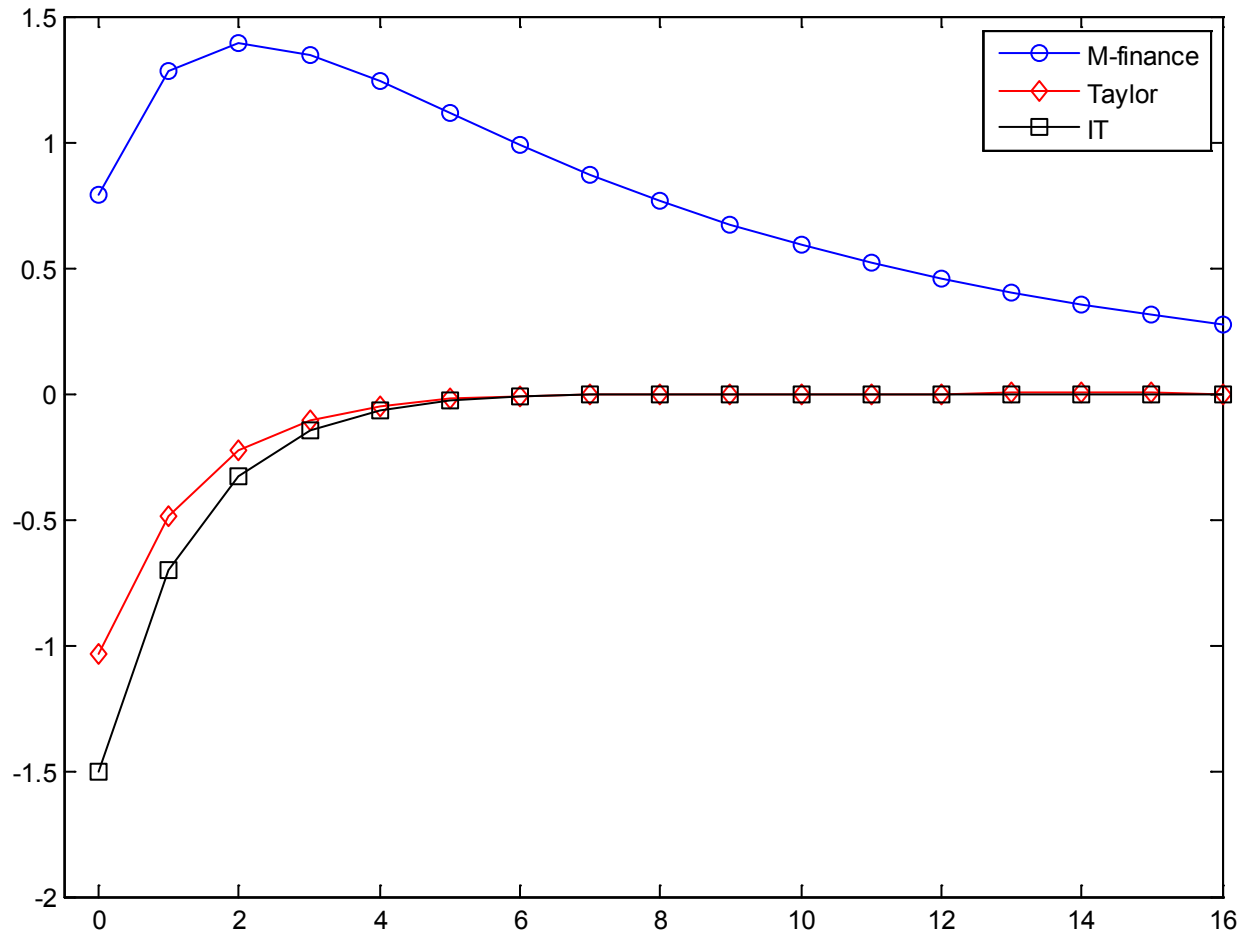


The Effects of a Fiscal Stimulus in a New Keynesian Economy

Money vs. Debt Financing



The Welfare Effects of a Fiscal Stimulus in a New Keynesian Economy



Second Lecture: Key Ideas

- Failure of ongoing policy responses to jumpstart the economy
- A proposal: A money-financed fiscal stimulus
- The effects of a money-financed fiscal stimulus: *highly model dependent*
- Classical model:
 - large frontloaded inflation
 - small output and employment effects
 - negative welfare impact
- New Keynesian model:
 - smooth price adjustment
 - large output and employment effects
 - likely positive welfare impact
- Key feature: "double boost" to aggregate demand: higher G and lower r
- Inflationary impact: not catastrophic

Thanks for your attention!