Discussion of "Monetary Policy and Fiscal Foresight"

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Monetary Policy and Fiscal Foresight

"Central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy."
[Mervyn A. King, 1995]

Summary of Paper

Addresses following question

- What are the implications for the monetary authority of news about future tax adjustments?
  - Optimal policy response
  - Welfare consequences

Summary of Paper

Basic Setup

- Standard New Keynesian model with forward-looking IS and AS equations
- Monetary authority minimizes standard quadratic loss function
- Main innovation: j-period delay between news and implementation of profit tax
- Further innovation: imperfect information on part of monetary authority

Summary of Paper

Procedure

- Derive optimal monetary policy
  - under discretion
  - under "timeless" commitment with full information
- Compute welfare consequences of presence of fiscal foresight
- Compare results with non-optimal policy rules (Taylor rules)
- Do same as before but assume monetary authority imperfectly informed about state of economy (private sector fully informed; MA's expectations updated using Kalman filter)
  - with inflation & taxes observable (output gap & technological productivity unobservable)
  - with inflation & technological productivity observable (output gap & taxes unobservable)

Summary of Paper

Key Results

- Full information (either discrete or "timeless" commitment)
  - Output gap decreases with news or realization of tax increase
  - Inflation rises with news or realization of tax increase
  - Interest rate increases with realization of tax increase but effect of news of tax increase ambiguous (more intuition would be useful here, e.g. why is effect unambiguous for realization of tax change but ambiguous for news - must be parameter-driven)
  - Taylor rules may make central bank respond to fiscal news in opposite way
  - Anticipated tax rate changes (slightly) costlier than unanticipated tax rate changes (variance of endogenous variables increases due to MA components)
  - Conditional on history of disturbances, anticipated tax rate changes welfare improving (agents have more information)
  - Upshot: fiscal foresight is irrelevant for monetary policy; policy independent of tax process

Summary of Paper

Key Results Cont'd

- Partial information
  - In absence of fiscal foresight, no effect
  - Responses of endogenous variables to realization of tax change same as under full information but responses to tax news differ
  - With fiscal foresight and taxes unobservable endogenous variables history dependent
    - interest rate serially correlated
    - welfare reducing

Comments

3 Key Observations

- Very useful exercise
- Central message not punchy enough
- Model too complex

Comments

Issues

- Assumption that $\widehat{\tau}_t = u^{\tau}_{t-j}$ with $u^{\tau} \sim N\left(0, \sigma^2_{\tau}\right)$ important:
  - problems with boundedness of τ?
  - implies tax changes are temporary
  - in fact: announced tax changes likely to be considered permanent $\Longrightarrow$ different responses
- Neglect of government expenditure questionable, particularly for welfare analysis
- In real world, large part of response to news about future taxes probably in non-Ricardian context
- Assumption that private agents have full information while monetary authority does not beggars belief

Comments

Some Confusion

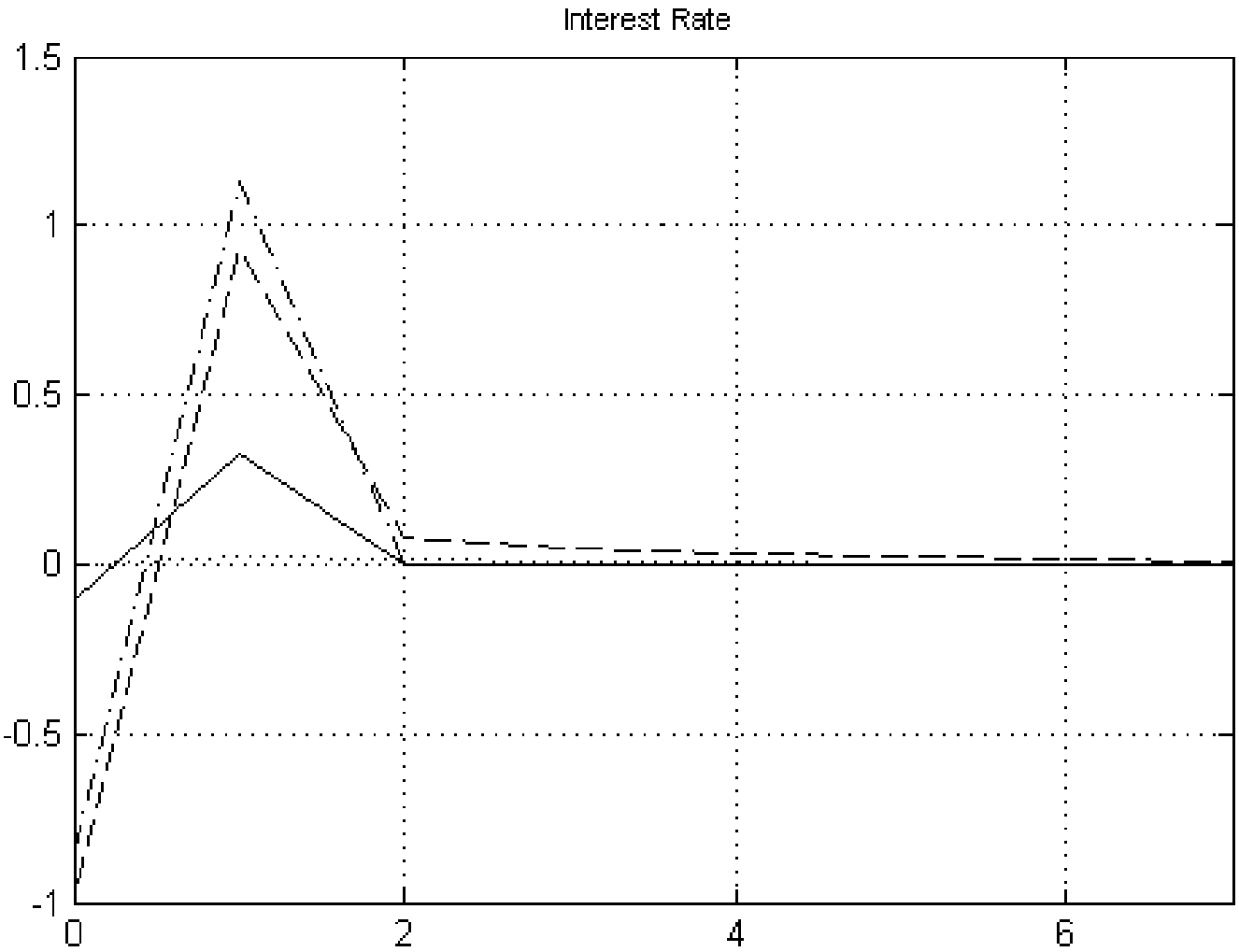
- Why asymmetry of welfare change in response to positive and negative tax shock? (Table 3)
- "Expected reductions in inflation can *dramatically* decrease the welfare losses."
  I can't see it. (Table 3)
- "With foresight, [Taylor rules] involve the monetary authority responding to fiscal news by moving the interest rate in the opposite direction from the response under the optimal monetary policy."
  Not for all Taylor rules. (Figure 2)
- "Interestingly, both unconditionally and conditionally welfare increases as the degree of fiscal foresight increases."
  I can't see it. (Table 3)

Comments

Loss Function Values (expressed as a percentage of steady state consumption)

	No Foresight		1 Period Foresight		4 Period Foresight	
	(+)	(-)	(+)	(-)	(+)	(-)
Discretion	0.05766	0.05766	0.05805	0.0572732	0.0588	0.05654
Timeless	0.0439	0.0439	0.04448	0.04386	0.04491	0.04382
Taylor Rule w/ $\hat{Y}_t$	0.07691	0.07691	0.07980	0.0742	0.0799	0.0739
Taylor Rule w/ $\hat{Y}_t - \hat{Y}_{t-1}$	0.076773	0.076773	0.07754	0.07606	0.07965	0.074085
Taylor Rule w/ $\hat{y}_t$	0.07643	0.07643	0.07718	0.07573	0.07915	0.07387

Comments



Conclusion

- Paper addresses relevant question
- Some interesting preliminary results
- More emphasis on intuition and basic story needed
- Rethink of tax process
- Simplify, please

Thank You.