RETHINKING THE ROLE OF FISCAL POLICY

Comments on Volker Wieland's and Paul de Grauwe's presentations

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INTRODUCTION

1. Two interesting and complementary papers with a surprising partial convergence:

- ***“Heterogeneity matters”***
  - ✓ “rule-of-thumb” versus “permanent income” households

    for Volker Wieland
  - ✓ “fundamentalists” versus” extrapolators” in the formation of output gap an inflation expectations

    for Paul De Grauwe

2. But major differences

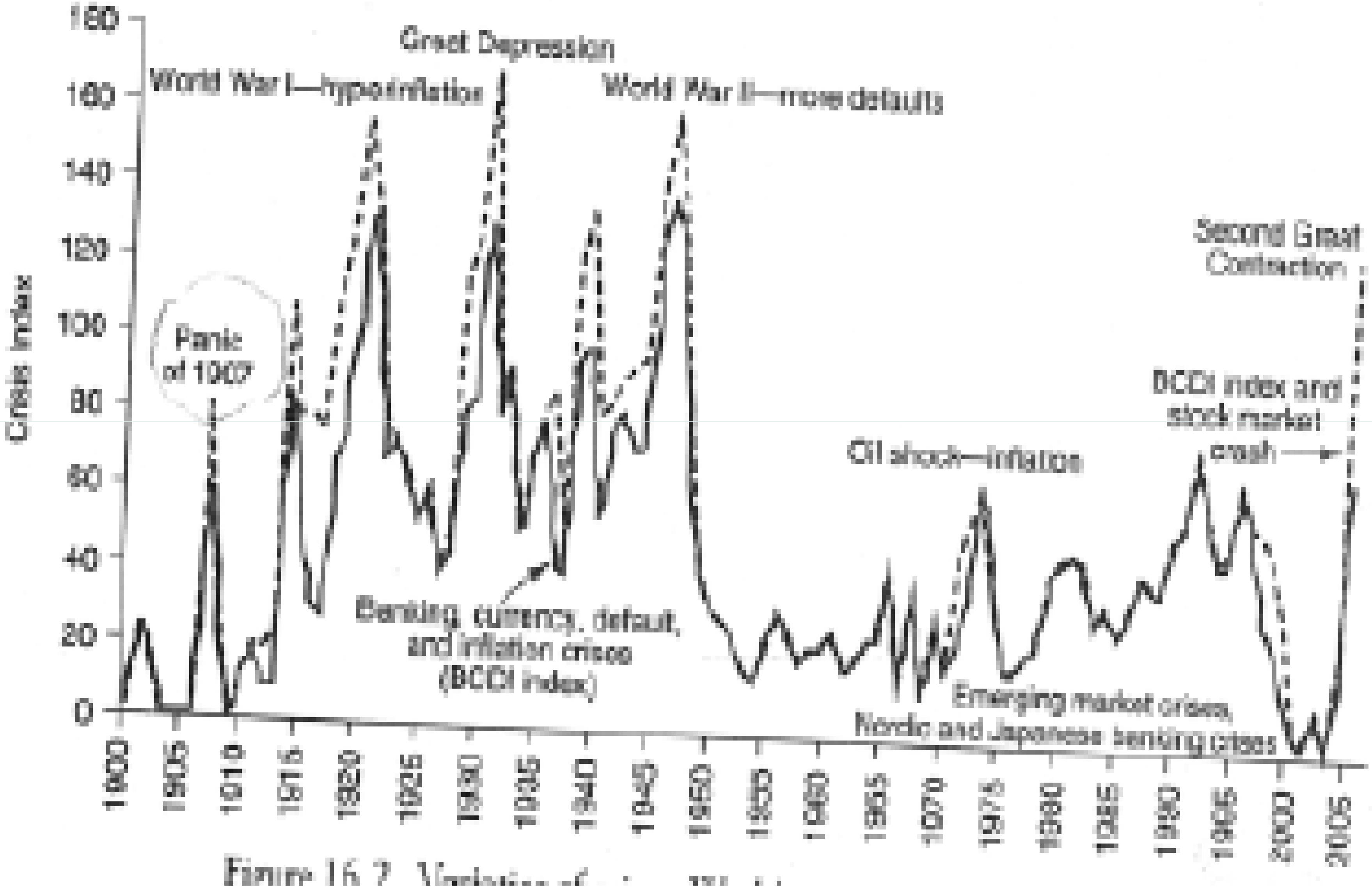
- *The agents are fully informed and therefore rational for VW …..*

  ….. but they adopt simple heuristics and learn from their mistakes for PDG

- *Cycles are generated by auto correlated exogenous shocks for VW…*

  ….by the learning process of agents that generates optimist and then pessimism expectations. For PDG

✓ The recurrence of bubbles and financial crises: a synthetic index

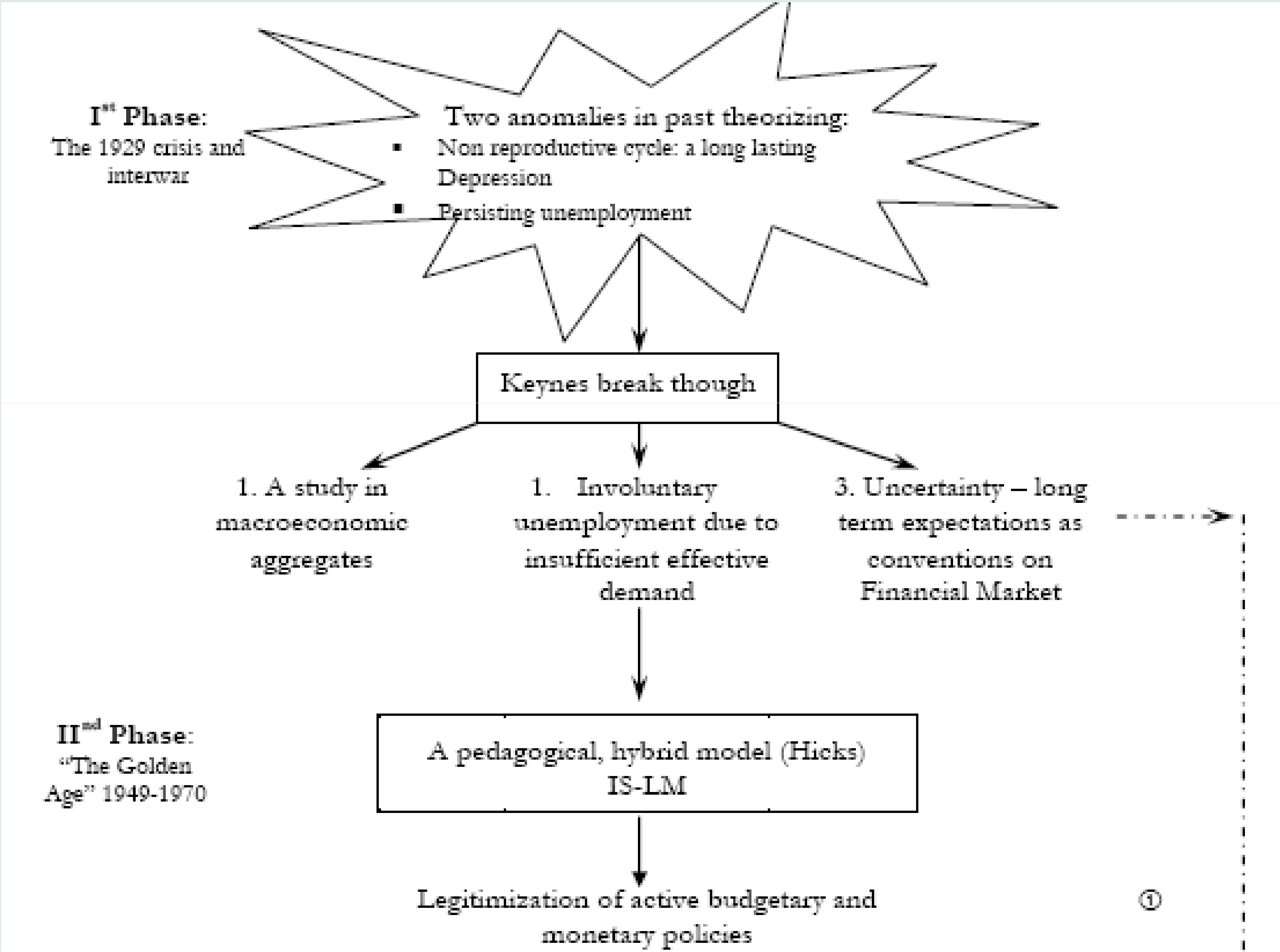


Source : C. M. Reinhart and K.S. Rogoff (2009), p. 253

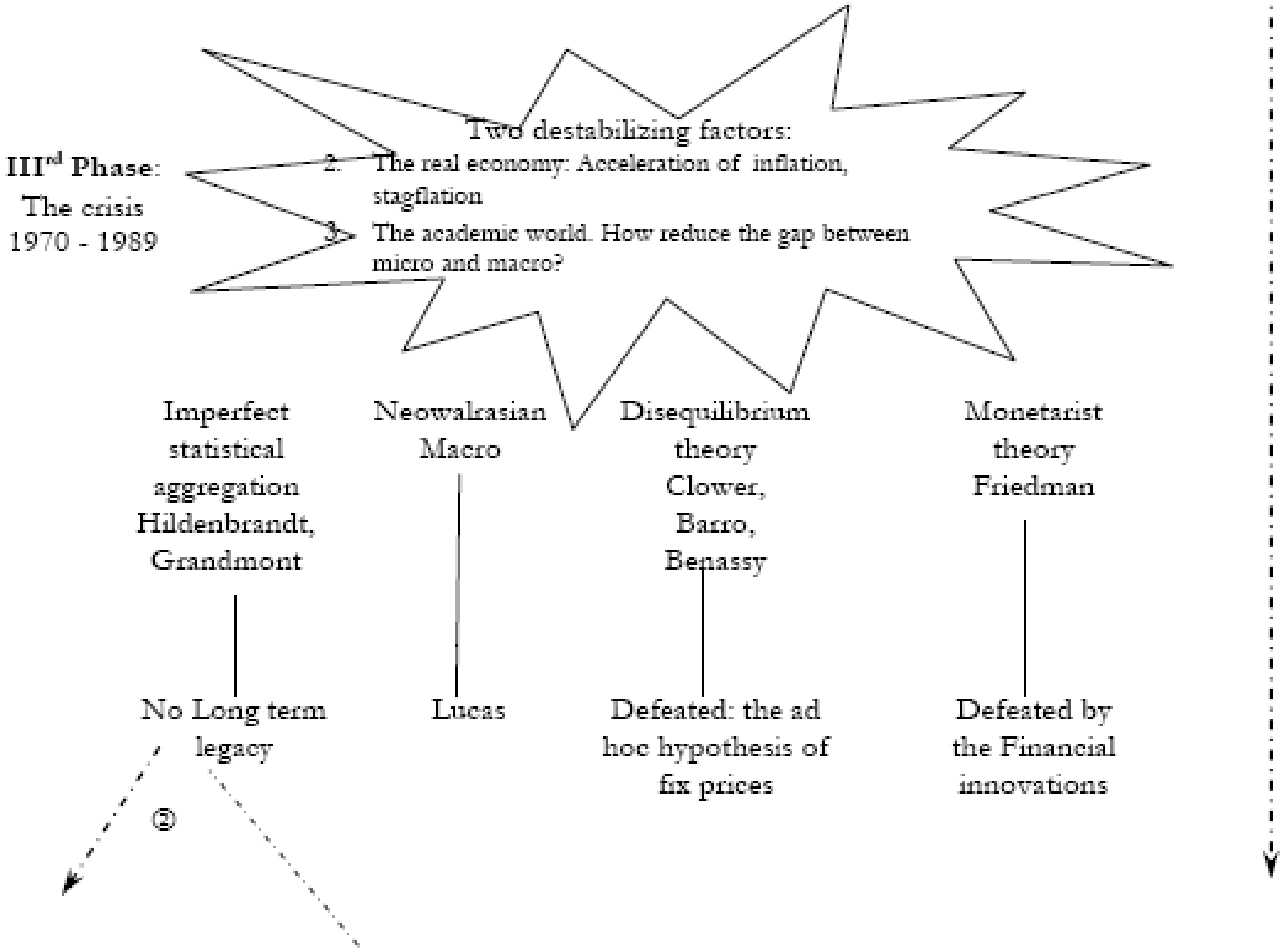
I. HOW DO THE TWO AUTHORS FIT INTO THE HALF CENTURY LONG HISTORY OF MACROECONOMIC THEORIES ?

1. A synoptic view of macroeconomic theory from the origins to present times

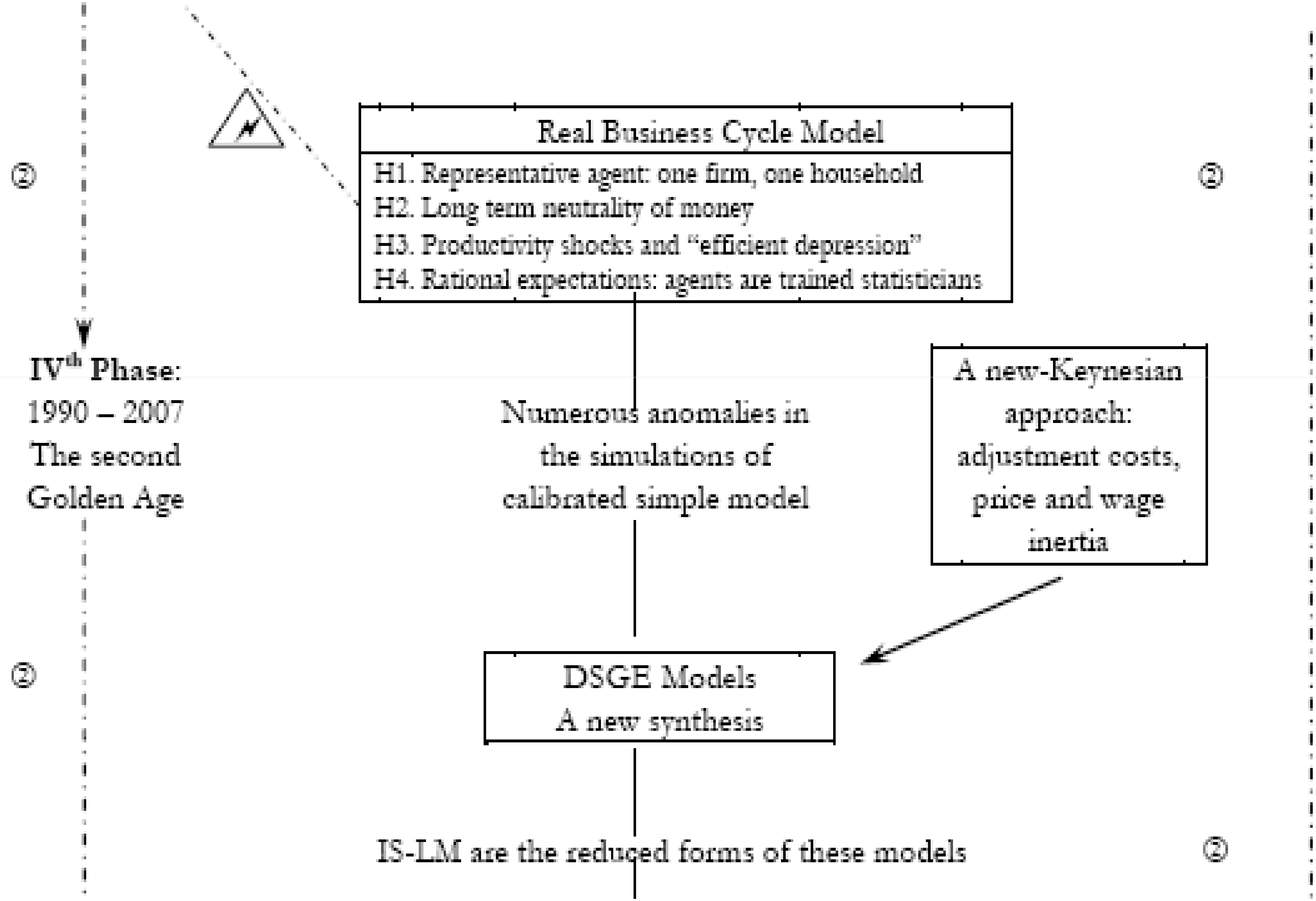
➢Keynesian invention of macroeconomics: a response to the anomaly of neoclassical theory facing 1929 crisis



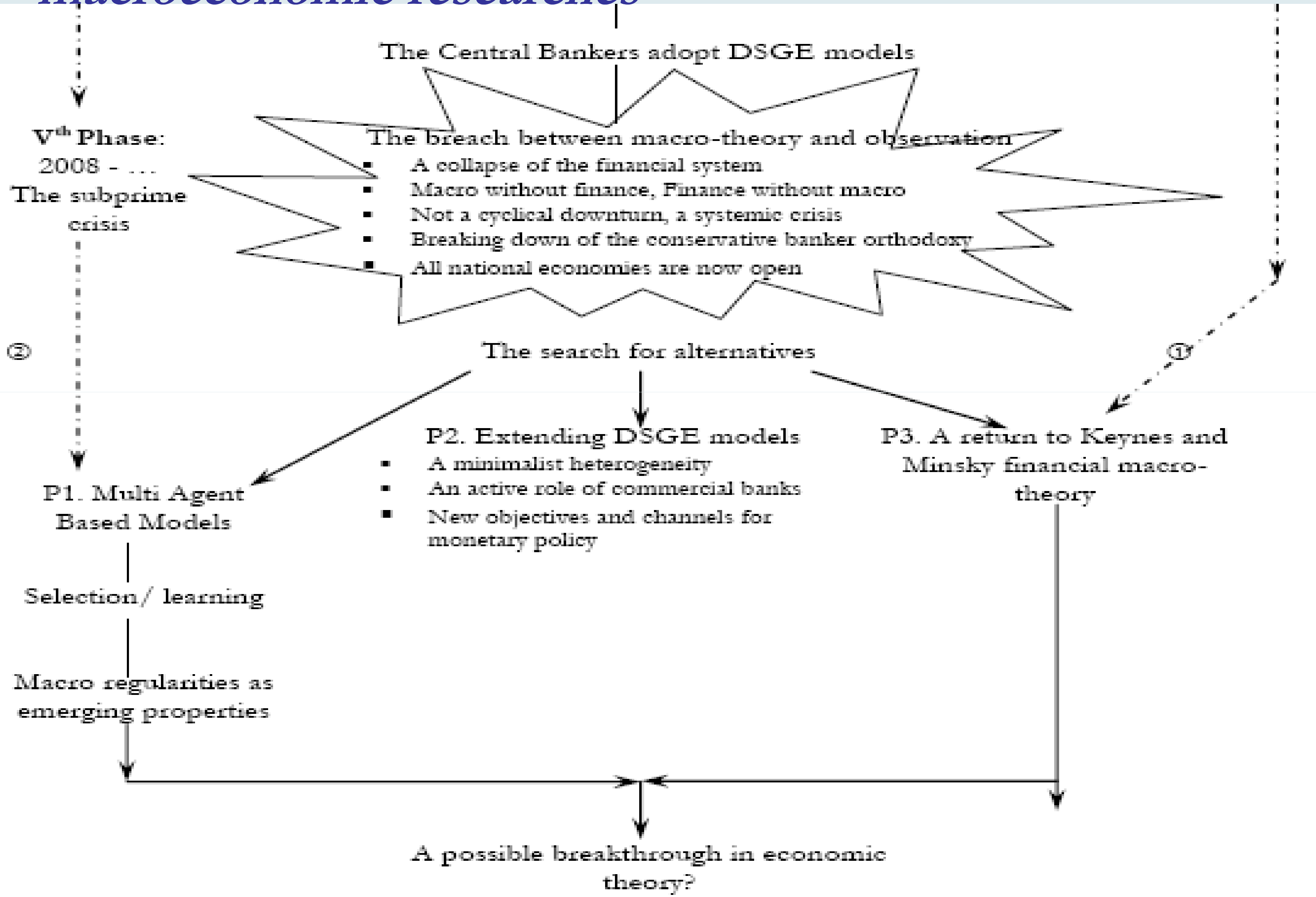
➢ *The two causes of Keynesian revolution demise*



➢ *After a trial and error process, the convergence towards a canonical model*



➢ *The irrelevance of past DSGE models opens new macroeconomic researches*



2. The two authors have different strategies

- ***Continuity*** ***of the DSGE research program in order to benefit from previous investments, competences and Central Bank support : VW***
- ***Need for new agent based macro modeling with heterogeneity and learning exhibiting "animal spirits" within a renewed keynesian approach***
- ***Do not major crises call for a paradigmatic shift: PDG might be right!***
- ***Given the organization and sociology of contemporary macroeconomists has not the DSGE program a definite advantage …however intellectually weak: VW has a point!***

II. THE IRRELEVANCE HAS BEEN WIDENING WITH THE NEO-WALRASIAN CONCEPTION EMBEDDED INTO RBC AND DSGE MODELS

- **From the failures of DSGE models to new research agenda**

DOMAIN	DSGE'S HYPOTHESIS	ALTERNATIVE
Agents	A representative agent	A1. Heterogeneous agents with different preferences, information, strategies → Multi agent based models
Rationality	Full substantive rationality with perfect information	A2. Limited / bounded rationality → Animal Spirits
Markets	Perfect with complete flexibility of prices, wage…	A3. Stickiness of prices, slow adjustments → New Keynesian DSGE
	(Implicitly) Complete future and spot markets	A4. Incomplete future markets imply Pareto inefficiency and possibly perverse dynamic → Overlapping generation models
Expectations	Rational about future market clearing prices	A5. Impossibility of rational expectations facing uncertainty - Experimental economies - Bayesian approach
Nature of shocks		

2. Recent extension of DSGE models in the domain of finance

Table 2 – Recent extensions of GSGE models: at last "Banks matter"

New hypothesis / Extension	Author (example)	Contribution to the understanding of crises
A representative *bank* uses household savings to borrow to entrepreneurs	Lawrence, Motto, and Rostagno (2007)	The Bank propagates monetary shocks ▪ The Fisher debt-deflation channel has a significant role in the impact of financial accelerator ▪ A *financial shock* moves consumption and investment procyclically
▪ The *balance sheet of banks* affects the propagation of shocks ▪ Shocks associated with the distress of financial markets	Césaire Meh and Kevin Moran (2008)	Well capitalized banks help the resilience of economies facing adverse shocks
Asymmetric information and difficult risk assessment lead banks to charge a spread over risk free rates	Fiorella De Fiore, Oreste Tristano (2009)	▪ The spread affects the level of activity and is endogenous ▪ Monetary policy can correct adverse impacts of financial markets imperfections
▪ Agent heterogeneity of households and banks, liquidity, endogenous default ▪ Cash in advance constraints	Goodhart, Osorio, Tsomocos (2009)	▪ Heterogeneity is essential for the welfare effects of shocks ▪ Interest determined the credit and money markets
Banks provide liquidity to firms and households select projects and use leverage	Ignazio Angeloni, And Ester Faia (2009)	▪ Transmission of shocks essentially via banks ▪ Optimal policy mixes anti-cyclical capital ratios and a monetary policy "learning-against-the-wind"
Monetary policy affects risk taking by financial intermediary, for a given regulatory system	Simon Dubecq, Benoît Mojon, Xavier Ragot (2010)	Underestimation of risk and high leverage due to regulatory arbitrage in the US 2000-2007
Role of balance sheet as an instrument of Monetary Policy	Vasco Cindria, Michael Woodford (2010)	Targeted asset purchases by the Central Bank improve welfare when the zero interest rate is reached but "quantitative easing" is inefficient

III. COMMENTS ON VOLKER WIELAND'S PAPER…

1. An original contribution

- *VW organizes a rigorous comparison of a large sample of DSGE models*
- *The tentative to reduce model uncertainty in the formation of economic policy*
- *He proposes various extensions of these models to cope with the crisis*
- *A Discussion about the impact of post 2008 stimulus plans*

…VOLKER WIELAND'S PAPER (2)

2. **More puzzling questions than definite and convincing solutions**

   - ***The multipliers of a fiscal stimulus range from negative to 1.6 from a new Keynesian DSGE to a Keynesian Model : how should the governments decide?***

   - ***The great 2009 recession cannot be generated by any of these models and they better fit for the recovery but it is simply a return to the mean !***

- *Are the multipliers the same during booms and crises with credit constraints, fire sales of assets and radical uncertainty? Giancarlo Corsetti 's contribution shows a huge difference.*

- *"Rule of the thumb" households might not be irrational but simply unemployed (see Xavier Ragot's contribution) without insurance nor access to credit*

- *The methodology of model comparison does not dig the theoretical issue of the various mechanisms able to generate booms and crises*

- *"The same size for all": does economy of Chile belongs to the same regime as the United States? Willi Semmler's argument: various regimes may prevail*

- ***Are the multipliers the same during booms and crises with credit constraints, fire sales of assets and radical uncertainty ? Giancarlo Corsetti's contribution shows a huge difference.***

- ***What is the interest of DGSE if finally all its basic hypotheses are removed because they are false and do not generate the observed business cycle (finance matters, beliefs replace rational expectations and agents do not optimize any more)***

- ***My suggestion: go directly to the point and develop PDG type approach!***

IV. COMMENTS ON PAUL DE GRAUWE'S PAPER…

1. The contribution

- *A relatively parsimonious model of endogenous cycles*
- *A minimalist heterogeneity of anticipations that have some relations with some really existing agents*
- *A nice and simple measure of "animal spirits"*
- *A renewed Keynesian spirit (beauties contests on financial markets)*

….COMMENTS ON PAUL DE GRAUWE'S PAPER (2)

2. The questions

- ***Is the Taylor rule mechanism explaining the reversal from boom to recession…***
- ***.. Or is it linked to the limits of optimism and conversely pessimism***
- ***Why not finance? Are expectations leading finance od conversely?***
- ***Is there a single regime or several?***
- ***How to justify "ad hoc" hypothesis: calibration, econometric tests***
- ***What about fiscal policy? Timing matters and this confirms Willi Semmler and Giancarlo Corsetti***

V. CHOOSING AMONG ALTERNATIVE STRATEGIES

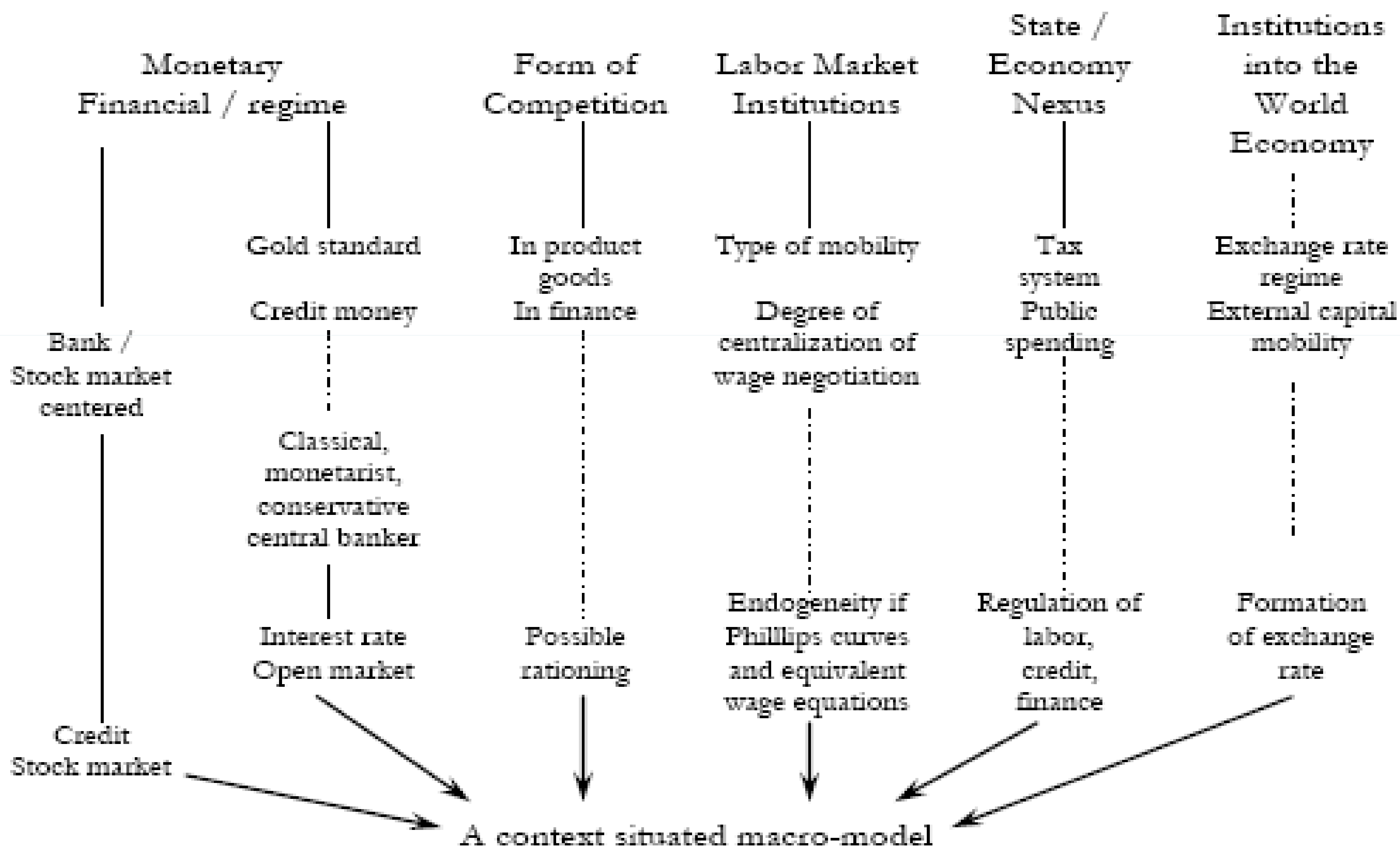
1. Extending DSGE models : continuity and use of competences but this does not overcome the original sin of walrasian core hypotheses

2. Agent based models : a bottom up emergence of macro regularities but seemingly ad hoc

3. Non linear dynamic models with endogenous crises: others tools and complex

4. Detecting generic mechanisms (positive and negative feedbacks) and empirically investigate which of them are dominant in a given context

5. An institutionally grounded macro modeling



VI. THESE EXTENSIONS UNDERESTIMATE THAT THE PRESENT CRISIS LARGELY ORIGINATED FROM A CLUSTER OF FINANCIAL INNOVATIONS WITH A LARGE DESTABILIZING ROLE AT THE MACRO LEVEL

Figure – Growth of Assets of Four Sectors in the United States (March 1954 = 1) (Log scale) (source: Federal

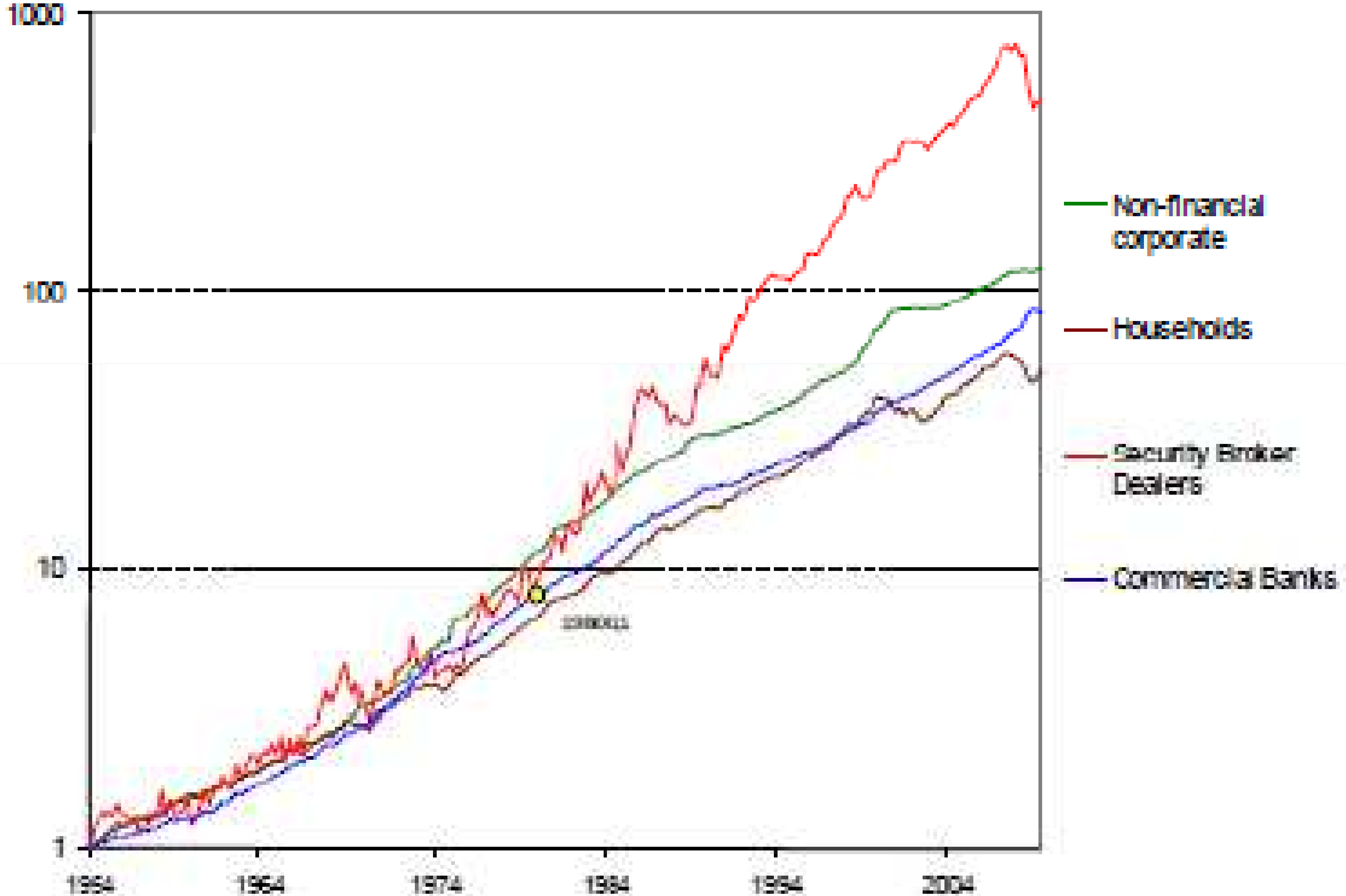
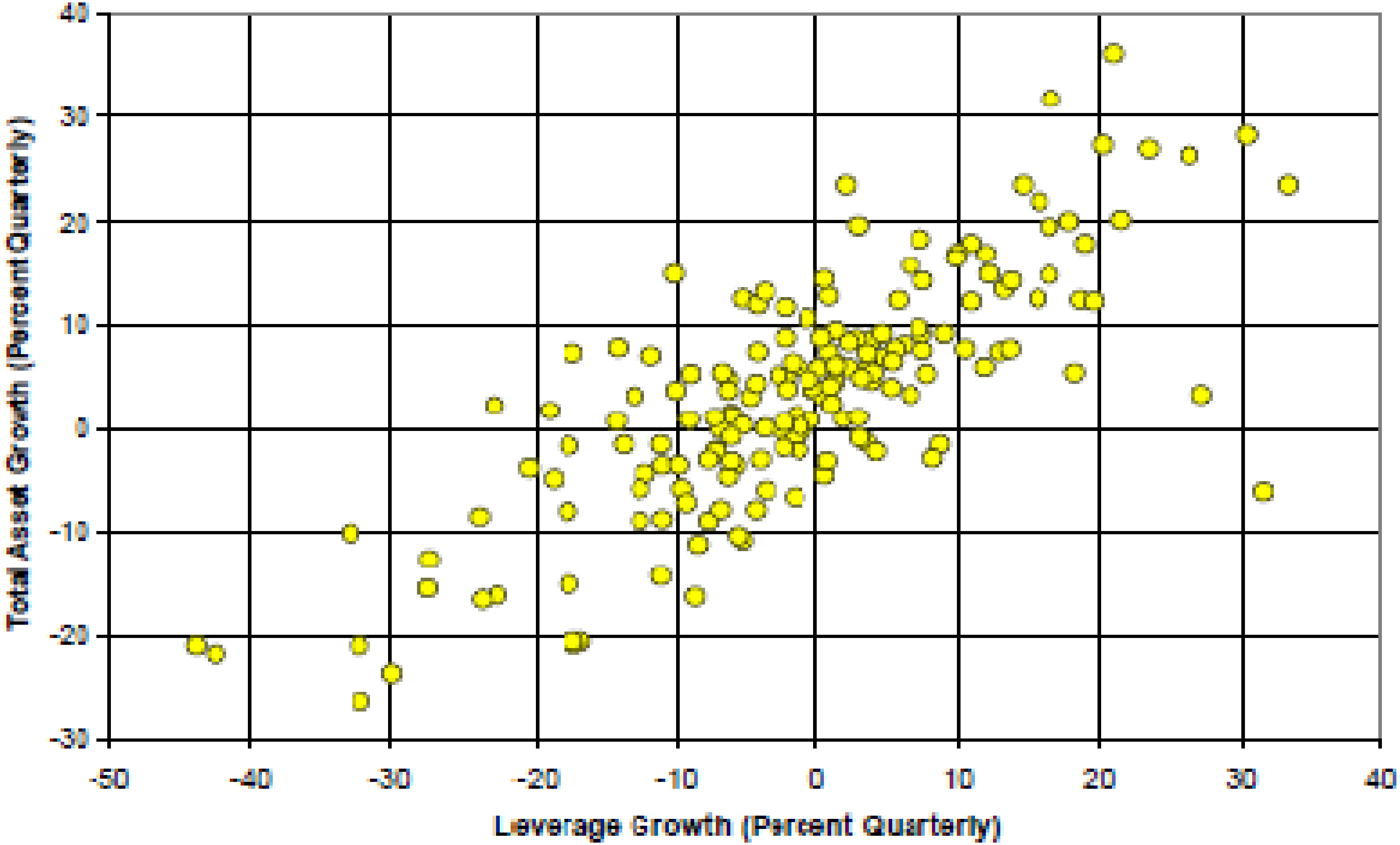


Figure – Broker Dealer Sector Leverage and Total Assets (Source: U.S. Flow of Funds, Federal Reserve, 1963-2007)



Source: Tobias Adrian, and Hyun Song Shin (2010), The Changing Nature of Financial Intermediation and the Financial Crisis of 2007-2008, Staff Report n° 439, Federal Reserve Bank of New York, March-April., p. 6-10 et 11.

Thanks for your attention and patience

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Fellow 2010-2011

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