Discussion of ”A Fiscal Theory of Trend Inflation” by F. Bianchi, R. Faccini & L. Melosi

Christian Matthes

Surrey Workshop on Macroeconomics

What are the Effects of the Conduct of Fiscal Policy on Inflation?

- Traditional approach (Leeper/Sims): It depends on whether fiscal policy stabilizes debt (*Monetary-led policy mix*) or monetary policy has to adjust to stabilize government debt (*Fiscally-led policy mix*)
- Narratives of US economic outcomes in that tradition assume changes in policy rules over time (Davig & Leeper, Bianchi & Ilut)

What are the Effects of the Conduct of Fiscal Policy on Inflation?

- Traditional approach (Leeper/Sims): It depends on whether fiscal policy stabilizes debt (*Monetary-led policy mix*) or monetary policy has to adjust to stabilize government debt (*Fiscally-led policy mix*)
- Narratives of US economic outcomes in that tradition assume changes in policy rules over time (Davig & Leeper, Bianchi & Ilut)
- **This paper:** What if monetary & fiscal policy react to some shocks as if they were in one regime, and according to the second regime otherwise?
- Embedded in a TANK model

How should we think about this paper?

- Model is linear(ized) - much easier to solve, estimate etc. than models using the regime change approach
- Can we distinguish between these different models using standard aggregate data?
- Even if not, the modeling approach presented here is very clear and sidesteps issues that arise in the regime switching literature.
- (side note: It would be useful to check if this model fits the data better than a version of the model with standard assumptions on policy rules and a time-varying inflation target)

Inflation

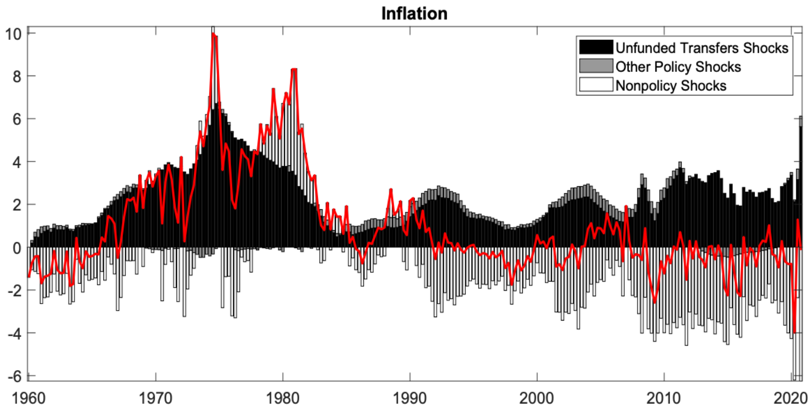

Figure 5: Drivers of Inflation. The red line is the inflation rate in the data in deviations from model's steady-state inflation. The bars represent the cumulative effects of unfunded transfers shocks (black bars), other policy shocks (gray bars), and nonpolicy shocks (white bars) on inflation (in deviations from steady state). Other policy shocks include shocks to funded transfers and surprise and anticipated monetary policy shocks. Shocks are estimated using the Kalman smoother and setting the model

What do agents know?

- The model requires all agents in the model to keep track of not only actual outcomes, but also one set of counterfactual outcomes
- Certainly not a new type of assumption: similar things happen in Smets-Wouters, for example.
- The assumption that fiscal and monetary policy reacts differently to some shocks than others is very useful.
- **But:** How different would outcomes be if agents weren't able to distinguish between funded and unfunded fiscal shocks?

Summing up

- **Great paper - a pleasure to read!**
- Lots to think about