ESSAYS IN MONETARY AND FISCAL POLICY
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This thesis is an empirical study of the behaviour of monetary and fiscal policymakers. The common objective of each of the three chapters is to understand how the conduct of policymakers interacts with the structure of the economy and with the exogenous shocks hitting the economy and how this interaction shapes the macroeconomic outcome. Given the problem at hand, the big issue is the identification of the three components: policy, economic structure and shocks.

In the first chapter we study the consequences of the creation of the European monetary union. The loss of an independent monetary policy is very costly if countries are characterised by heterogeneous responses to common policy actions. Our approach is then to identify a common monetary policy shock, by using a dynamic factor model, to compute the country-specific responses to this identified common shock and to infer what will be the responses of countries under the symmetric ECB regime. We identify the common monetary shock as the “closest” to the German shock, so to give formal content to the well-known fact that Germany was the only European country conducting an independent monetary policy in the period 1985-1998. The advantages of our approach are that: - it allows to control for the leading role of Germany, and thus for the endogeneity problem that affects country-specific studies – it controls for interdependencies between countries – it allows to disentangle between differences in shocks and differences in propagation mechanisms – it requires less identifying assumptions.

Results show that: – during the EMS Germany was relatively insensitive to monetary shocks and that other countries were bearing the adjustment costs, – Germany (and Spain) will be very sensitive to monetary shocks, – the weight of interest sensitive sector can explain some of the asymmetries, – the credit channel is not significant in explaining the differences.

In the second chapter, we test some implications of the Fiscal Theory of the Price Level (FTPL). Classical monetary theory states that good monetary policy is necessary and sufficient to have price stability. The FTPL challenges this view: good monetary policy is neither necessary nor sufficient to guarantee price stability. The crucial thing is the “right” co-ordination of fiscal and monetary policy. We build a general equilibrium model that delivers either the classical case or the FTPL case according to the parameterisation of the policy rules. These two cases are characterised by different impulse responses to fiscal shocks. We then test on US post-war data what policy regime is more in line with the empirical impulse responses.

We conclude that in the period 1960-1979 the data supports the predictions of the FTPL, that the period 1990-2001 is more in line with the classical predictions and that the period 1983-1990 is a transition period in which real debt was bearing the adjustment costs of the switch.

In the third chapter we study the performance of US monetary policy in the period 1982-2001. We develop a new econometric framework that takes into consideration the fact that policy makers analyse many data and that they have to extract the signal on the state of the economy from noisy data. We ask the following questions: how important is the monetary policy shock? What are the other “pervasive” shocks in the economy? How does the Fed responds to them? How do we evaluate Greenspan’s performance? From a technical point of view, we extend the literature on dynamic factor models showing how to recover fundamental common shocks, how to identify them and how to compute impulse responses to these common shocks.

Results show that: - two-three shocks explain the bulk of the volatility of the US economy, - the monetary shock is not one of the common shocks, - the “big” shocks are technology, demand and supply, - Greenspan was good, as he responded differently to different shocks, - Greenspan was lucky, as the US economy was hit mainly by “benign” shocks, technology and demand, that did not create any trade-off to monetary policymakers.