Q: Can we explain evolution of debt AND fluctuations in the monetary/fiscal policy mix?

A: Yes, but need to add political economy elements to the policy problem.

Q: What are the relevant political economy mechanisms we need to add?
Explaining the Data/Policy Mix

- Ramsey/Commitment policy too effective in controlling inflation to explain the data even with longer-term debt.
- Time-consistent policy can generate far greater volatility.
- Dependence of policy mix on debt levels and maturity may help explain some variation in the observed policy mix
  - conventional assignment - with low debt/long maturities monetary policy stabilizes inflation, taxation stabilizes debt.
  - unconventional assignment - with high debt/short maturities roles are reversed.
- Leith and Liu (2016) - Strategic Interactions between time-consistent monetary/fiscal policy also important.
Explaining the Data/Policy Mix

- Chen, Leeper and Leith (2016)
  - Linearised New Keynesian Model
  - Fiscal Policy - Switches between active/passive rules and Stackelberg leader.
  - Monetary Policy - Switches between more/less conservative follower.
Explaining the Data/Policy Mix

US Debt/GDP and Active/Passive/Optimal Policy

Debt-GDP Ratio
Optimal Fiscal Policy

Year

Debt/GDP


Campbell Leith (Glasgow)
Explaining the Data/Policy Mix

US Debt/GDP and Active/Passive/Optimal Policy

- Optimal Fiscal Policy
- Passive Fiscal Policy
- Debt-GDP Ratio

Year
- 1945
- 1955
- 1965
- 1975
- 1985
- 1995
- 2005

Debt/GDP
- 0.0
- 20.0
- 40.0
- 60.0
- 80.0
- 100.0
- 120.0
- 140.0

Campbell Leith (Glasgow)
Explaining the Data/Policy Mix

US Debt/GDP and Active/Passive/Optimal Policy

Optimal Fiscal Policy
Passive Fiscal Policy
Less Conservative Monetary Policy
Debt-GDP Ratio

Year
Alesina and Passalaqua (2016) survey possible explanations of the deficit bias:

- Deficits and Elections - fiscal illusion/political business cycles.
- Social Conflict - wars of attrition.
- Debt as a Strategic Variable.
- Bargaining in the Legislature.
- Intergenerational Redistribution.
- Rent Seeking/Lobbyists.

Political Scientists:

- Elite (not Popular) Polarization - Barber and McCarty (2013, chpt 2).
- Inequality - McCarty (2016)
Political Economy - US

US Debt/GDP & Party of President

Year

Debt/GDP


Dem Rep Dem Rep Dem Rep Dem Rep

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Linking Data to Optimal Policy

March 2016
US Debt/GDP, Party of President and Roll-Call Polarisation

- Debt/GDP
- Year
- US Debt/GDP, Party of President and Roll-Call Polarisation
- Dem
- Rep
- Dem
- Rep
- Dem
- Rep
- Dem
- Rep
- Conservative
- Mean House Republican
- Mean House Democrat
- Liberal

Campbell Leith (Glasgow)
Linking Data to Optimal Policy
March 2016
Political Economy - US

US Debt/GDP, Party of President and Income Inequality

Year

Debt/GDP Ratio

Income Inequality

Quintile Ratio=19
Quintile Ratio = 0.5
Debt-GDP Ratio

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Linking Data to Optimal Policy  
March 2016
Political Economy - UK

UK Debt/GDP & Party of Government

- Debt/GDP
- Year
- UK Debt/GDP & Party of Government
- Lab
- Con

Campbell Leith (Glasgow) Linking Data to Optimal Policy March 2016
Political Economy - UK

UK Debt/GDP, Party of Government & Income Inequality

- Debt/GDP Ratio
- Quintile Ratio = 5
- Quintile Ratio = 0

Inequality

Year

Debt/GDP
0 50 100 150 200 250
Conclusions

- Time-consistent optimal policy can begin to explain evolution of debt/policy mix when we allow for:
  - nominal debt
  - debt maturity structure
  - endogenous state-dependent change in policy mix
  - strategic interactions between monetary and fiscal policy makers.

- Political economy issues may also be important.
  - What changed with President Reagan?
  - Why the difference between US Republicans and UK Conservatives?
  - Is it Divided Government vs Parliamentary system? i.e. bargaining vs median voter?
  - Is there a role for polarization and/or inequality?