CLASS 5

TOPIC	***Policy Mix***
LEARNING CONTENT - DETAILED CHARACTERISTICS	The 2008 Great Recession has shown that one cannot ignore the interplay between monetary and fiscal policy. We develop the basic toolkit to analyze the fiscal policy effects and its transmission mechanism considering demand-side effects and Keynesian multiplier, Ricardian Equivalence, Crowding-out effect, and supply-side effects. Some fiscal controversies and their empirical dimensions are discussed. Four transmission channels of monetary policy are distinguished: the interest-rate channel, asset-price channel, credit channel, and external channel. All four transmission channels of monetary policy operate in parallel and contribute to the general equilibrium outcome but distinguishing them helps students understand how monetary policy works and what determines the magnitude of its impact. The interplay between monetary and fiscal policy, the concept of a policy mix, is considered through seigniorage, fiscal dominance, the monetary and fiscal policy coordination, and the distributional effects of monetary policy. The students should be aware that the income central banks earn from money issuance, the so called seigniorage, and the impact of unsustainable public finances on monetary policy may lead to fiscal dominance. So, the following questions arise: What are the challenges to monetary dominance? How central bank to end exceptional policies? Which is better – monetary or fiscal dominance?
KEY WORDS	A policy mix, transmission channels, Keynesian Multiplier, Ricardian Equivalence, Crowding-out effect, interest-rate channel, asset-price channel, credit channel, external channel, seigniorage, fiscal dominance, monetary dominance.
SUGGESTED TOOLS	Power-point presentation Critical thinking and analysis Economic data transformation Interactive and group discussions A personal study plan
TIPS / METHODOLOGICAL REMARKS **(if applicable)**	Learning-by-doing and case studies activities. The focus is on the interplay between monetary and fiscal policy and the fiscal and monetary dominance.

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IMPLEMENTATION OF THE CLASSES	**STEP 1**	The demand-side and supply-side effects of the fiscal policy are presented. The Keynesian multiplier mechanism is considered. We present an analytical primer on the Keynesian multiplier and discuss the factors that weaken the fiscal expansion on aggregate demand and income are discussed. See work card 1.
	STEP 2	Some fiscal controversies and arguments against the Keynesian approach are commented: the Crowding-out effect, the supply rigidity, the Ricardian Equivalence, and the supply side effects. Given ambiguities and theoretical controversies, we consider that the effectiveness of fiscal policy as a stabilization instrument is ultimately an empirical issue.
	STEP 3	We focus on specificities of the interest-rate channel, asset-price channel, credit channel, and external channel. The impact of the interest rate on the exchange rate is explicitly explained. The students should be aware that the relative importance of the various transmission channels varies from country to country depending on their financial structure.
	STEP 4	The students become familiar with seigniorage, the measures of seigniorage, the aspect of fiscal dominance as regards the debt monetization, the active and passive nature of fiscal policies. The short-run interdependencies between fiscal and monetary policies are considered. The students take note that the distributional consequences of monetary policy may lead interest groups to challenge decisions of the central bank. See work card 2.
	STEP 5	We consider key policy choices answering the following questions: What is the central bank-treasury relationship? What is the inflation objective? Which monetary strategy? Should the central bank care about asset prices? What are the challenges to monetary dominance? Monetary or fiscal dominance?

ADITIONAL MATERIAL 1 (WORK CARD, PICTURE, RECORDING, QUIZZ, PRESENTATION, ASSIGNEMENTS)

WORK CARD 1 – POLICY MIX

Benassy-Quere et al. (2019, pp. 190) cited Batini et al. (2014)[1] and Mineshima et. al (2014)[2] that provide a survey of recent results on the Keynesian multiplier behaviour. The main lessons they drawn are as follows:

1) The average expenditure multiplier is close to 1 in large, moderately open economies.
2) The characteristics of the economy affect the fiscal multiplier.
3) The impact of fiscal policy varies over time depending on the overall economic conditions.
4) The short-run impact of a temporary fiscal stimulus varies significantly depending on the fiscal instrument used.
5) The fiscal multiplier tends to be lower for countries whose fiscal position is weak.

What is the reasoning behind the lessons provided? Is there empirical support for using fiscal policy for stabilization purposes? What are the main features that affect the Keynesian multiplier behaviour?

ADITIONAL MATERIAL 2 (WORK CARD, PICTURE, RECORDING, QUIZZ, PRESENTATION, ASSIGNEMENTS)

WORK CARD 2 – POLICY MIX

Calculate the revenue from the seigniorage of the Bulgarian National Bank for 2017 and 2018 in million BGN
using the following data:

Indicator	2016	2017	2018
Monetary aggregate M3	79 595	92 408	93 256
Annual average inflation (%)	-1.30	1.20	2.60

Source: Bulgarian National Bank and National Statistical Institute

Comment what may account for changes in the value of seigniorage revenues. How does this affect central bank behaviour and does it have an effect on inflation in the country?

[1] Batini, N., L. Eyraud, L. Forni, and A. Weber. 2014. Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections. IMF Technical Notes and Manuals. No. 2014/04. Washington, DC: International Monetary Fund.
[2] Mineshima, A., M. Poplawski-Ribeiro, and A. Weber, 2014, Fiscal Multipliers, in Post-Crisis Fiscal Policy, ed. by C. Cottarelli, P. Gerson, and A. Senhadji, Cambridge: MIT Press.

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