

Stabilization vs. Redistribution: The Optimal Monetary-Fiscal Mix

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The views expressed on the slides are my own and do not necessarily represent those of the ECB.

*Economic and social inequality is one of the biggest challenges facing societies worldwide. [...]
Central banks are no longer considered bystanders in this discussion.*

Isabel Schnabel, “Monetary policy and inequality”, Nov. 2021

This paper

- Studies the policy trade-off between macro stabilization and consumption inequality in a tractable HANK model.
- Focus on business cycle fluctuations (as opposed to average level of inequality).
- Characterizes optimal monetary (and fiscal) policies.

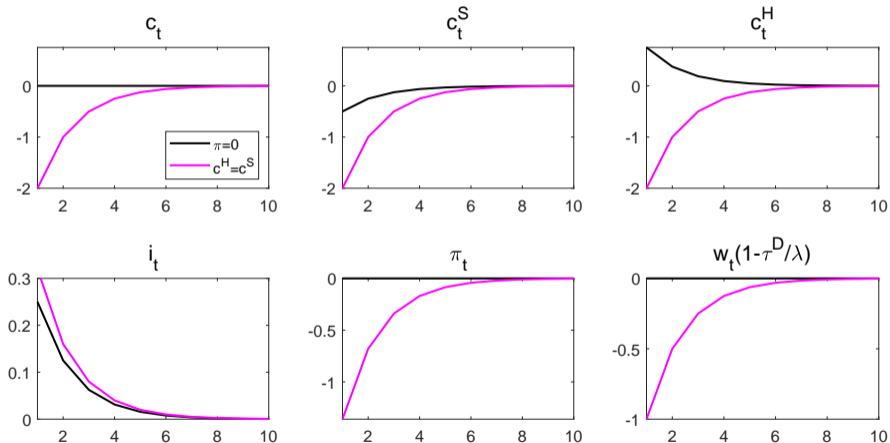
Macro stabilization and consumption inequality

$$\text{Inequality measure: } c_t^S - c_t^H = \frac{1 - \chi}{1 - \lambda} c_t - \frac{z}{1 - \lambda} f_t, \quad \underbrace{\chi \equiv 1 + \phi \left(1 - \frac{\tau^D}{\lambda} \right)}_{\text{Elasticity of } c^H \text{ to } c}$$

When $\chi \neq 1$

- movements in aggregate consumption and inequality are interlinked.
- fiscal transfers (f_t) create a trade-off between macro stabilization and taming inequality.

Impulse responses to a transfer shock (with $\chi > 1$)



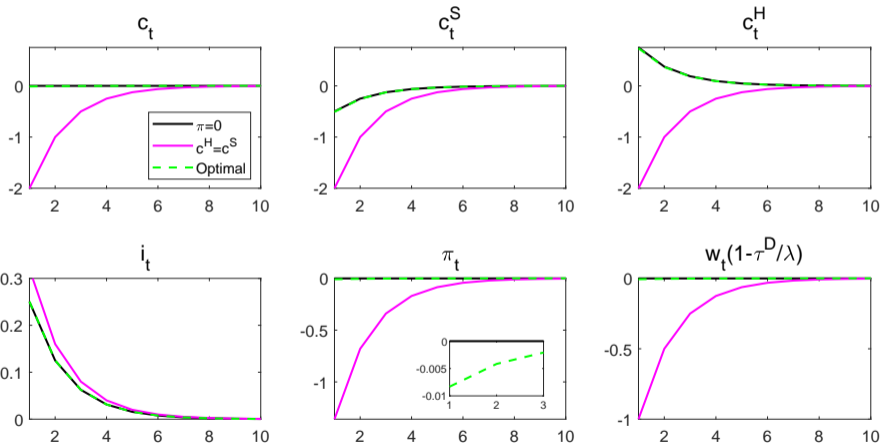
$\chi = 1.375$; monetary policy targeting rules: (i) $\pi_t = 0$, (ii) $c_t^H = c_t^S$.

Welfare and optimal monetary policy

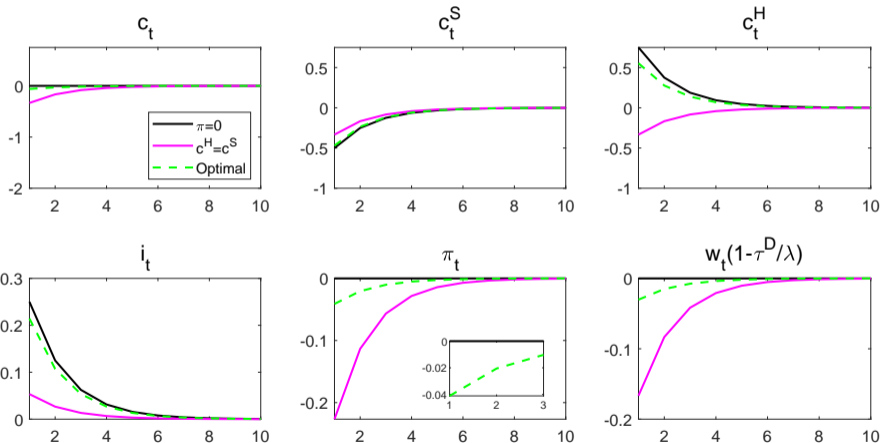
- Welfare criterion affected by movements in inflation, aggregate consumption, and consumption inequality.
- Optimizing policymaker “balances” trade-off between stabilizing real activity and taming consumption inequality.
- How does the policymaker balance the trade-off quantitatively?

Does one of the simple targeting rules provide a good proxy for the optimal policy?

Inflation targeting close to optimal?



But elasticity of hand-to-mouth income to aggregate income (χ) matters



$\chi = 3.25$ ($\lambda = 0.4$, $\tau^D = 0.1$).

Optimal monetary-fiscal policy

- The policymaker optimally chooses the policy rate *and transfers*.
- Suppose, the NK Phillips curve is subject to a cost-push shock, which creates a trade-off between inflation and the output gap.
- The policymaker uses the policy rate to balance the trade-off between inflation and the output gap, and he uses transfers to achieve perfect insurance ($c^H = c^S$).
- Allocation identical to allocation in the RANK model under optimal policy (Prop. 3).

Government spending

Suppose, there is government spending (G), financed by a redistributive taxation scheme.

1. Exogenous G

- Shocks to G create trade-off between macro stabilization and taming inequality.
- Trade-off arises because of redistributive taxation, not because of variation in G per se.
- The trade-off is shaped by the interaction of the taxation scheme (progressive vs regressive), and the dividend distribution scheme ($\tau^D < \lambda$ vs $\tau^D > \lambda$).

Government spending continued

2. Endogenous G

- Suppose, again, the NK Phillips curve is subject to a cost-push shock.
- The policymaker optimally chooses the policy rate and G .
- Optimal G is proportional to measure of consumption inequality because G is linked to changes in redistributive taxes.
- If transfer could be implemented independently of G , optimal G would not move in response to cost-push shock.

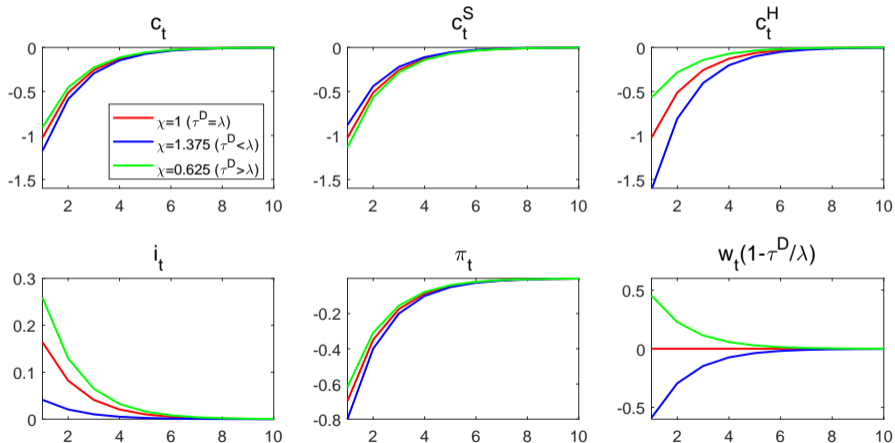
Extension with government debt?

- In the model, it matters whether government expenditures are financed out of current or future taxes.
- Fiscal instruments such as tax rates typically adjust slowly and with a lag to changes in economic conditions.
- When taxes adjust non-uniformly to movements in government debt, such movements—potentially triggered by a business cycle shock—will have redistributive effects.

Conclusion

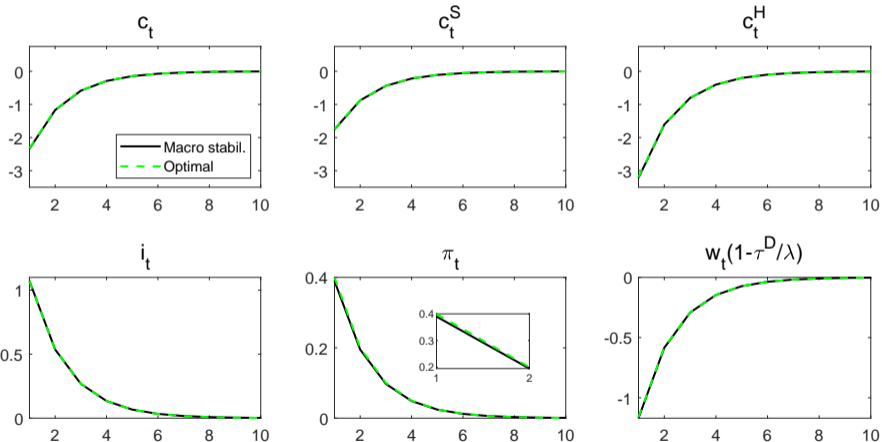
- Very interesting paper on policy-relevant topic.
- Neat analytical setup that makes it easy to follow the paper, and run your own experiments.
- Quantitative importance of consumption inequality motive for monetary policy?
- Extension with government debt?

Background slide: Impulse responses to a monetary policy shock



Monetary policy rule: $i_t = \alpha\pi_t + \epsilon_t$.

Background slide: Impulse responses to a cost-push shock



$$\chi = 1.375.$$