Course 3: Narrative approach and case/event studies

Topics in Empirical Macroeconomics and Finance, Econ 221

François Geerolf

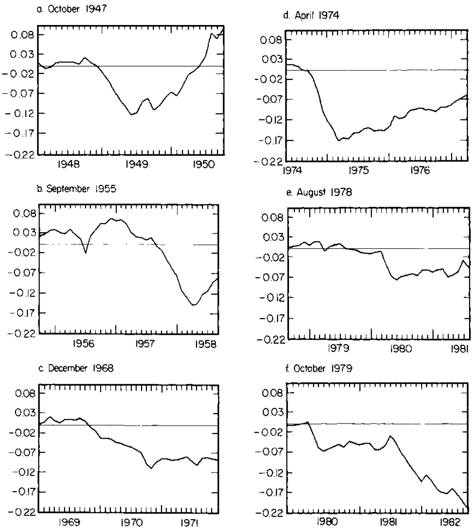
UCLA

October 3, 2018

Narrative Approach and case studies

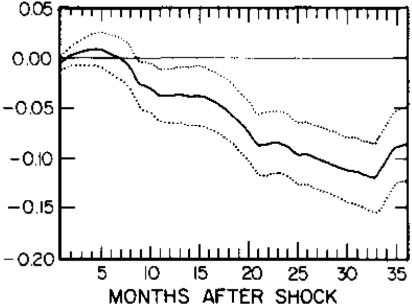
- First narrative approach study is Friedman and Schwartz (1963).
- Modern narrative approach study to monetary policy is Romer and Romer (1989). They argue that monetary policy does matter. Main outcome variable: industrial production.
- Narrative approach using fiscal shocks studied by Romer and Romer (2010).
- Policy world relies

Narrative Approach



Industrial production

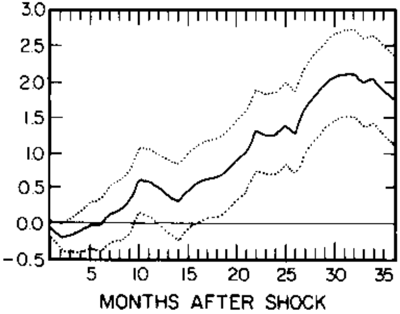
Figure 4 IMPULSE RESPONSE FUNCTION FOR BASIC INDUSTRIAL PRODUCTION REGRESSION



Notes: The impulse response function shows the impact of a unit shock to the monetary dummy variable. The impulse responses for the change in industrial production have been cumulated to reflect the effect on the log level. The coefficient estimates used to generate the impulse response function are given in Table 1. The dashed lines show the one standard error bands.

Unemployment

Figure 5 IMPULSE RESPONSE FUNCTION FOR BASIC UNEMPLOYMENT REGRESSION.



Notes: The impulse response function shows the impact of a unit shock to the monetary dummy variable on the level of the unemployment rate (expressed in percentage points). The coefficient estimates used to generate the impulse response function are given in Table 2. The dashed lines show the one standard error bands.

Romer and Romer (2004)

At times the Federal Reserve has been concerned about the exchange rate above and beyond any implications exchange rate movements might have for future inflation and output growth. This appears to have been the case in late 1984 and early 1985, when the FOMC repeatedly cited the strength of the dollar as one reason for easing policy (see, for example, Board of Governors, Annual Report, 1984, pp. 139 – 40, and 1985, pp. 87–8). Our shock series shows substantial negative values during this period.

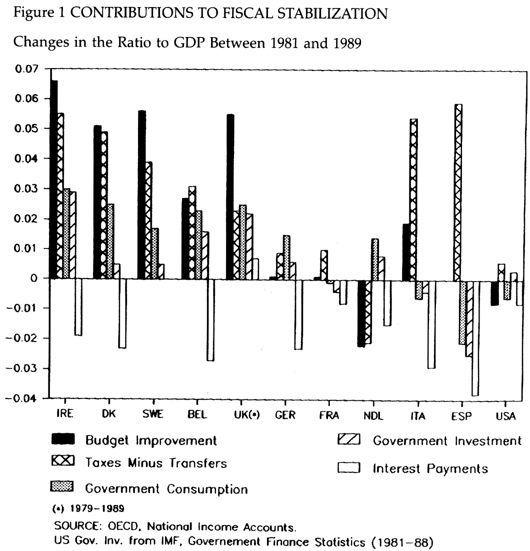
Romer and Romer (2010)

- This study is interested in the macroeconomic effects of tax changes in the United States.
- They find quite large effects of tax cuts and increases on economic activity (with multipliers close to 3).
- Let us replicate this paper.

Anti-keynesian effects of austerity policies: Giavazzi and Pagano (1990)

- A starting point is the evidence next slide: there were fiscal stabilization programs implemented throughout the world in the 80s, which did not lead to substantial reductions in output. In contrast, it is argued that by improving expectations about the future, those fiscal expansions lead households to consume more.

Contributions to fiscal



Two examples

- **Denmark**: in 1982, conservative government cuts spending. Note: interest rates are also reduced due to a decrease in inflation expectations (and devaluation expectations). Thus, the "expansionary austerity" comes together with a housing boom. Moreover, many mortgages in Denmark are variable rate.
- **Ireland**: in **1982**, first attempt at fiscal adjustment (large current account deficits then). Increases in discretionary taxes (5.5% of GDP – this is huge). "Monetary authorities embarked in a sharp desinflation plan, pegging the value of the Irish punt with the EMS, and thus, relative to the German mark. Although this resulted in a drop in both nominal and real interest rates, house and share prices declined – **contrary to what happened in Denmark about the same time**." Big difference: Denmark did not engage in sharp tax increases.

Two examples

- Ireland: in **1987**, led by Charles Haughley, tried again. This time, there were more G (consumption and investment) decreases rather than tax increases. The devaluation stimulated domestic demand by enhancing the credibility of the new parity and thus producing a fall in interest rates.

Bibliography I

Friedman, Milton and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960*, Princeton University Press, 1963.

Giavazzi, Francesco and Marco Pagano, "Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries," *NBER Macroeconomics Annual*, January 1990, *5*, 75–111.

Romer, Christina D. and David H. Romer, "Does Monetary Policy Matter? A New Test in the Spirit of Friedman and Schwartz," *NBER Macroeconomics Annual 1989, Volume 4*, January 1989, pp. 121–184.

__ and __ , "A New Measure of Monetary Shocks: Derivation and Implications," *American Economic Review*, September 2004, *94* (4), 1055–1084.

__ and __ , "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," *American Economic Review*, June 2010, *100* (3), 763–801.