

<b>Institution:</b> University of Cambridge
<b>Unit of Assessment:</b> UoA18
<b>Title of case study:</b> Stabilization policy in an open economy
<p><b>1. Summary of the impact</b> (indicative maximum 100 words)</p> <p>Giancarlo Corsetti has a long-term engagement with monetary authorities (the European Central Bank and since 2010 the Bank of England) where his research has had an impact on the development of frameworks for analysing stabilization policies in open economies. Since September 2010, his research has specifically focused on: (a) monetary policy trade-offs between internal objectives and exchange rate misalignment and external imbalances; (b) macroeconomic stabilization with high and variable sovereign risk; (c) the design of a monetary backstop to government debt. The research has had an impact through setting policy research agendas; through the inputs into scenario and econometric analyses; through forming the basis of Giancarlo's contribution to high-level policy seminars and the basis of his training of central bank officers.</p>
<p><b>2. Underpinning research</b> (indicative maximum 500 words)</p> <p>Giancarlo Corsetti has been Professor of Macroeconomics in Cambridge since September 2010. His research is highly topical, focusing on the crisis and monetary and fiscal policy in the crisis. He has simultaneously been doing underpinning research and ensuring that research has impact on current central bank policy.</p> <p>More specifically, his research has focused on three interrelated areas.</p> <p>The first aims at identifying new theoretical and empirical foundations for the trade-offs between internal and external objectives in the conduct of monetary policy. While these trade-offs are at the heart of traditional models such as Mundell-Fleming, they have been recently de-emphasised by new-Keynesian literature, with claims that optimal monetary rules are 'isomorphic' in closed and open economies, and that international policy coordination is at best irrelevant. After showing that the objective for policy makers includes not only output gaps and inflation, but also exchange rate misalignment and external imbalances, his recent research [1] explore policy trade-offs between controlling domestic inflation and inefficient capital flows/external borrowing associated with real appreciation. The analysis focuses on conditions under which monetary instruments can effectively redress external imbalances, and the scope for integrating monetary with macro-prudential policy.</p> <p>The second area of research consists of a reassessment of fiscal multipliers under conditions of financial and fiscal stress, at both the theoretical and empirical level. The theory (presented at the Jacques Polak Research Conference at the IMF in November 2010), and published in 2013 by the Economic Journal [2]) pursues a generalisation of standard monetary models to include a new channel of transmission, the "sovereign risk channel". According to this channel, risk premia on government debt increase the real cost of debt for private borrowers. Thus, when monetary policy is at the zero lower bound, this channel undermines macroeconomic stability. The model provides foundations for the design of fiscal stabilisation which rest on a combination of stimulus and budget consolidation strategies (analysed in [5]), and to a balanced assessment of pros and cons of fiscal austerity. A multi-country generalisation for a currency union stresses the prevention of belief-driven downturns as a new argument in favour of coordinated, asymmetric fiscal policies (procyclical cuts in the crisis countries offset by conventional, anti-cyclical fiscal policy in low-risk premia countries). Applied to countries pursuing a peg, the model corrects fallacies in the conventional textbook wisdom, suggesting that fiscal policy is not effective under a fixed exchange rate system.</p> <p>The empirical agenda alongside this model estimates the size of multipliers, conditional on macroeconomic and policy environments (exchange rate regimes, financial stress) and suggests</p>

that fiscal policy is particularly consequential at times of financial and banking crises.

In the light of the threat that sovereign risk poses to macro stability, a third area of research consists in specifying a rigorous analysis of the conditions under which a central bank can provide a credible monetary backstop to government debt, that is, when can it credibly act as a lender of last resort to the fiscal authorities. The popular view confounds the ability of a central bank to provide a monetary backstop, with the use of hyperinflation to debase public debt. By contrast, Corsetti shows that a monetary backstop (a) does not rest on the threat to debase government paper via inflation and (b) can be credible and effective even when the size of intervention falls short of covering government financing needs in full. This line of work [6] was originally developed joint with Luca Dedola at the ECB as background research on the design of the Outright Monetary Transactions launched by the ECB in 2012. It builds on the theory of self-fulfilling sovereign default crisis undertaken in the 1980s, especially by Calvo (1988), and integrates it with monetary theory.

### 3. References to the research (indicative maximum of six references)

Monetary policy trade-offs with misalignment and external imbalances:

1. G. Corsetti, L. Dedola, and S. Leduc (2012) "Demand Imbalances, Exchange-Rate Misalignment and Monetary Policy", available at <http://www.ssc.wisc.edu/econ/workshop/Spring%202012/Dedola-imbances-madison.pdf>, numerous presentations through 2011-2013, e.g. at: the CEPR European Summer Symposium in International Macro, Northwestern University, University of Wisconsin-Madison, LSE, EUI

Fiscal stabilization and consolidation:

2. "Sovereign Risk, Fiscal Policy, and Macroeconomic Stability," Joint with Keith Kuester, Andre Meier, Gernot Mueller. **Economic Journal**, February 2013, F99-F132.
3. "What determines government spending multipliers?", with Andre Meier and Gernot Mueller, **Economic Policy**, October 2012, 72:523-565.
4. "Floats, Pegs and the Transmission of Fiscal Policy" joint with K Kuester and G Mueller, in Luis Felipe Céspedes and Jordi Gali (eds.) *Fiscal Policy and Macroeconomic Performance*, Santiago, Chile: Central Bank of Chile, 2013
5. "Fiscal Stimulus with Spending Reversals", with Andre Meier and Gernot Mueller, **The Review of Economics and Statistics** November 2012, 94(4): 878–895.

Monetary Backstop:

6. G. Corsetti and L. Dedola, "The Mystery of the Printing Press: Self-fulfilling Debt crises, and Monetary Sovereignty" **CEPR Discussion Paper 9358, February 2013**

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### 4. Details of the impact (indicative maximum 750 words)

The impact of Corsetti's research has come primarily through a strategy of direct engagement with various central banks and of explaining his main research conclusions. While details of most of the advice to central banks are confidential, his research has also stimulated much public debate and Corsetti himself has written extensively in that policy debate, especially in VoXEU.

### International Dimensions of Monetary Policy [1 – section3]

Corsetti's research [1 – section 3] underlies much of Corsetti's activities in support of the International Economic Analysis Division at the Bank of England. The Chief Economist at the Bank writes (C1-section5), "[Corsetti's] research highlights that when financial markets are imperfect, then optimal monetary policy in an open economy may require a consideration of factors that go beyond the traditional closed economy output and inflation gaps, to include the terms of trade and demand imbalances. More broadly, his work on New Open Economy Macroeconomics has helped move our thinking about how shocks propagate internationally beyond the traditional trade linkages, to consider the roles of the exchange rate, financial variables and the substitutability of home and foreign goods. The implications of this work for UK monetary policy were presented to the Bank's Monetary Policy Committee (MPC) at a recent Research Away day [in July 2013]."

Corsetti's research has also impacted on how the Bank of England responded to the crisis. The Chief Economist at the Bank, writes (C1-section5), "his work on the build up of imbalances within currency unions has helped us better understand the run-up to the crisis in the euro area and we've taken up his idea of using inflation differentials as a summary statistic of total imbalances in our presentations to policymakers."

In addition to the Bank of England, this work [1 – section 3] has been presented to numerous central banks across the world including at the Bank of Canada-European Central Bank Workshop on Exchange Rates, the International Research Forum on Monetary Policy, the Swiss National Bank conference on Monetary Policy Advances, the Reserve Bank of Australia, Banco Central de Chile, Federal Reserve Bank of New York, Reserve Bank of New Zealand, Bank of Hungary.

### Fiscal Multipliers [2,3,4,5 – section3]

The main lessons from the research on the fiscal multipliers at times of fiscal and financial stress have been incorporated in numerous policy models and exercises at the ECB and European national central banks. The Head of Fiscal Policies Division at the ECB writes (C9 – section5): ". In our internal simulations we made extensive use of the concepts and ideas developed in the paper [2 – section 3], which proved to capture essential elements of interest to a central bank. It is notable that the paper was circulated well before the announcement of the OMT programme, which essentially focuses on the impact of risk premia on government bonds on the funding costs of the economy."

The main goal of these exercises is to clarify the appropriate role of fiscal consolidation as part of a strategy of output stabilization, with a critique of the idea of 'expansionary contractions'. The Director of DG Research at the ECB writes (C3-section5), "[Corsetti's] work on fiscal multipliers has been an important contribution to the debate about the appropriate pace of fiscal consolidation in Europe. In particular, his work on the importance of the sovereign risk channel has been highly influential." In concluding, he writes: "Overall, Giancarlo's research has had a significant and important impact on the way the ECB has understood and dealt with the crisis over the past three years".

The Head of Fiscal Policies Division at the ECB writes (C9 – section5): "Giancarlo's work on fiscal multipliers (Economic Policy October 2012 [reference 3 – section 3]) and on the impact of fiscal shocks on the exchange rate (such as in Review of Economic and Statistics November 2012 [reference 5 – section 3]) have been extensively used as reference in the division when assessing the impact of fiscal policies in the short and long-term and when elaborating scenarios."

Giancarlo's research on fiscal multipliers and the role of sovereign risk has underpinned his participation in and moderation of the Voxeu Debate "[Has austerity gone too far?](#) (C6-section 5, April 2012, 35888 reads), as well as his articles "[What is the size of the fiscal multiplier? An estimate you can't refuse](#)" (C7-section5, April 2011, 22738 reads) and "[Sovereign risk, macroeconomic instability](#)" (C10-section5, August 2011, 10424 reads).

### Monetary Backstops [6 – section3]

The research on monetary backstops has fed into both the ECB and the Bank of England. For the ECB, the Director of DG Research writes (C3-section5): "his work [6 – section 3] with Luca Dedola

## Impact case study (REF3b)

(a colleague at the ECB) on monetary backstops, the possibility of self-fulfilling runs on sovereign debt and the effects on incentives for structural reform was a very significant input in policy deliberations surrounding the sovereign debt crisis and the ECB's response."

For the Bank of England, the Chief Economist writes (C1-section5), "his recent piece 'The Mystery of the Printing press: self-fulfilling debt crisis and monetary sovereignty' [6 – section 3], gave us an analytical base to think about OMTs [Outright Monetary Transactions], and to explain to the MPC how countries with the ability to print their own currency can enjoy lower default premia without a corresponding rise in inflationary expectations, and to explain why confidence effects can be so powerful even in a model with rational agents."

Corsetti's research on monetary backstops has been presented in a non-technical way in Voxeu columns (**Is the euro a foreign currency to member states?** C4-section5, June 2013, 18288 reads).

His research on monetary policy trade-offs has had substantial impact on the recent policy debate around the OMTs (especially through various commentaries by Paul Krugman, C5-section 5). The research has provided a basis for a balanced discussion of possible economic and political issues in the implementation of the OMT strategy.

In addition to the direct impact of his research on the specific interactions between fiscal and monetary policy, the research in section 3 has also formed the core of the curriculum of central bank training. Since 2010, Corsetti has repeatedly presented his research at the Central Bankers Programme of the Study Center in Gerzensee, Bern. The Director of the Programme writes (C2-section5): Giancarlo's "research results on international monetary economics and international finance influence how the central bank community thinks about exchange rates, monetary policy coordination or capital flows. His research has a significant, lasting impact on the mindset of future leaders in monetary affairs."

##### 5. Sources to corroborate the impact (indicative maximum of 10 references)

- C1. Email from person 1 (Executive Director and chief economist of the Bank of England).
- C2. Email from person 2 (Director of the [Study Center Gerzensee](#))
- C3. Email from person 3 (Director General of the Directorate General Research of the European Central Bank)
- C4. Corsetti and Dedola "Is the euro a foreign currency to member states?" (5 June 2013) <http://www.voxeu.org/article/euro-foreign-currency-member-states>
- C5. Paul Krugman, New York Times, various articles between 2011 and 2013 "Who has Draghi's Back?" ([http://krugman.blogs.nytimes.com/2013/06/07/who-has-draghis-back/?\\_r=0](http://krugman.blogs.nytimes.com/2013/06/07/who-has-draghis-back/?_r=0)), "Original Sin and the Euro Crisis" (<http://krugman.blogs.nytimes.com/2011/11/10/original-sin-and-the-euro-crisis/>), "The Mafia Multiplier" (<http://krugman.blogs.nytimes.com/2011/06/26/the-mafia-multiplier/>)
- C6. Has austerity gone too far? (2 April 2012) <http://www.voxeu.org/article/has-austerity-gone-too-far-new-vox-debate> (35888 reads)
- C7. Sovereign risk, macroeconomic instability (12 August 2011) <http://www.voxeu.org/article/sovereign-risk-macroeconomic-instability> (10424 reads)
- C8. What is the size of the fiscal multiplier? An estimate you can't refuse. (4 April 2011) <http://www.voxeu.org/article/what-size-fiscal-multiplier-estimate-you-can-t-refuse> (22738 reads)
- C9. Email from person 4 (Head of the Fiscal Policies Division at the European Central Bank)