

Impact case study (REF3)

Institution: University of Surrey		
Unit of Assessment: 16 Economics and Econometrics		
Title of case study: Stabilizing Macroeconomic Activity		
Period when the underpinning research was undertaken: 2017-2020		
Details of staff conducting the underpinning research from the submitting unit:		
Name(s):	Role(s) (e.g. job title):	Period(s) employed by submitting HEI:
Ricardo Praca Cavaco Nunes	Professor	August 2017 - onwards
Period when the claimed impact occurred: 2018 - onwards		
Is this case study continued from a case study submitted in 2014? N		
1. Summary of the impact (indicative maximum 100 words)		
<p>By setting taxes and interest rates, fiscal and monetary policies have a strong impact on economic outcomes such as unemployment and inflation, and therefore play a crucial role in maintaining and improving the welfare of citizens. Research by Professor Ricardo Nunes has had a significant impact on monetary and fiscal policy both in the UK and internationally. His research on the objectives of central banks was key to the Swedish parliament review and the resulting changes to the policy objectives of the Swedish central bank. This research also had impact on policymaking in the central bank of the United States. His research on fiscal policy paved the way for his role as member of the Council of Economic Advisors to the Chancellor of Exchequer Phillip Hammond, where his analysis and research helped shape the 2018 Budget.</p>		
2. Underpinning research (indicative maximum 500 words)		
<p>The underpinning research analyses how governments and central banks should set policy such that the welfare of households is maximized. Optimal fiscal and monetary policy should maximize consumption, leisure, and attain the correct balance of these two goals. Optimal policy should also stabilize economic fluctuations such that agents face lower uncertainty and enjoy more stable economic paths, for instance avoiding unemployment or low consumption in adverse periods. The underpinning research, both on fiscal and monetary policy, develops solutions for meeting these objectives in order to stabilize economic fluctuations and promote economic activity to the benefit of society.</p>		
(i) Central Bank Objectives and Decisions that Maximize Society's Welfare		
<p>There is broad consensus among academics that central banks should focus on price stability and devote only modest efforts to stabilizing real economic activity. Many influential studies in the monetary economics literature show that such policies are the most beneficial from a social welfare perspective. Given this, it is not surprising that nearly all instrument-independent central banks focus on price stability with little or no role for stabilizing some measure of resource utilization; the outlier is the U.S. Federal Reserve that has a strong focus on economic activity through its "dual-mandate".</p>		
<p>The focus on price stability (versus a balanced "dual-mandate" approach) bears crucial consequences for interest rate decisions, which is the main instrument that central banks use to stabilize the economy and promote welfare.</p>		
<p>Paper [3.1] examines whether the prevailing consensus to focus on inflation and disregard economic activity is correct. The results in the paper depart from prior consensus. Using both analytical and quantitative results, paper [3.1] shows that objective functions of central banks should place a large weight on measures of economic activity, sometimes larger than the weight</p>		

on inflation. The paper discusses the drivers of the results and shows that the results are robust across a variety of models.

(ii) Fiscal Insurance, Commitment, and the Debt Portfolio

Treasury departments need to raise tax revenues to finance public expenditures, which are inherently volatile due to economic shocks and uncertainty. In addition to this volatility, if the economy enters a recession, households have less available resources and cannot maximize their utility by perfectly smoothing consumption over time.

Fiscal policy needs to take these issues into account and insulate households from such detrimental shocks and volatility. For instance, if public expenditures need to increase, the portfolio of government assets and liabilities should adjust such that these expenditures can be financed without changing taxes. Tax smoothing is a desirable property as households do not see their current incomes decrease (or face volatile tax payments).

Paper [3.2] revisits these issues. Ideally, the portfolio of government debt—for instance, the composition of short-term and long-term debt—should be carefully chosen such that the market value adjusts to economic shocks and tax smoothing is automatically achieved. However, paper [3.2] argues that such portfolios are difficult to construct. Treasury departments need to consider that different political parties may change their policies and private sector expectations must be managed. This leads to the so-called *time-inconsistency* problem. The paper shows that to alleviate the problem, the portfolio of debt maturities must be carefully chosen. Treasury departments should aim to achieve the optimal debt portfolio but acknowledge that this problem cannot be completely circumvented, and the economy will remain exposed to the problems just described.

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

[3.1] Davide Debortoli and Jinill Kim and Jesper Lindé and Ricardo Nunes, 2019 "Designing a Simple Loss Function for Central Banks: Does a Dual Mandate Make Sense?", *The Economic Journal*, vol. 129, pages 2010-2038. doi: [10.1111/eoj.12630](https://doi.org/10.1111/eoj.12630)

[3.2] Davide Debortoli and Ricardo Nunes and Pierre Yared, 2019. "Optimal Fiscal Policy without Commitment: Beyond Lucas-Stokey," NBER Working Papers 24522, National Bureau of Economic Research, Inc. Forthcoming, *Journal of Political Economy*. Doi: [10.3386/w24522](https://doi.org/10.3386/w24522)

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

Confidentiality Note: Elements of this section contained within curly brackets {...} are based on confidential letters and will be redacted for publication.

The impact of Professor Nunes research has been both international (items A-C below) and in the UK (item D).

(A) Parliamentary Committee in Sweden

The Swedish Parliament established a formal committee to evaluate the objectives of the Riksbank (the central bank of Sweden). Prior to this review, the Riksbank objectives did not include real economic considerations in the legislative text (as widely known and described in [5.1]). The Parliamentary Committee changed the objectives of the Riksbank by introducing real economic considerations and the paper [3.1] was central to this process.

These changes were prominently stated in the press release [5.2] and the summary documents [5.3], with additional details in the full document [5.1]. [5.3] states the changes: "*The Committee also proposes that, without setting aside the price stability objective, the Riksbank should contribute to a balanced development of production and employment*" (consideration of the real economy; see chapter 16).

The report [5.1] is explicit on the contribution and impact of paper [3.1]. The report [5.1] states in chapter 16 "*In the academic literature, there are various estimates of the relative importance that central banks should place on inflation versus real economic activity in order to maximise society's welfare. Previous studies found a recurrent result that real economic considerations are much less important than inflation. However, it should be noted that academic papers published in recent*

years have shown that, in order to improve social welfare, central banks should give more importance to real economic activity than what was previously established in the literature". See Debortoli et al (2019) and Galí (2018).

The paper by Debortoli et al (2019)—that is, paper [3.1]—is also cited several times for further considerations on the objectives that should be implemented. For instance, [5.1] states: "Whether a central bank should choose to stabilise production or hours worked to maximise the welfare of society varies between different model approaches". See for example Debortoli et al (2019) and the references therein. Mainly and as stated above, paper [3.1] deviated from previous findings, and the Swedish Parliament implemented changes consistent with and based on this research.

(B) Riksbank (central bank of Sweden)

The Head of Research of the Riksbank comments on paper [3.1] and states in [5.4]: {Text removed for Publication}

{Text removed for publication}

{Text removed for publication}

Besides this, the largest financial services group in the Nordic region and one of the biggest banks in Europe (<https://www.nordea.com/en/about-nordea/who-we-are/nordea-at-a-glance/>) cited paper [3.1] and the associated dissemination note on VoxEU [5.5] in their markets note [5.6]. This note detailed how this different monetary policy framework would impact financial markets and obtained substantial dissemination to households via the media [5.7] and [5.8].

(C) Federal Reserve Bank of Boston (part of the central bank of the United States)

The Research Director and Executive Vice President writes in his letter [5.9]: {Text removed for publication}

Letter [5.9] concludes: {Text removed for publication}

(D) Council of Economic Advisors (CEA) to the Chancellor of Exchequer Phillip Hammond

Professor Nunes was a member of the CEA to the Chancellor of Exchequer Phillip Hammond from February 2018 to July 2019. The CEA is an advisory panel made up of a small group of leading experts. The meetings take place at the Treasury or No11 Downing Street ([5.10] and [5.11]).

The Chair of the CEA writes in letter [5.11]: {Text removed for publication}.

Letter [5.11] contains specific examples of impact based on paper [3.2]: {Text removed for publication} and the letter also states the impact on {Text removed for publication} These elements are in line with the 2018 Budget presentation and documents available at [5.12]. The changes in the strategy for the bond portfolios can be found in the budget document itself in Annex A.

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

[5.1] The Riksbank Committee's proposal for a new Riksbank Act (Detailed Report)

<https://www.regeringen.se/4adffc/contentassets/e72df563b53f45e18f30f7438f45a068/en-ny-riksbankslag-del-2-av-3-kapitel-13-27-sou-201946.pdf> Certified English translation was also submitted.

[5.2] The Riksbank Committee's proposal for a new Riksbank Act (Press Release)

<https://www.government.se/4ae00d/contentassets/bb8176c9692d4b91bd939e817a83ef85/press-release-riksbank-committee-presents-proposal-for-a-new-riksbank-act.pdf>.

[5.3] The Riksbank Committee's proposal for a new Riksbank Act (Summary)

<https://www.government.se/4ade68/contentassets/57e0337f21a1480b8a5665cf8a51486c/the-riksbank-committees-proposal-for-a-new-riksbank-act-summary.pdf>.

[5.4] Head of Research, Sveriges Riksbank, Sweden. (Confidential Statement Letter)

[5.5] “Why central banks should not be inflation nutters” VoxEu article, September 17, 2018
<https://voxeu.org/article/why-central-banks-should-not-be-inflation-nutters>

[5.6] Nordea Markets – Macroeconomic Research, “Return to your rules, please” <https://e-markets.nordea.com/api/research/attachment/76233>

[5.7] “Bredda Riksbankens mandat” newspaper article, October 14, 2018
<https://www.di.se/debatt/debatt-bredda-riksbankens-mandat/>

[5.8] “Nordea: Bra Med Bredare Fokus I Penningpolitiken”, newspaper article, October 15, 2018
<https://www.affarsvarlden.se/bors/news/article/c6e7ad95-b2fd-4c29-a214-c0ff0c003b46/>

[5.9] Executive Vice President and Director of Research, Federal Reserve Bank of Boston, United States of America. (Confidential Statement Letter)

[5.10] Chancellor of the Exchequer Philip Hammond, Her Majesty's Treasury, United Kingdom. (Council of Economic Advisors Invitation Letter, Confidential Correspondence)

[5.11] Chair of the Council of Economic Advisers and Special Economic Advisor to the Chancellor of the Exchequer Philip Hammond, Her Majesty's Treasury, United Kingdom. (Confidential Statement Letter)

[5.12] UK 2018 Budget documents <https://www.gov.uk/government/topical-events/budget-2018>