Comment on “Stabilizing an Unstable Economy: On the Choice of Proper Policy Measures”

In this paper the authors develop and investigate the dynamic behavior of a non-linear macro-dynamic model. In particular, the authors take the ongoing financial crisis as the motivation to study stabilization policy options, since the current financial crisis has underscored once again the importance of the financial sector in the business cycle.

The theoretical framework is a Keynesian business cycle model with heterogeneous households. The model also uses a Tobin-like portfolio approach with heterogeneous agents in the asset market. The authors are interested in studying the financial, nominal and real cumulative feedback chains that may cause instability in the economy and hence to select a “stabilization policy”.

The authors conclude that in the context of the proposed model boom-bust cycles can be dampened. In particular, countercyclical labor and fiscal policies and a control on the wage-price spiral, raise stability in the model, but such result is not very unexpected given the Keynesian structure of the model. The authors also consider a Tobin tax on capital gains in order to reduce the fluctuations in the financial market. Finally, monetary policy should be used to dampen fluctuations in the financial market by buying equity in periods of bust and selling it in boom periods.

The paper is very interesting and technically brilliant. The authors have undertaken efforts to strengthen the analysis of linkages between financial and macroeconomic developments, linkages that have gained prominence during the recent financial crisis. Capturing these linkages requires going beyond standard economic models, which accord financial variables only limited roles. The model comprises strong theoretic features and is sufficiently disaggregated to be used for a wide range of policy-relevant questions.

Here are my comments:

1) The paper assumes that the share market consists of two types of traders: fundamentalists, who are forming rational expectations on the fundamental value of the asset, and chartists, a group which bases its trading decisions on an analysis of the past price trends. The asset price dynamics is influenced by the fundamentalists’ strength of adjustment to the difference between the expected fundamental value of the asset and the current price and the speed with which the chartists adjust their estimates of the trend to past price changes. The longer-term expectations, which are consistently stabilizing, are associated with the *fundamentalists*, and the short-term forecasts, which seem to have a destabilizing nature, with the *chartists*. The change in the price expected by the market is written as a weighted average of the two groups’ expectations. If the parameter α is

constant over time, this means that the weight of the two groups remains the same and also that switching is impossible, i.e. it is not possible for a fundamentalist to become a chartist and vice versa.
However, much evidence supports the possibility of switching. It may be very important to understand when instability is amplified by the internal dynamics of the traders market, that can lead to a full blown crisis. Besides it could be very interesting to establish a relation between market stability and the interplay among fundamentalists and chartists.

2) In my opinion to obtain a very clear understanding of the mechanisms at work it may useful to consider an open economy framework. Opening up an economy to trade does not only subject it to international linkages in the form of spillovers of foreign disturbances, but also may change the propagation of purely domestically originated shocks because of, for example, expenditure switching effects, current account imbalances, etc.. Also, monetary policy, and how the monetary policy transmission mechanism changes (which thus influence how shocks are propagated into the economy) cannot be neglected. Finally, the exchange rate and foreign prices should be considered in the conduct of monetary policy.

3) The selection of successful “stabilization policy” is very challenging. I find that the policies designed by the authors are based upon reasonable economic intuition but are designed under assumptions most favorable to stabilization policy. In this way the results derived are intuitively plausible but the paper fails to highlight the economic mechanisms generating them. The literature suggests that a successful selection is complicated. However, the determination of the effects of fiscal and monetary policies is in my view ultimately an empirical question.

4) I think that the paper is a bit too long and should be shortened. The authors may try to extract from the present paper a concentrated picture of the methodological approach and its application to the real-financial market interaction producing the stabilizing or destabilizing feedback effects within the dynamical system considered.