Optimal fiscal and monetary policy based on VAR analysis

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Abstract

The aim of this paper is to show how to determine optimal macroeconomic policy using a VAR rather a structural model of the economy. The advantage of using a VAR is that it is theory free. In order to determine the optimal policy first it is necessary to transform the VAR so that the state variables are conditioned on the policy instruments. We use this methodology to derive optimal rules for fiscal and monetary policy and to evaluate the welfare outcomes of alternative types of policy. We compare delegated fiscal and monetary policy with leader-follower and co-ordinated fiscal and monetary policy. We argue that this methodology may be automated to provide a simple benchmark for fiscal and monetary policy that would be easy for fiscal and monetary authorities to calculate and can therefore be used as a standard component of their decision-making processes.