

The fiscal impact on euro-area inflation

Callegari, Drudi and Kuester

Comments by

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What the paper does:

- Quantitative (model-based) assessment of contribution of fiscal consolidation to functioning of economy
- Are large fiscal adjustments self-defeating?
- Overall rich framework allowing to address important policy questions

Austerity beneficial?



New Keynesian model:

➤ Standard features:

- Two-countries forming monetary union
- Home bias in consumption
- Government spending on domestic products
- Law of one price (before VAT)
- Nominal rigidities
 - Prices
 - Wages (quadratic adjustment costs)

Model:

➤ More specific elements

- Borrowers and savers
- Location and type switches (asset pooling)
- Union-wide intermediaries taking risk-free deposits
- Private-sector borrowing subject to country-specific spreads: cost rises with cost of funding of the member states' sovereign

$$\chi_t = \chi_\psi [(1 + i_t^g)/(1 + i_t^d)]^{\alpha_\psi} - 1$$

- Fiscal limit: potential for partial sovereign default
- Menu of possible taxes

Comments on assumptions:

➤ “Banking landscape”

- In reality, no union-wide risk-free intermediary, but national banks paying different deposit rates, with riskiness dependent a.o. safety public debt.
- Are not differences in national private borrowing costs (and spread over sovereign interest rate) precisely the result of this pattern?

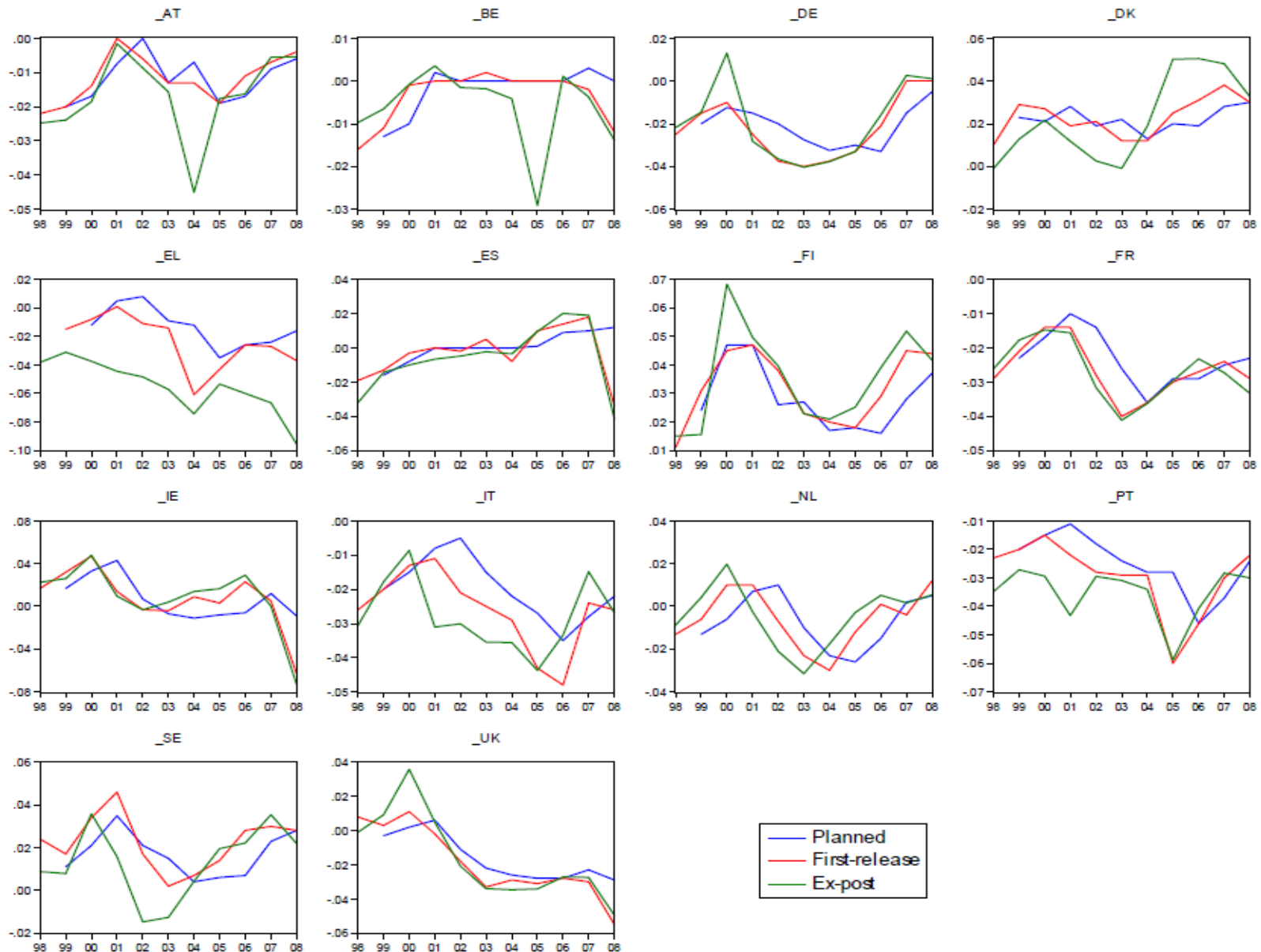
Comments on assumptions:

- No explicit fiscal responses to increasing default risk:
 - Projections coming 3 years are given: what if you reach fiscal limit in meantime?
 - Return to given rules are 3 years: rule depends on debt, but is unaffected by stochastic fiscal limit

Comments on assumptions:

- Text says “agents ... form expectations about the future in a way consistent with the ECB-ECSB forecast exercise”
- Agents do not take account of uncertainty about fiscal paths?
 - Governments renege continuously on future promises
 - What if promised consolidations are not credible, or government switches from-spending based to tax-based consolidation?

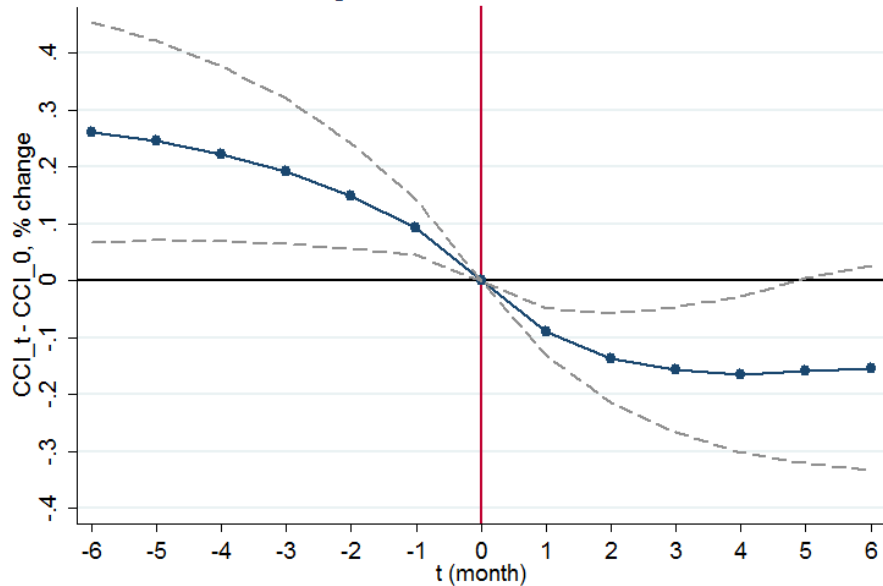
Planned, first-release and ex-post balances



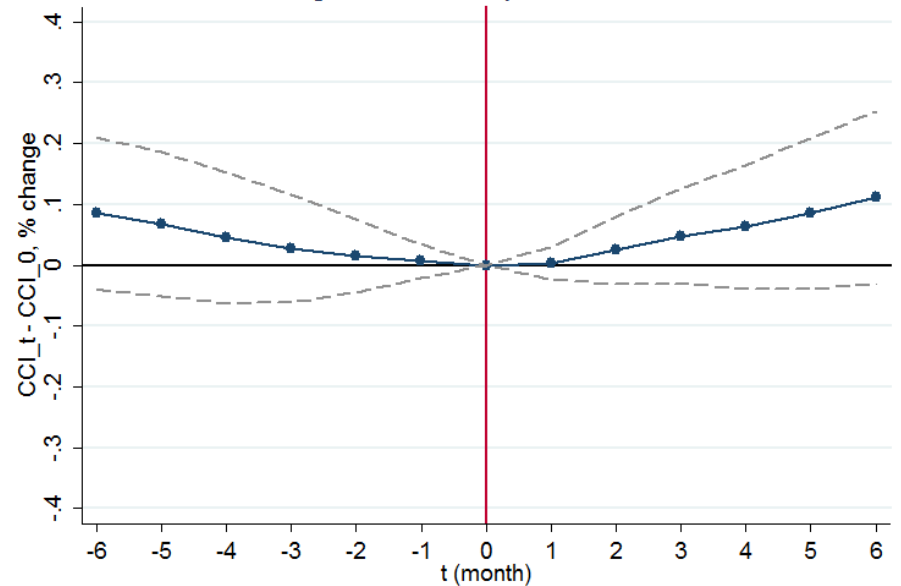
More fundamentally:

- Quantitative assessment of consolidation would require most relevant channels to be present in model
- No explicit role for confidence channel, allegedly important during euro crisis:

Change in CCI: revenue-based



Change in CCI: expenditure-based

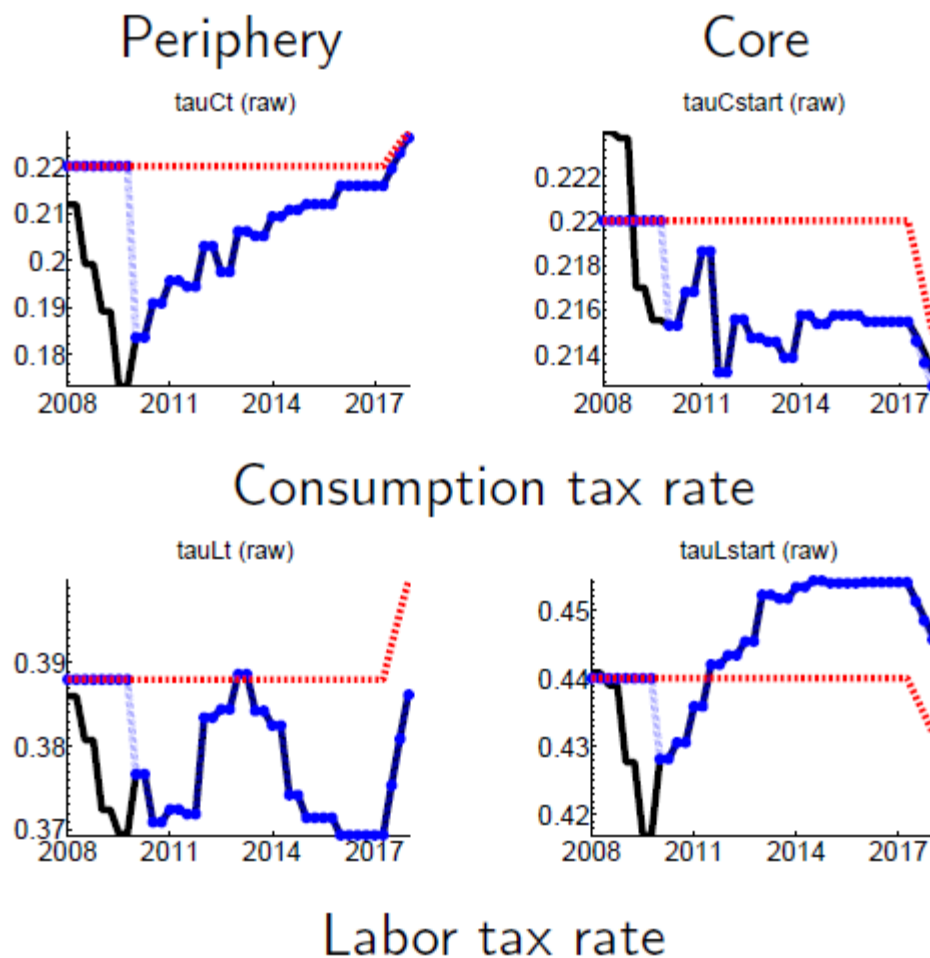


Experiments:

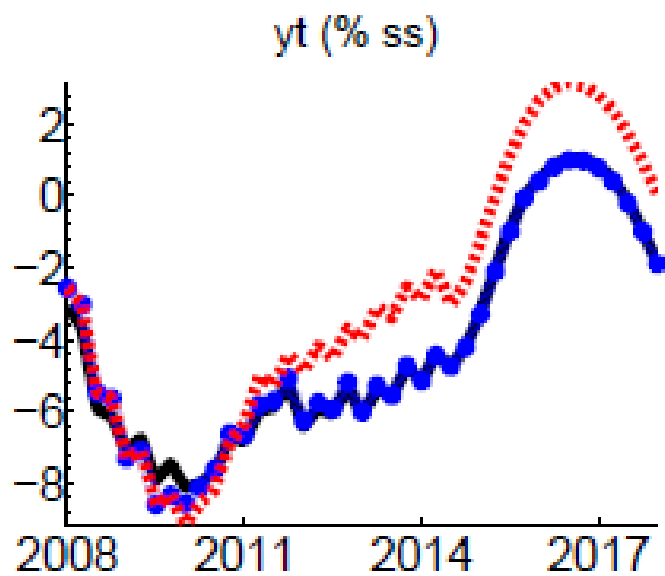
- Calculations are based on anticipated fiscal paths:
 - comparison actual projected fiscal paths to case where fiscal variables held constant, i.e. no consolidation
 - Give insight in default risks under counterfactual
 - Can economic effect of this risk be so strong that it makes consolidation the better option? Lump-sum tax rule sufficient?
 - Discuss magnitudes of effects, in particular domestic vs spillover effects

Experiments:

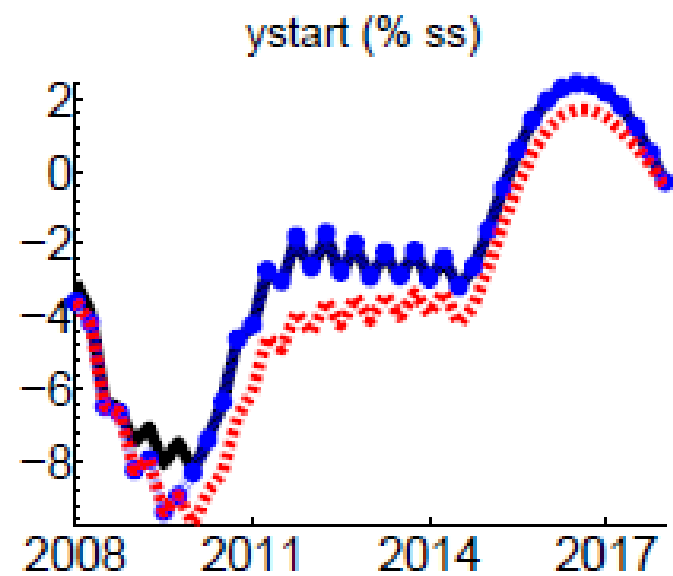
- Seems you feed projected paths all instruments at same time; current results rather difficult to follow; do one-by-one, keeping others constant



Experiments:

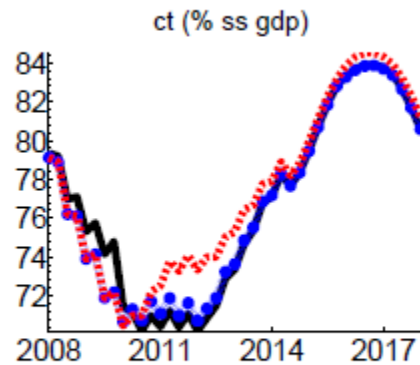


GDP periphery

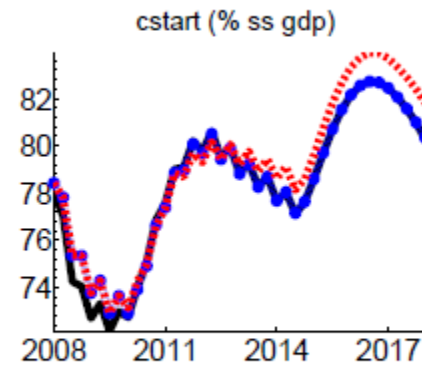


GDP core

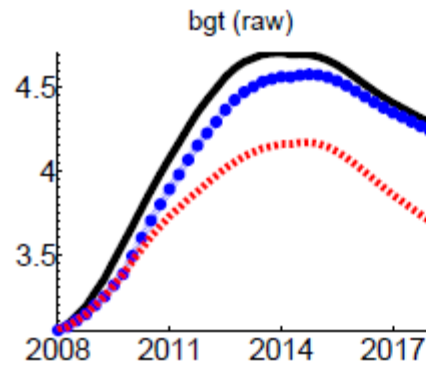
Experiments:



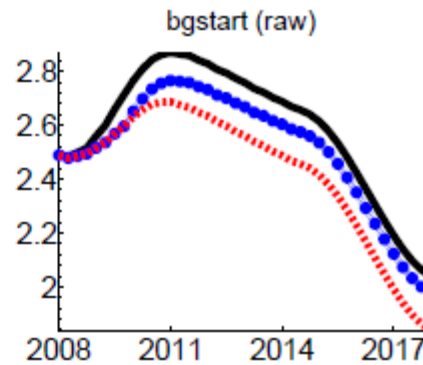
Consumption periphery



Consumption core



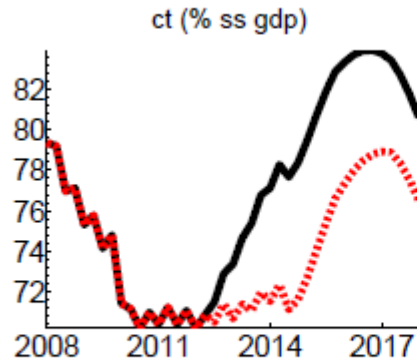
Gov't debt periphery



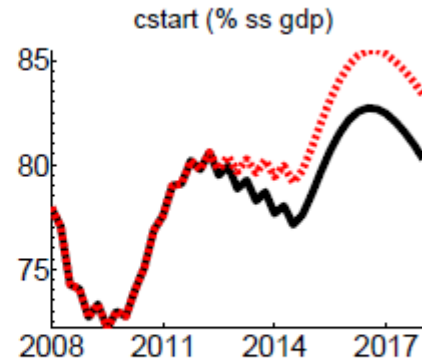
Gov't debt core

OMT:

➤ Why is OMT bad for core?



Consumption periphery



Consumption core

➤ Compare situations in which the ECB and the fiscal authorities coordinate, vs when they do not coordinate:

- ECB only provides OMT if fiscal authorities consolidate (credible?), and vice versa

Experiments:

- Investigate in more detail role of private debt
 - Household indebtedness important problem in some countries, substantial variation across countries
 - Look at scenarios with different levels of household debt.
 - Consequences of combination of high private debt and higher private borrowing spread?
 - Does assumption of asset pooling and type changing downplay harmful effects of private indebtedness