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 countryspecific 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:

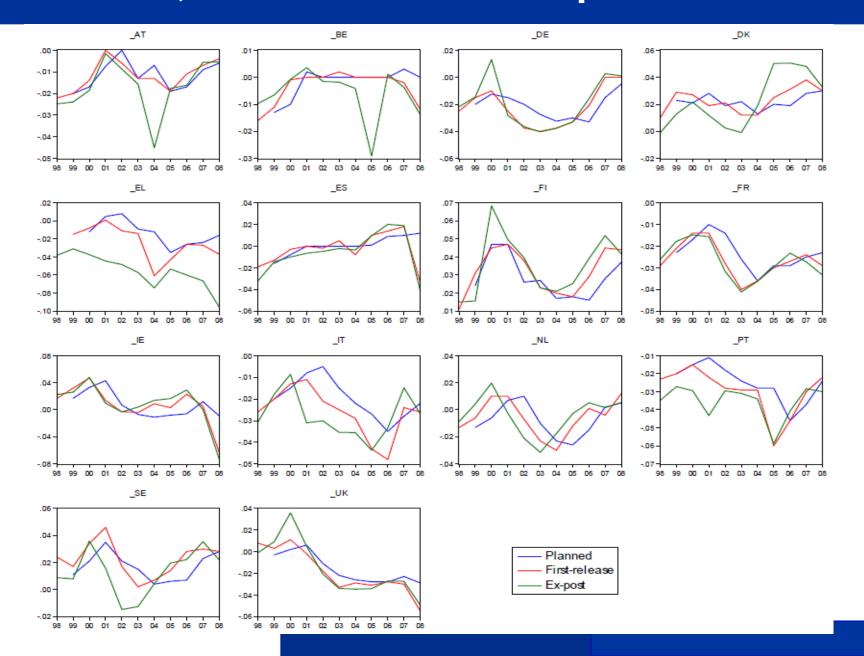
- ➤ No explicit fiscal responses to increasing default risk:
 - Projections coming 3 years are given: what if you reach fiscal limit in meantime?

 Return to given rules are 3 years: rule depends on debt, but is unaffected by stochastic fiscal limit

Comments on assumptions:

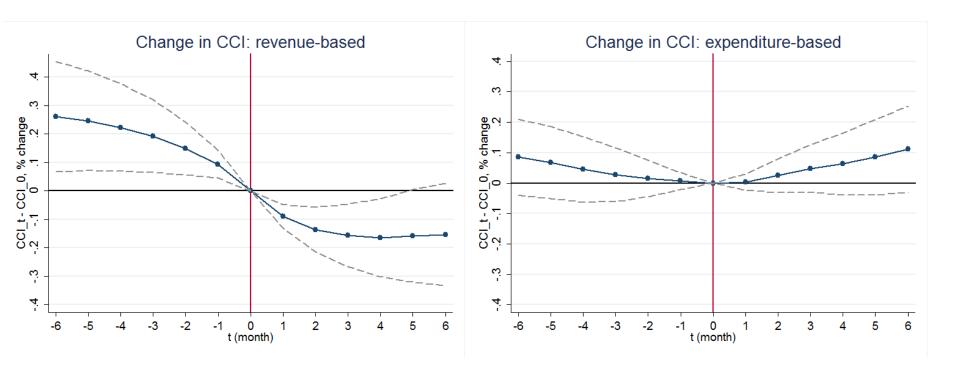
- ➤ Text says "agents ... form expectations about the future in a way consistent with the ECB-ECSB forecast exercise"
- Agents do not take account of uncertainty about fiscal paths?
 - Governments renege continuously on future promises
 - What if promised consolidations are not credible, or government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

Planned, first-release and ex-post balances



More fundamentally:

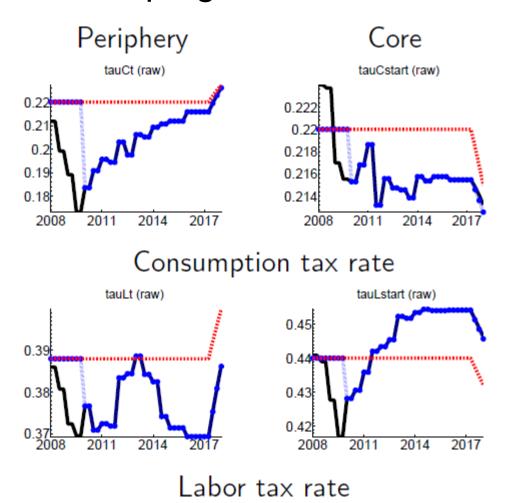
- Quantitative assessment of consolidation would require most relevant channels to be present in model
- ➤No explicit role for confidence channel, allegedly important during euro crisis:

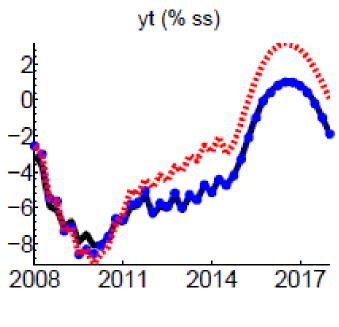


- ➤ Calculations are based on anticipated fiscal paths:
 - comparison actual projected fiscal paths to case where fiscal variables held constant, i.e. no consolidation
 - Give insight in default risks under counterfactual
 - Can economic effect of this risk be so strong that it makes consolidation the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

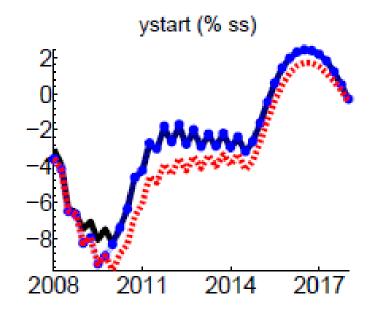
Discuss magnitudes of effects, in particular domestic vs spillover effects

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

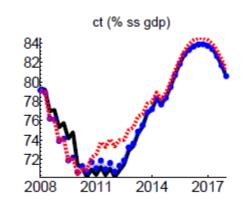




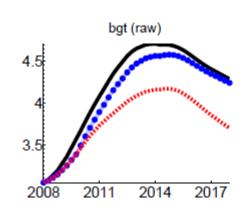
GDP periphery



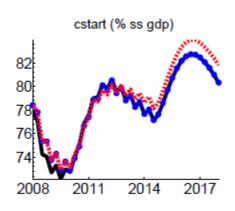
GDP core



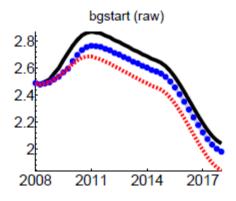
Consumption periphery



Gov't debt periphery



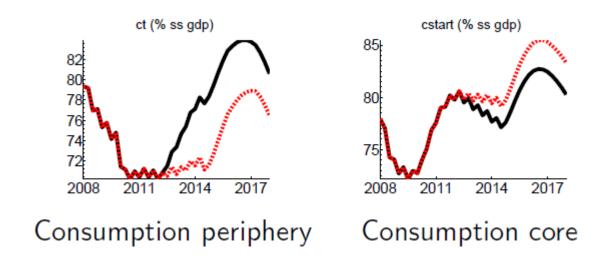
Consumption core



Gov't debt core

OMT:

➤ Why is OMT bad for 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

- ➤ 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