Discussion of "Sovereign risk and the effects of fiscal retrenchment in deep recessions" by Corsetti, Kuester, Meier, Müller

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Summary

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- Under what conditions can a reduction in government spending *raise* output? Is the *sign* of the short-run "spending multiplier" contingent on circumstances?

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- Conventional logic: If government spending is financed through distortionary taxation, expectations of lower taxes in the future could more than offset contractionary effect of spending reduction.
- Even more likely if fiscal consolidation reduces risk premia on government debt.

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- Two opposite effects of changes in government spending:
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  - Negative: Higher spread that cannot be offset by monetary policy.
- Examine which effect dominates for various parameter values, assumptions about fiscal rules.

Outline of comments

1. Effects of time-varying response of spreads?
2. The role of fiscal policy rules
3. Implications for euro area?

How sensitive are spreads to fiscal state?

- Interest rate spread as function of (expected) deficit or debt:

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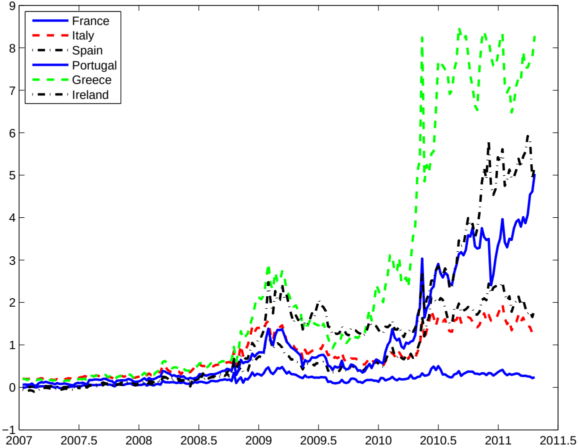
- ξ seems to vary substantially over time. Implications?

10-year sovereign spreads since 2007



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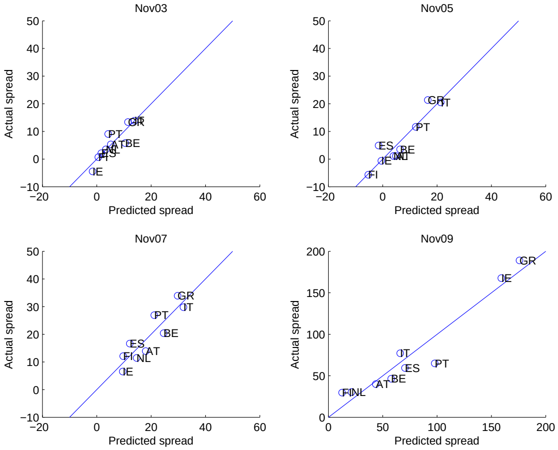
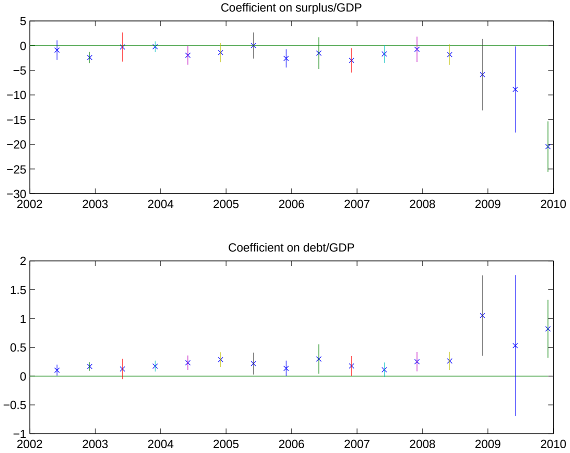
- At each date have only 10 observations and 3 regressors. Still, good fit.

Actual vs. fitted spreads from regressions on fiscal variables



Regression coefficients much larger during crisis



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- Proposition 1: Necessary condition for unique bounded RE equilibrium is

$$\mu(1 + \xi\chi\varsigma) < 1/(\beta\mu)$$

  Increase in ξ can push model into indeterminacy. Multiple self-fulfilling expectations equilibria.

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- Retrenchment today or
- Commitment to retrenchment in the future.
- In CKMM, spread depends on expected deficit next period, but horizon for assessing solvency might be much longer, room for commitment.

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  - Promise of persistent spending cut upon exiting ZLB
- Upon exiting ZLB, monetary policy offsets any interest rate spread $\rightarrow$ any stimulative effects from lower spreads accrue only during ZLB period.
- For sufficiently long duration of ZLB, high ξ get output expansion in response to contraction.

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- Commitment to a rule can have substantial gains, consistent with literature on monetary policy.
- Are promises of reversing debt increase on the spending side credible? Explore sensitivity of results to fiscal rules:
  - Earlier work by CKMM.
  - Bohn's results on historical fiscal adjustment.
  - Labor supply and distortionary taxation.

Implications for euro area fiscal policy?

- ZLB period over?
- Is monetary policy currently sterilizing increase in spreads?
- ξ is very high.