Discussion of

"Is There a Fiscal Free Lunch in a Liquidity Trap ?"

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Main argument of the paper

➢ The impact of fiscal measures on economic activity under the ZLB is a hot topic (Cogan et al 2009, Princeton conference).

➢ This paper provides an important contribution: using NK-models to evaluate the multiplier of spending shocks under the ZLB.

➢ Structural models are the appropriate tool to study the issue:

  ➢ not much empirical evidence,

  ➢ role of expectations, budget constraints, monetary-fiscal interaction

➢ Main message:

  ➢ multipliers can be large depending on the persistence of the ZLB,

  ➢ but unlikely to be so: due to lags in implementation of spending plans and financing with distortionary taxes

Main comments

➢ the impact of the monetary policy regime and the implementation of public spending plans on the multiplier

➢ the multiplier in the actual US context: the size of the underlying shock and the persistence of the ZLB

=> evaluate some of the arguments in the paper by using the SW 2007 model, augmented with public budget equations

Public spending shock and the monetary policy regime

- ➢ a binding ZLB changes temporally the nature of the monetary policy reaction to all type of shocks

- ➢ useful to remind how the multiplier of a public spending shock depends crucially on the monetary policy reaction or/and the MP regime:

  - ➢ estimated rule in SW (general Taylor rule): AMP - PFP

  - ➢ constant real rate: NMP - PFP

  - ➢ constant nominal rate: PMP - AFP

- ➢ crowding out/in effect depends on intertemporal substition effect (real rate), intratemporal substitution effect (labor supply) and wealth effect

- ➢ assuming lump-sum taxation for the moment

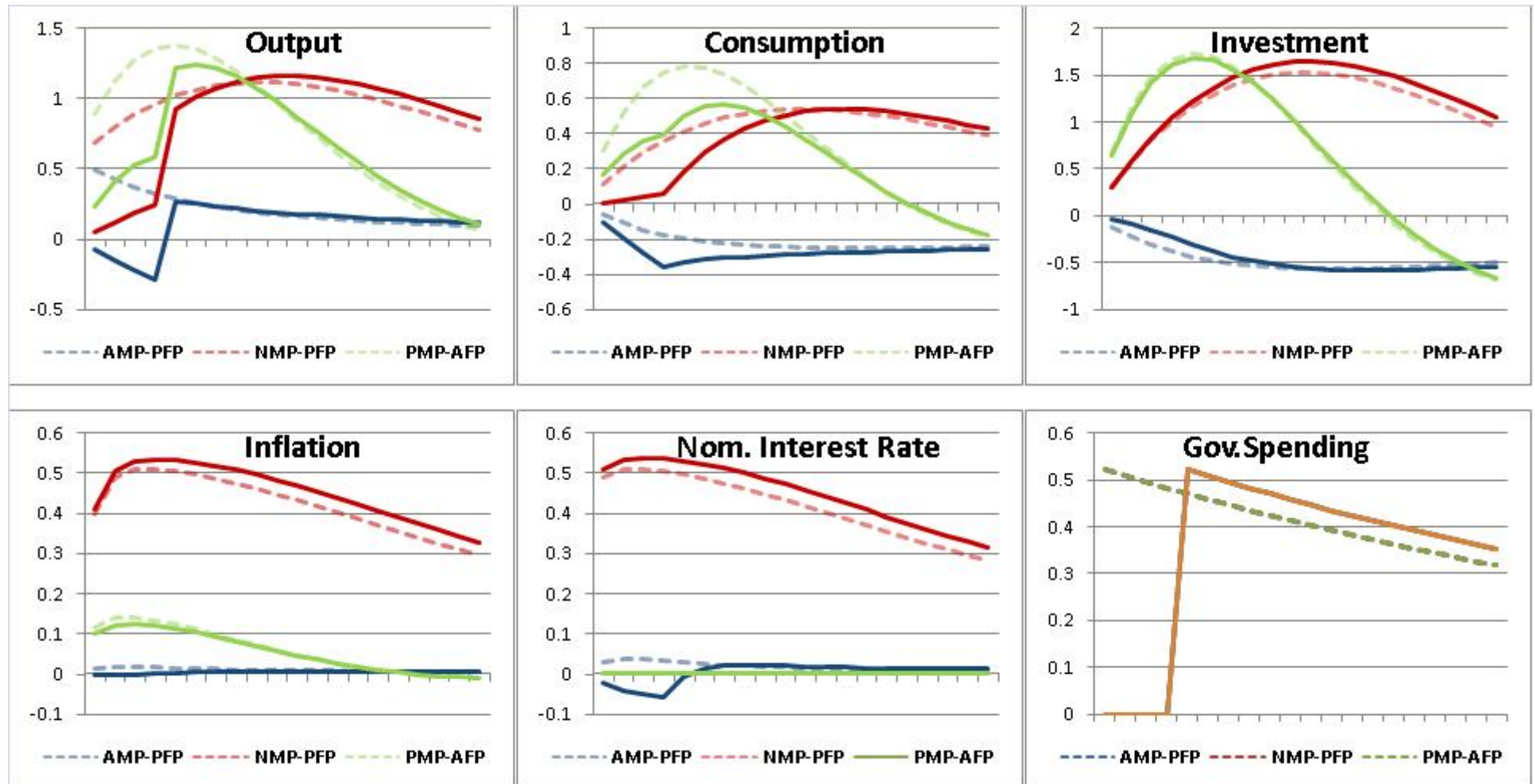# Public spending shock and the monetary policy regime
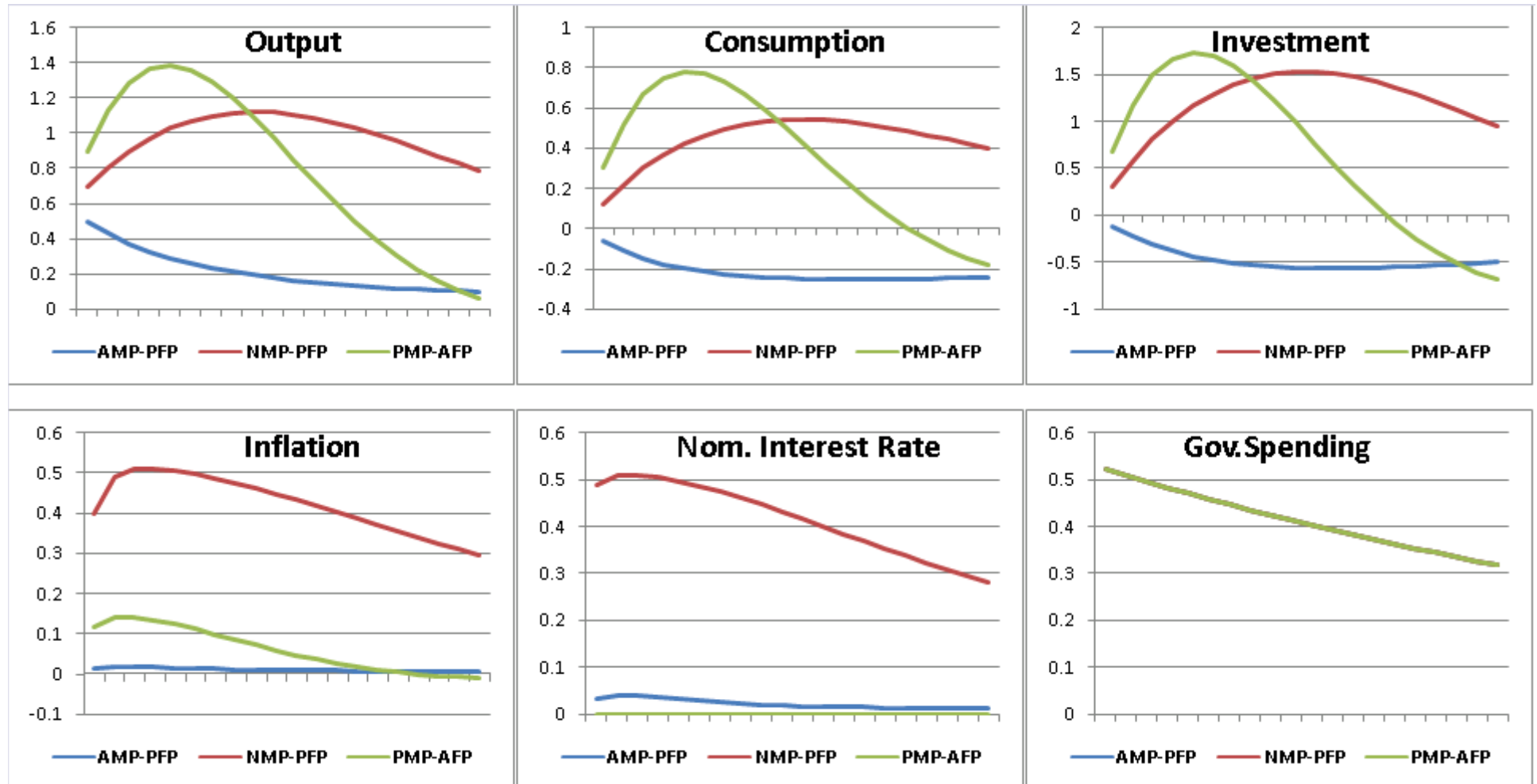
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Public spending shock and the monetary policy regime

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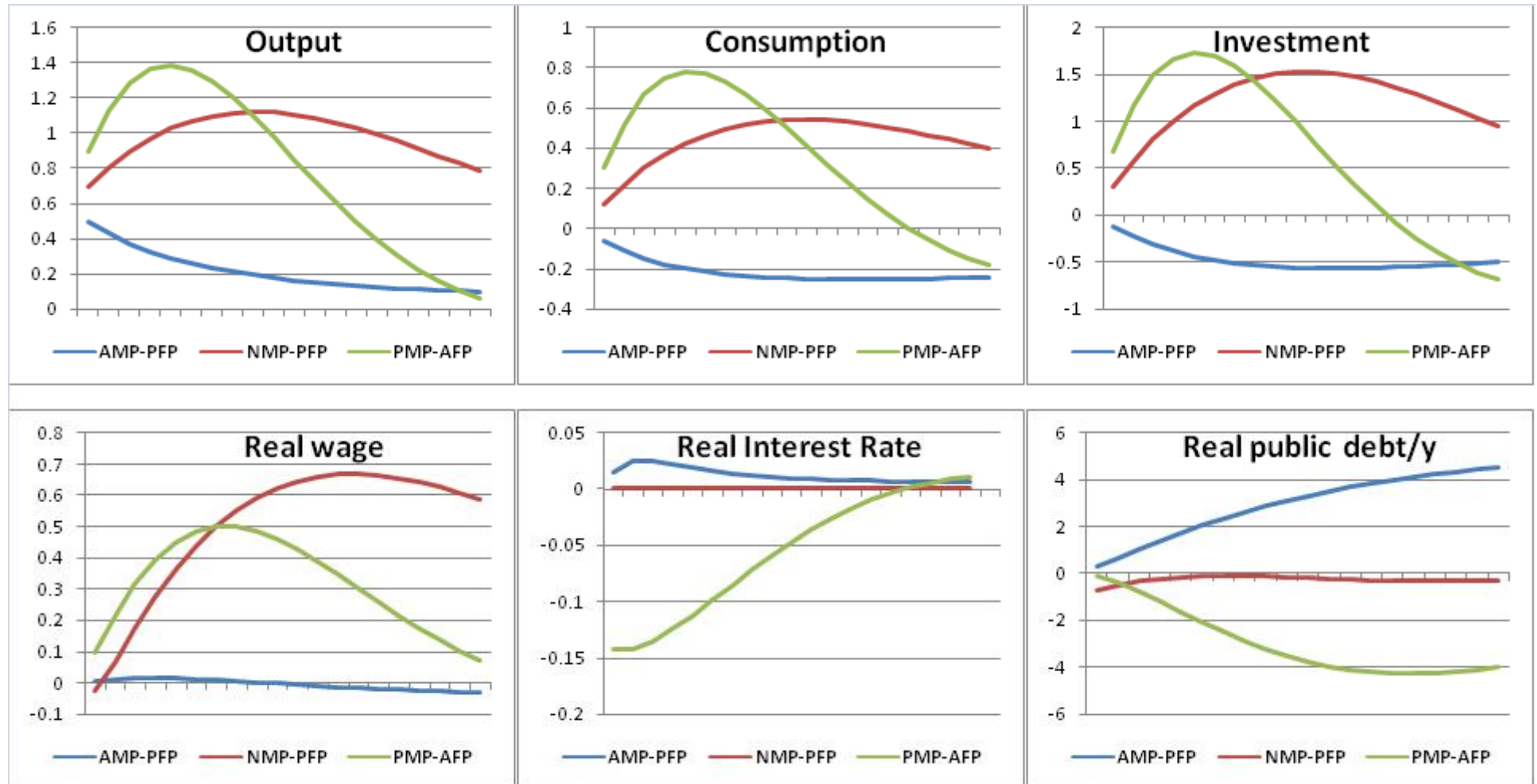
Public spending shock and the monetary policy regime

➤ A NK-DSGE model is not incompatable with a large positive multiplicator and accelerator effect of a public spending shock.

➤ This holds also for spending shocks that are announced but require an implementation lag:

Public spending shock and the monetary policy regime

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Public spending shock and the monetary policy regime

➤ This paper assumes that the ZLB temporally changes the MP-rule to a nominal peg, but agents anticipate a return to the AMP regime once inflation starts to rise again.

  ➤ inflation objective remains credible at all times ? (ECB - BMPE report June 2009)

  ➤ what if RE-hypothesis is replaced by learning dynamics (Evans et al 2008) ?

  ➤ stability depends on the size of the shock !

  ➤ fiscal policy remains in the passive regime, only discretionary shocks are considered !

➤ Alternative approach could consider switches between policy regimes: Davig and Leeper (2009) assume stochastic switches between alternative MP-FP regimes.
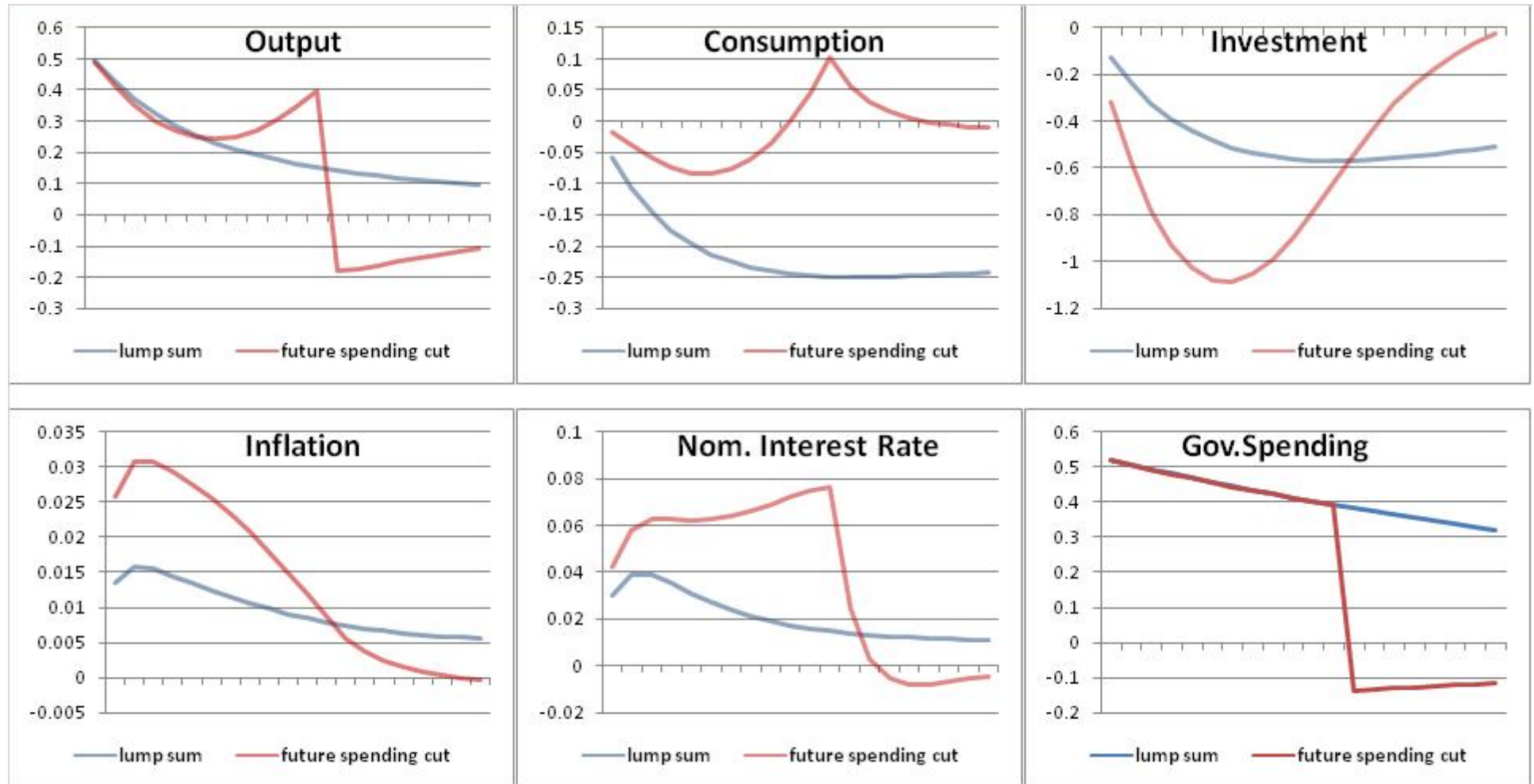
Public spending shock and its financing

- ➤ Multiplier of a spending shock depends on the way it is financed:
  - ➤ lump-sum taxation: with ricaridan households the timing does not matter
  - ➤ distortionary labor taxes: timing matters even with R-hh
  - ➤ future spending cuts

Public spending shock and its financing
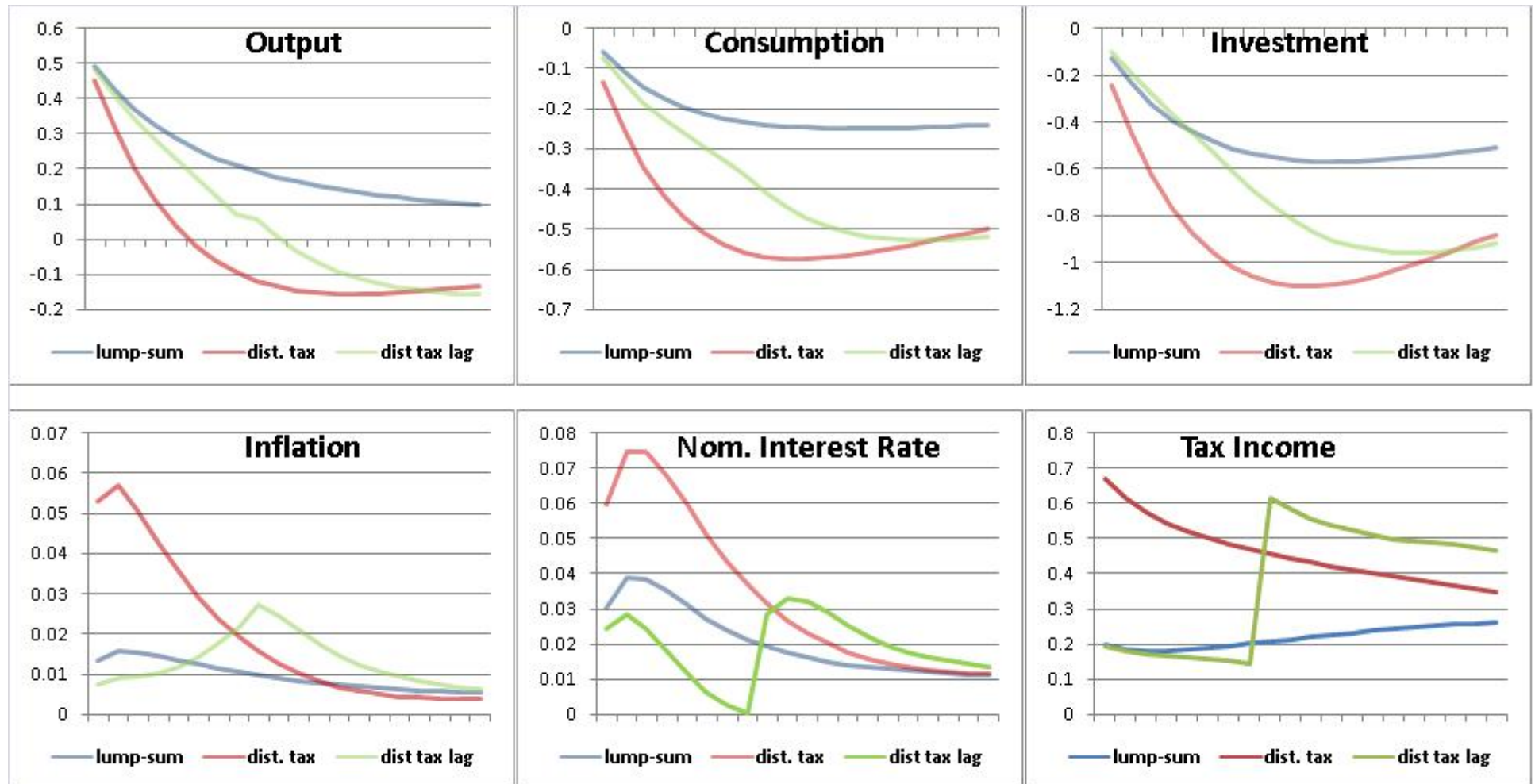
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  ➢ future spending cuts

➢ The importance of the financing depends strongly on how effective the spending shocks are: with large positive multipliers, tax income will raise and public debt will stabilize without a need for higher (distortionary) taxes.

Public spending shock in the present US situation

➢ the impact of the announced spending plan depends crucially on how persistent the ZLB will bind:

  ➢ how long will the implicit switch in the MP regime last ?

  ➢ how long will the potential destabilizing deflationary process last ?

➢ what is the nature and magnitude of the shocks underlying the actual US recession ?

➢ what does this imply for the baseline scenario against which the spending shock needs to be evaluated ?

➢ Impact with and without the binding ZLB

➢ Evaluate the multiplier under different assumptions about the intensity of the shocks

Innovations in SW 2007 - evaluated for last ten years - ending 2009q1
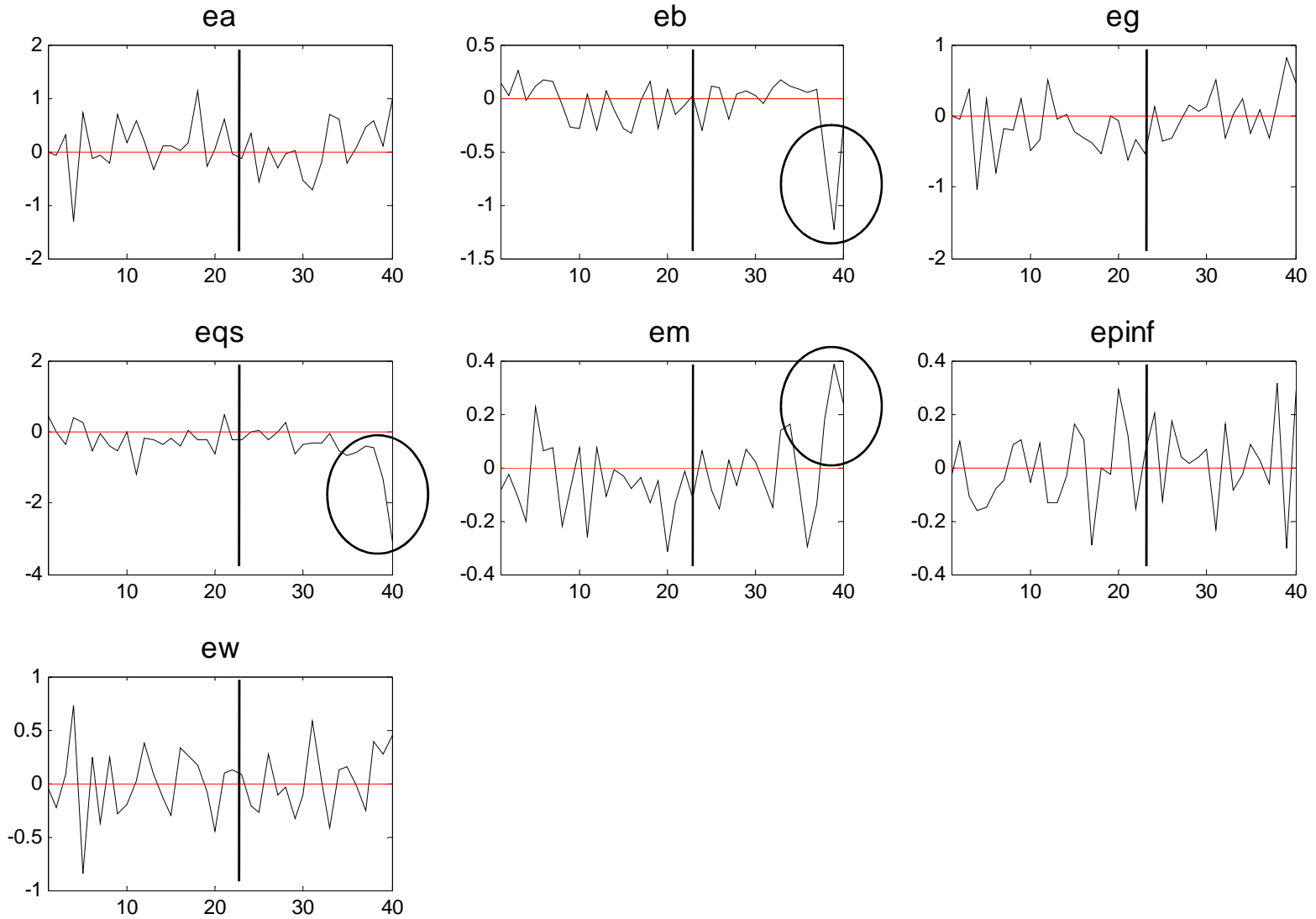
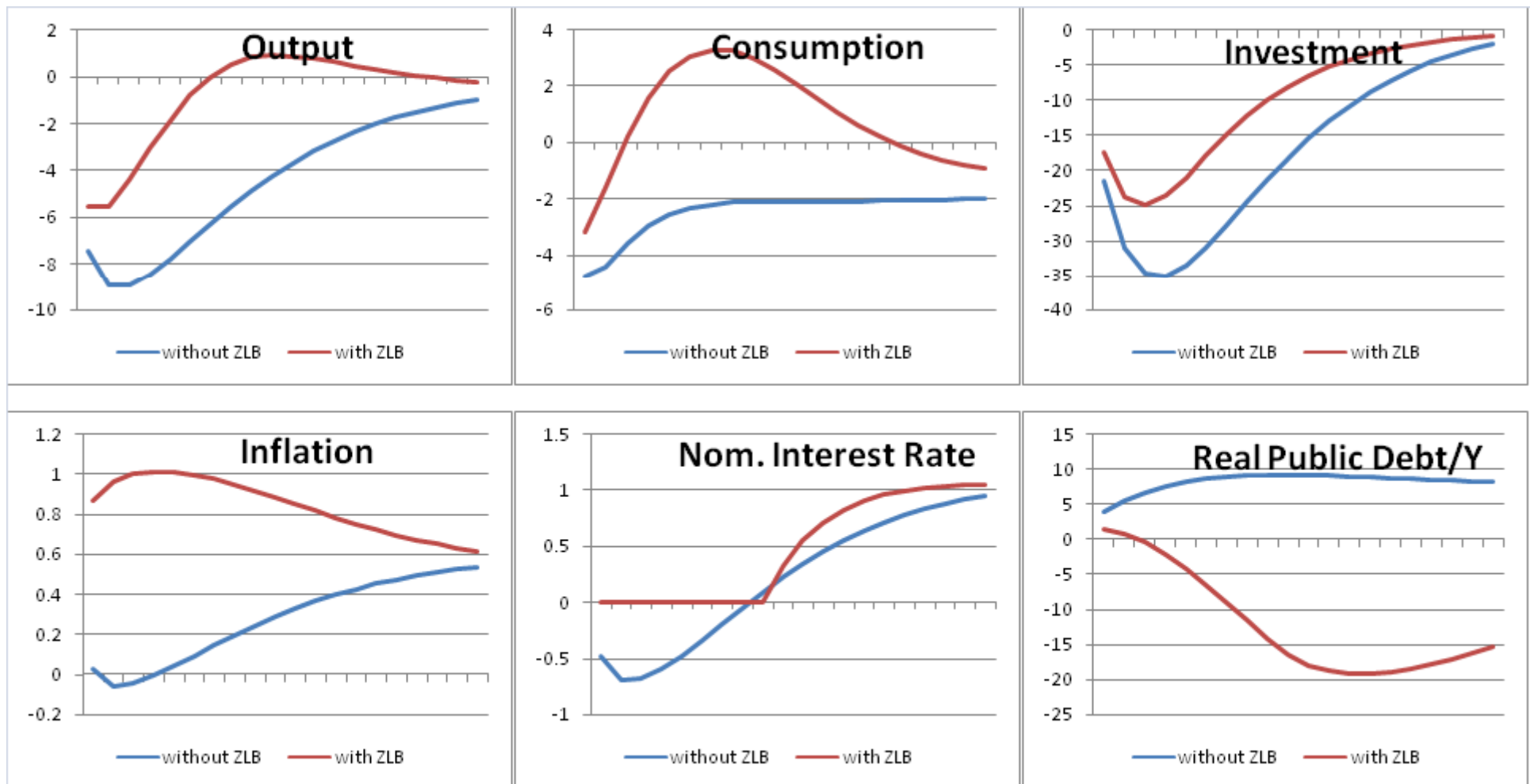# Baseline under estimated risk premium and investment shock
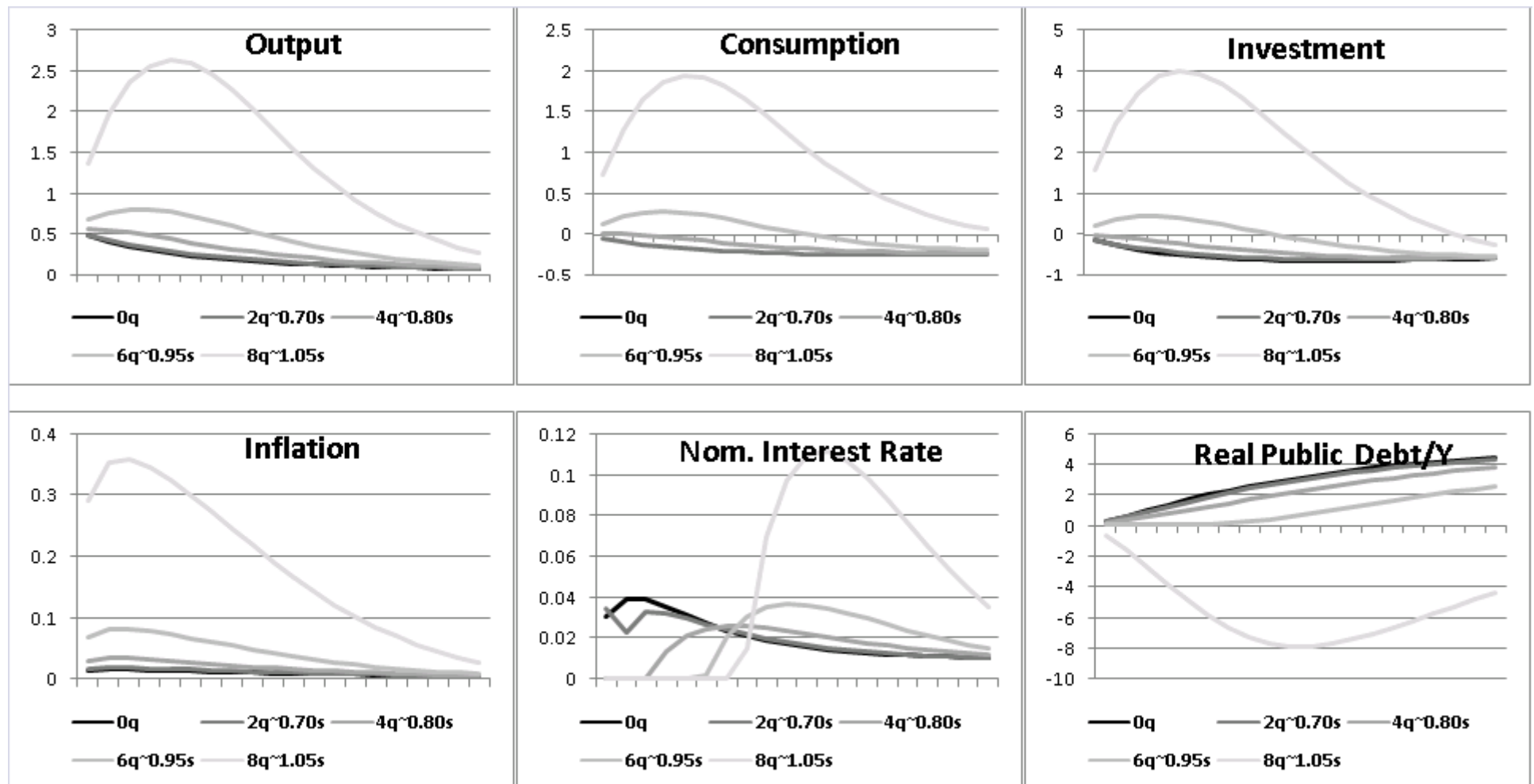
➢ disregarding other shocks and policy measures
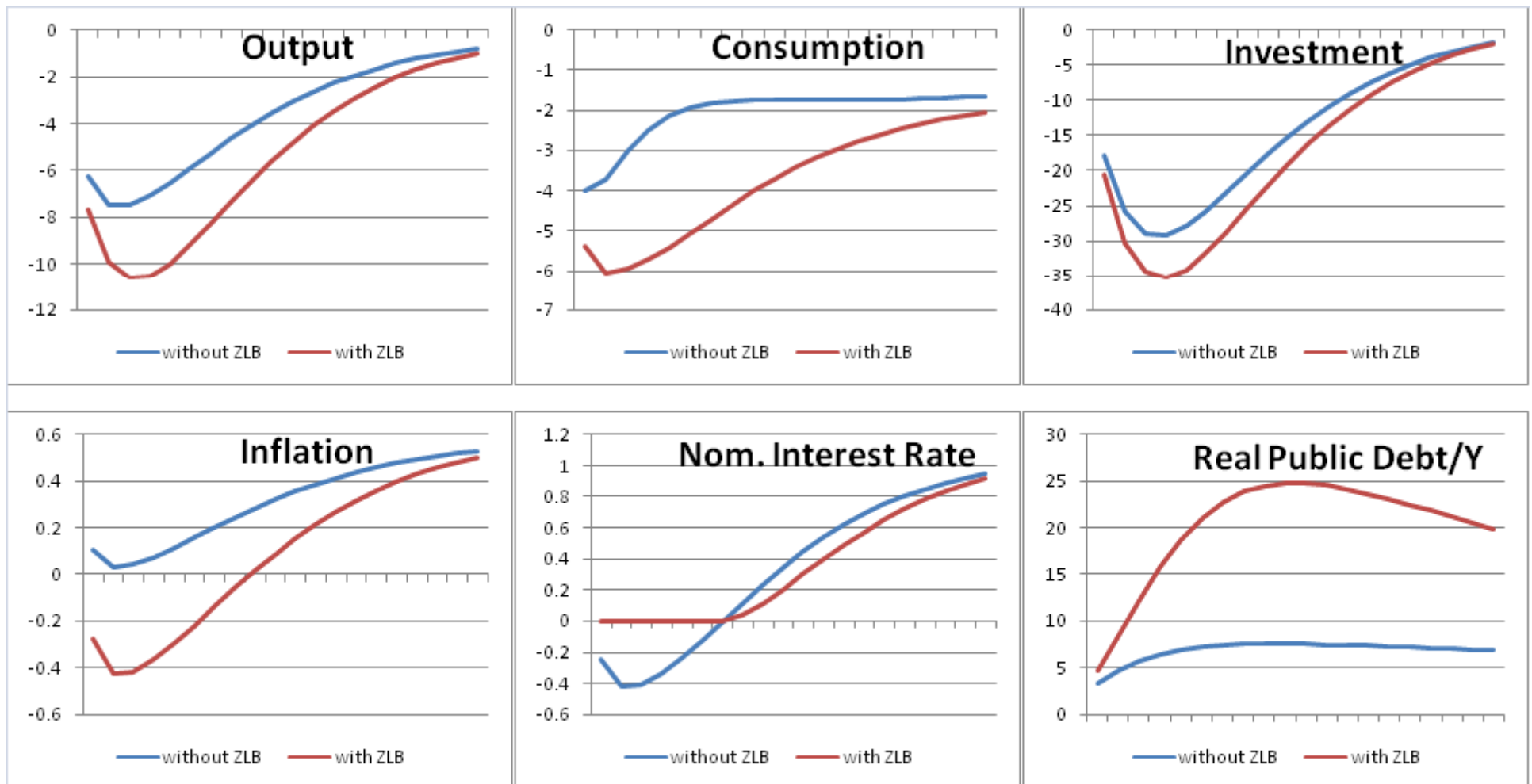
What if estimated shocks are underestimated by 20%

➢ solution method excludes explosive deflationary path

➢ inflation expectations not determined: ZLB produces boost

Public spending shock under the ZLB:

> ➤ multiplier depends crucially on the persistence of the ZLB or on the size of the underlying demand shocks

Public spending shock with implementation lag under the ZLB

➢ with a low persistence of the ZLB, the multiplier is negative SR

➢ with a high persistence of the ZLB, the multiplier is highly +
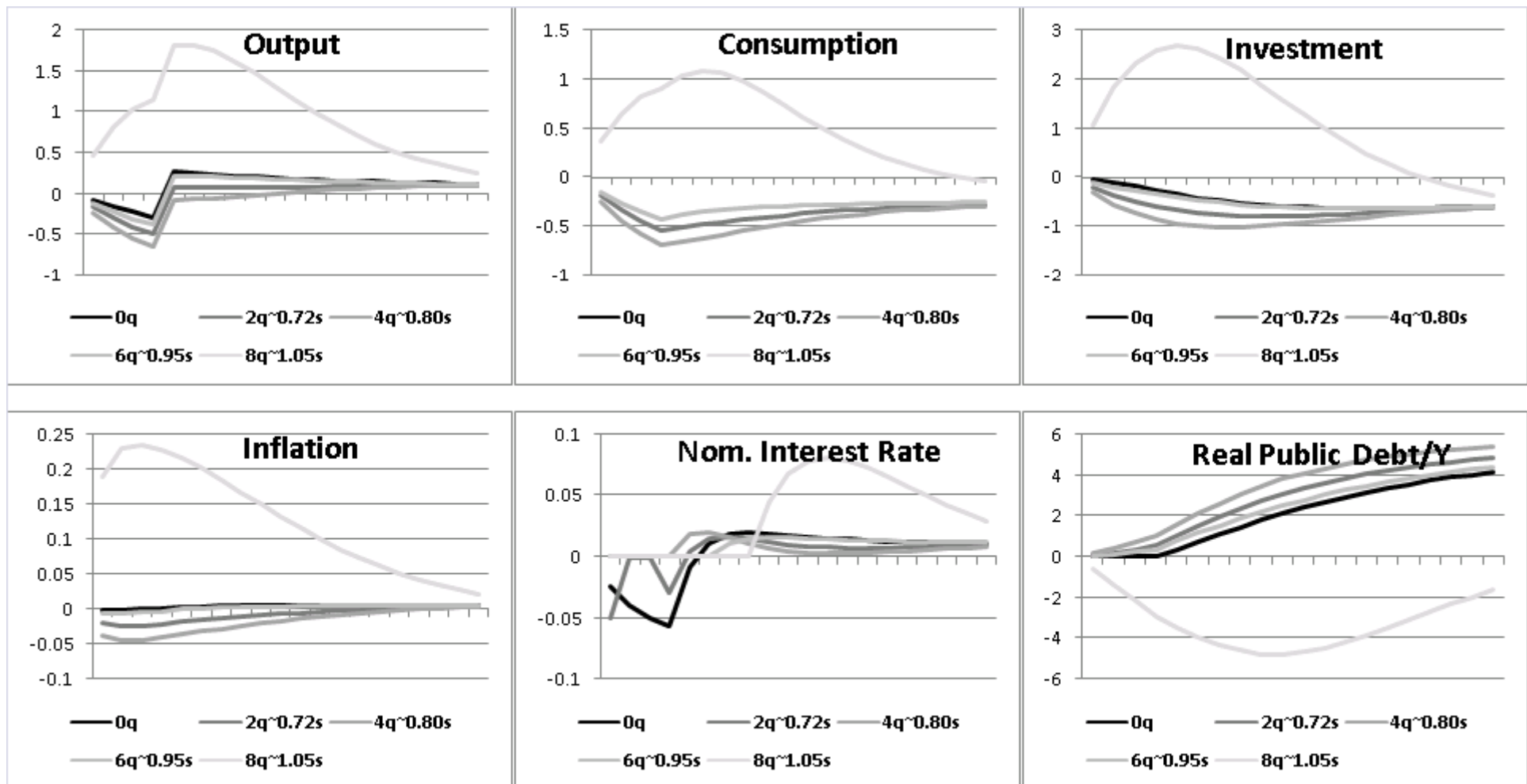
Concluding: Is there a fiscal free lunch under the ZLB

➢ the paper suggests that the multiplier depends on the anticipated persistence of the ZLB, therefore on the perception of the economic situation.

=> SW-model illustrates that in the current US environment, multipliers can indeed be high.

➢ In such circumstances, implementation lags and financing considerations are probably not as important as suggested in the paper.

=> Other assumptions may be more important:

➢ how will expenditure shock create higher inflation in a situation of large output gaps ?

➢ how will inflation expectations adjust: RE - credible targets ?