Sovereign risk, monetary policy and fiscal multipliers: a structural model-based assessment

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Discussion

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Overview

- **Very interesting paper**

- **Clear message on the relevance of fiscal multipliers for Italy in normal and crisis time**

- **Useful evaluation of fiscal consolidation in presence of sovereign risk**

Results

1. Public consumption multiplier > 1 only under exceptional conditions (constant monetary policy rate for at least 5 years).

2. Sovereign risk strongly shrinks the multiplier

3. Tax multipliers are lower than government consumption multipliers

Methodology

Simulations of public consumption multiplier and tax multiplier using the Bank of Italy DSGE model under differing assumptions on

- the monetary policy stance,

- the financing of the fiscal expansion,

- the role of sovereign risk.

Sovereign risk, monetary policy and fiscal multipliers: a structural model-based assessment:

Key ingredients:

- **Three –region DSGE model: Italy, the rest of the euro area (REA) and the rest of the world (RW)**

- **Households: consume, supply labour, accumulate and rent capital**

- **Firms: final consumption and investment goods, perfectly competitive; intermediate goods, monopolistic**

- **Central Bank: Taylor rule or constant rate at its steady-state value**

- **Fiscal authority: fiscal rule based on debt/GDP dynamics**

- **Sovereign spread: based on debt/GDP dynamics**

Sovereign risk, monetary policy and fiscal multipliers: a structural model-based assessment: Discussion

1. **Credit spreads modelling**. Increase linearly with debt/GDP ratio. Credit spread rise initially with fiscal expansion, then declines linearly returning to baseline level when fiscal expansion is withdrawn.

   But during fiscal expansion the sovereign risk does not fall and may continue to increase

   ⇨ Possible underestimation of the role played by sovereign risk

2. **Credit spreads channel**. Spreads impact household behavior via the interest rate paid by the Italian government.

⇨ Channel that works through intertemporal substitution in consumption.

But, in a model with capital accumulation, another important channel is given by the cost of capital. The larger the spread, the larger the cost of capital, the less the investment. Important to introduce a commercial banking sector.

3. **Constant monetary policy assumption**. Interest rate is held constant at its steady-state value. But this value is above the ZLB. It would be interesting to see the values of the multipliers when the nominal interest rate is constant at the ZLB.

⇨ Possible underestimation of the multipliers

4. **Imperfect exchange rate pass-through.** Short-term results of increasing public consumption by 1% of baseline GDP.

Fiscal stimulus => GDP increases => Italian prices increase

⇨ real exchange rate appreciation of Italy against partners

⇨ Italy's net exports diminish

But exchange rate pass-through is imperfect: in the short run is incomplete and delayed. Importers and exporters will react according to how long they expect the stimulus to last.

⇨ Attenuation and lag for the impact on net exports.

5. **Very interesting paper,** I have enjoyed reading it