

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

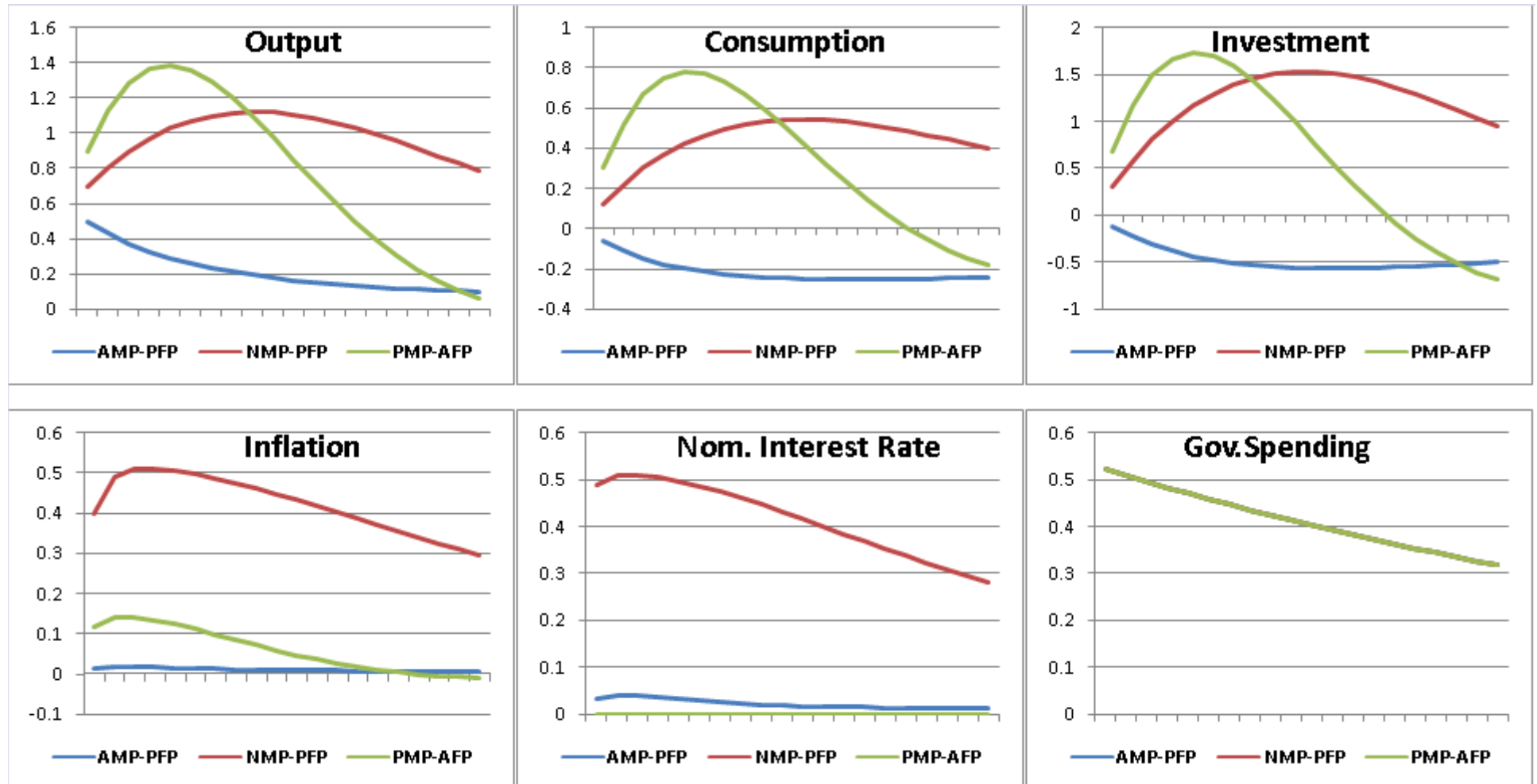
- the impact of the monetary policy regime and the implementation of public spending plans on the multiplier
- the multiplier in the actual US context: the size of the underlying shock and the persistence of the ZLB

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

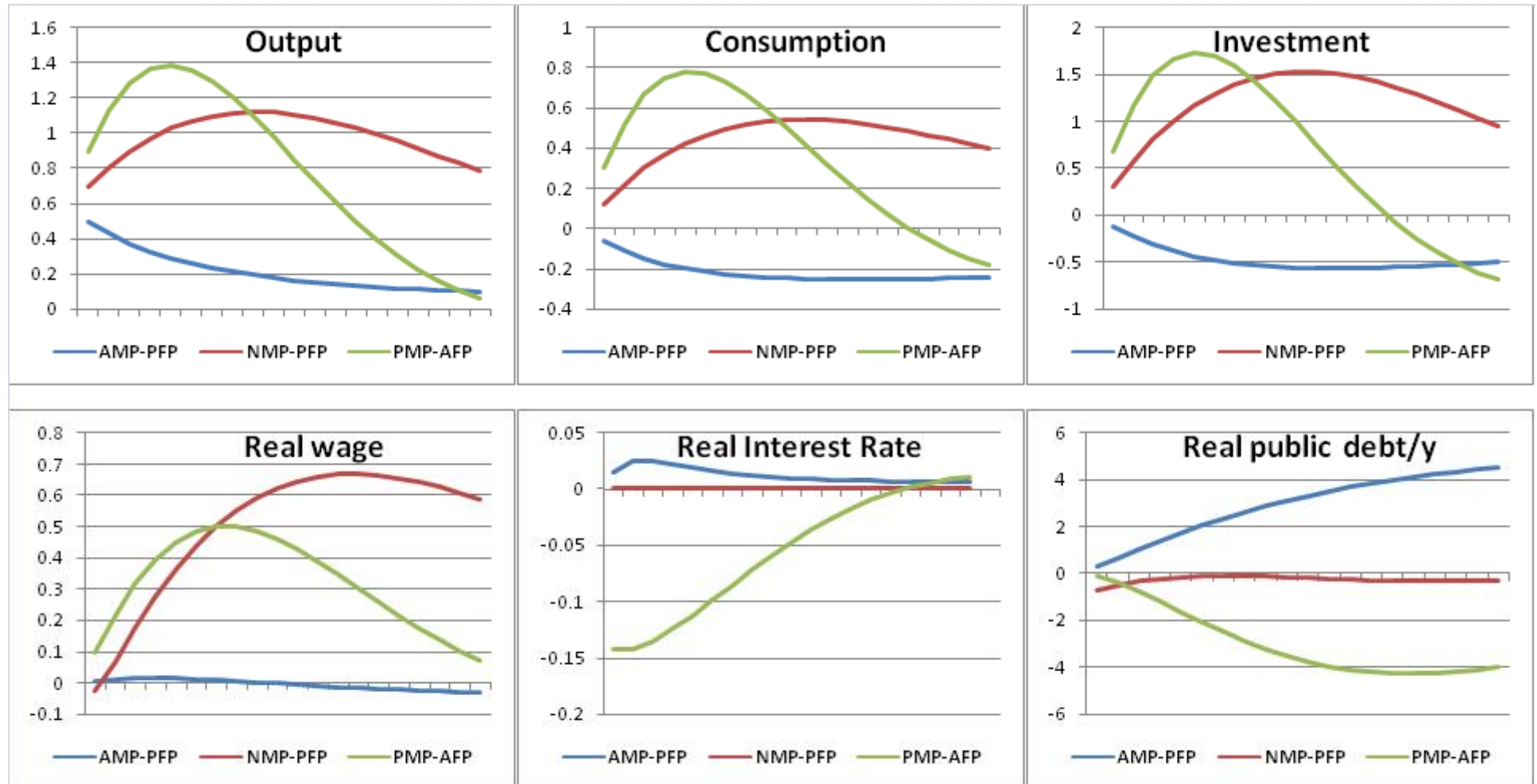
## Public spending shock and the monetary policy regime

- 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 substitution 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



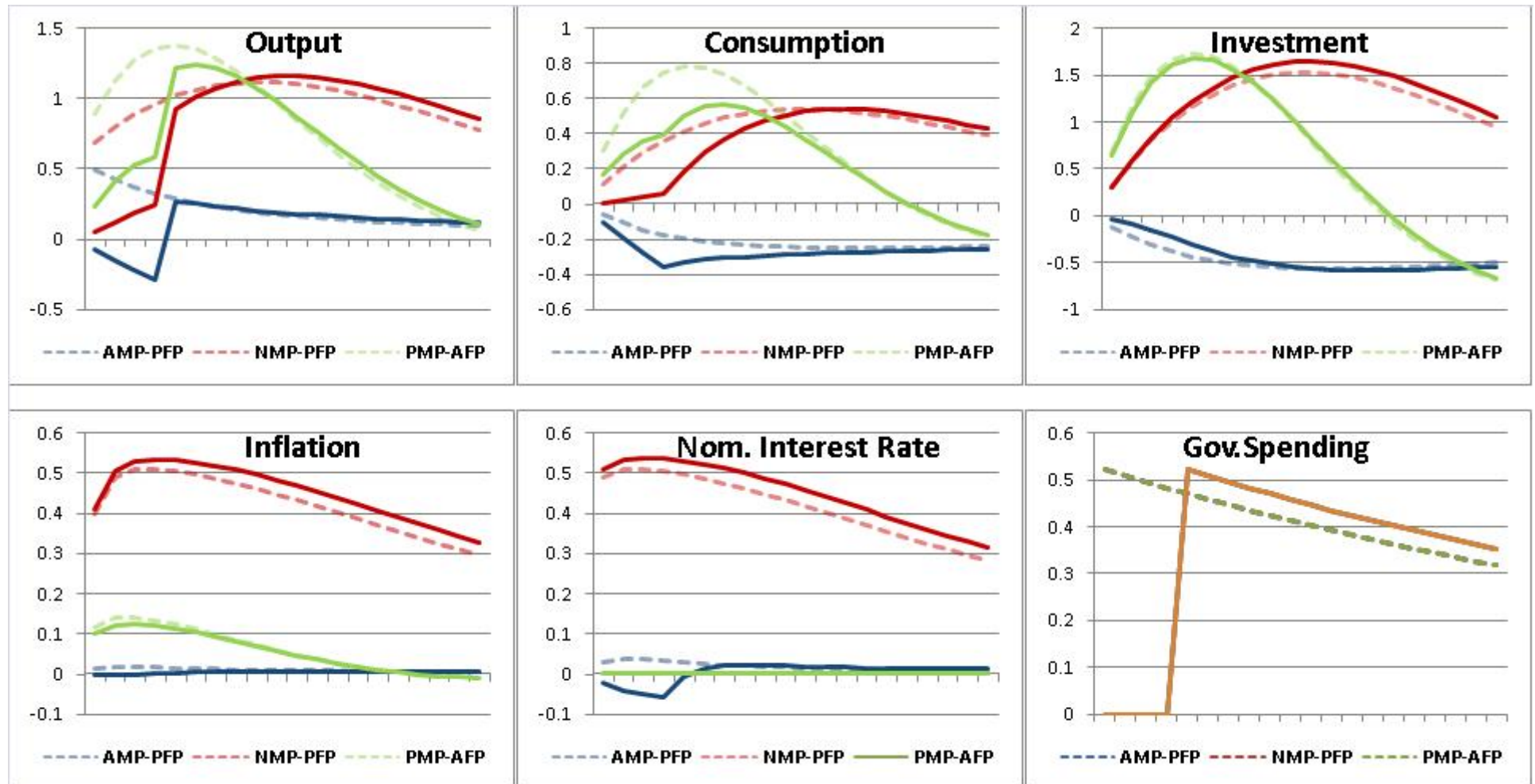
## Public spending shock and the monetary policy regime



## Public spending shock and the monetary policy regime

- A NK-DSGE model is not incompatible with a large positive multiplier 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



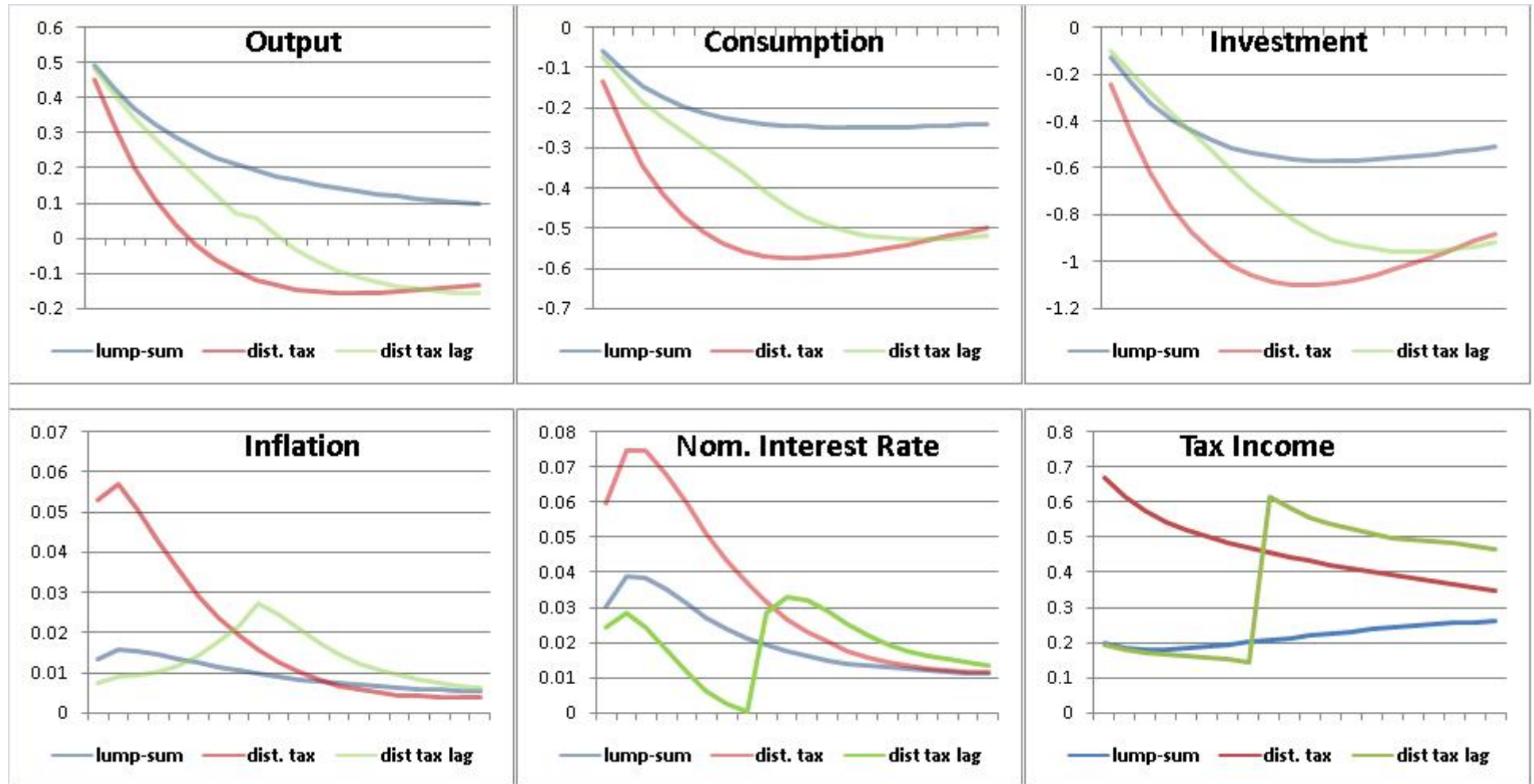
## Public spending shock and the monetary policy regime

- 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.

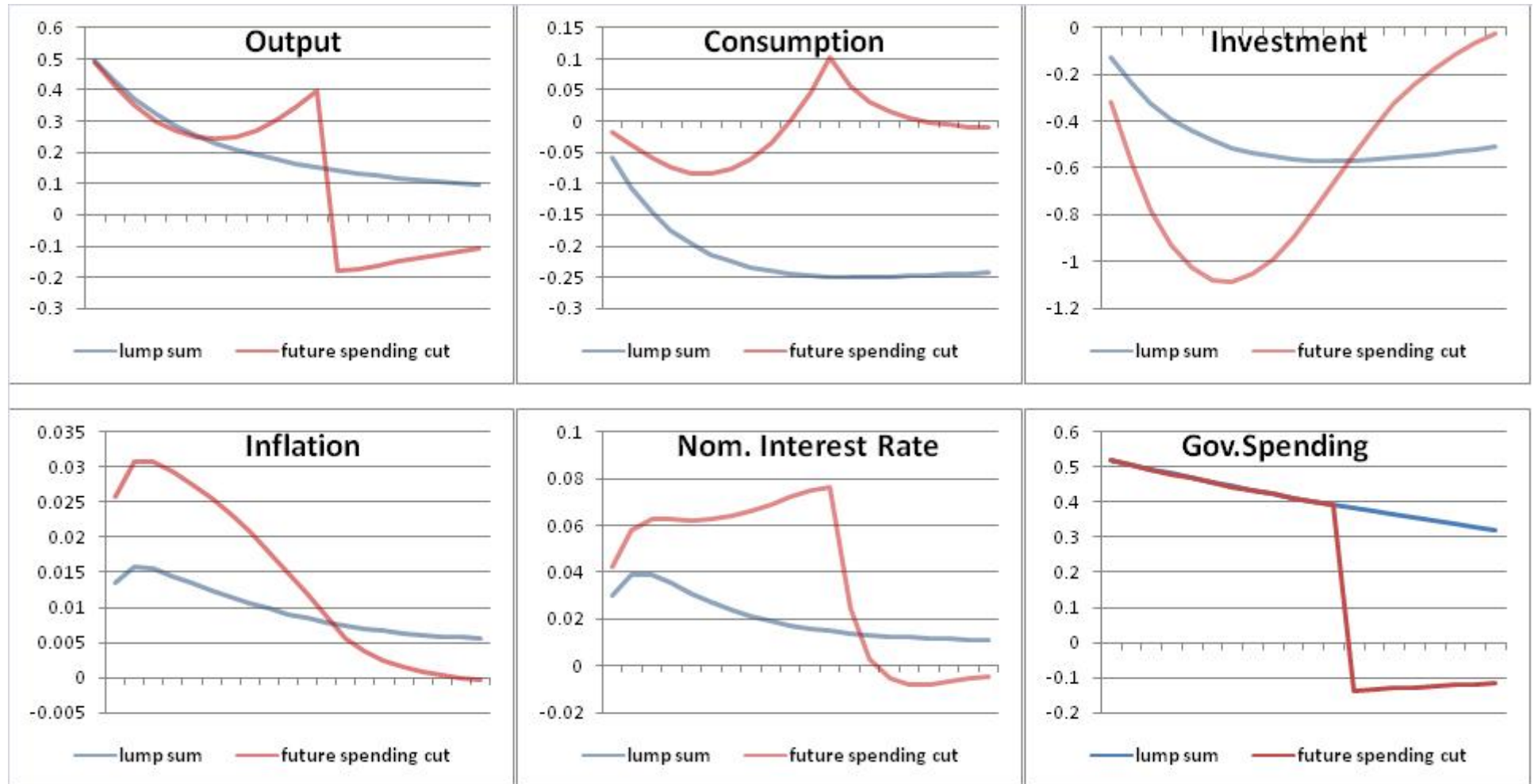
## Public spending shock and its financing

- Multiplier of a spending shock depends on the way it is financed:
  - lump-sum taxation: with ricardian 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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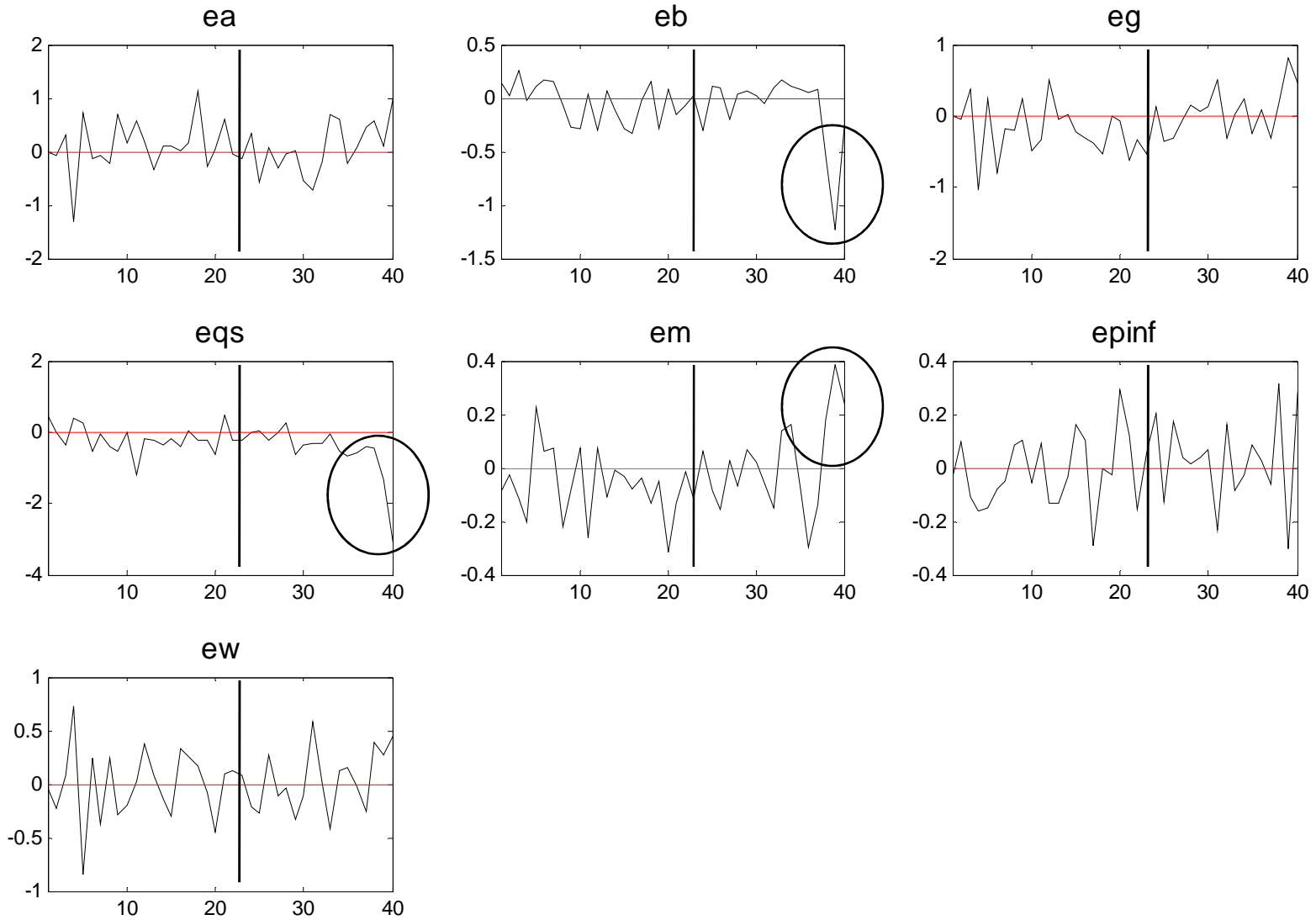
## Public spending shock and its financing

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  - lump-sum taxation: with ricardian households the timing does not matter
  - distortionary labor taxes: timing matters even with R-hh
  - 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

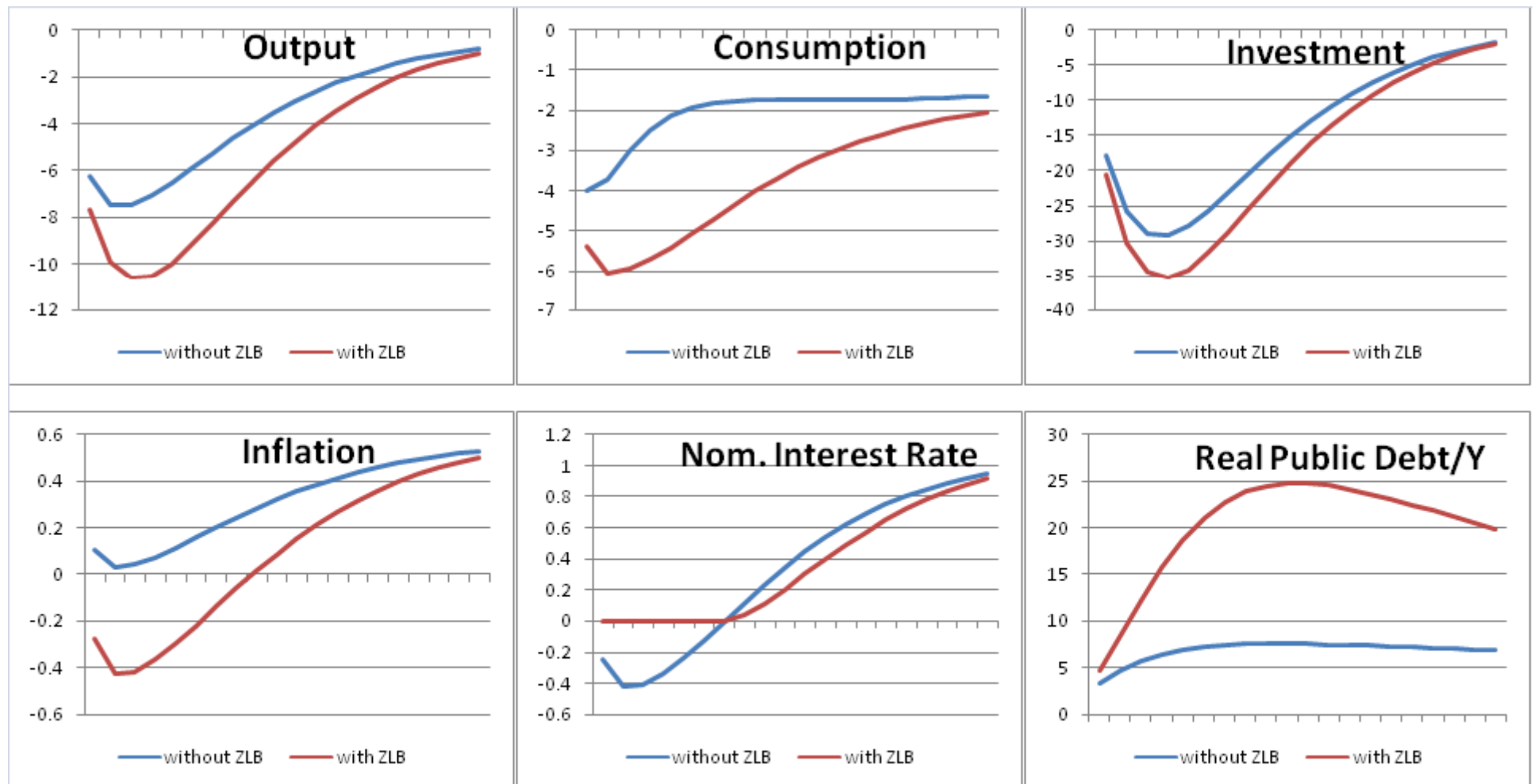
- the impact of the announced spending plan depends crucially on how persistent the ZLB will bind:
  - how long will the implicit switch in the MP regime last ?
  - how long will the potential destabilizing deflationary process last ?
- what is the nature and magnitude of the shocks underlying the actual 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



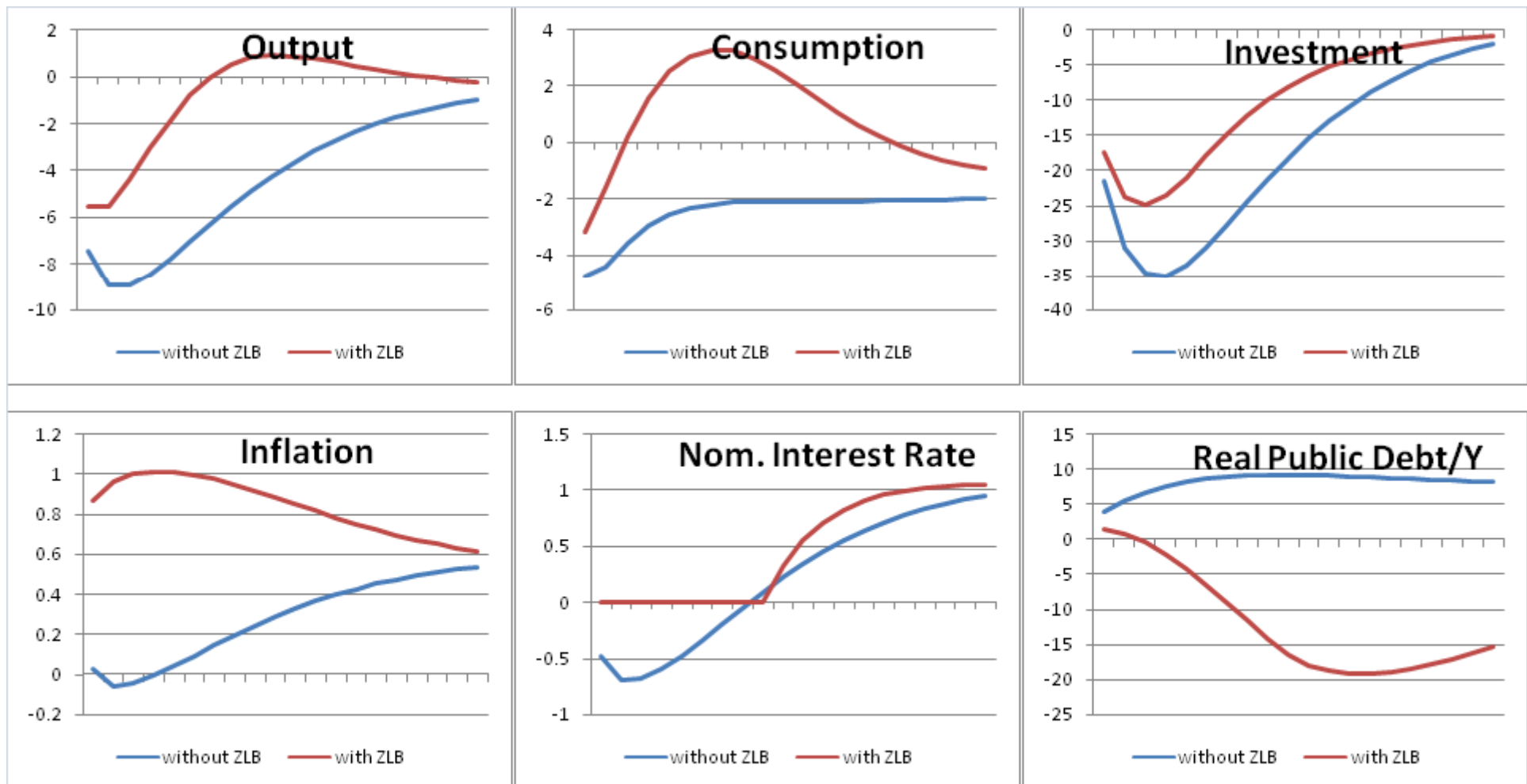
## Baseline under estimated risk premium and investment shock

- disregarding other shocks and policy measures



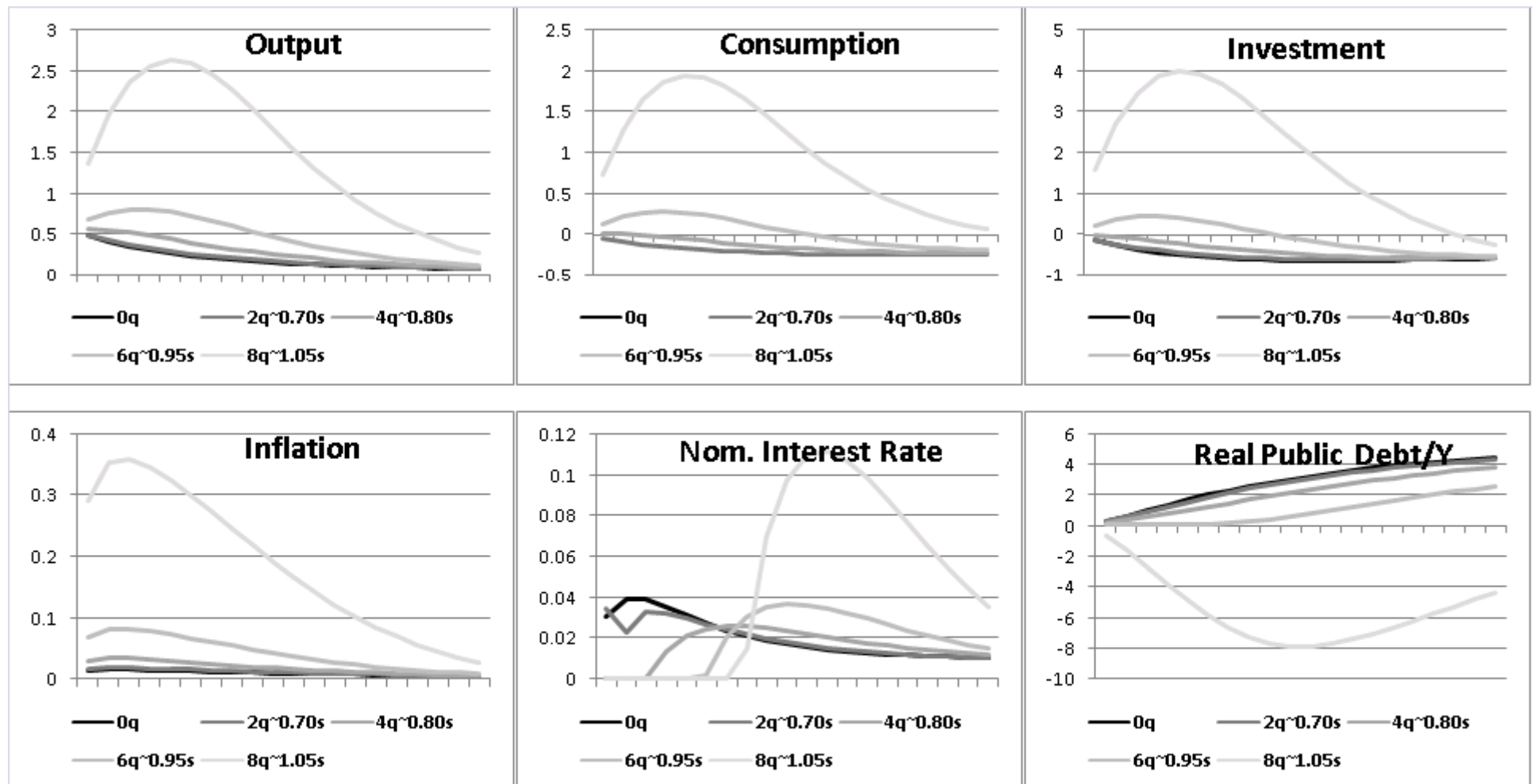
## What if estimated shocks are underestimated by 20%

- solution method excludes explosive deflationary path
- inflation expectations not determined: ZLB produces boost



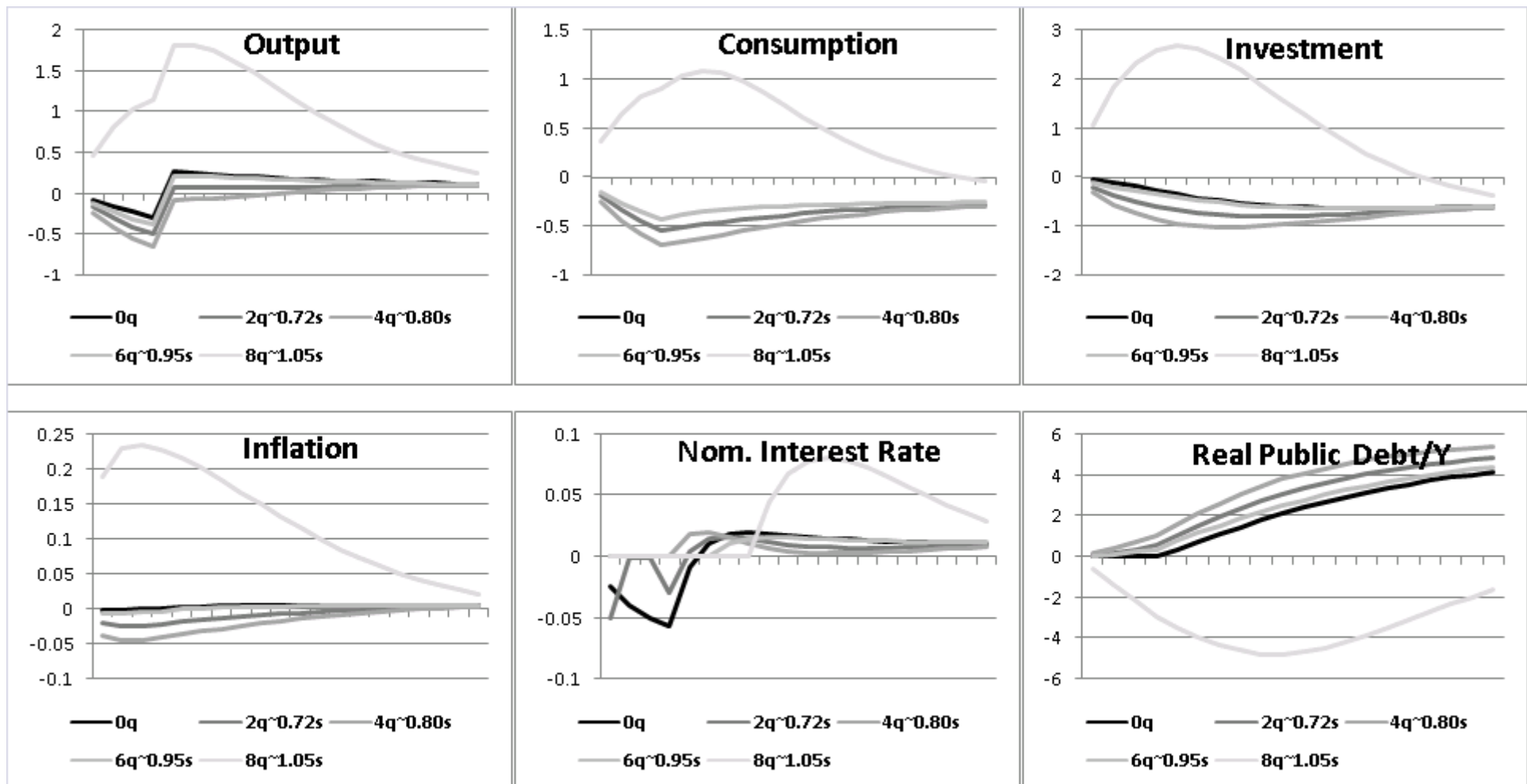
## Public spending shock under the ZLB:

- 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 ?

