FISCAL AFFAIRS

Discussion on "Brothers in Arms: Monetary-Fiscal Interactions Without Ricardian Equivalence" by Rachel and Ravn

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The paper: New mechanism on MF interaction without RE

Output	$\widehat{y}_t$	$=$	$\mathbb{E}_t\widehat{y}_{t+1} - i_t + \chi\widehat{v}_t + (1-\chi\gamma)\mathbb{E}_t\widehat{\pi}_{t+1}$
Inflation	$\widehat{\pi}_t$	$=$	$\beta\mathbb{E}_t\widehat{\pi}_{t+1} + \kappa\widehat{y}_t$
Real debt	$\widehat{v}_t$	$=$	$\frac{1}{\beta}(\widehat{v}_{t-1} - \widehat{s}_t) + \gamma\left(i_t - \frac{1}{\beta}\widehat{\pi}_t\right)$
Transfer rule	$\widehat{s}_t$	$=$	$\alpha_b(\widehat{v}_{t-1} - e_t^s) + \alpha_x\widehat{y}_t + e_t^s$
MP rule	i_t	$=$	$\phi_\pi\widehat{\pi}_t + \phi_x\widehat{y}_t + e_t^i$

RANK-based model: χ = 0

$$\hat{y}_t = E_t\hat{y}_{t+1} - i_t + E_t\hat{\pi}_{t+1}$$

Debt has no direct impact on household consumption

Policy regimes sharply split: (Fiscal and Monetary policy rule)

- RANK Taylor Principle
- RANK Fiscal Theory of Price Level

This paper's NOVELTY: χ >0

$$\hat{y}_t = E_t\hat{y}_{t+1} - i_t + \chi\hat{v}_t + (1-\chi\gamma)E_t\hat{\pi}_{t+1}$$

- Finitely-lived households (Blanchard-Yaari perpetual youth model) ➔ ***Non-Ricardian economies***
- Public debt becomes perceived household wealth (**χ >0**)
- Two-way monetary-fiscal interactions
  - MP ➔ FP: Inflation and interest rates affect debt (*usual accounting channel*)
  - FP ➔ MP: Fiscal deficits directly affect aggregate demand and inflation *[via wealth effect]*

Five Key Results

Rachel & Ravn show that once Ricardian equivalence fails, fiscal policy is no longer a background object. Public debt becomes household wealth, affects aggregate demand, and changes the determinacy properties of the New Keynesian model.

R1

No active/passive divide

Determinacy region is a connected set (not divided by . The usual distinction between active and passive policy regimes disappears.

R2

Taylor principle fails

- Neither necessary (HANK channels substitute)
- Nor sufficient (explosive region expands for large).

R3

Deficits are inflationary

Across the full determinacy region — not just the FTPL corner. Fiscal transfers stimulate demand directly.

R4

Timing matters

Surprise deficits: output boom + inflation.
Pre-announced: stagflationary — inflation erodes wealth before transfer arrives.

R5

Robust in medium-scale model

Results survive the introduction of capital, sticky wages, investment adjustment costs, long-term government debt, and interest-rate smoothing. *Debt maturity matters*.

1a: How large is the effective debt-wealth channel?

➔ **how to empirically discipline the strength of debt-wealth channel relative to other HANK mechanisms** *(binding borrowing constraints, heterogeneous MPCs, portfolio composition effects)*?

- Public debt is household net wealth, so the wealth channel is not empirically disciplined by the distribution of bond holdings across the MPC distribution
- Bond holdings are concentrated among low-MPC households, the net demand stimulus from deficit financing might be much smaller. In other words, $\chi_{effective} < \chi_{OLG}$

- *Implications*:
  - ➔inflationary pressure from deficit-financed expenditure will be smaller
  - ➔the recessionary effects of pre-announced deficits would be attenuated.
  - ➔determinacy regions may move closer to the RANK benchmark if $\chi_{effective}$ is small

1b: Taylor Principle and determinacy: Rachel–Ravn vs. Bilbiie

- **Rachel & Ravn (2025)**: ***debt-wealth channel*** ➔ determinacy depends jointly on monetary and fiscal rules
- **Bilbiie (2025)**: ***distributional income channel*** ➔ heterogeneity changes the aggregate IS curve through cyclical inequality

- **Bilbiie (2025)** emphasizes the "Catch-22" problem**:** aggregate-demand amplification requires countercyclical inequality, but solving the forward guidance puzzle requires procyclical inequality
- Does the **Rachel–Ravn** mechanism survives when combined with cyclical inequality, risk, and forward-guidance considerations

2: Discussion on dynamic profile of MPCs

$$\chi = \frac{(1-q)(1-q\beta)}{q}$$

- χ is the crucial parameter in the model, which depends on the households' subjective discount factor (β) and the survival probability (q).

- The calibration maps q to generate an MPC of 0.26, matching the ***average MPC***

➔This OLG-based approach may be limited in matching the **dynamic profile** of MPCs observed in standard HANK models: Fiscal transfers often generate ***a very front-loaded intertemporal-MPC*** profile because constrained households spend quickly ➔ A richer HANK model may generate a sharper impact response and faster decay than the OLG model

This matters given the discussion of the paper on the persistence and timing of shocks ➔ It would be useful to benchmark the results with standard HANK models

3: Going beyond lump-sum fiscal instruments

- The paper focuses on the lump-sum transfers and emphasizes the inflationary effects of deficits. The result may be instrument-specific, depending on the balance between demand-side and supply-side effects

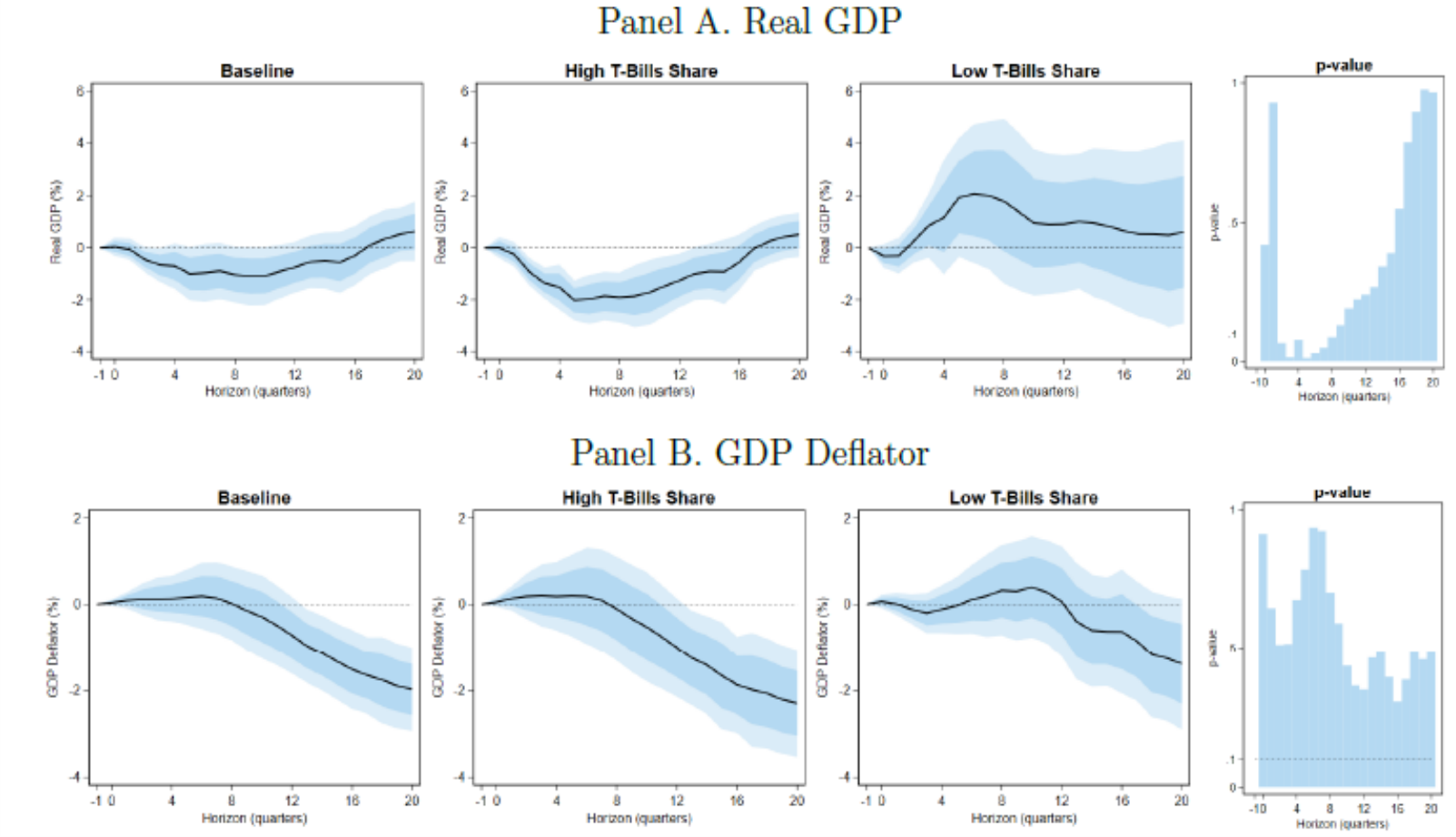
  - **An increase in public investment** raises short-term inflation in short term due to high aggregate demand, but possibly causes disinflation over the medium-term due to supply expansion

  - **A consumption tax cut** is possibly disinflationary (mechanically on impact)

  - **A cut in capital tax rate** boosts demand, but may also raise investment and future productive capacity

4: Empirical discipline of MP under different debt maturity

- In the model, monetary policy is **more powerful when public debt maturity is longer (capital gains following interest rate cuts)....but opposite in the data**



Source: Bettarelli et al. (forthcoming)

5: What if borrowing costs respond endogenously to debt?

- Higher debt may also raise **debt-sustainability concerns**, leading investors to demand a higher sovereign risk premium (Furceri et al. 2025, Plante et al. 2025, and Laubach 2009)

➔ Debt-financed expenditure could further crowd-out investments, limiting the stimulus impacts via wealth-channel

➔ *Allow the government borrowing cost to depend on debt or fiscal balances and examine how this modifies the determinacy regions and deficit-inflation results*

Thank You