Discussion of the paper
The perils of narrowing fiscal spaces
by Hanno, Leonardo, Sebastian and Matthias

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- The mechanism
- Welfare costs
- Fiscal policy design

The paper (1)

- Standard NK model with Rotemberg adjustment costs
- Monetary active + fiscal passive: FTPL does not hold
- Lump-sum taxes (almost Ricardian)
- **Exogenous public debt ceiling $\rightarrow$ endogenous interest rate ceiling**:

$$b_t = R_t \left(b_{t-1} \frac{Y_{t-1}}{\pi_t Y_t} - T_t \right) \leq \bar{b}$$

$$\downarrow$$

$$R_t \leq \frac{\bar{b}}{\left(b_{t-1} \frac{Y_{t-1}}{\pi_t Y_t} - T_t \right)}$$

- Global solution methods

The paper (3): 2 main policy conclusions

- Narrow fiscal space generates an inflationary bias
- Countercyclical fiscal policy may tighten the monetary constraint

My comments

Clear contribution, very well written, timely (energy shock) and policy relevant. The fiscal constraint:

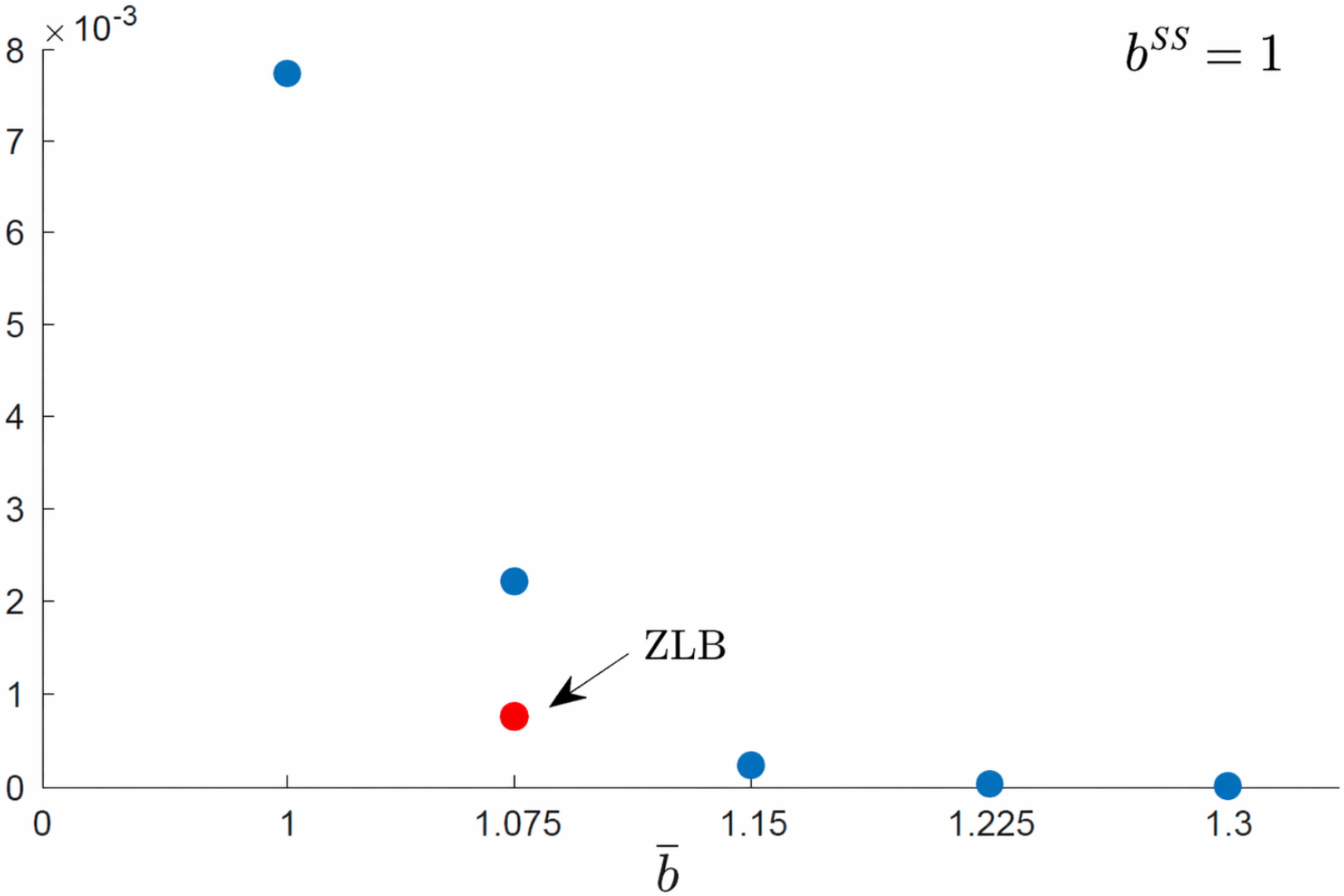
1. embeds **significant welfare costs**
   - decreasing in $\bar{b}$
   - larger than those associated with the ZLB

2. has **relevant normative implications**
   - Optimal policy may still fail if deficit-financed
   - Targeted and compensated policy can help

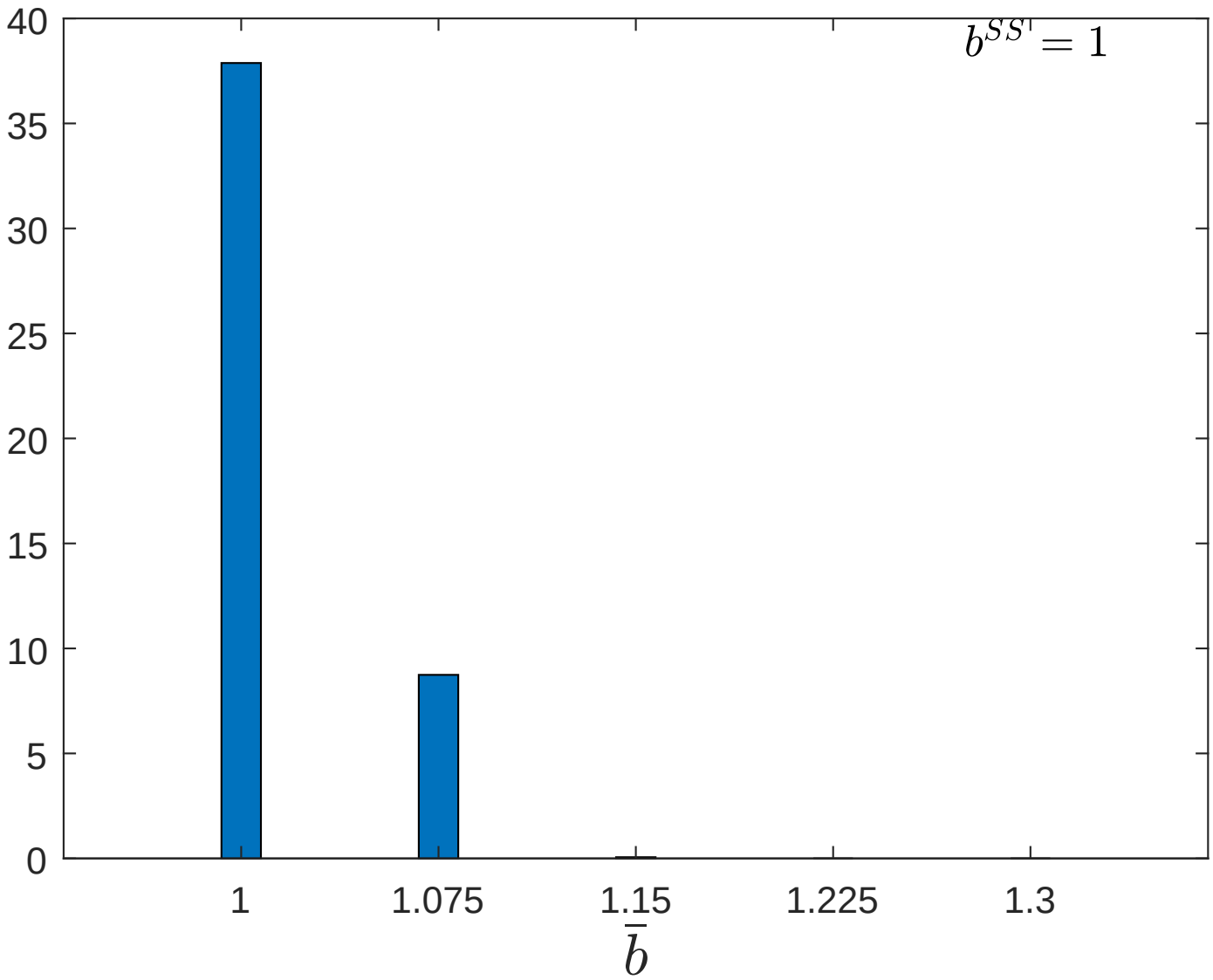
   My point: **not "less fiscal policy" but better fiscal design** (prioritize spending needs)

How large are the welfare costs of narrowing fiscal space?

The welfare costs of prudence



Frequency of binding constraints (%)

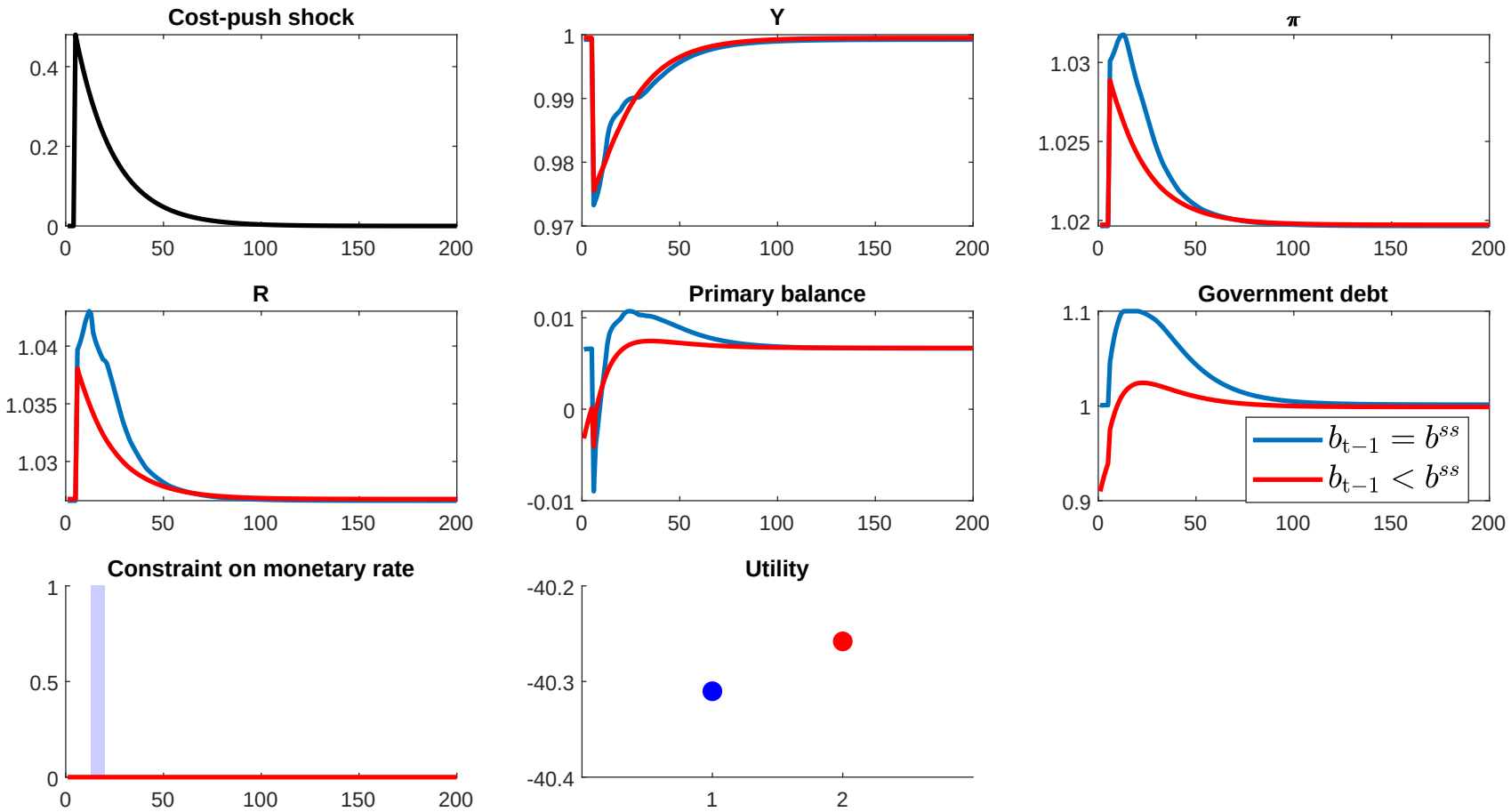


Equilibrium allocation

	$\bar{b}$				
	1	1.075	1.15	1.225	1.3
π	**2.65**	**2.04**	**1.85**	**1.83**	**1.83**
R	3.4	2.79	2.53	2.51	2.51
c	0.990	0.992	0.993	0.993	0.993

Narrower fiscal space is associated with higher inflation and lower consumption

The initial debt level matters



What type of fiscal policy works under narrow fiscal space?

Why generic countercyclical fiscal policy can be counterproductive

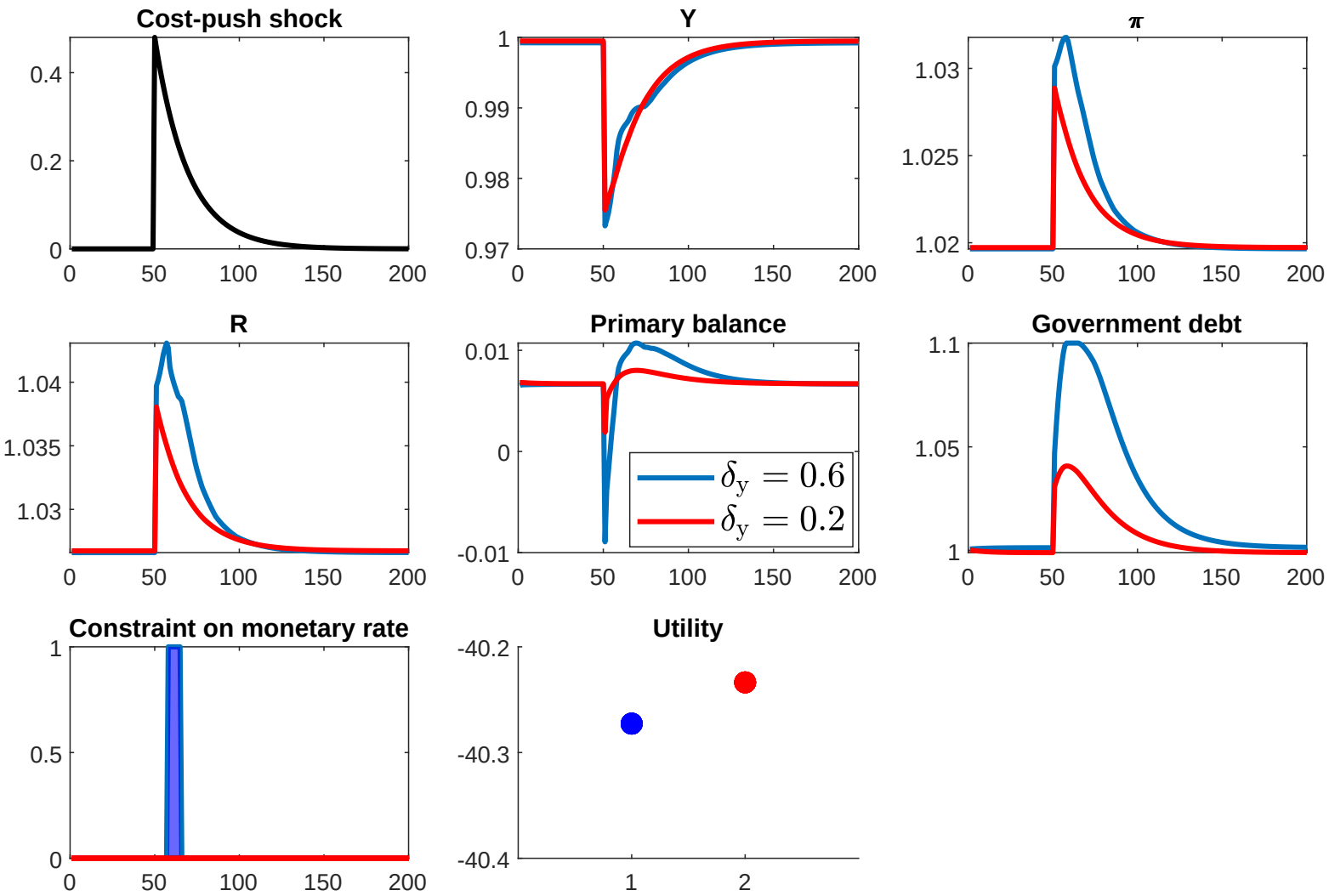
$$T_t = T + \delta(b_{t-1} - \bar{b}) + \delta_y(Y_t - \bar{Y})$$

Apart from the constraint, fiscal policy is Ricardian

Higher δ_y changes the cyclical response of fiscal balances, making the interest rate ceiling more likely to bind

$$R_t \leq \frac{\bar{b}}{\left(b_{t-1}\frac{Y_{t-1}}{\pi_t Y_t} - T_t\right)}$$

Countercyclical fiscal policy in the HLSM model: counterproductive



Can targeted fiscal policy relax the trade-off?

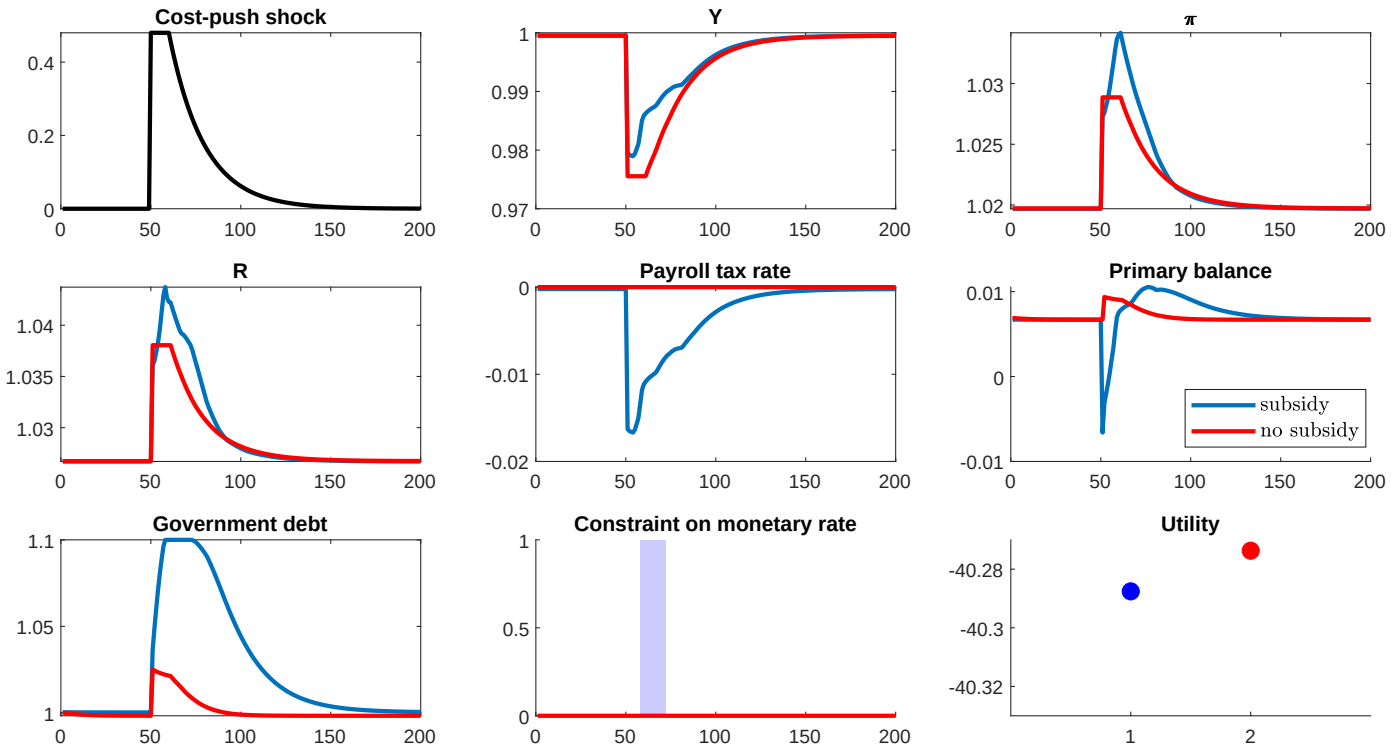
- What if we consider **targeted** fiscal policy (subsidy to firms)?

$$\phi\left(\frac{\pi_t}{\bar{\pi}}-1\right)\frac{\pi_t}{\bar{\pi}}=(1-\epsilon)+\epsilon MC_t(1+\tau_t)\downarrow+\ldots+ln(\mu_t)\uparrow$$

$$\tau_t=\delta_y(Y_t-\bar{Y})$$

$$\delta_y=\begin{cases}0.8 & \text{countercyclical}\\ 0 & \text{neutral}\end{cases}$$

Targeted but deficit-financed fiscal policy: not enough



Countercyclical, **targeted, and compensated** fiscal policy?

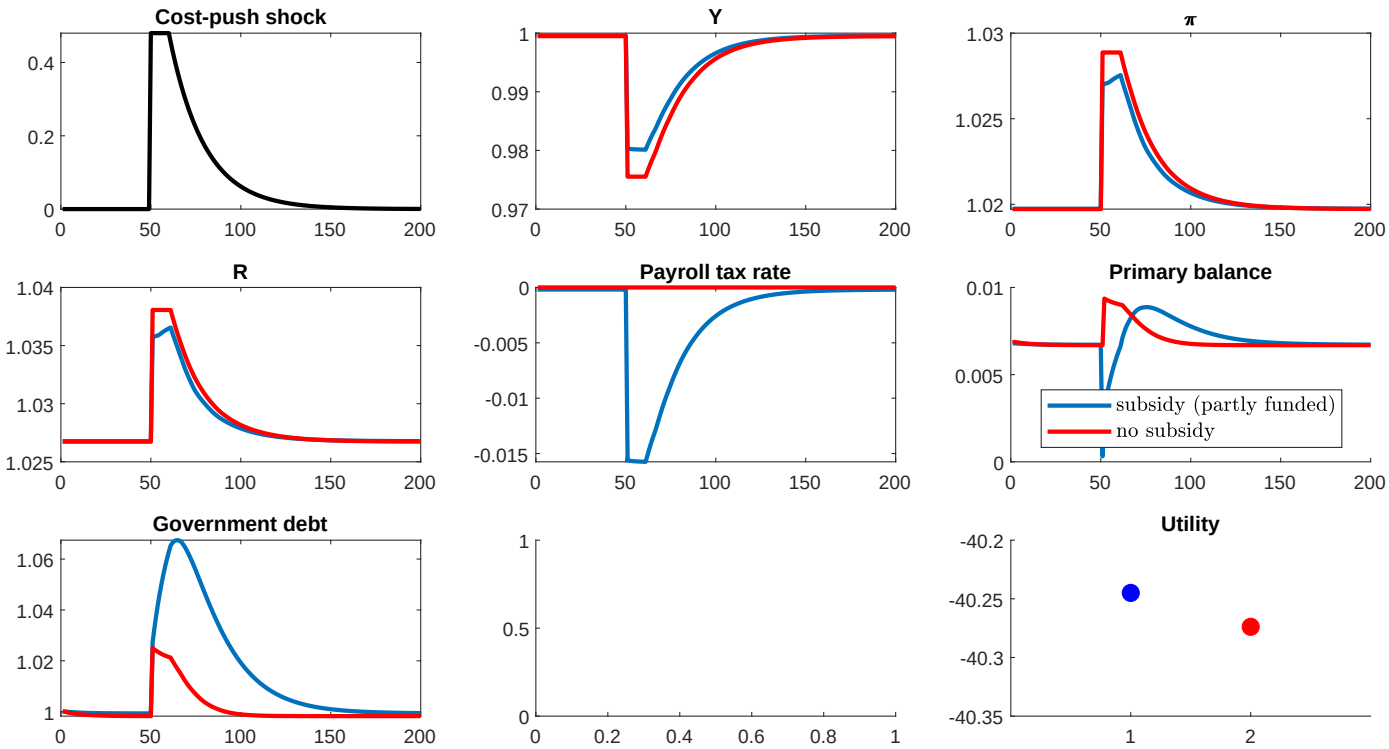
$$\tau_t = \delta_y (Y_t - \bar{Y})$$

$$T_t = T + \delta(b_{t-1} - \bar{b}) - \tau_t + \alpha\tau_t$$

Production subsidy

Other expenditure cuts limit deterioration fiscal space

Countercyclical **targeted, and compensated** fiscal policy: yes



Thank you!