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Effects of fiscal retrenchment in open economies

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Theory: Corsetti, Kuester and Muller (2011); Evidence: Ilzetzki et al. (2010), Serrato and Wingender (2010), Nakamura and Steinsson (2011)
Positive analysis of the effects of persistent spending cuts in a New Keynesian DSGE model of a small currency union (CU) member
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What we do
Environment and scope

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  - Focus on CU case, but use independent monetary policy (IMP) as a reference point
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  - Focus on CU case, but use independent monetary policy (IMP) as a reference point
- Use the workhorse model by Gali and Monacelli (2005) as starting point
  - Examine robustness in a fully-fledged DSGE model in which we allow for endogenous interest rate spreads
What we find
Role of credibility critical

- A gradual approach to consolidation is preferable, especially when credibility is impaired
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- A gradual approach to consolidation is preferable, especially when credibility is impaired
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  - Gradualism mitigates problems with credibility
Presentation outline

- Model
- Parameterization and modeling of credibility
- Impact of credibility under IMP
- Impact of credibility under CU
- Robustness analysis in fully-fledged model
- Summary and future work
Model Overview

- New Keynesian DSGE model for a small open economy (home economy take foreign prices and quantities as given) nearly identical to Galí and Monacelli (2005), CGG (2001)
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- Complete risk sharing domestically and internationally
- **Producer currency pricing, PPP holds in the long-run**
Model

Log-linearized representation

- IS curve \( x_t \equiv y_t - y_{t}^{pot} \)
  \[
x_t = x_{t+1|t} - \hat{\sigma}^{open}(i_t - \pi_{t+1|t} - r_{t}^{pot})
\]

- Pricing schedule (NKPC)
  \[
  \pi_t = \beta \pi_{t+1|t} + \kappa_x x_t,
  \]
  where \( \kappa_x \equiv \kappa_{mc} \phi_{mc} \) slope of the NKPC

- Terms of trade \( \tau_t \) determined by
  \[
  y_t = \hat{\sigma}^{open} \tau_t + g_y g_t \quad \text{(ToT)}
  \]

- Potential real interest rate \( r_{t}^{pot} \)
  \[
  r_{t}^{pot} = \tau_{t+1|t}^{pot} - \tau_t^{pot}
  \]
Model

IMP specification

- **Policy rule**
  \[ i_t = \gamma_{\pi} \pi_t + \gamma_{\chi} \chi_t \]

- Complete stabilization for spending shocks when either \( \gamma_{\pi} \) or \( \gamma_{\chi} \) are set arbitrarily large

- **Nominal exchange rate** \( e_t \) (\( p_t^* = 0 \))
  \[ e_t = p_t + \tau_t, \]
  where \( p_t = p_{t-1} + \pi_t \)
Model

CU specification

- Nominal exchange rate $e_t = 0$ for all $t$, so

$$\tau_t = -p_t$$

- Moreover, as the economy is a small, the nominal interest rate is fixed and $x_t$ hence determined by (ToT)

$$x_t = \hat{\sigma}^{open} (\tau_t - \tau_t^{pot})$$

where $\tau_t^{pot} = -\frac{1}{\hat{\sigma}^{open}} (1 - \frac{1}{\phi mc \hat{\sigma}^{open}}) g_y g_t$

- It follows that

$$\tau_t = \lambda \tau_{t-1} + \kappa x \hat{\sigma}^{open} \frac{\lambda}{1 - \beta \rho \lambda} \tau_t^{pot}$$

i.e. a spending cut always causes $\tau_t$ to depreciate
Parameterization
Calibration of key parameters

- $\kappa_{mc} = 0.012$, in line with empirical estimates for the U.S., e.g. GG (1999) and Altig et al. (2011)
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- Other parameters assume standard values; Frisch elasticity = 0.4, Labor share = 0.7, Government spending share = 0.25, period log utility of consumption
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- Other parameters assume standard values; Frisch elasticity = 0.4, Labor share = 0.7, Government spending share = 0.25, period log utility of consumption
- Elasticity between foreign and domestic goods, \( \varepsilon_{p} = 1.5 \), import share \( \omega = 0.3 \)
• Government spending, $g_t$ is the sum of the permanent ($g_t^{perm}$) and temporary ($g_t^{temp}$) components:

$$g_t - \bar{g} = (g_t^{perm} - \bar{g}) + g_t^{temp}$$

$$g_t^{temp} = \rho_{temp} g_{t-1}^{temp} + \frac{1}{g_y} \epsilon_t^{temp}$$

$$\Delta (g_t^{perm} - \bar{g}) = \rho_1^{perm} \Delta (g_{t-1}^{perm} - \bar{g}) - \rho_2^{perm} (g_{t-1}^{perm} - \bar{g}) + \frac{1}{g_y} \epsilon_t^{perm}$$

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Modeling of Credibility

Adopt standard approach in literature

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where the standard errors of $\epsilon_t^{perm}$ and $\epsilon_t^{temp}$ are $\sigma^{perm}$ and $\sigma^{temp}$, respectively.

- Assume agents have to solve signal-extraction problem to filter out $g_t^{perm}$ and $g_t^{temp}$ from observed $g_t$

  - Begin with unitroot assumption for $g_t^{perm}$, $\rho^{temp} = 0.78$, $\sigma^{perm} = 0.0836$, $\sigma^{temp} = 1.44$ (estimated off Irish data); implied SN-ratio 0.81
Impact of credibility under IMP

Effects of spending cuts for alternative credibility assumptions

- $g_t$ cut with 1 percent of trend GDP
Impact of credibility under IMP

Effects of spending cuts for alternative credibility assumptions

- $g_t$ cut with 1 percent of trend GDP
- Compare results for alternative assumptions:
Impact of credibility under IMP
Effects of spending cuts for alternative credibility assumptions

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- Results in Figure 1 shows effects under IMP
Impact of credibility under IMP

1 percent cut in spending in simple model
Impact of credibility under CU
Repeat same experiment under currency union membership

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We now repeat the same experiment under the assumption that the economy is a small member of a CU, implying that nominal exchange rates and interest rates will not adjust.
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- We now repeat the same experiment under the assumption that the economy is a small member of a CU, implying that nominal exchange rates and interest rates will not adjust.
  - ZLB irrelevant as CU central bank responds to CU aggregates only.
- Figure 2 shows results in CU case.
Impact of credibility under CU
1 percent cut in spending in simple model
Impact of credibility under CU

Results for more gradual adjustment

- Under CU membership, the output costs can be significantly larger, especially if credibility is impaired.
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- We now examine if a more gradual approach to consolidation can mitigate the output costs stemming from imperfect credibility.
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- Figure 3 shows results of this experiment.
Impact of credibility under CU

1 percent gradual cut in spending in simple model

Lemoine and Lindé (Banque de France and Sveriges Riksbank)
 Robustness analysis in fully-fledged model

Model overview

- DSGE model of Erceg and Lindé (2013) with one small and large country, each produces a single final good by aggregating a continuum of domestically-produced intermediate goods.
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Other features:
- External habit persistence in consumption.
- CEE type of investment adjustment costs.
- Imports are utilized in combination with final domestic output good to produce consumption and investment goods (CES baskets).
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Setup similar to experiment in simple stylized model

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- Adopt same parameters in Erceg and Lindé (2013)
Impact of credibility in fully-fledged model

1 percent cut in spending: comparing workhorse with simple model

- Stylized Model:
We now entertain the possibility that interest rate spreads respond endogenously to debt and deficits, following evidence by Laubach (2010)

\[ i_t^{Per} - i_t = \psi_b (b_{Gt+1} - b_G) + \psi_d (b_{Gt+1} - b_{Gt}) \]
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\[ i_t^{Per} - i_t = \psi_b (b_{Gt+1} - b_G) + \psi_d (b_{Gt+1} - b_{Gt}) \]

Set \( \psi_b = 0.025 \) and \( \psi_d = 0.05 \).
Robustness analysis in fully-fledged model
Allow for endogenous spreads

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- Redo previous experiment with this modification
Impact of endogenous spreads

1 percent spending cut in fully-fledged model with endogenous spreads

- No Endog. Spreads:
As a final experiment, we explore the role of adjustment pace, i.e. acceptance of short-term deviations from actual debt and the targeted level of debt.
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- Relax benchmark assumption of unaggressive tax rule to close the debt gap \( b_{Gt+1} - b^*_{Gt+1} \) in favor of an aggressive spending rule that cuts spending aggressively when \( b_{Gt+1} - b^*_{Gt+1} > 0 \)
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Pace of adjustment

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- Redo previous experiment with this modification, all other things unchanged.
  - Compare results with benchmark specification.
Impact of pace of adjustment under imperfect credibility

1 percent spending cut in fully-fledged model with endogenous spreads
Summary and future work

- Under CU membership, imperfect credibility can cause non-negligible output costs, especially if the consolidation is front-loaded.
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- If spreads fall persistently, consolidations should not be very costly
  - Gradualism is even more preferable
- View current results as a first pass, in next version we intend to measure degree of fiscal credibility using OECD forecasts for selected euro area countries and compare with the U.S.