Discussion of "Debt sustainability and Fiscal Space in a Heterogeneous Monetary Union: Normal Times vs the Zero Lower Bound"

by

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Outline

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What does the paper do?

In a nutshell, the model of **fiscal limits** (Bi, 2012) in a **monetary union** (Benigno and Benigno, 2006) with two **heterogeneous countries** (Germany and Spain) uncovers the **cross-country spill-overs** from...

- **unilateral fiscal consolidation**:
  - **permanent consolidation** (through tax rule) is costly for the union, especially if front-loaded, but less so for the high-debt (>90% GDP) country;
  - **transitory consolidation** (through discretionary spending) is less costly (in the short term) and could be beneficial (in the long term), and more so for the high-debt country;
- **(un)coordinated fiscal policy**:
  - **fiscal consolidation in both countries** reaps the largest benefits in terms of debt sustainability and macro stabilization;
- **(un)constrained monetary policy**:
  - **inactive monetary policy** mutes risk premium channel (through real interest rate) and reduces consolidation benefits;

A pleasant read, based on an original theoretical idea and with an excellent numerical implementation... a great contribution to the literature!

Outline

Main Issues for Discussion

- What are the **costs of being in a monetary union**?
  - With two monetary authorities, fiscal consolidation could lead to a faster debt reduction and a smaller (short-term) output contraction.
- How should we interpret the **constrained monetary policy scenario**?
  - The modeling choice of the ZLB may warrant an alternative interpretation.
- What are the **policy implications of a fully endogenous fiscal limit**?
  - A model-consistent maximum tax rate could significantly alter monetary policy implications.

Interpretation of constrained monetary policy

- The **ZLB** is typically a state of the economy where monetary policy is constrained as a result of **other (non-monetary policy) forces**, featuring, in its most recent episode:
  - recession;
  - savings glut (high debt);
  - low safe rates;
  - high risk premia;
- The **ZLB** is modeled as one of two states – i.e. **an integral part – of the monetary policy rule** $\Rightarrow$
  - The ZLB in the model is not linked to the rest of the economy (i.e. no features of the actual ZLB).
  - From a monetary policy perspective, the ZLB in the model is more similar to forward guidance.
  - From a fiscal policy perspective, it is not clear how to assess the asymmetric impact of spending shocks at the ZLB:
    - the cost of fiscal consolidation (deflation and spreads);
    - the help from fiscal expansion in exiting the ZLB.

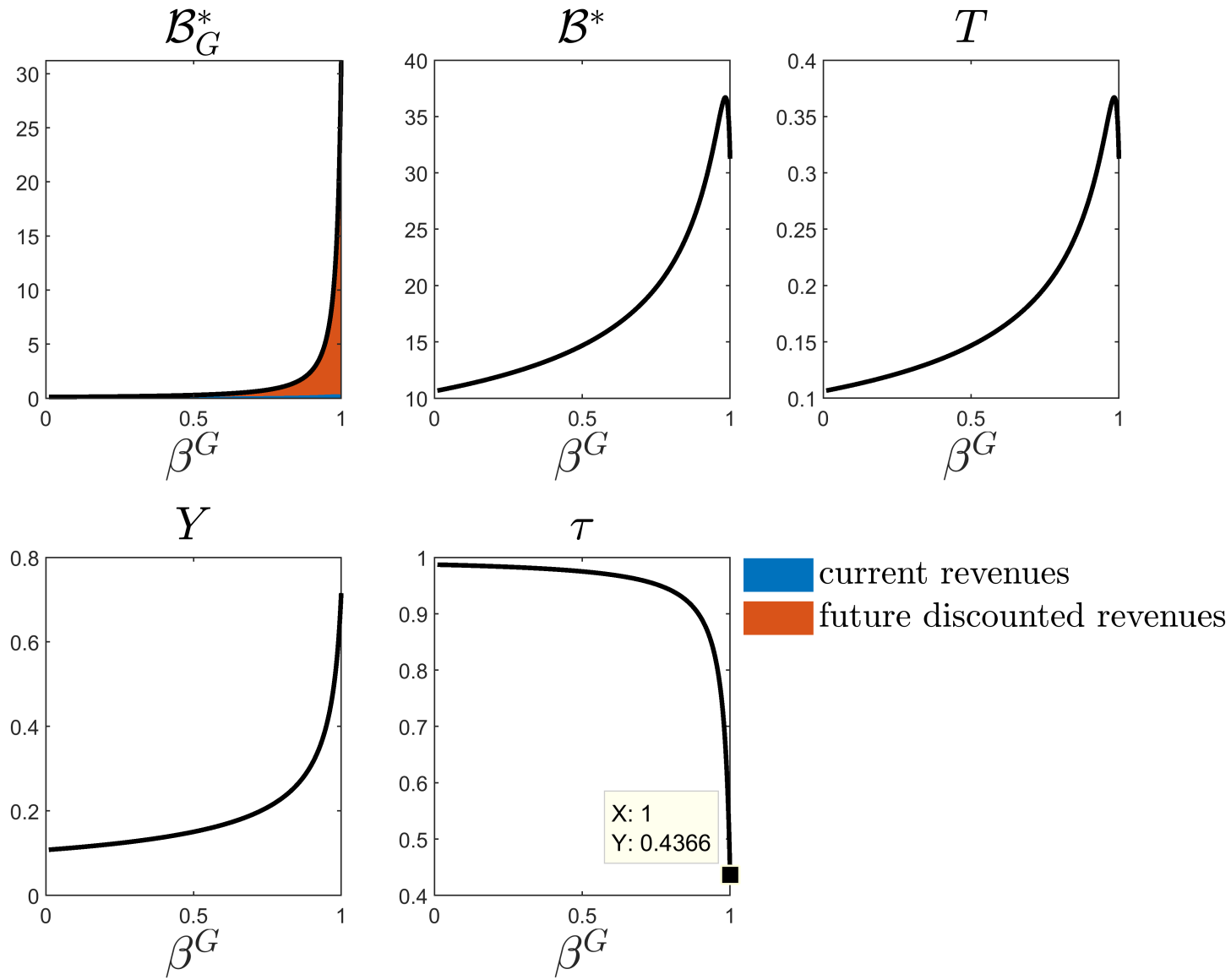
Endogenous fiscal limit and monetary policy implications

- ↑ monetary policy activeness → ↑ debt sustainability:
  - BLL (2018) (and ABS, 2019?): $\tau_t^{max} = 43.5\%$.
  - Bi (2012), BLL (2013): $\tau_t^{max} = \arg\max \tau_t Y_t$, with real economy.
  - BCC (2019): $\tau_t^{max} = \arg\max \tau_t Y_t$, with nominal rigidities.
- Degree of fiscal policy foresight may induce opposite effects of degree of monetary policy activeness on debt sustainability.
  - BCC (forthcoming): $\tau_t^{max} = \arg\max \mathcal{B}^*_{G,t}$, where

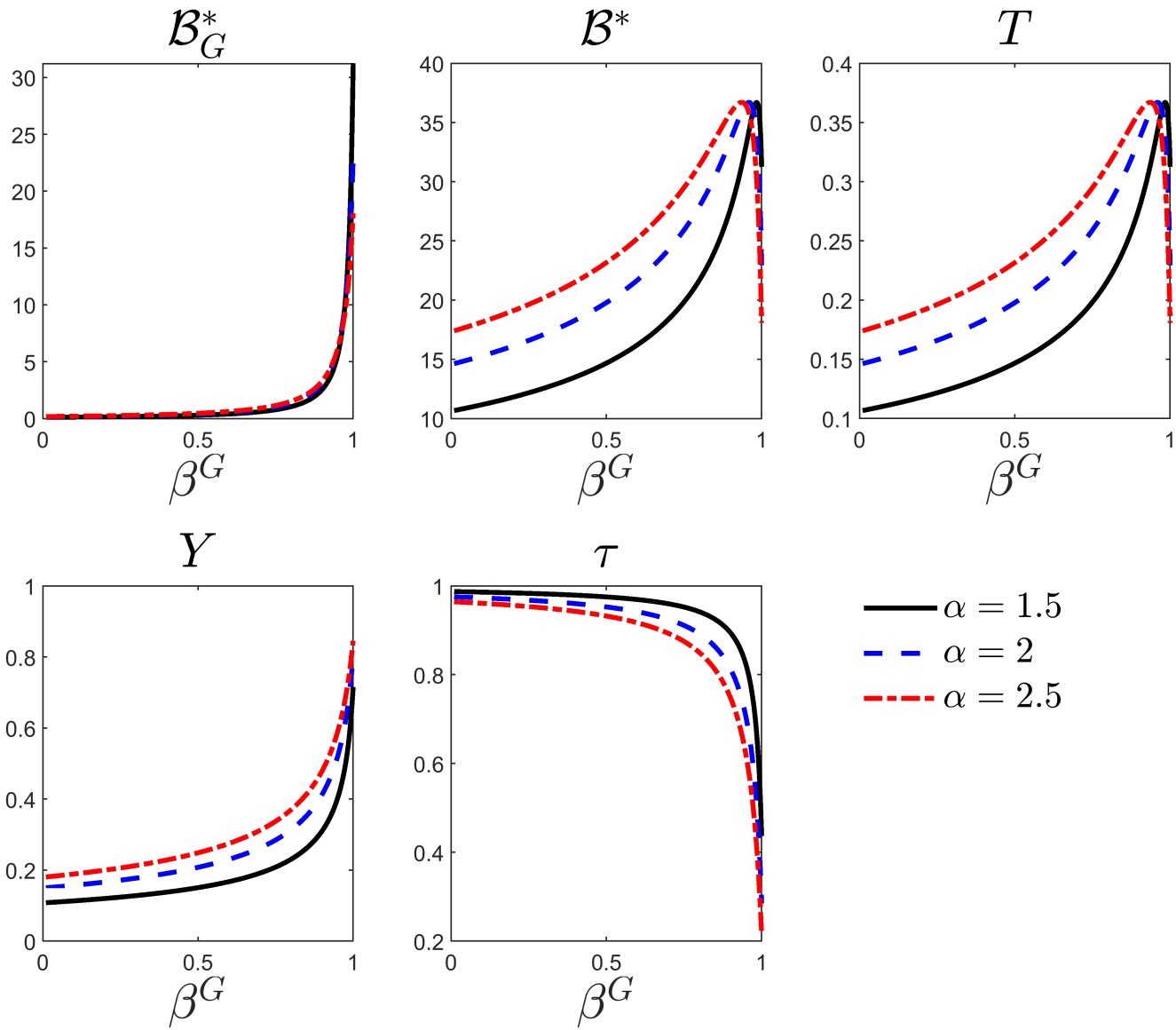
$$\mathcal{B}^*_{G,t} = \pi_t^{max} \left\{ \tau_t^{max} Y_t^{max} + \beta^G \frac{E_t \mathcal{B}^*_{G,t+1}}{R_t^{max}} \right\}$$

    with β^G denoting the degree of fiscal policy foresight.
    - If $\beta^G = 0$, government objective ($\mathcal{B}^*_{G,t}$) equals current revenues ($\tau_t^{max} Y_t^{max}$).
    - If $\beta^G = 1$, government objective ($\mathcal{B}^*_{G,t}$) equals fiscal limit ($\mathcal{B}^*_t$).
- If $\beta^G \sim 1$ (consistently with low maximum tax rate) ⇒ ↑ monetary policy activeness → ↓ debt sustainability.

Monetary-fiscal policy interactions at the steady state



Monetary-fiscal policy interactions at the steady state



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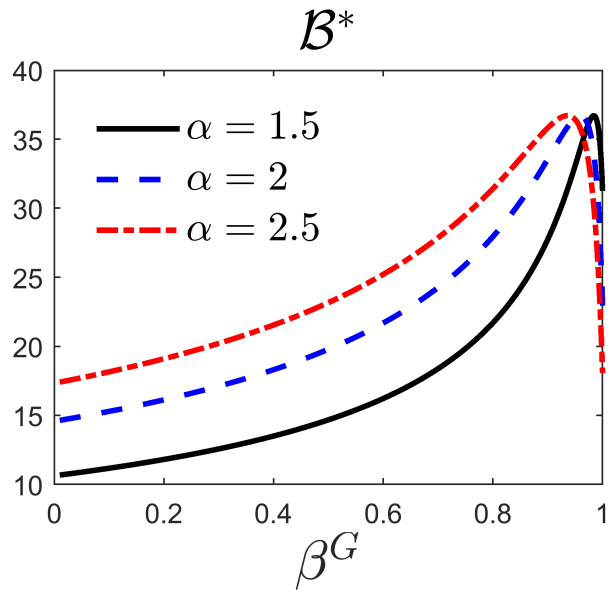

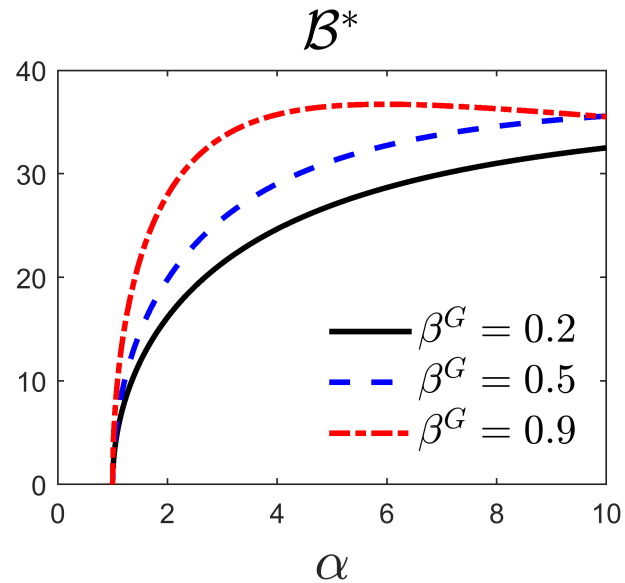

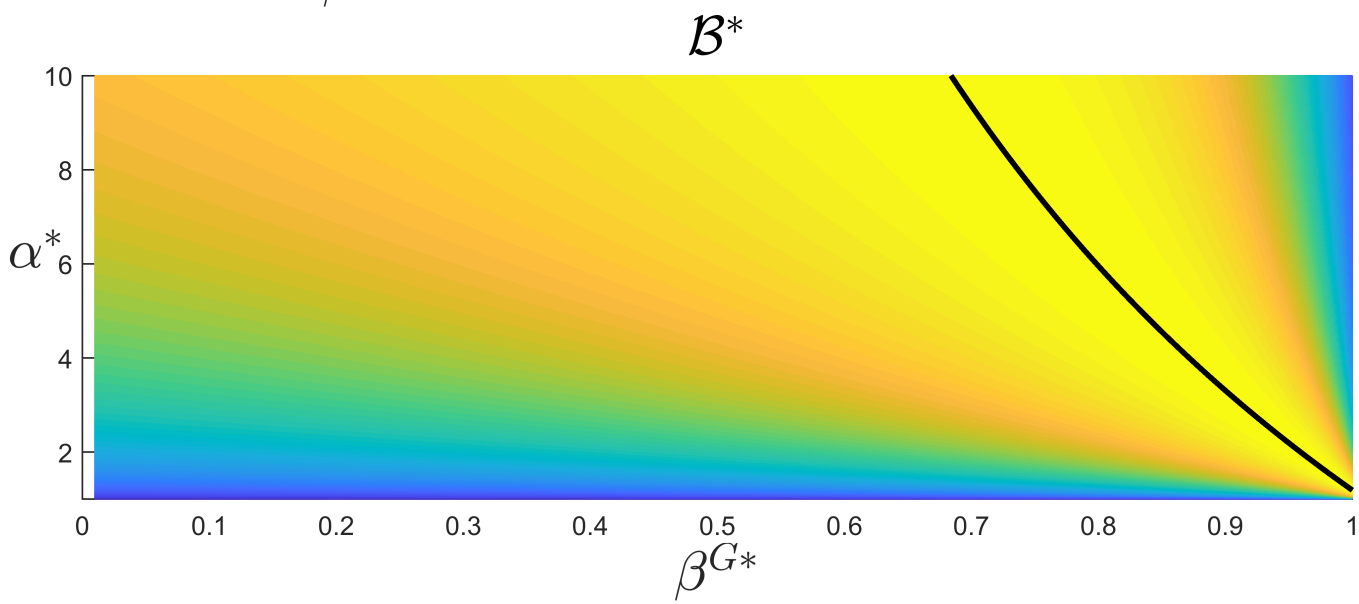

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Summary

- This paper is a very nice, well-crafted read, which answers important questions in a clear and concise way, thus filling an outstanding gap in the literature on fiscal limits and monetary policy.
- Main comments/suggestions:
  - Possible additional comparison: monetary union vs monetary autarky $\rightarrow$ assessment of the costs/benefits of a monetary union.
  - Possible caveat: constrained monetary policy is more similar to forward guidance than to ZLB.
  - Possible caveat: monetary policy implications depend on degree of fiscal foresight.

Thank you for your attention!