Discussion of “Timing Fiscal Retrenchment in the Wake of Deep Recessions” by Corsetti et al

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Introduction

- Resurgence in fiscal policy research
- Sovereign risk premium a key channel
- General-equilibrium modelling approach vital
Corporate bond yield an average across sovereign yield and risk-less interbank rate.

CB can reduce interbank rate to offset increase in sovereign yield.

But cannot do this if target rate is low: ZLB problem.

Implies feedback from SRP to output at ZLB.

(Fiscal Indeterminancy problem)
Main channel is banking sector
Large, export-orientated corporates might be insulated
GS: Portuguese 5-year corporate bonds 130bps below sovereign
Fiscal Strategies in a Deep Recession

- **Immediate Implementation**
  - Trade off: Decline in risk premium against recessionary impact

- **Late Implementation**
  - Decline in future short-term interest rate implies reduction in long-term rate, immediately boosting demand (positive feedback loop)

- **Intermediate Implementation**
  - Smaller reduction in risk premium
  - Near-term cuts cannot trigger reduction in policy rate
  - For high debt, indeterminancy problem

(Risk premium not the sole target for fiscal policy)
Endogenous risk premium reduces determinancy region

Pro-cyclical spending rule can rule out indeterminancy (needed, steeper is RP and less output-elastic are taxes)

Spending multiplier negative if RP channel strong enough

But positive impact of future austerity also enhanced by RP channel
Some Issues

- Expectations-driven liquidity trap (Mertens and Ravn)
- Volatility of risk premium (Fernandez-Villaverde et al)
- Wealth effects of government debt at ZLB (Devereux)
- Feedback from corporate RP to sovereign RP
- Welfare analysis (utility from G; heterogeneous population)
Open Economy Dimensions

- Fiscal adjustment under a peg or in a currency union
- Deflation versus real exchange rate depreciation
- Cross-border spillovers (trade, RP)
Conclusions

- Excellent, insightful paper
- Many unanswered questions