Floats, pegs and the transmission of fiscal policy

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An extremely popular piece of economics: fiscal policy is more effective under a peg



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• Conventional wisdom: Greater monetary accommodation.

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- Dornbusch solution: model medium-term adjustment. Expansion today foreshadows deficit monetization tomorrow.

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- Early critics also in the academic literature. Dornbusch (1980) qualifies the Mundell-Fleming prediction, that stimulus causes real appreciation, a theoretical curiosity.
- Dornbusch solution: model medium-term adjustment. Expansion today foreshadows deficit monetization tomorrow.
- But if this is the case, the conventional wisdom does not necessarily hold!

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 Analysis of the relative effectiveness of fiscal policy across exchange rate regimes using standard new-Keynesian small open economy model.

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- Following Corsetti Meier and Mueller (2009) (CMM), we shift our focus on plausible alternative monetary and debt-consolidation regimes, involving dynamic adjustment of taxes and/or spending.

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 but we abstract from deficit monetization.
- Following Corsetti Meier and Mueller (2009) (CMM), we shift our focus on plausible alternative monetary and debt-consolidation regimes, involving dynamic adjustment of taxes and/or spending.
- Instead of monetary accommodation per se, what matters is the monetary and fiscal policy mix at all horizons!

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- Implication for our question?

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 Impact multipliers (the impact response of long-term rates) are quite sensitive to alternative debt consolidation regimes under a float, less so under a peg.

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Main message:

- Impact multipliers (the impact response of long-term rates) are quite sensitive to alternative debt consolidation regimes under a float, less so under a peg.
- Fiscal stimulus not necessarily less effective under a float, despite less 'monetary accommodation'.

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Plan of the talk

• A NK model of a small open economy

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- Revisiting the conventional wisdom
- A useful analytical result: private demand and long-real rate under a peg.
- ► The conventional wisdom on its head: interaction of currency regimes with medium-term fiscal framework
- Sensitivity and extensions: incomplete markets and limited participation

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Model

- Standard new Keynesian small open economy model
 - ► Imperfectly competitive firms produce country specific varieties
 - Pricing in producer currency, prices sticky
 - Domestic consumption biased towards home goods
 - Government spending falls on home goods
 - Complete markets (but sensitivity with incomplete markets and fraction of households (λ) without access to asset market)
- Policies
 - Monetary policy: interest rate feedback rule or peg
 - **Debt-sensitive** government spending subject to exogenous shocks
 - Lump-sum taxes respond to spending and debt

Final goods and price indices

$$C_{t} = \begin{bmatrix} (1-\omega)^{\frac{1}{\sigma}} \left(\left[\int_{0}^{1} Y_{H,t}(j)^{\frac{e-1}{e}} dj \right]^{\frac{e}{e-1}} \right)^{\frac{\sigma}{\sigma}} \\ +\omega^{\frac{1}{\sigma}} \left(\left[\int_{0}^{1} Y_{F,t}(j)^{\frac{e-1}{e}} dj \right]^{\frac{e}{e-1}} \right)^{\frac{\sigma}{\sigma}} \end{bmatrix}^{\frac{\sigma}{\sigma-1}}$$

Price indices

$$P_{t} = \left[(1-\omega) P_{H,t}^{1-\sigma} + \omega P_{F,t}^{1-\sigma} \right]^{\frac{1}{1-\sigma}}$$
$$P_{H,t} = \left(\int_{0}^{1} P_{H,t}(j)^{1-\epsilon} di \right)^{\frac{1}{1-\epsilon}} P_{F,t} = \left(\int_{0}^{1} P_{F,t}(j)^{1-\epsilon} di \right)^{\frac{1}{1-\epsilon}}$$

Real exchange rate

$$Q_t = \frac{P_t \mathcal{E}_t}{P_t^*}$$

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Firm's problem

• If allowed, adjust $P_{H,0}(j)$ so as to

$$\max E_0 \sum_{t=0}^{\infty} \xi^t \Lambda_t Y_t(j) \left(P_{H,0}(j) - \Omega_t \right)$$

Subject to demand function

$$Y_t(j) = \left(\frac{P_{H,0}(j)}{P_{H,t}}\right)^{-\sigma} Y_t$$

$$Y_t = (1-\omega) \left(\frac{P_{H,t}}{P_t}\right)^{-\sigma} C_t + \omega \left(\frac{P_{H,t}}{P_t^*}\right)^{-\sigma} C_t^* + G_t$$

And production function

$$Y_t(j) = H_t(j)^{\alpha}$$

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Household problem

Allocate consumption and labor, trade in non-contingent bonds

$$E_0 \sum_{t=0}^{\infty} \beta^t \left[\ln(C_t) - \frac{H_t^{1+\varphi}}{1+\varphi} \right]$$

- subject to budget constraint
- Baseline: complete markets.
- More experiments: incomplete markets and limited participation

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Government

Monetary policy

under a float:
$$R_t = R + \phi(\Pi_{H,t} - \Pi_H)$$

under a peg: $\mathcal{E}_t = \mathcal{E}$

Government budget

$$R_t^{-1}D_{t+1} = D_t + P_{H,t}G_t - T_t$$

Spending and tax feedback rule

$$G_t = (1-\rho)G + \rho G_{t-1} + \psi_G \frac{D_t}{P_{t-1}} + \varepsilon_t$$
$$T_{R,t} = \psi_T \frac{D_t}{P_{t-1}}$$

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Transmission: the experiment

Exogenous increase of government spending by one percent of GDP

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Transmission: the experiment

Exogenous increase of government spending by one percent of GDP

Study response of economy for 30 quarters

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Model simulation: parameterization

Average spending share	gy	0.2
Autocorrelation spending	ρ	0.9
Debt-sensitivity of spending	ΨG	-0.02
Debt-sensitivity of taxes	ψ _T	0.02
Monetary policy	φ	1.5
Discount factor	β	0.99
Discount factor Inverse of Frisch elasticity	$\beta \\ \varphi$	0.99 1
Discount factor Inverse of Frisch elasticity Trade price elasticity	$egin{array}{c} \beta \ \varphi \ \sigma \end{array}$	0.99 1 1
Discount factor Inverse of Frisch elasticity Trade price elasticity Prob. of price fixed	$\beta \\ \varphi \\ \sigma \\ \xi$	0.99 1 1 0.9

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The conventional wisdom revisited: exogenous AR(1) shocks with $\phi_G = 0$



The conventional wisdom revisited: exogenous AR(1) shocks with $\phi_G = 0$

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- For future reference, note that by PPP, price level is stationary under a peg.
 - Price level and exchange rate instead display a unit-root behavior under a float.
- But let's have a closer look at the transmission mechanism.

• Well known that in NK model consumption demand is driven by the long-term rate (real return on a bond of infinite duration).

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- Well known that in NK model consumption demand is driven by the long-term rate (real return on a bond of infinite duration).
- In our specification, solving the Euler forward, holding the expectations hypothesis:

$$c_t = -\frac{1}{\gamma} E_t \underbrace{\sum_{s=0}^{\infty} (r_{t+s} - \pi_{t+1+s})}_{\equiv z_t}, \tag{1}$$

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• Since the long-term rate in real terms *z_t* synthesizes the whole path of current and future expected inflation and policy rates, it so depends on the fiscal and monetary mix at each point in time.

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- Since the long-term rate in real terms z_t synthesizes the whole path of current and future expected inflation and policy rates, it so depends on the fiscal and monetary mix at each point in time.
- In the example above, positive inflation and policy rates throughout under a float explain the smaller output response to stimulus.

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• Under a float, long-term rates are sensitive to the anticipated fiscal and monetary mix in the future.

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- Deviations of inflation from steady state, positive in the short run, turn negative over time, already in anticipation of the dynamic cuts in spending along the adjustment path.

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- Deviations of inflation from steady state, positive in the short run, turn negative over time, already in anticipation of the dynamic cuts in spending along the adjustment path.
- As lower inflation means lower policy rates, long-term real rates may well fall on impact, with expansionary effects on consumption.

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Debt consolidation is quite relevant to fiscal transmission under a float



• Under a peg, by PPP lim $t \to \infty P_t = P^*$, implying $\sum_{t=0}^{\infty} \pi_t = 0$.

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- Under a peg, by PPP lim $t \to \infty$ $P_t = P^*$, implying $\sum_{t=0}^{\infty} \pi_t = 0$.
- Given the exchange rate constraint on the nominal short-term rate, the initial response of the real long-term rate is:

$$z_{0} = \underbrace{\left(\sum_{t=0}^{\infty} -\pi_{t+1}\right) - \pi_{0}}_{=0} + \pi_{0} = \pi_{0}.$$
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• In response to stationary shocks, by PPP, a credible exchange rate target constrains the impact response of the real long-term interest rate to be equal to the initial, unanticipated, change in the CPI.

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- In response to fiscal shock, this is true for whatever regime of debt consolidation, as shown next.

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Debt consolidation less consequential for impact multipliers under a peg



Debt consolidation is less consequential for impact multipliers under a peg

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- As seen above, real rates must increase (and consumption fall) with impact inflation.
- By the dynamic of inflation, negative real rates in the short run are followed by positive rates in the medium run (all in deviations from steady state).
- In our experiment, negative and positive rates offset each other as regards their effects on the long-term real rate on impact.

So, is fiscal policy necessarily more effective under a peg?

• Without an exchange rate objective, prospective spending cuts boost the multiplier of government spending.

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- Without an exchange rate objective, prospective spending cuts boost the multiplier of government spending.
- Long-term rates respond more strongly to medium-run fiscal framework under a float, and can fall with spending reversals.

The conventional wisdom on its head



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• We have seen that under a peg, the long-term rate in real terms cannot but rise with inflation. It then generally moves in opposite direction relative to the short-term real rate.

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- Traditional counterargument:

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- Traditional counterargument:
 - rising domestic price level eventually crowds out exports, naturally stabilizing demand through the real exchange rate channel.
- The modern paradigm clarifies a deeper issue.
 - Competitiveness is still key as driver of PPP. But the real exchange rate and the interest rate channels cannot be treated independently of each other: they both shape the intertemporal price relevant for private consumption/saving decisions.

Sensitivity: financial imperfections

• Three exercises (AR(1) spending shock only):

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Sensitivity: financial imperfections

• Three exercises (AR(1) spending shock only):

Incomplete asset markets at international level

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Sensitivity: financial imperfections

• Three exercises (AR(1) spending shock only):

- Incomplete asset markets at international level
- Restricted asset market participation

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- Three exercises (AR(1) spending shock only):
 - Incomplete asset markets at international level
 - Restricted asset market participation
 - Risk premia

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Sensitivity: financial imperfections

- Three exercises (AR(1) spending shock only):
 - Incomplete asset markets at international level
 - Restricted asset market participation
 - Risk premia
- Not much action here. Intuitively, the transmission mechanism is driven mainly by intertemporal price movements (not by wealth effects). As long as these movements are not sensitive to financial-market structure, results do not change much.

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Incomplete vs complete international financial markets



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Restricted asset market participation



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• Let me conclude be repeating the main message:

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- Impact multipliers (the impact response of long-term rates) are quite sensitive to alternative debt consolidation regimes under a float, less so under a peg.
- ► Fiscal stimulus not necessarily less effective under a float, despite less 'monetary accommodation'.

• Let me conclude be repeating the main message:

- Impact multipliers (the impact response of long-term rates) are quite sensitive to alternative debt consolidation regimes under a float, less so under a peg.
- ► Fiscal stimulus not necessarily less effective under a float, despite less 'monetary accommodation'.
- and by adding a comment, about the usefulness of NK (DSGE) model in shedding new light on classical problems, clarifying theoretical, empirical and policy dimensions.

• Let me conclude be repeating the main message:

- Impact multipliers (the impact response of long-term rates) are quite sensitive to alternative debt consolidation regimes under a float, less so under a peg.
- ► Fiscal stimulus not necessarily less effective under a float, despite less 'monetary accommodation'.
- and by adding a comment, about the usefulness of NK (DSGE) model in shedding new light on classical problems, clarifying theoretical, empirical and policy dimensions.
- We see our work as a contribution to our understanding of the preconditions for successful (fiscal) stabilization.

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