

# Discussion of "When, Where and How Does Fiscal Stimulus Work?" by Corsetti, Meier and Muller

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- The paper estimates the fiscal multiplier using a two-stage panel regression which controls for different characteristics
- Similar to Ilzetzki, Mendoza and Vegh (2009), the following controls are included:
  - degree of openness
  - exchange rate regime
  - level of debt
- But the paper novelty is on one final control: the distinction between tranquil and crisis times  
**During financial crisis multiplier is substantially higher**
- Road map of discussion: first focus on 'crisis result' and then talk about particular issues on estimation results and approach

# The analysis of financial crisis

1. Can we generalize the results and state that "fiscal policy is more effective during financial crisis"?
  - Banking crisis episodes based on Rogoff and Reinhart (2008): database from Kaminsky and Reinhart (1999) and Caprio et al (2005)
  - Identify 4 crisis episodes: Spain (1984-85), Norway (1987), Finland (1991), Japan (1992)
  - Why exclude other episodes of banking crisis? E.g. Canada (1983), Denmark (1987), France (1994), UK (1991, 1995), US (1984)
2. What insight do we get from the exercise?
  - Can we explore and test the true economic mechanisms behind the results?

# Economic mechanisms behind the results:

## Why crisis times are different?

- Why would the transmission mechanism of shocks (government spending shocks and other shocks) be different during financial crises?
  1. because these are times of tight conditions in credit markets: consumers face stronger borrowing constraints.
  2. because during crisis the transmission mechanism of monetary policy may be impaired or monetary policy might be more accommodative
  3. because these are uncertain times: consumers change their behavior/decisions given the amount of risk

# Why crisis times are different?

## The credit constraint hypothesis

- Mixed evidence on whether models with credit frictions magnify the transmission mechanism of shocks
  - Meier and Mueller (2006) - No; Christiano, Motto and Rostagno (2007) - Yes
- But in the case of fiscal shocks...
  - Theoretical evidence: Perroti (1999), Gali, Lopez-Salido and Valles (2007), Roeger and Veld (2009).
  - Empirical evidence: Aghion and Kharroubi (2008)
- Study directly the effect of credit conditions on the multipliers
  - E.g. use corporate credit spreads - as done in Gilchrist et al (2009) to identify disruptions in credit markets

# Why crisis times are different?

Monetary Policy is different

- Davig and Leeper (2009), also in Corsetti et al (2009a), Roeger and Veld (2009) and others
  - Accommodative monetary policy increases the fiscal multiplier
- Christiano, Eichenbaum and Rebelo (2009), Eggertson (2009) and others
  - Multiplier is larger under the zero lower bound (public spending help increase expected inflation, reducing the natural rate when nominal rates cannot be reduced further)
- Include "monetary stance/regime" control
- Arguably, part of this channel is captured in the exchange rate regime  
⇒ but as discussed later – not entirely sure the mapping is consistent with evidence

# Why crisis times are different?

## The uncertainty channel

- This is a less studied channel:
  - Crisis times are times of great uncertainty and risk changes agents behavior and the transmission mechanism of shocks
- Uncertainty can induce agents to save for precautionary reasons  $\Rightarrow$  De Paoli and Zabczyk (2009) show that this can magnify the effect of demand shocks
  - The larger the uncertainty level the bigger is this magnifying effect
- Can such channel help explain the effect of "turbulent" periods on the fiscal multiplier?
  - Imagine a fiscal contraction that leads to a fall in output  $\Rightarrow$  Allowing for counter-cyclical precautionary savings would increase the impact on output  $\Rightarrow$  The larger the degree of uncertainty  $\Rightarrow$  the larger the impact on demand  $\Rightarrow$  the larger is the effect on output  
*High uncertainty  $\Rightarrow$  high multiplier*
- Could control for degree of macroeconomic volatility

# Other remarks:

## Some clarification on the open economy results

- Some points on the "open economy results"
  - These appear consistent with standard models but conditional on possibly counter-factual exchange rate dynamics
  - Monacelli and Perotti (2009), Corsetti et al (2009): real exchange rate depreciation following fiscal expansion
- Peg regime leads to higher multiplier  $\Rightarrow$  consistent with Mundell-Fleming:
  - Under a floating regime the nominal exchange rate tends to appreciate, but under a peg this appreciation is curbed by accommodative policy  $\Rightarrow$  larger multiplier
- Openness reduces multiplier  $\Rightarrow$  consistent with New Keynesian model:
  - In open economies fiscal stimulus is spilled over to other countries via higher imports
- But both channels imply an exchange rate appreciation following the shock, but is the empirical evidence consistent with these results?



## Other remarks:

### On the estimation specification

- Use of a dummy for openness and a dummy for indebtedness  
⇒ Can you explore the marginal effect of openness or debt levels – further advantage relative to Ilzetzki et al (2009)
- Can we see the results without the 'banking crisis' dummy in the first stage of the estimation procedure  
⇒ Technical reasons for imposing the dummy: it solves endogeneity/identification problem  
⇒ But are we missing something by eliminating the discretionary response to crisis from the sample?

- Interesting and topical paper
- Could explore further the true determinants of the fiscal multiplier
  - Why fiscal policy more effective during crisis
- Question whether open economy results are consistent with the empirical evidence on exchange rates
- Estimation procedure
  - Dummy approach
  - Identification of shocks during crisis