Discussion of

# "When Fiscal Consolidation Meets Private Deleveraging"

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# Disclaimer:

**The views expressed herein are those of the authors and should not be attributed to the International Monetary Fund, its Executive Board, or its management.**

# Focus of the Paper

- What are the cost of a fiscal consolidation in a highly leveraged small open economy in the euro area?
- The authors take the **need** for fiscal consolidation and institutional setup **EMU** as given
- What type of fiscal consolidation least painful when people are highly leveraged: front-loading or gradualism?
- What happens when private and public sector want to increase their saving at the same time?

# Key Ingredients of the Paper

Analysis of effects of fiscal consolidation with highly-leveraged private sectort that undergoes deleveraging...

(A) Structural model of a SOE without MP autonomy

(B) Households finance housing with private, nominal long-term debt from other households

(C) Amortization scheme creates an occasionally binding constraint on debt repayments and prolongs period of impaired balance sheets (two endogenous regimes)

(D) Large-enough shocks can tip the economy into a state of slow deleveraging with people and firms just repaying old debts and no new credit...

# Main Results

- Size and timing of fiscal consolidation matters as always...
- Instruments ranking rather standard ($\tau^K$ is the worst)

- Larger and front-loaded fiscal consolidations entail higher welfare cost than smaller and gradual ones

- Larger and front-loaded consolidation *delay* the end of deleveraging and recovery
- Long-term private mortgage debt is critical for the results

- It takes some effort in a DSGE model to obtain an intuitive result that fiscal multipliers are larger in a debt-overhang situation...

# Comments

1. Nitpicky comments
2. ‘Bigger-picture’ comments

# Narrow Comments (Nitpicking, really...)

- **No hysteresis in the model.** Some degree of hysteresis would affect the *cushioning* and *lengthening* effects trade-off
- 'Debt minimization' and **'debt fatigue'**: *Richard Koo* argues that households and firms burnt from debt overhang will try not to repeat their experience...and lower demand for debt emerges even when credit is available
- **More than one set of IRFs report needed** for assessing the properties of the model (IRFs galore in the appendix)
- Literature references? (Minsky, Koo, Fisher, Keynes ...)
- Govt' spending pure waste, $\psi$ sensitivity, ...

# ‘Bigger-Picture’ Comments (About Credit…)

“Financial crises leave behind a landscape of heavily indebted households and firms…” [page 8]

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**HOWEVER**

A large portion of the nominal private debt is **created by BANKS.**

# ‘Bigger-Picture’ Comments

“Financial crises leave behind a landscape of heavily indebted households and firms. . . ” [page 8]

**HOWEVER**

A large portion of the nominal private debt is **created by BANKS.**

This is relevant because banks **are not intermediaries**,
rather,
banks create new purchasing power.

# ‘Bigger-Picture’ Comments

- **In the model,** one type of households borrows resources from another type of household.
- Unless the households are ‘different’ transfers of resources is irrelevant. . .
- In the model patient household has to save (or borrow elsewhere) in order to lend. . .

- **In the real world,** bank loans create deposits and new purchasing power. **Nobody has to save first. . .**
- When loans get repaid, ‘money’ gets destroyed in the real world of monetary economies (Remember 1930s, 2008, or Japan,. . . )

# ‘Bigger-Picture’ Comments

- Bank loans, balance sheets, and purchasing power creation requires new and challenging ways of modeling…
- First “mainstream” attempts: Benes, Kumhof, and Laxton (2015), Jakab and Kumhof (2015), Andrle and Bruha (2016), …
- A lot of non-mainstream literature on fiscal policy and deleverageing in the post-Keynesian tradition or recently in agent-based modeling…

# T-Accounting

**Non-Despositary Institution**
**(Non-Bank, or ‘Patient Household’)**

Before the loan. . .

| Assets | | Liabilities | |
|---|---|---|---|
| Liquid Assets | 100 | Net Worth | 100 |
| Total | 100 | Total | 100 |

. . . after the loan

| Assets | | Liabilities | |
|---|---|---|---|
| Liquid Assets | 40 | Net Worth | 100 |
| Loans | 60 | | |
| Total | 100 | Total | 100 |

# T-Accounting

**BANKS (Depositary Institutions)**

Before the loan...

| Assets | | | Liabilities |
|---|---|---|---|
| Liquid Assets | 100 | Net Worth | 100 |
| Total | 100 | Total | 100 |

...after the loan

| Assets | | | Liabilities |
|---|---|---|---|
| Liquid Assets | 100 | Net Worth | 100 |
| Loans | 60 | Deposits | 60 |
| Total | 160 | Total | 160 |

# Conclusions

- Important paper
- Chances are that the estimates of the fiscal consolidation costs during deleveraging are the **lower bound** of possible outcomes
- The role of fiscal space and fiscal policy during ‘balance-sheet recessions’ is key
- It is important to start modeling bank loan creation

BACKUP SLIDES

# Fiscal Multipliers vs. Fiscal Consolidation. . .

"We believe that fiscal consolidation is a necessity. . . . countries cannot have a huge debt burden on their back if they want to grow, create jobs, and make sure that their populations are better off.

. . . we have reassessed and we've gone public to say, you know, "Clearly the multiplier is higher than we thought." But a fiscal consolidation process is not dictated by a fiscal multiplier. It has to take place."

Interview with the Managing Director of the IMF Ch. Lagarde, Jan 17, 2013, Reuters