

Fiscal Policy, Sovereign Risk, and Unemployment

BIANCHI, OTTONELLO AND PRESNO

Discussion by Franck Portier

New directions in Macroeconomics and Monetary Policy

IGIER-Banque du Canada Conference
June 9-10, 2017, Milan



Roadmap

1. (Short) Summary
2. An AD-AS representation
3. Comments

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type of framework
 - × Fluctuating endowment
 - × Representative agent has no access to international markets
 - × The benevolent gouvernement does, but cannot commit to repay sovereign debt (strategic default)
 - × In case of default, output of utility cost + temporary exclusion from international financial market.
 - × Result: there is an equilibrium risk premium on sovereign debt.
 - × Default incentives and interest rates are higher in recessions

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- × Government spending in non tradable goods can pull the economy out of unemployment.
- × How to finance it?
 - ▶ Taxes : distortion cost
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- ▶ Aggregate Supply:
 - × $c^T = y^T$, y^T is exogenous
 - × $p^T = 1$
 - × $\frac{w}{p^T} > \frac{\bar{w}}{\bar{p}^T}$
 - × Labor supply: $h^s = \bar{h}$
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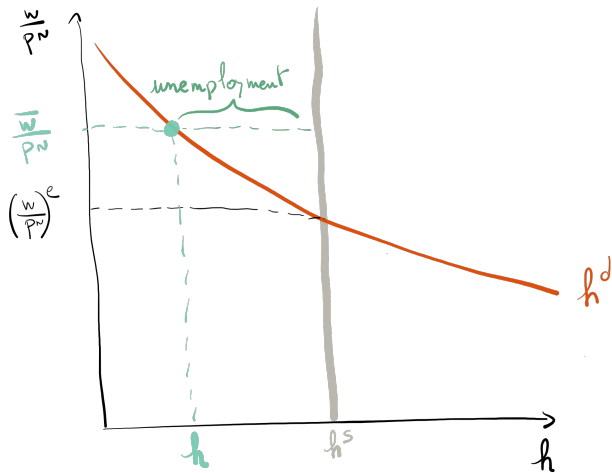
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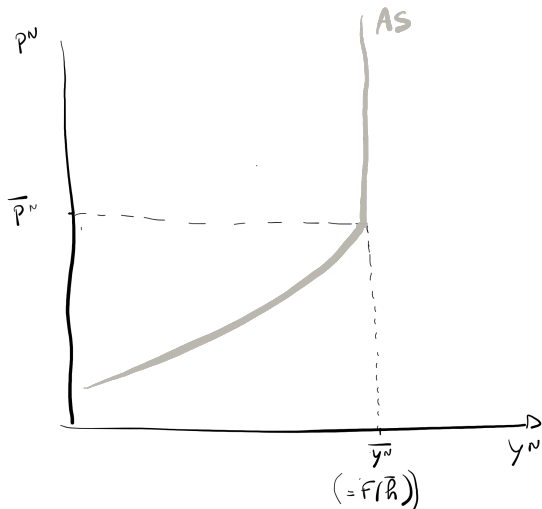
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Figure 1: Labor Market



2. An AD-AS representation

Figure 2: AS



2. An AS-AD representation

► Aggregate Demand:

$$\begin{aligned} \times \quad u &= (c^T)^\omega (c^N)^{1-\omega} \\ \times \quad \rightsquigarrow c^N &= \left(\frac{1-\omega}{\omega} c^T \frac{1}{p^N} \right) \\ \times \quad Y^N &= c^N + g^N \end{aligned}$$

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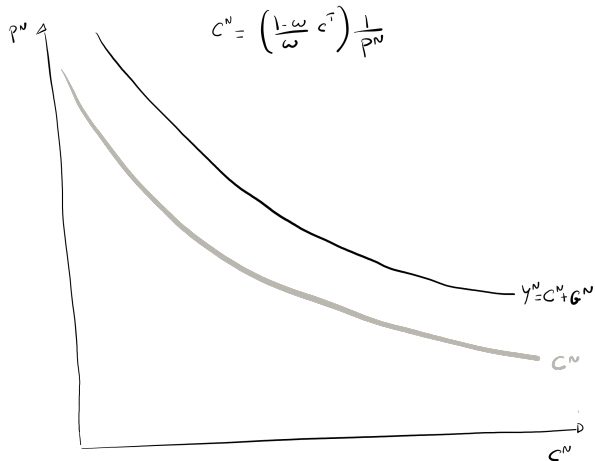
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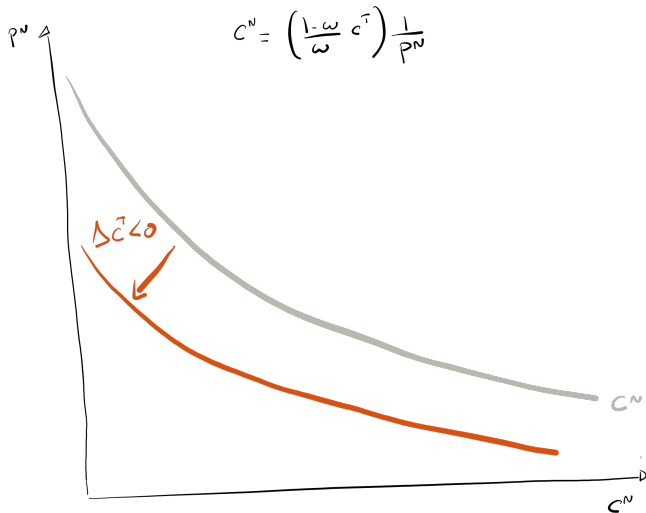
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Figure 3: AD



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Figure 4: AD-AS



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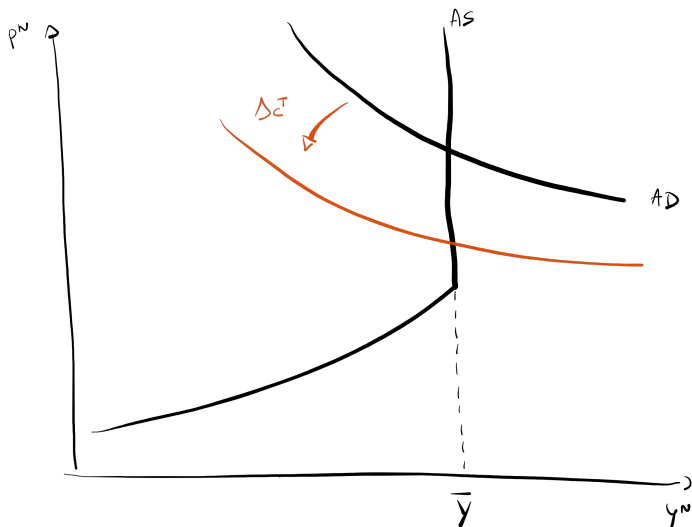
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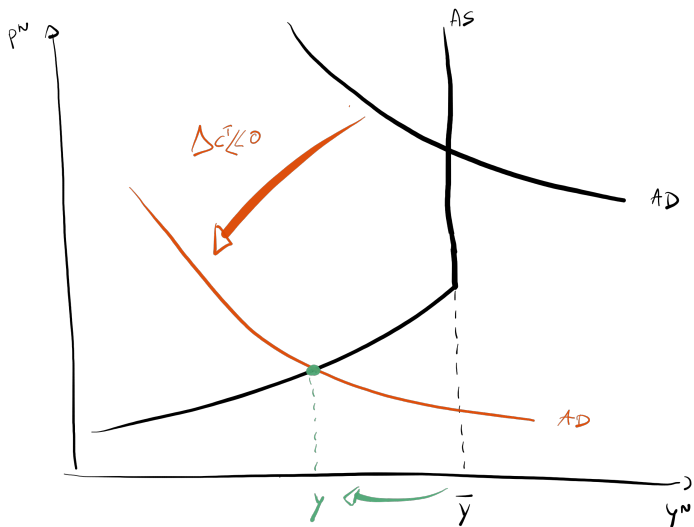
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Figure 5: AD-AS



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Figure 6: AD-AS



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- ▶ In such a situation, increasing G^N (financed by debt which is not costly for the moment)
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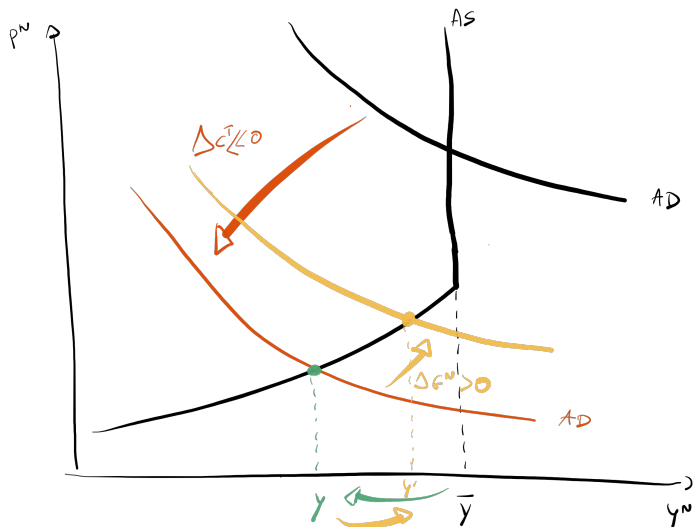
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- ▶ Because of the absence of commitment, there is a Laffer curve in borrowing revenues
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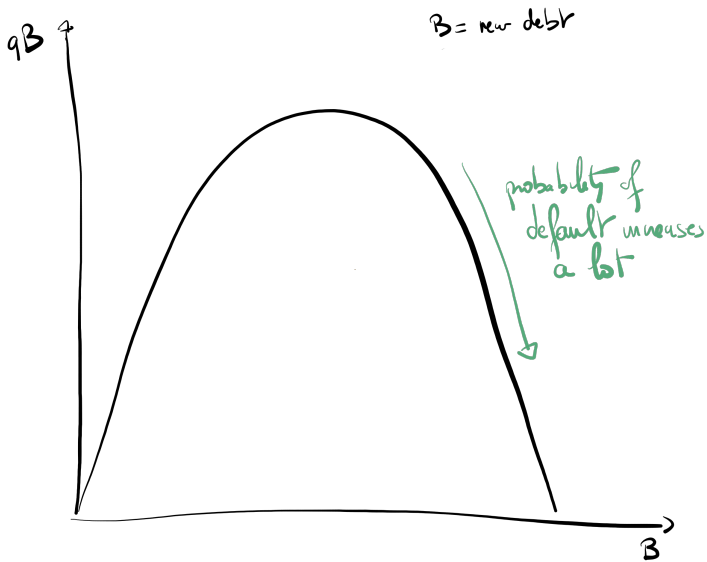
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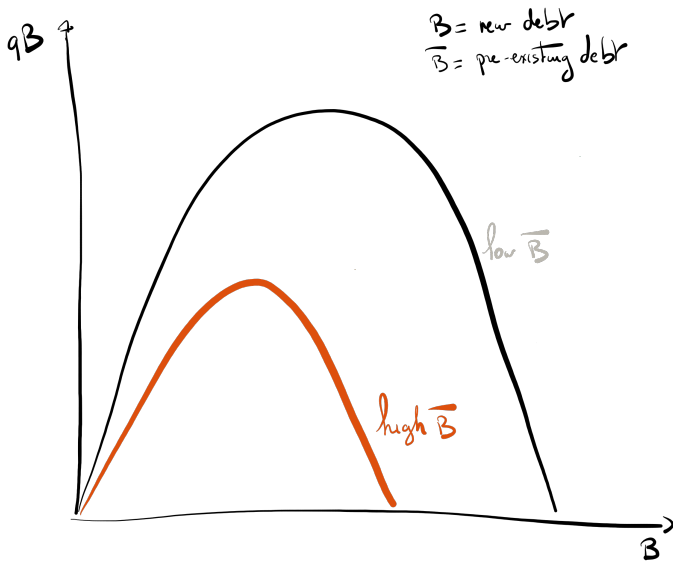
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Figure 8: Laffer curve



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Figure 9: Laffer curve



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 - × In NK (New Keynesian) models, the effect of demand shocks (say shocks to β) goes to zero when prices tend to be fully flexible
 - × We develop a RK (Real Keynesian) model in which demand shocks matter even when price are fully flexible.
 - × RK is favored by the data
 - × An RK model with sticky price has very different implications in terms of monetary policy:
 - ▶ Determinacy with a fixed nominal rate rule
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 - × We develop a RK (Real Keynesian) model in which demand shocks matter even when price are fully flexible.
 - × RK is favored by the data
 - × An RK model with sticky price has very different implications in terms of monetary policy:
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