Comments on “The Effects of Fiscal Policy on Output and Debt Sustainability in the Euro Area: A DSGE Analysis” by Davide Furceri and Annabelle Mourougane

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What the Paper Does

- Poses the question: what was the impact of the fiscal stimulus in the Euro area?
- Develops an DSGE model of the Euro Area with fiscal features to address this question
- Concludes that the euro-area fiscal stimulus boosts GDP by 0.8% in 2009 and 0.6% in 2010. Public debt as a % of GDP rises by 1.8% in 2010
- Short-term multiplier effect strongest for government investment
- Nice paper! Demonstrates how DSGE models can be useful for getting out of the crisis

Closer Look at the Fiscal Stimulus Result

- Average debt/GDP ratios in the OECD are now around 100% and deficit/GDP rations around 10%
- The fiscal stimulus in the paper amounts to 0.6% on spending and 0.3% on taxes or transfer. It only contributes 1.8% to the debt/GDP ratios in 2010 – policy has been to allow the automatic stabilizers to work
- Euro area GDP is forecast to fall about 4% in 2009 and rise by 1.2% in 2010. According to the paper would this would have been −4.8% and 0.6%, which is a significant effect despite the tiny impact on public finances
- Nature of Exercise: displacement from the steady state driven by instrument

Main Features of Model

- Endogenous government bond rate

$$\begin{aligned} \text{Bonds} : B_t &= (1 + ig_t)B_{t-1} + d_t \\ \text{Bond Interest Rate} : ig_t &= i_t + \theta E_t d_{t+1} \\ \text{Cost of Capital} : i_t^k &= ig_t + \delta \text{ Correct???} \\ \text{Taylor Rule} : i_t &= \rho i_{t-1} + (1 - \rho)(\text{usual stuff}) \end{aligned}$$

- Fiscal Rule: tax rates held fixed??? A stabilization rule for lump-sum taxes

$$T_t = \tau_1\left(\frac{B_t}{Y_t} - b^*\right) + \tau_t d_t$$

Other Features

Some ad hoc relationships:

- Unemployment Benefit: $ub_t = \epsilon log(GAP_t)$ – Not related to labour demand and supply (i.e. unemployment!)
- Non-Ricardian Mechanism – credit-constrained consumers
- **Both important!** They drive the automatic stabilizers and fiscal stimulus

Suggestions for Model Development

- An **explicit banking sector** - put at centre a loan production function with bonds and capital providing collatoral against which loans are made - see Goodfriend and McCallum, JME, 2007.e
- **Model Unemployment:** search-match approach?
- Estimate model by Bayesian methods - gives you a **probability** model (see Sims (2007)) which can be used to design robust monetary and fiscal rules for a return to normal times