Fiscal Consolidation in a Currency Union: Spending Cuts Vs. Tax Hikes

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Motivation

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- An important open question is the extent to which it is desirable to tailor the consolidation structure by taking account of monetary constraints imposed by CU membership and ZLB

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  - Duration of liquidity trap endogenously determined

Presentation outline

- Model
- Parameterization
- Effects of South consolidation in normal times
- Effects of South consolidation in a liquidity trap
- Mixed strategies
- Concluding remarks

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- Imperfect financial integration and producer currency pricing

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  - Policy rule more aggressive to inflation than standard Taylor rule ($\gamma_\pi = 2.5$)

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- Govt use either g_t or $\tau_{N,t}$ to implement b^*_{Gt+1}. The fiscal rule for $fi = [g_t, \tau_{N,t}]$ is

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- Results are reported in Figure 1 in the paper

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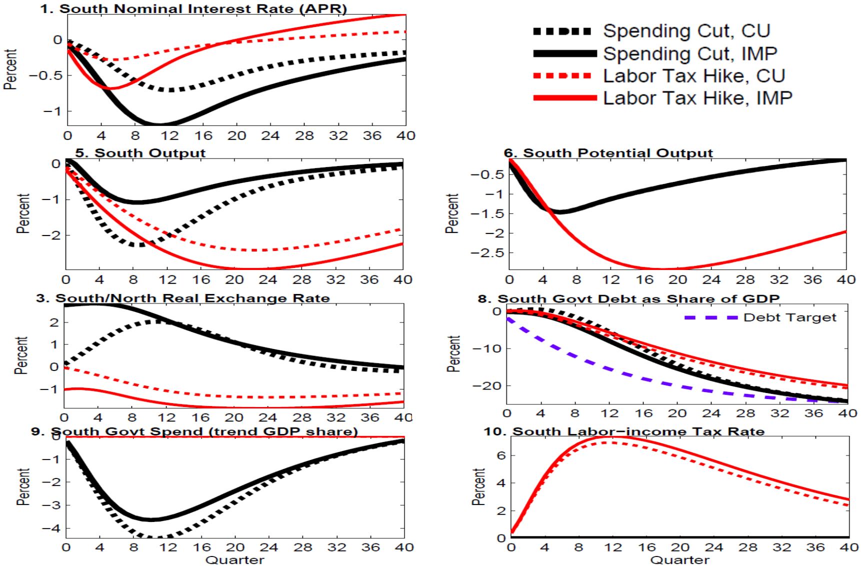
Comparing the effects in a currency union with monetary independence



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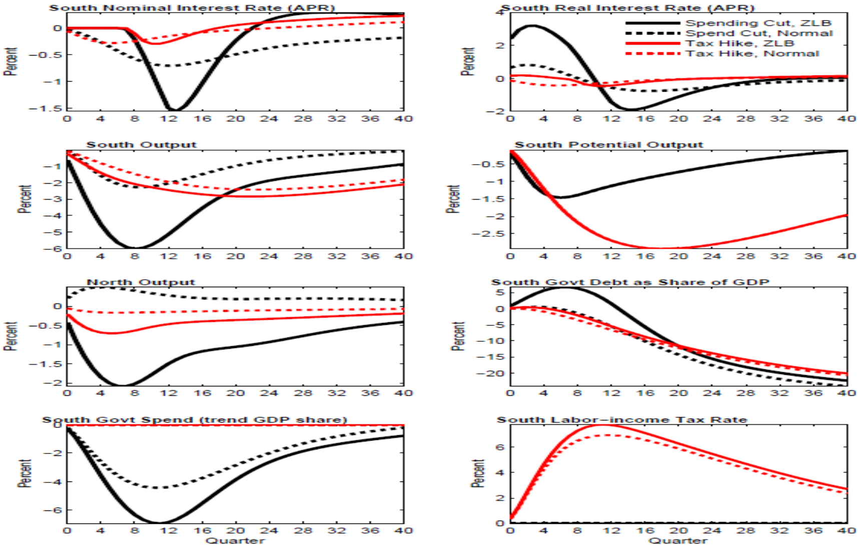
- To quantify impact of the ZLB, we also report results when CU monetary policy is unconstrained (but South is still a CU member)

Effects of South consolidation in a liquidity trap

Effects in a liquidity trap and in normal times when South is a CU member



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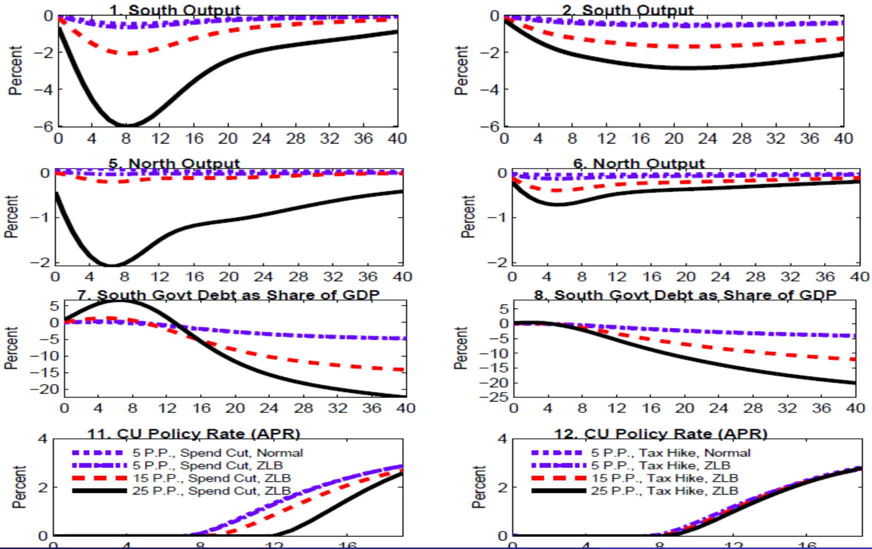
- To higlight this, we study differently-sized debt target reductions; -5%, -15% and benchmark (-25%)

Effects of South consolidation in a liquidity trap

Differently sized debt-target reductions; spending- (left panels) and tax-based (right panels)



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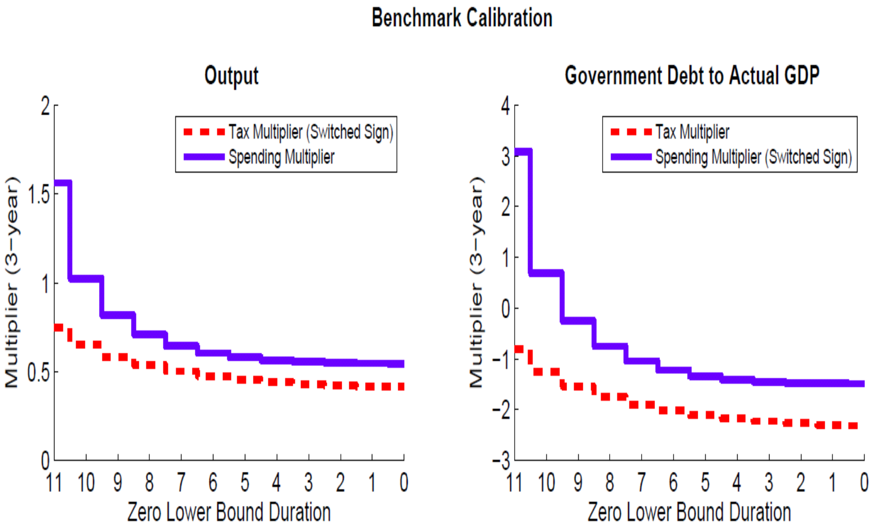
Marginal output and gov't debt 3-year multipliers as function of liquidity trap duration



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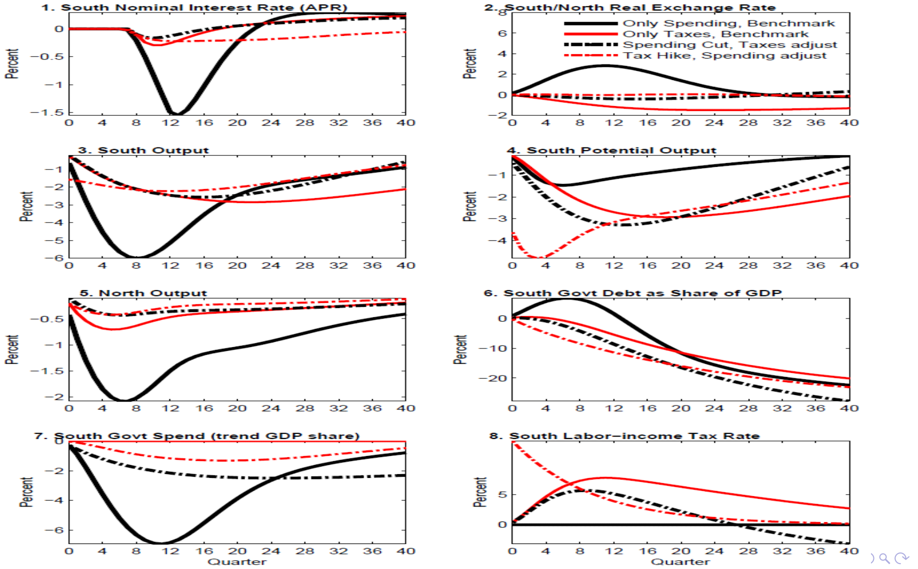
- Compare against the pure spending- and tax based consolidation strategies studied earlier

Effects of "Mixed Strategies"



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- Our analysis suggests that a mix of front-loaded *temporary* tax hikes and *gradual* spending cuts offers an effective route to reduce debt in the near- and long-term at low output cost in a liquidity trap
- Overall, our analysis illustrates the importance of taking constraints on interest and exchange rate adjustment into account when designing fiscal consolidation programs