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Comments on the Paper "Crunch Time: Fiscal Crises and the Role of Monetary Policy"

Eric S. Rosengren
President & CEO
Federal Reserve Bank of Boston

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Agreement with Some Key Points

- Greenlaw, Hamilton, Hooper, Mishkin contribute to the literature with a theoretical and empirical look at fiscal challenges faced in many advanced economies
- The paper's observations with which I concur
  - Unsustainable fiscal policies need to be sustainable
  - Tipping point for policies should be an area of concern and continued attention
  - Tipping point is difficult to pinpoint but it is very likely in the range of debt to GDP in many advanced economies

Use Caution with Empirical Results

- Regression model is parsimonious – however, may be too parsimonious
- R = f (debt/GDP, current account deficit, time and country dummy variables)
- Empirical work is similar to papers that
  - Estimate probability of sovereign default
  - Estimate size of sovereign default risk premium
- How well does simple model predict default? Consider the example of Ireland

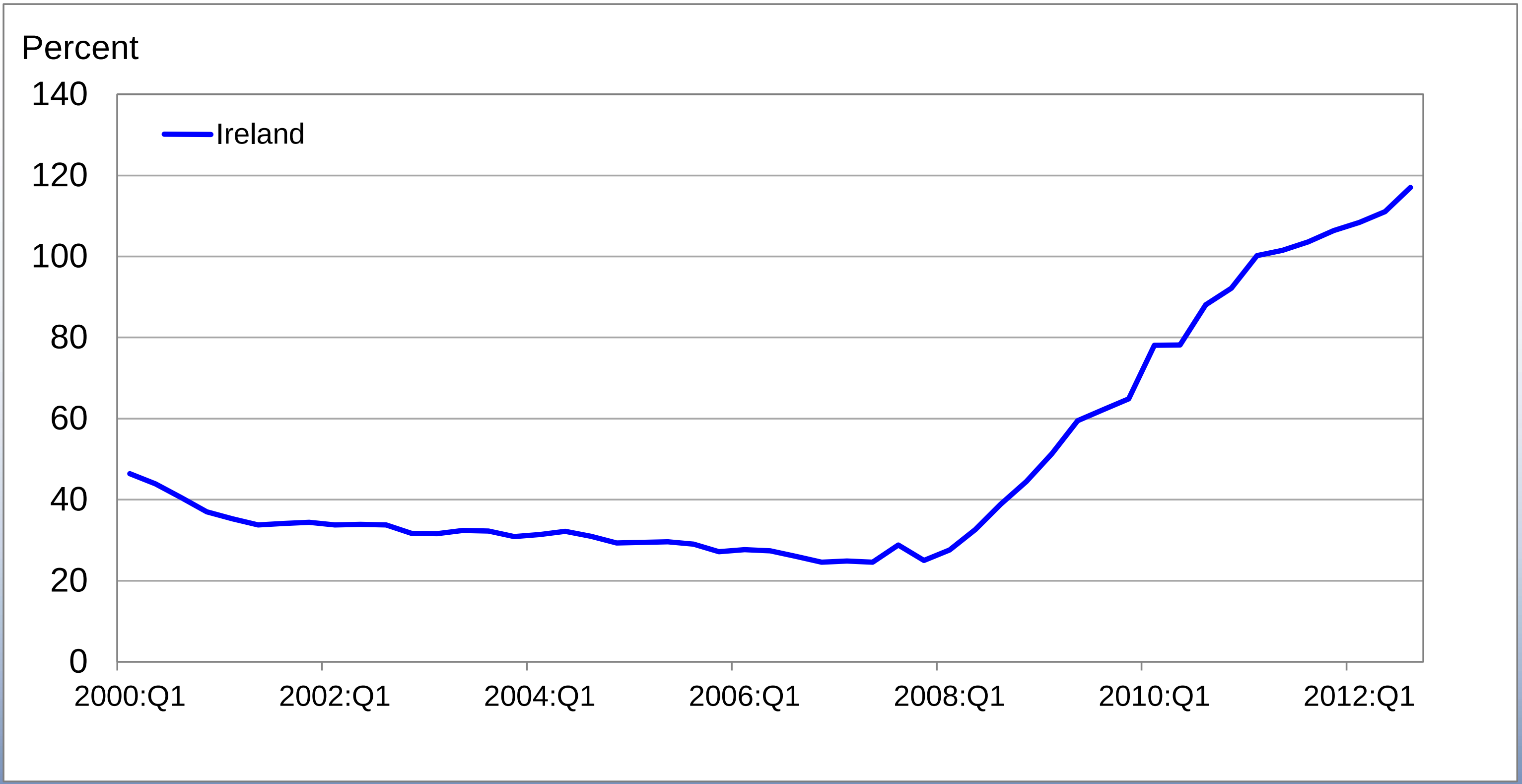
Figure 1
Fiscal Indicators for Select Countries

Country	General Government Gross Debt (% of GDP)	Current Account Balance (% of GDP)	Ten-Year Government Bond Yield (%)	
	2006	2006	January 2006	January 2013
Ireland	24.8	-3.5	3.34	4.27
France	64.1	-0.6	3.35	2.17
United Kingdom	43.0	-2.9	4.08	2.06
Unites States	66.6	-6.0	4.42	1.91

Source: IMF World Economic Outlook, October 2012, Financial Times, U.S. Treasury / Haver Analytics

Figure 2
Ireland: General Government Gross Debt as a Percentage of GDP

2000:Q1 - 2012:Q3



Source: Eurostat / Haver Analytics

Potential Omitted Variable Bias

- Are there variables that vary over time and by country that have been omitted from this analysis but might matter?
- *Financial* determinates of default premiums
  - Banking problems – nonperforming bank assets
    - Spain and Ireland: private credit problems became public problems
  - Bubble problems – residential real estate prices
    - Price bubbles in real estate that collapse have implications for banking and government expenditure – Spain and Ireland

More Potential Omitted Variables

- *Political* determinants of default premiums
  - Unstable government – number of governments in past 4 years – CDS spikes around elections
  - Unstable federalism – State and local debt to GDP – Spain: control of local/regional debt
- *Labor market* determinants of sovereign default premiums
  - Competitiveness of labor force – labor market productivity
  - Entitlement promises – unfunded pension liabilities/GDP

And More Potential Variables…

- Debt management strategies – Short-term debt to GDP – rollover risk and funding needs impact CDS
- Demographic trends – population growth, educational attainment of work force

Bottom Line

- Good first pass at studying tipping points, but need a richer model
  - Might not take coefficients in regressions too literally

How Should We Evaluate Costs and Benefits of LSAP?

- This paper focuses on remittances, but this is too narrow – does not do justice to policy trade-offs
  - Broader *fiscal* focus – consider the path of debt to GDP with and without LSAP – consider the fiscal impact of growing slowly
  - Broader *economic* focus – consider the path of dual mandate variables with and without LSAP

Estimated Benefit of Hypothetical Additional $750 Billion LSAP

- Long-term interest rates decline 20-25 basis points
- Cumulative gain in GDP of 1.6 percent or $260 billion
- Reduces unemployment by 0.25 percent or 400,000 jobs
  - Based on one of the more conservative models used by FRB Boston
  - Subject to considerable uncertainty

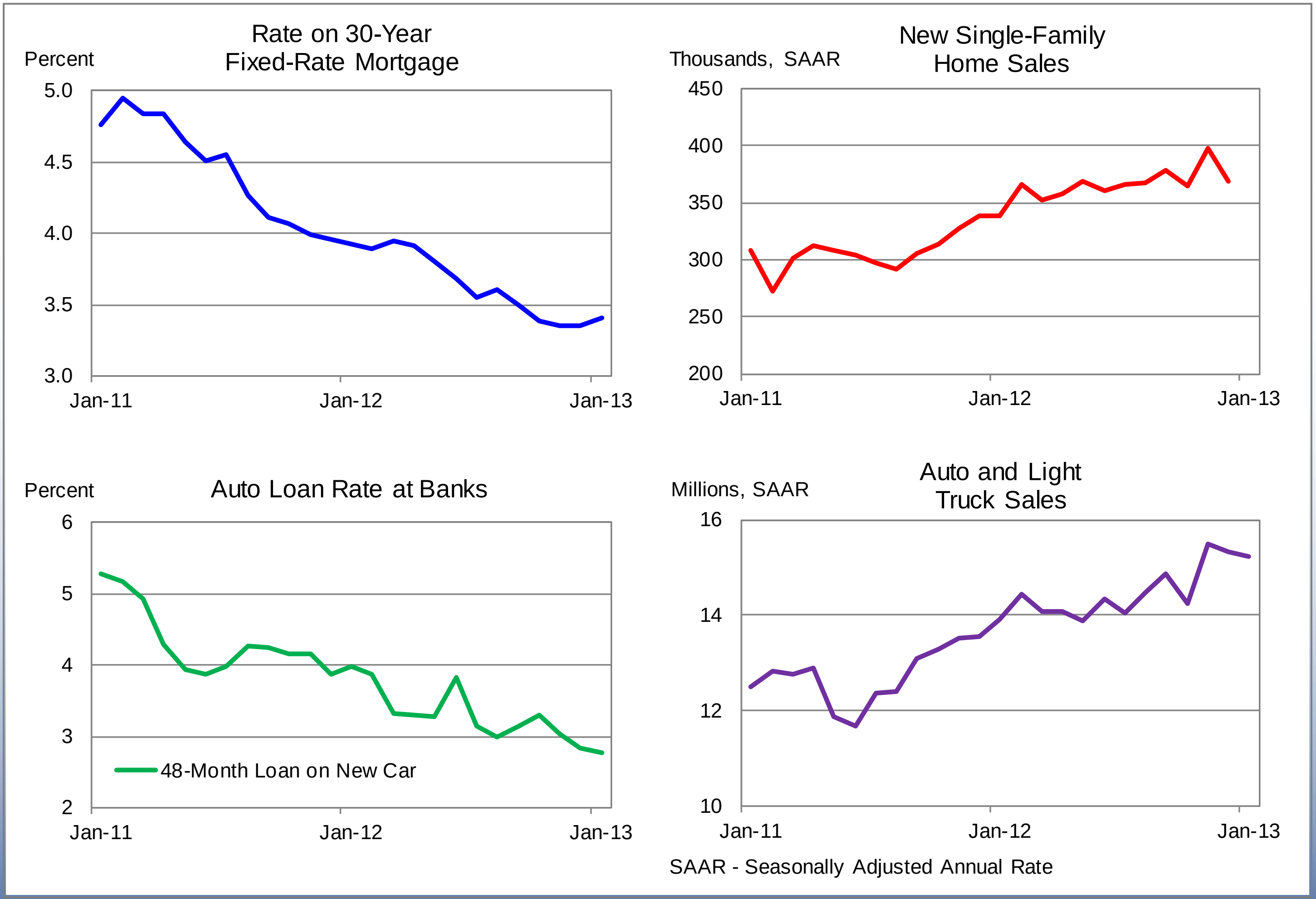
Remittances Do Not Capture Fiscal Impact of LSAP

- LSAP should result in faster economic growth and higher asset prices
  - Tax revenues improve (e.g., with higher income and capital gains)
  - Government expenditures reduced (e.g., lower unemployment benefits)

Federal Reserve's Dual Economic Mandate

- Current unemployment is 7.9 percent and PCE inflation is 1.3 percent – without LSAP we would be even further from both elements of the dual mandate
- Long run costs of elevated unemployment
  - Workers leave labor force
  - Permanent change in income stream

Figure 3
Housing and Auto-Related Indicators



Source: FHLMC, Census Bureau, WSJ, BEA / Haver Analytics

Concluding Observations

- The authors highlight the importance of fiscal tipping points
- Policymakers need to be mindful of how actions impact fiscal tipping points – particularly given uncertainty estimating tipping points
- Understanding remittances is important, but monetary policy should be evaluated on broader criteria
- We do well to also consider benefits, and the costs of inaction, when evaluating policy