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

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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
- \( R = f (\text{debt/GDP, current account deficit, time and country dummy variables}) \)
- 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

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<tr>
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</thead>
<tbody>
<tr>
<td></td>
<td>2006</td>
<td>2006</td>
<td>January 2006</td>
</tr>
<tr>
<td>Ireland</td>
<td>24.8</td>
<td>-3.5</td>
<td>3.34</td>
</tr>
<tr>
<td>France</td>
<td>64.1</td>
<td>-0.6</td>
<td>3.35</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>43.0</td>
<td>-2.9</td>
<td>4.08</td>
</tr>
<tr>
<td>United States</td>
<td>66.6</td>
<td>-6.0</td>
<td>4.42</td>
</tr>
</tbody>
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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

Rate on 30-Year Fixed-Rate Mortgage

New Single-Family Home Sales

Auto Loan Rate at Banks

Auto and Light Truck Sales

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.