Can Deficits Finance Themselves

By Angeletos, Lian and Wolf

Discussion by John Leahy

Central Bank of Iceland 2024

This paper has already been discussed many times

Chari (Portugal)

Portier (Hydra)

Dibortoli (ECB)

Bianchi (NBER EFG)

Luettike (Germany)

Ronglie (NBER ME)

Plan

- Quick overview
- Discuss all the papers that they did not write

Mechanism

Nothing fancy

Mechanism

Ingredient 1: Overlapping generations

- Breaks Ricardian equivalence
- Transfer T dollars to current generations and tax future generations
  - MPC =1
  - On impact $\Delta c = (1-t)T$

Mechanism

Ingredient 2: Output is demand determined

- $\Delta y = \Delta c$

- Leads to further increase in consumption

  $\Delta c = (1-t)\Delta y$

- Cumulative incrase in output (Keynesian cross)

  $\Delta y = T/t$

- Tax revenue = $t \, \Delta y = T$

Mechanism

Ingredient 3: Accommodative Monetary Policy

- Monetary policy needs to stay out of the way
- Assume policy targets the real interest rate

Three surprises

- Complete self financing possible

- Possible without significant inflation

- Sensibly parameterized model yields significant self-financing

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- "Big shock'' evidence often yields small multipliers
  - Barro (1981) argues that the multiplier in the US during WWII was about .6
  - Government spending rose by 1/3 and output by ¼
  - Presumably supply side constraints kick in at some point

Results hold for **small**, **symmetric**, **unanticipated** shocks about a **steady state** to which the fiscal authority is **committed** to return to.

- In many countries, government spending seems to rise more easily than it falls.

- Asymmetries may affect the steady state o the model, possibly through anticipated inflation.

Results hold for **small**, **symmetric**, **unanticipated** shocks about a steady state to which the fiscal authority is **committed** to return to.

- I believe that the paper could be extended to show that this does not matter, since inflating away the debt is not key to their results.

- Lags in fiscal policy implementation should not be a problem

Results hold for **small**, **symmetric**, **unanticipated** shocks about a **steady state** to which the fiscal authority is **committed** to return to.

- I think that the paper takes this commitment a bit for granted.

German model

Key difference: **Central Bank targets zero inflation at all cost**

German model

In this setting:

- There is no self financing

- The New Keynesian Philips pins down output.

- Real interest must rise to cancel out the wealth effect on Non-Ricardian agents

German model

Lesson:

To get self-financing must live with some inflation (or deflation)

Greek model

Key difference: **Greece is a small open economy**

Consider:

- Continuum of islands identical to the ALW economy
- Each island participates in frictionless world markets
- Each has its own government with its own fiscal policy

Greek model

In this setting

- There is no self-financing

- Non-Ricardian consumers consume the transfer

- Results in a current account deficit financed by foreign debt

- Supply side makes things worse

  – Rise in consumption raises marginal cost. Prices rise and output falls

- As current generations die off, current account deficit turns to surplus as future generations pay off the debt.

- Do not necessarily return to steady state.

Greek model

At the beginning of the Greek debt crisis, Greek debt to GDP ratio was over 100%

A large fraction (70%?) was held by foreigners

Greek model

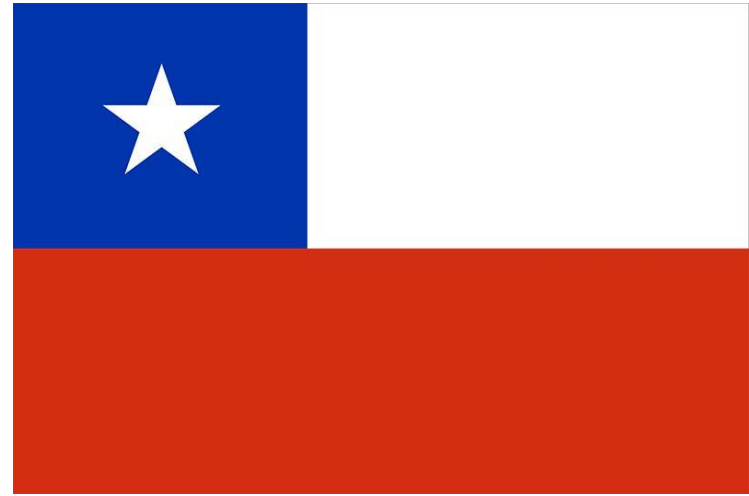This might be why Marios is quoted in the New York Times as saying:

"I wouldn't dare present this paper in Greece, where I'm from, because I don't want to give excuses for running bigger deficits there."

Greek model

Lesson:

- Small open economies may find it harder to self finance deficits

Chile^{-1} model

Suppose that Chile decided to reverse course and replace its self-financed pension system with a pay as you go system financed by government debt.

Chile^{-1} model

Consider a version of Gertler (1999) model of social security.

Now make a transfer to the living equal to their expected future tax liability and finance it with a tax hike in the far future

I believe that the results of this paper imply that this transfer would finance itself.

Chile^{-1} model

Lesson:

Paper seems to be missing something important

Great Paper!

Thank you!