Time-Consistent Fiscal Policy in a Debt Crisis

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Neele Balke[1,2] and Morten Ravn[1,2,3]

[1]Centre For Economic Policy Research, [2]Centre For Macroeconomics, [3]University College London

How should fiscal policy be adjusted during episodes that involve both deep recessions and debt crises, such as the circumstances that took place in Europe in 2009 onwards? Should the government implement stimuli measures to soften the recession or introduce austerity measures to tackle the debt crisis? This paper examines this question in a sovereign debt model where the government lacks commitment allowing for feedback from the policy instruments to the state of the economy. We stress concerns about inequality and redistribution. Commitment problems during debt crises motivate austerity measures which involve the government sacrificing social insurance in order to access international financial markets because governments have an incentive to renege on debt repayments that are priced in. Could a third party impose fiscal rules that constrain the government's ability to implement a post-default fiscal stimulus, austerity measures would no longer be optimal.

We study a small open economy in which the government issues non-state-contingent debt purchased by international lenders. Lenders can punish the sovereign for default through exclusion from financial markets and through sanctions that inhibit productivity. Output is produced by labor input subject to stochastic productivity shocks. There is frictional unemployment. Households are subject to uninsurable idiosyncratic income shocks that derive from unemployment risk, cannot save and employment contracts last for a single period so that agents are ex-ante identical at the beginning of each period but ex-post heterogeneous due to unemployment risk. The government chooses unemployment welfare benefits, income taxes, public goods, and debt policy.

The utilitarian government cannot commit to the future path of any of its policy instruments and we focus on Markov-Perfect equilibria. The government is concerned about providing intertemporal insurance (against productivity shocks) and intratemporal insurance (against unemployment shocks). Optimal fiscal policies depend crucially on the debt regime and distinguish between "normal times," financial autarky, and "debt crisis." In financial autarky and in "normal times," the government sets procyclical fiscal policy that provide intertemporal and intratemporal insurance. When default premia are sensitive to debt issuance, a "debt crisis," it becomes optimal to implement austerity policies that sacrifice household consumption. The austerity measures involve the government hiking income tax rates and cutting government purchases and welfare transfers.

There are two underlying sources of the optimality of austerity policies. When the default premium is high, it is expensive to issue debt and this motivates austerity measures by itself. But there is also a strategic motive due to the lack of commitment. When debt is high, lenders realize that the sovereign has a strong motive to free up resources to stimulate the economy in a recession by defaulting on debt. Lenders therefore set the debt price structure to induce the government to sacrifice household consumption in the crisis zone. We show that if a third party could enforce commitment to either fixed tax rates or welfare benefits, austerity expressed in terms of sacrificing household consumption is no longer optimal in a debt crisis while the pure fiscal motive remains. Thus, our results indicate that the extent to which countries can credibly commit to fiscal rules -- and in particular to not abandon these should they default -- is crucial for the design of fiscal policy in a debt crisis.