Discussion of Jarocinski and Mackowiak,

Monetary and Fiscal Interactions and the Euro Area's Malaise

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  - implied restrictions are **independent of fiscal policy** specification, as long as fiscal policy assumed to be **Ricardian**

  - hence doesn't matter that there are multiple fiscal authorities, or that CB is not committed to maintain public debt default-free [the EZ-relevant features of model]

Is the Euro the Problem?

- The possibility of a self-fulfilling solvency-risk crisis for regional fiscal authority is motivated by situation of southern EZ countries

  — but this **doesn't** have any consequences for equations that determine $\{Y_t, \Pi_t, R_t\}$

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- Doesn't mean the model of low-inflation trap is wrong for EZ; but not a critique of EZ structure or policies

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  - in 2012, people expect intermediate default probability for South debt [middle of 3 equilibria]; but lowest possible eq'm default rate in all other years

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    - in 2012, people expect intermediate default probability for South debt [middle of 3 equilibria]; but lowest possible eq'm default rate in all other years

- Apart from arbitrariness of the timing, the particular equilibria selected in 2012 are not obviously ones that it should be **easy for people to coordinate upon**

Multiple Equilibrium Default Probabilities

- Whenever gov't fiscal needs are in an intermediate range, there are **three possible equilibria** for expected default probability that year:

    - certain of no default $\Rightarrow$ high debt value $\Rightarrow$ low debt issuance $\Rightarrow$ no chance of default

    - certain of default $\Rightarrow$ low debt value $\Rightarrow$ high debt issuance $\Rightarrow$ default certain

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- Assumed that in 2012, intermediate eq'm occurs, rather than either of the others; but no-default eq'm is selected in other years, if it exists

Multiple Equilibrium Default Probabilities

- This is the kind of situation in which Morris and Shin (1998) argue that even a small lack of common knowledge about the gov't's exact fiscal needs should result in a **unique** equilibrium ["global games" selection]

  - then no role for "sunspot" state in determining default probability, for given fiscal need

  - and the eq'm default probability is **never** the intermediate one

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- The intermediate eq'm is an **unstable fixed point** of the best-response mapping:

  - expect slightly higher default probability $\Rightarrow$ higher debt issuance $\Rightarrow$ default probability **even higher** than expected

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- Hence adaptive **learning dynamics** should not converge to an eq'm of this kind

Multiple Equilibrium Inflation Expectations

- Model is one in which there are **two** possible steady-state inflation rates, each consistent with CB reaction function [given ZLB constraint]

  - target inflation rate [positive]

  - rate of deflation that [when $i = 0$] implies real return consistent with steady-state Euler equation

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  - not "E-stable" $\Rightarrow$ adaptive learning dynamics **won't converge** to this kind of equilibrium (Benhabib *et al.;* Woodford, 2013)

The Proposed Remedy: Comments

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   - such a commitment is inconsistent with the ZLB-trap steady state (or eq'a converging to it), but consistent with the target-inflation steady state (Woodford, 2003; Eggertsson and Woodford, 2003)

An Alternative Remedy

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  - commitment would be consistent with traditional doctrine of ECB (the "monetary pillar")

  - would not require that it be credible that fiscal authorities will not care about explosive path of real public debt

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  — policy still expected to be Ricardian (in long run) $\Rightarrow$ public debt has no effect on output, inflation determination

  — raising nominal interest rates $\Rightarrow$ raises perceived real return, reduces desired spending

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- Hence risky to try this

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③ Proposal to use eurobond issuance to preclude possibility of self-fulfilling solvency crises for peripheral EZ countries: a sound idea, and model worth developing

- But model of solvency crisis should be embedded in a different macro model than here
  - no interaction between solvency-crisis model and macro model of potential liquidity trap
  - would be desirable to embed solvency-crisis model in a macro model where higher default premia have consequences for the real allocation of resources