



BESS at MNB (MNB-CEU)

Debt consolidation, spending reversals, and the transmission of fiscal policy

Speaker: **Gernot Müller** (University of Bonn)
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Venue: MNB-Visitor Centre (1054 Budapest, Szabadsag ter 8.)

Co-author: Giancarlo Corsetti and Andre Meier

Abstract

The impact of fiscal stimulus depends not only on short-term tax and spending policies, but also on expectations about offsetting measures in the future. This paper first provides time-series evidence for the U.S. suggesting that positive shocks to government spending are associated with a rise in public debt, and after the initial increase, a gradual reduction of spending below trend over time. It then analyzes the transmission of government spending shocks, specifying plausible debt-stabilizing policies within a new Keynesian model. Specifically, we assume that both taxes and spending adjust in response to rising public liabilities. We show that accounting for reversals in spending brings an otherwise standard new Keynesian model in line with the stylized facts of fiscal transmission, including the 'puzzle' of real exchange rate depreciation.