FINANCIAL CRISIS INTERVENTIONS:
THE FISCAL-POLICY SETUP MATTERS

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Summary

Literature shows that ex-post policies completely avoid crisis. This result would make macro-prudential policies redundant (e.g. Benigno et al., 2014, 2016).

Parra-Polanía and Vargas (2015, 2016) show that under an alternative financial constraint, ex-post policies are completely ineffective, while ex-ante policies are still effective.

Above result is valid under a balanced budget fiscal policy.

With a counter-cyclical fiscal policy, there would be a role for ex-post policies in the management of financial crisis under an alternative financial constraint.

With balanced budget

		POLICY	
		Exante	Expost
FINANCIAL CONSTR.	Standard	✓	✓
	Alternative	✓	✗

Ex-ante policy is robust to the specification of the financial constraint

Ex-ante policy: tax on debt during normal times only.
It is returned to households as a lump-sum tax.

It is effective to implement the Social Planner allocation. It corrects externality.

Ex-post policy only works under the standard financial constraint

Ex-post policy: subsidy on non-tradable consumption during (potential) crisis.
It is returned to households as a lump-sum tax.

Under standard financial constraint: It completely avoid crisis. The economy will never be constrained.

Under alternative financial constraint: Completely ineffective, useless.

Equations

Financial constraint:

Standard: $B_{t+1} \leq \kappa(Y_t^T + P_t^N Y_t^N)$

Alternative: $B_{t+1} \leq \kappa(Y_t^T + P_t^N Y_t^N - T_t)$

Under alternative financial constraint, a counter-cyclical fiscal policy could avoid financial crises

Counter-cyclical fiscal policy: accumulate resources in a fund during normal times, and use them during periods of crises to mitigate or, under certain conditions, even avoid crisis.

Options:

Two policy tools:
In normal times: lump-sum tax
In periods of (potential) crisis: subsidy on non-tradable consumption

Three distortionary policy tools:
In normal times: taxes and subsidies on debt and tradable consumption.
In periods of (potential) crisis: Subsidy on non-tradable consumption.

Restrictions on above policies:

1. Policies to collect funds during normal times should not be so taxing that end up constraining the economy.
2. On average, combination of taxes and subsidies during normal times should add rather than subtract resources from the fund.
3. Policies during normal times should not distort the decision on consumption.

There is a limit to the amount of resources that could be accumulated during normal times.
The amount collected limits the size of the subsidy on non-tradable consumption during periods of crisis. If funds are not enough, subsidy may not take the economy out of the crises, it can only mitigate the size of the crises.

References

Parra-Polanía and Vargas (2016) "Relevance of the fiscal-policy setup in the analysis of macroprudential and ex-post financial crisis interventions" Borradores de Economía # 945.

Parra-Polanía and Vargas (2015) "Macroprudential vs. Ex-post Policy Interventions: when Domestic Taxes are Relevant for International Lenders" Borradores de Economía # 879.

References

1. Benigno, Chen, Otrok, Rebucci and Young (2014) "Optimal Capital Controls and Real Exchange Rate Policies: A pecuniary externality perspective" CEPR Discussion Papers No. 9936
2. Benigno, Chen, Otrok, Rebucci and Young (2016) "Optimal Capital controls and Real Exchange Rate Policies: A pecuniary externality perspective" NBER Working Papers No. 22224