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Relevance of the fiscal-policy setup in the analysis of macroprudential and ex-post financial crisis interventions

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In a previous paper (Parra-Polania and Vargas, 2015) we modify the financial constraint of a very standard model to incorporate the fact that international lenders take into account that taxes (or subsidies) affect borrowers' income available for debt repayments, and find that ex-post interventions are completely ineffective to manage crises (even though they are financed by taxes that do not entail further distortions) and, instead, macroprudential policies are still able to correct the underestimation of the social costs of decentralized debt decisions. These results are obtained under the assumption, also common in the related literature, that there is a balanced-budget fiscal policy. In this paper we extend our previous work to consider countercyclical fiscal policies (keeping the alternative financial constraint). We show that some combination of policy interventions could completely avoid crises, but under restrictive conditions.

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