Fiscal Policy and the Term Structure of Interest Rates in a DSGE Model

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Abstract

We examine how government spending influences the term structure of interest rates and how this effect depends on the commitment to consoli-date public finances in future, the volatility of government spending and monetary policy conduct. For this reason, we lay out a New Keynesian macro model with recursive preferences, nominal rigidities and Markov switching in monetary policy rule. We show that i) the yields jump up after rise in government spending; ii) turbulent fiscal policy amplifies the precautionary saving motive and risk aversion; iii) monetary policy plays crucial role in the transition mechanism of the government spending shock and iv) by commitment to fiscal consolidation government can immunize its impact on the term structure.