Monetary & Fiscal Institutions: ¿Have We Got Things Backwards?

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Overview

- Advanced economies face slowing economic growth & substantial long-run fiscal challenges
- Different problems call for different policies
  - short-run monetary-fiscal stimulus
  - long-run fiscal consolidation & sustainability
- Monetary & fiscal policy symmetries
- Strong opposition to immediate fiscal stimulus
  - no professional consensus on efficacy
  - policy institutions ill-suited to current & future economic realities
- A good time to rethink monetary-fiscal frameworks
- ¿Have we got things backwards?
Current & Future Economic Problems

- Advanced economies—Europe, Japan, U.S.—are struggling
  - forecasters torn between prolonged slow growth and double-dip
  - little doubt that the “recovery” is in jeopardy

- These countries and others face aging populations
  - promised old-age benefits rely on having many workers per retiree
  - major reforms to benefits and financing loom in future
Current Problems: Unemployment

- U.K.
- U.S.
- Euro Area
Brazil: Declining Unemployment

Brazil

Euro Area

U.S.

U.K.
Fiscal deficits and public debt are very high in many advanced economies. Although policy became much less stimulatory in 2010, real GDP growth picked up, suggesting a handoff from public to private demand. For 2011, fiscal consolidation is expected to be modest in advanced economies. As a result, the adjustment required to achieve prudent debt levels by 2030 remains very large. Fiscal adjustment will be larger in economies with high external surpluses than in economies with high deficits, which is consistent with widening global imbalances.
Future Problems

- The *real* fiscal problems lie in the future
U.S. “Unfunded Liabilities”

Percentage of GDP
U.S. “Unfunded Liabilities”

Percentage of GDP

- Medicare and Medicaid
- Social Security

U.S. "Unfunded Liabilities"

- Social Security
- Medicare and Medicaid
- Other Federal Non-interest Spending

Percentage of GDP
Long-Run U.S. Fiscal Stress

Percentage of GDP

Baseline Scenario

Baseline Scenario

Alternative Scenario

Alternative Scenario

Baseline Scenario

Baseline Scenario
Long-Run World Fiscal Stress

Graph 4

Public debt/GDP projections

Austria France Germany

Baseline scenario
Small gradual adjustment
Small gradual adjustment with age-related spending held constant

Sources: OECD; authors' projections.
Long-Run World Fiscal Stress

Graph 4
Public debt/GDP projections
Austria France Germany
0
50
100
150
200
250
300
80 90 00 10 20 30 40
Sources: OECD; authors' projections.

Japan
Netherlands
Portugal
Spain
United Kingdom
United States
Brazil: No Near-Term Fiscal Stress

Brazilian General Government Net Debt
as Share of GDP

What Are Policy Authorities Doing?

- Short-run fiscal contraction
- Massive monetary accommodation
- Long-run fiscal paralysis

- These fiscal actions (and inactions)
  - further weaken economies in near term
  - amplify uncertainty about fiscal policy in long term
Why Can’t Policy Deliver What’s Needed?

- Policy boxing: place monetary & fiscal policy in separate boxes
  - create firewalls between them

- Treat monetary & fiscal policy asymmetrically
  - Monetary policy:
    - independent central bank with clear mandate
    - staffed by professional economists
    - integrate academic research with practical policy
  - Fiscal policy:
    - utterly political without clear economic objectives
    - little input from economists
    - essentially no connection between research and policy
Policy Boxes: Historical Rationales

1. High and hyper-inflations have had fiscal roots
   ▶ central bank pressured to print money to finance government spending and keep government solvent

2. Inflation bias
   ▶ central bank tempted to err on side of excessive accommodation

Solution:
   ▶ create an independent central bank
   ▶ give central bank clear objectives
   ▶ permit central bank to “move first”—before fiscal policy
   ▶ force fiscal authority to adopt policies that ensure solvency
Institutions treat monetary & fiscal policy asymmetrically.

This denies intrinsic *economic symmetry* between the policies.
The source of economic symmetry

Monetary & fiscal policy have two tasks: (1) control inflation; (2) stabilize debt

Two different policy mixes that can accomplish these tasks

**Regime M:** conventional assignment—MP targets inflation; FP targets real debt

**Regime F:** alternative assignment—MP maintains value of debt; FP controls inflation

**Regime M:** normal state of affairs

**Regime F:** can arise in periods of economic or fiscal stress
Monetary-Fiscal Interactions: Regime M

- MP behavior completely familiar: target inflation by aggressively adjusting nominal interest rates
- FP adjusts future surpluses to cover interest plus principal on debt
- What is FP doing?
  - any shock that changes debt must create the *expectation* that future surpluses will adjust to stabilize debt’s value
  - people must believe adjustments will occur eventually
  - eliminates wealth effects from government debt
  - for MP to target inflation, fiscal expectations must be anchored on FP adjusting to maintain value of debt
- Any reason to believe expectations are now so anchored?
Primer on Monetary-Fiscal Interactions

- Monetary & fiscal policy have two tasks: (1) control inflation; (2) stabilize debt
- Beautiful symmetry: two different policy mixes that can accomplish these tasks

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- **Regime M:** normal state of affairs
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- Regime F arises in two ways
  1. Sargent & Wallace’s unpleasant monetarist arithmetic
Common Perception of Fiscal Inflation

- Arises from unpleasant arithmetic mechanism
  - hit fiscal limit; surpluses unresponsive to debt
  - seigniorage adjusts to stabilize debt

- A central banker’s take on this:

  “...the proposition is of little current relevance to the major industrial countries. This is for two reasons. First, seigniorage—financing the deficit by issuing currency rather than bonds—is very small relative to other sources of revenues. Second, over the past decade or so, governments have become increasingly committed to price stability.... This sea change in the conventional wisdom about price stability leaves no room for inflation to bail out fiscal policy.”

  —Mervyn King (1995)

I agree
Policy Boxes Again

- A deeply ingrained misperception: CB independence & inflation targeting insulate inflation from FP

- Stems from beliefs that
  - Regime M is best way to achieve two tasks
  - Regime F necessarily brings high inflation

- Beliefs underlie monetary reforms without corresponding fiscal reforms
  - assumes MP reform can force FP reform
  - Europe shows us how well that works

- There is another channel through which fiscal policy can affect inflation and aggregate demand
Primer on Monetary-Fiscal Interactions

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  1. Sargent & Wallace’s unpleasant monetarist arithmetic
  2. fiscal theory of the price level
Monetary-Fiscal Interactions: Regime F

- Governments issue mostly nominal (non-indexed, local currency) bonds
  - 90% U.S. debt; 80% U.K. debt; 95% Euro-area debt; most of Australian, Japanese, Korean, New Zealand, & Swedish debt
  - increasing important in Latin America: Chile (92%), Brazil (89%), Colombia (77%), Mexico (75%)

- In Regime F:
  - FP sets primary surpluses independently of debt
  - MP prevents interest payments on debt from destabilizing debt

- Nominal debt is revalued to align its value with expected surpluses

- Lower current or expected surpluses reduce value of outstanding debt: raises aggregate demand
Fiscal Transmission in Regime F

- Increase in current or expected transfers
  - no offsetting taxes expected, household wealth rises
  - lower expected path of surpluses reduces “cash flows,” lowers value of debt
  - individuals shed debt in favor of consumption, raising aggregate demand
  - higher current & future inflation and economic activity
  - long bonds shift inflation into future

- Demand for debt ⇔ aggregate demand
Current Monetary Policies

- Monetary policy in advanced economies in Regime F

- Policy interest rates:
  - Europe: 1.50%
  - Japan: 0.00 – 0.10%
  - U.K.: 0.50%
  - U.S.: 0.00 – 0.25%
  - BoJ, BoE, and Fed have made clear low rates will last
  - ECB is hinting they may return to low rates

- This makes the ground fertile for fiscal expansion…

- But gives fiscal consolidations large contractionary effects
Recent History of Fiscal Attitudes

- **2008–09**: Fiscal stimulus packages passed across G-20 & many emerging economies

- **late-2009**: Calls for retrenchment
  - fiscal “exit strategies”
  - officials trumpet “expansionary fiscal consolidation”

- **2010**: G-20 leaders commit to cut deficit in half by 2013

- **2011**: Fiscal consolidation begins in debt-tolerant & debt-intolerant countries

- **mid-2011**: Calls by Bernanke & Lagarde to avoid fiscal contraction (perhaps even expand?)

- Are you dizzy yet?
Why Strong Resistance to Stimulus Now?

1. Fiscal multiplier morass
   - evidence mixed on effectiveness of fiscal stimulus
Multiplier summarizes fiscal effectiveness:

How many $ of GDP does an additional $1 of government spending generate?

Multiplier is a complicated animal that depends on:

- type of spending increase
- timing of spending increase
- expected source of fiscal financing
- speed of fiscal financing
- behavior of monetary policy

Illustrate these in simple economic models
Government Spending Multipliers

$1$ more government spending ⇒ $0.65$ more GDP

All instruments adjust
Government Spending Multipliers

Output Multipliers

Only transfers adjust
If higher spending financed with lower transfers, GDP rises more.

Only transfers adjust.
Government Spending Multipliers

Output Multipliers

Government spending adjusts
Government Spending Multipliers

Output Multipliers

If government spending financed by lower government spending, GDP falls after 2 years.
Government Spending Multipliers

Output Multipliers

All instruments adjust

Only taxes adjust

Only government spending adjusts

Only transfers adjust
If government spending financed by higher taxes, GDP soon declines.
Speed of Fiscal Adjustment

- After implementing fiscal stimulus packages in 2009...
- Many countries have now reversed course to contract fiscal policy
- This reversal accelerates the usual speed of fiscal adjustment
Government Spending Multipliers

Output Multipliers

Historically Estimated

Speed of Adjustment

Faster Speed of Adjustment

Slower Speed of Adjustment
Government Spending Multipliers

- Allow monetary & fiscal policy is reside in different regimes

<table>
<thead>
<tr>
<th>Regime</th>
<th>5 quarters</th>
<th>10 quarters</th>
<th>25 quarters</th>
<th>∞</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regime M</td>
<td>0.79</td>
<td>0.80</td>
<td>0.84</td>
<td>0.86</td>
</tr>
<tr>
<td>Regime F</td>
<td>1.72</td>
<td>1.58</td>
<td>1.40</td>
<td>1.36</td>
</tr>
</tbody>
</table>

- An inconvenient truth about Regime F:
  - fiscal expansion raises output substantially
  - fiscal *contraction* lowers output substantially
Fiscal Multiplier Morass

- Complications make fiscal analysis hard
- Difficult to control experiment
  - how & when will policies adjust?
  - how will monetary policy behave?
- Hard to answer the counterfactual:
  - what would have happened without fiscal stimulus?
- Without unambiguous answers, can’t convince skeptics
Why Strong Resistance to Stimulus Now?

1. Fiscal multiplier morass
   - evidence mixed on effectiveness of fiscal stimulus

2. Regime M institutional structure
   - but without the required fiscal infrastructure
Regime M Institutional Structure

- Impose constraints on monetary policy
  - legislated mandates (inflation targeting, output stabilization)
  - independent but accountable
  - decisions grounded in economic research
  - emphasize transparency & communication
  - long & staggered terms of office

- Constraints designed to combat temptations to inflate
  - enforce consistency of decisions over time
  - “anchor inflation expectations”

- Remember: For Regime M to work, fiscal policy must anchor expectations on debt stabilization
Realities About Fiscal Institutions

- Few enforceable constraints
- No clear economic objectives (or too many)
- Policymakers’ incentives float with political winds
- Policies naturally erratic over time
  - Fiscal instruments operate on dynamic margins
  - Expectations play central role
  - Elected officials turn over frequently
  - New governments can (and do!) renege on previous government’s promises
- Fiscal policy far more capricious than monetary policy
  - Erratic fiscal policies so routine we don’t notice anymore
¿Have We Got Things Backwards?

- Potential for fiscal policy to go seriously wrong far greater than for monetary policy
- Need constraints on fiscal policy—at least at aggregate level
- Fiscal desiderata:
  1. remove deficit bias
  2. smooth tax rates & government investment spending
  3. adjust very gradually future policies that stabilize debt
  4. conceive mechanisms to allow precommitment to tie down future policy
  5. anchor fiscal expectations
Some Forward Thinking

- Deep recession and slow recovery have highlighted shortcomings of Regime M
  - rising debt brings forth fiscal consolidation
  - tighter fiscal policy & pegged nominal interest rate raise real rates & reduce economic activity
- Looming unresolved fiscal stress calls for substantial reforms
- It’s a good time to take a fresh look at monetary-fiscal framework
- Fresh look means shouldn’t be boxed-in by peculiar arrangements
Options Worth Considering: I

- Reside in Regime M in “normal times”
- Have option of switching to Regime F if conditions warrant
  - both monetary & fiscal policy must switch
  - now monetary has switched, but fiscal still behaving as if it’s in Regime M
- Need restrictions on fiscal policy to
  - ensure long-run sustainability
  - achieve fiscal desiderata
  - specify fiscal objectives
  - anchor fiscal expectations
  - create fiscal policy councils with public forums
  - subject fiscal plans to outside professional scrutiny
Options Worth Considering: II

- This one is heretical

- **Adopt Regime F**

  - monetary policy sets nominal interest rate in any way it desires as a function of underlying exogenous shocks
  - fiscal policy sets primary surpluses to achieve the fiscal desiderata or countercyclical policy
  - but fiscal policy freed from having to adjust future policies to stabilize debt
  - debt stabilization achieved by having central bank *not* raise interest rate sharply in response to rising inflation

- Heresy comes from making long-run inflation a *fiscal* responsibility
Options Worth Considering: II

- Fiscal policy determines long-run inflation
  - long-run inflation target imposes discipline on policy

- Monetary policy retains task of short-run stabilization
  - determines inflation in medium-to-long runs

- Democratic process chooses precise mix of taxes & spending
  - subject to long-run constraint consistent with inflation target

- Regime has the advantage of acknowledging inherent interactions between policies
  - does not pretend we can place policies in distinct boxes
Wrap Up

- Latin American hyperinflations taught how to design policy institutions to prevent bad inflations
  - on the whole, this has been successful
  - Brazil is a leading example of the success

- Europe, Japan & U.S. have taught us the limitations of existing policy arrangements for dealing with debt deflations
  - will advanced economies learn these lessons?
  - Japan is a leading example of not learning
  - Europe & U.S. appear to be following the Japanese path