IT TAKES TWO TO TANGO: MAKING MONETARY AND FISCAL POLICY DANCE

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A REMARKABLE TRANSFORMATION

• Central banks moved from “monetary mystique” to “culture of clarity”

• The transformed beliefs include
  • monetary policy should be independent of fiscal policy & political pressure
  • clearly articulated objectives of policy
  • monetary policy should not surprise or fool people to achieve objectives
  • monetary authorities should communicate transparently about objectives & strategies
  • central bankers should be held accountable

• RBNZ at vanguard of this movement

• Advocates point to two pieces of evidence that the transformation has been a big success
Inflation Success

Inflation Rates

AU NZ UK JP US NZ

GDP Growth Rates

Includes AU, UK, US, EU
GDP Growth Rates

Includes AU, JP, NZ, UK, US, EU
FINE IN PRACTICE

- But what about in theory?
Victory Declared

• Successes due to the new monetary regime delivering good policy

• But... this has been an especially benign period
  • recent recessions have been mild
  • no big & persistent adverse shocks
  • even the higher oil prices have proven temporary

• Until now... the test is on-going
Basic economic theory tells us it is dangerous to reform one macro policy—monetary—while ignoring the other one—fiscal policy.

Yet, have seen no comparable enlightenment in governments’ tax & spending policies.

- Fiscal policy remains nearly as opaque as ever.
When Fiscal Policy Runs Amuck: Germany

- After World War I
  - Versailles Treaty reparations
  - Government spending to rebuild
  - Weak tax base

- Large government budget deficits (revenues never more than 35% of expenditure)

- Financed by running the printing presses

- Outcomes
  - Inflation from July to November 1923: 560 billion %
  - US$1 = 4.2T Marks
WHEN FISCAL POLICY RUNS AMUCK: GERMANY
WHEN FISCAL POLICY RUNS AMUCK: UNITED STATES

- Ronald Reagan’s tax reforms
  - reduced personal income tax rates
  - reduced corporate income tax rates
  - accelerated depreciation allowances

- Produced record-high fiscal deficits

- Reversed the 30-year decline in government debt

- Debt-GDP ratio rose from 35% to 45% in 5 years

- Created massive distortions in international economy
When Fiscal Policy Runs Amuck: 
United States

US Nominal & Real Exchange Rates

[Graph showing US Nominal & Real Exchange Rates from 1975 to 2007]
When Fiscal Policy Runs Amuck: United States
Monetary & Fiscal Policy Linkages

- Governments face budget constraints (don’t tell W.)
- Things must add up: uses = sources

\[
\text{Expenditures} + \text{Debt Service} = \text{Receipts} + \text{Change in Debt}
\]
DYNAMIC POLICY LINKAGES

• Rational investors do not want to over-accumulate assets, so government debt cannot grow “too fast”

• Produces the solvency condition

  Market Value of Debt =
  Expected Present Value of Future Net Surpluses

  But

  Net Surpluses = Total Revenues +
  Central Bank Profits − Govt Consumption
  − Govt Transfer Payments

• A huge array of possible future adjustments in policy
• Each adjustment has a different effect on economy
Dynamic Policy Linkages

- If the government is solvent, then the solvency condition holds

  Market Value of Debt =
  Expected Present Value of Future Net Surpluses

- This is a debt valuation relation:

  - value of debt rises (more debt issued, higher price of debt, lower price level) $\Rightarrow$ higher debt service $\Rightarrow$ requires higher future surpluses
  - higher expected surpluses $\Rightarrow$ can support higher debt service $\Rightarrow$ allows high value of debt
**MONETARY & FISCAL POLICY PARALLELS**

1. Macroeconomic impacts
   - Both influence real economic activity
   - Either can target inflation

2. Ensuring government solvency

3. Most effective when transparent & credible
Monetary & Fiscal Policy Parallels

4. Operate strongly through expectations

- Effective monetary policy manages expectations of future interest rates & inflation
- True of fiscal policy in spades
  - some taxes—e.g., on saving—operate entirely through expectations
  - firms’ production decisions depend on anticipated payroll and profits taxes
- Turn to an example of how expectations of policy adjustments can matter for a practical policy action
Debt-Financed Fiscal Stimuli

- Governments around the world are increasing spending and decreasing taxes in effort to stimulate economies.

- Fiscal expansions financed by selling debt to public.

- Central banks are building these stimuli into their decisions and even relying on fiscal stimulus.

- Will the policies actually stimulate the economies?

- Maybe... 

- The answer depends on how future policies are expected to adjust.
1% Government Spending Increase

Transfers adjust
1% Government Spending Increase

Transfers adjust

No Empirical Support
1% GoVernment Spending Increase

Transfers or labor taxes adjust
1% Government Spending Increase

Transfers, labor or capital taxes adjust
1% Government Spending Increase

Transfers, labor or capital taxes adjust

Some Empirical Support
Will the Fiscal Stimuli Stimulate?

- Only some beliefs about future policy adjustments are consistent with desired outcomes

- Success of fiscal initiatives hinges on guiding people’s expectations about future policy adjustments

- This is why fiscal policy is most effective when it’s transparent & credible
WHERE ARE GOVERNMENT DEBT POSITIONS NOW?

- Fiscal consolidations & reforms have improved conditions in a number of countries

- This is a good thing because the future looks pretty grim
  
  - short-run worries: current financial crisis & fiscal responses will rapidly worsen fiscal positions
  
  - long-run worries: aging populations imply massive “unfunded liabilities”
Government Debt Positions Improving

Government Debt as Share of GDP

NZ
US
AU

EXCEPT JAPAN

Government Debt as Share of GDP

180
160
140
120
100
80
60
40
20
0


JP
NZ
US
AU
But Where Are We Headed?
United States
But Where Are We Headed?

United States

US Government Debt: Pessimistic Projection
But Where Are We Headed?

New Zealand

NZ Gross Sovereign-Issued Debt

% of GDP


What Should We Make of Long-Term Projections?

- Clearly, exploding long-run debt projections won’t happen
- To an economist, they make no sense
  - either the future liabilities are actually expected to be funded in some manner
  - or they aren’t really liabilities because the government will renege on its promises
- To households and firms making economic plans, it matters a great deal how policies will adjust in future
The Pink Elephant

- The world economy is facing serious financial threats
- How is any of this relevant?
- Two major reactions to the crisis are *fiscal*:
  - fiscal stimulus (in US: 1 plan done; another on the way?)
  - debt-financed recapitalizations & bailouts (banks & others)
- $700B is 5% of US GDP; add to this fiscal stimulus packages and US deficit could top 12% of GDP
- No government has coupled its fiscal actions with any discussion of how resulting debt expansions will be financed
- Long-run consequences will be primarily fiscal $\Rightarrow$ need for fiscal transparency urgent
What is Fiscal Transparency?

- In monetary policy, several central banks have taken transparency to the next level by announcing a “forward track” for policy interest rate:
  - it’s understood this is not a commitment
  - it’s understood this does not bind future decisions

- Apply this to fiscal policy:
  - fiscal authority reveals as much as possible about future policy

- Fiscal policy is more complex
  - many more instruments
  - many more decision makers; governments come & go
What is Fiscal Transparency?

- But people are going to form expectations about paths of tax rates & components of expenditures
  - government can help or hinder expectations formation
- How do countries’ fiscal frameworks fare in light of this?
Fiscal Transparency & Predictability: The Euro Way

- Stability & Growth Pact: about sustainability
- In the face of violations by France, Germany & Greece, pact was “reformed”
  - seriously weakened the constraints on large budget deficits in EU countries
  - will reformed rules be any better enforced?
- Not about transparency
**Fiscal Transparency & Predictability: The Swedish Way**

- Fiscal Policy Council
- Designed to combat “deficit bias” and ensure sustainability
- Asserts moral suasion
  - no authority to change policy
- Not about transparency
Fiscal Transparency & Predictability: The UK Way

- Code for Financial Stability
- About sustainability
- Encourages the “golden rule” to separate government investment from consumption
- Not about transparency
FISCAL TRANSPARENCY & PREDICTABILITY: THE AMERICAN WAY
FISCAL TRANSPARENCY & PREDICTABILITY: THE AMERICAN WAY
FISCAL TRANSPARENCY & PREDICTABILITY:
THE KIWI WAY

- Spirit of NZ’s Fiscal Responsibility Act
  - reduce to & maintain debt at “prudent” levels
  - seeks to enhance predictability of tax rates
  - a kind of “golden rule”
- Sort of a debt target (20% of GDP)
- But it’s not clear whether a government that violates the spirit of the Act will bear obvious costs
- Also no requirement that government must announce explicitly how any change in debt will be financed
- Not about transparency
A Stunning Fact

- Countries are super vague about goals of fiscal policy
  - maximize growth; build infrastructure; offset business cycles; encourage work effort; equalize income distribution; help the disadvantaged; eliminate inefficiencies; reduce emissions; provide national defense; reduce smoking; help farmers & ranchers; minimize deadweight loses; maximize revenues; ensure re-election; ensure election; reduce global poverty; support monetary policy
  - all of the above
- in absence of goals, fiscal decisions are totally political
- Some countries break goals into short-run, medium-run, long-run
  - no discussion of whether they are mutually consistent
  - no discussion of relative weights
A STUNNING FACT

- In contrast, monetary policy goals are quite specific: target inflation; stabilize output; ensure value of currency

- Countries seem to set the bar for fiscal policy rather low

- Achieving a “prudent” level of debt (NZ FRA) ⇔ fiscal policy is not utterly incompetent

- A CEO whose sole goal was to avoid bankruptcy would soon be fired
  - we can ask for more from our elected officials
Steps Toward Transparency

1. Agree on broad principles; for example
   - taxes should raise revenues in least inefficient way
   - use spending programs—rather than taxes—to achieve social goals
   - fiscal policy should (or should not) include countercyclical components
   - fiscal policy should aim to be as transparent as monetary policy
Steps Toward Transparency

2. Reach consensus on rules to determine government spending & taxation decisions
   • rules should be reasonably stable but not immutable

3. Design polices to be consistent with principles

4. Communicate how policy choices are consistent with principles
   • communicate about current *and future* policies
   • Treasury projections must make sense (don’t explode)
MONETARY-FISCAL FRAMEWORK

• Industrialized countries entering a prolonged period of fiscal stress
  • short-run problems associated with The Pink Elephant
  • long-run problems associated with aging populations and rising health costs

• I am NOT calling for de-democratizing fiscal decisions
I am highlighting three things

1. importance of establishing principles to guide fiscal policy

2. need to dramatically improve transparency of fiscal decisions by discussing future policies

3. the need to think about a joint monetary-fiscal framework
NATTERING NABOBS OF NEGATIVISM
NATTERING NABOBS OF NEGATIVISM MADE POSITIVE

- Society can never agree on principles to guide fiscal policy
  - managed to do it for monetary policy
- Government cannot credibly announce future policies
  - central banks do it
- Fiscal policy complex; communication difficult
  - same for monetary policy
- All these arguments were made about monetary policy
  - objections were overcome by professional & political consensuses
- Can we transform fiscal policy making?

Yes, we can. At least we oughta be able to.