Discussion of 'Fiscal R-Star: Fiscal-Monetary Tensions and Implications for Policy'

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Views are my own and not necessarily those of the Treasury.

Anyone who is at all interested in monetary and fiscal policy issues and especially their intersection will have noticed the increasing tensions between the US Federal Reserve and the Trump Administration since President Trump's re-election. As President Trump continues to test the limits of his ability to influence the Fed's decision making and government debt in the US continues to rise, this dynamic has brought into question some of the key tenets of macroeconomic management we typically take for granted in the developed world. In particular, if monetary independence is in question, what does this mean for how we think about optimal strategies for macroeconomic management? Are we edging closer to an era of fiscal dominance? And is this an argument for closer coordination of monetary and fiscal policy, to protect against the breakdown of the compact between monetary and fiscal authorities that underpins monetary independence?

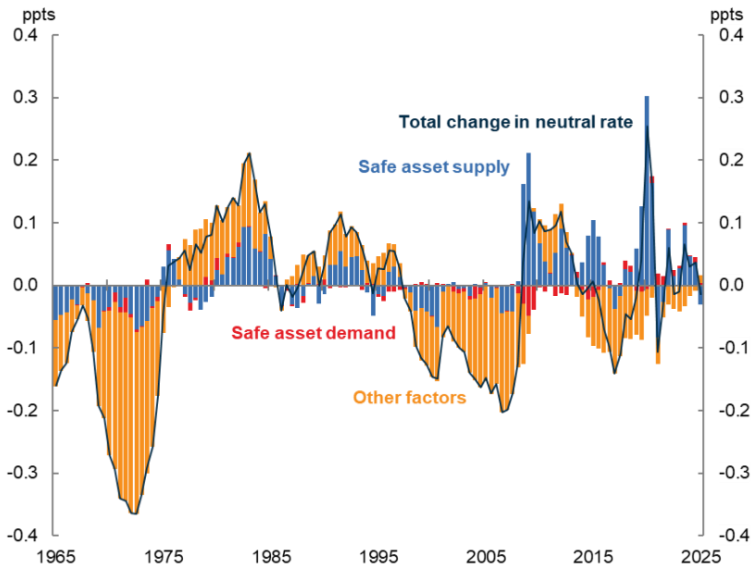
This paper proposes an approach that puts some structure around how we might consider the tensions between two different definitions of the long term interest rate or r-star. The monetary r-star is what we typically think of as the neutral interest rate – that is the real interest rate for which inflation is stable, output is growing at potential, and inflation expectations are anchored and at the inflation target. The fiscal r-star is defined in the paper as the real interest rate that stabilises countries' debt-to-GDP ratios when output is growing at potential and inflation is at target, given a path of primary deficits or surpluses set by the fiscal authority. I found this conception of a 'fiscal r-star' to be a useful and innovative way to try to quantify some of the tensions we are observing in the macroeconomic management space today.

I also found the definition of passive fiscal policy, where the primary balance accommodates the return of debt-to-GDP to stability in the long term, to align with our traditional thinking about the role of fiscal policy outside of crises. The paper highlights that fiscal policy appears to have become more active since the GFC and the pandemic, that is the primary balance appears not to be responding to higher debt levels. This result doesn't surprise me given heightened geostrategic tensions are leading to greater spending on defence and supply chain diversification globally, and structural shifts such as population ageing and the net zero transition are also putting increased pressure on government budgets.

Having spent some time earlier in my career while working at the Reserve Bank of Australia building models to estimate Australia's neutral rate, I am naturally somewhat sceptical of our ability to know anything about neutral rates with any precision. In this paper we're relying on not one but two estimates of neutral – so my level of caution about how much we can rely on the precision of such estimates is further heightened. As acknowledged in the paper, their estimates of monetary neutral are exogenously determined and do not account for the interaction with the fiscal stance.

But we expect there to be a direct channel through which increased borrowing by governments can influence neutral through the supply of savings/risk-free assets. For example, Chart 1 shows work by Ferreira and Shousha (2023) at the Federal Reserve on decomposing the monetary neutral rates for a number of countries, this graph shows their results for Australia. It highlights that the impact of safe asset supply can be a key driver of changes in neutral rates, as shown by their estimates of key drivers of changes in Australia's neutral rate through time.

Chart 1: Changes in estimate of Australia's neutral rate and contributions by components

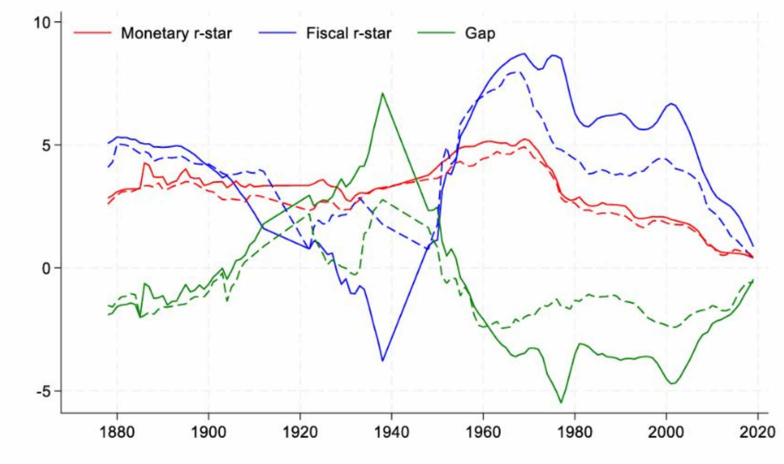


Source: Ferreira, Thiago, Mitch Lott, and Keith Richards (2025). "Real-Time Global Longer-Run Neutral Rates," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, April 09, 2025.

While acknowledging these limitations of the estimates, I think the paper makes an important contribution in providing a more quantitative framework for having this debate on monetary-fiscal interactions in a structured way. It also allows us to try and draw lessons from past episodes of history.

From this perspective, figure 5 from the paper (Chart 2 below) captured my attention. The large positive gap between monetary and fiscal r-star seen following WWII when debt levels were historically high across many advanced nations, and the trend of the gap moving back towards positive territory more recently is worth considering alongside some of the work we have done at Treasury on historical debt cycles.

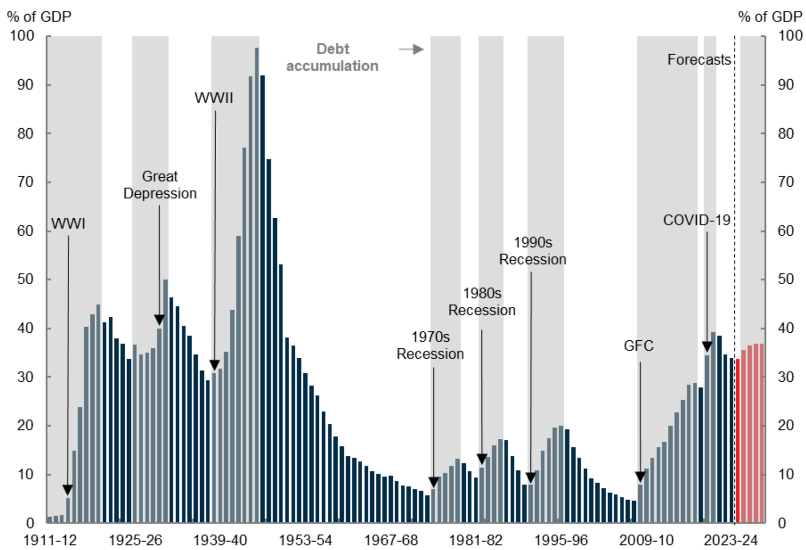
Chart 2: Historical estimates of Fiscal R-star and the Fiscal-Monetary Gap



[1] Dashed lines represent medians of samples, while solid lines represent unweighted means.
Source: Jorda et al. (2017) and authors' calculations.

Chart 3 shows the large run up in debt from the Global Financial Crisis onwards. Notably with the quick succession of shocks to the economy during that period there wasn't much time for debt to be returned to lower levels between shocks. Comparing this to the earlier period up to the end of WWII it looks to me like the old expression about how history may not repeat, but it does sometimes rhyme.

Chart 3: Historical debt cycles



Source: ABS, AOFM, Butlin (1985), Australian Federal Budget Papers, PBO and Treasury.

Notes: Gross debt is presented in face value terms. Shaded areas indicate debt accumulation period. Data is in in financial years. Historical debt figures abstract from debt issued by the Commonwealth on behalf of the states and territories, and as such, differ from those reported in Commonwealth budgets.

What does this environment of rising government debt across many advanced economies mean for the rising risk of potential tensions between monetary and fiscal policymakers? And if tensions are rising, what does that mean for economic outcomes? In this framework when the r-star for monetary policy is below or equal to the r-star for fiscal policy the tradeoffs are not large and we can use our standard frameworks to note that monetary policy should take care of the business cycle and fiscal policy should focus on debt sustainability (i.e. remain passive) outside of crises. But if the gap between the r-stars is large and positive (i.e. the neutral rate to stabilise inflation is much higher than the one needed to stabilise debt levels), then there is a more acute tradeoff between higher inflation or unsustainable debt. As the paper notes, in countries where there are large positive gaps, we tend to see debt accumulating over time, inflation rising relative to other countries, and a depreciation in exchange rates, which further feeds into inflation. The results also suggest there is an elevated risk of crises in the future.

The paper highlights financial repression, or liquidation of debt, as one of the key ways these tensions can and potentially have been resolved in the past. Post WW2 this is likely to have been part of the story. In a world where capital flows are freely flowing financial repression may well not be possible as a way to deal with high debt levels, as capital could simply escape offshore instead of being devalued.

Growth-enhancing reforms in this framework shift both monetary and fiscal r-star up so productivity growth improvements may not be a panacea either.

In the current environment, this framework seems to me to reiterate the importance of fiscal policy returning to a more passive role, and for primary balance surpluses to be the margin of adjustment to stabilise debt. Central bank independence also remains important when tensions are high, with the recent RBA Review and the response to it a strong investment in institutional quality in Australia that is likely to support this.

But we should also keep a close eye on the evolution of monetary r-star estimates, and particularly whether neutral rates might return to the lower levels seen before the pandemic. If this were to occur, it might reduce the urgency of fiscal adjustments.

However, an important caveat is that the unbacked nature of the fiscal expansions during WW2 and COVID-19 were likely part of what made them so effective at combatting those crises. Arguing that fiscal policy should always be passive doesn't seem very compelling given the complexity of these issues. Finding the right balance is clearly key here, and I'm really interested to hear the reactions of the experienced academics and policymakers in this room on this topic in the discussion.