

# Monetary and Fiscal Institutional Arrangements: Have We Got It Backwards?

by Eric Leeper

*Discussion*

Chris Edmond  
University of Melbourne

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## Conventional Wisdom

- Monetary policy should have the lead role in inflation determination, demand management. Fiscal policy in a crisis.
- Driven by two mutually-reinforcing considerations:
  - (1) *practical*: fiscal policy powerful, but clumsy  
[long and variable lags in decisions *and* transmission]  
  
monetary policy less powerful, but more nimble  
[long and variable lags in transmission *but hopefully not* decisions]
  - (2) *institutional*: independent central bank removed from short-run political considerations, more likely stable policy framework  
  
[if not independent, not clear there is a meaningful distinction]
- Standard monetary models *build in* this conventional wisdom, minimising role of fiscal policy in inflation determination etc.

## Not Actually Independent

- But even in standard models that minimise the role of fiscal policy, monetary and fiscal policy are not actually independent.
- *Monetary policy depends on fiscal policy:*
  - natural real rate  $r_t^n$  depends on government consumption and investment etc dynamics through resource constraints
  - in textbook models, lump-sum taxes adjust to accommodate effects of interest rates, inflation, output on intertemporal budget constraint
- *Fiscal policy depends on monetary policy:*
  - effects of government spending depend on monetary reaction, both through  $r_t^n$  and through inflation and output gaps etc [ZLB etc]
  - debt-servicing costs depend on path of interest rates
- To say nothing of real-world policy making that necessarily entails background monetary-fiscal coordination, especially in a crisis.

# Monetary Science vs. Fiscal Alchemy

- In short, standard monetary models downplay their implicit assumptions about fiscal policy. They have a *fiscal blindspot*.
- That said, still a lot to admire about monetary policy research:
  - systematic, draws on coherent models
  - lively back-and-forth between basic research and policy questions
  - rich history of quantitative work [conditional and unconditional forecasting, historical decompositions etc]
- Fiscal policy suffers by comparison:
  - too often governed by simple heuristics, accounting cross-tabs
  - lacks coherent framework for evaluating outcomes, lacks history of back-and-forth between basic research and policy questions
- To fix ideas: monetary policy research provides non-vacuous objective function stated in terms of plausible targets for policy.  
*What is the fiscal policy counterpart to  $L = (\pi - \pi^*)^2 + \lambda(y - y^*)^2$ ?*

# My Reactions

- Generally sympathetic to Eric's critique.
- Less concerned about fiscal blindspot of standard monetary models:
  - models are necessarily abstractions, no escaping a series of judgement calls about what to leave out
  - if insist on fully-specified fiscal policy, why not also fully-specified macro-prudential policy? etc
  - in federal systems, unified fiscal policy is also a convenient fiction, should we insist on fully-specified federal-state fiscal interactions?
  - in any case, conceptually straightforward to assess robustness to alternative fiscal scenarios, should be standard practice
  - real problem is *groupthink* when people begin to forget to scrutinise assumptions and/or misunderstand the assumptions they're making
  - Eric's work has been instrumental in breaking down that groupthink

## Beyond Fiscal Alchemy?

- More concerned about state of fiscal policy research.
- Can always do better, but hard to imagine fiscal policy research being put on similar footing to monetary policy research. Why?
- Monetary policy technocratic, find best way to achieve relatively *agreed goals* [price stability, full employment]
- Fiscal policy goals *essentially contested*, political
  - what is the proper scope of government? how much intra- and intertemporal redistribution should it do? how should it trade off distortions in a second-best world?
  - no reason to expect stationary policies, or much coherence at all

# Fiscal Policy Research

- Given this, hard to have a fiscal policy research program along same lines as monetary policy research program.
- Hard to get even 'normal science' in basic research, let alone on more immediate policy controversies.
- For example, seems impossible to imagine a purely technocratic analysis of the pros and cons of the Stage 3 tax cuts.
- So how can we do better?

# How Can We Do Better?

- Fiscal institutions should have serious research departments and invest in basic fiscal research:
  - not to provide high-level advice on ‘optimal fiscal policy’ — which is always going to be contested
  - but to build stock of credible answers to interim fiscal policy questions [e.g., how to manage maturity structure of government debt, maybe even how to structure wage insurance programs...?]
  - help populate the public policy space with ideas grounded in credible research, show norms of what good research looks like, put on the table key outstanding questions, magnitudes etc
  - help catalyse complementary research by academics, statistical agencies, *and central banks*



## How Can We Do Better?

- Monetary policy depends on fiscal policy and vice-versa.
- Would be healthier for everyone if this was straightforwardly acknowledged in macroeconomic policy discussions.
- Don't expect central bank governor to routinely comment on controversial fiscal issues, or vice-versa.
- But encouraging research that acknowledges this reality, supported by public discussion from relevant officials would help gradually *normalise* this kind of communication, to the public good.

# A Joint Monetary-Fiscal Authority?

- Eric's proposal: joint monetary-fiscal authority, operates under well-specified national objectives
  - 'independent' of central bank and fiscal authority
  - evaluates monetary/fiscal policy plans for consistency, recommends coordinated policies consistent with jointly optimal policy
  - seat at the monetary and fiscal policy tables
  - policies continue to be implemented by central bank and government
  - staffed by research economists

# A Joint Monetary-Fiscal Authority?

- Eric's proposal: joint monetary-fiscal authority, operates under well-specified national objectives [fiscal objectives contested]
  - 'independent' of central bank and fiscal authority [with what powers? in what sense independent?]
  - evaluates monetary/fiscal policy plans for consistency, recommends coordinated policies consistent with jointly optimal policy [seems to suggest 'one true model' or close to it]
  - seat at the monetary and fiscal policy tables [hard to imagine seat in cabinet ... ]
  - policies continue to be implemented by central bank and government [would have to be true by anything like current law]
  - staffed by research economists [who could object to more jobs for PhD economists?]