

Monetary and Fiscal Institutional  
Arrangements:  
Have We Got Them Backwards?

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Reserve Bank of Australia Conference  
June 2022

# A Thought Experiment

- ▶ Imagine we are designing monetary & fiscal institutions from scratch
  - ▶ what policy arrangements would we adopt?
  - ▶ apply what we've learned over past 40 years
- ▶ What have we learned?
  - ▶ inflation a joint monetary/fiscal phenomenon
  - ▶ optimal financing smooths *all* taxes, including inflation
  - ▶ expectations central to *both* monetary & fiscal policies
  - ▶ inability to fully commit common to both policies
  - ▶ fiscal finance matters for policy outcomes
- ▶ Start by asking what the policies can do

# What Monetary Policy Can Do

1. Perform asset swaps: alters (net) maturity structure of government liabilities held by the public
  2. Change short-term real interest rates: induces intertemporal substitution
  3. Extend short-term loans to financial institutions
  4. Supervise & regulate some financial institutions
- ▶ **Command over resources depends on private behavior**

# What Fiscal Policy Can Do

1. Directly transfer resources among private individuals or between private individuals and government (including helicopter drops)
  2. Adjust tax rates to directly affect incentives to work, consume, invest
  3. Provide public goods; make productivity-enhancing investments
  4. Uniquely determine price level: rate of exchange between resources & nominal government liabilities
  5. Determine initial (gross) maturity structure
  6. Provide lender-of-last-resort resources
- **Command over resources enforced by jail time**

# Let's Dispense With a Myth

- ▶ Monetary policy can always control inflation & failure due to: insufficient resolve; self-perpetuating inflation expectations; excessive concern for other objectives
- ▶ This is false on many levels
  1. The stable eqm that MP models focus on...
    - ▶ is one of many solutions; all but *that* one are explosive
    - ▶ nothing in the economics delivers the stable one
    - ▶ not about communicating inflation target
  2. Right FP delivers that or another unique, stable eqm
    - ▶ usual “passive FP” won't do the trick
    - ▶ passive FP *enables* explosive paths to be eq
  3. Without fiscal support, MP may be unable to combat inflation
    - ▶ raising interest rates may slow economy & temporarily reduce inflation
    - ▶ eventually inflation rises with higher nominal rates

# Why the Hype About Monetary Policy?

- ▶ In a phrase: blame-shifting
  - ▶ “independent” MP a gift from elected officials to themselves: whipping boy when economy turns sour
- ▶ Reinforced by research, policy makers, & media. . .
  - ▶ “the central bank has the tools to control inflation”
  - ▶ “inflation always & everywhere a monetary phenomenon”
  - ▶ “monetary policy only game in town”
  - ▶ “central bank behind the curve on inflation”
- ▶ CBers bear some responsibility
  - ▶ fear of losing “independence” attenuates push-back
  - ▶ they rarely speak clearly about fiscal policy
  - ▶ reluctant to decline heaping-on of tasks: climate change, inequality
- ▶ Fears are overblown: elected officials’ desire for blame-shifting is insatiable

# What Lurks Behind Monetary Omnipotence?

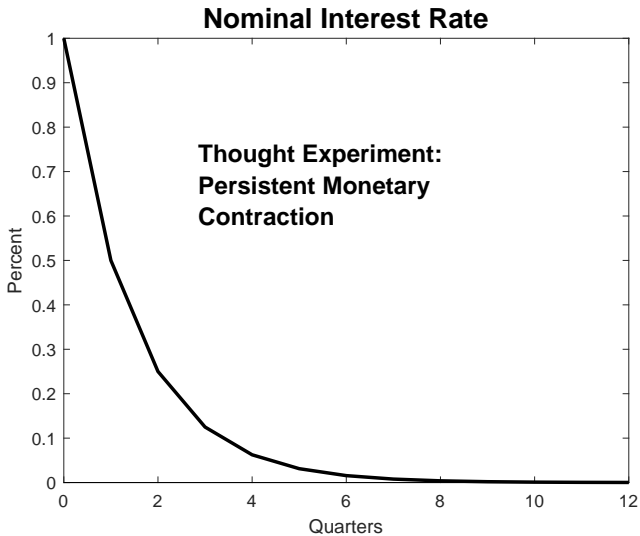
- ▶ Our models are *designed* to make MP all-powerful
- ▶ What's really going on is obscured in representative-agent settings but apparent with heterogeneity
- ▶ A little work reveals ubiquitous monetary-fiscal interactions
- ▶ Simplest New Keynesian model (basis of those in central banks)
- ▶ Model consists of

$$y_t = E_t y_{t+1} - \sigma(i_t - E_t \pi_{t+1} - r_t^n) \quad (\text{AD})$$

$$\pi_t = \beta E_t \pi_{t+1} + \kappa y_t \quad (\text{AS})$$

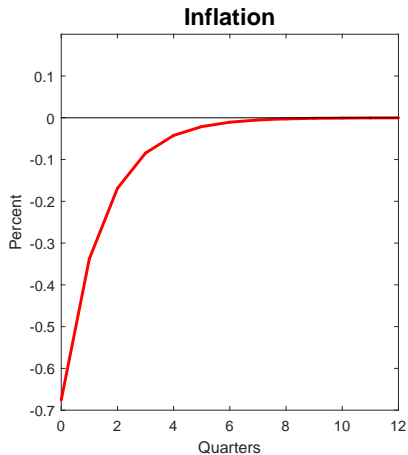
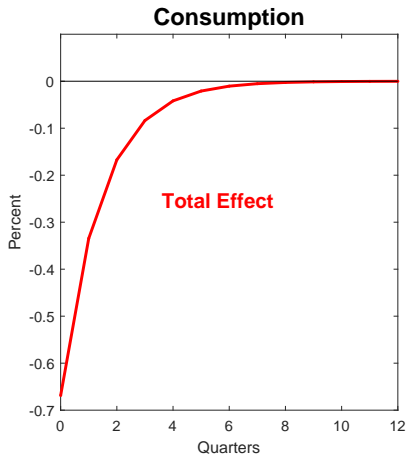
- ▶ Policy experiment: raise path of  $\{i_t\}$ , trace out paths of  $\{y_t, \pi_t\}$

# Monetary Contraction: Interest Rate Path





# Monetary Contraction: Total Effects



What underlies these impacts?

# What Fiscal Policy Does

- ▶ Typically, no mention of fiscal policy in monetary policy experiment
- ▶ Let's take fiscal policy seriously
  1. explicit about instruments & behavior
  2. show exactly the role it plays in delivering monetary policy projections
  3. consider impacts of alternative fiscal behavior
- ▶ Do this in the simple model
- ▶ Tells us the required fiscal backing for MP

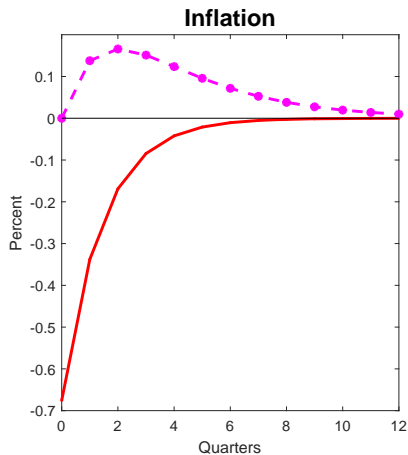
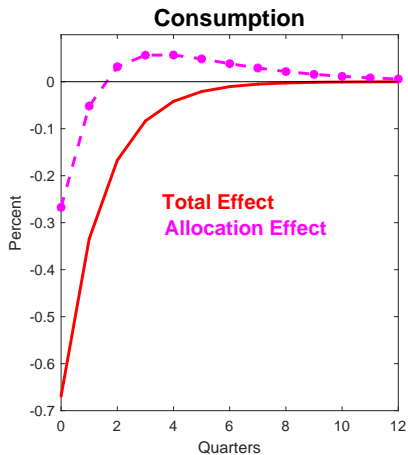
# Some Microeconomics

- ▶ Behind the impacts are two distinct effects of higher interest rate path
  1. intertemporal allocation: affects *timing* of consumption
  2. wealth or income effect: affects *total* consumption

$$\text{Total Effect} = \text{Allocation Effect} + \text{Wealth Effect}$$

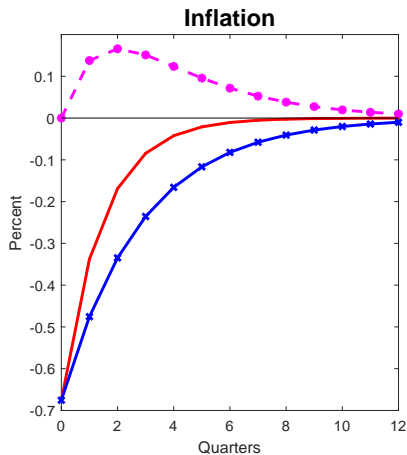
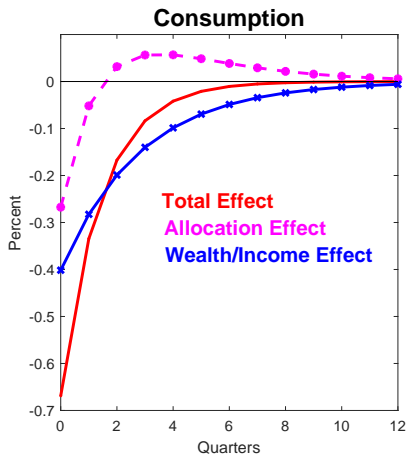
- ▶ Stems from distinct policies
  - ▶ allocation effect from monetary policy
  - ▶ wealth effect from fiscal policy

# Monetary Contraction: Decomposition



With no change in wealth, higher interest rate moves consumption across time and *raises* inflation

# Monetary Contraction: Decomposition

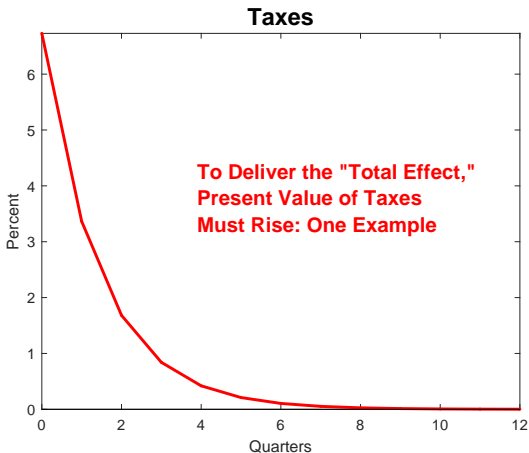


Large negative wealth effects deliver persistent declines  
in consumption & inflation

# Source of Negative Wealth Effects

- ▶ Fiscal consequences of monetary contraction raise wealth
  1. higher real rates raise interest payments on debt
  2. lower inflation raises real value of nominal treasuries
- ▶ These positive wealth effects from monetary contraction are counteracted by higher taxes
  - ▶ reduce wealth & demand, generate declines in output & inflation
- ▶ Without fiscal contraction, debt explodes
- ▶ Fiscal policy central to monetary impacts *in central bank models*

# Monetary Policy's *Assumed* Fiscal Backing



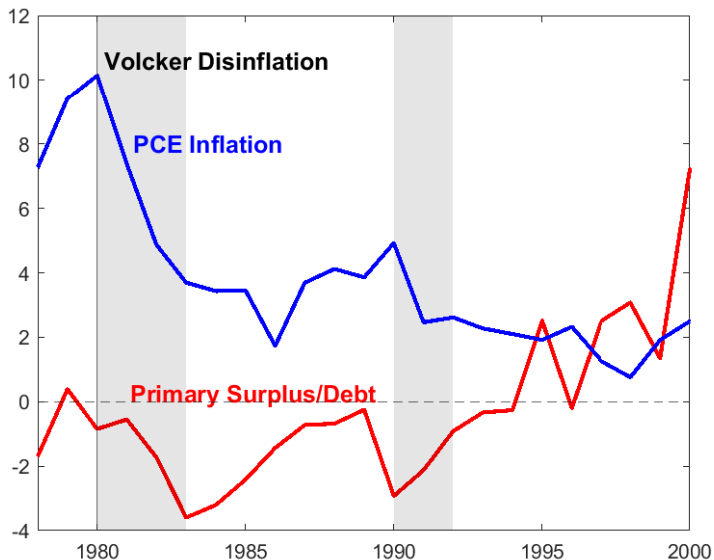
Tax response amplified by elevated debt & shorter maturity with higher rollover rate

# Fiscal Backing for Monetary Policy in Data?

- ▶ MP backing raises interest payments on debt
  - ▶ fiscal contraction must at least service debt
  - ▶ without backing, debt grows, stimulating demand, undermining MP contraction
- ▶ Volcker's disinflation
  - ▶ after massive 1981 tax cut. . . 5 tax hikes between 1982 & 1990
  - ▶ then large Clinton consolidation
  - ▶ fiscal contraction supported Volcker's disinflation
- ▶ What about Powell's disinflation?
  - ▶ Volcker faced 25% debt-GDP
  - ▶ Powell faces 100%
  - ▶ if interest rates rise to 5%, adds \$1 trillion to annual deficit

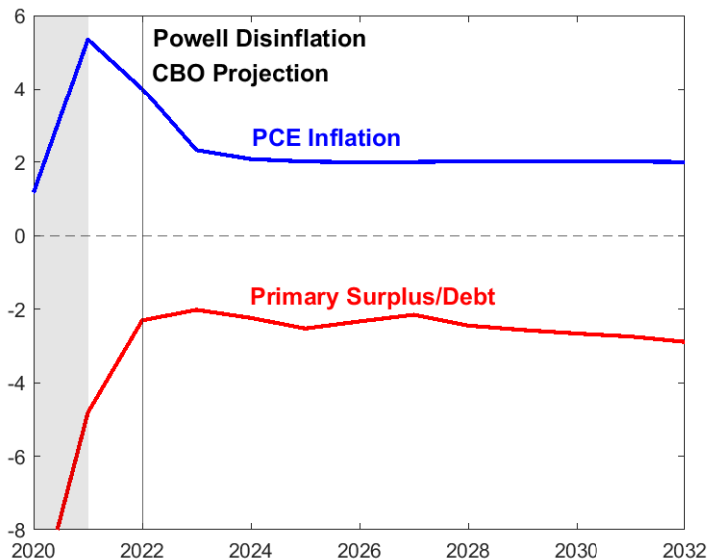


# Fiscal Backing for Volcker



Fiscal contraction signaled by 1982

# Fiscal Backing for Powell?



Any prospects for fiscal contraction?

# Monetary Science

- ▶ Clearly articulated objectives
- ▶ Commitment to model-based *dynamic* analyses
  - ▶ staffed by research economists
  - ▶ history of substantive research contributions
- ▶ Great nuance in monetary analyses
  - ▶ 25 vs 50 basis points; corridors vs floors; private vs government asset purchases; long- vs short-term treasury purchases; medium- vs long-term expectations
- ▶ Heavy emphasis on communication
  - ▶ forward guidance in host of applications
- ▶ Continual innovation in tools
  - ▶ interest on reserves; extensive balance-sheet operations; creation of new “standing facilities”
- ▶ Objective external assessments

# Fiscal Alchemy: A U.S.-Centric View

- ▶ Fiscal policy has few of these attributes
- ▶ If anything, US fiscal policy analysis has regressed
  - ▶ contrast 2009 to 2020/21 stimulus analyses (Romer-Bernstein vs nothing)
- ▶ Congressional Budget Office
  - ▶ tightly circumscribed remit
  - ▶ remains spreadsheet-based; sparse economics
  - ▶ uninformative projections (see previous graph)
- ▶ Policy discussions framed in static IS-LM
  - ▶ little, if any, role for expectations
  - ▶ no analysis of financing schemes
- ▶ US fiscal policy hangs on Hamilton's norm
  - ▶ “deficits beget surpluses”
  - ▶ no laws, rules, or targets enforce the norm
  - ▶ we have seen how fragile norms of all sorts can be

# Fiscal Norm: Then & Now

## Then

*“... today I’m pledging to cut the deficit we inherited in half by the end of my first term in office.”*

President Obama, 23 February 2009 at Fiscal Responsibility Summit, six days after \$831 billion for American Recovery and Reinvestment Act signed into law

- ▶ The norm: “ordinary” expenditures, backed by future taxes

## Now

*“It’s important to note that we believe this should be provided on an emergency basis, not something where it would require offsets.”*

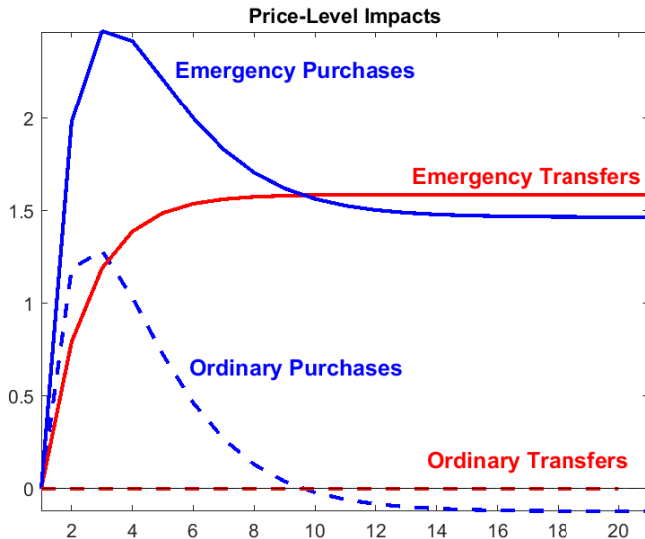
Jen Psaki, White House Press Secretary, 15 March 2022, referring to \$22.5 billion request for Covid funding after \$4.6 trillion allocated in earlier relief

- ▶ Break from the norm: “emergency” expenditures, unbacked by future taxes

# Fiscal Finance Matters

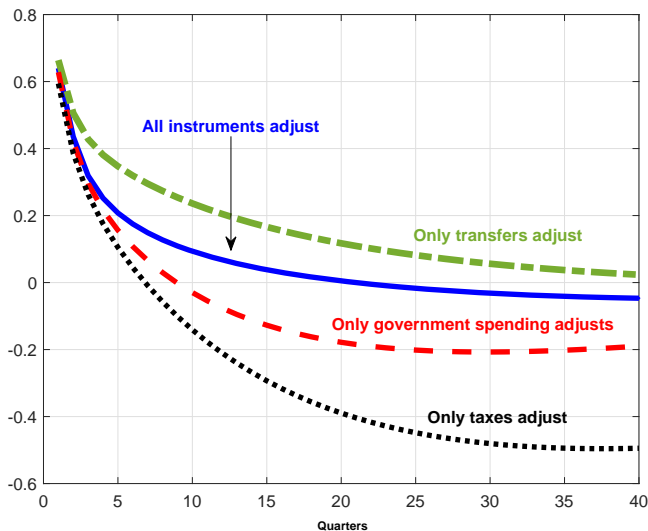
- ▶ Financing answers the question: What backs government debt?
- ▶ When debt is nominal, in currency government controls, *on the margin* debt may be backed by taxes or only by new dollars
  - ▶ when unbacked by taxes, fiscal impacts bigger
  - ▶ examples: US in 1933 & 2020-21
- ▶ When debt is backed, the nature of backing matters for spending impacts
  - ▶ lower transfers
  - ▶ higher taxes
  - ▶ spending reversals
- ▶ Financing receives far too little attention
  - ▶ brings in dynamics, expectations, commitment
  - ▶ enhances efficacy of fiscal policy

# Fiscal Financing: Backed vs Unbacked



Ordinary purchases & transfers fully backed by future taxes  
Emergency purchases & transfers unbacked by future taxes

# Fiscal Financing: Matters Even When Backed



Output multipliers for government purchases (US data)  
Best fit when all instruments adjust to stabilize debt



# Where Might A Rethink Take Us?

1. Task assignments likely to be state-contingent
  - ▶ at ELB, fiscal is only stimulative policy
2. Coordination essential
  - ▶ actions must be consistent across all policies
3. “Anchoring expectations” needs redefining
  - ▶ expand to include all policies
4. Discover inconsistencies in current arrangements
  - ▶ commitment to fiscal backing for MP is in the same hands we don't trust to resist the temptation to inflate
5. Usual policy rules inadequate
  - ▶ treat MP & FP as economically decoupled

# One Possible Approach

- ▶ A joint monetary-fiscal policy authority
  - ▶ operates under well-specified set of national objectives
  - ▶ “independent” of central bank & fiscal authority
  - ▶ evaluates M/F policy plans for consistency
  - ▶ recommends coordinated policies consistent with jointly optimal commitment policy
  - ▶ seat at the monetary & fiscal policy tables
  - ▶ policies continue to be implemented by CB & government
  - ▶ staffed by research economists