General Discussion of 'Inflation and Interest Rates'

The foregoing presentation proposed that a successful inflation targeting regime required other parts of government to exercise fiscal discipline over time. Participants discussed whether this had normative implications for central bank independence, particularly if it implied that some level of policy coordination was needed between central banks and government. Participants noted that a need for fiscal prudence by government in the medium to long-run could coexist with the central bank's ability to independently set certain interest rates in the short-run. In particular, government could achieve fiscal prudence by strengthening existing fiscal policymaking institutions and taking steps to signal publicly that they were committed to paying down debt in a sustainable way over time. This need not impact the contemporary operating frameworks of central banks.

The discussion proceeded to the question of whether central banks' financial stability objectives meant that in practice they might sometimes face the danger of underwriting excessive borrowing by governments; for example, central banks might purchase heavily discounted sovereign debt assets in the event that not doing so would be a threat to the financial system. In addition to supporting unsustainable borrowing, this could also complicate inflation management efforts if the central bank needed to address high inflation at the same time. It was suggested that in such an instance, it would be important for central banks to unwind or sterilise their financial stability operations quickly, to avoid complicating the achievement of inflation management objectives.

Participants discussed the interaction of fiscal policy with quantitative easing and tightening, where central banks buy and sell government debt to achieve monetary policy objectives. Through quantitative easing, central banks effectively extend the duration of government debt, while quantitative tightening does the opposite. Under a fiscal theory of the price level, quantitative tightening might be expected to increase the amount of government debt outstanding, making inflation management harder. One participant suggested that governments should look to issue debt for relatively long periods, which would give policymakers more time to deal with price stability issues arising from changes in average debt duration. More generally, more research was required to understand the implications of changes in the maturity structure of government debt and quantitative easing/tightening for fiscal theories of the price level.

One participant questioned whether who owned government debt had implications for the impact of government borrowing on price stability. For example, were the price effects of a given level of fiscal prudence different if more debt was owned by domestic versus foreign lenders? It was suggested that further research was needed in this area, to understand whether different types of lenders were likely to behave differently in response to various economic shocks.