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Monetary–Fiscal Interactions: How to Improve Policy Outcomes?*

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It has long been recognised that the interaction between monetary and fiscal policy may be an important determinant of the outcomes of both policies. To provide some insights into how this interaction and macroeconomic outcomes can be improved, a symposium was held at the 2010 Australian Conference of Economists. This piece summarises the discussion, with the full papers by Michal Franta, Jan Libich and Petr Stehlík; Don Brash; Carl Walsh; Jacopo Cimadomo; Stephen Kirchner; and Eric Leeper and Todd Walker appearing later in this issue.

Keywords: monetary–fiscal interactions, institutional design, commitment.

1. Introduction to the Session

There are few current policy issues as pertinent as the optimal setting of fiscal and monetary policies. A cursory view of the heated debate in the United States today, between proponents of fiscal tightening and loosening, is a case in point.

Choosing optimal fiscal and monetary policy is, however, made difficult by the fact that the tools used by governments and central banks in conducting the two policies affect many of the same (current and expected future) variables: for example, unemployment, inflation, investment sentiment or asset prices. Furthermore, not only is there a high degree of uncertainty about policy effects and interlinkages, but for many countries there is a question of whether governments and central banks agree at all on the macroeconomic outcomes to be achieved.

To contribute to the understanding of fiscal–monetary interactions, a symposium was held at the 2010 Australian Conference for Economists. It featured speeches and a round-table discussion by the following five economists (in order of appearance).[4]

Dr Jan Libich is a Senior Lecturer at School of Economics and Finance, La Trobe University, Melbourne. His recent research, supported by the Australian Research Council, examines the interactions between fiscal and monetary policies.

Dr Don Brash was Governor of the Reserve Bank of New Zealand (RBNZ) from 1988 to 2002 and the leader of the New Zealand National Party from 2003 to 2006. During his tenure at the

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[4]Professor Eric Leeper was unable to participate in the panel in person but his written contribution appears in this issue. We would also like to acknowledge the contribution to the debate of our invited guest Dr David Gruen, executive director at the Australian Treasury.

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RBNZ he presided over the world's first explicit inflation targeting regime – subsequently emulated by over two dozen countries.

Carl Walsh is Distinguished Professor in the Department of Economics at the University of California, Santa Cruz. He has published numerous influential papers as well as a leading graduate textbook on monetary policy.

Dr Jacopo Cimadomo is a researcher in the Fiscal Policies Division of the European Central Bank (ECB). His recent work has focused on estimating the effectiveness of fiscal policy in the European Monetary Union, and how it has changed over time.

Dr Stephen Kirchner is a Senior Lecturer at the School of Finance and Economics, University of Technology, Sydney. His research interest lies in the institutional design of macroeconomic policies.

Eric Leeper is Professor in the Department of Economics at Indiana University, and one of the most prolific experts on monetary–fiscal interactions. His seminal work on ''active'' and ''passive'' policies initiated a large stream of literature on the possible monetary effects of fiscal policy known as the ''fiscal theory of the price level.''

The panellists discussed the monetary–fiscal interactions from several different view points – based on their own research and policy experience. We provide brief summaries of the key points made during the discussion in the following paragraphs – the full speeches appear later in this issue.

2. The Big Picture of Monetary–Fiscal Interactions – Michal Franta, Jan Libich and Petr Stehlík

It is clear that different countries have had markedly different fiscal and monetary outcomes. How are we to formally consider such different fiscal/monetary situations as Japan, the United States, Greece, Zimbabwe or Australia in a unified framework?

In his speech Jan framed the medium-term monetary–fiscal interactions as a strategic game between the central bank and the government, whose interests may or may not align. Jan identified several potential scenarios that may obtain, depending on the ''type'' of the government. If the government is fiscally prudent then we are likely to observe a monetary–fiscal ''symbiosis'' scenario, as coined by Dixit and Lambertini (2001), in which both policies produce optimal medium-run outcomes. However, if the government's finances are on an unsustainable path we are likely to observe a coordination problem and/or an outright conflict between the policies. In such cases fiscal excesses may spill over, and threaten the credibility and outcomes of monetary policy. Whether or not this happens depends on various structural and policy parameters.

Jan's primary finding is that legislated medium-term commitment of the central bank to low inflation may alter the incentives of the government, and thus have a containing effect on its spending, especially in small open economies. However, much of this effect is lost when small countries join a currency union. Jan reported some empirical evidence for these findings, contrasting the outcomes in inflation targeting countries pre- and post-adoption of the regime, and comparing them with outcomes in countries without an explicit inflation target.

3. Policy Interactions: How an Agreed Inflation Target Affects Fiscal Policy – Don Brash

To provide real-life examples of the political economy of the strategic interactions between governments and central banks, Don Brash recounted an early experience as Governor of the Reserve Bank of New Zealand. Shortly after he took up leadership of the central bank, Sir Roger Douglas, the finance minister, announced that the RBNZ would begin targeting inflation without reference to the objectives of the government (which was subsequently formalised in the RBNZ Act of 1989). Don admits that neither of them ''fully appreciated the extent to which our agreement would inevitably affect fiscal policy.''

Don recounts how shortly after, in 1990, the government proposed an expansionary budget, and how he tightened monetary conditions as a consequence. He recalls an editorial in

New Zealand's largest daily newspaper observing that: ''Electors are frequently bribed to their ultimate cost. This time the independence of responsible monetary control quickly exposes a fiscal fraud.''[5]

This case, and the outcome of the subsequent election in which the opposition National Party won on a promise of fiscal consolidation, indicates that governments and central banks need to take into account the behaviour of the other authority in their decision-making. The 2004 and 2007 federal elections in Australia were fought on similar premises, adding weight to the argument.

4. Central Banking Independence Revisited – Carl Walsh

In his contribution, Carl first reviewed the basic argument for central bank independence as a means of dealing with the types of political pressures that many blame for excessive inflation during the 1970s and 1980s. He then focused on two questions.

First, he asked: ''Is the concept of central bank independence meaningless without fiscal acquiescence?'' He gave an affirmative answer for two reasons. He first reviewed the ''unpleasant monetarist arithmetic'' argument by Sargent and Wallace (1981). They showed that the failure of the fiscal authority to balance its intertemporal budget would mean that monetary policy could, at best, only temporarily reduce inflation. By reducing inflation now, and thereby reducing the government's revenue from the inflation tax, future inflation would have to be higher.

Carl then discussed the emphasis of the fiscal theory of the price level on the link between the real value of the government's debt and the public's expectations about future fiscal surpluses. This means that there are two equilibrium conditions that involve monetary and fiscal policy – the real demand for money must equal the real supply, and the real liabilities of the government must equal the present discounted value of future primary surpluses. Shifts in the demand for either money or the government's debt can have consequences for aggregate demand if these shifts are not appropriately accommodated.

As a second question, Carl asked: ''Does central bank independence forgo potential gains from monetary and fiscal policy coordination?'' In normal times, the need for such coordination is limited. In fact, monetary policy should be used to offset the macroeconomic effects of fiscal policy to ensure output and inflation stability. However, in a crisis, such coordination can become important. In the United States, the Federal Reserve has been engaging in policies with a strong fiscal element. While appropriate in a crisis, fiscal actions by a central bank can put its independence at risk. Cooperation – just as normal policy – needs to be transparent so that it is clear that actions by the central bank are consistent with its mandate and do not threaten its independence.

5. The Fiscal Stimulus and Challenges Ahead: Views on the Euro Area – Jacopo Cimadomo

Jacopo focused on fiscal developments in the euro area in the context of the global financial crisis, and presented some empirical results based on his econometric analysis on the effectiveness of fiscal stimulus measures.

He discussed the findings of his research in Kirchner *et al.* (2010) on the effectiveness of euro area fiscal policy. He presented estimates of fiscal multipliers – both short- and long-term – and how these changed over the past three decades. To do so, he used various empirical techniques including both fixed and time-varying parameter vector autoregressions estimated via Bayesian methods.

It was shown that the size of multipliers has been decreasing since the late 1980s (with the contemporaneous expenditure multiplier being around 0.5, and the long-term effect negative). When testing for the driving forces of this reduced effectiveness of fiscal policy, Jacopo showed that the responses of monetary policy may have played a role (together with other factors such as increased openness).

[5] *New Zealand Herald*, 3 August 1990.

Jacopo concluded by outlining the ECB's official proposals stated in ECB (2010) to the Van Rompuy Task Force, which was set up to reinforce economic governance in the euro area. The ECB's proposals include developing a stronger European fiscal framework that would feature an independent fiscal agency, assurance of better quality fiscal statistics and more enforceable penalties for countries that fail to comply.

6. Reforming Fiscal Responsibility Legislation – Stephen Kirchner

Stephen spoke on his idea for the re-design of fiscal rules – along the lines of the institutional changes towards independence, transparency and accountability that have occurred in monetary policy. The main motivation for fiscal rules is to limit the government's capacity to spend excessively even when it is highly tempted to do so.

His proposal, spelled out in Carling and Kirchner (2009), suggests replacing the Australian Charter of Budget Honesty with firm rules, to be put into law. It has three main pillars:

1. A balanced budget rule on average over the cycle. Within this rule, there could also be a more restrictive limit on the size of the budget deficit/surplus in any particular year.
2. A ceiling on the net government debt to gross domestic product (GDP) ratio.
3. A limited government rule, which would require that fiscal policy be conducted so as to maintain the size of the government at a predictable, non-increasing proportion of GDP.

The numerical parameters within these rules can be set based on the economic and political specifics of the particular country. In terms of implementation, Stephen argued for creation of a Fiscal Commission, an independent institution that would ''enhance the independence, transparency and accountability of the federal budget process.''

7. Fiscal Limits in Advanced Economies – Eric Leeper and Todd Walker

Eric Leeper and Todd Walker's article constitutes a valuable contribution across several dimensions. First, it summarises and discusses the observed and predicted fiscal imbalances in developed countries. The data speak clearly: the fiscal stance in most developed countries is unsustainable, and significant policy adjustments are required to improve the situation.

Second, the article provides a much needed survey of the literature on monetary–fiscal interactions in the presence of fiscal stress. In doing so, Eric and Todd highlight the structural differences between advanced and emerging economies, pointing out that these ''may limit applying insights from the emerging markets literature to the problems that advanced economies face.'' Because of that, the authors emphasise the value of economic theory: there simply exist too few relevant data points for econometric analyses to offer conclusive answers.

Third, the authors develop a simple model that is a good reference point for their survey, and surprisingly powerful in demonstrating the key insights. For example, it shows how the probability of the passive monetary/active fiscal policy regime determines whether expected inflation converges to target or drifts from target, and how conservative monetary policy can have counter-intuitive effects on inflation expectations.

Fourth, the authors set up a research agenda regarding the effects of fiscal stress to better inform real-world policy decisions. They discuss in detail four main areas of interest: (i) identifying policy behaviour; (ii) quantifying fiscal limits; (iii) integrating heterogeneity and policy uncertainty; and (iv) anchoring fiscal expectations appropriately so that monetary policy can control inflation.

The importance of such research is evident – as the authors argue: ''Policy decisions will be made, even in a research void. The time to fill that void is now.''

8. Conclusions

History teaches us that poor fiscal and monetary policies can heighten the risk of crises and hinder prosperity; for an extensive account see, for example, Reinhart and Rogoff (2009). The round-table discussion highlighted the importance of understanding the *interactions* between the two policies, and their consequences for the outcomes of both policies.

Most importantly, the contributions emphasised the need for ''institutionalising'' good policies through transparent and accounted for legislated rules. This is to ensure that the policy-makers' actions are predictable, and their incentives are correctly aligned with public interest. As argued by Douglass North,[6] ''Institutions form the incentive structure of a society, and the political and economic institutions, in consequence, are the underlying determinants of economic performance.''

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[6]From the Nobel Prize lecture, Stockholm, 9 December 1993.