Should monetary and fiscal policy pull in the same direction?

D. Bergholt (Norges Bank), T. Sveen (BI), Ø. Røisland (Norges Bank), R. Torvik (NTNU)

Sveriges Riksbank Conference:
New Challenges for Monetary-Fiscal Policy Interactions
Stockholm, October 6-7 2025

POLITICS & GOVERNMENT

Trump says Powell is a 'total stiff' — but also says he won't fire him

The president continued his attacks on the Federal Reserve chair, but reiterated that Powell will stay in the job

Trump warns of economic slowdown unless Fed cuts rates, triggering selloff

By **Howard Schneider** and **Ismail Shakil**

April 21, 2025 8:13 PM GMT+2 · Updated April 21, 2025

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Trump calls Fed Chair Powell an 'average mentally person' and says he's working on replacements

By Matt Egan, CNN

3 minute read · Updated 12:50 PM EDT, Wed June 25, 2025

President Donald Trump leaves following a press conference at the NATO summit in The Hague.
JEROME POWELL Published April 21, 2025 10:27am EDT

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Trump insults Powell again as another top Fed official joins the ...


Jerome Powell throws cold water on a rate cut in Jul


Fed officials are starting to break rank and join Trump

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Trump Renews Call for Rate Cut, Slams Fed Chair

President hinted last week that he might look to fire Jerome Powell

By Nick Timiraos Follow

April 21, 2025 10:36 am ET

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President Trump expressed confidence that he could remove Federal Reserve Chair Jerome Powell from his position. WSJ's Nick Timiraos and former Fed Vice Chairman Richard Clarida explain how much influence the White House has over the central bank. Photo Illustration: Rio Roye and Annie Zhao

Trump slams Jerome Powell as 'Mr. Too Late,' calls Fed chairman a 'major loser'

Trump called for Powell and the Federal Reserve to move forward with 'preemptive cuts' to interest rates

President Trump on Monday renewed his call for the Federal Reserve to immediately

Common view: the fiscal-monetary policy mix should be congruent

"[Expansionary fiscal policy...] adds to the challenges faced by monetary policy in bringing inflation back to target"

OECD Economic Outlook (Iss. 1, 2023)

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OECD Economic Outlook (Iss. 1, 2023)

"Tighter fiscal policy... should complement efforts by monetary authorities, ... making it possible for central banks to increase interest rates less."

IMF Fiscal Monitor (April, 2023)

Common view: the fiscal-monetary policy mix should be congruent

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K. Knot, President of the Netherlands Bank, ECB policy panel, EEA congress (August 27, 2024)

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*Lately, however, monetary and fiscal policy have gotten mixed up again, although with both policies now having traded places. The recent energy crisis and its impact on inflation led to a **monetary tightening, while fiscal policy continued to be very loose**. This monetary/fiscal policy mix is equally **undesirable**.*

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This paper: we challenge the common view of policy congruence

In an open economy, **fiscal and monetary policy should be *divergent***

- In a high inflation environment, monetary and fiscal authorities should pull in opposite directions **even if they fully co-operate** (share the same loss function)

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This prescription holds under quite general conditions

1. Reduced form static model
2. Canonical NK model for a small open economy
3. Additional bells and whistles
4. SOE-TANK model with fiscal transfers

Some related literature

- Monetary-fiscal policy co-ordination
  - Mundell (1962), etc
  - Lombardo and Sutherland (2004), Blanchard and Summers (2020), Bilbiie, Monacelli, Perotti (2024)
  - Adam and Billi (2008)
  - Currency union: Beetsma and Jensen (2005), Galí and Monacelli (2008), Ferrero (2009)
- Fiscal policy when monetary policy is constrained
  - Gabaix (2020), Billi and Walsh (2022), Wolf (2024), Mian, Straub and Sufi (2024)
- Debt dynamics and fiscal vs monetary dominance
  - Sargent and Wallace (1981), Leeper (1991), Leith and Wren-Lewis (2000), Leeper and Leith (2016), Bianchi, Faccini and Melosi (2023)
- Fiscal policy multipliers
  - Hall (2009), Ramey (2011, 2018)
  - Haavelmo (1945), Blinder and Solow (1973), Galí, López-Salido and Vallés (2007), McKay and Reis (2016), Druedahl, Ravn, Sunder-Plassman, Sundram and Waldstrøm (2025)
- Transfers and household heterogeneity
  - Bilbiie (2021), Acharya, Challe, Dogra (2023), Auclert, Monnery, Rognlie and Straub (2024), Bilbiie et al. (2024)

THE ARGUMENT

A reduced form static world

Domestic demand:	$y = y^e - \alpha_1 r + \alpha_2 e + \alpha_3 g + v$
CPI inflation:	$\pi = \pi^e + \gamma_1 y + \gamma_2 e + u$
Exchange rate:	$e = e^e - \left(r - r^*\right) + z$

Policy mandate: minimize a simple loss function in inflation and the output gap:

$$\mathcal{L} = \pi^2 + \lambda y^2$$

The argument in a nutshell

$$\mathcal{L} = \hat{\pi}^2 + \lambda \hat{y}^2$$

Suppose an inflation shock hits the economy, $\hat{\pi} \uparrow$.

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(A) Only MP responds

- Classic policy trade-off, optimal MP achieves $\hat{\pi} = \hat{\pi}_A > 0$, $\hat{y} = \hat{y}_A < 0$

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- At first, a FP expansion leads to $\hat{\pi} > \hat{\pi}_A$, $\hat{y} > \hat{y}_A$

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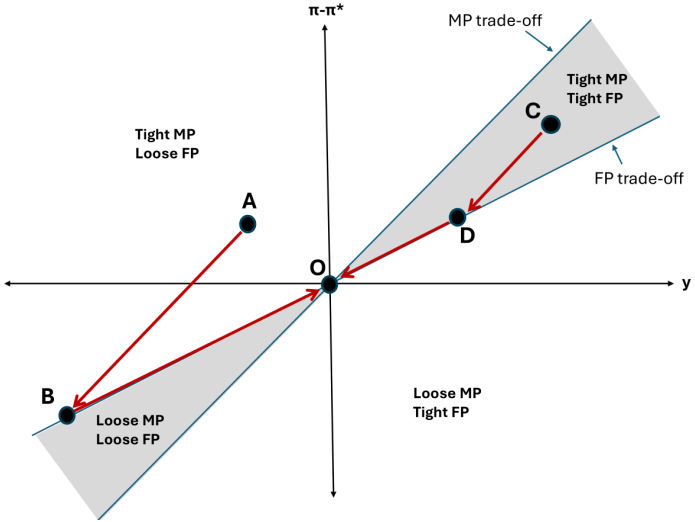
Observations about case (B):
- Strictly better outcome than case (A): $\mathcal{L}_B < \mathcal{L}_A$
- Implies a *divergent* policy mix
- Always policy divergence, but signs change if MP has less influence than FP on $\hat{\pi}$

Graphical representation



Taking stock

- When is policy divergence optimal?
  - Trade-off situations ⇒ always
  - Sometimes even absent trade-offs
- If MP and FP trade-offs become more similar
  - Policy divergence **more frequently**
  - Policy divergence **stronger in magnitude**
- Closed economy as a special case: optimal policy mix is *indeterminate*, consistent with Gabaix (2020) and Wolf (2025)

Key requirements

- Comparative advantages, MP and FP have **unequal "sacrifice ratios"**
- CPI stability mandate
  - If not, we're back to divine coincidence (Woodford (2000), Galì 2005)

A NK MODEL WITH FISCAL POLICY

Simple extensions of Justiniano and Preston (2008, 2010)

- Core: canonical SOE-NK model of Galí and Monacelli (2005)
- Wage rigidities á la Erceg, Henderson and Levin (2000)
- Consumer habits, price indexation, policy inertia
- HtM vs. Ricardian households á la Bilbiie (2008)
- Active fiscal policy: public spending, lump-sum taxes, and debt

▸ Model details

Policy

Policy mandate approximated by a simple quadratic loss function

$$\mathcal{L}_t = \mathbb{E}_t \sum_{j=0}^{\infty} \beta^j \left[\pi_{a,t+j}^2 + \lambda y_{t+j}^2 \right]$$

Optimal policy under coordination: minimize $\mathcal{L}_t$ wrt. r_t and τ_t

Restriction: fiscal policy needs to ensure stationary public debt dynamics

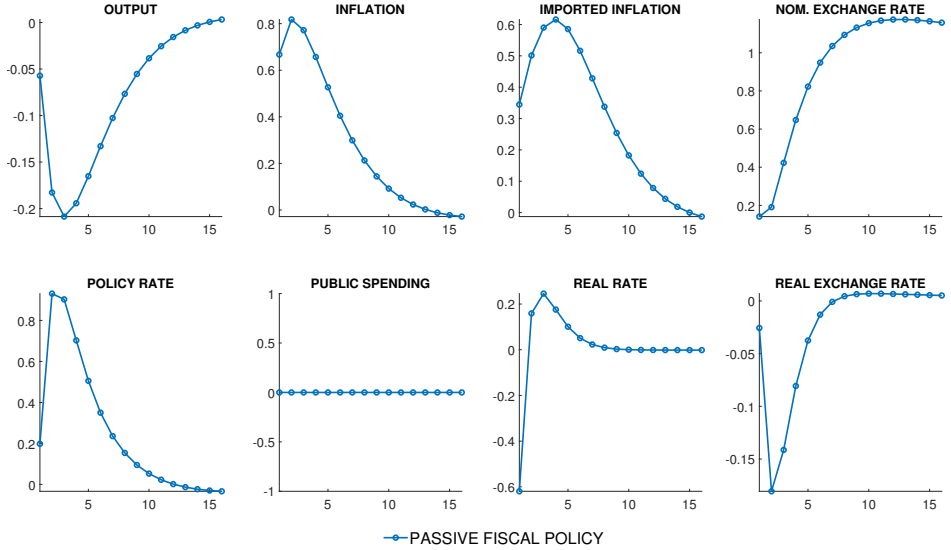
$$b_t = \beta^{-1} b_{t-1} + g_t - \tau_t$$

Haavelmo theorem: "if taxes and public purchases increase by the same amount, then aggregate demand in the economy will increase" (Haavelmo, 1945)

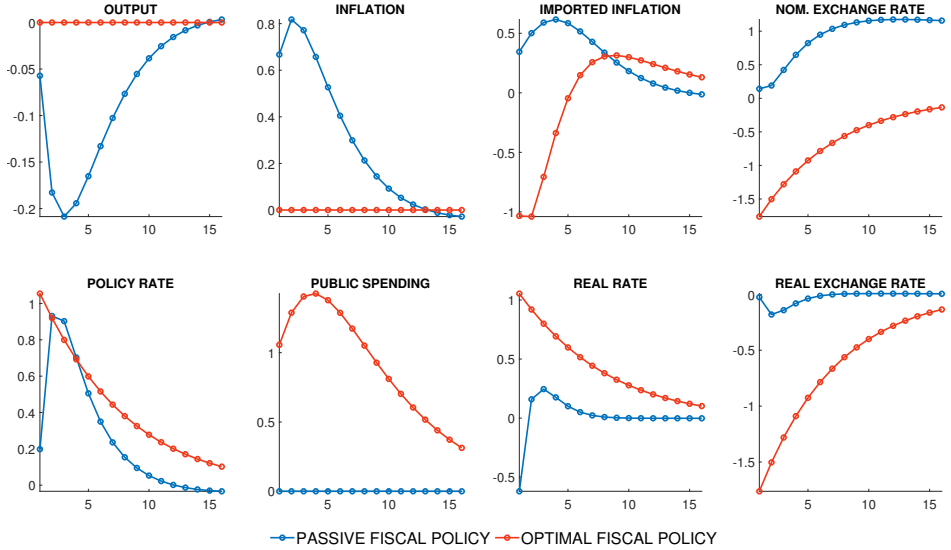
- Sufficient condition: aggregate MPC < 1

OPTIMAL MONETARY-FISCAL POLICY INTERACTIONS

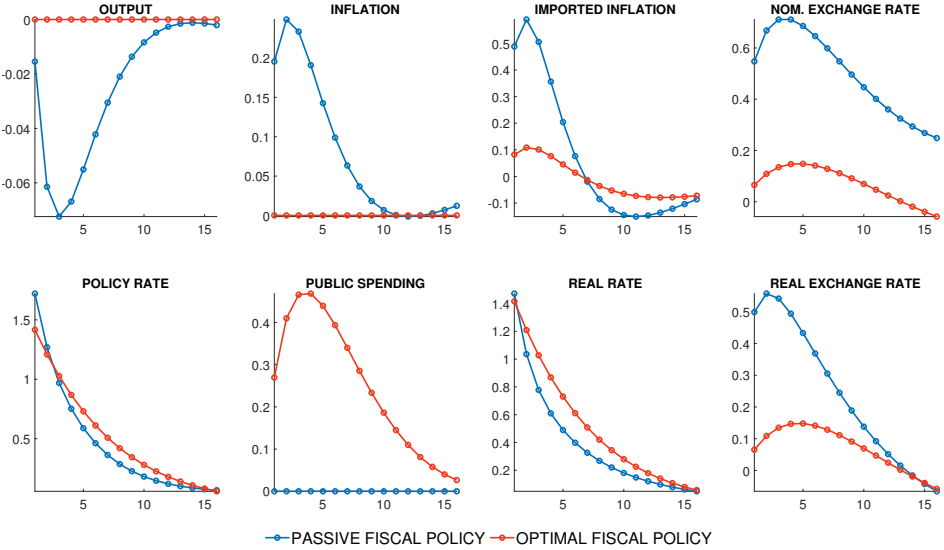
Optimal policy responses to an inflation shock



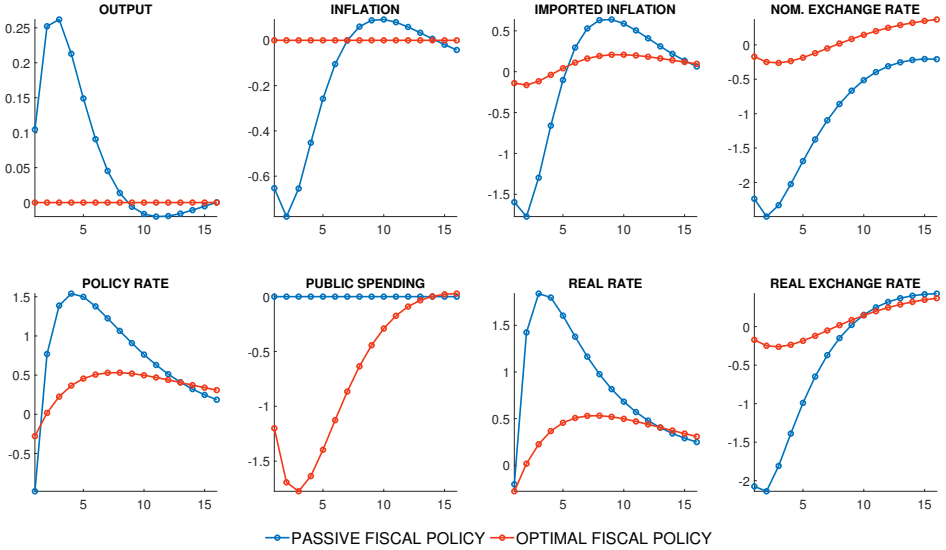
Optimal policy responses to an inflation shock



Optimal policy responses to an exchange rate shock



Optimal policy responses to demand shocks



EXTENSIONS

Extensions

A. Policy transmission with HtM (high MPC) households ▸ Details
B. When inequality matters for policy makers ▸ Details
C. The role of automatic stabilizers ▸ Details
D. When fiscal adjustment is costly ▸ Details
E. “Liz Truss” effects ▸ Details
F. Complementarity between private and public consumption ▸ Details
G. Inflation shocks originating abroad ▸ Details

LIZ TRUSS EFFECTS

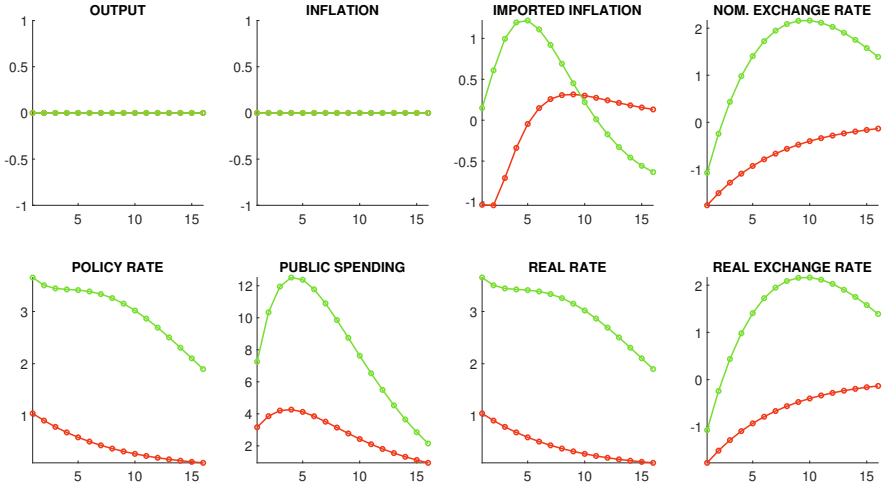
The Liz Truss effect

In the baseline model only monetary policy (and the risk premium) affects the exchange rate

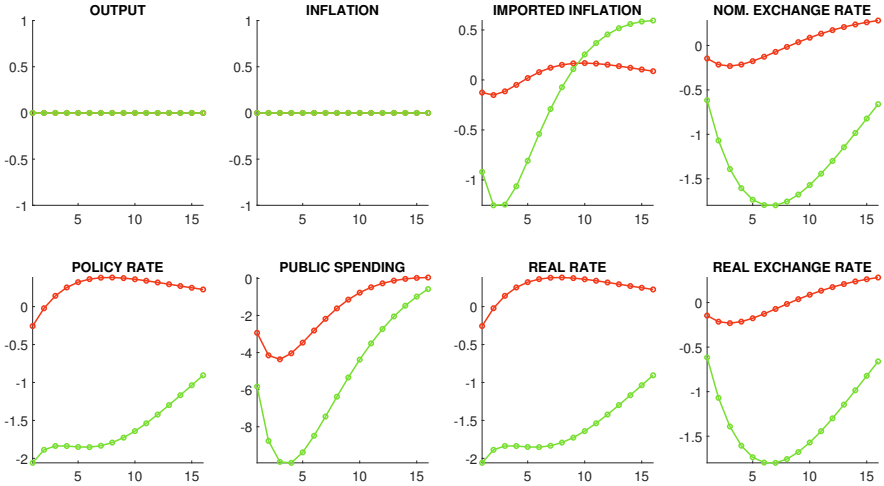
- The Liz Truss effect: announcement in September 2022 of a significant debt-financed fiscal expansion caused considerable concern in financial markets and led to a sharp depreciation of the British pound
- We let the stock of public debt influence the risk premium on domestic currency

$$rp_t = -\xi nfa_t + \xi_b b_t + \varepsilon_t$$

Optimal coordination with Liz Truss effects



Liz Truss: policy divergence even with demand shocks



LIMITS TO THE POLICY SPACE

Adjustment costs and other limits to the policy space

Policy may be restricted in practice

- Uncertain effects of policy, transmission lags
- Tax distortions, spending misallocations
- Debt induced fiscal consolidation
- Political economy considerations
- Financial stability concerns
- Distributional consequences

These restrictions imply less instruments than targets $\Rightarrow$ **Tinbergen principle** violated

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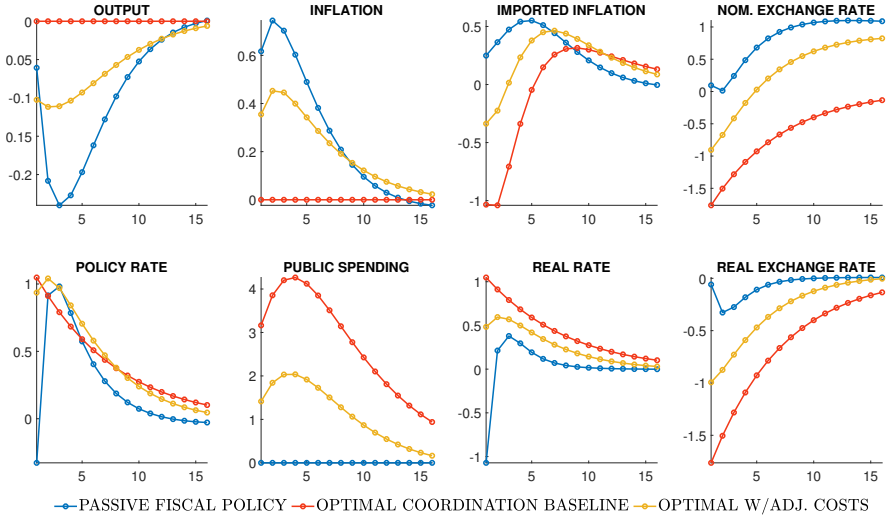
Simple illustration: adjustment costs in the loss function

$$\mathcal{L}_t = \left(\pi_t^a\right)^2 + \lambda_y y_t^2 + \lambda_g g_t^2 + \lambda_r \left(r_t^a\right)^2$$

Optimal coordination with adjustment costs



MP adjustment costs may imply policy congruence

Divergence overturned if (i) sufficiently large MP adjustment costs and (ii) sufficiently muted exchange rate response

Modified UIP in the simple model:

$$e = e^{e} - \theta\left(r - r^{*}\right) + z$$

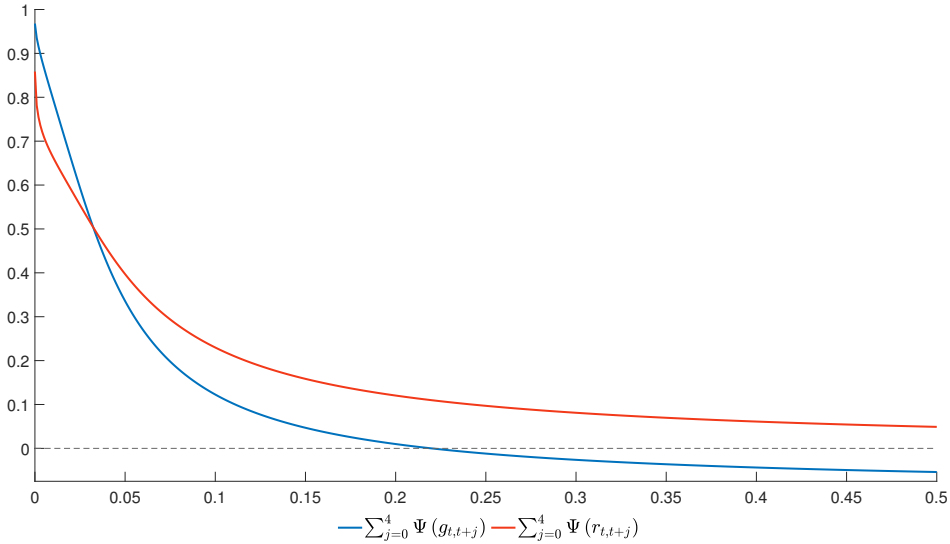
Policy congruence only if

$$\lambda_r > \frac{\theta\lambda_y\gamma_2\left(\alpha_1 + \theta\alpha_2\right)}{\gamma_1}$$

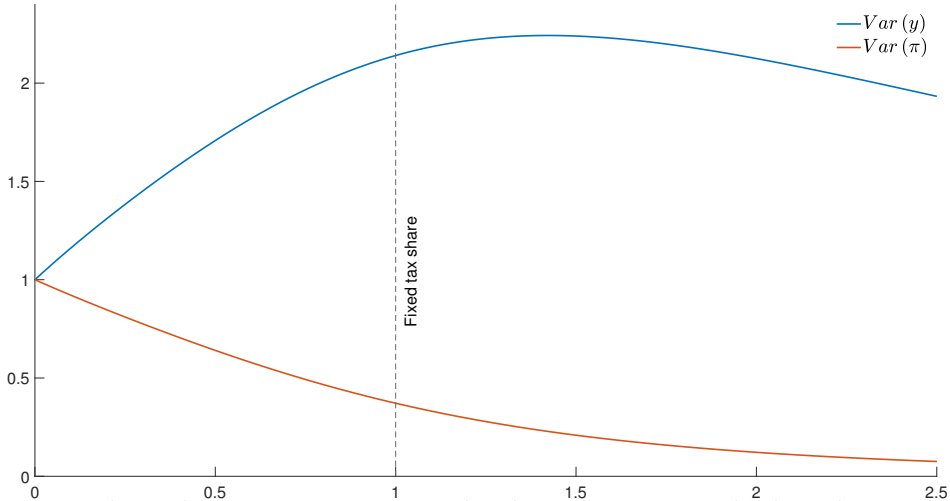
Lessons:

1. Fiscal adjustment cost irrelevant
2. UIP violation ($\theta < 1$) not sufficient, need $\lambda_r > 0$ as well
3. If $\lambda_r > 0$ *and* $\theta < 1$: FP and MP more similar $\Rightarrow$ larger hikes needed $\Rightarrow$ larger costs, may discourage MP

If large enough MP adjustment costs: FP may need to "take over" MP



Automatic stabilizers may *optimally* increase macro volatility



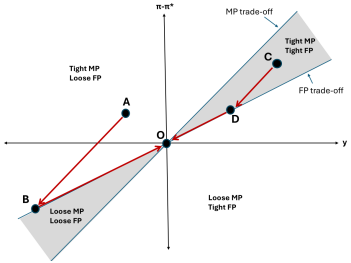
Notes: the horizontal axis represents the value of ψ_y, the vertical axis the variance of output and inflation relative to the case with passive fiscal policy ($\psi_y = 0$). Conditional on inflation shocks only.

Concluding remarks

Popular view: monetary and fiscal policy should be congruent, i.e. pull in the same direction

Our paper challenges the validity of this view *in an open economy*

- Key: exchange rate channel ⇒ MP has comparative advantage in stabilizing inflation
- Comparative advantage ⇒ policy specialization and divergence
- High inflation environment tends to call for divergent policies
- Especially relevant for many SOEs
  - Trade wars, heightened energy prices, and other supply-side shocks



Important policy implications in quite general settings

APPENDIX

Model details

$$\lambda_t = \mathbb{E}_t \lambda_{t+1} + \left(i_t - \mathbb{E}_t \pi_{t+1}\right) + v_t \tag{1}$$

$$\lambda_t = -\frac{\sigma}{1-h}\left(c_t - h c_{t-1}\right) \tag{2}$$

$$y_t = c_y\left\{\alpha c_t + (1-\alpha)\left[y_t^* + \eta\left(tot_t + q_t\right)\right]\right\} + \left(1-c_y\right) g_t \tag{3}$$

$$y_t = a_t + n_t \tag{4}$$

$$\pi_{w,t} - \gamma_w \pi_{t-1} = \beta \mathbb{E}_t\left(\pi_{w,t+1} - \gamma_w \pi_t\right) - \kappa_w\left(w_t - \left(\varphi n_t - \lambda_t\right)\right) + z_{w,t} \tag{5}$$

$$\pi_{h,t} - \gamma_h \pi_{h,t-1} = \beta \mathbb{E}_t\left(\pi_{h,t+1} - \gamma_h \pi_{h,t}\right) - \kappa_h\left(a_t - w_t - (1-\alpha)\, tot_t\right) + z_{h,t} \tag{6}$$

$$\pi_{f,t} - \gamma_f \pi_{f,t-1} = \beta \mathbb{E}_t\left(\pi_{f,t+1} - \gamma_f \pi_{f,t}\right) - \kappa_f\left(\alpha tot_t - q_t\right) + z_{f,t} \tag{7}$$

$$\pi_t = \alpha \pi_{h,t} + (1-\alpha)\,\pi_{f,t} \tag{8}$$

$$w_t = w_{t-1} + \pi_{w,t} - \pi_t \tag{9}$$

$$tot_t = tot_{t-1} + \pi_{f,t} - \pi_{h,t} \tag{10}$$

$$q_t = q_{t-1} + \Delta e_t + \pi_t^* - \pi_t \tag{11}$$

$$nfa_t = \beta^{-1} nfa_{t-1} + tb_t \tag{12}$$

$$tb_t = y_t - c_y\left[c_t + (1-\alpha)\, tot_t\right] - \left(1-c_y\right) g_t \tag{13}$$

$$i_t = i_t^* + \mathbb{E}_t \Delta e_{t+1} - \xi nfa_t + \varepsilon_t \tag{14}$$

$$b_t = \beta^{-1} b_{t-1} + \left(1-c_y\right)\left(g_t - \tau_t\right) \tag{15}$$

back

Calibration

Textbook calibration as a baseline: $\beta = 0.99$, $\sigma = 1$, $\varphi = 2$, $\alpha = 0.65$, $\theta_w = \theta_h = \theta_f = 0.75$, $h = 0.75$, $\gamma_w = \gamma_h = \gamma_f = 0.5$, $\xi = 0.01$, $\lambda = 0.25$.

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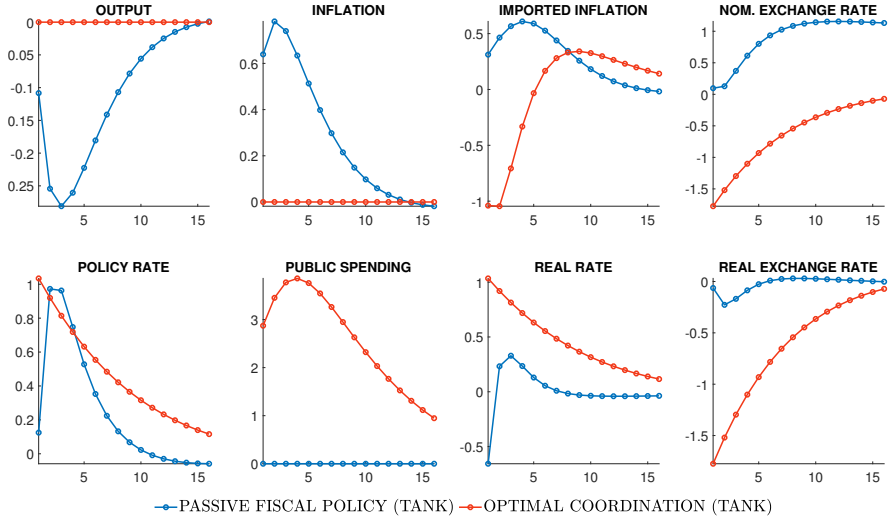
Optimal coordination with restricted households



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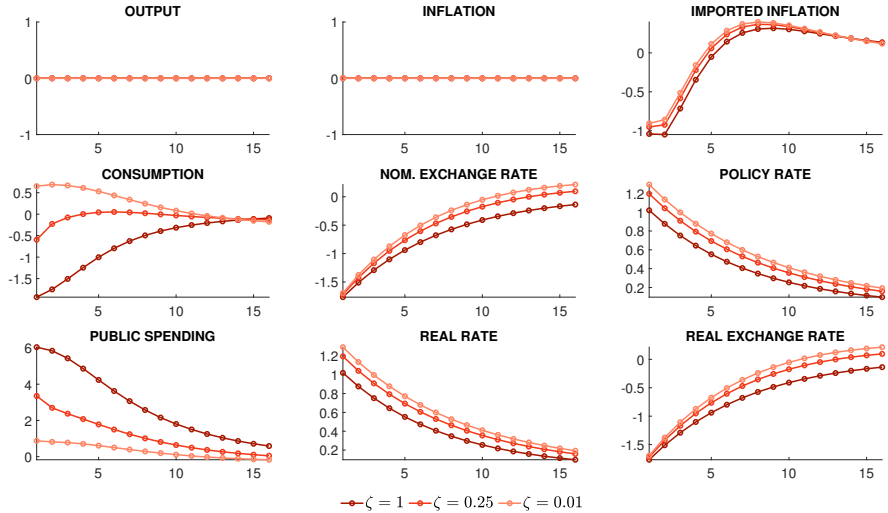
Public-private sector complementarity



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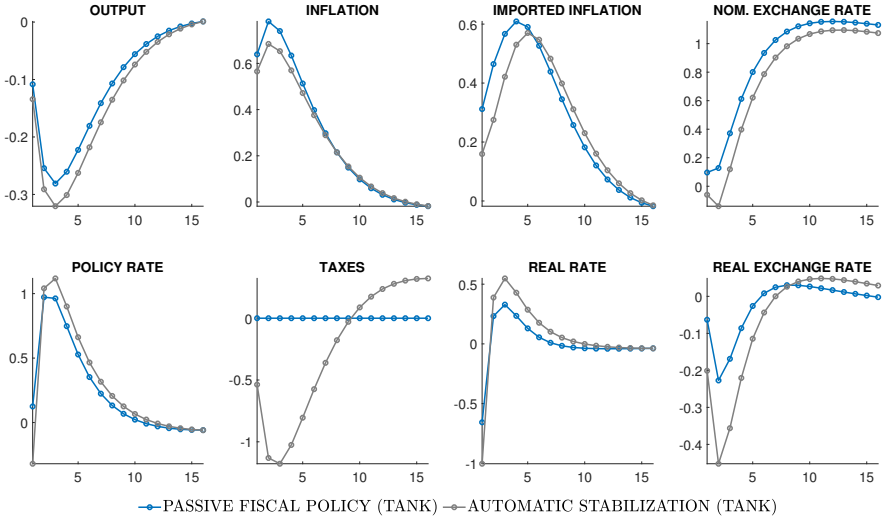
Role of automatic stabilizers



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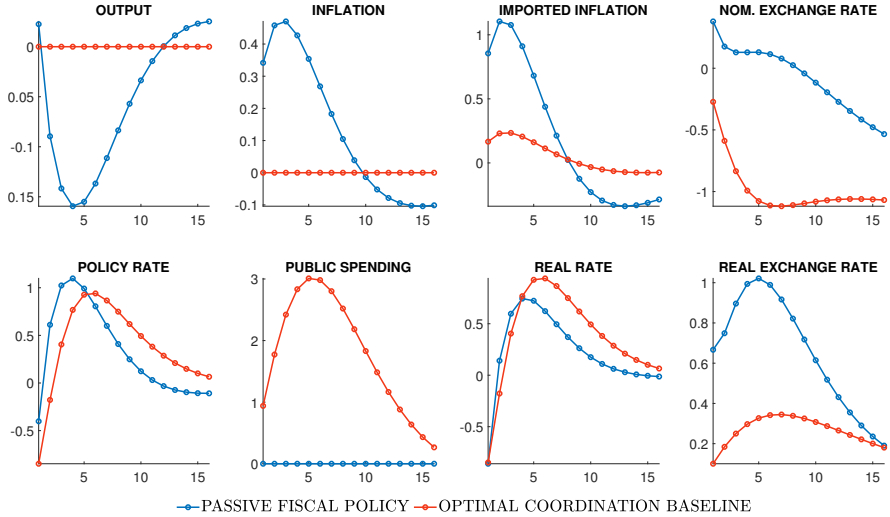
A foreign inflation shock



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