“Monetary-Fiscal Interactions”

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Getting the Mean Right

- Faust-Henderson's inflation-targeting paper
- Two issues
  1. "Getting the mean right"
  2. "Getting the variance right"
- How does fiscal policy affect getting the mean right?
- Here's something you rarely see in central bank documents: the government budget constraint

$$\frac{Q_t B_t}{P_t} + S_t = \frac{(1 + \rho Q_t) B_{t-1}}{P_t}$$

ρ: geometrically decaying maturity to show how this enters the discussion

Long Run Consistency

- Faust-Henderson: π^* inherently about “the long run”
- Policy interactions in the long run: convert gbc to shares of output
  - long-run constants: shares of output; inflation; real growth; maturity structure; real interest rate

$$\frac{s}{b} = \frac{r-g}{(1+r+\pi^*-\rho)(1+\pi^*+g)}$$

- Choice of π^* forces consistent choices of (s, b, ρ). Fix ρ:
  1. given π^*: if set $s^* \Rightarrow b^*$
  2. given π^*: if set $b^* \Rightarrow s^*$
  3. if set (s^*, b^*), no reason to think $\pi = \pi^*$

Complications

- Inflation-targeting literature *assumes* long-run neutrality of monetary policy
- I have problems with that, but let's grant it
- Long-run neutrality of fiscal choices implausible
  - tax rates, government purchases, social security program all have long-run impacts
  - long-run real rate, r, likely depends on (s, b)
- Need to go beyond the government budget constraint to ensure monetary & fiscal targets internally consistent
- GBC alone: if s/b "too high," tendency for $\pi < \pi^*$
- EU fiscal rules developed without asking if they are consistent with monetary objectives

Why Does This Matter?

- IT's central claim: π^* anchors long-run inflation expectations
- Presumes people pay attention the π^*
  - natural to assume they pay attention to (s^*, b^*) also
  - s^* directly affects tax liabilities & govt benefits—people frequently vote on these things
  - b^* likely gets less attention & if debt low, effects may be small
- From what I can tell, none of this enters current discussions about fiscal rules
- They are designed to combat 1920s hyperinflations
  - modern fiscal dominance is more nuanced

Central Bank Resource Allocation

- Countless economist-hours devoted to tracking the stars
  - $y^*, u^*, r^*, rer^*, \ldots$
  - theoretical & empirical models to estimate them
- Any honest assessment...
  - estimation uncertainty huge
  - conceptual/model uncertainty more huger
  - impossible to track—even *ex post*
- Stars are the product of creative economists' imaginations
- Why do central banks do this?

Unwavering Faith in a Narrow Framework

Inflation is always and everywhere an overheating pehnomenon

except when it's due to relative-price changes

- Demand affects inflation *only* through intensity of resource utilization
- Explicit in new Keynesian model; implicit in MMT
- But if slope of Phillips curve is time/state-invariant, we get into a bind
  - sometimes inflation associated with output gap
  - sometimes not
- After decades of flatness, during Covid inflation, Phillips curve stood up

Shaking the Faith

- Two possible reactions to Phillips curve shift
  1. stop to question narrowness of framework
  2. apply creative econometrics to the creative theory: exogenous shifts in slope
- Framework remains intact
- Covid as close as we get to a natural experiment in macro
  - pandemic exogenous to economic conditions
  - fiscal/monetary reactions treated as “emergencies”
  - departure from policy-as-usual
  - shifted expectations to fiscal transfers unbacked by future taxes
  - people treated them as gifts to be spent

Married to the Narrative

- CBs toed the narrative line:
  - “supply chains & bottlenecks combined with strong demand caused inflation”
  - no explicit acknowledgment of the role of fiscal transfers & fiscal financing
  - assurance “we have the tools” to control inflation
- An understanding of fiscal inflation would have delivered a completely different narrative
  - fiscal inflation requires a fiscal remedy
  - monetary policy alone cannot fix a fiscal problem
- Lost another opportunity for CB economists to broaden their views of inflation

Weakness in Policy Analyses?

- Gosh, I dunno...
- Maybe
  - unwillingness to contemplate that fiscal policy matters
  - the absence of anything other than trivialized fiscal policy in CB models
  - little, if any, attention to fiscal data, including expectations
  - disregard of the government budget constraint
  - insistence that models must produce the Monetary Narrative—suppress anything else to which models give probability mass