Discussion: "The Dire Effects of the Lack of Monetary and Fiscal Coordination"

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Summary

- Main Issue: how is government debt financed when there is a *lack* of coordination between monetary and fiscal authorities?
- Analytical and quantitative analysis in benchmark New Keynesian model
- Findings:
  1. Coordinated policy crucial for good outcomes: more hawkish monetary policy can increase inflation without fiscal backing
  2. Proposal of coordinated "emergency-budget" rule which raises welfare and lowers uncertainty

Context: Monetary considerations of Fiscal Policy Over Time

Excerpts from Croushore & Van Norden (2016)

- Early Federal Reserve statements link monetary-fiscal policy
  - *It is monetary (not fiscal) policy that must adapt itself to the hard facts of the budget–and not the other way 'round.* –Chairman Martin, December 8, 1965.
  - *I think it's an interrelation between action on the fiscal side and action on the monetary side that sets the direction of the economy....I don't think monetary policy can operate in isolation from what is going on in other parts of the system.* –Chairman Miller, January 24, 1978

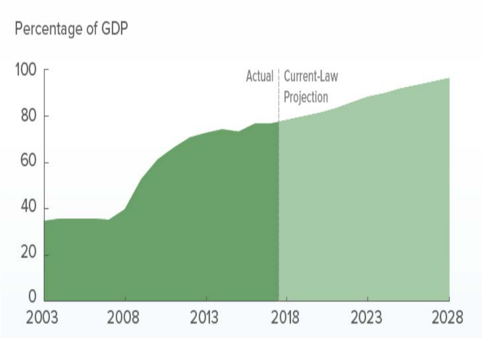
Context: Monetary considerations of Fiscal Policy Over Time

Excerpts from Croushore & Van Norden (2016)

- More recent statements perceive fiscal policy as passively financing debt and exogenously influencing economy
  - *In practice, recently and for the indefinite future, fiscal policy is dominated with the task of reducing the deficit, leaving the stabilization objective almost exclusively in the hands of the Federal Reserve.* –Governor Meyer, September 8, 1996.
  - *On the monetary side, authorities should try to stabilize the economy without anticipating help from fiscal policy.* –Governor Gramlich, April 22, 1999.

Context: Current Fiscal State

- CBO forecasts U.S. federal deficits will increase from 3.5% of GDP in 2017 to 5.4% in 2022.



CBO Budget Outlook, April 2018

- Much uncertainty about future debt financing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DEBT
WE HAVE TO TALK ABOUT THE ELEPHANT IN THE ROOM!
WHAT ELEPHANT?
Canadians blasé about debt - POLL

Main Results: Conflict Augments Problems

- Consider simple, flexible-price, endowment economy
- Period 1: fiscal authority abandons fiscal backing & nothing financing debt
- Agents know that either monetary or fiscal authority reverts to financing debt from period 2 onward
- How does inflation from exogenous demand shock propagate in economy?

Main Results: Conflict Augments Problems

- Consider simple, flexible-price, endowment economy
- Period 1: fiscal authority abandons fiscal backing & nothing financing debt
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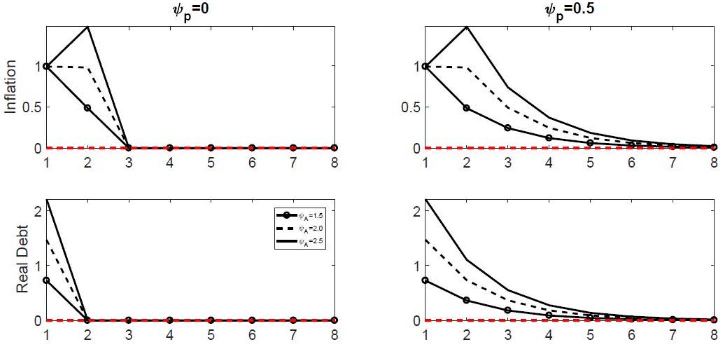
- How does inflation from exogenous demand shock propagate in economy?
- Scenario 1: fiscal authority reverts to financing debt with lump-sum taxes in period 2
  - Agents know inflation contained by monetary authority from period 2 onwards; don't expect future inflation today
  - Higher exogenous demand today leads to inflation & contractionary monetary policy
  - Temporary withdrawal of fiscal support for debt simply augments debt level for one period; $\uparrow r_1 \rightarrow \uparrow b_1$

Main Results: Conflict Augments Problems

- Scenario 2: monetary authority gives up on stabilizing inflation in $t = 2$
  - Expect inflation in period 2 to finance debt
  - More hawkish monetary policy at $t = 1$ has no effect on inflation today and *raises* future inflation



- Paper shows same problem arises in quantitative New Keynesian model where agents uncertain of future policy regimes

Main Results: Emergency-Budget Rule Undoes Problem

- Taxes and interest rate follow rules:

$$\begin{aligned}
\hat{\tau}_t &= \rho_{\tau,M}\hat{\tau}_{t-1} + (1-\rho_{\tau,M})[\delta_{b,M}\hat{b}^S_{t-1} + \delta_{b,F}(\hat{b}_{t-1} - \hat{b}^S_{t-1}) + \delta_y(\tilde{y}_t - \tilde{y}^*_t)] + \sigma_\tau \epsilon_{\tau,t} \\
\tilde{R}_t &= \rho_{R,M}\tilde{R}_{t-1} + (1-\rho_{R,M})[\psi_{\pi,M}\tilde{\pi}^S_t + \delta_{\pi,F}(\tilde{\pi}_t - \tilde{\pi}^S_t) + \psi_y(\tilde{y}_t - \tilde{y}^*_t)] + \sigma_R \epsilon_{R,t}
\end{aligned}$$

  where $\hat{b}^S_t$ and $\tilde{\pi}^S_t$ are debt and inflation in a shadow economy without demand shocks

- After negative demand shocks, $\uparrow$ debt $\rightarrow$ $\uparrow$ inflation expectation $\rightarrow$ $\uparrow$ inflation

- Interest rates fall, helping offset negative demand

- Welfare substantially higher in short and long run relative to conflict without emergency-budget rule

Thoughts on the Paper

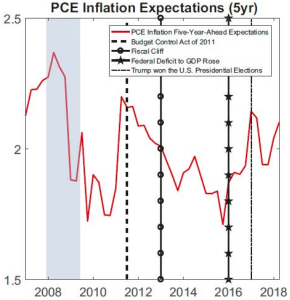
- Provides clear explanations of mechanisms of policy dynamics
- Great illustration of importance of policy coordination today and in expectation
- Comments mainly directed at connections to policy in practice

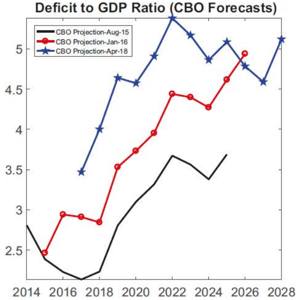
1. Shock-Specific Solution

- Emergency-budget rule requires 1) knowledge of what shocks hit economy; 2) accurate counterfactuals of world without shocks; 3) coordination of these forecasts between monetary & fiscal authority
  - In practice, 1 & 2 uncertain and 3 doesn't hold (e.g., Federal Reserve & CBO budget forecasts historically differ)
- Negative supply shocks potentially have different implications
- Does it matter if rule written in terms of shocks or rule written in terms of threshold of joint inflation and output (or unemployment) thresholds?

2. What do we know about debt financing expectations?

- Paper argues PCE inflation expectations consistent with changing beliefs on latent conflict between monetary and fiscal authorities on financing debt

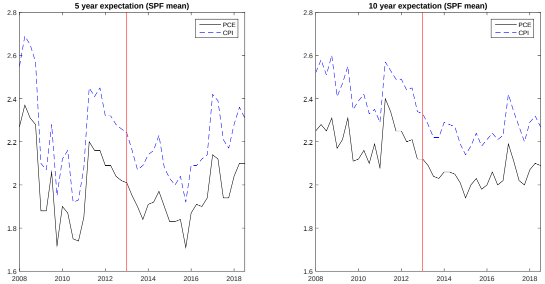




- 2013: budget sequestration lowers federal spending (passive FP $\rightarrow \downarrow \pi^e$)
- 2016-on: higher deficits (less passive FP $\rightarrow \uparrow \pi^e$)

2. What do we know about debt financing expectations?

- Expectations reflect latent conflict on *future* policy or actual changes in demand from *current* policy?
  - March 2013: Chairman Bernanke notes "federal fiscal restraint in 2013 is cutting something like 1.5 percentage points off of growth"
  - Remainder of 2013 & some of following, press release of every FOMC meeting notes "fiscal policy is restraining economic growth"
- Longer-term forecasts have less variation



2. What do we know about debt financing expectations?

- Surveys of debt financing?
- Role of news, policy briefs, and expectations?
  - Recent, growing literature on textual analysis and monetary policy: E.g., Baker, Bloom & Davis (2016); Coibion, Gorodnichenko, Kumar & Pedemonte (2018); Ehrmann & Talmi (2018); Fuksa & Sornette (2013); Hansen, McMahon & Prat (2018); Shapiro, Sudhof & Wilson (2018)
  - Fiscal policy less explored

Conclusions

- *Inflation is the outcome of interplay between decisions about taxation, government spending, and central bank open market operations.*
  – Sims (2016)

- This paper offers a great illustration of this point!

- More attention to joint monetary-fiscal policy trade-offs and manner by which real-world expectations influenced needed