Is it time to review the division of roles in macroeconomic policy?

Sveriges Riksbank (8 December 2021)

S V E R I G E S   R I K S B A N K

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Deputy Governor

The crisis of the 1990s

- Domestic cost and financial crisis the result of long-term problems
  - Strong domestic inflation trend in conflict with the fixed exchange rate
  - Often excessively expansionary fiscal policy, tendencies towards structural deficits
- Macroeconomic policy needed to be reshaped
  - Fiscal policy: confidence in long-term sustainable public finances (new budget process, surplus target, etc)
  - Monetary policy: confidence that inflation will be kept low and stable (independent Executive Board, inflation target)


20 november 1992
Vecka 47
FREDAG
DAGENS NYHETER.
SVERIGES STÖRSTA MORGONTIDNING
Sid 1-20 A
Nytt krispaket hjälpte inte • Riksbanken släpper fasta valutapolitiken
Svenska kronan flyter fritt
Riksbanken gav på torsdagseftermiddagen upp slaget om den svenska kronan. Riksbankschef Bengt Dennis meddelade då att kronan ska flyta, i praktiken en devalvering. Beslutet fattades sedan nära 160 miljarder kronor lämnat landet på en vecka.
Lägre räntor — dyrare bensin

Persistently too *low* inflation is also a problem

- Less scope for cutting the policy rate during economic downturns
    - Very low inflation on average means low nominal interest rates
    - Effective lower bound of the policy rate
- Negative policy rate thus becomes more common
    - Opponents of negative interest rates should advocate that the inflation target be maintained (or raised)!
- Plays a key role in the ECB's strategy review (July 2021) and the Federal Reserve review (August 2020)

Fiscal policy and monetary policy mutually dependent

- Separate frameworks for fiscal and monetary policy
- But confidence in one depends on confidence in the other!
- **If public finances are perceived as unsustainable:** Expectation of expansionary monetary policy to inflate debt away – the anchor of monetary policy may loosen
- **If inflation rises sharply:** rapidly rising interest rates and interest costs for the government – the anchor of fiscal policy may loosen
- “It’s really both monetary policy and fiscal policy that do the anchoring” (Eric Leeper)

A common view is that monetary policy is in the driver's seat

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The policy regime of recent decades with inflation targeting

MONETARY POLICY
the **active** party

Is expected to keep the economy
in balance and inflation low and stable

FISCAL POLICY
the more **passive** party

Is expected to keep finances under control, stabilisation via automatic stabilisers

Major impact
in academic research and in policy departments at ministries of finance and central banks

But the division of roles may no longer be so obvious?

- Monetary and fiscal policy probably more dependent on each other than we have thought
- Has been strengthened by changed macroeconomic conditions – record low global real interest rates

Interdependence between fiscal policy and monetary policy

Pulling in the **same** direction

Higher inflation → Higher interest rate → Higher interest expendi-ture → Expectation of tighter fiscal policy (stabilises debt) → Dampening demand and inflation

Interdependence between fiscal policy and monetary policy

Pulling in **different** directions

Higher inflation → Higher interest rate → Higher interest expendi-ture → **No** expectation of tighter fiscal policy (does **not** stabilise debt) → Does **not** dampen demand and inflation

More difficult to keep inflation at target

Interdependence between fiscal policy and monetary policy

If inflation falls

Pulling in **different** directions

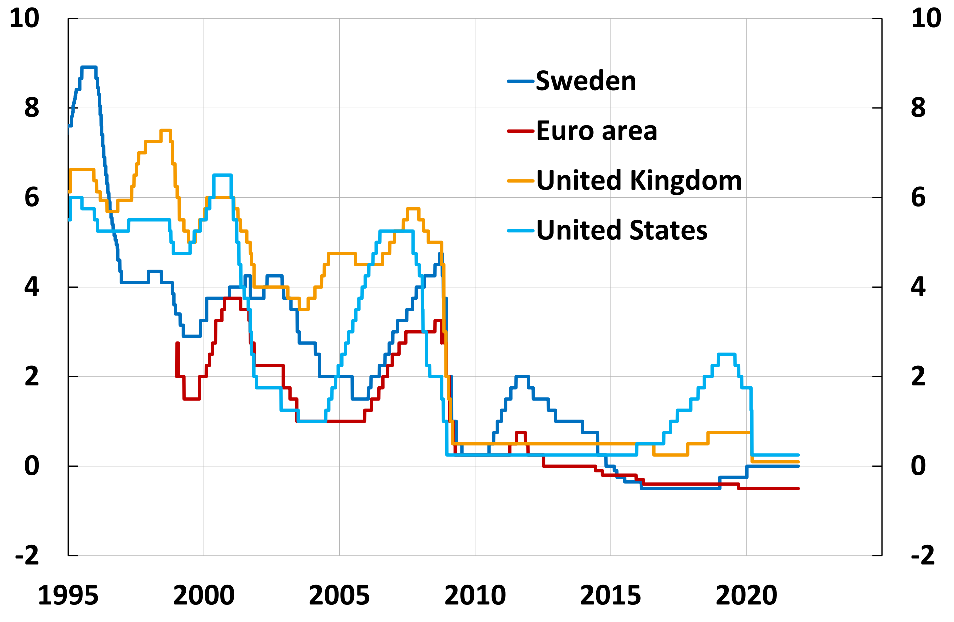
Lower inflation → Lower interest rate → Lower interest expendi-ture → **No** expectation of more expansionary fiscal policy (does **not** stabilise debt) → Does **not** increase demand and inflation

More difficult to keep inflation at target

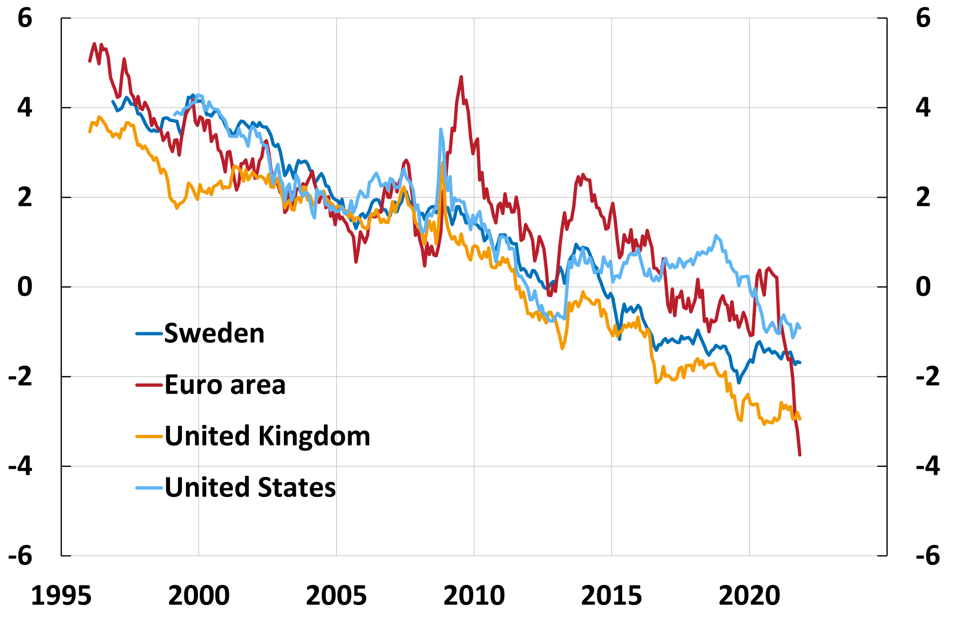
Asymmetry in practice
– shrinking government debt has *always* tended to be perceived as positive

Low global real interest rates have made it more difficult to use monetary policy

Policy rates



Long inflation-linked bond yields

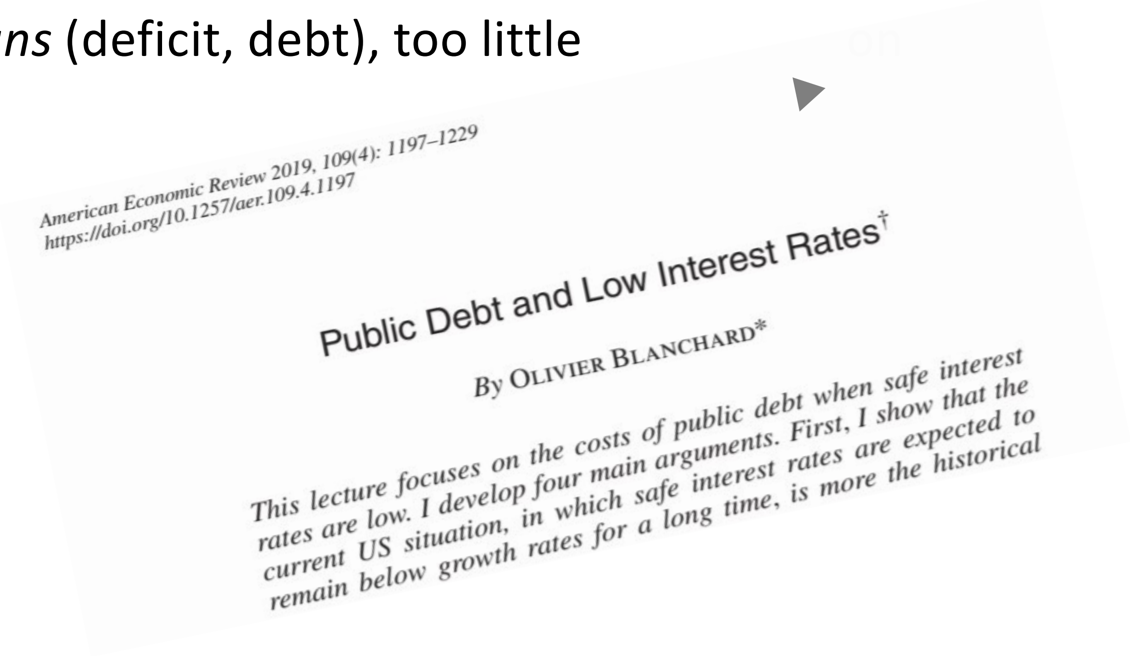


Note. Per cent.

Sources: Macrobond, national central banks and the Riksbank.

A renewed discussion of the possibilities of fiscal policy

- Low interest rates facilitate fiscal policy
  - Easier to recoup public investments
  - If growth exceeds interest rate sufficiently, debt/GDP need not increase (e.g. Blanchard)
  - Zero interest rate or even negative interest rate is a pretty ‘generous offer’ in itself…
- Fiscal policy framework: large focus on the *means* (deficit, debt), too little the *target* (welfare)
  - Monetary policy framework: evaluation (most often) on basis of *target* (inflation)
- This does *not* mean that public borrowing is never problematic!



American Economic Review 2019, 109(4): 1197–1229
https://doi.org/10.1257/aer.109.4.1197

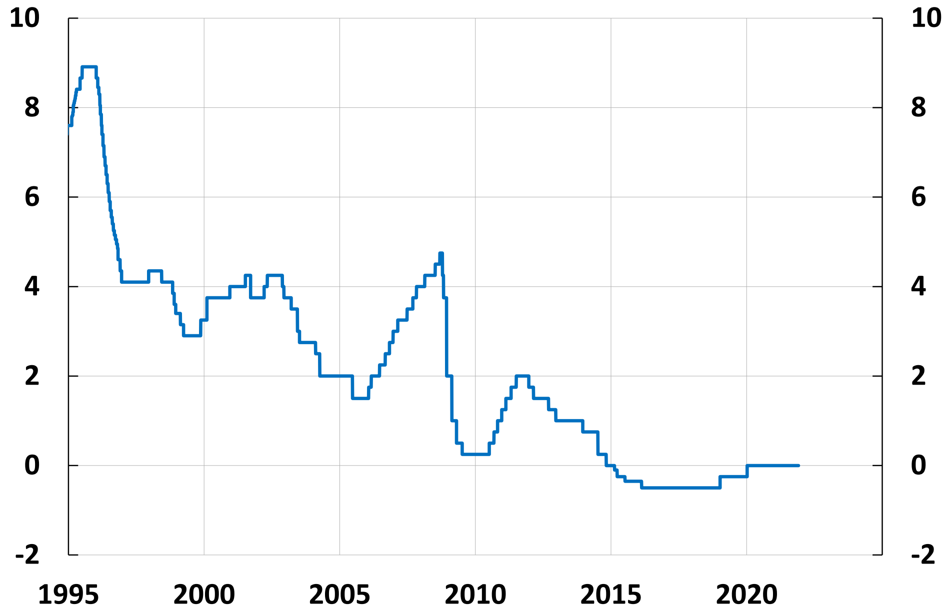
Public Debt and Low Interest Rates†

By Olivier Blanchard*

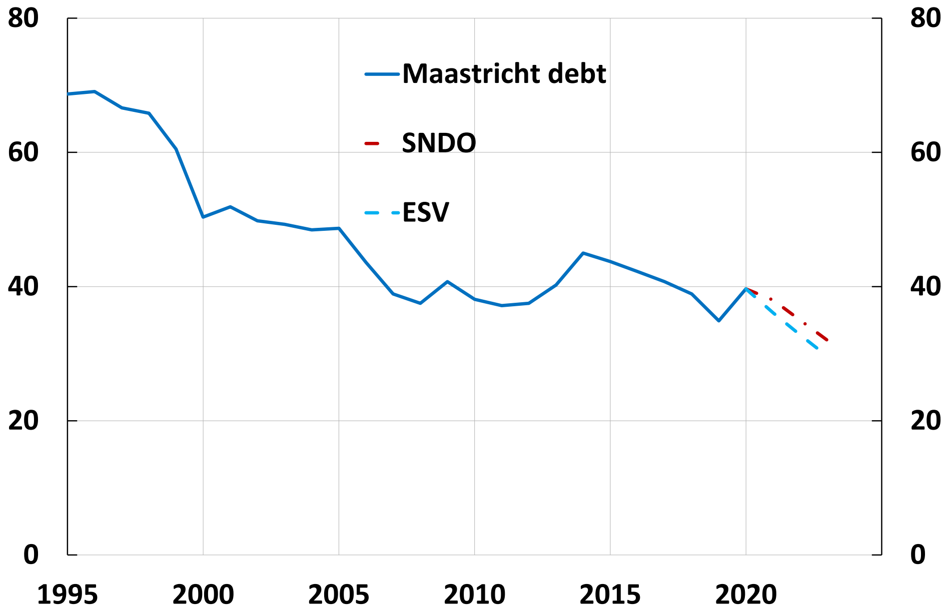
This lecture focuses on the costs of public debt when safe interest rates are low. I develop four main arguments. First, I show that the current US situation, in which safe interest rates are expected to remain below growth rates for a long time, is more the historical

Trend towards lower policy rate and public debt

Repo rate



The Maastricht debt as a share of GDP



Note. Per cent.

Sources: Swedish National Financial Management Authority (ESV), Swedish National Debt Office (SNDO), Statistics Sweden and the Riksbank.

A new policy regime with fiscal policy in the driver's seat?

- A matter of more than "helping monetary policy to maintain the inflation target"
  - But inflation target is not insignificant – central economic objective with political support
  - The economy works better with a certain, low inflation rate (Fed, ECB reviews)
- Also structural challenges:
  - Ageing population
  - Climate transition
  - Improved integration, etc
- Some measures will eventually increase production capacity but will raise demand and inflation in the shorter term – not a drawback

Advantage of formalising a more active fiscal policy?

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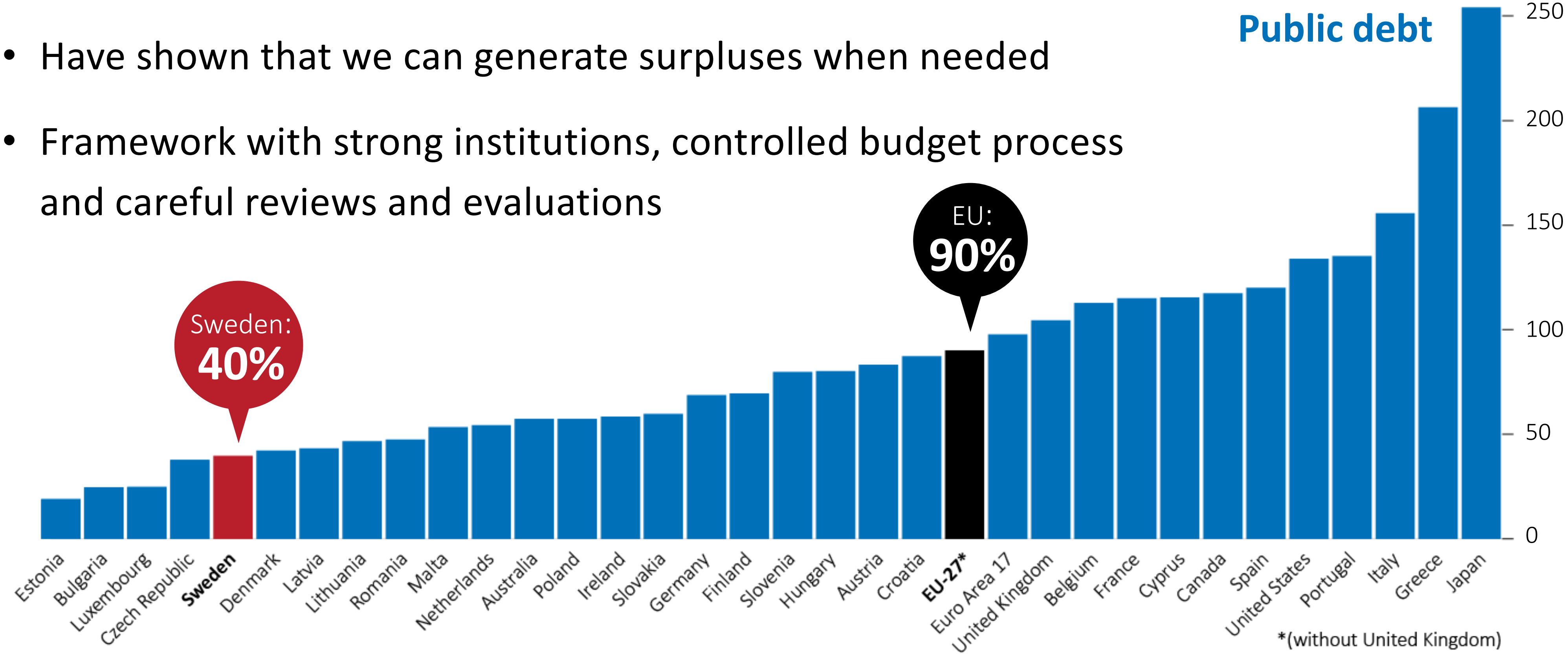
- Expansionary policy with temporary deficit until measurable *target* achieved (state contingent)
- Temporary deficit for a *certain length of time* (time contingent) according to a given path
  - Maybe less attractive to economists, but probably easier to implement (sunset clause)
- Return to debt stabilisation once the period is over or the target has been achieved
- Swedish Fiscal Policy Council (or other institution) regularly evaluates
  - Perhaps also *overall* policy, i.e. monetary policy too

Good conditions for conducting a more active fiscal policy

- Sweden’s debt low internationally, about 40 per cent (for example Germany and Finland about 70 per cent)
- Have shown that we can generate surpluses when needed
- Framework with strong institutions, controlled budget process and careful reviews and evaluations



The importance of an open discussion

- My input to an important discussion
- No complete proposals – much additional work is required
- Good to deal with the problems, even though we may have to take difficult decisions and think in a slightly new way
- Ultimately, of course, these are issues that need to be addressed and resolved politically
- But an open discussion is a good start!

Thank you!