THE FISCAL FOOTPRINT OF CENTRAL BANK ACTIONS: IMMEDIATE AND FAR FUTURE

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The Future of Inflation Targeting
Bank of England

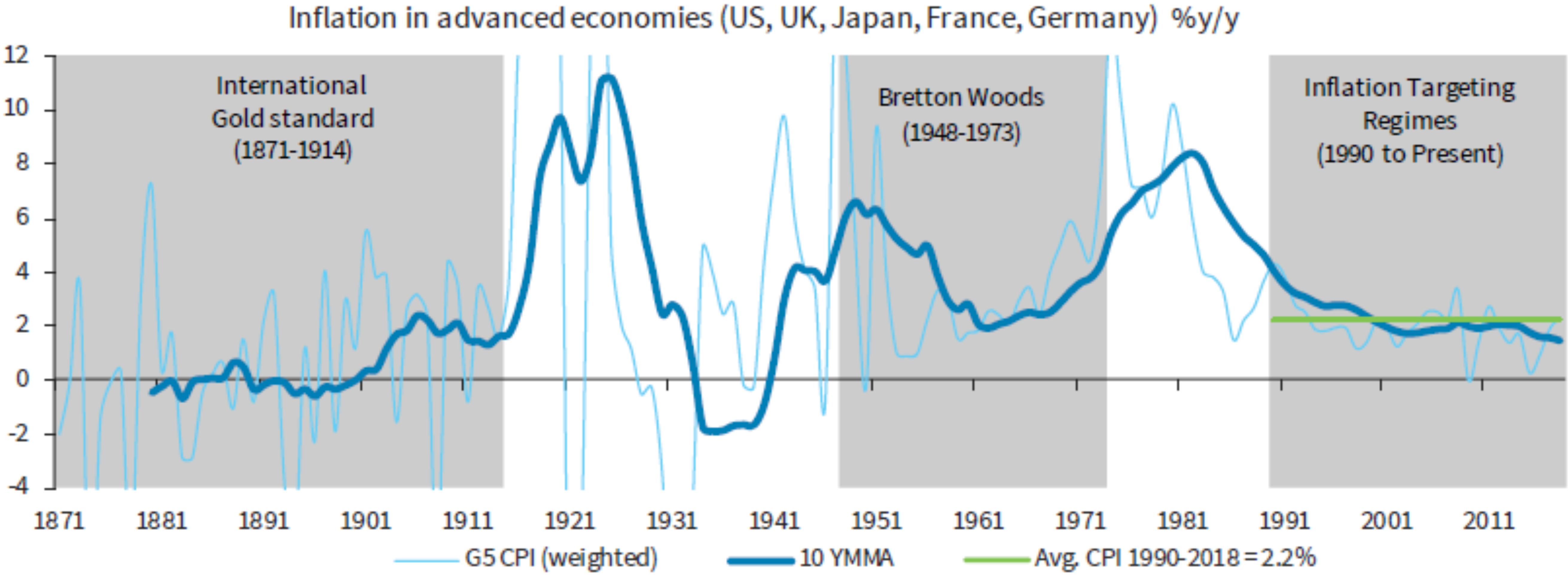
Monetary policy affects inflation!

The Most Dangerous Idea in Federal Reserve History: Monetary Policy Doesn't Matter†

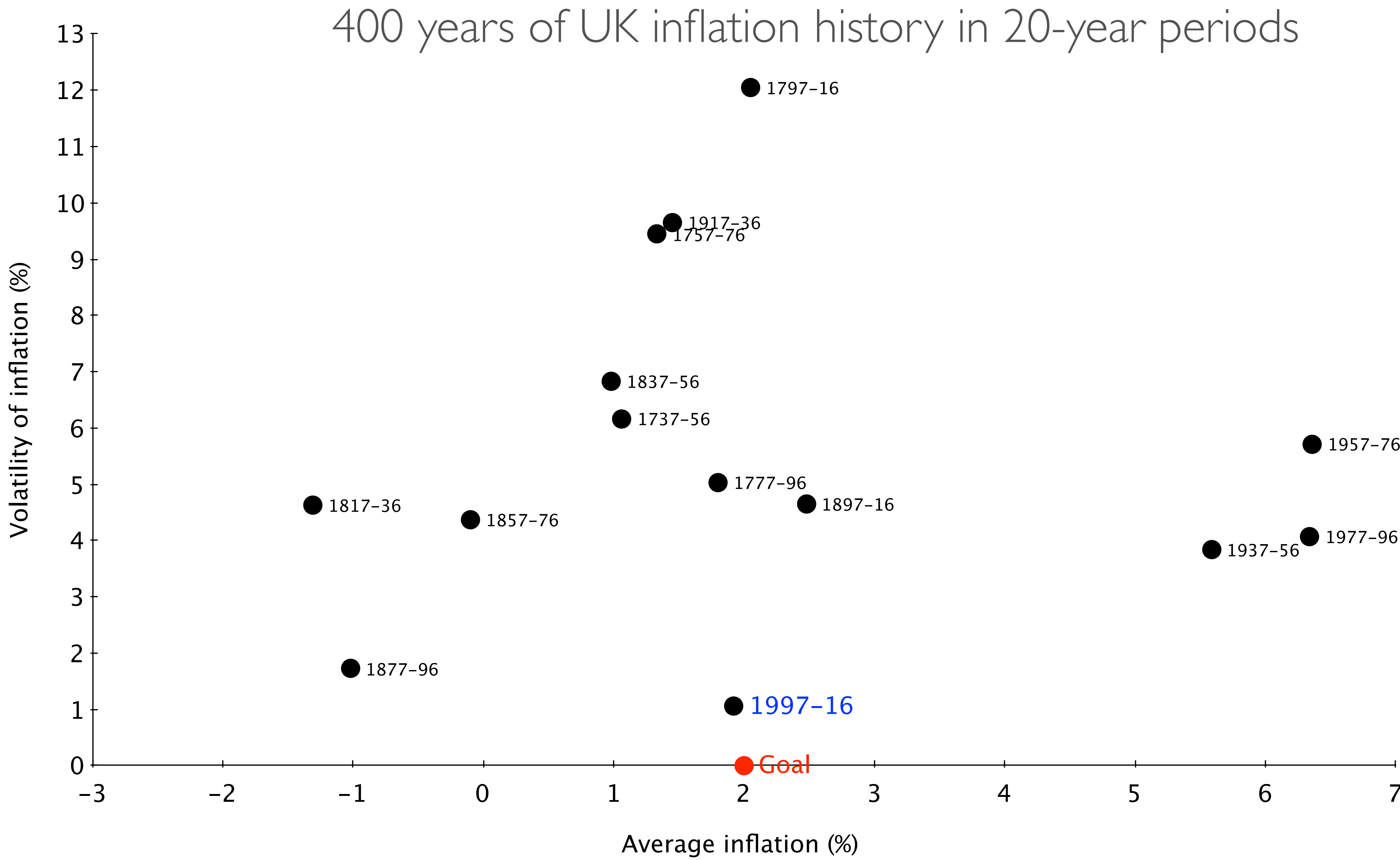
American Economic Review: Papers & Proceedings 2013, 103(3): 55–60
http://dx.doi.org/10.1257/aer.103.3.55

By Christina D. Romer and David H. Romer*

Fiscal policy may give give tail/head-winds, but "*The (E)CB's mandate for price stability is unconditional*" (Lane, 2019). **And can do it.**



Source:: Barclays research (2019)



Fiscal footprint CB: relax budget constraints

- Budget constraint of the fiscal authority

$$\mathbb{V}(\text{surplus}) \geq \frac{B}{P} - \mathbb{V}(\text{CBdividends}) - \mathbb{V}(\text{Bpremium})$$

- Budget constraint of the central bank

$$\mathbb{V}(\text{CBdividends}) \leq \mathbb{V}(\text{seignorage}) + \frac{B^c - V}{P} + \mathbb{V}(\text{VBpremium})$$

- Combined budget constraint

$$\mathbb{V}(\text{surplus}) \geq \frac{B + V - B^c}{P} - \mathbb{V}(\text{seignorage}) - \mathbb{V}(\text{Bpremium}) - \mathbb{V}(\text{VBpremium})$$

Negative footprint of too low inflation

$$\mathbb{V}(\text{surplus}) \geq \frac{B + V - B^c}{P}$$

➡ Reflate the debt

$$-\mathbb{V}(\text{seignorage})$$

➡ Lower seignorage

$$-\mathbb{V}(\text{VBpremium})$$

➡ Low investment profits

$$-\mathbb{V}(\text{Bpremium})$$

➡ Demand for government bonds

Central bank policies (to stimulate inflation)

$$\mathbb{V}(\text{surplus}) \geq \frac{B + V - B^c}{P}$$

➡ Reflate the debt

- Need unexpected persistent low inflation + long maturity
- Since $B/P = \sum Q^j B^j = \mathbb{V}(B^j/\pi_j)$

$$-\mathbb{V}(\text{seignorage})$$

➡ Lower seignorage

- Low for long interest rates, less seignorage from currency
- Combined with downward trend if cash less used

$$-\mathbb{V}(\text{VBpremium})$$

➡ Low investment profits

- Short-long balance sheet, earns term premium
- Low term premium, no gains

$$-\mathbb{V}(\text{Bpremium})$$

➡ Demand for government bonds

- Opposite direction: force banks to hold government bonds
- Create safety premium, financial repression, but less credit

Future blurring the monetary/fiscal separation

Dominance of inflation on CBs choices was sustainable in the past 30 years since:

- Yes, central bank can generate fiscal resources (alleviate fiscal burden). But…
- small effect: need persistent and unexpected to inflate away, need triple-digits inflation for seignorage, need anti-Friedman rule for investment profits, need financial repression for B premia.
- and side effects on: long-term financing costs through inflation risk premia, hyperinflations, contractions in credit, lower output.

Myopia was the justification when it happened as: fast, elastic, not legislative.

But in fiscal crisis times…

$$\mathbb{V}(\text{surplus}) \geq \frac{B + V - B^c}{P}$$

➡ Inflate away the debt

- More debt, more base to inflate away
- QE determines effective maturity

$$-\mathbb{V}(\text{seignorage})$$

➡ Raise seignorage

- Large changes in demand for currency
- Safe haven if default without inflation

$$-\mathbb{V}(\text{VBpremium})$$

➡ Investment profits

- V if unit of account shielded from default: safety premium
- V is held by banks: provides default insurance for them.

$$-\mathbb{V}(\text{Bpremium})$$

➡ Higher demand for government bonds

- Tighten macropru, help fiscal authority roll over its debt
- Loosen macropru, spur lending and tax collection

And in joint fiscal-financial crisis

$$\mathbb{V}(\text{surplus}) \geq \frac{B + V - B^c}{P}$$

$$-\mathbb{V}(\text{seignorage})$$

$$-\mathbb{V}(\text{VBpremium})$$

$$-\mathbb{V}(\text{Bpremium})$$

➡ Inflate away the debt

➡ Raise seignorage

➡ Investment profits

- Lender of last resort actions, effect on bailout costs.
- CB as supplier of safe asset, significant profits

➡ Higher demand for government bonds

- Tighter macropru can lower incidence or size of financial crisis, it attenuates fiscal crisis associated with it.
- But tighter macropru, makes banks hold more bonds, worsens the diabolic loop

General point: in fiscal-financial crisis, separation of monetary and fiscal policy is moot.

Conclusions on the footprint

- **Immediate future:** central bank actions to push for higher inflation in the face of tight fiscal policy have a negative fiscal footprint. Compromise facing fiscal policymakers.

- **Far future:** on average, in normal times, ignoring the footprint is fine— small and bad side effects—with non-myopic government. Independent inflation-focussed central bank

- **Far future** usage of fiscal footprint, fear will move to fiscal focus:
  - If fiscal crisis, appealing. Mix of inflation, seignorage, QE, financial repression.
  - If financial-fiscal crisis: what separation? Macropru/LOLR plays centre stage

Points based on:

- "Can the Central Bank Alleviate Fiscal Burdens" In The Economics of Central Banking, edited by Mayes, Siklos, and Strum, OUP 2019.
- "QE in the Future: The Central Bank's Balance Sheet in a Fiscal Crisis." IMF Economic Review, 1-42, 2017.
- "The Second Decade of the Euro: New Challenges in Old Clothes" ECB Sintra Forum, 2019.
- "The Fiscal Footprint of Macroprudential Regulation." Working paper: June 2019.