The political economy of monetary/fiscal cooperation

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“Does the current allocation of policy responsibilities into separate domains remain appropriate? Would a closer coordination of policy areas be desirable in some circumstances. What are the risks of blurring the lines between well-established policy domains.”

Is the consensus assignment dead for the foreseeable future?

Yes, and the post-GFC period shows that conclusively

Unconventional monetary policy cannot replace fiscal policy in these circumstances until it’s impact is as predictable, which will only come with more observations = more recessions with inadequate policy responses.

Inflation was on target, so what is the problem? When inflation is low (around 2%), it is a poor indicator of demand deficiency.

When nominal rates hit their lower bound, fiscal policy makers embarked on fiscal consolidation (austerity) rather than fiscal expansion, a first order policy error with devastating economic and political consequences.

Not the central bank’s problem?

Central Banks have in the past been at the forefront of promulgating the consensus assignment

Central banks have been until recently extremely reluctant to tell fiscal policy makers about how the consensus assignment no longer applies.Indeed after the GFC some central bankers told policy makers that additional austerity was required.

In part this involved suggesting that unconventional monetary policy was a reliable anti-recession tool, when in reality central bankers had little idea how much they needed to do.

Denial of the problem by CBs means they carry the blame in recessions. This will only make MMT more popular. MMT (almost) reverses the conventional assignment, and puts today's CBs out of a job.

Why did governments enact austerity

Crucial to choosing between alternative monetary/fiscal arrangements

1) Ignorance e.g.

> "[New Keynesian] Models of this kind underpin our whole macroeconomic policy framework – in particular the idea that by using monetary policy to manage demand and control inflation you can keep unemployment low and stable. And they underpinned the argument David Cameron and I advanced last autumn – that monetary policy should bear the strain of stimulating demand…."
>
> George Osborne, 2009 RSA speech which fails to mention we had just hit the ZLB

2) Misplaced fears of a financing crisis

3) A recession is a good time to shrink the state, because fear allows politicians to cut public spending by more than is popular in normal times, and/or by more than is optimal

Forms of monetary/fiscal coordination 1) discretionary advice

Continuation and strengthening of emerging practice. Growing consensus among central banks that fiscal stimulus is required at ZLB.

> "In a global liquidity trap, central banks cannot be the only policy makers who do “whatever it takes.” There are clear gains from coordination, with other policies – particularly fiscal policy"
> Mark Carney

The next step would be to tell this directly to governments as a recession emerges. Central Banks (CBs) in a recession would advise governments that now was the time for a fiscal stimulus. This could be combined with QE, effectively monetising the deficit.

But CBs fear two way advice, so in practice CB advice may be understated = politically ineffective.

So discretionary advice deals with ignorance and financing fears, but weak against a shrink the state government

Forms of monetary/fiscal coordination 2) helicopter money

Let’s not waste time over whether HM is fiscal or monetary.

Let’s also not waste time over whether HM threatens CB Independence. The fiscal authority of CB nightmares that fails to provide backing to a central bank that runs out of assets to unwind Helicopter Money = a fiscal authority that will end CB Independence.

Helicopter Money is equivalent to a fiscal expansion accompanied by QE, except that the CB has control over whether the fiscal expansion happens.

Serious problem with Helicopter Money is political. A ‘shrink the state’ fiscal authority may regard Helicopter Money as enabling an even greater (even less optimal) squeeze of public spending.

Forms of monetary/fiscal coordination – 3) state dependent assignment

CB gives up stabilisation role in any significant economic downturn. Consensus Assignment becomes state dependent. In a significant economic downturn, Fiscal Authority is in charge of stabilisation, and the CB becomes passive.

In non-downturn periods the CB is in charge of stabilisation and the Fiscal Authority reverts to its role of stabilising debt.

Who provides information to Fiscal Authority about the likelihood of a significant downturn, and perhaps the amount of stimulus required? Could be CB, or could be fiscal council. Delegation is a clear advantage to avoid deficit bias.

Forms of monetary/fiscal coordination - state dependent assignment

Scheme very similar to the fiscal rule proposed by Portes and Wren-Lewis. That rule switches fiscal policy to stimulus when interest rates hit ZLB.

If we add in the need to anticipate possible ZLB periods, then some fiscal stimulus is sensible before ZLB actually hit.

Problem with the Portes/Wren-Lewis rule is that fiscal authority needs to adopt it, which a ‘shrink the state’ government is unlikely to do. In contrast if a state dependent assignment can become the new consensus, then a ‘shrink the state’ government is seen during a recession as failing one of its primary duties.

Conclusions

Central Banks are now recognising that in recessions fiscal stimulus is required

This is a consequence of the GFC, when fiscal policy makers enacted austerity

One of the reasons they were able to enact austerity was the dominance of the traditional consensus assignment

Our most effective way of preventing this happening again is to make a state dependent assignment the new consensus