The ECB and its Watchers

Monetary and Fiscal Interactions

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Outline

1. The immediate problem: High current inflation
2. The bigger problem: Mission creep and excessive policy activism
3. The solution: Tighten policy, reverse increase in stocks of public liabilities, focus on price stability, stop being hyperactive-trying to be jack of all trades

The immediate problem

- Current inflation figures, 7.9% in the US and 5.8% in the EZ, are embarrassing for Central Banks (CB)
- How did this happen? Was it caused by the government (fiscal and monetary policy)?
- What do the CBs (and fiscal authorities) need to do about it?

The immediate problem: How did it happen

The vindication of Milton Friedman

- Inflation happened because CBs banks fueled it/let it happen
- Fiscal policy contributed significantly but the buck should stop here: monetary policy is the main culprit

For those who did not believe Cochrane, Summers,..

Figure: US Nominal GDP

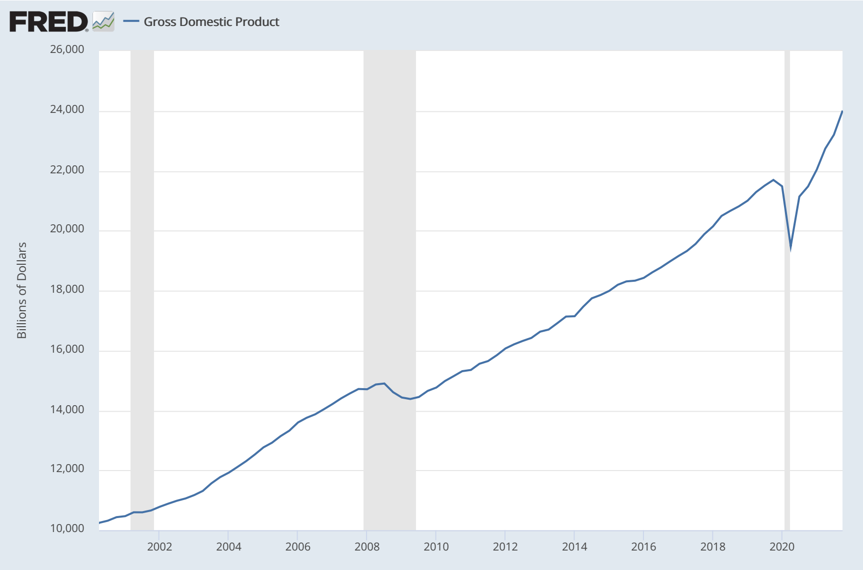
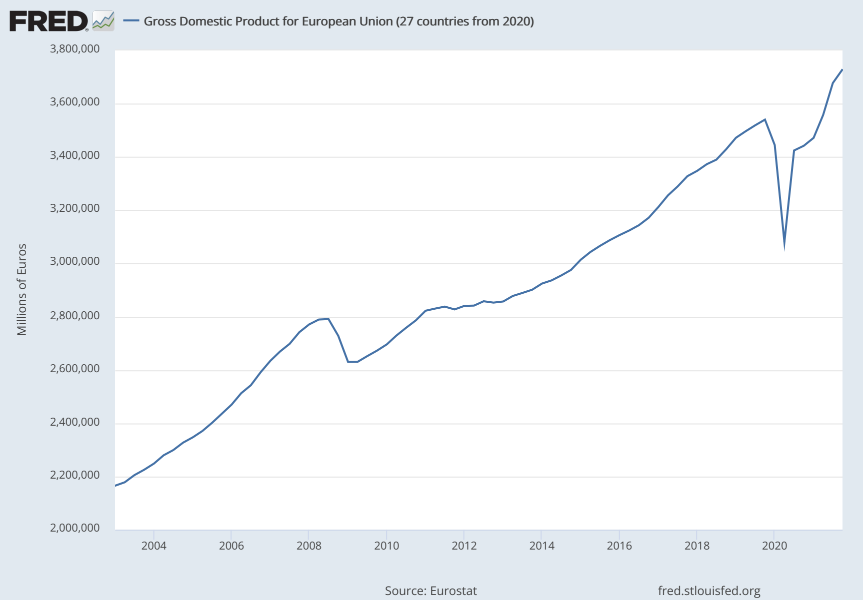


Figure: EU Nominal GDP



The immediate problem: How did they let it happen?

Inflation Attention Deficit Syndrome

- Data: A long period of low, stable inflation lulled CBs to believe that they had mastered the art of price stability
- Theory: Reliance on the NK Phillips curve. Empirical estimates (and calibration exercises) suggested a super flat curve and thus, a credible CB ($E\pi = \bar{\pi}$) need not worry much about the impact of aggregate demand/ output gap on inflation! $\pi_t = \beta\pi_{t+1} + \kappa y_t + u_t$
- Empire building: So many other cool things to go after (climate change, income distribution,..)

Hyperactivity/feeling of omnipotence

- No negative shock was ever deemed as unworthy of a "generous" monetary and fiscal policy response

The immediate problem: What needs to be done

- Monetary and fiscal policy tightening
- Monetary tightening should be far greater than currently advocated because of its positive overall fiscal implications

Fiscal implications

1. Fiscal implications of inflation management : A delicate trade off between the short and medium-long term effects of an increase in the policy rate, R

- Under full commitment to inflation target, CB can afford a series of -smaller- R adjustments over time rather than a big SR adjustment, without upending inflation expectations
- But there is an inverse relationship between path of tightening and path of inflation decline

Fiscal implications

Costs and Benefits of a Timid Approach

Going the slow way

- + SR economic activity (and tax revenue)
- + Debt repayment cheaper (erosion of real value of debt)
- + New, short term public debt cheaper

But failure to contain inflation could create doubts about commitment /ability to deliver price stability, increasing inflation risk premia and uncertainly

- **-** LT real rates on debt $\uparrow \rightarrow$ tax rates $\uparrow$
- **-** Effect on investment/economic activity/tax revenue

Given complexity of optimal adjustment path, prudence (contain LR expectations) dictates erring on the side of far- rather than near sightedness

TIGHTEN UP

Fiscal implications

2. Fiscal multipliers at the ZLB

- Raising CB policy rate has the traditional negative effect on AD (I, C durables) but it may have the additional effect of reducing the size of fiscal multipliers by taking the economy away from the ZLB
- Reducing the footprint of fiscal policy on the output gap blunts the inflationary effects of fiscal policy (could remove some of the inflation sting of things such as the ''Build Back Better" package)

TIGHTEN UP

Fiscal implications

Liquidity premium on govt liabilities

- Shrinkage of the CB balance sheet (public debt) will increase the liquidity value of govt liabilities, lowering the govt's borrowing costs
- Keeping liquidity scarce not only creates fiscal space but it may represent socially optimal policy (Angeletos, Collard, Dellas, 2012)
- Not a good idea to satiate the markets with liquidity (Friedman rule), specially during financial recessions

TIGHTEN UP

The bigger problem: Monetary policy practice

DOING TOO MUCH

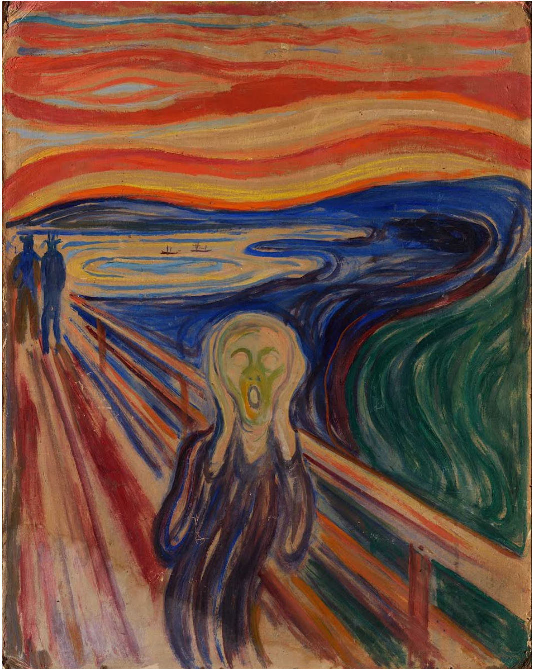
- Policy has been excessively activistic-discretionary along both the intensive and extensive margin (excessive response to too many things) For instance, it is obsessed with the minutia of financial stability
- Such a practice fuels (goods and asset) inflation, and is a source of moral hazard/ financial instability!
- Missing humility: Need to understand/accept what monetary policy CANNOT do (Friedman, 1968)
- Missing discipline: Need a Taylor rule

The bigger problem: Policy practice

LACKING FORESIGHT

- Policymakers seem to subscribe to shallow wisecracks of the type "In the long run we are all dead!"
- Have focused exclusively on flows and completely neglected the stocks of liabilities (public debt, CB balance sheet)
- Don't large stocks of liabilities hinder response to the inevitable future large shocks/compromise price stability?
- High inflation expectations (doubting CB commitment/ability) can be a hard to tame beast

The future?



The solution: A rethinking of policy practice

- Keep your eye on the ball (tighten up aggressively to put the inflation genie back into the bottle)
- Get fit: Normalize policy (R and Balance Sheet and Public Debt) to prepare for the next crises
- Focus on price stability and resist **mission creep** (macroprudential regulation, climate change, income inequality,..): Have we not already seen what happens when CBs take their eye off the ball?
- Stop playing/projecting the image of being god (resist the temptation of **excessive activism**)