Panel on The Interaction of Fiscal and Monetary Policy: Yesterday, Today and Tomorrow

Alan S. Blinder

The subject of this panel is a hardy perennial; it has been touched upon many times in Jackson Hole's illustrious history. However, the specific issues emphasized under that general heading have differed dramatically over time.

Starting at the beginning, it turns out that I delivered the very first paper at the very first Jackson Hole conference, *in person* of course, in 1982. The title was: "Issues in the Coordination of Monetary and Fiscal Policy."[1] Notice the word "coordination." The big issue of the day was the clash between tight monetary policy and loose fiscal policy.

Things have changed a lot since then, and not just my age. When I spoke on this topic again on a panel here in 2012, the focus was much closer to today's.[2] In preparing for this session, I read what I wrote then and found, unsurprisingly, that my views on fiscal-monetary interactions have not changed much in just nine years. Sorry—but none of you have checked back to that 2012 symposium, anyway.

I. Yesterday

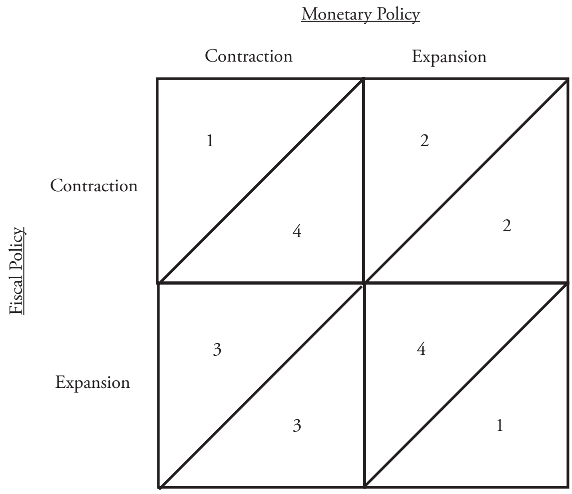
Back to the summer of 1982. Economists were then concerned about the sharp clash between Paul Volcker's tough anti-inflation policies and Ronald Reagan's huge tax cuts, which had passed a year earlier and were being phased in over several years. The tax cuts were clearly going to blow a big hole in the budget and give aggregate demand a big boost. The conventional wisdom of the day—which, by the way, came true—was that the policy mix of loose fiscal policy and tight money would raise real interest rates and reduce the share of investment in GDP.[3] The unemployment rate in August 1982 stood at 9.8%, and one of my discussants that day, the estimable James Tobin, was deeply worried that the Fed's tight monetary policies would stifle the recovery.

I presented a simple game-theoretic argument that day, showing why *uncoordinated* fiscal and monetary policy choices would likely lead to the policy mix we were getting—tight money and loose fiscal policy—even if *both* authorities preferred the opposite policy mix. The simple two-by-two payoff matrix that I used to make the point is replicated in Figure 1.

I assume that each policymaker can pursue either a contractionary or an expansionary policy but that they rank the outcomes differently. Specifically, the fiscal authority (whose preference ordering appears below the diagonal in each box) is assumed to favor expansionary policies. The best outcome from its point of view in when both parties play "expansion" (rank 1, lower right-hand cell), and the worst outcome is when both play "contraction" (rank 4, upper left-hand cell). The monetary authority (whose ordering appears above the diagonal) is fighting inflation, and so orders the "best" and "worst" alternatives in the opposite way. However, as between the two outcomes which combine expansion and contraction, both authorities favor easy money and a tight budget rather than tight money and a loose budget—presumably because of its more favorable effects on real interest rates and investment.

Quick examination of the payoff matrix reveals that the Nash equilibrium comes when the Fed plays "contraction" and the fiscal authority plays "expansion"—which sounds just like the Volcker-Reagan policy mix. Even though both parties prefer fiscal contraction and monetary expansion, they are trapped into the opposite policy mix by the inability to *coordinate*.

Figure 1



What to conclude? Should the two authorities therefore coordinate their policy choices, which would likely mean the central bank surrendering its independence? Everyone in this room would probably say *no*—and Volcker's steadfast performance is widely lauded. It may surprise you to learn, however, that both James Tobin and Milton Friedman, who agreed on approximately nothing during their illustrious careers, answered *yes*. Neither man supported central bank independence (CBI); both worried about the lack of democratic control:

TOBIN: "Outcome preferences are essentially political. In my view they are choices that elected officials must ultimately make … It seems to me that the President and Congress should agree as to the desired path of, say, nominal GNP over the coming fiscal year, and that both the budget and the monetary policy should be in a coordinated manner committed to that target."[4]

FRIEDMAN: Central bank independence "embodies the very appealing idea that it is essential to prevent monetary policy from being a day-to-day plaything at the mercy of every whim of the current political authorities," but he rejects the concentration of vast powers "in a body free from any kind of direct, effective political control."[5]

Yes, the world has changed. Today, *both* fiscal *and* monetary policy are strongly expansionary. That said, the world could change again, perhaps even in the near-term future. Though it is not in the Federal Open Market Committee's (FOMC) current plans, it is not difficult to believe that the Fed will turn to inflation fighting before the administration is ready to give up on stimulative fiscal policy. In fact, it is next-to-impossible *not* to believe that. If so, the matrix in Figure 1 could become relevant again.

II. Today

The public debt was under 30% of GDP in 1982 and, with interest rates sky high and the economy sputtering, no one was exploring debt dynamics when $r<g$. Nowadays, the debt-to-GDP ratio is around 100%, but interest rates are so low that $r<g$ is not only an interesting case theoretically, it's also the realistic case empirically. And unlike in Tobin's and Friedman's day, the advisability of central bank independence is rarely questioned—certainly not by anyone invited to Jackson Hole!

Last, but certainly not least, today's policy issue is not the monetary-fiscal *mix*; both authorities are doing everything they can to stimulate aggregate demand. The more immediate fiscal-monetary issue (at least potentially) is what has come to be called *quasi-fiscal policy*, meaning central bank purchases of assets (or making loans) that entail some risk of loss—thus "spending taxpayer money" in an actuarial sense.

This issue first came to the fore in the U.S. in 2009, when the FOMC ventured away from long-held norms in two dimensions: To fight the financial crisis, it did an extraordinary volume of lender-of-last-resort lending, and it started adding non-Treasuries to its portfolio—specifically, agency debt and mortgage-backed securities. Some members of Congress saw the Fed's novel operations as encroaching on Congress's power of the purse. "Probabilistic spending, not just lending," you might call it. In consequence, there was notable blowback against the Fed's unbridled powers and against some of its specific anti-recession actions.[6]

For that and other reasons, several proposals to curb the Fed's powers were seriously considered while Congress debated what eventually became the Dodd-Frank Act of 2010. Miraculously, however, the Fed dodged almost all of these bullets and emerged with more power than before. Kudos to Ben Bernanke. The main exception was some limitations on the Board's Section 13(3) emergency lending powers.[7] The quasi-fiscal issue is still with us, however; I will return to it below.

But I want to focus more on a broader issue and make the case that maintaining the traditional wall that separates (and insulates) the central bank from the Treasury may be neither *feasible* nor *desirable* in a serious crisis. Put differently, *we don't want* and *we can't get* central bank independence in a crisis. As this may be a revolutionary thought in this venue, let me elaborate.

Start with feasibility. Financial markets are always interconnected, but those connections tighten in a crisis. Remember the old market adage: "In a crisis, all correlations go to 1." In normal times, some markets and financial institutions are supervised and regulated by the central bank (examples: banks, the payments system, …) while others are supervised and regulated by other agencies (examples: the stock market, futures markets, …). Institutional arrangements differ across countries. And it is probably not disastrous if each regulator makes its own decisions.

But linkages across markets tighten in a crisis, perhaps alarmingly so, and panic can spread quickly both within and between markets. So, someone needs to take overall charge. Who will sit in first chair? The central bank is one obvious candidate. But it seems unlikely that the Treasury and other government agencies will step aside and cede their authority to the central bank. One reason is the same one that bothered Tobin and Friedman decades ago: the central bank's lack of political legitimacy.

In addition, the central bank may lack the relevant expertise in areas that fall outside its normal purview. The Fed's failed Main Street Lending Program is one prime example. The central bank was, of course, unfamiliar with lending to "Main Street" businesses. Maybe that's why its original term sheet posted a *minimum* loan size of $1 million.[8] That probably looked like pocket change to the Fed, but it is rather more than most "main street" businesses want to borrow. The job of lending to main street belonged in other hands.

Then should the Treasury take overall charge? Probably. But it will almost certainly have to lean heavily on the central bank for expertise, personnel, and—above all—for funds. After all, only the central bank has an unlimited balance sheet and can serve as the lender of last resort, a role that is certain to be critical in a crisis. This means that the Treasury and the central bank must *cooperate*.

Which brings me to *desirability*. Surely, we do not want the central bank and the Treasury acting *independently* during a crisis. When markets are seized with fear, allowing market participants to see any daylight showing between the Treasury and the central bank courts disaster. The two agencies must present a united front. Metaphorically and probably actually, the heads of the central bank and the Treasury should be on the phone several times a day. That's a far cry from independence, but it's needed in a crisis. Remember, the main argument for central bank independence is that the time horizons of political decisionmakers are too short. In a crisis, however, everyone, including the central bank, has a short time horizon. We have to find ways get to close-of-business on Friday.

In sum, the doctrine of CBI probably needs to go into hibernation during a crisis, much as the bears in the Grand Tetons do each winter. The trick, of course, is ending the hibernation as easily and naturally as the bears do. How easy or hard it will be for the central bank to regain its independence after a crisis will vary from country to country, and perhaps across time, depending mainly on how friendly the government is toward the central bank. It all worked out fine in the U.S. after 2009, and I suspect it will again once the COVID crisis passes.

III. Tomorrow

Which brings me to the near-term future. Mindful of Yogi Berra's warning about predicting the future, I nonetheless feel confident in predicting that central banks around the world will be dealing with the effective lower bound on short-term nominal interest rates regularly over, say, the next decade. This prediction presumes, of course, that real rates won't revert to their higher historical norms and that inflation will not spiral upward—except transitorily. Either supposition could prove wrong, but both are widely shared.[9]

If our future is one of "permanently" low short rates, and the business cycle has not been repealed, the Fed and other central banks will be forced to rely more than before on forward guidance and large-scale asset purchases—not short rates—as their main tools for influencing aggregate demand. This is a big change that raises a host of issues, including the one I mentioned earlier: The regular use of QE in *non-Treasury* instruments could lead to periodic confrontations with Congress and others over what are seen as "quasi-fiscal" operations—especially if the Federal Reserve ever incurs a loss.

The credit risk on GSE debt issues in the U.S. is, of course, nearly zero. But optics may matter as much as, or more than, financial realities. Congress and the public may worry more than they should about the Fed suffering losses on mortgage-backed securities (MBS). And how many realize that the Fed holds only agency MBS—or even that there is a difference? The possibility of incurring losses is an even bigger issue in other nations, where central banks buy a wider range of assets.

Nor are possible central bank losses the only issue raised when a central bank strays away from a Treasuries-only portfolio. For example, sectoral allocation of resources is now once again an issue in the U.S. as the Fed acquires MBS during what some people see as a house price bubble. An analogous issue for the European Central Bank is how to allocate its purchases of sovereign bonds across member states.

I close with a piece of unsolicited advice for the FOMC, many of whose members are here today. When the time comes for tapering, taper MBS purchases faster than Treasury purchases. And when the time comes to shrink the balance sheet, shrink the MBS portion faster. Yes, it's true that acquiring both Treasuries and MBS exert general downward pressure on long-term interest rates. But MBS carry some political and sectoral baggage that Treasuries do not. That's a fiscal-monetary interaction that the Fed does not want.

Author's note: I am grateful to William Dudley for extremely helpful comments on an earlier draft. The opinions expressed herein, however, are entirely my own.

Endnotes

[1]Alan S. Blinder, "Issues in the Coordination of Monetary and Fiscal Policy," in Federal Reserve Bank of Kansas City, *Monetary Policy Issues in the 1980s*, Proceedings of the Jackson Hole Symposium, August 1982, pp. 3-34.

[2]Alan S. Blinder, "Central Bank Independence and Credibility During and After a Crisis," in Federal Reserve Bank of Kansas City, *The Changing Policy Landscape*, Proceedings of the Jackson Hole Symposium, August 2012, pp. 483-490.

[3]That policy mix also drove up the exchange rate and decimated American manufacturing. But that concern came a bit later.

[4]James Tobin, Discussion, in Federal Reserve Bank of Kansas City, *Monetary Policy Issues in the 1980s*, Proceedings of the Jackson Hole Symposium, August 1982, pp. 45-46.

[5]Milton Friedman, "Should There Be an Independent Monetary Authority?" in Leland B. Yeager (ed.), *In Search of a Monetary Constitution*, Harvard University Press, (1962), pp. 178, 188.

[6]I document some of this in Alan S. Blinder, *After the Music Stopped*, Chapter 13.

[7]Some people at the time viewed these limitations as a serious problem. But when push came to shove in 2020, the Treasury not only eagerly approved everything but probably pushed the Fed into new areas of emergency lending.

[8]*https://www.federalreserve.gov/newsevents/pressreleases/files/monetary 20200409a7.pdf*

[9]At the time of the symposium, the TIPS market was forecasting a 10-year inflation rate of about 2.4% *for the CPI*. This rate almost exactly matches the Fed's 2% target for *the PCE deflator*.