

General Discussion: Should the European Central Bank and the Federal Reserve Be Concerned About Fiscal Policy?

Chair: John B. Taylor

Mr. Taylor: Thank you very much, Sebastian. We have a couple of questions here, Jean-Philippe would you please get us started?

Mr. Cotis: I am not going to say the Stability and Growth Pact is an ideal theoretical object, but it is there. I am not sure it imparts such a deflationary bias to European activity. I guess the recent doctrine in Europe was that we should aim, at least, at structural budget balance. This is not silly in a context of aging populations, staffing pension reforms, and very high unfunded liabilities. Having reached a position of structural budget balance, you have ample room for automatic stabilizers to play and enough to cope with large negative output gaps, from 4 to 6 percentage points of GDP. I don't have to remind you that automatic stabilizers are twice as large in Europe than in the United States. So, what went wrong in Europe over the past few years? I guess fiscal policies went wrong, quite independently from the pros and cons of the stability pact.

A number of European countries ran pro-cyclical fiscal policies during the late 1990s, leading to a marked deterioration of their structural balances. It was neither good for economic stabilization nor for the long-run sustainability of public finances. So, I doubt that deteriorating further the structural balances in Europe will be helpful on either count. A few words about Germany now. Unfortunately, I am not quite

sure that Germany's main problem is primarily a demand one. It is much more of a structural problem. In any case, Europe is now faced with an area-wide slowdown, which has been met with reasonably accommodative monetary conditions. They will benefit Germany. From a theoretical point of view again, I am sure the Stability and Growth Pact is something that is not perfect, but in practice it was not applied. The fact that some countries did not really stick to the philosophy of the pact during the previous upswing—running pro-cyclical fiscal policies—is really at the root of the problem. Not sticking to the spirit of the pact has been the major source of economic destabilization.

Mr. Taylor: Thank you. Let's go through other comments before we have the panel respond. Larry Summers, please.

Mr. Summers: We have talked about the fiscal theory of the price level and Alan's equation 1 with respect to the United States, Europe, and emerging markets. I want to raise the possibility of whether it doesn't have very substantial relevance to the situation in Japan, which is the one place where we have not talked about it.

If you look at Alan's equation 1, we traditionally talk about fiscal policy, which is the right-hand side of the equation, and monetary policy, which is left-hand side of the equation. The problem we encounter, if there is a liquidity trap, is that m and b are perfect substitutes. So, switching m and b back and forth doesn't have any effect. One way around that is the one that Allan Meltzer has suggested a couple of times, which is to say that there is some other asset, and if you switch around $m + b$ for that asset, you will have a substantial effect. That is a way of looking at the problem. Another way of looking at the problem is to think about what used to be called "money-financed fiscal expansion." That is, an increase in g minus t , supported by an increase in m with no change in b . That doesn't change the government's level of indebtedness. That does provide for a significant expansion. It doesn't involve the kind of proximate external implications that a change in the exchange rate, as was earlier suggested, and is available as a mechanism if the whole world were to find itself in this difficulty. So, I'd be interested in somebody commenting on the fiscal theory of the

price level as relevant in Japan and whether we are not a bit hobbled or held back by our traditional divisions conceptually between what constitutes fiscal and monetary policy in Japan.

Mr. Taylor: Thank you, Larry. Alan Auerbach is next.

Mr. Auerbach: I have two related points about debt measurement and a short point about the fiscal theory of the price level.

First of all, regarding the Growth and Stability Pact, there was a discussion of problems relating to basing it on deficits rather than debt. Both of these relate to deficits and debt as measured. In the United States and even more so in Europe, we have enormous and very rapidly increasing levels of implicit debt, so that both the deficits and the debt would look very different if one incorporated these accumulating liabilities. Indeed, how to measure them is not clear. Having a pact that attempts to pick a particular measure and impose restrictions on that strikes me as a first-order problem in fiscal control. I don't think this issue has gotten enough attention.

A similar point relates to the interchange between the authors and Alan about finding the effects of the explicit debt level or deficits on interest rates: Any theory that says explicit liabilities should matter because we are in a world of finite horizons also says that implicit liabilities should matter. Those move around a lot, so leaving them out of an equation trying to explain interest rates is a really good explanation for why the included variables don't have any impact or as much of an impact as we believe them to have.

Finally, on the fiscal theory of the price level, I offer a comment that relates a little bit to the point Sebastian Edwards made about indexed debt. If you had a world in which there were no nominal assets at all—if you were in a nonmonetary world—the government's budget constraint would still hold. We could still do the test of whether we are in a Ricardian or non-Ricardian world. And we might reject that we are in a Ricardian world. What would that tell us? It wouldn't tell us that the fiscal theory of the price level applies because this world doesn't have a price level—the price level is indeterminate; it doesn't matter.

We would know in that world there would be some other adjustment. It might be default of the debt. It might be a change in regime, a future tax increase, a cut in government spending. All of those possibilities, as Alan pointed out, exist when you put money back in the model. I find it very unconvincing when one looks at whether short-run policy satisfies or doesn't satisfy the budget constraint that that tells us anything about whether it is going to be monetized or whether there is going to be a jump in the price level. All it tells us is that something is wrong with current policy and there is going to be some adjustment. It doesn't tell us that the fiscal theory of the price level applies.

Mr. Taylor: Guillermo Ortíz.

Mr. Ortíz: I have just a very brief comment on Sebastian's last remarks. Putting capital controls or imposing other types of limits to the indebtedness of private agents is a pretty bad idea. It is much better to provide incentives for firms to hedge foreign-exchange exposure rather than to think in terms of controls. Let me suggest that one way of doing so is simply by developing derivative markets so that firms can hedge their exposure in a cost-effective way. Another very important incentive is associated with the adoption of flexible exchange rates. We conducted a study in Mexico recently and found there has been a structural change in private-sector indebtedness in the sense that the foreign indebtedness of corporates is now heavily concentrated on exporting firms, while before several firms producing nontradable goods had significant exchange rate exposure. So, firms by themselves are hedging their own foreign-exchange risk once they are provided with the right incentives. It is interesting to look at.

Mr. Taylor: Mickey Levy, please.

Mr. Levy: In your paper you try to identify and test the impact of fiscal policy (changes in fiscal surpluses or deficits) on interest rates or the yield spread, and you find an inverse correlation between projected budget surpluses and the yield spread. I find in looking at your equation 11, both the yield spread and the deficit or surplus projections are both jointly and endogenously determined by real, nominal, and cyclical variables. So, your empirical findings do not seem particularly instructive.

Mr. Taylor: Okay, would you like to respond to some of the comments and then we will take a break?

Mr. Cumby: Let me just start with a couple of brief comments and then Behzad Diba and Matt Canzoneri can join in. First, I think we all agree with Alan Blinder's view that neither the Fed nor the ECB ought to be staying up nights worrying about the fiscal theory of the price level. The reason is that all of the evidence that we look at—direct and indirect, and no matter how we slice it—supports the conclusion that fiscal policy has been sufficiently disciplined to be Ricardian.

Second, it is a bit unfortunate that, for reasons of an expositional clarity, we tend to focus on an economy with flexible prices and with real income and real interest rates given. With sticky prices, the important point still remains that if the fiscal authorities don't maintain sufficient discipline, it is the fiscal authority that controls nominal aggregate demand, not the monetary authority. So, the key question is not whether prices are sticky, but whether fiscal policy is sufficiently disciplined. Price stickiness will affect the economy's response to a change in nominal aggregate demand but not whether the nominal anchor is determined by fiscal or monetary policy.

Third, with indexed debt or real debt, the price level cannot adjust to satisfy the government's present value budget constraint. Something else has to give. It is probably worth recalling the literature on unpleasant monetarist arithmetic, which is a predecessor to the literature on the fiscal theory of the price level. In that earlier literature, the price level does not move to satisfy the present-value budget constraint. Instead, that literature considers how changes in seigniorage can satisfy the present value budget constraint if taxes and spending do not.

Finally, I want to express appreciation to Sebastian Edwards for validating our expectations. We thought about having discussion of how this would apply to emerging markets. We figured that you knew a whole lot more about that than we did, and we wanted to leave you something to say.

Mr. Taylor: Okay, is that it? Anything else?

Mr. Diba: Thanks for the comments. Alan Blinder's point about stocks and flows is well-taken; we just follow the literature in using deficits instead of debt. There is actually a footnote in the latest version of the paper acknowledging the point. In terms of Alan's discussion of the stability conditions under money or debt finance, the main point of the fiscal theory of the price level, as articulated by Mike Woodford, is that in an economy with nominal debt, the present-value budget constraint must always hold in equilibrium. Regardless of the government's financing decision, the private sector satisfies its present-value budget constraint, and the government's budget constraint is just the mirror image of the private sector's constraint. This is also related to a point Alan Auerbach made. We are explicitly dealing with an economy that has nominal debt. So, the present-value budget constraint is satisfied. The question is: To what extent is it going to be satisfied through an endogenous adjustment of nominal GDP, either prices or output?

I fully agree with Alan Blinder's assertion that the FOMC need not worry about the fiscal theory. In fact, the reason we articulated the proposition in the paper was that there were some suggestions in the earlier literature that surpluses must react strongly to debt to put the economy in a Ricardian regime. More specifically, the proposition says that the fiscal response does not have to be larger than the interest rate on debt and can be fairly minimal. So, it should be safe to ignore the issue in terms of practical thinking about monetary policy during normal times.

Once we think that this sort of minimal fiscal policy is present, the question is where do we go with our thinking about how fiscal policy affects the central bank? Our approach is to think of fiscal policy as a source of shocks to which monetary policy may respond. I fully agree with Alan that his Act 4 is the one where the more interesting questions are. In the paper, we offer one particular way of addressing such questions by documenting the responses of interest rates, output, and prices to fiscal shocks.

On Sebastian's points, the comments are appreciated. His comment about indexation is certainly right. If some of the outstanding debt is indexed or denominated in foreign currency, nominal GDP will be more volatile in a non-Ricardian regime. And in the extreme case that he was highlighting, when all the debt is indexed, the present-value budget constraint cannot be satisfied through fluctuations of nominal GDP. The applicability of the fiscal theory to Latin American economies is certainly an interesting topic. There is a very nice paper by Eduardo Loyo that argues the Brazilian inflation of the 1980s can be understood as a combination of non-Ricardian fiscal policy and the adoption of a Taylor rule by the central bank. I think there are interesting and open questions along these lines. However, saying that fiscal policy matters does not necessarily mean that the fiscal theory of the price level is true. For example, in Brazil, it may have been the case that fiscal policy was increasing the supply of bonds that had some liquidity services. The fiscal theory doesn't just say that fiscal policy matters; it also says that the effects of fiscal policy work through changes in the nominal net worth of the private sector. So, the theory emphasizes the types of wealth effects that Alan does not seem to find very reasonable.

Finally, Larry Summers' question points to another interesting application. The fiscal theory would say that switching bonds into money should not matter much, regardless of whether or not the economy is in a liquidity trap. I don't know what the theory would say about Japan, because the theory would imply that changes in expectations about primary surpluses are what matters.

Mr. Taylor: Okay, thank you very much.