General Discussion: The Interaction of Fiscal and Monetary Policy

Chair: Janice C. Eberly

Mr. Dudley: This is a question for all the panelists. Obviously quantitative easing is an important aspect of this linkage between fiscal policy and monetary policy. I think it's pretty obvious that QE has been pretty powerful in terms of making financial conditions very accommodative. That's the good news; it seems to work quite effectively. But I have a couple of questions for the panelists about QE over the longer term. Number one: Is it sustainable long term? We've gone from $900 billion of assets at the Fed to $4.5 trillion to $8 trillion. And if you think that down the road we're going to get hit with some sort of shock that pushes us back to the zero lower bound, you're going to want to use quantitative easing again. Where does this end in the long run? Obviously the bigger the Fed's balance sheet, the more interest-rate risk the Fed takes on its balance sheet. And so how does that work? How do you feel about that? Second, do you think quantitative easing erodes fiscal discipline by artificially pushing down long-term interest rates? Right now, the marginal cost of adding additional debt is really, really low. Bond term premium are zero, or actually negative. Real rates are minus 1%. So, clearly you can borrow a lot without any consequence. How do you feel about that? And third, do you think there's a risk of a crackup in the future when quantitative easing has done in the Fed's raising interest rates

and all of a sudden all these debt service costs that have basically been depressed, come roaring back. Do we actually have sort of a stop/start kind of problem?

Mr. Furman: My question is in most of your comments. You talked about the advanced economies as a whole. I know you differentiate between them and just didn't have enough time to talk about that differentiation. And one or two in particular, to ask what we could learn from two things. The first is inflation in the United States, in the euro area being massively different. Both economies effected by COVID. Both economies have supply-side bottlenecks. Both economies have a lot of the same shocks, but using the HICP (Harmonised Index of Consumer Prices) for a comparable measure of inflation over the last 12 months, it's been 6% in the United States and 2% in the euro area. Moreover, you look deeper into it, both of them have seen increases in goods price inflation, but in Europe service price inflation has fallen. Whereas in the United States service price inflation has risen. Does that say that demand is a bigger part of the story? Does that say there may be more persistence in a different inflation dynamic in the two economies going forward? The second one to learn from is just that huge difference in the Beveridge curves. From the first paper today, you might've thought that the United States, which had unemployment insurance, which goes to a person rather than a job would handle reallocation better than Europe, which did job retention to connect people to the same job. But yet you've seen a big outward shift in the Beveridge curve in the United States. It should have been better at the reallocation and no shift in the Beveridge curve in Europe, and what can be learned from that.

Mr. Blinder: I'll be very brief on Bill Dudley's very good questions. Will there be a crackup in the future? I think it's a possibility, and I alluded to that. We may be facing a period of time in the not-too-distant future, but not immediately, where the central banks wants to be more, much more, contractionary and the fiscal authority does not. To take another part of your question. I believe one of the things that will create more fiscal discipline, which has certainly been eroded, as you said Bill, and as Eric (Leeper) also said, is the burden of debt service. I've had a number of reporters over the last few years ask me: when is the Congress going to get serious about reducing

the deficit? And I said, when interest rates go up—a lot. I probably started saying that four years ago, and it hasn't happened yet, so who knows when interest rates are going to go up a lot. But I think that's likely to be the triggering mechanism.

Mr. Leeper: The only thing that I would add, I think Bill's question is exactly the question we should be asking. That was what I was hinting at when I talked about where do we see norms going. What is the new steady state? Does anybody have a vision of that? And what worries me is when I read what the Fed says about normalization of policy, it sounds like we're going to go back to 2000, and I don't see that. I don't see that at all. And if we're not going to go back to 2000, then we have to confront Bill's questions directly. And I would like to see more serious discussion about that and where we're headed.

Ms. Gopinath: I think the billion-dollar question is what you expect r^* to be, and that plays a very important role. Secondly, I think it is the case that given the size of the balance sheets right now, what else are you going to go and buy? Right. And maybe you're pushing on a string already and now is just getting to be even worse. And so, Jason's (Furman) question on inflation. Jason you're right. You're absolutely right. A very different story between the U.S. and euro area. So, what we find, and this applies more generally, not just to the comparison between the U.S. and euro area, which is if we look at where exactly is core inflation coming back up strongly it's in places where the current growth rates compared to trend is much higher than what we've seen in their history. So, the difference then between the U.S. and euro areas, basically that in the U.S., the recovery came back just faster, much more strongly. And so, we see, we see this inflation effect. And in fact, on the other hand, in the euro area, it's been, it's coming back now, it's coming back with a lag, it's taking a little longer. And secondly, of course, there was also a difference in initial conditions. Core inflation in the U.S. was higher even normal times than it was in the euro area. But as such, I think the demand side story is indeed very important, which is that parts of the world, and this is true when you look at Mexico, Brazil, other countries we're seeing inflation came back, wherever you're seeing demand recovering really fast, is where you're seeing inflation come back up. And that applies to the inflation in services

too, which is that again, this is just that the demand came back much more quickly in the U.S. than it has in these other parts of the world. And of the Beveridge curve indeed it's quite different between the euro area and the U.S., but I think that also has to do with some very important structural differences in the two countries and all these different packages in terms of, you know the Kurzarbeit, that is the short-time work schemes in Germany, the word that all of us have learned now fully, which makes things function quite differently.

Mr. Leeper: I disagree with Gita (Gopinath) about pushing on a string. I think we are pushing on a string in terms of reserves, but we're sucking up so many Treasuries that that's my argument for why I think it might be contractionary to keep doing these LSAPs.

Ms. Gopinath: That sounds worse than pushing on a string then, Eric.

Mr. Leeper: Yes. We're contractionary.

Mr. Taylor: About Alan's (Blinder) recollection on 1982. I gave a paper at the same meeting and it was called "The Role of Expectations in the Choice of Monetary Policy." And it seems to me, as we look at both fiscal and monetary policy, we're not focusing enough on expectations of where we're going. We're debating quantitative easing, undoing. There's very little discussion of where the interest rate is. We didn't even talk about the interest rate at this meeting thus far. And it's very important. In fact, the message of 1982, when Volcker was chair, was let's lay out a path and the Fed did, and it worked pretty well. You had an unemployment rate of 10% in 1982; the inflation rate was way over 5%, and both came down. So, it kind of works. The question is, why not lay out a path for the interest rate as best you can. We've done it before; we've done it in the past. That'd be my main suggestion going forward.

Ms. Guerrieri: Yes. I have a question for Eric (Leeper). Given what you said that I heard about the missed opportunity for the U.S., we show COVID bonds differently financed. I was wondering if you think that the European recovery fund in a sense went in the right direction by basically issue a bounce, the worst specifically created for that moment. And what's your view on that?

Mr. Brunnermeier: I would like to come back to points related to and going beyond macroprudential regulation. In particular I would like to point out that is there a danger that we end up in financial depression especially, given the high debt level we are facing. How would the financial depression play out at the end? How would it interact with monetary and fiscal dominance regimes? What will be the interplay, if we add to it a financial dominance regime. I would appreciate it if the panel members could elaborate on these connections.

Mr. Leeper: The critical thing about the idea of COVID bonds is how they get financed. It's not what they are, what the revenue or the is getting spent on. So, that was the insight, I think, from the recovery of 1933, was that Roosevelt specifically made the financing of the bonds that were sold for relief measures, conditional on developments in the economy, in particular, he wanted to raise the price level. And so that's the really critical point, is that he said, I'm not going to raise taxes until the economy recovers. And, so, if you know, Europe did that, if they tied the financing of the bonds to the bonds themselves, then I think it could work, but it's harder because they don't control money. Right? The individual countries. So, they would have to do it in a coordinated way across the whole union.

Ms. Gopinath: Yes. To Markus's (Brunnermeier) point, again, to be clear, talking about the need for expanding macroprudential regulation beyond where it is now narrowly, which is mostly in the banking sector, but also to start paying attention to non-bank financial corporations, to all the kinds of new forms of digital money that's out there and all the new, new kinds of financial tech that's out there. So, I think so, given that we are going, it looks like we will be in this challenging environment of interest rates being low. In terms of financial repression, I do think of that being a concern in emerging and developing economies.

Mr. Blinder: To John's (Taylor) question, expectations surely matter. I would never say they don't matter. But I think a lot of modern macro—now, this is my personal opinion—overstates their importance. It's hard to say that without sounding like a Neanderthal, so I want to repeat: I don't think they're unimportant. They are; they

do matter. They absolutely do matter. You may remember as I do the days when only the Reserve Bank of New Zealand projected what it thought interest rates were going to be in the future and almost all the other central bankers that came to Jackson Hole thought they were nutty. You could only do that in New Zealand, or something like that. And now it's routine. They may not go out as far as you'd like, John, but I think if you were computing error bands on forecasts of the short rate that go beyond the Fed's, current horizon, which varies a little bit depending on the time of year, they'd be so enormous that the forecast would be deemed meaningless. The last point I want to make, and I made this a number of times but nobody ever listens, is that the Volcker disinflation went right along with the conventional Phillips curves of the day. That is, if you plugged into Bob Gordon Phillips curves of that era the path of the unemployment rate caused by that tight monetary policy, it predicts the decline in inflation almost perfectly.