General Discussion:
Monetary Policy Implications of Greater Fiscal Discipline

Chairman: Gordon Thiessen

Mr. Thiessen: Thank you very much, Helmut. I think the experience of Germany and the proposals of the European Union are certainly very important. Time for questions. I can't resist having the first question. When I heard Mervyn King's unpleasant arithmetic for fiscal policy of a disinflationary monetary policy, I must say, I was thinking about the alternative. Mervyn, in your example, if you start out with a 6 percent inflation rate, I just wonder how credible a policy that is—if that's the alternative to disinflation? And I wonder if, in the end, you don't generate a lot of uncertainty about future inflation and end up with some substantial uncertainty premiums in your interest rates; and I wonder whether fiscal policy in the end doesn't pay equally dearly? To start off with a situation of high debt and high inflation, that's a terrible place to be. You don't want to have to start from there.

Mr. King: That is exactly the right answer. The cost you incur when you try to bring inflation down is simply recognizing the cost you have incurred while allowing inflation to rise in the past. At some point, you are going to have to tackle the problem—but it is better to tackle it earlier than later on.

Mr. Thiessen: Okay. Questions?

Mr. Angell: John, I have a question. You talked about the impact of moving from the present deficit as a percentage of GDP in the United States to zero on interest rates. But I didn't hear you say, or read in your paper, if we made that transition, what would happen to the price of gold. What would happen to the price of houses? What would happen to steel scrap prices? What would happen to the price of oil?

Mr. Taylor: Well, what about the price of a college education? I don't know; you could fit everything in there. I think the answer to your gold question depends on monetary policy's reaction to the deficit reduction. If the central bank continues to assume there is no change in the real interest rate, then the lower deficit would lower inflation and would thereby have an effect on all prices, including gold. There may also be some relative price changes of the goods you mention in your questions, but I would say my only real confident answer would be about average prices and that would depend on inflation. Some of the relative price changes depend on *how* the budget deficit is reduced. You know, is reduction more on spending? More on taxes? I would have to have a lot more information to get to some of those other relative prices.

Mr. Thiessen: Question over there.

Mr. Wessel: John, I'd like to ask a question in my simple-minded reporter's way that I think actually represents the way similarly simple-minded politicians think about this. It's true that monetary policy should be forward-looking. Monetary policy works with a lag. Deficit reduction will have a contractionary effect on the economy. It might even happen in advance of the actual spending cuts—truly, defense contractors aren't going to hire if they know there are no contracts down the road. Surely, people will react differently if they know their Medicare premiums are going up a year or two in advance, or the subsidies to college education are disappearing. Another premise: that long-term interest rates, or at least medium-term in the three-year to five-year window, reflect in part expectations about what short-term rates are going to be. Why doesn't all that lead you to conclude that the Federal Reserve should reduce

interest rates in advance, rather than waiting? Perhaps, instead of doing the whole 100 basis points, discounting it for the expectation that there will be a lot of slippage, and reduce them by 50 or 75 basis points?

Mr. Taylor: Well, first remember that it is only my simple example that leads to one-seventh of the 1 percent per year. If there's more deficit reduction in the first year, and that seems like a good forecast, then, I would say a little bit more interest rate reduction in the first year makes sense. I think the principle of matching the fiscal policy, not necessarily lagging it, but basically doing it simultaneously makes a lot of sense. Because, first of all, long rates will decline if it's clear what is going on—and long rates are very important in a number of these markets. The lower long rates would be somewhat stimulative. In fact, there could even be some upward pressure on short rates because of a favorable effect of long rates on the economy in the short run. Some econometric model simulations show that. So, just to talk it through, it seems to me that if you do it gradually it makes a lot of sense; it is consistent with the gradual reduction in the deficit. And the other thing I mention in my paper is that there are a lot of problems with the central bank's making a judgment about the credibility of the fiscal policy. For example, what if you make a 75-basis-points change and next year's deficit reduction doesn't happen. Are you going to say, "I'm sorry, we're going to take those cuts back because fiscal policy wasn't credible?" I think that would be kind of hard to do. So, I think those issues are important too. They may be harder to explain, but I would add that to my list of why to go slow in adjusting monetary policy.

Mr. Thiessen: Question down here?

Mr. Barnes: Obviously, the financial markets are going to give you a lot of information about the credibility of changes in fiscal and monetary policy. But what you really want to know is the split between inflation expectations and changes in the real rate, and you can't determine that in the United States. As Mervyn King pointed out, the United Kingdom does have quite a long history of index-linked bonds over a period of which there have been big changes in

fiscal policy. I was wondering if he could tell us if there is any information that he's gleaned out of the relationship between index-linked behavior and conventional bond behavior. How does the credibility of fiscal policy changes come through in those markets?

Mr. King: Well, as you say, it is certainly true that the existence of index-linked bonds makes it much easier to try to form an estimate of inflation expectations and real interest rates. Of course, in the United Kingdom, a small, open economy, it's not likely that the sorts of changes to fiscal policy that one sees from year to year would actually have a major impact on real U.K. rates, because those are set largely in the world capital market. But one can see the impact over a period of time of adopting what I called "sound policies" on expected inflation, which has certainly come down. It is true that we have not reduced expected inflation to a level consistent with our own stated inflation target. And that, I think, is a reflection more on public opinion in the United Kingdom. Will public opinion over the next ten years support the commitment to sound policies that we've seen over the past ten? It is not a reflection on any government; it is on the public as a whole. But I think the use of index-linked bonds can be very helpful indeed, both in looking at trends over time and looking at the impact of particular events, such as the announcement of a fiscal consolidation package on expectations. And I would commend that use to others.

Mr. Thiessen: Question over here?

Mr. Malkin: Something I haven't heard about is the effect of the globalization of financial markets over the past five, six, or ten years, which have been greatly accelerated. To what degree can practitioners tell us—and I'm thinking of the two discussants—whether or not they figure more heavily in their own calculations, either the inability to inflate away debt or, in Mr. King's case, adopting an unsustainable policy which the markets immediately veto? I'm thinking about hedge funds and bond funds obviously moving more quickly now than they would have ten years ago. Does that, in fact, change the operation within a central bank—the way it operates, the way it thinks?

Mr. King: Well, if I can give a quick response, and then allow Helmut to have more time. It doesn't change the way one thinks, in the sense that the way monetary policy is set is by looking ahead to where inflation is likely to go in the absence of a policy change and then changing policy in order to hit the inflation target. But certainly the existence of highly mobile international capital flows affects, first, the relationship between national deficits and the interest rate and, secondly, the speed with which changes in anticipations about future monetary policy show up in current interest rates. And that is a highly useful reminder to those who set interest rates in the United Kingdom, but it is important not only to stick to, but to be seen to stick to, the commitment to the inflation targets. So it doesn't change the basic framework, but it changes some of the parameters within which that framework is operated.

Mr. Thiessen: Helmut?

Mr. Schieber: Yes, thank you. Of course, we have to take into account the integration of the international market, but I think these issues make us even more cautious in respect to our assessment of fiscal policy. If you look at the different countries, G-7 countries or other countries, you see that we have large differences in long-term interest rates, despite the integration of the international market. That means that the markets are well aware of the fiscal positions of different countries and the general political situation in different countries. And it shows clearly which countries have earned the confidence of the international investor and which ones have not. So, if you want to have low nominal as well as real interest rates in an integrated international capital market you have to pursue a very convincing fiscal policy—and a convincing monetary policy as well. So I think credibility of fiscal policy and monetary policy are even more important in a world of integrated financial markets than before.

Mr. Malkin: My question was whether or not over a period of, let's say, a decade or fifteen years, in your experience, this has made a notable difference?

Mr. Schieber: Yes, I think it has made a considerable difference. Fifteen years ago, it was easier to make monetary policy focused mainly on the domestic situation. Now, we have much more to bear in mind: the considerations of the international investors and markets as well as the assessment of our own position by the international media. This has changed dramatically in the last fifteen years.

Mr. Thiessen: It also means that the exchange rate is going to be an important channel for monetary policy—certainly for small, open economies. A tightening or easing of monetary policy is certainly going to show up in the exchange value of your currency. Okay, another question.

Mr. Kenen: I'd like to ask Mr. Schieber to elaborate a bit on his suggestion that an additional treaty might bind the members of the European Monetary Union. As I understand the present treaty, it already contains a binding commitment on the part of member countries to avoid excessive budget deficits—in other words, to conform to the 3 percent and 60 percent deficit and debt figures to which you referred. I agree that the sanctions in the present treaty are weak. What more would you hope to accomplish by an additional treaty?

Mr. Schieber: Yes, thank you for this question. If you look closely at Article 104C of the Maastricht Treaty, which contains the "excessive deficit procedure," there is less a weakness of the sanctions, I think, than a weakness of the procedures. It provides very difficult procedures to come to a sanction, in case of a slippage of fiscal policy. So what we have in mind is to talk with our future partners in the EMU about having mainly a quicker response to a slippage in fiscal policy. For example, one possibility would be to introduce automatic sanctions and use the procedures of Article 104C only to allow exemptions from these automatic sanctions. This would strengthen fiscal discipline substantially, accelerate the working of sanctions, and change the role of the Ecofin Council, the Commission, and the Monetary Council. Exemptions would only be possible, for example, in case of a real depression of an economy, a justified and accepted working of automatic stabilizers, or similar cases.

Mr. Thiessen: We've got time for one more question. Murray?

Mr. Sherwin: As a representative of perhaps one of the smallest and most open of the economies around here, I'd like to offer a few observations on these fascinating issues. I guess our starting position would have been much the same as John Taylor's in the presumption that declining fiscal deficits and declining public sector debt would assist the credibility of monetary policy. Now that we are reducing public sector debt very sharply, and indeed running fiscal surpluses, has monetary policy credibility in New Zealand been enhanced as a consequence? Frankly, I don't know. I suspect not a heck of a lot has happened. And that comes back to the point that someone was making before about small economies and large mobile international capital markets. The debt issues and the fiscal issues become important at the edges; and in between time what happens is a consequence of what is going on with international real rates. We don't make any presumption that monetary policy should be eased in line with fiscal consolidation. Indeed, as fiscal consolidation has proceeded apace over the last couple of years, we have, if anything, been tightening monetary policy. And that is a consequence of very strong growth and emerging inflationary pressures, which we felt obliged to counter. Finally, just a note on Mervyn King's unpleasant fiscal arithmetic: Yes, indeed, that's exactly what we saw. We really had to run very hard to stand still in those early phases as real interest rates went up, as growth went down, and the fiscal situation or the deficit situation became very difficult to hold. The other side of the coin is the speed of the improvement once we got over the hump, which has been very dramatic; and I think that most people find that a rather pleasant scenario to be going through.