General Discussion: Luncheon Address

Chair: Peter Blair Henry

Mr. Bullard: If you look at the debt levels for major countries post-crisis they’re all kind of lowish or going lower, and the graphs all go way up, and it really doesn’t look like it’s coming down. If anything, it might be drifting a little higher to stabilize. So, that looks exactly like what you just described and I don’t see the inflation from that. So, explain this to me.

Mr. Sims: That’s why I said, it’s not deficits; it’s deficits together with convincing people that these are deficits aimed at producing inflation and that don’t imply future contraction.

Mr. Bullard: But it really doesn’t look like that.

Mr. Sims: If you really believe that, if you can get the markets to believe that, it would be great. But if the markets really believed that, they should be unloading this stuff and they’re not. There seems to be a tremendous appetite for government nominal bonds. There are two kinds of pathology for monetary policy from this perspective of fiscal theory. One is that you have made government nominal liabilities too unattractive. Everybody’s trying to get rid of them; the economy is exploding with inflation. The other is that you’ve made government nominal liabilities too attractive and everybody wants them; you’ve got to persuade them that they’re not that great an investment.
Mr. Kimball: So, think of a situation where there’s a substantial amount of government debt. It seems to me that governments tend to stare at the regular deficit numbers, that there would be a marginal propensity to consume out of the kind of wealth effect of the changes in interest rates that was pretty close to one. If a government saves on paying less interest as the interest rate goes down, and you went to negative rates as far as you needed to, wouldn’t just the government spending that amount stabilize things?

Mr. Sims: This is a little technical. If you have no lower bound on the interest rate, then it is enough that as the money flowing into the budget goes in, eventually the legislature wakes up and starts running smaller primary surpluses. That’s exactly the same, though with the opposite sign, as how you kill a hyperinflation. But that doesn’t work if you’ve got the zero lower bound. You get to the zero lower bound, and a one-time fiscal expansion only creates a one-time effect. It doesn’t create the permanent shift that you need. But you’re right, if we did what you would like to do, which is eliminate the zero lower bound, then all you’d need in the way of a fiscal reaction would be that eventually the legislature wakes up and sees, “Gee there’s this money flowing in; let’s do something with it.” The reason it doesn’t work, unless they do something, is this money is coming out of the private economy. It’s a kind of fiscal contraction. When you run negative interest rates, you’re taking spending power out of the economy. Those negative interest rates can only be stimulating if some of what you’re taking out gets pumped back into the private economy.

Mr. Reis: As you nicely put it, generating inflation in the fiscal theory of the price level is about making the government bonds less attractive investments, so that the price level will jump. However, this implicitly assumes that default will never happen. Your policy suggestion requires the government to make its bonds less attractive and, as importantly, to commit to always pay them in full, so the only possible way for them to lose value is through inflation. How do you think governments can do this commitment? Can you rule the equilibrium in which people start thinking, “Well, if the governments are doing this they must be willing to default,” and then we have default instead of inflation in equilibrium?
Mr. Sims: Yes, you can add default to these models and make them still more complicated. Default on nominal debt never of course has to occur. It does sometimes occur especially if foreigners hold most of the nominal debt. But my view is that analyzing outright default is really hard. The appeal of inflation is that it is not just a form of default. It’s uniform, the courts don’t get involved, nobody has to argue about who’s taking what loss. As soon as you start defaulting, questions arise: is it that you’re not going to roll over this current issue of the debt; are you going to postpone payment on this issue or that issue; will you default on all the debt or just that held by the foreigners. You can see how messy it got in the case of the Greek debt. I think any time you get default you get effects that are bad on financial markets and on general uncertainty that are beyond and quite different from what you get from inflation. But it’s certainly true that the possibility of default is worth considering. Nobuhiro Kiyotaki, my colleague at Princeton, argues that inflation is not really a way for the Japanese to get out of their problems because their net debt is much smaller than their gross debt. So, there’s lots of maturity transformation within government agencies. As a result, if they started to inflate, there would be problems with agencies like the postal savings system, which is huge and holds maturity mismatched assets. Inflation and interest rate rises would cause balance sheet problems in such agencies that could become new charges on the fiscal system. So you could see how it’s possible selective default might be more appealing than inflation. But then analyzing that, I don’t want to try to get into it. In principle it makes everything more interesting.

Mr. Spriggs: You say that people should believe that there’s a credible expectation that the fiscal authorities would respond with a stimulus at the zero lower bound, but you’ve seen political discourse. President Obama was raked over the coals for one stimulus, raked over the coals because that created a deficit and then, even though he reduced the deficit at a rapid rate, he got raked over the coals because he’s still running deficits. His critics are saying, “He’s ruining the country, we’re going to have these debts forever because of President Obama.” Where’s the rational expectation coming from? The fight that the administration has had to try and even do something has been ruinous to his reputation.
Mr. Sims: It’s not true just in the United States. In Europe it’s as least as bad, the rhetoric that says that government deficits and debt have gotten very high, running deficits are bad. Any notion that there could be a kind of fiscal stimulus that would actually get us off the zero lower bound is very hard to get across. In the United States, I like to quote the Gallup poll—my written paper, which will be available afterward, I think has that link to the Gallup poll—where they ask people what about Social Security when you retire. The majority of people who aren’t retired yet say, “Oh, I don’t think there will be any Social Security when I retire.” So Alan Blinder says, “See, that’s not rational expectations. That’s people don’t even have a clue.” It’s true, but you don’t need rational expectations for this to undo the effects of fiscal stimulus. All you need is when they see a deficit they don’t feel richer. And I think if they think that their Social Security is at risk because of the deficits and the debt, deficits are not going to make them want to spend. The concentration of people who think carefully about the economy in the central banks is greater than any other institution. The best hope for people understanding these dynamics is that the people in the central banks understand it and are willing to say publicly that this is what’s necessary. Of course it’s very difficult to change views on these things, but it won’t start if the people who do understand it keep their mouths shut.

Mr. Kaplan: My question is a follow-up to that. Let’s assume, as central bankers, we are increasingly talking about this—about the need for fiscal policy and other economic tools beyond monetary policy. It still could take many years, as was just suggested, for there to be action. What shall we, as central bankers, do in the meantime regarding monetary policy?

Mr. Sims: I think it’s very difficult. If I were in a policy position in a central bank, I would be trying to monitor what people expect of fiscal policy and adapting monetary policy to that. In Brazil, when they got into this situation, the central bankers realized raising interest rates is not actually helping; it’s making things worse. So they held back. The interest rates were already very high, but not as high as the inflation rate. I think the corresponding thing here is to say, well if we’re thinking about going to negative rates, how is that going
to do good? It’s going to take money out of the banking system and my colleague, Markus Brunnermeier, has a paper which goes through the micro details of that. But it takes money out of the banking system. If the banking system manages to overcome that by passing it off to depositors, it will be taking money from the depositors. You have to ask what are your monetary policy actions going to do given what you can predict fiscal authorities are going to do in response and given what you can predict about the way the public is going to interpret it. When you get to very low interest rates and you’re at zero, and you make some institutional changes that allow you to go to negative rates, what does the public think? They think things must be really bad, and furthermore that rates are at the bottom. They can’t go lower. Stephanie Schmitt-Grohe and Martin Uribe suggested that doing the reverse, raising rates, might be a good idea. But raising rates only works if everybody is convinced that there will not be bad fiscal reaction in the opposite direction. Actually in models with sticky prices monetary tightening in the form of interest rate rises still creates a recession and still reduces inflation temporarily. But when the effect of that recession is over the inflation rate is at a new higher level. So monetary policy in these circumstances becomes extremely difficult. If you could be sure that fiscal policy was completely stuck, i.e., that the primary surplus was going to be what it was going to be no matter what, then an interest rate rise would be temporarily contractionary but might eventually have good effects. I think it’s hard to guarantee that you wouldn’t get counterproductive fiscal responses and you wouldn’t get effects on the public’s beliefs that are counterproductive. So I don’t advocate increases in interest rates. Increases in the interest rates work to increase inflation if you’re on an equilibrium that everybody understands, in which primary surpluses are stuck and the central bank is setting the interest rate without regard to the inflation. But we’re not in that kind of equilibrium. One reason this discussion is so difficult is that we don’t have any long history of an equilibrium in which fiscal policy and monetary policy had the forms they do now. We had this long span from the 1960s through the 1990s when monetary policy was in a relatively stable form, fiscal policy was probably basically Ricardian. We could estimate stuff from that. And the public could form expectations based on the stable history. Right now in the situation where the Fed...
can't do what the central policy rules say it should be doing, and it's taking on doing new kinds of actions, the public doesn't know how to predict the effects of those actions. Even the central banks are not completely sure. And we can't estimate the results of any action by looking at periods in history where this was actually done. You can look at the Great Depression. In the Great Depression at the time of the United States going off gold, there were also legislative initiatives and political campaigns with inflationist platforms. There's a nice paper by Andrew Jalil and Gisela Rua examining this episode. And that episode was temporarily very effective in expanding demand. But people got so scared by the fact that it actually did increase inflation that a lot of it was reversed within the year. But it did look like initially expectations adjusted very rapidly. The business press went from saying Roosevelt’s not going to change anything, to saying, whoa, we’re in an inflationary era. Maybe you can engineer that here.

**Mr. Fischer:** I wonder if you could help me with an argument I lost many years ago about a note you wrote to Karnit Flug, the governor of the Bank of Israel today. Treasury wanted the Bank of Israel to pay for something. I don’t know, I think it as membership in some international organization. It wasn’t here, it was Shar Pei. And I said, “Well, this is ridiculous. In the end, every payment we make comes out of the profits we transfer to you. So, why don’t you just pay now?” Well, the Bank of Israel’s balance sheet is heavily foreign exchange as is common in small countries that trade fairly extensively. And so there’s an ongoing problem and as the currency appreciated, the Bank of Israel had losses. So Israel’s reply was, look, we never expect to get any money out of you anyway, so pay it. What should I have told him?

**Mr. Sims:** You know the answer obviously. If I pay, I’ll issue even more money. This notion of a lean balance sheet is something that is possible in countries like the United States, U.K., and Japan where we have fiscal authorities issuing debt in our own currency. The European Union has a tough time with it because there isn’t a euro bond yet. Maybe there will be; one hopes. But in Israel or other small countries that have to stabilize the exchange rate and hold large amounts of foreign reserves, there’s always fiscal risk. Actually, I think
in those countries, people kind of understand that. Peter Stella has
documented that there are lots of central banks that operate with
negative net worth at market value for long periods of time. That’s
possible so long as they aren’t issuing interest-bearing liabilities that
are larger in value than their interest earning assets. When you get
to that point, you really need a capital injection. And if you’re in a
country with commodity markets that are very volatile or otherwise
very unstable, it’s quite possible to get into that situation. And some
countries just handle it, it’s just understood. Every once in a while
the central bank may need a little plunk of government bonds. Fine.
In Chile they’ve gone for years with negative net worth on their cen-
tral bank balance sheet, but they’ve voted a plan to recapitalize over
years and years the central bank. And markets don’t worry about it.
Nobody worries about the fact that the central bank balance sheet is
negative. But there’s clearly a fiscal impact. If you have a lot of inter-
est bearing liabilities and not many interest earning assets, you’re not
going to be turning much seigniorage over, and part of central bank
independence is that fiscal guys are not supposed to complain about
that. That’s what you should tell them. Central bank independence
says you don’t complain.