

Thoughts on fiscal versus monetary policy as stabilization tools

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The theme.

Ignoring political economy and governance issues:

Fiscal policy has more and better tools than monetary policy to stabilize output.

Unfortunately, political economy and governance issues matter very much...

What can be done? Two directions:

To limit discretion: Quasi-automatic stabilizers. Harder to use than it sounds

To deal with remaining discretion: SDSAs. Also harder to use than it sounds

But both are still worth exploring (more than has been the case today).

A starting point. The plain vanilla NK model

One (and a half) distortions: nominal rigidities. (monopoly power). Preference, productivity shocks

Set interest rate equal to flexible price neutral rate (remove monopoly markup, then first best)

Divine coincidence. Natural output, inflation. Two birds, one stone.

Give independence to the central bank.

Very powerful paradigm, has shaped discussion, research, and policy mix itself.

Obviously, much too simple:

Heterogeneous consumers. Different wealth levels, distribution effects

Role for fiscal policy as redistribution, not stabilization.

Getting closer to reality (still ignoring political economy). 1

More distortions, more complex shocks. Then, fiscal policy can easily dominate

Reason: It has many potential tools, can affect intra-temporal and inter-temporal tradeoffs.

Balance of income and substitution effects (income tax, temporary decrease in VAT, etc)

Example 1. Proportion x of hand-to-mouth households, with zero interest rate elasticity.

Obvious limits of monetary policy. Only affects directly $1-x$ of households

Fiscal policy works, particularly strongly on the hand-to-mouth households

In a recession, can focus on this particular subgroup, which has the largest consumption decrease

Difference with monetary policy however. Legacy debt. How costly depends on $(r-g)$

Getting closer to reality (still ignoring political economy) 2

Example 2. (of current relevance). Economy hit by an adverse supply shock (say one-time permanent energy price increase)

Fixed markup over cost. Real wage rigidity: Takes x periods for workers to accept the cut.

High but not full anchoring of long run inflation expectations.

Monetary policy. Have to accept inflation for some time and increase unemployment.

Fiscal policy. Compensate workers for the loss of real income for x periods. No second-round effects

Even better. Subsidize the price of energy and avoid first round effects altogether. No inflation.

Dangers (as we saw in the US).

Two goals. Protection, and aggregate demand management. Not the same.

Phase out not easy. Legacy. Yes, higher deficit for x periods. Again, cost depends on $r-g$.

Has it worked? Too early, but for the time being, conditional yes.

Getting closer to reality (still ignoring political economy) 3.

Other relevant dimensions. Reliability, uncertainty, and scope.

Monetary policy. One and a half instrument (QE) .

Long/variable lags (fixed rate mortgages e.g.). Zero lower bound.

Unclear effects of QE. Collateral effects

Decreased interest elasticity of aggregate demand (?)

Fiscal policy. Plethora of potential tools:

Intra-generational, playing with income and substitution effects. U benefits/Cash for clunkers

Intergenerational, through deficits and debt.

Fairly reliable effects. Multipliers.

Reintroducing the political economy.

If benevolent, technically competent, dictator: Fiscal policy wins.

If not, clear advantage to monetary policy:

A clear mandate, widely accepted. (especially under divine coincidence).

Can be given independence.

Challenges of fiscal policy. Deficit bias. Wars of attrition. Political lags.

The more tools, the worse the Christmas tree aspect, the worse the lobbying.

Can we do better? No magic solution, but two directions to explore:

Make more of fiscal policy automatic.

Put in place rules to maintain debt sustainability.

Quasi-automatic stabilizers. 1.

Existing ones: Not designed for stabilization. Fiscal stabilization coefficients vary from 0.2 to 0.6 as function of size of government, progressivity of tax system, etc.

Need quasi-automatic: function of some aggregate measure (longer u benefits as function of level of U)

Not so simple. The challenges

1. Scope?

Clear that cannot address exceptional (but not so exceptional) events: GFC, Covid: has to be discretionary

For standard fluctuations, many different sources of shocks. Potentially many stabilizers (lower VAT rate for construction if construction is weak, subsidy if energy price increase, etc...).

Mandate: wide political agreement for stabilization, much less for more specific measures.

Hard to design a large set. Down to: income tax cut versus consumption tax cut?

Quasi-automatic stabilizers. 2.

2. Trigger?

Stabilizers stabilize output (or unemployment) not the output gap (or the unemployment gap)

In real time, do not know whether change in $U - U^*$, or U^* ($Y - Y^*$ or Y^*)

Better to use variable whose natural value X^* changes slowly.

Blanchard Quah (updated). Proportion of variance due to transitory (“demand shocks”) 8 quarters ahead: 11-25% for Y , 53-81% for U (depending on detrending assumptions)

So suggests unemployment rate as trigger. But can lead to change in income tax or other.

3. Debt neutrality? Symmetry of the essence, but not enough:

If $(r-g) > 0$, will increase debt. Need a feedback rule a la Bohn. $x = a(U - U^{*e}) - b D_x$
such that $r-g-b < 0$. Over time $(U - U^{*e})$ goes to zero, and D_x goes to zero.

Can such a rule be implemented?

Making sure debt is sustainable. 1

Can one put in place rules which enforce debt sustainability, without excessively constraining fiscal stabilization policy?

Automatic stabilizers can be designed to be neutral for debt.

Discretionary fiscal policy will however remain central, especially re exceptional shocks.

Nearly by nature, all exceptional shocks are adverse shocks. What deficit can a country afford?

Discussion of EU fiscal rules has been extremely productive.

Substantial intellectual progress, some policy progress likely.

Making sure debt is sustainable. 2

Debt is sustainable if it is expected to converge to a stable debt ratio with high probability.

Trajectory matters more than level.

Simple numbers will not do in a changing environment. Painful lesson from EU rule history.

SDSA is the right diagnostic tool. Ways to organize the discussion.

In practice, many assumptions, reflecting true uncertainty. But DSA part gives clear signals.

Discussion useful on its own. And publication allows investors to make a better assessment

What intermediate target? Structural primary balance. Net expenditure path.

Current situation $r-g = 0$. Need primary deficit to credibly converge to zero.

Taking seriously the German worries. Is there need and room for debt or deficit “safeguards”?

Enforcement is of the essence. Top-down allocation of funds. Strong national fiscal councils.

At EU level, withholding of funds. At national level? Naming and shaming? Market reactions.

Conclusions

Too much weight on monetary policy.

Many potentially useful fiscal tools

More room for quasi automatic stabilizers. Progress remains largely to be made.

Better ways of monitoring and insuring debt sustainability. Some progress made, with lessons for others.