



AN UNCONVENTIONAL COLLABORATION

Sometimes monetary and fiscal authorities need to break the rules and act together

Giancarlo Corsetti

Since the conquest of inflation in the 1980s, economic policy in advanced economies has converged toward the model that shapes our thinking today. By targeting low inflation, monetary policy can stabilize economic activity. That frees fiscal authorities of the need to fine-tune policies to support aggregate demand, allowing them to focus on delivering public goods and pursuing redistributive goals. Fiscal policy's contribution to anti-cyclical stabilization should ideally be left to automatic stabilizers, such as unemployment insurance.

Each of these policies is best implemented by independent institutions with clear mandates

concerning their objectives. Explicit coordination across fiscal and monetary authorities confounds responsibilities and tends to misdirect instruments (for example, monetary financing of deficits). This can erode the credibility and hence the effectiveness of a policy. The model has an international dimension as well. By keeping their house in order countries contribute to global stability and welfare.

Why reforms are needed

Recent history has highlighted several “cracks in the vase.” First, in a low-inflation environment, nominal interest rates are low on average, leaving little room for expansionary cuts—what’s known

as the “effective lower bound” constraint. This may prevent monetary authorities from delivering the required countercyclical stimulus. Second, when government debt is high, monetary and regulatory authorities—even if formally independent—may feel pressured to act in favor of budget sustainability by, say, keeping rates too low for too long. This issue is especially relevant when inflationary shocks call for a credible monetary response. Third, when private debt and leverage are high and tangled up in financial markets, high government debt leads to systemic vulnerability to liquidity and solvency crises, which may also weigh excessively on the conduct of monetary and fiscal authorities.

Since the global financial crisis, these “cracks” have already led to changes in the institutional structure of economic policy. In many countries, supervisory, regulatory, and resolution powers in the banking sector are no longer delegated to dedicated institutions but have been returned to central banks. Central banks have expanded their unconventional policies, letting their balance sheets grow very large by purchasing government bonds and other assets. These policies may have significant implications for income and wealth inequality, crossing paths with fiscal policy. Macroprudential policy is now an important component in the design of regulation. Across borders, central banks have set up extensive currency swap lines with their counterparts to address international liquidity.

Economic vulnerability to large shocks has clearly not abated. If anything, economies should strengthen their resilience to deal with climate, energy, demographic, social inclusion, and geopolitical challenges. The question is, Should the economic policy model be reformed further? Most crucially, does stabilization require closer coordination and engagement across decision-making institutions within and across borders? If so, how would this coordination work?

We do not have good answers, but there are important lessons from theory and history that can arguably help structure our thinking.

The (r)evolution of the ‘policy mix’

In classical economic theory, the workings of the policy mix are illustrated by Nobel laureate James Tobin’s “funnel” model: stimulus originates from two taps, M (monetary) and F (fiscal), but the amount that flows into the economy is independent of the relative contributions of M and F.

The same aggregate stimulus (that is, nominal demand) can be generated via loose money and a tight budget—or the opposite. The social value of countercyclical fiscal expansions is highest where policy rates are stuck at their effective lower bound and inflation remains stubbornly below target. Maintaining ample fiscal space to pursue budgets in such situations is therefore a prerequisite for effective stabilization. This is what motivates precautionary budget saving—controlling spending and/or maintaining tax revenues—during the expansionary phase of the cycle.

Recent theory offers a new perspective on how F and M interactions can jointly stabilize an economy at risk of a deflationary spiral. With rates at the effective lower bound, when low demand generates deflation, this translates into high real interest rates, depressing demand further. To avoid this spiral, suppose that the fiscal authority temporarily scales up deficits, committing to neither raise taxes nor cut spending. This means that, all else equal, debt is no longer sustainable and financial markets may start charging a risk premium. Suppose, however, that given such deficits the central bank, again temporarily, commits to guaranteeing the face value of outstanding government liabilities in nominal terms (to rule out outright default risks) and does not react to any change in inflation. In this way the central bank de facto lets the economy run hot with the deficits. Provided these policies are not anticipated by the private sector and/or the maturity of outstanding nominal government liabilities is long enough, the ensuing rise in the price level will reduce the real value of public debt, in line with the present discounted value of primary surpluses.

It is worth reflecting on the complexity of this strategy. Its success rests on the idea that, in special circumstances, the monetary and fiscal authorities may benefit from acting together in ways that are particularly improper in normal circumstances. The budget creates unsustainable debt; the central bank de facto monetizes this debt. For this mix to work, however, the suspension of good-behavior rules must be temporary and limited to exceptional circumstances. Not a walk in the park: the policy can succeed only where constitutional rules are strict and monetary and fiscal institutions are strong and independent. Yet it is worth noting that the policy should also work in reverse: by the same mechanism, running budget surpluses that increase the real value of debt would help reduce inflation.



Restoring moderation

For the reasons explained above, price, financial, and macroeconomic stability places a strict joint requirement on monetary and budget policy. Central banks must pursue price stability in the medium and long term. Fiscal authorities must guarantee debt sustainability, adjusting their policies consistent with the inflation objectives of the central bank: in practice, the government must credibly raise the structural primary surplus—and with sufficient intensity—in response to any rise in the stock of debt.

There is a strong argument for sticking to these policy prescriptions in the current high-inflation, high-debt environment. First, even if unexpected inflation can provide some short-term fiscal relief, giving in to a regime of high and variable inflation eventually leads markets to charge an inflation premium, that is, higher interest rates. Hence it is bound to raise government borrowing costs and worsen the fiscal outlook. Second, since fiscal consolidation (spending cuts or higher taxes) contributes to containing aggregate demand, it makes the central bank's job easier—the monetary contraction can be less severe.

Nonetheless, the explosion of public liabilities during the COVID-19 years challenges the model's resilience. The required adjustment of primary surpluses may be difficult to achieve and sustain on political and economic grounds. Now it may well be that, after the current inflation crisis passes, the world will go back to a secular stagnation scenario, with low real interest rates (r) below the growth rate (g). But this is cold comfort. A negative r minus g would help contain the debt-to-GDP dynamic but would likely come with other negatives, such as low productivity growth. Governments could be pressured to run very large deficits for economic or social reasons; high debt could still result in high risk premiums that systematically destabilize the fiscal outlook.

A test bench for the model

In the aftermath of the global financial crisis, most central banks provided a monetary backstop to public debt. That is, implicitly or explicitly, they stood ready to intervene in the government debt market and prevent increases in borrowing costs based on expectations of rising interest rates. A leading example is the European Central Bank's Outright Monetary Transactions program in 2012.

A successful monetary backstop does not require the central bank to actually purchase government

bonds. It works best as a credible threat to intervene that discourages market speculation (in economic jargon, it prevents investors from coordinating their expectations on a high-interest-rate equilibrium). The credibility of this threat, however, depends on several conditions, including, crucially, cooperation by the fiscal authorities. Why? Because bond purchases expose a central bank to the risk of balance sheet losses. Such losses would force the monetary authorities to fire up the money printing press and thus deviate from their price stability mandate. Unless the Treasury offers contingent fiscal guarantees on the central bank balance sheet (that is, transfers money to the central bank in case of losses), investors may doubt whether the monetary authorities will really take the risk and intervene in the market.

A well-designed monetary backstop can rule out self-fulfilling sovereign risk crises, but stability ultimately depends on fiscal policy. Unless, conditional on the backstop, debt is on a sustainable path, central bank engagement in the government debt market can only destabilize inflation expectations. The economy would remain vulnerable to self-fulfilling expectations of inflation that drive up both nominal and real borrowing costs for the government.

These are major risks facing advanced and some emerging market economies where debt is (predominantly) denominated in their own currencies and central banks are independent. A credible understanding between fiscal and monetary authorities about how to act together to contain vulnerability to expectations-driven crises is an essential building block of a reliable economic policy regime. **FD**

GIANCARLO CORSETTI is the Pierre Werner Chair and a professor of economics at the European University Institute.

Further reading:

Bartsch, Elga, Agnès Bénassy-Quéré, Giancarlo Corsetti, and Xavier Debrun, eds. 2020. *Geneva 23: It's All in the Mix: How Monetary and Fiscal Policies Can Work or Fail Together*. London: CEPR Press.

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Zhang, Tongli. 2021. "Monetary Backstop and Sovereign Default on Domestic Debt." Johns Hopkins University Department of Economics, Baltimore, MD.