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Chapter 8 Interaction of Monetary and Fiscal Policies: Why Central Bankers Worry about Government Budgets

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This is a topic on which there is an abundance of literature. Books are filled with information on the topic of the interaction between monetary and fiscal policies, which is one of the key, but also one of the more complex, relationships in economic theory. With the role of the central bank lawyer in mind, the discussion below will address the issue from one specific angle, namely the relevance of fiscal policy for central bankers.

Background

Fiscal policy generally refers to the government's choice regarding the use of taxation and government spending to regulate the aggregate level of economic activity. In the same vein, the use of fiscal policy entails changes in the level or composition of government spending or taxation, and hence in the government's financial position. Key variables that policy makers focus on include government deficits and debt, as well as tax and expenditure levels.

Monetary policy refers to the central bank's control of the availability of credit in the economy to achieve the broad objectives of economic policy. Control can be exerted through the monetary system by operating on such aggregates as the money supply, the level and structure of interest rates, and other conditions affecting credit in the economy. The most important objective of central bankers is price stability, but there can be others such as promoting economic development and growth, exchange rate stability and safeguarding the balance of external payments, and maintaining financial stability. Key variables in this policy area include interest rates, money and credit supply, and the exchange rate.

While monetary and fiscal policy are implemented by two different bodies, these policies are far from independent. A change in one will influence the effectiveness of the other and thereby the overall impact of any policy change. Tensions can arise between what

each will do to help smooth economic cycles and achieve macroeconomic stability and growth. That is why it is crucial to pursue a consistent monetary-fiscal policy mix and coordinate these (and other) policies as much as possible to avoid tensions or inconsistencies. This policy mix is a key component of the IMF's macroeconomic policy advice and of IMF-supported economic adjustment programs, together with external, structural, and financial sector policies. In practice, imbalances in the budgetary position have in many cases proven to be a key element in both macroeconomic problems and their solution. For this reason, the IMF was sometimes jokingly said to stand for "It's Mostly Fiscal," although in reality the macroeconomic problems countries are faced with generally consist of a broader mix of imbalances and require a broader set of policy responses.

Relationship

How does fiscal policy affect monetary policy and thus the central banks? There are both direct and indirect channels. Starting with the first category, there are a number of ways in which fiscal policy may impinge on monetary policy. First and foremost, an expansionary fiscal policy may result in excessive fiscal deficits, which may create a strong temptation for governments to resort to the printing press (i.e., monetary financing by the central bank) to finance the deficits. An expansionary fiscal policy, then, leads to an expansionary monetary policy, fueling inflationary pressures, causing a possible real appreciation of the currency and hence balance of payments difficulties, potentially even resulting in a currency (and/or banking) crisis.

But even if governments finance their deficits in a non-monetary way, that is, through the markets, there may be cause for concern, specifically about crowding out: if governments take up (too) much funding in the markets, the result may be too little or too expensive credit for the private sector. This may harm economic development and growth, which would certainly be a concern of central bankers. On the external side, there is the risk that too much dependence on foreign funding of domestic debt results in exchange rate and/or balance-of-payments risks, which again would be worrying to central banks.

There is another, more direct channel of fiscal policy affecting central bankers and that is the impact of indirect taxes on the price

level and thus on inflation. If governments feel forced to resort to substantial increases in indirect taxes—sales taxes, value added taxes—rather than taxes on various forms of income, this will have a direct impact on prices. The key concern here is that a one-off increase leads to a wage-price spiral and therefore permanent (higher) inflation and inflationary expectations.

In addition to these direct relationships between fiscal and monetary policy, there is the more indirect channel through expectations. Perceptions and expectations of large and on-going budget deficits and resulting large borrowing requirements may trigger a lack of confidence in the economic prospects. This may become a risk to the stability in financial markets. Such a lack of confidence in the sustainability of the financial position of the government may become a potential destabilizing factor on bond and foreign exchange markets, eventually even leading to the collapse of the monetary regime.

Impact of Fiscal Expansion

Conceivably, expansionary fiscal policy may at some stage become ineffective as a means to stimulate demand and, similarly, fiscal contractions may turn out to be expansionary.[1] When economic agents realize that the government is borrowing too much for its own good, they will conclude that this can only lead to higher taxation levels in the future, and they may decide to compensate for that already now by saving more and consuming less. This so-called "Ricardian equivalence" means that the financial behavior of economic agents—on which central banks base their monetary policy decisions—depends on their perception of fiscal sustainability. It is therefore another example of how fiscal policy can (indirectly) affect the effectiveness of monetary policy.

It should be noted that the impact of fiscal policy on central bank objectives is not automatically avoided when the central bank is independent. Even when the central bank has independence, and hence is not submitted to the fiscal needs of the government, the need to offset the impact of expansionary fiscal policy on aggregate demand and inflation in the economy could prompt the central bank to tighten monetary policy, by raising interest rates or reducing credit in the financial system. The resulting high interest rates could depress economic activity, attract short-term and easily reversible capital in-

flows—thereby adding to inflation and appreciation pressures on the currency, and eventually damaging macroeconomic and financial stability.

Severe budgetary problems may even lead to crises. There have been a number of examples of such severe tensions in the past, in which large and growing fiscal deficits—in the absence of needed public sector reforms—led to high real interest rates. This intensified the government's debt-servicing costs, causing a buildup of short-term and foreign currency-linked public debt, thus increasing the sensitivity to interest rate, exchange rate, and rollover risks, which materialized as foreign capital inflows that had helped to finance the debt were suddenly reversed. Examples of this set of circumstances were apparent in the run up to the crises in Turkey (1994, 2001), Mexico (1994), Russia (1998), Brazil (1999), and Argentina (2001).

Even in countries where such extreme conditions did not materialize, the sustainability of the monetary regimes can be challenged by fiscal policies that are too accommodating. This has happened in the past in, for example, Israel and Poland where expansionary fiscal policy caused an overheating of the economy, reviving inflationary pressures and worsening the current account. High interest rates—required to contain inflation—attracted capital inflows that complicated the implementation of monetary policy. Sterilization of capital inflows to keep inflation under check became increasingly difficult and costly for the central bank.

Financial Markets

Another area where monetary and fiscal policy come together is the development of financial markets. Both finance ministries and central banks have a strong interest in financial market development because (1) it is indispensable for economic development and growth; (2) it facilitates funding of deficits and debt; and (3) it enables market-based operations by central banks. As part of financial market development, it is important for the authorities to engage in a discussion with (potential) market participants about market practices, conditions, and possible impediments.

The relationship between monetary and fiscal policy depends strongly on the development of financial markets. The transition from

a rudimentary financial system to a fully developed system can be divided into four stages.[2] In the undeveloped stage, there is no government debt outside the central bank, and fiscal deficits are essentially accommodated by money creation. In the next stage, marketable securities are introduced, but there is no secondary market and interest rates are inflexible. In the transitional stage, a secondary market for government debt instruments exists, interest rates have become more flexible, and central banks conduct more active and independent liquidity management. In the final developed stage, medium-term debt instruments are offered through auctions, interest rates are fully flexible, and central banks control liquidity in the markets through indirect and market-based instruments (e.g., repos). In particular, in the latter two stages, good coordination between the government's financial management (issuance of treasury bills, etc.) and the central bank's monetary policy operations is required.

The Role of Central Bankers

What can central banks do about fiscal policy? First of all, coordination is very important. Even if central banks act on the short end and governments on the long end of the market, their financial activities should be coordinated. Second, communication is key as well. Central bankers expressing views on budgetary policies have become regular features in the international financial press, often in the context of presentations in Parliament and at presentation of reports on the economy. Of course, timing and frequency are important elements, and governors are not expected to issue statements each day. The effectiveness of the message will be affected by the stature and image of the governor and his or her institution.

In their messages, central bankers tend to focus on the medium-term sustainability of fiscal policy more than the short-term policies. This includes a focus on a solid and realistic budgetary process that (1) does not require frequent adjustments during the year (which tend to make markets nervous); (2) is based on "conservative" macroeconomic assumptions, in particular with regard to economic growth (a key variable in any budget), but also with respect to interest rates, exchange rates, and exogenous variables such as energy prices; (3) does not include too many one-off measures and open-ended commitments; and (4) does not imply too many and too frequent fundamental changes in the tax regime (which might create uncertainty and

inefficiencies). At the same time, they will focus on the bottom-line (i.e., deficits and debt) rather than on the specific line-items, to avoid being dragged into a very specific political debate. Last but not least, there appears to be a certain tendency among central bankers to "lean against the wind," that is, to not to be too optimistic when things go well, and not too pessimistic when thing take a turn for the worse, but rather to be realistic.

Medium-term Fiscal Frameworks

In recent years, an increasing number of countries have adopted formal fiscal rules. Central bankers are generally among the proponents of such rules, which can help fiscal authorities better withstand pressures for higher spending and slower fiscal consolidation. The rules, which are often focused on targets for deficits and debt, or on a multiyear spending timeline, are to be embedded in a medium-term fiscal framework based on balanced assumptions for macroeconomic developments.[3]

Fiscal rules can be particularly helpful in cases in which there is no unique counterpart for the central bank, as is the case, for example, in the euro-zone, which is also faced with the issue of a new currency that has a limited track record. In order to enforce fiscal discipline and to ensure that national fiscal policies support the stability-oriented monetary policies by the European Central Bank (ECB), member countries adopted the Stability and Growth Pact (SGP) as a tool for fiscal policy coordination. The rules of the SGP aim at fiscal sustainability by strengthening fiscal discipline through requirements for budget deficits and debts and medium-term fiscal policy objectives.[4]

Transparency

Finally, incorporating transparency into monetary and fiscal policy is key to their effectiveness. In this context, the IMF has developed two important international standards: the Code of Good Practices on Transparency in Monetary and Financial Policies[5] for central banks and supervisors, and the Code of Good Practices on Fiscal Transparency[6] for governments. These codes are important instru-

ments to support clarity in discussions on the necessary coordination between monetary and fiscal policy.

Notes

[1] *See* Rodrigo de Rato, *Benefits of Fiscal Consolidation*, Presentation to the Real Academia de Doctores (Barcelona, 2004).

[2] *See* Sundararajan, V., Peter Dattels and Hans Blommestein, eds., *Coordinating Public Debt Management*, International Monetary Fund, Washington, 1997.

[3] *See* Teresa Daban, Enrica Detragiache, Gabriel di Bella, Gian Maria Milesi-Ferretti, and Steven Symansky, *Rules-based Fiscal Policy in France, Germany, Italy and Spain*, IMF Occasional Paper 225, 2003.

[4] *See* Anthony Annett, Jorg Decressin, and Michael Deppler, *Reforming the Stability and Growth Pact*, IMF Policy Discussion Paper, PDP/05/02.

[5] IMF, 2000, http://www.imf.org/external/np/mae/mft.

[6] IMF, 2001, http://www.imf.org/external/np/fad/trans/code.htm#.