The effects of monetary policy and the role of fiscal policy in the euro area

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Monetary and fiscal policy in the euro area...

Figure 1: ...did not always move in tandem

Fiscal stance: annual change in cyclically adjusted primary balance (% of trend GDP), median and interquartile range of 20 EA countries.

Monetary stance: annual change in shadow rate (%)

Source: AMECO Online Database (cyclically adjusted primary balance) and Cynthia Wu’s website (shadow rate).
Global financial crisis: moving in tandem

Figure 2: Monetary and fiscal policy in the euro area

- **Fiscal stance**: annual change in cyclically adjusted primary balance (% of trend GDP), median and interquartile range of 20 EA countries
- **Monetary stance**: annual change in shadow rate (%)

*Source*: AMECO Online Database (cyclically adjusted primary balance) and Cynthia Wu’s website (shadow rate).
Sovereign debt crisis: policy misalignment

Figure 3: Monetary and fiscal policy in the euro area

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COVID-19 crisis: harmonious policy response

**Figure 4: Monetary and fiscal policy in the euro area**

- **Fiscal stance**: annual change in cyclically adjusted primary balance (% of trend GDP), median and interquartile range of 20 EA countries
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Energy crisis: butting heads again?

**Figure 5: Monetary and fiscal policy in the euro area**

- **Fiscal stance**: annual change in cyclically adjusted primary balance (% of trend GDP), median and interquartile range of 20 EA countries
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*Source: AMECO Online Database (cyclically adjusted primary balance) and Cynthia Wu’s website (shadow rate).*
Q: Do the effects of monetary policy depend on the fiscal stance?

Yes

Kloosterman et al. (2022) estimate effects of monetary policy shocks on inflation and output growth in the euro area. . . across regimes of contractionary and expansionary fiscal policy.

- Contractionary fiscal policy: characterized by positive change in cyclically adjusted primary balance
- Expansionary fiscal regime: characterized by negative change in cyclically adjusted primary balance

Panel smooth transition local projection model, 10 EA countries, 1999Q1-2019Q4
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Kloosterman et al. (2022)

Estimate effects of monetary policy shocks on inflation and output growth in the euro area...

...across regimes of contractionary and expansionary fiscal policy
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Panel smooth transition local projection model, 10 EA countries, 1999Q1-2019Q4
It takes two to tango

Figure 6: Responses to a contractionary monetary policy shock

Notes: First column shows responses to an unconditional one st. dev. monetary policy shock. Second and third columns show responses to a monetary policy shock conditional on being in the contractionary and expansionary fiscal regime, resp. Shaded areas reflect the 90% confidence interval based on Driscoll-Kraay standard errors. Source: “The effects of monetary policy across fiscal regimes” by Kloosterman et al. (2022).
It takes two to tango

Figure 7: Responses to an expansionary monetary policy shock

Notes: First column shows responses to an unconditional one st. dev. monetary policy shock. Second and third columns show responses to a monetary policy shock conditional on being in the contractionary and expansionary fiscal regime, resp. Shaded areas reflect the 90% confidence interval based on Driscoll-Kraay standard errors. Source: “The effects of monetary policy across fiscal regimes” by Kloosterman et al. (2022).
What (else) do we find?

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- The difference in the output response to monetary policy shocks across fiscal regimes is mainly driven by the response of private consumption.

- The importance of the fiscal stance for the effects of monetary policy is more pronounced during recessions.
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- The difference in the output response to monetary policy shocks across fiscal regimes is mainly driven by the response of private consumption.

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- Results underscore the importance of proper alignment of monetary and fiscal policy for the effectiveness of monetary policy, especially during economic crises.
What’s going on?

Two (non-mutually exclusive) views: results reflect...

1. two shocks hitting the economy at the same time, in clashing or complementing ways

2. importance of **wealth channel** of monetary and fiscal policy:  
   (Leeper, 2016; Caramp and Silva, 2022)
   - Monetary policy: interest rate receipts, valuation of bond holdings
   - Fiscal policy: disposable income, amount of bond holdings
Transmission of monetary policy and wealth channel

Consider an increase in the interest rate:

- **Intertemporal substitution effect** makes households want to consume *less*
- **Positive wealth effect** could make households want to consume *more*:
  - if higher interest rate raises interest rate receipts on savings
  - if negative revaluation effect on asset holdings not too strong

Which of the two effects dominates depends on how fiscal policy responds to the rise in interest expenses and increase in public debt:

- Is fiscal policy sufficiently geared towards stabilizing public debt?
- Is there a risk of fiscal dominance?
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The implications of fiscal dominance

- **Monetary dominance**: central bank actively targets inflation, government ensures debt sustainability
- **Fiscal dominance**: forego inflation and debt targets, and let price level ensure debt sustainability
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In theory, if risk of moving to regime of fiscal dominance is sufficiently high, then positive wealth effect could dominate:

- **Rise in interest rate** raises interest rate receipts...
- ...and leads to an increase in government debt...
- ...which households do not expect to be (fully) offset by future taxes...
- ...making them feel wealthier and want to raise consumption...
- ...which **raises inflation**

(Sims, 2011)
Risks of fiscal dominance in the euro area?

Perceptions of fiscal burden \(\Rightarrow\) long-run inflation expectations

- Under fiscal dominance, would expect positive impact
Risks of fiscal dominance in the euro area?

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Table 1: Perceptions of fiscal burden did not raise long-term inflation expectations

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Fiscal burden, Spain</td>
<td>-0.022* (0.01)</td>
<td>-0.12** (0.05)</td>
</tr>
<tr>
<td>Fiscal burden, Italy</td>
<td>-0.022 (0.01)</td>
<td>-0.07** (0.03)</td>
</tr>
<tr>
<td>Fiscal burden, France</td>
<td>0.00 (0.02)</td>
<td>0.09 (0.06)</td>
</tr>
</tbody>
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Notes: The table reports results for the regression of daily changes in five-year, five-year forward inflation swaps on the first common factors of various indicators of sovereign risk for Spain, Italy and France. To preserve space, the coefficient estimates of other control variables (e.g., macroeconomic news variables, the Euro-Bund future implied volatility and Stoxx Europe 600 indices) are omitted. Standard errors are in parentheses. * and ** indicate significance levels at 90% and 95%, respectively. Source: “Do markets see risks of fiscal dominance in the euro area?” by Bonam et al. (2021).
Summing up

- The effects of monetary policy depend on the fiscal stance

- Monetary and fiscal policy interact through the wealth channel

- Wealth effects depend on risks of fiscal dominance
How to better align monetary and fiscal policy?

- More coordination helpful, but could threaten CB independence
  - Need sound fiscal rules that help ensure long-run fiscal solvency…
  - …and rule out fiscal dominance

- Fiscal rules important, but should allow for counter-cyclical fiscal policy
  - Effectively respond to crises, create policy headroom during booms
  - Use transparent and cyclically-adjusted operational targets
  - Establish credible and country-specific debt reduction paths

- May require more fiscal space in the face of large adverse shocks
  - Occasionally activate escape clauses

- Enhance public risk sharing within the euro area
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A naive (ok, maybe not so naive) question. Given how hard it appears to slow down the US economy through monetary policy, maybe fiscal policy could help?
References
References I


