Fiscal and monetary policy interactions

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50th OeNB Economics Conference and 60th SUERF Anniversary Conference
Vienna, 23 May 2023

Conjunctural backdrop

- Inflation remains too high
  - Monetary policy (MP) continues to tighten
- Fiscal policy (FP) consolidating after some years in emergency mode
  - Response to Covid-19 pandemic
  - Response to cost-of-living increases following Russia’s invasion of Ukraine
- Interaction between fiscal and monetary policy important for getting inflation back to target

These remarks

- Highlighting importance of FP-MP interaction, using data since early 1970s on fiscal-monetary regimes
  - Banerjee, R, V Boctor, A Mehrotra and F Zampolli (2022): "Fiscal deficits and inflation risks: the role of fiscal and monetary regimes", *BIS Working Papers*, no. 1028.
- Focus on the effects of fiscal deficits on inflation
  - The policy regime matters for the strength of the relationship between deficits and inflation
- Also some discussion about the current combination of fiscal and monetary policy stance

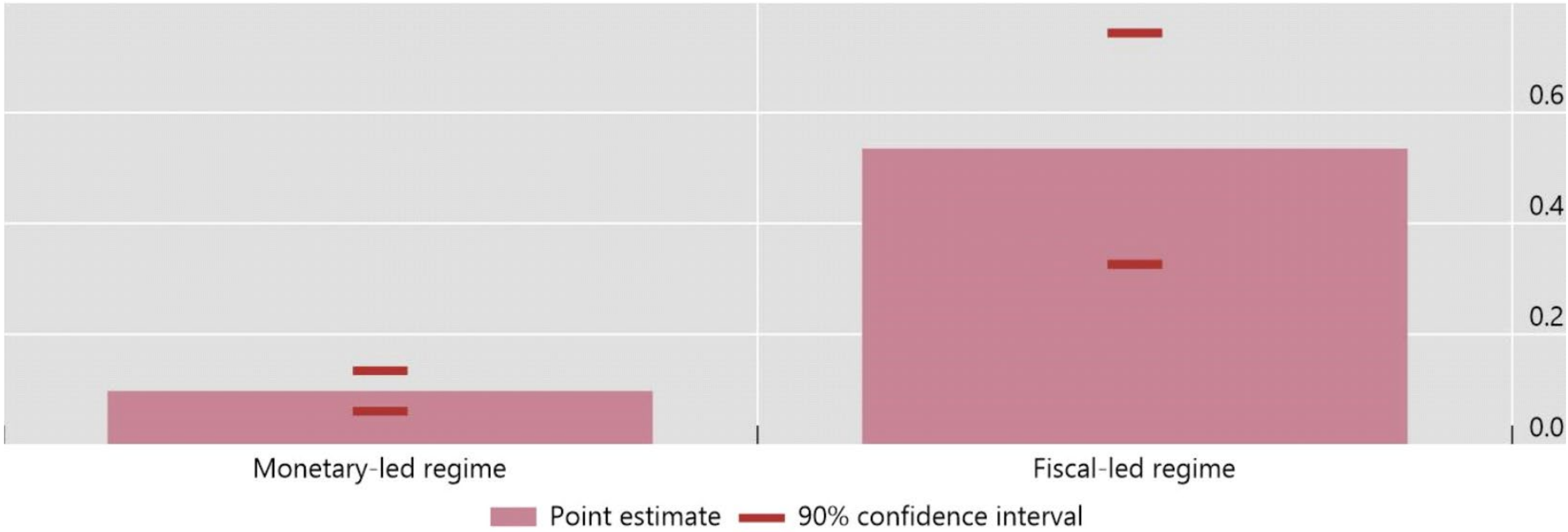
Two fiscal-monetary regimes

- "Monetary-led"
  - Fiscal policy is prudent, ie it stabilises debt over time (Mauro et al (2015))
  - Monetary policy enjoys high independence (Romelli (2022))
    - Condition to ensure inflation stabilisation
- "Fiscal-led"
  - Fiscal policy is profligate, ie it does not stabilise debt
  - Monetary policy only weakly independent
- Data for 21 advanced economies, 1972-2011

Effect of fiscal deficits on inflation by fiscal-monetary regime

In percentage points

Graph 1



The graph shows the effect of a one percentage point increase in the headline fiscal deficit on average inflation over the next two years.

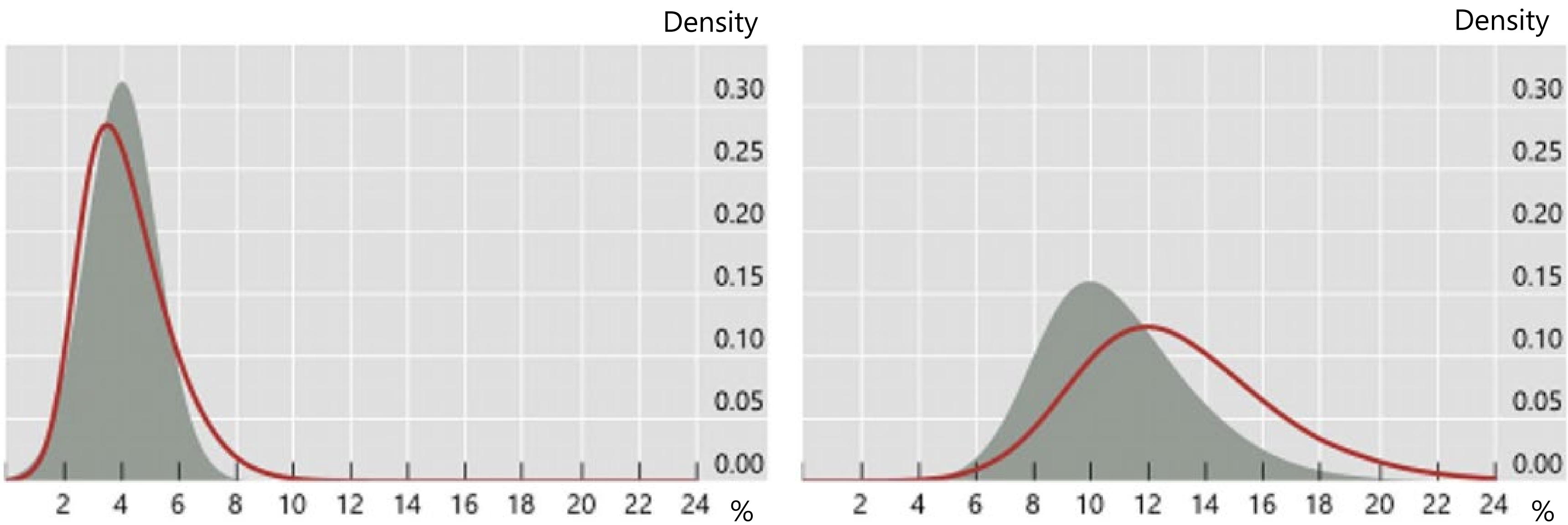
Source: authors' calculations.

Inflation risks

- Policymakers not only concerned about the most likely outcome, but also about the range of possible outcomes
  - Higher deficits could affect tail risks to inflation

- Analysing the behaviour of the entire inflation forecast distribution in the two fiscal-monetary regimes

Inflation forecast distributions vary by regime



(a) Monetary-led regime (b) Fiscal-led regime

The grey shaded density shows the conditional inflation forecast distribution evaluated at the regime-specific sample means of all variables. The red density shows the conditional distribution evaluated at a two standard deviation increase in the fiscal deficit, with other control variables at their regime-specific means.

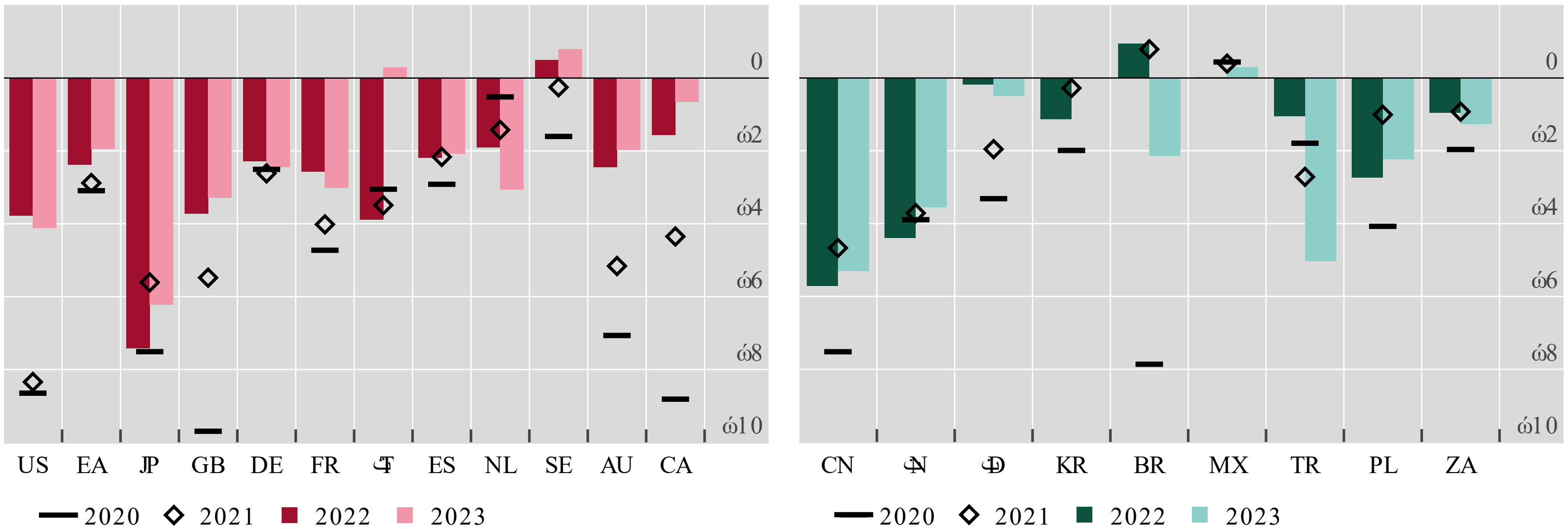
Current combination of policy stances

- Fiscal consolidation should help monetary policy in cooling inflation
  - Less upward pressure on aggregate demand
  - Interest rates would need to rise by less
  - Could also help from financial stability perspective

Cyclically adjusted primary deficits are projected to decline

As a percentage of potential GDP — Graph 3

A. Advanced economies — B. EMEs

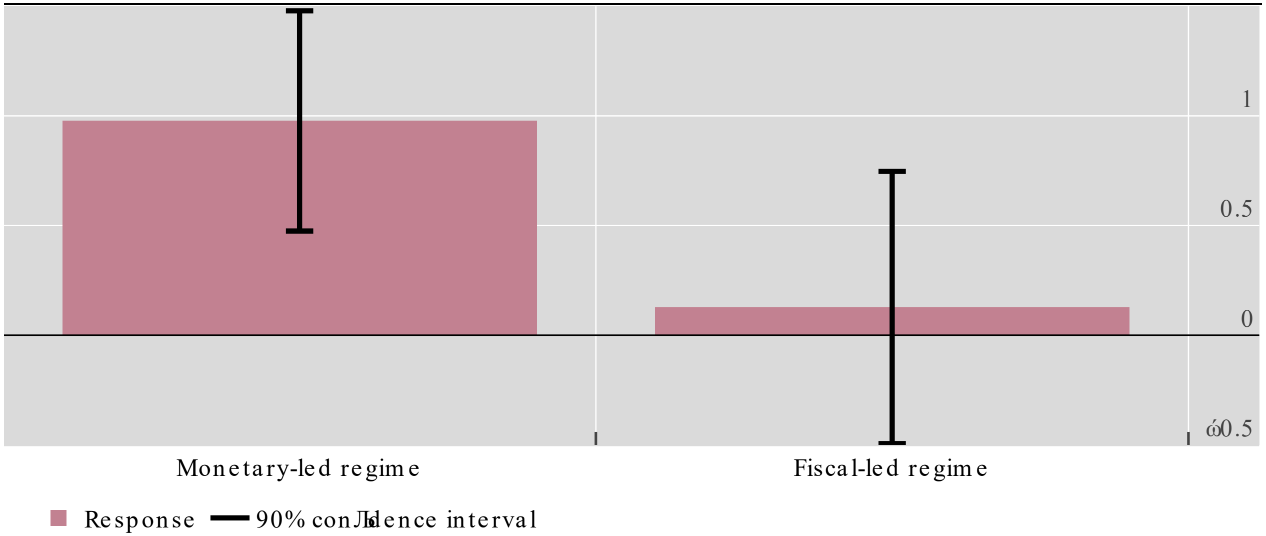


Source: IMF, *Fiscal Monitor*, April 2023.

Impact of monetary tightening on primary balance[1]

In percentage points

Graph 4



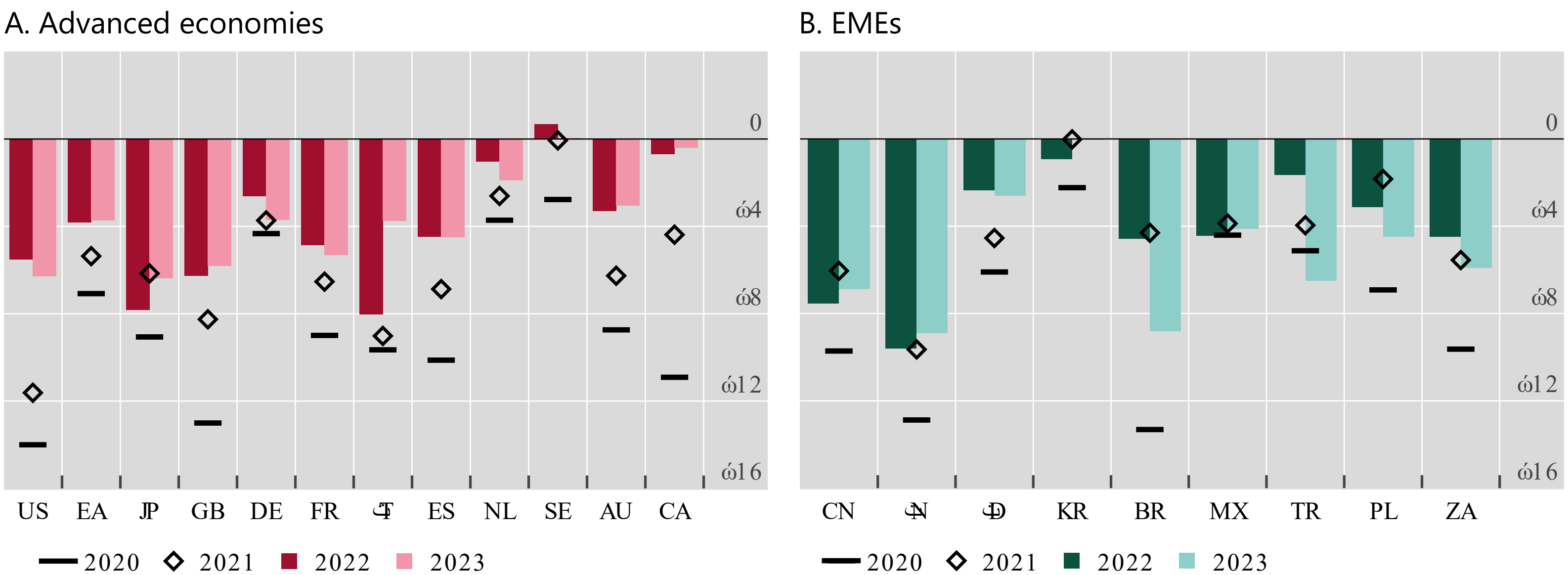
[1] The panel shows the coefficient on a monetary tightening dummy variable in an estimated fiscal rule, based on data for 20 AEs during 1972-2011. A positive coefficient indicates an improvement in the primary balance, over the same year as when a monetary tightening takes place.

Sources: authors' calculations and Boissay et al (2023).

Headline deficits are projected to remain high

As a percentage of GDP

Graph 5



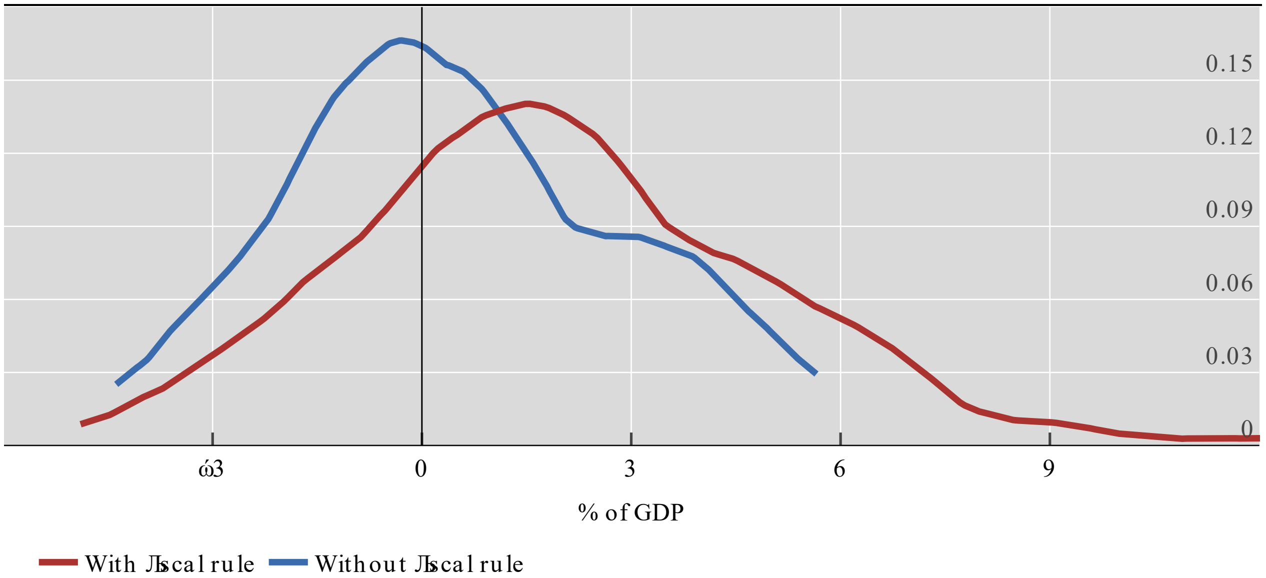
Source: IMF, *World Economic Outlook*, April 2023.

Could fiscal rules help?

- During the pandemic, many countries suspended fiscal rules
- These are now being reintroduced, sometimes with modifications

Primary balances, monetary tightening and fiscal rules[1]

Density | Graph 6



[1] Distribution of primary balances during episodes of monetary tightening. Based on data for 20 advanced economies since 1985.

Sources: authors' calculations and Boissay et al (2023).

Concluding remarks

- Fiscal-monetary regimes and policy interaction key for price stability

- Fiscal consolidation helps monetary policy to curtail inflation

- But fiscal deficits and public debt are projected to remain high in many countries
  - Higher interest rates will increase debt servicing costs
  - Fiscal balances remain vulnerable to future shocks