

CEPR-RIETI Workshop  
“Fiscal Sustainability”

Handout



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# Monetary Policy Responsibility for Fiscal Sustainability

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- Fiscal sustainability is not an exclusively fiscal issue.
  - Monetary policy clearly affects fiscal sustainability
    - Through cost of borrowing
    - Through seigniorage
- If it is not a purely fiscal problem, whose problem is it?
  - The answer matters

# General Framework

Based of Davig and Gürkaynak, IJCB 2015

- Assume the two important issues in the economy are inflation and “the other thing”
- Other thing may be output gap or exchange rates or prudential financial regulation...
- ...or fiscal sustainability
- Social loss depends both on inflation and other thing
- What does optimal policy look like?

- When the central bank is the only policymaker
  - it will balance the two objectives when setting policy
  - In general it will respond to any variable that households care about and is responsive to interest rates
  - No objective will be exactly met but social welfare will be maximized

- When there is another policymaker with a tool that can address “the other thing”, who puts weight on social welfare and also an idiosyncratic objective
  - optimal policy is to assign each policy maker one task (forcing other policymaker to disregard idiosyncratic objective)
  - social welfare is maximized, each objective will be exactly met

# Optimal policy III

- When the second policymaker is maximizing her own objective, what does optimal monetary policy look like?
- This is the key question
- Monetary policy internalizing social loss allows other policymaker to pursue private goals
- It may be better to focus on inflation only to force the other policymaker to take socially desirable action

## Social loss function

$$L_t^S = E_t \sum_{i=0}^{\infty} \beta^i \left( \pi_{t+i}^2 + \lambda^S x_{t+i}^2 \right).$$

## Policymakers' loss functions

$$L_t^{CB} = E_t \sum_{i=0}^{\infty} \beta^i \left( \pi_{t+i}^2 + \lambda^{CB} x_{t+i}^2 \right),$$

$$L_t^F = E_t \sum_{i=0}^{\infty} \beta^i \left( \left( \frac{\lambda^S - \lambda^{CB}}{\lambda^S} \right) x_{t+i}^2 + \left( 1 - \left( \frac{\lambda^S - \lambda^{CB}}{\lambda^S} \right) \right) \tau_{t+i}^2 \right).$$

This mechanically makes the other (fiscal) policy maker put more weight on private goal  $\tau$  when central bank takes on more of the social loss.



# Model II

Even in a model without the mechanical link between loss functions it may be better for the central bank to focus on its own narrow mandate

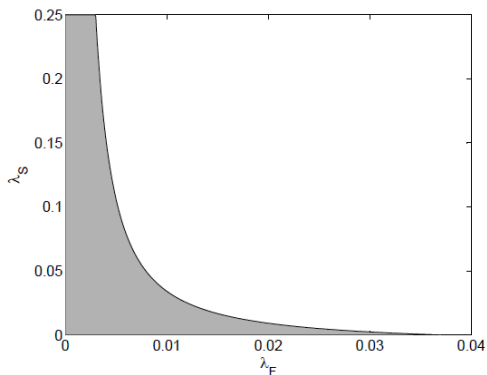


Figure 3: Monetary-Fiscal tradeoffs under relatively steep Phillips curve ( $\kappa = .1$ ): The shaded area represents conditions when social welfare is higher under a pure inflation targeting regime.

- Doing good things that nobody else is doing is not always good
- If you do not do it perhaps somebody who is better able will feel compelled to take care of the problem
- The world does not have a single policymaker and multiple problems
- There are multiple problems and multiple policymakers
- Policymakers play a game among themselves
- Who leads and who follows matters

# Relating to fiscal sustainability

- The fiscal sustainability interpretation of this idea is fiscal dominance in emerging markets
- Monetary policy being the follower (passive) makes fiscal policy worse and also worsens inflation
- Fiscal policy can be too loose because monetary policy will mind sustainability
- Monetary policymakers can discipline fiscal policymakers by adopting a narrower mandate that excludes fiscal concerns
- Turkey in 2002-2007 was a good example

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- Actually hurt recovery in many countries
- Had monetary policy been less willing to shoulder expansionary policies at the ZLB, would we still have such fixation on austerity?
- Very worth thinking about

This is trickier

- Japan does have a fiscal sustainability issue
  - Hoshi & Ito, Economic Policy 2014
- Japan also has a more pressing demand management and reflation issue
- Current expansion and experimentation seems correct



# When fiscal sustainability problem dominates in Japan

- In that case it may well be that allowing inflation to be above target for a while is optimal
- Strict inflation targeting may turn into Central Bank's private concern, inconsistent with social welfare
- Foreseeing this, committing to some form of limited-duration price level targeting now may be beneficial
- That would both increase inflation expectations and ease fiscal sustainability concerns
  - Inflating away some of the debt at ZLB (in expectation and practice) is fine, as long as the deficit is under control and borrowing costs do not soar

# In general

- Developed economies have much to learn from emerging markets about crisis management
- Global financial crisis taught this for banking crises, much less for fiscal sustainability
- Procyclical fiscal policy is a definition of emergingness
- Many developed economies succumbed to this during the crisis
- Being able to blame the ECB for cyclical ills made this easier in the euro area
- Japan does not seem to be in this fold

# Conclusions

- The distribution of mandates and blame across policymakers matters for outcomes
- Central banks have become policymakers of last resort for all policies
- This makes other policymakers less likely to act in line with social welfare
- Emerging markets know this painfully too well for fiscal sustainability purposes
- Many developed economies learned it during the recent recession and austerity
- Japan has its own problems but monetary-fiscal discordance does not seem to be one
- This issue will become more important when fiscal sustainability becomes the pressing issue here