The Interaction of Monetary Policy and Fiscal Policy

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Various Channels of Interaction

- Financing/Monetizing Government Deficits
- Effect of Inflation on Tax Rates and Revenues
- Open Market Operations in Treasury Securities
- Liquidity Trap
- Lags in Monetary and Fiscal Policy
- Short-run vs. Long-run Uses of Policy
- Application to Current Economic Situation
Financing Government Deficits

• Peg Interest Rate to Reduce Financing Costs to Treasury
  • Constrains monetary policy
  • Monetization of large sustained deficits is inflationary
• Treasury-Federal Reserve Accord, 1951
Inflation and Tax Rates

• Tax Code is Not Completely Indexed
  • Historical cost depreciation
  • Taxation of nominal capital gains
  • Feldstein: 2 pct. pt. reduction in inflation increases welfare by 1% of GDP permanently

• Indexation of Tax Code
  • Would sever link with inflation

• IITS
  • Not completely protected against inflation risk for taxable investors
Effect on Deficit of 1 Percentage Point Reduction in Measured CPI

(fiscal years, billions of dollars)

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<tr>
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<tbody>
<tr>
<td>Δ Revenues</td>
<td>1.9</td>
<td>10.5</td>
<td>44.2</td>
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<tr>
<td>Δ Outlays</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social Security</td>
<td>-2.8</td>
<td>-10.7</td>
<td>-44.6</td>
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<tr>
<td>Debt Service</td>
<td>-0.2</td>
<td>-2.0</td>
<td>-32.0</td>
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<tr>
<td>Other</td>
<td>-0.9</td>
<td>-4.5</td>
<td>-19.3</td>
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<tr>
<td>Δ Total Outlays</td>
<td>-3.9</td>
<td>-17.2</td>
<td>-95.9</td>
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<tr>
<td>Δ Deficit</td>
<td>-5.8</td>
<td>-27.7</td>
<td>-140.1</td>
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Open Market Operations Conducted in Treasury Securities

• What If Treasury Debt Disappears?
    • Small debt → small monetary base
      • Inflation and interest rates will have to be high—too high—to clear money market
    • Shrinking debt exacerbated by:
      • Foreign demand for U.S. currency
      • Limit on the fraction of outstanding debt held by Fed
  • Conduct open market operations in other securities
    • Discount window lending at market interest rate is equivalent to OMO
      • Packages of loans, stocks, etc.
    • Loss of risk-free benchmark
Will Treasury Debt Disappear?

<table>
<thead>
<tr>
<th>Holdings of Federal Debt - Billions of Dollars</th>
<th>2001</th>
<th>2011</th>
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<tbody>
<tr>
<td>End of Fiscal Year:</td>
<td>2001</td>
<td>2011</td>
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<tr>
<td>Held by Government Accounts</td>
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<td></td>
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<tr>
<td>Social Security</td>
<td>1170</td>
<td>3722</td>
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<tr>
<td>Other*</td>
<td>1288</td>
<td>2352</td>
</tr>
<tr>
<td>Total in Government Accounts</td>
<td>2458</td>
<td>6074</td>
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<tr>
<td>Debt Held by Public</td>
<td>3294</td>
<td>876</td>
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<tr>
<td>Including Federal Reserve</td>
<td>535</td>
<td>??</td>
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<tr>
<td>Gross Federal Debt</td>
<td>5752</td>
<td>6950</td>
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</table>

*mainly Civil Service Retirement, Medicare, unemployment insurance and the Airport and Airway Trust Fund

(most data from CBO, The Budget and Economic Outlook, August 2001)
Long-Run Debt Projections
(Debt held by public, calendar year, percentage of GDP)

Source: CBO, The Long-Term Budget Outlook, October 2000, Figure 3.
Liquidity Trap

• Requires fiscal expansion to supplement or replace monetary expansion

• Liquidity trap in Japan?
  • Discount rate changes in 2001

<table>
<thead>
<tr>
<th></th>
<th>Jan. 4</th>
<th>Feb. 13</th>
<th>Mar. 1</th>
<th>Sept. 19</th>
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<tbody>
<tr>
<td>Discount</td>
<td>0.50</td>
<td>0.35</td>
<td>0.25</td>
<td>0.10</td>
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• Is U.S. headed toward liquidity trap?
  • Discount rate changes in 2001

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<tbody>
<tr>
<td>Discount</td>
<td>5.75</td>
<td>5.5</td>
<td>5.0</td>
<td>4.5</td>
<td>4.0</td>
<td>3.5</td>
<td>3.25</td>
<td>3.0</td>
<td>2.5</td>
<td>2.0</td>
<td>1.5</td>
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# Short-Run Stabilization: Lags

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<tr>
<th></th>
<th>Monetary Policy</th>
<th>Fiscal Policy</th>
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<tbody>
<tr>
<td>Recognition</td>
<td>Short</td>
<td>Short to medium</td>
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<tr>
<td>Decision</td>
<td>Short</td>
<td>Long</td>
</tr>
<tr>
<td>Action</td>
<td>“Long and variable”</td>
<td>Medium to long</td>
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Short Run vs. Long Run

• Use Monetary Policy for Short-Run Stabilization
  • Long-run goal of monetary policy: low, stable inflation
• Use Fiscal Policy to Achieve Long-Run Goals
  • Spending
    • Guided by benefit/cost considerations
    • Correcting market failures
  • Taxes
    • Collect sufficient revenue with efficiency and equity
    • Minimize distortions
    • Redistributive goals?
• Short-run stabilization with automatic stabilizers
Fiscal Stimuli in 2001

• Spring 2001
  • Economic Growth and Tax Relief Reconciliation Act of 2001
  • Attention to stabilization misplaced at the time?
  • Bizarre phasing of provisions

• Fall/Winter 2001
  • Stabilization use of fiscal policy may be appropriate because of shorter than usual recognition and action lag?
  • Long-run consideration: huge and growing Social Security liabilities