Comments on "Perceptions and Misperceptions of Fiscal Inflation" by Leeper and Walker

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- Under some conditions, the fiscal backing may never be directly invoked in equilibrium.

Stable evolution of beliefs about backing

- It's possible to have a monetary authority committed to a "Taylor principle" policy rule, yet for fiscal actions to affect inflation.
- This is like the Leeper-Walker "regime switch at T" scenario at the end of their paper.
- The difference is that T is unknown, with beliefs about it, or about the nature of the regime after the switch, changing over time.
- Fiscal worries, and the effects of fiscal policy actions on those worries, then directly impact inflation.

What does the "stable evolution of beliefs" economy look like to a New Keynesian?

- Monetary contractions and expansions still affect inflation and output roughly as in a standard NK model.
- The Phillips Curve seems to have an unstable "natural rate".
- The evolution of fiscal worries on the part of the public looks like fluctuations in the Phillips Curve constant term.

Could this have been part of the story of inflation in the 1970's-1980's?

- US fiscal policy was certainly unstable in this period.
- From 1975-85, the US ran primary deficits, often large, as frequently as primary surpluses.
- And the Phillips Curve did seem unstable.
- Deserves further empirical exploration.

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- Conventional theory says these do not matter, only the consolidated government balance sheet is relevant.
- FTPL says these are the battlefield on which fiscal-monetary interactions play out.
- A central bank that is "superficially independent", i.e. with no fiscal backing except its access to seignorage revenue, faces limits on its ability to control inflation.

Balance sheets, cont.

- Most central banks (unlike the pre-2008 US Fed) carry substantial balance sheet risk, with foreign-currency assets balanced by domestic-currency liabilities. Many also end up with bad assets via bailouts. (Peter Stella)

- If net worth at current market prices becomes negative, this places bounds on the bank's ability to control inflation.

- If the negative net worth is only a future possibility, the bank may be tempted to expand capital to a politically dangerous level.

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- So long as the possibility of negative net worth remained remote, the lack of a fiscal counterpart created no immediate problem.
- The possibility is no longer so remote, so fiscal institutions are being invented and modified in real time, with the ECB a major player.
- This may or may not work.

Can a central bank in a monetary union make fiscal transfers?

- This issue is raised in an incomplete analysis at the end of the Leeper-Walker paper.
- It would work via shifts in the allocation of seignorage revenue.
- The amount of the possible wealth transfer is limited by central bank net worth, inclusive of the present value of seignorage.
- The ECB's allocation of seignorage revenue is on paper inflexible, risks to its net worth are currently non-trivial, and it is committed to not generating large seignorage revenue via inflation.

- Hence the ECB's intense interest in fiscal mechanisms to allocate explicitly the losses arising from explicit or implicit default on Euro sovereign debt.