Charles I Plosser: Fiscal policy and monetary policy – restoring the boundaries

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, at the US Monetary Policy Forum, sponsored by The Initiative on Global Markets, University of Chicago Booth School of Business, New York City, 24 February 2012.

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The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.

Introduction

I am pleased to participate in this important forum once again. I am particularly delighted to be a part of such a distinguished panel. This conference has rapidly become one of the premier venues for serious discussions of monetary policy and I am honored to be a part of it.

Fiscal imbalances

During the past year, we have witnessed the ongoing saga of governments, both in Europe and in the U.S., struggling with large deficits and soaring public debt. For the most part, these challenges are self-inflicted. They are the result of governments choosing fiscal policies that they knew would be unsustainable in the long run. Financial market participants remain skeptical about whether the political process can come to grips with the problems. So far, this skepticism appears to be wholly justified. Neither the European nor the American political process has developed credible and sustainable plans to finance public spending. Instead, politicians continue to engage in protracted debates over who will bear the burden of the substantial adjustments needed to put fiscal policies back on a sustainable path. In my view, these prolonged debates impede economic growth, in part, due to the uncertainty they impose on consumers and businesses. Moreover, the longer the delay in developing credible plans, the more costly it becomes for the respective economies.

Given the magnitude of the fiscal shortfalls, the way in which the political process restores fiscal discipline will have profound implications for years to come. Will there be higher taxes on investments by the private sector that risk reducing productive capacity and output in the future? Will there be higher taxes on labor that discourage work effort or hiring? Will there be cutbacks in government expenditures on defense or basic research that might force significant resource reallocations and affect a wide array of industry sectors? Will there be cutbacks on entitlements that could affect health care, social insurance, and other aspects of our safety net? Or will a viable fiscal plan combine various types of tax increases and spending cuts?

These are important questions that involve hard choices and trade-offs between efficiency and equity. Yet, until fiscal authorities choose a path, uncertainty encourages firms to defer hiring and investment decisions and complicates the financial planning of individuals and businesses. The longer it takes to reach a resolution on a credible, sustainable plan to reduce future deficits and limit the ratio of public debt to gross domestic product, or GDP, the more damage is done to the economy in the near term.

Some observers say cyclical factors and the magnitude of the recent global recession caused the current fiscal crisis. It is certainly true that the policy choices made by governments to deal with the financial crisis and ensuing recession have caused a significant deterioration in fiscal balances and debt levels in many countries. However, the underlying trends that are at the root of unsustainable fiscal deficits in many countries, including the U.S., have been in place and known for some time. In the U.S., for example, the major long-run drivers of the structural deficit at the federal level are entitlements such as health care and Social Security.[1]

Thus, even after cyclical effects play out, many countries will continue to have large structural budget deficits. In this sense, the financial crisis and recession have simply exacerbated the underlying problems and perhaps moved up the day of reckoning. In some cases, such as Greece, that day has come. In light of these realities, market participants have begun to question the solvency of governments and their ability to honor their sovereign debt obligations in the absence of deep structural reforms. In Europe, the doubts have greatly complicated the political problems as various countries debate the question of "who pays" for the anticipated bad debts of individual countries. Here, too, the protracted nature of the political debate creates uncertainty, which undermines economic growth and exacerbates the crisis. While some have argued that preventing Greek default would keep the crisis from spreading, that argument has proven false.

The interaction of monetary policy and fiscal policy

The fiscal challenges alone are daunting. Yet, they can also have profound implications for monetary policy and the role of central banks. Today, I want to focus my remarks on that interaction between monetary policy and fiscal policy. Of course, the appropriate relationship between the two is not a new topic. Yet, it has taken on new relevance and importance as a result of the recent crisis and the actions undertaken by policymakers. Let me elaborate.

It is widely understood that governments can finance expenditures through taxation, debt, or printing money. In this sense, monetary and fiscal policy are intertwined through the government budget constraint. Nevertheless, there are good reasons to prefer an arrangement that provides a fair degree of separation between the functions and responsibilities of central banks and those of the fiscal authorities. For example, in a world of fiat currency, central banks are generally assigned the responsibility for establishing and maintaining the value or purchasing power of the nation's monetary unit of account. Yet, that task can be undermined or completely subverted if fiscal authorities independently set their budgets in a manner that ultimately requires the central bank to finance government expenditures with significant amounts of seigniorage in lieu of tax revenues or debt.[2] The ability of the central bank to maintain price stability can also be undermined when the central bank itself ventures into the realm of fiscal policy.

Imagine a situation in which public debt levels are high and rising. Now stretch your mind even more and imagine that fiscal policymakers are reluctant to make the hard choices of cutting expenditures or increasing taxes. Of course, neither of these assumptions requires much imagination. Indeed, history and our daily newspapers provide numerous examples. Unless governments are constrained institutionally or constitutionally, they often resort to the printing press to try to escape their budget problems. Yet, we all understand that this option is a recipe for creating substantial inflation.[3] Indeed, history shows that it is often a path toward hyperinflation.[4]

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[1] In other countries and jurisdictions, such as the state and local level, pension and entitlement commitments also account for a significant source of the growth in commitments and thus are central to the fiscal problems.

[2] See Sargent and Wallace (1981).

[3] Inflation, of course, is also a tax. It is a hidden tax on holding nominal assets, and when it is unanticipated, it can have significant consequences that redistribute wealth from creditors to debtors. The near-term effects of money creation often appear to be positive, while the undesirable consequences only become apparent over time. While money creation results in lower nominal interest rates and perhaps a modest boost to real activity

Awareness of these long-term consequences of excessive money creation is the reason that over the past 60 years, country after country has moved to establish and maintain independent central banks. Without the protections afforded by independence, the temptation of governments to exploit the printing press in the absence of fiscal discipline is just too great. Thus, it is simply good governance and wise economic policy to maintain a healthy separation between those responsible for tax and spending policy and those responsible for money creation.

But it is equally important that independent central banks be constrained from using their own authority to engage in activities that enter the realm of fiscal policy or distort private markets.[5]

There are several ways to place limits on central banks so that the boundaries between monetary and fiscal policy remain clear:[6]

First, the central bank can be given a narrow mandate, such as price stability. In fact, this has been a prominent trend during the last 25 years. Many major central banks now have price stability as their sole or primary mandate.

Second, the central bank can be restricted as to the type of assets it can hold on its balance sheet. This limits its ability to engage in credit policies or resource allocations that rightfully belong under the purview of the fiscal authorities or the private marketplace.

Third, the central bank can conduct its monetary policy in a more systematic or rule-like manner, which limits the scope for discretionary actions that might violate the boundaries between monetary and fiscal policy. Milton Friedman's famous k-percent money growth rule is one example, as are Taylor-type rules. Such approaches to systematic policy can be a commitment device that limits discretionary behavior and thus helps to solve time-consistency problems.

The breakdown of the accepted boundaries

Unfortunately, over the past few years, the combination of a financial crisis and sustained fiscal imbalances has led to a substantial breakdown in the institutional framework and the accepted barriers between monetary and fiscal policy. The pressure has come from both sides. Governments are pushing central banks to exceed their monetary boundaries and central banks are stepping into areas not previously viewed as acceptable for an independent central bank. Let me give you some examples.

I will start with what I see as a not-so-subtle undermining of the commitment to price stability. Despite the well-known benefits of maintaining stable prices, there are calls in both Europe and the U.S. to abandon this commitment and create higher inflation to devalue outstanding nominal government and private debt. Such an inflation tax would transfer wealth from those who have lent money, in good faith, to the borrowers. I am deeply skeptical of such a strategy. In my view, inflation is a blunt and inappropriate instrument for assigning winners

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in the short run, over time, it results in higher inflation and higher nominal interest rates and ultimately requires painful efforts to restore price stability.

4 Some of the more notable examples include Germany, Hungary, and Austria after World War I. Hungary and Greece experienced hyperinflations after World War II. More recently, countries from South and Central America have had episodes of hyperinflation, including Argentina, Bolivia, Brazil, Peru, Mexico, and Nicaragua. Zimbabwe is the most recent example, and its hyperinflation episode ended with a currency reform in 2008.

5 See Plosser (2010) for further discussion on the risks of unconstrained policy tools and the necessity of commitment devices.

6 Sargent (2010) has a thoughtful and insightful discussion on these and related issues.

and losers from profligate fiscal policy or excessive borrowing by private individuals and firms. Forced redistributions of this kind, if undertaken at all, should be done through the political process and by the fiscal authorities, not through the backdoor by the central bank by way of inflationist policies. As a monetary policymaker, I do not want to be complicit in such a strategy. Moreover, history has shown that once inflation is unleashed, it is not always easy to bring it back down, especially if the central bank loses the public's confidence and damages the credibility of its commitment to price stability. Thus, proposals to use inflation to fix the debt overhang problem are nothing more than a call for debt monetization to solve a problem that is fundamentally fiscal in nature.

Pressure on central banks is also showing up through other channels. In some circles, it has become fashionable to invoke "lender of last resort" arguments as a reason for central banks to engage in fiscal actions. This is a strained argument at best. The basic role of a lender of last resort is to provide liquidity to financial institutions that are solvent but facing temporary liquidity problems. Yet recently, some have used the concept to argue that the central bank should be the lender of last resort to governments. This is a perversion of one of central banking's core concepts. It is a fig leaf to conceal the process of monetizing the sovereign debt of those countries that are insolvent due to their inability to manage their fiscal affairs. Monetary policy should not be used to solve a fiscal crisis.

Unfortunately, from my perspective, breaching the boundaries is not confined to the fiscal authorities asking central banks to do their heavy lifting. The Fed and other central banks have also undertaken actions that have blurred the distinction between monetary policy, credit policy, and fiscal policy. These steps were undertaken with the sincere belief that they were absolutely necessary to address the challenges posed by the financial crisis.

For example, the Fed established credit facilities to support particular asset classes, such as commercial paper and asset-backed securities. In November 2008, the Fed announced it would begin purchasing housing agency mortgage-backed securities and agency debt to increase the availability and reduce the cost of credit in the housing sector. When the Fed engages in targeted credit programs that seek to alter the allocation of credit across markets, I believe it is engaging in fiscal policy and has breached the traditional boundaries established between the fiscal authorities and the central bank. Indeed, some of these actions have generated pointed criticisms of the Fed.

I view the breakdown of the traditional institutional arrangements as dangerous and fraught with longer-term risks. While it is popular to view such blurring of the boundaries as appropriate "cooperation" or "coordination" between the monetary and fiscal authorities, the boundaries were established for good reasons and we ignore them at our own peril.

Restoring the boundaries

Once a central bank ventures into fiscal policy, it is likely to find itself under increasing pressure from the private sector, financial markets, or the government to use its balance sheet to substitute for other fiscal decisions. Such actions by a central bank can create their own form of moral hazard, as markets and governments come to see central banks as instruments of fiscal policy, thus undermining incentives for fiscal discipline. This pressure can threaten the central bank's independence in conducting monetary policy and thereby undermine monetary policy's effectiveness in achieving its mandate.

I have long argued for a bright line between monetary policy and fiscal policy, for the independence of the central bank, and for the central bank to have clear and transparent objectives. I have also stressed the importance of a systematic approach to monetary policy that serves to limit discretionary actions by the central bank. At this conference three years ago, I argued for a new accord between the Treasury and the central bank that would severely limit, if not eliminate, the ability of the central bank to lend to private individuals and firms outside of the discount window mechanisms.[7] I argued that decisions to grant subsidies to particular market segments should rest with the fiscal authorities – in the U.S., this means the Congress and the Treasury Department – and not with the central bank. Thus, I proposed that the new accord limit the Fed to an all-Treasuries portfolio, except for those assets held as collateral for traditional discount window operations. Should the fiscal authority ask the central bank to engage in lending outside of its normal operations, the fiscal authority should exchange government securities for the nongovernment assets that would accumulate on the central bank's balance sheet as a result. This type of swap would ensure that the full authority and responsibility for fiscal matters remained with the Treasury and Congress and the Fed's balance sheet remained essentially all Treasuries.

Congress has mandated the goals of monetary policy to promote price stability, maximum employment, and moderate long-term interest rates. Asking monetary policy to take on ever more fiscal responsibilities undermines the discipline of the fiscal authorities and the independence of the central bank. Central banks and monetary policy are not and cannot be real solutions to the unsustainable fiscal paths many countries currently face. The only real answer rests with the fiscal authorities' ability to develop credible commitments to sustainable fiscal paths. It is a difficult and painful task to be sure, but a monetary solution is a bridge to nowhere at best, and the road to perdition at worst – a world of rising and costly inflation and a weakening of fiscal discipline.

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[7] See Plosser (2009) and Plosser (2010).