

TETHERING THE FISCAL SOW: MONETARY POLICY THAT KEEPS PORK IN THE STY

Independent central banks can help restrain government spending
argue **James Savage** and **Jan Libich**

Interest rates have been a recurring topic in recent Australian federal election campaigns. During the 2004 campaign, John Howard's incumbent government let there be no doubt: 'Interest rates under a Labor government would be higher!' The Labor Opposition retorted that such a claim was unwarranted as it was not the government that set the interest rate but the (independent) Reserve Bank of Australia (RBA). Such mixed messages have done no favours to the public's understanding of the interactions between fiscal and monetary policy.

The apolitical reality is that the policies of governments and central banks are interdependent—even though the central bank is formally independent of the government. This is because of the feedback effect between fiscal and monetary policy, and spill-overs of macroeconomic outcomes between them. By examining the main channels through which the two policies interact we can draw some conclusions about the optimal design of macroeconomic institutions and policies. Let us stress that our attention is on long-term policy interactions and outcomes under normal circumstances, rather than during recessions or financial crises.

Tug-of-war or cat-and-mouse? Fiscal-monetary interactions

Monetary policy in Australia is conducted independently by the RBA, but the term 'independence' is flexible. Technically, monetary policy can be influenced explicitly (by government

diktat) or implicitly (by government behaviour). The explicit channel is the Treasurer's power to override the RBA board, an option that has never been used. Until late 2007, the Treasurer could also appoint RBA board members. Unlike the overriding provision, the capacity of the Treasurer to appoint partisan governors has been used and, in at least one instance, attracted claims of shadiness.

The implicit relationship between government and the central bank is complex and less well understood. Essentially, the policies of both institutions affect the same variables—prices, asset values, and unemployment—but government and central bank administrators of the policies may disagree about what those variables should look like. The disagreement commonly stems from political realities: politicians face re-election, central bank bureaucrats don't. This institutional setup results in an imbalance of priorities: past

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experience teaches us that, commonly: i) politicians think *short* whereas central bankers think *long*, and (ii) politicians focus on low *unemployment* whereas central bankers focus on low *inflation*.

So how does this potential mismatch in the preferences of the two institutions affect the outcomes of fiscal and monetary policy? Attempts by governments to reduce unemployment are characterised by fiscal profligacy. Rather than tackling unemployment by pursuing the long and politically difficult road of tackling entrenched interests (both corporate and labour), governments around the world too frequently purchase low unemployment directly through higher government expenditure. This is possible temporarily because some economic variables are slow to adjust, leading to the short-run trade-off between unemployment and inflation that Bill Phillips first noticed decades ago.

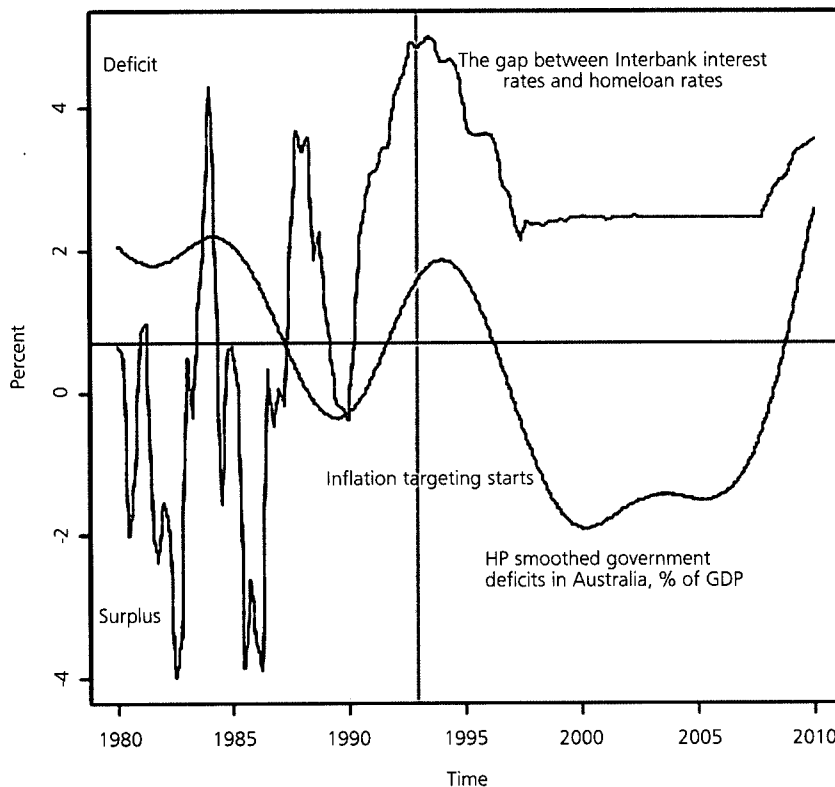
Excessive government spending however stimulates aggregate demand to a level at which firms find it easy to increase prices, and so inflationary pressures brew. The best recent

example of this kind of behaviour is Greece. From the creation of the European common currency zone to the start of the global financial crisis, Greece had an average government deficit of nearly 5% of GDP (if the numbers are to be believed), in part financing a reduction in unemployment from 12.1% to 7.65%. Over the same period, Greece had average inflation of 3.3%, nearly twice the German average of 1.7%, and well above the European Central Bank's 2% target.

Irresponsible fiscal behaviour affects monetary policy and interest rates in four main ways.

- First, deficits soak up savings that may otherwise be used to finance private investment—the so-called ‘crowding-out’ effect. In economic theory, this pushes up interest rates in the market for loanable funds as private investors bid higher repayments over a dwindling pool of savings. In practice, however, this is a strongly contested point—all else infrequently being equal. Interest rate changes are partially driven by the monetary

Figure 1: Smoothed Australian government budget position and interest rate spreads



Note: An HP filter is a Hodrick Prescott filter, a statistical device to try to show only the trend in data.

policy of the central bank; the remaining changes must be driven by credit conditions: demand and supply of savings, perceived risks, expectations, competition between lenders, and so on. As not all the drivers of interest rate changes are observable, and because many drivers may move at the same time, it is difficult to determine the extent to which crowding out occurs. Figure 1 illustrates what may be interpreted by some as being crowding-out in action—at least in the years after inflation targeting was introduced in Australia, fiscal surplus is correlated with a smaller, more stable gap between the rate at which banks lend to each other and the home-loan rate.¹

- Second, when markets believe the government has run up too much debt, the risk premium paid by the government increases. This occurs because investors aren't as willing to pay as high a price for bonds that may not pay off. At the time of writing, the spread between Greek government bonds and German bonds was nearly 500 basis points (5%), implying a considerable belief in the market that the Greek government would default. Worse still is what will happen if such a sell-off occurs quickly: if investors sell down government debt and the central bank uses an interest rate rule, the central bank is practically obliged to buy bonds—printing money. Needless to say, that is not an ideal outcome.
- Third, when fiscal policy results in increased inflation, investors require compensation in the form of higher nominal interest rates—readers may recall term deposit accounts in the late 1980s bearing 12.5% interest. Transitions both to and from high inflation are distortionary—an increase in inflation reduces wealth stored in assets that are not inflation linked; dis-inflating requires higher-than-usual unemployment.
- Fourth, when the central bank has a legislated inflation target, fiscal policy that causes inflation requires the central bank to

raise its target rate to dampen the prospect of further price rises. This fourth link between fiscal behaviour and monetary outcomes is perhaps the most important in a policy sense. It suggests that an institutional setup that brings forward the political pain of fiscal mismanagement may dissuade governments from engaging in it.

Through these four channels, excessive fiscal policy is likely to push interest rates upward and affect monetary outcomes—even if the central bank is independent. The two policies then tend to work in the opposite direction, and such tug-of-war (also referred to as the game of chicken) benefits no one. It only leads to higher mortgage repayments now and higher taxes in the future. History has taught us that governments tend to have an upper hand in this policy conflict and eventually force their central banks to inflate the accumulated debt away.

It is possible, of course, that the aims of a government and a central bank are in step and sustainable in the long run—this ideal situation is called the 'symbiosis' of monetary and fiscal policy. But most countries are not so fortunate. The question for them is how to emulate the conditions under which that ideal situation is arrived at *even if* the government is politically driven. Given the welfare consequences of unsustainable debt accumulation and high inflation, and the fact that the factors driving the political economy are unlikely to disappear, a large body of research has developed in assessing the kind of arrangements that could improve the interactions and outcomes of policies.

The key word is *commitment*. It has long been recognised that people respond to incentives, and that various commitment devices can alter those incentives. For example, a number of companies now offer customers the option of putting a binding contract on themselves to better achieve their goals using financial incentives.

Such reasoning was first used in monetary policy. Many countries have significantly strengthened the commitment of their central bank by legislating a long-run numerical inflation target. In combination with a number of additional transparency measures, a stronger monetary

commitment has led to enhanced accountability of central bankers and subsequent improvements in the outcomes of monetary policy.

These successes can be emulated to make fiscal policymaking more transparent and accountable (and perhaps even partly independent from government) and secure long-term fiscal sustainability.²

The role of monetary commitment in fiscal policy

A novel insight from the policy interactions literature has been the importance of the long-run credibility of the central bank in determining government policy. If a government loosens the purse strings to reduce unemployment knowing that the central bank will do the same, the resulting inflation whittles away government debt—so there is little incentive for the government to reconsider its policy stance. If, however, a government is aware of the resolve of the central bank to fight inflation regardless of what short-run effect that may have on unemployment, the government has a large disincentive to engage in unsustainable fiscal policy.

When will the central bank have enough credibility and ammunition to fight the government and potentially ‘discipline’ its fiscal behaviour? A necessary condition seems to be a formal legislated independence of the central bank from the government; indeed, central banks in developed countries have been officially granted independence over the past few decades. Central bank independence however does not seem to be sufficient. Another crucial ingredient identified in the literature is how strongly (explicitly) the central bank’s commitment to price stability is grounded in the central banking legislation or statutes.

The *Reserve Bank of New Zealand (RBNZ) 1989 Act* pioneered a type of monetary policy commitment never used before: a numerical target for (average) inflation. There are some good reasons to think this approach is preferable to the US Fed’s ‘just do it’ approach for containing fiscal misbehaviour. The main reason seems to be that a transparently legislated inflation target enhances accountability of monetary policy. Only when the aims of monetary policy are clearly specified is it possible for society to hold the central bank

accountable for missing its given target. Such threat of punishment strengthens the central bank’s determination to achieve its inflation target over the long term and gives it more ammunition to fight the government over excessive fiscal policy.

This argument is consistent with the account of Don Brash, the Governor of the RBNZ during 1988–2002, who ‘taught’ inflation targeting to the world.

In the middle of 1990, the Government, faced with the prospect of losing an election later in the year, brought down an expansionary budget. I immediately made it clear that this expansionary fiscal policy required firmer monetary conditions if the agreed inflation target was to be achieved, and monetary conditions duly tightened. Some days later, an editorial in the *New Zealand Herald*, New Zealand’s largest daily newspaper, noted that New Zealand political parties could no longer buy elections because, when they tried to do so, the newly instrument-independent central bank would be forced to send voters the bill in the form of higher mortgage rates.³

Most inflation targeting countries
...have improved their fiscal
outcomes after adopting a
numerical inflation target.

One might suggest that the government could change the central banking legislation and get rid of the numerical inflation target to sway the policy fight in its favour. Interestingly, there does not seem to be a single example of an inflation targeting country abandoning the monetary commitment. This is related to the effect of transparency: such actions would be visible by the market participants and voters, with dire political consequences.

The \$64,000 question, then, is: has explicit inflation targeting acted to coerce governments into reducing excessively loose fiscal behaviour?

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