Monetary/fiscal policy mix in the current international context

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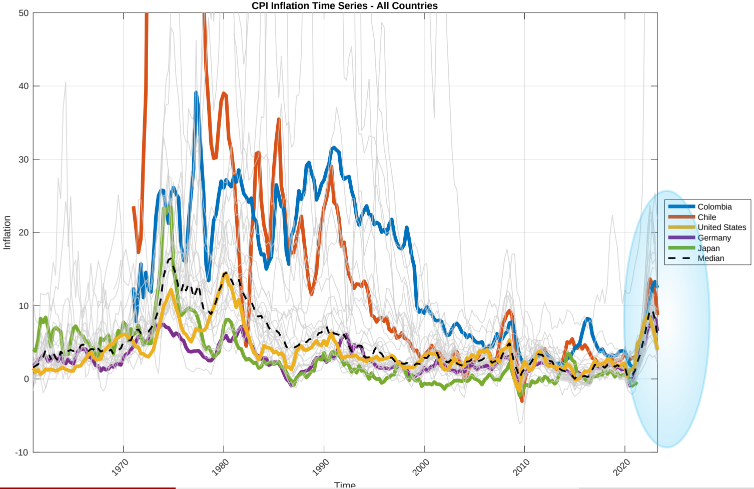
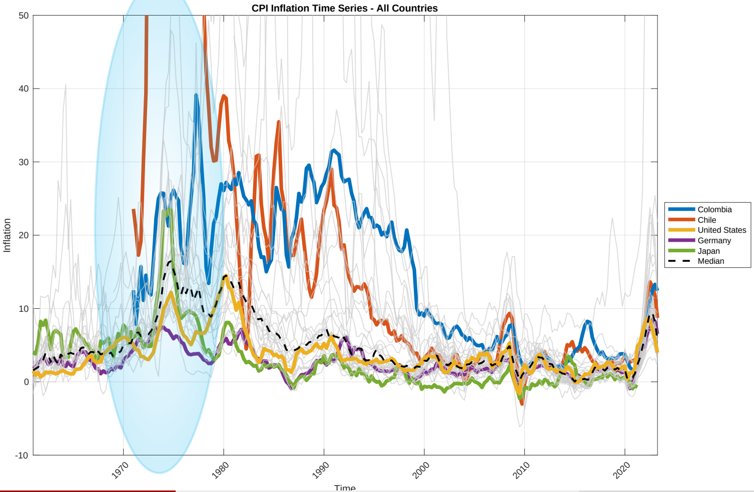
Inflation across space and time

- How does the post-pandemic increase in inflation compare with the past?



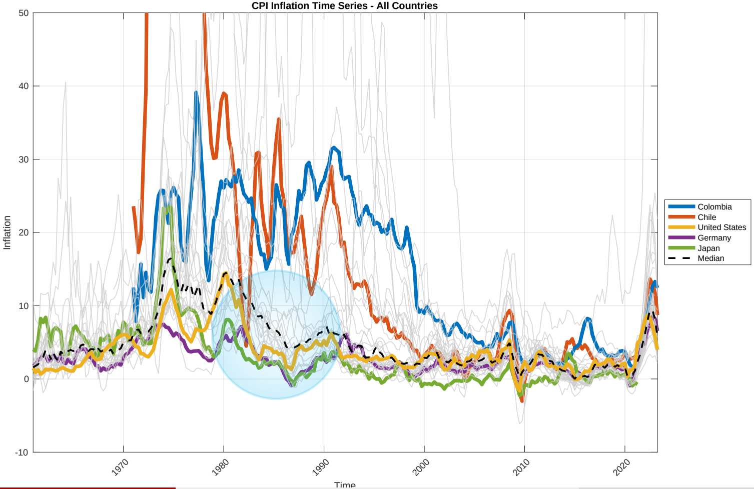
Inflation across space and time

- High and volatile inflation in several countries in the 1960s and 1970s



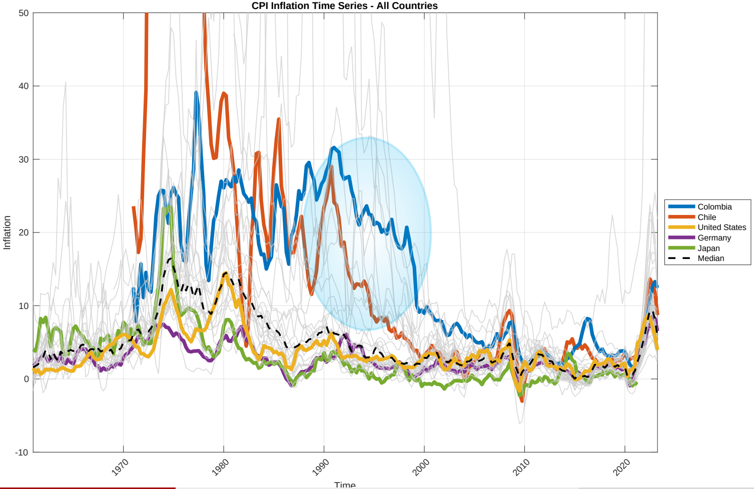
Inflation across space and time

- Break for advanced economies starting from the 1980s



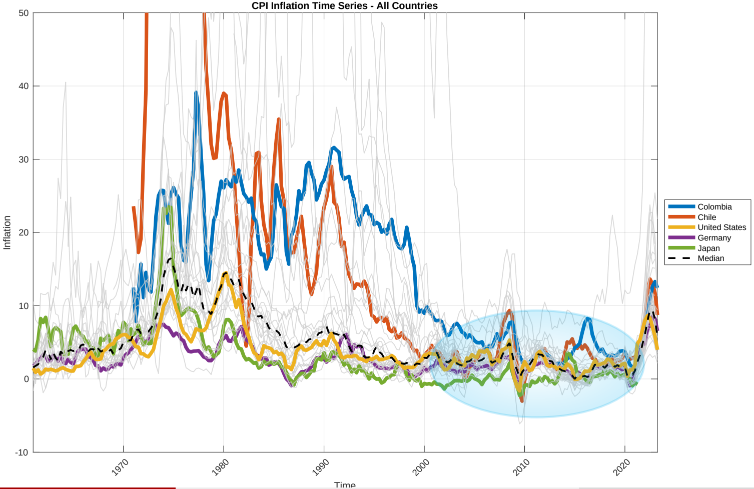
Inflation across space and time

- Break in the late 1990s for the other countries



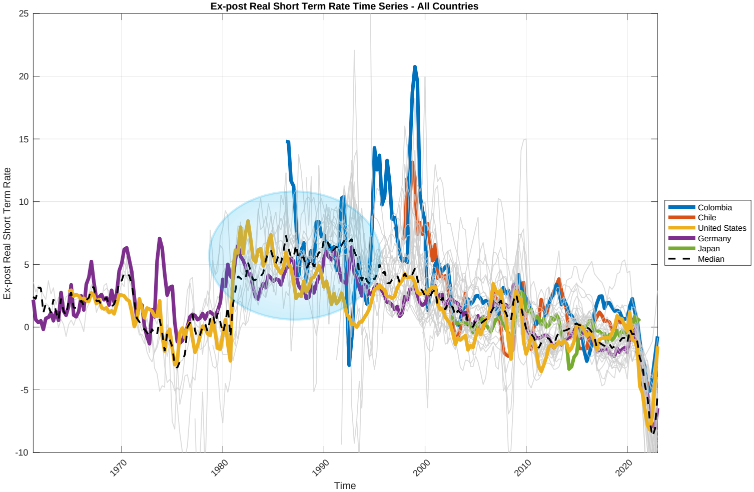
Inflation across space and time

- Remarkable convergence to low and stable inflation across countries in the 1990s



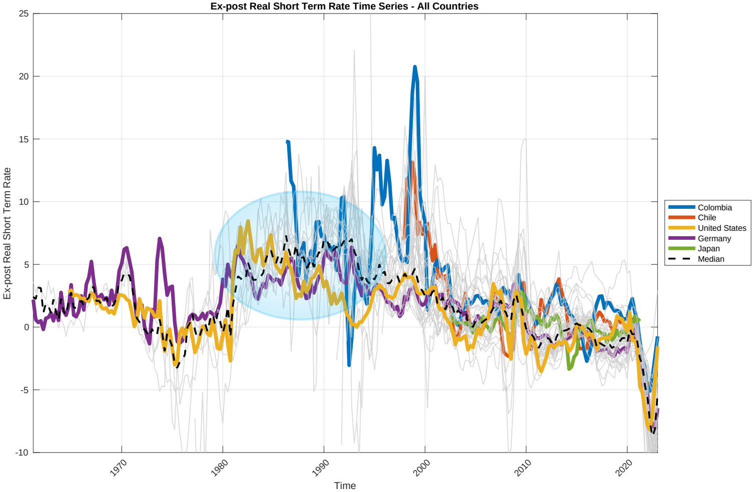
Large swings in real interest rates

- Decline in inflation associated with a prolonged period of high real interest rates



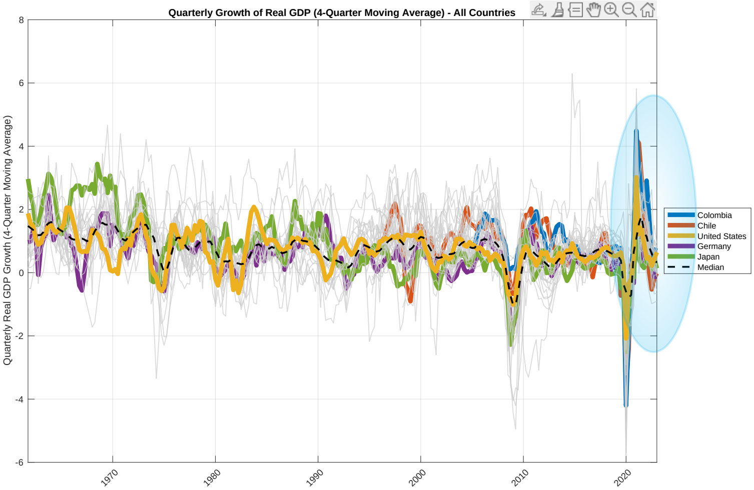
Large swings in real interest rates

- Emerging economies traditionally vulnerable to these structural changes



Post-pandemic recovery

- Post pandemic inflation associated with a quick rebound in real activity



How to interpret the post-pandemic inflation?

- Decline in inflation often attributed to changes in monetary policy, but...
- ...conquest of inflation better understood as a monetary/fiscal policy phenomenon:
  1. Key role of central bank independence (US, UK, ...)
  2. Shift in fiscal practice (Euro Area, Chile, ...)
  3. Reduction in both the mean and volatility of inflation
- If the conquest of inflation is the result of a change from a Fiscally-led to a Monetary-led policy mix, how should we interpret the post-pandemic inflation?
  1. Return to a Fiscally-led policy mix?
  2. An emergency budget that generated a quick recovery?

Overview

This talk is based on three papers that provide an optimistic, a concerned, and a pessimistic view on the post-pandemic surge in inflation:

1. A Fiscal Theory of Persistent Inflation with Renato Faccini and Leonardo Melosi (QJE, 2023)
2. Inflation as a Fiscal Limit with Leonardo Melosi (2022 Jackson Hole Economic Symposium)
3. Who is Afraid of Eurobonds? with Leonardo Melosi and Anna Rogantini-Picco (2023 NBER working paper)

Optimistic view (A Fiscal Theory of Persistent Inflation):

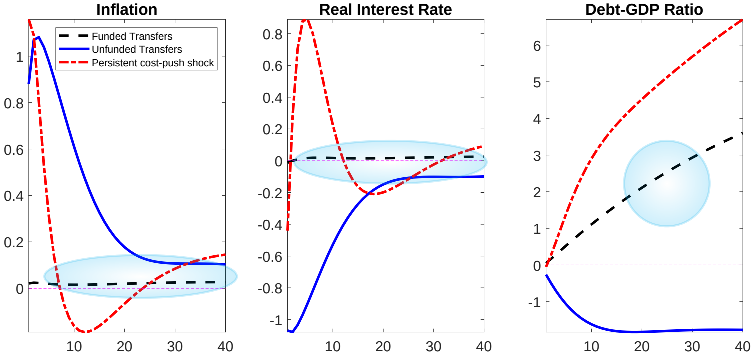
- Policy coordination generated a quick rebound of the economy from the pandemic
- Large spur of fiscal inflation was the cost
- **Mission accomplished**, we are on our way back to **normality**

A Fiscal Theory of Persistent Inflation

- New class of general equilibrium models with partially unfunded government debt
  1. At any given point in time, part of the outstanding government debt is unfunded
  2. Unfunded debt is not backed by future fiscal adjustments $\Rightarrow$ Inflationary pressure accommodated by the central bank
  3. Debt stability achieved with a mix of fiscal adjustments and inflation
- With nominal rigidities, unfunded fiscal shocks cause persistent movements in inflation and in real interest rates $\rightarrow$ A fiscal theory of persistent inflation
- We estimate a TANK model augmented with **unfunded fiscal shocks** on US data:

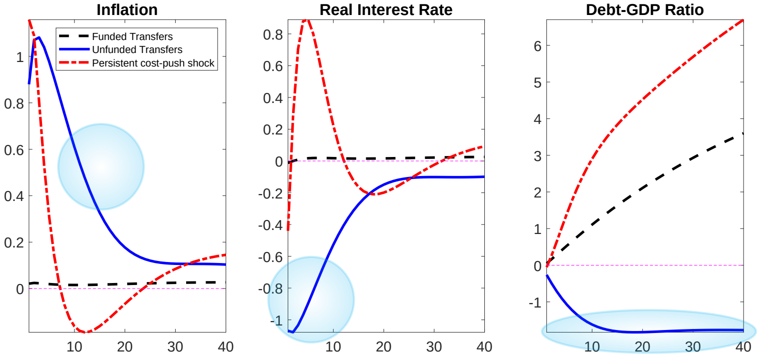
  $\Rightarrow$ Post-pandemic inflation and recovery were the result of unfunded fiscal shocks: Two massive fiscal stimuli and a new monetary framework
- Optimistic view: Inflation expected to slowly revert to its 2% target

Identification of unfunded transfers shocks



- **Funded transfers**: Modest impact on the macroeconomy, debt increases
- **Unfunded transfers**: Persistent inflation increases, real rate and debt decline
- **Phillips curve shifter**: Short-lasting inflation spike, real rate and debt increase

Identification of unfunded transfers shocks



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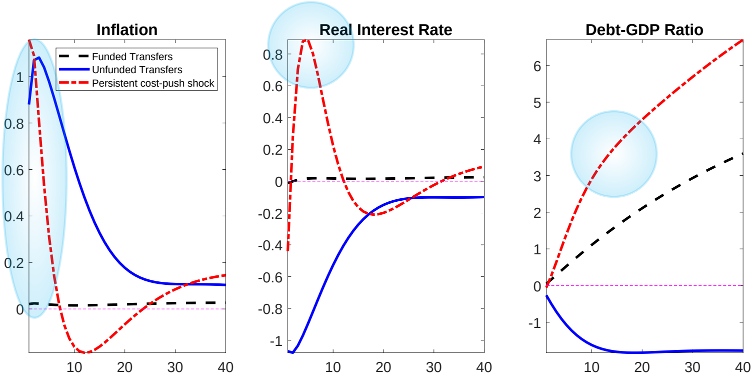

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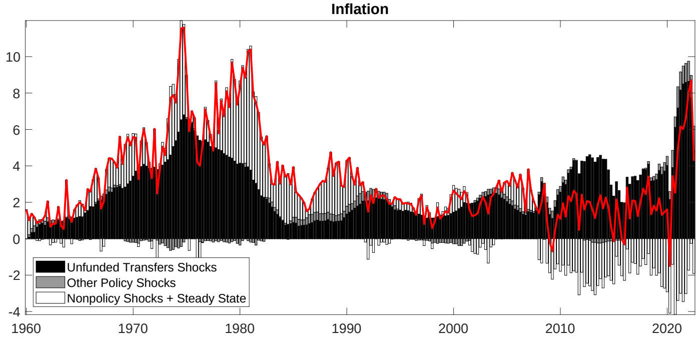
Drivers of Inflation

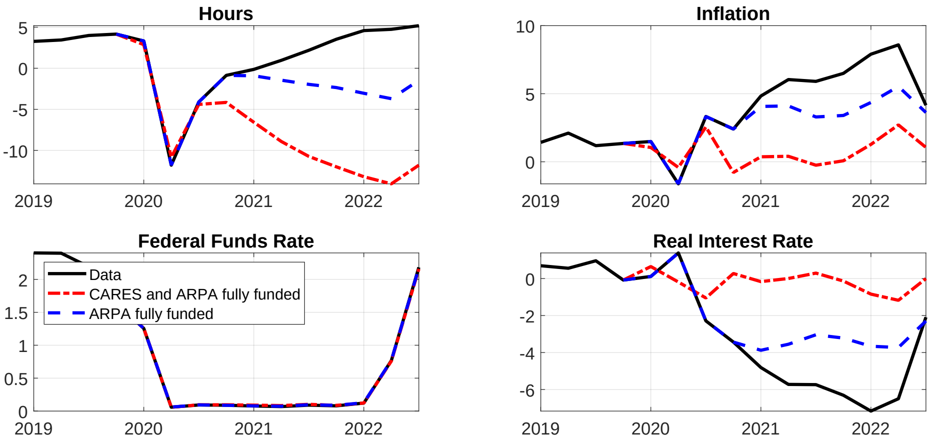


Unfunded transfers shocks: BEI

1. Accounts for rise of trend inflation in the 1960s-1970s and decline in the 1980s
2. Offsets the deflationary bias that non-policy shocks have set off since early 1990s

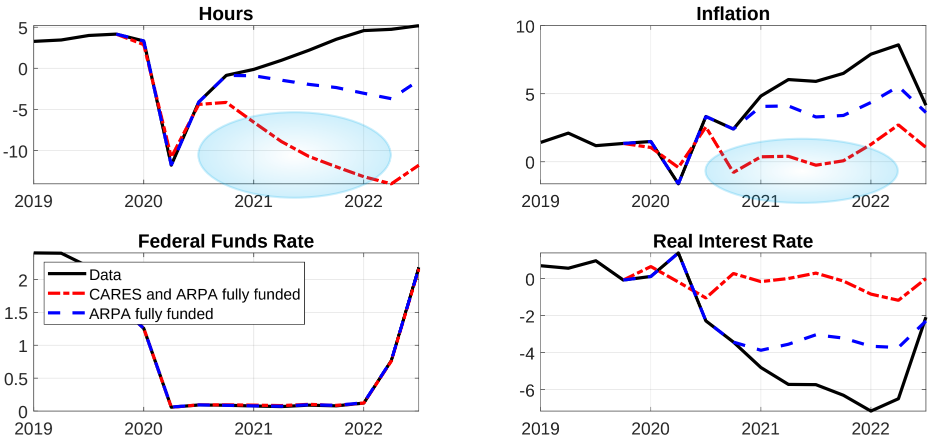
Unfunded Debt and Reflation of the Economy

- Counterfactual simulations to assess the effects of unfunded share of fiscal stimuli



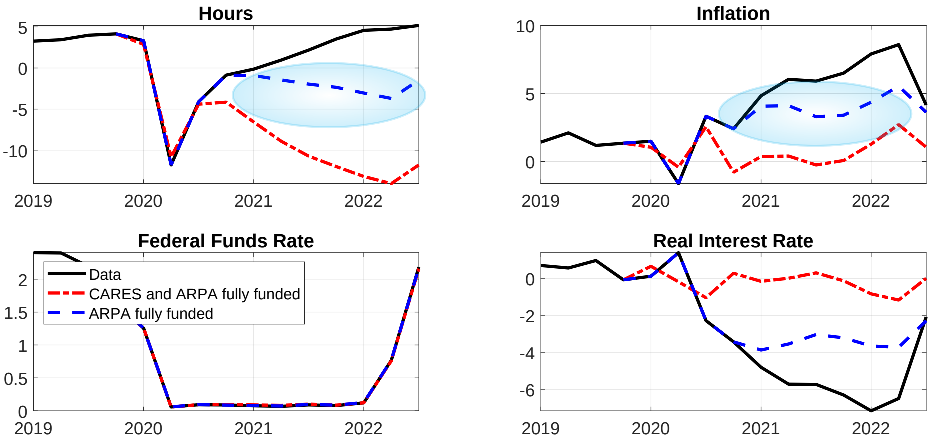
Unfunded Debt and Reflation of the Economy

- No unfunded fiscal shocks



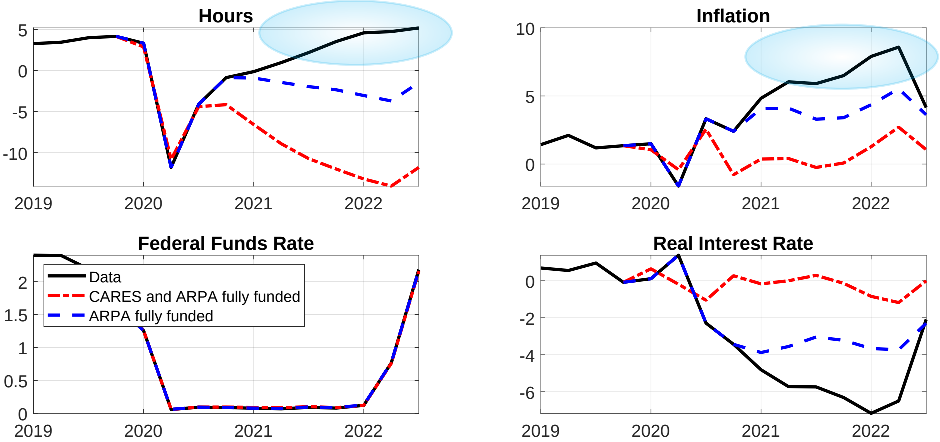
Unfunded Debt and Reflation of the Economy

- Effect of CARES act



Unfunded Debt and Reflation of the Economy

- Effect of CARES act + ARPA



Concerned view (Inflation as a Fiscal Limit):

- Large fiscal stimulus shifted the perception about future policy mix
- Fiscal inflation due to changes in policymakers' behavior and **beliefs**
- **What if fiscal and monetary policy fail to coordinate?**
- Monetary policy has changed, fiscal policy not yet $\Rightarrow$ **risk of fiscal stagflation**

Agents' Beliefs and Fiscal Stagflation

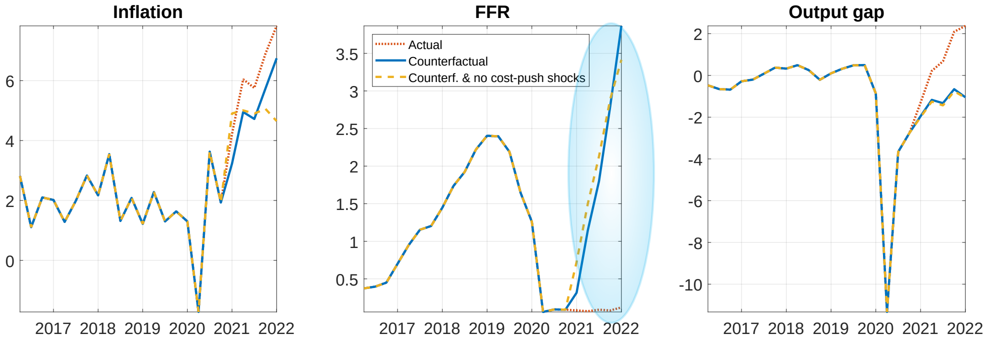
We estimate a model that allows for changes between a **Monetary-led** and a **Fiscally-led** policy mix and **changes in agents' beliefs about the future policy mix**:

1. Movements in trend inflation are explained by fiscal shocks and by changes in the policy mix. Cost-push shocks have only transitory effects.
2. Following the ARPA, the probability of a return to the Fiscally-led regime has increased, helping the recovery, but also causing a **jump in fiscal inflation**.
3. Monetary tightening alone would not have prevented the increase in inflation.

$\Rightarrow$ When inflation has a fiscal nature, monetary tightening can spark **fiscal stagflation**

$\Rightarrow$ **Conquering the post-pandemic inflation necessitates an overhaul of the fiscal framework** aimed at financing the present and future public expenditure.

Could monetary policy have averted the recent rise in inflation?



Counterfactual: Increase in interest rates, but with same beliefs about future policy mix

1. The Federal Reserve increases rates in response to inflation

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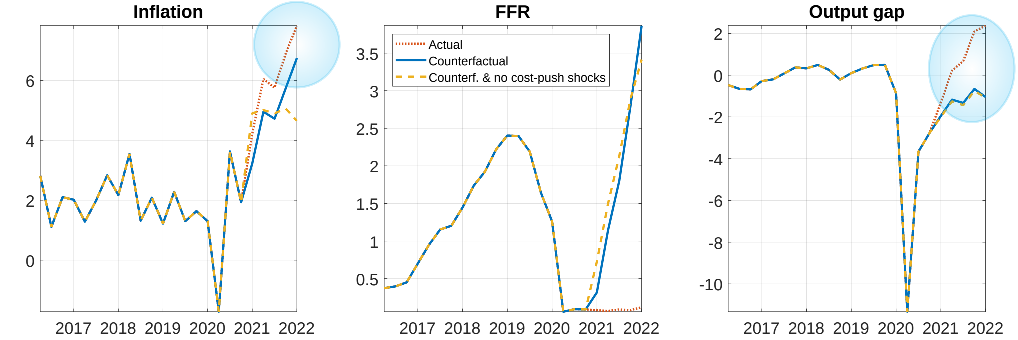

Counterfactual: Increase in interest rates, but with same beliefs about future policy mix

2. Modest gain in terms of inflation, at the cost of a large output loss

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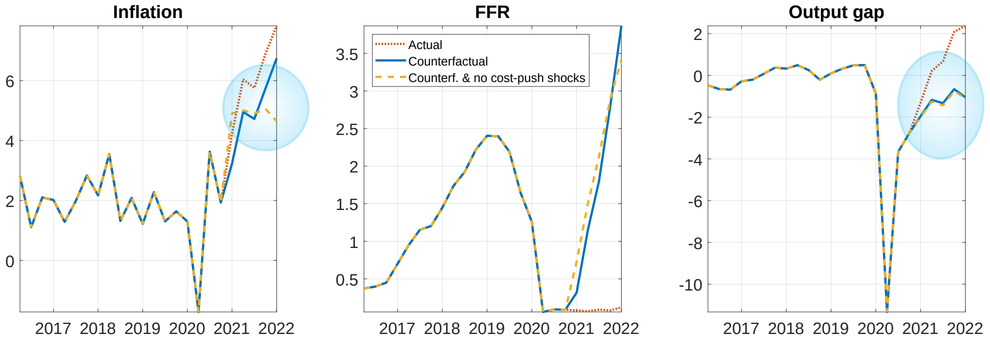

Counterfactual: Increase in interest rates, but with same beliefs about future policy mix

3. The result is not driven by cost-push shocks

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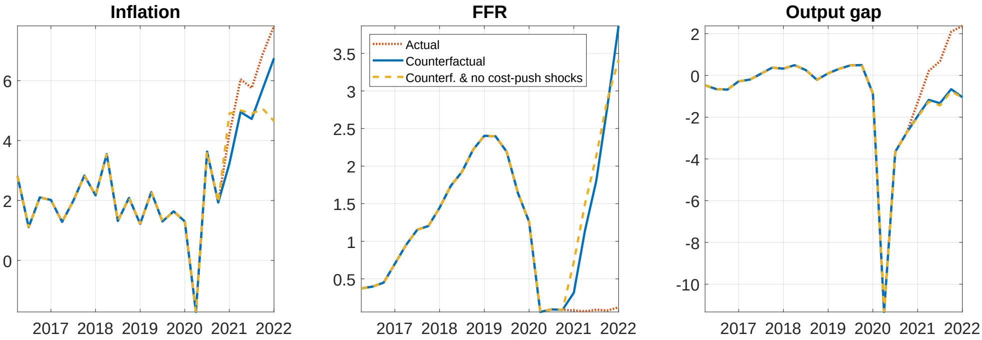

Counterfactual: Increase in interest rates, but with same beliefs about future policy mix

4. When inflation has a fiscal nature, increasing rates, in itself, is not enough

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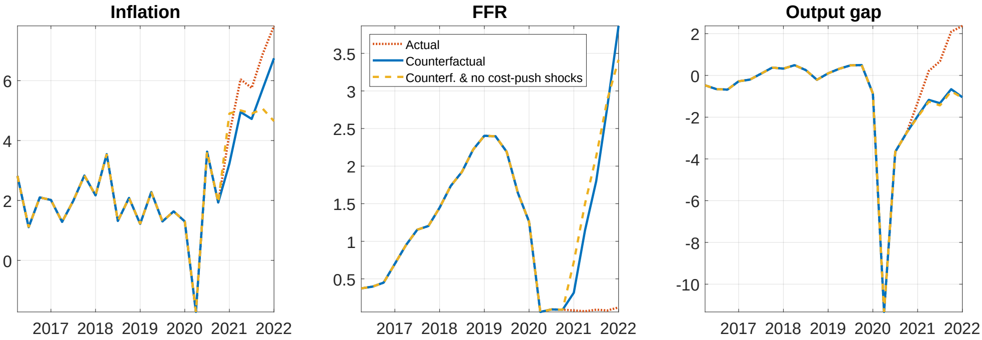
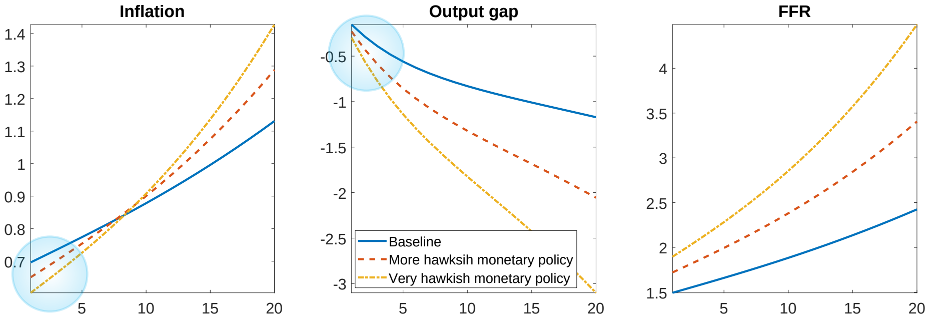


Counterfactual: Increase in interest rates, but with same beliefs about future policy mix

5. The whole policy mix needs to adjust to avoid **fiscal stagflation**

How to conquer the post-pandemic inflation?



More hawkish monetary policy?

1. Inflation lower in the short run, at the cost of a larger output loss
2. Short-term inflation gain is ephemeral, as inflation paths eventually cross

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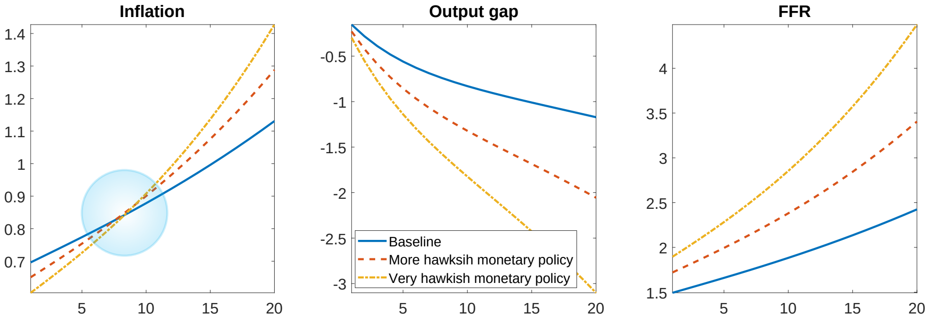

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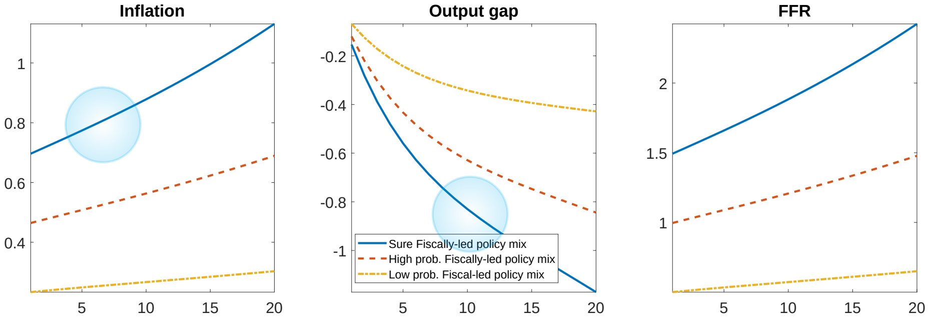

More sustainable fiscal policy?

1. As we progressively reduce the probability of a change to the Fiscally-led policy mix, the inflationary pressure goes down and fiscal stagflation is mitigated
2. If a change to the Fiscally-led policy mix is completely ruled out, the inflationary pressure and fiscal stagflation disappear

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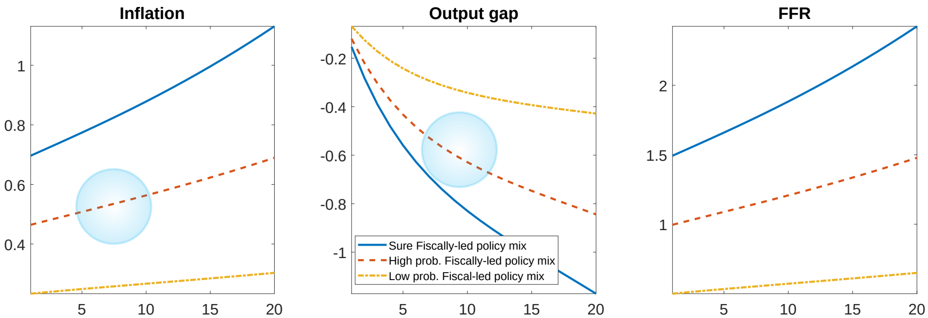

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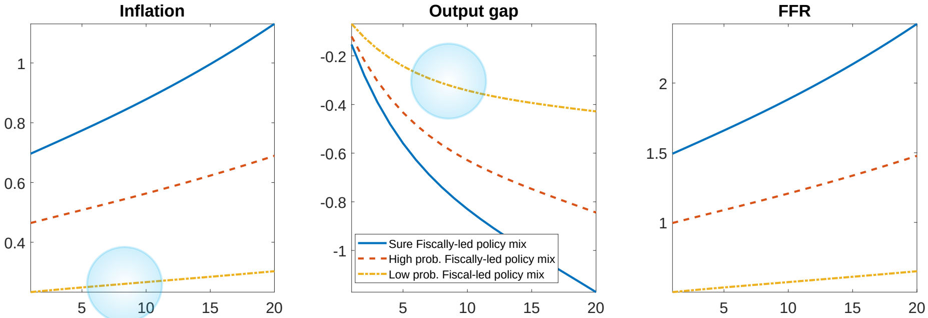

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Pessimistic view (Who is Afraid of Eurobonds?):

- Large fiscal imbalances $\Rightarrow$ fiscal and monetary authorities on a **colliding course**
- Euro area **suspended fiscal rules** to avoid **risk of deflation**
- Fiscal inflation due to changes in policymakers' behavior and **beliefs**
- **If one large country keeps deviating $\Rightarrow$ risk of fiscal stagflation**

The Euro Area at a Crossroad

In the Euro Area, coordination is harder to achieve ⇒ beliefs matter even more:

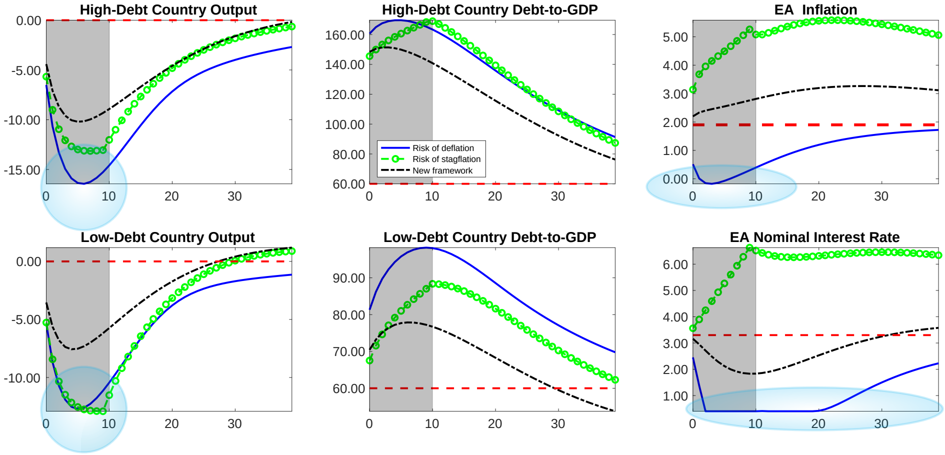
+ Hard to implement quick fiscal interventions
+ Hard to guarantee long-run fiscal sustainability

Deterioration of fiscal positions and high inflation put Euro Area at crossroads:

+ Reintroduce old monetary/fiscal framework. Risk of:
    1. Deflation because of the lack of stabilization tools
    2. High inflation if fiscal rules are suspended
    3. Fiscal stagflation if incentives for high debt countries not to comply with fiscal rules
+ Adopt a new monetary and fiscal framework based on Eurobonds and a EA Treasury to separate stabilization policies from the need of long-run fiscal sustainability

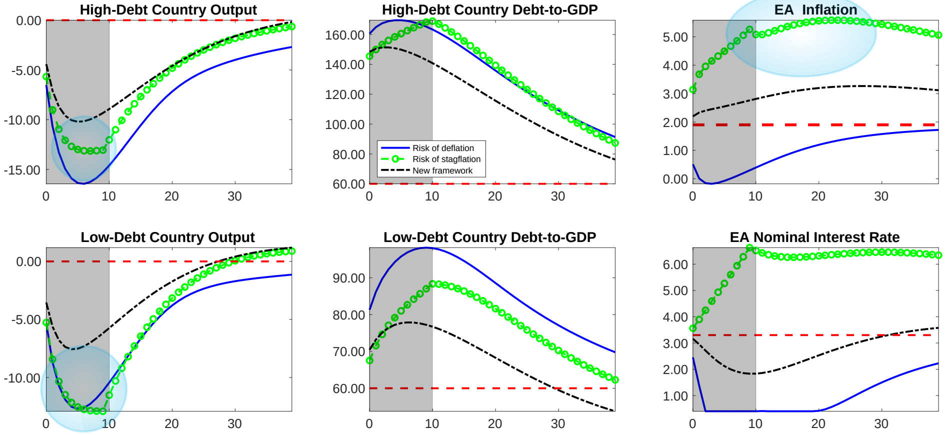
Euro Area: From risk of deflation to risk of stagflation

- Strict fiscal rules + zero lower bound $\Rightarrow$ Risk of deflation and deep recession



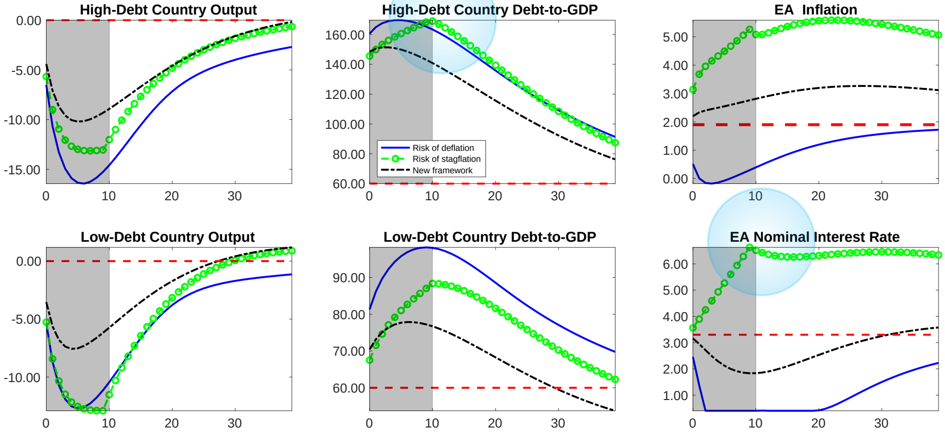
Euro Area: From risk of deflation to risk of stagflation

- Suspend fiscal rules ⇒ Risk of stagflation if one country unwilling to revert to them



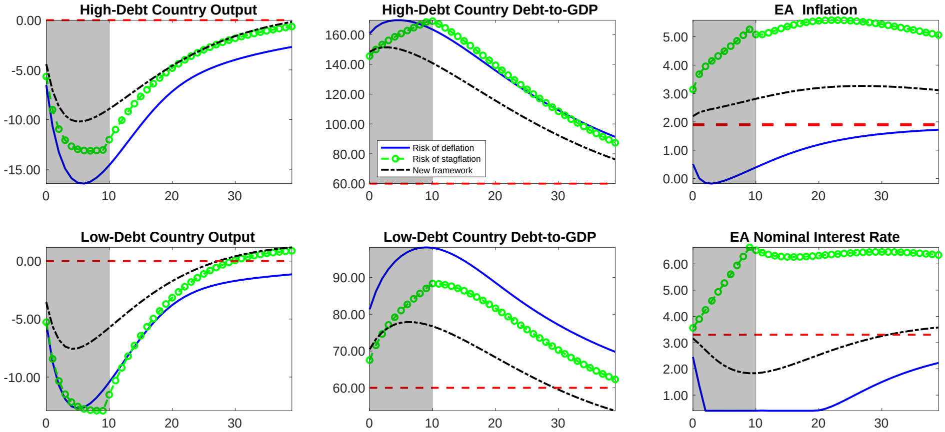
Euro Area: From risk of deflation to risk of stagflation

- Monetary tightening further increases debt-to-GDP in high-debt country



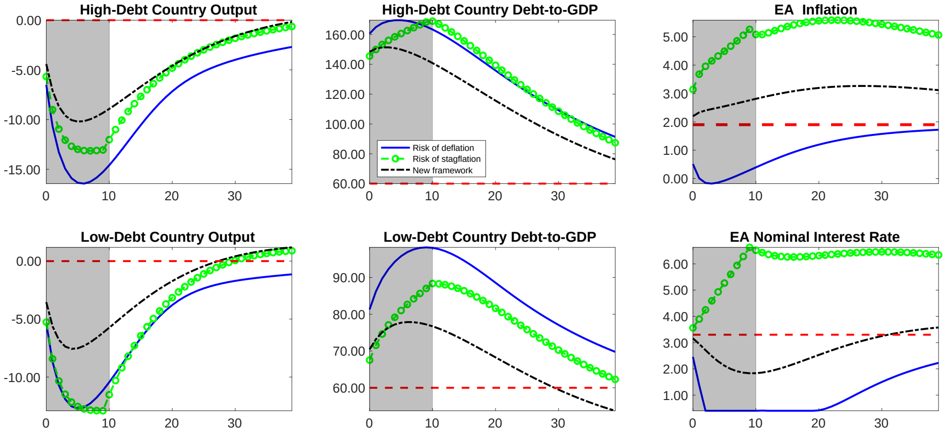
Euro Area: From risk of deflation to risk of stagflation

- Spiral of growing inflation, deeper recession, and debt accumulation



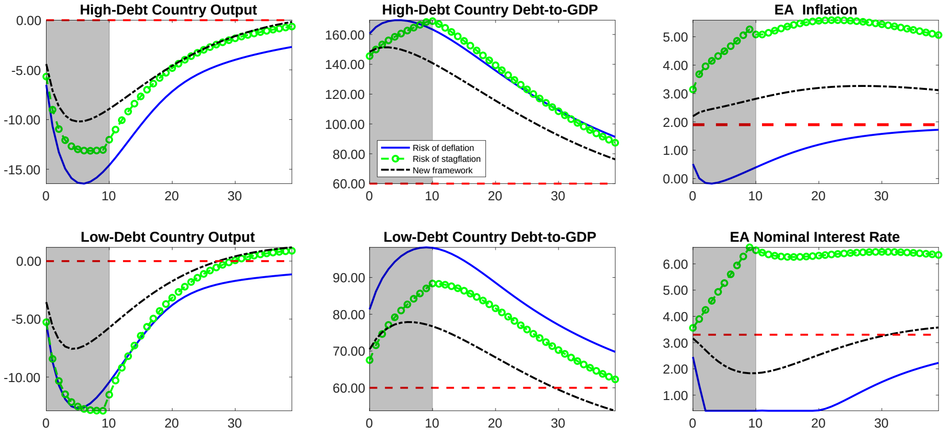
Euro Area: From risk of deflation to risk of stagflation

- New policy framework based on Eurobonds and EA Treasury eliminates both risks



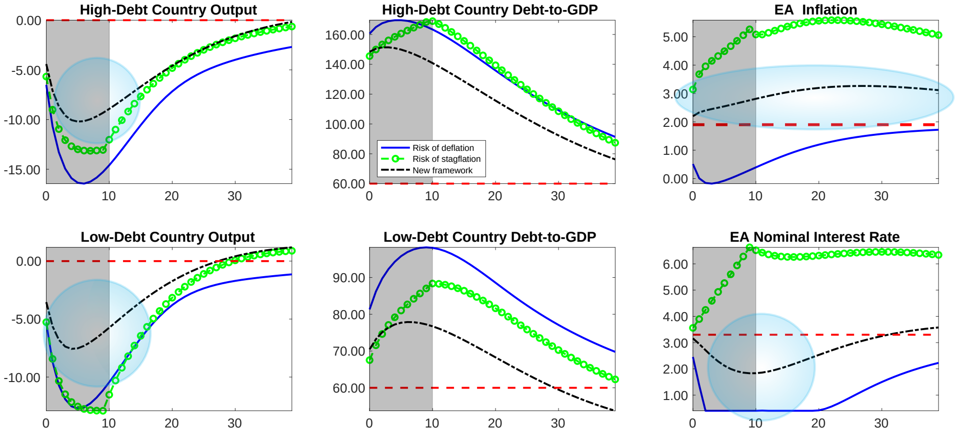
Euro Area: From risk of deflation to risk of stagflation

- No need to suspend the rule + ability to coordinate policies at ZLB



Euro Area: From risk of deflation to risk of stagflation

- No ZLB, milder recession, contained increase in inflation



Summary

- An implicit **fiscal limit** exists to the extent that **a low and stable inflation target requires fiscal policies that are consistent with this goal**
- Following the COVID pandemic, several countries have implemented robust fiscal interventions $\Rightarrow$ Quick rebound of the economy, but also **surge in fiscal inflation**
  - **Optimistic view**: Central banks are now increasing rates $\Rightarrow$ Signal about future policy changes $\Rightarrow$ **inflation will slowly decline** as unfunded share of spending fades away
  - **Pessimistic view**: Fiscal situation is very different from the 1980s $\Rightarrow$ Risk of **fiscal stagflation**
- Euro area in need of a new policy framework that facilitates policy coordination without jeopardizing credibility for long-run fiscal sustainability
- Emerging economies subject to the risk of large swings in global real interest rates

What is the most likely scenario?

- Inflation is **cooling down** in most countries, supporting the most optimistic view.
- However, there are **three reasons for concern**:
  1. **Threats to central bank independence**. These can be more or less explicit, but they are common across countries and across the political spectrum
  2. **Large fiscal imbalances** have not been addressed and pressure will increase on central banks if a new recession were to occur
  3. **Geopolitical conflicts** might prevent a return to pre-pandemic level of integration
- Experience of the 1960s and 1970s is a warning not to declare victory too early
- Low inflation requires mutually consistent monetary and fiscal policies providing a clear path for both inflation and debt sustainability