

The Interplay between Monetary Policy and Fiscal Policy

Opening Remarks

Jiří Rusnok

Governor, the Czech National Bank

Ladies and gentlemen, dear guests, I wish you a good morning. It is my pleasure to welcome you to the conference on “The Interplay between Monetary Policy and Fiscal Policy” hosted by the Czech National Bank. Before I give the floor to the distinguished speakers, let me first make a few remarks that will set the stage for the upcoming presentations and discussions.

The interaction between monetary and fiscal policy has always been a fascinating topic. Recent decades witnessed central banks moving towards a higher degree of independence in terms of instruments, procedures for appointment of central bank governors, and central bank financing. In a world of independent central banks, the interactions between monetary and fiscal policies consist of influencing the same macroeconomic variables using different instruments. Therefore, the actions of one authority can be to a large extent viewed as exogenous from the point of view of the other authority. This setting has been acknowledged and accepted by all players.

The outbreak of the financial crisis in 2008 ushered in a period when the relationship between fiscal and monetary policy had profound impacts on advanced economies. The fiscal-monetary mix went through several phases and changes. In the first few months of the crisis, central banks played the key role, taking action to keep the acutely threatened financial system going. In 2009, demand-stimulating fiscal policies partly dampened what was still an unprecedented economic contraction. At this time, both types of policy were expansionary and countercyclical.

However, the macroeconomic stimulation, coupled with the rapidly rising need to bail out the financial sector, led to a sharp increase in government deficits and growth in government debt. Given the relatively high pre-crisis debt levels, the room for public finance maneuver turned out to be exhausted in most advanced economies in 2010, and fiscal policies thus hit their limits. There followed a period of fiscal consolidation when fiscal policy turned from loose to tight for around four years. This tight policy had a very large

adverse effect on the real economy, as it was one of the main causes of the subsequent recession. It also contributed in large measure to a fall in inflation and the establishment of a low-inflation environment. In an attempt to boost growth and encourage inflation to rise, central banks began to use unconventional tools such as quantitative easing and negative interest rates. This entire period was characterized by a combination of restrictive fiscal policy and loose monetary policy. It was not until the middle of the decade that fiscal policies started to move towards a more neutral stance, allowing monetary policies to gradually become less expansionary.

Simplifying somewhat, the financial crisis exposed the small initial fiscal policy room available for economic stabilization. This shifted a large part of the adjustment burden to monetary policy. At least in terms of euro-area public debt levels, the repercussions of the financial crisis have yet to be overcome, and the question is when it will happen. All this has implications for central banks, which, with various delays, are starting to return to conventional instruments and more neutral policy stances.

In addition to this main issue, new open questions arise in the area of fiscal and monetary policy interactions relevant for policymakers. Let me elaborate on those that I perceive as topical.

First, there is a question of the proper mix of fiscal consolidation tools in the low-inflation environment when interest rates are at their lower bound or even negative. It is acknowledged that in such an environment, fiscal multipliers may be much higher than in standard times and therefore fiscal consolidation policies may have dramatically different impacts. It is therefore of utmost importance to carefully analyze the impact of various fiscal consolidation measures on the real economy in such an environment. The paper by Bandeira, Pappa, Sajedi, and Vella will deal with these issues.

Second, further challenges that affect the interplay between monetary and fiscal policies are related to the unprecedented high levels of government debt reinforced by the gloomy long-term outlook in developed countries connected with population aging. There are concerns that price stability may erode due to fiscal dominance. Economic theory provides several scenarios in which such dominance could imply unstable growth in prices. In my view, these scenarios should not be neglected. The paper by Franta, Libich, and Stehlik provides useful insights into this research.

Finally, the interaction between fiscal and monetary policy is especially intricate in a monetary union that is not a fiscal union. As an example, let me mention that the effects of negative shocks may be amplified if fiscal policies are badly coordinated. Fiscal restriction in a large country may have unfavorable effects on smaller countries if their growth is weak and there is slack in their labor markets. Fiscal policy coordination may thus have important consequences for growth and prosperity and is under great scrutiny in the euro area. This topic will be discussed by Kirsanova, Machado, and Ribeiro in their presentation.

The degree to which the relationship between fiscal and monetary policy in the Czech Republic has mirrored that in the euro area in 2010–13 is remarkable. Although our public debt-to-GDP ratio was half that in the euro area at the start of the crisis, our fiscal policy was also procyclical in that period. This contributed to inflation staying well below the Czech National Bank's inflation target and transferred the burden of adjustment to monetary policy. As you know, our unconventional instrument for a further easing of the monetary conditions was the adoption of an exchange rate commitment in November 2013, which we discontinued at the start of April this year. It would be wrong, of course, to attribute our low-inflation environment to domestic fiscal restriction alone, because we imported strong disinflationary pressures from abroad. The fact remains, however, that from 2010 the two policies were working against each other and hence were inconsistent with what the textbooks teach us about advisable countercyclical macroeconomic stabilization.

Recently, we have witnessed that the inflow of European Union funds represents a substantial driver of the overall fiscal influence on macroeconomic dynamics in the Czech Republic and some other new EU countries. The drawdown of EU funds is scheduled in the so-called programming periods, which are seven-year cycles of current and capital transfers from the EU budget to the national economies. The impact of the funds can be substantial: we estimate that in 2015 the contribution of these funds to real GDP growth in the Czech Republic was about 1 percentage point. The experience from the previous programming period has demonstrated that the EU funds programming period is a cycle with specific peaks and bottoms that represents an independent and sometimes very important factor for the development of the Czech economy and hence also for inflation.

The analysis of the impacts of the above-mentioned fiscal consolidation and of EU funds on the Czech economy and inflation requires a careful treatment of fiscal policy in the CNB's forecasting and policy analysis framework. Let me briefly describe it. The CNB staff uses a DSGE model called g3 as the main forecasting macroeconomic tool. On the forecast horizon, government spending is assumed to be exogenous, and its awaited future trajectories are inserted into the forecasts. Besides inserting government spending as exogenous trajectories, there is close cooperation between the forecasting team and the experts from the Fiscal Policy Analysis Unit. Future fiscal policy measures are evaluated in terms of their impacts on the main macroeconomic variables and—where appropriate—inserted as expert judgments. For example, higher future government investment can be captured by an increase in productive technology which increases investment expenditure and propagates through the model mechanisms into other variables. I find it to be a great advantage that the treatment of fiscal policy in the CNB forecasts is far from being mechanical. A mechanical “press-button approach” to the forecast can be rather misleading in times of severe fiscal restriction or expansion and can imply an inappropriate monetary policy stance.

I believe that good policymaking will always benefit from cutting-edge research. Regardless of the country of interest, for a central banker, the relationship between monetary and fiscal policies represents one of the most important topics. Despite the substantial progress in macroeconomics in recent years, there are still open questions in this area. I hope this conference will be a step towards providing policymakers with a better understanding of this subject and more robust modeling tools that can increase the accuracy of central bank forecasts.

Ladies and gentlemen, thank you for listening. I wish you an interesting conference and an enjoyable stay in Prague.