NBP Narodowy Bank Polski

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Fiscal, monetary and structural policies under inflation targeting: strictly separated or strictly co-ordinated? Two alternative views

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Outline

Two macroeconomic paradigms: mainstream vis-á-vis Post-Keynesian or market self-regulation versus aggregate demand regulation

- Monetary policy goals and tools
  - Mainstream: price stability under: (i) gold standard, (ii) control of money supply, (iii) inflation targeting;
  - Post-Keynesian: stability of long-term interest rates through flexible supply of credit.
- Fiscal policies:
  - Mainstream: fiscal and monetary policy neutralities; counter-cyclical adjustments;
  - Post-Keynesian aggregate demand regulation to achieve and maintain full employment.
- Structural policy:
  - Mainstream: market self-regulation – removing market imperfections,
  - „New industrial policy" and government suport.
- Strict separation or tight coordination - under which paradigm?

Mainstream: macroeconomic axiology

- Economy operating as a rule at full employment of factors of production; full employment being defined as NAIRU (NAWRU) – clearly in accordance with monetary policy objective.
- If macro equilibrium at full employment is distorted by random or other shocks, undisturbed market mechanism restores it.
- Neutrality of fiscal and monetary policy: expansionary policies generate no changes in output and employment, and only generate price rises.
- In case of demand shocks, they should be countered by monetary (but not fiscal) policy.
- Structural policy should aim at ensuring undisturbed operation of the market mechanism.

Post-Keynesian macroeconomic axiology

- Market economy as a rule operates below capacity even at the peak of the boom.
- Market mechanism is unable by itself to restore and maintain full employment of factors of production.
- Except for raw materials and agricultural products, prices are determined by producers under oligopoly competition (mark-up prices).
- Aggregate demand regulation to achieve and maintain full employment (non-neutral fiscal policy).
- Monetary policy (flexible supply of money adjustment) and structural policy both to assist the key role of fiscal policy.
- Essence of „new industrial policy” is goverment selective support for entrepreneurs.

Inflation targeting strategy

Objective of monetary policy: stability of prices

- Collapse of the Bretton Woods system (and of the Gold Standard as a nominal anchor) in 1970s, and
- failed control of monetary aggregates, leading to
- inflation targeting introduced in late 1980s,
- yet becoming inadequate in many countries in the face of the 2008 Global Financial Crisis (GFC) to bring recovery.

Inflation targeting strategy (2)

Definition: a policy framework – central bank sets a quantitative goal (headline inflation) as a target.

Key features:

- publicly announced goal,
- based on a wide set of information and inflation forecast;
- transparency, and
- public accountability.

Essence:

Establishing a reputation of the central bank being capable to keep actual inflation rate in long-run equal to inflation target and to bring inflation to its target rate following any short period shocks

Limitations – affecting cost of credit on one hand, and zero lower bound (which after the GFC led to QE and other non-conventional monetary policy instruments) on the other hand (when interest rates are stuck at ZLB, or effective LB, fiscal expansion is called for!).

Price stability and alternative theories of price determination

- Inflation determined by money supply – nominal anchor required

versus

- Prices determined by unit prime costs marked-up by gross profit margins (except for prices of raw materials and agricultural products which are demand determined). Hence inflation determined by changes in unit product wage rates (or the relation of changes in real wage rates to changes in labour productivity), therefore:
  - inflation is generated by attempts to change relative shares of income distribution between wages and profits;
  - given the income distribution, as long as the economy operates below capacity, changes in money supply do not generate price changes, nor does expansionary fiscal policy;
  - no nominal anchor is required.

Fiscal policy recommendations under mainstream economics neutralities

- Cyclically adjusted balanced government budget

or

- zero structural government budget deficit (proviso for transition economies);
- tight control over public debt;
- Maastricht criteria.

Post-Keynesian national accounts framework (stock-flow consistent macro model)

$$YD + T + M = CP + IP + G + X \quad (1)$$

$$YD - CP = IP + (G - T) + (X - M) \quad (2)$$

$$SP - IP = D + (X - M) \quad (3)$$

where YD is disposable income of private sector, T is disposable income of government, M is import, CP is private consumption, IP is private investment, G is government expenditure, X is export, SP is private savings and D is fiscal deficit.

X – M is the net current account balance with the rest of the world which must be zero for the world as a whole

If X – M = 0 then $SP - IP = D$

Equation (3) is an equilibrium condition that holds at any volume of output and employment

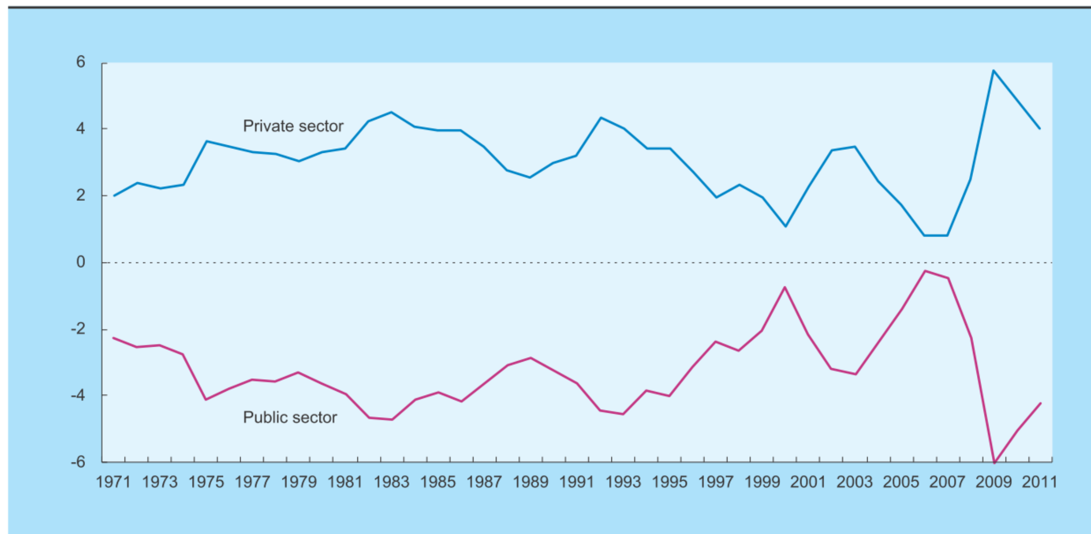
Post-Keynesian fiscal expansion adjustment mechanism

When as a rule SP > IP (evidenced by data, not an economic theory corollary), D must be positive (see next slide borrowed from Laski, 2015).

When for M – X ≠ 0, for SP – IP > 0, then - depending on whether the current account balance offsets, or adds to the SP – IP > 0 balance, the difference between the desired private savings, SP, and the intended private investment, IP - fiscal deficit, D, may be positive or will have to be negative. This explains D persistency.

When fiscal expansion is needed to ensure SP = IP at full employment, the adjustment mechanism operates through multiplier effects of D which improve expected profitability and capacity utilization encouraging thereby new investment decisions.

Private and public sector financial balances, worldwide, 1971-2011 *(in % of world GDP)*



Note: Figures above zero denote a surplus and below zero a deficit. Surpluses indicate additions to the net stock of financial wealth, and deficits indicate additions to the stock of debt. Except for small errors of measurement and aggregation of large numbers, the surpluses and deficits mirror each other.

***Source*: UNCTAD Trade and Development Report, 2013**

Limitations of fiscal expansion under financial capitalism

- For the EU 27 countries – costs of debt servicing when significant part of debt is foreign financed.
- For the EA 17 countries – absence of central bank as the lender of last resort; delayed intervention of ECB and its restrain on purchasing government securities.

Countries without sovereign money (unless their debt is domestically financed, e.g. Italy) are heavily dependent on pressure of capital markets (e.g., Spain versus Great Britain).

Hence, pressure to develop marco-financial stability instruments that in case of emergency would allow their central banks to purchase government securities and use other instruments securing marcoeconomic stability (including some forms of short-term capital flows taxation).

Mainstream economics adjustment mechanism through fiscal austerity measures

Inadequate effects of interest rate reductions because:

- they affect portfolio rather than volume of savings,
- little impact on long-term interest rates and therefore on investment decisions, and
- Zero (and/or „effective”) Lower Bound.

Hence fiscal and structural rather than monetary policy instruments are used nowadays to restore equilibrium.

Fiscal policy adjustment through „expansionary contraction”

- short-term economic contraction due to reduced output, employment and incomes from which savings are made, but
- long term expansion thanks to improved cost competition, increased domestic savings and supply side effects.

Limitations of ‘expansionary contraction’

- Exports apart, short- and long-term negative impact of increased household savings on private investment decisions (under below capacity employment)

  [What is the assumed private investment function?]

- Can debt/GDP ratios improve when GDP rates are declining (and lower than interest rates)?
- Impact of declining shares of wages in GDP on secular declines of GDP growth rates and unemployment rates
- High economic, social and political costs of restrictive fiscal and monetary policies

Structural policies under mainstream and Post-Keynesian economic paradigms

General observation – long gestation periods to mature

Mainstream (as a rule appealed to when fiscal and monetary policies fail):

- Improve market mechanism operation and reduce government intervention;
- Improve competitive position through „internal devaluation";
- Reduce budget deficit/GDP and public debt/GDP ratios („fiscal prudence");

versus

„Modern industrial policy" (Mazzucato, Rodrik, Wade)

- Theory and practice of „state driven innovation" and of the „entrepreneurial state";
- Risks to go overboard in former centrally planned economies.

Fiscal, monetary and structural policies - strictly separated or strictly co-ordinated - conclusions

Mainstream:

- Fiscal and monetary strictly interdependent but policy making tightly separated and mainly in hands of central banks.
- Difficulties in deciding when QE and other post GFC policy instruments are of monetary or fiscal nature.
- Structural – separated from the first two and mainly in hands of government

Post-Keynesian:

- All three heavily interdependent and to be tightly co-ordinated.
- Inflation targeting does not change substantially those conclusions.
- Whether inflation targeting is a satisfactory instrument of monetary policy in the post WFC times is a separate question for discussion.

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