

The Interaction of Monetary Policy and Fiscal Policy

Andrew B. Abel

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Various Channels of Interaction

- Financing/Monetizing Government Deficits
- Effect of Inflation on Tax Rates and Revenues
- Open Market Operations in Treasury Securities
- Liquidity Trap
- Lags in Monetary and Fiscal Policy
- Short-run vs. Long-run Uses of Policy
- Application to Current Economic Situation

Financing Government Deficits

- Peg Interest Rate to Reduce Financing Costs to Treasury
 - Constrains monetary policy
 - Monetization of large sustained deficits is inflationary
 - Treasury-Federal Reserve Accord, 1951

Inflation and Tax Rates

- Tax Code is Not Completely Indexed
 - Historical cost depreciation
 - Taxation of nominal capital gains
 - Feldstein: 2 pct. pt. reduction in inflation increases welfare by 1% of GDP permanently
- Indexation of Tax Code
 - Would sever link with inflation
- IITS
 - Not completely protected against inflation risk for taxable investors

Effect on Deficit of 1 Percentage Point Reduction in Measured CPI

(fiscal years, billions of dollars)

	1998	2000	2007
Δ Revenues	1.9	10.5	44.2
Δ Outlays			
Social Security	-2.8	-10.7	-44.6
Debt Service	-0.2	-2.0	-32.0
Other	-0.9	-4.5	-19.3
Δ Total Outlays	-3.9	-17.2	-95.9
Δ Deficit	-5.8	-27.7	-140.1

Source: Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1998-2007, January 1997, p. 41.

Open Market Operations Conducted in Treasury Securities

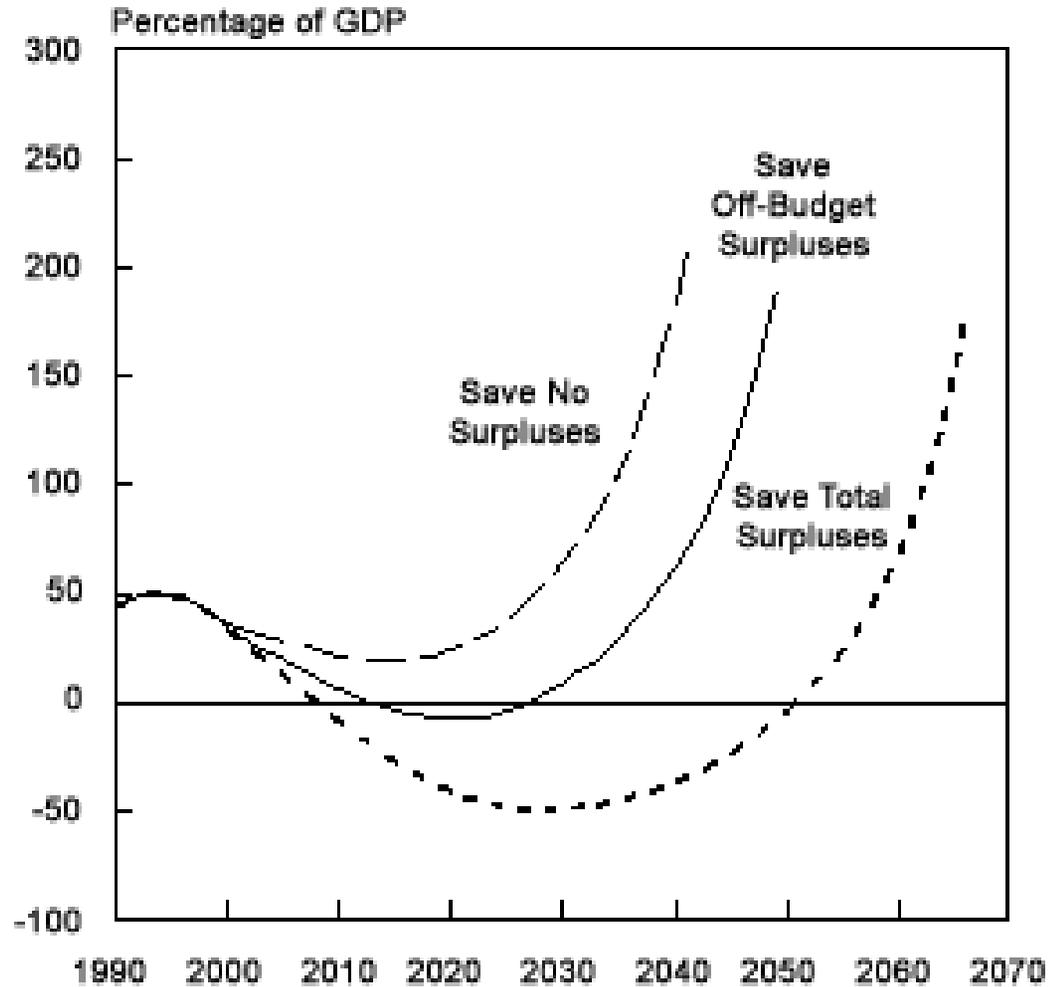
- What If Treasury Debt Disappears?
- Paal, Schreft and Smith, “The Conduct of Monetary Policy with a Shrinking Stock of Government Debt,” Sept. 2001.
 - Small debt \Rightarrow small monetary base
 - Inflation and interest rates will have to be high—too high—to clear money market
 - Shrinking debt exacerbated by:
 - Foreign demand for U.S. currency
 - Limit on the fraction of outstanding debt held by Fed
 - Conduct open market operations in other securities
 - Discount window lending at market interest rate is equivalent to OMO
 - Packages of loans, stocks, etc.
 - Loss of risk-free benchmark

Will Treasury Debt Disappear?

Holdings of Federal Debt - Billions of Dollars		
End of Fiscal Year:	2001	2011
Held by Government Accounts		
Social Security	1170	3722
Other*	1288	2352
Total in Government Accounts	2458	6074
Debt Held by Public	3294	876
Including Federal Reserve	535	??
Gross Federal Debt	5752	6950
*mainly Civil Service Retirement, Medicare, unemployment insurance and the Airport and Airway Trust Fund		
(most data from CBO, The Budget and Economic Outlook, August 2001)		

Long-Run Debt Projections

(Debt held by public, calendar year, percentage of GDP)



Source: CBO, The Long-Term Budget Outlook, October 2000, Figure 3.

Liquidity Trap

- Requires fiscal expansion to supplement or replace monetary expansion
- Liquidity trap in Japan?
 - Discount rate changes in 2001

Jan. 4	Feb. 13	Mar. 1	Sept. 19
0.50	0.35	0.25	0.10

- Is U.S. headed toward liquidity trap?
 - Discount rate changes in 2001

1/3	1/4	1/31	3/20	4/18	5/15	6/27	8/21	9/17	10/2	11/6
5.75	5.5	5.0	4.5	4.0	3.5	3.25	3.0	2.5	2.0	1.5

Short-Run Stabilization: Lags

	Monetary Policy	Fiscal Policy
Recognition	Short	Short to medium
Decision	Short	Long
Action	“Long and variable”	Medium to long

Short Run vs. Long Run

- Use Monetary Policy for Short-Run Stabilization
 - Long-run goal of monetary policy: low, stable inflation
- Use Fiscal Policy to Achieve Long-Run Goals
 - Spending
 - Guided by benefit/cost considerations
 - Correcting market failures
 - Taxes
 - Collect sufficient revenue with efficiency and equity
 - Minimize distortions
 - Redistributive goals?
 - Short-run stabilization with automatic stabilizers

Fiscal Stimuli in 2001

- Spring 2001
 - Economic Growth and Tax Relief Reconciliation Act of 2001
 - Attention to stabilization misplaced at the time ?
 - Bizarre phasing of provisions
- Fall/Winter 2001
 - Stabilization use of fiscal policy may be appropriate because of shorter than usual recognition and action lag?
 - Long-run consideration: huge and growing Social Security liabilities