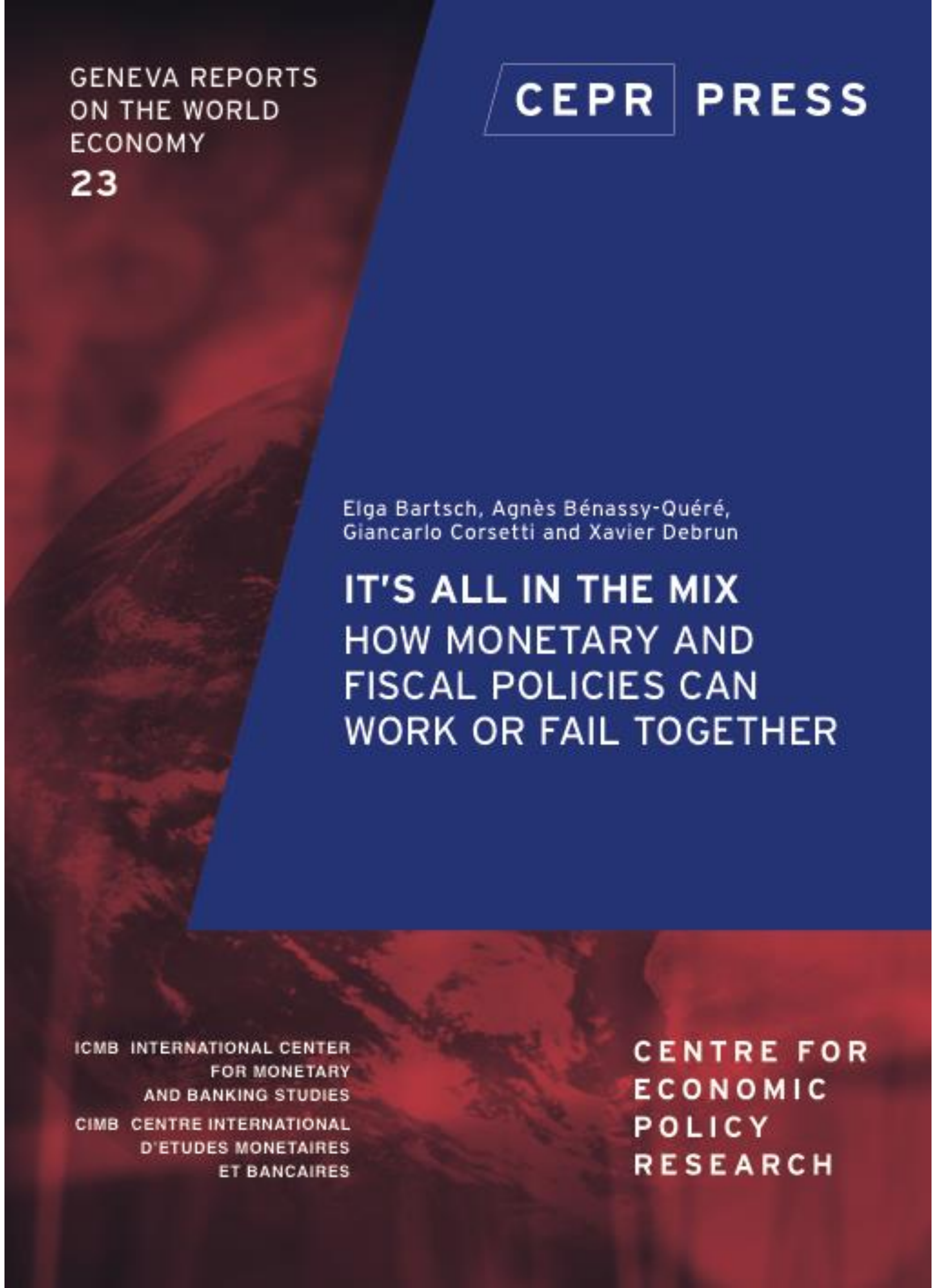


Chapters

Theory

The classics

Evidence

The mix in OECD countries

Tail risk challenges

GFC, EA sovereign risk crisis, COVID-19

A great normalization

R* as a global compass

Rethink the policy mix

…with a low R* + high debt + vulnerability to `tail events'

- Classical view: Monetary and Fiscal policy <u>strategic substitutes</u>, (enough "policy space" to deliver stimulus).

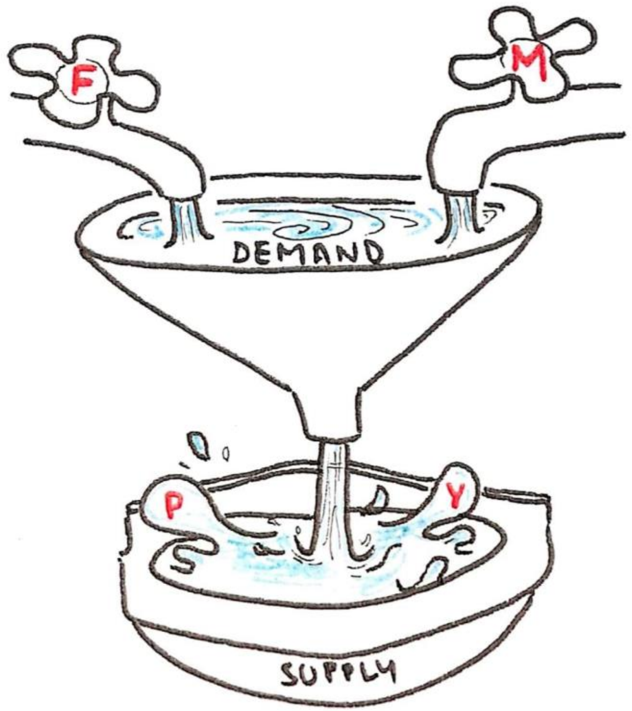
- New view: M and F <u>strategic complements</u>
  - Both needed to stabilize the economy
  - Virtuous complementarity <u>preserves space and credibility (hence effectiveness) of policies</u>
  - Instrument and institutional independence.

- Policy mix for a great normalization

Classical view: M and F substitutes (Tobin funnel)

- Both feed nominal spending = Aggregate demand.
  - M and F need not be both counter-cyclical (<u>congruent</u>)

- Aggregate supply determines the split of PY into inflation and economic activity.
  - M and F are relevant also at the AS level.

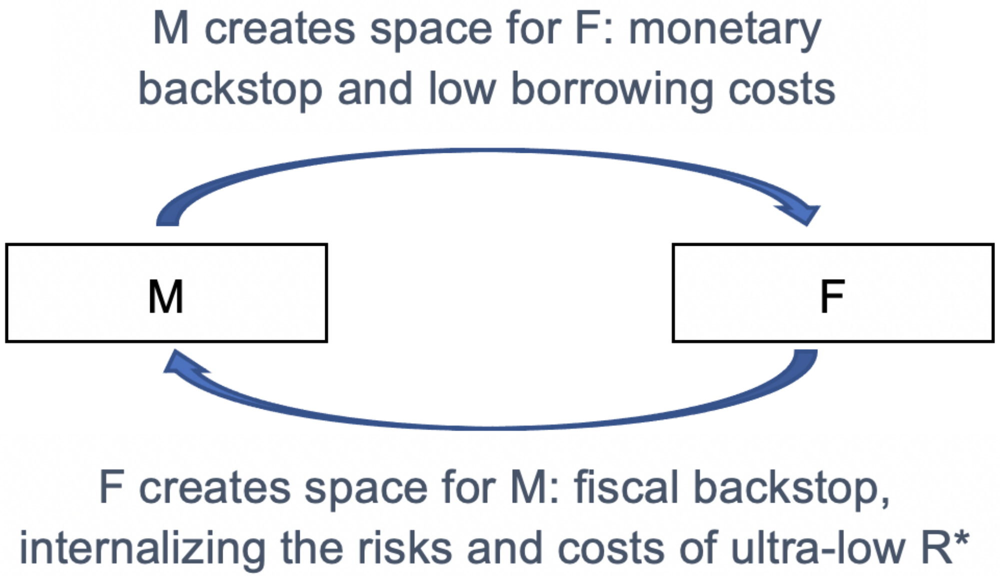


The evidence

- While a good policy mix need not have all instruments deployed countercyclically at all times, countercyclical monetary and fiscal policies should occur much more often than not.
- In advanced countries (1986-2019), a ‘congruent’ policy mix of countercyclical policies is rare
- Most often, monetary and fiscal policies pull in different directions. This may be for good reasons (supply or financial shocks) that require one of the instruments to be procyclical.
- But especially for fiscal policy, procyclicality is driven by political factors or financial constraints on the government.

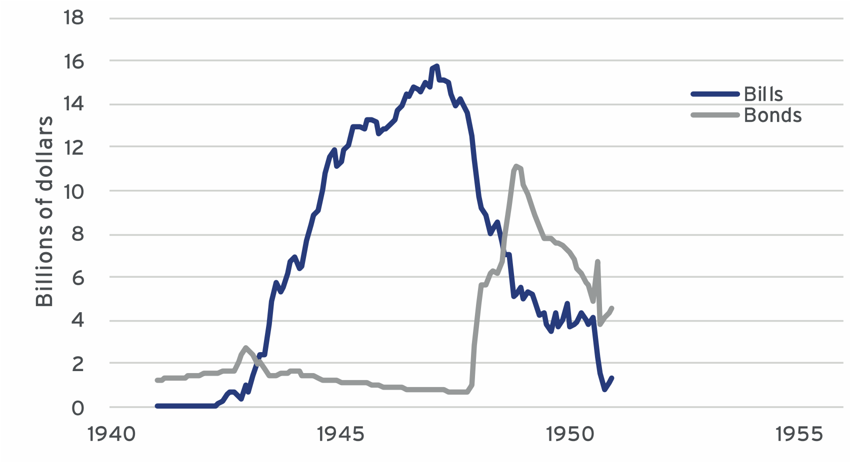
Policy mix today: Complementarities & coordination

- Tail events stretch existing instruments to the limit
  - Not enough policy space for **substitutability** between M and F
  - Look for new instruments (unconventional monetary policy)
  - But need to be aware that each influences the space and credibility of the other

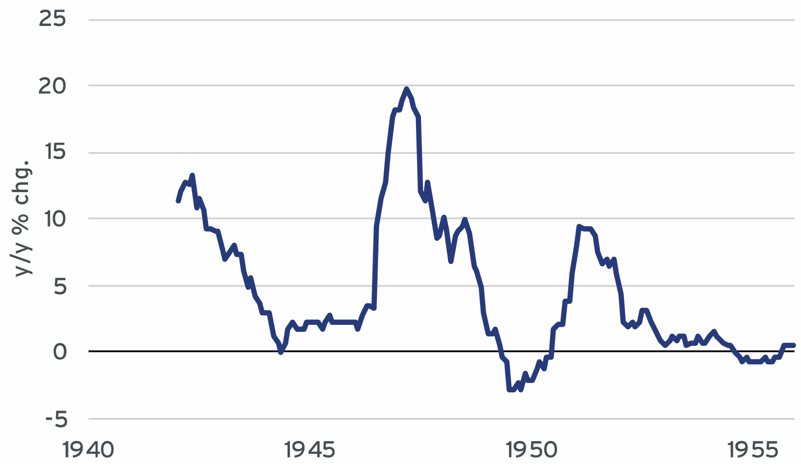


Lessons from history: Yield Curve Control

B) FEDERAL RESERVE HOLDINGS OF US TREASURY SECURITIES



C) US CONSUMER PRICE INDEX



Source: Federal Reserve; Haver Analytics.

"The dispute [between the Fed and the U.S. government] came to a head in 1951, when President Truman falsely told the press that the FOMC had agreed to support the Treasury's interest rate peg. In response, Eccles released the FOMC minutes that showed otherwise. The incident led to the Treasury-Fed Accord in March 1951."

Source: www.federalreservehistory.org

Getting back to the “middle of the road”

- In the current context, rebuilding and preserving policy space for economic stabilization of large disturbances is a key priority.
- A good policy mix should fully exploit complementarities between monetary and fiscal instruments and be coordinated across countries.
- Credible commitments to long-term goals – strong and balanced growth under price stability and public debt sustainability – needed.
- For EMU, this includes completion of EMU, creation of a permanent fiscal facility & a common safe asset and a(nother) review of the fiscal rules (simplify the two-pack, six-pack, and the MIP?).

Thank you!