Monetary-Fiscal Policy Coordination

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Desirable short- to medium-term stabilization goals are
  - Price stability
  - Balance of payments equilibrium (external stability)

Both fiscal and monetary policy, in this case covers flexible exchange rate policy, can affect price and external stability as well as short-term output growth.

This is why there may be gains from coordination.

What does successful coordination require?
1. Framing the question
   - Roles of monetary and fiscal policy
   - Linkage between the two
   - A solution to the coordination problem and implications

2. Requirement for successful coordination

3. The practical side of things: Coordination in practice

4. Challenges going forward: The case of Thailand
1. Framing the question

- Role of monetary and fiscal policy
- Linkage between the two
- Solution to the coordination problem and implication
How monetary policy works

- Central bank uses short-term interest rate and steers expectations of future short rates to influence longer term interest rates
- Monetary policy influences short-term aggregate demand and inflation pressure through various channels
- Low inflation keeps long-term rates low on average and provides environment conducive to investment
Across countries, fiscal policy have multiple roles. It is used to:

- Stabilize the economy through changes in fiscal stance
- Ensure fairness in distribution of income both within and across generations
- Influence incentives to save, invest in physical and human capital, and therefore enhance long-run (aggregate supply) growth
Fiscal policy and short-term economic stabilization

- Fiscal policy influences demand and inflation pressure in the short run via
  - Direct spending by the government
  - Changes to private disposable income through taxation and benefit system

- Fiscal effect on price stability can be tangible through short-run aggregate supply (cost-structure) as well
  - Tax changes can affect firms’ marginal costs over the business cycle
  - Firms’ profit-motivated price setting behavior passes on cost increase/decrease to consumers
A large deficit can cause “unacceptable” pressure on (nominal) market interest rates, requiring higher (nominal) debt payment.

Independent monetary policy also has fiscal consequences:
- Through influences on interest rate term structure, inflation and inflation expectations.

Monetary policy can affect real public debt burden; which needed to be paid back by taxation:
- Putting additional stress on government solvency condition.

Temptation to force central bank to “fund” large fiscal deficits can arise.
How fiscal dominance can happen in modern days

- Days of seigniorage-financed government deficits are over
- Today, seigniorage accounts for insignificant portion of government revenue
- Central bank can, however, be forced to suppress interest rates on government debt for some time while government sees its real debt burden reduced through higher inflation
US Fed, as residual buyer/seller, effectively fixed interest rates on US government debt at suppressed levels between WWII and 1951.

Passive monetary policy allowed inflation to rise until the scheme was abandoned.

Monetary autonomy of central banks can be fragile even today

- Monetary policy may be compromised if central bank is obliged to lend to government or provide subsidies, e.g. support price of government debt
- Fewer emerging markets than industrial economies have rules that prohibit such lending practice, making passive monetary policy possible

<table>
<thead>
<tr>
<th>Central bank lending to government (national or federal level)</th>
<th>Total</th>
<th>Industrialised countries</th>
<th>Emerging market economies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Percentage of central banks surveyed</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Lending to government: the central bank ...</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Must lend</td>
<td>10%</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>May lend</td>
<td>45%</td>
<td>36%</td>
<td>54%</td>
</tr>
<tr>
<td>Must not lend</td>
<td>48%</td>
<td>54%</td>
<td>36%</td>
</tr>
</tbody>
</table>

Source: BIS (2005) based on 2004 survey among Central Bank Governance Network
A sustainable case for policy coordination needed

- To recap, fiscal and monetary policy can affect price stability and growth rate in the short-run
- Both policies can respond to economic shocks
- Monetary policy can affect government intertemporal solvency condition
- Fiscal policy can affect aggregate price through demand and supply pressure
- A welfare maximization problem can be written to help characterize an answer to this coordination problem
If goal is to achieve and maintain economic stability, then what, in theory, is the solution like?

- **Outlining a coordination problem** (Benigno and Woodford, 2003; Woodford, 2001)
  - Find time paths of prices, allocation (output and consumption), tax rates, and public debt levels that minimize the (welfare) loss function subject to structure of the economy, given the shocks and initial debt burden

- **Solution (equilibrium) is characterized as follows:**
  - Monetary and fiscal authorities should use their instruments to **jointly** ensure low near-term inflation with small projected change in near-term output gap
  - The assignment of targets to policy instruments is not unique
Implication for policy coordination: A task assignment example

- After an assessment of shocks, Fiscal authority and central bank should coordinate to set near-term growth and inflation targets.
- Fiscal authority announces public debt level, budget surplus/deficit and commit to them as well as to the jointly determined inflation target.
- Central bank then operates a Taylor-type interest rate rule that pays attention to effects of fiscal plans (plus other shocks) on inflation target and change in output gap.
  - To follow the Taylor Principle, monetary policy must be active; i.e. it should have instrument independence.
Theoretical work on coordination in open economy setting is lacking

- Work on open-economy monetary policy rule is progressing rather fast
- But there is not much recent literature on how managed floating exchange rate policy works in this classic coordination/interaction problem
- Most assumes fully flexible (endogenous) exchange rates that relates to short term interest rates via UIP
- The flexible exchange rate then helps keep balance of payments in equilibrium at all time
2. Requirement for successful coordination
Coordination requires information sharing, and commitment

- Monetary and fiscal policy have long lags, must be forward looking
- Central bank needs to incorporate fiscal plans when assessing the future path of interest rates needed to meet the inflation target
  - Advance notice of new fiscal initiatives allows central bank to anticipate and respond to any material fiscal impulse to demand and inflation pressure
  - Commitment to fiscal plans ensure better chance of correct monetary policy response
- Likewise, government needs to consider the fiscal impulse on aggregate demand and hence monetary policy response when making fiscal initiatives
Predicting future policy moves is made easier when policy follows a well-understood and well-defined rule

- High degree of transparency in fiscal and monetary policy helps
- As well as active consultation (exchanges of information and views on issues and challenges) between the fiscal and monetary authorities

Each retains responsibility for their individual areas of policy
One practical coordination arrangement: Task delegation

- Government sets monetary policy goal consistent with price stability (inflation target) and fiscal objectives (underpinned by fiscal sustainability rule)
- Government gives central bank instrument independence
- This way, fiscal and monetary authorities have similar preferences
  - Makes no sense for government to set inflation target that is inconsistent with fiscal objectives because central bank will counteract any fiscal impulse that harms inflation target
  - Also encourages government to have medium-term fiscal framework and pay attention to fiscal sustainability
3. The practical side of things: Coordination in practice
Policy coordination arrangements depend on local institutional setup, but tend not to vary much

<table>
<thead>
<tr>
<th>Country</th>
<th>Operational or goal independence</th>
<th>Coordination arrangements</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>Instrument (Goal set by Government)</td>
<td>Treasury representative attends MPC meetings. Principle of “a voice without a vote.”</td>
</tr>
<tr>
<td>Euro area</td>
<td>Goal</td>
<td>President of ECOFIN* can attend ECB Governing Council meetings and can submit “motion for deliberation”  Commission can send a representative who cannot submit a “motion for deliberation”</td>
</tr>
<tr>
<td>Japan</td>
<td>Goal</td>
<td>A Ministry of Finance official attends monetary policy meetings</td>
</tr>
</tbody>
</table>

* Economic and Financial Affairs Council (ECOFIN) is composed of the Finance Ministers of the 27 EU states.
### Policy coordination arrangements (Continued)

<table>
<thead>
<tr>
<th>Country</th>
<th>Operational or goal independent?</th>
<th>Coordination arrangements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Canada</strong></td>
<td>Instrument (Target set jointly by Government and Bank of Canada)</td>
<td>Minister can, after consulting Governor, issue written directive on monetary policy.</td>
</tr>
<tr>
<td><strong>Australia</strong></td>
<td>Goal</td>
<td>Government reserves the right to comment on monetary policy. At times of disagreement, Government can issue a written directive.</td>
</tr>
<tr>
<td><strong>New Zealand</strong></td>
<td>Instrument</td>
<td>Regular exchange of information between Treasury and Reserve Bank. Fiscal Responsibility Act ensures a medium-term focus for fiscal policy that is highly transparent.</td>
</tr>
</tbody>
</table>
**Active consultation:** Emerging markets tend to see more frequent meetings between central bank and fiscal authority

Source: Moser-Boehm, BIS (2006)

<table>
<thead>
<tr>
<th>Type of meeting</th>
<th>Percentage of central banks having this type of meeting</th>
<th>Average number of meetings per year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>IC</td>
<td>EME</td>
</tr>
<tr>
<td>A Governor and Minister of Finance</td>
<td>73</td>
<td>31</td>
</tr>
<tr>
<td>B Governor and other high-level government officials</td>
<td>91</td>
<td>62</td>
</tr>
<tr>
<td>C Deputy Governor and high-level government officials</td>
<td>27</td>
<td>15</td>
</tr>
<tr>
<td>D Senior officials and department heads</td>
<td>36</td>
<td>15</td>
</tr>
<tr>
<td>E Government representative on central bank's board</td>
<td>18</td>
<td>62</td>
</tr>
<tr>
<td>F Governor at (economic) cabinet meeting</td>
<td>9</td>
<td>54</td>
</tr>
<tr>
<td>G Financial stability or supervisory committee</td>
<td>18</td>
<td>38</td>
</tr>
<tr>
<td>H Other</td>
<td>36</td>
<td>23</td>
</tr>
</tbody>
</table>
Governor-Minister meetings are more of an industrialized countries’ practice

Emerging markets tend to have government representatives on central bank board, or Governor participate in “economic cabinet” meetings

For all types/levels of meetings, average number of meetings per year is higher in emerging markets
Survey evidence (2): Emerging market authorities meet more than industrial counterparts to arrange crisis management, discuss monetary policy and policy coordination.

Source: Moser-Boehm, BIS (2006)
Survey evidence (3): Public comments and communication

- Central banks in general comment more on fiscal policy than vice versa, particularly so for industrialized countries

<table>
<thead>
<tr>
<th>Public comments on policies of counterpart</th>
<th>Must comment</th>
<th>Often or always</th>
<th>At times</th>
<th>Rarely</th>
<th>Never</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of responses (among 22 central banks)</td>
<td></td>
<td>IC</td>
<td>EME</td>
<td>IC</td>
<td>EME</td>
</tr>
<tr>
<td><strong>Comments by the central bank on ...</strong></td>
<td></td>
<td>IC</td>
<td>EME</td>
<td>IC</td>
<td>EME</td>
</tr>
<tr>
<td>Government's budget</td>
<td>10</td>
<td>3</td>
<td>30</td>
<td>33</td>
<td>40</td>
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<tr>
<td>General aspects of fiscal policy</td>
<td>-</td>
<td>-</td>
<td>50</td>
<td>17</td>
<td>30</td>
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<tr>
<td>Financial sector policy</td>
<td>-</td>
<td>33</td>
<td>33</td>
<td>17</td>
<td>60</td>
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<tr>
<td>Structural policy</td>
<td>-</td>
<td>-</td>
<td>40</td>
<td>17</td>
<td>40</td>
</tr>
<tr>
<td><strong>Comments by the government on ...</strong></td>
<td></td>
<td>IC</td>
<td>EME</td>
<td>IC</td>
<td>EME</td>
</tr>
<tr>
<td>Monetary policy decisions</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>17</td>
<td>70</td>
</tr>
<tr>
<td>General aspects of monetary policy</td>
<td>-</td>
<td>17</td>
<td>-</td>
<td>17</td>
<td>50</td>
</tr>
</tbody>
</table>

Source: Moser-Boehm, BIS (2006)
4. Challenges going forward: The case of Thailand
The conceptual framework in Thailand

Key aspect: Budget size determined by revenue estimation

Macroeconomic forecast

Estimated Revenue

Budget Balance (Appropriate fiscal impulse)

Fiscal Sustainability Framework
- Public Debt/GDP <50%
- Debt Services/Budget <15%
- Capital Exp/Budget >25%
- Balanced Budget since FY2005

Budget Deficit Financing
- Difference impact on economy
- Ceiling of deficit borrowing

Impact on Economy

Budget Size

△Tax Measures
Multi-year budgeting framework

- Medium-term expenditure framework adopted since 2001 to enhance transparency
- 3-year-ahead forecast of revenue and expenditure used
- Published in budget documents
- In practice, its reliability as future direction of fiscal policy has to be improved
Thai fiscal policy acts as an automatic stabilizer, while monetary policy targets inflation and accommodate growth when necessary.

Source: BOT staff’s calculation
Fiscal and monetary policy mix in Thailand

- *Cyclical* deficit in slower years tend to be followed by surplus in stronger years, pointing to built-in stabilizing role of fiscal policy
- Change in fiscal stance, i.e. discretionary (*structural*) balance, does not seem to help smooth business cycle in recent years
- Monetary condition has been accommodating growth after 2000-2003, tightening toward 2006 and accommodating again in 2007
Challenges for policy coordination in Thailand in 2008-9

- Recent economic expansion is heavily reliant on exports
- Going forward, risk to US growth can cause export slowdown
- Domestic demand recovery still at incipient stage
- Risk to inflation exists from global oil and commodity price pressure. May constrain monetary policy.
Requirement for robust growth and low inflation

- For growth to reach 4.5-6% in 2008, private consumption and investment should expand by 5 and 9.5%,
- It is essential that government expenditure rise by at least 8%. Robust public sector spending will also revitalize business and consumer confidence
  - Continue with budget deficit into FY 2009
  - Maintain high disbursement rate
  - Implement mass transit and other infrastructure mega-projects
- Monetary policy remains vigilant against inflation, while accommodating growth in case
  - Price pressure reduces more than expected from exchange rate appreciation or oil price letoff
  - US slowdown impacts Thailand’s export growth more than expected
Conclusion

- Fiscal and monetary policy can affect price stability and growth rate in the short-run
- Fiscal authority and central bank should coordinate in setting near-term growth and inflation targets
- Successful coordination requires information sharing (transparency), commitment and a significant degree of monetary policy independence to pursue stabilization goal
- Coordination arrangements tend to be similar in advanced countries, but can vary across emerging markets
- As fiscal and monetary authorities coordinate their action, short-term stabilization goals should be set in context of long-term sustainable growth objectives
References