

# TETHERING THE FISCAL SOW: MONETARY POLICY THAT KEEPS PORK IN THE STY

Independent central banks can help restrain government spending argue **James Savage** and **Jan Libich**

Interest rates have been a recurring topic in recent Australian federal election campaigns. During the 2004 campaign, John Howard's incumbent government let there be no doubt: 'Interest rates under a Labor government would be higher!' The Labor Opposition retorted that such a claim was unwarranted as it was not the government that set the interest rate but the (independent) Reserve Bank of Australia (RBA). Such mixed messages have done no favours to the public's understanding of the interactions between fiscal and monetary policy.

The apolitical reality is that the policies of governments and central banks are interdependent—even though the central bank is formally independent of the government. This is because of the feedback effect between fiscal and monetary policy, and spill-overs of macroeconomic outcomes between them. By examining the main channels through which the two policies interact we can draw some conclusions about the optimal design of macroeconomic institutions and policies. Let us stress that our attention is on long-term policy interactions and outcomes under normal circumstances, rather than during recessions or financial crises.

## **Tug-of-war or cat-and-mouse?**

### **Fiscal-monetary interactions**

Monetary policy in Australia is conducted independently by the RBA, but the term 'independence' is flexible. Technically, monetary policy can be influenced explicitly (by government

diktat) or implicitly (by government behaviour). The explicit channel is the Treasurer's power to override the RBA board, an option that has never been used. Until late 2007, the Treasurer could also appoint RBA board members. Unlike the overriding provision, the capacity of the Treasurer to appoint partisan governors has been used and, in at least one instance, attracted claims of shadiness.

The implicit relationship between government and the central bank is complex and less well understood. Essentially, the policies of both institutions affect the same variables—prices, asset values, and unemployment—but government and central bank administrators of the policies may disagree about what those variables should look like. The disagreement commonly stems from political realities: politicians face re-election, central bank bureaucrats don't. This institutional setup results in an imbalance of priorities: past

**James Savage** works in macroeconomic modelling, and is also a research assistant at La Trobe University.

**Jan Libich** is a Senior Lecturer in the Department of Economics and Finance at La Trobe University. He is working on an Australian Research Council 2008–10 project examining the interactions between fiscal and monetary policy.

experience teaches us that, commonly: i) politicians think *short* whereas central bankers think *long*, and (ii) politicians focus on low *unemployment* whereas central bankers focus on low *inflation*.

So how does this potential mismatch in the preferences of the two institutions affect the outcomes of fiscal and monetary policy? Attempts by governments to reduce unemployment are characterised by fiscal profligacy. Rather than tackling unemployment by pursuing the long and politically difficult road of tackling entrenched interests (both corporate and labour), governments around the world too frequently purchase low unemployment directly through higher government expenditure. This is possible temporarily because some economic variables are slow to adjust, leading to the short-run trade-off between unemployment and inflation that Bill Phillips first noticed decades ago.

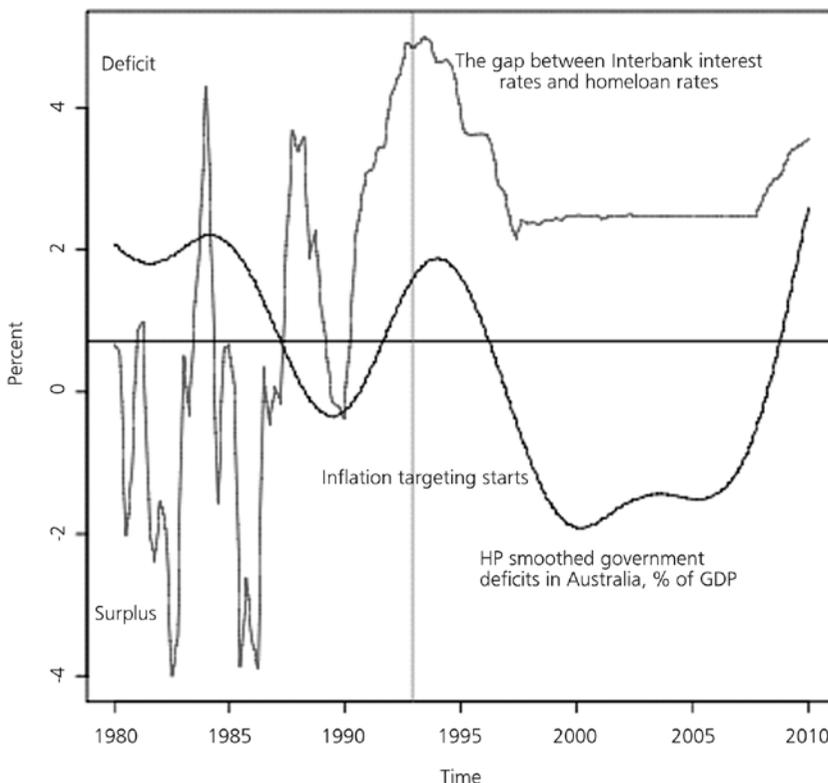
Excessive government spending however stimulates aggregate demand to a level at which firms find it easy to increase prices, and so inflationary pressures brew. The best recent

example of this kind of behaviour is Greece. From the creation of the European common currency zone to the start of the global financial crisis, Greece had an average government deficit of nearly 5% of GDP (if the numbers are to be believed), in part financing a reduction in unemployment from 12.1% to 7.65%. Over the same period, Greece had average inflation of 3.3%, nearly twice the German average of 1.7%, and well above the European Central Bank's 2% target.

Irresponsible fiscal behaviour affects monetary policy and interest rates in four main ways.

- First, deficits soak up savings that may otherwise be used to finance private investment—the so-called ‘crowding-out’ effect. In economic theory, this pushes up interest rates in the market for loanable funds as private investors bid higher repayments over a dwindling pool of savings. In practice, however, this is a strongly contested point—all else infrequently being equal. Interest rate changes are partially driven by the monetary

**Figure 1:** Smoothed Australian government budget position and interest rate spreads



**Note:** An HP filter is a Hodrick Prescott filter, a statistical device to try to show only the trend in data.

policy of the central bank; the remaining changes must be driven by credit conditions: demand and supply of savings, perceived risks, expectations, competition between lenders, and so on. As not all the drivers of interest rate changes are observable, and because many drivers may move at the same time, it is difficult to determine the extent to which crowding out occurs. Figure 1 illustrates what may be interpreted by some as being crowding-out in action—at least in the years after inflation targeting was introduced in Australia, fiscal surplus is correlated with a smaller, more stable gap between the rate at which banks lend to each other and the home-loan rate.<sup>1</sup>

- Second, when markets believe the government has run up too much debt, the risk premium paid by the government increases. This occurs because investors aren't as willing to pay as high a price for bonds that may not pay off. At the time of writing, the spread between Greek government bonds and German bonds was nearly 500 basis points (5%), implying a considerable belief in the market that the Greek government would default. Worse still is what will happen if such a sell-off occurs quickly: if investors sell down government debt and the central bank uses an interest rate rule, the central bank is practically obliged to buy bonds—printing money. Needless to say, that is not an ideal outcome.
- Third, when fiscal policy results in increased inflation, investors require compensation in the form of higher nominal interest rates—readers may recall term deposit accounts in the late 1980s bearing 12.5% interest. Transitions both to and from high inflation are distortionary—an increase in inflation reduces wealth stored in assets that are not inflation linked; dis-inflating requires higher-than-usual unemployment.
- Fourth, when the central bank has a legislated inflation target, fiscal policy that causes inflation requires the central bank to

raise its target rate to dampen the prospect of further price rises. This fourth link between fiscal behaviour and monetary outcomes is perhaps the most important in a policy sense. It suggests that an institutional setup that brings forward the political pain of fiscal mismanagement may dissuade governments from engaging in it.

Through these four channels, excessive fiscal policy is likely to push interest rates upward and affect monetary outcomes—even if the central bank is independent. The two policies then tend to work in the opposite direction, and such tug-of-war (also referred to as the game of chicken) benefits no one. It only leads to higher mortgage repayments now and higher taxes in the future. History has taught us that governments tend to have an upper hand in this policy conflict and eventually force their central banks to inflate the accumulated debt away.

It is possible, of course, that the aims of a government and a central bank are in step and sustainable in the long run—this ideal situation is called the 'symbiosis' of monetary and fiscal policy. But most countries are not so fortunate. The question for them is how to emulate the conditions under which that ideal situation is arrived at *even if* the government is politically driven. Given the welfare consequences of unsustainable debt accumulation and high inflation, and the fact that the factors driving the political economy are unlikely to disappear, a large body of research has developed in assessing the kind of arrangements that could improve the interactions and outcomes of policies.

The key word is *commitment*. It has long been recognised that people respond to incentives, and that various commitment devices can alter those incentives. For example, a number of companies now offer customers the option of putting a binding contract on themselves to better achieve their goals using financial incentives.

Such reasoning was first used in monetary policy. Many countries have significantly strengthened the commitment of their central bank by legislating a long-run numerical inflation target. In combination with a number of additional transparency measures, a stronger monetary

commitment has led to enhanced accountability of central bankers and subsequent improvements in the outcomes of monetary policy.

These successes can be emulated to make fiscal policymaking more transparent and accountable (and perhaps even partly independent from government) and secure long-term fiscal sustainability.<sup>2</sup>

### The role of monetary commitment in fiscal policy

A novel insight from the policy interactions literature has been the importance of the long-run credibility of the central bank in determining government policy. If a government loosens the purse strings to reduce unemployment knowing that the central bank will do the same, the resulting inflation whittles away government debt—so there is little incentive for the government to reconsider its policy stance. If, however, a government is aware of the resolve of the central bank to fight inflation regardless of what short-run effect that may have on unemployment, the government has a large disincentive to engage in unsustainable fiscal policy.

When will the central bank have enough credibility and ammunition to fight the government and potentially ‘discipline’ its fiscal behaviour? A necessary condition seems to be a formal legislated independence of the central bank from the government; indeed, central banks in developed countries have been officially granted independence over the past few decades. Central bank independence however does not seem to be sufficient. Another crucial ingredient identified in the literature is how strongly (explicitly) the central bank’s commitment to price stability is grounded in the central banking legislation or statutes.

The *Reserve Bank of New Zealand (RBNZ) 1989 Act* pioneered a type of monetary policy commitment never used before: a numerical target for (average) inflation. There are some good reasons to think this approach is preferable to the US Fed’s ‘just do it’ approach for containing fiscal misbehaviour. The main reason seems to be that a transparently legislated inflation target enhances accountability of monetary policy. Only when the aims of monetary policy are clearly specified is it possible for society to hold the central bank

accountable for missing its given target. Such threat of punishment strengthens the central bank’s determination to achieve its inflation target over the long term and gives it more ammunition to fight the government over excessive fiscal policy.

This argument is consistent with the account of Don Brash, the Governor of the RBNZ during 1988–2002, who ‘taught’ inflation targeting to the world.

In the middle of 1990, the Government, faced with the prospect of losing an election later in the year, brought down an expansionary budget. I immediately made it clear that this expansionary fiscal policy required firmer monetary conditions if the agreed inflation target was to be achieved, and monetary conditions duly tightened. Some days later, an editorial in the *New Zealand Herald*, New Zealand’s largest daily newspaper, noted that New Zealand political parties could no longer buy elections because, when they tried to do so, the newly instrument-independent central bank would be forced to send voters the bill in the form of higher mortgage rates.<sup>3</sup>

Most inflation targeting countries  
...have improved their fiscal  
outcomes after adopting a  
numerical inflation target.

One might suggest that the government could change the central banking legislation and get rid of the numerical inflation target to sway the policy fight in its favour. Interestingly, there does not seem to be a single example of an inflation targeting country abandoning the monetary commitment. This is related to the effect of transparency: such actions would be visible by the market participants and voters, with dire political consequences.

The \$64,000 question, then, is: has explicit inflation targeting acted to coerce governments into reducing excessively loose fiscal behaviour?

The answer is yes, with caveats. There exists no large-scale empirical testing of this hypothesis to date (we have a paper attempting to do so currently in progress). Nevertheless, there is some anecdotal evidence. For example, the comparison of the fiscal balance of inflation targeting and non-targeting countries is broadly consistent with the hypothesis. With the exception of the United Kingdom and the Eurozone, most inflation targeting countries (including Australia, New Zealand, Canada, Sweden, and Finland) have improved their fiscal outcomes after adopting a numerical inflation target. In contrast, the main non-targeters such as the United States, Switzerland and Japan have all seen their fiscal outcomes unaffected or deteriorate over the same time.

There are several caveats in testing whether explicit inflation targets ‘discipline’ fiscal policy. First, inflation targeting has often been introduced along with a suite of other austerity measures by fiscally conservative governments: the Lange government in New Zealand, the Keating and Howard governments in Australia, and the Cardoso government in Brazil. Typical of these reforms were enhanced fiscal-reporting requirements (like the *Australian Charter of Budget Honesty Act 1998*), tax reform, and labour market reform. Where institutions like these have been adopted along with inflation targeting, it is difficult (if not impossible) to determine what proportion of subsequent government austerity is owed to each policy.

Another difficulty with empirical testing of such hypotheses is that it is not solely fiscal behaviour that causes inflation—at best, only a proportion of price rises are due to excessively eager governments. Conversely, in this most recent period of globalisation, many prices that otherwise may have risen due to fiscal imprudence have been kept in check by cheap imports from China; meanwhile, the Chinese Miracle has kept unemployment low and reduced the incentives for fiscal neglect in commodity exporting countries (who make up a large proportion of inflation-targeters).

The biggest caveat, however, is a potential membership of the country in a monetary union (such as the Eurozone) or its periphery (like the United Kingdom). It may seem contradictory to

discuss the proposition that inflation targeting begets fiscal prudence in the midst of the largest debt crisis of the century—one originating from within the Eurozone, home of the world’s most inflation-wary central bank. By many measures, the European Central Bank is the world’s most independent inflation-targeting central bank. This is because its target inflation rate can be modified only by treaty between all countries with voting members on the bank’s Governing Council. Needless to say, that would be a task of the greatest political difficulty, all but making it impossible. The resulting independence and actual goal variable—keeping inflation below but close to 2%—are the two main features of an inflation targeter.

Why then, would so many of its member countries, especially Greece and the rest of the PIIGS (Portugal, Italy, Ireland, Spain), have such lax fiscal policy compared to Australia? It is unlikely that Australian politicians are more prudent by nature, or that the Australian taxpayers don’t enjoy political pork as much as the Greeks. The real reasons may be the moral hazard and free-riding problems inherent in monetary unions. A monetary union has a common monetary policy, but the fiscal policies of the member states are independent and uncoordinated. Each government, especially in the smaller member countries, can act freely safe in the knowledge that its fiscal excesses will have only a negligible effect on the union as a whole. So the punishment in the form of (slightly) higher interest rates is spread all over the union, whereas the political benefit of the fiscal stimulus occurs primarily in the undisciplined country. The common central bank in a monetary union loses the above described indirect influence over the stance of fiscal policy, especially in small member countries, since the bank’s punishment does not reach them. More direct ways to discipline fiscal actions must be implemented, but the failure of the non-binding Stability and Growth Pact to restrict budget deficits and national debt in the Eurozone shows it may be a difficult task.

### Conclusion

For several reasons, interest rates can depend on the policies of the government even if the central bank is formally independent from it, and vice versa. A sound institutional design of monetary policy with a strong, legislated long-term commitment to price stability may be able to improve ('discipline') the long-term outcomes of fiscal policy by changing the incentives and payoffs from excessive spending. This avenue seems to have worked well in Australia and other inflation targeting countries, and would likely benefit non-targeters such as the United States, Japan and Switzerland.

### Endnotes

- 1 It should be noted that some part of the high positive correlation between the surcharge of commercial banks and fiscal policy is driven by a third factor: the business cycle. Fiscal policy is counter-cyclical and in recessions, it automatically tips into a deficit due to increased spending and lower tax receipts. This increases the risk of loan default by firms, to which banks respond by increasing their surcharge over the cash rate as insurance.
- 2 For a recent proposal for Australia, see Robert Carling and Stephen Kirchner, *Fiscal Rules for Limited Government: Reforming Australia's Fiscal Responsibility Legislation* CIS Policy Monograph No. 98 (Sydney: The Centre for Independent Studies, 2009). Nevertheless, in many countries such fiscal reforms seem a long way away. Even in countries where direct fiscal commitment is not (yet) politically feasible, fiscal outcomes may be improved indirectly through strengthening monetary commitment.
- 3 Jan Libich, Andrew H. Hallett, and Petr Stehlik, 'Monetary and Fiscal Policy Interaction with Various Degrees and Types of Commitment,' CEPR discussion paper 6586 (2010).

## CIS CAPITAL FUND

*'We must make the building of a free society once more an intellectual adventure, a deed of courage. If we can regain that belief in the power of ideas which was the mark of liberalism at its best, the battle is not lost.'*

F. A. Hayek

More than thirty years of CIS research, publishing, events, and other activities have created a vast network of scholars, contributors, supporters, and participants. The Capital Campaign has been a solid foundation for the Centre to establish an intellectual base, bringing together, from all around the world, people who believe in pursuing the promotion of liberty and freedom. However, it is now that the financial security of CIS needs to be assured through the continued support and commitment of friends and associates who trust in one of the truly independent voices in public policy debate. The CIS Capital Campaign is an opportunity to support the longevity of the Centre, to invest in its future, and to invest in a freer society.

For more information on the CIS Capital Campaign visit [www.cis.org.au](http://www.cis.org.au), contact the Centre on **(02) 9438 4377**, or email [cis@cis.org.au](mailto:cis@cis.org.au).