Monetary Policy and Fiscal Policy in a Nash Equilibrium

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Some questions

- How can economic policies be distinguished?
- What is the relation between monetary policy and fiscal policy?
- Should they be conducted separately or coordinately?
- Should they be conducted by the same or different authorities?
- My answers refer to normal and non-crisis times, when flexible inflation targeting for monetary policy and a fiscal framework for fiscal policy have been established

Some questions

- How can economic policies be distinguished? Goals, instruments, responsible authorities
- What is the relation between monetary policy and fiscal policy? Very different, considerable interaction
- Should they be conducted separately or coordinately? Separately, each policy aiming to achieve its goals while taking into account the conduct and effects of the other policy (Nash equilibrium)
- Should they be conducted by the same or different authorities? Different
- My answers refer to normal and non-crisis times, when flexible inflation targeting for monetary policy and a fiscal framework for fiscal policy have been established

Economic policy

- Overall goal of economic policy: Maximize welfare
- Allocate specific goals to specific economic policies (monetary, fiscal, financial, labor, commercial, industrial, trade, …)
- Each economic policy
  - Suitable goals (goals that can be achieved)
  - Suitable instruments
  - Responsible authorities, accountable for achieving the goals

Monetary policy (simple)

- Goals (simple)
  - Flexible inflation targeting: Price stability and full employment
  - Stabilize inflation around inflation target and unemployment around its minimum long-run sustainable rate
- Instruments (simple)
  - Normal times: Policy rate and communication (forecasts, forward guidance, …)
  - Crisis times, crisis management: Unconventional measures, balance sheet policies (QE), FX policy (interventions, currency floors) …
- Authority
  - Central bank (independent)

Fiscal policy (complex)

- Goals (complex)
  - Stabilization (high and stable resource utilization)
  - Efficiency (efficient allocation of resources)
  - Distribution (equitable distribution of income and wealth)
- Instruments (complex)
  - Public expenditure, taxation, legislation, regulation, …
- Authorities (somewhat complex)
  - Ministry of finance (central government), local governments

Swedish fiscal policy framework

- Budget targets keep fiscal policy sustainable
  - Public-sector budget surplus target
    (1% of GDP over business cycle, 1/3% of GDP 2019-)
  - Public debt anchor (35% of GDP in medium term)
  - 3-year government-expenditure ceilings
  - Local-government budget balance
- Tight government budget process (top-down)
- External monitoring and evaluation
  - National: Fiscal Policy Council, National Audit Office, Financial Management Authority, National Institute of Economic Research
  - International: IMF, OECD, European Commission,…
- Transparency and clarity
  - Rules on reporting, coverage, government bills, freedom of information

Interaction between fiscal and monetary polices

- Considerable interaction
- Fiscal policy affects inflation and employment
- Monetary policy affects activity, inflation and interest rates: Thereby tax income, public interest expenditures, need for public expenditures (welfare expenditures), the real value of public debt, ….

Conducted separately or coordinately?

- Considerable interaction: Case for coordination
- But historical experience:
  Case for separation of policies and independence of the central bank
- Nash equilibrium
  - Each authority aims to achieve its goals, taking into account the conduct and effects of the other authority's policy
- Protects the central bank from political pressure for short-run political gains
- Allows the central bank to be held accountable for achieving its goals
- Has historically worked much better than coordination
- Furthermore, a fiscal framework, respected by all political parties, keeps fiscal policy sustainable and accountable
- But, in crises and during crisis management: Coordination