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A More Robust Macroeconomic Policy Framework Is Needed

Paul J. Sheard

The COVID-19-triggered economic shutdown has precipitated the second collapse in economic activity and surge in unemployment in 12 years. The resulting monetary and fiscal policy responses have been dramatic and necessary, and have underscored the need to make the macroeconomic policy framework fit for 21st-century purposes.

Macroeconomic policy aims to keep the economy operating at full employment (so that whoever wants to work can) and to keep inflation low and stable (so that the purchasing power of people's savings is preserved over time). An ancillary aim is to maintain financial stability, because a market economy is prone to financial crises, which can wreak havoc on employment and price stability.

While institutional details vary by country, the existing macroeconomic policy framework has two pillars: "monetary policy" and "fiscal policy." Monetary policy aims to guide economic activity and inflation by influencing interest rates and other financial conditions, and is the responsibility of the central bank. Fiscal policy involves budgetary matters (changes in government spending, taxation, and transfers), and is the responsibility of the government of the day and its treasury.

Monetary policy is seen as being separate from fiscal policy; it is viewed as being the primary tool of macroeconomic (aggregate demand management) policy; and

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the independence of the central bank from the political sphere is taken to be critical, if not sacrosanct.

This framework needs to be made more robust to a range of economic challenges. It is well adapted when high inflation is the main threat to price stability and government spending needs to be held in check. It is not optimally designed when the proximate policy challenge is a large or persistent shortfall in aggregate demand, chronic deflation, or a very low real equilibrium rate of interest (what Harvard economist Larry Summers calls "secular stagnation").

Since the Great Recession, there has been a growing recognition that too much burden has been placed on monetary policy, that monetary policy has limits, and that some circumstances call for a much more active role for fiscal policy, and for the monetary and fiscal authorities to coordinate much more closely, if not act jointly.

The limits of monetary policy are clear to see. Prior to the financial crisis, the main policy tool of central banks was the overnight interest rate (the policy rate), the anchor rate of the yield curve and, indirectly, of the prices of all financial market instruments. When warding off the threat of high inflation was the main policy challenge, there was no problem, because central banks could raise the policy rate and tighten financial conditions without limit. Knowing this, the public's inflation expectations were kept in check. Everything was hunky-dory.

But when there is a big negative shock to aggregate demand, when the economy falls into a semi-permanent state of deflation (as happened in Japan in the mid-1990s), or when the "natural rate of interest" gets too low, things change. A central bank has limited room to cut the policy rate and may hit the "zero (interest rate) bound" or, allowing for a limited negative policy rate, the "effective lower bound."

That is the cue for the central bank to start to do "quantitative easing" (QE): the purchase of assets, usually government debt securities, paid for by creating central bank money (reserves). There is nothing wrong with QE per se, but its stimulatory effects are weak. Once a central bank reaches the effective lower bound and has to launch into QE, it is a sure-fire sign that much more active use of fiscal policy needs to be made; then central bank independence becomes a hindrance, not a help.

The distinction between what we term "monetary policy" and what we term "fiscal policy" is not as clear-cut as commonly supposed. It reflects the institutional arrangements that have evolved over the past century or so, particularly making the central bank independent so as to stop governments from abusing their ability to

create money at will. Too much money being created relative to the capacity of the economy to produce output leads to inflation.

Money, thought of as the feedstock of purchasing power, comes into existence in two different ways: when banks lend and when governments run budget deficits.

When a bank makes a loan, it simultaneously creates a deposit, that is, money. Most people, having been exposed to a textbook exposition, have the idea in their head that central banks control the "money supply" by buying or selling government bonds and doing so constitutes "monetary policy." This is misleading. The essence of monetary policy is the central bank's direct control over the interest rate at which banks lend to, or borrow from, each other the reserves (deposits) they hold at the central bank (by controlling this rate indirectly, they can influence other interest rates and financial market prices).

Monetary policy only indirectly influences (bank) money creation inasmuch as it influences the willingness of borrowers to borrow and banks to lend. Before the financial crisis, the Fed and most central banks did not pay any interest on reserves, which meant that they always had to adjust their asset holdings to keep actual reserves in line with required reserves (which they also set). This is a far cry from central banks mechanically controlling the "money supply."

When a government runs a budget deficit, it creates money by virtue of the fact that it injects more purchasing power into the economy by its spending than it withdraws via its net taxes (taxes net of transfers). Usually this money is issued and held in the form of government bonds, but at a primitive level budget deficits create reserves (money).

Deficits create reserves, issuing bonds extinguishes them, and central banks increase (decrease) reserves when they buy (sell) bonds. Fiscal policy is actually very "monetary" in nature, and monetary policy is not as detached from fiscal policy as it is made out to be; to the extent it is, it is because monetary policy is really a joint activity of the central bank and the banking system and financial markets more broadly.

If the central bank was just a cashier function of the treasury, there would be no limit on the ability of the government to create money by running budget deficits; high inflation would be sure to result. By making the central bank independent of the treasury and by not allowing the treasury to run an overdraft in its account at the central bank, the treasury is forced to "finance" its deficit by issuing bonds to the private sector. Government bonds and central bank reserves are just two alternative ways in which the money or purchasing power created by government budget deficits is held.

Now QE can be seen in its proper light. When it involves government bonds, QE is just a debt refinancing operation of the consolidated government (the government including the central bank) whereby the consolidated government, via the central bank, retires government bonds and refinances them into central bank money (reserves). Budget deficits create new money; bond issuance operations on the one hand and QE on the other change the form of that money.

Central bank independence, and the conceptual and operational distinction between monetary and fiscal policy, have proved useful in preventing high inflation, but they are a hindrance when circumstances call for fiscal policy to play a bigger, if not the leading, role in achieving full employment and price stability quickly (and speed is important because of the very high social costs of unemployment).

Economists are so enamored of the idea of central bank independence that they react almost viscerally to any suggestion that it should be qualified. The narrative that, were it not for the independence of central banks, politicians would be running the printing presses overtime, holds strong sway over them. That is one of the lessons of monetary developments of the 20th century, and the innovation of the central bank independence has much to commend it.

But there is such a thing as social learning. It should be possible for society to embrace a shared understanding that price stability is a good thing and that macroeconomic policymakers must always have it in their sights. Price stability should be seen in the category of public safety or the rule of law: there is a shared societal understanding of, and commitment to, it.

A policy framework is not robust if it works well in some circumstances but not in others. Optimal policy in some macroeconomic environments calls for close coordination between, if not in effect a fusion of, monetary and fiscal policy. I see three ways to make the macroeconomic policy framework more robust.

One is to establish formal institutional mechanisms to facilitate better communication, coordination, and cooperation between the central bank and the (rest of the) government, and amend relevant central bank legislation to give effect to this. There are already examples of such coordination mechanisms, which tend to get overlooked or frowned upon by economists given their love affair with central bank independence.

Japan probably presents the most highly articulated example of mechanisms existing for coordinating monetary and fiscal policy (although the extent to which they have been used effectively is a different matter).

Article 4 of the Bank of Japan Act requires the central bank to maintain close contact with the government and ensure that its "currency and monetary control" are "compatible with the basic stance of the government's economic policy." Two key economic ministers ex officio can attend Monetary Policy meetings and, while they cannot vote, they can express opinions and submit proposals. The governor of the Bank of Japan gives a report to the monthly meeting of the Economic Cabinet. The output of this meeting is the Cabinet Office's Monthly Economic Report, which sets out the above-mentioned "basic stance of the government's economic policy." In January 2001, the government established a high-level advisory body to help formulate and coordinate economic policy, the Council on Economic and Fiscal Policy; its membership comprises the prime minister, the chief cabinet secretary, senior economic ministers and four members from the private sector—and notably the BOJ Governor.

Australia offers another example where there is more recognition than usually meets the eye of the need for monetary policy to be coordinated with government policy. Under the Reserve Bank Act (1959), the secretary to the Department of the Treasury, the most senior official in the department, ex officio is a voting member of the Reserve Bank Board, the entity that, among other things, sets monetary policy. Article 11 of the Act sets out a detailed procedure for reconciling any "differences of opinion with the Government on questions of policy," and Article 13 requires the governor and the secretary to "establish a close liaison with each other and…keep each other fully informed on all matters which jointly concern the Bank and the Department of the Treasury."

Which brings me to the United States. In the financial crisis, and again in the COVID-19-driven crisis, there has been close cooperation between the Federal Reserve and the U.S. Treasury. However, there is a strong case for formal mechanisms to be established to codify communication, coordination and cooperation between the Fed and the administration, particularly the Treasury. Consideration should be given to one or more of the secretary of the Treasury, the director of the National Economic Council, and the chair of the Council of Economic Advisers to be ex officio (non-voting or even voting) members of the FOMC (Federal Open Market Committee).

Another change, in a similar spirit, would be for the Fed chair to be ex officio a member of the National Economic Council. Establishing formal mechanisms for better two-way communication between the Fed and the administration need not compromise the Fed's operating "independence." Independence is a means to an end, not an end in itself.

A second modification to the existing macroeconomic policy framework would be to introduce a "switching regime," such that the operative framework and the degree of coordination between monetary and fiscal policy would change depending on the circumstances prevailing, notably whether the proximate threat was one of "too much" aggregate demand and inflation pressure or "too little."

When the primary challenge is to constrain inflation or when any shortfall in aggregate demand or intensification of disinflationary pressure can be checked by monetary policy fine-tuning, the current framework would prevail.

When there was a serious shortfall in aggregate demand, powerful deflationary forces were being unleashed, or the natural rate of interest was very low, however, the framework would switch to one involving much closer communication, coordination, and cooperation between the monetary and fiscal authorities, if not jointly designed and implemented action ("helicopter money," for instance).

This switch in regime would be made conditional on the levels of relevant and publicly observable or able-to-be-estimated economic variables, such as the inflation rate, the output gap, or the neutral rate of interest. An independent and expert body could be assigned the task of designating when a switch in regime was called for, much as the National Bureau of Economic Research in the United States is tasked with calling recessions (although this call would need to be made in real time, not with a lag).

A third, and the most radical, option for overhauling the macroeconomic policy framework would be to establish an entity that subsumes the aggregate demand management components of both monetary and fiscal policy, an Agency of Aggregate Demand Management. Akin to today's central banks, this would be given a clear mandate and autonomy over when and how to deploy its authorized policy tools.

The normal argument is that, while the responsibility for carrying out monetary policy can be given to an independent, technocratic central bank, fiscal policy involves issues of income redistribution and the favoring of certain sectors over others and therefore is inherently political in nature and needs to be kept in the purview of the political sphere.

However, there is also a pure aggregate demand management component to fiscal policy. What sense does it make to assign one part of aggregate demand management to the sphere of technocrats and another part to the political realm, when their respective decision-making is very different and there is little or no explicit coordination between the two?

Similarly, after years of QE and "forward guidance" aimed at lowering long-term interest rates and buoying asset prices to help create positive wealth effects, it is being increasingly recognized that monetary policy also has redistributive wealth and income effects. Monetary policy has distortive sectoral impacts too. Because it works via its impact on financial market conditions, monetary policy is tied at the hip to one key sector of the economy, the financial sector, which exacerbates the "over-financialization" of the economy. Why aren't these factors explicitly recognized and addressed by fiscal policymakers?

The idea of an Agency of Aggregate Demand Management would be to try to bring about a more consistent and coherent separation of the task of trying to keep the economy at full employment with price (and financial) stability, using the right mix of monetary and fiscal policy tools, from the inherently political issues of income and wealth redistribution, reallocating resources, regulating economic activity, and sectoral and credit policies. It should not be beyond our collective wits to design such a system.