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Comments on Stefan Niemann and Jürgen von Hagen: Coordination of monetary and fiscal policies: A fresh look at the issue

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This interesting and nicely executed analysis sheds new light on the issue of fiscal/monetary interaction by evaluating the steady state implications of policy coordination in a dynamic Markov game. As is well known, Kydland and Prescott (1977) and Barro and Gordon (1983) showed that discretionary policy may yield inflation bias and inferior equilibria when policies are centralised. Suggested remedies for such dynamic inconsistency include rules for monetary policy and the appointment of a conservative central banker, as suggested by Rogoff (1985). When endogenising fiscal policy, however, it is less clear whether monetary commitment is still a solution as this gives rise to strategic concerns and potential interaction between fiscal and monetary authorities; see Alesina and Tabellini (1987). Dixit and Lambertini (2003) show that discretionary fiscal policy may offset the benefits of monetary commitment.

Stefan Niemann and Jürgen von Hagen address the issue of coordination of fiscal and monetary policies from a novel perspective. Instead of analysing the short-run stabilising properties of fiscal and monetary policies, the paper provides a theory of the long-run effects of the institutional design of fiscal and monetary authorities. The model is a dynamic game where the central bank sets its inflation target and the fiscal authority its budgetary targets simultaneously. The key results are as follows.

First, although policies are decentralised, i.e. delegated to two separate authorities, there is an inflation bias in the model. The reason is that the impatient fiscal authority can exploit the monetary authority's inability to commit to zero inflation in the presence of nominal public debt.

Second, central bank conservatism enables the central bank to commit to a lower rate of inflation for a given level of debt. This is internalised by the fiscal authority which increases the debt level. The

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higher level of debt will need to be financed by higher distortionary taxes which imply welfare losses to consumers. Excessive central bank conservatism may therefore lead to high public debt and reduced welfare. These results suggest that there may be gains from coordination: characteristics of the fiscal authority should be taken into account in the institutional design of central banks.

The interaction between fiscal and monetary authorities is a very exciting field of research and the paper makes some nice contributions to the previous literature. The model has some new and interesting implications for the design of institutions and policy rules. I will keep the discussion fairly general and oriented towards economic policy.

1. Temporary suspension of central bank independence

One of the implications of the model is that high central bank conservatism may cause the fiscal authority to accumulate more debt, levy more distortionary taxes and thereby reduce consumer welfare. Taken at face value, this suggests that there are welfare gains to be made by reducing central bank conservatism. In addition, a less conservative central bank leads to a faster convergence to the steady state. This leads Niemann and von Hagen to conclude that it may be advisable to temporarily suspend central bank independence when debt is high.

I would like to argue that such an institutional arrangement could jeopardise the credibility of the inflation targeting regime. What would be considered a sufficiently severe cause for such suspension? Central bank independence is an effective means of maintaining credibility, precisely because it is irrevocable. To me, the idea of temporary suspension of central bank independence is similar in spirit to having a fixed exchange rate but with the option of devaluation. There is now a general consensus that the only way of sustaining a fixed exchange rate regime is by relinquishing that option completely, as by monetary unification. My concern is that the option of temporarily reducing central bank conservatism would be abused in recessions and times of political hardship.

2. Myopic politicians and the lack of long-term commitment

The results in the model derive from the assumption that the fiscal authority is more impatient than a representative household, i.e. it is less forward-looking. This assumption is realistic indeed, since incumbent governments are subject to electoral uncertainty and political cycles. Such uncertainty provides an incentive for politicians not to pursue political agendas with long-term effects if they believe that it affects their probability of being re-elected in a negative way. This propensity of governments to pursue expansionary fiscal policies and run budget deficits prior to elections is sometimes referred to as a *deficit bias*.

Although I support the belief that politicians are myopic, I believe that in this particular framework, the assumption is a little inconsistent. Voting is a black box in the model, but I do not think that this particular government would have to worry about electoral uncertainty since a representative household and the fiscal authority have identical period utility functions. In the absence of asymmetric information, the incumbent government in this economy would therefore always be re-elected.

However, given the assumption about the impatient fiscal authority, a key result in the paper is that a less myopic government would be less prone to exploit the conservative central bank, which would improve welfare. The issue raises some age-old questions. How do we make politicians more forward looking? How do we trade off electoral uncertainty and democracy? Are there other means of increasing the appeal of long-term policies? Are there suitable fiscal rules? If so, how should they be designed?

3. Fiscal-monetary interactions under collective bargaining: A Swedish perspective

Finally, I would like to put a Swedish perspective on the issue by suggesting that collective wage bargaining may impose additional constraints on monetary and fiscal authorities and the interaction between them; see, for instance, Cukierman and Dalmazzo (2006) and Larsson (2007). A recent but growing literature has shown that monetary policy may have real effects, even under flexible prices when there is non-atomistic wage setting. The reason is that, recognising that they may influence the aggregate price level by their wage claims, large trade unions will interact strategically with the central bank. On the other hand, there is reason to believe that there may be a conflict of interest between the fiscal authority and large wage setters if excessive wage claims threaten to reduce employment. These two strands of literature suggest that in economies with collective bargaining, the presence of large wage setters may affect the behaviour of fiscal and monetary authorities.

A key result in Larsson (2007) is that if the fiscal authority is very myopic, or pursues a very activist fiscal policy, unions will exploit its response and set wages relatively higher, thereby reducing employment. Consistent with the paper by Niemann and von Hagen, this suggests that there are welfare gains to be made by making the fiscal authority less myopic. The extreme case of reducing myopia, equivalent to imposing a fiscal rule for the provision of public goods, would force unions to assume responsibility for their wage claims and thereby increase employment and welfare.

4. Concluding remarks

I find the issues raised by Niemann and von Hagen very interesting. The paper should serve as a useful starting point for a debate on institutional reform as well as the objectives of fiscal and monetary policy.

The message of the paper that I perhaps find most appealing is the importance of striving for less myopia in the implementation of fiscal policy. I do not think that this is easily done by reducing electoral uncertainty. I think it is far more productive to further explore the path of fiscal rules. There is now an emerging consensus on the desirability of such rules under monetary commitment. In addition to increasing debt and reducing welfare as argued by Niemann and von Hagen, fiscal discretion (or fiscal activism) may offset the benefits of monetary commitment (Dixit and Lambertini, 2003) and decrease employment and welfare in economies with non-atomistic wage setting (Larsson, 2007).

The literature on fiscal and monetary interaction has so far considered rather blunt measures of fiscal policy. The stabilisation properties of this policy are then typically evaluated under different assumptions about commitment and discretion and timing of the game; see Dixit and Lambertini (2001, 2003) and Lambertini (2006). Although there now seems to be some agreement on the desirability of fiscal rules in this strand of literature, we lack a precise theory of the appropriate design of such rules under monetary commitment. Our ignorance in this area stands in sharp contrast to the consensus on suitable instruments and objectives for monetary policy. This is perhaps not surprising as fiscal policy is, in many ways, more complicated than monetary policy. There is a larger variety of policy instruments available to the fiscal authority than to the monetary authority. Moreover, the fiscal authority is a political institution and delegating fiscal responsibility to an independent authority raises a number of questions, many of them related to democracy. The desirable properties of fiscal rules and institutions under monetary commitment therefore require careful consideration indeed and are highly interesting topics for future research.

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