Monetary policy: how relevant are other policymakers? Bundesbank Spring Conference 2003

In May the Bundesbank held its fifth spring conference. This year's theme was "Monetary policy: how relevant are other policymakers?", and the participants considered to what extent a central bank should take into account the decisions of other economic policymakers, ie foreign central banks and fiscal policymakers, in its decision-making process. In the past few years this has increasingly been the subject of academic studies. At the same time, economic policymakers have been increasingly confronted with the questions raised by such studies. As expected, the conference did not offer any conclusive answers, but it did draw attention to several important, and some new arguments, which are to be considered below.

Important questions concerning economic policy making

Monetary policymakers in many countries are again facing the question as to just how closely they should consider in their decision-making process the decisions of other economic policymakers at home and abroad. One relevant issue is the relationship between monetary policy and fiscal policy. Does fiscal policy making impair or support monetary policy and what rules for the individual areas of policy making could defuse any possible conflicts? The discussion surrounding the Stability and Growth Pact in Europe and the relevant provisions in the Maastricht Treaty concerning public deficits and indebtedness in the countries participating in monetary union are examples of just how seriously the relationships between these two areas of policy

making are taken. Another topic is the relationship between domestic and foreign monetary policy. Many countries are now considering, for example, whether their own central bank should tie its policy to that of other central banks by setting fixed exchange rates or at least taking them into account during its decision-making process or whether to allow free-floating exchange rates. Finally, one can combine both of these issues and discuss the interaction of monetary policy and fiscal policy within an international framework. Another important question is what the appropriate fiscal policy for a given monetary union is, or more generally, what the implications of choosing a particular exchange rate system are for the international harmonisation of fiscal policy?

Academic in nature, the conference did not, however, set out to provide answers to the questions at hand, but instead was more concerned with discussing theoretical and empirical models which could help to improve the analysis of concrete problems, examine conventional arguments and create the basis for future solutions. The conference programme is on page 79.

General equilibrium models form basis of academic discussions

Economic research today tends to make statements based on models which describe a general equilibrium and which are derived from very fundamental principles. One of these principles is that households maximise their benefits and companies maximise their profits and that expectations are consistently derived from the structure of the model in use. By using such models, one is more immune to accusations that false conclusions have been drawn as behaviour patterns have simply been maintained instead of being derived from the principles mentioned above. Furthermore, such models are generally well suited to identifying the implications of economic policies for the welfare of a country. All of the analyses presented at the conference attempted to satisfy the strict requirements of the model framework.

However, using this method also has its price. The analysis becomes more complex, and many phenomena occurring in the real world cannot be sufficiently considered. Therefore, economic research is currently preoccupied with finding out which aspects of the economy are to be studied so that a model will capture basic features that are empirically significant without losing its manageability. Conversely, we also want to know how robust some conclusions are if the model framework is enlarged or modified. The conference showed, for example, that the consideration of imperfect competition between companies and of sticky prices in an economy has consequences for determining monetary and fiscal policies that will maximise the welfare of a society. One result of imperfect competition is that positive interest rates are advantageous from an economic welfare point of view; inertia witnessed in the price-formation process can justify why central banks should strive for low and steady rates of inflation instead of a highly volatile price level. These conclusions may appear to be trivial at first glance. However, they confirm our belief that this class of economic models is capable of revealing other, less obvious insights.

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Programme of the conference on 2-3 May 2003

Welcoming address by Hermann Remsperger (Deutsche Bundesbank)

Optimal fiscal and monetary policy under imperfect competition

Stephanie Schmitt-Grohé (Rutgers University), Martin Uribe (University of Pennsylvania)

Discussants: Charles Carlstrom (Federal Reserve Bank of Cleveland), Harald Uhlig (Humboldt University)

Are countercyclical fiscal policies counterproductive?

David Gordon (Clemson University), Eric Leeper (Indiana University)

Discussants: Henning Bohn (University of California, Santa Barbara), Carsten Detken (European Central Bank)

Mark-up fluctuations and fiscal policy stabilization in a monetary union

Henrik Jensen (University of Copenhagen), Roel Beetsma (University of Amsterdam)

Discussants: Frank Smets (European Central Bank), Ester Faia (University Pompeu Fabra)

Active monetary policy, passive fiscal policy and the value of public debt: Some further monetarist arithmetic

Leopold von Thadden (Deutsche Bundesbank)

Discussants: David Gordon (Clemson University), Marco Hoeberichts (De Nederlandsche Bank)

The interaction of fiscal and monetary policies: Some evidence using structural econometric models

Anton Muscatelli (University of Glasgow), Patrizio Tirelli (University of Milan), Carmine Trecroci (University of Brescia)

Discussants: Carlo Favero (University Bocconi), Axel Weber (University of Cologne)

Should the European Central Bank and the Federal Reserve be concerned about fiscal policy?

Matthew Canzoneri (Georgetown University), Bob Cumby (Georgetown University), Behzad Diba (Georgetown University)

Discussants: Hans Peter Grüner (University of Mannheim), Allan Bödskov Andersen (Danmarks Nationalbank)

Monetary policy rules in an interdependent world

Robert Kollmann (University of Bonn)

Discussants: Simon Wren-Lewis (University of Exeter), Andreas Schabert (University of Cologne)

Monetary and fiscal interactions in open economies

Giovanni Lombardo (Deutsche Bundesbank), Alan Sutherland (University of St. Andrews)

Discussants: Javier Valles (Bank of Spain), Campbell Leith (University of Glasgow)

Exchange rate policy and endogenous price flexibility

Michael Devereux (University of British Columbia)

Discussants: Luca Guerrieri (Federal Reserve Board), Fabio Ghironi (Boston College)

Summary of the conference

Bennett T. McCallum (Carnegie Mellon University), Giancarlo Corsetti (Yale University)

* The conference was held in English.

Deutsche Bundesbank

When analysing the relationship between monetary and fiscal policies, several different aspects can be emphasised. One can ask, for example, how an "all-powerful government" should use the instruments available in these two policy areas to optimise economic performance. The result then becomes a benchmark for evaluating sub-optimal policies although these appear to be more realistic. Other approaches tend to show that various institutions with different objectives are responsible for these two areas of policy making, and this leads to a degree of strategic interaction. The question here is under which constellations do monetary and fiscal policies tend to support each other and when do they tend to conflict with each other. Finally, one can change the point of view further still and ask the question from a monetary policy standpoint, ie to what extent a particular fiscal policy impedes monetary policy in achieving its goal. One of these perspectives will prove to be more appropriate depending on the question posed.

Complex relationship between monetary and fiscal policies

One prerequisite to approaching these complex questions is to be aware of the most important transmission channels of these policy areas as well as their interdependencies. A direct relationship exists between monetary and fiscal policies since, as a rule, profits made by central banks are turned over to the government. Monetary policy can also affect public finances because, by determining the price level, it also contributes towards setting the real value of public debt. Finally, there are also more indirect points of reference since both monetary and fiscal policies influence economic variables which are of common interest, such as demand. All of these aspects were discussed at the conference.

With regard to transmission channels, special attention was also given to expectation effects, which are triggered by fiscal policy – namely that today's deficits will in future lead to higher taxes or lower expenditure. A study presented in the United States points out that the inclusion of such effects presents anticyclical fiscal policy in a much less favourable light. This is ultimately also important with regard to whether, from the perspective of the monetary policymakers, fiscal policymakers are to be considered to be strategic partners or a possible hindrance. Another paper also gave the impression that at least the discretionary components of US fiscal policy have tended to have a more disruptive rather than a stabilising effect on economic development. At the same time, however, the paper concluded that this did not seriously embarrass monetary policymakers. The paper also tempered concerns that policymakers in the United States and Europe could not succeed in moderating inflation expectations through monetary policy measures owing to an increasing level of government debt. During discussions, however, it was pointed out that the paper had neglected important aspects of the European debate. In particular, possible coordination deficits as well as external effects were not addressed in European fiscal policies, which *inter alia* make it tempting to act simply as a free rider. Finally, the other point of view was considered, namely which monetary policy trends appear advantageous from the standpoint of fiscal policy. In this context, two monetary policy rules were com-

pared: on the one hand, monetary targeting, which sets a target for monetary growth, and, on the other, a policy which aims to adhere strictly to an inflation goal. The advantages of monetary targeting become apparent here since it permits fluctuations in price developments. This in turn makes it easier for fiscal policy to keep under control any government debt arising from the issue of nominal securities.

An empirical study examined how monetary and fiscal policies in the United States and Germany have interacted in the past. The study concluded that the two policies have often pushed economic development in opposite directions. When economies are faced with a demand shock, however, it is more probable that the two policies will both pull in the same direction, thus providing mutual support. This study also pointed out that such conclusions are not independent of the model structure in use. This again highlights just how important it is to be very careful when developing economic models.

The analysis of the link between one's own monetary policy and that of other countries was another focal point of the conference. If one asks whether and, if yes, how a central bank should coordinate its policies with other central banks, the next question is whether it should strive for fixed exchange rates, for monetary union (in an extreme case), or for free-floating exchange rates or whether an intermediate regime may make more sense.

In general flexible exchange rates advantageous

In the aforementioned general equilibrium models flexible exchange rates mostly appear to be advantageous because they make it easier for an economy whose prices are not entirely flexible to deal with shocks in an optimal way. During the conference, two possible objections to this viewpoint were discussed. The discussion first examined what consequences arise from the fact that exchange rates are not always a result of uncovered interest rate parity but rather that this underlying relationship is also influenced by shocks, which happen in systems with free-floating exchange rates in particular. Reducing or avoiding such shocks by selecting fixed exchange rates or exchange rates with limited flexibility can prove to be advantageous in such models. This especially applies to open economies with a large export sector whereas traditional arguments in favour of more flexible exchange rates dominate in more closed economies. Interestingly, arguments in favour of fixed exchange rates (or monetary union) carry more weight than traditional reasoning, which states it is imperative that participating countries be exposed to similar productivity shocks.

A second possible objection to the traditional argumentation in favour of flexible exchange rates may result from the fact that companies' pricing policy and the prevailing exchange rate system are not unrelated. In a country with fixed exchange rates, where companies may be confronted with fairly large demand shocks, it may be worth setting prices more flexibly in order to absorb such shocks. This conclusion must, however, be treated with a certain degree of caution. If a harmonised monetary policy in the participating countries reduces demand shocks, it is

conceivable that companies may not attach much importance to price flexibility. One therefore cannot simply assume that a monetary union will exhibit greater price flexibility.

Fiscal policy in open economies

Finally, if one were to consider several economies together, the obvious question is how monetary policy and fiscal policy (should) relate to one another. European monetary union and the debate on the role of national fiscal policies provide an occasion for just such a discussion. The discussion of the pros and cons of coordinating monetary and fiscal policies at a global level also makes examining such models interesting. In this context, views presented at the conference state that the advantages of an internationally agreed fiscal policy, which actively seeks to correct disruptive factors in an economy, depend on the monetary regime in the participating countries as well as the type of shocks involved. It would therefore appear advisable that, in addition to having a common monetary policy (ie monetary union) or a harmonised monetary policy, fiscal policy should also be harmonised. By contrast, in a world without monetary coordination, a harmonised fiscal policy can actually be detrimental.

Another paper dealt with a related subject. If one assumes that two countries form a monetary union and have also agreed to coordinate their fiscal policies, the question arises as to just how the harmonised policy should function and which tasks should it and/or monetary policy assume when it comes to correcting shocks. It becomes evident here, too, that it is essential to recognise the type of disruption before the appropriate fiscal policy can be set. In this context, the conference examined in particular the case where the price-setting behaviour of companies exhibits unexplained fluctuations and compared this with the results seen during times of productivity shocks. One further conclusion was that, while a (common) monetary policy ought to focus on stabilising economic development within monetary union, an optimal fiscal policy should concern itself exclusively with solving national problems.

While the newer models developed by academic economists do offer advantages over traditional analyses, they have hitherto paid little attention to the coexistence of monetary and fiscal policies. The conference has shown that this was not justified. Indeed, this fact has raised many new questions and challenges for economic researchers. This holds even more true if an international dimension is brought into the picture.