

Discussion of
“**The effects of monetary policy across fiscal regimes**”
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“**The monetary and fiscal policy mix in a
changing world**”

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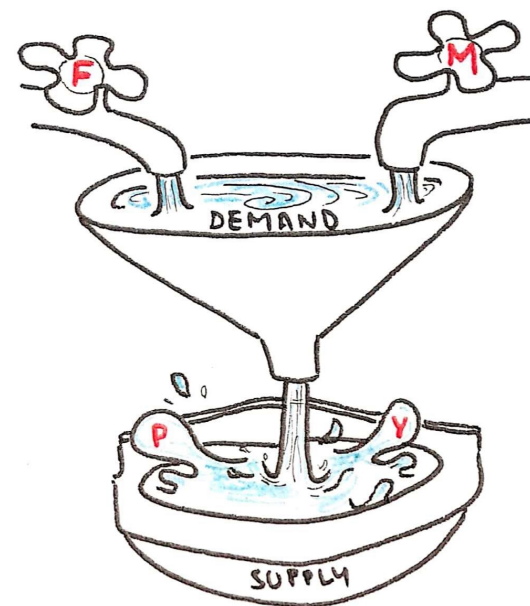
Outline

1. Policy Mix
2. Debates
3. What does this paper do and say?
4. A long run perspectives on M F regimes
5. “Strategic complementarity” foundations of an effective mix

Policy Mix

- Policy Mix theory (J Tobin)
 - Monetary and fiscal policy (**M and F**) together determine nominal demand $P*Y$
 - **Strategic substitutes:** If M is constrained, F should kick in, and vice-versa.
 - Aggregate supply determines the split between P and Y

See Geneva Report 2023



Debates

- M/F mix matters for growth (Tobin)
 - “Loose M Tight F” favor investment (critique of Reagan Volker in the 1980s)
- Prudent to keep M and F to the “middle of the road” (Okun)
 - Elasticities may be quite different for non-standard M and F
- Confidence and expectations
 - Given F, cost of G-based consolidation lower than T-based. But see Perotti and Sala 2025 ([Fiscal consolidations: announcements and reality - CEPR RPN European Economic Policy](#))

Debates...

- With below-target inflation and constrained M, **strategic complement**.
MF create policy space for each other (Geneva report 23)
 - Loose M help F by keeping borrowing costs low,
 - Deficits help M to reign in expectations of deflation

The paper

- Panel evidence on **effects of EA-level M** conditional on **National-F**
- Frontier research methods:
 1. Identification of M shock
 2. Conditioning transmission on
 - a) F Policy “Regime”
 - b) State of the economy (recession vs. boom, crisis vs. normal)
- Sample of 10 EA countries, 1999-2019, quarterly data

Existing work mostly on F conditional on M

- Step 2 challenging (see e.g. Mario Alloza 2022).

Methodology

- “Regime” = “enhanced measure of stance” (regime not a great label)
 - Construct quarterly Changes in Cyclically Adjusted Primary Balance (ΔCAPB)---F stance beyond automatic stabilizers
 - Not (necessarily) exogenous to cycle
 - Transform ΔCAPB into probability of persistence in/transitioning to expansionary/contractionary regime
 - Transition smoothing parameter θ
- Caveats: measurement errors, interpolation, filtering, generated regressors and time aggregation (Buda et al. 2023).

ΔCAPB and $F(\Delta\text{CAPB}, \theta)$

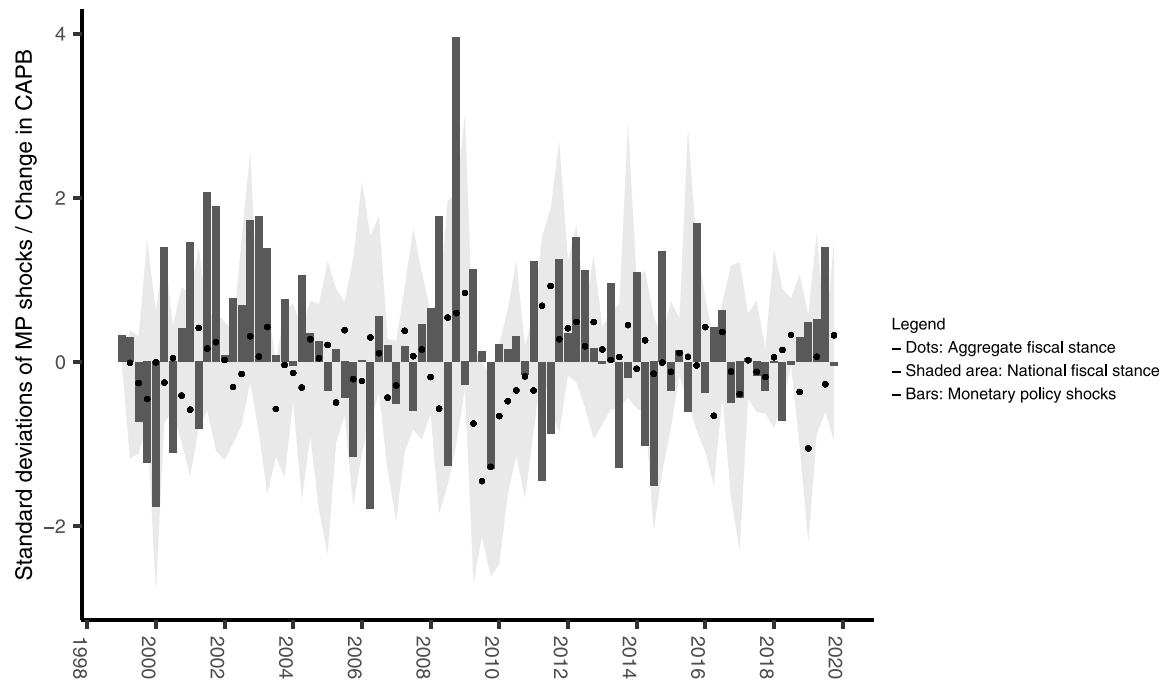


Fig. 1. Euro area fiscal stance and monetary policy shocks.

Notes: The graph depicts the change in the euro area aggregate cyclically adjusted primary balance (CAPB) as a % of potential GDP (dots), along with the 10th and 90th percentiles of the changes in the CAPBs of the individual countries in our sample (gray area) and the monetary policy shocks (bars), which are taken from Jarociński and Karadi (2020) and which are scaled by their standard deviation.

Results and interpretation

		National Fiscal regime	
		Contractionary	Expansionary
ECB policy Innovation:	Expansionary	Puzzling: $Y \downarrow$ Inflation \downarrow Especially when conditioning <u>also</u> on recession; G only; low spread countries	$Y \uparrow$ Inflation \uparrow
	Contractionary	$Y \downarrow \downarrow$ Inflation $\downarrow \downarrow$	Muted

- The prevalence of F on M is driven by consumption response
 - Investment independent of Mix
 - Conjecture: wealth effects of fiscal policy?

Expansionary M shock

Contractionary M shock

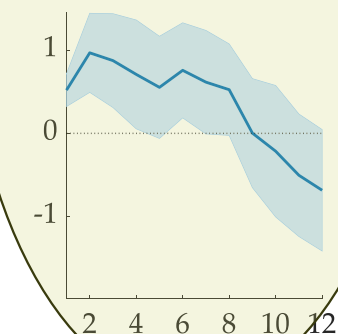
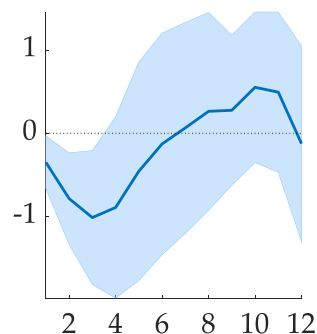
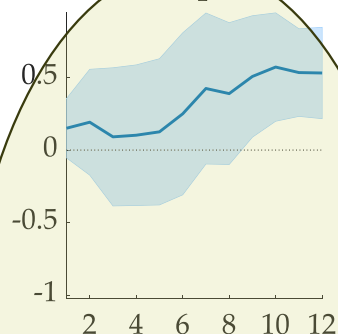
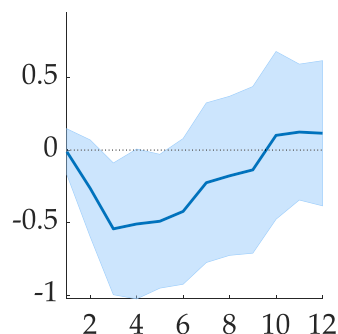
Responses to an expansionary monetary policy

Responses to a contractionary monetary policy

**M F regime
same direction
(Congruent)**

Fiscal contraction

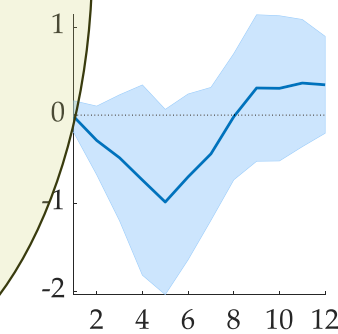
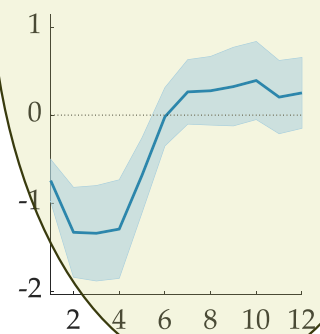
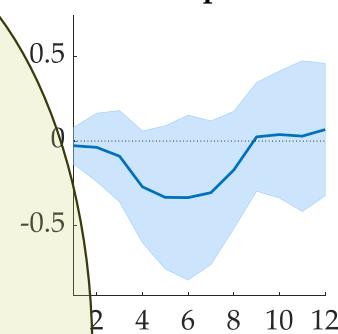
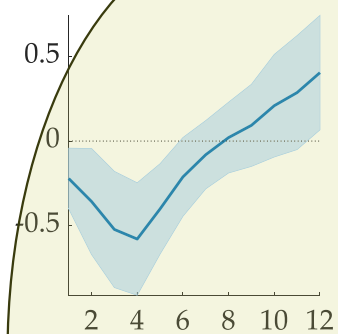
Fiscal expansion



Quarters since shock

Fiscal contraction

Fiscal expansion



Quarters since shock

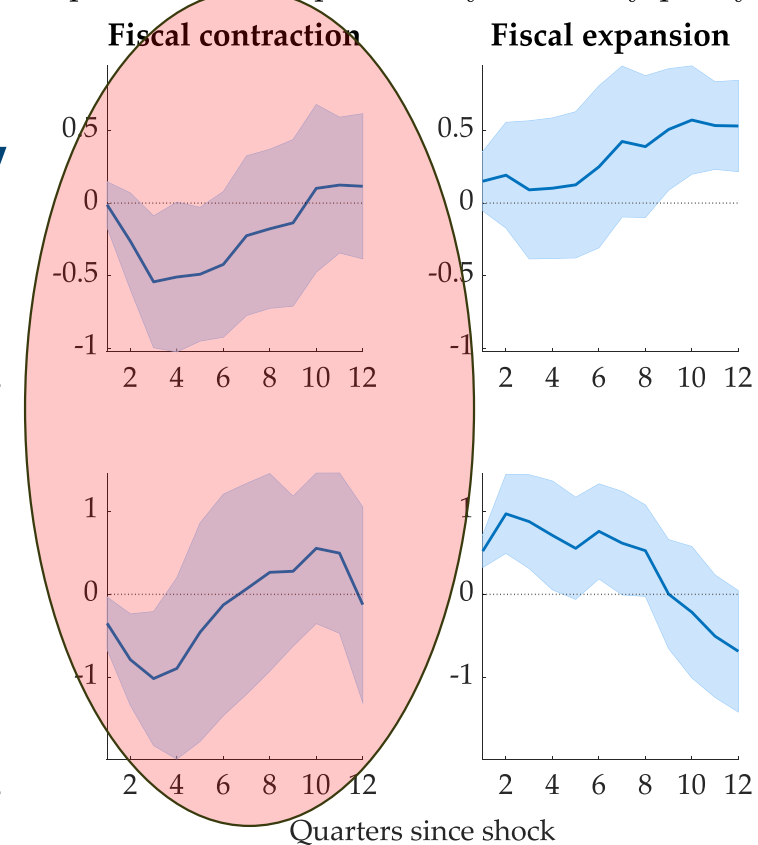


Expansionary M shock

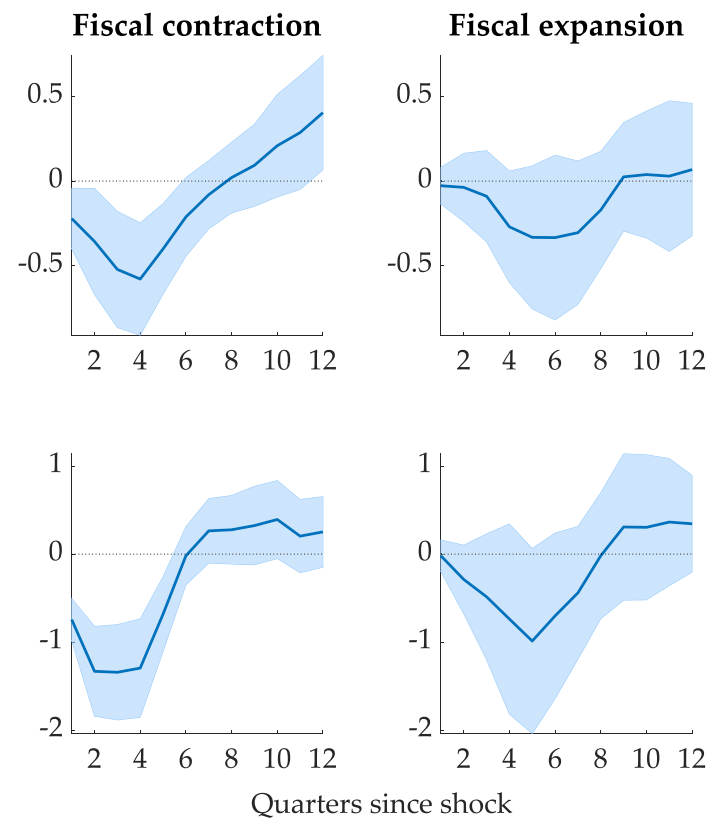
Contractionary M shock

**M expansion +
Contractionary
F regime
(not
congruent)**

Responses to an expansionary monetary policy



Responses to a contractionary monetary policy



Results and interpretation

		National Fiscal regime	
		Contractionary	Expansionary
ECB policy Innovation:	Expansionary	<p>Even more puzzling $Y \downarrow$ Inflation \uparrow when conditioning also on EA-level Expansionary Fiscal</p>	$Y \uparrow$ Inflation \uparrow
	Contractionary	$Y \downarrow \downarrow$ Inflation $\downarrow \downarrow$	Muted

Let's take it as a sensible warning about the risks of relying on M alone

A long-run perspective on “regimes”

Question forcefully voiced by Cochrane--- how can we exclude that inflation is already (or will soon be) determined by “fiscal dominance”?

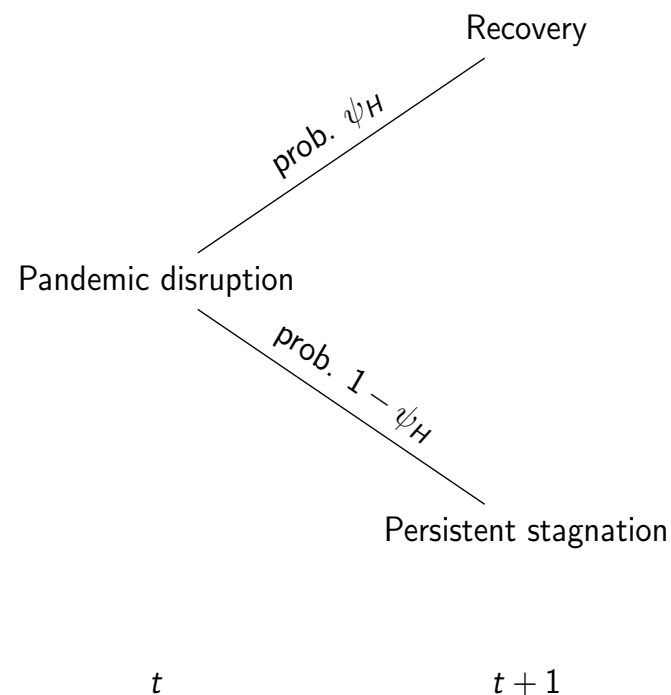
Is there a better way we think about this question than in terms of two alternative and incompatible regimes?

- All fiscal decisions entails some risk that current deficits will not be compensated by future surpluses given the path of inflation.
- Even in a regime of fiscal dominance, monetary policy can keep prices stable for some (even long) time.

Rethinking the question

A plausible interpretation of the policy strategy since the GFC

- F has responded to the sequence of adverse shocks with large debt-financed stimulus
- M has pursued “price stability” on expectations that sufficient recovery/fiscal correction would occur with some probability ψ in the future
- Temporary stability ‘buys time’ for the correction to have a chance to materialize



“Gambling on price and fiscal stability”

- “No fiscal/price adjustment now” vs. “deeper adjustment in the future with some probability” (Corsetti & Mackowiak, IMF Economic Review 2024)
- The “gamble” can be perfectly rational and desirable, but entail risks:
 1. Sufficient recovery/consolidation may never occur
 2. **Vulnerability to self-fulfilling sovereign risk crises may frustrate the plans of policymakers---i.e. it may severely shorten the time to the crisis**
 - Probability, timing and extent of the recession subject to self-validating beliefs

Beliefs drive time and intensity of crises

Example: posit that the probability of a correction falls in its size

- If investors coordinate on anticipating a correction with high probability, they **remain optimistic** and charge a low inflation premium on debt---debt accumulates at a low rate. At each point in time the size of the required correction remains relative contained, therefore relatively likely to occur (validating the optimistic expectations)
 - The gambling can stretch for a long time. Bond yields remain flat in this equilibrium for some time.
- **If investors turn pessimistic**, they charge a high inflation premium--debt accumulates at a high rate, magnifying the size of the required correction already in the immediate future. Spreads hike.

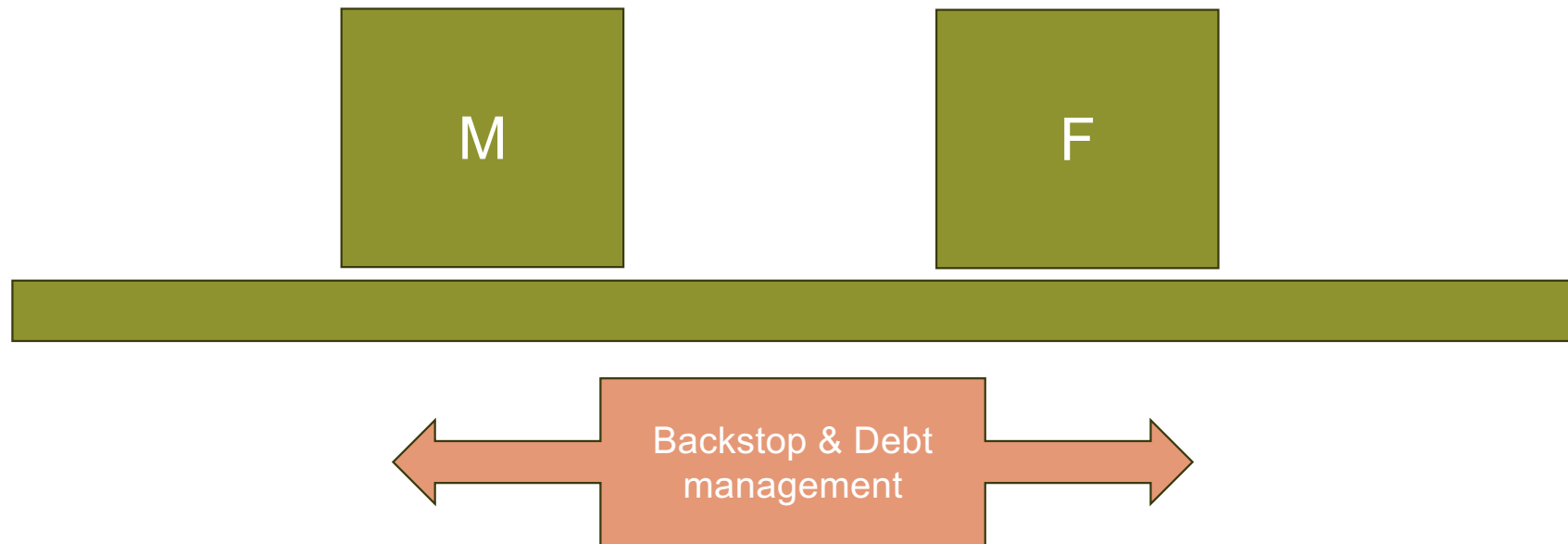
Conclusions

- Since the GFC, it has become apparent that successful stabilization builds on effective modes of policy interactions.
 - The evidence of Bonam and co-authors warns that monetary stabilization of national economies may be hampered by diverging fiscal “regimes” = stances
- But the theoretical and institutional model that can frame M-F interactions in the both the short and the long term correctly is yet to be defined.
- What do we know? An effective policy mix requires combining policies, M and F, that are themselves separate and independent. Hence, it would not work in a “regime” of deficit monetization/fiscal dominance.

Conclusions

- What is yet to be fully understood? While M and F are **strategic substitutes in delivering aggregate demand, they are strategic complements in creating policy space of each other.**
 - M cannot be effective unless F sticks to one path that ensure monetary dominance
 - But sticking to this path requires M to shield bond markets from belief-driven crises
 - Only independent and credible M authorities can provide monetary backstop to the government debt
- This involves rethinking both macro, regulatory and supervisory regimes, at both national and supranational level.

The inner plumbing of policy credibility and resilience



Thank you



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