

Discussion of Christopher Sims "Monetary/Fiscal Policy"

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Times have changed

- In normal times:
 - Connections between FP and MP are in the background
 - Stable Fed balance sheet means implicit backing of Fed irrelevant
 - Low debt/gdp make it easy for MP to ignore FP

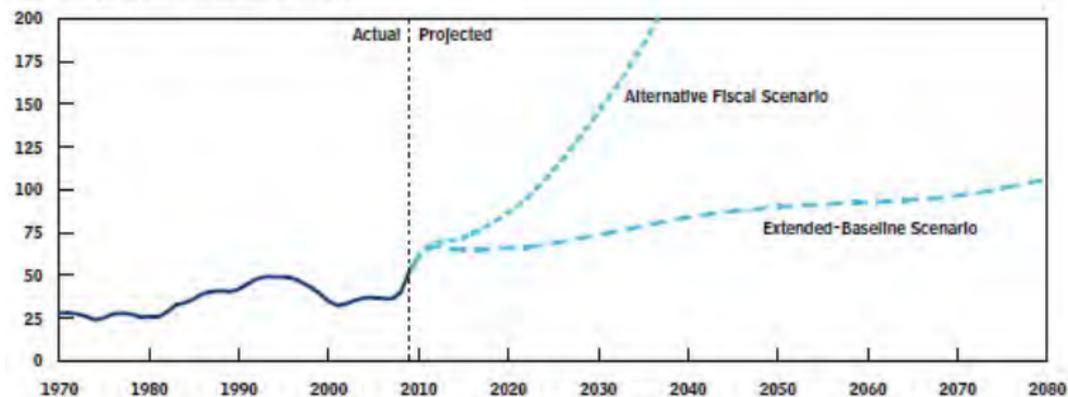
Tectonic shift at the Fed

Fed balance sheet					
(\$ billions)			8/8/2007	10/22/2008	9/29/2010
Assets			903.0	1839.0	2340.9
Securities (Treasury and Agencies)			790.8	490.6	965.8
MBS			0.0	0.0	1078.5
Repo			18.8	80.0	0.0
Loans (incl. discount window, TAF, etc)			0.3	698.1	49.8
Other (incl. swaps)			93.2	570.4	246.9
			0.0	0.0	0.0
			0.0	0.0	0.0
Liabilities			903.0	1839.0	2340.9
Currency			814.6	856.8	954.8
Reverse repo			30.1	96.0	67.4
Liab to Treasury (general)			4.7	55.6	57.8
Liab to Treasury (supplement)			0.0	559.0	200.0
Other			46.8	50.9	79.3
Reserves (required and excess)			6.8	220.8	981.7

Tectonic shift at the Treasury

Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios Through 2080

(Percentage of gross domestic product)



Source: Congressional Budget Office.

- The extended-baseline scenario adheres closely to current law
- The alternative fiscal scenario incorporates changes **widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period**

Links between MP and FP now in foreground

- 1 Could Fed's risky balance sheet substantially affect FP?
- 2 Will fiscal imbalances challenge the Fed?
 - Will Fed adjust interest rates to reduce real debt burden?
 - Does Fed's control over the price level suffer?
 - How independent is the Fed?

Attention must be paid

FOMC minutes word-counts			
		Fiscal <i>(excluding "fiscal agent")</i>	Deficit <i>(excluding "trade deficit")</i>
Jan-07		0	0
Mar-07		0	0
May-07		0	0
Jan-10		4	1
Mar-10		5	2
Apr-10		9	1

1. Could Fed's risky balance sheet substantially affect FP?

- Fed's actions were consistent with its responsibilities: "maintaining the stability of the financial system and containing systemic risk that may arise in financial markets "
- Nevertheless, ex ante there was concrete risk of low return
 - William C. Dudley, July 2009: "the Federal Reserve is taking on some interest-rate risk in terms of its balance sheet. ...The bigger our balance sheet, the greater the amount of interest-rate risk we are assuming."

Did Fed's balance sheet represent a substantial potential constraint on FP?

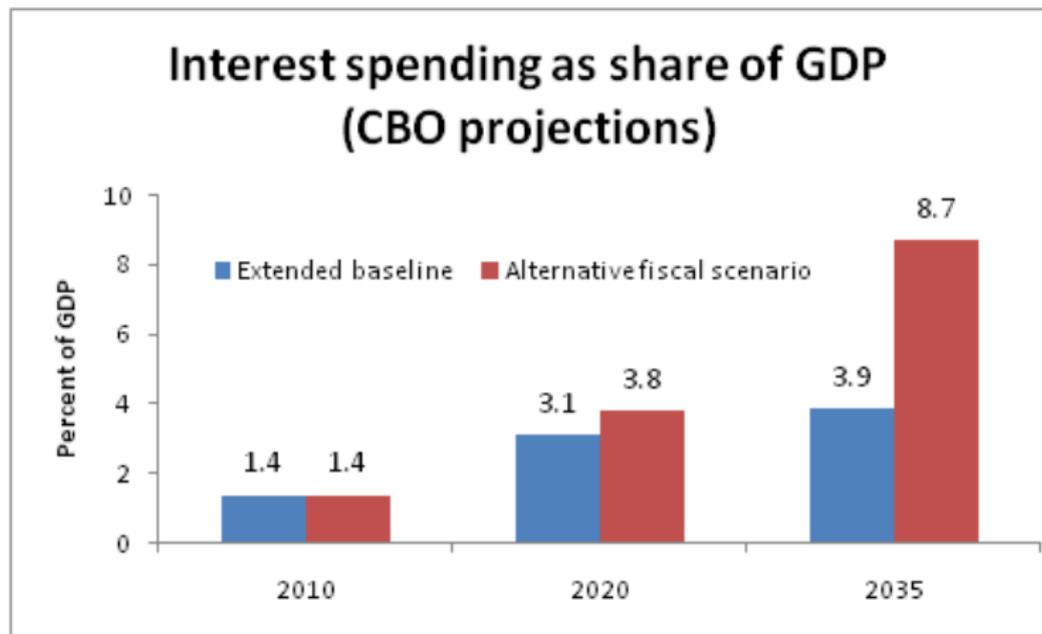
- Unlikely.
 - ① Counterfactual could have been even worse for FP
 - How much worse would recession, fiscal situation have been?
 - Blinder/Zandi report estimates "financial policies" saved 4.5 M jobs (includes Fed actions and TARP), 2.5% of GDP in 2009, 2010.
 - Did Fed's action actually prevent constraints on FP?
 - ② FP could have offset Fed's asset purchases ex post.
 - Ex post bank profits tax based on size of sales to Fed and MBS quality?
 - ③ Actual risk was small relative to FP magnitudes
 - Small. Even if all MBS worth 50%, one-time loss is \$500 billion.
 - Defense budget for 2010=\$664 billion; ARRA=\$787 billion

2. Will fiscal imbalances challenge the Fed?

- Will Fed adjust interest rates to reduce real debt burden?
- Does Fed's control over the price level suffer?
- How independent is the Fed?

Will Fed adjust interest rates to reduce real debt burden?

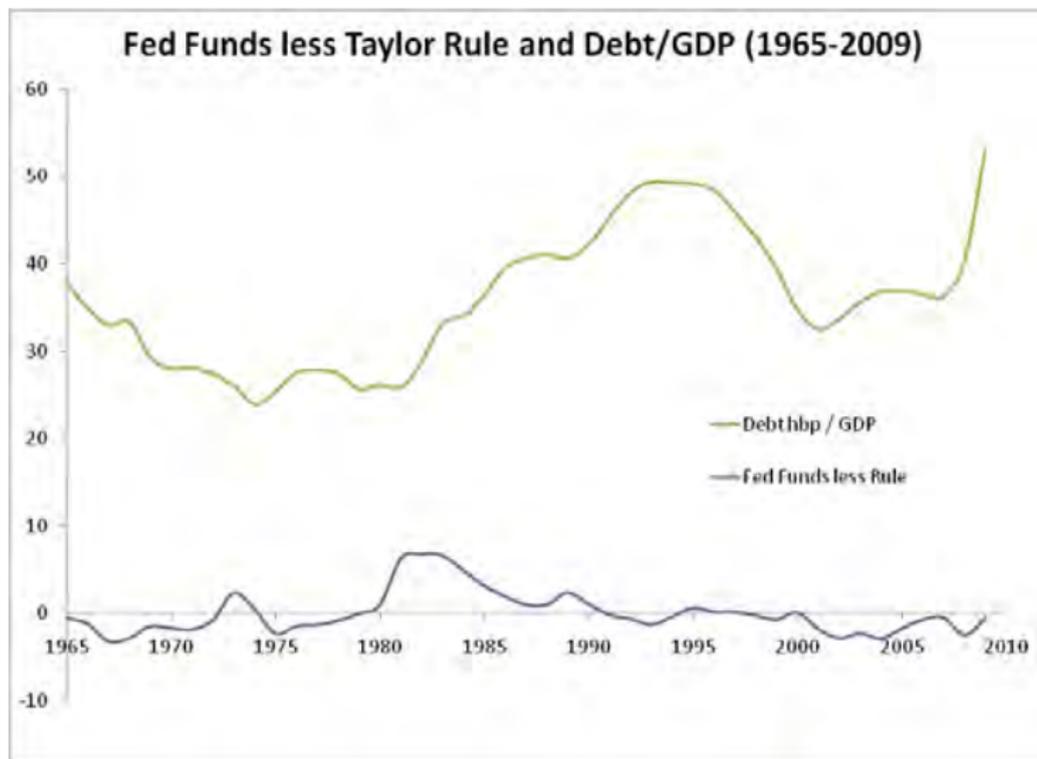
- May seem tempting, if CBO is right, next time we are in recession:



Reasons the Fed is unlikely to let debt burden affect rates

- Pragmatically, inflation may not help very much:
 - Short-term maturity structure of debt (e.g., Jim Hamilton's paper)
 - Indexation of entitlement programs
- On principle: William C. Dudley, July 2009: "I can assure you that the Federal Reserve will never engage in a program to accommodate or facilitate an unsustainable fiscal policy program."
 - Independence
 - Mandate to control inflation
 - Desire to resist moral hazard

Little evidence Fed has taken this into account over last 50 years



Does the Fed's control over the price level suffer?

- FTPL: Chris has written:

the assumption that there is a stable, fiscal rule that makes primary surpluses increase with the size of the debt is implausible in the US during 1970-2000.... This implies that the convention that omits fiscal policy and the government budget constraint from macro models, under the assumption that monetary policy alone determines the price level, is untenable.

- With new increase in the size of the debt, and no fiscal rule offsetting, is Fed's ability to choose P limited?
- Yes, if Fed will not let US government default
 - Key role of Fed independence

Key role of independence

- May be difficult to see a rule like what Chris was looking for in fiscal data, given that don't see full future path.
 - May be a presumption that FP will adjust over the long-enough term to MP, so MP dominates setting of P
 - But such a presumption would depend critically on the Fed's independence: e.g., willingness to let government default

- Chris has said:

Policy makers should be clear and explicit that the central bank cannot control inflation if fiscal policy provides it with no backing.

- Would doing so weaken presumption of MP dominance?
- Have we made presumption of MP dominance impossible with the Treasury's support of Fed?

FTPL and Ricardian Equivalence

- Parallel to Ricardian Equivalence—once you push the issue, the restriction binds?
 - Will people assume MP dominance until FP gets very out of hand?
- Bottom line: if Independence sacrificed (or if we're worried it might have been), FP should be in our monetary models in a more sophisticated way.