Fiscal and Monetary Policy for Difficult Times: MMT Solutions

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Fiscal and Monetary Policy for Difficult Times

- Fiscal and Monetary policy
- Fiscal and Monetary policy coordination
- Normal Case: higher unemployment, low interest rates, low inflation, stable political relations.
- Current Situation: low unemployment, high interest rates, high inflation, unstable political situation.
- Best course of action
- Expected outcome

Fiscal Policy

- Money is a flow: Efflux and reflux.

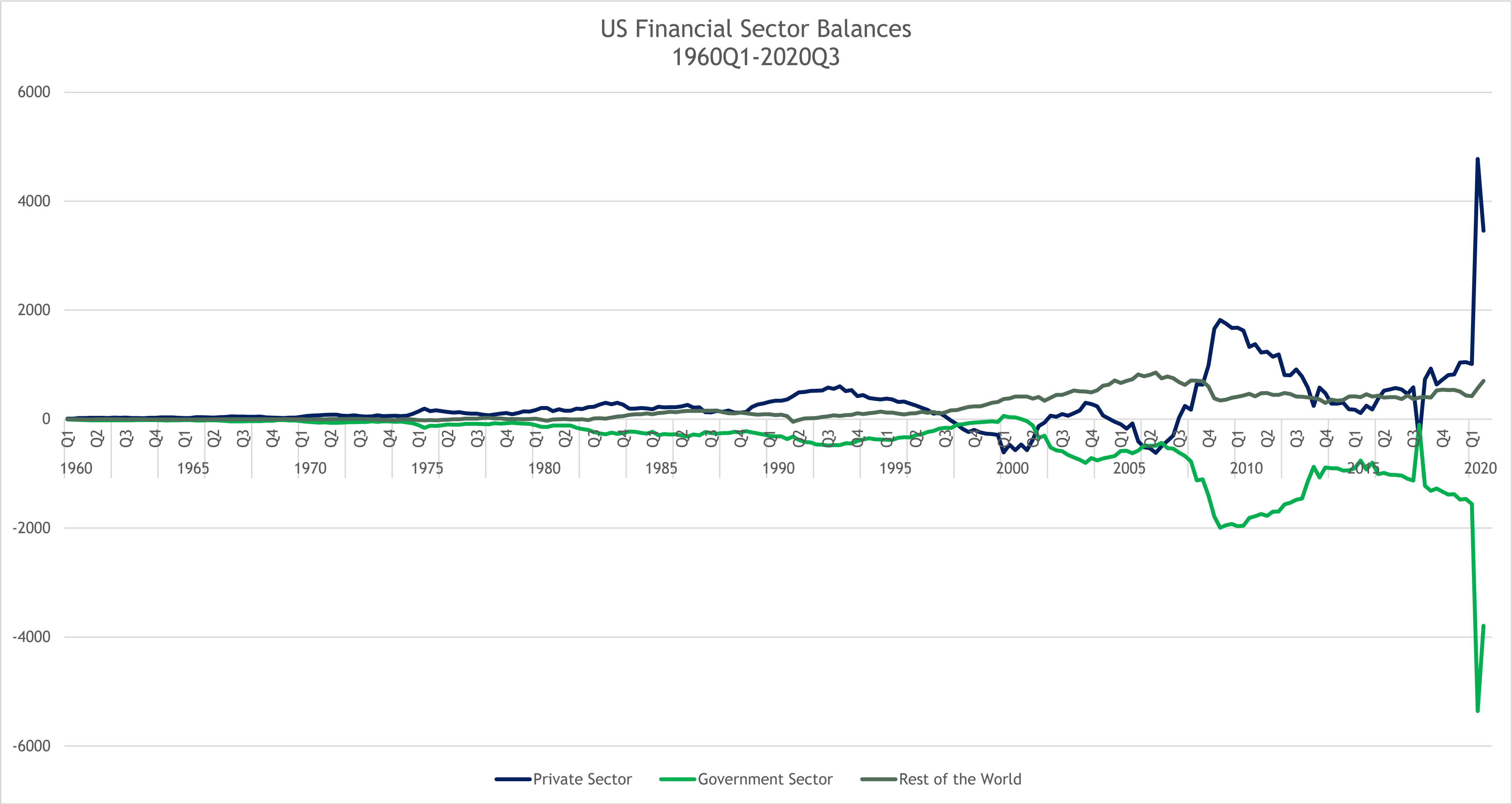
- Government spending increases income in the economy.
  - Reserves are credited by the Central Bank: Reserves increase
    - Individual Accounts are credited by banks: Deposits increase

- Taxing takes income out.
  - Individual Accounts are debited by banks: Deposits decrease
    - Reserves are debited by the Central Bank: Reserves decrease

Fiscal Policy

- When Government spending exceeds taxing, then we have a budget deficit.
  - Deficit is a flow and creates net financial assets (stock).
  - New financial assets are held as some combination of reserves, cash and Treasury Bonds.
  - Deficit is only known ex post.

- When Government spending is less than taxing, we have a budget surplus.
  - Surplus is a flow and destroys net financial assets (stock).
  - Assets destroyed are some combination of reserves, cash and Treasury Bonds.


US Financial Sector Balances
1960Q1-2020Q3
6000
4000
2000
0
-2000
-4000
-6000
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
2020
Private Sector
Government Sector
Rest of the World

Monetary Policy: US

- Interest rates are determined by policy action to meet objectives of **price stability and maximum employment** in the US, and only **price stability** in Canada and the EU.
- In the US, Federal Reserve sets the Federal Funds Rate target, the rate on reserve balances (IORB), and the discount rate.

- **Federal Funds rate:** rate at which banks borrow and lend reserves overnight between themselves (no reserve requirement 7/29/21). **3-3.25** (9/21/22)
- **Rate on reserves:** rate paid on reserve balances held at the Fed. **3.12** (9/22/22)
- **Discount rate:** rate paid by banks to borrow reserves from Fed. **3.25** (9/22/22)

Monetary Policy: EU

- In the EU, policy goal is price stability only (Canada too).
- ECB sets rate on main refinancing, marginal lending facilities rate and the deposit facility rate.

- **Main refinancing operations:** Rate paid by banks to borrow reserves for over a week.**1.25 (9/8/22).**
- **Deposit Facility Rate:** Rate paid by the ECB on deposited reserves.**0.75 (9/8/22).**
- **Marginal lending facilities rate:** Rate paid by banks to borrow reserves overnight. **1.5 (9/8/22).**

Monetary Policy Corridors

US (9/22/22)

Rate on reserves: 3.12

Federal Funds rate: 3-3.25

Discount rate: 3.25

EU (9/8/22)

Deposit Facility Rate:.0.75

Main refinancing operations: 1.25

Marginal lending facilities rate: 1.5

Fiscal and Monetary Policy Coordination: US

- Federal government spending increases income in the economy.
  - Reserves will increase creating excess reserves.
- Interest rate is the price of money.
- Excess reserves temporarily push overnight interest rates down.
  - Fed Funds Rate falls to lower bound.
- Excess reserves represent net new financial assets.
  - may be held as reserves, cash or used to purchase Treasury Bonds.

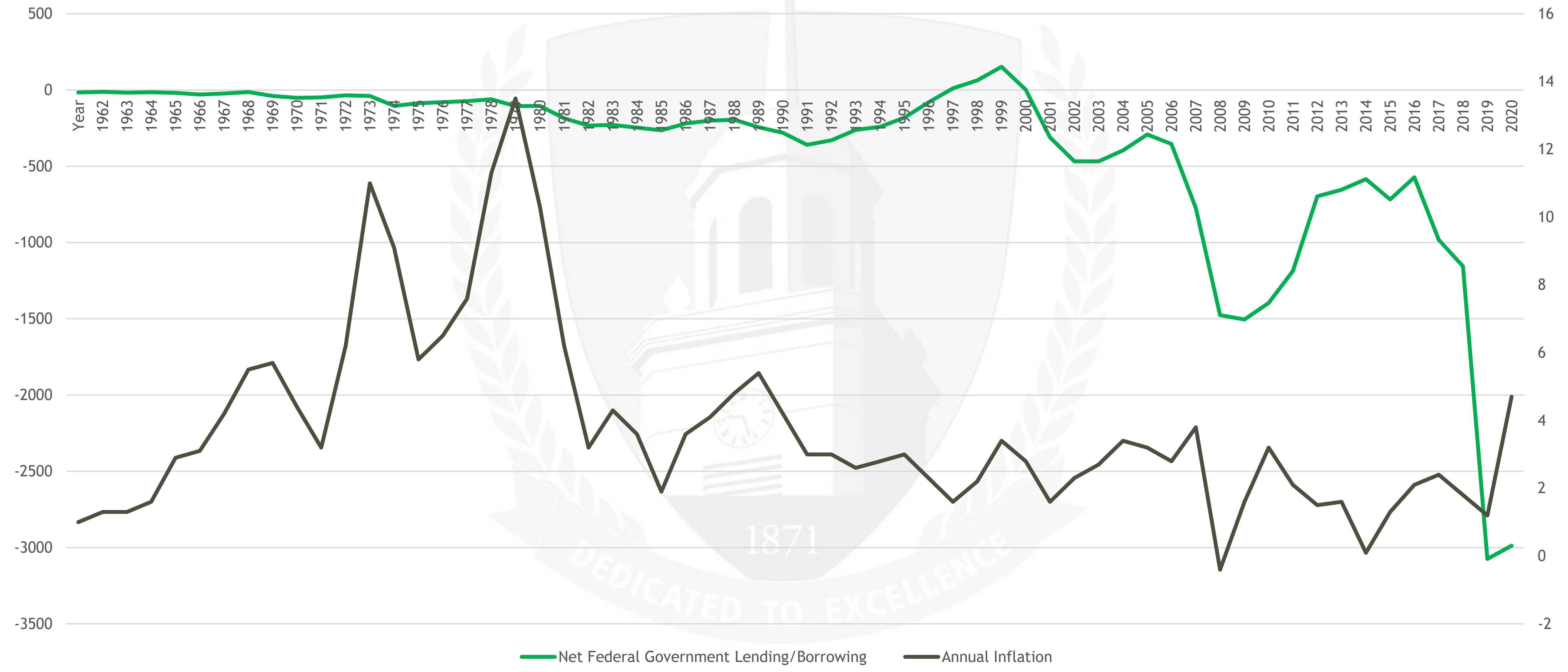
Fiscal and Monetary Policy Coordination: EU

- Like the US, Federal government spending increases income in the economy.
  - Reserves will increase creating excess reserves.
- Interest rate is the price of money.
- Excess reserves temporarily push overnight interest rates down so pressure exists to push the Marginal Lending Facility Rate down.
- Excess reserves represent net new financial assets
  - may be held as reserves, cash or used to purchase EU Bonds and/or National Government Bonds.

Normal Situation: higher unemployment, low interest rates, low inflation, stable political relations

- Government spending:
  - may increase demand for certain goods, services or financial assets as income, saving and net wealth is increased.
  - may increase purchases of government (or EU) bonds depending on operating procedures adopted by the Treasury and the Central Bank.
    - In US, net increase in Treasury Bonds is very close to deficit but the central bank may buy many of those Treasury Bonds.
  - Has no effect on interest rates. Interest rates are a policy variable determined by the central bank.

US Inflation and Net Federal Government Spending
1962-2021



Current Environment: Low unemployment, high interest rates, high inflation, unstable political situation

Deficit spending:

- creates net new financial assets that may be held as reserves, cash or Treasury, or EU Bonds.
- may increase demand for certain goods, services or financial assets as income, saving and net wealth is increased.
- may increase purchases of government (or EU) bonds depending on domestic operating procedures between the government and the central bank.
- Has no effect on interest rates.

Low unemployment:

- may provide incentive to increase wages to meet greater temporary and new demand for certain goods and services.

Production shortages and speculation:

- may increase prices for certain goods, services.

High interest rates (policy choice):

- Increases costs of production
- Increases leverage
- Lowers bond yields
- May lower demand for goods, services or financial assets.

Alternative Solutions: Treat shortages and speculation, Value work and productivity

Production shortages and speculation:

- may increase prices for certain goods, services.

Low unemployment:

- may provide incentive to increase wages to meet greater temporary and new demand for certain goods and services.

- **Deficit spending** to increase production in key areas related to production chain blockages.
- **Replace sensitive areas** like energy with domestic production.
- **Lower interest rates** to encourage new spending in these key productive and employment producing areas.
- **Encourage unionization** to keep wages growing with productivity.
- **Reduce taxes** to shift production to new areas.
- Ration, encourage postponed consumption, patriotic saving, regulate.

Government Deficits and Debt

- **Government spending** is a new injection of reserves into the economy, taxing destroys reserves from the economy. Efflux/Reflux
- (G>T): Deficit spending leaves more reserves in the economy than are drawn out.
  - Excess reserves put downward pressure on the interest rate (Fed Funds Rate/Marginal Lending Facility Rate).
  - Excess reserves may be used to purchase Government bonds.

Government Debt

- Government bonds are offered to banks as a safe alternative to holding undesired reserves.
- These bonds sales to banks drain undesired reserved and help push market interest rates up to hit the target overnight rate.
  - Banks may then sell Treasury bonds to investors.
  - When investors have liquid assets, they may choose to hold government bonds instead which offer interest.

Government Debt

- The demand for government bonds reflects the desire to hold a safe asset at a higher interest rate than the interest rate paid on reserves by the market, or the central bank deposit rates.

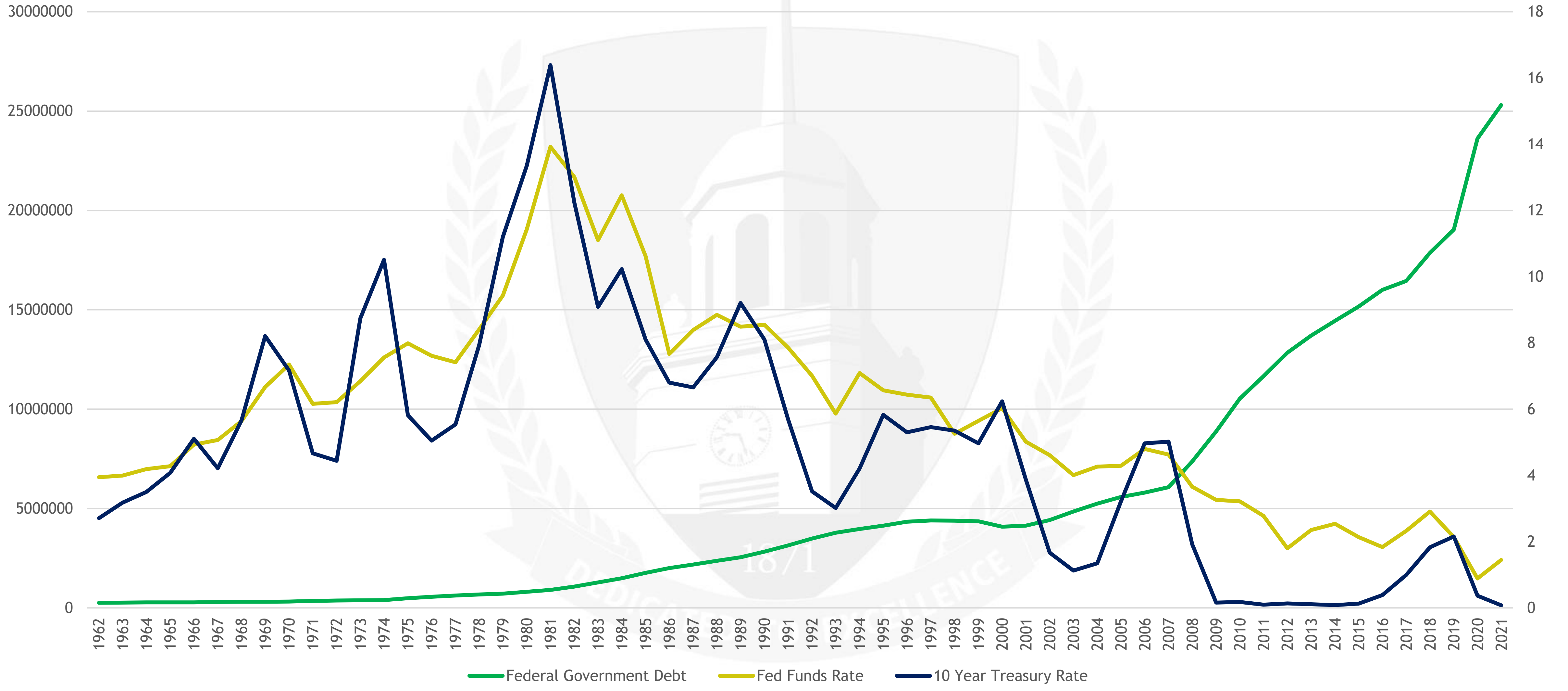
Limits of Government Deficit Spending

- Government deficit spending is not limited.
- More deficit spending will result in an increase in net financial assets.
  - These may be held as reserves, cash or Treasury Bonds.
- Spending will result in more goods, services, jobs, savings and Treasury Bonds.
- Real constraints to production exist but not financial constraints.

Limits of Government Debt

- Government debt is not limited.
- Holding US government debt is holding a safe asset. It represents a flight to safety during uncertain times.
- High government debt holdings by investors reflect a high degree of uncertainty and offer a hedge against that uncertainty.
- Real constraints to growth exist but not financial constraints.

US Federal Government Debt, Federal Funds Rate and 10 Year Treasury Rate
1962-2021



Conclusions

- Current Situation: Low unemployment, high interest rates, high inflation, unstable political situation.

- Best course of action:
  - **Government spending** to increase production to key areas related to production chain blockages.
  - **Replace sensitive areas** like energy with domestic production.
  - **Lower interest rates** to encourage new spending in these key productive and employment producing areas.
  - **Encourage unionization** to keep wages growing with productivity.
  - **Reduce taxes** to shift production to new areas.
  - Ration, encourage postponed consumption, patriotic saving, regulate.

- Desired outcome

Conclusions

- Increased government spending has beneficial effects long term on inflation, production blockages:
  - US inflation reduction act, (EU equivalent?).
  - Spending on the right goods and services can increase supply side.
- Increased interest rates have negative effects
- Do we have labour policy that touches unemployment and productivity?
  - Could be beneficial over long term.
- Policy to alleviate issues in Ukraine/Russia.

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