ASK AN ECONOMIST

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Q. Are fiscal and monetary policies interdependent?

Yes, indeed they are. Some of the key insights in our understanding of the link between fiscal and monetary policies were articulated in an influential 1981 paper by Thomas Sargent, an economist at NYU and 2011 Nobel laureate, and by Neil Wallace, an economist at Penn State.

Arguably, one of the main roles of any central bank (e.g., the Federal Reserve) is to manage the inflation rate. Inflation erodes the real value of nominal assets and is, therefore, costly to society. However, when a government issues bonds in its own currency, inflation alleviates the financial burden of inherited debt. Thus, central banks have a natural incentive to finance past deficits by using inflation to reduce the real value of government debt.

When a fiscal authority (e.g., the Treasury Department) evaluates how to finance its obligations with taxes and debt, it takes into account its expectations about future monetary policy. In particular, issuing more debt today may induce the central bank to increase inflation tomorrow, which would make the new debt less financially burdensome. This bias toward deficit financing is mitigated (and even overcome) by the fact that higher expected inflation translates into lower demand for bonds and, thus, higher interest rates.

There are episodes that highlight this interaction. During World War II, the U.S. federal debt climbed to about 100 percent of output. What followed was a period (1946-1948) of significant inflation. Lee Ohanian, an economist at UCLA, estimates that the reduction of the real value of debt due to the increase in prices was equivalent to a repudiation of debt worth 40 percent of GNP.

Various institutions have been developed in order to mitigate the incentives to use inflation as a means to finance current and/or past deficits. More and more central banks are endowed with explicit low-inflation objectives and are sheltered from political influence. In addition, central banks are usually prohibited from directly financing deficits—a lesson learned from numerous hyperinflation episodes. Fiscal authorities can also help in disciplining monetary policy. For example, starting in 1997, the U.S. Treasury has been issuing Treasury Inflation-Protected Securities (TIPS). As of October 2011, these inflation-indexed bonds accounted for about 7 percent of the total federal debt held by the public.

REFERENCES

Ohanian, Lee. *The Macroeconomic Effects of War Finance in the United States: Taxes, Inflation, and Deficit Finance.* New York, Garland Press, 1998.

Sargent, Thomas J.; and Wallace, Neil. "Some Unpleasant Monetarist Arithmetic," *Quarterly Review*, Federal Reserve Bank of Minneapolis, Fall 1981.

Submit your question in a letter to the editor. (See instructions at right.) One question will be answered by the appropriate economist in each issue.

LETTERS TO THE EDITOR

This is in response to an article headlined "Is Shadow Banking Really Banking?" This article appeared in the October 2011 issue.

Dear Editor:
Excellent survey of securitization. However, if you didn't know that there had been a major financial and economic crisis, you'd never find out from this article. Will there be a sequel that picks up where this one leaves off and explains the severity of the crisis and offers remedies? Last, maybe this isn't a contradiction, just a difference of opinion that isn't reconciled. 1. "Economist Gary Gorton argued in a book last year that deregulation and increased competition in banking rendered the traditional model of banking unprofitable." 2. "In summary, the shadow banking system can be viewed as a parallel system—one that is a complement to and not a substitute for traditional banking."

Richard Cohen, assistant professor of finance at the University of Alaska at Anchorage

This is in response to an article that appeared more than 11 years ago in *The Regional Economist*. The article was headlined "Is Federal Home Loan Bank Funding a Risky Business for the FDIC?" and was published in the October 2000 issue. The letter writer said he had come across this article while researching a related topic. He was prompted to comment on the article because he believes it contains food for thought for today's policymakers.

Dear Editor:
"In short, access to FHLB funding enables community banks to take risk without paying a price. And an increase in risk today makes it more likely that the FDIC will have to close the bank tomorrow." The price they are paying whether they are relatively a greater or smaller risk is that they have to pledge collateral that cannot be used in other ways. Albeit, I liked the points about the disconnect between risk and reward that have become integrated into the financial system due to the FHLB. It's an unintended consequence of trying to lend to good credit when there's no money left. Perhaps, we need to pare down the leverage some more. Almost 12 years later and this article still has serious value for policy discussion.

Aaron Freed, risk analyst in the banking industry in Cincinnati, Ohio

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