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Central bank communication on fiscal policy

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ABSTRACT

The issue of central bank communication on fiscal policy has so far received very little attention in the literature. This article aims to shed light on the determinants of central bank communication on fiscal policy by analysing the intensity of central banks' fiscal communication for five central banks (the Federal Reserve, the ECB, the Bank of Japan, the Bank of England and the Swedish Riksbank) over the period 1999–2011. The ECB communicates intensively on fiscal policies, in a normative way. The other central banks emphasise foreign fiscal developments, fiscal policy as input to forecasts, or the use of government debt instruments in monetary policy operations. The empirical analysis indicates that the financial crisis has overall increased the intensity of central bank communication on fiscal policy. The evolution of the government deficit ratio is a driver of the intensity of fiscal communication in the euro area, the US and Japan, and for Sweden since the start of the crisis, while in the UK its intensity is related to government debt developments as of the start of the crisis.

"*Central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy.*" (King, 1995)

1. Introduction

A perhaps not much advertised side-effect of the financial crisis is that central bankers increasingly – and more publicly – communicate on fiscal policy developments and perspectives. Such communication, which may occur for a variety of reasons, takes place amidst the acknowledged importance for central bankers to be clearer and more transparent about their policy decisions and underpinning analysis.

While the established literature on central bank communication traditionally deals with communication of monetary policy messages to the general public and financial markets,[2] the more specific issue of central bank communication on fiscal policy has so far received very little attention.[3] Yet, given the numerous ways in which fiscal policy affects the environment in which monetary policy operates, the question arises what fiscal policy aspects enter into a central bank's main communication channel

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[2] Monetary policy aspects of central bank communication are extensively dealt with in the overview article by Blinder et al. (2008). Financial stability issues are analysed in Geraats (2010), exchange rate aspects in Fratzscher (2008) and money market aspects in Neuenkirch (2012).

[3] To our best knowledge, Moser-Boehm (2006, 2009) and Rozkrut (2008) are the only studies dealing with fiscal policy communication.

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of monetary policy, and whether public finance issues have gathered more attention recently. This article aims to shed light on these questions by empirically reviewing the intensity of central banks' communication on fiscal policy for a set of five central banks (the US Federal Reserve, the ECB, the Bank of Japan, the Bank of England and the Swedish Riksbank).

Our findings indicate that the Federal Reserve, the Bank of Japan, the Bank of England and the Swedish Riksbank devote about 2 to 4% of their main monetary policy communication outlet to fiscal issues, mostly describing recent fiscal developments and outlook. On average the ECB devotes around 12% of its introductory statements to fiscal issues, and for the larger part ECB's communication on fiscal policy is of a normative nature. Government deficits are identified as a main driver of the intensity of fiscal communication in the US, the euro area and Japan. Since the onset of the financial crisis developments in public finances have become a driver of fiscal communication also for the Bank of England and the Swedish Riksbank.

The remainder of this article is organised as follows. Section 2 briefly reviews the main channels through which fiscal policy affects the short to longer-term environment for monetary policy. Section 3 recalls the importance of central banks' external communication. Section 4 sketches out our developed indicator for central bank communication on fiscal policy and carries out an empirical analysis of its intensity over the period 1999–2011. Concluding remarks are offered in Section 5.

2. Fiscal policy effects on the economy and prices

Fiscal policy is one among the main factors determining the macroeconomic environment in which a central bank operates. There are three main channels through which fiscal policy affects the short-term environment for monetary policy: automatic fiscal stabilisers, discretionary fiscal measures and, among the latter, measures having a direct price-impact (e.g. value-added or sales tax rates). Taking a longer-term view, fiscal policies matter to central banks mainly because of their implications for the more general sustainability of public finances and their effects on potential economic growth.[4]

Automatic fiscal stabilisers are the first channel through which fiscal policy can affect the economy, and thereby the monetary policy setting. Automatic stabilisers by their very nature contribute to lower amplitudes of business cycles and less volatility in prices. Automatic stabilisation may arise from the responses of tax systems to income changes (e.g. the progression in personal income taxes) and spending changes (notably unemployment benefits), but also from a more or less rules-based system of government spending reactions to economic developments, as in the US.

As regards discretionary measures, standard macroeconomic analysis suggests that expansionary fiscal measures have a positive effect on growth and price developments in the short-term. The resulting sign and size of fiscal multipliers vary depending on a range of factors including the composition of budget changes, product and labour market flexibility, and reactions in foreign exchange and bond markets (for a survey of fiscal multipliers in the literature, see Spilimbergo et al., 2009).

Some discretionary measures have a direct impact on price developments. Changes in indirect tax rates, such as value-added, sales, tobacco or energy taxes, feed quickly into prices. Governments also set administered prices and provide subsidies, especially in areas with a public service character (for instance healthcare). Others such as government wage agreements can also affect the price level, not only through their impact on aggregate demand, but also as they may play a leading role for private wage negotiators.

As to longer-term effects, unsustainable fiscal policies ultimately have very adverse macroeconomic effects: higher taxes, government default or high inflation. High inflation generates seignorage and reduces the real value of outstanding liabilities. While central bank independence has strengthened on a global scale, such independence is never absolute, and lasting fiscal concerns may eventually raise doubts about the capacity of a central bank to control inflation in the longer term.

Regarding potential economic growth, fiscal policy can impact its determinants (physical and human capital investment, technological change, employment and savings). Tax rates and the tax structure have an impact on incentives to work, save, invest and innovate, and government expenditure on physical and human capital can improve the quality of production factors. Lower public deficits can crowd-in private investments.

3. Why do central banks publicly communicate on fiscal policy?

In general, central banks communicate to the public, the media and financial markets for two main purposes. First and foremost, communication contributes to the effectiveness and efficiency of monetary policy; clarity about the mandate and the means of pursuing it helps central banks foster their credibility and better anchor inflation expectations. At the same time, transparent communication enhances market participants' understanding of the central banks' “reaction function”, making monetary policy decisions more predictable.[5] Second, better communication fosters public acceptance of the central bank's monetary policy strategy, contributing to accountability of independent central banks in modern democracies.

The role of fiscal policy in central bank decision-making and communication is likewise twofold. On the economic side, fiscal policy developments and plans are part of the information set that central banks use to assess macroeconomic and price developments and their outlook. In this respect, fiscal policy is not fundamentally different from e.g. oil price or wage developments. Central bank statements may not only refer to contemporaneous fiscal developments but also to forecasts that most central banks produce. References to fiscal policy in central bank communication in this context will most often refer to domestic fiscal policy but

[4] While there are many more channels running from fiscal policy to economic developments, this section limits the overview to what can be considered the main channels, also being the ones that are most often alluded to in central bank communication.

[5] On the predictability of monetary policy decisions, see Blattner et al. (2008).