



Euro Area Business Cycle Network Training School

Monetary-Fiscal Policy Interactions

University of Amsterdam
Amsterdam

14-16 September 2010

Application Deadline 13 June 2010

General Description

We are pleased to announce details of the latest EABCN Training School; a three-day course entitled "Monetary-Fiscal Policy Interactions".

Professor Eric M. Leeper will teach the course. It is primarily aimed at participants in the Euro Area Business Cycle Network, but applications will also be considered from doctoral students, post-doctoral researchers and economists working in central banks and government institutions outside of the network, as well as commercial organisations (fees applicable for non-network organisations).

Course Detail

The course aims to provide some of the background necessary to understand and conduct research at the frontier of monetary-fiscal policy interactions. Although much research studies monetary policy in isolation from fiscal policy, and vice versa, doing so implicitly imposes strong maintained assumptions on policy behaviour that may not hold in practice. When those assumptions do not hold, the resulting equilibria can look very different. The course uses a variety of dynamic stochastic general equilibrium models to develop the economic reasoning behind this logic. Models will range from simple "toy" models whose solutions can be derived analytically to more complex models that must be solved numerically.

Even the briefest of reflection on recent economic developments around the world makes it clear why, more than ever, it is essential to study monetary and fiscal policies jointly. So-called "unconventional" monetary policy operations that many central banks undertook are, in fact, fiscal policy in the sense that the assets the central banks acquired are ultimately backed by the government's taxing authority. In addition, many governments implemented substantial fiscal stimulus plans in response to the worldwide recession. Those plans, coupled with aging populations in many advanced economies, portend substantial fiscal stress in the future.

Fiscal stress can undermine the ability of central banks---even inflation targeting central banks that are firmly committed to achieving their targets---to control inflation and to anchor inflation expectations. One well-understood mechanism is Sargent and Wallace's "Unpleasant Arithmetic:" if net-of-interest surpluses do not adjust to back the value of debt, then money creation must do the adjusting. Many economists regard this outcome as relevant only to hyperinflations in countries that do not have the institutions in place to prevent the central bank from caving into

fiscal pressures. According to this reasoning, an independent central bank with a mandate of price stability ensures the Sargent-Wallace outcome will not occur.

But Unpleasant Arithmetic is only one mechanism by which fiscal stress can produce inflation. Most government debt is denominated in nominal terms, as in the country's domestic currency. And debt is priced like equities: it derives its value from the expected discounted streams of surpluses and seigniorage. Like equities, the price of debt can adjust to absorb expected fluctuations in those expected streams. News about lower future surpluses reduces the expected backing of debt and, therefore, reduces the value of debt today. Debt's value can fall either because the current price level jumps, reducing the real value of outstanding debt, or because the price of bonds declines (or some combination of the two). Lower bond prices, in turn, raise expected inflation, spreading out the inflation consequences and propagating the effects of news over time.

Whereas Sargent and Wallace's mechanism leads to high and growing inflation, the second mechanism---sometimes called the "fiscal theory"---need not generate high or even especially volatile inflation. The fiscal theory mechanism does, however, imply that inflation is no longer under the control of the central bank.

Under what conditions might the fiscal theory mechanism become operative? What kind of fiscal behaviour is necessary for the central bank to successfully target inflation? Are there observable implications that distinguish between these two ways that fiscal policy can be inflationary? How do policy interactions change when fiscal instruments distort behaviour? If monetary and fiscal policies undergo periodic shifts in the rules they obey, how do equilibria change? How do monetary and fiscal policies interact in open economies or in a monetary union? How can we model and analyze the uncertainty intrinsic to future monetary and fiscal behaviour?

The course consists of several distinct, but interconnected lectures:

- Lecture 1. Simple Models of Policy Interactions: Some Monetary Doctrines
- Lecture 2. Fiscal Theory of the Price Level
- Lecture 3. Policy Interactions with Tax Distortions
- Lecture 4. Fiscal Limits
- Lecture 5. Policy Interactions in Open Economies and Monetary Unions
- Lecture 6. Generalizing Policy Interactions
- Lecture 7. Foresight and News: Theory and Econometrics
- Lecture 8. Efficacy of Fiscal Stimulus

Administrative Information

The course will take place in Amsterdam at the Trippenhuis Centre and participants will be invited to make their own arrangements regarding their accommodation and meals. Further information will be available to applicants. Candidates should fill in the enclosed form and return it to CEPR's Meetings Manager, Nadine Clarke (nclarke@cepr.org) by **June 13th, 2010**. **We ask that you send a current version of your CV with your application.** EABCN gratefully acknowledges the generous assistance of the University of Amsterdam for this course.

About the Instructor

Professor Eric M. Leeper holds a PhD from University of Minnesota. He was Assistant and Associate Professor at Indiana University and a research officer at Atlanta Fed. He is now a Professor at Indiana University. He is a Research Associate of NBER and an associate editor of *European Economic Review* and editor the *Berkeley Electronic Journals in Macroeconomics*. He is the Director of the Center for Applied Economics and Policy Research at Indiana University.