Comments on “Shotgun Marriage”

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A great paper

- It combines historical examples with careful equilibrium modeling to lay out the inevitable connections between monetary and fiscal policy.
- It connects a broad array of papers, both old and recent, that discuss these issues.
- Everyone should read it.

My main comments

- $r < g$: Paper follows literature in focusing on steady states.
- Central Bank independence: So it's a myth. Is it also a mistake?
- Limits of theories that lean heavily on rational agents with unlimited computational capacity.

$$r < g$$

- This means that debt can be issued, then never paid off, simply rolled over indefinitely, while B/Y shrinks nonetheless.
- *The Economist* calls this "free money".
- You can do this once. You can even do it twice. You can even do it every year, but in that case we have to think about some limits.

$$r + h < g$$

- If we're thinking of running a primary deficit every year, with it being a fraction h of the outstanding debt, then it is feasible to do this, while keeping B/Y bounded, so long as $h < g - r$.

- Notice that this means that the size of the primary deficit we can sustain without making B/Y grow is larger the larger is B/Y!

The fly in the ointment

- We are not, in the US, in one of these equilibria, since in these equilibria B/Y is constant or steadily shrinking.

- Approximately, then, we are in an equilibrium in which $h > g - r$, so that B/Y is growing.

- Now the arithmetic reverses and bites back: The fiscal adjustment that is required to bring h back to a value consistent with stable B/Y is larger, as a proportion of Y, the larger is B/Y.

Why are we concerned about rising B/Y?

- $r < g$ in most models requires that government bonds have liquidity, transactions, or hedging properties that make them more attractive than other assets.
- But the gap that creates between r and the returns on other assets in most models must decline as B/Y increases.
- This means, as this paper notes, that average and marginal fiscal costs of additional debt can be very different.
- If we already have a high B/Y, then additional debt, even though it leaves $r < g$, may increase r enough so that the primary surplus must rise to maintain fiscal balance.

Central bank independence

- CB independence is a convention, that the fiscal authority hands off responsibility for inflation to the CB, without complaining about fluctuations in seigniorage.
- It also implicitly requires that the fiscal authority stands ready to recapitalize the CB if necessary.
- These are useful conventions.
- But an oversimplified version of them risks undermining them. If the fiscal authority gets the idea that the CB can control inflation by itself, no matter what the fiscal authority does, this can lead to uncontrolled expansion of the debt.

- If institutions are set up to completely disconnect fiscal and monetary institutions, fiscal backing may be hard to explaina and organize when it is needed.

Rationality

- The essential insight of FTPL is that wealth effects of expanding debt will eventually affect demand if there is no tax backing.
- This does not require rationality. Just that when people get rich, they eventually spend more.
- If we insist on tying FTPL-based policy discussion to models with infinite horizon rational agents, we may find the theory discredited because its predictions are not observed, when it is only the hyper-rationality that is failing, not the basic insight of the theory.