

# Summary

Fiscal and monetary policy are both key to effective business cycle stabilisation. The experiences of the 1970s and 1980s with high inflation, low growth and recurring devaluations in Sweden led to institutional reforms with greater independence from the political system for the *Riksbank*, which is responsible for monetary policy, and the introduction of a stricter fiscal framework. The latter imposes constraints on fiscal policy, while the Riksbank pursues a flexible inflation target according to which stabilising economic activity is also an objective.

Since the mid-1990s, there has been a widespread consensus that, under a floating exchange rate, cyclical fluctuations should mainly be countered by monetary policy. According to this view, fiscal policy should primarily be confined to allowing the automatic stabilisers to operate, while discretionary (active) fiscal policy measures should be used sparingly.

Over the past 15 years, major macroeconomic shocks – the global financial crisis and the Great Recession of 2008–10 as well as the pandemic of 2020–21 – have demonstrated that strong fiscal policy measures are occasionally necessary. At the same time, traditional monetary policy, in the form of changes in the policy interest rate, has become increasingly constrained by the *effective lower bound* on interest rates. Structural factors in the global economy have caused the neutral real interest rate, that is the real interest rate consistent with a normal level of resource utilisation and stable inflation, to trend downward for decades. Given that inflation is low and that the nominal policy rate can likely only be set marginally below zero, interest rate policy is not always able to provide sufficient stimulus in deep recessions. To reach inflation targets, central banks around the world have therefore in recent years resorted to unconventional measures such as *forward guidance* on future policy and large-scale

asset purchases, so-called balance sheet operations or *quantitative easing*. Our knowledge of the effects of these measures over different horizons is limited and negative side effects are a cause for concern. All in all, this has led to the conventional wisdom on economic policy, according to which monetary policy is mainly responsible for stabilisation, being called into question.

The economy has thus undergone substantial change since the current frameworks for fiscal and monetary policy were introduced in the 1990s. This raises the question of whether they need to be adjusted – fundamentally or marginally. Since fiscal policy and monetary policy both affect aggregate demand, the interplay between them is crucial. The aim of this report is to analyse how the conditions for stabilisation policy have changed and whether this calls for revisions of the policy frameworks in Sweden.

## The fundamentals of stabilisation policy

Business cycle downturns are usually caused by falling *demand*, failing to maintain normal levels of economic activity. In booms, demand increases cause resource overutilisation. To stabilise the economy, both fiscal and monetary policy should be *countercyclical*, that is stimulating in recessions and tightening in booms.

The economy is also exposed to supply shocks, sometimes very severe, such as during the pandemic and in connection with the Ukraine war. Such disturbances cannot be managed by policies stimulating demand. Demand can instead become too high so that inflation increases sharply. Which policies are appropriate after a major supply shock depends to a large extent on whether it is permanent or temporary and which industries are affected. Temporary supply shocks may have to be met by bridging policies. In the event that the supply shocks are permanent, however, such policies are harmful. This was, for example, the case during the oil crises of the 1970s.

## Acyclical discretionary fiscal policy but congruent fiscal and monetary policy

We assess the stance of fiscal policy from 1996 onwards by comparing general government net lending (the difference between revenue and expenditure) with the surplus target. Measured in this way, fiscal policy as a whole, including the automatic stabilisers, has generally been countercyclical. *Discretionary* fiscal policy, on the other hand, appears on average to have been acyclical, that is, has not covaried with resource utilisation. There are also several examples of *procyclical* discretionary fiscal policy that reinforced economic imbalances at times when these were large.

We define the current monetary policy stance by comparing the real policy rate with the neutral real interest rate. Monetary policy then appears to have been *countercyclical* on average.

Fiscal and monetary policy should normally pull in the same direction, that is, be congruent. The difference between government net lending and the surplus target has co-varied positively with the difference between the real interest rate and the neutral real interest rate. There has thus typically been congruence: when fiscal policy as a whole has been expansionary (contractionary), so has monetary policy.

## The neutral real interest rate likely to remain low in the future

The neutral real interest rate is difficult to predict. However, the most common assessment is that fundamental structural factors suggest that it will remain low in the future as well, albeit probably not as low as during the last decade. Stabilisation policy should therefore be prepared to handle situations where the *effective lower bound* on interest rates binds in future recessions. In such situations, central banks could perhaps lower policy rates further below zero than previously, but our assessment is that it may be difficult to gain legitimacy for such policies and that they are therefore unlikely.

## Reasons to avoid balance sheet operations

*Balance sheet* operations involve the central bank buying government bonds and other long-term securities. It pays for these purchases by creating central bank money that becomes the reserves of commercial banks in the central bank. The interest on these reserves tracks the policy rate. These large-scale asset purchases seem to have lowered long-term bond yields as intended, but the effects on inflation and economic activity are difficult to estimate and thus uncertain.

Asset purchases imply that long-term borrowing by the consolidated government (including the central bank) is replaced by short-term borrowing in the form of central bank money, that is *maturity transformation* is taking place. This entails interest rate risk. If the central bank trades in financial instruments other than government bonds, greater financial risks arise and credit as well as resource allocation in the economy is affected to a greater degree. This means that decisions normally taken within the political system are transferred to unelected officials in the central bank's executive board. Hence there are strong arguments for trying to avoid large-scale balance sheet operations, unless, as in the spring of 2020, they are deemed necessary to maintain a well-functioning financial system.

## The Riksbank's bond holdings should be liquidated

The Riksbank should liquidate its large asset holdings. As policies that affect risk premia distort pricing signals in financial markets, it is particularly important that covered (housing) and corporate bond holdings are liquidated. The Riksbank has indicated that these securities will be held until maturity. We are critical of this strategy. It is unlikely that the optimal liquidation rate would coincide with how the holdings mature.

## **Raising the inflation target creates more scope for monetary policy but now is not the time**

To avoid negative interest rates and balance sheet operations, one option is improving the scope for monetary policy by raising the *inflation target*. For a given neutral real interest rate, a higher target means a higher nominal interest rate on average. There would thus be greater scope for policy rate cuts in recessions, so that monetary policy would be better able to stimulate demand.

But it would be risky to raise the inflation target in a situation like the present (August 2022) when inflation is far above the target: it might be perceived as an adjustment to failures to keep inflation down and therefore lead to expectations of further increases that could contribute to even higher inflation. Raising the inflation target is only feasible once inflation is under control, so that the target chosen is *credible*.

## **Arguments for a greater role for fiscal policy**

The risk that monetary policy will be constrained by the effective lower bound on interest rates in recessions strengthens the arguments that fiscal policy should play a greater role in stabilising the economy. Using fiscal policy measures in a recession has the advantage that they can help maintain low unemployment without having unintended effects on the wealth distribution and financial stability. Fiscal policy is also particularly effective at stimulating demand when the economy is close to the effective lower bound because then it does not trigger interest rate reactions. Low real interest rates also mean that the public-finance risks of higher government borrowing in economic downturns are smaller.

## **The automatic stabilisers should be strengthened**

One way to enhance the role of fiscal policy in business cycle stabilisation is to strengthen the automatic stabilisers. Their advantage is that they trigger expansionary policies in recessions and contractionary policies in booms without requiring discretionary decisions. This reduces the risk that fiscal policy will be misused and

that a greater role for it in cyclical stabilisation will lead to excessive government borrowing.

One possibility is *automatic variations in the central government grants* to local governments. This would reduce the risk that the spending of local governments becomes procyclical due to the legal balanced-budget requirements on them that form part of the Swedish fiscal framework. The rules for these grants could be designed so that they automatically compensate for deviations in the growth of the local government sector's tax base from a moving average. *Cyclically dependent unemployment insurance*, which in recessions is made more generous in terms of higher benefit levels or longer maximum duration, is another option.

A disadvantage of stronger automatic stabilisers is that they can be destabilising after supply shocks. This problem must be taken into account, but our assessment is that stronger automatic stabilisers would be valuable.

## Fiscal policy must not be misused

Since we find no countercyclical pattern for the discretionary fiscal policy that has been pursued in Sweden, it is not obvious that more activist fiscal policy would improve business cycle stabilisation. It is even conceivable that the practice established during the 2020–21 pandemic, with recurring new decisions on stimulus measures in supplementary budget bills, may have shifted the norms of decision-making so that politicians have become more willing to extend selective support to groups exposed to negative real income shocks. This entails risks that more of discretionary fiscal policy may in fact destabilise the economy.

A greater role for fiscal policy therefore requires a stronger fiscal framework. The *Fiscal Policy Council* could be tasked with recommending *in advance* how fiscal policy should be designed with regard to the cyclical situation. The Riksbank should also inform the government and parliament if monetary policy is unable to stabilise the economy and achieve the inflation target without major negative side effects, and therefore needs backing from fiscal policy.

## Clearer guidelines for the balance between fiscal and monetary policy

At present, there are no clear guidelines – while such previously existed - for what role fiscal policy should play in stabilising the economy. Such guidelines ought to clarify that monetary policy and the automatic stabilisers should normally be responsible for business cycle stabilisation, but also that discretionary fiscal policy – unless fiscal sustainability considerations dictate otherwise – should support monetary policy in the event of severe economic disturbances so that it is not overloaded. The supporting role should not only apply in the event of large deviations from normal levels of economic activity, but also when inflation deviates significantly from the inflation target.

The establishment of a forum where representatives of the Riksbank and the government can meet and discuss the interaction between different policy areas, much like in the *Financial Stability Board*, should also be considered. Another possibility would be to expand the remit of the Fiscal Policy Council to also cover the interplay between fiscal and monetary policy.

## Stagflation requires holistic approach

After a long period of low inflation, prices are now (August 2022) rising sharply both in Sweden and the rest of the world. Experiences from the stagflation in the 1970s show the importance of restraining stabilisation policy so that it does not create a large positive GDP gap spurring inflation.

Since the current inflation is due to supply shocks, which have a negative impact on potential GDP, a positive GDP gap can arise despite low growth. If strong fiscal stimulus measures are implemented in such a situation, for example to compensate households for reduced purchasing power caused by higher prices and to counteract rising unemployment, the Riksbank's fight against inflation becomes more difficult. A situation where fiscal and monetary policy counteract each other should be avoided. It could force a very contractionary monetary policy that causes too large

strain on highly indebted households and firms, with associated risks for financial stability.

## **The relationship between different changes to stabilisation policy guidelines**

Changes in specific aspects of stabilisation policy have consequences for other areas. The more we are willing to accept large-scale asset purchases by the Riksbank, the less the need for changes.

Stronger automatic stabilisers mean less need for discretionary fiscal policy to supplement monetary policy in the event of demand disturbances, and thus less need to build in barriers against misuse of fiscal policy. At the same time, automatic stabilisers only counteract demand shocks. In the event of supply shocks that affect potential GDP more than actual, automatic stabilisers can instead exacerbate the imbalances and thereby increase the need for discretionary fiscal policy decisions.

The more one is prepared to rely on fiscal policy to stabilise the economy, the weaker are the reasons for reconsidering the inflation target. But the more sceptical one is about the possibilities of implementing carefully crafted fiscal policy measures, and the greater the confidence in the potential efficacy of interest rate policy, the stronger the reason to widen the Riksbank's room for manoeuvre by raising the inflation target.

## **Policies in acute economic crises**

This report focuses on stabilisation policy in the face of normal economic fluctuations. This does not mean that crisis policy is unimportant – quite the opposite. *Financial crises* in particular can have catastrophic economic effects and cause depressions. Effective crisis policy can prevent such developments. An example of this is the pandemic. The measures taken by the government, the Riksbank and other authorities with the aim of mitigating the economic consequences of the pandemic were powerful, fast and involved many new tools. The combined measures, together with similar efforts in other countries, were in all probability crucial for the



economic effects of the pandemic being considerably smaller than initially feared.

The fiscal and monetary policy frameworks currently in place did not hamper swift and powerful crisis management. On the contrary, the frameworks were crucial for sustaining confidence in Sweden's public finances and price stability throughout the crisis. Our assessment is that the coordination of the measures taken during the covid crisis was unproblematic. It is true that the Riksbank implemented measures that bordered on, or exceeded, the limit of what should be considered monetary policy. This includes the purchases of covered (housing) bonds and in particular the purchases of corporate bonds. The need for fast and powerful policy responses at the onset of an acute financial crisis clearly suggests that the Riksbank should be able to pursue such measures in the future as well. They should, however, only be resorted to in extreme situations when the stability of the financial system is at stake.

## Overall conclusions

There are good reasons to avoid large-scale asset purchases on the part of the *Riksbank*, unless when on the brink of a financial crisis. Strengthening the automatic stabilisers would be worthwhile, but probably insufficient if the objective is to significantly expand the possibilities of using fiscal policy to stabilise the economy in severe recessions. In such situations, considerable discretionary fiscal stimulus may be required for effective stabilisation. But this also means greater risks of fiscal stimulus being misused and overused. These risks can be reduced, however, if the fiscal policy decisions to a greater extent than today are based on independent assessments. If this cannot be achieved, more active use of fiscal policy for stabilisation purposes can be risky.

At present, there are no clear guidelines for what role fiscal policy should play in stabilisation policy. Such guidelines are needed. They ought to clarify that monetary policy and the automatic stabilisers of fiscal policy should normally be responsible for stabilising the economy, but also that discretionary fiscal policy should support monetary policy in the event of severe shocks. Fiscal policy should

be of such a magnitude that large-scale asset purchases in recessions and extreme interest rate hikes in booms can be avoided.

A key tenet of effective fiscal policy is a political willingness to respect the economic policy frameworks. These frameworks enabled powerful policy responses during the covid crisis. The necessary measures in the acute stage of the crisis could be implemented without being constrained by a fear of their consequences for the long-term sustainability of public finances. In normal times, however, economic policy cannot be conducted this way. To preserve the scope for economic policy, it is crucial to return to a coherent budget process, where the overall fiscal stance and government net lending is determined explicitly instead of being the result of a series of individual and uncoordinated decisions. The political parties in the Riksdag must all act responsibly in this regard.