



The new policy mix

**The relationship between monetary
and fiscal policy – lessons from the crisis**

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Key numbers

7

EU countries have public debt above 100% of GDP. The debt limit in the Maastricht Treaty is 60% of GDP; fewer than half of member states meet this condition

1.7% of GDP

spending on interest on public debt in the US in 2020. This is two times less than in 1990, even though public debt is over twice as high now (in relation to GDP)

57% higher

the scale of quantitative easing in the US during the pandemic crisis, compared to the financial crisis that began in 2008. This instrument was also introduced significantly faster and its use did not cause significant controversy

15-fold

increase in the number of mentions of climate in speeches by representatives of the European Central Bank in 2016-2020. In statements by representatives of the Bank of England, words relating to climate appear more often than “inflation” and “macro”

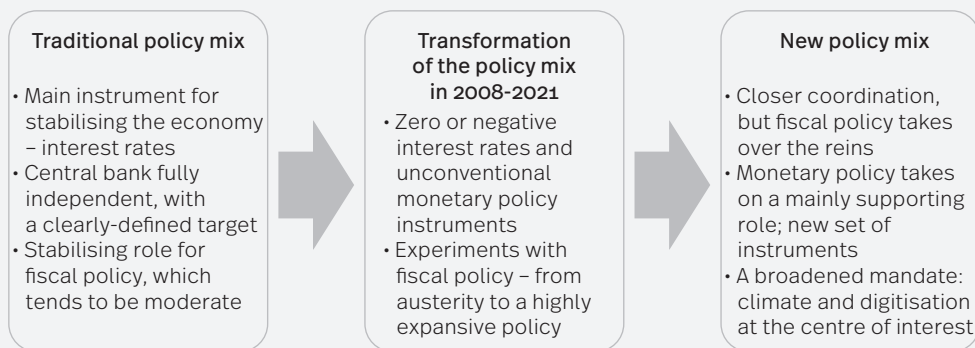
3-4%

inflation targets in developed economies should be raised to this level, according to a former chief economist of the International Monetary Fund. This would increase central banks’ ability to conduct countercyclical policy

Key findings

- **In the traditional policy mix (meaning a combination of monetary and fiscal policies) monetary policy plays a dominant role in stabilising economies.** The main stabilising instrument of this policy are changes in interest rates. Fiscal policy plays a supporting role; it is mainly limited to the use of the so-called automatic stabilisers (such as progressive taxes or unemployment benefits).
- **However, in conditions of persistently low interest rates, the traditional policy mix has become ineffective.** For this reason, central banks increasingly use unconventional instruments of monetary policy. However, their use shortly after the pandemic crisis began was not enough. Significant stimulus packages from the fiscal policy side were also necessary.
- **In the new policy mix, fiscal policy that plays the leading role in stabilising and stimulating the economy.** Its main instruments are not only automatic stabilisers, but also large stimulus packages, which are the subject of decisions by the public authorities. Monetary policy plays a supporting role; it creates space for the effective operation of fiscal policy.

↘ Infographic 1. Fiscal policy plays a growing role in the policy mix



Source: prepared by PEI.

- **In the new policy mix, new goals are set for both fiscal and monetary policies, especially those relating to climate and digitisation.** This is a novelty, in particular for monetary policy; so far, its mandate had been limited almost exclusively to stabilising prices and the economic situation. However, the change in narrative is clearly visible in statements by representatives of the largest central banks.

- **As part of the new policy mix, it seems unreasonable to keep the EU fiscal rules in their current shape.** The transition to the new policy mix requires more freedom in conducting fiscal policy. However, in the ongoing economic debate, no consensus has been reached as to the new fiscal rules' direction. Selected proposals include introducing fiscal standards or architecture for semi-automatic fiscal policy.
- **The new policy mix requires much closer cooperation between monetary and fiscal policies. However, this raises concerns about the former's independence.** The independence of central banks is considered one of the foundations of the traditional policy mix. Under the new circumstances, it may be much more difficult to distinguish between the mandates and objectives of monetary and fiscal policy.
- **One way to increase the importance and effectiveness of monetary policy is to raise inflation targets.** A higher nominal interest rate would leave more space for countercyclical policies by central banks; they could cut interest rates more in response to a recession. In the short term, the destabilisation of inflation expectations poses a risk for raising inflation targets. In the long run, this course of action could result in greater volatility in the price level, making it more difficult to control.



Introduction

The most important long-term consequence of the pandemic crisis for economic policy could be a change in the relationship between fiscal and monetary policy. The crisis triggered an unprecedented response in both policies, with measures on an unprecedented scale. However, the circumstances also forced central banks and governments to cooperate more closely, and shifted the primary responsibility for stabilising the business cycle from monetary policy to fiscal policy to a greater extent.

This report aims to summarise the economic debate concerning the post-crisis policy mix architecture. Moving away from numerical debt limits, changing fiscal rules, raising inflation targets, changing the rules of cooperation between central banks and the government – these are the topics at its centre. In this report, we present an overview of this discussion and its implications for the future.

The report has four chapters. The first contains the theoretical basis for further analysis; we present the main assumptions of four relatively new macroeconomic theories that the pandemic crisis has made more popular. In the second chapter, we describe how economic policy was conducted during the crisis and its goals for the years ahead. In the third and fourth chapter, we present the implications of the measures adopted during the crisis for fiscal and monetary policy, respectively. We consider both the practical future consequences of these policies and the potential institutional changes suitable for the new policy mix. In the summary, we point out that the implementation of the new policy mix is not yet a foregone conclusion; the changes could be hampered by, for example, resistance from conservative economic circles and the lack of consensus regarding the final shape of the new policy mix.

▸ Box 1. What is the policy mix?

The policy mix is the combination of the central bank's monetary policy and the government's fiscal policy. The state uses this combination to influence economic activity, stimulating the economy when it is in recession and cooling it down at peak times when there is a risk of inflation rising and asset bubbles building up.

1. New macroeconomic theories

The pandemic crisis has increased interest in new macroeconomic theories.

Their creators propose principles for the functioning of fiscal and monetary policy that offer an alternative to mainstream economics. These

include: the demand side and supply side secular stagnation, the fiscal theory of the price level and modern monetary theory (MMT). The theories are summarised in Table 1. We outline their main assumptions further on in this chapter.

▸ **Table 1.** Description of selected new macroeconomic theories

Theory	Description	Recommendations	Source
Demand side secular stagnation	<ol style="list-style-type: none"> 1. An excess of global savings causes a decline in demand and lower interest rates. 2. Insufficient demand weakens economic growth. 	<ol style="list-style-type: none"> 1. Increasing the demand in the economy and eliminating the excess of savings. 2. Aim of the reforms: to increase the propensity to invest. 	Summers (2014)
Supply side secular stagnation	<ol style="list-style-type: none"> 1. No more opportunities to generate growth through education, expansion of sales markets, etc. 2. Lower pace of technological growth slows down economic growth. 	<ol style="list-style-type: none"> 1. Limited ability to react. 2. Aim of the reforms: to increase market efficiency and innovation. 	Gordon (2015)
Fiscal theory of the price level	<ol style="list-style-type: none"> 1. Fiscal policy shapes price level. 2. Subordinate role of monetary policy. 	<ol style="list-style-type: none"> 1. Stabilisation of the business cycle through fiscal policy. 	Cochrane (1999)
Modern monetary theory (MMT)	<ol style="list-style-type: none"> 1. The state introduces money into the economy by issuing debt and collects it through taxes. 2. Unlimited possibilities of servicing debt issued in the national currency. 3. Inflation is the economy's only constraint. 	<ol style="list-style-type: none"> 1. Expansive fiscal policy until full employment is ensured. 2. Excessive inflation controlled by tax increases. 	Mitchell, Wray (2019)

Source: prepared by PEI.

Demand side secular stagnation

Secular stagnation theory predicts a long-term slowdown in economic growth.

Its authors also expect more frequent episodes of deflation in the future. These phenomena would be caused by a decline in demand in the economy, caused by six factors (Summers, 2014):

1. The decline in the population growth rate lowers the demand for new goods.
2. The aging of the population increases the propensity to save.
3. When the price of capital goods falls, many more can be purchased.
4. Increasing inequality increases propensity to save by the richest households'.
5. New regulations limit the crediting of non-financial investments.
6. Falling inflation reduces investment demand.

These changes in the economy lead to excessive savings. This increases the imbalance between the increasing propensity to save and the decreasing propensity to invest (Summers, 2016). Surplus savings limit the demand in the economy, which slows down economic growth.

In these conditions, the constraints of monetary policy push the economy into a deflationary trap.

Since the central bank cannot cut nominal interest rates below zero, conventional monetary policy becomes helpless. The economy may find itself in a new equilibrium, in which it permanently operates below full potential (i.e. that of employment and production) and in conditions of deflation (Eggertsson, Mehrotra, Robbins, 2019).

The deflationary trap can only be escaped – and the risk of long-term stagnation mitigated – through active fiscal policy.

Measures that can protect the economy against demand side stagnation include promoting a higher fertility rate, active fiscal policy during periods of slowdown or creating institutions that protect households against the sudden need to repay excessive debt (Eggertsson, Mehrotra, Robbins, 2019; Rachel, Summers, 2019; Summers, 2014). Attention is also drawn to the need to reduce economic inequality; it leads to an increase in savings, but not investment, which reduces aggregate demand and creates pressure on a decline in interest rates (Mian, Straub, Sufi, 2020; Summers, 2014).

Supply side secular stagnation

Some authors look for the causes of potential secular stagnation in supply-side factors, too.

Gordon (2015) argues that the chronic slowdown in economic growth results from the following changes in the structure of supply:

1. The aging population reduces the percentage of people working in the economy.
2. Growing income inequality worsens the situation of the poor.
3. The return on the spread and improvement of the quality of education is decreasing.

4. Public finances are becoming less stable because of too much debt.

Some of the factors that accelerated economic growth in the past were of a one-off nature.

These included selling products to a broader range of markets and improving human capital by combating illiteracy and promoting education (Gordon, 2016). There is currently a lack of stimuli that can fuel high GDP growth again. The pace at which new technologies are developed is declining; despite increasing spending on research and

development, the R&D sector is becoming less efficient (Bloom et al., 2020). The slowdown in the development of new technologies is further slowing down the supply side of the economy and thereby economic growth, too.

The economic policy's ability to counteract supply side secular stagnation is

limited. This task is much more difficult than in the case of demand side stagnation and must focus on increasing productivity in the long run. Potential tools include improving the quality of education, reforms minimising market inefficiencies, and increasing funding for basic research.

Fiscal theory of the price level

According to the fiscal theory of the price level, fiscal policy plays a dominant role in economic policy. According to this theory, it is assumed that the price level in the economy is shaped by the amount of public debt, and current and future budget revenue (Cochrane, 1999). This means that the role of monetary policy is limited.

The economy returns to equilibrium mainly through price adjustments. The theory centres on how the real (i.e. price-adjusted) value of public-sector liabilities is equal to its expected future net liabilities. An increase in public debt – for example, as a result of an active fiscal policy during a recession – will be balanced by an increase in prices, which will

reduce the real value of the state's liabilities accordingly.

The recommendations of the fiscal theory of the price level are consistent with the policies of some developed countries. The European Central Bank (Draghi, 2019) and the Swedish Fiscal Policy Council (2019) argue for an active fiscal policy in a recession to achieve the desired (i.e. higher) price level in the economy. Nevertheless, whether the fiscal theory of the price level is compatible with the empirical evidence is under discussion. For example, Canzoneri, Cumby, and Diba (2001) argue that the private sector can expect debt to be offset by future budget surpluses, which could severely limit the freedom to conduct fiscal policy.

Modern monetary policy (MMT)

According to modern monetary theory, a public deficit constitutes a private-sector surplus – it is therefore a positive phenomenon, in principle. In a fiat money system, the state is the sole issuer of the currency. The state puts money into circulation by issuing debt and collects it through taxes.

An overly expansionary fiscal policy is limited not by the size of the deficit or public debt, but inflation. A country with a sovereign currency can always handle its obligations, so no level of debt constrains the economy

(Kelton, 2020). As a result, the state can pursue an expansionary fiscal policy until the factors of production are put to full use (above all, full employment).

The state should constantly adjust the level of taxes to stabilise the economy and the level of inflation. Fiscal policy should respond to the appearance of too much demand, and with it inflation, by raising taxes. The increase enables the state to collect excess money from the private sector. This requires active tax rate adjustments throughout the business cycle.

2. The policy mix before, during and after the pandemic crisis

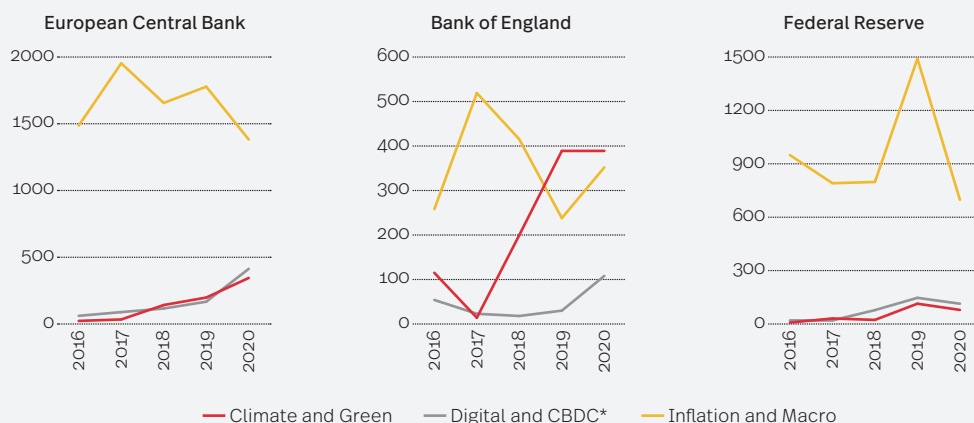
The global financial crisis in 2008 triggered significant changes in how monetary policy is conducted. On the one hand, lowering interest rates and keeping them permanently at record-low levels took away one of the basic tools that central banks could use to help stabilise the economy. On the other hand, asset purchase programmes have become a common instrument for supporting economic activity.

After the global financial crisis, central banks' mandate expanded – they began to use new tools, but also to get involved in new goals. Central banks began to be perceived as institutions that could not only stabilise,

but also actively shape the financial system and support the achievement of strategic economic goals. For example, the Bank of England states its ambition to “play a leading role [...] in the transition to a net-zero economy” (Bank of England, 2021). An analysis of statements by central bankers in developed countries points to a growing interest in climate change and digitisation in particular. In the case of statements by representatives of the Bank of England, climate-related phrases are even more common than words such as inflation and macro. The changes in the interests of representatives of the ECB and Fed are less spectacular, but also significant (Chart 1).

↘ **Chart 1. Climate and digitisation increasingly appear in speeches by central bank representatives**

Frequency of selected words in speeches by central bank representatives



* CBDC – Central Bank Digital Currency.

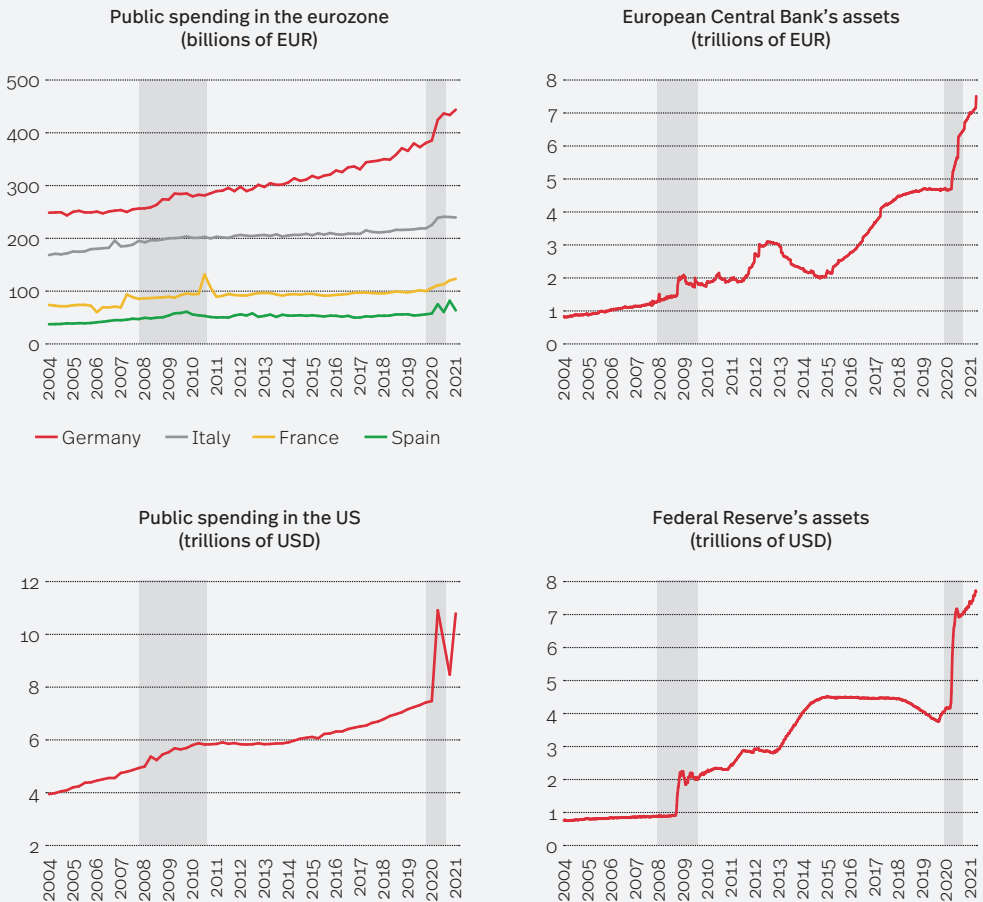
Note: in total, 1361 speeches from 2016-2020 were analysed.

Source: prepared by PEI based on the transcripts of speeches by central bank representatives (presidents, vice-presidents, managing directors, board members and chief economists) available in Bank for International Settlements database.

During the pandemic crisis, the new monetary policy instruments were applied immediately and on an unprecedented scale. This proves that they have become a standard tool of monetary policy. During the 2008 financial crisis, the US Federal Reserve

System began quantitative easing some nine months after the crisis. Following the outbreak of the COVID-19 pandemic, the asset purchase programme started right away, and its value was greater than in all the previous cases (Chart 2).

↘ **Chart 2. The monetary and fiscal policy response to the pandemic crisis was much faster and stronger than in 2008 and 2009**



Note: the grey fields indicate the crisis period. For France, spending by the central government (available quarterly) was used; in other cases, the data refers to public spending. The data is seasonally adjusted.

Source: prepared by PEI based on Macrobond (public spending) and FRED data (assets).

However, during the pandemic, the economy was mainly stabilised using fiscal policy. This distinguishes the economic policy response during the pandemic from the actions taken during the global financial crisis. At that time, monetary policy played the main stabilisation function while, within the fiscal framework, austerity packages were implemented relatively quickly. During the pandemic crisis, large stimulus packages became the basic tool for stabilising the economy. The scale of direct protection programmes alone in developed economies amounted to over 7.5% of GDP (IMF, 2021a).

The current fiscal policy is not limited to rebalancing the economy – it is also meant to be expansionary after the recovery from the recession. Contrary to the previous crisis, this time the reduction of public debt is not supposed to be achieved through savings, but via gradual adjustment, leaving the relative reduction of its burden to future economic growth and inflation. Fiscal policy has come to be seen as an instrument for supporting economic growth and prosperity, and for dealing with long-term challenges. Academic proposals increasingly emphasise the possibility of using fiscal policy to reduce poverty (Gaspar, Garcia-Escribano, 2017), health (Allen, 2019; Sassi, 2019) and educational inequalities (Partridge, Weinstein, 2013), or to accelerate the energy transition (Robinson, Keay, Hammes, 2017). These intentions are already becoming visible in the economic policy of developed countries (IMF, 2021b). Both European and American plans to support the economy after the pandemic emphasise the reconstruction of public infrastructure, the digitisation of the economy, the development of low-emission transport and combating climate change (European Commission, 2021; www4).

This could be the start of the mission-economy. Mariana Mazzucato (2018) has shown that the state has a significant share in creating innovation and accelerating technological

progress. The development of this vision is the mission economy (Mazzucato, 2021), a vision of the economy in which the state actively supports economic development and engages in areas of key importance from the perspective of development. In a report prepared for the French government, Blanchard and Tirole (2021) indicate that meeting contemporary economic challenges requires greater state involvement in key sectors of the economy (their recommendations are summarised in Table 2). The nature and scale of the recovery programmes in the US and EU suggest that the public sector is indeed beginning to take an interest in supporting economic development intensively and directly.

The pandemic crisis has therefore outlined a new paradigm of economic policy.

Within this paradigm, two basic points can be distinguished:

- a) **the state is to be more active and engage in achieving strategic goals** – new goals that go beyond the current mandate are set for both monetary and fiscal policy;
- b) **fiscal policy is meant to play the leading role in stabilising and stimulating the economy;** the role of monetary policy will be mainly supportive. This is a reversal of the previously dominant model, in which the central bank stabilises the economy through decisions on interest rates, while the fiscal policy supports these activities, primarily with the help of automatic stabilisers.

However, the implementation of the new paradigm requires institutional changes. When creating a new philosophy of economic policy, it is necessary to adjust institutional rules; for example, concerning the central bank's tasks and independence, and fiscal rules. This explains the intensification of the economic debate concerning the new fiscal policy framework and central banks' mandate. The main axes of this debate are presented in the next two chapters.

▼ **Table 2. Recommendations for France in the report prepared by the committee headed by O. Blanchard and J. Tirole**

Challenges	Fiscal policy response	Institutional solutions
Climate change	<ol style="list-style-type: none"> 1. A high tax on CO₂ emissions, growing at a predictable pace (revision of the EU ETS system). 2. Increasing investment in green technologies. 	<ol style="list-style-type: none"> 1. Establishing institutions at the EU level coordinating climate-related investments and scientific re-search priorities. 2. Additional standards and bans in EU legislation (e.g. withdrawing products with a high carbon footprint).
Economic inequality and pension system	<ol style="list-style-type: none"> 1. Pension system linking the size of contributions to the average remuneration in a given year. 2. Including maternity leave and unemployment in the contribution period. 3. The state boosting the lowest earners' contributions. 4. Taking into account the difficulty of the work done when determining pension size. 5. Indexing pensions in relation to the average salary, rather than inflation. 	<ol style="list-style-type: none"> 1. Reform of public finances towards greater transparency, including a simple pension system. 2. Later retirement increases pension size by an appropriate amount (no early retirement bonus). 3. The need to choose between a higher retirement age and lower pensions – in a referendum, following a broad information campaign. 4. Gradual elimination of special retirement privileges. 5. Making employment contracts more flexible for seniors and introducing vocational training for them. 6. Increasing the emphasis on health protection – primarily through the treatment of chronic illnesses.

Source: prepared by PEI based on: Blanchard, Tirole (2021).

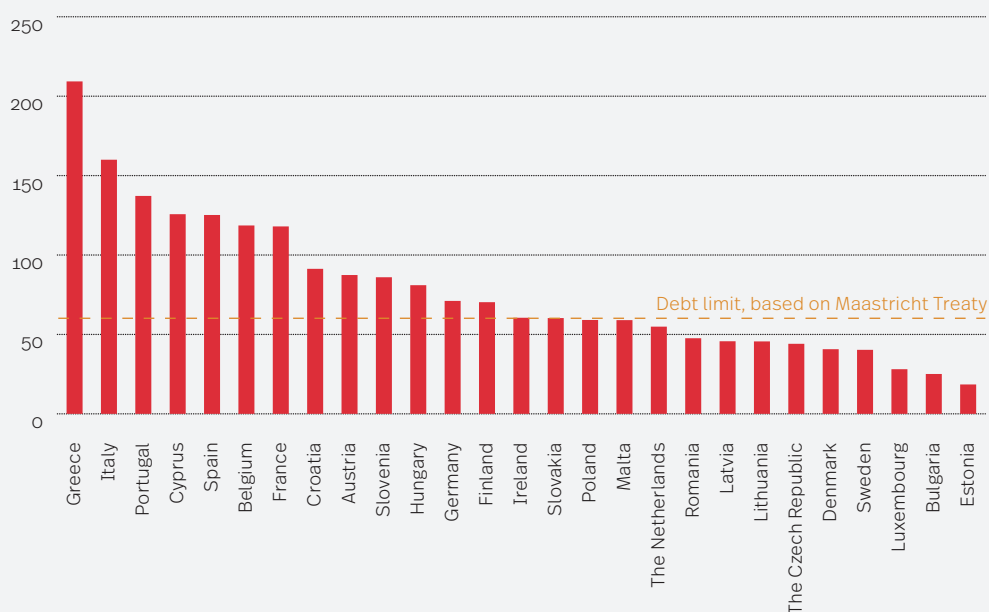
3. The new policy mix – implications for fiscal policy

The transition to the new policy mix requires more freedom in conducting fiscal policy. In the short term, this freedom should allow economies to re-enter the path of growth. In the long run, it should allow the state to respond to crises efficiently and effectively, as well as to implement strategic goals.

It seems impossible to maintain the current fiscal rules within the framework of the new policy mix. For example, in the first

quarter of 2021, 15 out of 27 EU countries exceeded the public debt limit of 60% of GDP set out in the Maastricht Treaty, and in 7 countries public debt was above 100% of GDP (Chart 3). It is difficult to imagine how these countries could return to below the established limit (regardless of the rightness of this course of action). In response to the pandemic crisis and the need to stabilise the economy, the European Commission temporarily suspended the fiscal rules in the EU.

↘ **Chart 3. Many EU countries have public debt far above the 60% of GDP limit**
General government sector's debt (% of GDP, Q1 2021)



Source: prepared by PEI based on Eurostat.

One of the key arguments in favour of revising the fiscal rules is the low cost of servicing debt. The current fiscal rules in the EU were constructed to stabilise economies during a period of positive real interest rates (Blanchard, Leandro, Zettelmeyer, 2021). However, interest rates today are historically low, with a downward trend for at least 700 years (Schmelzing, 2019). One of the explanations for their decline in recent decades is the theory of demand-side secular stagnation presented in the first chapter. The growing propensity to save and decline in investment demand in developed economies may result in interest rates remaining close to zero (or even negative) for years (Eggertsson, Mehrotra, Robbins, 2019; Rachel, Summers, 2019). Low interest rates reduce the cost of servicing sovereign debt and make debt more stable, both today and in the future. For example, the cost of servicing federal debt in the US in 2020 was below 1.7% GDP, almost twice as low as three decades earlier, despite the increase in debt from 57 to 127% of GDP.

The possible effects of low interest rates reinforce the arguments in favour of greater fiscal policy activity. Rachel and Summers (2019) argue that an increase in savings and a decrease in investment (causing a drop in interest rates) will slow down economic growth on the demand side. This will lead to larger deficits and require structural reforms to stimulate investment. Real negative interest rates will not force surpluses to reduce public debt levels. In these conditions, the ratio of debt to GDP may be stable even if the state permanently generates (limited) budget deficits. Additionally, the efficiency of fiscal policy (expenditure multipliers) may be higher amid low interest rates (Di Serio, Frageta, Melina, 2021).

The new framework for fiscal policy is currently the subject of a lively debate among economists, but it has not been resolved so far. Most of the proposals are aimed at

pursuing an active countercyclical fiscal policy, strengthening automatic economic stabilisers, increasing the freedom to spend public funds and supporting long-term development goals. A summary of selected proposals is presented in Table 3. Currently, they are rather general and, at best, directional.

Before the pandemic crisis, the European Fiscal Board (EFB) proposed to reform the EU's fiscal framework. These proposals can be seen as the first steps towards fiscal policy taking over the main stabilising and stimulating role. The EFB suggested limiting the fiscal rules to one indicator: the debt limit of 60% of GDP. After exceeding this limit, states would be obliged to limit the increase in spending to ensure the stabilisation of public finances within 15 years. However, governments would retain the option of pursuing a countercyclical fiscal policy. The EFB proposed to exempt some countercyclical expenses, such as unemployment benefits, from the rules. The proposal also assumed the creation of a unified exit rule in exceptional situations. In 2020, the EFB also proposed to exclude some spending that supports development from the spending rules (Thygesen et al., 2020).

Fiscal rules must take greater account of the fight against climate change. Darvas and Wolff (2021) calculate that the implementation of the “Fit for 55” plan by the EU and achieving climate neutrality in 2050 requires an increase in annual investment outlays of 2% of GDP, of which 25-50% should be covered by the public sector. Meanwhile, a return to existing fiscal rules would work in the opposite direction, limiting the space for new public investments. As a minimum option, the authors cited recommend excluding spending on green investments from the fiscal rules monitored by the European Commission. At the same time, they recommend introducing or increasing the taxation of fossil fuel emissions and the establishment of an EU-level fund with an annual budget amounting

to 1% of the EU's GDP. The fund's task would be to redistribute funds between EU countries so that the projects that would reduce CO₂ emissions the most effectively are financed.

▸ **Table 3. Selected proposals to reform fiscal rules**

Proposal	Authors	Country /region	Recommendations
Simplified fiscal rules	Beetsma et al. (2018)	EU	<ol style="list-style-type: none"> 1. The level of debt (60% of GDP) as the only fiscal anchor. 2. Limiting the growth of budget spending as a path to achieve the goal within 15 years. 3. Correction for some of the automatic stabilisers. A simple exit rule in exceptional situations.
Greater fiscal space in the EU	Thygesen et al. (2020)	EU	<ol style="list-style-type: none"> 1. The reaction of fiscal policy via a larger EU budget. 2. The simplification of fiscal rules (debt limit, flexible paths of debt reduction, simple exit rule). 3. Excluding some spending that supports growth from the rules.
Easing of fiscal rules	Teulings (2018)	EU	<ol style="list-style-type: none"> 1. Active fiscal policy amid lowering interest rates and an aging population. 2. An average deficit of 2% of GDP and up to 5-6% in the event of severe recessions.
Fiscal standards	Blanchard, Leandro, Zettelmeyer (2021)	EU	<ol style="list-style-type: none"> 1. Replacing the current rules with looser standards – debt must be stable in the medium term. 2. The ability to adjust the level of debt to the current economic situation. 3. Requiring standards at the EU level.
Green fiscal pact	Darvas, Wolff (2021)	EU	<ol style="list-style-type: none"> 1. Excluding spending on the energy transition from the fiscal rules. 2. Financing the transition in countries with a worse fiscal situation from the EU Recovery Fund. 3. Incentivizing private green investments through higher taxation of emissions and legal regulations.
Semi-automatic fiscal policy	Orszag, Rubin, Stiglitz (2021)	US	<ol style="list-style-type: none"> 1. Strong automatic stabilisers and countercyclical infrastructure spending. 2. Broad indexation of benefits and spending. 3. More freedom to shape the rest of fiscal policy. 4. Increasing the sustainability of public finances by extending bond maturity.

Source: prepared by PEI.

Blanchard, Leandro and Zettelmeyer (2021) propose a fiscal system based on flexible standards. Their proposal would oblige EU countries to estimate the probability of a sovereign debt crisis on the basis of simulations of future deficit levels, economic growth, inflation and interest rates. Governments would be required to take corrective action if the risk of medium-term instability proves too high. Lack of corrective action when a risk of instability is identified (rather than the risk itself) would be considered a breach of the standard. However, the authors admit that the economic variables that determine debt stability are uncertain (Blanchard, Leandro, Zettelmeyer, 2021). A system of fiscal standards based on macroeconomic modelling may pose a risk of the accumulation of systemic risk that is difficult to control, in the spirit of Minsky's financial instability hypothesis (Keen, 1995).

Orszag, Rubin and Stiglitz (2021) propose a semi-automatic fiscal policy, based on a combination of automatic and discretionary elements. They identify the policy's five main components:

1. Strong automatic stabilisers.
2. Anticyclical infrastructure programs.
3. Extending the maturity of issued bonds, even above 30 years.
4. The indexation of government benefits and spending.

5. Increasing the discretion of other fiscal spending.

According to the authors cited, the stabilising aspect of fiscal policy must primarily use tools that operate automatically (without a political decision). This requires higher tax progression and a generous social policy, among other things. At the same time, issuing long-term bonds would make debt servicing costs independent of short-term fluctuations in interest rates. However, governments should also have room to spend in categories that support development, regardless of the phase of the business cycle.

One of the solutions for reconciling various fiscal policy goals within the framework of the new policy mix are targeted fiscal funds.

Fiscal policy's stabilising objective will be increasingly linked to supporting development. Orszag, Rubin and Stiglitz (2021) propose the creation of countercyclical programmes that support investment in infrastructure, broadly understood; that is, transport, energy, communication and digitisation. They would play a dual role:

- in the short term: countercyclical, by stimulating demand and investment in a recession,
- in the long term: fostering development, by supporting the struggle against key challenges (climate change, digitisation, healthcare).

4. The new policy mix – implications for monetary policy

Within the framework of the new policy mix, much closer interaction between monetary and fiscal policies becomes crucial. The weaker impact of monetary policy means that, in conditions of low inflation, the fundamental countercyclical policy must be fiscal (Buiter, 2021; Draghi, 2019; Reichlin, Ricco, and Tarbe, 2021; Schnabel, 2021). However, this does not mean that monetary policy is useless. Quantitative easing and maintaining low interest rates reduce debt servicing costs. The cost of fiscal expansion is therefore falling, increasing the potential to support the economy and making it easier to reduce debt (Bartsch et al., 2020). Moreover, the impact of fiscal policy is much greater amid real negative interest rates (Di Serio, Frageta, Melina, 2021).

However, this raises concerns about central banks' independence, one of the foundations of the policy mix to date. In these new conditions, it may not be possible to distinguish between the mandates and goals of monetary and fiscal policy. For monetary and fiscal policy to work together, central banks need to be independent from political pressure and both authorities need to be credible (Bartsch et al., 2020). Central bank balance sheets become dominated by government bonds. Attempting to mitigate any supply shock through extensive quantitative easing will limit monetary policy's ability to react in the future (Haldane, 2021). This means that economic policy is at a crossroads: states may face a choice between maintaining a genuinely independent central bank and monetary policy's greater involvement in the new policy mix (de Haan, Eijffinger, 2016).

The new policy mix is therefore associated with a risk of fiscal domination. Coordination of monetary and fiscal policy, combined with high levels of debt, can lead to the so-called fiscal domination (Weidmann, 2021). A high level of state debt may make it impossible to normalise the monetary policy. The central bank is then faced with a dilemma, as raising interest rates simultaneously raises the cost of debt servicing by the government and have a negative impact on fiscal policy. Withdrawing from this mechanism is difficult (Bartsch et al., 2020).

Monetary policy may be made more effective by a higher inflation target. In the economic debate, raising inflation targets in developed economies to 3-4% a year is increasingly discussed. Bartsch et al. (2020) call this proposal a normalisation of the policy mix, a response to the decreasing room for monetary policy manoeuvre due to the decline in interest rates. In their opinion, this course of action is needed so that central banks' reference rates do not constantly hit the zero barrier, which forces states to activate unconventional monetary policy instruments. The fundamental arguments for and against raising inflation targets are presented in Table 4.

A higher inflation target reduces the risk of deep recessions. Increasing the inflation target will result in an equilibrium increase in the nominal interest rate. The central bank will be able to cut interest rates more in response to the recession and pursue a stronger countercyclical policy (Blanchard, Dell'Ariccia, Mauro, 2010; L'Huillier, Schoenle, 2020). A higher inflation target may also increase the effectiveness of unconventional monetary policy tools

– quantitative easing and forward guidance (Gagnon, Collins, 2019). The risk of the economy falling into a deflationary crisis is also reduced (Eggertsson, Mehrotra, Robbins, 2019). Using

the example of Japan, Leigh (2010) notes that more room for monetary expansion would have reduced the scale of the recession there in the 1990s significantly.

▾ **Table 4. Possible consequences of a higher inflation target**

Advantages	Threats
<ol style="list-style-type: none"> 1. It is possible to conduct a stronger countercyclical policy (Ball, 2013). 2. Less risk of an economic recession (Leigh, 2010). 3. Protection against falling into a deflationary spiral (and therefore also against demand side secular stagnation) (Eggertsson, Mehrotra, Robbins, 2019). 	<ol style="list-style-type: none"> 1. It may be more difficult to control inflation (Bernanke, 2010a). 2. Destabilization of inflation expectations (Bernanke, 2010b). 3. More frequent adjustments of prices and wages (L’Huillier, Schoenle, 2020).

Source: prepared by PEI.

However, raising inflation targets involves two types of risk:

1. **In the short run, it destabilises current inflation expectations.** Central banks’ actions in recent decades have supported the anchoring of inflation expectations at low levels (Blanchard, Dell’Arricia, and Mauro, 2010). The stability of inflation expectations and credibility of central banks make it easier to conduct economic policy. It is unclear how difficult it will be to anchor inflation expectations at higher levels (Ball, 2013; Bernanke, 2010b; Blanchard, Dell’Arricia, Mauro, 2010; Mishkin, 2011).
2. **In the long run, it may mean higher inflation volatility.** Higher inflation levels may turn out to be less stable (Bernanke, 2010a; Mishkin, 2011). In this case, a stronger countercyclical fiscal and monetary policy will be needed. The benefits obtained from

a higher inflation target may be neutralised by the need for tighter control of inflation.

Analysis of the academic literature does reveal the optimal inflation target and level of inflation. Academics’ estimates are extremely divergent – the optimal change in prices ranges from deflation of 2% to inflation of 4% a year (Table 5). On the one hand, the positive nature of deflation is still cited (for example, Amato et al., 2009; Wolman, 2011); on the other hand, taking into account nominal rigidities and changes in relative prices constitutes an argument in favour of a low but positive inflation rate (for example, Carlsson, Westermarck, 2016; Ikeda, 2015; Kim, Ruge-Murcia, 2009). One of the explanations for these discrepancies is the defectiveness of general equilibrium models (Podkaminer, 2021), as well as the imperfect nature of the data on inflation collected (Boskin et al., 1996; Gordon, 2016).

▾ Box 2. Increased inflation – temporarily or for a long time?

The current period of high inflation may raise doubts about the effectiveness of the new policy mix.

Inflation in the developed world has risen to unprecedented levels as a result of the rapid economic recovery. In August 2021, price growth amounted to 5.4% year-on-year in the US and to 3% year-on-year in the eurozone. This is clearly above the inflation target of the Fed and the ECB (2%). In this situation, the key question is: is the heightened inflation temporary (short-term) or is it likely to remain above the target for several years? The answer will determine how strong the policy mix's response to the current situation should be.

Heightened inflation is a natural consequence of the recovery phase from the pandemic crisis – this is the main argument used to claim that it is temporary. According to it, the normalisation of the economic situation will automatically trigger a drop in inflation. As a result, no significant monetary or fiscal policy moves are needed. Fed Chair Jerome Powell lists five arguments in support of the idea that the current inflation is temporary (Powell, 2021):

- it is caused by an increase in the prices of a narrow category of goods,
- the prices of goods hardest hit by the pandemic are starting to stabilise,
- wages are growing at a steady pace,
- inflation expectations are still anchored,
- secular stagnation puts pressure on the stabilisation of price growth in the longer term.

The pandemic crisis triggered permanent changes in the economy, which will systematically drive up inflation – this is the argument used to claim that the period of heightened inflation will last longer.

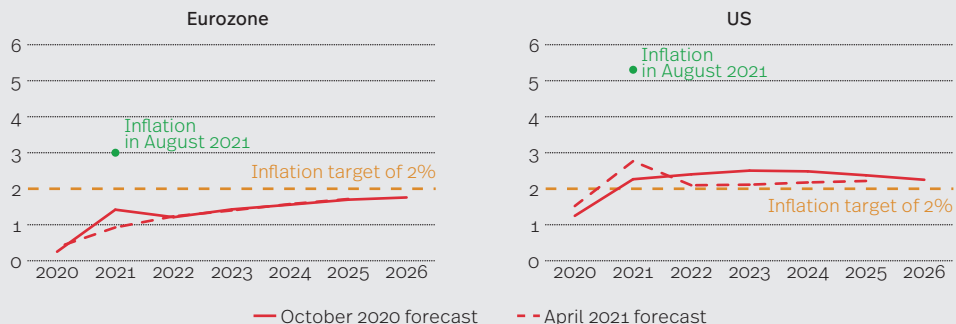
The pandemic has led to a change in consumer preferences: an increase in demand for goods and a decrease in services. As global supply chains cannot adapt to changes in demand in the short term, the consequence may be a longer period of heightened inflation (Morawski, 2021). This phenomenon may be reinforced by the large stimulus programmes (pandemic recovery plans) (Blanchard, 2021; Summers, 2021). Climate policy could also contribute to the permanent increase in inflation – unexpectedly rapid growth in CO₂ emission allowances could cause supply shocks (Osterloh, 2020) and destabilise inflation expectations (Network for Greening The Financial System, 2020).

IMF forecasts from April 2021 suggest moderate inflation in the US and eurozone in coming years.

These forecasts probably did not take into account the possibility of inflation reaching current levels (Chart 4). We should therefore expect higher inflation forecasts in the next round of forecasts.

▾ Chart 4. Average annual inflation in the US and eurozone in 2021 will probably be much higher than the IMF forecast in April

IMF forecast for inflation in the eurozone and US (%)



Source: prepared by PEI based on IMF WEO data.

▼ **Table 5. The optimal inflation target – review of the literature**

Authors	Country/ region	Optimal inflation target	Space gained for rate cuts in the event of a recession	Description
Amano et al. (2009)	-	-1.9%	-	The increase in productivity in the economy multiplies the negative effects of inflation.
Kim, Ruge-Murcia (2009)	US	1.2%	-	Restricted inflation stimulates the labour market due to the rigidity of nominal wages.
Wolman (2011)	-	-1 – 1%	-	Depending on how the model is calibrated, deflation (around 1%) or inflation (also around 1%) is optimal.
Coibion, Gorodnichenko, Wieland (2012)	US	around 0%	-	The cost of moderately higher inflation exceeds the risk of a liquidity trap (nominal interest rates cannot fall below 0%). A countercyclical fiscal policy should work.
Ikeda (2015)	US	1.97%	-	Nominal rigidity and a decline in relative investment prices are arguments for positive inflation. The optimal CPI growth is 1.97% year-on-year.
Andrade et al. (2018)	US	2.2 – 3.7%	around 1.1 pp for every 1 pp	Raising the inflation target neutralises the fall in the natural interest rate. Higher targets protect against particularly severe shocks.
Andrade et al. (2018)	Euro-zone	2.4 – 2.7%	-	-
Carlsson, Westermark (2016)	US	1,16%	-	Nominal rigidity of the labour market makes positive inflation optimal.
Adam, Weber (2019a)	Britain	2.6 – 3.2%	-	The higher inflation target offsets the effect of the rapid decline in relative prices.
Adam, Weber (2019b)	US	1%	-	Changes in companies' productivity lowered the optimal inflation target from 2% in 1986 to 1% in 2013.
Gagnon, Collins (2019)	US	Higher	2.5 pp for each 1 pp	Raising the inflation target will make forward guidance and quantitative easing more effective.
L'Huillier, Schoenle (2020)	US	4%	0.6 – 1.5 pp	Price elasticity reduces the effectiveness of the monetary policy response. The rate cut must be stronger to achieve the desired effect.

Source: prepared by PEI.

Conclusion

The past two decades have been a period of shaping a new relationship between monetary and fiscal policy.

Developed countries have departed from the traditional policy mix; instead monetary policy has become the main means of stabilising the economy and fiscal policy has taken on a secondary role. During the transitional period – before the COVID-19 pandemic – two processes took place:

1. Central banks resorted to non-standard instruments, including quantitative easing, increasingly often due to traditional monetary policy's ineffectiveness.
2. Governments' actions started to move towards an active fiscal policy due to the negative effects of the austerity policy implemented shortly after the global financial crisis.

Economic policy assigns increasing importance to major development challenges, especially climate. In recent decades, there has been a significant increase in public interest in challenges such as climate change and reducing inequality. Facing them requires the coordination of economic policy at the global level. This created, in a natural way, a space for states to conduct an active economic policy, including fiscal policy. This view was further supported by new economic theories, which place a strong emphasis on the importance of state intervention in the economy.

The stabilisation policy during the pandemic has been the first attempt to implement a new policy mix. The response to the COVID-19 pandemic and the pandemic recovery plans encompassed several key elements:

1. The monetary and fiscal policy response was unprecedented in its speed and scale.

2. Fiscal policy was not limited to automatic measures; significant stimulus packages were implemented.
3. Monetary policy actively supports fiscal policy.
4. The economy is also being stimulated during the period of recovery from the recession and economic expansion.
5. The post-crisis recovery plan encompasses strategic, long-term goals: tackling climate change and the digitisation of the economy.

However, the establishment of the new policy mix in practice is not a foregone conclusion. To become a permanent part of economic practice, the new policy mix needs to be institutionalized; it needs to be embedded in the law and practice of governments and economic institutions. This will require far-reaching legal changes and social acceptance, at both the national and the international level.

The new policy mix's institutionalisation may be hampered by resistance from conservative economic circles. We analysed 16 statements by representatives of selected central banks in 2021 in detail in this respect. The results are presented in Figure 5. The central bank representatives' comments convey scepticism or reluctance towards the new policy mix, in particular solutions that potentially limit the monetary authorities' independence. Similarly, the fiscal conservatism of certain groups in the EU could make it impossible to reform fiscal rules. Major politicians and officials from EU member states, including the president of the Bundestag and the ministers of finance of Germany, Austria, the Netherlands, the Czech Republic and the Scandinavian

countries (Schauble, 2021; www1; www2), are against the changes in this respect. The proposal to take on common European debt has also been met with resistance (www3).

A similar phenomenon was observed before the pandemic crisis – new paradigms often operated only at the declaratory level.

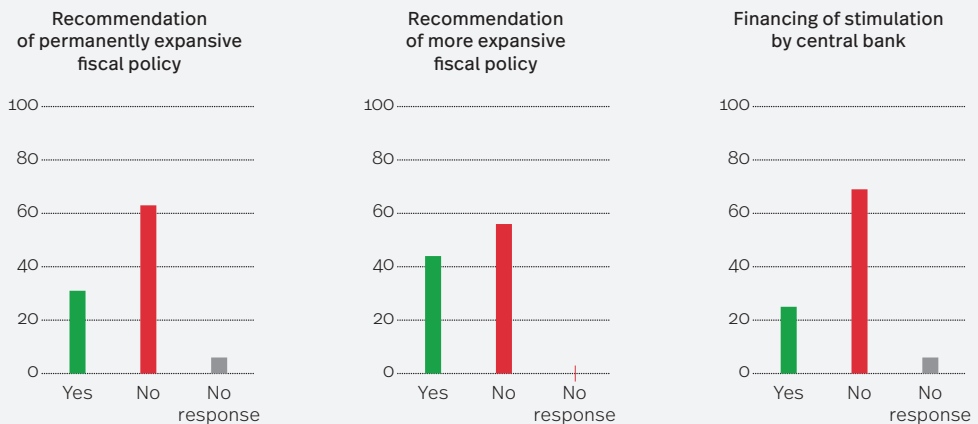
For example, Kwarciński, Nowak-Posadzy and Pawluczuk (2019) showed that, after the financial crisis in 2008, the IMF management’s rhetoric supported a socially inclusive and economically expansive policy increasingly often. However, specific country recommendations remained conservative.

The change could also be hampered by the lack of consensus on the exact shape of the new policy mix. Supporters of the new

economic policy recommend changes in the same direction, based on an active countercyclical fiscal policy, a supporting role for monetary policy, and countering climate change and other new goals for the policy mix. However, when it comes to institutionalisation, the specific proposals diverge. They range from proposing slight adjustments to the current system to creating it anew (for example, proposing a slight loosening of the EU’s current fiscal rules vs. replacing them with a completely new system of fiscal standards). Also, the effects of some of the reforms – such as increasing the inflation target – are debatable, and academic research does not predict their full consequences reliably.

↘ **Chart 5. Central bank representatives are sceptical when it comes to the new policy mix**

Detailed analysis of selected statements by representatives of central banks
(recommendation direction, %)



Note: We analysed seven statements by representatives of the central banks of eurozone countries, two from the Bank of Japan, two from the ECB and one each from the Fed and the central banks of England, Russia, the Philippines and Australia. All the statements were made in 2021.

Source: prepared by PEI.

From Poland's perspective, the most important implications of the new policy mix relate to supporting development and climate policy. The risk of secular stagnation in Poland – at least in the next few years – is small. The Polish is growing relatively rapidly and there are no systematic problems with deflation or overly low inflation. The role of countercyclical fiscal policy therefore seems to be limited; it is

not necessary on such a large scale to stabilise the economy on the path of stable growth as in the most developed economies. However, it can be used as a tool to foster policy that supports development. From Poland's perspective, the most important recommendations concern the institutionalisation of investment in the energy transition or digitisation.

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