REASSESSING THE EFFECTIVENESS AND
TRANSMISSION
OF MONETARY POLICY

Discussion of R. Gomez-Cram, H. Kung, and H. Lustig

"Government Debt in Mature Economies: Risky or Safe?"

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Government Debt in Mature Economies: Risky or Safe?

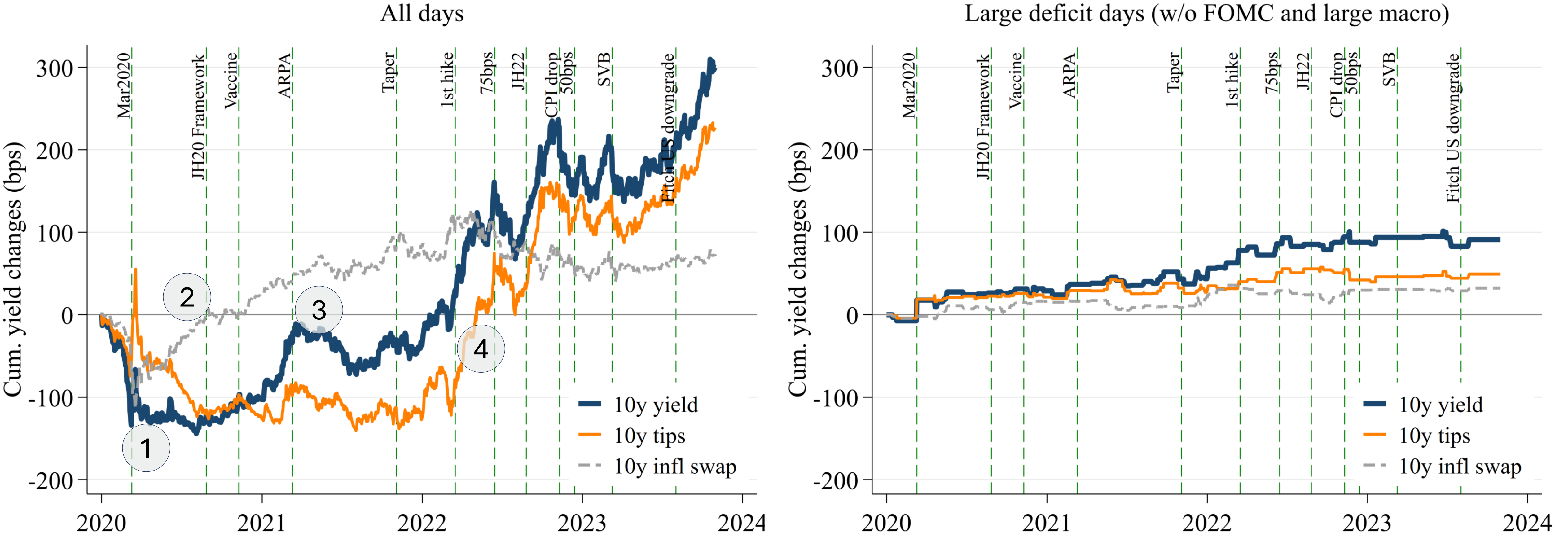
- **GCKL's paper:** Active fiscal – passive monetary regime since March 2020
  - Central bank accommodates fiscal actions; QE in support of fiscal policy
  - Treasury debt becomes risky
  - Evidence: expected inflation ↑, term premia ↑, real rate ↑, stock-bond comovement ↑, convenience yield ↓

Did markets price active fiscal – passive monetary switch since 2020?

- **My discussion:** Not a regime shift but a market-perceived monetary policy "mistake"
  - Delayed Fed's response to address inflation
  - Origins of delay pre-date inflationary fiscal shock in Covid
  - Market perceptions consistent with active monetary policy, but uncertainty about reaction function

- **Provocative and timely:** Treasury debt still relatively safe, but significant uncertainty about fiscal-monetary interaction with potentially dire consequences for Treasuries

GCKL's evidence and interpretation



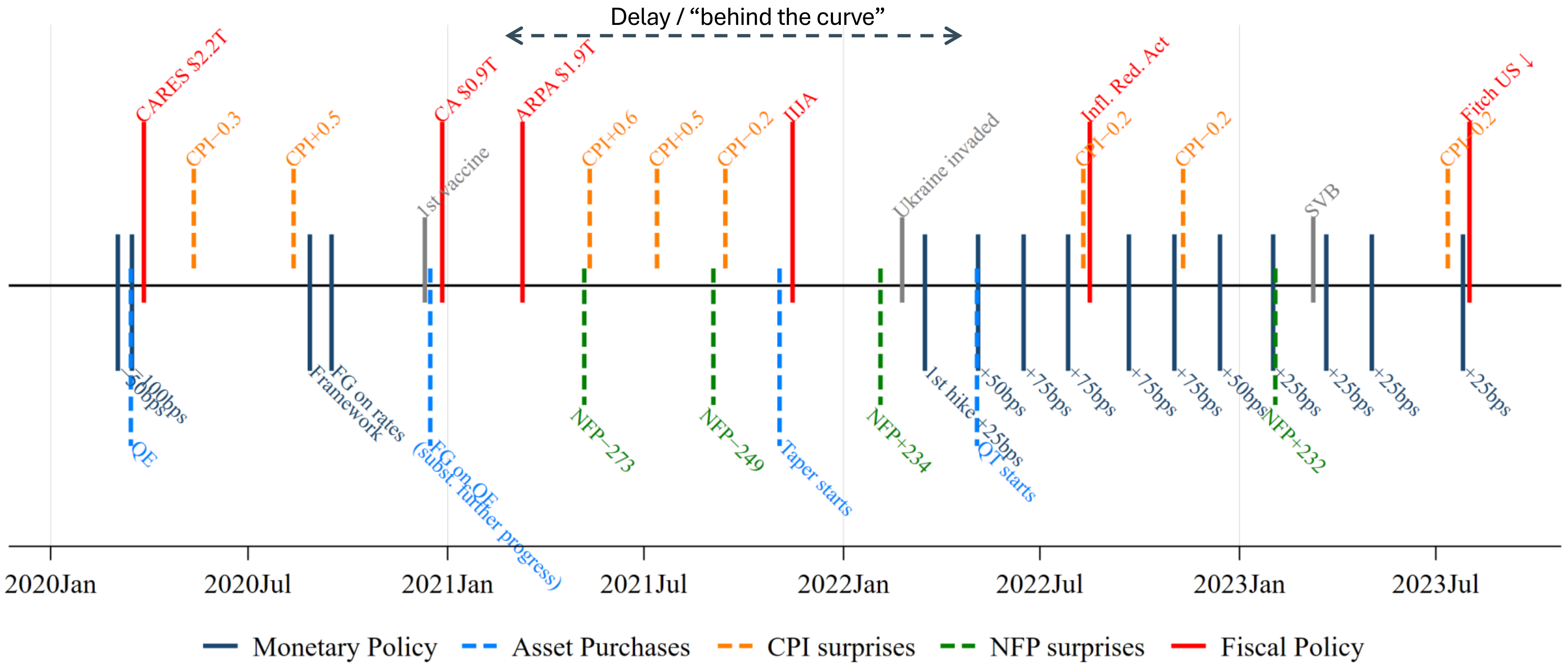
GCKL's interpretation as evidence for fiscally-led regime

1. Unfunded spending news: yields ↑, stock-bond corr ↑
2. Front-loaded inflation expectations ↑
3. Term premia ↑
4. Back-loaded real rate ↑

Alternative interpretation

1. Liquidity constraints, dash for cash, fiscal stimulus warranted
2. Initial recovery from negative demand shock; ongoing supply shocks
3. Fed's reaction function uncertainty amid fiscally-driven excess demand
4. Aggressive Fed rate tightening and incoming macro news

Context matters



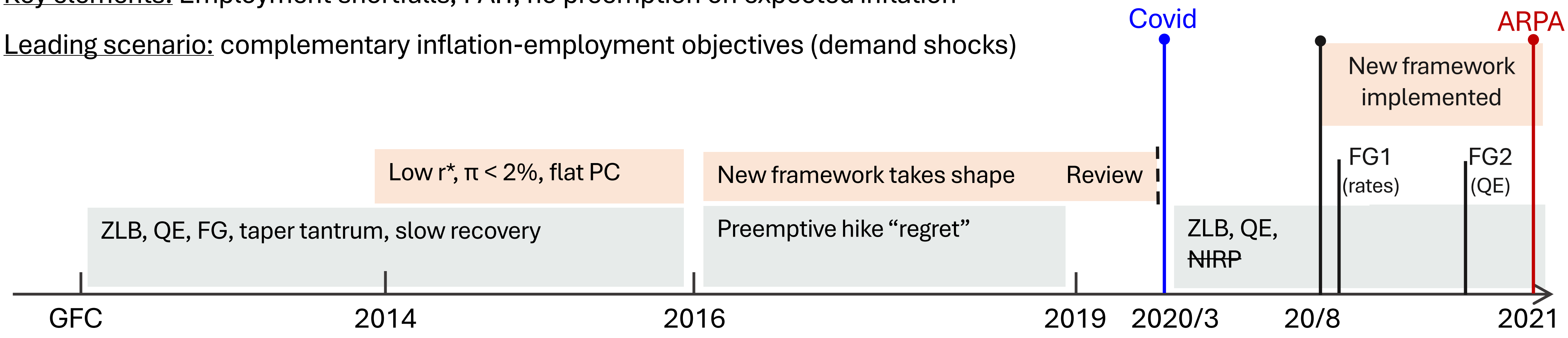
- Complex environment with multiple shocks co-occurring and high uncertainty
- GCKL focus on a specific shock: unfunded fiscal spending is bad (marginal utility ↑)

“In hindsight, the paths of inflation, real output (…) may have seemed preordained, but no such insight existed as we experienced it at the time. From time to time the FOMC made decisions, some to move and some not to move, that we came to regret.” (Greenspan 2004)

Origins of Fed's "delay" pre-date 2021 inflation

Fed announced "new" framework in Aug 2020

- Key elements: Employment shortfalls, FAIT, no preemption on expected inflation
- Leading scenario: complementary inflation-employment objectives (demand shocks)



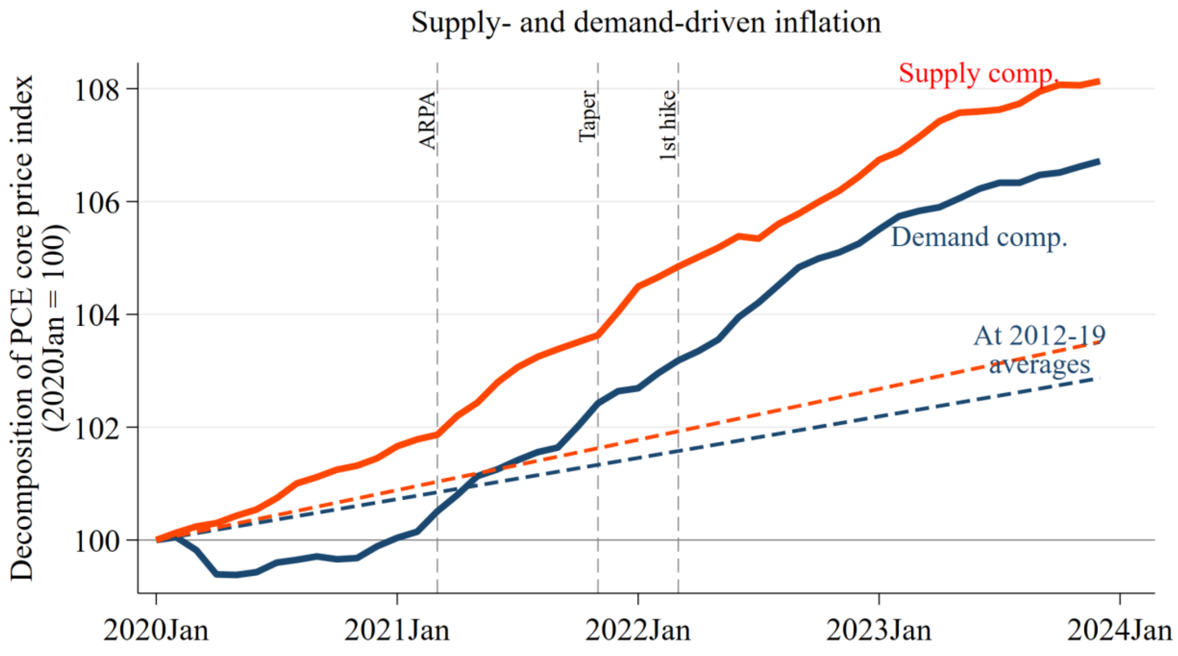
Ex-post (acknowledge real-time uncertainty)

- Constraints from framework + forward guidance
- Escape clauses to address non-complementary objectives (supply shocks) available but difficult to access
- Underestimate of excess demand from fiscal stimulus, overestimate of slack

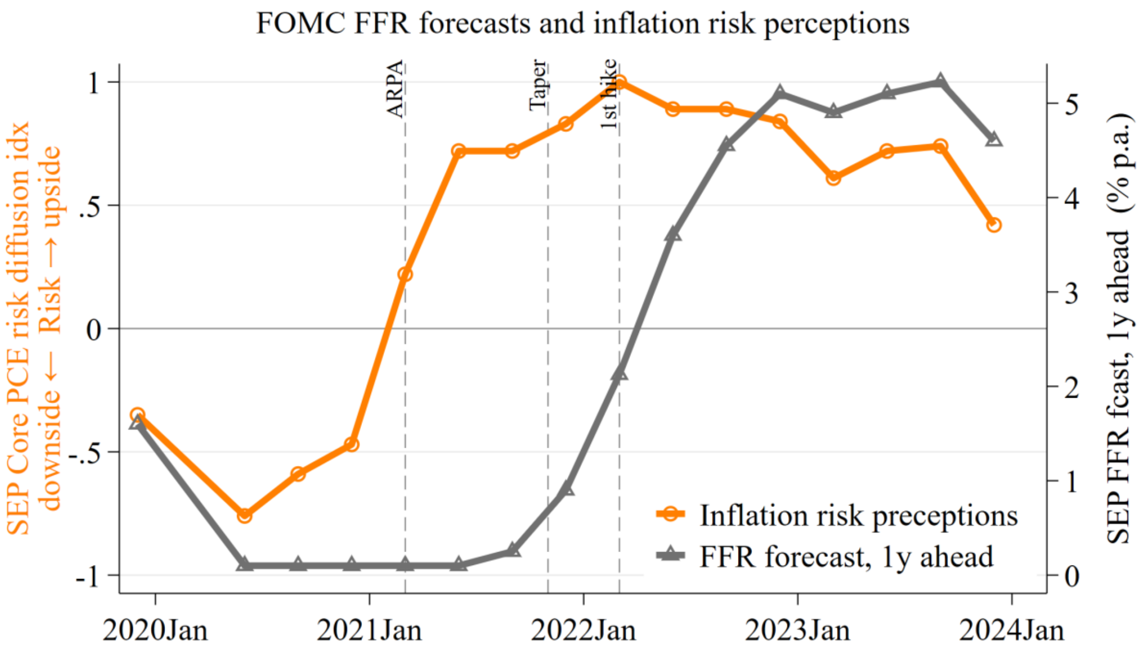
Market perceptions

- Fed's desire for inflation overshoot and lower-for-longer rates was clearly communicated and understood
- Uncertainty about Fed's inflation response increased term premia as data diverged from leading scenario

Inflation drivers and Fed's beliefs



Note: Based on Shapiro (2024) core PCE decomposition



Note: Risk diffusion idx = 1 when all FOMC members perceive risk weighted to the upside of their forecast

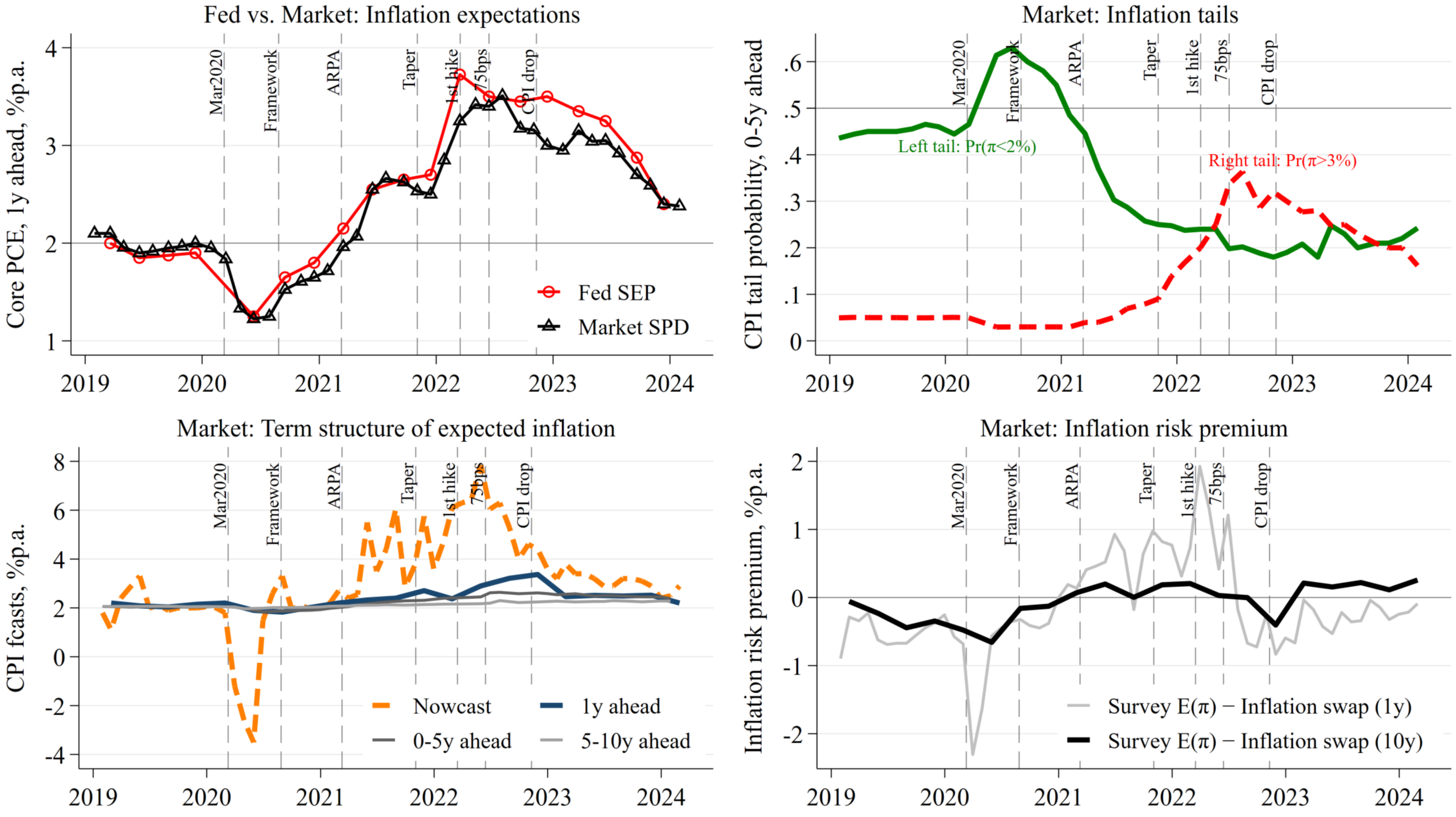
Underestimate demand, overestimate slack?

- Ongoing supply shocks from mid-2020
- Rapid demand recovery from 2020 Q4
- Demand-driven inflation accelerated post-ARPA 2021 Q1

Constraints from framework + FG?

- FOMC perceived upside inflation risks from early 2021 (highest on record; employment risks then viewed as balanced)
- But forecast lower-for-longer FFR

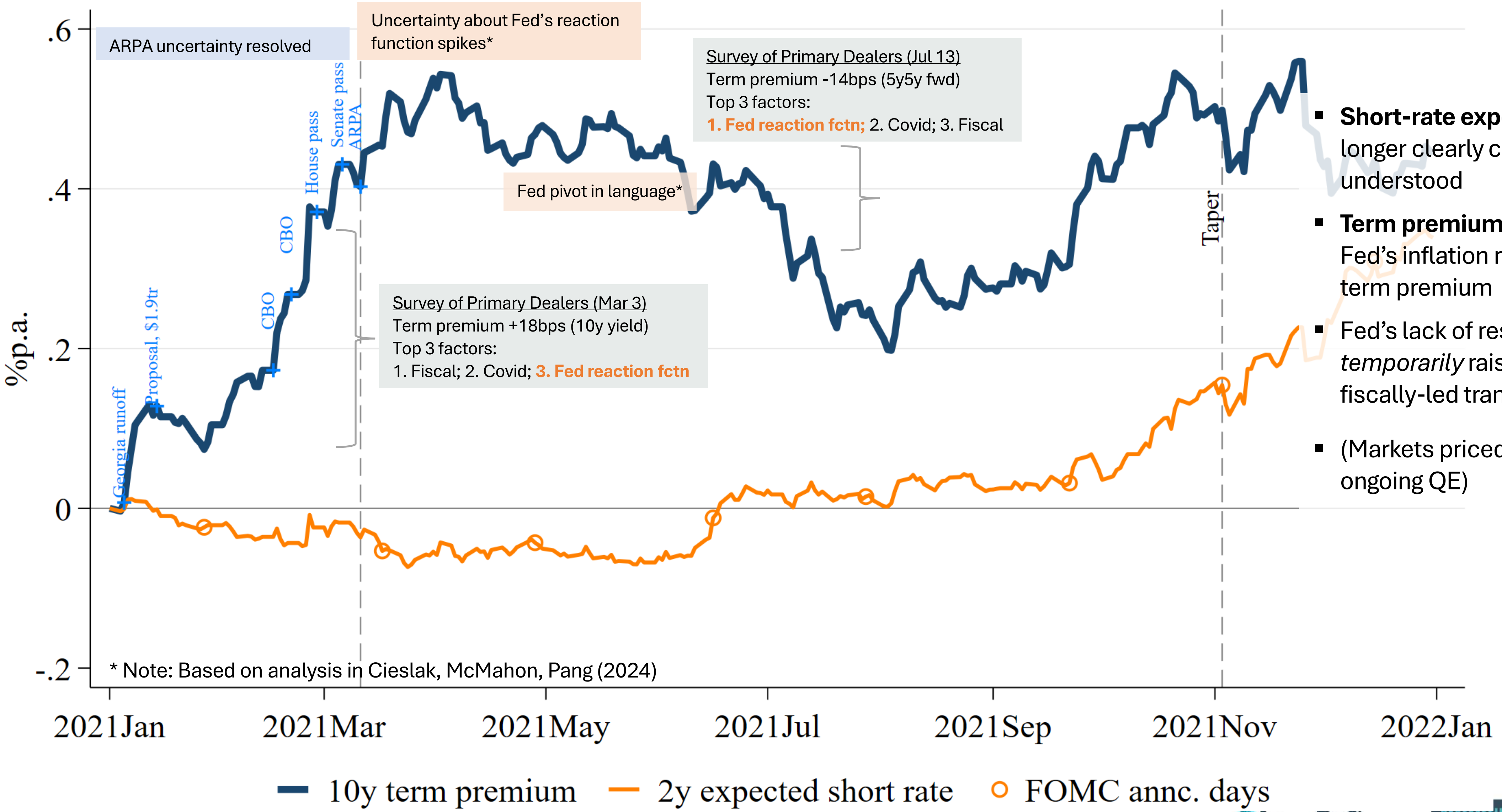
Market inflation beliefs, tails, and risk premia



- Inflation expectations, tails, and premia don't indicate investors pricing a shift to fiscally-led regime in 2020
- Covid shock spurred disinflationary fears, which reversed by 2021 Q1
- Market and Fed agreed on mean forecasts and thus made similar forecast errors
- ARPA was inflationary*, but beliefs reverted fast to Fed's target
- Credibility buffer: Belief that Fed will take action

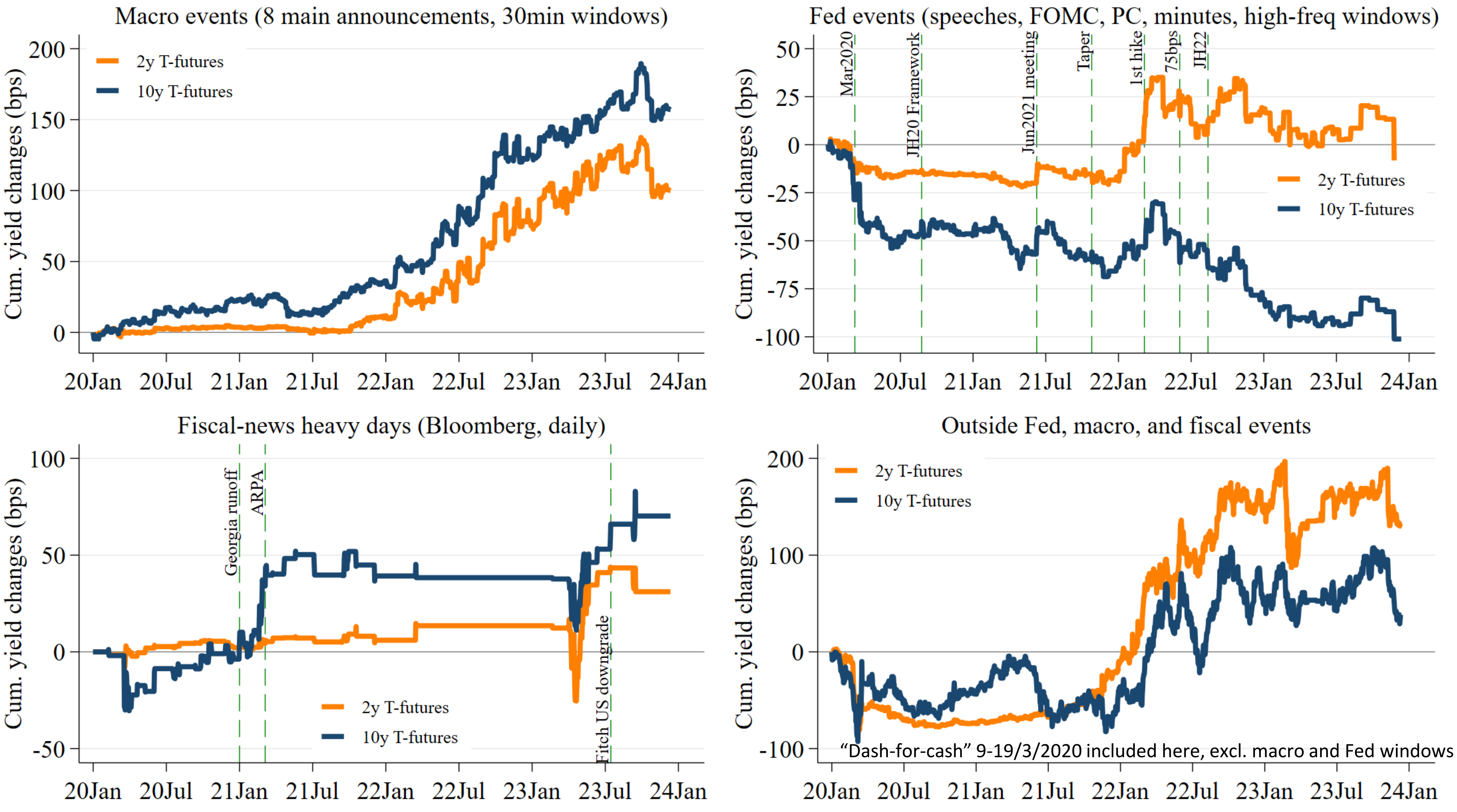
*E.g., Bianchi, Faccini, Melosi (2023); Hazell and Hobler (2024)

Reaction function uncertainty around ARPA 2021



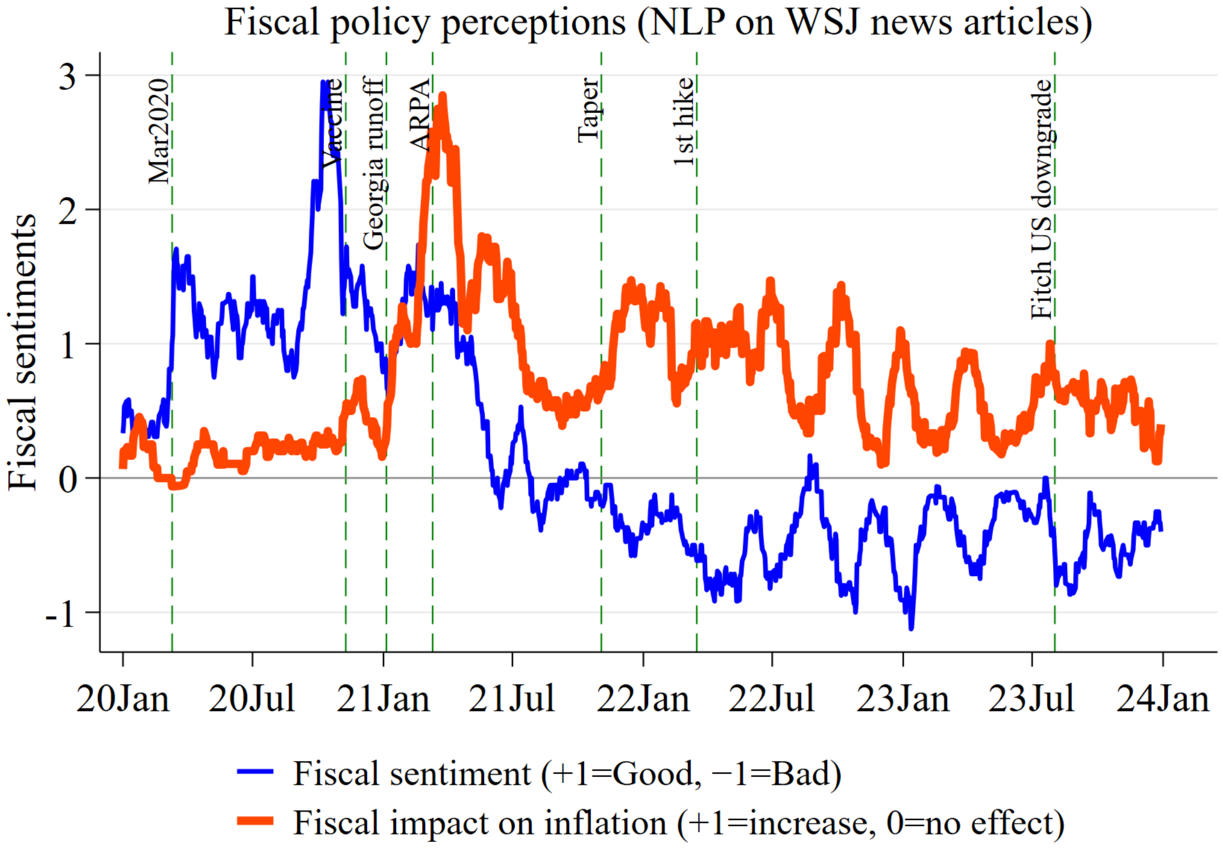
- **Short-rate expectations**: Lower-for-longer clearly communicated and understood
- **Term premium**: Uncertainty about Fed's inflation response contributed to term premium
- Fed's lack of response may have *temporarily* raised probability of fiscally-led transition
- (Markets priced risks in bonds despite ongoing QE)

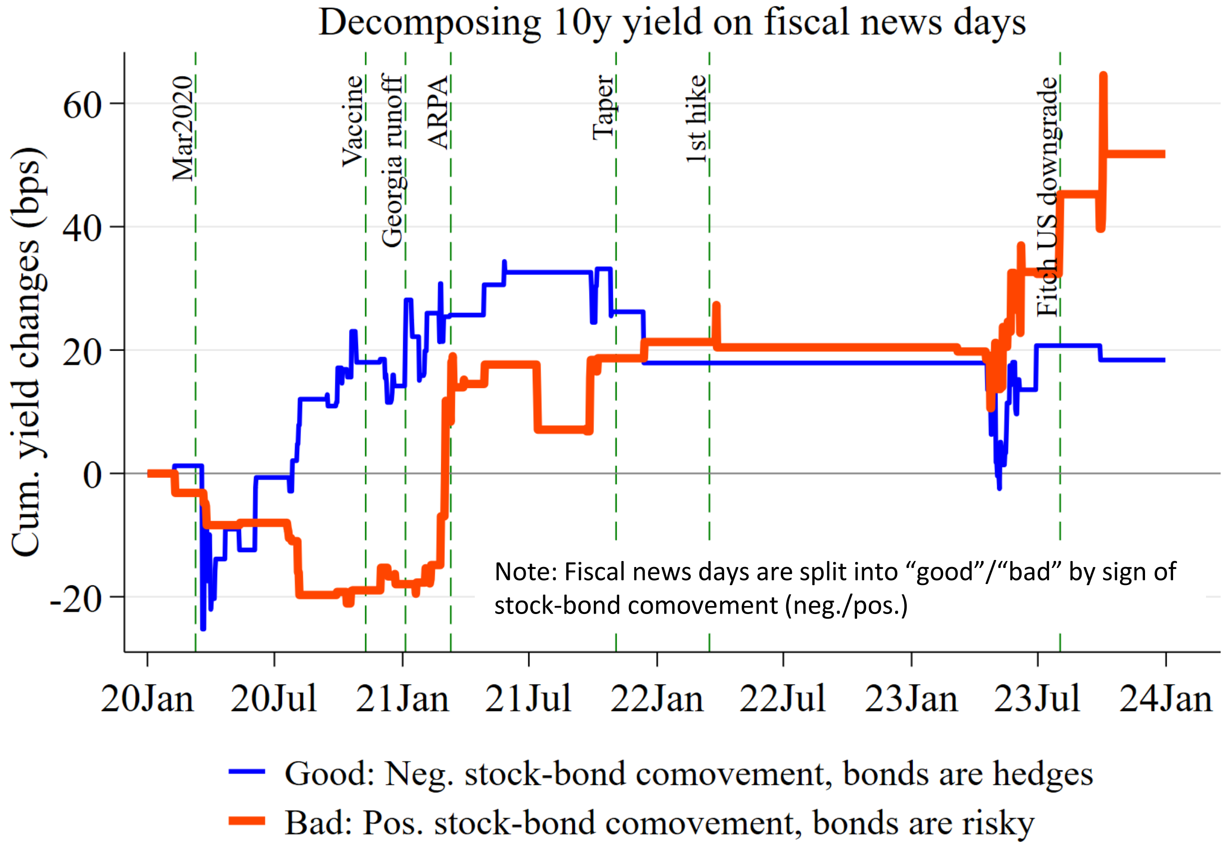
Event study: Macro, Fed, and fiscal news in yields



- **Macro** news windows contributed +160bps to long yield ↑
- **Fed** tightened short end but offset long end (post-hike):
  - Hawkish stance ↓ term premium
- **Interpretation:** Market revised beliefs about appropriate Fed's reaction given incoming news
- **Fiscal** events added +70bps
  - Not all fiscal news was "bad" – *see next page*
  - Key episodes: ARPA, 2023 H2

Good and bad fiscal news





- Two distinct periods: Covid-ARPA and post-ARPA
- Covid-ARPA: Fiscal stimulus warranted to offset negative output gap
- ARPA: Inflationary fiscal concerns peak on excess demand and Fed stance

- Covid-ARPA: "Good" hedging premium reverts from flight-to-safety by 2021 Q1 (yield ↑)
- ARPA: "Bad" premium jumps (yield ↑)
- 2023 H2: "Bad" fiscal drivers again more prominent (yield ↑)

Conclusions

- **Timely and important agenda** warning against consequences of a bad fiscally-led scenario
- **It could happen. Did it happen in 2020+?** Data suggest markets did not price a switch to fiscally dominated regime, but did price uncertainty about Fed's reaction function

<u>Lessons</u>

- CB's credibility is a valuable fiscal asset
  - Fed's large credibility buffer in 2021
  - Perception of CB accommodating fiscal shocks is costly
- Forward guidance can be constraining
  - Markets can undo intended policy when data assessment diverges from CB's assumed baseline
  - With risk premia involved, CB's "grip on the steering wheel" is weakened
- Credibility of narratives
  - Communication focused on objectives + reaction function (≠ rigid rule) + well-argued economic assessment + uncertainty around it