Biases of economic policy when fiscal and monetary authorities have different objectives

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ABSTRACT

The question addressed in this work is, which biases of monetary policy may occur when monetary and fiscal authorities have different preferences about the importance of closing the gaps of production and inflation which were generated by adverse shocks? To achieve such objective, this study uses a game theory model in which fiscal and monetary authorities interact to stabilize the economy, considering they have different preferences and they control different policy instruments. Modeled either as an equilibrium of Nash type or as of Stackelberg type, absence of coordination of macroeconomic policies implies that an increase in divergence of preferences between fiscal and monetary authorities leads to, ceteris paribus, greater fiscal deficits (the instrument of policy of the fiscal authority) and to higher real interest rates (the instrument of central banks). The empirical section of this work provides evidence in favor of this conclusion in a panel data sample of 19 developed countries with annual data for the period of 1970-1994. The study concludes that second-generation reforms, that ease the coordination of policies, may alleviate biases of excessive conservatism of monetary authority, and of liberalism of fiscal authority.

JEL Classification: *E5, E6, C72*
Keywords: *Monetary policy; fiscal policy; coordination; Nash; Stackelberg; developed countries; panel data; central banks Independence; inflation targeting*