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Green fiscal dominance

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Abstract

This paper discusses green fiscal dominance, a situation where it is primarily fiscal policy that addresses the financial challenges related to climate change but where the central bank accommodates these actions. This perspective departs from that of regimes where monetary policy dominates, and which are usually characterized by an independent central bank focused on controlling inflation. Here, we propose fiscal measures such as renewable energy subsidies and climate investments financed with green bonds, which are then bought, at least partially, by the central bank. While this may incur some costs in terms of inflation expectations management, green fiscal dominance also comes with some benefits. First it makes investments in climate transition more feasible. Second, it is a way to involve monetary policy in the climate transition effort, albeit through an indirect channel. Ultimately, the paper highlights the need for credible quantification of the trade-offs related to fiscal dominance and public investment in climate transition in order to obtain the correct balance between competing policy objectives.

Keywords: green deal, fiscal dominance, central banking, green bonds

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Introduction

Fiscal and monetary policy interactions play a crucial role in economic policy-making. These interactions are important not only for immediate economic outcomes related to demand stabilization but also for long-term financial stability and economic growth. Historically, there has always been a tension between fiscal and monetary policy, with one of the policies "dominating" the other. Under fiscal dominance, the central bank's actions are constrained by fiscal policy. Under monetary dominance, the opposite occurs and central bank policy is set independently without interference from fiscal policy. This paper reviews the concepts of fiscal and monetary dominance in the context of the euro area, and then reviews the case for fiscal dominance in the context of sustainable development, what can be referred to as green fiscal dominance.

From fiscal dominance to monetary dominance

Fiscal dominance occurs when the government's fiscal policy—its decisions on spending, borrowing, and taxation—determines the terms for monetary policy. In a regime of fiscal dominance, the central bank's ability to control inflation and stabilize the currency is compromised, as it may be compelled to finance government deficits or maintain low interest rates to manage the government's borrowing costs, regardless of the impact on price stability. For example, Pina (2015) proposes a model where the central bank decides on optimal policy under the constraint that it must finance government spending shocks. Quantitative easing has sometimes been viewed as an example of fiscal dominance: central banks purchase public bonds after a crisis and alleviate the interest costs of higher public spending while maintaining financial stability (see Cochrane, 2014; Reis, 2017).

In contrast, monetary dominance represents a scenario where a central bank operates with full independence from fiscal policy. Traditionally, it is the case that the central bank prioritizes control of inflation and overall monetary stability. The inflation-targeting regime that started in the early 1990s, and that is now the paradigm of monetary policy, is one way to implement a regime of monetary dominance to ensure price stability. Central banks maintain a credible commitment to their primary objectives, irrespective of the current political climate or fiscal policy pressures. In the monetary dominance paradigm, maintaining the independence of the central bank is crucial for economic credibility and effectiveness. Independent central banks can anchor inflation expectations, preventing inflationary spirals and fostering a stable economic environment.

Figure 1 plots the unweighted average central bank independence index for 155 countries between 1923 and 2023, as measured by Romelli (2024). Higher values of this index indicate higher levels of central bank independence. The index is relatively low and stable around 0.4 to 0.5 until the late 1980s. Starting from the late 1980s and early 1990s, there is an increase in the value of the index, indicating increasing central bank independence. This increase becomes particularly steep in the 1990s and coincides with the global trend towards adopting inflation targeting and greater central bank independence as part of economic reforms. The index reaches a plateau for a while in the early 2010s but then continues to rise in the years leading to 2020. This trend reflects a worldwide movement towards central banks operating with more autonomy.

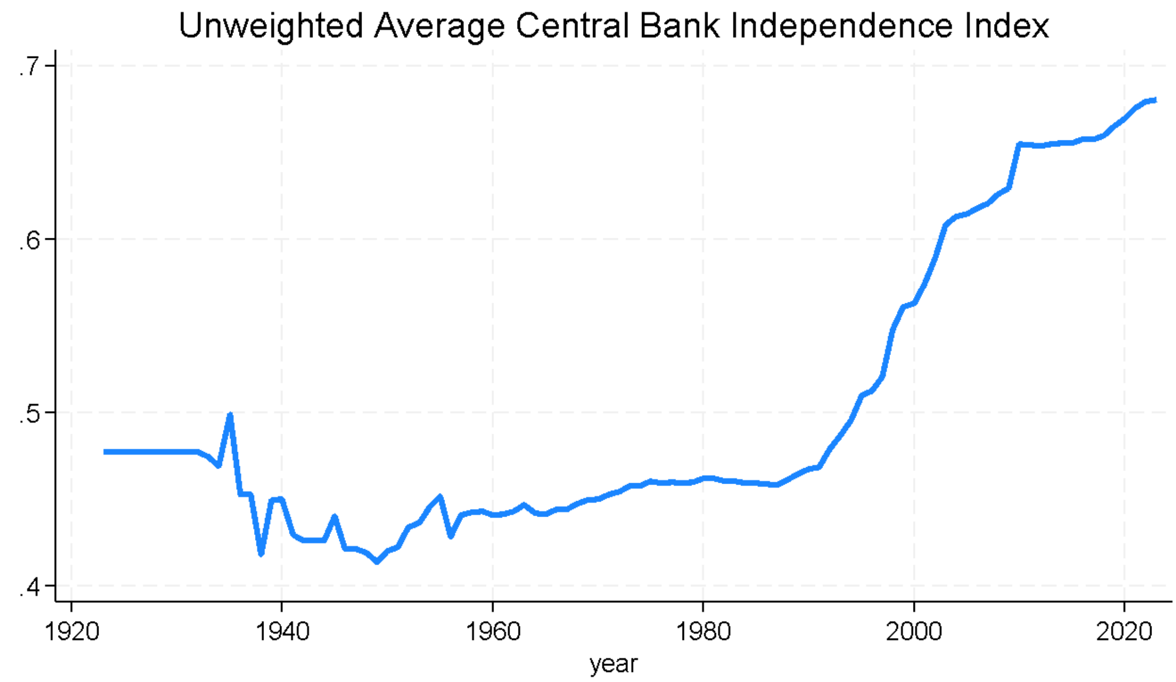

Figure 1: Unweighted average central bank independence index for 155 countries between 1923 and 2023 (data from Romelli 2024)

What's wrong with fiscal dominance?

Fiscal dominance comes with several economic challenges. It can lead to excessive government spending and borrowing, free from the constraints traditionally imposed by financial markets. Governments may engage in expansive fiscal policies, particularly focusing on short-term projects for political reasons, which could undermine long-term economic stability. Additionally, fiscal dominance comes with inflationary risk as the central bank prints money to buy government debt or keeps interest rates artificially low. Unsurprisingly, fiscal dominance raises the risk premiums on government bonds, as well as expected inflation.

The separation between the two macroeconomic equilibria, fiscal dominance on the one hand, and monetary dominance on the other hand, must not hide the fact that to achieve one or the other, some cooperation is needed between governments and the central bank. Fiscal dominance is conditional on the fact that the central bank accommodates the large public deficit, whereas monetary dominance is conditional on the fact that the government ensures public debt sustainability. But cooperation may not be automatic: governments may well embark on a policy of larger deficits while the central bank raises policy rates to curb inflation. A race towards excessively expansive fiscal policies and restrictive monetary policies would ensue, which would destabilize the whole economy.

The case for more cooperation between governments and the central bank has been recently discussed (e.g. Creel et al., 2024a) in relation to the management of the inflation surge. The monetary dominance equilibrium has been a bit blurred by the involvement of many European governments in curbing inflation with price caps and subsidies that provoked higher public deficits.

So, if fiscal dominance returns, it requires close cooperation between fiscal and monetary policies. Moreover, if the latter retains its institutional independence, its accommodation to expansive fiscal policy must remain consistent with its mandate[1].

The case for green fiscal dominance

Despite the problems associated with fiscal dominance, one dimension where it may be necessary and perhaps beneficial is in addressing climate change and promoting sustainable development. This we refer to as "green fiscal dominance."

Government intervention is needed when traditional market mechanisms fail to internalize environmental costs, leading to excessive pollution. The assumption is that targeted fiscal policies, such as subsidies for renewable energy or green investments, in addition to taxes on carbon emissions, can help correct these market failures and realign the economy towards sustainable growth paths, thus creating a role for green fiscal policies.

One crucial question is of course how to pay for these expenditures.[2] The current level of movement of capital (and labor) makes it difficult and unpopular to raise additional taxes, leaving debt issuance as the most obvious source of funds. In fact, this debt issuance opens up another potential role for green fiscal policy. If the bonds issued by governments are themselves "green bonds," for example, bonds earmarked to finance a specific green investment or even sustainability-linked bonds, this may encourage the overall green bond market, reducing the capital cost for sustainable projects also by private agents, and further incentivizing private investment in the green transition.

However, increasing interest rates and the return of fiscal rules in Europe will likely make it difficult for policymakers to use debt effectively, particularly to finance long-term projects with limited short-term electoral benefits. Central banks can play a supportive role in this transition by focusing all of their asset purchases on public green debt. Asset purchases are now part of the toolkit at the ECB. This not only would keep interest rates on public green debt relatively low, it would also aid in the development of a robust green bond market for the private sector, so that the financial system as a whole is better aligned with climate goals. Furthermore, this would allow the central bank to avoid making "green policy" directly, and instead delegate to governments the choice of investments and sustainability strategies. This is important because central banks have less of a democratic mandate than governments. Green fiscal dominance allows central banks to play a passive but crucial role in financing the climate transition.

This last point is important because of the debate about whether a central bank should target market neutrality with its financial decisions. For example, market neutrality in the context of the European Central Bank (ECB) refers to the idea that the ECB aims to conduct monetary policy in a way that does not favor or disadvantage any particular market participant or sector within the euro area financial markets. In the context of asset purchases, this means that the ECB buys the eligible market, so not to distort relative prices between different assets. This means that the ECB purchases more assets from bigger firms, or from larger countries.

However, in the presence of negative externalities, market neutrality is a mirage. The strategy to "buy the market" may in fact perpetuate distorted market outcomes. For example, "brown" firms are more likely to be older and larger, and have higher credit ratings,

[1] The ECB reviewed its monetary policy strategy in 2023 and upgraded the achievement of its secondary objectives, provided the primary objective of price stability is met.
[2] See the recent proposal for a "European Climate fund" in Creel et al. (2024b).

thus making them more likely to be eligible for asset purchases by the ECB. One approach would be for the ECB to make purchases that are "social-value neutral," taking into account sustainability concerns. However, contrary to the market value of firms or countries' debts, it is not as easy to estimate their social value. The estimation of this social value also likely depends on political views which govern some of the assumptions in the estimation. The lack of democratic legitimacy to make political choices further complicates the role of the ECB.

In other words, it is not obvious which deviation from "market neutrality" the ECB should consider. Therefore green fiscal dominance can provide a way for monetary policy to indirectly foster sustainable practices. By delegating the choice of green investments to government policymakers with a clearer democratic mandate, the central bank can focus its intervention on the financial dimension of choices made by others.

Of course, this green fiscal dominance will have some consequences for the ability of central banks to control inflation and inflation expectations. This is a second-best world. The benefits of green fiscal dominance must be compared to the costs related to inflation risks. Crucially, second-best arguments need credible quantification. Further research should investigate the trade-offs related to fiscal dominance in the green context and determine whether this policy is worth pursuing.

Some practical issues

Suppose the trade-off computation is in favor of implementing something like the green fiscal dominance we describe here. What are some of the issues in the implementation? One difficulty with this approach is of course the possibility of greenwashing. In this context, the issuance of green bonds, that is, bonds issued with the goal of making green investments, does not necessarily raise overall expenditure in the climate transition. There are a few reasons for this. Funds are fungible. At best, the proceeds from this debt issuance could finance a specific green project. But this project could also be financed by other sources. At worst, these funds could end up financing fraud, given that often there are no real commitments or control mechanisms over their use, especially in the context of sovereign debt. Looking at some green debt contracts already in existence, they are full of language that suggests an intention to use the funds for certain projects, but no legal obligations to use the funds a specific way. Therefore, green bonds may be insufficient to achieve climate goals. These and other considerations are discussed in Bolton et al. (2023). An alternative highlighted by the authors is to issue debt linked to verifiable green commitments, with payments contingent on sustainability targets, for example, reductions in pollutant emissions or benchmarks for renewable energy production. However, these types of state-contingent assets are also very difficult to implement in practice as discussed in Pina (2022).

An important consideration in green investments is the level of government at which such initiatives should be implemented. The argument for a centralized European approach, as discussed in Creel and Pina (2022), suggests that European-level programs are most relevant to coordinate environmental challenges that have effects beyond country's boundaries. The effectiveness of a centralized approach can be attributed to several key factors. A centralized approach can benefit from economies of scale. Green investments often require significant amounts, and it may be difficult for individual member states to finance them, while European programs would likely be larger. They can also be more coordinated and harmonized across countries. Such harmonization is particularly beneficial in creating a unified market for green technologies and services, making it easier for innovators and businesses to scale solutions across the continent. It also helps to internalize externalities, environmental ones but also relating to investments in the climate transition.

Conclusion

While monetary dominance remains critical for economic stability, there are strategic areas, particularly relating to sustainability, where fiscal dominance might not only be necessary but desirable. Balancing these approaches, while maintaining the core principles of central bank independence and fiscal responsibility, will be crucial in navigating the contemporary economic landscape and achieving long-term sustainable growth.

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