Editorial

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Monetary Tightening, the Threat of Fiscal Dominance and Political Instability

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By mid 2023 inflation rates in the industrialized countries had declined from their peak levels at the end of the year 2022, while remaining far above the commonly used inflation targets. As particularly core inflation remained high, with the risk of price-wage-spirals growing, many central banks – with the main exception of the Bank of Japan – have signaled further monetary tightening. At the same time, political and geopolitical tensions persisted. The Ukraine war and the sanctions of the western industrial countries against Russia continued, concerns about a possible Chinese invasion in Taiwan did not fade out. On a national level, climate change, identity politics and social justice remained on the top of the political agendas, coming along with tensions among different parts of the societies.

In the context of macroeconomic policy making conflicts between monetary policy and fiscal policy making as well as a trade-off between price and financial stability became visible. With the Federal Reserve System continuing to tighten monetary policy, in March 2023 the US Silicon Valley Bank had to be taken over by the Federal Deposit Insurance Corporation. Rescue measures for Credit Swiss and several US regional banks followed suit, raising concerns about global financial stability. Rising interest rates put a constraint on government expenditure, while cost-intensive policies such as climate protection and social cohesion remained high on the political agendas. The new fiscal constraints imposed by central banks became reflected by the conflicts about the US debt ceiling, the French pension reform and the ongoing reform debate of the EU's fiscal governance.

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Against this background, this issue of Economists' Voice includes a number of policy papers addressing several of these current challenges and a Policy Forum that focuses at the interplay of monetary and fiscal policy in this environment.

Bernardo de Melo Pimentel (ISEG Lisbon and Nova SBE) and Guillermo Ramírez (ESCP Madrid) cover a neglected aspect in the current debate on a possible need for more national economic autonomy. In their article *Davids and Goliaths: Hidden Champions in an Age of Industrial Policy*, they emphasize how the political economy of industrial policy with substantial influence of large company interests may divert the attention from the hidden champions: small, competitive and innovative firms that contribute significantly to an economy's resilience. Dennis Weisman (Kansas State University) asks: *Can You Have Your Corporate Wokeism and Eat it too?* He scrutinizes corporate wokeism based on the economics of discrimination of Gary Becker. Becker had posited that in a competitive environment discrimination is unsustainable because of a less efficient use of input and thereby higher costs. Weisman argues that corporate wokeism may be sustainable in an imperfect market, when the higher costs caused by the inefficiency in employing labor inputs are offset by the increase in revenues from being "woke".

Nicolas Cachanosky (The University of Texas at El Paso), Emilio Ocampo (Universidad del CEMA) and Alexander Salter (Texas Tech University) draw three *Lessons from Latin America Dollarization in the Twenty First Century*. Firstly, keeping the central bank after dollarizing is an unnecessary institutional vulnerability that facilitates compulsive de-dollarization. Secondly, the public opinion offers the most important defense of dollarization. Third, dollarization is superior to high and volatile inflation, even if not supported by structural reforms. Jonathan Benchimol (Bank of Israel), Itamar Caspi (Bank of Israel) and Sophia Kazinnik (Federal Reserve Bank of Richmond) present results on *Measuring Communication Quality of Interest Rate Announcements* for the Bank of Israel. They emphasize the need for a clear and transparent central bank communication to foster financial stability. They employ textual analytical tools to quantify the accessibility of central bank statements and how the communicated uncertainty is linked to the actual market volatility. Their results point to a more comprehensible communication of the Bank of Israel as compared to the Fed and the ECB.

The article *The Political Economy of Transatlantic Security –A Policy Perspective* from Jordan Becker (West Point), Ringailė Kuokštytė (General Jonas Žemaitis Military Academy of Lithuania) and Vytautas Kuokštis (Vilnius University) studies the collective good problem NATO has been confronted with from its beginning. It provides a comprehensive survey of the literature with a particular interest for the challenges of NATO enlargement. The article reveals that burden sharing in transatlantic defense does not follow a simple free-rider pattern but is influenced by specific threats, domestic factors and is furthermore time-variant.

The Policy Forum with the title *Monetary Policy and the Threat of Fiscal Dominance* sheds light on the interaction between monetary and fiscal policy in an environment, where monetary tightening puts a constraint on public spending. The discussion is opened by Otmar Issing (Goethe University Frankfurt), the former chief economist of the European Central Bank. Based on a brief historical record of central banking he relates the question *Depoliticized Money –An Illusion?* to the ECB's experience. According to his observations, different monetary policy traditions and the increasing ECB responsibility for containing sovereign spreads cast doubt on the effective independence of this central bank. From this and the historical precedents he concludes that longer phases of "apolitical money" are observable and that the institutional design does matter, but that times of severe crises often lead to more politicized money and higher inflation. Kathrin Assenmacher (ECB) defends under the title *The ECB's Transmission Protection Instrument and Fiscal Stability* the ECB's Transmission Protection Instrument (TPI), which critics see as a hidden fiscal support for the highly indebted euro area countries. According to Assenmacher the TPI supports (along with other tools) the effective transmission of the monetary policy throughout the euro area as a precondition to fulfil the mandate of price stability. If activated, the Eurosystem would purchase securities of euro area member states that experience a deterioration in financing conditions not warranted by country-specific fundamentals.

Cinzia Alcidi (CEPS) looks at one of the main innovations in the European Commission's reform proposal for the EU fiscal framework. In her article *Debt Sustainability in the Emerging New EU Fiscal Framework: A Major Change* she describes how the emerging new rules put debt sustainability analyses into the center of the newly emerging rules. Her analysis identifies the strengths and challenges of this innovation. She concludes that the success of the new governance will depend to a large extent on the member states taking a responsible and forward-looking role in the new procedure. Nicolas Carnot (INSEE) and Stéphanie Pamies (European Commission) survey the state of knowledge on *Government Bond Spreads in the Euro Area*. The existing evidence confirms the role of fundamentals such as fiscal sustainability, institutional quality and growth potential. Moreover, fundamentals like the debt level impacts on spreads in a non-linear way with high increases of debt above certain critical levels.

Kerstin Bernoth (DIW) and Sara Dietz (LMU Munich) ask whether the ECB should deviate from market neutrality through *Selective Bond Purchases – May the ECB Chose Winners and Losers?* The contribution describes how the ECB increasingly wants to impact on spread either to support monetary policy transmission or to promote decarbonization or other policy objectives. The authors take a skeptical position and conclude that these increasingly ambitious approaches are outside of the ECB's democratic foundation. David Marsh (OMFIF) provides a very concise picture of the attempt of the British Prime Minister Liz Truss to cut taxes in an environment of monetary tightening (*Britain's Failed Attempt at Monetary and Fiscal Exceptionalism*) and the response of the Bank of England to the resulting financial instability. The budget of the Chancellor of the Exchequer Kwasi Kwarteng is characterised as the '*most ambitious and disastrous … in modern British history*'. Marsh nicely illustrates how the intertwined dynamics of politics and economics set limits on fiscal policies, with the implications of failed coordination between monetary and fiscal policy leading to far-reaching instabilities in highly complex financial markets.

Hiroaki Miyamoto (Tokyo Metropolitan University) sheds light on Japan (*Government Debt and Monetary Policy Perspectives in Japan*), which has accumulated most government debt among the industrialized countries, which is a strong constraint on monetary policy. Miyamoto illustrates that in an environment of global monetary tightening the hesitance of the Bank of Japan to increase interest rates has come along with yen depreciation and inflation. The Bank of Japan is recommended to carefully observe market reactions, whereas the government should improve its fiscal situation. Finally, Thomas Mayer (Witten/Herdecke University) analyzes *Long-Term Strategies to Reduce Public Debt from a Historical Perspective.* In the past, inflation was often caused by uncontrolled government expenditure and a lack of structural reforms. Mayer distinguishes three ways, how public debt can be reduced: repayment, default, and indirect default through monetary financing accompanied by the debasement of the currency. He provides valuable case studies how the vicious circle of fiscal and monetary exuberance can be resolved. In the course of history, repayment was more the exception than the rule.