

OLGA KUZNETSOVA

National Research University Higher School of Economics, Russian Federation

SERGEY MERZLYAKOV

National Research University Higher School of Economics, Russian Federation

THE ROLE OF UNCERTAIN GOVERNMENT PREFERENCES FOR FISCAL AND MONETARY POLICY INTERACTION

Abstract:

This paper explores the role of uncertain government preferences in a linear-quadratic model of fiscal and monetary policy interaction. We show that the effects of preference uncertainty are fastened on multiplicative uncertainty about the policy effectiveness. If the effects of fiscal and monetary policies on the economy are known, preference uncertainty does not alternate the symbiosis result of interaction. In this case, inflation and output are equal to their targets irrespective of the central bank and the government preferences. Multiplicative uncertainty about the fiscal policy effects creates the inflation bias, and preference uncertainty deteriorates it by lowering output and rising inflation up. Multiplicative uncertainty about the monetary policy effects creates either standard inflation bias or negative inflation bias with output higher than the target and inflation lower than the target. In this case, preference uncertainty enlarges the absolute value of the output gap, while the effect on the inflation gap depends on the extent of uncertainty about the monetary multiplier. Thus, under some circumstances uncertain government preferences can even reduce the negative effect of multiplicative uncertainty. If the effects of both the policies are uncertain, the impact of preference uncertainty depends not only on the extent of multiplicative uncertainty, but also on the inflation and output targets. After studying the impact of uncertainty on inflation and output gaps, we proceed with the welfare properties of the equilibrium and discuss the optimal conservativeness of authorities for different types of uncertainty.

Keywords:

fiscal and monetary policy interaction, uncertain government preferences, multiplicative uncertainty, symbiosis result

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