Monetary, fiscal policy & financial system …

Japan and the EU in the global economy, Bruegel (7 October 2013)

Jens Ulbrich, Deutsche Bundesbank

„My ambition is for monetary policy to be boring“

Mervyn King, former governor Bank of England

Outline

Financial stability and monetary-fiscal interactions

What went wrong in EMU?

Some recent policy initiatives in EMU

Fiscal and monetary policy

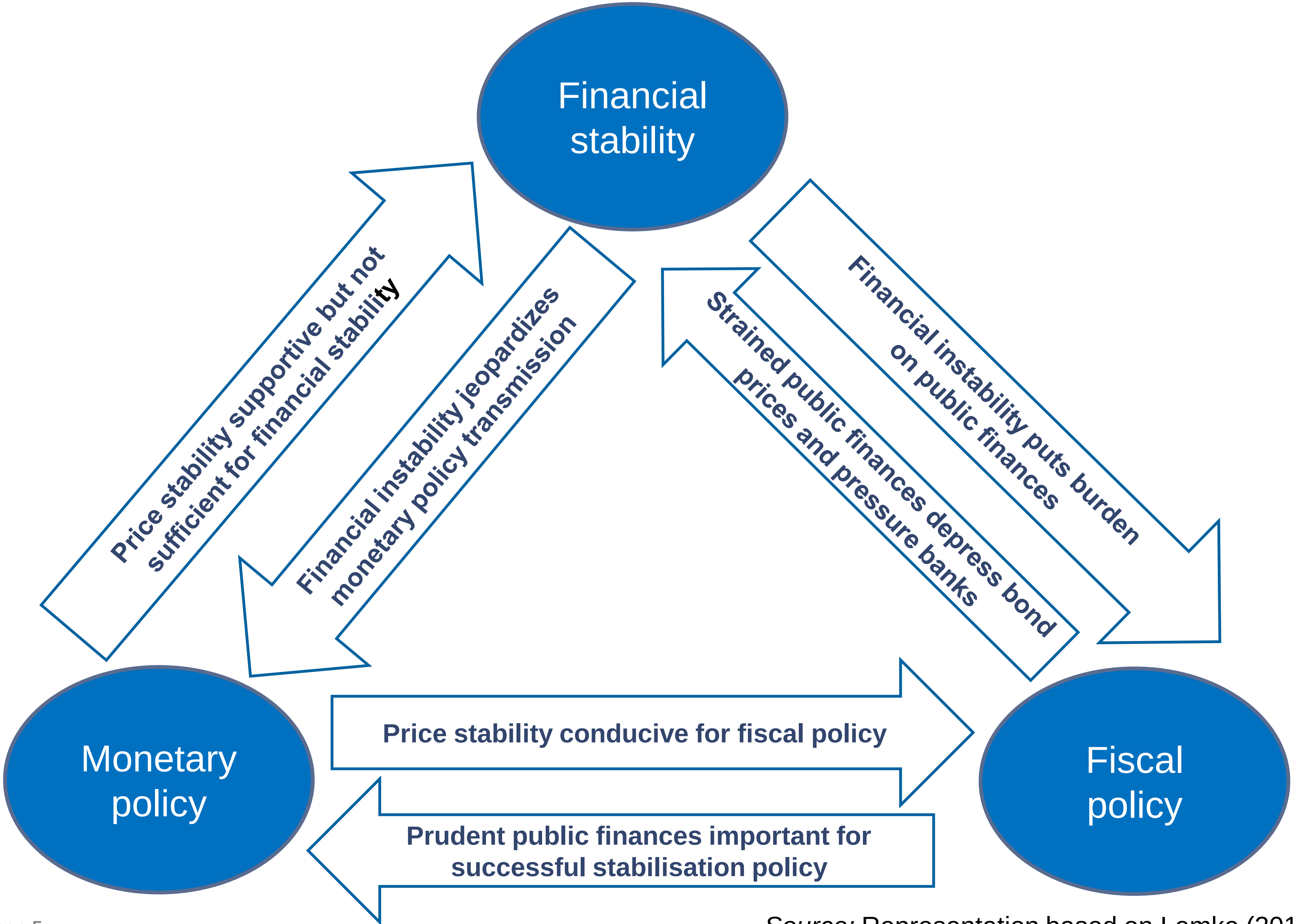
Session is about monetary policy, fiscal policy and financial stability.

This can be a holy trinity.

But when things go wrong, trinity turns into trilemma.

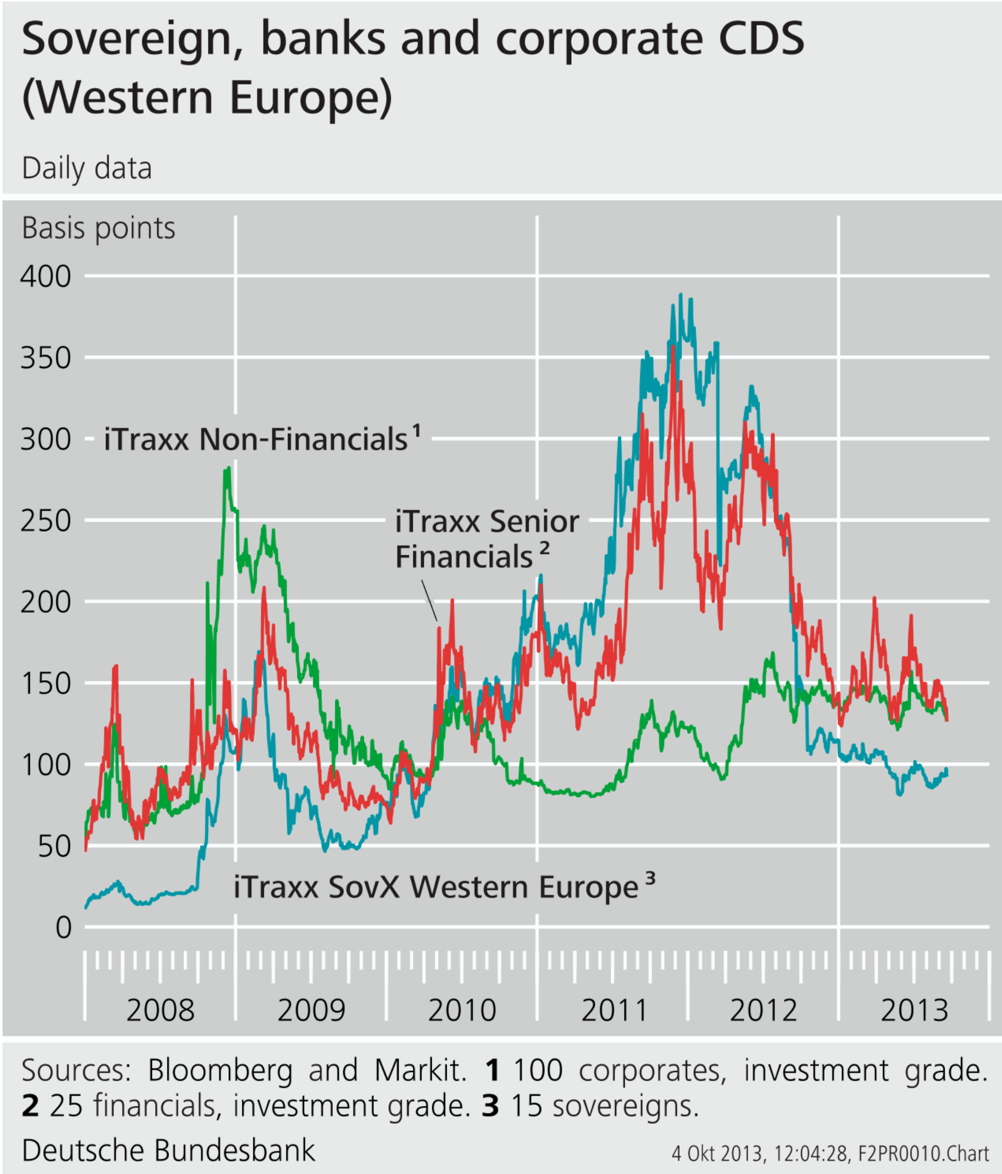
Especially in a monetary union built on a supranational monetary policy and sovereign fiscal and economic policies.

Fiscal-monetary interactions and financial stability

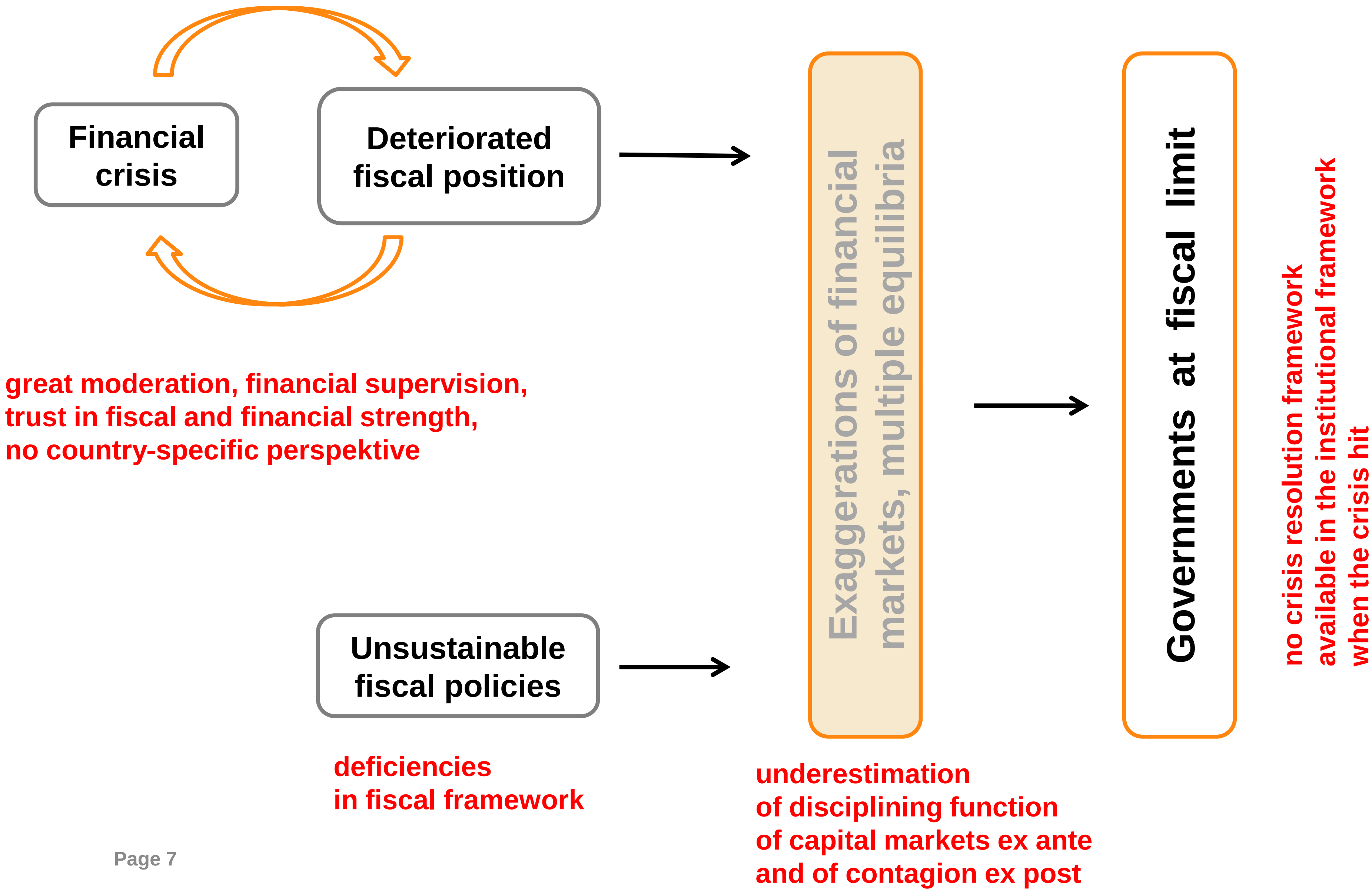


Source: Representation based on Lemke (2012)

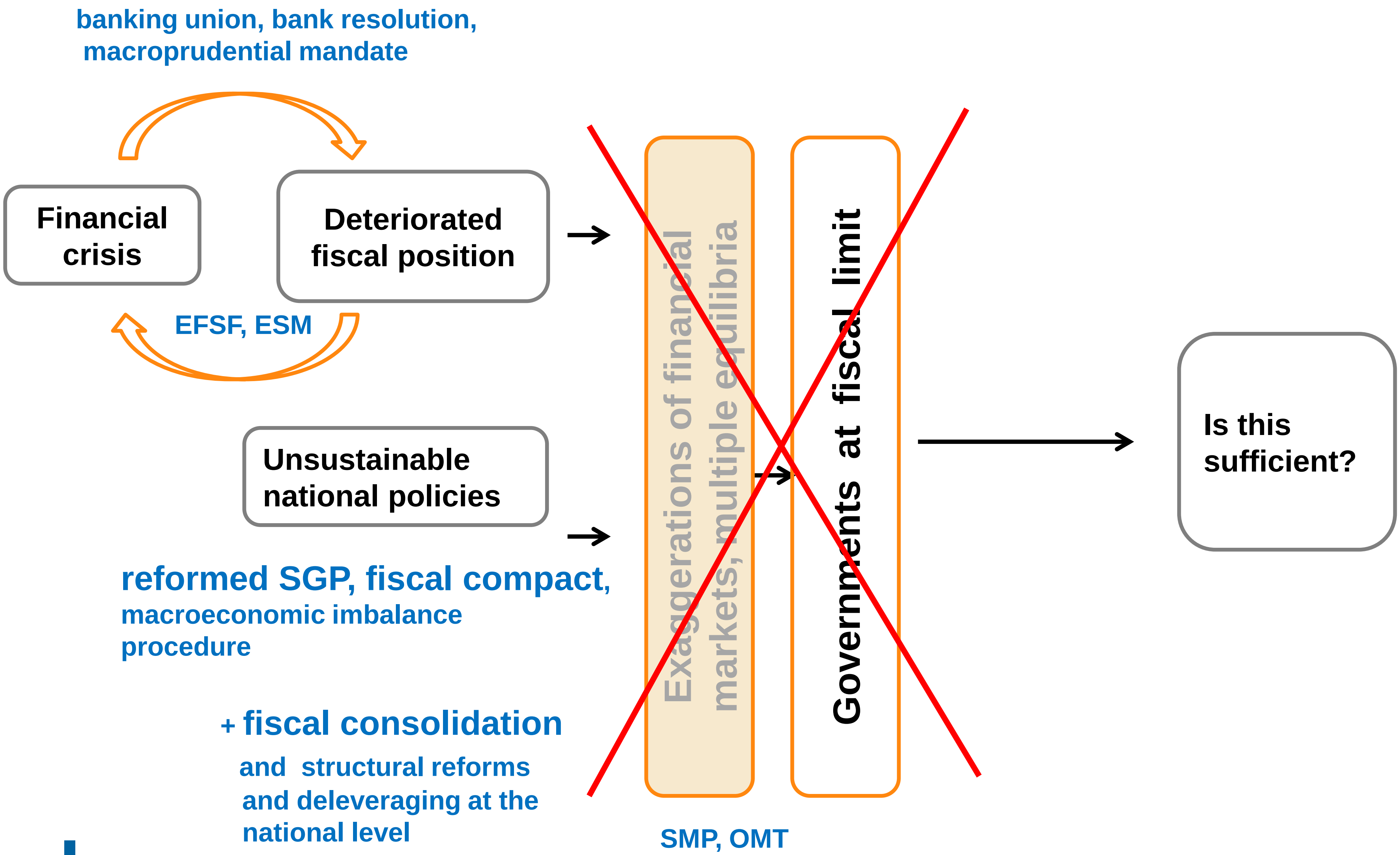
Sovereign risks and risks in the banking sector highly correlated



What went wrong in EMU?



Policy initiatives in EMU



+ conventional and unconventional monetary policy

The role of fiscal policy

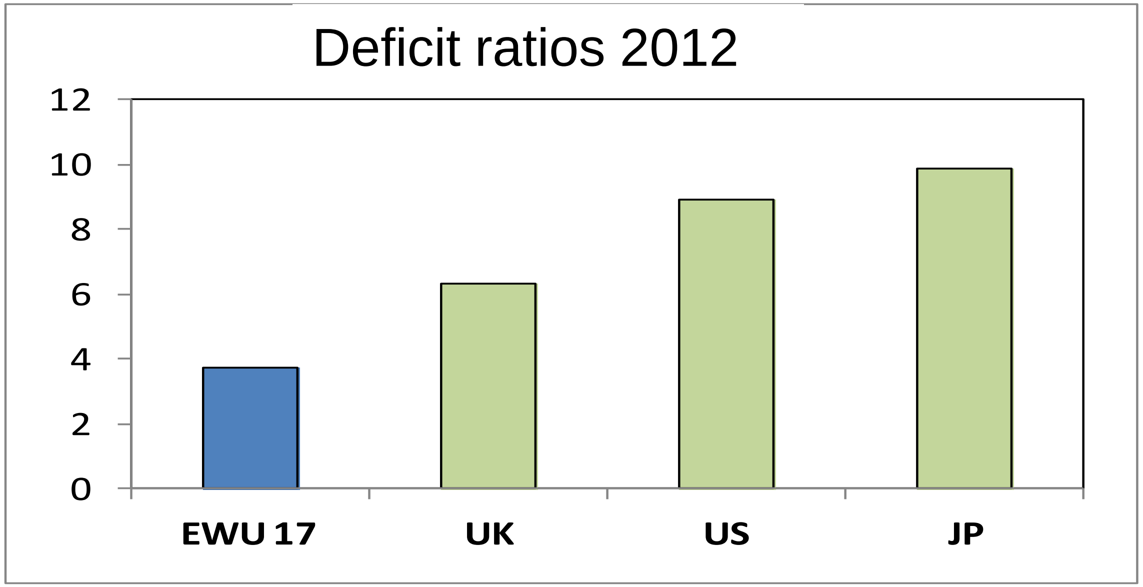
How to phrase the story?

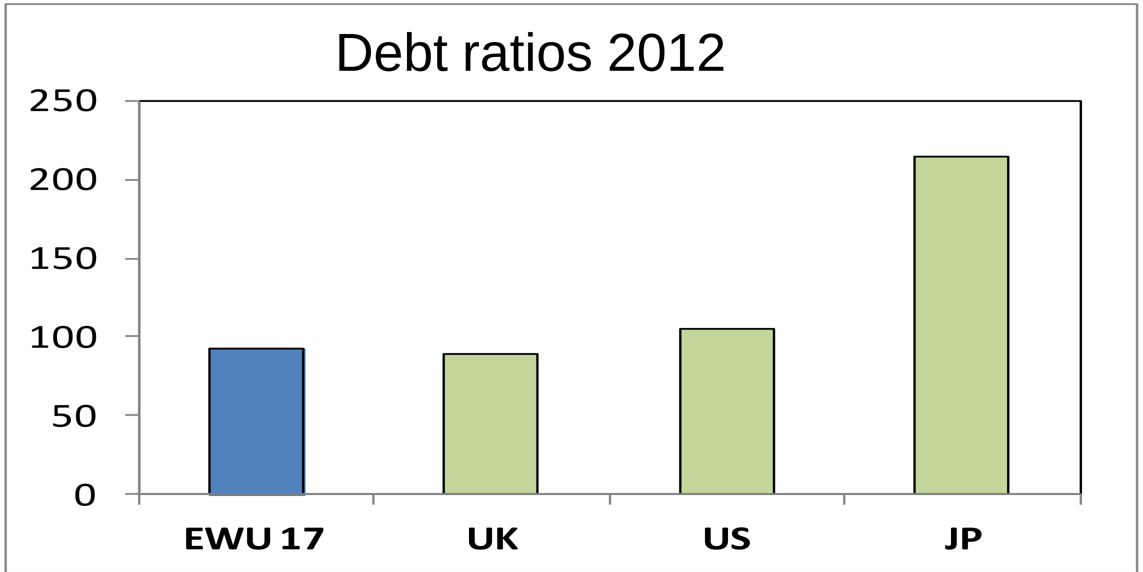
Self defeating austerity in the face of large fiscal multipliers

versus

Indispensable consolidation in a monetary union where some (sovereign) member countries experience balance-of-payment crisis, sudden stops and fiscal limits.

Why spotlight on EMU?





- **On aggregate deficit and debt relatively low in EMU**
- But:
  - Several countries with severe solvency problems
  - General confidence crisis (countries, framework, EMU)

Reform of fiscal rules: a success story?

- **Hardening of rules after disappointing experiences indispensable:**
  - Less „sinners judge over sinners“
  - Faster sanctions also in the preventive arm
  - Taking debt ratios into account
  - Stronger national anchoring
- **EU-Commission in an important role as referee**
- **Referees not always popular**

The role of monetary policy

- **Interest rates:**
  - MRO rate: lowered from 4,25% (Sept. 2008) to 0,5%
  - Money market corridor: lowered from 200 BP (Sept. 2008) to 100 BP
  - Forward Guidance (July 2013)

- **Liquidity operations:**
  - Allotment policy: full allotment (Oct. 2008)
  - Collateral framework: Significant broadening of eligible collateral
  - Switch to longer term refinancing operaqtions
  - Provision of foreign currency liquidity (Swaps)

Aim: Improving the refinancing situation for banks to support credit to the real economy

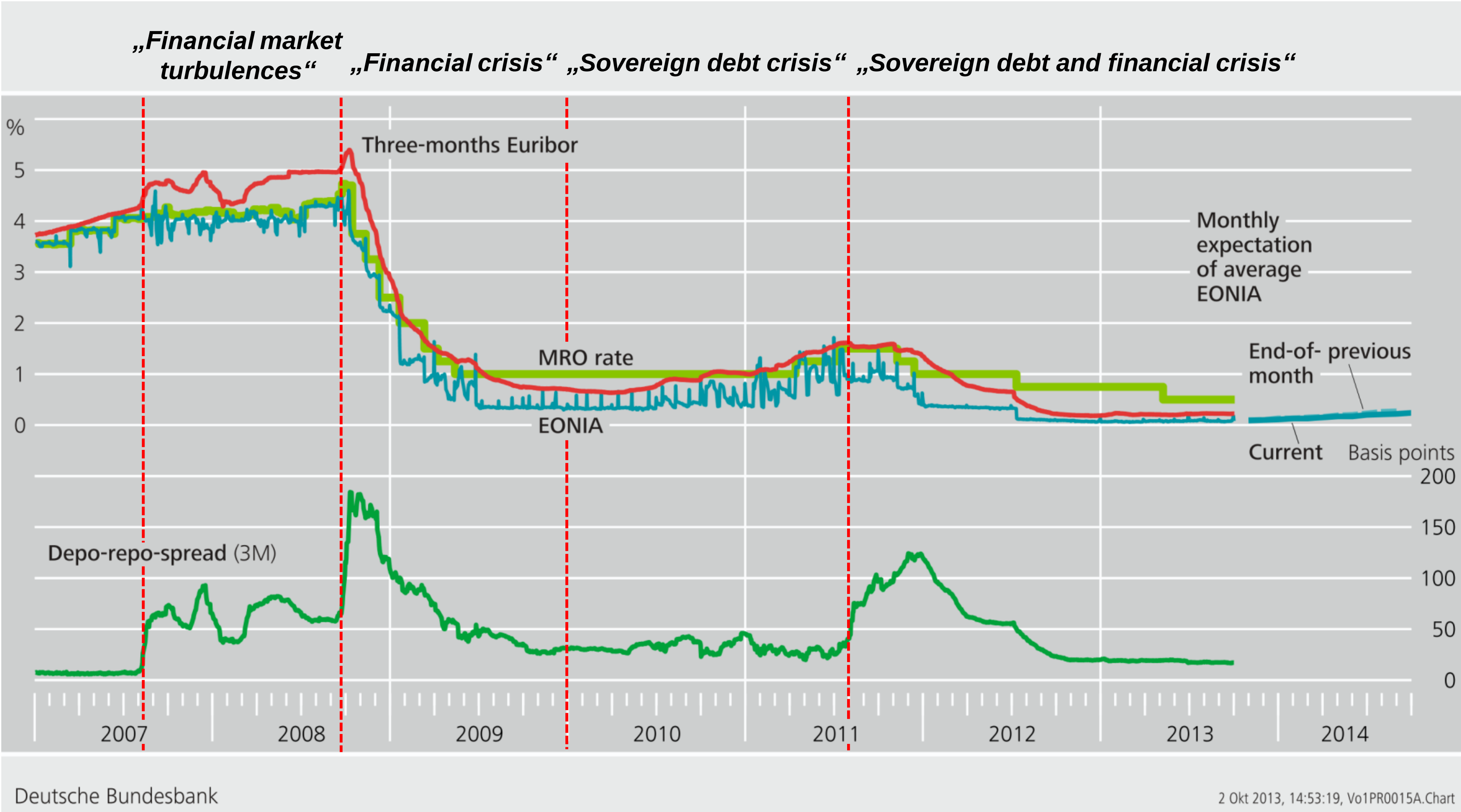
- **Purchase programs**:
  - Covered bonds: CBPP1 (Jun. 2009), CBPP2 (Nov. 2011)
  - Government bonds: SMP (May 2010), OMT (Sept. 2012)

Aim: Improving the monetary policy transmission

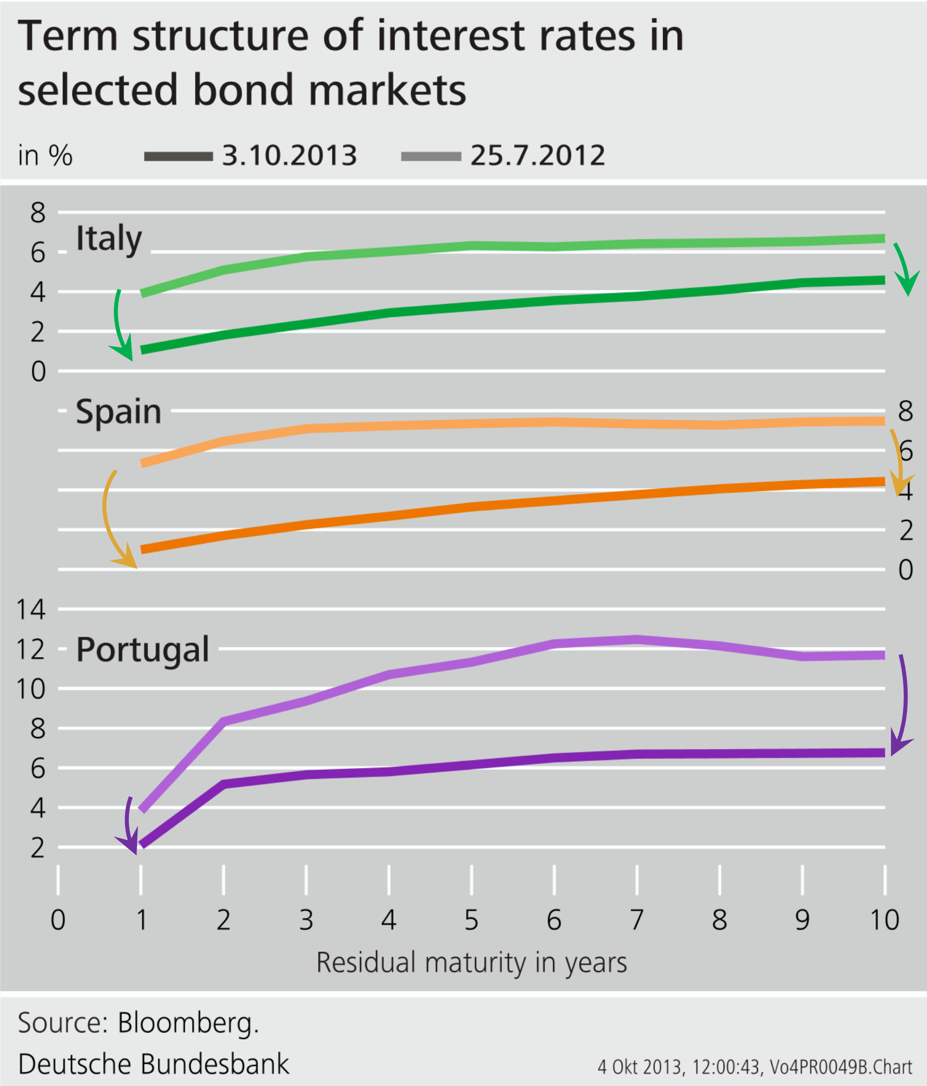
- **Emergency liquidity operations (ELA)**

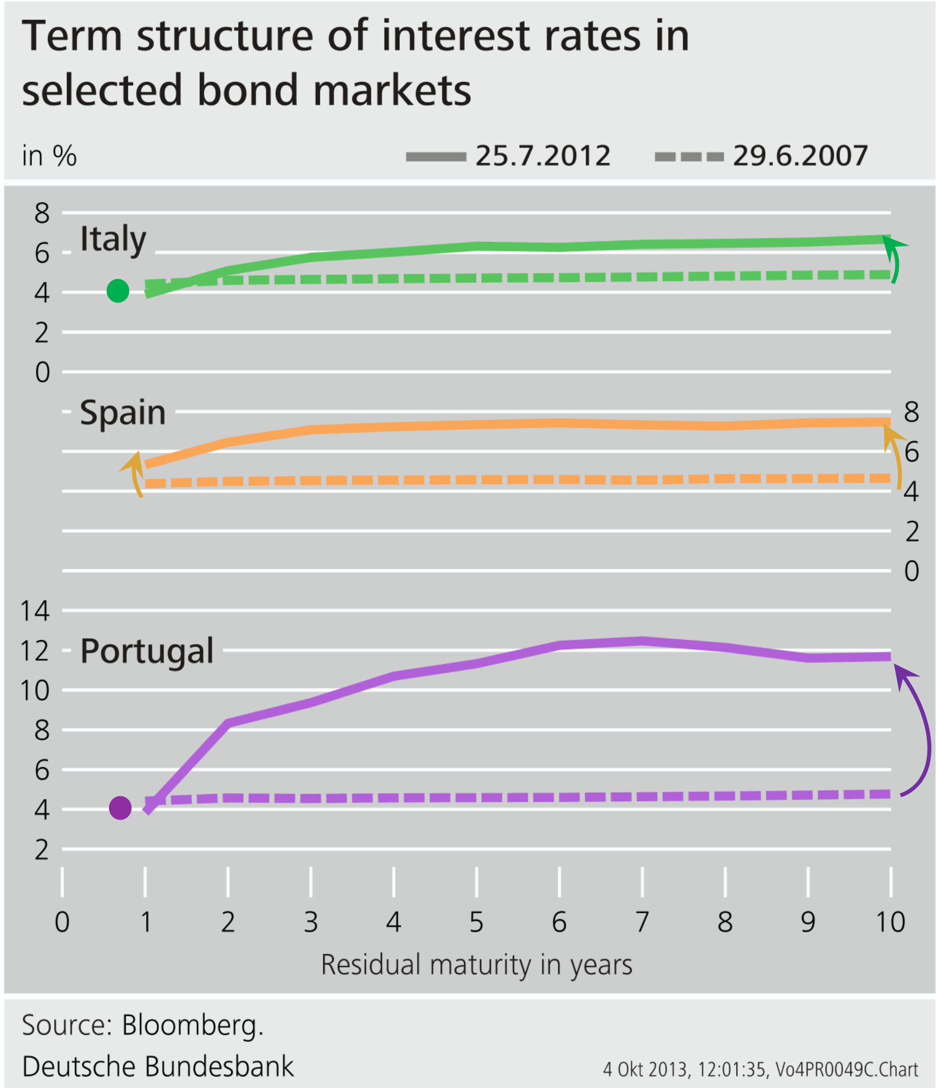
Aim: Lender of last resort in national responsibility

Development of money market rates



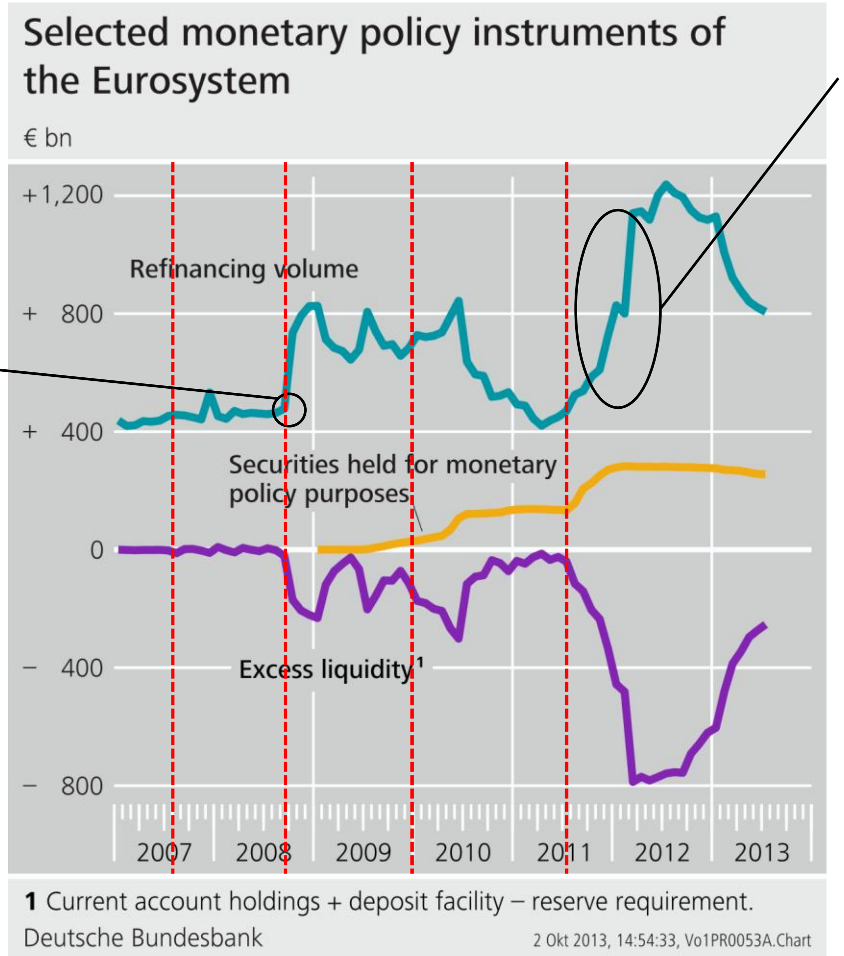
Effets of monetary policy measures:
Impact on capital market interest rates





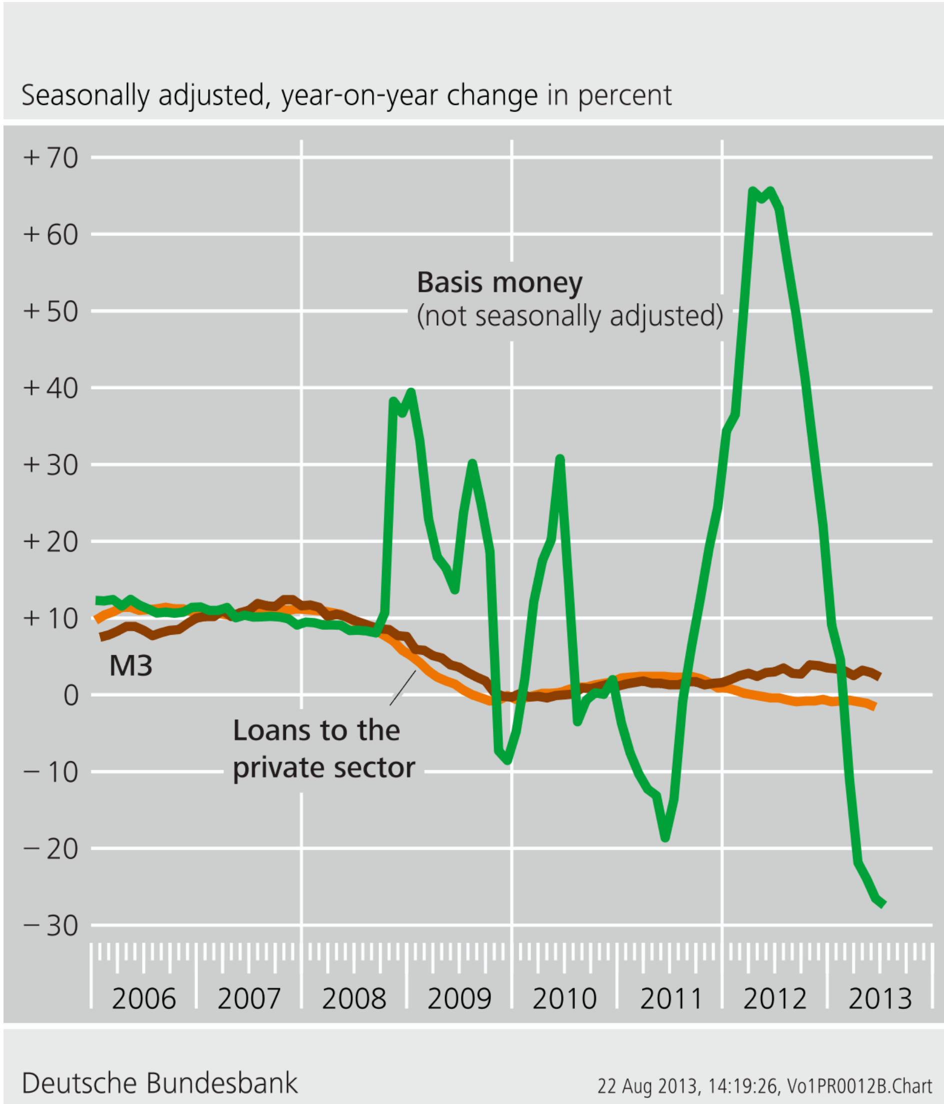
Effects of monetary policy measures:
Liquidity effect of selected monetary policy measures

October 2008: Fixed-rate tender with full allotment and extension of the collateral framework



December 2011/March 2012: Two additional refinancing operations with maturities of 3 years

Limits to the effects of monetary policy measures:
Central bank money and broad money and credit growth



The role of monetary policy

- Monetary policy has helped to mitigate escalations of the crisis.
- Monetary policy has supported the real economy and the adjustment process in countries hit most hardly in the crisis.
- Monetary policy has entered the border area to fiscal policy.
- The Eurosystem has gained weight in important other policy fields (Troika, banking supervision).
- Most important challenge: Avoid fiscal dominance (also in a financial stability disguise) to preserve credibility and independence.

Background slides I: Monetary and fiscal interactions – the fiscal limit

Times of high public debt

- **Current debate on fiscal consolidation:**
  - **When** to consolidate? Textbook gives trivial answer: consolidate **in economic upswing** → Reality seems to tell a different story
  - **How** to consolidate? **Reduce government spending** rather than increase taxes → Policy debate seems to be different (e.g. Germany, France)

- **Policymakers face difficult judgements under uncertainty:**
  - weighting probability of risking **hysteresis** (e.g. Delong & Summers, 2012)
  - against danger of running into **debt overhang**

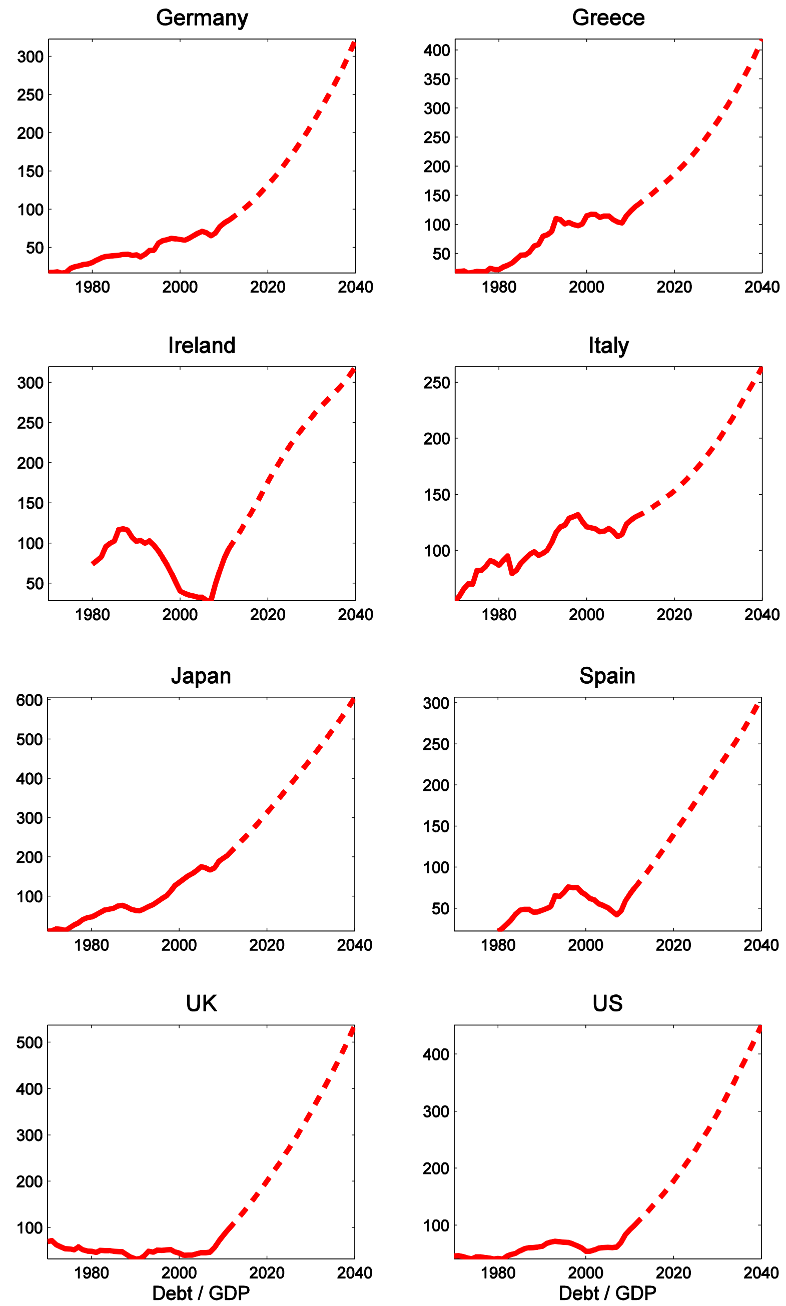
- **Proponents** of postponing consolidation seem to assume that
  - governments are still able to increase debt further = remain creditworthy
  - consolidation / stabilisation of debt will happen sometime in the future

Rising debt: today and tomorrow

- Recently **rising** levels of government **debt**

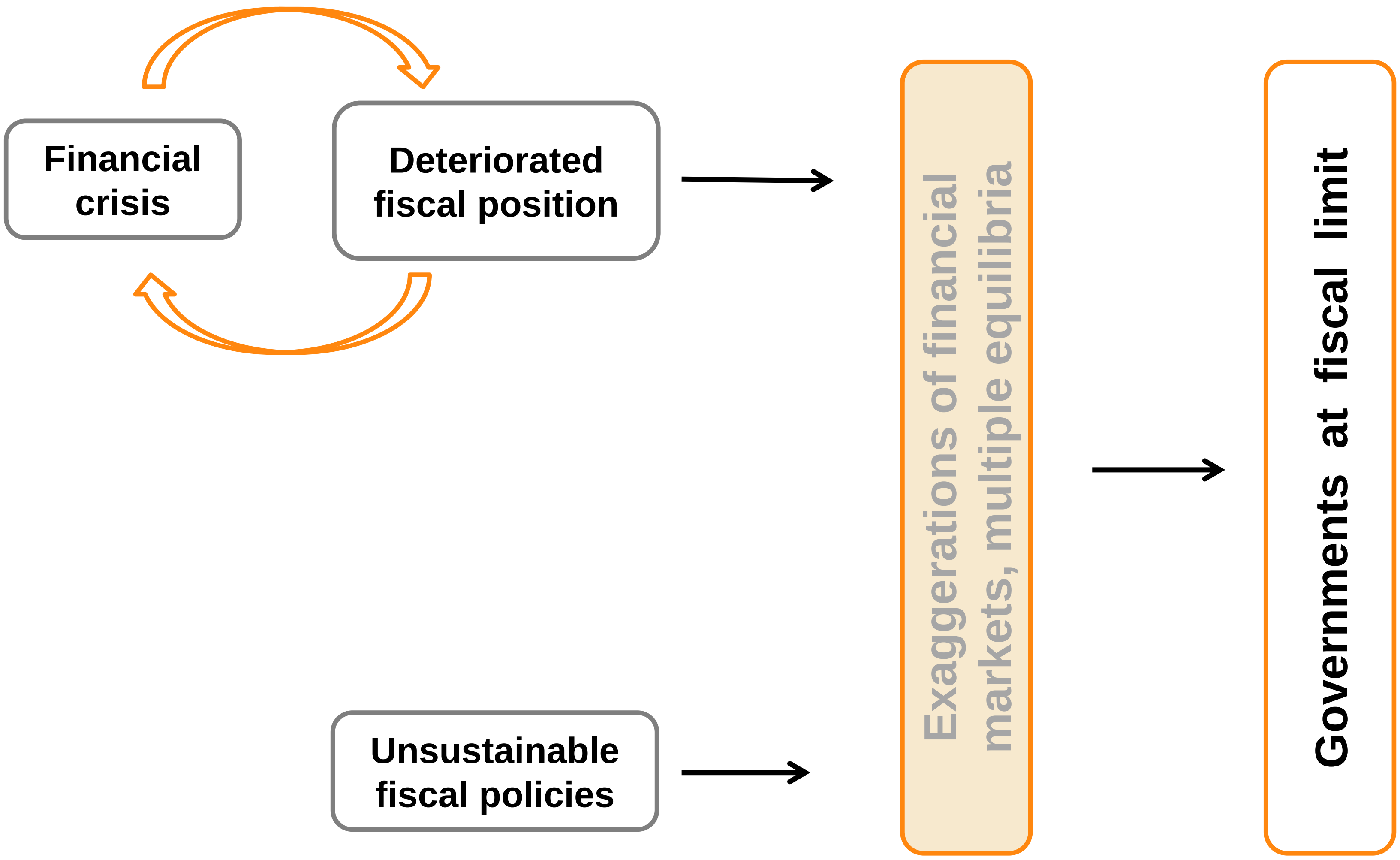
→ Increased probability of reaching a point where **fiscal sustainability is in question.**

- Beyond those debt levels we currently observe
  - loom even larger piles of **implicit debt**
  - stemming from potentially unstable transfer regimes (e.g. pensions, health care).



Source: Cecchetti, Mohanty & Zampolli (2010)

When things go wrong



Fiscal limit

- Increased risk of approaching **fiscal limit:**

  A point at which government surpluses can no longer adjust to stabilise government debt. Basically, the fiscal limit is obtained as the sum of discounted maximum future primary surpluses.

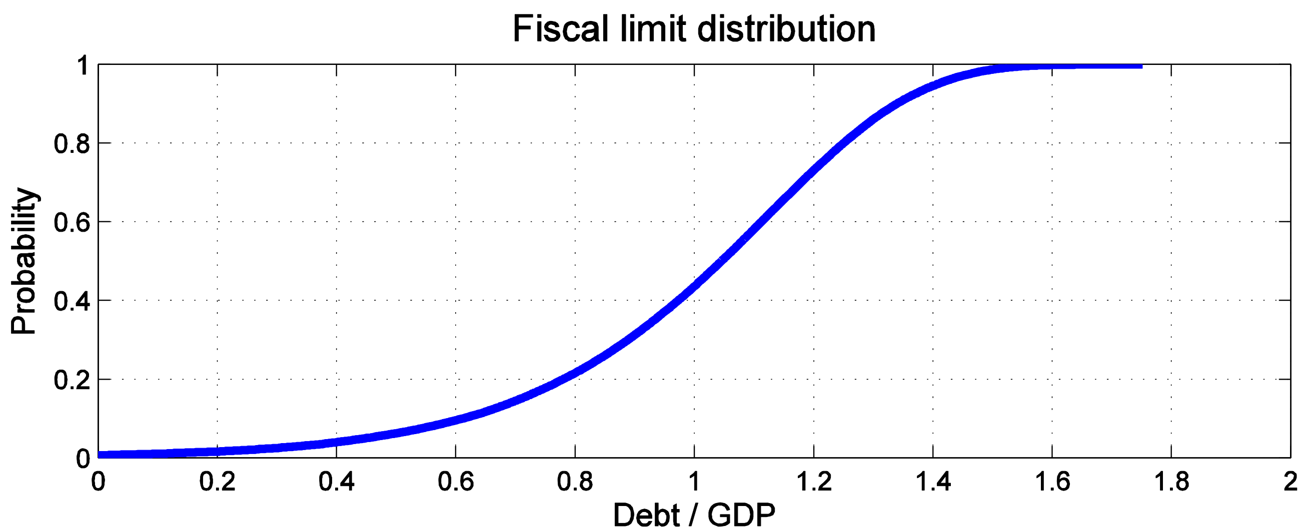
- The limit may become binding due to
  - **economic reasons** like the peak of the Laffer curve or
  - **political reasons** which make it infeasible to raise government revenues (e.g. “austerity backlash”).

- Fiscal limit seems to differ across countries
  - some peripheral European countries lost market access, i.e., hit fiscal limit
  - for the US, the day of reckoning lies farther into the future (e.g. Kotlikoff, 2006)
  - Japan?

Debt-to-GDP ratio and fiscal limit

- Actual **fiscal limit is highly uncertain** in many dimensions:
  - it is rather a **probability distribution** than a point;
  - it depends on expectations and, hence, is **forward-looking;**
  - shocks and policy measures also affect the fiscal limit so that it is **country and time specific.**

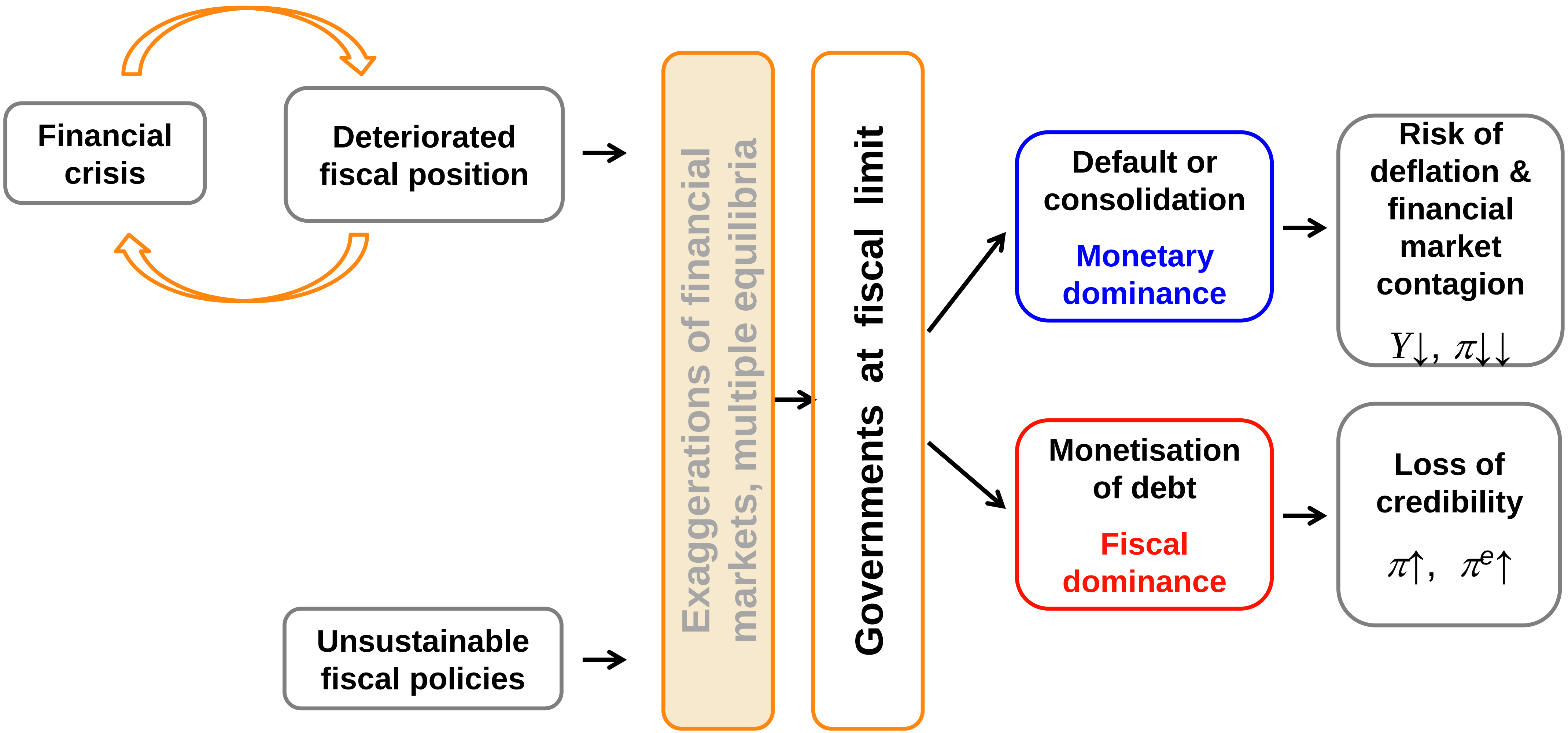
- Common misperceptions:
  - focus on current debt and deficits is **insufficient**
  - **no "one-size-fits-all"** number for debt-to-GDP ratio



E.g. given debt/GDP of 120% probability of hitting fiscal limit is about 75%.

Source: Stylised representation based on Bi & Leeper (2013)

Principal policy options at the fiscal limit when default is possible



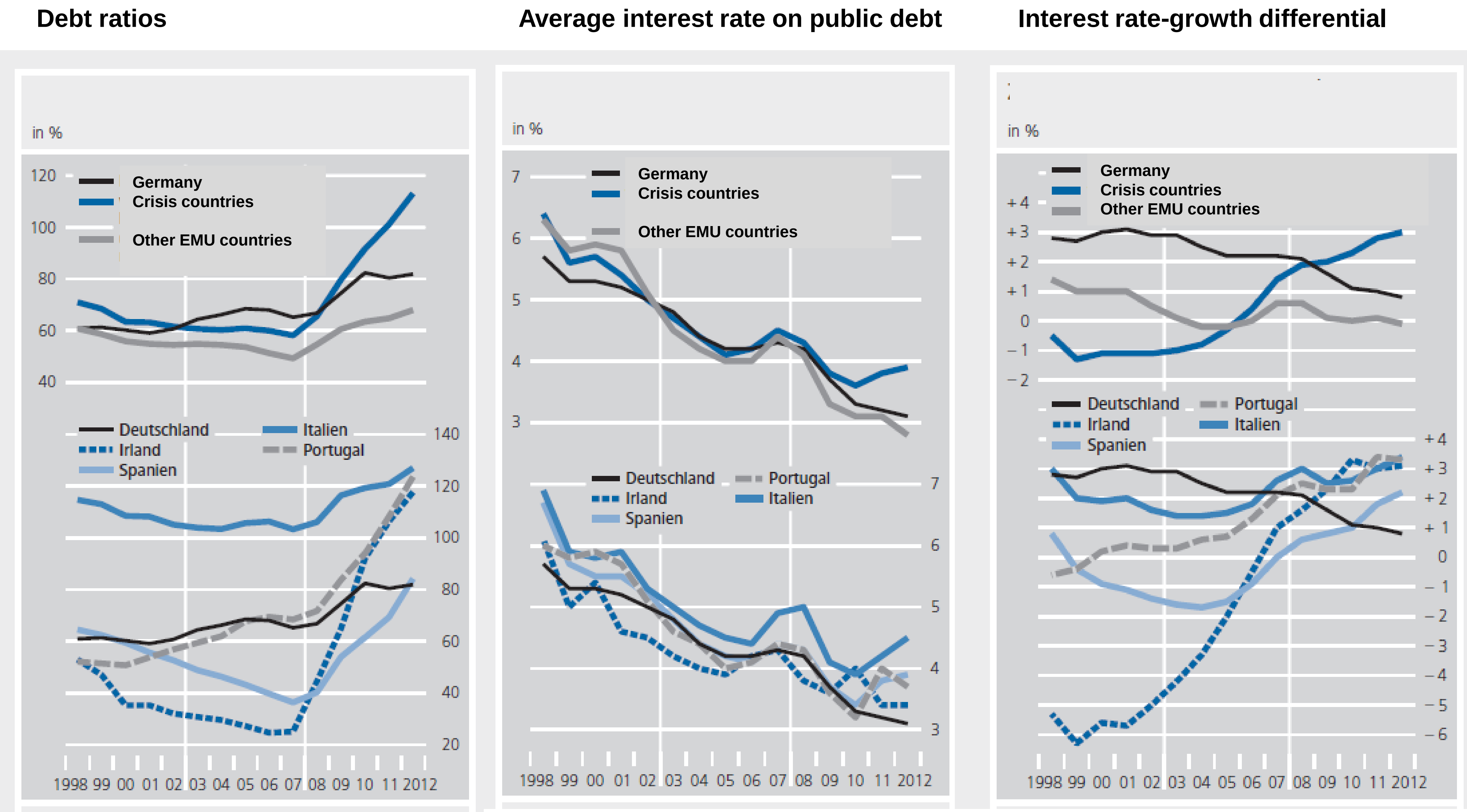
Source: Representation based on Lemke (2012)

Background slides II

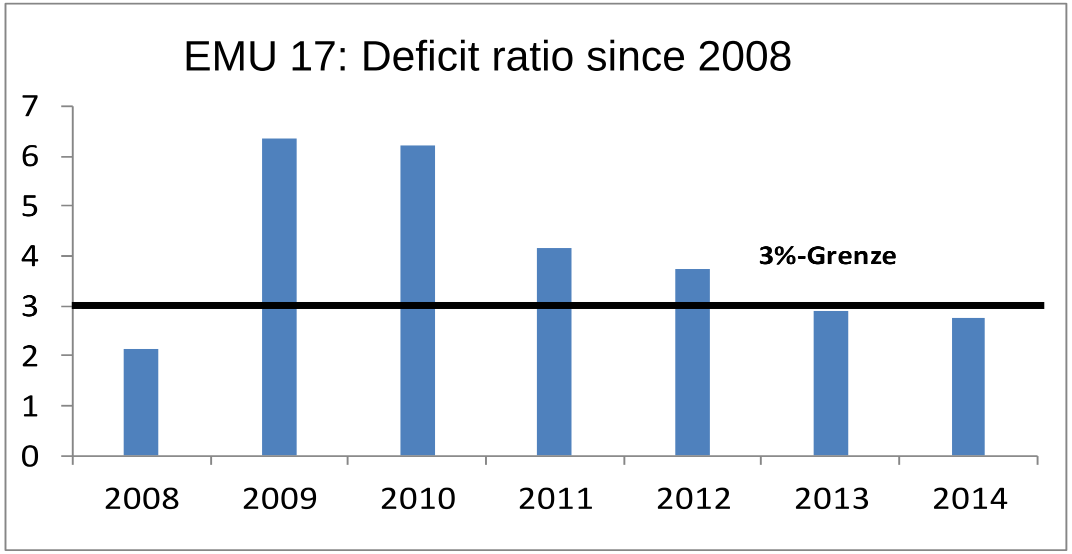
Has the implementation been a success?

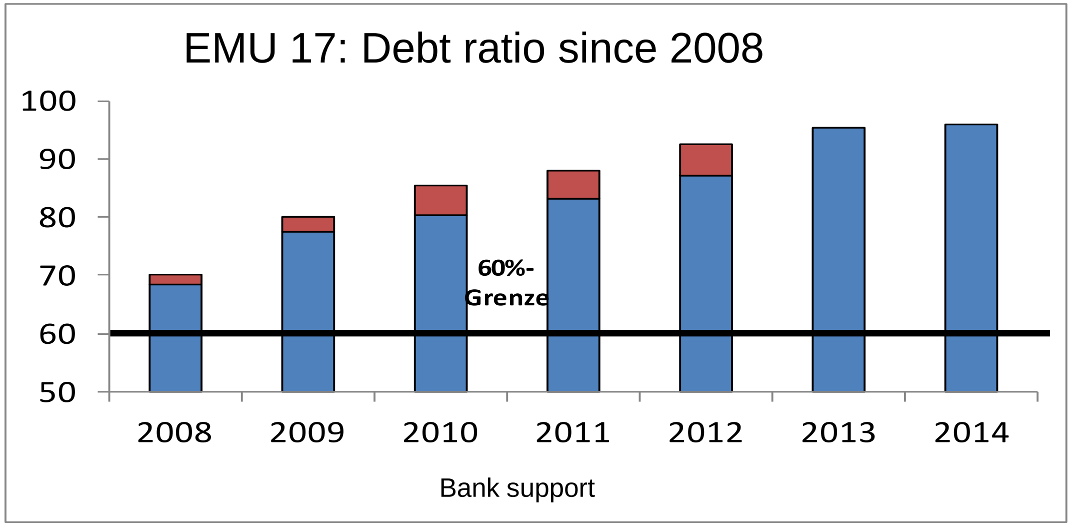
- Implementation somewhat disappointing
- Complex and more intransparent rules
- Numerous exemptions and extensions of deadlines (consolidation = moving target?)

Fiscal policy in an era of very low interest rates



Fiscal policy: why spotlight on EMU?



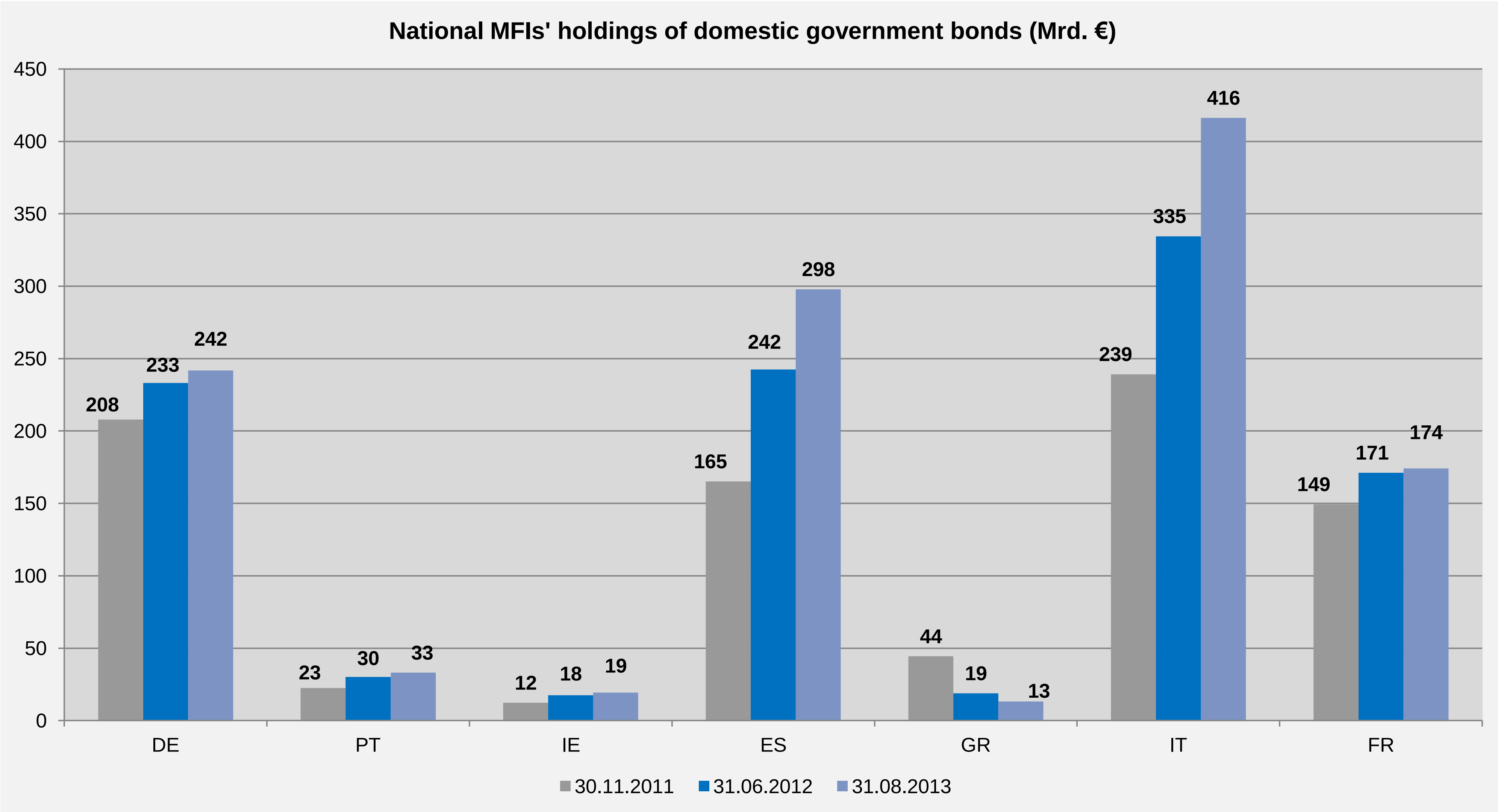


EU-Commission. 2013/14 Bank support for 2013/14 not explicitly mentioned

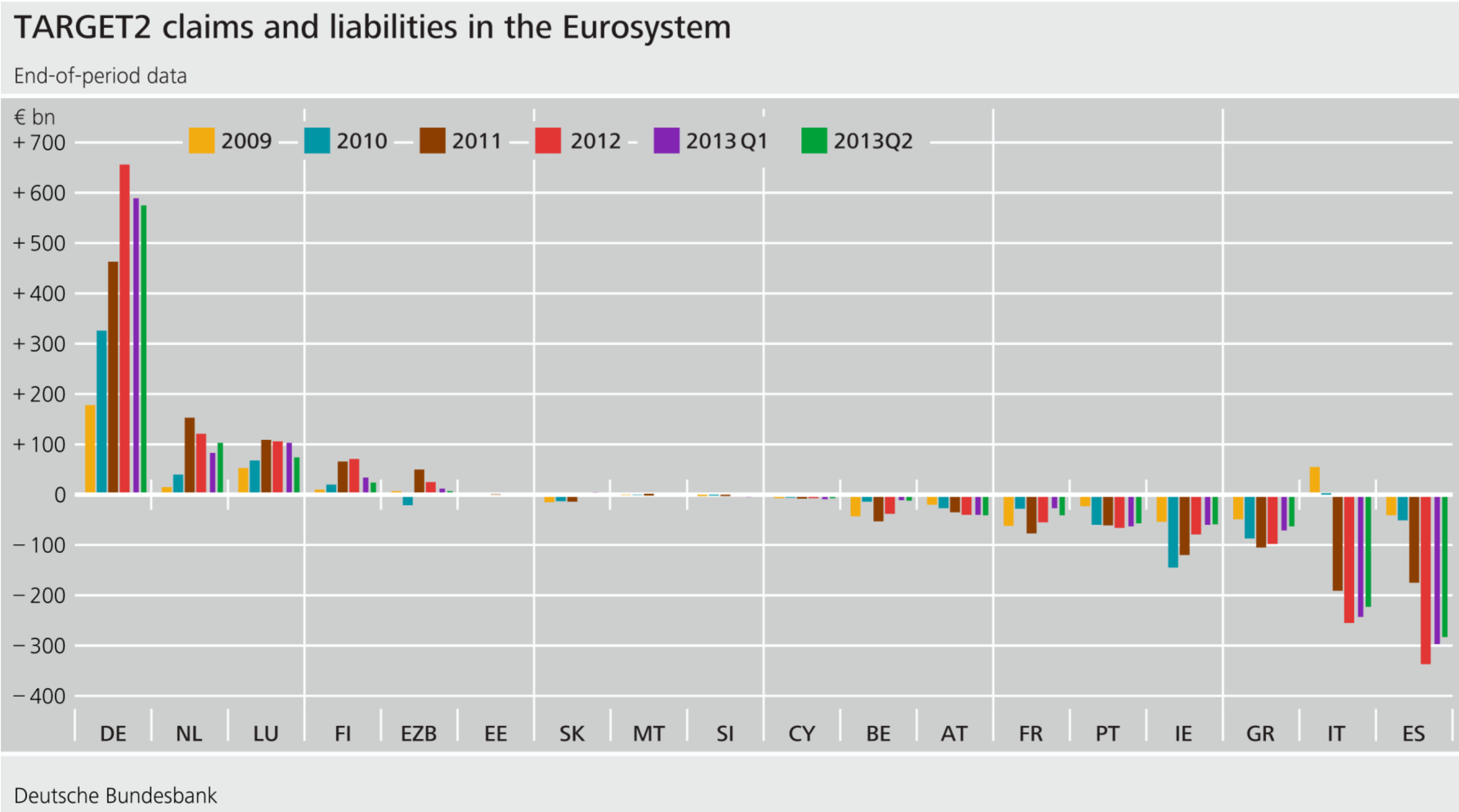
EMU-Aggregate:

- **Deficit**
  - Strong increase, then decline to 3% in 2013
- **Debt**
  - Very high level above 90%
  - Ongoing increase until 2014
- **Strong cross-country heterogeneity**

Negative side- effects of monetary policy measures:
3Y-LTROs and MFI holdings of domestic government bonds



Effects of monetary policy measures:
Target2 claims (+) und liabilities (-) in the Eurosystem



Institutional framework to facilitate successful policy

- Successful stabilisation of the economy requires
  - **Fiscal policy** safeguarding government solvency
  - and **monetary policy** to focus on maintaining price stability
  - This constellation is not sufficient …

- **Financial stability policy** is a necessary complement:

  Macroprudential instruments and **financial sector reform** (regulation, banking union) to mitigate build-up of imbalances and to increase resilience of the economy

  - reduce pressure on fiscal policy by e.g. breaking vicious feedback loop between banks and sovereigns

  - avoid overburdening monetary policy as interest-rate instrument is too blunt a tool