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

Price stability conducive for fiscal policy

Prudent public finances important for successful stabilisation policy

Financial stability

Fiscal policy

Monetary policy

Financial instability jeopardizes monetary policy transmission

Strained public finances depress bond prices and pressure banks

Financial instability puts burden on public finances

Price stability supportive but not sufficient for financial stability

Source: Representation based on Lemke (2012)
Sovereign risks and risks in the banking sector highly correlated

Sovereign, banks and corporate CDS (Western Europe)

Daily data

Basis points

- iTraxx Non-Financials
- iTraxx Senior Financials
- iTraxx SovX Western Europe

Sources: Bloomberg and Markit. 1 100 corporates, investment grade. 2 25 financials, investment grade. 3 15 sovereigns.

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What went wrong in EMU?

Financial crisis

Deteriorated fiscal position

Exaggerations of financial markets, multiple equilibria

Governments at fiscal limit

Great moderation, financial supervision, trust in fiscal and financial strength, no country-specific perspective

Unsustainable fiscal policies

deficiencies in fiscal framework

Underestimation of disciplining function of capital markets ex ante and of contagion ex post

No crisis resolution framework available in the institutional framework when the crisis hit
Policy initiatives in EMU

- Financial crisis
- Deteriorated fiscal position
- Unsustainable national policies
- Exaggerations of financial markets, multiple equilibria
- Governments at fiscal limit
- Is this sufficient?

- EFSF, ESM
- Reform SGP, fiscal compact, macroeconomic imbalance procedure
- Fiscal consolidation and structural reforms and deleveraging at the national level
- SMP, OMT

- Conventional and unconventional monetary policy
- Banking union, bank resolution, macroprudential mandate
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 operations
  – Provision of foreign currency liquidity (Swaps)

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

• Emergency liquidity operations (ELA)

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

Aim: Improving the monetary policy transmission

Aim: Lender of last resort in national responsibility
Development of money market rates

"Financial market turbulences" "Financial crisis" "Sovereign debt crisis" "Sovereign debt and financial crisis"

Three-months Euribor

MRO rate

EONIA

Depo-repo-spread (3M)

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Monthly expectation of average EONIA

End-of-month previous

Current Basis points

2 Oct 2013, 14:53:19, Vo1PR0015A Chart
Effets of monetary policy measures: Impact on capital market interest rates

Term structure of interest rates in selected bond markets

Source: Bloomberg. Deutsche Bundesbank

4 Okt 2013, 12:00:43, Vo4PR00498.Chart
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

*Selected monetary policy instruments of the Eurosystem*

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

Seasonally adjusted, year-on-year change in percent

Basis money
(not seasonally adjusted)

Loans to the private sector

M3

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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

Financial crisis → Deteriorated fiscal position

Deteriorated fiscal position → Exaggerations of financial markets, multiple equilibria

Exaggerations of financial markets, multiple equilibria → Unsustainable fiscal policies

Unsustainable fiscal policies → Governments at fiscal limit
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

![Fiscal limit distribution](image)

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

- Financial crisis
- Deteriorated fiscal position
- Unsustainable fiscal policies

Governments at fiscal limit

- Exaggerations of financial markets, multiple equilibria
- Default or consolidation
- Monetary dominance
- Risk of deflation & financial market contagion
  \(Y \downarrow, \pi \downarrow\)

- Monetisation of debt
- Fiscal dominance
- Loss of credibility
  \(\pi \uparrow, \pi^e \uparrow\)

Source: Representation based on Lemke (2012)
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

Debt ratios

Average interest rate on public debt

Interest rate-growth differential

- Germany
- Crisis countries
- Other EMU countries

- Deutschland
- Italien
- Irland
- Spanien
- Portugal

- +4
- +3
- +2
- +1
- 0
- -1
- -2
- -3
- -4
- -5
- -6
Fiscal policy: why spotlight on EMU?

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**

EU-Commission. 2013/14 Bank support for 2013/14 not explicitly mentioned
Negative side-effects of monetary policy measures: 3Y-LTROs and MFI holdings of domestic government bonds

National MFIs' holdings of domestic government bonds (Mrd. €)

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<th>Country</th>
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</table>
Effects of monetary policy measures:
Target2 claims (+) und liabilities (-) in the Eurosystem

TARGET2 claims and liabilities in the Eurosystem

End-of-period data

€ bn
+ 700
+ 600
+ 500
+ 400
+ 300
+ 200
+ 100
0
- 100
- 200
- 300
- 400

DE | NL | LU | FI | EGB | EE | SK | MT | SI | CY | BE | AT | FR | PT | IE | GR | IT | ES

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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