Fiscal policy and its implications for monetary and financial stability

Stephen Cecchetti[1]

Economic Adviser at the Bank for International Settlements, and Head of its Monetary and Economic Department

Remarks prepared for the 10th BIS Annual Conference

Lucerne, Switzerland, 23–24 June 2011

It is my great pleasure to welcome all of you to the 10th BIS Annual Conference that brings together central bankers and academics. The topic of today's conference, "Fiscal policy and its implications for monetary and financial stability", is one that we have all been thinking about for some time.

I recall the first time that I began thinking about fiscal sustainability. It was roughly a decade and a half ago when I read a paper that Paul Masson and Michael Mussa, then of the IMF, wrote for the Federal Reserve Bank of Kansas City's 1995 Jackson Hole Symposium on "Budget deficits and debt: issues and options". In that paper, Masson and Mussa put the estimated net present value of the unfunded pension liabilities of the G7 countries at something like two to four times their 1994 GDP.[2]

We know what people did over the next decade to address this problem: nothing! So, unsurprisingly, things just got worse. The unfunded liabilities of advanced country governments arising from their pension and health care commitments continued to rise. But economists kept working. They kept looking at the data, and they kept ringing alarm bells.

A decade after Masson and Mussa, Jagadeesh Gokhale published estimates showing that the unfunded liabilities of EU countries were on average more than four times their 2004 GDP.[3] At the time Gokhale estimated the Greek government's unfunded pension at more than eight times that country's GDP.

These estimates are notoriously dependent on the assumptions that go into computing them. They depend on discount rates, growth rates, and the like. But I would suggest that any set of assumptions that are even remotely reasonable leads inevitably to the conclusion that fiscal paths in many advanced countries are simply unsustainable. And, we have known this for nearly two decades.

So, the fact that fiscal trajectories of advanced economies are unsustainable is old news. What is new news, and one of the important lessons from the financial crisis, is an increased appreciation of the importance and the multi-faceted nature of the interrelations between

[1] I thank Leonardo Gambacorta for his contributions to this presentation. The views expressed here are those of the author and do not necessarily reflect those of the BIS.

[2] P Masson and M Mussa, "Long-term tendencies in budget deficits and debt", in *Budget deficits and debt: issues and options*, Federal Reserve Bank of Kansas City, 1995, pp 5–55.

[3] J Gokhale, "Measuring the unfunded obligations of European countries", National Centre for Policy Analysis, *Policy Report*, no 319, January 2009.

fiscal policy, monetary policy and financial stability policy. Governments' capacity to support the financial sector, through rescue packages, and the real economy, through fiscal stimulus, has been crucial in preventing a complete financial and economic meltdown. But the fallout from the crisis has accelerated a process that was already in train, so that now – I am tempted to say *finally* – fiscal policy itself is perceived to be a key risk to financial and monetary stability.

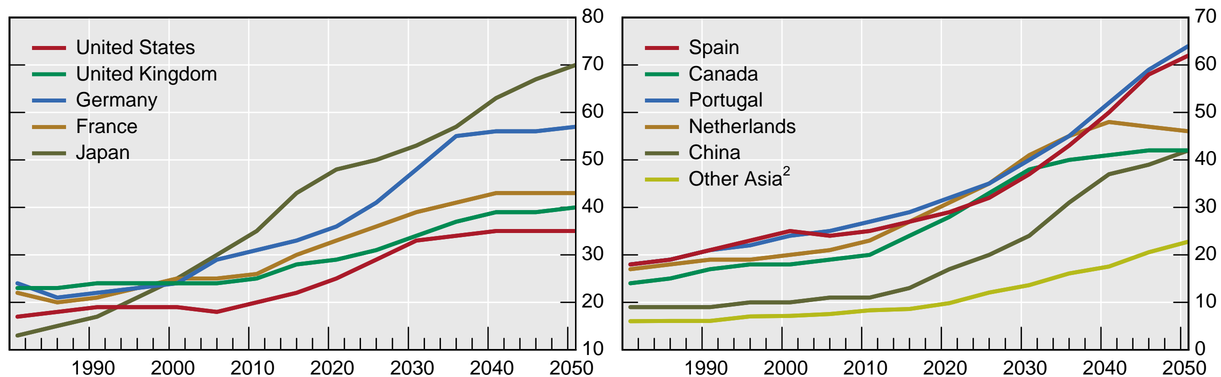
As Alan Auerbach will point out shortly, there is an urgent need for fiscal adjustments in many advanced countries. And, with rapidly ageing populations, pension and health care reforms must take centre stage. You can see this in Graph 1, where I plot the ratios of the population aged 65 and over to the population aged 15 to 64. In 2000, every country displayed here had an old age dependency ratio of 25% or less. Put another way, there were at least four people of working age for each retiree. Today, the numbers for the advanced countries are between 20% for the US and 35% for Japan.

What is terrifying in this picture is what happens over the next 30 years. In several countries, we are on our way to having fewer than two people of working age per retiree! Whenever I see numbers like these, I have to remind myself that every single person who will be of working age 20 years from today has already been born. Countries can play a zero-sum immigration game – something the US has been pretty good at – but for the world as a whole, what you see is what you get. And, what you get is a dramatically ageing population with a doubling of the elderly dependency ratio.

Graph 1

Old-age dependency ratio[1]

In per cent



[1] The population aged 65 years or over to the population aged 15–64. [2] Weighted average of Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand by size of population.

Source: United Nations, *World Population Prospects*, 2010 Revision.

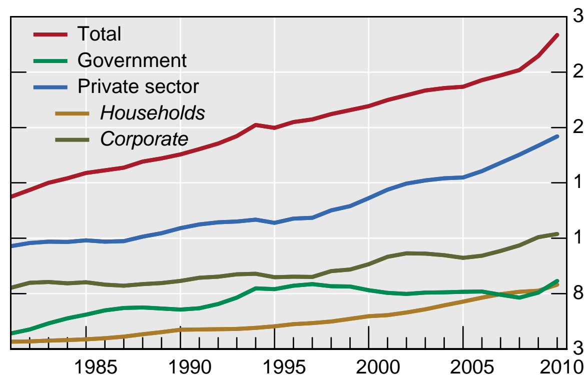
This very difficult situation is made even more complicated by the very high level of non-financial private sector debt in the affected countries. Graph 2 shows this equally frightening aspect of the current reality. For the 18 OECD countries for which we have data, household plus non-financial corporate debt in 2009 was on average well over 200% of GDP. In real terms, this represents an increase of 50% over the past decade. So, one of the short-term legacies of the financial crisis is that a number of large economies are more fragile. They are likely to have become more sensitive to changes in financial conditions and more vulnerable to shocks. As Roberto Perotti will point out later this afternoon, these vulnerabilities are at the heart of the debate about the timing, gradualism and flexibility of fiscal consolidation.

Without a change in their fiscal trajectories, advanced economies run a number of serious risks. As Carmen Reinhart will tell us tomorrow morning, the historical record is littered with examples of countries restructuring their debts indirectly through various forms of what she labels financial repression. And, Eric Leeper will discuss the somewhat more conventional inflationary concerns arising from public debt that is out of control.

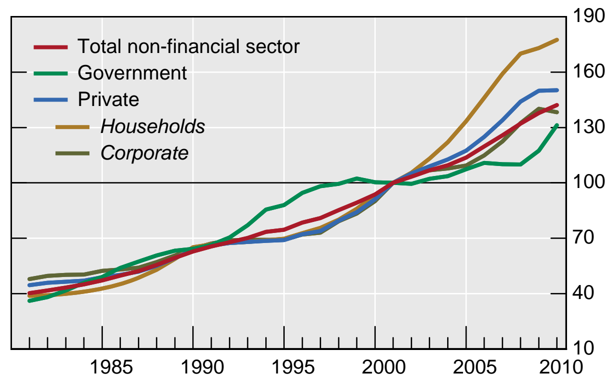
Graph 2

Non-financial sector debt

As a percentage of GDP[1]



Real levels, deflated by consumer prices[2]



[1] Simple averages for 18 OECD economies. [2] Rebased to 2000 = 100; simple average of 16 OECD economies, including the United States.

Sources: OECD; national data.

Even as we face these challenges, we must not lose sight of one of the central lessons of the crisis: our institutional framework did not work. The pre-crisis division of responsibilities among fiscal, monetary and prudential policymakers failed to deliver the stability that we sought.

As we rethink our institutional arrangement, it is useful to go back over the pre-crisis consensus on that division of labour. It went something like this: (i) monetary policymakers had the task of stabilising inflation near its target and output near potential; (ii) in addition to putting automatic stabilisers in place, the fiscal policymaker's job was to build the foundations for high growth and employment, as well as determining the relative size of government programmes to meet societal objectives; and (iii) prudential policymakers were told to focus on individual institutions, so as to reduce the moral hazard risks created by the government safety net, prevent banking panics and protect small depositors.

The financial crisis has revealed significant deficiencies in this distribution of responsibility: (i) price stability is not enough, nor are interest rates; (ii) fiscal policy provides the only available insurance against systemic events, whether arising from natural disasters or man-made financial crises, so cyclically balanced budgets in normal times are not enough; and (iii) prudential authorities need to take a system-wide perspective in regulation and supervision, so focusing on the solvency of individual institutions is not enough.

The conclusion is that we need a stability framework in which monetary, fiscal and prudential policy work together to build a robust and stable macroeconomic and financial system that will make the next crisis both less likely and less severe.

Turning to the specifics of fiscal policy, tomorrow Andrés Velasco will speak about the relationship between institutional factors and fiscal performance.

For now, let me say that designing a successful institutional framework for fiscal policy, refining the necessary governance, responsibilities, accountability and the like, is much more complex than is the case for monetary policy.[4] Or at least, that's the way it seems to me. Let me list a few of the reasons:

- First, fiscal policy has many objectives, quite a few of which are extremely difficult to quantify.
- Second, there are trade-offs among this multiplicity of objectives, especially those that involve significant redistribution of resources.
- Third, unlike monetary policy, where there is a clear consensus about the long-run neutrality of money and the high costs of inflation, there is no such agreement over the long-run impact of government deficits and debt.
- Fourth, there is a deficit bias arising from the fact that politicians naturally forsake long-term stability for short-term prosperity.

That said, in designing a framework for fiscal policy, we can build on the experience of the most successful central banks. Here are three lessons that may be helpful:

- First, adopt an explicitly forward-looking orientation, including multi-year budgeting. We should require that any expansion or tightening of fiscal policy come with an indication of the future measures that will be needed to ensure fiscal sustainability. There is a growing consensus that, as is the case for monetary policy, the effectiveness of discretionary fiscal policy hinges on the expectations of future policy. Indeed, fiscal policy multipliers have been shown in recent research to vary quite dramatically depending on the type and size of future corrective measures.
- Second, improve communication and transparency, including the publication of what has been promised, to whom and by when. Fiscal policies put in place today have consequences for generations. Making fully informed decisions, ensuring intergenerational equity and constraining political largesse means clearly telling everyone about the consequences. Getting people to ask questions like "Will I get my pension? Will I be able to get decent medical assistance?" will go some way towards reducing short-term biases.
- And third, as I suggested a moment ago, we should adopt a more prudent approach to budgeting, including the creation of buffers both to guard against the consequence of forecasting errors and as contingencies. The government is, in many respects, an insurance company (providing insurance against natural disasters, financial crises, demographic changes and much more). Yet, its budget is based on cash flow accounting, without any compulsory reserves. To create such buffers against contingencies, fiscal authorities could accumulate budget surpluses in good times in order to provide a government with the ability and the debt capacity to respond in times of financial crisis. To draw an analogy with the banking sector, the government needs to build up fiscal buffers during good times that can be drawn down to support the financial system and the real economy in bad times.

To implement these principles, we need rules that tell politicians what they can or cannot do and that cannot be easily changed. The problem with these sorts of rules is that it is difficult to write them in ways that are both difficult to circumvent and sufficiently flexible to allow for

[4] For a comprehensive discussion of these issues, see B Eichengreen, R Feldman, J Liebman, J von Hagen and C Wyplosz, "Public debt: nuts, bolts and worries", *Geneva Report on the World Economy*, 13, August 2011 (forthcoming).

unforeseen events. For example, one could put in place very strict limits that leave macroeconomic stabilisation to automatic fiscal stabilisers and monetary policy alone, allowing for discretionary fiscal policy only under very exceptional circumstances. But how exceptional should these circumstances be? Recent experience with Europe's Stability and Growth Pact and the US budget rules is not encouraging.

So, if it is difficult to tell politicians what they should do or not do, it should at least be possible to make them more honest with the public and themselves. Hence, at the minimum, this is what we need:

- independent agencies to assess the economic impact of current and proposed future programmes, as well as certify the integrity of public accounts;
- production of unbiased and realistic macroeconomic forecasts that form the basis for decisions; and
- improved communication assuring disclosure of rigorously compiled information that is accessible to a large, non-technical audience.

All of these are some of the hallmarks of successful central banks – the ways in which they have been made accountable and in which they communicate to the public could be a model for independent fiscal authorities too.

Thank you all for coming, and I look forward to the next day and a half of discussion.