Monetary policy, fiscal policy and public debt management

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Abstract

This paper touches on the interaction between monetary policy, fiscal policy and public debt management. ***The first part*** looks at public debt sustainability and monetary policy. When measuring the fiscal stance, data such as current fiscal income and expenditure, the scale of public debt, and the coverage of budget revenue and expenditure should be properly monitored. In addition, factors that could influence the mid-term fiscal stance should be taken into consideration. Central bank assets may not be used to offset public debt, and pension funds are not in practice used to offset gross government debt in most economies. To some extent, oil and commodity stability funds held by resource-abundant economies may be used to offset gross government debt. Monetary policy is influenced by the financing of the fiscal deficit by way of bond issuance. ***The second part*** is about the development of money markets, the maturity and yield curves of domestic government bonds, and the deepening of domestic financial markets and financial stability in China. ***The concluding part*** concerns the central bank and public debt management. There is no need for the central bank in economies with a well developed treasury bond market to issue debt of its own. In emerging economies, a regular rollover issuance of central bank debt may help to form a consecutive short-term risk-free yield curve, serving as a benchmark for pricing in money and bond markets. Central banks involved in public debt management need to coordinate closely with the debt management agency on the policy objectives for various macro control instruments associated with fiscal policy, monetary policy and public debt management.

Keywords: Monetary policy, fiscal policy, public debt management, China

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I. Public debt sustainability and monetary policy

(1) When measuring the fiscal stance, the following factors should be taken into consideration:

· The following data should be monitored:

1. Current fiscal income and expenditure. In recent years, China's deficit has remained low, compared with those of the major developed economies. In 2009 and 2010, the fiscal deficit amounted to RMB 950 billion and RMB 1050 billion respectively, slightly less than 3% of GDP.

2. Public debt. By the end of 2010, China's outstanding government debt stood at around RMB 7 trillion, or 20% of the GDP, a relatively safe level. However, some local government liabilities are not included in the statistics and thus need to be monitored closely as to their scale and potential impact on China's fiscal condition.

3. Coverage of budget revenue and expenditure. In many economies for statistical reasons, not all public revenues and expenditures are included in the national budget. The revenues and outgoings of local governments and state-owned enterprises are a case in point. These should be taken fully into account when measuring the fiscal stance. China's government budget covers the revenue and expenditure of both the central and local governments but not all such items. Not included are some special funds (eg pension funds and land transfer funds etc), as well as the profits and losses of state-owned enterprises.

· Factors that could influence the mid-term fiscal stance, especially those that could increase contingent liabilities.

Among these factors is the ageing problem. It is estimated that, by 2030, China's elderly population will reach twice today's level. This calls for more fiscal input into related pension and healthcare services. This ageing trend will also offset the "demographic dividend" effect and thus indirectly influence future fiscal income. Moreover, the potential losses of government-led construction projects take a long time to show up in the balance sheet. This may increase government's mid-term contingent liabilities to a certain extent.

· Characteristics of emerging market economies.

Compared with developed countries, emerging markets enjoy faster growth but face higher inflation and more volatility, which may have significant negative implications for their mid-term fiscal stance.

(2) Public sector assets as offset to gross debt

Central bank assets cannot be used to offset public debts. Central bank assets are acquired by injecting base money, meaning that any increase in the central bank's assets implies a simultaneous and equal increase in its liabilities. Nor is it the practice in most economies for pension funds to be used to offset gross government debts**.** In reality, a large pension funding gap is a problem for most developed and emerging markets. Pension funds cannot be used as an offset to gross government debt, and the funding gap may even increase the government's contingent liabilities. ***To some extent, oil and commodity stability funds held by resource-abundant economies may be used to offset gross government debt.*** However, authorities should take a prudent approach if they choose to follow that course, and they should take into account that such funds may become contingent liabilities and could cause maturity and structure mismatches in the balance sheet. Thus, these funds should be duly discounted when used as offsets.

(3) The influence of fiscal deficit financing on monetary policy

Governments usually finance their deficits by levying taxes or issuing bonds. Taxation has basically no effect on monetary policy, whereas bond issuance has either a direct or indirect influence on monetary policy. Excessive government bond issuance will worsen the government's future fiscal condition, which could result in the central bank being forced to acquire government bonds and thus compromise the independence of monetary policy.

II. Domestic currency-denominated public debt in China's domestic market

(1) Money market development

The volume of interbank lending in China has steadily and rapidly increased since the beginning of this year. From January to October, interbank lending totalled RMB 26.6 trillion, up 18.3% year on year. From January to October, the total borrowing of the state-owned commercial banks — the main borrowers in the interbank market, reached RMB 16.2 trillion, up 35.3%, accounting for 60.9% of the total borrowing in the market. On the other hand, the total lending of the main lenders, namely joint-stock commercial banks, city commercial banks and state-owned commercial banks, registered RMB 19.4 trillion, up 2.20%, accounting for 72.9% of the total lending in the market. The lending of foreign-funded financial institutions totalled RMB 2.80 trillion, up 68.30%, and the lending of other financial institutions reached RMB 4.4 trillion, up 99.20%.

(2) Maturity and yield curves of domestic government bonds

The Chinese government started to issue treasury bonds with maturities of more than 10 years after the Asian financial crisis in 1997. Maturities of 15 years and 20 years were issued in 2001, of 30 years in 2002 and of 50 years in 2009. At the end of October 2011, 148 batches of bonds were outstanding in the interbank bond market, with a volume of RMB 5.84 trillion and maturities ranging from three months to 50 years.

The People's Bank of China has issued a series of rules and guidelines since 2001 on standardising yield calculations in the interbank bond market. In June 2011, the People's Bank of China and the Ministry of Finance issued a joint notice, with detailed guidelines for market-makers on market-making for treasury bonds with key maturities. This has improved liquidity as well as the quality of treasury bond quotations, and it has further extended the yield curve.

(3) Deepening domestic financial markets and financial stability

In recent years, China's bond market has continued to expand, with enhanced market liquidity and more foreign investors involved. The deepening of the bond market has contributed to the stability of China's financial system. First, by accelerating the transformation from indirect financing to direct financing, thus diversifying the risks in the banking system and lowering financing costs in the real economy. Second, financial institutions have been provided with tools to replenish Tier 2 capital and the resilience of financial institutions has been improved. Third, market participants have adopted investment and risk management tools, so that the risks faced by credit entities have been diversified. Fourth, with a diversified base of bond market investors and increased bond trading volumes, the bond pricing mechanism has become more market-oriented, which has improved capital allocation and promoted financial market stability.

III. Central bank and public debt management

(1) Whether the central bank can issue its own debt paper, and its coordination with the Ministry of Finance

Whether a central bank can issue its own debt paper depends on the development of domestic treasury bond market and its monetary management policies. In economies with well developed treasury bond markets, the issuance of the bonds may perform two functions: as a financing tool for the central government, and as an instrument for regulating and managing financial markets. There is no need for the central banks in these economies to issue debt paper of their own. However, in emerging economies with less developed bond markets, bond issuance serves solely as a financing tool for government activities. In this case, long-term bonds account for most of the total volume, whereas short-term bond issuance is inadequate. In these economies, a regular rollover issuance of central bank debt may help form a consecutive short-term risk-free yield curve, serving as a benchmark for the pricing in the money market and bond market. Moreover, in economies with excess liquidity, central bank bond issuance can effectively absorb any excess short-term liquidity in the banking sector, and create a favourable environment for economic growth and price stability. In this case, central bank debt issuance could itself be regarded as an important measure in strengthening the coordination between fiscal and monetary policies.

(2) Involvement of central banks in public debt management

Central banks may involve themselves in public debt management based on each country's specific circumstances. Central banks tend to engage more deeply in the management of short-term rather than long-term debt, because short-term debt is more useful as a policy instrument for adjusting the base money supply. Central banks can adjust market liquidity and the money market interest rate by purchasing short-term government bonds via open market operations or by issuing central bank bills. Sound communication and cooperation between the ministry of finance and the central bank should be maintained in managing foreign currency-denominated debt. If financial resources raised by issuing foreign currency-denominated bond are invested domestically, the debt-service risk arising from exchange rate movements should be fully taken into account. In this case, government plans for managing its foreign debt could have significant implications for the coordination of local and foreign currency policy by central banks.

Quasi-fiscal operations and unconventional monetary policy will expand central bank balance sheets and are likely to reduce, to some extent, the quality of central banks' assets and therefore their profits. Apart from direct financial losses, the excessive issuance of money as a consequence of quasi-fiscal operations is likely to drive up market expectations for inflation and therefore undermine the credibility of central banks in maintaining the value of the currency. In addition, the independence of central banks will be undermined if they take on responsibility for fiscal functions. As a consequence, central banks should attach great importance to the hidden threat of inflation, whether or not quasi-fiscal operations or unconventional monetary policy will directly affect their financial condition.

(3) Institutional arrangements for coordinating monetary policy and public debt management

First of all, the debt management agency and the central bank should reach a consensus on the policy objectives of the various macro control instruments associated with fiscal policy, monetary policy and public debt management. Principles should be established for public debt management that reinforce the coordination between public debt management and monetary policy. Second, choices about the scale, variety and pace of public debt issuance should be made with great consistency, and they should be fully coordinated with the central bank so that the latter can carry out liquidity management effectively. Third, central banks and governments should step up their efforts to improve the bond market environment in order to enhance the liquidity of secondary markets for government bonds. This will provide a solid foundation for the formation of a reliable yield curve for risk-free market interest rates, thus enhancing the efficiency of the monetary policy transmission mechanism. Fourth, public debt issuance should not undermine the implementation of monetary policy and the stability of the currency's value. And if the government launches a plan for large-scale debt issuance to combat an economic and financial crisis, a fiscal consolidation programme should also be in place with a view to protecting the central bank's independence.