Lorenzo Bini Smaghi: Intervention at Sveriges Riksbank conference "Monetary policy in an era of fiscal stress"

Intervention by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, in the panel "Challenges for monetary and fiscal policy", at the Sveriges Riksbank conference "Monetary policy in an era of fiscal stress", Stockholm, 17 June 2011.

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It is a pleasure for me to contribute to this Sveriges Riksbank conference entitled "Monetary Policy in an Era of Fiscal Stress". The subject is indeed a very topical – and global – one. Not just in Europe but around the world, the crisis has progressively acquired a fiscal dimension that may be with us for a number of years to come.

Against this background, it may be useful for me to briefly look back over the relationship between monetary policy and fiscal policies, stressing in particular the challenges that monetary policy may face in an environment of sharply rising fiscal deficits and debt. Coming from the ECB, I will of course primarily focus on the euro area experience and lessons.

If, in a simple one-country setting, sovereign debt becomes unsustainable, the central bank always retains the option – in theory and partly in practice – to monetise the debt. The short-term implication of such monetisation is that sovereign credit risk will be replaced by both an inflation and exchange rate risk. In other words, the currency of that country will no longer be considered as a good store of value, either domestically or externally.

None of the above constitutes a feasible scenario for the euro area, which is characterised by a unique combination of centralised monetary policy-making and largely decentralised, albeit closely coordinated, fiscal policy-making. This one-monetary-policy-and-many- fiscal-policies approach is at the heart of the institutional arrangement which governs the interactions between monetary and fiscal policies in the euro area. Importantly, the Treaty specifically excludes any "fiscal dominance of last resort", due to the prohibition of monetary financing.

So what are the implications of all this?

Ruling out the possibility of monetising sovereign debt in turn rules out inflation and exchange rate risks. However, if we exclude the possibility of monetising the debt and of bailouts between countries, the risk of sovereign default could arise. Furthermore, this type of risk may emerge in financial markets in a rather disruptive way, at least compared with other risks, such as inflation and exchange rate risks. The reason is twofold. First, inflation risk may take time to materialise and to be factored in, even when the central bank monetises the debt. Second, financial markets may find it easier to manage and hedge against inflation and currency risk than against sovereign risk.

The separation between monetary and fiscal policies may create non-linearities and even multiple equilibria in the pricing of credit risk, which in turn may fuel self-fulfilling expectations and precipitate crises. Given the role that government bonds play in advanced economies' financial markets, such instability may impair the transmission of monetary policy. This may justify targeted action by a central bank to push markets towards a more stable equilibrium.

In general, the lack of fiscal dominance and the exposure to sovereign risk should promote overall better fiscal policies. This is certainly the case for most of the euro area countries. Fiscal consolidation started already in 2010, when the euro area general government deficit-to-GDP ratio and the debt-to-GDP ratio reached around 6% and 85% respectively. This compares with a deficit of 11.2% and a debt of 92% in the US, a deficit of 9.5% and a debt of 220.3% in Japan, a deficit of 10.4% in the UK and a debt of 80%. Further improvements in the fiscal situation of all the euro area members is expected for the current year, with the euro area average coming down to slightly above 4%. The euro area debt-to-GDP ratio is expected to stabilise in 2013 and come down thereafter.

In the euro area three countries are facing severe problems regarding market access. Overall these three countries account for about 6% of the euro area GDP. I will not elaborate on these three cases, and the fact that they have emerged in the midst of the worst economic and financial crisis since World War II.

The solution to these three cases entails a specific role to be played by the fiscal authority of the respective countries, the fiscal authorities of the other countries supporting the adjustment programme in those countries and the ECB. Some commentators have said that in a crisis stronger coordination between monetary and fiscal policy is desirable, even if it comes at the expense of reducing the independence of monetary policy. The opposite is actually true. Especially in a crisis the responsibilities for monetary policy and for fiscal policy have to remain quite separate.

The reason is that it is precisely during a crisis that the fiscal authorities try to push the central bank towards solving the fiscal problem through the inflation tax. However, the central bank is protected from this pressure by its statutes and the rules it adopts for the conduct of monetary policy. In the case of the ECB, the rules specify that it can lend only to sound institutions and against appropriate collateral. The appropriateness of the collateral depends in particular on whether the country under stress follows rigorously the IMF/EU adjustment programme and is on track to regain market access. The soundness of institutions, which is assessed primarily by supervisors, is also a key principle. It has ensured that all adjustment programmes envisaged sufficient funds for the recapitalization of the banking system.

These rules and principles apply to the central bank but are ultimately there to protect taxpayers and to prevent monetary policy from being misused to bail out insolvent governments. They constrain the actions of the central bank, but also give it sufficient flexibility to react in the event of a crisis.

There is no doubt that these rules cause some frustration to those who would instead like to shift the responsibility for solving the crisis entirely to the central bank, even if the crisis is of fiscal origin.

It is quite paradoxical that the very same people who criticise the ECB for having taken too many risks during the financial crisis are also those who criticise it for opposing any form of debt restructuring. This same group even suggests that the ECB should stand ready to accept, after a debt restructuring, the signature of a default-rated government as collateral. How are such contradictions possible? In my view they are only possible when the analysis is partial or the rationale is unclear. Let me give a couple of examples.

One reason for debt restructuring – which is often made by some theoretical economists – is that it helps financial markets to function better and it eliminates moral hazard. The problem with this view is that it totally omits the broader impact on the markets. Trying to eliminate moral hazard in the middle of a systemic crisis is like shooting yourself in the foot. Think about it: did the failure of Lehman Brothers make markets work better, or worse? Did it reduce moral hazard?

Another reason for private sector involvement (PSI) is to minimise the taxpayer's contribution and to penalise bad investments. This reason is even less economically sound. Lehman Brothers' failure proved that if PSI is applied in the wrong way, the taxpayer will in the end pay more. Short-term speculative investors benefit from perverse forms of PSI, while long term investors are punished. That doesn't sound very clever to me.

Having a clear objective, which in the case of the ECB is price stability, helps us to be consistent and to implement a policy which is in the best interests of taxpayers, given that inflation is ultimately a tax.

The architecture of the euro area – which clearly divides responsibilities between the single monetary policy and the many national fiscal policies – offers strong protection for taxpayers: the Treaty and the Stability and Growth Pact are intended to ensure sound fiscal policies and to guarantee the independence of the Eurosystem's monetary policy.

Some strengthening of the institutional framework underlying the Stability and Growth Pact is needed in order to avoid any repetition of the problems we are currently experiencing. Progress has been achieved, although not as much as we would have hoped. However, looking back, it is encouraging to note that, when facing difficult choices, the political authorities of the euro area have always decided to move forward, towards greater integration and a more solid foundation for Economic and Monetary Union.

The trialogue between the Commission, Council and European Parliament has tried to finalize an agreement on the strengthening of fiscal discipline in the euro area, in time for next week's ECOFIN Council and European Parliament plenary meetings. The Parliament is asking for a reverse Qualified Majority in the Council to vote down a Commission recommendation to a Member State with clearly unsound budgetary policy already under the preventive arm of the Pact. This should not be seen by the Member States as a reduction of their sovereignty but rather as a way to better protect themselves against the negative impact of undisciplined policies in diverging countries. It will also better protect the euro. I hope that the Council will show courage and leadership in this important endeavour.

Thank you for your attention.