Jens Weidmann: Who calls the shots? The problem of fiscal dominance

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the 4th Bank of France-Deutsche Bundesbank Macroeconomics and Finance Conference, Paris, 24 May 2013.

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1. Introduction

Ladies and gentlemen

I would like to thank you for the opportunity to speak here today. Indeed, in springtime there is no better place to be than Paris. As Henry Miller put it: "God knows, when spring comes to Paris the humblest mortal alive must feel that he dwells in Paradise".

However, other parts of Europe are currently a long way from Paradise. Numerous countries are experiencing a severe crisis, and many people are going through a time of great hardship. Thus, our most important challenge is to overcome the crisis, restore growth and lead Europe back to prosperity – without endangering price stability.

To achieve this objective many difficult and far-reaching decisions have to be taken. Against this backdrop, conferences such as this one are essential. After all, scientific research is a central pillar of good decision-making. Thus, I would like to thank the Banque de France for hosting this event.

This session of the conference is titled: "Fiscal Policy in a Monetary Union". What is a central banker's role in such a discussion? Well, Mervyn King once said: "Central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy." As so often, Mervyn King was right, we central bankers are indeed obsessed with fiscal policy – and German ones quite probably somewhat more so than those of a different nationality.

This obsession is driven by two interrelated observations: First, high levels of public debt harbour the risk of higher inflation. Second, sooner or later high levels of public debt are bound to hurt economic growth.

Given the high levels of public debt in many European countries, one would expect a broad consensus in favour of consolidation – and not just among fixated central bankers.

However, the reality is a bit more complex than I just implied. There are different views on the dangers and merits of public debt. In fact, we are currently observing a change of mood that has been dubbed the "austerity backlash". Some politicians claim that their countries are dying from mere austerity on its own; others convey the impression that the policy of consolidation has reached its limits. Consequently, they call for it to be postponed.

These "backlashers" argue that in the current economic situation inflationary pressure is only of limited concern. Along the same lines they argue that consolidation rather than debt hurts growth the most – at least in the short run.

In my speech I would like to discuss these two issues: first, the relationship between public debt and inflation and second, the question of consolidation and growth.

2. Sound public finances as a prerequisite for monetary policy

Public debt and inflation are related on account of monetary policy's power to accommodate high levels of public debt. Thus, the higher public debt becomes, the greater the pressure that can be put upon monetary policy to respond accordingly. Suddenly it might be fiscal policy that calls the shots – monetary policy no longer follows the objective of price stability but rather the concerns of fiscal policy. A state of fiscal dominance has been reached.

Technically, fiscal dominance refers to a regime where monetary policy ensures the solvency of the government. The traditional roles are reversed: monetary policy stabilises real government debt while inflation is determined by the needs of fiscal policy.

In the conventional view, fiscal dominance entails the famous "unpleasant monetarist arithmetic". In the words of Sargent and Wallace: "…the monetary authority … must try to finance with seigniorage any discrepancy between the revenue demanded by the fiscal authority and the amounts of bonds that can be sold to the public."[1] In their setup, fiscal policy runs a chronic primary deficit which leads to a corresponding increase in the money supply. As a simple money demand holds in the model, the price level adjusts to establish equilibrium in the money market. Put more bluntly: the central bank finances government deficits through the printing press.

Recently, however, another concept of fiscal dominance has gained much attention in the academic literature: the fiscal theory of the price level. According to this theory, fiscal policy can affect inflation even if it does not monetise public debt along the lines of Sargent and Wallace. In the words of Woodford: "Fiscal dominance manifests itself through pressure on the central bank to use monetary policy to maintain the market value of government debt."[2] The main pillar of the fiscal theory rests on the fact that bonds are claims to nominal payoffs. Now, if governments are unable to raise sufficient real resources, a new direct link arises between current and expected deficits and inflation.

Intuitively, the logic of the fiscal theory can be described as follows: Let us assume additional expenditure, for instance higher transfers, which are not financed by additional taxes but by issuing additional bonds. Consequently the value of real debt is now higher than the present value of future tax payments. Households feel richer and thus consume more, causing output and inflation to increase. Monetary policy has to stabilise real debt to avoid an inflation spiral, with the result that it responds at a rate of less than 1 to 1 to inflation, thereby violating the Taylor principle. Thus, higher inflation reduces debt in real terms and lower real interest rates reduce the real debt service burden of existing government debt.

In each of the two cases, a regime of fiscal dominance is characterised by higher inflation and probably also more volatile inflation. Monetary policy is no longer able to control the inflation rate, and therefore welfare losses will occur.[3]

However, the story does not end here. Remaining within the world of theory, we can continue as follows: because economic agents are forward-looking, it is quite possible that the consequences I have just described could manifest themselves before the economy has entered the regime of fiscal dominance. Looking ahead, public debt cannot be accumulated forever. Sooner or later, governments that run large deficits for a long period of time risk hitting a fiscal limit – a point at which government revenues can no longer be increased to stabilise government debt.

This inability to raise revenues might have economic reasons, such as a crossing of the peak of the Laffer curve. But there might also be political reasons that make it infeasible to raise taxes.[4]

Certainly, the actual fiscal limit is highly uncertain in many ways: it is a probability distribution rather than a point and depends on expectations, shocks and policy measures taken.[5] And forward-looking agents know: once the government hits the fiscal limit, either an adjustment of fiscal spending or an adjustment of monetary policy needs to occur. Otherwise debt cannot be stabilised. And as a consequence, monetary policy might come under pressure to step in and stabilise government debt.

Thus, even if fiscal policy has not yet reached its limit, the economic mechanisms attached to the fiscal theory of the price level might already swing into action. To be specific: let us assume that agents expect, with some probability, that monetary policy will bear the burden of adjustment and stabilise real government debt through higher inflation. Once inflation expectations start rising, the same might happen with inflation as well. Thus, even if the fiscal limit has not been reached, it may still affect inflation. In other words, how policy makers are expected to cope with the fiscal limit, including their efforts to consolidate, not only affects expectations concerning future policy regimes but can also affect today's welfare.[6]

Against the backdrop of this theoretical analysis, one thing should be made clear from a monetary policy perspective: policymakers should not assume that they are on safe ground just because inflation expectations are firmly anchored. Only if agents expect deviations from a "virtuous regime" of monetary dominance to be short-lived – say, because policymakers still enjoy high credibility – will inflation expectations remain well anchored. However, if agents learn that the deviation is going to last for longer than initially expected, their inflation expectations will change. And this might happen very suddenly.[7]

3. Hence, the case for consolidation

What conclusion can we draw from this theoretical analysis? Well, the right conclusion is that fiscal consolidation is crucially important to keep inflation expectations anchored.

On this basis, one could make a solid case for consolidation. For it is incumbent on governments to reduce the level of public debt. Indeed, they have to do this to promote economic growth and to ensure price stability. As Olivier Blanchard put it: we have to get out of the danger zone.

Certainly, over the past three years many countries have made great efforts to consolidate their public finances. However, the main driver of these efforts was not academic theory but profane market pressure. As Simon Nixon recently wrote in the Wall Street Journal: "For euro-zone countries facing high borrowing costs or reliant on international aid to fund their budget deficits, fiscal consolidation wasn't a choice but a necessity." And it still is.

Even so, now that market pressure has eased somewhat, so has the political will to consolidate. Many argue that consolidation has gone too far and that it will impede growth given the current state of the economy. But is that a tenable argument against the need to reduce public debt, to get out of the danger zone? Let us take a closer look at the relationship between consolidation and growth.

4. But will consolidation hurt growth?

To put my view in a nutshell: I see no conflict between consolidation and growth. And, indeed, there is not much controversy regarding the long-term relationship between consolidation and growth. Various studies have confirmed that, in the long run, solid public finances have a beneficial effect on growth – and I am not just referring to the Reinhart-Rogoff study that has received some criticism recently. Cecchetti and others, for instance, also find that high debt levels inhibit potential growth.[8]

Nevertheless, the short-term relationship between consolidation and growth is hotly debated. And this debate is currently obscuring the consensus on the longer-term effects of consolidation. This is because the debate relates directly to policy decisions and to their short-term effects on which politicians are very strongly focused. More specifically, the debate is focusing on the appropriate pace of consolidation in the current circumstances.

The discussion, therefore, is revolving around the size of the fiscal multiplier. The larger the multiplier, the greater the negative effect consolidation has on short-term growth. In general, the size of the multiplier depends on a number of factors. It depends on the specific fiscal and economic situation of the relevant country, including the size of the export sector, the exchange rate regime, trust in fiscal sustainability and the concrete design of the consolidation measures.

Recent research has highlighted the fact that the multiplier might also be state-dependent. This would imply the possibility that the multiplier is larger in a crisis. One reason for this could be that monetary policy is constrained by the zero lower bound. Another reason could be that the number of liquidity-constrained households is increasing.[9]

Empirical studies tend to find that multipliers are indeed larger in recessions and in situations where consolidation takes place during a financial crisis.[10] However, many of these studies suffer from a lack of data as deep recessions tend to be quite rare events. Moreover, the way in which such studies are set up is often rather basic and fraught with estimation challenges. Finally, there are also studies which imply that the fiscal multiplier might be smaller when public debt ratios are high and the sustainability of public finances is in doubt.[11]

Now, what does all this tell us about the current situation and the appropriate pace of consolidation? Blanchard and Leigh, in a recent working paper, suggest that the fiscal multiplier is currently larger than previously thought. Therefore, they conclude that consolidation would currently be rather costly in terms of growth and more "backloading" would be desirable. However, the data set from which these results have been obtained is rather small. Once other control variables are included and variation of the country sample is taken into account, the results are no longer robust.

All things considered, the size of fiscal multipliers seems to be subject to considerable uncertainty – both in general and with regard to the current situation. Consequently, I think we should look beyond the size of the short-term fiscal multiplier when discussing consolidation. In general, if consolidation is achieved by reducing public spending, for instance, it will enhance potential growth. In addition, consolidation will foster fiscal sustainability.

In this regard, it is important to consider how financial markets judge a country's fiscal situation and translate the results in their risk assessment. There is widespread agreement that the influence of country-specific fiscal characteristics has risen over the course of the crisis.

The current crisis is, to a large extent, a crisis of confidence – financial markets have lost their confidence in the sustainability of public finances. Against this backdrop, sustained and credible consolidation would send a clear signal. Also, with regard to political acceptance, I doubt that turning deferment of consolidation into a never-ending story will find more public support than a fairly swift correction.

And this is why I believe that determined consolidation would help convince the markets that the future fiscal position is going to be sound. This, in turn, would bring down long-term interest rates or ensure that they remain at a low level, which would be beneficial for economic growth. By delaying consolidation, on the other hand, governments would risk an increase in market uncertainty. As a consequence, sovereign bond spreads would remain high or go up even further.

5. Conclusion

Ladies and gentlemen

High levels of public debt are one of the major economic policy challenges of our times – especially from a central banker's point of view. Sustainable public finances are a necessary prerequisite for a stable currency – a prerequisite that monetary policy itself cannot create. Given that high levels of public debt also hurt economic growth, there is a solid case for consolidation.

True, in the short run, consolidation can dampen growth; that is undisputed. Nevertheless, a credible commitment to sound public finances will also inspire confidence. And confidence is what is lacking in the euro area.

Thank you.

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