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Foreword

The BIS 10th Annual Conference took place in Lucerne, Switzerland on 23–24 June 2011. The event brought together senior representatives of central banks and academic institutions, who exchanged views on the conference theme of "Fiscal policy and its implications for monetary and financial stability". This volume contains the opening address of Stephen Cecchetti (Economic Adviser, BIS), a keynote address from Martin Feldstein (Harvard University), and the contributions of the policy panel on "Fiscal policy sustainability and implications for monetary and financial stability". The participants in the policy panel discussion, chaired by Jaime Caruana (General Manager, BIS), were José De Gregorio (Bank of Chile), Peter Diamond (Massachusetts Institute of Technology) and Peter Praet (European Central Bank).

The papers presented at the conference and the discussants' comments are released as BIS Working Papers 361 to 365.

Programme

Thursday 23 June 2011

12:15–13:30		Informal buffet luncheon
13:45–14:00		Opening remarks by Stephen Cecchetti (BIS)
14:00–15:30	**Session 1:**	**The risks and challenges of long-term fiscal sustainability**
	Chair:	Øystein Olsen (Central Bank of Norway)
	Author:	Alan Auerbach (University of California, Berkeley) “Long-term fiscal sustainability in major economies”
	Discussants:	Pier Carlo Padoan (OECD) Ray Barrell (NIESR)
	Coffee break (30 min)	
16:00–17:30	**Session 2:**	**The effects of fiscal consolidation**
	Chair:	Stefan Ingves (Sveriges Riksbank)
	Author:	Roberto Perotti (Universitá Bocconi) “The ‘austerity myth’: gain without pain?”
	Discussants:	Carlo Cottarelli (IMF) Harald Uhlig (University of Chicago)
19:00	**Dinner**	
	Keynote lecture:	Martin Feldstein (Harvard University/NBER)

Friday 24 June 2011

8:00–9:30	**Session 3:**	**Fiscal policy and financial stability**
	Chair:	Patrick Honohan (The Central Bank of Ireland)
	Author:	Carmen Reinhart (Peterson Institute for International Economics) “The liquidation of government debt”
	Discussants:	Ignazio Visco (Bank of Italy) Alan Taylor (University of California – Morgan Stanley)
	Coffee break (30 min)	
10:00–11:30	**Session 4:**	**Fiscal policy and inflation**
	Chair:	Prasarn Trairatvorakul (Bank of Thailand)
	Author:	Eric Leeper (Indiana University) “Perceptions and misperceptions of fiscal Inflation”
	Discussant:	Christopher Sims (Princeton University) Michael Bordo (Rutgers University)
	Coffee break (15 min)	

Friday 24 June 2011 (cont)

11:45–13:15	**Session 5:**	**Fiscal policy challenges in EMEs**
	Chair:	Axel Weber (The University of Chicago Booth School of Business)
	Author:	Andrés Velasco (Harvard Kennedy School) "Was this time different ? Fiscal policy in commodity republics"
	Discussants:	Choongsoo Kim (Bank of Korea) Guillermo Calvo (Columbia University)
13:15	**Lunch**	
15:00–16:30		**Panel discussion** **"Fiscal policy sustainability and implications for monetary and financial stability"**
	Chair:	Jaime Caruana (BIS)
	Panellists:	José De Gregorio (Central Bank of Chile) Peter Diamond (Massachusetts Institute of Technology) Peter Praet (European Central Bank)

Contents

Fiscal policy and its implications for monetary and financial stability

Stephen Cecchetti[1]

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 liabilities 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 multifaceted nature of the interrelations between 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.

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[1] Economic Adviser at the Bank for International Settlements, and Head of its Monetary and Economic Department.

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.

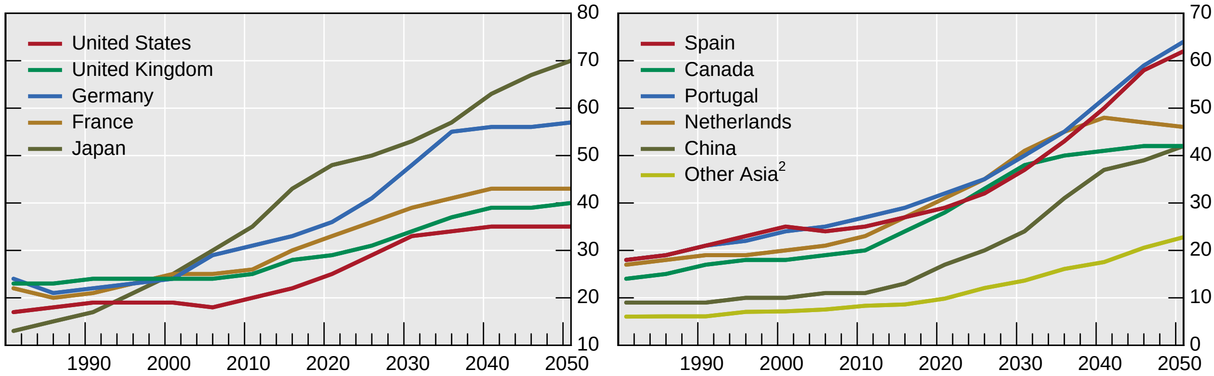
[3] J Gokhale, "Measuring the unfunded obligations of European countries", National Center for Policy Analysis, *Policy Report*, no 319, January 2009.

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 United States and 35% for Japan.

Graph 1

Old-age dependency ratio[1]

In per cent



[1] The population aged 65 years and 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.

What is terrifying in this picture is what happens over the next 30 years. Several countries are on their 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 15 years from today has already been born. Countries can play a zero-sum immigration game – something the United States 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.

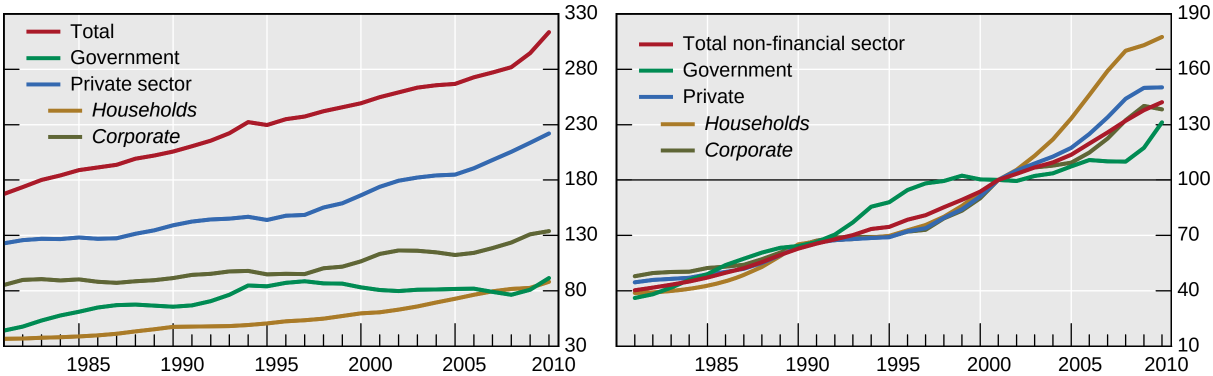
This very difficult situation is made even more complicated by the very high level of non-financial private sector debt in the affected countries. Graph 2 shows this equally frightening aspect of the current reality. For the 18 OECD countries for which we have data, household plus non-financial corporate 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 rate adjustments; (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:

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[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).

- 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 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.

The falling dollar

Martin Feldstein[1]

I am pleased and honoured by the invitation to present this year's annual BIS lecture.

My subject tonight is the falling value of the dollar. My theme is that the dollar will continue to fall over at least the next few years relative to a trade-weighted index of other currencies and that, on balance, this will be good for the US economy. Indeed, the falling dollar may be the only major economic change that can accelerate the current anaemic pace of economic recovery and prevent a new downturn in US economic activity.

As you know, the official mantra of the US government is now, and has been for some time, that "a strong dollar is good for America". I say the official "mantra" rather than the official "policy" because neither the US government nor the Federal Reserve does anything to strengthen the dollar or to prevent it from falling.

A more accurate description of US policy – and one that I have advocated in the past – is to have a strong dollar at home and a competitive dollar abroad. A strong dollar at home means a low inflation rate that maintains the purchasing power of the dollar domestically. This is clearly the goal of the Federal Reserve and one that has been achieved reasonably well over the past three decades with an average inflation rate of 3%.

In contrast, the competitiveness of the dollar abroad requires a decline in the trade-weighted value of the dollar to make US exports more attractive to foreign buyers and foreign goods less attractive to American consumers by reducing the relative price of American goods and services. The dollar has in fact fallen over the past several decades and fallen sharply in the past year despite the mantra favouring a strong dollar. And the fall in the international value of the dollar has not prevented maintaining the low inflation rate at home.

Here are the facts: In the 12 months through May of this year, the real trade-weighted value of the dollar fell 10.6% against the Federal Reserve's index of major currencies and 9.1% against the broader index of currencies that is also calculated by the Federal Reserve.

The government's willingness to allow this rapid decline of the dollar – and perhaps even to encourage it by urging the Chinese to cause the dollar to depreciate relative to the renminbi and by the Fed's policy of quantitative easing – shows that US policy is more about achieving a competitive dollar than about a strong international value of the dollar.

The same is true if we look at the dollar's performance over a longer period. Over the past 10 years, the real trade-weighted value of the dollar fell 31% against the index of major currencies and 26% against the broader index of currencies.

The future

But what of the future? There are four major reasons why the dollar is likely to continue falling for at least the next few years. Note that I am not advocating policies to make that happen. I am just looking at the fundamental economic forces that I believe will cause that continued decline to occur.

[1] Professor of Economics, Harvard University.

The primary reason is that major investors around the world want fewer dollars in their portfolios. I talk with major fund managers in Asia, in the Middle East, and elsewhere. These individuals are responsible for sovereign wealth funds and for national pension funds. A common theme in their comments about their current investments is that they believe that they are overweight dollars and want to diversify their portfolios away from that overconcentration on dollar securities.

Those governments accumulated large amounts of foreign exchange as a result of trade surpluses. In some countries this was the caused by undervalued exchange rates that led to increased exports and reduced imports. In the oil-producing countries, it was the result of the rapid rise in the price of oil. They initially regarded these foreign exchange holdings as traditional foreign exchange reserves to be held as a way of bridging future temporary gaps between the cost of imports and the country's export earnings.

Eventually, however, these countries recognised that they did not need such large amounts of foreign exchange to bridge the temporary import-export gaps that might arise in the future. Korea, Taiwan, Singapore and others with more than $200 billion in foreign exchange each came to understand that only a small portion of that was needed for the traditional purpose of foreign exchange reserves. That is even more true of the major oil-producing countries and of China with $3 trillion of foreign exchange.

Once they recognised that these were really important national investment funds, they asked themselves in what currencies they should be held, in what asset classes, in what maturities. The traditional investment in short-term US Treasury bills ceased to make sense.

So they began shifting out of the dollar and into other currencies. The primary currency that they bought was the euro. Although funds also went into the Swiss franc, the Australian dollar, the Norwegian krone and other smaller currencies, only the market for euro bonds was large enough to absorb substantial shifts of funds. The result of this portfolio shift was to reduce the value of the dollar relative to the euro and to the other currencies.

This diversification into the euro was temporarily halted by the start of the crisis in Greece and the other peripheral countries. The result was a fall of the euro relative to the dollar and other currencies. But after a while these investors realised that the problem of Greece and the other peripherals was not a problem of the euro as such but of the individual countries with excessive national debts and deficits. They concluded correctly that these problems should be reflected in the interest rate spreads and in the cost of credit default swaps rather than in the value of the euro.

So the euro began rising again, increasing from about $1.35 per euro to $1.50. The more recent confusion and uncertainty about the resolution of Greece's need for additional credit temporarily reduced the euro back to $1.43 but, in my judgment, it will start rising again. The recent reports that China has invested some three fourths of its increased foreign assets this year in euros is consistent with this pattern of renewed portfolio reallocation.

Predicting that the euro will continue to rise may seem to ignore the very high prices that anyone who now travels to France or Germany must pay. It is easy to conclude that the euro is fully valued and not likely to increase further. This casual empiricism is supported by official government calculations of purchasing power comparisons. But both bits of evidence are misleading. What matters are the prices that drive current account balances. The prices paid by tourists are only a small part of the relevant price of tradables. And the price calculations of government officials do not accurately reflect the quality differences as judged by consumers. So while government statisticians may believe that German cars are expensive relative to American cars, consumers around the world are clearly willing to buy German luxury cars at the existing high prices. That's one of the reasons why Germany has a current account surplus of nearly $200 billion. In short, the apparent high price of European goods and services is not a reason why the dollar will not continue to fall relative to the European currencies.

The second reason that the dollar will decline is the enormous size of the US current account deficit. During the last 12 months the merchandise trade deficit was $680 billion (more than 4% of US GDP) and the current account deficit was $470 billion.

Reducing the large US current account deficit can only be done by reducing the value of the dollar relative to the currencies of other countries. The United States is a major exporter with exports last year of more than $1.3 trillion. A more competitive dollar would increase the volume of exports and reduce the volume of imports.

Which currencies are able to rise relative to the dollar, leading to a decline of the US current account deficit? The euro is again the natural candidate. The euro zone represents a large capital market and has a current account deficit of only 1/2% of the euro zone's GDP. Other countries with large current account surpluses, implying that they have the room to absorb the effect of a currency increase, include China with a current account surplus of more than $300 billion, Japan with a current account surplus of nearly $200 billion (causing the yen to rise despite the problems of the Japanese economy), Switzerland with a current account surplus of $80 billion despite the strength of the Swiss franc, and the key Asian countries – Singapore, Taiwan and South Korea – that together have a current account surplus of more than $100 billion.

In short, the large US current account deficit and the corresponding large current account surpluses elsewhere provide a natural pressure for the dollar to decline relative to those other currencies.

The third reason that the trade-weighted value of the dollar will decline over the next few years is China's new goal of increasing consumer spending in China.

Although China's rapid economic growth has led to a substantial increase in the standard of living of Chinese households, the level of consumer spending has not increased as rapidly as China's overall GDP. The new 12th five-year plan calls for a rise in consumption as a share of GDP, plus increased government spending on services for consumers like health care and education.

This in turn will imply a decline in China's enormous national saving rate, estimated by some to be nearly 50% of China's GDP. Since any country's current account surplus is the difference between its national saving and its national investment (ie investment in business structures and equipment and in housing), China's very high saving rate allows it to have both a very high investment rate and a current account surplus of about 3.5% of its GDP.

If China's net saving rate falls by just 4% of its GDP, China's current account surplus will end and will change to a current account deficit. An end to its current account surplus would mean that China would no longer be a net buyer of foreign securities. Until now, China has been the largest lender to the United States to finance our current account deficit. If China will no longer be buying dollars in order to invest in dollar bonds, the dollar will fall.

Moreover, if China wants to continue to make real investments in the rest of the world – buying oil in the ground, agricultural land in Africa, businesses in various western countries, etc – it will have to become a net seller of some of the $3 trillion of foreign securities – primarily dollars – that it currently owns. That means further downward pressure on the dollar.

Although the fall in the dollar that would result from the reduced Chinese demand for dollars need not mean a fall in the dollar relative to the renminbi, the Chinese government's policies are likely to cause that rise in the renminbi-dollar exchange rate. The renminbi is of course a controlled exchange rate. The government of China has allowed the renminbi to rise relative to the dollar by about 5.5% over the past 12 months. But since the dollar was falling during this time relative to the euro, the yen and other currencies, the trade-weighted value of the renminbi did not rise over this period.

During the past year, the Chinese government prevented a faster rise of the renminbi relative to the dollar because it wanted to protect Chinese export manufacturers. But in coming years the rise in spending by Chinese consumers and by the Chinese government will substitute for the reduced value of net exports that occurs as China's current account surplus declines.

The Chinese government has been reassuring its domestic manufacturers that it will not let the renminbi jump sharply as some foreigners have advocated. But it has also made it clear that the renminbi will continue to rise and it has advocated that its manufacturers shift production to products for the domestic market.

The implication of all this is that China can now allow the renminbi to rise more rapidly. There is also a further reason why the Chinese government is now likely to let the renminbi rise faster. The increased domestic spending in China will increase demand and raise inflationary pressures. A stronger renminbi would offset this inflationary pressure in two ways. By increasing the relative cost of Chinese exports, a stronger renminbi will reduce the demand for those products and therefore limit that source of inflation. A stronger renminbi also reduces import costs, including the costs of raw materials that are used in Chinese production.

This brings me to the fourth and final reason to expect the dollar to continue declining over the next few years: the relatively low level of real interest rates in the United States. Because of the weakness of the US economy, the Federal Reserve has set the short-term federal funds rate at near zero and promised to keep it at that level for an extended period of time. Based on this promise of continued low short rates, multi-year rates are also very low. After allowing for current and expected inflation, the implied real rates are negative.

In contrast, the ECB has raised the short-term rate and indicated that it will raise it further. The ECB needs to do this in order to prevent imported inflation from food and energy prices triggering a wage-price spiral in Europe's heavily unionised economy. In the United States, real wages are declining and unions hardly exist. Since only 7% of private sector workers are unionised, there is little current danger of a price-wage spiral. So the real interest gap will widen, making investment in short-term Eurobonds of Germany or France more attractive than investment in the corresponding US bonds.

In summary then, there are four reasons to expect that the dollar will continue to decline relative to the euro and other major currencies over the next several years: a portfolio rebalancing by investors who regard their portfolios as overweight dollars, a continuing large US current account deficit, a Chinese policy to reduce net exports, and interest rate differences that make dollar investments less attractive.

It is of course impossible to say how fast the dollar will decline. Although it may fall only gradually, it could continue to fall at the 10% rate of the past 12 months or even faster if the holders of large dollar investments want to exit their positions to avoid the losses that will result from the dollar's decline.

How likely is that? China is of course reluctant to reduce its dollar position rapidly because of the adverse effect that that would have on the dollar-renminbi exchange rate. In contrast, smaller countries and private investors could shift from the dollar to other currencies without causing a significant impact on the value of their dollar exchange rate. But if each of these countries – Korea, Taiwan, etc – wants to move before selling by others causes the dollar to decline further, the cumulative effect as they all try to do so could be a sharp decline of the dollar. And if China sees that coming, it might want to move more rapidly to shrink its dollar position.

The effect of the dollar decline

A declining dollar would have a powerful positive effect on the short-run performance of the US economy. A continued decline of the dollar will raise the current annual exports of more than $1.3 trillion and will induce American consumers to shift from imports to American-made products and services. Although exports are less than 10% of US GDP, more than one third of the increase in US GDP over the past four quarters was accounted for by the increase in exports.

Without a boost to demand from a future increase in net exports, the American recovery is likely to remain weak and could run out of steam, leading to a new downturn of GDP. Although the US recession officially ended in the summer of 2009, the expansion since then has been very weak. In the first three quarters of 2010 GDP grew at an annual rate of just 2.7% and more than half of that increase was just inventory accumulation rather than final sales. Although the fourth quarter of last year saw a temporary surge of consumer spending, this improvement of final demand and GDP did not follow through in the current year.

The annualised rate of growth fell from 3.1% for the fourth quarter of last year to just 1.9% for the first quarter of 2011. Moreover, two thirds of this first quarter GDP increase was just inventory accumulation. Final sales rose at an annual rate of only 0.6% or a quarterly rate of just 15 basis points, very close to no increase at all.

Even this understates the extent of the slowdown in 2011. Private estimates of monthly GDP by Macroeconomic Advisers indicate that the level of GDP actually fell between December of 2010 and January of 2011, and then fell further in February. March was the only positive month in the first quarter. The average level of GDP was 0.6% higher in the first quarter than in the previous one only because December was a strong month, allowing GDP to fall after that and still be higher for the first quarter as a whole than the average of the previous quarter.

The data for April and May showed renewed weakness with a rising unemployment rate, a sharp fall in employment gains, lower real weekly earnings, reduced retail sales and industrial production, declines in business and consumer confidence, a continued collapse of housing prices and the first decline in the index of leading indicators since early 2009, before the upturn began.

Without a dollar decline the near-term outlook is very negative. A decline in the value of the dollar can change this significantly. Cutting the US trade deficit from the current level of 3% of GDP by 2 percentage points of GDP would provide an initial demand stimulus equal to 2% of GDP. This would be more powerful than a comparable size fiscal stimulus and would provide that stimulus without adding to the national debt. It would also provide more stimulus than anything that the Federal Reserve might do at the current time.

There are of course also negative effects of a falling dollar. The unambiguously adverse effect is to reduce the real value of any given level of personal incomes by raising the cost to households of the imported products that they consume. The magnitude of this effect is substantial but should not be exaggerated. Since imports are only 16% of GDP, a 20% cumulative fall in the dollar would reduce real incomes by no more than about 3%. Even this overstates the adverse effect of the weaker dollar on real incomes since various imports are either priced in dollars (like oil) or experience adjustments in the foreign currency price as foreign exporters seek to offset the adverse effect of the weaker dollar on their exports.

The other adverse effect of a lower dollar is to create inflationary pressure. Again, the effect is relatively small. A 10% annual fall of the dollar would raise the price level and the rate of inflation by less than 2%. Given the state of the labour market, this would only affect the price level and would not be the beginning of a price-wage spiral.

In conclusion, there would be both strong positive effects of a dollar decline on aggregate demand but also adverse effects on real incomes and on the price level. If I am right, the decline of the dollar during the next few years is not a matter of choice to be decided by weighing the advantages and disadvantages of a lower dollar. It is something that will happen. We will see a continuing decline of the dollar and with it a greater hope for a stronger economic recovery.

Introductory remarks for the panel session on “Fiscal policy sustainability and implications for monetary and financial stability”

Jaime Caruana[1]

This is the last session of a very interesting conference in which we’ve heard a fascinating range of opinion and argument on the future of fiscal policy. In this panel, we have the opportunity to listen to a group of extremely experienced practitioners – who need no introduction – and to learn their views on “Fiscal policy sustainability and implications for monetary and financial stability”.

Let me introduce the discussion by putting five questions that to my mind emerge from the papers presented yesterday and this morning. Panel members are not in the least constrained to answer these questions.

The first question, related to Alan Auerbach’s remarks on the urgency of adjusting fiscal policy immediately in many developed countries, is: How best to address the risks of long-term fiscal sustainability?

Related to this point, and drawing on Roberto Perotti’s comments about the timing, gradualism and flexibility of fiscal consolidation, is the second question: How do we balance the urgency of fiscal consolidation with the need to safeguard the recovery?

My third question is prompted by Eric Leeper’s discussion of the possible inflationary effects of public debt: What are the possible channels through which falling confidence in the management of public debt could produce inflationary consequences?

The fourth question, based on the work of Andrés Velasco, is: What kind of rules or institutional arrangements can add to the effectiveness of fiscal policy in small open economies?

My last question is prompted by Carmen Reinhart’s reminder that financial repression is not so uncommon: What should be the role of fiscal policy in achieving financial stability? Is it sufficient to think about fiscal policy in the traditional way – that is, to leave monetary policy independent and to smooth the economic cycle mainly through fiscal stabilisers?

I am very much looking forward to hearing the panel’s opinions – and, in particular, their views on the future of fiscal policy and its interactions with monetary and financial stability. I will not introduce the speakers because they are already very well known to you. Following the seating order, I will first ask José De Gregorio to make his presentation.

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Challenges for fiscal policy during turbulent times

José De Gregorio[1]

Thank you for inviting me to participate in this panel. It is also an honour to share this panel with my former professor Peter Diamond, who unfortunately will not be a central banker owing to problems in his confirmation by the US Congress for "lack of monetary policy expertise". This is really incomprehensible, and it shows that the irrationality of politicians afflicts not only less developed economies but also the most advanced economies.

It is difficult to add further insights after two days of very interesting discussions on fiscal policy and its relationship with monetary policy, and on issues such as commodity booms, financial stability, and sustainability. My plan is to talk first about the state of the world economy, which sets the stage for discussions of fiscal policy, and then I would like to talk in more detail about fiscal policy around the world.

The world economy

In the last few months the world economy has deteriorated. The big issue right now is whether we are in a "soft patch", caused by high oil prices and disruptions in the supply chain stemming from the earthquake in Japan, or if we are facing a more persistent deterioration – a "double-dip" or a phase of non-recovery. This currently a problem mostly for the advanced economies, but the repercussions for emerging markets could also be very relevant. In emerging markets, we have experienced many recessions coupled with financial crisis, and they are different from the usual cyclical downturns faced by industrial countries. Recessions are much more costly when combined with a financial crisis.

Domestic demand is growing slowly in advanced economies, particularly in the US. It is likely that this weakness will continue due to excessive levels of debt. Households face a debt overhang, and prospects for recovery are gloomy. Cautious consumers threatened by high unemployment cannot provide a source of increasing domestic demand. Recovery is much slower after a financial crisis, as the balance sheets of economic agents need to be repaired.

From a policy point of view, advanced economies are hampered by a lack of instruments to provide macroeconomic stimulus. Monetary policy rates are at minimum levels or close to them. Meanwhile, fiscal policy has little room for manoeuvre given the problem of sustainability.

Implications for advanced economies

I would like to emphasise two concerns from our discussions over these two days. First, although there are many historical examples of expansionary fiscal contractions, we have learned from Roberto Perotti's research that the conditions needed for them to spur economic activity do not hold today. Therefore we can conclude that any fiscal retrenchment at this juncture will be contractionary. Second, we learned from Eric Lepper's presentation

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that many countries may be entering into an “F” regime, in which monetary policy is subordinated to monetary policy, and that this could become particularly problematic for the credibility of central banks that are committed to an inflation target, limiting their ability to conduct expansionary monetary policy.

What are the current challenges for fiscal policy in the world? The starting point is heterogeneous. There are countries that are in an extremely weak position, where servicing current debt is clearly unsustainable. The clearest case is Greece. Fiscal consolidation is needed; increased taxes and lower expenditure are the only way to make debt levels sustainable. Although undesirable from the point of view of growth, there is no space for further stimulus and growth should come from structural reforms that ensure competitiveness. This will take time, as evidenced by the experience of many emerging economies in the postwar period. Perhaps the most similar case is the early 1980s debt crisis in Latin America. It was long and costly. Moreover, in the euro zone, the problem is more acute since exchange rates cannot help the adjustment. Markets know this and increase the risk premium, making the sustainability problem even more acute.

However, adjusting the primary balance is not enough, since the magnitude of the adjustment is clearly not feasible given the ensuing decline in demand. Some reduction of public debt is needed. Excessive public indebtedness cannot be solved with more debt. Moreover, creditors that made a poor decision of lending to sovereigns beyond their capacity to service the debt should also bear the cost. This adjustment can take the form of “re-profiling”, “re-phasing”, “private sector involvement”, or plain default. The longer this is postponed, the more likely becomes a messy default. This will not only damage the economies in trouble, but will also create severe contagion effects throughout the euro zone. We cannot rule out a case of multiple equilibria in which contagion increases the cost of financing to levels where current debt levels become unsustainable.

Fiscal positions in many countries are vulnerable to market sentiment and economic performance. Low growth may further erode the fiscal position. Central banks can act as lenders of last resort to governments that are finding it difficult to borrow. This is an issue that was discussed with insight by Guillermo Calvo. Buying public debt, or even some toxic assets, is not, of course, part of normal monetary policy, but represents central banking under extreme conditions. In normal times, central banks should only provide liquidity against good collateral, and conduct open market operations without bearing credit risk. But the purchase of risky assets (or the acceptance of them as collateral) may be necessary during emergencies. However, these actions entail serious risks that must be taken into account. Beyond the subordination of monetary policy to fiscal policy needs, central banks may become trapped in their conduct of monetary policy. Raising interest rates against the prospect of higher inflation increases the cost of borrowing, and could erode the central bank’s balance sheet of the central bank if it holds public debt.

Another challenge for fiscal policy in advanced economies is the impact that changes in the global economy may have on fiscal sustainability. Let just consider one example of the additional complications that may arise. Suppose that the world goes through a much-needed global re-balancing and that, as part of this adjustment, commodity exporters’ and emerging markets’ currencies appreciate further. Interest rates may rise and there could be a lack of demand for advanced countries’ public debt. Who will buy the debt from the advanced economies? And what are the implications of higher world interest rates on fiscal sustainability?

As these remarks show, the challenges for fiscal policy in advanced economies are enormous, and a poor resolution of the sovereign debt problem could have disastrous consequences for the world economy.

Implications for emerging markets

Fiscal policy across emerging markets is much sounder than in the industrial world, but the global financial crisis has also driven home lessons on the conduct of fiscal policy over the business cycle. Of course, there are also some cases of fiscal weaknesses, in particular those that are concealed by good fiscal results stemming from a strong cyclical position or high commodity prices. However, I want to focus on countries with sound fiscal policies. This is, for example, the case in Chile, which has had a prudent fiscal policy for more than 20 years.

After many years of lax fiscal discipline that led to procyclical fiscal policies which magnified recessions, emerging markets have made serious progress on the fiscal front. This is true of most Latin American countries, even those that were once famous for fiscal profligacy. As Cespedes and Velasco argue, the commodity price boom has been much better managed than in the past.

During the financial crisis, fiscal policy was allowed to be expansionary. This, together with monetary expansion, let emerging markets mitigate part of the external shock and sow the seeds for a strong recovery. The fiscal balance deteriorated not only for cyclical reasons, but also because expansionary fiscal programmes were implemented.

Nevertheless, the current challenge for policymakers in emerging markets is how to manage a rapid recovery, given the resumption of capital inflows, and the pressures on their currencies. From the fiscal point of view, this requires withdrawing the fiscal expansion, and this has not happened at the speed required. The reason is that many avowedly temporary fiscal programmes have become permanent. To make fiscal policy more flexible, temporary expansions of government expenditure should be implemented through automatic stabilisers. The issue today is that, given a deterioration of the global economy, more macroeconomic stimulus could be necessary, but the space for implementing that fiscal expansion may be more limited than before due to the partial adjustment that has taken place after the crisis.

Challenges for fiscal policy in the US

Peter Diamond[1]

I will touch on two topics relevant for US fiscal policy: stubbornly high unemployment and the long-run debt issue. Addressing these issues should incorporate concern as well for the quality of spending and taxing. While raising the debt limit has great importance and has the potential to impact other issues (for better and worse), I will not address it as anything written now will be out of date by the time it reaches readers.

I. Unemployment

The Fed has very little left with which to address this problem and it has announced that, other than by holding on to its portfolio, it will not do much. And I think that, by and large, it can't do very much. So if the US is to address its stubbornly high unemployment, we want more fiscal stimulus. In the eyes of many, including Marty Feldstein and Paul Krugman, the first fiscal stimulus bill was too small.

In judging the size of the fiscal stimulus, it is necessary to consider a counterfactual – what would have happened with a different size bill (perhaps zero). That we still have high unemployment does not say anything about whether it would have been even higher without the fiscal stimulus. Many analysts with macro models estimate that it would have been much higher. Similarly, the fact that the Obama administration was overoptimistic about what would occur after the stimulus also does not answer the questions of whether it helped and whether a larger stimulus would have helped more.

It seems to me that we need more fiscal stimulus, and certainly not an overall reduction in stimulus, as may happen when the previous stimulus phases out and is threatened by some proposed short-run spending cuts to address the long-run debt problem. Of course, some spending can be cut back and some taxes increased along with other actions that are more than fully offsetting from a stimulus perspective. In considering the mix of actions, it is appropriate to pay attention to both macro and micro dimensions – how much stimulus occurs with different policies relative to the direct increase in deficit and how valuable is the increase in consumption and/or investment that is accomplished as a consequence of the stimulus. The US has an enormous backlog of infrastructure needs. If an investment will be made eventually anyway, it is cheaper to do it at a time when you're drawing in part from idle resources and when you will get a multiplier of some kind.

An increased stimulus can make a critical start on addressing high unemployment, but it can't deal with the problem alone, because some of the increased unemployment is structural. As we've had a sudden large increase in unemployment, the bulk of it is not structural – the quality of matching of workers and jobs just does not deteriorate that quickly for structural reasons. First, an unusually large fraction of the unemployed is long-duration unemployed. It is well documented that it's hard for them to come back to work, so down the road this is a problem. There are some estimates of the current size of this impact that I think make very little sense. Looking just at individual job finding, some estimates are essentially built on the assumption that employment equals labour supply, so that when you get an

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extension of unemployment benefits, this calculates out as less labour supply. But when you have a very high ratio of unemployed to vacancies across all industries, and you reduce the willingness of a fraction to take jobs, that may have little effect on the availability of the unemployed to fill the jobs. Thus, it's not clear that benefit extension is a significant short-run issue, but in a longer run it is.

Second, we overbuilt both residential construction and commercial construction. That will affect further construction for an extended period. This calls for some reallocation of labour, at least on a temporary basis, which affects the efficiency of the labour market. Third, small businesses are growing more slowly compared to large businesses than traditionally. I think part of that is that lending by small banks has been tightened a lot. Large firms are sitting on a lot of money and can tap the bond market directly, but small firms are heavily reliant on banks. Moreover, a lot of small business startups rely on accumulated wealth as well as borrowing. For many potential entrepreneurs, their wealth is mostly housing, and much of that is gone. So while we do have a significant scope for an aggregate-demand increase to reduce unemployment, I think we should approach it somewhat cautiously, not relying on it exclusively or excessively.

II. Long-term debt

Carmen Reinhart showed us the history of the debt-to-GDP ratio in the US in the last century, a pattern that broke down in the late 1970s. Until then, the ratio rose sharply in wars and depressions, and trended down afterwards. Had Carmen included the 19th century in her chart, we would have seen the same pattern after the Revolutionary War, the Civil War, and some of the depressions. So there was a big break starting in the late 1970s. The 1980s and 1990s saw several legislative attempts to address the size of the debt, legislation that did not work in the 1980s but did in the 1990s. So a key issue in projecting the future of US debt is the kind of politics the US will have.

Alan Auerbach showed us the Congressional Budget Office baseline, which is focused on current law and does not reflect that Congress regularly undoes some parts of current law, including the sunsets of some tax reductions.[2] For example, the lapsing of all of the Bush tax cuts would raise a great deal of money. But that is not expected to happen. The Alternative Minimum Tax is projected to affect a rising fraction of the public, but again, that is not expected to happen as annual fixes are expected. Another example is that Congress regularly votes for some harsh cutbacks in Medicare payments to providers, and then delays them, putting them in place to start later on.[3] Alan also showed us the debt projection under a more realistic policy-as-usual projection, showing a much more serious problem. Eventually, continuation of this policy as usual would become unsustainable. It is not clear when "eventually" would occur, but absent a debt-limit triggered response, I don't think that continuing policy as usual will trigger a large bond market reaction for an extended period. If the debt trend does continue with no apparent change in politics, then at some time, the bond market will respond based on the debt level and the political forecasts at the time. The stock market may well react sooner than the bond market does.

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[2] An exception to this approach is the scoring convention for Social Security. By law Social Security can not borrow and can only pay benefits from accumulated and present revenues. Yet the CBO projection includes benefits without the limitation this imposes.

[3] In contrast, the Social Security payroll tax had future tax rate increases on the books from the beginning until 1990. While these increases were sometimes delayed, they were never cancelled.

While we can hope the US will simply go back to policies resembling the earlier, longstanding policy of trend reductions in debt/GDP, that hope seems extraordinarily weak. Thus there are proposals for legislation that attempt to alter this pattern as part of the discussion of increasing the federal debt limit.

Ideally, in the near term, the US would put into place something that will impact the debt significantly, something that moves in slowly so as not to worsen unemployment (or even better lowers it), something that handles the commitment issue, something that is not likely to be done and then undone, and something that does not have bad effects. Restoring actuarial balance to Social Security has the potential to be a perfect contribution to the debt problem.

Social Security is money in and money out. Everybody who looks at it understands how it works. We have good estimates of the behavioural responses to changes of its parameters. Everyone agrees that we have a Social Security problem, even if we didn't have a debt or overall deficit problem. The system's trust fund is scheduled to run out of money in 2036 according to the latest projection. Of course the payroll tax revenue will continue to flow in, so that benefits would need to be cut by a quarter, not to zero. And, everyone agrees that when you fix Social Security, you need to phase it in slowly.[4] If we fix Social Security, we are very unlikely to undo it.[5] So it's the perfect thing to do. It has a significant effect on debt held by the public in the long run, it has no significant tightening effect on the economy in the short run, and it has little or no commitment problem. [6] If it is a well designed reform it also passes the test of good spending and revenue increases and so is worth having.

There is the possibility that this might be a (relatively) good time to try to fix Social Security. Fixing Social Security involves raising taxes and/or lowering benefits, both of which are very hard to do before Social Security faces an imminent crisis. That this might be a good time to fix Social Security comes from heightened concern about the long-run debt held by the public and a relatively good ability to address one of the two major issues in trying to reform Social Security. The harder issue is what mix to have between additional revenues and decreased spending. To get the 1983 Social Security reform, President Reagan and Speaker of the House Tip O'Neill agreed it would be 50/50, and set a committee to work that out. Congress stayed fairly close to balance, but not right on it. Part of the change was to introduce taxation of benefits, which hadn't been there before, with the revenue going back to Social Security. The Republicans claimed that that was a reduction in benefits, and they negotiated well and got more than 50% on the benefit side. The Democrats claimed that was taxation, so they got more than 50% on the revenue side. So, everyone was sort-of happy. Finding an acceptable mix remains a serious problem and we need to find a mechanism for addressing it.

The second issue that has held up reform since 2000 is whether to use existing payroll tax revenues for individual accounts. I assume that this idea is now mostly dead, because one of the essential consequences of diverting payroll tax revenues from the trust fund, which holds public debt, to individual accounts with diversified portfolios is an increase in the debt held by the public. Instead of the payroll tax revenues flowing into the trust fund for purchase of government debt, some revenue goes to purchase stocks and corporate bonds, resulting in

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4 Although one exception is the proposal to lower the cost of living adjustment, which would presumably kick in rather quickly and which I think would be bad Social Security policy.

5 The US got a pretty good fix out of the 1983 reform of Social Security. If you run 50 years off a piece of legislation without having to make significant changes, you've done a pretty good piece of legislation, even if it didn't run the 75 years it was aiming for.

6 For example, the reform proposed in my book with Peter Orszag would have reduced debt held by the public by 25% of GDP by 45 years after enactment.

more debt that gets sold to the public.[7] Some proposals have had massive implied increases.[8] I think that add-on voluntary individual accounts could be something that everyone could be comfortable with.

Could we get an agreement on a split between revenue increases and benefit cuts? That is looking particularly hard with the kind of politics we have seen around raising the debt limit. One possibility is to set up a commission, similar to the Base Closing Commission, whose report (with a sufficient majority) would receive special congressional rules requiring an up-or-down vote and not allowing a filibuster. The instructions to the committee would first have them separate out the contribution to restoring actuarial balance chosen by the commission from coverage expansion (any increase in the taxable maximum or coverage of state and local workers). Since coverage expansion increases both revenues and benefits, it is not really part of distinguishing between actions that directly increase revenues or reduce benefits. The remaining deficit would be covered by increases in revenue and decreases in benefit expenditures, with a requirement that the commission hit a required balance of the latter two. Unlike changes in spending and revenues that have many parts, the public could fairly readily understand what it would mean to refuse any revenue increases or to refuse any benefit cuts. Neither position is viable for a plan to rescue Social Security from its projected imbalance. And polls have shown the public wants a balanced Social Security reform, suggesting that there would be sufficient pressure on Congress to reach a legislated balance.

In contrast to fixing Social Security, addressing healthcare costs, the elephant in the room, has none of these traits. We don't understand how to make it work better. We do understand how to shift costs from the government to the private sector, but we not only have a healthcare problem for the federal budget, we have a healthcare problem for state and local budgets, we have a healthcare problem for Americans. We have a system that doesn't work well and learning how to fix it is going to take experimentation, evaluation, and repeated corrections. And we have a repeated history of undoing previous legislation.

The idea that anyone today knows the right level of spending on Medicare 10 years from now is silly. Maybe we will learn how to lower costs while improving quality and should spend much less. Or maybe there will be valuable but expensive scientific breakthroughs or some terrible new disease and we should spend an even larger fraction of GDP. Medicare legislation is an annual affair because we have limited understanding of the effects of changing rules and changing spending. These considerations make Medicare a poor candidate for including distant spending patterns as part of addressing today the future debt problem, even though Medicare is one of the big spending items today, and projected to get even larger.

While a future Congress could correct today's faulty choice of future spending by new legislation, that process is subject to the familiar checks and balances that can make it hard to get legislation passed unless both parties see room for improvement from the default spending level. With only spending on Medicare in the legislation, one party or the other may make it hard to change the level of spending when good policy calls for more or for less. For a default to lead to good outcomes, it would help for the default to contain elements neither party likes. If neither party likes the default, there will be an incentive to legislate around it, to make explicit choices on spending and taxes, rather than letting the default kick in. And if

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7 For example, the proposal from the Bush administration would have added 19% to the debt-to-GDP ratio by 2050.

8 For example, the proposal by Congressman Ryan and then-Senator Sununu would have added more than 90% to the debt-to-GDP ratio by 2050.

both parties are going to dislike the default, it probably needs to work on the tax side and the spending side simultaneously.

As part of dealing with the long-run debt problem, I think it's important to realise that the US has some programmes that work very well and ought to be expanded, and some programmes that don't work very well and ought to be contracted or closed. So anything that ends up with across-the-board percentage cuts is not going to do well at addressing the inefficiencies in spending. Similarly, if we just raise all of the marginal tax rates and don't make changes to the tax code, we won't resolve the inefficiencies in the tax structure.

By itself, of course, a second round of stimulus would add to long-term debt issues, so one would hope that we would get a package, something that would address long-term debt issues in ways that are not significantly contractionary in the short run, at the same time that something expansionary is done in the short run.

Economic, financial and monetary stability in Europe: reinforcing our policy instruments

Peter Praet

1. Fiscal sustainability and its implications for monetary and financial stability in the euro area

The recent crisis has led to a severe deterioration of public finances in most industrialised countries. Governments in the advanced countries came out of the recession with the highest deficit and debt-to-GDP ratios since World War II. In the euro area, deficit and debt numbers surged. According to the European Commission, the euro area general government deficit increased from 2.0% of GDP in 2008 to 6.0% of GDP in 2010. The euro area general government debt, after declining to around 66% of GDP in 2007, is projected to increase to almost 88% of GDP in the current year. For some individual euro area and EU countries – but also for the US and Japan – the fiscal deterioration has been even worse. Fiscal consolidation in many euro area countries started in 2010 and according to the EC Spring 2011 Forecast it is expected to bring the euro area general government deficit down to 3.5% by 2012.

In many cases fiscal problems in euro area countries have their origin in unsound fiscal policies that were already in place before the crisis. Fiscal positions also deteriorated because many euro area states missed several opportunities during favourable macroeconomic times before the crisis to cut public deficits and debt faster, and create margins to let automatic stabilisers operate freely. In 2007, one year before the start of the crisis, the euro area deficit was 0.7% of GDP and debt remained well above the 60% of GDP threshold.

We should, however, not forget that in the recent crisis fiscal policy faced a double challenge. On the one hand, it had to address the sharp contraction in economic activity. Many governments adopted fiscal stimulus packages to soften the real economic impact of the crisis. On the other hand, governments had to rescue financial institutions and counter the risk of a financial system collapse. Deteriorating fiscal positions stemming from government support measures to the banking sector – as particularly in the case of Ireland – have highlighted the linkage between financial sector stability and public debt and deficit levels. The fragility of a large multinational banking system can have a severe impact on public finances that were previously perceived to be sound.

The impact of a banking crisis – even of a large, cross-border nature – ultimately has to be absorbed by national budgets. The euro area has so far lacked integrated regulatory, supervisory and resolution institutions for the financial sector at European level. Such Europe-wide institutions could mitigate the risks of the link between multinational banking systems and public finances by closer and better regulation and supervision of systemically important financial institutions. More fundamentally, there is an urgent need for a European resolution framework.

Fragile public finances can also have serious implications for the stability of the financial sector. Public debt is commonly held as a low-risk asset by financial institutions and it is also used as collateral in refinancing operations, for example. When the financial markets doubt the sustainability of public debt, the liquidity and even the solvency of financial institutions can deteriorate, in turn potentially destabilising the financial sector.

Operating under such forms of “fiscal stress” can also put a central bank in a difficult position. If in a situation of sustained financial instabilities stemming from distressed financial institutions or sovereigns, the delegation of fiscal tasks to monetary policy endangers the central bank's primary mandate of ensuring price stability. A central bank may find itself overburdened with the task of providing sufficient liquidity to the financial sector on the one hand, and maintaining sufficient independence and operational capability to ensure price stability on the other hand. In the long run, the credibility of the central bank's commitment to price stability may be called into question. Thus, to avoid the build-up of excessive risks on the central bank's balance sheet and to avoid the creation of adverse incentives in the financial markets, all non-standard measures by a central bank must remain exceptional and temporary. Moreover, the support of insolvent financial institutions or sovereigns is clearly a task for fiscal authorities, not the central bank.

In the euro area, the ECB accordingly lends to its counterparties against "adequate collateral" in accordance with Article 18.1 of its Statute in order to ensure protection of the Eurosystem from losses in the conduct of credit operations. If the adequacy of the sovereign collateral is called into question, however, this would make it difficult for the central bank to perform its role of providing sufficient liquidity to the financial sector.

All of this points to the conclusion that we require clear policy tools to pursue economic, financial and price stability.

First, the independent central bank has to be mandated to ensure price stability. At the same time, it should take due account of the implications of asset price developments for medium- to longer-term risks to price stability. Second, fiscal policy – in general, but particularly in the euro area – has to be conducted in a way that ensures sound public finances at all times. This will allow national governments to effectively let automatic stabilisers counteract business cycles. To this end, public debt has to be put on a sustainable path and balanced positions have to be reached such that fiscal policy has sufficient margins to operate even in severe economic crises. Margins also prevent pressures on the central bank to use monetary policy for economic stimulus purposes rather than price stability in the case that fiscal leeway is exhausted. The original Stability and Growth Pact, with the objective of balanced budgets in normal times and its deficit and debt limits, would have provided such margins for all but the most extreme scenarios. And third, macroprudential policy, if well designed, would not only mitigate the downside tail risks in financial markets – reducing the hazard for fiscal and monetary policy – but also moderate the amplitude of financial cycles.

2. Reinforcing fiscal and macroprudential policy instruments in the euro area

This brings me to the reform of the euro area's economic governance framework. I think we can agree that the economic governance framework was insufficient to ensure economic policies in the euro area countries that were commensurate with the requirements of a monetary union. The Stability and Growth Pact was not implemented to a degree that would have ensured sound fiscal policies in member states. We also lacked tools for preventing the emergence of large and persistent divergences in competitiveness among the euro area countries, and this led to large and unsustainable imbalances within the currency union.

Against this background, the ECB has welcomed the European legislation on its way to implementation as a step in the right direction of broadening and strengthening the existing framework for fiscal and macroeconomic surveillance in the EU. However, the ECB's Governing Council is untiring in its efforts to remind policymakers that more is needed if the economic governance reforms currently being discussed in European legislatures are to ensure the euro area's fiscal and, more broadly, macroeconomic sustainability. It cannot be said often enough: we need more speed and automaticity in the sanctioning mechanism, particularly in the Stability and Growth Pact, but also in the broader macroeconomic policy surveillance framework. The experience of the past months has vividly demonstrated the importance of a timely correction of internal and external imbalances. The enforcement tools within the governance framework need to be more effective, leaving as little room for discretion as possible. Requirements for fiscal and other macroeconomic indicators should be more ambitious. Finally, the implementation of sound policies is best ensured if these are solidly anchored at the national level, which calls for strong national budgetary frameworks in the euro area member states.

We have also made progress in the area of macroprudential supervision in Europe and in the international policy forums. As you know, stricter banking regulations and more ambitious capital requirements to absorb losses have been devised. These should increase coverage, reduce incentives for excessive borrowing and make capital buffers more countercyclical. At the same time, the organisational structure of financial oversight has been overhauled. The ESRB – the European Systemic Risk Board – has been set up to warn and make recommendations as regards systemic risk. And the ESAs – the European Supervisory Authorities, comprising the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) – will closely monitor Europe's financial markets.

However, more also needs to be done in macroprudential supervision. First, we need to ensure that the envisioned reforms are fully implemented at European and international level. And second, as the ECB has repeatedly pointed out, more progress has to be achieved in other areas, including the treatment of systemically important financial institutions, the oversight of the shadow banking system, and the further regulation and oversight of financial markets and their functioning.

Given the link between the stability of the financial sector and the solvency of sovereign member states, I personally believe we should consider going a step further in the euro area. We should seriously consider a European banking resolution mechanism that could address banks in distress and break up this dangerous link.

In summary, the reformed economic governance system of the euro area should provide effective and well defined tools to ensure economic and financial stability. To this end, we need to strengthen the fiscal and macroeconomic governance framework in the euro area. We need to implement and further strengthen the macroprudential supervision framework at European and at global level while at the same time continue to ensure price stability in the euro area.