Stefan Gerlach: Fiscal imbalances and monetary stability

Address by Mr Stefan Gerlach, Deputy Governor of the Central Bank of Ireland, to the German-Irish Chamber of Industry and Commerce, Dublin, 28 September 2012.

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1. Introduction

I am delighted to be here today. Let me start by acknowledging the important work the Chamber has undertaken since its establishment in 1980 in promoting closer links between Irish and German companies. As you may know, in terms of trade with the EU, Germany ranks jointly as the 2nd largest market for Irish exports, and is the 3rd largest source of Irish imports.[1] Our close economic links with Germany are important, particularly in the present environment in which the German economy continues to grow and absorb our exports.

Today I will speak on fiscal imbalances and the problems they create for monetary policy. One of the most visible outcomes of the current sovereign debt crisis is that fiscal deficits and public debts have become very large in many countries inside and outside of the euro area. Given the severe economic difficulties that Ireland and a number of other economies in the euro area have been experiencing in the last few years, these issues have been prominent in the public debate. Since it is difficult to reduce fiscal imbalances quickly, it is clear that pubic debts will remain large for the foreseeable future. It is therefore timely to talk about why they matter and what concerns they raise for central banks.

In my remarks I hope to shed light on just how large fiscal imbalances currently are in many countries and what concerns such imbalances raise for central banks. I will then review a number of institutional arrangements in force in the euro area that are intended to limit the need for government borrowing and that prohibit the ECB from lending to governments. I will also reflect on how these large debts are likely to be reduced.

2. The state of public finances in Europe and in Ireland

Let me start by reviewing how debts and deficits have evolved in Europe over time. Across the euro area, average general government deficits rose from less than 1% of GDP in 2007 on the eve of the crisis to more than 6% of GDP in 2010 (Figure 1). In the same period, the average debt ratio rose from 66% to 87% in 2011 (Figure 2). For some euro area and EU countries (and also for Japan and the US) the deterioration has been even more pronounced. Between 2007 and 2010 increases in debt ratios of 30% of GDP or more were recorded in Ireland, Greece, Latvia, Iceland, the UK, the US and Japan. Annual deficits larger than 7% of GDP have also been recorded in several countries including Greece, Spain, Portugal, the US and the UK.

Specifically, Irish general government debt rose from below 25% of GDP in 2007, which was much below the 60% limit of the Maastricht Treaty, to over 106% of GDP in 2011, and is projected to rise until 2013. In the same period, the headline balance deteriorated from a surplus of 0.7% of GDP in 2007 to a peak of a staggering 31% of GDP in 2010 (of which about two-thirds was related to banking support measures). In 2011 the deficit was almost

[1] Of total exports (goods and services) to the European Union, 17% go to the United Kingdom, and 9% to each of Belgium and Germany. On the imports side, 19% come from the United Kingdom, 9% from the Netherlands and 5% from Germany (based on CSO data).

13% of GDP.[2] Therefore, unfortunately, in spite of nearly 16% of GDP in budgetary adjustment measures undertaken since 2008, a deficit of 8.3% is projected for this year, falling slightly to 7.5% for 2013.

Three factors have led to the rapid increase in public debt in the wider European context. First, the large recession triggered by the financial crisis has led tax revenues to be much weaker than projected. To mitigate this effect, governments have raised tax rates and relied on one-off revenues. In spite of these efforts total revenues as a share of GDP have remained relatively flat (Figure 3). Second, the recession has led to higher expenditure on unemployment support and welfare spending. Between 2000 and 2010, social transfers as a share of GDP increased by 4.2% in Ireland, more than the euro area average of 1.8%. Third, governments in some countries have been faced with large bills for rescuing troubled financial institutions. In the euro area at end 2011, spending on banking support measures constituted 4.9% of total gross government liabilities outstanding, with impacts of more than 6% of GDP recorded in Ireland, Germany, Netherlands and Belgium.[3] In Ireland the gross debt-worsening impact of bank-related outlays over 2008 to 2011 amount to almost 47 billion euro or 30% of GDP, a truly staggering number. Of course, this figure could have been smaller had loss-sharing with bank bondholders been greater. While burden sharing with subordinated debt-holders eventually totalled over 10% of GDP, further sharing was prevented initially by the breadth of the original government guarantee and subsequently by the Programme agreement.

3. The adverse effects of public debts

Why are central banks so concerned about large public debts? There are several reasons.

3.1 Debts and growth

First, large public debts tend to reduce economic growth, which in turn means lower future incomes and greater difficulties for governments to finance spending. There is a large body of evidence linking elevated debt levels to subsequent periods of low growth performance.[4] In brief, public debt-to-GDP ratios exceeding 90% of GDP appear to reduce median real economic growth by 1%.[5] While seemingly small, over an extended period of time this effect has a dramatic impact on income levels, and therefore on tax collections and on governments' ability to finance their spending.

Why do high debts reduce growth? As debts grow, governments face increasing interest burdens. To finance these, they may be forced to raise taxes to increasingly high levels that cause the economy to function less efficiently.

Moreover, consumers may recognise that large debts imply higher future taxes and therefore cut spending in anticipation of these. Furthermore, historically, governments with large debts have frequently resorted to financial repression, that is, they have regulated the financial system in such a way as to artificially expand the demand for public debt. This reduces the interest rate at which debt is financed, sometimes to such an extent that real interest rates

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[2] Disregarding the €5.8bn portion of the PCAR 2011 banking injection to AIB/EBS and ILP, the underlying deficit was –9.0% GDP.

[3] The largest amounts of general government liabilities outstanding at end 2011 relating to banking injections (as a percentage of GDP) were recorded in Ireland (30%), Germany (11.2%), Netherlands (7.4%), Belgium (6.6%).

[4] See Reinhart and Rogoff (2010), Reinhart and Rogoff (2012), Kumar and Woo (2010), Checherita and Rother (2010), Cecchetti et al. (2011) for a review of the evidence.

[5] See Reinhart and Rogoff (2010) and Cecchetti et al. (2011).

has fallen below zero.[6] Of course, such regulations are a tax on the financial sector that to make it more difficult and more costly for other borrowers, in particular growing firms, to obtain credit.

Furthermore, whenever debts are large, there is always a risk that if some adverse economic event occurred, the debts would become too large, forcing governments to restructure them. As a consequence of the resulting credit risk, the interest rate on public debt tends to increase as the debt-to-GDP ratio rises. This is problematic because yields on treasury bonds frequently serve as a floor for the interest rates at which firms and households can borrow. Large and growing government debts therefore tend to raise the cost at which the private sector can finance itself, slowing growth. In the euro area this has led to a situation in which firms and households in different countries face sharply divergent lending rates and conditions, depending on the fiscal situation of the Sovereign, despite that fact that the ECB sets a single short-term interest rate for the entire monetary union. This is evident in Figure 4 which shows that the increase in interest rates on new loans to households and businesses since the end of 2009 has been greatest in the peripheral euro area countries that have experienced the greatest fiscal difficulties.

3.2 Debts and inflation

A further reason why large public debts are worrying is their tendency to end in high inflation.[7] Historically, a lack of central bank independence has played a central role in that process. Governments with large deficits and debts in the past all too frequently managed to finance them by borrowing from the central bank, for instance by the central bank participating directly in auctions of new government debt. While this mechanism has played a crucial role in episodes of hyperinflation, it was also operative in the moderate inflation experienced in some European countries as late as in the 1970s and 1980s.

But in modern economies there are a number of devices that make inflationary finance of this form impossible. Legal independence and a prohibition on government borrowing from central banks are of crucial importance. Furthermore, central banks operate with high levels of transparency that make it difficult for them to finance governments without the public becoming aware of this. Any attempt to extend credit directly to governments will therefore stoke inflation expectations, causing long interest rates to rise. In turn, this slows the economy, which offsets any benefit that would accrue to governments from such operations. Central bank independence and high levels of transparency thus serve as safeguards against the inflationary booms triggered by weak government finances.

Transparency helps in another way. Many central banks communicate to the public what level of inflation they are aiming for. For instance, the Bank of Canada and the Bank of England have adopted inflation targeting and announced what their targets for inflation are. Similarly, the ECB and the Swiss National Bank have announced that price stability is the overriding target for monetary policy and defined it numerically.[8] Since the inflation objective is public knowledge, public scrutiny will force central banks to tighten monetary policy if inflation rises above target for a protracted period.

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[6] Periods of negative interest rates were prevalent between 1945 and 1980, and more recently since 2008. Reinhart and Sbrancia (2011) find that real interest rates were negative roughly half of the time between 1945 and 1980. Annual liquidation of debt via negative real interest rates amounted to 3-4% of GDP per annum in the US and the UK.

[7] There is a very long literature that establishes the close link between public deficits and inflation, see Sargent and Wallace (1981), Sims (1994), Woodford (1994, 2001), and Catao and Teronnes (2003). For a discussion of fiscal deficits and hyperinflation, see Sargent (1982) and Dornbusch and Fischer (1986).

[8] The ECB's objective for inflation is "below but close to two per cent." Inflation surveys suggest that financial market participants believe that the ECB aims for inflation of about 1.7 to 1.9 % per annum.

To my mind, the risk with high levels of public debt is not that average inflation rates will rise, but rather that central banks' control of inflation will worsen. It is easy to see why. If inflation rises, the central bank must determine whether the increase is likely to be lasting or temporary.[9] In the latter case, there is no need to increase interest rates since inflation will return to the previous level on its own. In practice, of course, it is difficult to know whether increases in inflation are permanent or transitory, so policy makers have to judge whether to raise interest rates immediately, or to wait and see how the situation evolves. If public debts are large, monetary policy makers may worry that higher interest rates will worsen the fiscal situation by increasing the cost of debt service and by slowing the economy and therefore dampening tax revenues. As a result, there is a risk that they may delay tightening policy in response to rising inflation, resulting in reduced inflation control and an amplification of the business cycle. It is therefore essential that public debts are reduced from the very high levels they have reached in many countries.

3.3 Some current problems

The current difficulties experienced in the euro area illustrate two further reasons why large fiscal imbalances are problematic for monetary policy. The financial crisis has led real economic activity to weaken severely. At the same time, the rapid increase in public debts and the attendant difficulties in financing them have forced governments in a number of countries to tighten fiscal policy sharply to improve debt trajectories, further weakening economic activity.[10] To offset the fall in demand, interest rates have been cut to almost zero in several countries. Nevertheless, growth has not returned and some central banks have therefore adopted unconventional monetary policy measures, whose effectiveness is not yet fully established, to support economic activity.[11] Needless to say, it would have been natural to use fiscal policy to expand economic activity but that is impossible for the simple reason that the debts are already too large.

A further problem is when government debt becomes so large as to trigger perceptions of credit risk, the functioning of financial markets deteriorates. Large government debts worsen the credit worthiness of banks and other holders of government debt. This causes money markets to function poorly, in particular since government debt serves as collateral for secured lending. Furthermore, it raises interest rates in the economy more broadly and raises banks' funding costs. Finally, it reduces the collateral base of banks, which impairs banks' access to central bank funding. These problems are evident in the euro area, where government debt levels and interest rates vary sharply between countries. The net effect is a weakening of the transmission of monetary policy and the creation of asymmetries across the monetary union. For this reason the ECB's Governing Council adopted on September 6 a programme of Outright Monetary Transactions to mitigate these adverse effects.[12]

4. Institutional limits debts and deficits

Since large public debts have highly adverse consequences for the economy, a number of institutional arrangements have been adopted to limit debt accumulation in the euro area and the European Union more broadly. It is useful to distinguish between rules on deficits and

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[9] Temporary increases in inflation can arise from a wide variety of price level shocks such as increases in energy prices or exchange rate changes.

[10] While tighter fiscal policy can in theory be stimulatory, in practice it more likely that it will be contractionary. See the literature on "expansionary fiscal contractions", e.g., Alesina and Perotti (1995), and Giavazzi and Pagano (1990).

[11] Such measures include an increase in the size, frequency and maturity of liquidity providing operations. A number of central banks have also purchased financial instruments issued by the public or private sector.

[12] http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html.

debts and rules embedded in the institutional arrangements underpinning the ECB that are intended to make it impossible for governments to finance themselves by way of privileged access to central bank funding.

4.1 Rules on debts and deficits

Since the establishment of the Maastricht Treaty in 1992, the EU has introduced a number of fiscal rules. In 1997, the Stability and Growth Pact (SGP) introduced rules intended to ensure fiscal discipline. These rules, which essentially limited fiscal deficits to 3% of GDP and public debts to 60% of GDP, however, suffered from poor compliance in the EU, even before the crisis took hold (Figure 5). The onset of the present fiscal crisis has exposed a number of weaknesses in the SGP framework including the lack of a definition of a "satisfactory pace" of debt reduction, poor enforcement mechanisms and the fact that the assessment of compliance was often based on overly optimistic underlying budgetary forecasts.

In response to these deficiencies, a much strengthened SGP, known as the *Six Pack*, entered into force in November 2011, entailing a stronger preventative arm and with stronger corrective action requirements. The Six Pack ensures stricter application of the fiscal rules by defining quantitatively what constitutes a "significant deviation" from the *Medium Term Objective* (MTO). The MTO is the required structural balance which will ensure sustainability of the public finances, set out in the SGP. Furthermore, an *Excessive Deficit Procedure* can now be launched when a country's debt is in excess of 60% of GDP, and not only on the basis of a deficit exceeding 3% of GDP, as was previously the case. Finally, financial sanctions for euro area members can now be imposed at an earlier stage and in a proportionate and graduated manner. Furthermore, the timely imposition of such sanctions is now more likely since the voting rules have been changed.

The most recent articulation of EU fiscal rules is the Fiscal Compact (or *Treaty on Stability, Governance and Co-ordination*, TSGC), which requires countries to ensure convergence with their respective MTOs. It introduces a more explicit Budget Rule, whereby all States must strive for budgetary balance and achieve a structural deficit of no more than –0.5% of GDP.[13] In addition, Member States are henceforth required to reduce the excess of their debt over 60% of GDP by an average of 1/20th per annum. Importantly, the Fiscal Compact requires that both budget rules must be implemented in national law, preferably in the constitution, that compliance is monitored by independent institutions and that an automatic correction mechanism is put in place to correct divergences from these rules.

It is interesting to note in passing that many of these developments in the fiscal sphere – the introduction of numerical objectives for deficits and debt, written down in law, and with some involvement of independent monitors – that limit governments' ability to run large deficits are similar to changes introduced to monetary policy frameworks in recent years. Thus, by now it is common for the legal acts that govern central banks to indicate that price stability is the overriding objective for monetary policy and to define it in numerical terms. Moreover, through the adoption of high levels of transparency, central banks have made it easier for outside observers to monitor their conduct of policy.

4.2 Regulations concerning the ECB

The *Treaty on the Functioning of the European Union* contains two Articles intended to promote monetary stability. This is achieved by removing any risk of pressure from national governments to force central banks to finance fiscal imbalances. Specifically, Article 123 prohibits "overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States … in favour of … central governments, regional, local or other public authorities" and "the purchase directly from them by the

[13] This ceiling excludes one-off measures and cyclical effects.

European Central Bank or national central banks of debt instruments." Furthermore, Article 124 prohibits any measure, not based on prudential considerations, that grants central governments, regional, local or other public authorities privileged access to financial institutions.

However, these articles do not prohibit the ECB from operating in financial markets by buying or selling marketable instruments, including government debt.[14] That is of course natural. In pursuing their statutory objectives central banks operate in a range of financial markets, particularly in government debt markets, since these are large and liquid and since government debt has historically been seen as risk free. Such operations of course also augment the demand for public debt, thereby reducing the interest rate on the debt and making it easier for governments to finance themselves. But this effect is entirely incidental to monetary policy.

5. Reducing public debts

Public debts are currently very large in many countries and must be reduced. The European Union has adopted a number of measures that restrict governments' ability to run deficits and require many of them to reduce public debt. But how will these debts be reduced? What mechanism should be relied on?

As a preliminary, it is useful to recall that there are many historical examples of episodes in which public debts have risen to very high levels. Both after World War I and World War II public debts reached levels as high or even higher than observed in some countries today. However, these debts were, in many cases, soon reduced sharply.

To see how public debts can be reduced, note that the growth of the debt-to-nominal GDP ratio depends on three factors.

1. Interest rates: the higher the interest rate, the greater the cost of debt service.
2. Real GDP growth and inflation: the faster growth of real GDP and the higher the rate of inflation, the greater the growth in nominal GDP and thus tax revenues.
3. Primary (or non-interest) budget deficit: the larger the deficit, the greater the rate of growth of the debt.[15]

One way to reduce debts is thus to seek to reduce the interest rate on the debt below the market level through regulation. For instance, interest rate ceilings or requirements that increase banks' and other financial institutions' demand for public debt can be used to reduce the interest rate burden. Financial repression of this form was common after World War 2 and led to rapid contractions in debt/GDP ratios.

Of course, such regulations merely amount to taxation of the holders of public debt. While it may facilitate debt reduction, it will lead financial markets to worry that it may happen again, and therefore cause them to demand higher interest rates to purchase government debt in the future. Thus, reducing the debt in this way may not be desirable. In any case, it presumes a regulatory environment that is very different from that of today. I thus don't think that it will play much of a role in reducing the current high debt levels.

A second strategy is to seek to increase the growth rate of nominal GDP. This mechanism also played an important role in debt reduction after World War 2, as growth picked up sharply in the 1950s and 1960s and inflation was high during the Korean war boom in the

[14] See Article 18 of the Statute of the European System of Central Banks and the European Central Bank, Protocol 4 of the *Treaty on the Functioning of the European Union*).

[15] Debts may change even if the deficit is zero, e.g., because of a transfer of local government debt to the national government or a restructuring of the public debt.

early 1950s. While I expect many governments to adopt structural reforms that increase real GDP growth in the coming decade, large debts tend to reduce growth. It therefore seems unlikely that growth on its own can be relied on to restore fiscal stability.

Higher inflation could in theory also reduce debts. However, the adverse consequences for economic performance of high and variable inflation are now better known than during previous periods of high debt. Moreover, inflation is a tax. While parliaments have the power to introduce taxes, central banks should not. Relying on inflation for debt reduction is difficult in a democratic society. Moreover, in the euro area and elsewhere, monetary policy is set with the objective of stabilising inflation at low levels and it would be very undesirable to change that objective.

Overall, I therefore do not think that economies can grow or inflate away the debt with the ease to which they may have done so in the past. This leaves the third mechanism, primary surpluses, as the only way in which debts can be reduced. Primary surpluses can be achieved either by reducing spending or by raising taxes. While economic research suggests that fiscal stabilisation efforts that rely on expenditure cuts are more likely to be successful than those that rely on revenue increases[16], precisely how the necessary budget surpluses are achieved is entirely a matter for elected parliaments to decide since fiscal policy has large redistributional effects. My point here is simply that debts must be reduced through budgetary surpluses since the other avenues for debt reduction are closed.

Of course, the 29 June EU Summit opened another possible avenue for debt reduction through the use of the ESM to directly recapitalise banks.[17] A decision to recapitalise banks directly, as opposed to via the sovereign as had previously been the favoured method, would reduce the burden on already stressed sovereigns and avoid the reinforcement of the sovereign-bank link that has been evident in a number of countries.

Will monetary policy hinder or facilitate governments' efforts to reduce debts? While monetary policy is best set independently, I believe that a monetary policy that is focussed on price stability will make it easier for governments to reduce debt. The reason is simple. It seems unavoidable that tighter fiscal policy will restrict overall demand for goods and services in the economy. In turn this will tend to reduce inflation pressures. To prevent inflation from falling too low, it seems likely that many central banks will maintain interest rates at low levels for an extended period of time, which will support growth and debt reduction.

6. Conclusions

Public debt in a number of countries has risen sharply during the financial crisis and has now reached very high levels. As a consequence, growth is likely to be lower than it otherwise would have been, in turn making it more difficult to reduce debt. But letting debts remain at this high level is not an option. While the exact path of fiscal adjustment in the immediate future will vary in light of country-specific circumstances, and in the case of Ireland will be agreed with the Troika, not reducing debt levels will have a detrimental effect on income and that effect will grow over time. It may also increase the risk of a deterioration of central banks' inflation control, and harm the functioning of financial markets.

Unfortunately, it seems unlikely that the current very high levels of public debts will melt away through low interest rates, rapid growth or inflation. Regardless of any relief that a movement towards banking union and any potential benefits which direct ESM bank recapitalisation could deliver, countries need to restore more stable fiscal balances. In place of low interest

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[16] See Blochliger, Song and Sutherland (2012) and Alesina and Ardagna (2009) for further discussion.

[17] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

rates, high growth or inflation, debts will need to be reduced by running fiscal surpluses. It will no doubt be difficult to achieve to do so, but there is no other option. Thank you.

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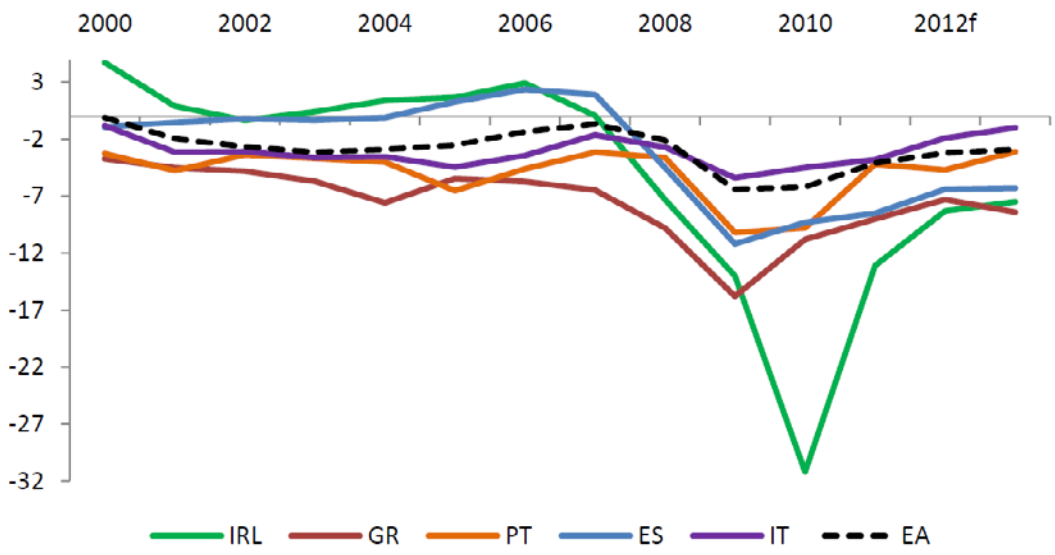
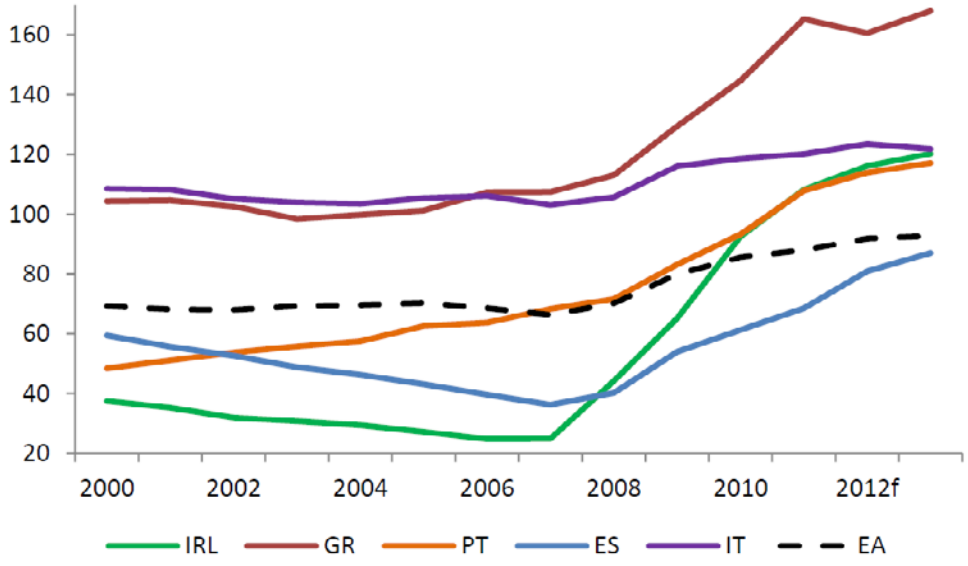
Figure 1: General Government Deficit as % of GDP



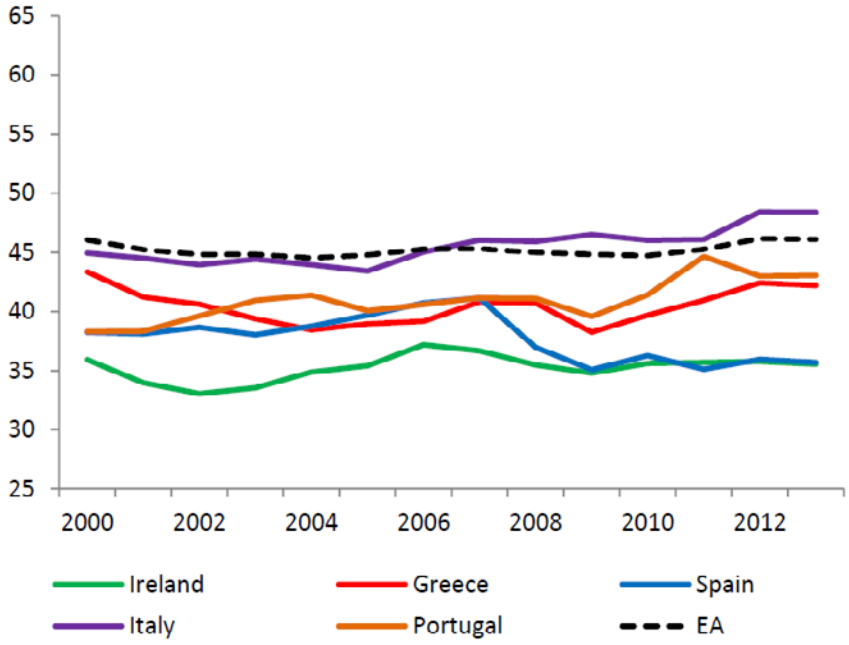
Source: AMECO database. European Commission Spring Forecasts, May 2012.

Figure 2: General Government Debt as % of GDP



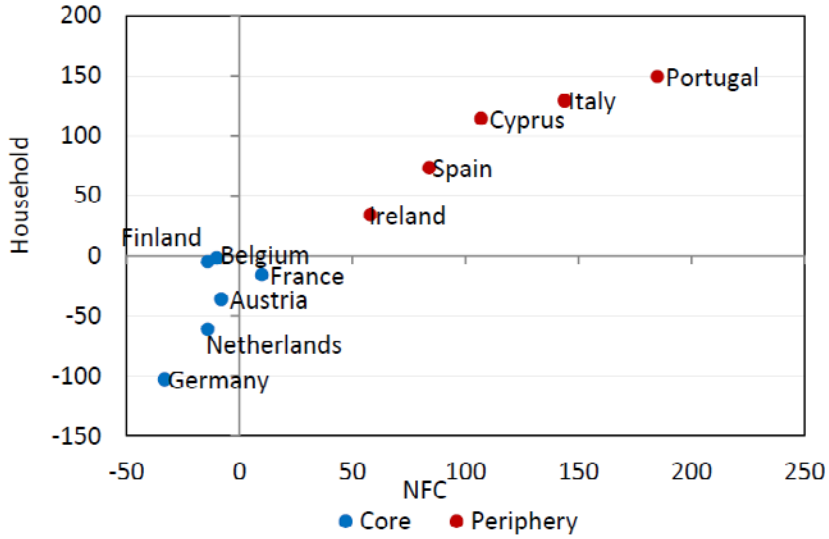
Source: AMECO database. European Commission Spring Forecasts, May 2012.

Figure 3: Total Revenues as % of GDP



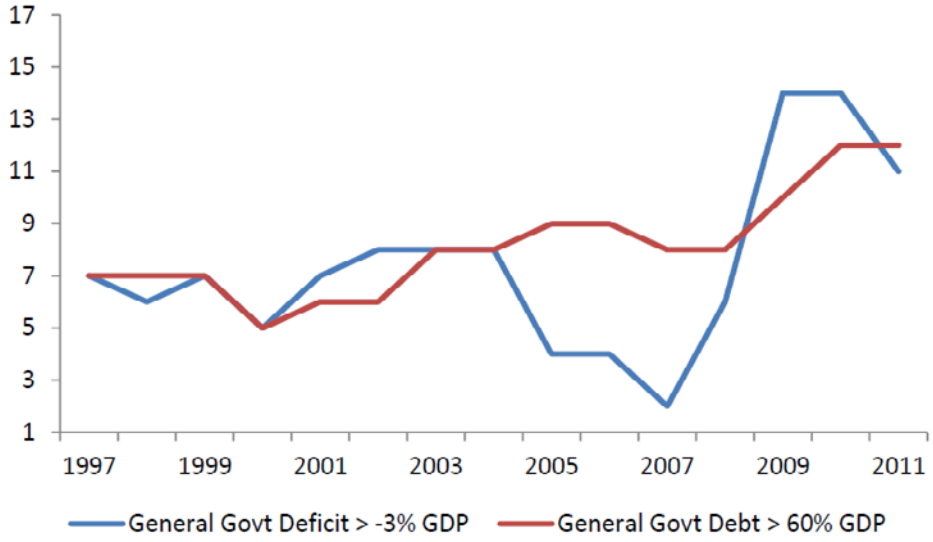
Source: AMECO database. European Commission Spring Forecasts, May 2012

Figure 4: Basis point change in interest rates on new loans, December 2009 – July 2012



Source: ECB and Central Bank of Ireland calculations

Figure 5: Number of Euro Area countries in breach of SGP 1997-2011



Source: Central Bank of Ireland calculations based on AMECO (European Commission) data.