Fritz Zurbrügg: Fiscal and monetary policy – interdependence and possible sources of tension

Speech by Mr Fritz Zurbrügg, Member of the Governing Board of the Swiss National Bank, at the University of Lucerne, Lucerne, 21 November 2012.

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Ladies and Gentlemen,

It is a great pleasure for me to be giving this presentation at the University of Lucerne this evening. Tonight's topic is one that has interested me for some time. During my ten years at the International Monetary Fund, I repeatedly dealt with questions of fiscal and monetary policy and the interplay between them – albeit in a general and rather abstract way. Over the past six years at the Federal Finance Administration, my work was focused on fiscal policy, and in particular its implementation. This summer, I transferred to the Governing Board of the Swiss National Bank (SNB), and now have the unique opportunity, and the privilege, to focus on monetary policy. Although it is probably a little early for me to be making definitive speeches on both of these economic policy areas, I would like to share a few initial thoughts with you.

Introduction

In some countries, the scope for fiscal policy action has recently come up against its limits. Governments today find themselves in the position of being virtually unable to finance their normal range of activities, meaning that there is also no scope left for discretionary economic stimulus measures. This has raised expectations on monetary policy to do something to stabilise the economy and the financial markets. And indeed, central banks across the world have introduced unconventional measures, in order to fulfil their mandates even under these unusual circumstances. Some of these measures have come in for criticism, because they encroach on the territory of fiscal policy.

Thus, there is currently tension between monetary and fiscal policy in a number of countries. How does this tension come about? Which factors might exacerbate or mitigate it? And what is the current situation in Switzerland?

To address these questions, I will first review the goals and the division of responsibilities in these two areas of economic policy. In a second step, using the recent crisis as an example, I will highlight the importance of rules and a culture of stability for an economic policy that is both sustainable and tension-free. I will finish by describing the current situation in Switzerland.

Fiscal and monetary policy goals and complementarity

Must there necessarily be tension between monetary and fiscal policy? This might be true if these two areas of economic policy were pursuing conflicting goals. However, if we look at the objectives of monetary and fiscal policy, we can see that they are very similar (cf. chart 1).

Today, in most advanced economies, monetary policy is conducted by independent central banks, with the primary objective being to ensure price stability while taking due account of economic developments. If, for example, a central bank raises interest rates because inflation is edging upwards, it can expect this to have a dampening effect on the economy. At the same time, monetary policy authorities must always bear in mind that monetary policy can only create favourable conditions for growth temporarily; in the long term, expansionary monetary policy cannot achieve a lasting stimulation of aggregate demand. If it nevertheless attempts this, it will have an inflationary impact in the long term, and destabilise the

economy. To avoid this, the central bank must focus on a goal which is achievable with the resources at its disposal, namely ensuring price stability. Price stability is not an end in itself. By ensuring price stability, monetary policy creates conditions favourable for companies and households, and thereby makes an important contribution to stable economic development.

Fiscal policy is aimed at ensuring that expenditure and receipts are balanced over the long term. At the same time, budgetary policy has to take account of the state of the economy. This is how the Confederation's primary fiscal policy goal is set out in the Federal Constitution.[1] These clear principles ensure that fiscal policy can fulfil its important function of stabilising the economy without the soundness of public finances being called into question. If fiscal policy focuses exclusively on encouraging growth and pays no attention to budget soundness, it runs the risk of losing its room for manoeuvre. This is essential in enabling it to react to new challenges, and to smooth the economy in the event of a crisis. Thus, budget soundness is not an end in itself, because it fosters employment and prosperity.

Fiscal policy thus pursues a similar goal to monetary policy. By creating favourable conditions for lasting and balanced economic growth, they both foster a prosperous society. The economic policy goals of monetary and fiscal policy are closely intertwined – or even overlapping.

In both of these economic policy areas, sustainability is key: Fiscal policy can only ensure the lasting achievement of its goals if public finances remain healthy over the long term. Monetary policy, for its part, should focus on the medium to long term, because any economic stimulus motivated by short-term considerations carries the risk of raising inflation expectations.

To recap: The goals of fiscal and monetary policy overlap to a large extent, which means that in normal times there should be no tension between the two policies. Nevertheless, there is a strong complementarity between fiscal and monetary policy, as their operations have a reciprocal impact as regards both the financial markets and the real economy.

Let's look at the financial markets first (cf. chart 2). Monetary policy steers a reference interest rate on the money market, which is used as a basis for the valuation and trading of securities such as government bonds on the financial market. If monetary policy is credible and succeeds in ensuring price stability, inflation expectations are low and well anchored. In this case, small changes in the reference rate cause relatively large adjustments to long-term rates – the monetary policy transmission mechanism is working. The inflation risk premium and capital market rates are low. Lower interest rates mean lower funding costs for the government. However, if the government seeks capital market funding, another factor comes into play in addition to inflation expectations and the inflation risk premium: the credit risk premium. The more sustainable the public finances, the greater investor confidence will be. This leads to a lower credit risk premium. This makes public finances more affordable, which in turn reduces credit risk. Monetary policy also benefits, because the transmission of monetary policy stimuli is not impeded. In this way, sustainable monetary and fiscal policy together achieve greater stability, less uncertainty and lower rates.

Let's now turn to the real economy (cf. chart 3). On the one hand, lower interest rates mean lower funding costs for companies and private households. This provides favourable conditions for economic growth but does not create it per se. Growth itself is founded on productivity gains, population growth and capital formation. A stability-oriented monetary policy allows households and companies to make their economic decisions (work, consumption, saving and investment) in a less uncertain environment. In this way, the

[1] Swiss Federal Constitution, Art. 126 (budget): "The Confederation shall keep its expenditure and receipts in balance in the long term"; art. 100 (economic policy): "In their budgetary policy, the Confederation, Cantons and Municipalities shall take into account the economic development".

allocation of resources and capital is improved. Fiscal policy can benefit from this, because a steady economic cycle means more stable receipts and expenditure.

Fiscal policy also facilitates the planning of economic decisions, when it is focused on stability. A balanced budget allows relatively constant taxation. But if a government is heavily in debt, there is a danger that households will save rather than consume, despite a low level of taxation, because they are expecting future tax increases (Ricardian equivalence). Economic policy stability reduces uncertainty and thereby creates favourable conditions for economic growth. In such an environment, the central bank is able to focus entirely on its mandate of maintaining price stability.

So successful monetary policy is predicated on healthy fiscal policy, and vice versa. To achieve stability and prosperity in the long term, fiscal and monetary policy must both focus on sustainability. When that happens, tension can be avoided.

Good rules limit discretionary freedom

To achieve as tension-free an economic policy as possible, fiscal and monetary policy implementation thus has to focus on stability. But how can this be guaranteed? The freedom of action of a central bank, in particular, is considerable, given that it has the note-issuing privilege and implements monetary policy independently of political considerations. But in fiscal policy, too, the government and parliament enjoy a relatively large amount of discretion in the performance of their mandate. They can set the level of both taxes and expenditure, although there are, a priori, no clear guidelines on the optimal levels.

In order to ensure that fiscal and monetary policy authorities do not exploit their discretionary freedom, but instead use their instruments in a targeted way with the aim of achieving sustainable economic policy, there need to be clear and binding rules.

In the monetary policy domain, the "rules versus discretion" debate started early. Its origins can be traced back to the beginning of the 19th century. At that time, disciples of the so-called currency school were demanding that the issuance of paper money be closely tied to the central bank's gold reserves, whereas advocates of the banking school took the view that a stability-fostering expansion in the money supply would also come about without such a rule.

The first arguments in favour of rules appeared early on in the literature on monetary policy.[2] Today, there is a consensus that a rules-based monetary policy is more successful in ensuring price stability. The lack of clarity in past rules had led to monetary policy being more exposed to political pressure. As a result, monetary policy authorities were tempted to focus more on short-term growth stimulus than on the long-term repercussions of such stimulus on price stability. This is why monetary policy needs to be conducted by a rules-based, independent central bank, with the main focus on the assessment of the future path of inflation.[3] Thus, the actual goal of monetary policy – price stability – can be achieved (cf. chart 4).

In the fiscal policy domain, the "rules versus discretion" debate is of much newer vintage. Whereas, in 1990, there were only five countries with fiscal rules (Germany, Indonesia, Japan, Luxembourg and the US), today there are 81.[4] The current financial crisis and the associated debt crisis have highlighted the importance of fiscal rules. In principle, fiscal policy can be implemented by means of automatic stabilisers and discretionary measures. To be effective, discretionary measures have to fulfil a number of conditions. These can be

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[2] Cf. Friedman (1948).

[3] Cf. Kydland and Prescott (1977), and Barro and Gordon (1983).

[4] Cf. Budina et al (2012).

summed up as the three T-criteria: timely, targeted and temporary.[5] In other words, discretionary measures have to take effect in good time, to avoid them having a procyclical effect. This risk arises, in particular, from the fact that discretionary measures require political decisions. So their implementation can take a lot of time. Second, such measures need to be targeted, so that support can be given to the sectors and industries affected. Third, they must be temporary, so as not to permanently weigh on public finances.

Experience has shown that, in the upswing, budget deficits are not offset by surpluses, and that discretionary measures therefore often result in government finances being burdened even beyond the downswing.[6] To achieve a balanced budget, it is necessary to limit the room for manoeuvre in the political domain. To this end, politicians use fiscal rules as a form of self-imposed restraint (cf. chart 5). As a result, automatic stabilisers now play an increasingly important role compared to discretionary measures.

The automatic stabilisers are designed to fulfil the three T-criteria. Unemployment insurance is an important automatic stabiliser. It triggers automatic government expenditure or receipts, depending on the economic situation, and thus has an immediate, or timely effect. Second, it provides targeted support to those affected by the economic downswing. Third, it is temporary.

But rules alone are no guarantee of stability, for there is often considerable room for interpretation when implementing them. There is always a way to circumvent them. Fiscal rules existed in a number of countries even before the onset of the sovereign debt crisis. A good example is the Maastricht criteria in the EU, which various countries repeatedly failed to meet, without effective sanctions being brought to bear. The history of monetary policy is also rich with examples, from all over the world, which show how a departure from the objective of price stability can have drastic consequences for the economy. If the central bank is unable to ensure price stability, it calls its credibility into question, and thereby runs the risk of reducing the effectiveness of future measures.

What factors help to ensure that rules are complied with?

First, we need good rules. In the fiscal policy domain, the elements of a good rule are: It is clear and easy to understand; it is binding, i.e. has a basis in law – ideally at the constitutional level; and it is equipped with a specific sanctioning mechanism. Finally, it must make provision for exceptions, and these should be clearly defined.

In the monetary policy domain, too, there are certain requirements regarding what makes a good rule. First, it must set out how the central bank should use its policy tools to achieve the goal of price stability. It defines criteria according to which monetary policy measures are taken. For many central banks, inflation forecasts play an important role. On the one hand, they serve as the main indicator for the interest rate decision. On the other, they are an important communication tool. A good rule creates a certain degree of transparency vis-à-vis the public, and makes monetary policy more predictable. It provides an anchor for inflation expectations and helps to improve the credibility of monetary policy.

Second, we need a culture of stability which is well anchored in the minds of both politicians and the general public – part of the national mentality (cf. chart 6). Economic literature has repeatedly demonstrated that certain political structures and a culture of stability are mutually reinforcing.[7] For fiscal policy, these structures can be, for example, fiscal federalism (tax competition), the subsidiarity principle, direct democracy structures and political continuity (e.g. the concordance principle). In the area of monetary policy, central bank independence

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[5] Cf. Summers (2007).

[6] Cf. IMF (2008).

[7] Cf. Feld and Kirchgässner (2008) and Poterba (1994).

plays an important role. It has been empirically demonstrated that a higher degree of independence goes hand in hand with lower inflation rates.[8] To retain its independence, the central bank must show good performance, and acquire credibility and respect. This is the only way to make politicians and the public acknowledge the value of independence.

Tension during a crisis

The financial and economic crisis provided an impressive demonstration of how important it is for fiscal and monetary policy to remain focused on their mandate and on sustainability.

If public finances are already running a high level of indebtedness in good times, fiscal policy's room for manoeuvre will be severely curtailed (or very quickly used up) in a crisis. In this situation, the central bank faces growing pressure from both politicians and the public to stimulate the economy with monetary policy measures.[9] If the central bank gives in to this pressure, it endangers its own independence and thereby its credibility. With an unsustainable fiscal policy, a stable monetary policy is no longer possible over the long term, even if the central bank is independent and not under pressure to stabilise the economy. A glance at economic history shows that high inflation rates have very often been accompanied by high levels of public debt.[10]

Monetary policy can only act in a crisis if its credibility is intact. Some central banks, including the SNB, have reached the zero lower bound for interest rates as a result of the recent crisis. Even after hitting the lower bound, these central banks are still able to pursue their objectives. In order to retain their freedom of action, they are resorting to unconventional measures. Some of these measures, such as purchasing securities of private sector issuers, are described as quasi-fiscal, meaning that they are part of monetary policy but, like fiscal policy, they have distribution effects. For this reason, they attract public and political attention and can therefore threaten the central bank's independence.

There is also a danger that politicians, economic agents and the public will expect monetary policy to have a solution for every problem. Numerous problems in the real economy, such as the lack of competitiveness and the current account imbalances, are structural in origin. In this area, it is the responsibility of governments to introduce reforms. Resolving such problems is outside the scope of monetary policy.

The management of the recent financial and economic crisis has resulted in a much greater overlap between fiscal and monetary policy activities than before the crisis. In some countries, this has given rise to tension between fiscal and economic policy. The lack of a sustainable fiscal policy can lead to excessive demands being placed on monetary policy, which could result in the latter also straying from the path of stability.

Switzerland is an exception

In Switzerland, despite the difficult economic environment, there is currently no tension between monetary and fiscal policy. There are two reasons for this. First, public finances are very healthy. Second, monetary policy has always been focused on stability.

The healthy state of public finances is mainly due to fiscal rules at cantonal level and the debt brake at federal level (cf. chart 7). The debt brake was introduced in 2003 to halt the growth in Swiss public debt that had taken place in the 1990s.[11] The core element of the debt

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[8] Cf. Alesina and Summers (1993) and Klomp and de Haan (2010).

[9] Cf. Jordan (2011, 2012a).

[10] Cf. Bernholz (2003).

[11] Sovereign debt grew from CHF 39 billion in 1990 to over CHF 120 billion in 2002, peaking at CHF 130.3 billion in 2005. In 2011, it stood at CHF 110.5 billion. Cf. FDF (2012).

brake is a simple expenditure rule: Expenditure must not exceed receipts over the course of one economic cycle. The advantage of this is that no specific debt level needs to be defined or aimed for. I would like to point out that, rather than limiting fiscal policy's room for manoeuvre, the debt brake increases it. It combats excessive debt, leaving fiscal policy in a better position from which to act, should it need to.

The debt brake provided a specific and workable expenditure rule, which takes account of the economic cycle, allows clearly defined exceptions and contains a predefined set of sanctions. The debt brake is enshrined in the Federal Constitution, and the exceptions and the sanctioning mechanism are defined in the Federal Act on the Federal Financial Budget. Under the sanctioning mechanism, if a stipulated limited is exceeded, the excess amount must be recouped within the next three years.

Thus, the debt brake provides Switzerland with a rule at federal level which fulfils the requirements for a good fiscal rule. Stability is reflected in the level of sovereign debt, which is moderate by international standards. Should a need for fiscal policy action arise, fiscal policy's room for manoeuvre would be unimpaired.

In the most recent financial and economic crisis, fiscal policy in Switzerland has primarily relied on the effects of automatic stabilisers, and has been sparing in its use of discretionary stabilisation measures. Nevertheless, in view of the severity of the crisis, the Federal Council initiated targeted discretionary measures, in line with the debt brake requirements. However, as mentioned, the debt brake also allows for exceptions in certain unusual circumstances. This exceptions rule made it possible to provide UBS with temporary support in 2008, without jeopardising the Confederation's ability to fulfil its normal mandate.[12]

There is another reason for restraint in discretionary fiscal policy. The impact of a government economic stimulus programme in a small open economy such as Switzerland is slight. The high proportion of imports means that much of the government spending dissipates abroad. It has been empirically demonstrated that the fiscal multiplier in small open economies is zero or even negative.[13] The impact is further reduced if the shock does not originate in the domestic economy, but from outside – as was the case in the most recent crisis. The crisis has confirmed the limits of discretionary fiscal policy stabilisation. For example, the measures adopted by the Confederation in 2009 and 2010 could not be implemented fully and in a targeted way.[14]

Swiss monetary policy has also made an important contribution to economic stability. It is also subject to binding rules. For example, the requirement to ensure price stability is enshrined in the National Bank Act and is defined in the SNB's monetary policy strategy, which has been in force since 2000 (cf. chart 8).[15] The SNB equates price stability with a rise in the national consumer price index of less than 2% a year. Moreover, the SNB's independence is enshrined in the Federal Constitution. This requires it to operate without political pressure. As a counterweight to this independence, the SNB has a duty of accountability; it must report regularly to the government and the general public on monetary policy matters. Thus, monetary policy is also equipped with good rules, and this is reflected in a high degree of stability. By international standards, Switzerland has very low inflation rates and low interest rates.

During the most recent crisis, the monetary policy authorities cut interest rates sharply and rapidly, and expanded the supply of liquidity. In response to the strong and rapid appreciation

[12] Cf. FDF (2012). The Confederation acquired a CHF 6 billion stake in UBS in the form of convertible bonds.

[13] Cf. Ilzetzki et al (2010).

[14] Cf. SECO (2012).

[15] Cf. art. 99 Federal Constitution, art. 5 para 1 National Bank Act and SNB, *92nd Annual Report*, 1999.

of the Swiss franc facing the Swiss economy in summer 2011, the SNB introduced a minimum exchange rate of CHF 1.20 against the euro, thereby helping to stabilise the economy. The excessive appreciation of the Swiss franc is a monetary problem, because it carries the risk of deflation. So it is a problem that has to be dealt with through monetary policy. The minimum exchange rate has met with the support of the general public and the political domain. However, it should be regarded as an extreme measure. It is not a panacea for all the problems facing the Swiss economy, and carries considerable risks.[16]

We have seen that both monetary and fiscal policy in Switzerland are focused heavily on stability. Swiss economic policy stands out for having good rules and a stability culture that work through the political structures in a mutually reinforcing way. Thanks to this culture of stability, Switzerland was able to combat the financial and economic crisis with sound finances and a credible and effective monetary policy. The automatic stabilisers were able to take full effect. Moreover, targeted measures could be financed without generating a destabilising increase in debt. Monetary policy authorities were able to deploy the full range of tools at their disposal, thereby helping to stabilise the economy and the financial markets. The high level of credibility enjoyed by monetary policy was also a major factor in the successful implementation of the unconventional measures. The tension between monetary and fiscal policy that is now observable in other countries does not currently exist in Switzerland.

Conclusions

We have seen that, in normal times, there is no tension between monetary and fiscal policy, but that instead fiscal and monetary policy are pursuing higher, closely related goals, namely ensuring macroeconomic stability, exploiting economic growth potential to the fullest extent, and thereby creating prosperity.

A prerequisite for macroeconomic stability – especially in times of crisis – is the sustainability of both economic policy areas, i.e. price stability and a balance between public receipts and expenditure. For this to happen, there need to be good rules on the one hand, and a culture of stability on the other.

In crisis situations – as the recent financial and economic crisis has amply demonstrated – tension can arise between monetary and fiscal policy. If fiscal policy is no longer able to act, there is a danger that politicians, economic agents and the public will expect monetary policy to come up with a solution for every problem.

In Switzerland, where good rules and a strong culture of stability exist, there is currently no tension. But even if our country is in a relatively good position, this is no reason to rest upon our laurels. Stability-oriented fiscal and monetary policies must be constantly maintained, to ensure that they are sufficiently robust when the next challenge presents itself.

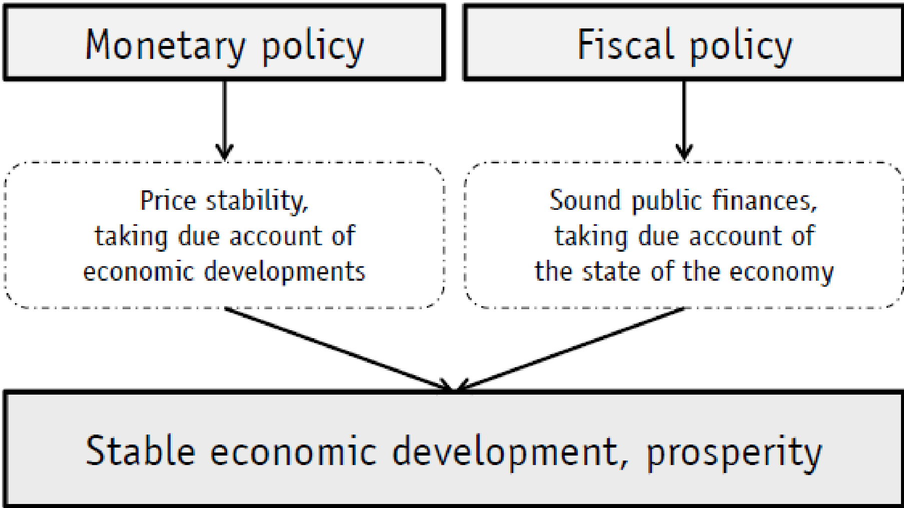
One of the greatest challenges for fiscal policy is demographic changes, which will place a heavy burden on public finances in the future. Calculations show clearly that, if policy is not changed, age-related costs will rise sharply. It will not be possible to solve these problems using only fiscal rules such as the debt brake. Profound structural reforms to social security arrangements are needed.

Central banks, too, face major challenges. In the last few years, central banks across the world have broken new ground. They have cut interest rates practically to zero, supplied the financial system with generous amounts of liquidity and introduced unconventional monetary policy measures. These measures carry a number of risks, of which inflation is the most frequently cited. Allow me to conclude my presentation with a few words on that subject.

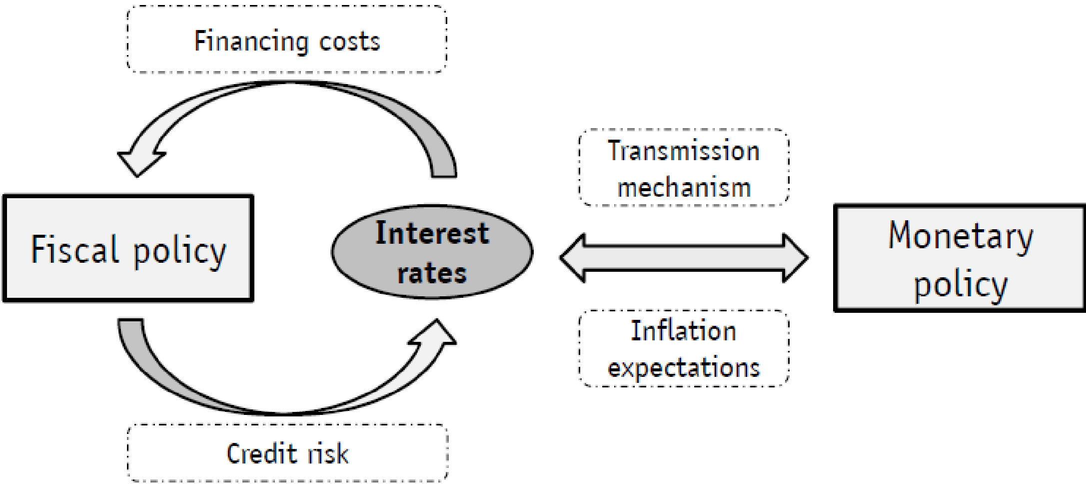
[16] Cf. Jordan (2012b).

There is no sign of inflation for the short or medium term. Globally, stable inflation expectations and the underutilisation of capacity suggest that there is no inflationary pressure. According to the SNB's inflation forecast, price stability in Switzerland is not under threat for the next few years. As the crisis recedes, however, central banks will face the challenge of returning monetary policy to normal in a timely manner and reabsorbing liquidity. The SNB's mandate is to ensure price stability while taking due account of economic developments. We will continue to take all action necessary to fulfil this mandate.

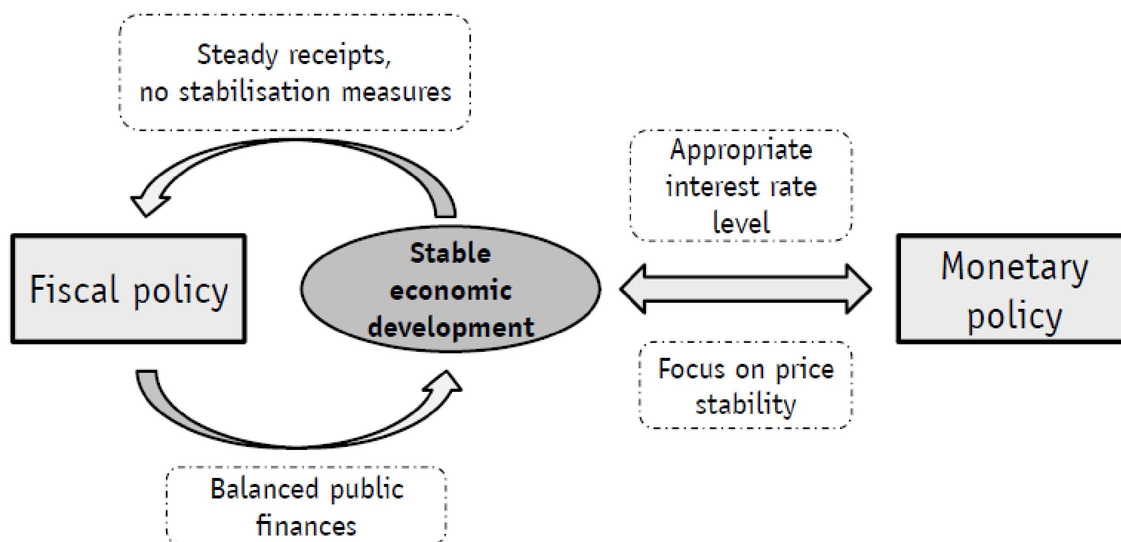
Goals of fiscal and monetary policy



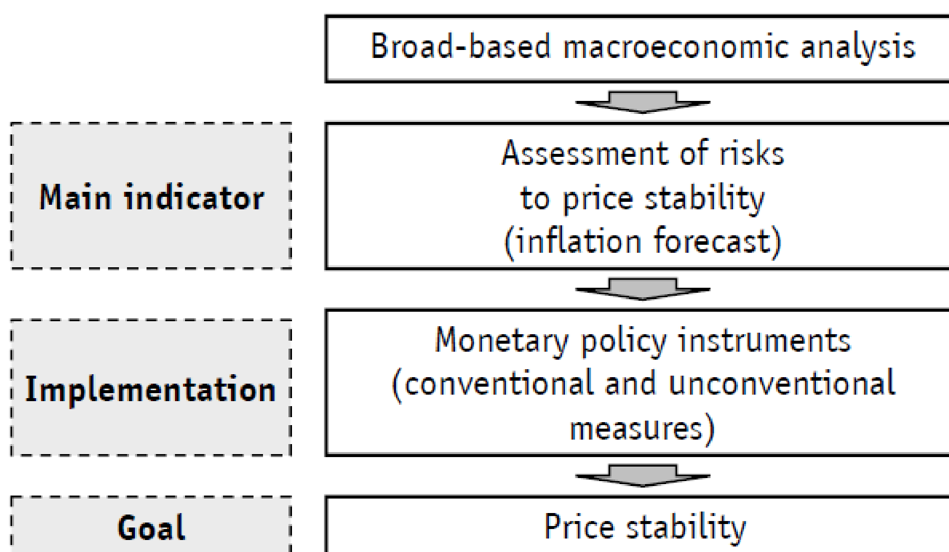
Mutual dependency: financial market



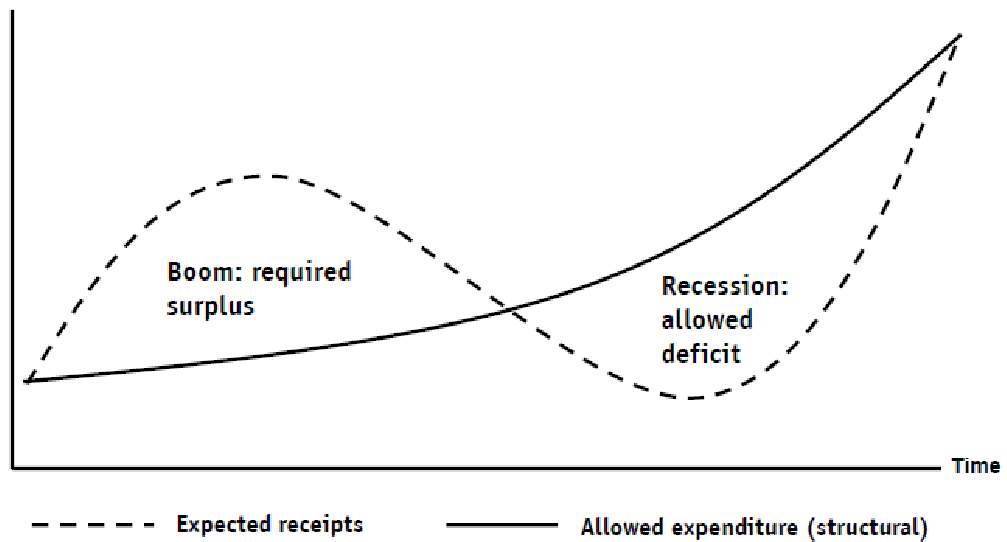
Mutual dependency: real economy



Rules-based monetary policy

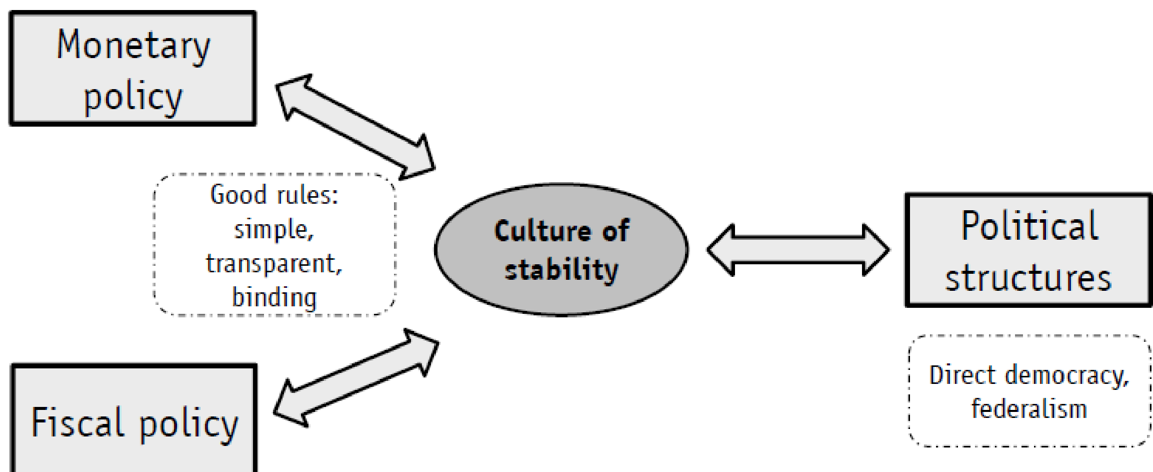


Rules of fiscal policy

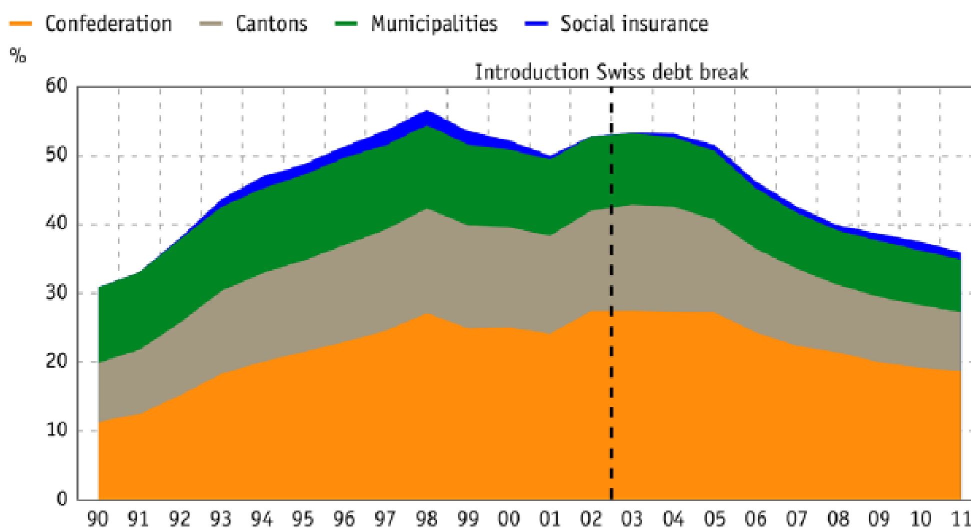


Source: based on Geier (2011)

Culture of stability



The debt brake in Switzerland



Price stability in Switzerland

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