Bostjan Jazbec: Rethinking monetary-fiscal policy coordination

Opening remarks by Mr Bostjan Jazbec, Governor of Bank of Slovenia, at the BoS-IMF High Level Seminar on Rethinking Monetary-Fiscal Policy Coordination, Portorož, 19 May 2016.

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It is a great pleasure to welcome you all to the high-level seminar on "Rethinking Monetary-Fiscal Policy Coordination" organized jointly by the Bank of Slovenia and International Monetary Fund. It is a great honour to have a very distinguished gathering of central bank governors, senior officials of governments and international institutions, leading academics and practitioners to discuss a very critical issue that occupies the minds of policy makers in the euro area and elsewhere.

The objective of the seminar is to explore current thinking on the roles and coordination of monetary and fiscal policies. The presentations and discussion will focus on three main themes: (1) the principles and practical experience in the coordination of monetary and fiscal policies; (2) fiscal policy implementation in the EU institutional framework and implications for monetary policy; and (3) conducting monetary policy when fiscal space is limited. I will now briefly touch on these themes in general terms.

Policy makers in the euro area face considerable challenges in fostering sustained strong growth, price stability and financial stability. Following the onset of the global financial crisis, economic recovery has been slow and growth remains lackluster. Inflation is much below the medium-term objective of lower than, but close to 2 percent. For some time now, inflation continually has been weaker than expected and market-based measures of inflation expectations stand at their historical lows. Therefore, monetary policy has become increasingly accommodative relying on several non-standard measures and negative interest rate policy.

There is broad agreement that in the current setting there are limits to the scope of monetary policy actions and their effectiveness for lifting the Eurozone's economy. Concerns are mounting that the outlook may be one of a prolonged period of low inflation and low interest rates, which can adversely affect both the real and financial sectors. Therefore, many of us have emphasized on numerous occasions that "monetary policy cannot be the only game in town". Strong sustainable growth, price stability and financial stability will require a coherent, integrated policy strategy that also includes fiscal and structural policies.

The message on the importance of fiscal policy supporting monetary policy is founded on historical precedence. In 1936, prescribing the way out of the Great Depression, Keynes wrote:

> *"It seems unlikely that the influence of [monetary] policy on the rate of interest will be sufficient by itself. I conceive, therefore, that a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment."*

These words are very relevant at the current juncture as well.

The ECB has emphasized that fiscal policies should support the economic recovery while remaining in full compliance with the EU's fiscal rules. Otherwise, credibility in the fiscal framework cannot be maintained. A critical question, therefore, is whether the prevailing rules could be barriers to achieving the desired coordination of monetary and fiscal policies.

There are two key prerequisites for obtaining effective fiscal support to monetary policy within the Stability and Growth Pact rules. Governments must have adequate fiscal space and fiscal policy must ensure the sustainability of public finances. In both respects, there appears to be little room for a meaningful fiscal expansion within the existing rules. There is broad agreement that the fiscal framework has failed to ensure long-term sustainability while avoiding pro-cyclical fiscal behavior. Countries did not build up sufficient fiscal space during the pre-crisis expansionary period and fiscal space narrowed following the onset of the financial crisis. Public debt increased sharply during the crisis years and the policy focus turned to an austerity mode when market pressures heightened. Most of the Eurozone countries still face long-term fiscal sustainability issues and are expected to keep their fiscal consolidation effort, in terms of the cyclically-adjusted deficit, ongoing. In 2016, only four countries – namely, Germany, Luxembourg, Cyprus, and Estonia – have fiscal space for additional discretionary measures according to the Stability and Growth Pact rules.

What then is the way forward? It has been emphasized on many occasions that for countries without fiscal space, fiscal policy can still support demand by altering the composition of the budget. In particular, they point out that consideration should be given to cutting distortionary taxes and unproductive expenditure and increasing investments that improve total factor productivity over the medium term. Investment and structural reforms that increase the growth potential of the economy create fiscal space by raising future government revenues. It should be noted that some of these measures will require political resolve and social support as they are likely to affect social entitlements. Some analysts have remarked that these measures will not have much impact in the short term.

Should there be a re-thinking of the monetary policy framework? In a recent blog in April 2016, Bernanke has argued that:

> *under certain extreme circumstances – [such as] sharply deficient aggregate demand, exhausted monetary policy, and unwillingness of [fiscal authorities] to use debt-financed fiscal policies – [money-financed fiscal programs, colloquially known as helicopter drops] may be the best available alternative"* and that *"it would be premature to rule them out"*.

Earlier in this vein, in 2003, Bernanke had recommended that Japan fight deflation through an expansionary fiscal policy financed by permanent purchases of government debt by the central bank. The permanency of central bank purchases of public debt rules out that the new debt will ever be placed on the market, thereby eliminating Ricardian equivalence effects and preventing new public debt accumulation.

However, an essential aspect of money-financed fiscal programs is that it involves revocation or suspension of central bank independence. Precisely for this reason and because governance of money-financed fiscal programs is inherently difficult (since it creates perverse incentives for legislators to facilitate tax cuts or spending when such actions no longer make macroeconomic sense), this option is not something that central banks in general are discussing or even considering.

In the euro area, the principle of central bank independence is one of the cornerstones of the economic policy constitution enshrined in the Maastricht Treaty. A fundamental expectation is that monetary-fiscal policy coordination will be achieved with different institutions acting independently within their mandates. To preserve this framework, the focus should be on improving the governance structure so as to ensure that the euro area does not gradually slide into a regime of fiscal dominance. Within the constraint of its given mandate, the ECB has moved towards improving the policy mix through the expansion of its balance sheet aimed at stimulating economic activity.

It is my sincere hope that the seminar will provide a useful springboard for moving forward with bolder policy actions and reforms that will help put the Eurozone on a path of strong sustained growth and price stability.