Gent Sejko: Conducting monetary policy when fiscal space is limited

Speech by Mr Gent Sejko, Governor of the Bank of Albania, at the high-level seminar on "Rethinking monetary-fiscal policy coordination", jointly organised by the Bank of Slovenia and the International Monetary Fund, Tirana, 20 May 2016.

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Dear Panel Moderator,

My honorable fellow Panelists,

I believe this seminar provides a perfect platform for exchanging insights on the coordination of monetary and fiscal policies. This issue is quite topical from the perspective of challenges central banks are facing today.

Before going into more detail on the topic of this panel, I would like to share some thoughts with you regarding the coordination of monetary and fiscal policies.

The price stability mandate of the central bank and their operational independence does not lessen the need of effective coordination between monetary and fiscal policies. At a strategic level, the foremost objective of the macroeconomic policy is to achieve sustainable growth, in a context of price stability and a viable external account.

This goal requires the contribution of both the fiscal and the monetary policies, within their respective domains, as well as a fair degree of coordination amongst them.

On a macro scale, a balanced policy mix and an effective policy coordination requires:

– ***Policy sustainability:*** monetary and fiscal policies need to be on a sustainable path. Prevailing academic consensus requires this sustainability to be anchored in simple and effective policy rules, such as an inflation targeting regime and some kind of fiscal sustainability law. Furthermore, sustainability is mutually reinforcing: inflation expectations can only be anchored if the fiscal policy does not rise destabilizing fears while, at the same time, the fiscal policy can be more sustainable if it is not burdened by excessively high interest rates, fueled by a not so credible monetary policy;

– ***Policy credibility:*** monetary and fiscal policies need to be credible. Policy credibility arises from a combination of a clear and sustainable policy framework, the right structure of incentives, as well as a positive track record;

– ***Policy awareness:*** in other words, the recognition of different goals, different transmission channels and different time frames, informing and constraining monetary and fiscal policies.

In the long run, a balanced policy mix would minimize demand volatility, enhance the allocation of resources, and promote long-term growth. Effective policy coordination would limit the fiscal deficit to a level that can be financed via capital markets, without recourse to monetary financing, without distorting the allocation of resources, and without unsustainable external borrowing. Effective policy coordination would also bind monetary policy towards achieving its price stability mandate, thus reducing long-term risk premia and supporting financial stability.

As a corollary to all what I mentioned, a weak stance in one policy area burdens the other policy area with excessive demands.

This brings me to the specific topic of this panel: conducting monetary policy when fiscal space is limited.

The aftermath of the recent crisis left all economies in the region struggling to reignite economic growth. Most of the countries are doing this while at the same time facing the pressing need to consolidate their public finances.

Albania is no exception. Although the repercussions of the crisis were not so severe, economic growth has almost halved compared to its pre-crisis trajectory. Aggregate demand is unable to generate full employment of labor and capital, while CPI inflation has continuously undershot our target. In this economic landscape, our monetary policy has taken an ever more expansionary stance: the policy rate – now at 1.25% – is at a historical minimum, which would have been unthinkable a few years ago; we have increased our liquidity injection operations as well as expanded the range of accepted collateral; and we have also made use of conditional forward guidance as an alternative instrument of monetary policy.

On the other hand, our public debt jumped from around 55% of GDP in 2008 to around 72% of GDP today, on account of the joint action of automatic stabilizers and some degree of countercyclical fiscal stimulus. However, this fiscal expansion was thought to be unsustainable, especially given the difficult financing conditions in international financial markets. It was also thought to be counterproductive, because of crowding out concerns in the presence of tight liquidity conditions in domestic financial markets and because of negative feed-back loops through higher risk premia.

As a result, our fiscal policy is now locked on a consolidation path, aiming to bring the public debt below 60% of GDP within the end of this decade. This means the monetary policy remains the only countercyclical tool to stimulate economic activity. Taking everything into account, I believe fiscal consolidation, coupled to an expansionary monetary policy, delivers the correct policy mix in the country.

However, given our experience so far, I would like to conclude my speech on three observations:

– ***First, monetary policy remains effective even in the presence of fiscal consolidation.*** In Albania, we have been able to steer interest rates into a downward trajectory and to stimulate credit growth in the domestic currency. ***However, the effectiveness of monetary policy is hampered by fiscal contraction.*** While the two policies moving in opposite directions would not be ideal in the best of times, it is doubly so in the presence of balance sheet adjustment in the private sector and heightened risk premia and deleveraging in the financial sector.

– ***Second, monetary policy can still achieve its goal of price stability in the presence of fiscal consolidation.*** However, this statement needs to be qualified further. On a longer term perspective, inflation remains a monetary phenomenon. If a central bank is committed to its price stability mandate and given enough time for the monetary transmission mechanism to work, there should be no reason why we should not be able to meet our inflation targets. However, there are two caveats here:

    – *In pursuit of its inflation target, a central bank can and might be forced to engage in un-conventional monetary policy tools.* This is very much the case when central banks are flirting with the limits of conventional instruments of monetary policy (zero lower bound of policy rates or extreme risk aversion in the financial system). As we know, un-conventional tools can be both distortionary and present us with the risks of unintended consequences in terms of financial stability. Under certain premises, the risk associated with employing un-conventional monetary policy tools might be sufficiently strong to revisit the scope or the speed of fiscal consolidation;

  - *A prolonged undershooting of the inflation target might decouple inflation expectations from the inflation target of central banks requiring a more active monetary policy.* This is not an argument against the policy mix per se; rather, it is a reminder of the crucial role that central bank communication and management of expectations should have.

- ***Third, we should avoid burdening monetary policy with too many goals or risk losing our credibility.*** With public finances highly indebted, politicians have been only too happy to place the burden of economic recovery on central banks. As central bankers, we might enjoy this visibility, but we must be cautious on not getting carried away. We must always remind ourselves of what monetary policy can and cannot achieve: we can ultimately affect nominal variables in the economy, i.e. the price level, but we can affect neither long-term growth nor general prosperity in the economy. To that extent, I think we must always remind politicians on carrying out their duties on structural reforms and make best use of the breathing space provided by monetary policy.

Thank you for your attention!