Monetary and fiscal policies at a crossroads: New Normal or New Path?[1]

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I would like to thank the organisers for the kind invitation. I am pleased to be on this distinguished panel to discuss the nexus between monetary and fiscal policies in the years ahead.

The issue of the nexus between the two policies is a perennial one. But it has risen to renewed prominence post-Great Financial Crisis (GFC) and, especially, post-Covid. Post-GFC, because monetary policy came to be regarded as the "only game in town". Central banks, rather unusually from a historical perspective, were calling for more fiscal stimulus to support macro stabilisation. Post-Covid, because monetary and fiscal policies worked in close concert to stabilise the financial system and the economy. And they succeeded.

In my remarks today, I will *not* focus on the short-term policy mix, which is often the issue that attracts most attention. Rather, I would like to explore the nexus in the medium to long term, which is more important. In so doing, I will be drawing on the latest BIS Annual Economic Report, which explores these issues in detail and which I would strongly encourage you to read for further elaboration.[2]

I would like to highlight three key policy tasks ahead.

First, the need for monetary and fiscal policies to renormalise over the medium term starting when conditions allow. The objective would be to re-establish safety margins or buffers in the form of room for policy manoeuvre. As in any other walk of life, safety margins are essential to overcome the inevitable hazards ahead.

Second, as a longer-term guideline, the need for the two policies to maintain those margins, so as to remain within a kind of "corridor of stability" – a concept that Axel Leijonhufvud coined some

[1] The views expressed are my own and not necessarily those of the BIS.

[2] See BIS, *Annual Economic Report 2021*, Chapter I.

40 years ago and applied to the economy as a whole. This is essential for the economy to evolve along a sustainable path.[3]

Finally, the imperative of raising long-term growth through structural and growth-friendly policies. This is essential to better manage the tough challenges involved and for longer-term prosperity.

Think of this as abandoning the so-called "New Normal" and taking a New Path.

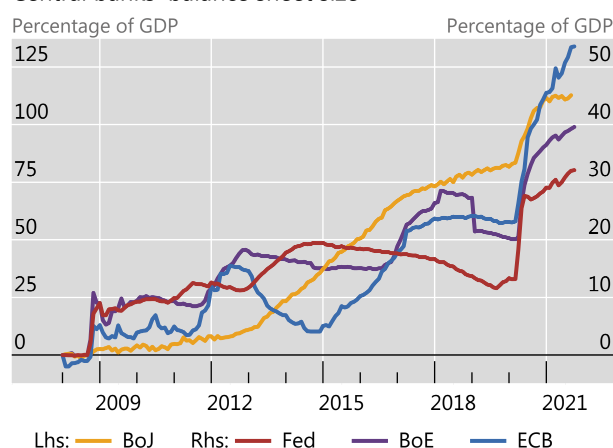
Let me explore the journey, the destination, and the challenges along the way.

The starting point: the New Normal

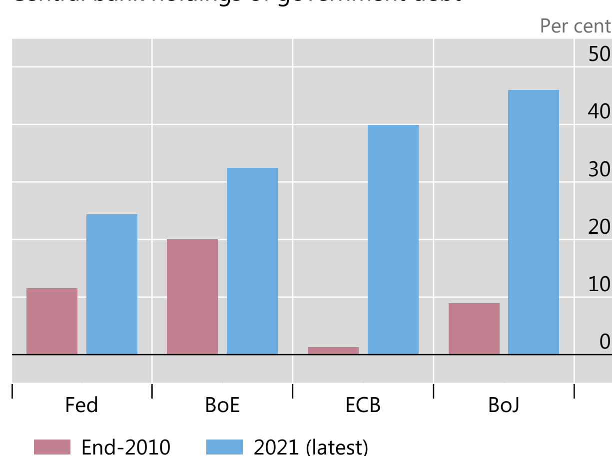
Where does the journey begin? What are the initial conditions? Monetary and fiscal policies are in a delicate position.

Central banks' larger "fiscal" footprints — Graph 1

Central banks' balance sheet size[1]



Central bank holdings of government debt[2]



[1] Cumulative changes in total balance sheet size since 1 January 2008, as a percentage of four-quarter moving sum of quarterly GDP. [2] Holdings of total debt securities issued by the central government as a percentage of the total outstanding. For the Bank of England (BoE), holdings of gilts as a percentage of total outstanding gilts. For the ECB, securities held under the Pandemic Emergency Purchase Program (only public sector securities), Public Sector Purchase Programme (only sovereign bonds) and the Securities Market Programme as a share of total debt securities issued by the central government. [3] For the ECB, as of July 2021; for the Bank of Japan (BoJ) and Federal Reserve, August 2021 and for the BoE, Q1 2021.

Sources: ECB; Bank of Japan; Bank of England; Board of Governors of the Federal Reserve System; United Kingdom Debt Management Office; Datastream; national data; BIS calculations.

[3] A Leijonhufvud, "Stabilities and instabilities in the macroeconomy", *VoxEU*, 21 November 2009. For an elaboration of these arguments, see C Borio and P Disyatat, "Monetary and fiscal policy: privileged powers, entwined responsibilities", *SUERF Policy Note*, no 238, May 2021.

The two policies have been very successful during Covid-19.[4] They rightly worked in close concert leveraging their comparative advantage. Monetary policy deployed its power to create and distribute liquidity; fiscal policy its power to transfer resources and spend. Together, they prevented a much deeper contraction and laid the basis for the recovery.

But the policy headroom has narrowed substantially.

As regards monetary policy, in key advanced economies policy rates are at zero or thereabouts. And balance sheets have risen further (Graph 1, left-hand panel). In the four largest jurisdictions, central banks now hold between one fourth and close to half of the total government debt outstanding (right-hand panel). And only a few emerging market economy (EME) central banks have raised policy rates again, given concerns with inflation and capital outflows.

As regards fiscal policy, government debt in relation to GDP has soared around the globe, so far by around 10 percentage points. And in EMEs, even if debt ratios may be lower than in advanced economies, the policy headroom is generally smaller: financial markets are far less tolerant of high debt – although, so far, the search for yield has muted the markets' pressure.

Since the GFC – and even more so since the pandemic began – this picture of very low interest rates and high public sector debt has often been described as "the new normal". Even on the heels of the recent rise in inflationary pressures, financial markets and most economists see low interest rates as far as the eye can see. And, with interest rates so low, higher debt levels are often regarded as par for the course.

But, from a long-term historical perspective, it is hard to see how the picture can be described as "normal".

In no phase in history have nominal interest rates been as low as they are now. Real interest rates have never been negative for as long, even during the exceptional Great Inflation era – I suspect, therefore, ever since records began. Central bank balance sheets have been as high only during wars. After a relentless rising trend since the mid-1980s, government debt has, globally, reached levels not seen since World War II – surely a historical peak, too (Graph 2, left-hand panel). And despite this, service costs have fallen to a trough (right-hand panel). The debt burden has never felt so light.

It does not seem either prudent or desirable to assume that we are in a new normal. Not prudent, because conditions at some point might change, catching policymakers wrong-footed. Not desirable, because we should strive to live in a world in which fiscal policy is able to operate *comfortably* with interest rates well above zero – with both nominal and real interest rates firmly in positive territory. This would re-establish policy headroom for monetary policy. And no doubt a well functioning economy cannot operate for very long and allocate capital efficiently when real interest rates languish below zero.[5]

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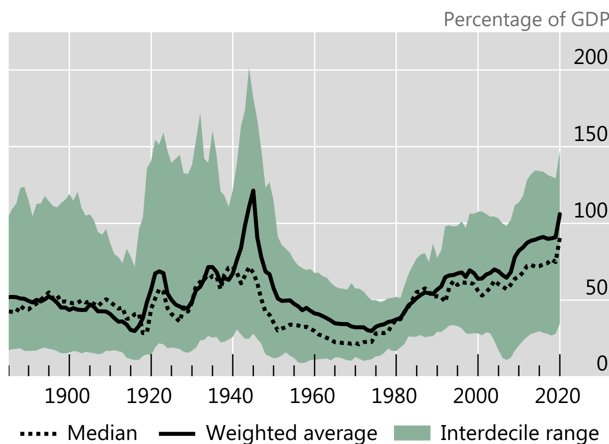
[4] BIS, *Annual Economic Report 2020*, Chapters I and II.

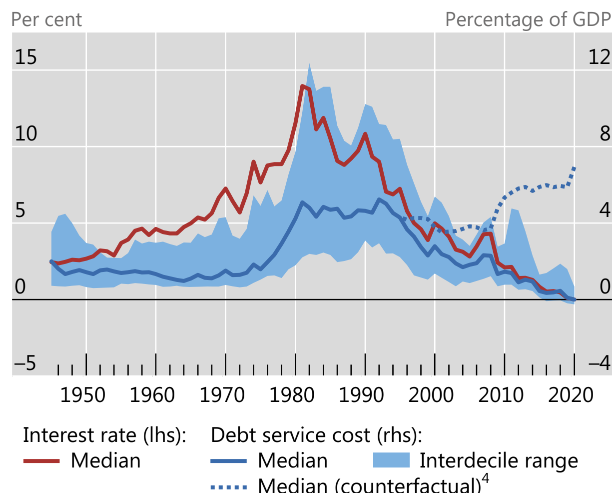
[5] A Carstens, "Central banks facing the pandexit challenge", speech on the occasion of the BIS Annual General Meeting, Basel, 29 June 2021.

Rising debt but debt service cost at historical trough: no reason to worry? Graph 2

Government debt[1, 2]



Debt service cost[1, 3]



[1] Sample of 19 AEs and five EMEs. [2] General government debt at nominal value, latest available quarter for 2020. [3] Debt/GDP multiplied by the simple average of short- and long-term interest rates. [4] Median debt service if nominal interest rates had stayed at the 1995 level.

Sources: O Jordà, M Schularick and A Taylor, "Macrofinancial history and the new business cycle facts", in M Eichenbaum and J Parker (eds), *NBER Macroeconomics Annual 2016*, vol 31, 2016; S A Abbas, N Belhocine, A El-Ganainy and M Horton, "A historical public debt database", *IMF Working Papers*, no 10/245, 2010; European Commission, AMECO database; IMF, *World Economic Outlook*; OECD, *Economic Outlook*; Bloomberg; Datastream; Global Financial Data; Oxford Economics; BIS total credit statistics; BIS calculations.

Hazards ahead

What are the hazards along the journey ahead?

The ultimate, most damaging, hazard would be a kind of "instability trap". In this scenario, rather than taking advantage of low rates to adjust, governments take the opportunity to raise debt further – a risk underlined by the belief that borrowing costs will remain structurally low. In turn, higher government debt (alongside higher private debt) makes it harder to raise interest rates, as the economy becomes less able to bear them. Indeed, after such a long time with such low rates, the economy has adapted to them. This process can be self-reinforcing and reduce both fiscal and monetary policy headroom over time. As a result, the economy becomes more vulnerable to future recessions, which will necessarily come at some point. And what about unexpected events, such as Covid?

Here is some idea of the orders of magnitude involved. Imagine interest rates went back to their mid-1990s levels. This was *after* inflation had been conquered, so that rates had declined to a kind of average level by historical standards. With rates at those levels, government service costs in relation to GDP would be higher than during World War II – no doubt yet another historical peak (Graph 2, right-hand panel, dotted line).

In addition, one should factor in a consideration which is often overlooked (Graph 3). Central bank purchases of long-term government debt financed with bank reserves (QE) *raise* the sensitivity of fiscal positions to higher interest rates. From the perspective of the consolidated public sector balance sheet – aggregating the balance sheets of the central bank and the government – the purchases amount to a large-scale debt management operation: the public sector retires long-term debt and replaces it with overnight debt (bank reserves). Higher interest on reserves cut central bank profits (or raise losses) and hence depress remittances to the government. Government debt may appear long-term, but in fact it is not. Given the size of central bank purchases of long-term government debt, in the largest advanced economy jurisdictions, as much as some 30–50% of it is already de facto overnight.

Graph 3: How long-term government debt may in fact be overnight

Government		**Central Bank**		**Consolidated**	
Assets	*Liabilities*	*Assets*	*Liabilities*	*Assets*	*Liabilities*
↑ Long-term assets	**Short-term bills**	**↑ Long-term bonds**	**↑ Overnight debt**	**↑ Long-term assets**	**Short-term bills**
	↑ Long-term bonds				**↑ Overnight debt**

The figure shows what happens to the consolidated government-cum-central bank balance sheet if the government issues long-term debt (green rectangle) purchased by the central bank and financed with interest-bearing bank reserves (de facto overnight debt – orange rectangle).

Source: Borio, C and P Disyatat (2021): "Monetary and fiscal policy: privileged powers, entwined responsibilities", *SUERF Policy Note*, no 238, May.

Policies for the right destination: the New Path

What is the final destination?

The journey's destination is not predetermined. It is policy that chooses the path ahead. We do not want to go down the one that leads to an instability trap. Where should we go, then? Which path should we take?

The previous analysis suggests that we would like monetary and fiscal policies to operate within a "corridor of stability". That is, we would like them to travel along a sustainable path, with sufficient safety margins to deal not just with "garden variety" recessions, but also with the unexpected. Economies that operate without safety margins are vulnerable and exposed.

The Covid-19 crisis has highlighted the importance of safety margins. Those countries with greater fiscal and monetary room for policy manoeuvre were able to respond more strongly. And the post-GFC prudential policy-induced increase in their capital strength allowed banks to be part of the solution, rather than of the problem, in sharp contrast to what happened during the GFC.

To arrive safely at this destination, three policy responses appear desirable.

First, once the Covid-19 crisis has been left behind and macroeconomic conditions allow, it would be important to normalise fiscal and monetary policies *over the medium term*.

The challenge is that, given starting conditions, this is a joint task. Along the long path ahead, the two policies will at times be working at cross purposes, putting pressure on each other. Higher interest rates increase the size of the required fiscal adjustment, and fiscal consolidation puts pressure on monetary policy to remain accommodative for longer. The closest equivalent is the post-World War II period. And we know that the resolution of the tension involved high inflation: we don't want to repeat that experience.

Importantly, successfully reducing government debt-to-GDP ratios has typically required a combination of running fiscal primary surpluses and favourable interest rate-economic growth differentials. Such differentials have now prevailed for some time. This suggests that the window of opportunity should not be missed.

Second, it will be important to reaffirm clear boundaries between monetary and fiscal policies. Blurring the dividing lines was necessary during the Covid crisis. But circumstances were exceptional. Failing to reaffirm the boundaries would heighten the risk of the "instability trap". Along the way, central bank independence – an invaluable asset – could come under threat. Fiscal policy sustainability is indispensable.

Finally, to facilitate the adjustment process, raising long-term growth is essential. This would improve the interest rate-economic growth configuration and allow fiscal consolidation to take place alongside higher real interest rates – critical for a vibrant economy. This requires reinvigorating structural reforms, which have been flagging for at least a decade now, and supporting them with a growth-friendly structure of government expenditure and taxes.

Conclusion

Unfortunately, in contrast to the proverb, not all roads lead to Rome. Policymakers are at a crossroads. They can decide to travel along the path that assumes we are in a new normal, adjusting to it, with all the risks that that entails. Or they can decide to take a new path, changing it. The destination is not predetermined.