Monetary and fiscal policy: safeguarding stability and trust

Speech by Claudio Borio
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Some things never change. One of them is monetary and fiscal policy's perennial search for coherence and stability. The two policies are simply too closely intertwined. And their influence on the economy too powerful.

Over the past year, we have seen the latest example of tensions. Monetary policy has been restraining aggregate demand to quench inflation; fiscal policy has been boosting it to shield activity from higher commodity prices. And higher interest rates have widened fiscal deficits.

But the challenges go way beyond the short-term policy mix. They have to do with long-term trajectories and their cumulative impact. This is the focus of this year's *Annual Economic Report*.

To shed light on those challenges, we put forward the notion of the region of stability. The region maps constellations of the two policies that foster *sustainable* macroeconomic and financial stability, and that keep tensions between the policies manageable.

We reach three conclusions.

First, even before the Covid crisis struck, the two policies had been approaching the boundaries of the region. Hence the recent unique combination of high inflation and widespread financial vulnerabilities.

Second, looking ahead, longer-term government debt trajectories pose the biggest threat. They have been relentlessly narrowing the region of stability and will continue to do so.

Finally, operating firmly within the region calls for adjustments to strategies, institutions and, above all, mindsets. The objective is to dispel a kind of "growth illusion" – a de facto excessive reliance on monetary and fiscal policy to drive growth.

Let me say a few words about the nexus between monetary and fiscal policy as well as the region of stability, the journey to the boundaries, the risks ahead and the policy implications.
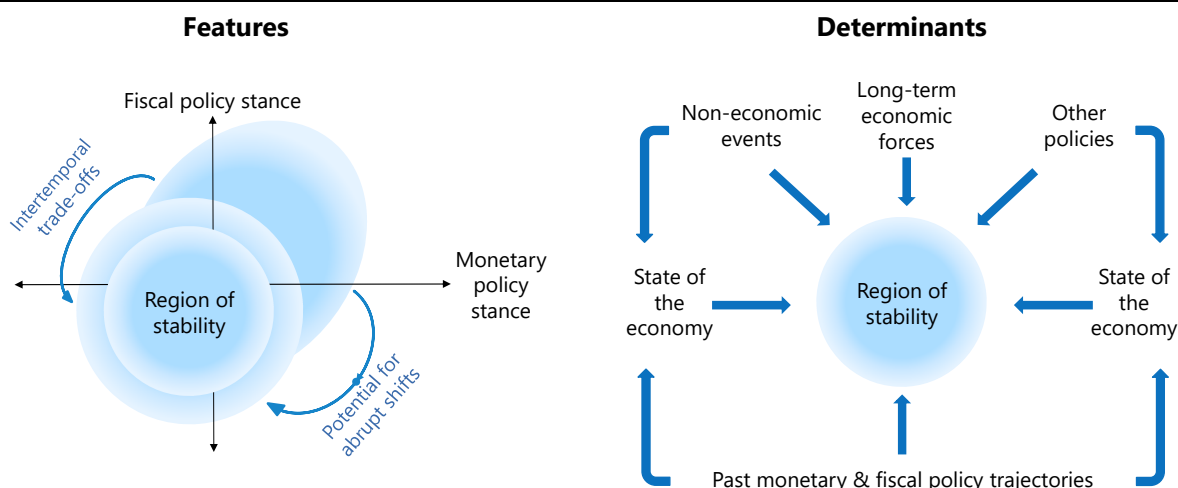
The policy nexus and the region of stability

Monetary and fiscal policy are inevitably tied closely together. They give the state privileged access to resources, through the issuance of money and the power to tax, respectively. They back each other up: monetary policy can avoid the government's technical default; the power to tax ultimately backs the value of money. They operate through intertwined balance sheets – those of the central bank and the government. Their transmission mechanisms overlap, notably through financial conditions. And they have a major impact on the economy.

With this great power comes great responsibility. The region of stability, illustrated in Graph 1, delineates the range of policy settings that are consistent with the proper exercise of that power. Drifting outside the region generates large economic costs, in the form of slumps, high inflation and financial instability.

Region of stability   Graph 1

Features

- Fiscal policy stance
- Intertemporal trade-offs
- Region of stability
- Monetary policy stance
- Potential for abrupt shifts

Determinants

- Non-economic events
- Long-term economic forces
- Other policies
- State of the economy
- Region of stability
- State of the economy
- Past monetary & fiscal policy trajectories

Source: BIS.

The region's location, size and shape depend on the state of the economy, not least that of the financial sector. In turn, the state of the economy depends on two sets of factors. One includes factors other than monetary and fiscal policy. Think, for instance, of non-economic events, eg a pandemic or a war, of powerful long-term economic tectonic forces, eg globalisation and financial liberalisation, or of other policies, notably, prudential policy. The other set comprises monetary and fiscal policies themselves – in particular, their past trajectory and their cumulative impact on the current state of the economy. Think, for instance, of the impact of past deficits on government debt or of long periods of very low interest rates on financial vulnerabilities.

Two important features stand out.

First, the two-way feedback between the state of the economy, on the one hand, and monetary and fiscal policy, on the other, opens the door to intertemporal trade-offs. Policy settings that may appear reasonable, indeed compelling, in the near term may cause problems down the road.

Second, the contours of the region are fluid and can be hard to discern in real time. They may become clearly visible only ex post. And instability may emerge abruptly, as confidence evaporates.

The journey so far

These two features figure prominently in the journey that has taken the two policies to the boundaries most recently.

Even before the Covid crisis, the two policies were approaching the boundaries (Graph 2). Globally, after a long string of deficits, government debt in relation to GDP had climbed to historical peaks (left-hand panel). Interest rates in nominal terms had fallen to historical troughs, while, in inflation-adjusted (real) terms, they had been negative in the wake of the Great Financial Crisis (GFC). And central bank balance sheets had reached wartime peaks. Ostensibly, policy buffers and safety margins had become uncomfortably small, leaving the economy highly exposed and vulnerable.

Policies did manage to ease aggressively once again as the Covid crisis struck, but at the cost of further flirting with the boundaries and laying the ground for the recent economic dislocations.
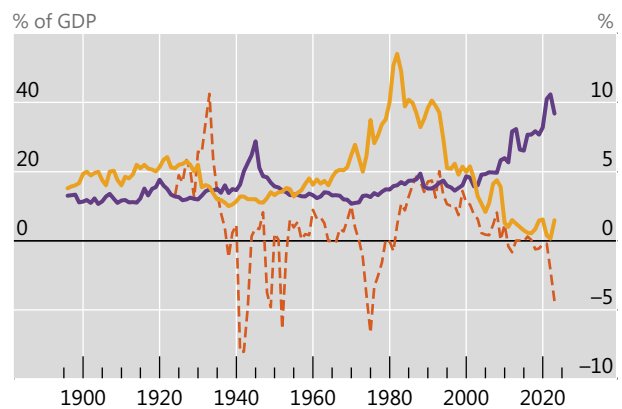
Monetary and fiscal policy in historical perspective[1]   Graph 2

Fiscal deficits and government debt[2]
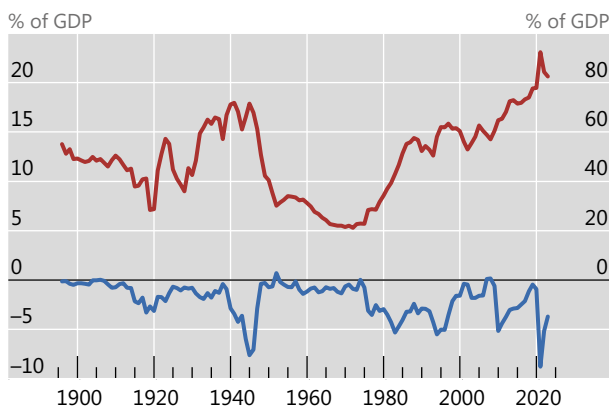
Median: ── Fiscal balance (lhs)   ── Government debt (rhs)

Policy rates and central bank balance sheets[3]

── Total central bank assets (median, lhs)

Policy rates (median, rhs): ── Nominal   --- Real

[1] Statistics are computed using a smaller set of countries when data are not available.   [2] General (if not available, central) government core (if not available, total) debt at nominal (if not available, market) value. The sample covers AR, AT, AU, BE, BR, CA, CH, CL, DE, DK, ES, FR, GB, GR, IN, IT, JP, NL, NO, NZ, PT, RU, SE and US.   [3] The sample covers AR, AU, BE, BR, CA, CH, CL, CN, DE, ES, FI, FR, GB, HK, ID, IE, IN, IT, JP, KR, MX, MY, NL, NO, PE, PH, SE, SG, TH and US.
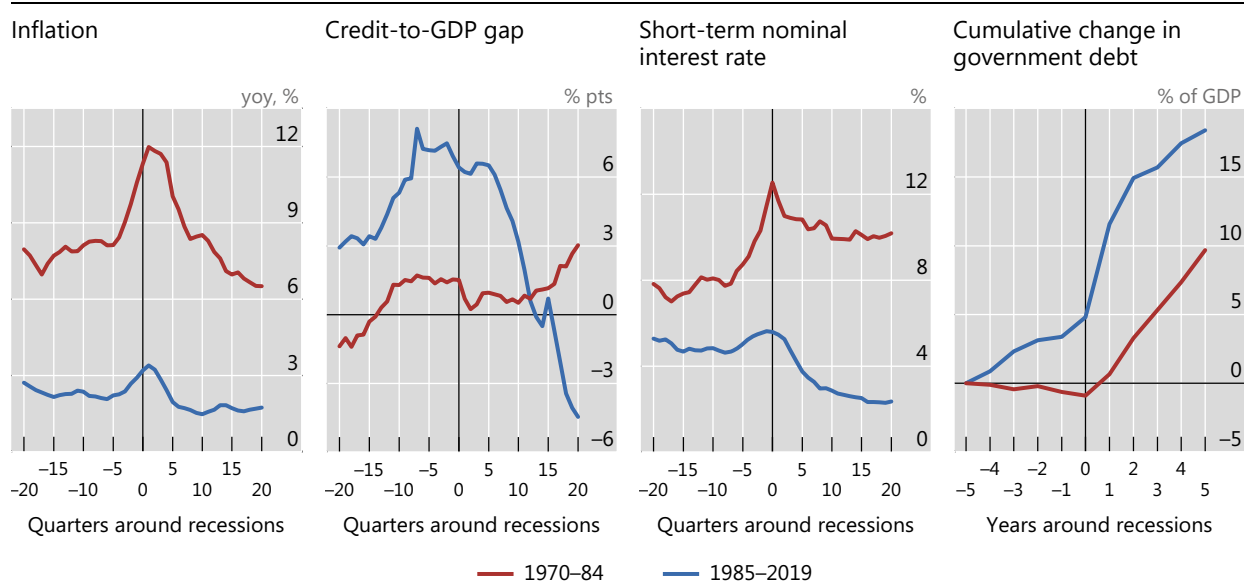
Sources: S Abbas, N Belhocine, A El-Ganainy and M Horton, "A historical public debt database", *IMF Working Papers*, no 245, 2010; Ò Jordà, M Schularick and A Taylor, "Macrofinancial history and the new business cycle facts", in M Eichenbaum and J Parker (eds), *NBER Macroeconomics Annual*, vol 31, University of Chicago Press, 2016; European Commission; IMF; OECD; Datastream; Global Financial Data; Oxford Economics; national data; BIS.

Looking at the longer journey, back to the 1970s, this was not the first time that the boundaries were tested or breached. All such episodes shared one feature: policies underestimated the constraints on economic expansions.

That said, the symptoms evolved over time, along with the changing nature of the business cycle and the signals of impending recessions (Graph 3). Until the mid-1980s (red lines), at least in advanced economies (AEs), the signal was rising inflation (first panel). Think of the Great Inflation of the 1970s. Thereafter, until the Covid crisis, it was the build-up of financial imbalances (second panel, blue line), here denoted by the deviation of the credit-to-GDP ratio from a slow-moving trend. Think of the GFC as the most spectacular example.

Symptoms of testing/breaching the boundaries[1]   Graph 3

| Inflation | Credit-to-GDP gap | Short-term nominal interest rate | Cumulative change in government debt |

1970–84   1985–2019

[1] The horizontal axis denotes quarters/years around recessions in the business cycles, with the peak date set at zero (vertical lines). Lines show the mean evolution of the time series across 16 AEs and events from 1970 to 2019, upon data availability. Business cycle dates are from National Bureau of Economic Research for US; Economic Cycle Research Institute for AU, CA, CH, DE, ES, FR, GB, IT, JP and SE. For BE, FI, IE, NL and NO business cycles are dated with a business cycle-dating algorithm. Episodes for which data for the previous and next 20 quarters are available are used in computing the medians.

Sources: IMF; OECD; Datastream; Economic Cycle Research Institute; National Bureau of Economic Research; national data; BIS.

This helps explain the gradual loss in policy buffers following the mid-1980s: policies became less *systematically* countercyclical. Monetary policy (third panel, blue line) had little reason to tighten during expansions, as inflation remained subdued, thereby accommodating the build-up of financial imbalances; but it eased strongly and persistently to fight the recessions, now at times exacerbated by banking crises. These financial recessions, in turn, drove large holes in the fiscal accounts (fourth panel, blue line), that were not replenished during subsequent upswings.

In the background, powerful long-term tectonic forces were also shaping the journey. Financial liberalisation amplified financial cycles. And the globalisation of the real economy helped central banks hardwire low inflation.

In a nutshell, after the mid-1980s, low and stable inflation masked the constraints on economic expansions, encouraging policymakers to test them. Partly as a result, growth became increasingly reliant on debt accumulation, both public and private (Graph 4).

Greater reliance on debt-fuelled growth[1]   Graph 4

Decadal change in debt-to-GDP ratio: ■ Public ■ Private
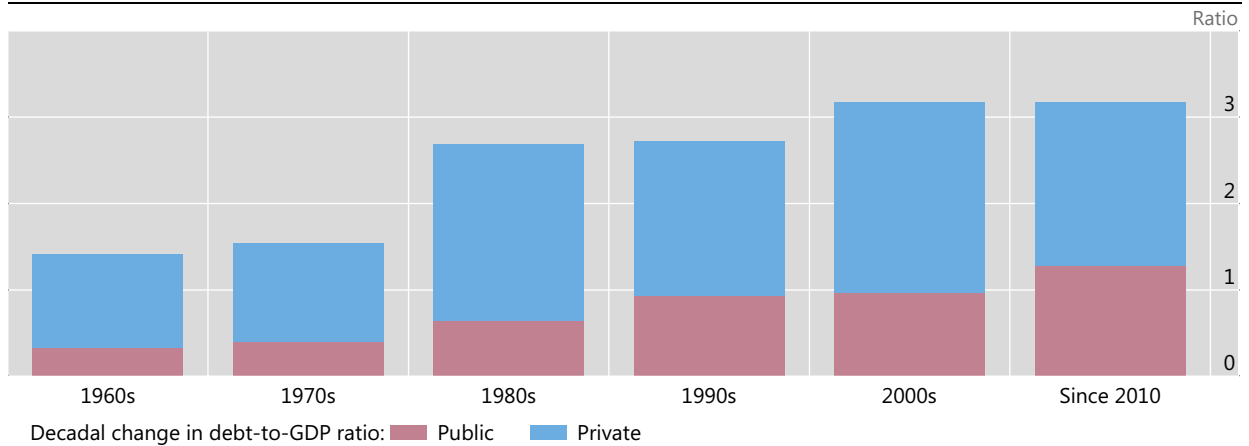
[1] Decadal change of total nominal values across economies. The sample covers AR, AU, BE, BR, CA, CH, CL, CN, CO, DE, DK, ES, FR, GB, HK, ID, IN, IT, JP, KR, MX, MY, NL, NO, NZ, SE, SG, TH and US upon data availability.

Sources: IMF; national data; BIS.

The journey in emerging market economies (EMEs) was similar in significant respects. After all, the same long-term forces were at play. Hence, the similar evolution of key indicators (Graph 5) – inflation, the policy rate, the fiscal balance and public debt.

Monetary and fiscal policy in advanced and emerging market economies[1]   Graph 5

— AEs   — EMEs
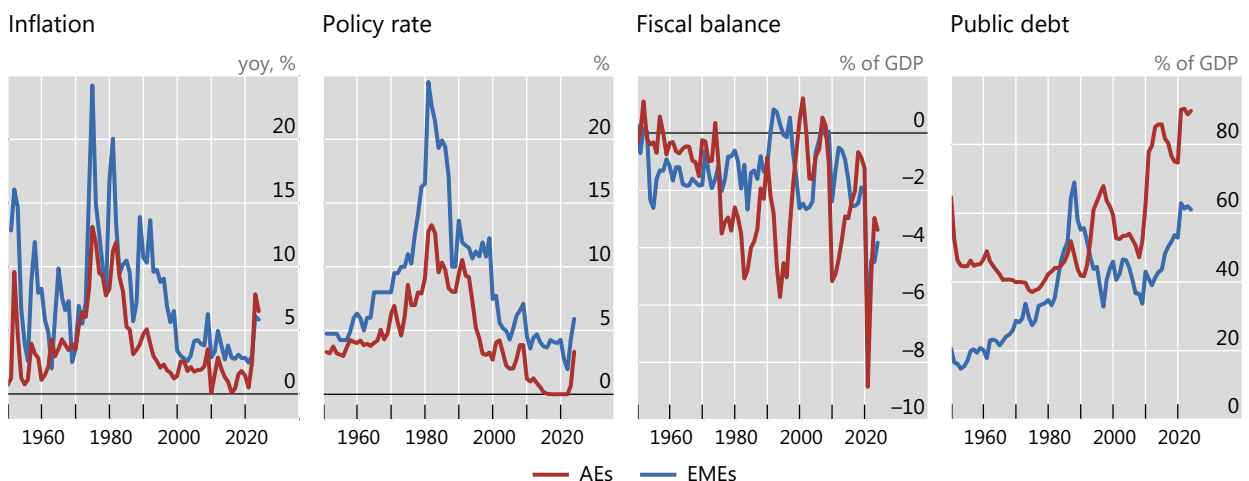
[1] Median across AEs = AU, BE, CA, CH, DE, ES, FI, FR, GB, IE, IT, JP, NL, NO, SE and US. EMEs = AR, BR, CL, CN, CO, HK, ID, IN, KR, MX, MY, PE, PH, SG, TH and VN. For fiscal balance and public debt, IMF forecasts for 2023.

Sources: IMF; Global Financial Data; national data; BIS.

However, regional and timing differences aside, the journey differed in one critical respect: these countries have been much more sensitive to global financial conditions, notably to monetary conditions in AEs, especially those in US dollars – the dominant international currency. Thus, the exchange rate has also played a more salient role.

The long journey explains why, today, we are seeing a unique combination of previous symptoms. In part because of the policy response to Covid, inflation has surged. In part because of the long phase of very low interest rates, vulnerabilities have built up and financial stress has broken out. This makes the current situation particularly challenging.
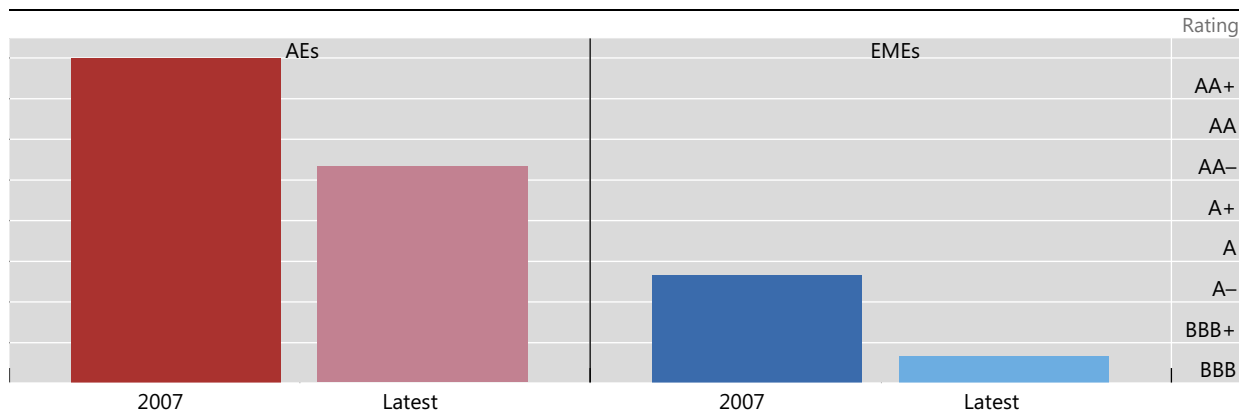
The journey ahead

What about the risks along the journey ahead?

As monetary policy normalises, the biggest risk is the unsustainability of government debt trajectories – a factor which has already started weighing on credit ratings for both AEs and EMEs (Graph 6).

Sovereign ratings deteriorate[1]   Graph 6

[1] Average sovereign debt ratings from Fitch, Moody's and S&P. The series plotted represent cross-country medians, for a smaller sample when data are not available. AEs = AT, AU, BE, CA, CH, CY, DE, DK, EE, ES, FI, FR, GB, GR, HR, IE, IT, JP, LT, LU, LV, MT, NL, NO, NZ, PT, SE, SI, SK and US. EMEs = BR, CL, CN, CO, CZ, HK, HU, ID, IL, IN, KR, MA, MX, MY, PE, PH, PL, RO, SG, TH, TR, VN and ZA.
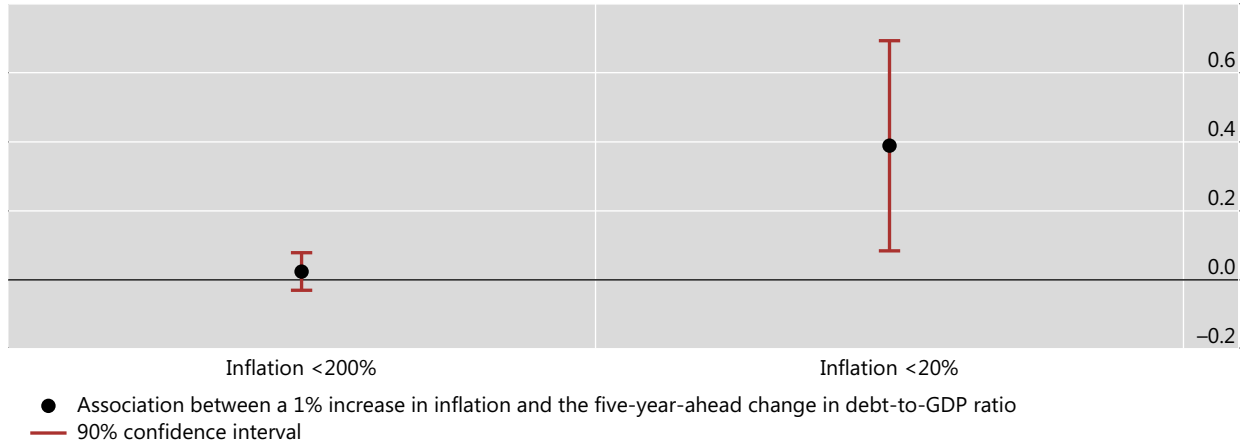
Sources: Fitch; Moody's; S&P Global; BIS.

Let me stress that the recent inflation flare-up has cut debt-to-GDP ratios *only temporarily*. Historical evidence indicates that, in both AEs and EMEs, higher inflation has, if anything, ushered in *higher*, not *lower*, debt-to-GDP ratios in the following years (Graph 7). The impact is hardly different from zero even at high inflation rates (left-hand dot and whisker).

Higher inflation does not improve government finances[1]

Graph 7

Coefficient

Inflation <200%   Inflation <20%

● Association between a 1% increase in inflation and the five-year-ahead change in debt-to-GDP ratio
— 90% confidence interval

[1] The sample includes annual data between 1970 and 2022 for AE, AR, AT, AU, BE, BR, CA, CH, CL, CN, CO, CZ, DE, DK, DZ, ES, FI, FR, GB, GR, HK, HU, ID, IE, IL, IN, IT, JP, KR, MA, MX, MY, NL, NO, NZ, PE, PH, PL, PT, RO, RU, SA, SE, SG, TH, TR, US and ZA. The estimated effects are obtained from regressing the change in general government debt as a percentage of GDP between year t and t+5 over inflation in year t and country fixed effects. The regression sample excludes periods when a debt restructuring took place.
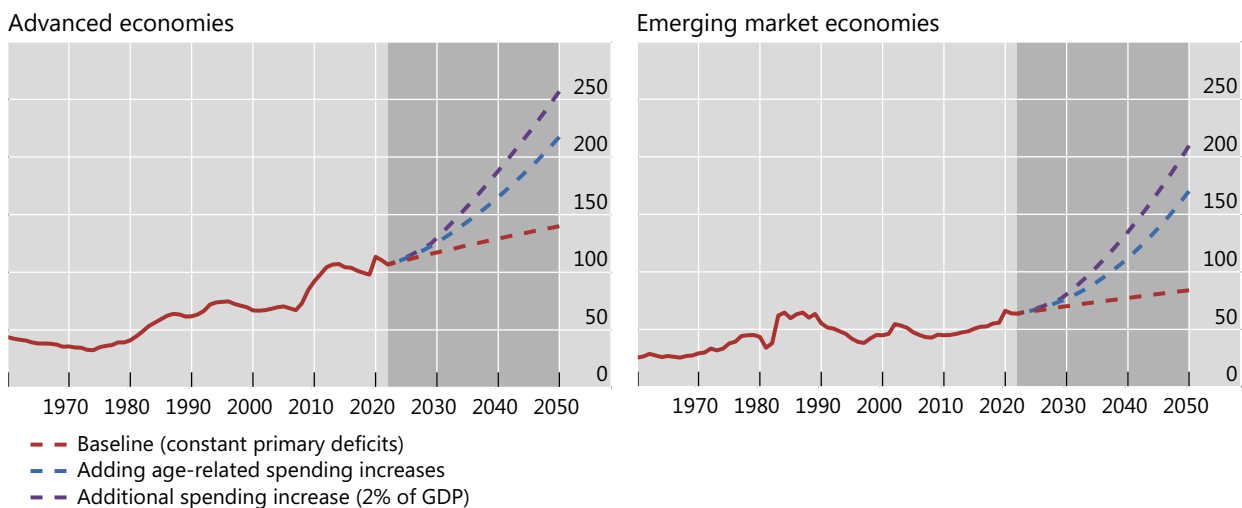
Sources: IMF; national data; BIS.

Stylised projections underline the longer-term risk to government finances (Graph 8). Even if interest rates stay below growth rates, absent consolidation, debt-to-GDP ratios are set to climb in the long term from their current historical peaks. The increase would be substantially larger if one factored in the impact of ageing populations as well as those of the green transition and higher defence spending linked to possible geopolitical tensions.

Worrying public debt projections[1]

As a percentage of GDP

Graph 8

Advanced economies

Emerging market economies

- - - Baseline (constant primary deficits)
- - - Adding age-related spending increases
- - - Additional spending increase (2% of GDP)

[1] Baseline projections assume an interest rate-growth differential equal to −1% and constant primary deficits in percent of GDP as of 2022. Age-related spending are based on IMF projections for pension and healthcare spending for 2030 and 2050. For the additional spending increase scenario it is assumed that the primary deficit will increase by 2% of GDP by 2030 and stay at that level afterwards. Historical debt is computed using a smaller set of countries when data are not available. Simple average across AEs = AT, BE, DE, ES, FI, FR, GB, IE, IT, JP, NL, PT and US. EMEs = AR, BR, CL, CN, CO, CZ, HU, ID, IL, IN, KR, MX, PL and ZA.

Sources: IMF; OECD; BIS.

Should interest rates exceed growth rates again, the self-reinforcing dynamics would be much stronger. Moreover, it is not uncommon for the differential to switch sign (Graph 9, left-hand panel). To get a sense of the possible impact of high debt, if today's interest rates were as high as those in the mid-1990s – a typical level – all else equal, debt service burdens would over time exceed their historical peak.

This grim outlook for government debt is quite worrying since it raises serious risks for price and financial stability. Let's consider each in turn.

The interest rate-growth differential and the debt service burden

Graph 9

Interest-growth differential[1]

Debt service cost[2]

— AEs (mean)

— Median   ● Counterfactual
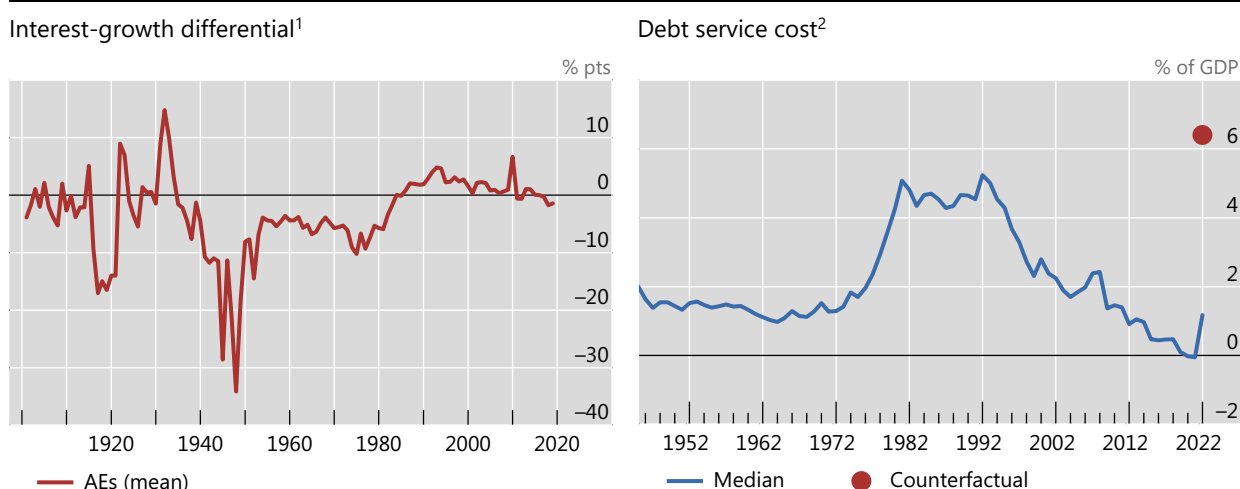
[1] Computed as the effective interest rate (ratio of the interest expense to debt) less inflation less real GDP growth. AEs = AU, BE, CA, DE, DK, ES, FR, GB, IT, JP, NL, NO, NZ, PT, SE and US.   [2] The sample covers AR, AT, AU, BE, BR, CA, CH, CL, DE, DK, ES, FR, GB, GR, IN, IT, JP, NL, NO, NZ, PT, RU, SE and US. Statistics are computed using a smaller set of countries when data are not available. Government debt-to-GDP multiplied by the simple average of short-term and long-term interest rates, where government debt is general (if not available, central) government core (if not available, total) debt at nominal (if not available, market) value. The counterfactual median debt service cost is constructed using the interest rate levels prevailing in 1995.

Sources: S Abbas, N Belhocine, A El-Ganainy and M Horton, "A historical public debt database", *IMF Working Papers*, no 245, 2010; Ò Jordà, M Schularick and A Taylor, "Macrofinancial history and the new business cycle facts", in M Eichenbaum and J Parker (eds), *NBER Macroeconomics Annual*, vol 31, University of Chicago Press, 2016; European Commission; IMF; OECD; Bloomberg; Datastream; Global Financial Data; Oxford Economics; national data; BIS.

Price stability

Fiscal policy can greatly constrain monetary policy in its fight against inflation.

Within a certain range, the constraints are manageable: expansionary fiscal policy increases the required degree of monetary policy tightening only to a limited extent and central bank independence provides sufficient safeguards. But when the credibility of fiscal policy or the creditworthiness of the sovereign are lost, monetary policy can be hamstrung: a tightening would only heighten those concerns and fuel inflation, typically through an uncontrolled exchange rate depreciation – a form of fiscal dominance.

Stylised empirical evidence is consistent with these considerations (Graph 10). The inflationary impact of a fiscal expansion is greater when the fiscal policy regime is less concerned with fiscal

sustainability – "spendthrift" rather than "prudent". Moreover, extreme situations aside, central bank independence is key: inflation is lower regardless of the fiscal policy regime.

Inflationary effects of fiscal stimulus across fiscal and monetary regimes   Graph 10

Fiscal policy: ■ Prudent   ■ Spendthrift
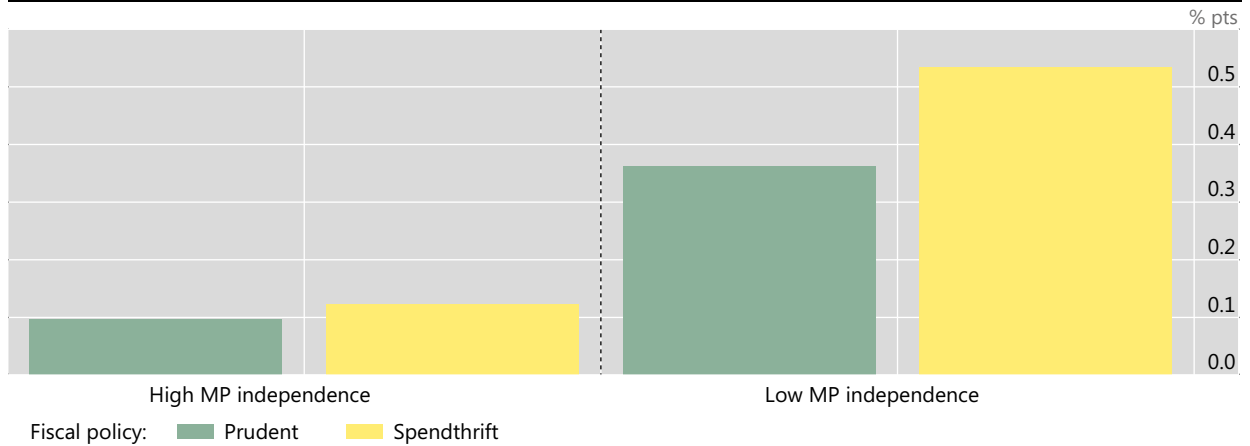
[1] The sample covers AT, AU, BE, CA, CH, DE, DK, ES, FI, FR, GB, GR, IE, IT, JP, NL, NO, NZ, PT, SE and US. Fiscal regimes are classified as prudent or spendthrift based on P Mauro, R Romeu, A Binder and A Zaman, "A modern history of fiscal prudence and profligacy", *Journal of Monetary Economics*, vol 76, 2015, pp 55–70. Monetary policy (MP) independence is defined as being high or low based on legal limitations on central bank lending to the public sector in D Romelli, "The political economy of reforms in central bank design: evidence from a new dataset", *Economic Policy*, vol 37, no 112, 2022, pp 641–88. Estimation sample from 1972– 2011 upon data availability.

Source: R Banerjee, V Boctor, A Mehrotra and F Zampolli, "Fiscal deficits and inflation risks: the role of fiscal and monetary regimes", *BIS Working Papers*, no 1028, July 2022.
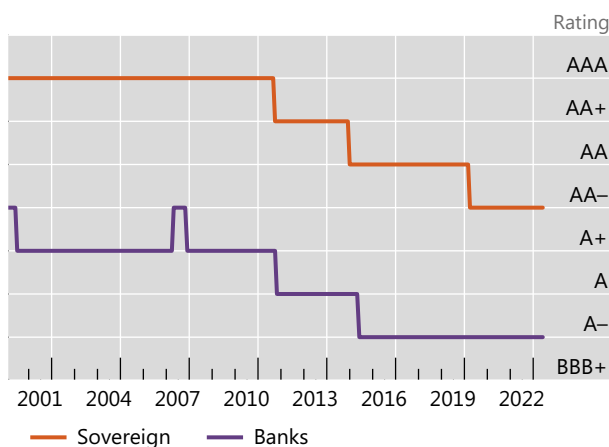
Financial stability

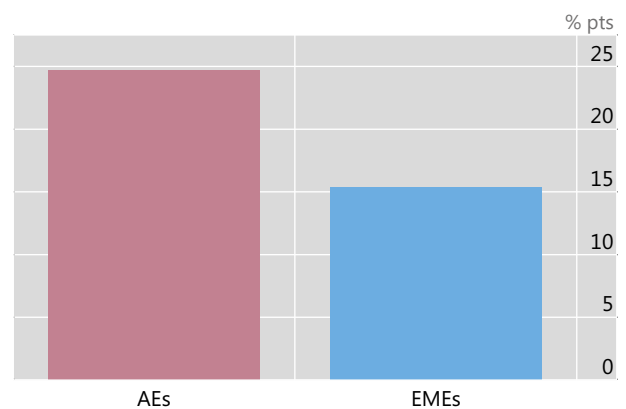Fiscal policy can also constrain monetary policy by triggering or amplifying financial instability.

Two-way causality between fiscal policy and financial instability   Graph 11

Sovereign and bank ratings AEs[1]

Change in government debt five years after a banking crisis[2]

— Sovereign   — Banks

[1] Median ratings across AU, BE, CA, DE, ES, FI, FR, GB, GR, HR, IE, IT, JP, MT, NL, NO, NZ, PT, SE, SI, SK and US.   [2] See C Borio, M Farag and F Zampolli, "Tackling the fiscal policy-financial stability nexus", *BIS Working Papers*, no 1090, April 2023.
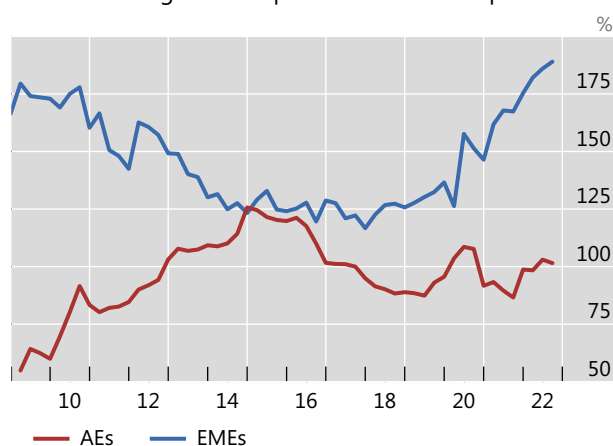
Sources: Fitch; BIS.

The direction of causality between fiscal policy and financial instability goes both ways. On the one hand, high sovereign indebtedness can cause financial system stress by generating losses for financial institutions, either because of their exposures to sovereign debt or simply by destabilising the economy. This is a key reason why government and bank credit ratings tend to co-move (Graph 11, left-hand panel). On the other hand, financial system stress, regardless of its origin, can cripple fiscal soundness. It can do so directly, as the sovereign may need to backstop the financial system, and, most importantly, indirectly, as the economy tanks. The surge in public sector debt following banking crises is typically well above 10 percentage points of GDP (right-hand panel). This two-way causality can give rise to the infamous sovereign-bank doom loop.

Post-GFC in particular, as sovereign debt has soared, financial institutions have absorbed growing amounts. The corresponding increase in relation to bank capital in both AEs and EMEs has been sizeable (Graph 12, left-hand panel). Given the lengthening of maturities, exposures to interest rate (or duration) risk have also grown substantially (right-hand panel), even where central banks have engaged in large-scale asset purchases. The corresponding potential losses can be quite large.
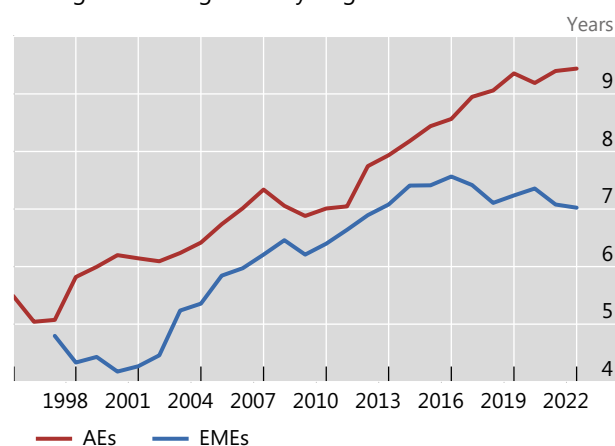
The fiscal policy-financial instability nexus   Graph 12

Banks' sovereign debt exposure as ratio to capital[1]   Average remaining maturity of government securities[2]

[1] The sample consists of AEs = AT, DK, ES, FR, IT, JP, LU, NL, PT and US. EMEs = AR, BR, CL, CO, CZ, HU, ID, IN, KR, MX, MY, PE, PH, PL, SG, TH, TR and ZA, where data are available. Other depository corporations net claims on central government and their claims on state and local government by residence, as percentage of banks' Tier 1 capital. The reporting depository corporations comprise all solo entities resident in the country, including those which are foreign-owned subsidiaries or branches of foreign entities. Branches and subsidiaries abroad of domestically owned entities are not included. Latest corresponds to latest available quarterly figure in 2022. For AT, data up to Q3 2021; for CL, data up to Q4 2021; for SG, data up to Q4 2019.   [2] Simple average maturity of central government debt securities issued across countries in the region upon data availability. AEs = AT, AU, BE, CA, DE, ES, FR, GB, GR, IT, JP, NL and US. EMEs = AR, BR, CL, CO, CZ, HK, HU, ID, IN, KR, MX, MY, PE, PH, PL, SA, SG, TH, TR and ZA.

Sources: IMF; Bloomberg; Datastream; BIS.

Indeed, in the year under review, we have already seen how interest rate risk alone can cause stress in the system. Think of the turmoil in UK gilts markets, or of the failure of a number of US banks. The stress would be much more severe should the creditworthiness of some sovereigns be questioned at some point.

Policy

What are the implications of this analysis for policy?

The overriding priority is for monetary and fiscal policy to operate *firmly* within the region of stability. This requires adjustments to strategies, institutions and mindsets, well beyond monetary and fiscal policies themselves.

For fiscal policy, it is essential to ensure that debt evolves along an unambiguously sustainable path. This is the cornerstone of a well functioning economy and a prerequisite for monetary policy to retain headroom. With regard to strategies, it would be important to pay greater attention to the impact of financial factors on fiscal space, notably to the flattering effect of financial imbalances and to the potential fiscal costs of banking crises. With regard to institutions, it is crucial to give fiscal councils and fiscal rules more bite, possibly through constitutional safeguards.

For monetary policy, the priority is to ensure price stability while paying due attention to financial stability. As regards strategies, once price stability is re-established, it would be desirable to exploit the self-stabilising properties of low-inflation regimes, documented in detail in last year's *Annual Economic Report*. This means greater tolerance for moderate, even if persistent, shortfalls of inflation from narrowly defined targets. Greater tolerance would also reduce the incidence of long periods of unusually low interest rates, thereby limiting their side effects, such as the build-up of financial vulnerabilities, the misallocation of resources and the incentive for governments to accumulate debt. As regards institutions, safeguarding central bank independence will be even more important if fiscal positions continue to deteriorate.

Two additional policy areas can substantially enlarge the region of stability.

One is prudential policy, both micro- and macroprudential – the first line of defence against financial instability. An effective prudential framework involves a whole range of elements. Concerning sovereign exposures, more specifically, there is a need to revisit the favourable treatment of sovereign debt in market and credit risk.

Another, badly neglected, area is structural policy. Higher sustainable growth can be achieved only through decisive measures to improve the supply side of the economy. Structural policies have been flagging for too long. They need to be revived with urgency.

Ultimately, however – and let me conclude with this – a change in mindsets is called for. A keener recognition of the limitations of demand management policies is key to overcoming the "growth illusion" described earlier. The concept of the region of stability, hard as it may be to apply in real time, can promote the necessary shift in perspective. The concept is first and foremost a lens through which to look at the world and guide policy. It can help preserve the vital trust that society must have in the state and its decision-making.