



Monetary and fiscal policy: safeguarding stability and trust

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Monetary policy Fiscal policy

**REGION
OF STABILITY**

Key takeaways

Monetary and fiscal policy have been testing the boundaries of the region of stability

Longer-term government debt trajectories pose the biggest threat

Operating firmly within the region of stability calls for adjustment to strategies, institutions and **mindsets**



The policy nexus and the region of stability

Two policies inextricably intertwined

Privileged access to resources

Mutual backstops

Intertwined balance sheets

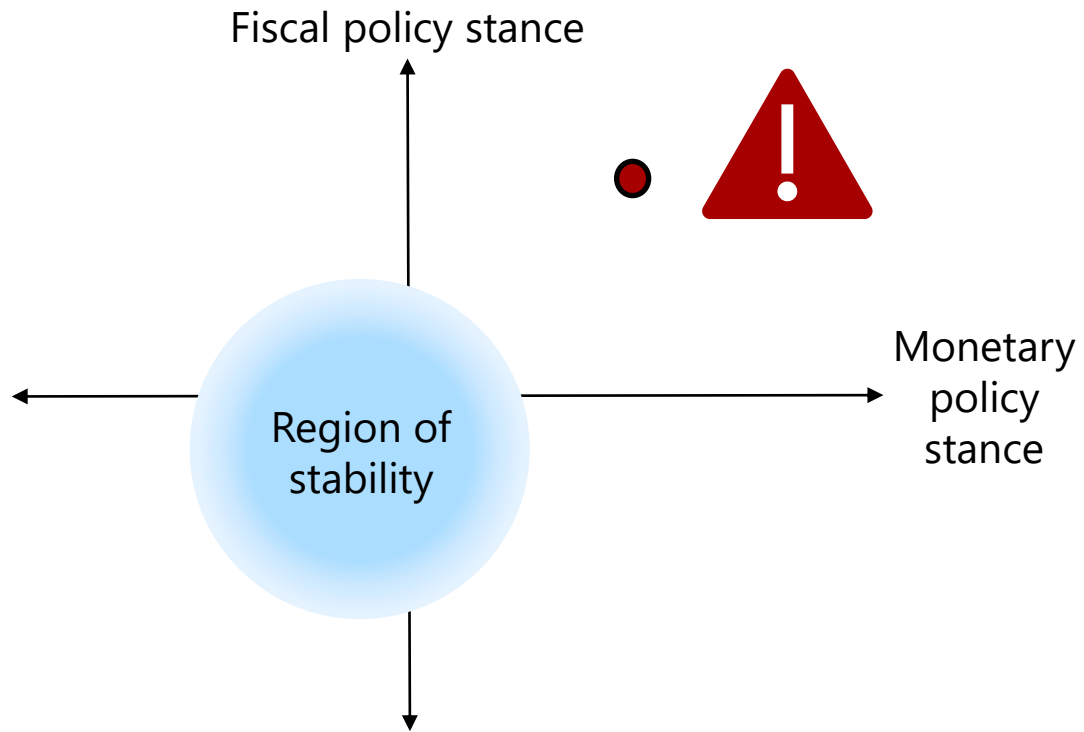
Overlapping transmission mechanisms

Major impact on the economy



Region of stability

Region of stability



Drifting outside the region of stability

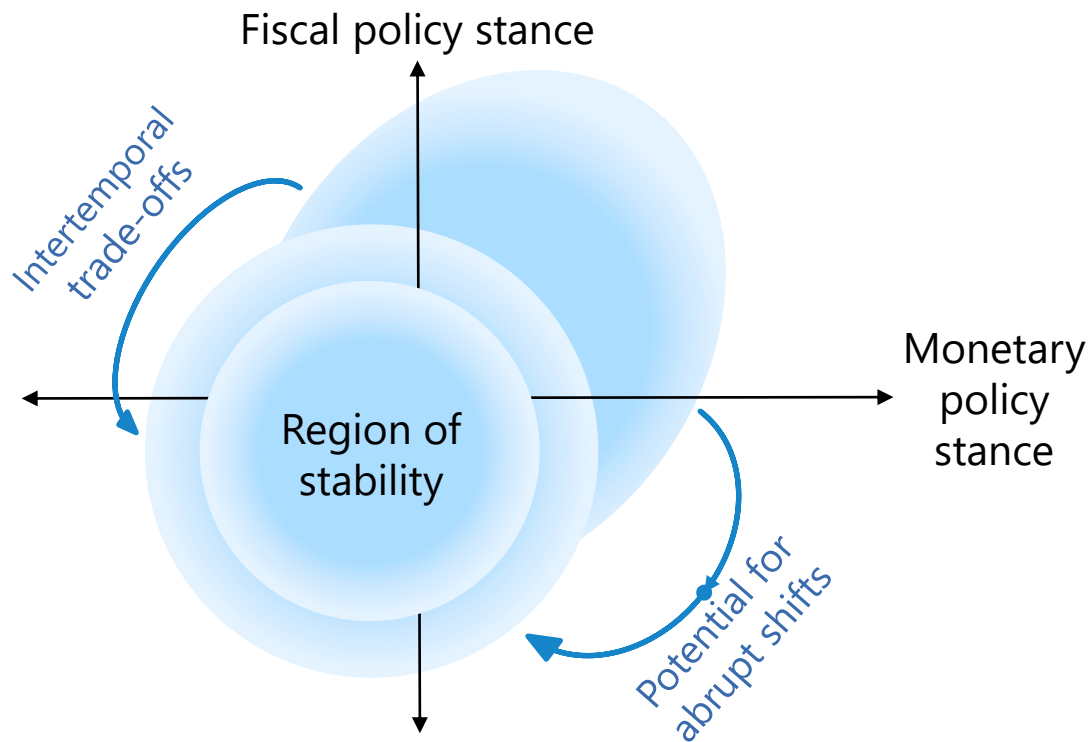


Large economic costs:

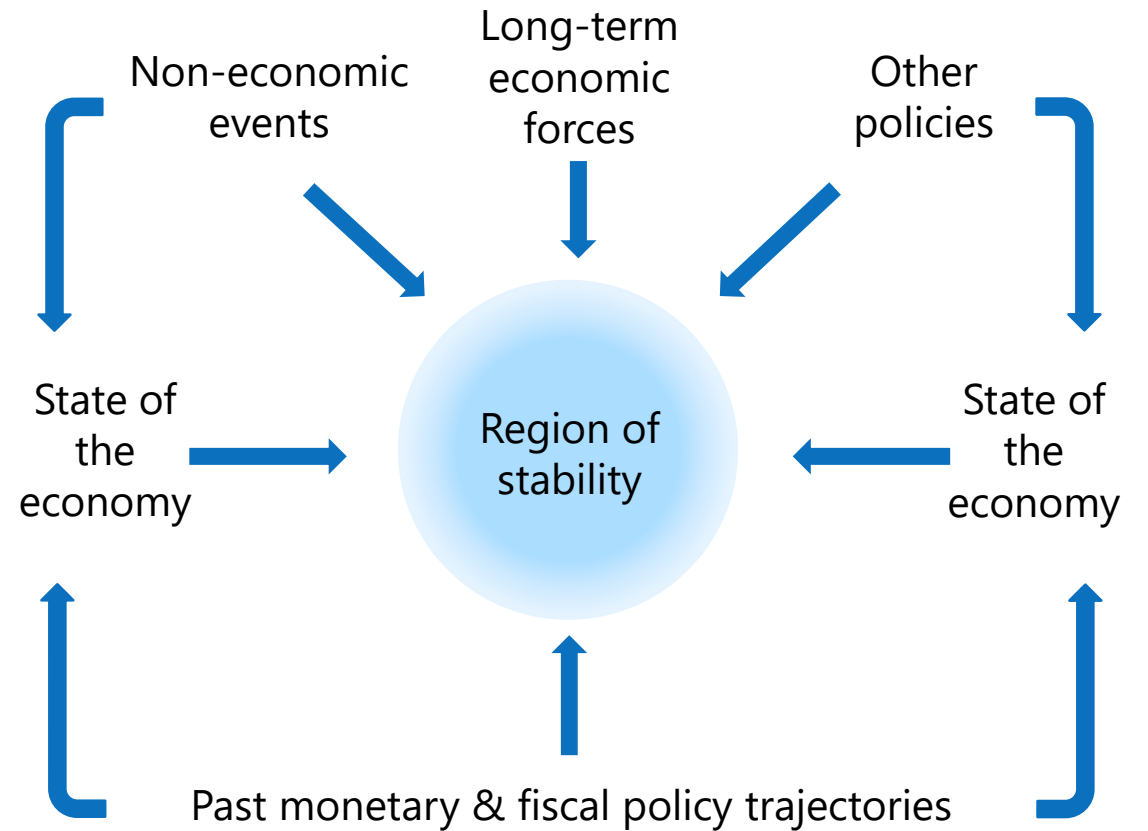
- Slumps
- High inflation
- Financial instability

Region of stability

Features



Determinants

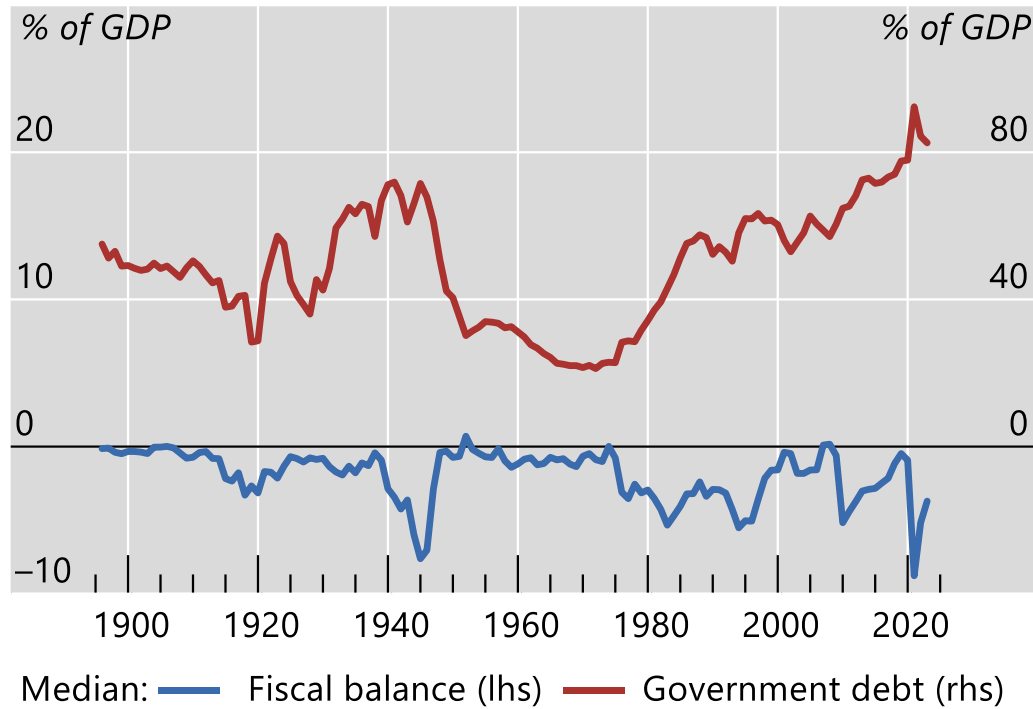




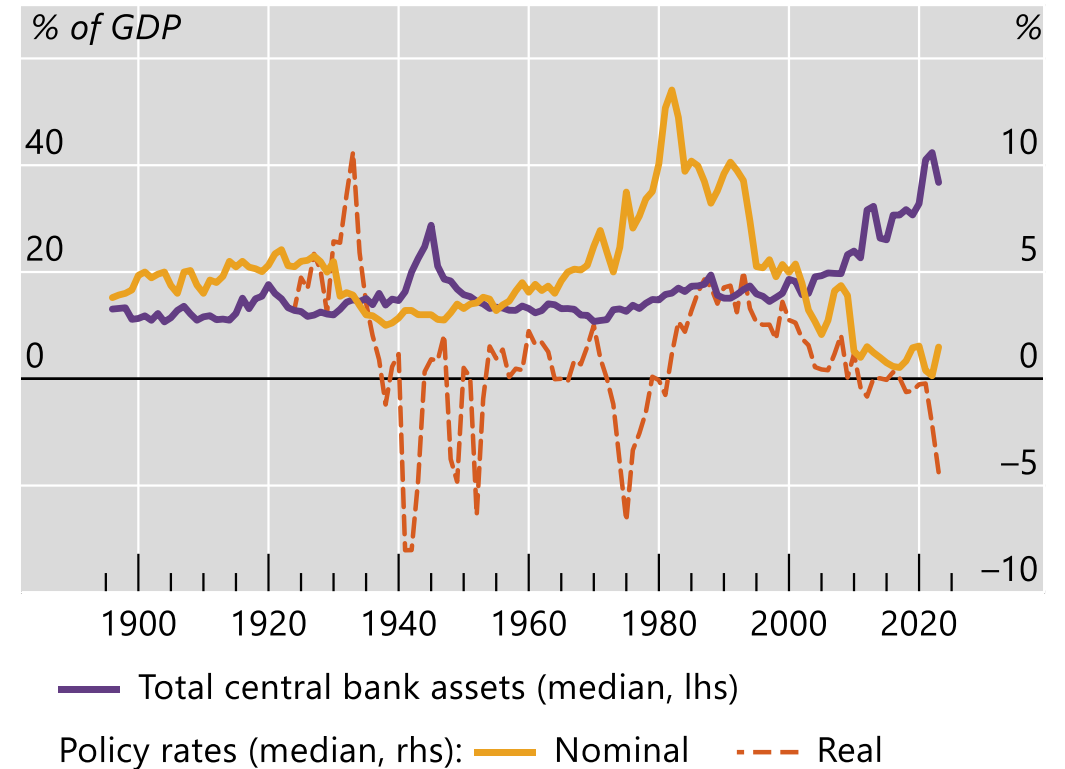
The journey so far

Monetary and fiscal policy in historical perspective

Fiscal deficits and government debt

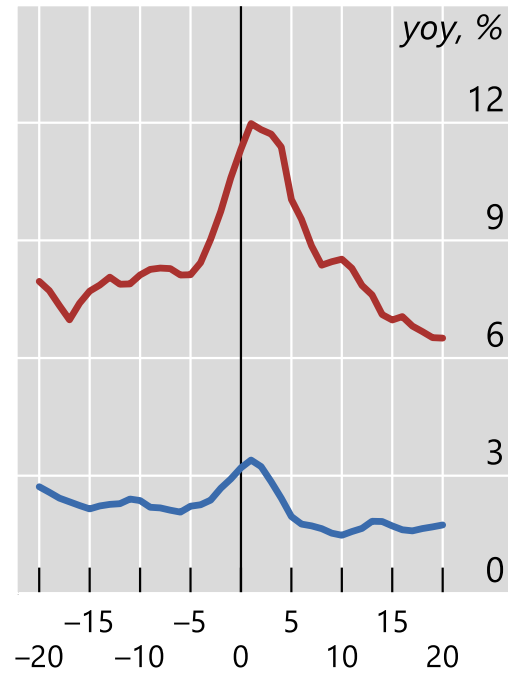


Policy rates and central bank balance sheets

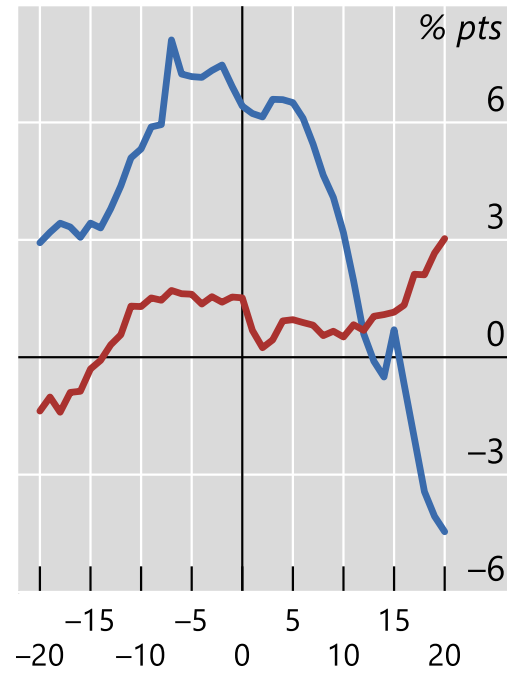


Symptoms of testing/breaching the boundaries

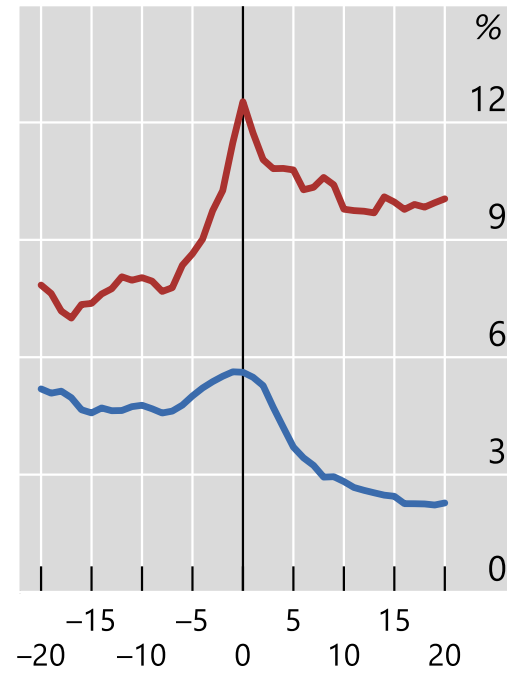
Inflation



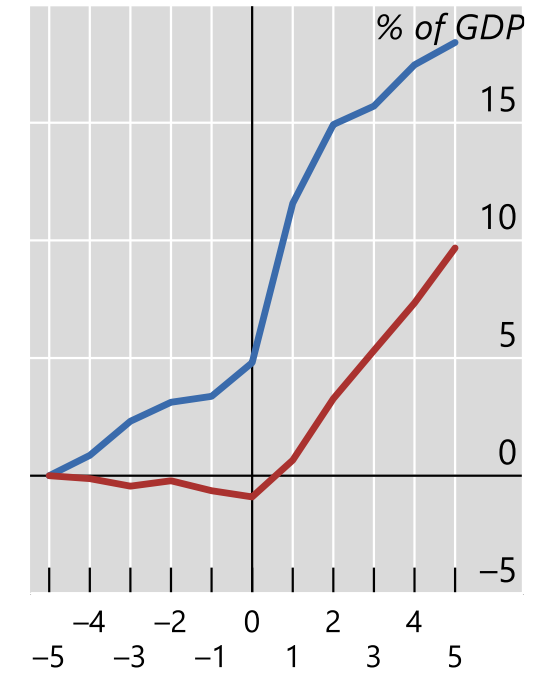
Credit-to-GDP gap



Short-term interest rate



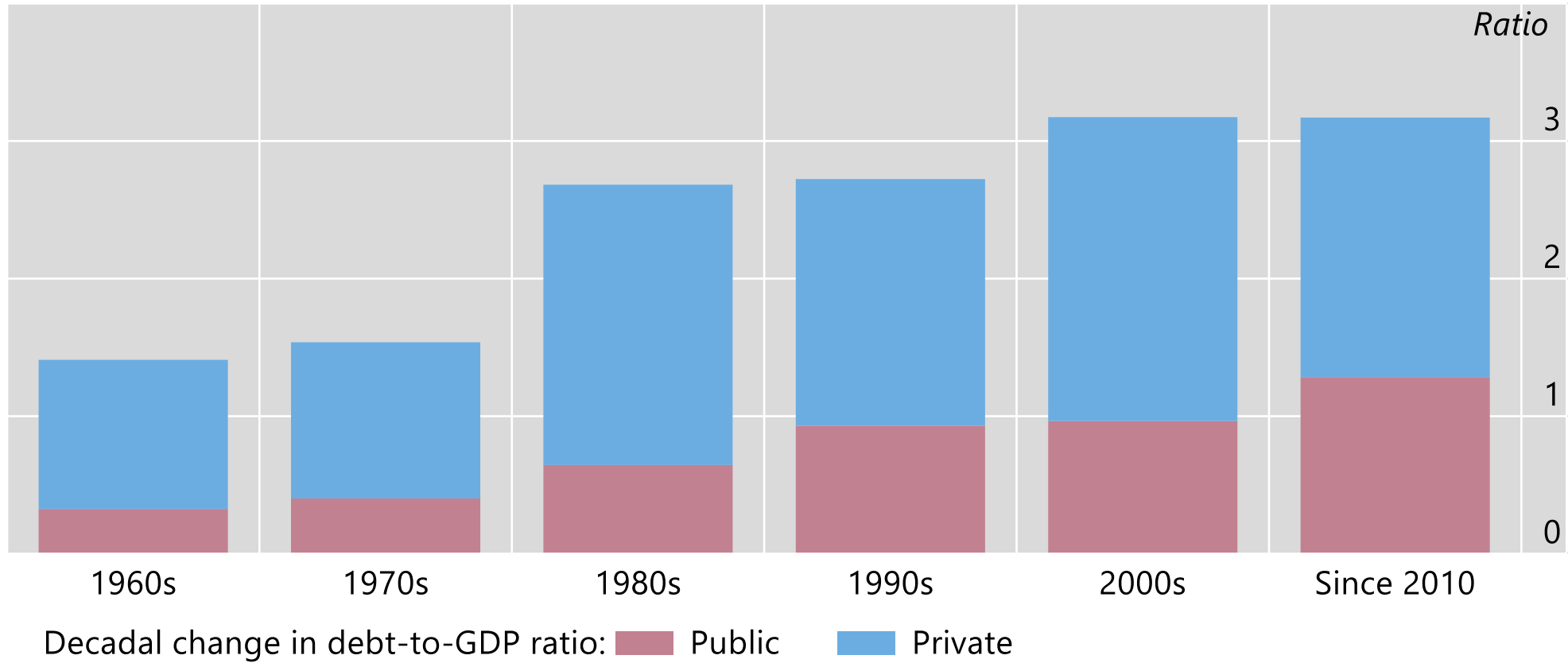
Cumulative change in government debt



— 1970-84

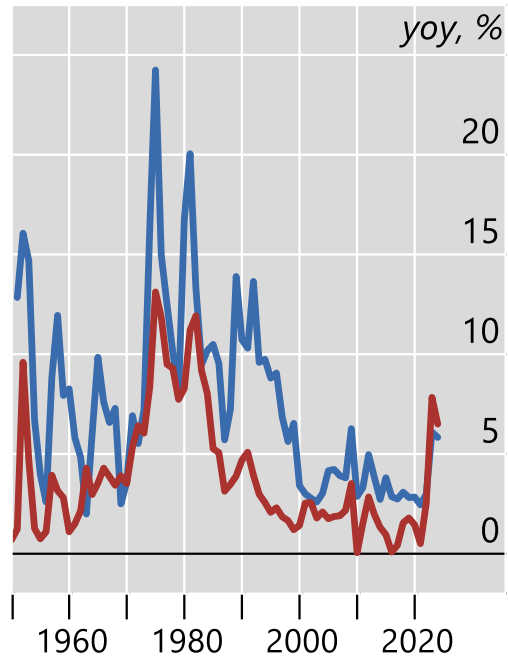
— 1985-2019

Greater reliance on debt-fuelled growth

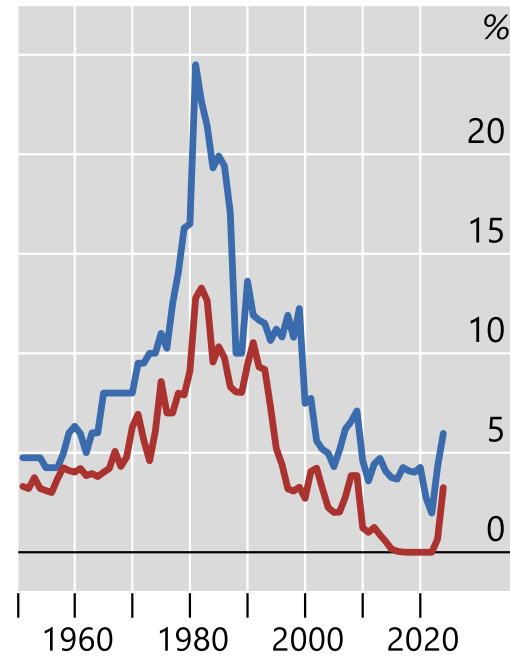


Monetary and fiscal policy in advanced and emerging market economies

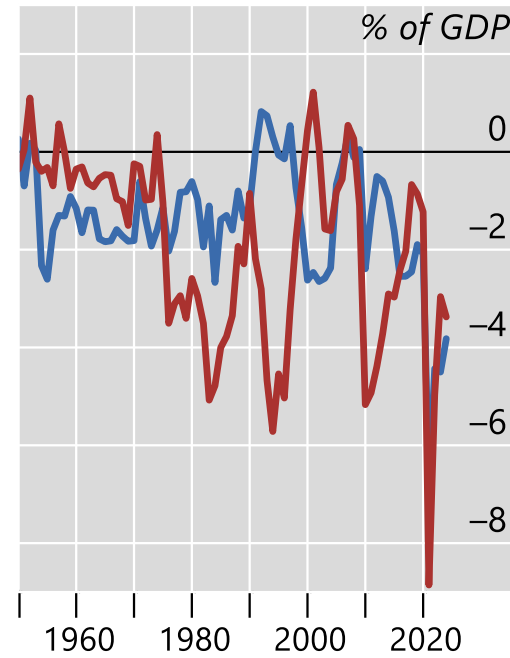
Inflation



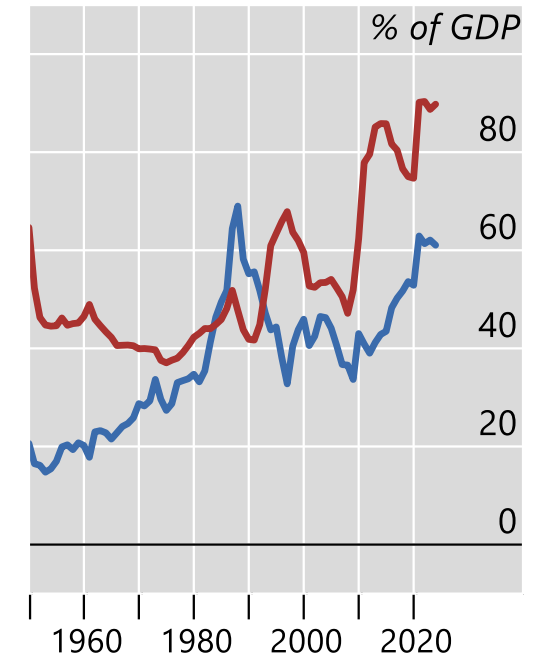
Policy rate



Fiscal balance



Public debt



— AEs — EMEs

A unique combination of previous symptoms

Inflation



Financial stress

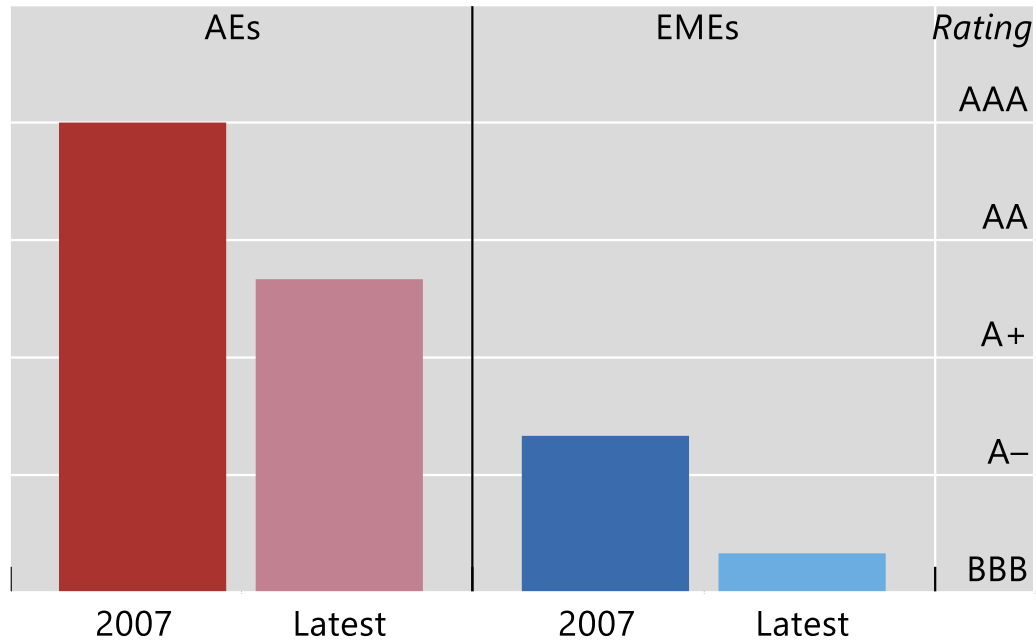




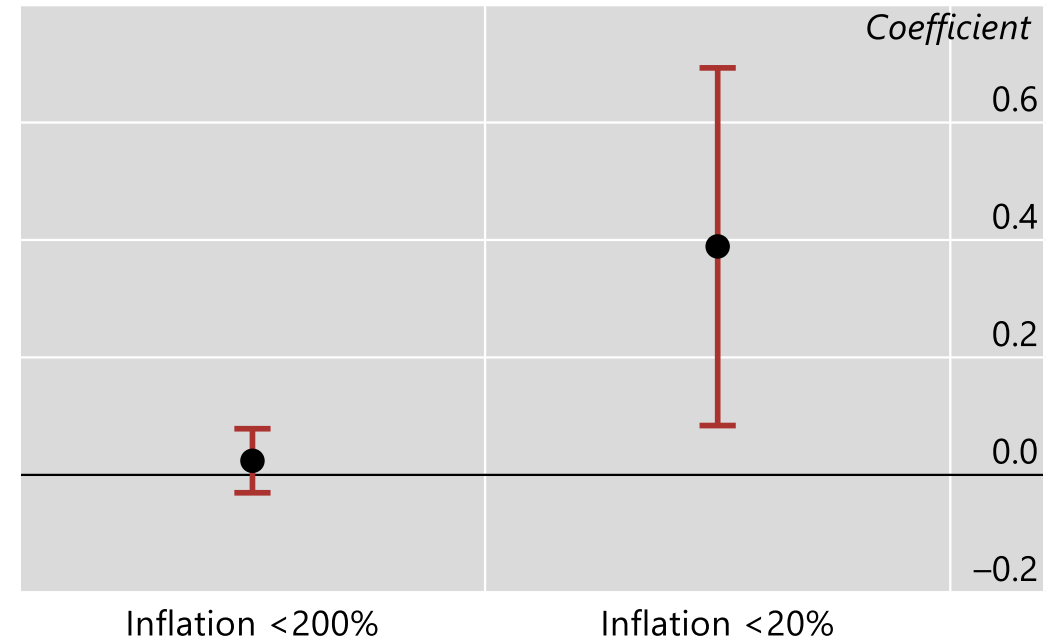
The journey ahead

Sovereign ratings, inflation and government debt

Sovereign ratings deteriorate



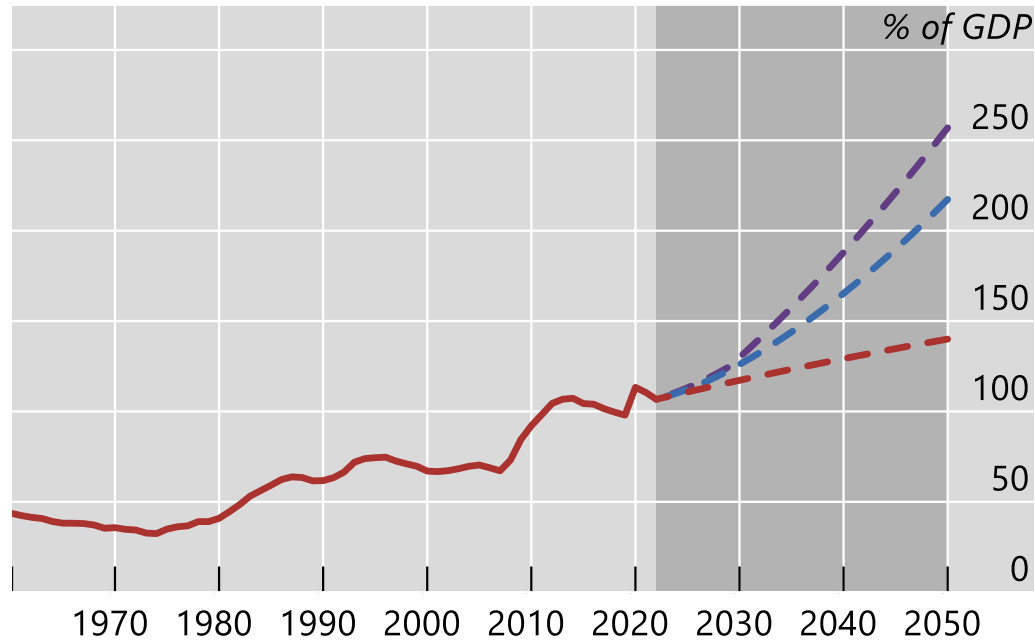
Higher inflation does not improve government finances



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

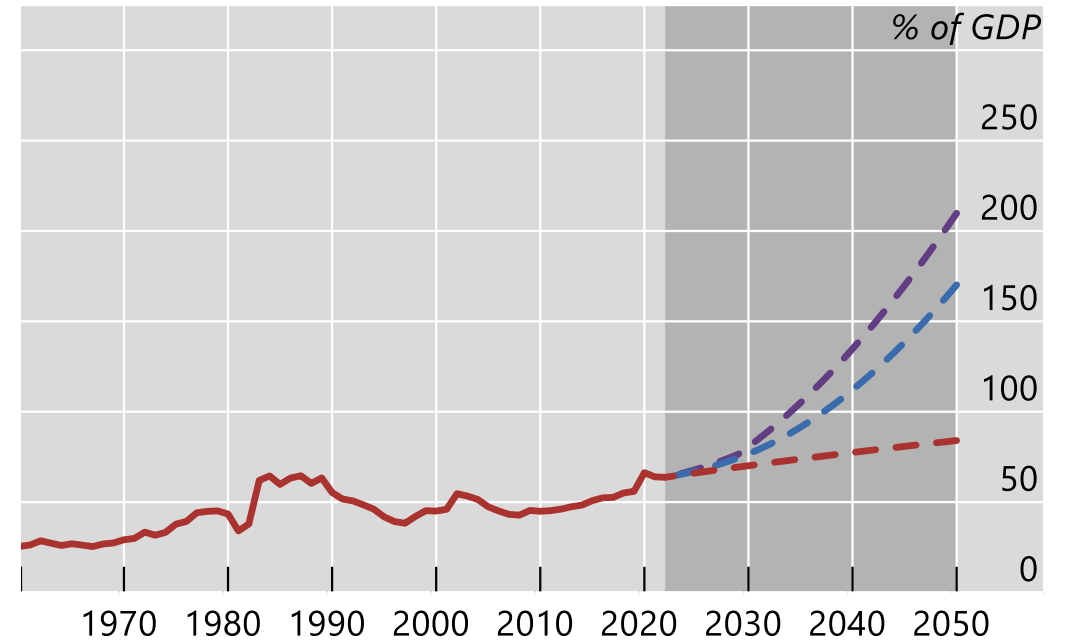
Worrying public debt projections

Advanced economies



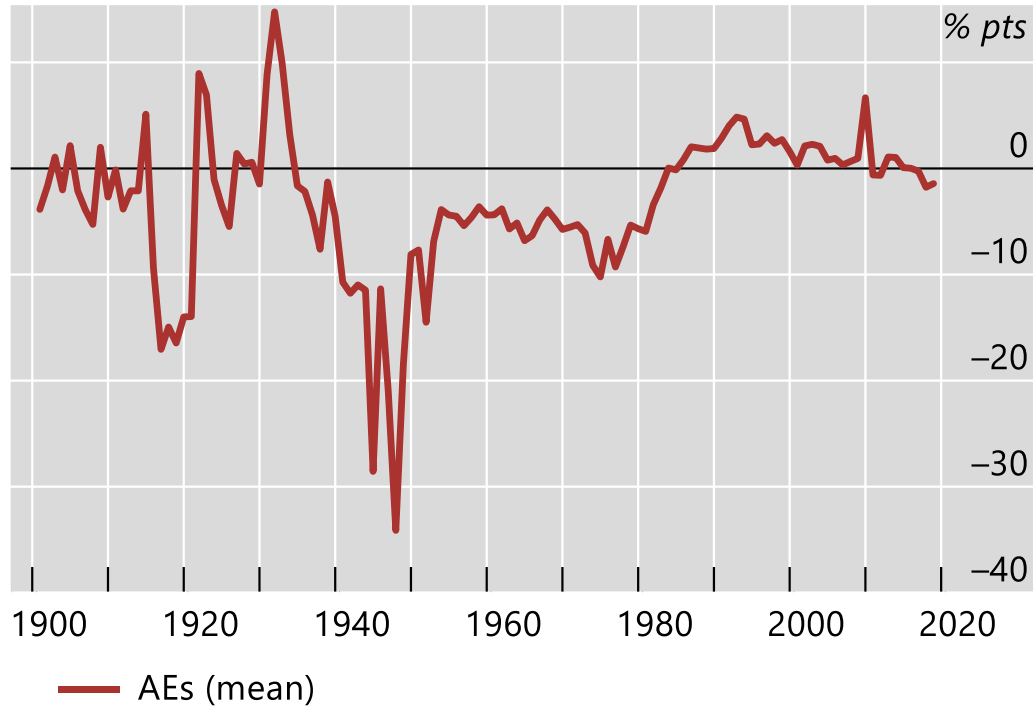
- Baseline (constant primary deficits)
- Adding age-related spending increases
- Additional spending increase (2% of GDP)

Emerging market economies

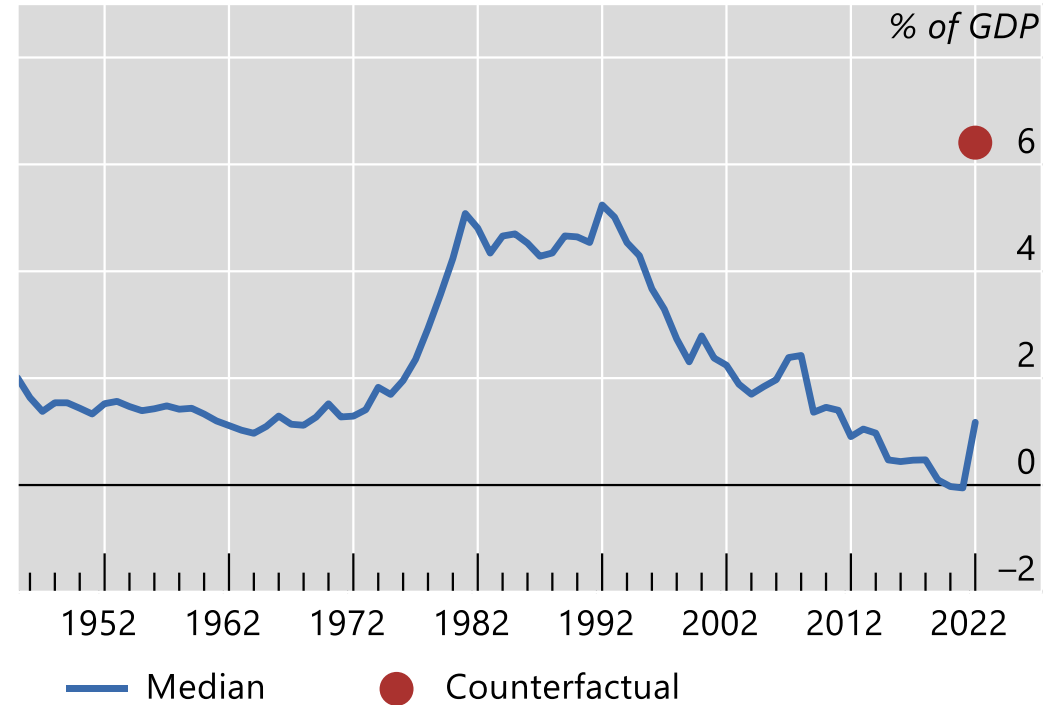


The interest-growth differential and the debt service burden

Interest-growth differential



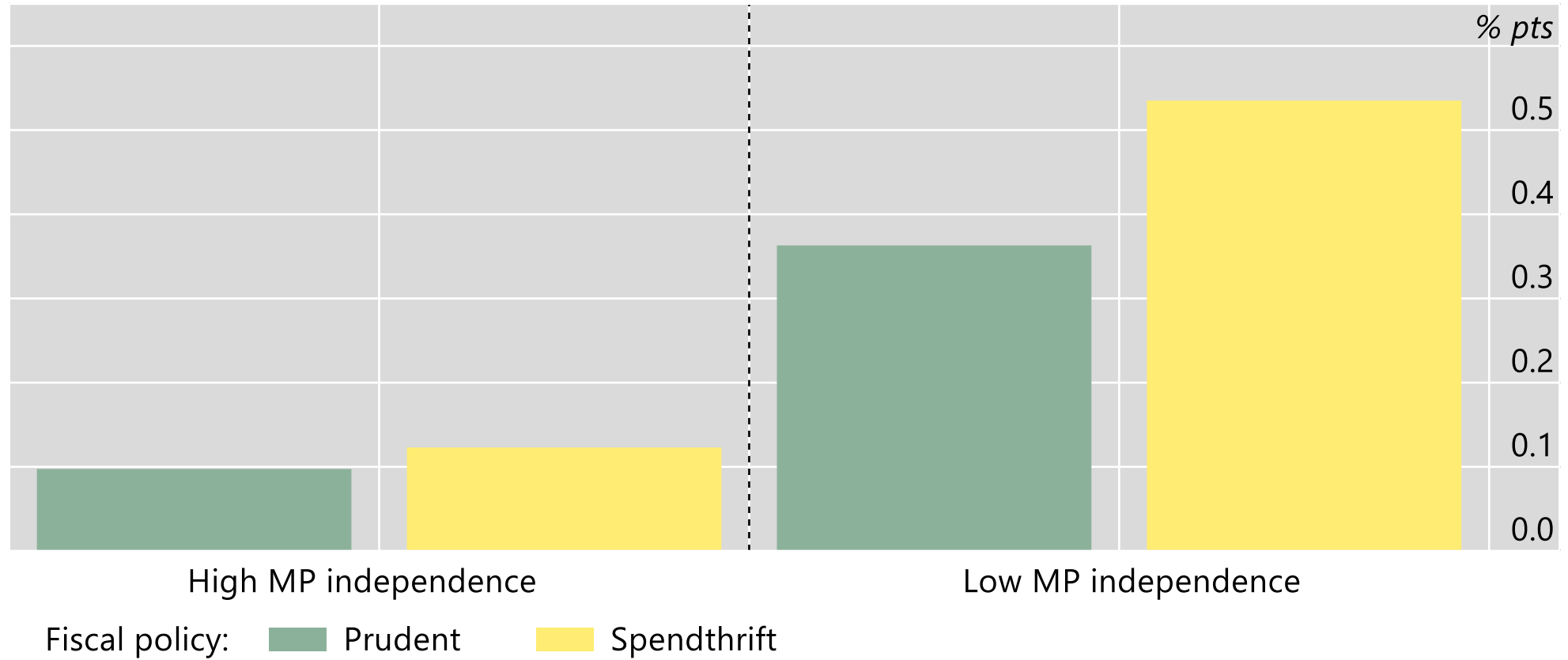
Debt service cost





Risks to price stability

Inflationary effects of fiscal stimulus across fiscal and monetary regimes

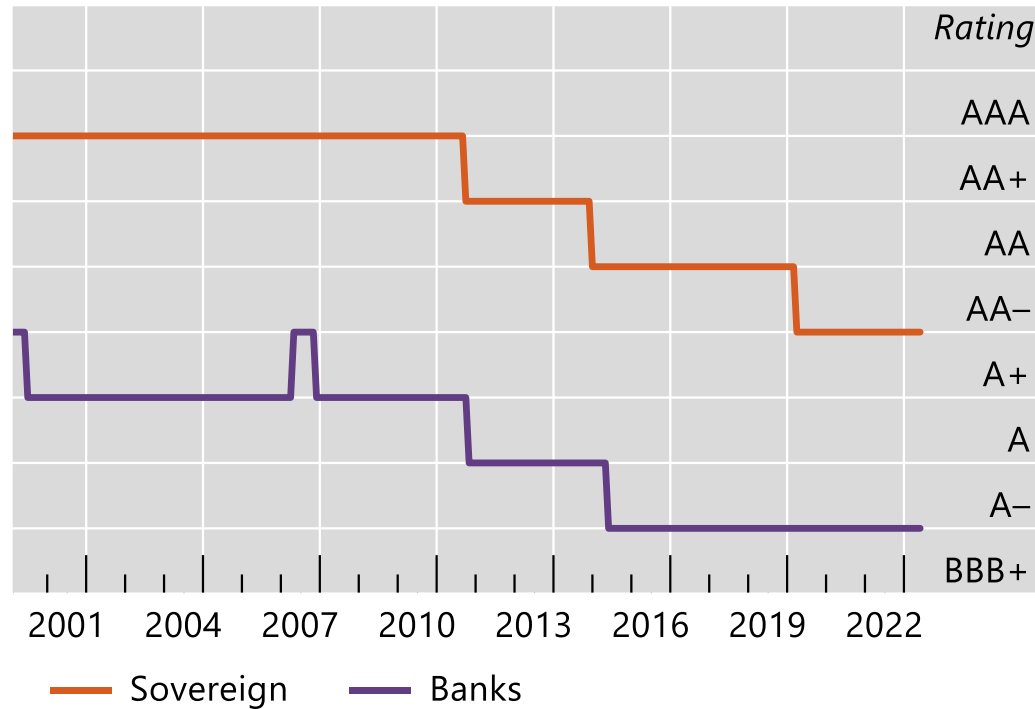




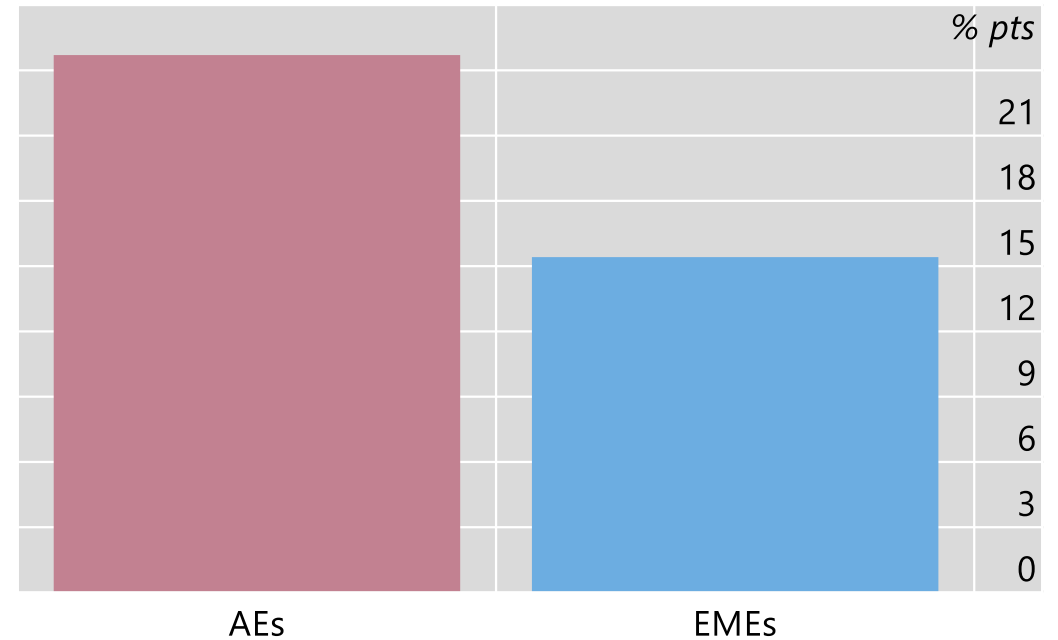
Risks to financial stability

Two-way causality between fiscal policy and financial instability

Sovereign and bank ratings in AEs

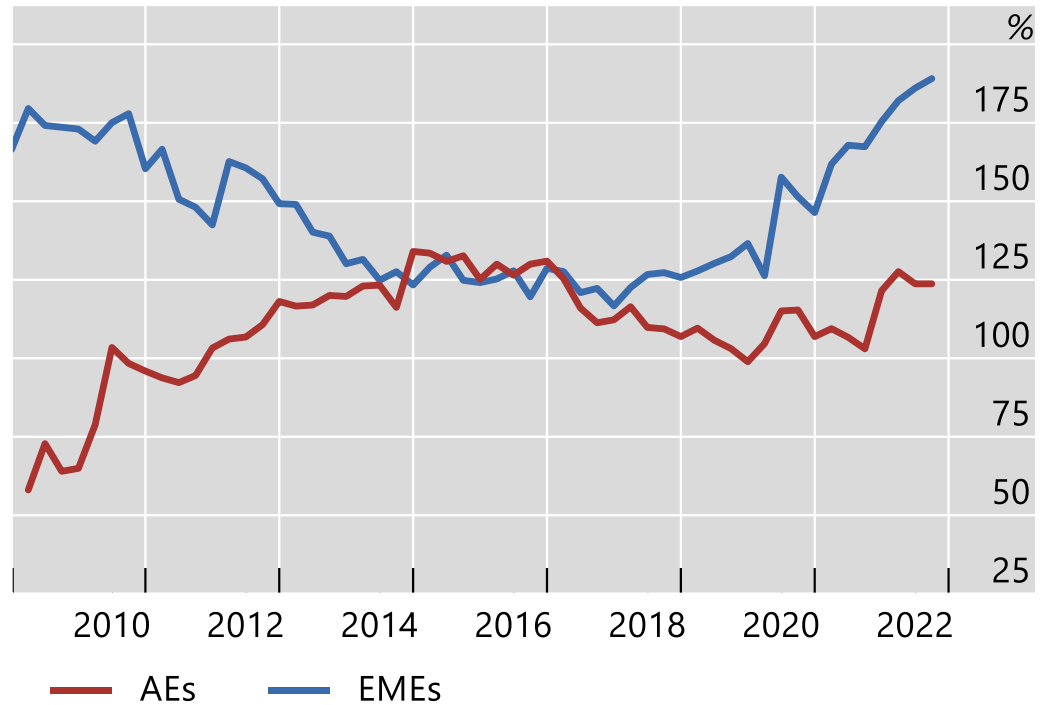


Change in govt debt five years after a banking crisis

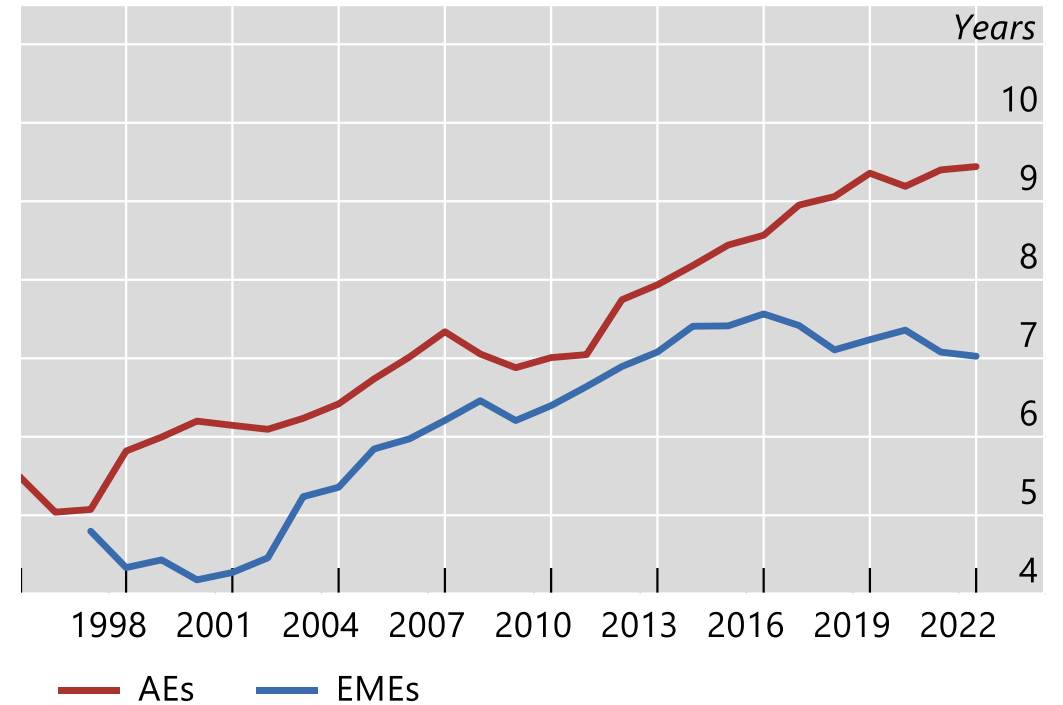


The fiscal policy–financial instability nexus

Banks' sovereign debt exposure as ratio to capital



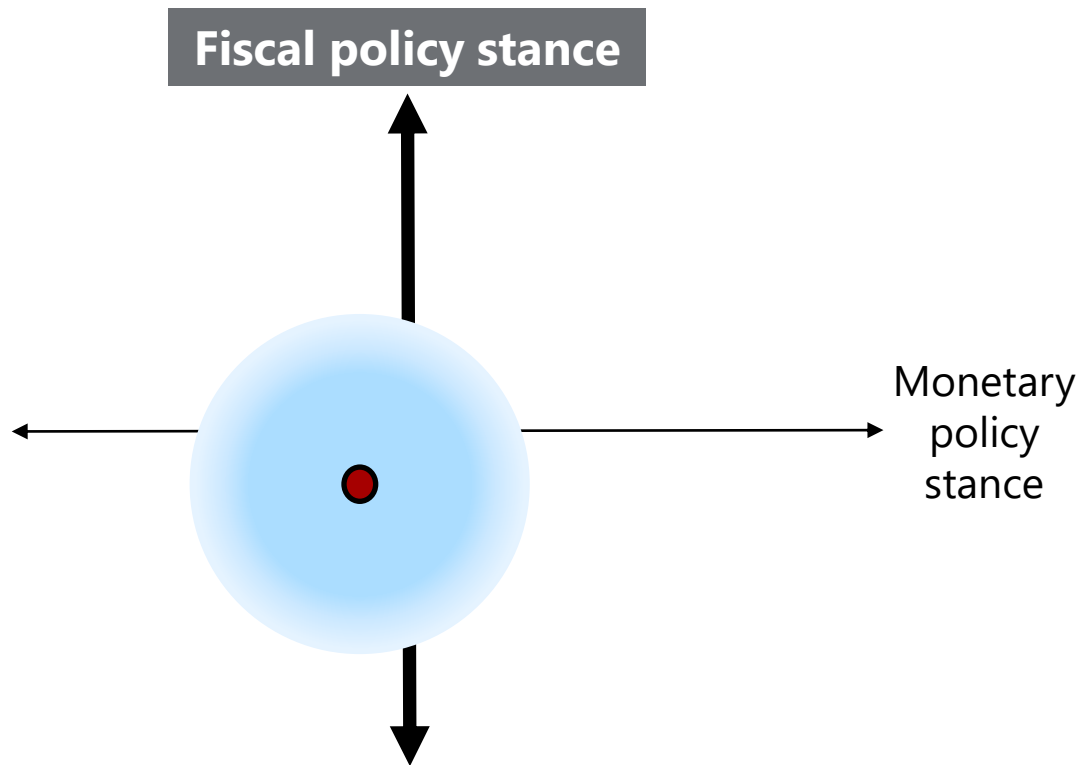
Average remaining maturity of government securities





Policy

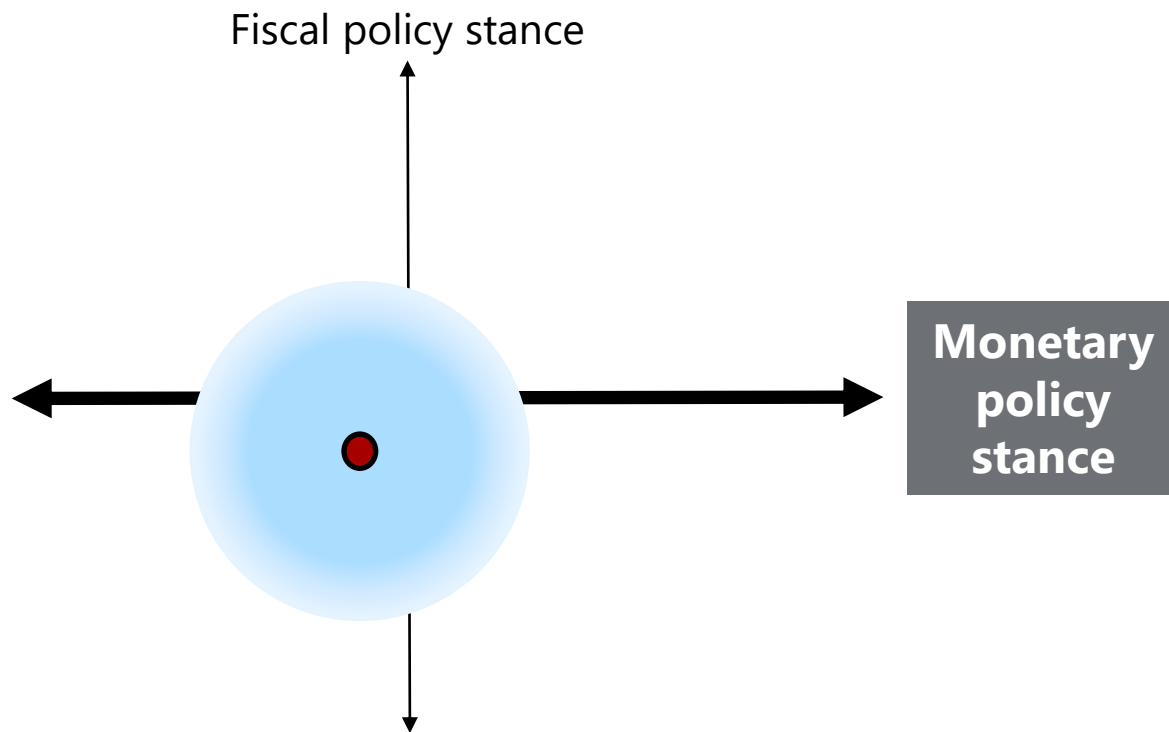
Monetary & fiscal policy should operate firmly within the region of stability



Fiscal policy

- Ensure that debt evolves on a sustainable path
- Pay greater attention to financial factors
- Give more bite to fiscal councils and fiscal rules

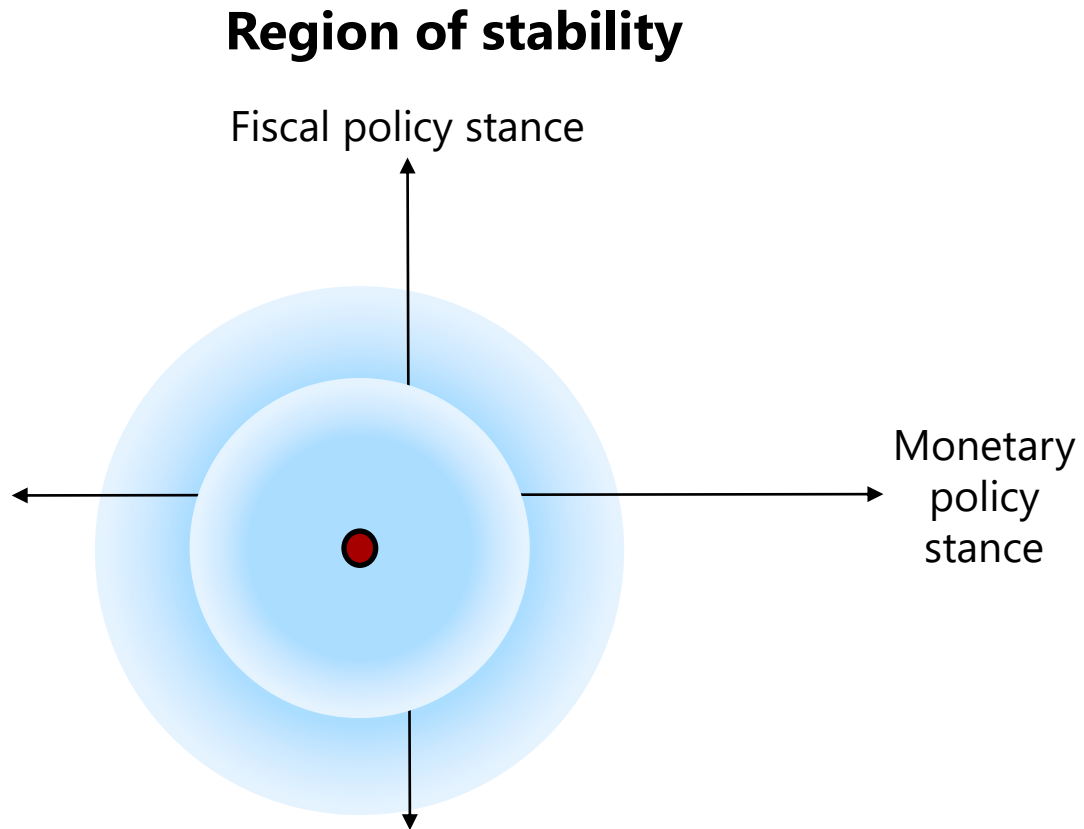
Monetary & fiscal policy should operate firmly within the region of stability



Monetary policy

- Ensure price stability with due attention to financial stability
- Exploit self-stabilising properties of low-inflation regimes
- Safeguard central bank independence

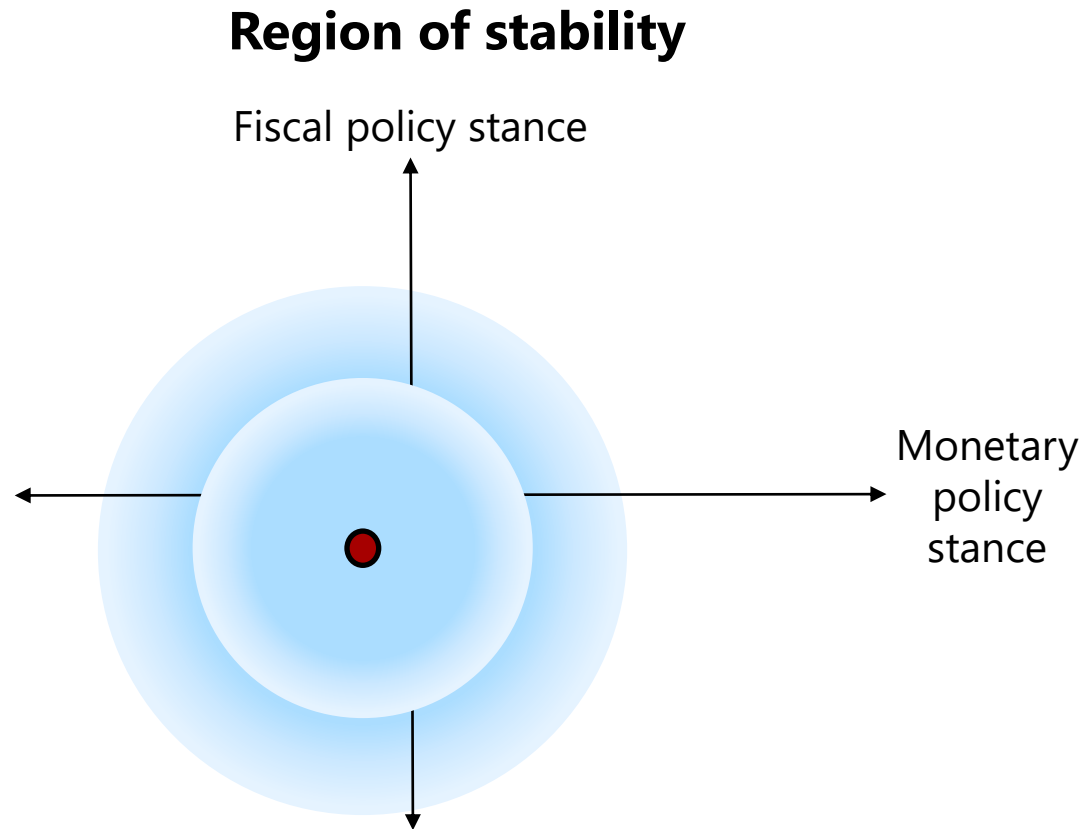
The role of prudential policy



Prudential policy

- First line of defence against financial instability
- Strengthen broad range of elements
- Revisit the favourable treatment of sovereign debt

The role of structural policy



Structural policy

- Higher *sustainable* growth achievable only by improving the supply side
- Urgent need to revive structural reform agenda

Conclusion

Change in mindset
needed to dispel a
“growth illusion”

The concept of the
region of stability can
promote a necessary
shift in perspective...

...to guide policy and
preserve trust in the
state and its decision-
making.

