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Concluding remarks at the Banque de France / Deutsche Bundesbank Spring Conference on "Fiscal and Monetary Policy Challenges in the Short and Long Run"

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1 Introduction

Ladies and gentlemen,

Before this spring conference on “Fiscal and Monetary Policy Challenges in the Short and Long Run” comes to an end, I would like to congratulate and thank you all for your contributions, your stimulating papers and the intense discussions on a highly relevant topic. For central banks, sound scientific research forms the basis for good-decision making in a very complex setting and as such also lends weight to the voices of central banks in the public discourse as well as in the various decision-making bodies they belong to. The importance we attach to research is also underlined by the fact that this conference has been hosted by two central banks, and I would like to thank the Banque de France for the excellent cooperation and for making this event possible.

The topic of this conference “Fiscal and Monetary Policy Challenges in the Short and Long Run” is an evergreen. But this time it was particularly well chosen: the recent crisis has brought monetary and fiscal policy to the centre of attention. It has become apparent that they can be important instruments to contain a crisis. However, we have also seen that fiscal and monetary policy may be at least partly responsible for the emergence of a crisis.

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Speaking in general terms, both fields of policy are faced with complex problems. The effects of the various measures are uncertain; and as the title of this conference correctly emphasises, it is important to take into account the short term but at the same time essential not to lose sight of long-term effects. Stabilisation is of particular concern during a crisis, yet allocation and the preservation of appropriate incentives in a market economy are crucial. It might be necessary to bear costs now to prevent even higher costs from emerging in the future. Hence, when evaluating policy measures we have to make a clear distinction between the actual crisis and its aftermath.

The financial crisis was caused by a cocktail of shortcomings in different areas, such as regulatory loopholes, monetary and fiscal policy mistakes, macroeconomic imbalances and insufficient risk management practices in systemic financial institutions in an environment of dynamic financial innovations. Thus, I would be very sceptical regarding overly simplistic explanations for the crisis. But all these deficiencies led to exaggerations in different sectors and countries. When these exaggerations suddenly reversed themselves, the crisis emerged and affected the world economy in a way not observed in post-war years. During the crisis, fiscal and monetary policy both played a decisive role in stabilising the financial markets and the real economy. The challenge now is to turn back to normal mode. This is a particularly demanding task in a volatile and erratic environment. However, overdoing expansionary policies will rather start a new and probably even worse crisis instead of bringing the current crisis to an end.

Thus, it is imperative to learn from the current crisis and to improve and strengthen the existing framework in order to minimise the likelihood of crises: we need new rules for financial markets in general, for banks in particular and for public finances. We have to analyse more intensively the emergence of macroeconomic imbalances and scrutinise

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structural deficiencies. Finally, monetary policy frameworks will have to integrate macroprudential aspects. Nevertheless, in all areas we have to resist the temptation of regulatory and macroeconomic fine-tuning. Markets have to remain the main tool for coordination and we should not attempt to eliminate all risks. Risks and uncertainty are essential elements of a market economy.

At the end, of course, it is imperative that the economic and political framework is broadly supported by the public – and this is especially true for the European Union and European monetary union. It is necessary to ensure that current measures to contain the debt crisis do not cause a longer-term problem of general acceptance. The current framework includes largely decentralised responsibility for fiscal policy and an independent monetary policy that focuses on price stability. This framework sets the range of measures that monetary and fiscal policy can and should take – barring a fundamental revision.

Against this general backdrop, let us now take a look at some specific monetary and fiscal policy issues which were discussed at this conference.

2 Monetary and Fiscal Policy during the Financial Crisis

For any institution that attempts to stabilise the economy and the financial system during a crisis, two things are particularly important: credibility and room for manoeuvre. Central banks certainly had both. Thus, when liquidity dried up on financial markets and systemic breakdown became a real threat, monetary policy acted as an important instrument of stabilisation. By applying a number of non-standard measures, central banks took over the role of the money market and supplied the financial system with ample liquidity. Despite the

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success of this policy in preventing a systemic breakdown, one should not forget the risk of adverse side effects in the long term. Sticking to non-standard policy measures for too long will not only change the perception of risk in financial markets in an undesired manner but will also preserve inefficient banking structures. History tells us this has been a key mistake in the aftermath of past financial crises. Consequently, the question is not whether an exit from non-standard monetary policy is necessary, but when it will take place.

Fiscal policy, too, contributed significantly to preventing a downward spiral at the height of the crisis. It helped shore up the financial sector through guarantees, recapitalisation schemes and the set-up of bad banks to relieve banks' balance sheets, and it supported aggregate demand through automatic stabilisers as well as discretionary measures. How effective have these discretionary measures been? During this conference Walker and others argued that the presence of a fiscal multiplier larger than one is far from certain. Other papers presented during the conference clarified the conditions under which fiscal multipliers may be large. One key aspect is the zero lower bound on nominal interest rates, which may amplify the effects of fiscal policy, at least in the short run.

Let me add something on a personal note: What I learned during my years in government is that in normal times discretionary fiscal policy is surely not an advisable tool of stabilisation. Far too many lags exist that reduce the effectiveness of expansionary measures. Moreover, looking at the long term, we have to bear in mind that political economy mechanisms bias fiscal policy towards incurring deficits. However, in an exceptional crisis things are slightly different and it cannot be denied that discretionary fiscal policy had a stabilising effect. In this connection the zero lower bound is certainly a critical aspect, although its relevance might be larger for the United States: Eurosystem experience shows that the lower bound rendering monetary policy ineffective might be less of an issue than commonly believed in

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the pre-crisis mainstream view. At least, non-standard measures seem to have prevented a given monetary policy stance – set by traditional interest rate instruments – from becoming overly restrictive during the crisis.

The sovereign debt crisis strongly reminded us that, in the long run, only sound public finances provide the necessary room for manoeuvre when a major shock occurs. And, even more importantly, only sound public finances generate the credibility that is necessary for discretionary measures to be effective. Once credibility is lost, fiscal multipliers become zero or might even turn negative. Furthermore, as long as structural problems exist, stabilisation cannot be a substitute for reforms. In this regard, the experience of past crises teaches us another lesson: more often than not, structural deficiencies are wrongly interpreted as a lack in aggregate demand, leading to an overstimulation of the economy that may well lay the basis for the next crisis.

As both fiscal policy and monetary policy have to find an exit strategy, the question arises of how the respective exits should be sequenced, given the interactions between the two policy areas. Angeloni, Faia, and Winkler took such a perspective in their policy-oriented paper that simulates different exit scenarios. They make clear that in returning to normal conditions, fiscal and monetary policy should work together. An interesting result of the simulations is that rapid consolidation by the fiscal sector is preferable to gradual approaches. At the same time, spending-based consolidation is preferable to revenue-based consolidation. Regarding the sequence of fiscal and monetary policy exits, Angelonie, Faia and Winkler find that fiscal policy should exit first.

In Europe, we see a situation in which in some countries confidence in public finances has eroded massively, which in turn complicates matters for monetary policy. While this problem

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is most pressing in the euro area, it is also relevant for other countries; fiscal dominance is no longer a mere theoretical notion but a real threat. This was forgotten during the Great Moderation but has now become a highly relevant issue.

The world over, awareness of the urgent need for fiscal consolidation has increased. However, confidence in the sustainability of public debt will only stay firm, let alone be restored where it is at stake, if this awareness quickly translates into credible and ambitious steps to cut expenditure or raise revenue. Otherwise, it will be increasingly difficult to convince investors and the public that the alternatives to consolidation, namely sovereign default or a debt-reducing inflation, can be ruled out. The serious risks emanating from these alternatives are discussed in three papers. Krause and Moyen highlight the quantitative effects of an increase in inflation targets in the United States aimed at reducing the real value of outstanding obligations, as discussed by Blanchard, Rogoff and others at various occasions. The applied model combines forward-looking interest rate determination in the presence of long-run debt and shows that short-term manipulations of the inflation rate are not very effective in reducing the real value of government debt. Rather, in addition to a high average maturity of outstanding government debt it would take a persistent increase in the expected inflation target to achieve a sizable reduction in the real debt burden. Such a policy is definitely not advisable: Apart from the costs associated with higher inflation, central bank credibility, established in past decades at great costs and now one of our most important assets, would be seriously or even critically damaged.

The papers by Adam and Grill, as well as Uhlig, investigate the alternative, that is, disruptive means of reducing public debt: sovereign default. It is easily overlooked that in advanced economies, sovereign default is usually a political decision rather than an economic necessity. Hence, understanding the reasons why governments decide to default on parts of

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their debt is crucial for developing strategies on how to avoid such situations in the first place. Adam and Grill address this fundamental question, and show the conditions under which it is optimal for a country to occasionally default on its debt after large shocks. Defaults are rare events if they are costly for a country. However, this result applies to a model without contagion across countries and perfectly insured international investors. Uhlig tackles these issues in the setting of a currency union, taking into account many of the additional aspects that complicate the situation we face now. In his model, membership in a monetary union and the resulting prospect of financial assistance to counter the risks of contagion can extend a country's borrowing constraint and weaken the incentive to consolidate. In the end, there is certainly a non-negligible risk of only delaying, rather than averting, a default.

Because of this mechanism and the large risks borne by the tax-payers of countries granting financial support, conditionality has to be a core principle of such support programmes – including those launched in the European debt crisis. Conditionality has two dimensions: *Ex ante*, countries have to commit to a credible and frontloaded adjustment programme in order to get access to financial support, a programme that is suitable to restore the sustainability of, and thus confidence, in public debt. *Ex post*, once financial support has started to flow, compliance with the programme has to be monitored continuously, and deviations from the programme have to be corrected swiftly and convincingly. If a country fails to do so, further support should no longer be taken for granted and the country should be prepared to bear the severe consequences that are likely to ensue once financial assistance is withdrawn. It is true that in such a case the other member countries and their financial system would suffer as well – being tough on violations of conditionality does come at a price. But these costs have to be weighed against the damage to long-term stability of monetary union that would result if the binding force of support programmes and the no-bail-out principle were

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ultimately eroded. Shifting burdens to other member countries' tax payers should not be permitted to appear to be a viable and attractive option.

Against this background, current events in Greece have brought the euro area to a crossroads: the future character of European monetary union will be determined by the way in which this situation is handled. There can be no doubt that it is first and foremost up to Greece itself to take appropriate additional steps should it turn out that the adjustment programme is not on track. It is surely the case that the consolidation efforts and the structural reforms are far from easy to implement, entailing many hardships on the Greek economy and the population. But these measures are inevitable to restore the soundness of public finances, and without financial support from other member countries, the EU and the IMF, the immediately necessary adjustment would be much more severe.

Conversely, "reprofiling" Greek bond maturities cannot substitute for fulfilling the adjustment programme. The sustainability of public finances would hardly change, since a prolongation would do nothing to improve the other factors that determine the sustainability of the current debt level: growth prospects and the primary surplus. Furthermore, a prolongation of Greek government bonds in an environment of prevailing strong doubts about the sustainability of public finances would make it impossible to accept them as collateral for refinancing operations under the existing rules of the Eurosystem's collateral framework, and consequently large parts of the Greek financial sector would be cut off from funding. In addition, the risks for contagion to other countries would significantly rise. Hence, proposals for such a step seem to assume implicitly that the Eurosystem would provide financial means against insufficient collateral. But such a monetisation of public debt cannot be tolerated. Instead of blurring the responsibilities of monetary and fiscal policy even further,

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fiscal policy must take up its responsibility in fighting the sovereign debt crisis in the respective countries and at the European level.

3 Measures to Prevent Future Crises

Dealing with the imminent challenges of the current crisis, however, should not let us lose sight of the efforts to prevent future crises. Even when proper fiscal consolidation has brought public debt back to sustainable levels, this alone offers no guarantee against fiscal policy getting off track again in the future. History tells us that maintaining sound public finances is a notoriously difficult task. Against this backdrop, Auerbach has discussed the usefulness of an independent fiscal entity which would to a certain degree mirror the independent role of central banks. It is also reminiscent of a proposal made by Leeper for an "office of independent thinking". Long-term government commitments are usually not a topic of public debate, and if they are, the discussion is often not based on sound facts or analysis. Thus, better information and a debate at a higher level would allow the public to make an informed judgment and put pressure on politicians.

Alas, I am somewhat sceptical of this proposal – both in terms of political viability and with regard to the extent that the budget authority of elected parliaments can legitimately be constrained to such an extent. The independence of monetary policy from the immediate influence of parliament and government seems to be rather the exception that proves the rule than a suitable recipe for reining in other fields of economic policy, in particular fiscal policy.

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In my view, however, the financial markets are fundamentally better at exerting discipline on policy makers. Investors are less subject to the problems of moral hazard and time inconsistency that we usually run into when relying on policymakers to ensure fiscal soundness. This confidence in financial markets may come as a surprise, given their recent track record in identifying risks early on. To act as more reliable correctives for fiscal policy, market participants have to assess risks timely and correctly and factor them into their investment decisions. The experience of the crisis has already led to a fundamental assessment of risks associated with various assets. To ensure that markets effectively discipline fiscal policy it is equally important that investors themselves can expect to bear the consequences of their investment decisions, that is to say, both profits and losses. This requires a stronger institutional framework and an overhaul of financial market regulation which is currently under way. Relevant aspects have been discussed in some papers presented at this conference. Cooper and Kempf as well as Cukierman and Izhakian, for instance, have discussed the problem of bailouts with regard to their potential costs and benefits or their impact on risk assessments.

Markets are a powerful complement in disciplining fiscal policy, but we should not rely on them alone. Especially a monetary union with decentralised fiscal policy needs a strong regulatory framework to prevent excessive deficits in individual member states that might spill over negatively to the rest of the union. With regard to European monetary union, the crisis has revealed that the existing framework is not strong enough and hence needs to be strengthened and broadened.

Relevant reforms have already been agreed upon. They include a strengthened Growth and Stability Pact, a new mechanism for macroeconomic surveillance and a new mechanism to deal with actual crises. In principle, the envisaged reforms aim in the right direction but are

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far too timid in some parts and of a flawed design in others – the Bundesbank has on various occasions raised more detailed criticisms. Nevertheless, to make a rather general point: Incentives for sound public finances and responsible investment decisions must be strengthened not weakened. Especially with regard to public finances, it is often overlooked that fiscal soundness is not an end in itself. Instead, it is a precondition – albeit an indispensable one – for the continued success of the euro, the single most important project of united Europe. We must not forget that the euro has delivered enormous benefits so far. The euro is a stable currency both externally and internally – inflation has been historically low since its introduction – and during the financial crisis, the common currency proved to be a very important stabilising element.

4 Conclusion

Ladies and gentlemen, you have dealt with highly relevant but also very complex issues at this conference. Although research has made progress, the relevant questions are far from being resolved, and I am sure that there is scope for many further conferences. Seen in this light, times have seldom been as exciting for economic research as they are right now. I encourage you to continue with your work and wish you every success.

Thank you very much for your attention.

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