THE TWENTY- SEVENTH DUBROVNIK ECONOMIC CONFERENCE

Organized by the Croatian National Bank

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Stronger Together: A Reassessment of the Mix Between Monetary and Fiscal Policy

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CROATIAN NATIONAL BANK

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Stronger together

A Reassessment of the Mix Between Monetary and Fiscal Policy

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Geneva Report on the World Economy 23. 2020

2020 Geneva report: It is all in the mix

- **Policy mix**
  Strategic substitutability in normal time => complementarity in tail events
- **Evidence from the OECD countries**
  Policies more likely to be procyclical when constrained
- **Learning from large crises (tail risk)**
  Joint responsibility in preserving policy space and credibility
- **Engineering a greater normalization**
  R* as a global compass

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Taking care of tail events

- Large shocks to economic activity or financial system
  1. Often driven or exacerbated by **endogenous market dynamics** (unanchored expectations)
  2. Snowballing because of **insufficient policy response** (e.g., high vulnerability when R* is low)

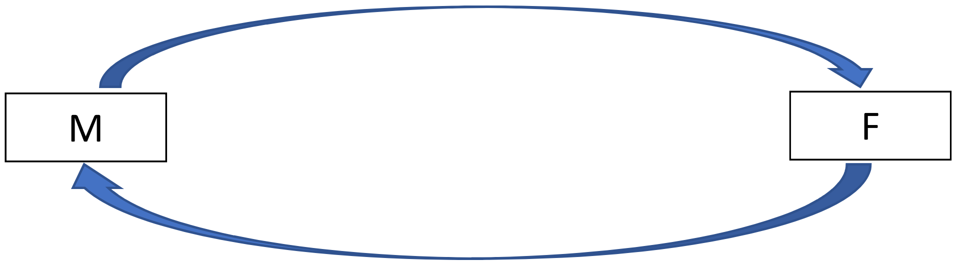
- Key to stabilization, M and F need
  - **Policy space** to deliver on the required scale
  - **Credibility** to anchor expectations

Policy space creation at the ZLB

- Fiscal authorities need good financial conditions **and** monetary backstop to safeguard fiscal policy space
  - Fend off a belief-driven surge in borrowing costs (*bad equilibrium*).
- Monetary authorities benefit from fiscal authorities backstopping losses and boosting R*.
- Mix can easily unravel leading to material financial and macroeconomic instability.
  - Lessons from the euro area experience after the GFC.

Two-way policy space creation

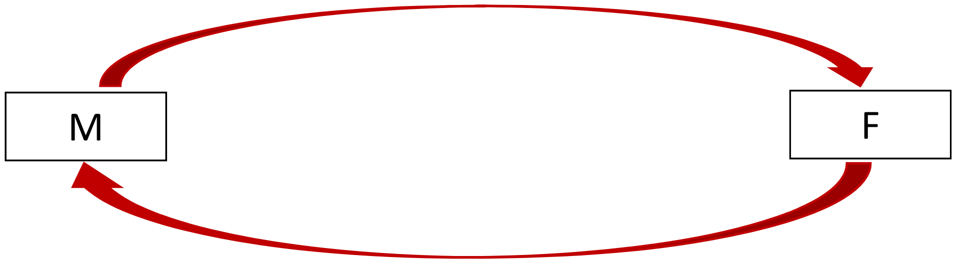
M creates space for F:
monetary backstop and
low borrowing costs



F creates space for M: fiscal backstop,
internalizing the risks of unanchored
inflation and negative R*

Two-way policy space restriction

M restricts space of F: monetary credibility is lost, no backstop, no control on borrowing costs



F restricts space of M: QE and monetary backstop not credible

All good but difficult “exit”: the case of Yield Curve Control YCC

- In the wake of COVID 19, many central banks are inching towards **implicit or explicit yield curve control (YCC)** as specific form of coordination between monetary and fiscal authorities.
- History suggests that YCC is very difficult to exit due to acute political pressures on the central bank.
  - USA 1942-51, UK after WW2.
  - Japan: a permanent regime?
  - Australia 2020; USA 2021, Europe???
- Exit from YCC might only be possible after serious inflation pressures materialize.

Tail risk challenges for policy in a nutshell

- In tail events, strong interdependence between M and F.
- Credibility-flexibility trade-off difficult to get right. Experience shows:
  - Getting the macro framework wrong results in the unravelling of the policy mix---loss of space for at least one instrument.
  - <u>Objectives/mandates must be clear</u>. Examples of YCC suggest that when the central bank appeared to have a primary mandate to help treasury financing, it proved extremely difficult to exit YCC.
  - More recent examples of YCC indicate that central banks remained within their remit. The challenge for the exit appears to be less the risk of political pressure not to exit, than the credibility of the fiscal backstop that might be required if a quick exit is needed.

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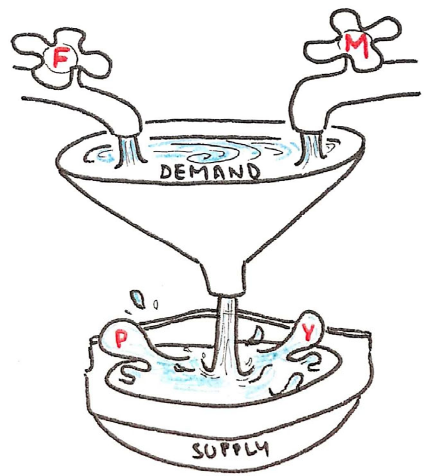
How to get back to the "middle of the road"

The mix in the great moderation
- M does inflation, F the rest (only M is "active", "M dominance")
- Commitment creates more space for stabilization
- Congruence (M and F on the same side):
  not required but consistent with cutting debt in booms.

Plenty of aggregate demand AD
(M alone can keep the funnel full).
Focus on the bottom of the funnel
- M efficiently anchors P, most AD goes into Y.
- F works on potential output and other objectives



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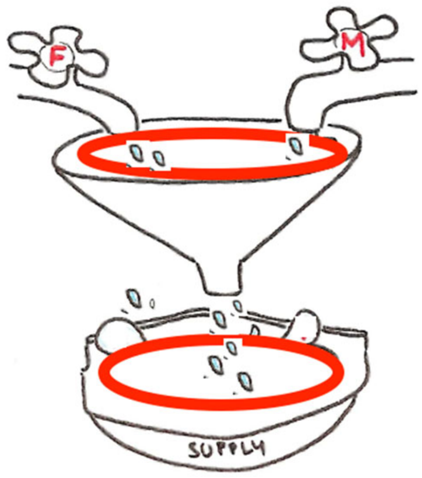
Where are we now? What lies ahead in Europe?

- M still constrained
- F also constrained (sovereign risk), or when unconstrained not necessarily used
- Debt high and rising, R* is low

The funnel is not full

Refocus on the top of the funnel



Both M and F needed: proposals on the table

Boost F

- Using the fiscal space created by low borrowing costs with r-g<0
- To re-anchor inflation expectations, fiscal expansion with temporary (exceptional) monetary financing.
- Institutional implementation: Another escape clause for SGP? Helicopter drops by the ECB?

Increase the supply of safe assets

- With credible monetary backstop and a good fiscal outlook, deficits can increase the supply of nominally safe assets-- key for euro area

Will it work? Will R* ultimately rise?

The risks with a "high debt, low R*" future

- Debt overhang constraints investment and feed precautionary saving by both households and the government, keeping R* low
- Low rates create the illusion of "sustainability"

=> persistent and potentially rising vulnerability
as debt tolerance is getting tested

- Raising R*: book of dreams?
  - Realistically there is little economic and financial resilience in a world with a low and falling R*

Post-pandemic opportunity to raise R*?

De facto converging macroeconomic policies across borders

- Increasing focus on infrastructure, digitalisation and reallocation
  - …spells Investment on ageing, climate change, digitalization, human capital
- Need for strong M and F “forward guidance”
  - reducing uncertainty about employment and income
- Emergence of a transatlantic divide due size of fiscal stimulus and divergent monetary policy frameworks?
- The Fed already has more than enough fiscal support to return to price stability. But the ECB does not. How do we solve this issue?

Thank you very much!