BANK FOR INTERNATIONAL SETTLEMENTS

Monetary and fiscal policies: Year 2 of the pandemic

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Panel 4, Monetary and fiscal policies: too close for comfort?

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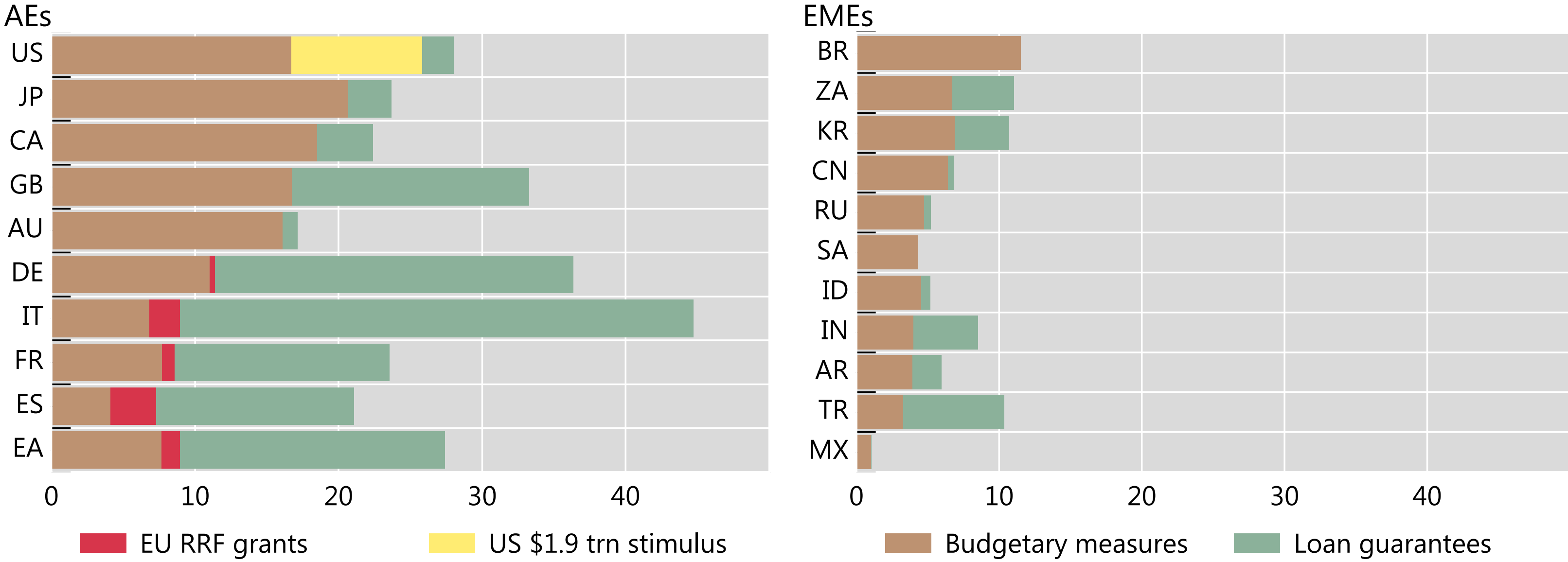
Views expressed are those of the presenter and not necessarily those of the BIS.

Powerful fiscal response to the pandemic

Fiscal support $10 trillion globally (>9% of world GDP, March 2021)
AU, CA, JP, UK, US 17–26% of GDP over 2020–22; EU 7–11%, plus grants from NGEU
EMEs 5–12% of GDP
Measures above-the-line, below-the line, contingent liabilities

Fiscal stimulus like none since World War II[1]

As percentage of GDP



[1] Health- and non-health-related spending measures announced through 17 March 2021. For the European Recovery and Resilience Facility (RRF), 50% of grants assumed to be spent in 2021.

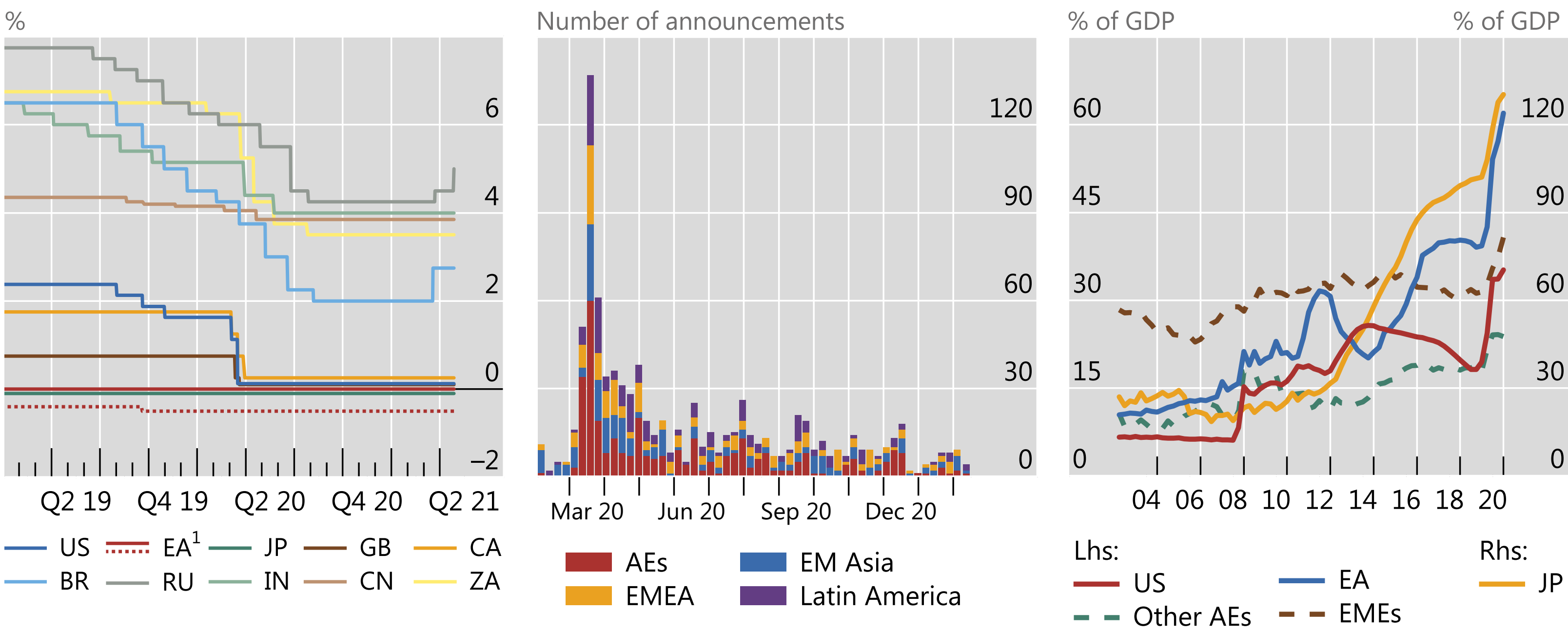
Sources: European Commission; IMF; OECD; BIS; BIS calculations.

Swift and forceful monetary response

All monetary policy tools used: interest rates, asset purchases, forward guidance, yield curve control, macroprudential tools
Novelties: corporate bond/CP purchases, funding-for-lending schemes for SMEs, asset purchases in EMEs

Forceful monetary policy boost matches fiscal largesse

Evolution of monetary policy rates | Weekly announcements of policies | Central bank balance sheets[2]



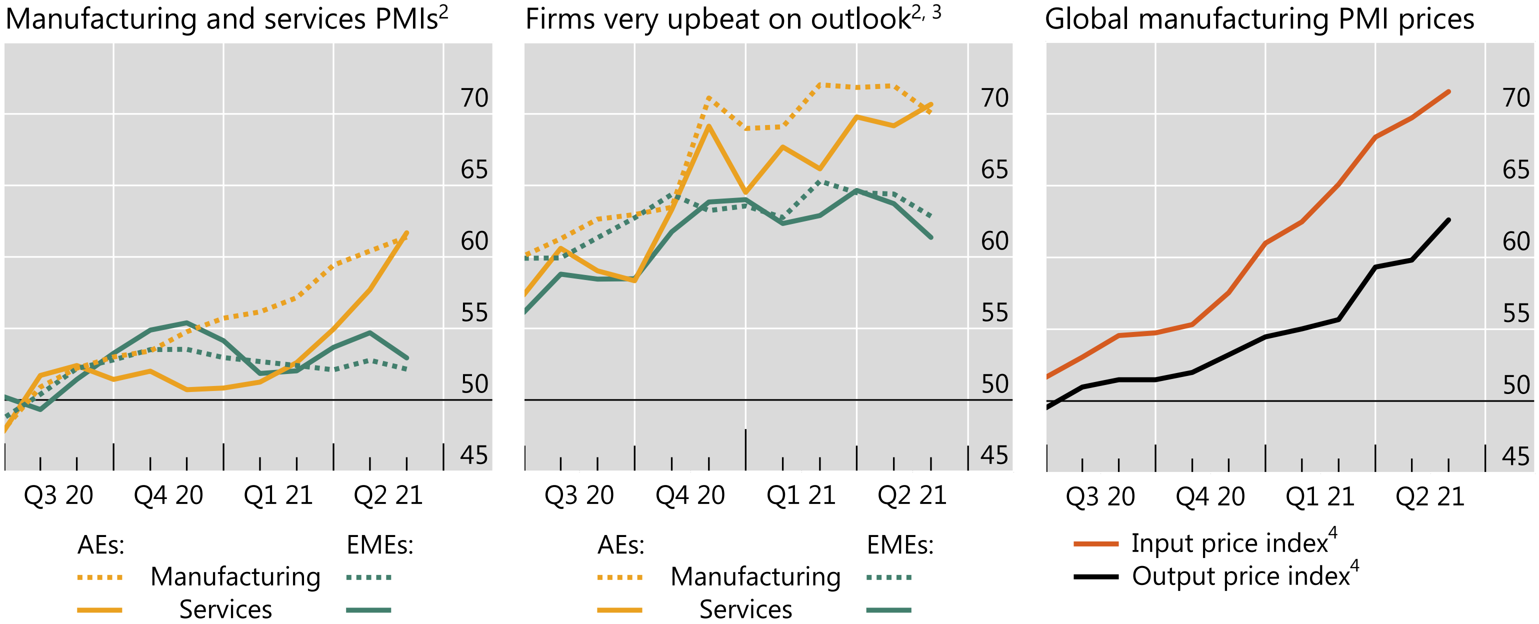
[1] Dotted line: deposit facility rate. [2] Total assets. "Other AEs" and "EMEs" show median values for eight AEs and 22 EMEs.

Sources: IMF; national data; BIS; Cantú et al (2021); BIS calculations.

Global effects of fiscal/monetary synergy…

Strong rebound of global economy
Rising cost pressures, partly spilling over to CPI inflation

Global manufacturing fires on all cylinders, services rebound, costs rise further[1]



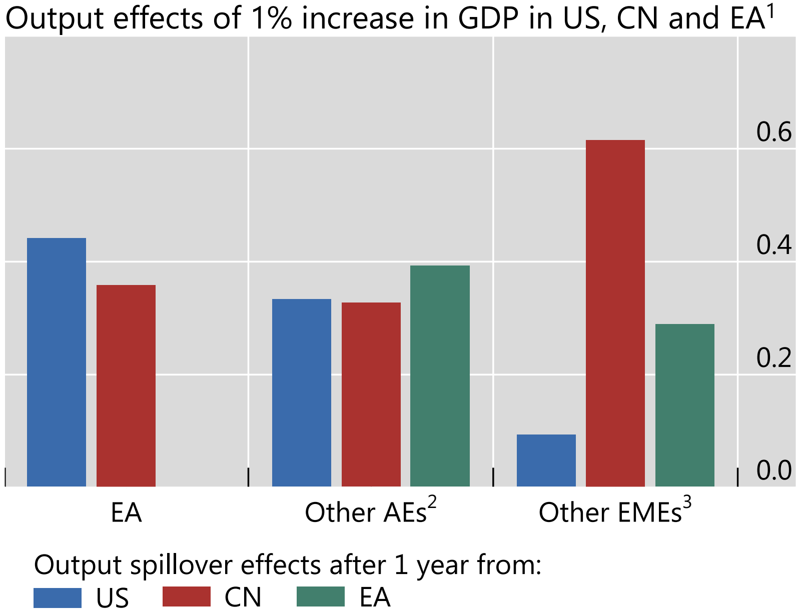
[1] Purchasing managers' indices: a value of 50 indicates that the number of firms reporting improvement in activity is the same as the number reporting deterioration. [2] Weighted averages based on GDP and PPP exchange rates. For manufacturing, six advanced economies (AEs) and 19 EMEs (16 EMEs for growth outlook); for services, five AEs and four EMEs. [3] Expectations of output (for services, business activity) growth over the next 12 months. [4] Average prices of all goods purchased/sold (volume-weighted) in the current compared with the previous month.

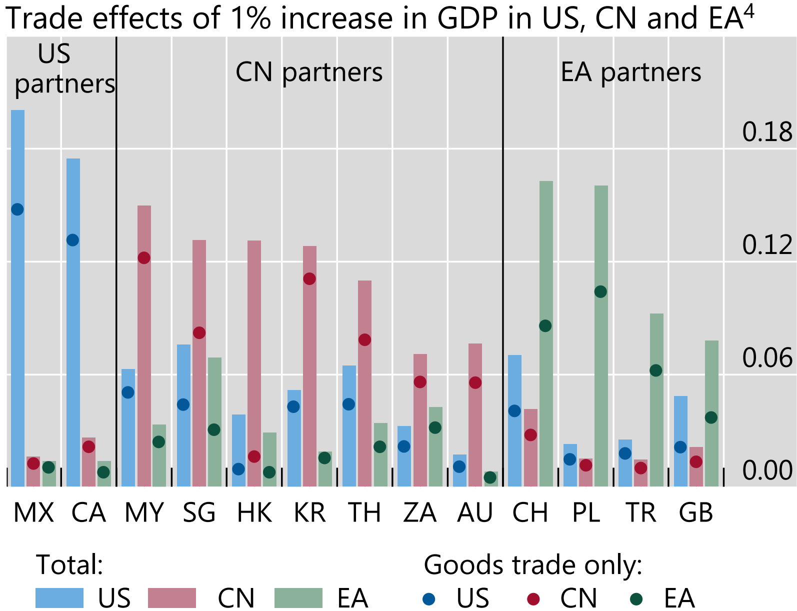
Sources: Datastream; IHS Markit; BIS calculations.

… operating through trade …

Positive real spillovers from Positive expansion in major economies

In per cent





[1] Estimates from Global VAR model. For other AEs and other EMEs, GDP PPP weighted averages of the estimates. [2] AU, CA, GB and JP. [3] BR, IN, KR and MX. [4] Effects of 1% increase in nominal GDP of source countries on exports of recipient countries, accounting for the domestic value added of the latter and spillovers via third-party countries.

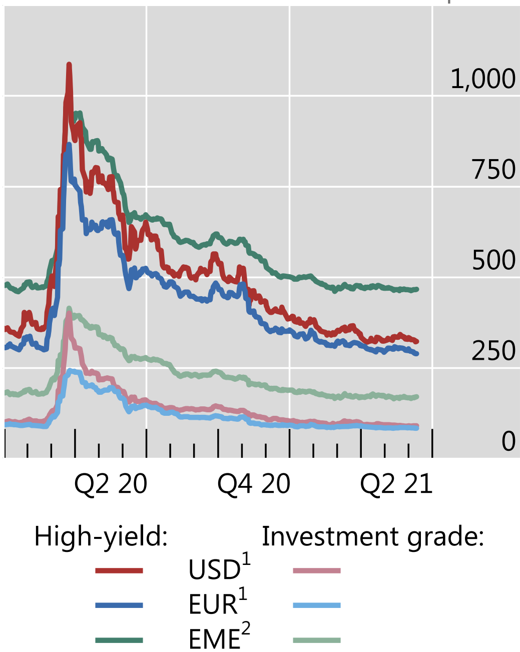
Sources: Wu and Xia (2016); IMF; OECD; Bloomberg; national data; BIS; BIS calculations.

… and financial channels

Financial conditions remain favourable – except in some EMEs

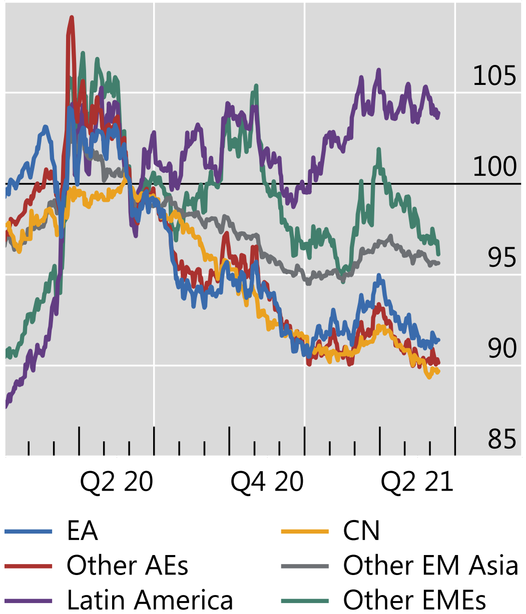
Corporate bond spreads

Basis points



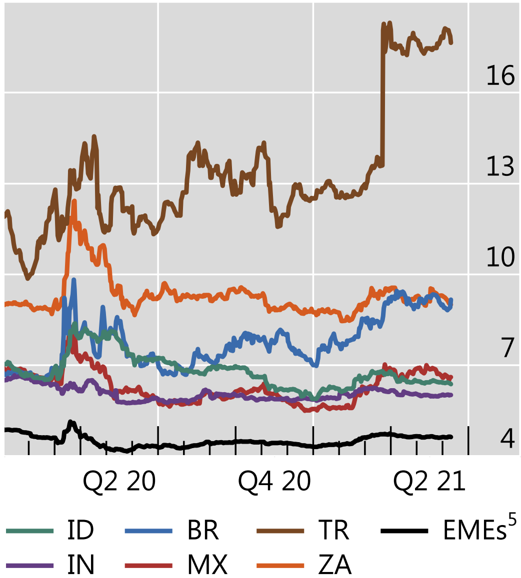
Exchange rates against USD[3]

1 Jun 2020 = 100



EME local currency sovereign yields[4]

Per cent



[1] Option-adjusted spreads over Treasuries. [2] For US dollar-denominated debt issued by EME corporations; JPMorgan CEMBI index, stripped spreads. [3] Bilateral USD exchange rates; a decrease indicates USD depreciation. Simple averages across country groups. [4] Ten-year local currency sovereign yields. [5] JPMorgan GBI-EM broad, yield on traded index.

Sources: Bloomberg; Datastream; ICE BofAML indices; JPMorgan Chase; BIS calculations.

Monetary and fiscal policy interactions ahead

- MFP interaction very successful in pandemic recession
- But this "beautiful friendship" will end at some point:
  - Public debt has risen everywhere
  - Inflation has risen, too – temporarily only?

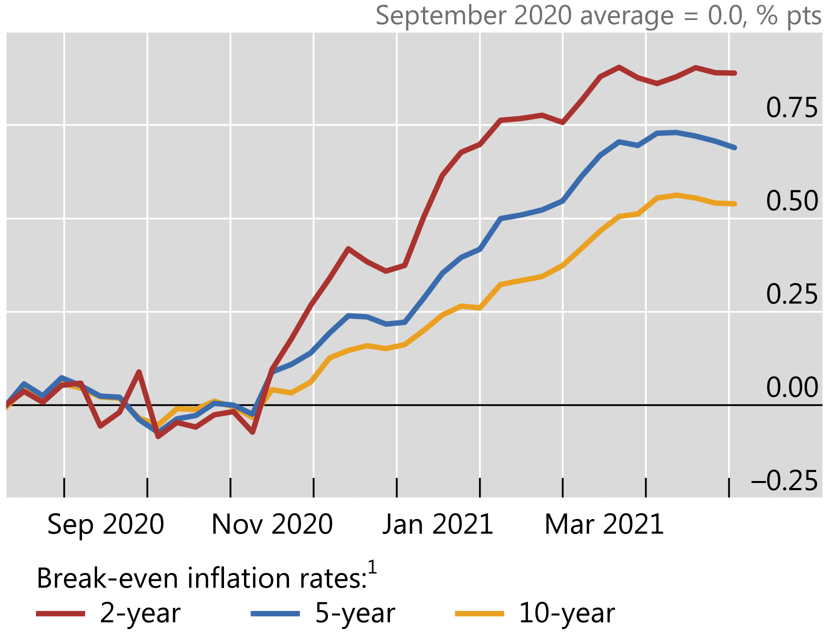
    (rising house prices are a related concern)
  - Fiscal sustainability issues loom …
  - … and questions being asked about normalisation of MFPs
- Regaining greater room for manoeuvre important for both M&FP
  - But fiscal consolidation will put pressure on MP to stay easy
  - MP normalisation will put pressure on government borrowing costs

Could inflation surprise on the upside?

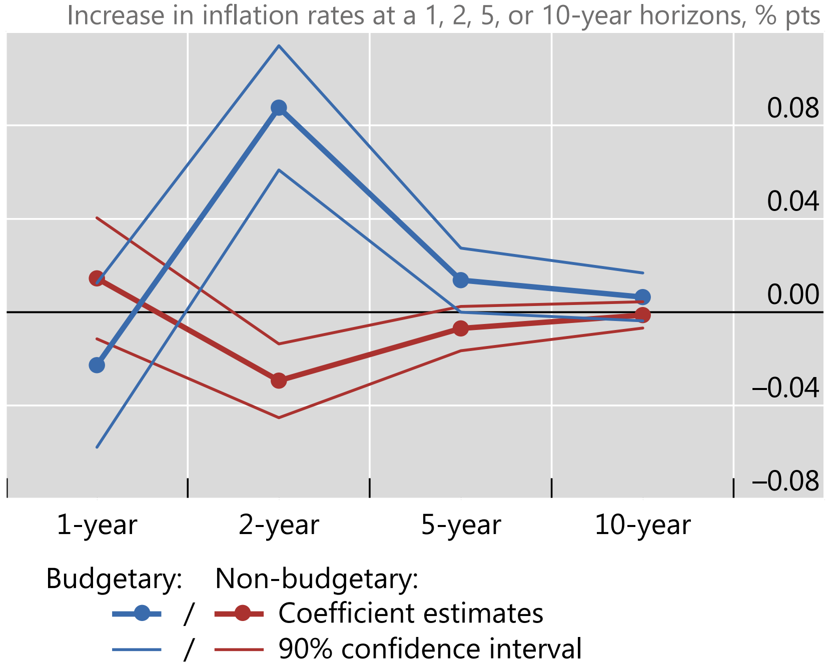
- Fiscal policy may have done “too much” in some countries: could inflation surprise on the upside and financial conditions tighten before MP moves?
- Higher inflation welcome where it’s been stubbornly below target
- But sharp adjustment in financial markets would be disruptive
- Reasons to believe such prospects are slight
  - Expectations inferred from bond yields show increases mostly centred on near term
  - Fiscal expansion in advanced economies does not seem to have lifted market participants’ inflation expectations beyond medium term
- But the risk of inflation surprises cannot be dismissed entirely

Fiscal stimulus lifted inflation expectations in the medium term

Long-term break-evens climbed to a lesser extent



Effect of 1 ppt increase in fiscal stimulus/GDP on break-even inflation rates[2]



[1] Cross-country weekly simple averages for G7 countries; 2-year break-even inflation rates for Canada and Germany are not available. [2] Includes all budgetary and non-budgetary measures announced through 17 March 2021. The lines connect the dots that correspond to regression-based estimates of the effect of a 1 percentage point increase in the fiscal stimulus to GDP ratio (either budgetary or non-budgetary measures) on break-even inflation rates at a 1, 2, 5, or 10-year horizon; in percentage points. See Box A1 for details.

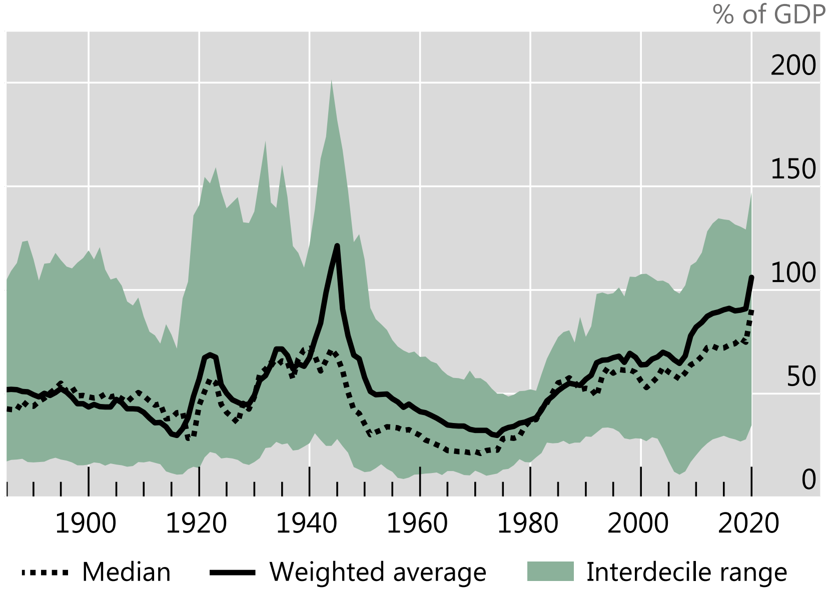
Sources: European Commission; IMF; Bloomberg; Datastream; national data; BIS; BIS calculations.

How much to worry about (much) higher public debt?

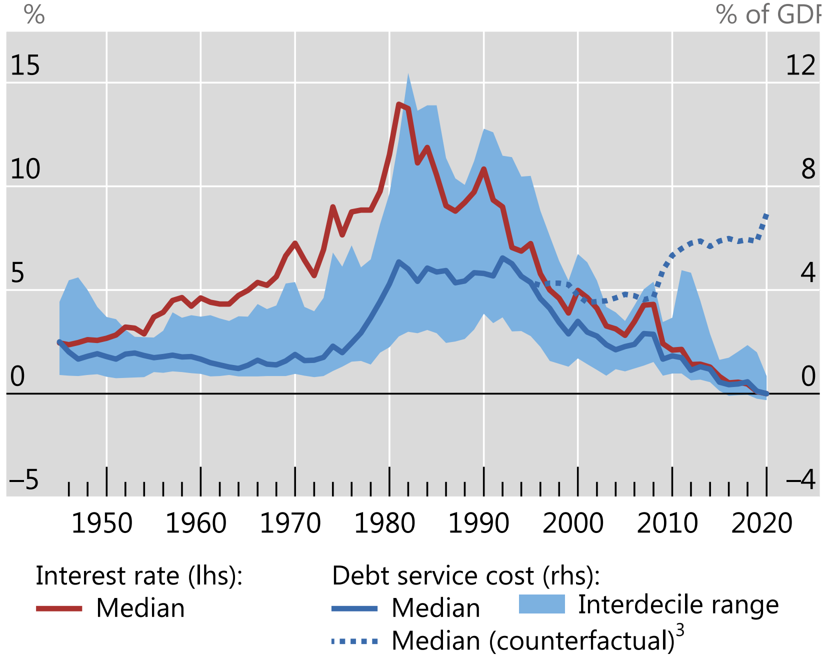
- Debt/GDP ratios on a par with World War II peaks
- Nominal interest rates at historical low
- Real interest rates likely at historical low, too. Negative for longer than during the Great Inflation
- Debt burden has never seemed so light
- But still need to worry about $r - g$

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

Government debt[1]



Debt service cost[2]



[1] General government debt at nominal value, latest available quarter for 2020. Sample of 19 AEs and five EMEs. [2] Debt/GDP multiplied b the simple average of short- and long-term interest rates. Sample of 16 AEs and one EME. [3] Median debt service if nominal interest rates ha stayed at the 1995 level.

Sources: Abbas et al (2010); Jordà et al (2016); European Commission; IMF; OECD; Bloomberg; Datastream; BIS; BIS calculations.

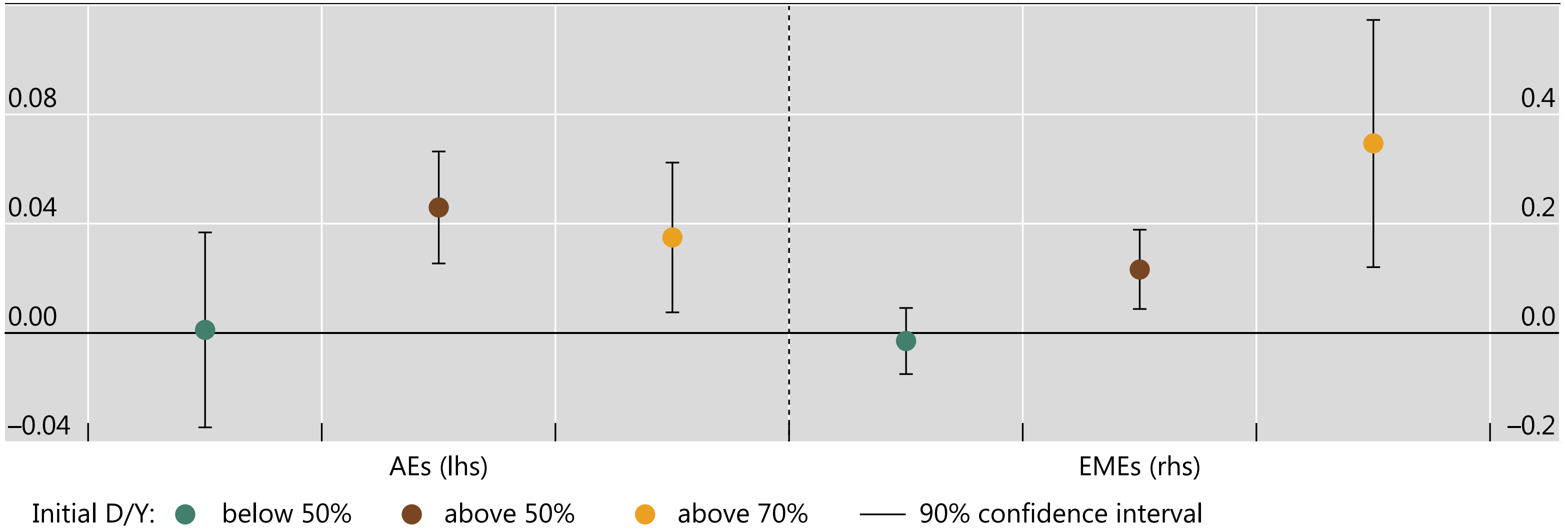
How relaxed can one be about $r - g < 0$?

- Advanced economies: increase in D/Y is associated with economically small increase in $r - g$, irrespective of initial D/Y
- EMEs: increase in D/Y associated with large increase in $r - g$, notably when initial D/Y > 70%
  - In those EMEs, D/Y up 1 ppt $\rightarrow$ $r - g$ up 0.4 ppt

(23 advanced economies, 35 EMEs, Q1 1995 – Q1 2021)

$r - g$ rises non-linearly with government debt[1]

In percentage points



[1] The dots correspond to coefficient estimates of the effects of a 1 pp increase in the D/Y on $r - g$ one year ahead, depending on whether the initial D/Y is below 50% (sample median), above 50%, or above 70%. The regressions feature time fixed effects (to control for secular trend in r) and country fixed effects. r is the 10-year government bond yield and g is the year-on-year GDP growth rate. Sample includes 60 countries from 1980 to Q1 2021.

Sources: BIS; BIS calculations.

How were fiscal consolidations achieved in the past?

- Successful debt reductions in the past:
  - at least three consecutive years of declines in D/Y
  - 57 episodes from 1960–2020
  - cumulative reduction: ave. 17 ppt GDP (range 9–20 ppt)
- Need a combination of
  - primary surpluses (ie tax hikes/spending cuts) and $r - g < 0$ (64% of cases)
  - favourable $r - g$ alone helped in 22% of cases
  - Primary surpluses alone helped in 15% of cases

→ Taking advantage of current $r - g < 0$ for fiscal consolidation

→ Raise g on a sustainable basis: growth-friendly structural policies