Monetary and fiscal policies: in search of a corridor of stability[1]

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Monetary and fiscal policies, as deeply entwined functions of the state, face a looming dual long-term challenge. They need to regain policy headroom so as to be able to effectively fulfil their macro-stabilisation role. And once those safety margins are restored, the policies need to remain firmly within a "corridor of stability", in which neither can endanger the other or push it to the limit. Navigating the path ahead will require a mix of "opportunistic normalisations" and structural reforms to raise long-term growth.

The Covid-19 crisis has highlighted the nexus between monetary and fiscal policies. Faced with an unprecedented economic collapse, monetary and fiscal authorities acted in unison to stabilise markets and shore up activity. Monetary policy deployed its power to create and distribute liquidity; fiscal policy its power to transfer resources and spend. Together, they prevented a much deeper contraction and laid the basis for the recovery (BIS 2020). The two policies have worked smoothly together so far. But this happy state is unlikely to continue indefinitely.

The fault lines lie in the interwoven structure of the two policies, which inevitably encroach on each other's territory. Both policies have a first-order impact on financial conditions, economic activity and inflation. And the nexus between them becomes even tighter, more mechanically, through interlocking balance sheets – income transfers to and from the government and central bank purchases of government debt. The ultimate reason for this tight relationship is that both policies reflect the state's privileged command over resources, through the power to tax or issue money (Borio and Disyatat (2021)). That power can be a major force for good, when it provides the stable foundation for a thriving economy, but it can also cause great harm, when it leads to inflation as well as financial and macroeconomic instability.

What does the journey ahead look like? What are the hazards along the way?

When considering these issues, the debate often focuses on the interaction between monetary and fiscal policies in near-term macroeconomic stabilisation – the policy mix (Bartsch et al (2020). This issue no doubt matters. But it pales in comparison to a looming dual longer-term challenge. First, there is a need to regain policy room for manoeuvre so as to be able to carry out effectively that macro-stabilisation function in the first place. This means operating with comfortable *safety margins*, which will allow each policy to address inevitable future recessions and equally inevitable unexpected shocks. Second, once those safety margins are re-established, there is a need for the two policies to remain firmly within a "corridor of stability",[2] in which neither of them can endanger the other or push it to the limit. Fiscal sustainability is essential in this context.

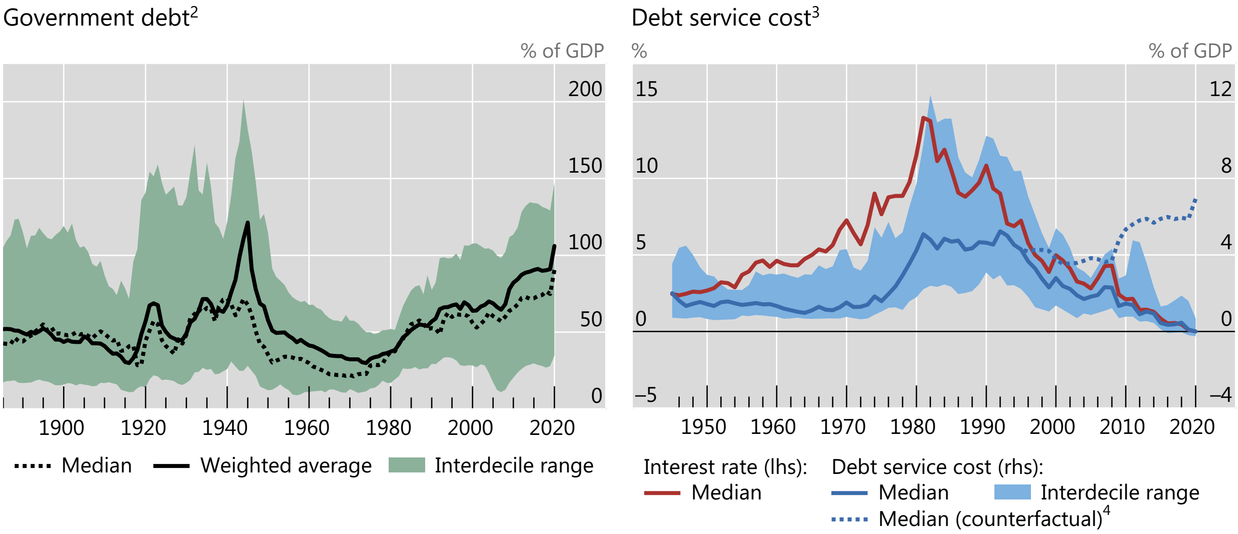
1 The views expressed are our own and do not necessarily reflect those of the Bank for International Settlements or the Bank of Thailand.

2 This is a term coined by Leijonhufvud (2009) in the early 1970s to indicate how the economy can become unstable if it is operating outside a particular range. Here we use it to emphasise how *policy* can widen that corridor if it remains sustainable and operates with sufficient safety margins.

Managing the interaction: the exceptional starting point of the journey

What makes the journey ahead so hazardous is the exceptional starting point. In no phase in history have nominal interest rates been as low as they are now. Rea interest rates have never been negative for as long, even during the exceptional Great Inflation era. Central bank balance sheets have been as high only during wars. At the same time, after a relentless rising trend since the mid-1980s, government debt has, globally, reached levels not seen since World War II (Graph 1, left-hand panel) – no doubt another historical peak. And despite this, service costs have fallen to a trough (right-hand panel). The debt burden has never felt so light.

Government debt and service cost[1] Graph 1



[1] Sample consists of 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 is not available. [2] General (if not available central) government core (if not available total) debt at nominal (if not available market) value. Latest available quarter for 2020. [3] Government debt-to-GDP multiplied by the simple average of short-term and long-term interest rates. [4] Median debt service had interest rates stayed at 1995 level.

Sources: Borio and Disyatat (2021).

It is quite common to describe this situation as "the New Normal". Clearly, though, it is anything but. What has so fundamentally changed in the global economy since its inception that we should expect current conditions to prevail without generating forces to upend them? In fact, policymakers' task is arguably to ensure a smooth transition to a new, more resilient, path (Borio (2021a)).

Managing the interactions: the hazards ahead

The much diminished policy headroom in the monetary and fiscal spheres poses risks. The ultimate, most damaging, hazard is a kind of "instability trap". In this scenario, rather than taking advantage of low rates to adjust, governments take the opportunity to raise debt further – a risk underlined by the belief that the New Normal will ensure structurally low borrowing costs. In turn, higher government debt (alongside higher private debt) makes it harder to raise interest rates, as the economy becomes less able to bear them.[3] Indeed, after such a long time with very low rates, the economy has adapted to

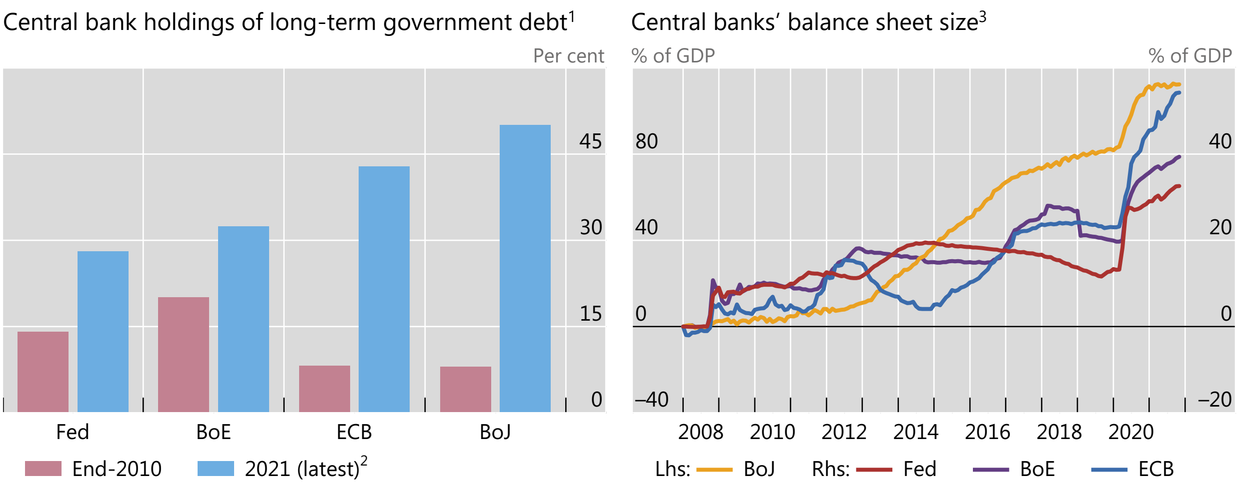
[3] This is what Borio and Disyatat (2014) refer to as a "debt trap" in the context of private sector balance sheets.

them. This process can be self-reinforcing and reduce both fiscal and monetary policy headroom over time.

The above reasoning turns the usual argument on its head. In this scenario, it is not so much that interest rates are structurally and exogenously low so that governments can afford higher debt. Rather, the belief that they are structurally and exogenously low encourages policies that end up validating those rates. The difference in perspective is hardly immaterial: it is the difference between a stable and an unstable economy.

To get a sense of the orders of magnitude involved, imagine that interest rates rose back to their mid-1990s levels. This was after inflation had been conquered, so that rates had declined to historically typical levels. In that scenario, government service costs in relation to GDP would be higher than during World War II (Graph 1, right-hand panel, dotted line).

Central bank balance sheets grow larger as government debt purchases soar — Graph 2



[1] Estimates of central bank holdings of long-term government securities as percent of the total outstanding. [2] For ECB, as of August 2021; for the Bank of England (BoE), Q1 2021; for the Bank of Japan (BoJ) and the Federal Reserve, September 2021. [3] Cumulative changes in total balance sheet size since 1 January 2008, as a percentage of four-quarter moving sum of quarterly GDP.

Sources: ECB; Bank of England; Bank of Japan; Board of Governors of the Federal Reserve System; United Kingdom Debt Management Office; Datastream; national data; BIS calculations.

One reasonable objection to this counterfactual is that it does not take into account that a large, and possibly growing, chunk of government debt now has a long maturity. But this argument fails to consider that central banks have purchased large amounts of that debt (Graph 2, left-hand panel) – by far the main force behind the surge in their balance sheets (Graph 2, right-hand panel). Central bank purchases of long-term government debt financed with bank reserves (QE) raise the sensitivity of fiscal positions to higher interest rates (eg Borio and Disyatat (2010), Greenwood et al (2014)). From the perspective of the consolidated public sector balance sheet – aggregating the balance sheets of the central bank and the government – the purchases amount to a large-scale debt management operation: the public sector retires long-term debt and replaces it with overnight debt (bank reserves) (Graph 3). Higher interest rates on reserves cut central bank profits (or raise losses) and hence depress remittances to the government.

Graph 3: How long-term government debt may in fact be overnight

Government		Central Bank		Consolidated	
Assets	*Liabilities*	*Assets*	*Liabilities*	*Assets*	*Liabilities*
↑ Long-term assets	**Short-term bills**	**↑ Long-term bonds**	**↑ Overnight debt**	**↑ Long-term assets**	**Short-term bills**
	↑ Long-term bonds				**↑ Overnight debt**

The figure shows what happens to the consolidated government-cum-central bank balance sheet if the government issues long-term debt (green rectangle) purchased by the central bank and financed with interest-bearing bank reserves (de facto overnight debt – orange rectangle).

Source: Borio, C and P Disyatat (2021): "Monetary and fiscal policy: privileged powers, entwined responsibilities", *SUERF Policy Note*, no 238, May.

Government debt may appear long-term, but in fact it is not. In the largest advanced economies the share of marketable government debt now exceeds 80% and can be as high as almost 100%. But once the large-scale central bank purchases are taken into account, as much as some 30–50% of that debt is already de facto overnight.

Managing the interactions: policies towards the final destination

Navigating the path ahead will require well-grounded policies with a clear medium-term orientation and conducted with a great deal of deft. The fact that normalisation is a *joint* task complicates matters significantly. Along the long path ahead, the two policies will at times be working at cross purposes, putting pressure on each other. Higher interest rates increase the size of the required fiscal adjustment, and fiscal consolidation puts pressure on monetary policy to remain accommodative for longer.

Such tensions can be partly alleviated by staying attuned to economic developments and implementing "opportunistic normalisations". For fiscal policy, as the history of successful reductions in government debt-to-GDP ratios indicates, it is essential not to miss the window of opportunity provided by the prevailing favourable interest rate-economic growth differentials through fiscal consolidation once the post-pandemic recovery is well under way. (BIS (2021)). This is also important to reduce the risk of fiscal dominance. For monetary policy, reflation can go hand in hand with the gradual withdrawal of stimulus (Borio (2021b)) – as many central banks have already begun to do.

Fundamentally, though, the only way of improving trade-offs is to raise long-term growth. And this cannot be done through monetary or fiscal policy; reinvigorating structural reforms remains a priority. It is hard to imagine that an economy can allocate capital efficiently and thrive with real interest rates persistently negative. Favourable interest rate-growth differential should reflect higher growth, not lower real interest rates.

These policies provide the best chance for the economy to reach the right destination: one in which both monetary and fiscal policies have regained safety margins and operate firmly within a corridor of stability. Along such a corridor, the two polices could finally operate "consistently", avoiding the risk of long-term and hard-to-reverse damage to institutional credibility to which an unbalanced reliance on one of the two can give rise.[4] The final destination of the journey would be the foundation of a resilient economy – a place to call home.

[4] Arguments for temporary "irresponsible" monetary or fiscal policies in order to boost inflation, such as those in Eggertsson (2006), need to be considered in this light.

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