SOME COMMENTS ON THE INTERACTIONS BETWEEN PRIVATE DEBT, PUBLIC DEBT, FISCAL DEFICITS AND MONETARY POLICY

By
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I have divided my comments today into two parts. In the first one, I will elaborate on some of the points made by Professor Canzoneri with regards to the policy implications of high public debt ratios and the size of fiscal multipliers. In the second part, I will offer some thoughts on the interaction of fiscal policy, private and public indebtedness and monetary policy in Emerging Market Economies (EME) in the context of the current global outlook.

A. On the reflections of Professor Canzoneri

- In discussing the functional independence of central banks in some advanced countries, Professor Canzoneri suggests that the fiscal theory of the price level may become relevant and indicates that the ability of central banks to independently determine prices or nominal GDP could be hindered by "non-Ricardian" fiscal policies. This is a possibility, as shown by the disturbing experiences of some European countries after WWI or of some Latin American economies in the XX century.

- However, it is by no means the only way to preserve the intertemporal public budget constraint. As noted in a recent comment by Stephen King of HSBC,[2] an alternative is financial repression, which amounts to reducing the interest rate embedded in the discount factor used to calculate the present value of expected fiscal surpluses. Thus, at least for a while, highly indebted governments may be able to meet their intertemporal budget constraint without resorting to inflationary finance. The question in this regard is whether financial repression would, in addition, hamper long term economic growth so as to render public debt unsustainable due to lower future tax revenues. In the absence of exogenous productivity gains, this is a threat that must be considered seriously.

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[1] Governor of the Banco de la República de Colombia. Participation notes for the Colloquium in honor of Prof. José Manuel González-Páramo, organized by the European Central Bank.
[2] King, Stephen. "From depression to repression", HSBC Economics Global, April 23, 2012

- In a second interesting comment, Professor Canzoneri expresses concern about the size of fiscal multipliers in highly indebted countries like Greece that are forced to undergo a sharp adjustment in public finances. Some evidence suggests that the multipliers may be low in those circumstances, so that the effects of a fiscal contraction may be relatively subdued. However, it would be interesting to empirically explore possible asymmetries in the multiplier effects of fiscal expansions and contractions. Low effects on output are expected from an expansion by an over-indebted government. Increased risk premia or expected future tax increases may depress private spending. In contrast, a fiscal contraction in the same context may have mixed effects that yield an uncertain impact on output. On the one hand, risk premia may fall, moderating the drag caused by the fiscal tightening. On the other hand, no future tax reduction is likely to be expected, so the contraction in aggregate expenditure may be substantial.

- This means that if fiscal retrenchment is not accompanied by a significant reduction in risk premia for the private sector, the effect on output could be sizable. Hence, fiscal adjustment ought to be supported by ample access to credit, or else it may become self-defeating. In the presence of financial repression, this risk is heightened since credit to the private sector may be further crowded out. Central banks in this situation may alleviate credit constraints by loosening monetary policy (economic slowdown would probably contain inflation). However, this option may be limited in the Eurozone since there may be significant differences in the conditions of various economies in the region.

B. Some ideas from the point of view of Emerging Market Economies (EME)

- The fiscal and financial problems as well as the policy responses in advanced economies affect the emerging world and pose policy challenges that require the examination of the interactions between debt, the fiscal deficit and monetary policy in those economies.

- To begin with, a new sustainable equilibrium in the world economy will probably involve higher current account balances in advanced countries and, consequently, lower current account balances in EME. This implies larger capital inflows and more appreciated currencies in the latter. Barring extreme negative shocks, in the transition toward such an equilibrium, there may be an "overshooting" of these trends as monetary policy would remain abnormally relaxed and domestic absorption would be depressed in advanced economies. In some commodity-exporting EME, the appreciation of the currency could be reinforced by higher terms of trade.

- History is replete with the dangers that such a "rebalancing" may entail for EME. In the seventies, the oil-producers' surpluses were recycled as loans to governments in Latin America. The excesses this allowed finally led to the fiscal, balance of payments and financial crises that opened the "lost decade" in the subcontinent during the nineteen-eighties. Similarly, low interest rates in the advanced world in the nineties contributed to large capital flows to EME that, again, fed excesses both by the public and private sectors in several EME. The Asian and Russian crises followed as a result. My own country, Colombia, experienced a financial crisis at that time and the worst output contraction in several decades.

- These lessons were fresh in the memory of the policy makers in the EME of Asia and Latin America, so steps were taken to improve the resilience of the EME throughout the last decade. Flexible monetary and exchange rate regimes were adopted, sustainable public debt ratios were achieved and financial imbalances and mismatches were limited. As a consequence, after a period of rapid financial globalization, EME in those regions withstood the Lehman crisis shock reasonably well and growth quickly resumed afterwards. Countercyclical monetary policy reactions, solid financial systems and the absence of procyclical fiscal policy responses were of the essence in this process.

- Whether the emerging countries will be able to shield their economies from the possible excesses stemming from the transition toward a new world economic equilibrium depends on the fiscal institutions in place in each country and on the duration of this process.

- After the Lehman crisis, some EME have not completely withdrawn the fiscal stimulus that was introduced in response to the shock. As illustrated by the IMF in the most recent version of the REO for the western hemisphere,[3] most economies in the region have continued stimulative fiscal policies amid strong domestic demand and favorable external conditions. Although several countries have implemented institutional reforms to preserve the sustainability of public finances (fiscal rules, stabilization funds etc.) and fiscal policy is less prone to be procyclical with respect to past decades, the coincidence of public and private deficits is a possibility that can not be dismissed.

- In a world of large capital flows, this event will not lead to higher local interest rates, but to smaller current account balances, big inflows and sharp currency appreciation. Even with inflation targeting regimes and flexible exchange rates, it could be difficult for monetary policy alone to contain aggregate demand and preserve financial stability. Firstly, inflationary pressures would be moderated by the appreciation. Secondly, increased domestic policy interest rates could attract more capital flows. Capital controls and measures to restrict private sector indebtedness (domestic and foreign) could be adopted, in effect repressing the financial system. Thus, as in advanced economies, insufficient fiscal policy adjustment ends up conditioning monetary and financial policy in EME.

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[3] IMF, "Regional Economic Outlook". Western Hemisphere Department, April 2012

- If effective, financial repression imposes costs on the private sector beyond those justified by the presence of undue leveraging by households and firms. Alternatively, the measures to repress the financial system end up inducing "innovations" to circumvent them in ways that could disguise vulnerabilities. This is the worst possible outcome, for in that case, excesses are neither prevented nor detected.

- But even if institutions are in place that ensure fiscal savings and limit the pro-cyclicality of fiscal policy, the transition toward a new world sustainable equilibrium may take a long time thus raising the probability of private sector overextension. This is a difficult situation because fiscal policy usually lacks the incentive or the flexibility to easily adjust and offset private sector excesses. In this case, the role of restrictions on foreign and local indebtedness are justified, but the risk remains of ineffectiveness and hidden fragilities.

- In summary, inflation targeting and exchange rate flexibility are key features of a robust policy regime in EME. Permanent regulation of the financial system's currency and liquidity mismatches as well as some exchange rate volatility (to avoid one-sided bets) are important to maintain the shock-absorber role of the exchange rate and the ability to pursue countercyclical monetary policy. However, the overall resilience of the EME in a period of continued capital inflows depends crucially on the fiscal policy responses and institutions. They determine the extent to which financial repression is adopted and, so, the risks and costs of external shocks for EME.

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