Monetary Policy Issues when Public Debts are Large

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Motivation

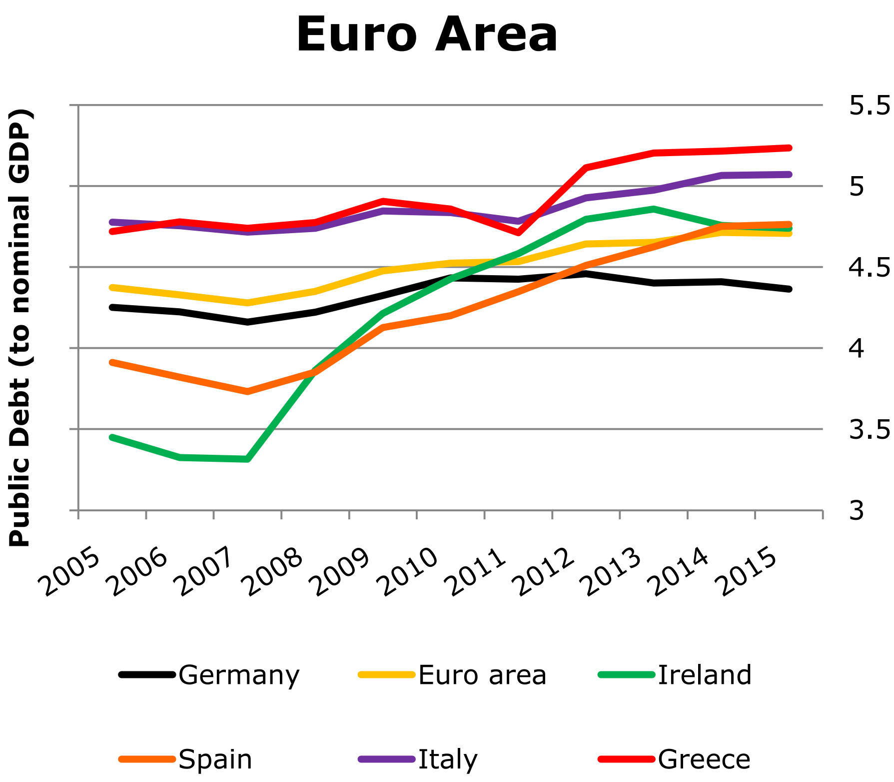
- Sustainable public finances are of crucial importance for monetary policy.
  - In recent years, several euro area members have experienced severe fiscal difficulties.
    - Some small economies required a bail out.
    - Some large economies were stressed.
  - Many believed that these were country-specific events of little importance to the euro area.
    - But spill overs over sovereign risk appear to have been much larger than expected.
    - Cross-country holdings of debts and counterparty risk provides transmission mechanism.

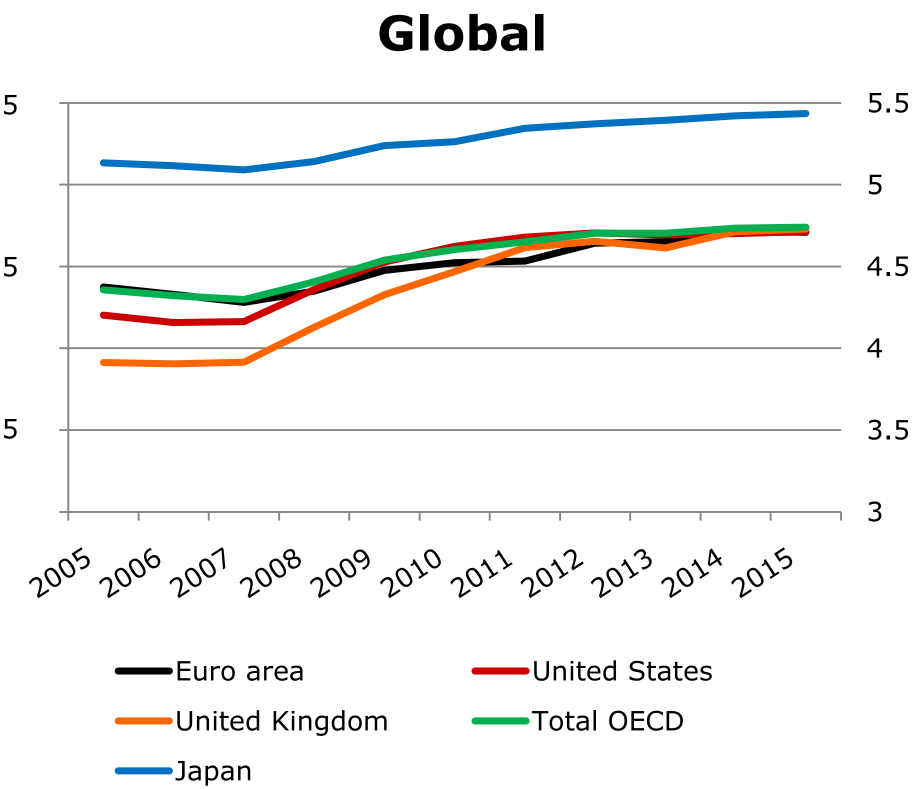
Motivation (2)

- Focus on what has been learned about the monetary policy implications of large public debts.

- Outline:
  - Review debt/deficit developments.
  - Discuss how public debts constrain monetary policy.

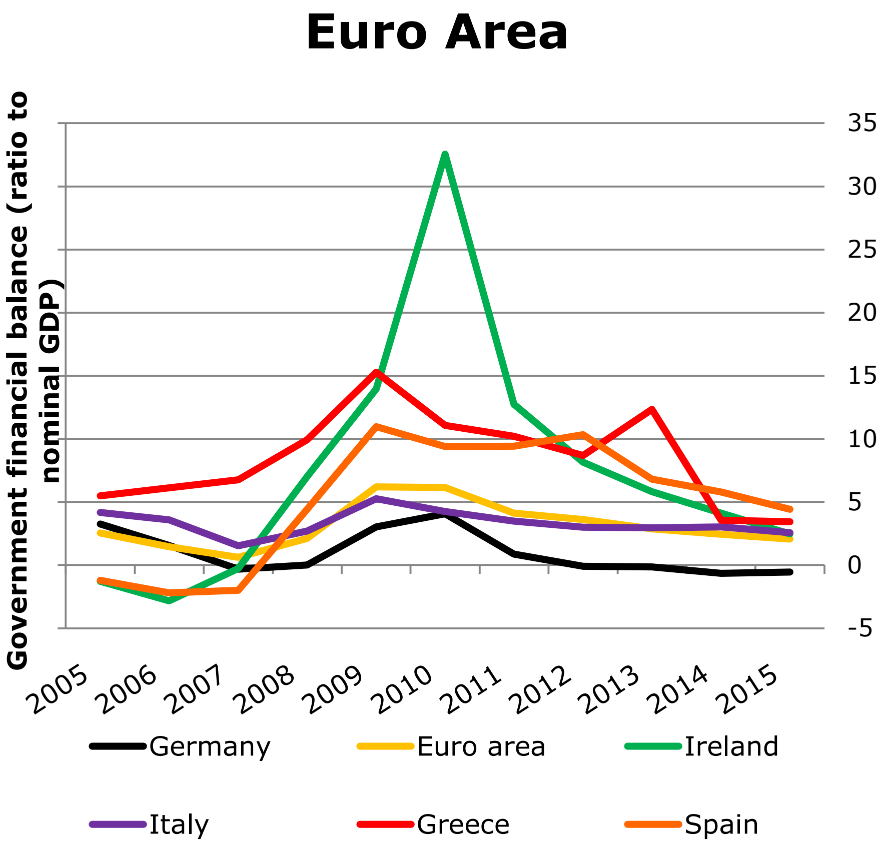
Public Debt, 2005-2015

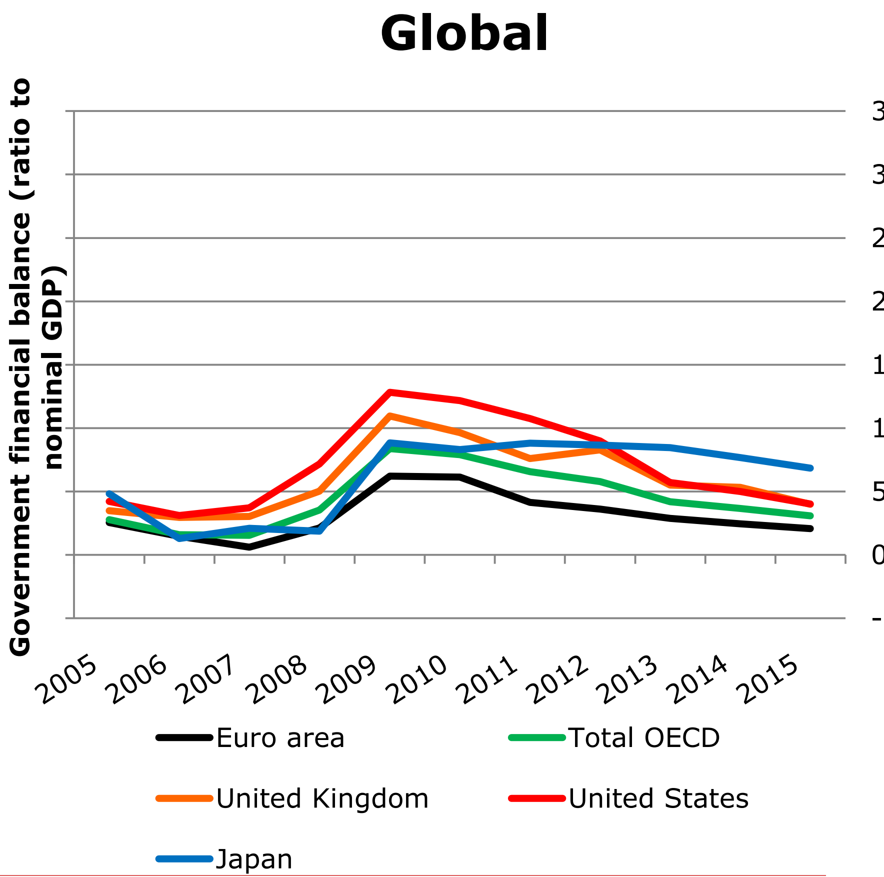




Source: OECD Economic Outlook

Fiscal Deficit, 2005-2015

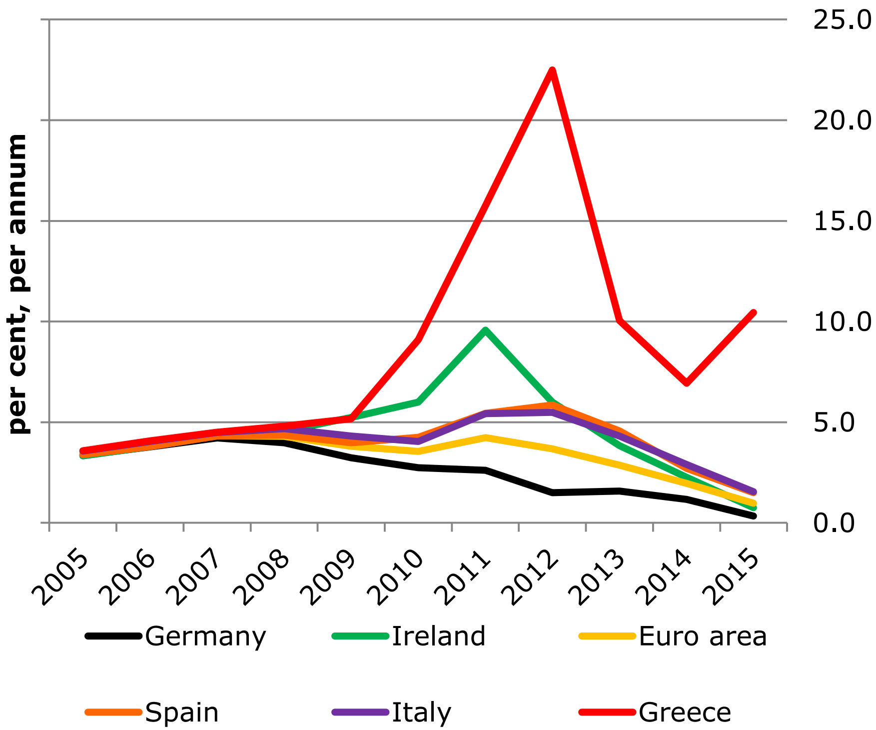




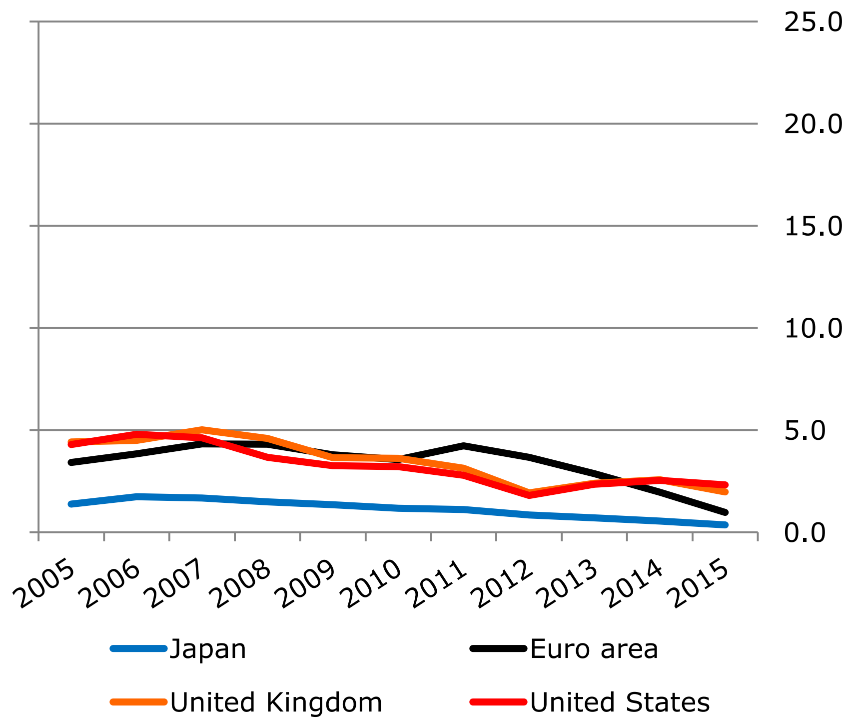
Source: OECD Economic Outlook

Long-term interest rates, 2005-2015

Euro Area



Global



Source: OECD Economic Outlook

Policy concerns

- Debt and inflation.
- Distraction for monetary policy.
- Debts and fiscal policy.
- Debts and the monetary transmission mechanism.
  - Price channel
  - Liquidity channel
  - Balance sheet channel

Debts and inflation

- A common concern is that large public debts are seen as invitations for inflation.
  - Hyperinflations in Germany and elsewhere in 1920s.
  - But not in a number of other countries.
    - Combination of large debts, unstable politics and lack of central bank independence.

- Not a current concern in euro area.
  - Prohibition on monetary financing.
  - Difficult to raise inflation quickly.
  - Market participants alert.
  - Relatively short maturity structure of debt.

Debts as a distraction for monetary policy

- Policy makers may worry about unstable debt dynamics.
  - Raising interest rates aggravates debt problems:
    - Slows the economy, raising deficits and debt/GDP ratio.
    - Increases debt-servicing costs.
  - Risk that central banks hesitate to raise rates when needed.
  - Not an issue in euro area.
    - Debt dynamics so far mainly an issue in a few peripheral countries.

Debts can overburden monetary policy

- Tight fiscal policy necessary when debts are large.
  - With fiscal policy unable to support demand, monetary policy risks being overburdened.
  - Not easy to adopt more expansionary monetary policy when interest rates are at zero.

  - Relevant to euro area.

Debts and financial system

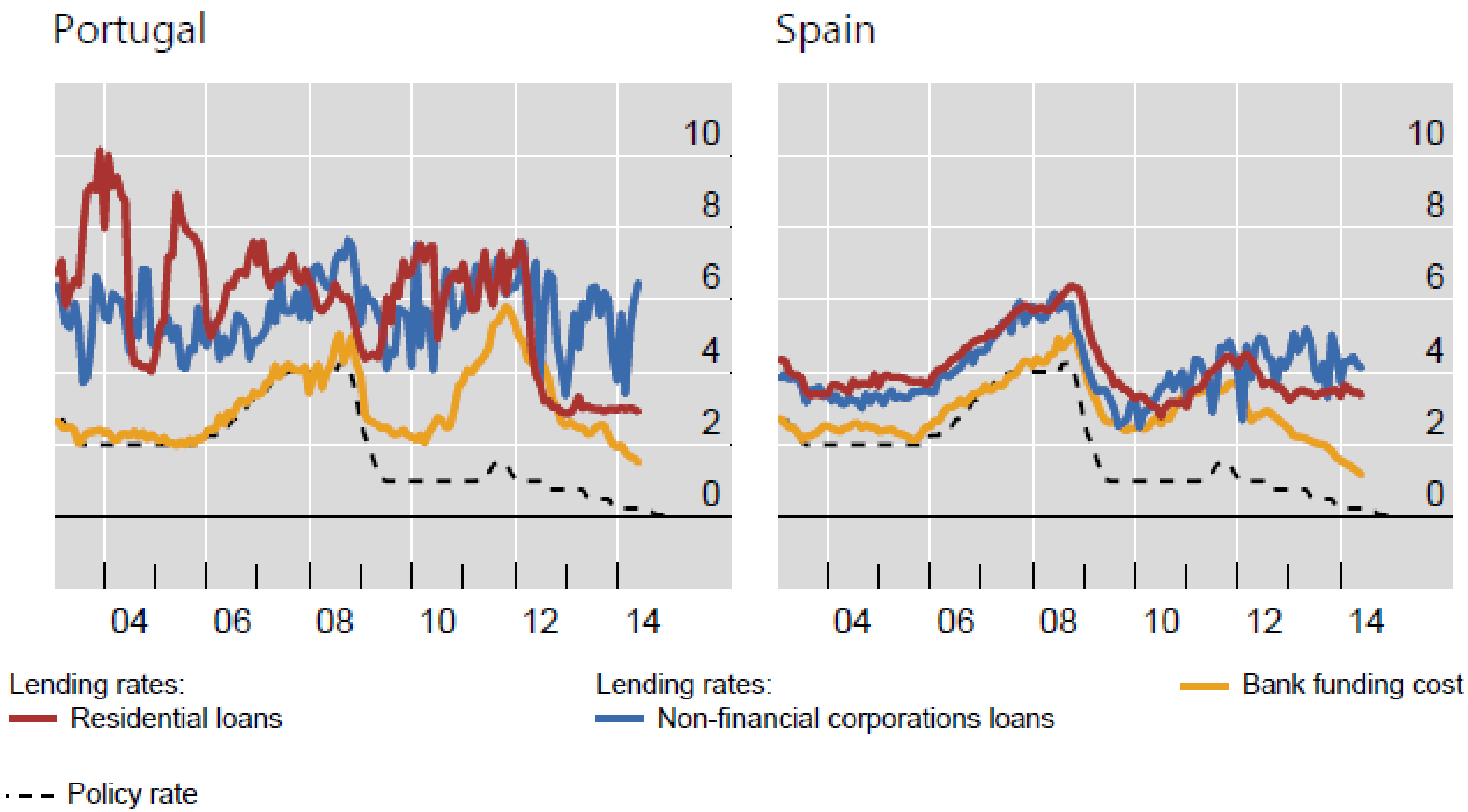
- Perceptions of sovereign credit risk can impair the monetary transmission mechanism.
  - Often the most serious problem.
  - Of direct relevance to euro area.

- Several mutually reinforcing channels:
  1. Price.
  2. Liquidity.
  3. Balance sheet.

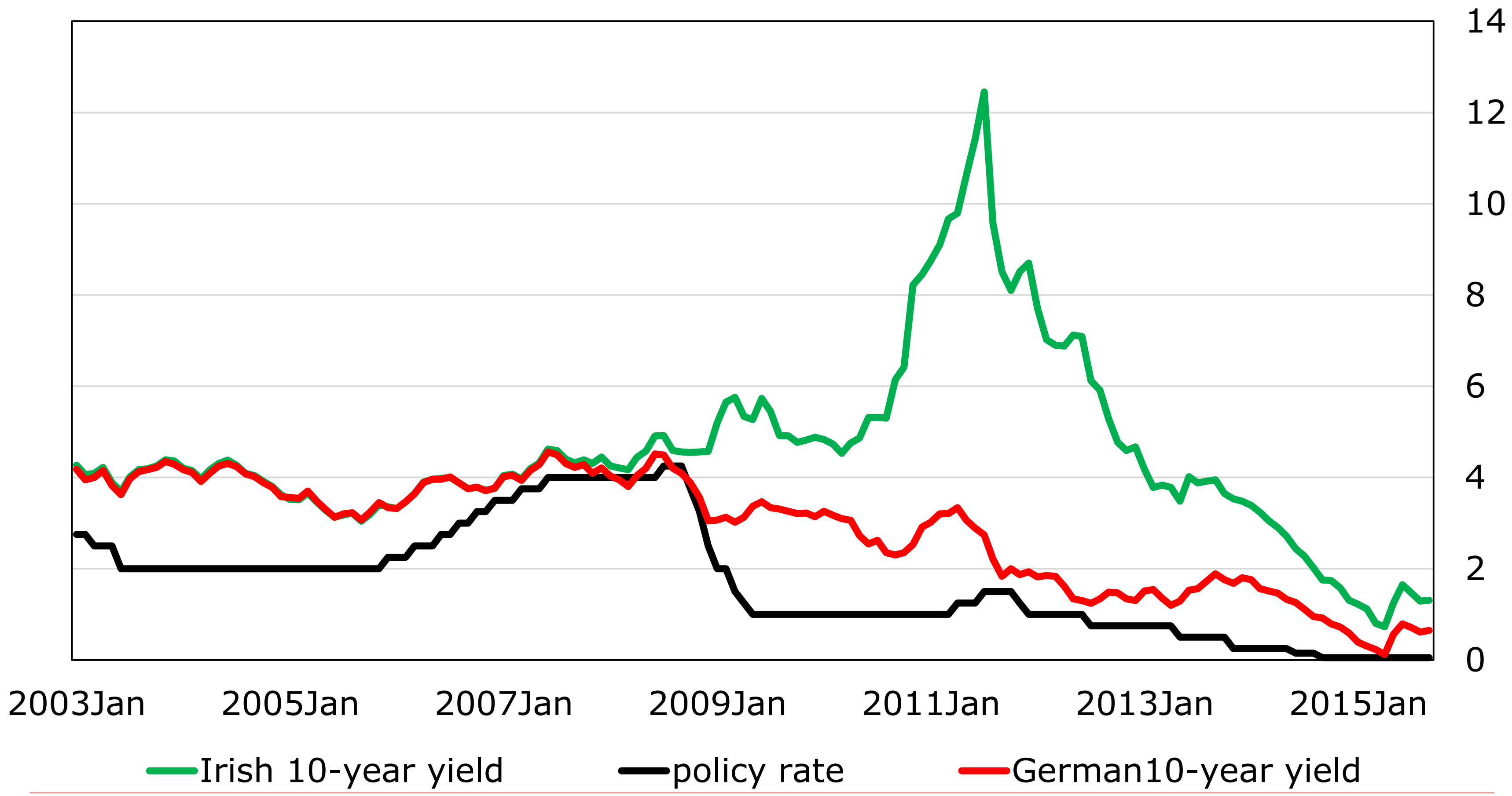
Debts and financial system (2)

I. Price channel:
   - Sovereign yields influence lending rates by affecting banks’ cost of funding.
   - Euro area sovereign risk raised government bond yields and led to higher funding cost in a number of countries.
   - Risk that fluctuations in sovereign risk premiums dominate monetary policy signals.

Bank funding costs and policy rate



Long-run yields and ECB policy rate



Debts and financial system (3)

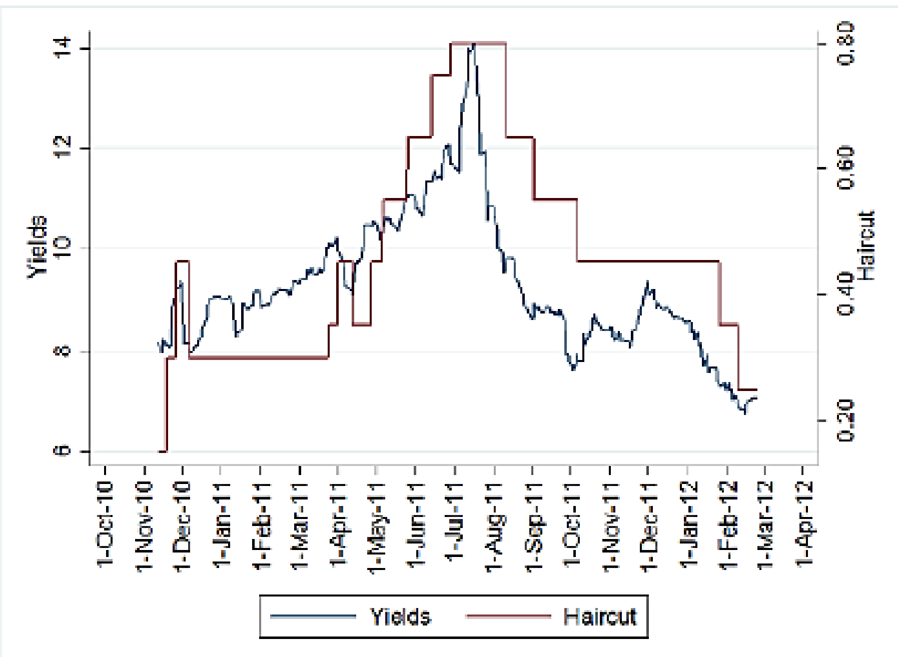
II. Liquidity channel:

- Government bonds are often used as collateral for banks’ borrowing.

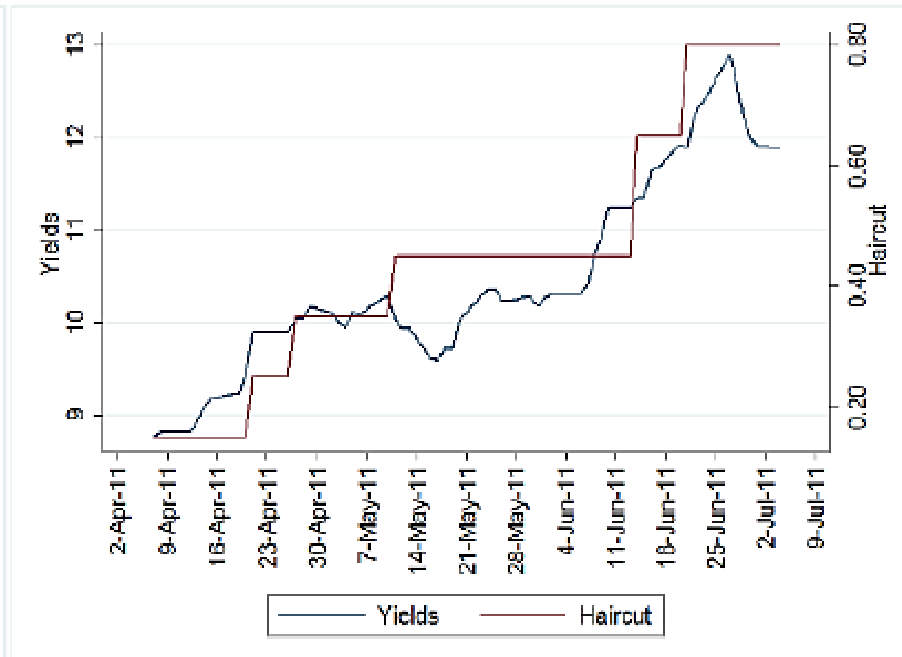
- Sovereign credit risk leads to increased haircuts and reduces liquidity.
  - Can lead markets to freeze up.
  - Can restrict banks’ capacity to lend.
  - Did increase banks’ reliance on euro system funding as collateral rules are more favourable.
    - Monetary financing.
    - Strengthens link between sovereign and banks.
    - Risk to ECB’s balance sheet.

Yields and haircuts on 10-year government bonds

Ireland

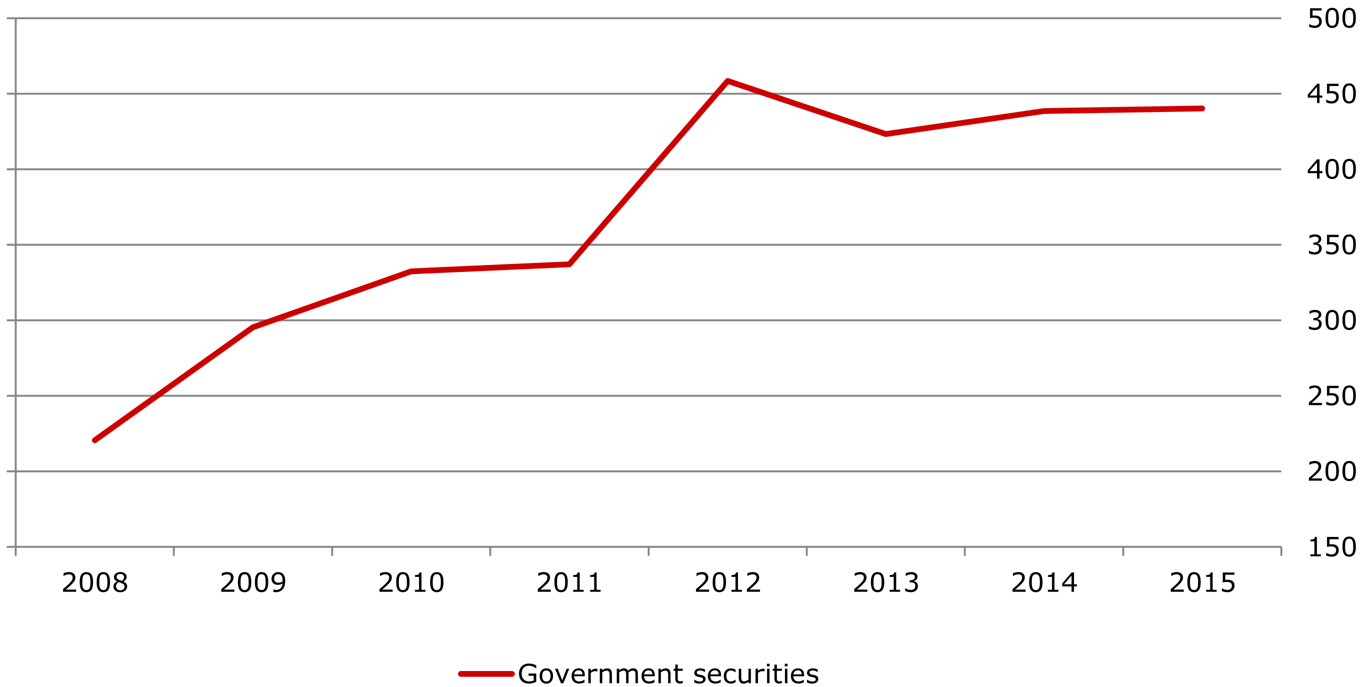


Portugal



Sources: Global finance data and LCH Clearnet website

Increased use of government securities as Eurosystem collateral



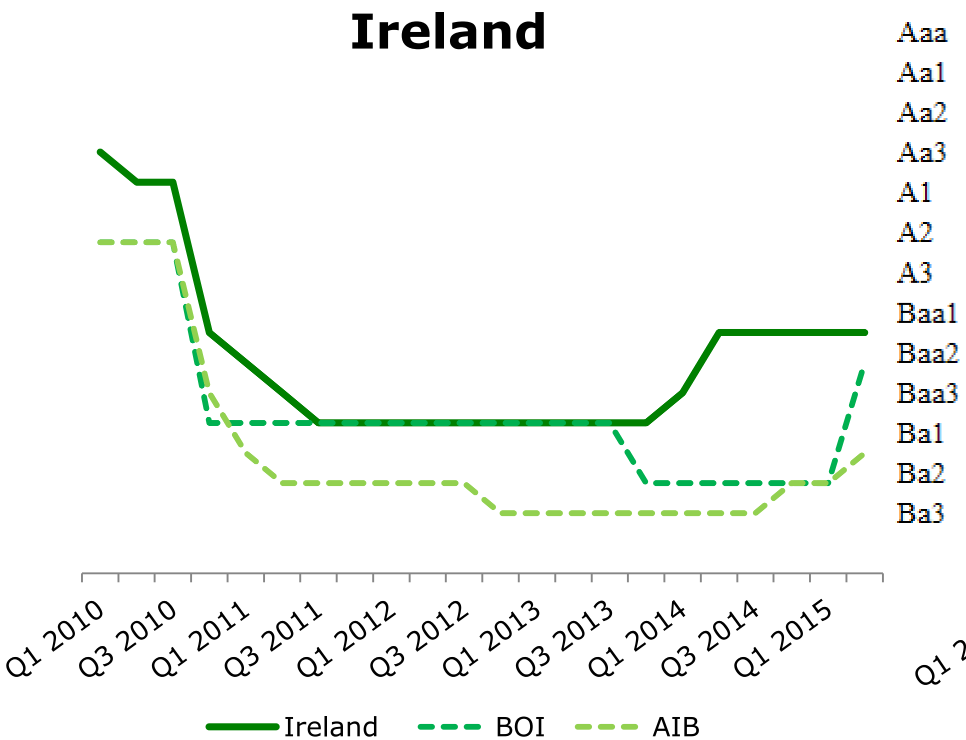
Note: EUR billion, after valuation and haircuts. Includes central and regional government debt
Source: ECB, own calculations

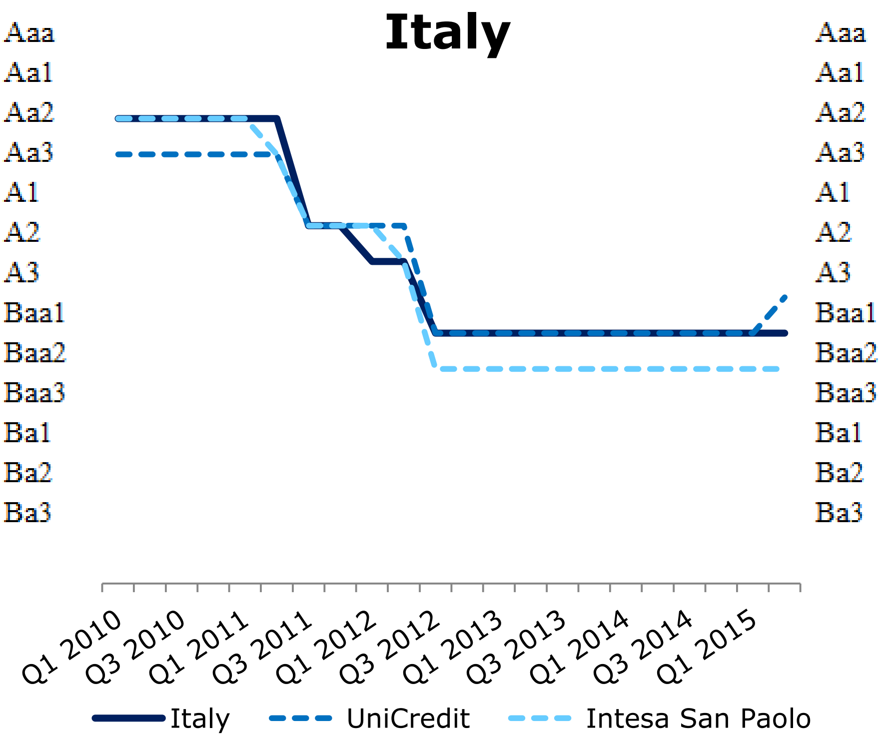
Debts and financial system (4)

III. Balance sheet channel:

- Higher yields and lower bond prices reduce bond holders' net wealth.
  - Banks hold large amounts of domestic public debt; falling net wealth reduce their capacity to lend.
  - Borrowers' credit standing impaired, reducing their capacity to borrow.
  - Financial intermediaries net worth declines, raising credit risk in financial markets.

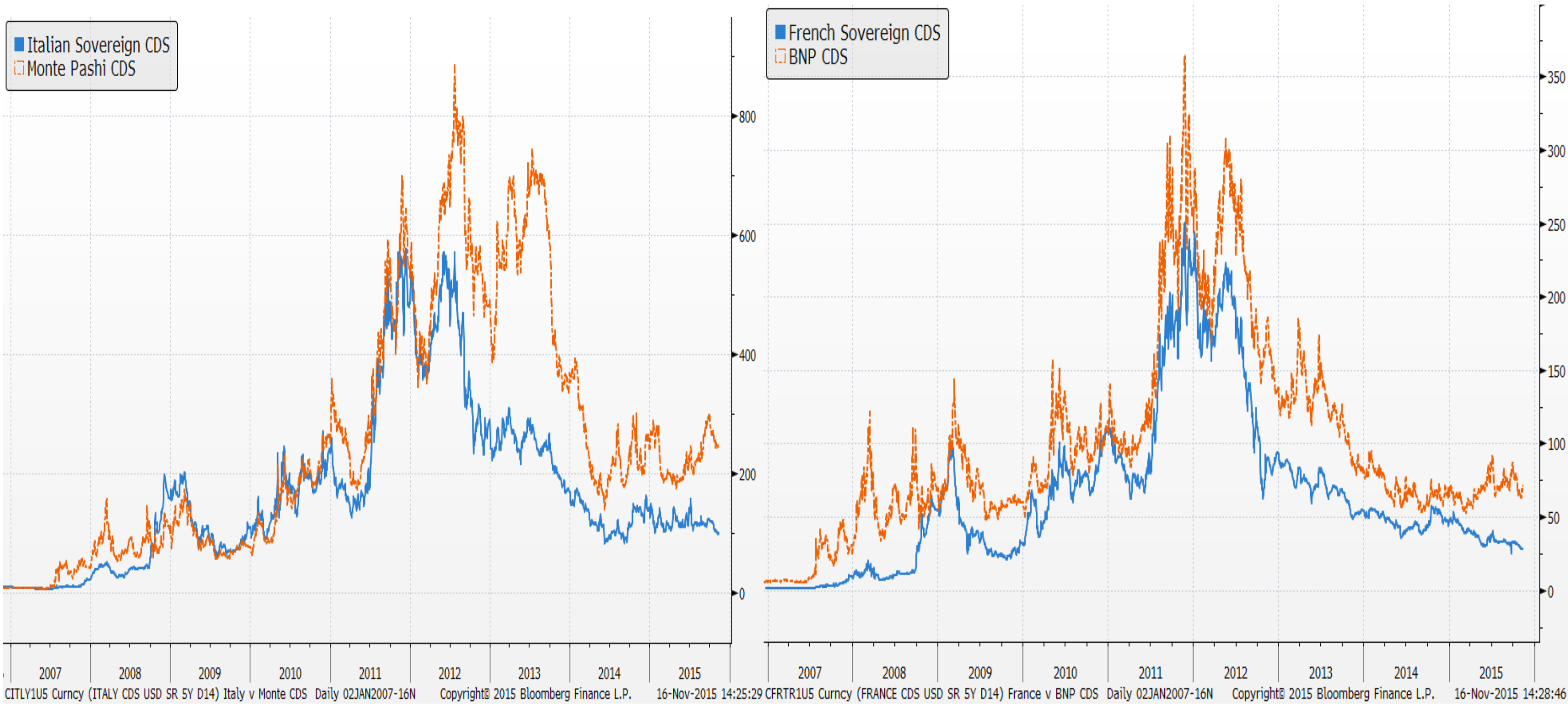
Sovereign and bank downgrades





Source: Moody’s ratings from Bloomberg, own calculations

Euro-area banking CDS spreads versus sovereign CDS



Source: Bloomberg

Conclusions

- Large public debts are problematic from a monetary policy perspective.
  - Can be inflationary, if combined with political instability and lack of central bank independence.
  - Sovereign risk impairs the functioning of the financial system and weakens the monetary transmission mechanism.
- Easier to pursue monetary policy in euro area if public debts were reduced.