

Rethinking the Central Bank's Mandate (and Other Things)

Eric M. Leeper

Indiana University

June 2016

Conference Theme

- ▶ As conference program makes clear, “rethinking the central bank’s mandate” requires us also to rethink fiscal & financial policies
 - ▶ carries implications for the central bank’s mandate
- ▶ I’ll focus on fiscal considerations
- ▶ Europe is great for fiscal discussions
 1. Have had some fiscal issues recently
 2. Countries have been explicit about fiscal goals & targets, making them excellent examples

The Big Fiscal Picture

- ▶ On the heels of fiscal crises. . .
 - ▶ early 1990s in Sweden
 - ▶ 2010s in Euro Area
- ▶ . . . countries have adopted rules/frameworks/goals designed to ensure fiscal sustainability
 - ▶ sustainability is good
- ▶ But “sustainability” has come to mean single-minded austerity
- ▶ Two points:
 1. Monetary policy control of inflation requires appropriate fiscal backing.
 2. Do the frameworks provide appropriate backing?

Features of Fiscal Frameworks

1. Ceiling on nominal expenditures
 2. Some wiggle room over cycle
 3. Designed to ensure “sustainability”
 4. And to support central bank’s goals: “. . . if [government] finances are not sustainable in the long run, the Riksbank’s efforts to maintain price stability will be impeded.” [*Sweden’s Convergence Programme 2015*]
- ▶ Frameworks driven by political, rather than economic, considerations

Fiscal Frameworks & Monetary Policy

- ▶ Framers have two channels in mind
- 1. Large & volatile risk premia on government bonds hamper MP transmission mechanism
 - ▶ thwart efforts by MP to shift down yield curve
 - ▶ increase overall level of risk in financial markets & banking system
- 2. Out-of-control FP can exert pressures on central bank to buy bonds
 - ▶ confronts central bank with tradeoff between government solvency & inflation control
 - ▶ threatens central bank independence
- ▶ I grant (1) but think (2) is a non-issue

Fighting a 100-Year-Old War

- ▶ No advanced country has faced serious fiscal pressure to excessively monetize since 1920s
 - ▶ a well-understood road to disaster
- ▶ Reflects a narrow view of how FP can affect inflation
 - ▶ after WWI, gov't debts were real—gold or foreign currency
 - ▶ were commitments to pay in goods, which required real resources—taxes or seigniorage
- ▶ Today most government debt is nominal
 - ▶ promise to repay in fiat money
- ▶ Nominal debt means inflation can revalue outstanding debt
 - ▶ dramatically changes nature of monetary-fiscal interactions

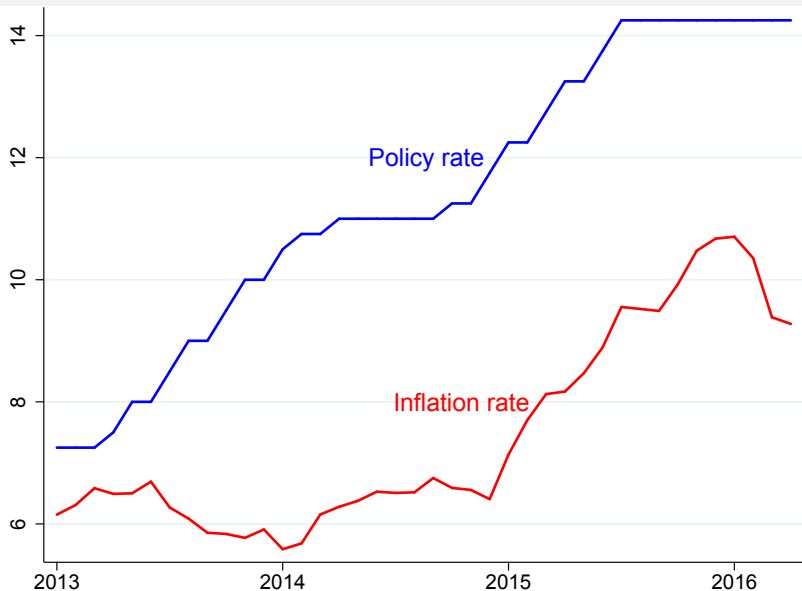
Fiscal Backing Example

- ▶ MP control of inflation requires appropriate fiscal backing
- ▶ If CB wants to reduce inflation it raises policy rate
 - ▶ generally all rates raise, including on gov't bonds
 - ▶ increases debt service payments to bond holders
 - ▶ if higher debt service were permitted to flow into higher nominal debt growth. . .
 - ▶ . . . people would feel richer & try to buy more goods
 - ▶ inflation will eventually rise, not fall as intended
- ▶ Appropriate fiscal backing eliminates these wealth effects
 - ▶ taxes raised/expenditures cut to finance debt service
 - ▶ fiscal backing enables higher policy rate to reduce inflation

When the Backing Ain't There

- ▶ Brazil may have experienced effects of lack of fiscal backing
 - ▶ Loyo explained Brazil's high inflation in late 80s/early 90s this way
 - ▶ Today 90% of spending is fixed & tax increases politically infeasible
 - ▶ Inflation rising despite aggressive MP

Brazil Now



Source: IBGE & Banco Central do Brasil

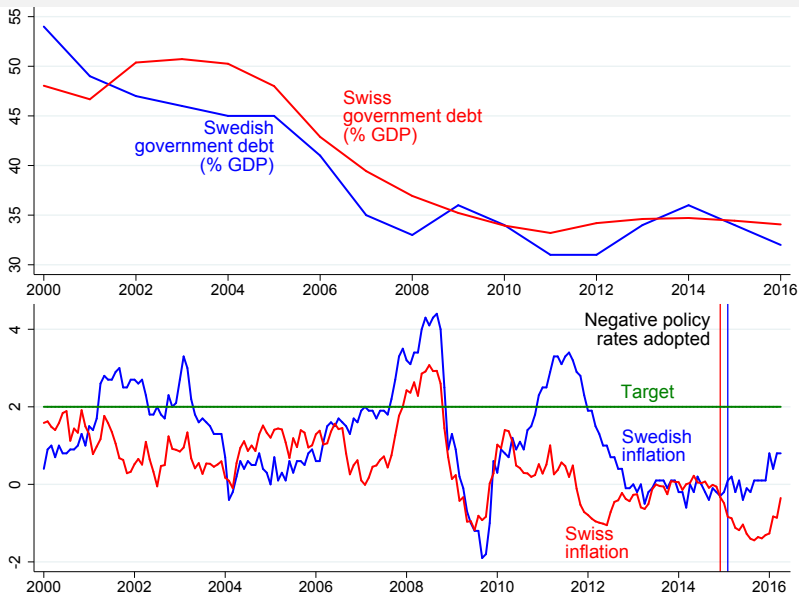
Fiscal Backing is Symmetric

- ▶ To raise inflation with lower (negative) policy rates. . .
 - ▶ which reduce bond yields & bond holders' wealth
 - ▶ FP needs to cut taxes/raise expenditures to nullify impacts on wealth
- ▶ I worry that fiscal frameworks are not geared toward delivering appropriate fiscal backing
- ▶ And fiscal frameworks may even prevent central banks from achieving their mandates

Switzerland & Sweden

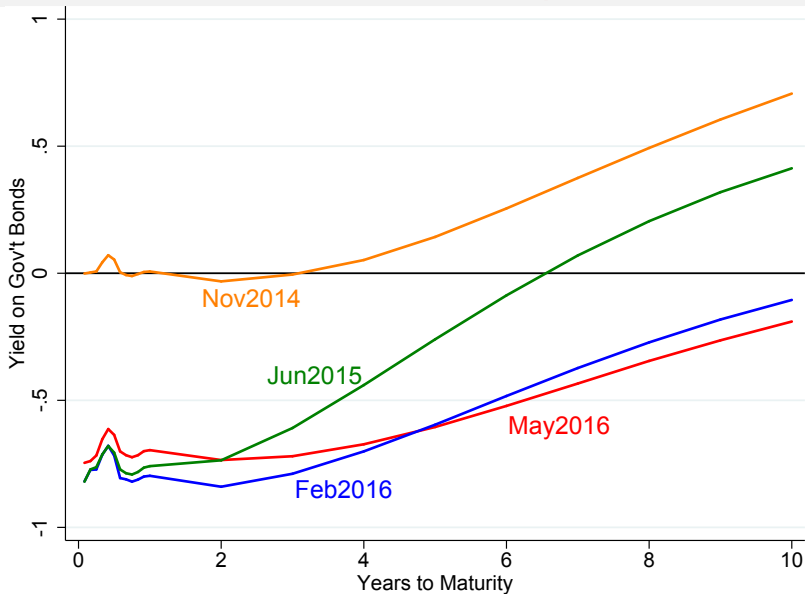
- ▶ These two countries have had serious fiscal rules for 15 or more years
 - ▶ “serious” means they actually follow them
- ▶ Switzerland: debt brake
- ▶ Sweden: net lending target
- ▶ Do these fiscal rules provide appropriate fiscal backing for monetary policy?
- ▶ Their experiences raise some questions

Switzerland & Sweden



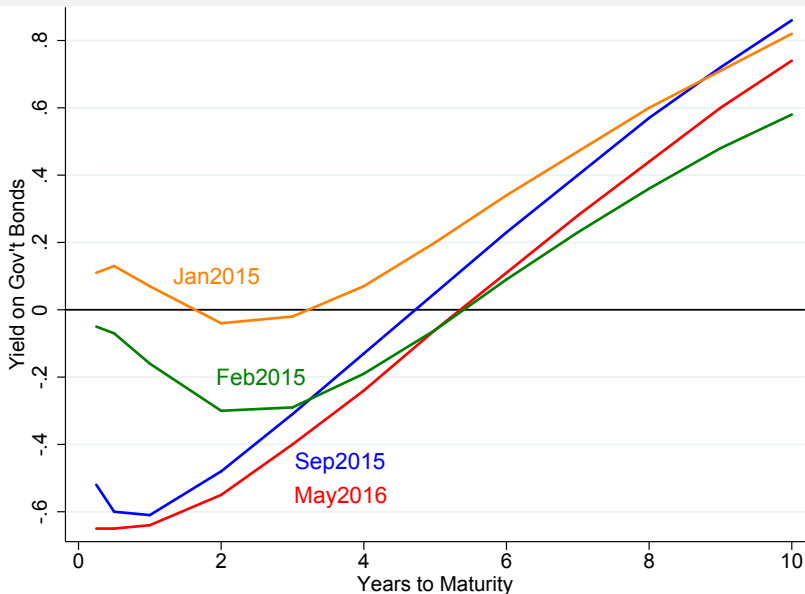
Source: Statistics Sweden, Swedish National Debt Office, & Swiss National Bank

Swiss Yield Curve (Zero Coupon Bonds)



Source: Global Insight

Swedish Yield Curve (Zero Coupon Bonds)



Source: Riksbank

Interpreting Negative **Nominal** Bond Yields

- ▶ Each type of government bond produces a distinct service flow
 - ▶ services from maturity, liquidity, collateral, risk, etc.
 - ▶ bond price reflects usual stuff—cost of postponing consumption, expected inflation—*and the service flow from the bond*
 - ▶ high value of service flow \Rightarrow lower yield
 - ▶ negative nominal yield implies a very high value of the service flow (holding usual stuff fixed)
 - ▶ high value reflects scarcity of bonds of particular type
 - ▶ low yields may also reflect speculation about future MP

Interpreting Negative **Nominal** Bond Yields

- ▶ Total supply of these bonds is controlled by government; composition of bonds held by public is controlled by central bank
 - ▶ extraordinary dearth of these special assets may be a sign of bad policy
 - ▶ at a minimum it seems government would want to issue debt up to the point where yields are zero
 - ▶ but maybe want to satiate public's demand for government bonds, driving marginal value of service flow to zero
- ▶ Do the special roles that government bonds play in the financial system factor into MP decisions?
- ▶ It is clear they are not part of fiscal rules countries adopt.

The Central Bank's Mandate

- ▶ Needs to be examined within a country's fiscal context
 - ▶ applies equally to financial stability context
- ▶ To do list:
 1. Understand implications of fiscal rules for MP
 2. Understand government liabilities writ large
 3. Participate in development of fiscal rules
 4. Stop fighting ancient policy wars