Bundesministerium
der Finanzen

Fiscal risks and monetary policy

Ludger Schuknecht

I. Fiscal policy can (over) burden monetary policy

- Main risk from ever increasing "insurance" role of government (in a broad sense):
  - social security
  - employment and aggregate demand
  - sectoral insurance, esp. financial sector
  - International insurance
- Public insurance:
  - Pro: risk pooling, consumption smoothing
  - Risk: moral hazard, fiscal dominance

Source: L. Schuknecht (2013) Has Public Insurance Gone to Far? CesIFO Working Paper.

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Social insurance

Total social expenditure

% of GDP	1980	1990	1999	2007	2009	2011
France	20,8	25,1	29,7	29,7	32,1	32,1
Germany	22,1	21,7	26,7	25,1	27,8	26,2
Korea	..	2,8	6,2	7,6	9,4	9,2
US	13,2	13,6	14,6	16,3	19,2	19,7
Averages						
OECD #	17,4	19,7	21,3	22	25,4	24,9
Euro area*	18,4	21	22,7	23,6	27,1	26,7
G 7	16,4	18	20,8	21,7	24,7	24,6

Sources: OECD, Social Expenditure; Tanzi and Schuknecht, 2000

* Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, Spain

unweighted average excl. Singapore + Korea

Aggregate demand insurance

Total expenditure by general government

%GDP	About 1870	About 1920	1960	1999	2009	2013
France	12,6	27,6	34,6	52,6	56,8	56,8
Germany*	10	25	32,4	48,2	48,2	45,5
Korea	..	..	..	18	23	21,2
US	7,3	12,1	27	34,2	42,8	39,9
Averages						
OECD #	11,1	18,9	27,8	44	48,4	46,5
Euro area 12 ~	..	..	..	48,1	51,3	49,6
G 7	..	..	..	37,8	42,2	40,5

Sources: Ameco, WEO, Tanzi and Schuknecht, 2000.

~ *before 1999: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain*

*=until 1990 only West Germany

unweighted average excl. Singapore + Korea

Sectoral insurance

Financial costs recent crisis

(Cumulative until December 2011 / February 2012 in percentage of 2011 GDP)

	Direct support	Recovery	Net direct support
Belgium	7,0	0,6	6,3
Ireland	41,6	3,5	38.0
Germany 2)	12,2	1,5	10,7
Greece	14,8	3,9	11,0
Netherlands	14,1	9,3	4,8
Spain	4,1	2,7	1,4
United Kingdom	6,8	1,4	5,4
United States	5,3	2,3	3,0
Average	7,2	2,4	4.9

Note:
Fiscal outlays of the central government, except in the cases of Germany and Belgium, for which financial sector support by subnational governments is also included.

2) Support includes here the estimated impact on public debt of liabilities transferred to newly created government sector entities (10¼ percent of GDP), taking into account operations from the central and subnational governments. As public debt is a gross concept, this neglects the simultaneous increase in government assets. With this effect taken into account, the net debt effect amounted to just 1.6 percent of GDP, which was recorded as deficit. The European Commission has assessed the aid element of these transfers at about 0.8 percent of GDP.

Source: IMF Fiscal Monitor - October 2012

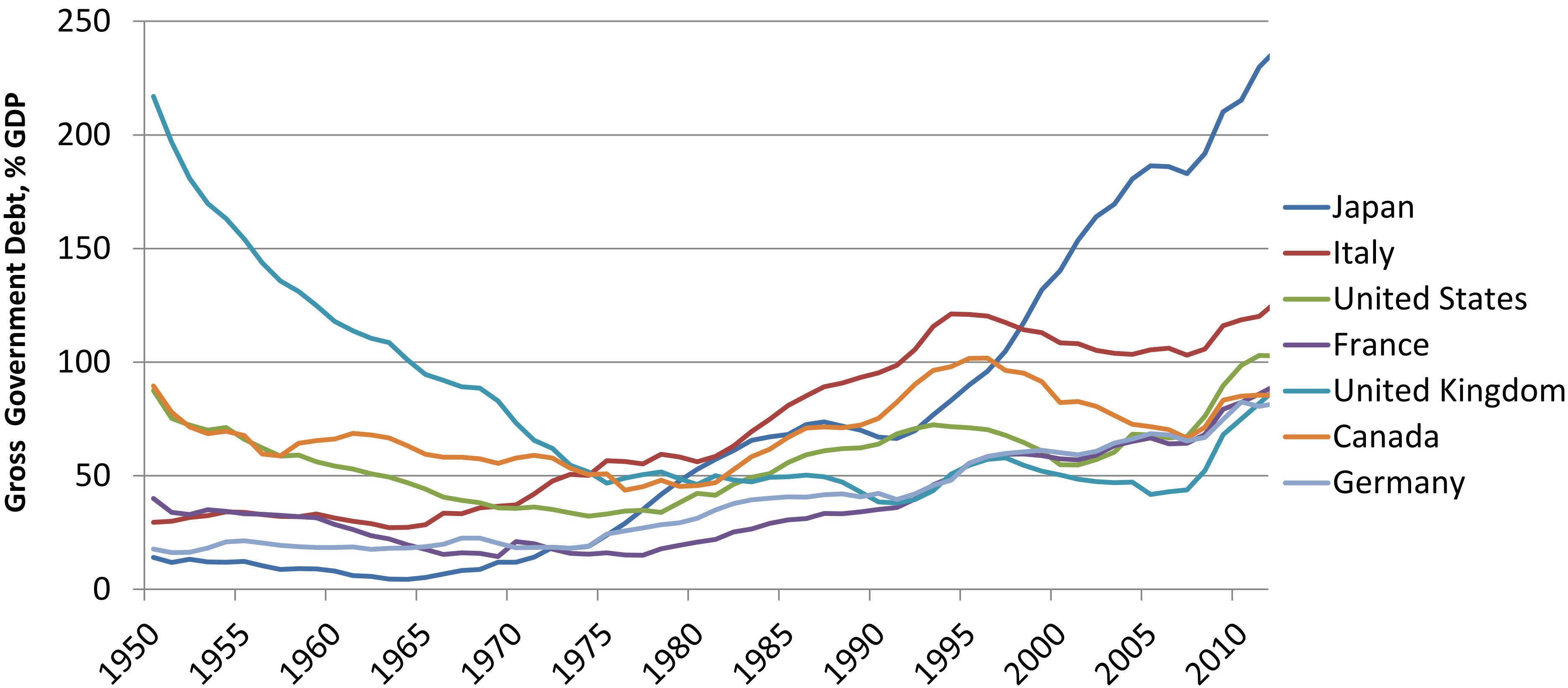
International insurance (II)

	Bilateral	EFSM	EFSF/ESM	IMF	Total	% of GDP[1)]
Greece						
Already disbursed	52,9	-	133	28,5	214,4	110,7
Committed	52,9	-	144,6	39,2	236,7	122,2
Portugal						
Already disbursed	-	22,1	21,1	22,5	65,7	39,8
Committed	-	26,0	26,0	27,5	79,5	48,2
Ireland						
Already disbursed	4,5	21,7	15,4	21,8	63,4	38,7
Committed	4,8	22,5	17,7	22,5	67,5	41,2
Spain						
Already disbursed	-	-	41,4	-	41,4	4,0
Committed	-	-	100	-	100	9,7
Cyprus						
Already disbursed	-	-	4,5	0,2	4,7	26,5
Committed	-	-	9	1	10	56,4
Total						
Already disbursed	57,4	43,8	215,4	73,0	389,6	4,1
Committed	57,7	48,5	297,3	90,2	493,7	5,2
Total potential	57,7	60	700	90,2	907,9	9,6

Source: Own calculations

1) % of 2012 national GDP / % of 2012 euro area 17 GDP for "Total"

Public debt at record highs



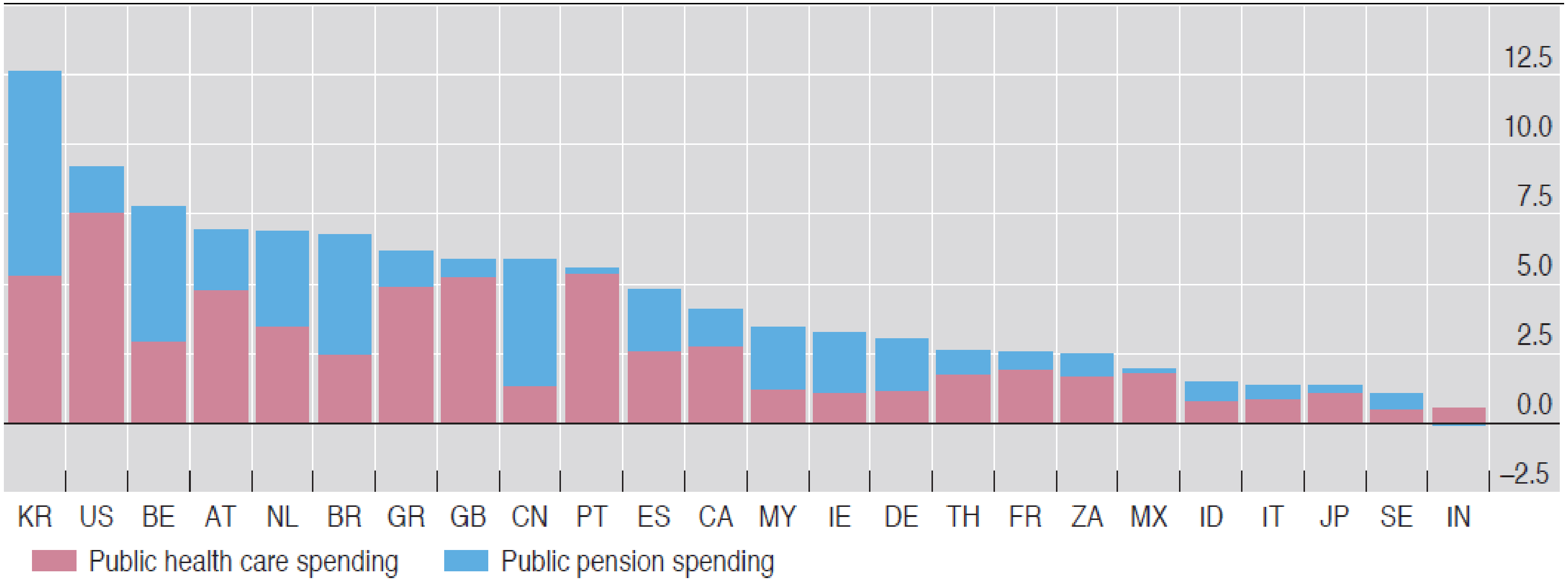
Source: IMF

Going forward: Demographic challenges

Projected changes in age-related spending, 2013–40[1]

In percentage points of potential GDP

Graph IV.1



AT = Austria; BE = Belgium; BR = Brazil; CA = Canada; CN = China; DE = Germany; ES = Spain; FR = France; GB = United Kingdom; GR = Greece; ID = Indonesia; IE = Ireland; IN = India; IT = Italy; JP = Japan; KR = Korea; MX = Mexico; MY = Malaysia; NL = Netherlands; PT = Portugal; SE = Sweden; TH = Thailand; US = United States; ZA = South Africa.

[1] The 2013 levels of age-related spending represent a linear interpolation between (a) the actual 2010 levels of pension and health care spending and (b) the projected 2015 health care and 2020 pension spending levels.

Source: BIS Annual Report 2013

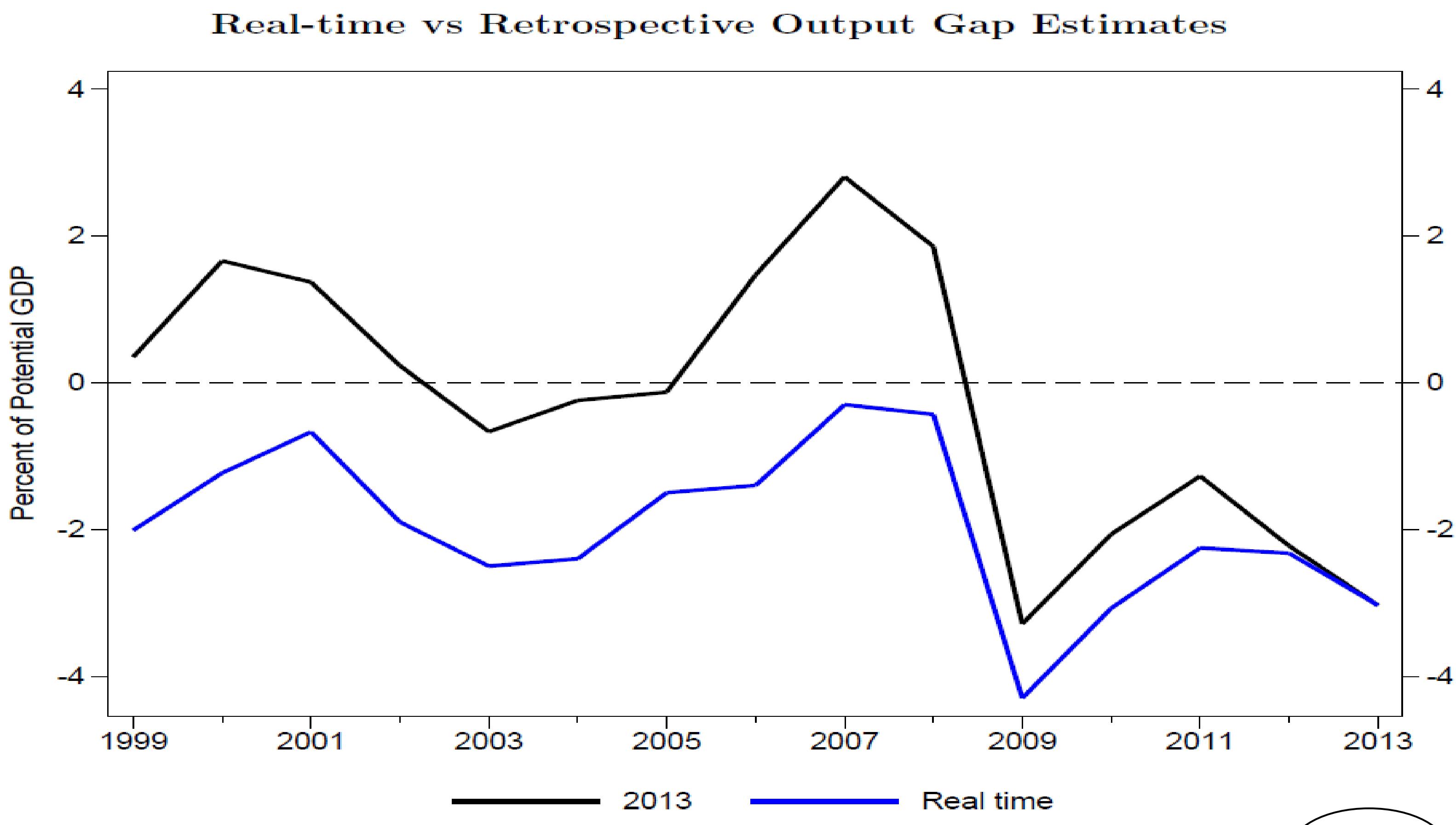
Declining potential growth makes it more difficult to grow out of debt

Potential GDP, volume, % change on preceding year

	5-year average							Forecast		
	1994-1998	**1999-2003**	**2004-2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Germany	1,7	1,5	1,3	0,7	1	1,3	1,5	1,4	1,5	1,5
France	1,8	1,9	1,7	1	1	1,1	1,1	1	1	1
Italy	1,5	1,5	0,8	-0,3	-0,1	0,1	-0,8	-0,5	-0,1	0,1
Portugal	2,9	2,5	1	-0,1	0	-0,3	-1,4	-0,8	-0,5	-0,1
Ireland	8,1	7,5	3,5	-1,3	-0,6	-0,3	-1	-0,1	0,8	1,6
Greece	2,4	4,6	2,7	-0,3	-1,4	-2,6	-3	-3,4	-3	-2,7
Spain	2,4	3,7	3,2	0,9	0,3	-0,3	-0,8	-1,3	-1,3	-1,1
Eurozone	:	2,2	1,7	0,6	0,6	0,7	0,4	0,4	0,5	0,7
EU	:	:	1,9	0,7	0,7	0,8	0,6	0,6	0,7	0,9

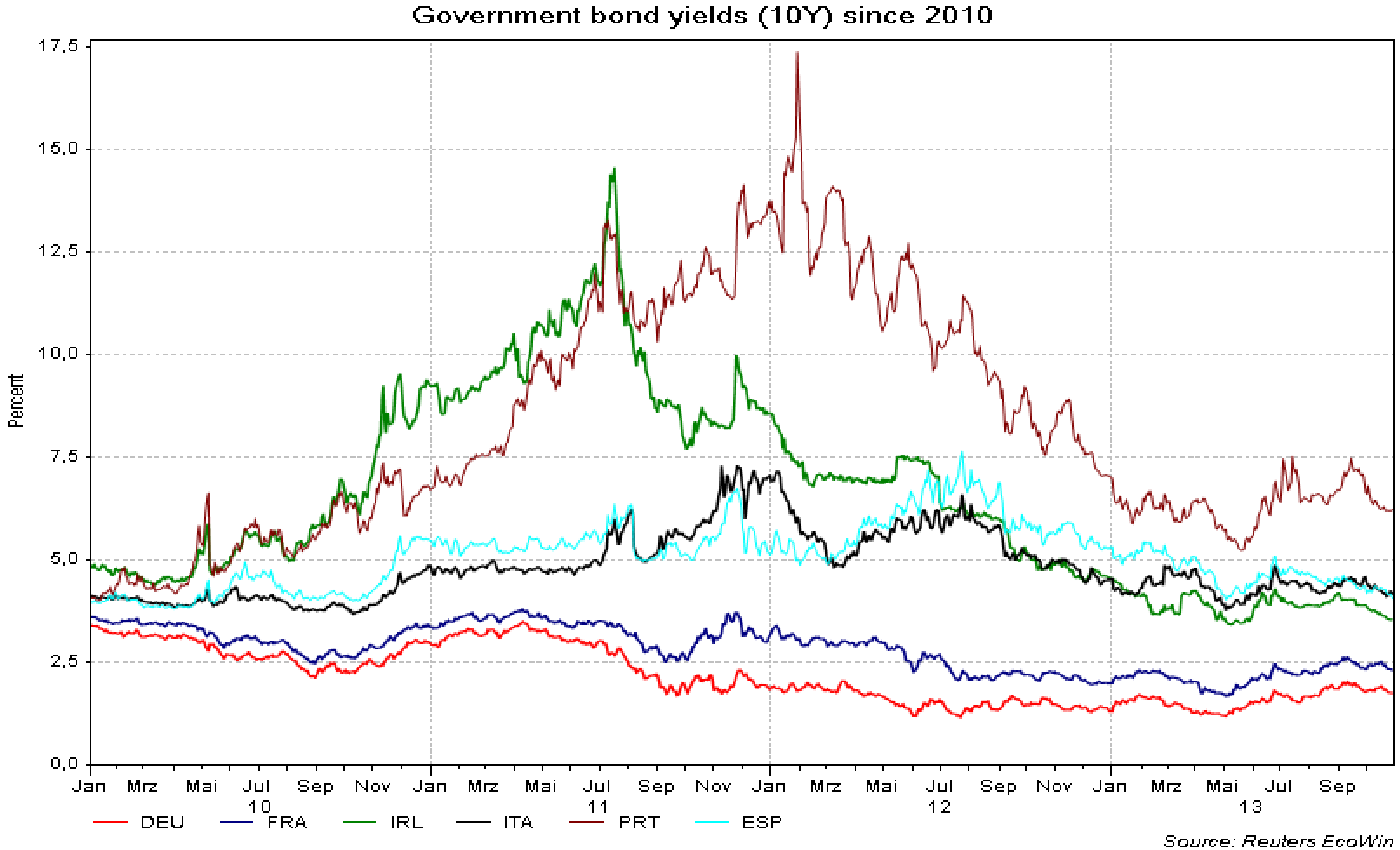
Source: EU Commission

Large estimation errors for output gaps can make governments complacent



Source: A. Orphanides, Is Monetary Policy Overburdened?, IMFS Working Paper No. 75, 2013

Some countries experienced a loss of market confidence



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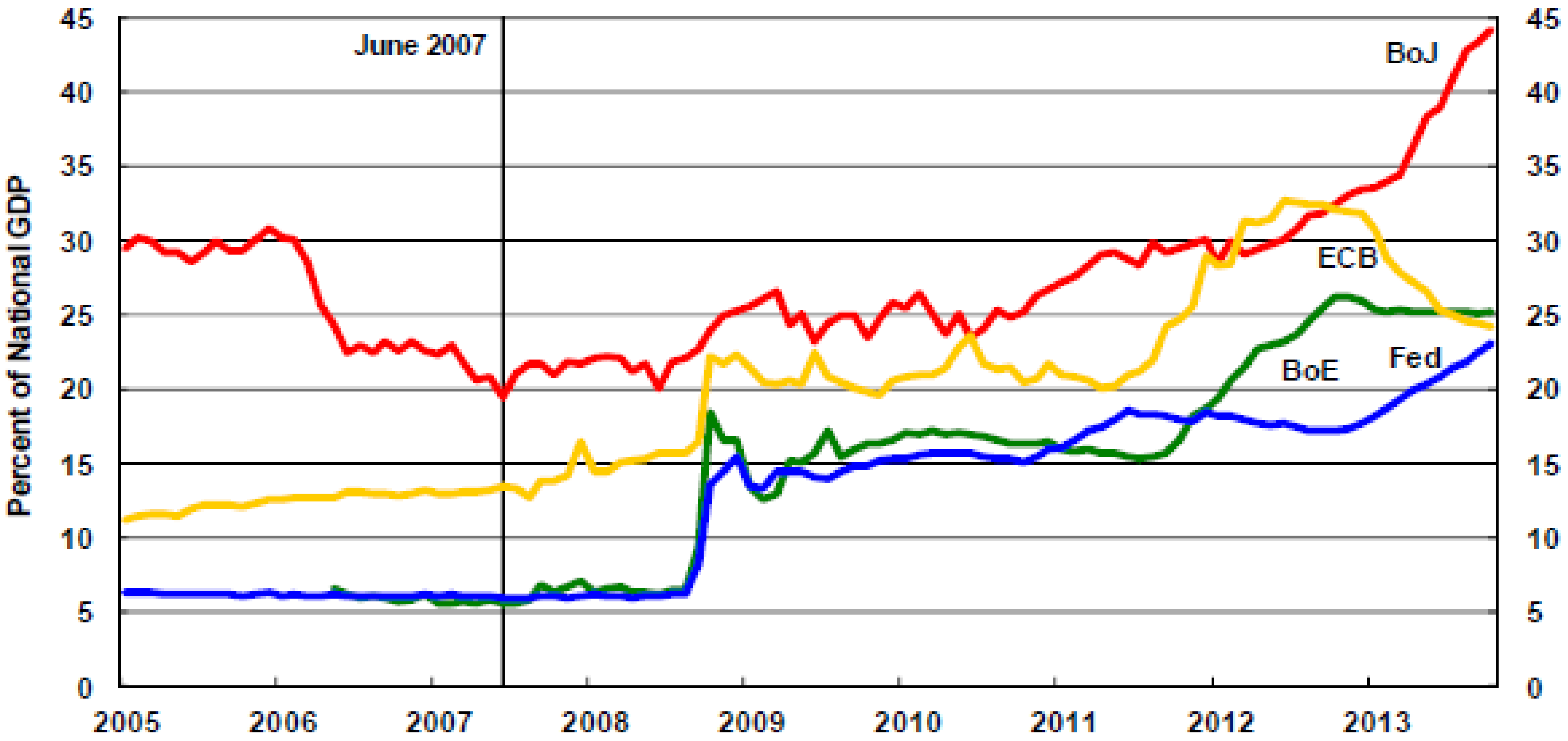
II. Monetary policy has been contributing to „insurance“ as LoLR

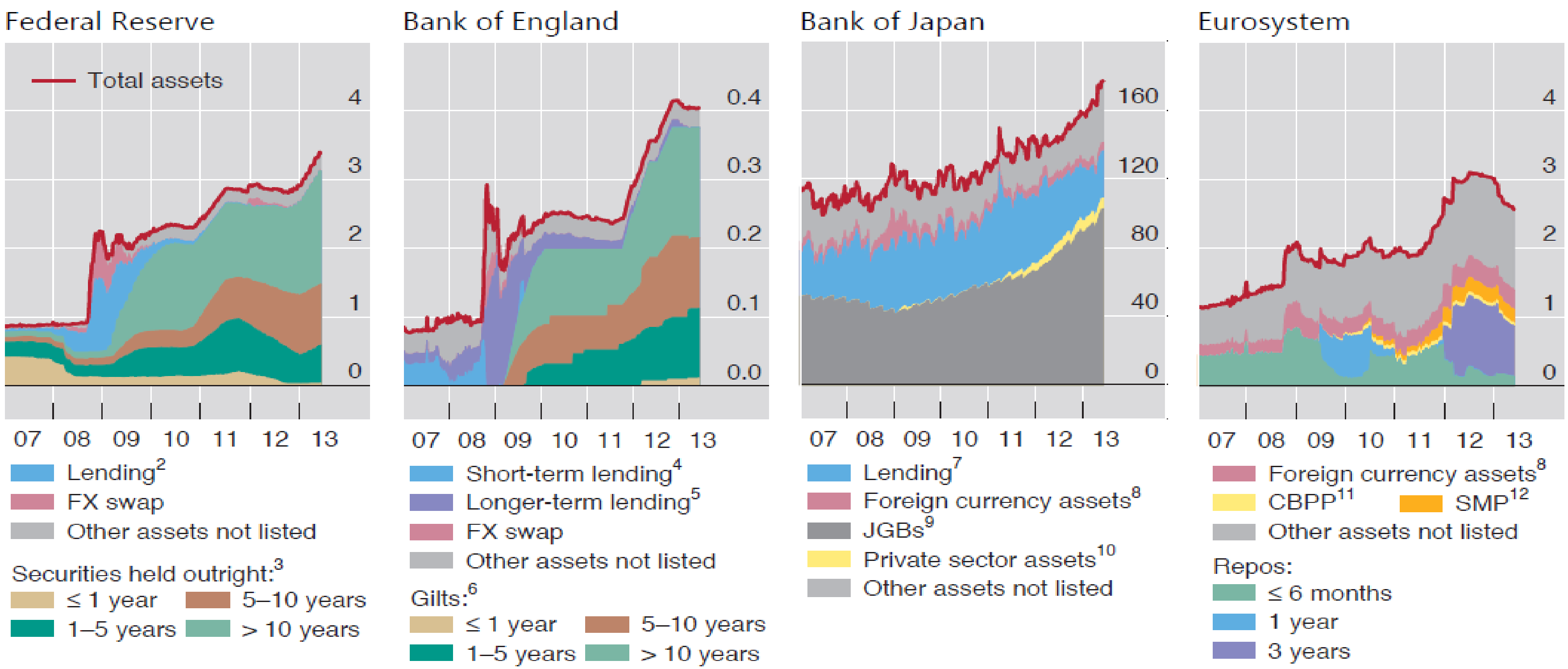
- Policy interest rates close to zero
- Government bond purchases
- Covered bonds purchases
- Lower collateral standards
- Full allotment/LTRO
- Emergency measures (ELA)
- Minimum reserves
- OMT perspective
- Quantative easing outside euro zone

Central banks‘ balance sheets



Source: Citi Research

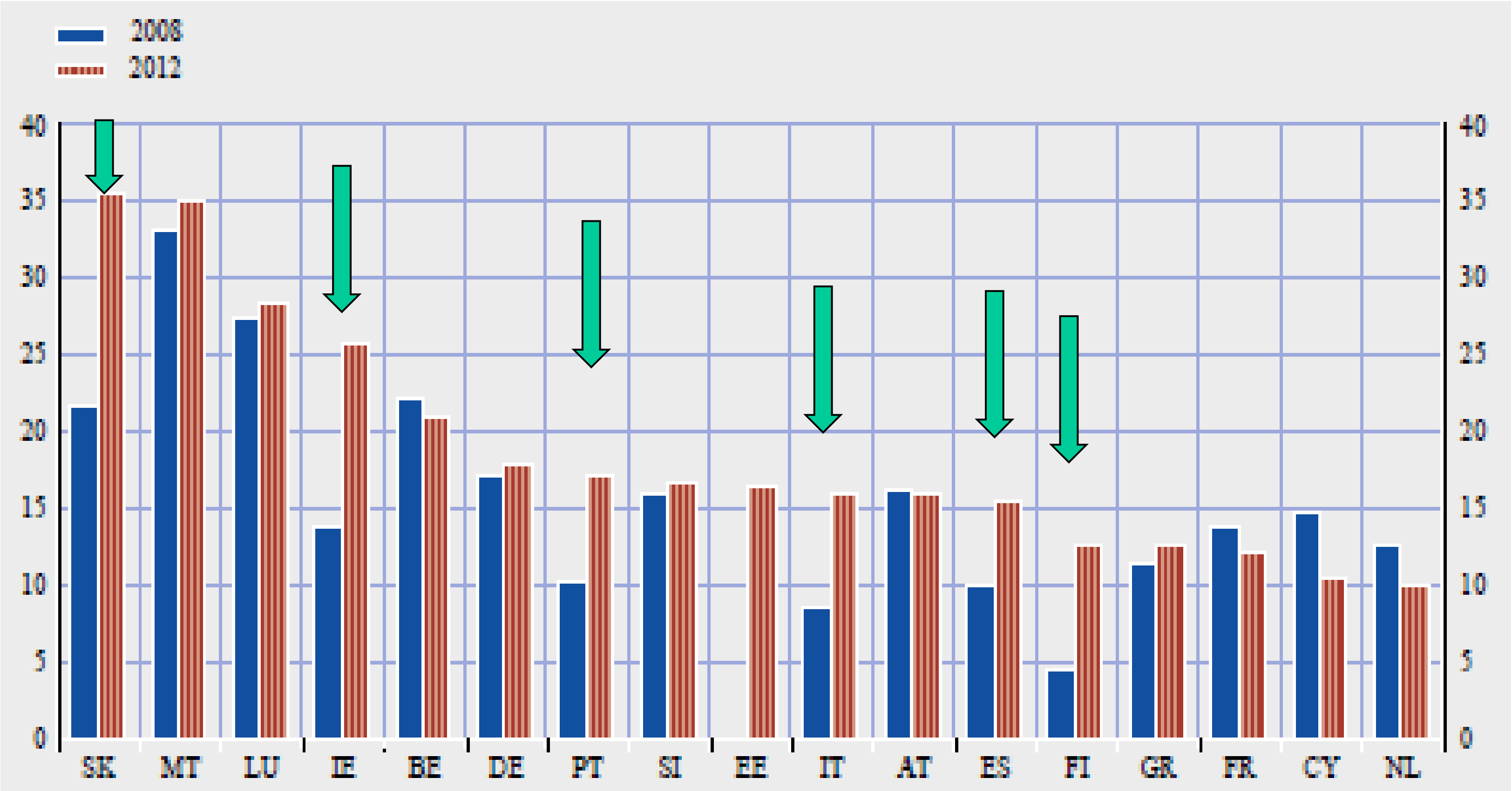
Public bonds in central banks' balance sheets



[1] Bank of England and Federal Reserve: breakdown by remaining maturity; Eurosystem: breakdown of outstanding repo operations by original maturity. [2] Outstanding in repos, term auction facility, other loans and net portfolio holdings of Commercial Paper Funding Facility LLC. [3] US Treasury securities, mortgage-backed securities and agency debt; face value. [4] One-week, other maturity within-maintenance period, and fine-tuning repo operations. [5] Longer-term repo operations. [6] Holdings of the Asset Purchase Facility; proceeds. [7] Receivable under resale agreements and loans excluding those to the Deposit Insurance Corporation. [8] Includes US dollar liquidity auctions. [9] Japanese government bonds. [10] Commercial paper, corporate bonds, exchange-traded funds and listed real estate investment trust securities. [11] Covered bonds held under the Covered Bond Purchase Programme (CBPP) 1 and the CBPP 2. [12] Securities held under the Securities Markets Programme (SMP).

Source: BIS Annual Report 2013

Share of debt securities in total banking assets increased in some MS



Source: ECB/FSC Consolidated Banking Data statistics.

III. We know little about incidence and transmission of fiscal dominance in modern economies

- „Classical“ approach: government prints money
- Monetary theory of the price level: expectations and price level adjust
- Big grey area between liquidity and solvency crisis, blurred by (CB or international) lender of last resort
- How related to: short run risks (deflation?) vs very long run (does the relation M-Y return to normal?)
- Can financial repression re-establish sustainability?
- Or how would FD transmit to inflation today?
  - Aggr.demand/wage/price spirals?
  - Expectations and confidence/ role of global financial markets,
  - currency substitution, collapse of money demand?
  - Global stability needs anchor/insurer of last resort?

IV. Prudence requires remaining within the bounds of „insurability“

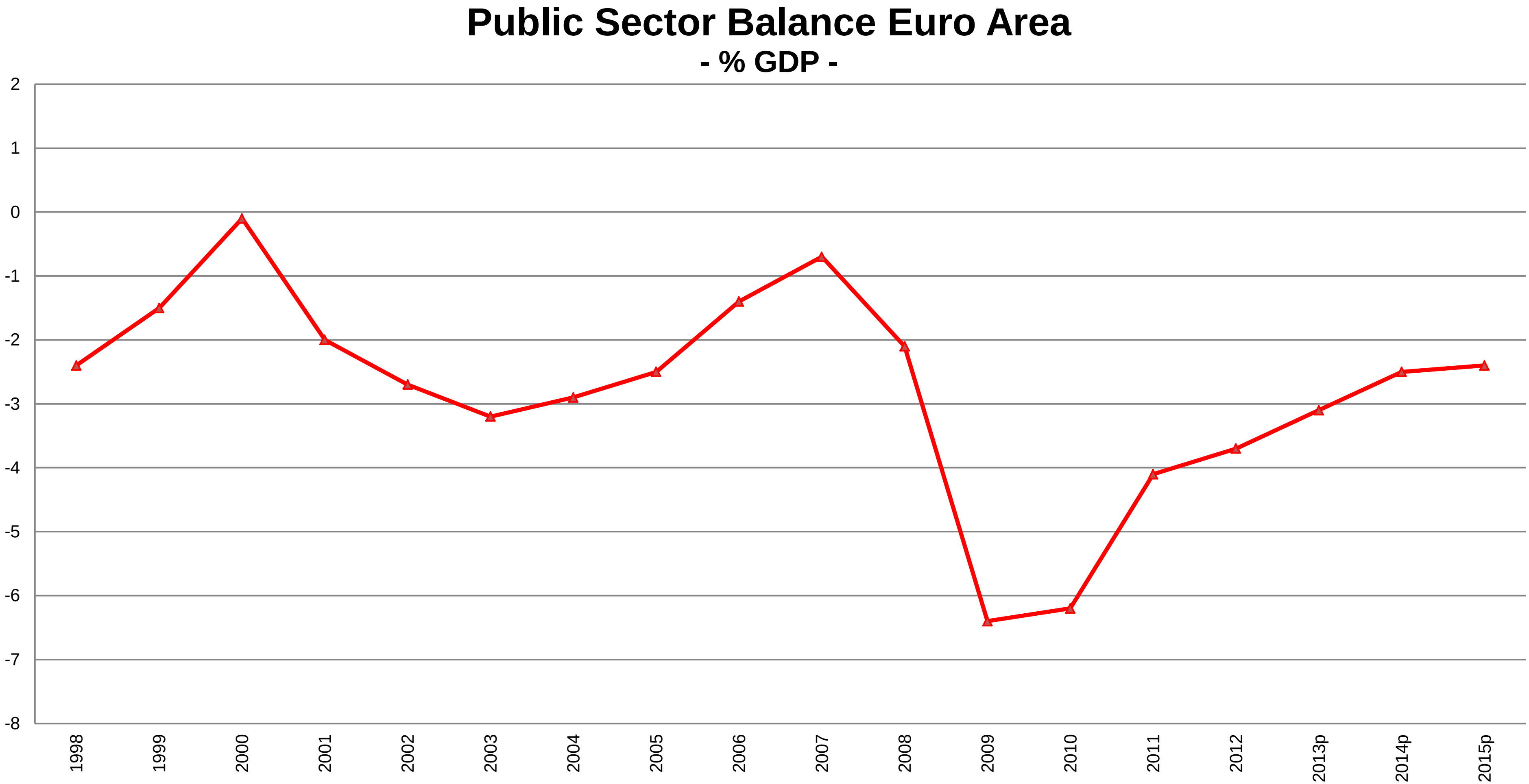
G20 on the mark:

“…ensuring fiscal sustainability remains a key priority and we reaffirm our commitment to implement our medium-term fiscal strategies flexibly to take into account near-term economic conditions, while putting government debt on a sustainable path“

G20 Communiqué Finance Ministers/CB Governors

10 – 11 October 2013

Fiscal policy: Progress in the Euro Area



Source: Commission Autumn Forecast, November 2013

Public debt in Euro Area is peaking

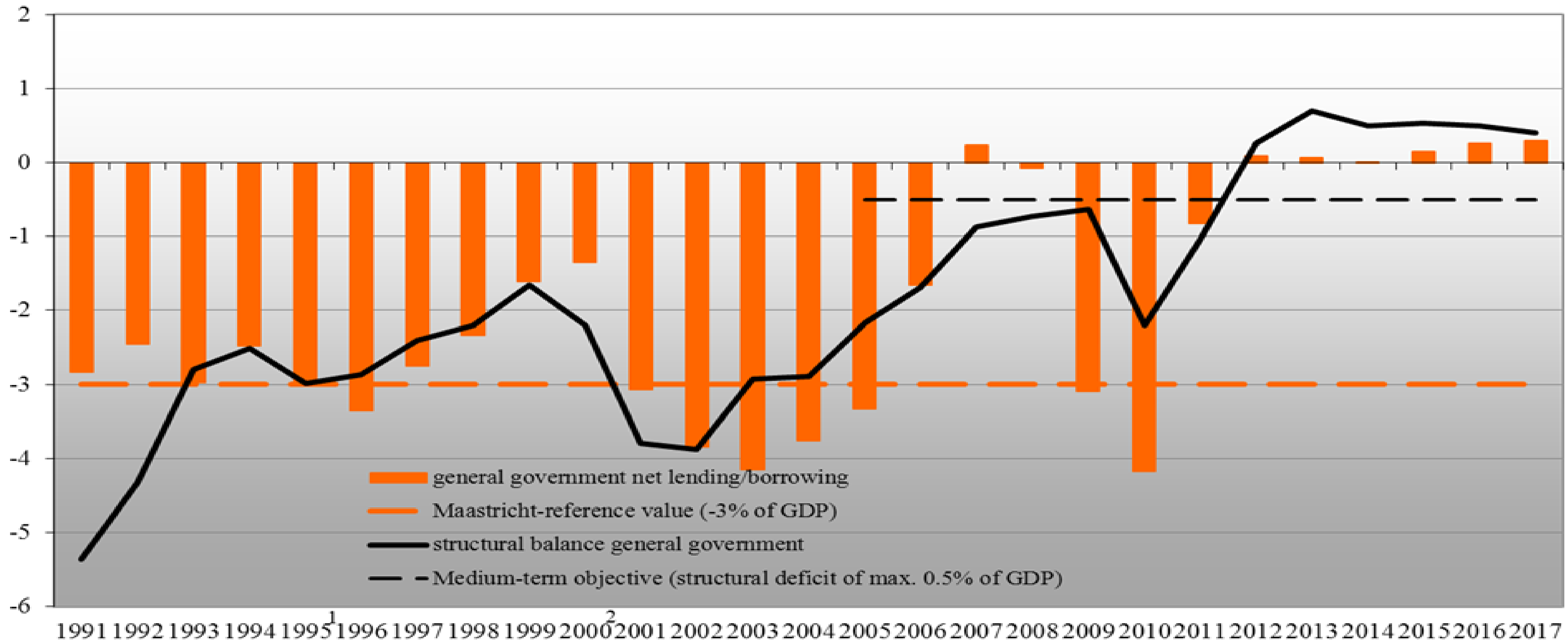
Gross Public Debt, General Government, % GDP

						Forecast		
	2008	2009	2010	2011	2012	2013	2014	2015
Germany	66,8	74,5	82,5	80	81	79,6	77,1	74,1
France	68,2	79,2	82,4	85,8	90,2	93,5	95,3	96
Italy	106,1	116,4	119,3	120,7	127	133	134	133,1
Portugal	71,7	83,7	94	108,2	124,1	127,8	126,7	125,7
Ireland	44,5	64,4	91,2	104,1	117,4	124,4	120,8	119,1
Greece	112,9	129,7	148,3	170,3	156,9	176,2	175,9	170,9
Spain	40,2	54	61,7	70,5	86	94,8	99,9	104,3
Eurozone	70,2	79,9	85,6	87,9	92,6	95,5	95,9	95,4
EU	62,2	67,1	78,4	84,3	88,7	94,3	96,9	98,6

Source: EU Commission

Germany as anchor in Europe?

Actual and structural general government balance (in % of GDP):



1995: Excluding capital transfers as a result of taking on the debts of the Treuhand agency and the housing authorities of the GDR. Including this effect, the general government deficit stood at 9.5% of GDP.
2000: Excluding revenue from UMTS licences. Including this effect, the government budget ran a surplus of 1.1% of GDP.

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Conclusions

- Fiscal solidity pre-requisite for taking burden of monetary policies
- Plus: financial deleveraging and banking union reduce financial sector risks
- regaining competitiveness in crisis countries boosts growth prospects

=> Reforms must go on!