Dangers for monetary policy from unsustainable fiscal policy

Panel discussion contribution by Thomas J. Jordan, Chairman of the Governing Board of the Swiss National Bank, 16 May 2012

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1. Introduction

It is a great honour for me to have been invited to this colloquium on unconventional monetary policy to mark the end of José Manuel González-Páramo's eight-year term as a member of the Executive Board of the European Central Bank (ECB). I am also delighted to contribute to the panel on 'Private and public debt, deficits and monetary policy: exploring the interaction' in company with so many distinguished speakers. I regret very much that José's term has already expired. My colleagues at the Swiss National Bank (SNB) and I have enjoyed a very pleasant, productive and successful collaboration with him over the last few years. Our collaboration was especially close at the height of the financial crisis, when the ECB and the SNB implemented unconventional monetary policy measures to restore the functioning of our money markets. We highly appreciated not only José's wisdom and strength of judgement, but also his friendship over the last eight years. I wish José all the best for the future.

In my remarks I will briefly address the effects of the euro area sovereign debt crisis on Switzerland. I will then offer some thoughts on sovereign debt and central bank independence in general. Finally, I will ask what central banks should do to reduce the risk of losing their independence in the long run.

2. Effects of the euro area fiscal crisis on Swiss monetary policy

Interestingly, the escalating sovereign debt crisis in the euro area in the second half of 2011 did not lead to a general weakening of the euro. But it did lead to a massive appreciation of a relatively small selection of safe-haven assets. Switzerland has a long experience with the Swiss franc playing the role of a safe haven. The Swiss economy has often proven capable of absorbing strong appreciations that occurred within a short period. However, the appreciation of the Swiss franc, triggered by the escalation of the sovereign debt crisis in July and August 2011, was unprecedented in terms of speed and size. The real export-weighted Swiss franc exchange rate rose to almost 30% above its long-term average. This massive overvaluation of the Swiss franc posed an acute threat to the Swiss economy and a risk of deflation in Switzerland.

Against this background, the SNB was forced to implement various, far-reaching measures to fulfil its mandate of maintaining price stability. First, in August 2011, we expanded the supply of liquidity significantly. Although our liquidity measures achieved a certain amount of success – the Swiss franc did weaken temporarily – they did not have the desired lasting effect. The upward pressure on the Swiss franc persisted, and intensified again at the beginning of September. The reason was the continuing uncertainty on the financial markets and the debt situation of some sovereigns in the euro area. We therefore decided to announce a minimum exchange rate of CHF 1.20 per euro. We also emphasised that we were prepared to purchase foreign currency in unlimited quantities in order to enforce this minimum rate. Given that the three-month Libor had declined to 0% in September, interest rates could not be lowered any further. Setting a minimum exchange rate was the most effective option available to combat the acute threat to the Swiss economy and the risk of deflationary developments originating from the massive overvaluation of the Swiss franc. Moreover, by introducing a minimum exchange rate against the euro, we opted for a simple and clear policy. The minimum rate has been effective and the financial markets believe that the SNB will enforce it by all means. The Swiss experience shows clearly how an unsustainable debt and deficit situation abroad can have serious repercussions on the domestic economy of a country and force the central bank to take far-reaching measures.

3. Unsustainable public debt, price stability and the independence of monetary policy

Another crucial factor for monetary policy is the domestic fiscal situation. Specifically, unsustainable public debt poses a serious risk for price stability and for the independence of the central bank. In fact, the relationship between central bank independence on the one hand, and the fiscal policy and budgetary position of a country on the other, is basically characterised by conflicting tensions. Persuasive theoretical arguments, empirical evidence and simple common sense have led to broad agreement among academics and practitioners that central bank independence contributes significantly to economic stability and therefore should be sheltered from attempts to dilute it. Central bank independence, coupled with an explicit mandate and accountability, has contributed to improving long-term economic performance, and above all price stability. Independence enables monetary policymakers to run a more credible monetary policy and avoid time-inconsistency problems.

However, it is crucial for central bankers to be aware that their independence cannot be taken for granted. Central bank independence is regulated by law, which can be changed at any time, even if it is enshrined in the country's constitution. In other words, central bank independence is a borrowed privilege, not a law of nature. A good example that illustrates the fragility of a central bank's independence is the financial and public debt crisis. First, fiscal problems can generate substantial political pressure on central banks to actively finance the deficit. Often this pressure starts with the wish to keep interest rates low – especially for government debt. It may end, in the worst case, with the implicit or explicit suspension or abolition of the central bank's independence, accompanied by the compulsion to monetise public debt. Second, even if not leading directly to central bank funding of the public sector, a weak budgetary situation may, at times, seriously threaten the independence of the central bank in other ways. In particular, once the fiscal situation has got out of control, the government will no longer be capable of taking appropriate action in a crisis. This will force the central bank to act, even if it means implementing quasi-fiscal policy measures. In such a situation, the central bank faces a dilemma: Either it steps in at the risk of going to the limit of its mandate, or it puts the country's stability at risk. The unconventional policy measures taken by central banks may have been appropriate to absorb the various shocks hitting their economies over the last few years. Nevertheless, the

question has been raised whether these policy measures were entirely in line with the concept of granting the central bank a high degree of independence in maintaining price stability. This is particularly true of quasi-fiscal policy measures, which have distributional effects and can therefore attract a great deal of public and political attention. Increased political attention is not without risks for the central bank, because this too can threaten the principle of independence.

All in all, therefore, I see two serious threats to the independence of central banks from unsustainable fiscal imbalances. First, fiscal imbalances may force the central bank to take measures that can blur the traditional division of responsibilities between fiscal and monetary policymakers, laying it open to the reproach that it has overstepped its mandate. Second, the central bank may be misused to finance the government's budget if fiscal discipline is lacking and society cannot agree on how to restore a sustainable public budget. In this case, the central bank may lose control over prices in the long term.

4. Dealing with these challenges

What should central banks do in view of the risks to their independence caused by unsustainable fiscal balances? First, the importance of the budgetary situation for the soundness of monetary policy cannot be overstated. Central banks should always warn against the dangers of unsustainable fiscal policy. It is important for central bankers to emphasise that legal independence is not sufficient for the achievement of price stability in the long run. It needs to be accompanied by sound fiscal policy. This requires a sustainable consolidation of budgets and the elimination of structural budget deficits in many countries. Second, unconventional monetary policy measures are appropriate when they prevent a worst case and at the same time ensure that the stability objectives of a country can be reached in the medium to long term. However, the central bank has to proceed carefully when it takes unconventional measures, in particular when they have a quasi-fiscal character. As soon as circumstances allow, it should revert to a 'normal' approach to monetary policy, which will, in turn, reduce the risks to the central bank's independence. In the long run, focusing monetary policy on price stability – and, in so doing, taking due

account of the development of the economy – is the best strategy for a central bank to support the prosperous development of the economy.