



# Looking Ahead

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## **Countries must begin now to devise economic strategies to accompany recovery**

**T**HE global economy is showing signs of improvement—there is light at the end of the tunnel—but prospects remain highly uncertain. So while it is too early to exit from crisis-response policies, it is vital to begin defining a strategy to accompany recovery. Failure to do so would destabilize expectations and weaken the effect of the fiscal and monetary support now being provided.

Fiscal authorities and central banks have fought the global economic downturn by replacing sagging demand from consumers and businesses and by providing substantial support for the financial and other key sectors. As a result, their balance sheets have grown—and have grown riskier.

Not only did the crisis-related policies weaken public balance sheets, the surge in public debt took place while health and pension spending were increasing because of aging populations—especially in advanced economies. The ongoing debt surge has overwhelmed more than a decade of efforts in many countries to strengthen public budgets

in anticipation of an aging population. An easing of the monetary policy stance and the use of unconventional central bank policy measures may have been essential to preventing the collapse of the financial sector, but the substantial acquisition of impaired assets has exposed a number of central banks to potential losses, and the quasi-fiscal nature of some of these policy actions may lead to political pressures on central bank independence.

What does this mean for policies to accompany recovery? First, the fiscal problems that stem from population aging must be attacked with greater vigor. Second, the capacity of central banks to control inflation must be preserved and even enhanced. Third, policies will have to foster strong and sustainable economic growth by restoring private sector control of the financial and other sectors to allow competition and the improvement in productivity this will bring.

### **Fiscal problems are unprecedented**

Three factors are contributing to a major weakening in the state of the public finances:

- the plunge in economic activity and the slowdown in economic growth in the next few years compared to pre-crisis projections;
- fiscal stimulus packages; and
- government intervention operations in support of the financial sector.

The ratio of debt to gross domestic product (GDP) is expected to rise to 115 percent in the advanced economies in 2014, based on the July WEO Update projections, from 75 percent in 2007. Debt ratios will be close to, or exceed, 90 percent by 2014 in all G-7 economies except Canada (that is, France, Germany, Italy, Japan, the United Kingdom, and the United States).

This surge in public debt is unprecedented during peacetime. Major increases occurred in the 1930s, but started from lower levels (for example, about 20 percent of GDP in the United States in 1929). Moreover, demographic trends were favorable in the 1930s.

Only a relatively small portion of the debt surge in advanced economies—6 percent so far—is due to financial support operations. The bulk of the debt increase stems from fiscal stimulus and, especially, tax revenue losses associated with the recession and the collapse in asset prices. Thus, the fiscal problem cannot be solved simply by unwinding financial support operations.

### Fiscal risks

Failure to address the trend of rising debt could lead to concerns that the debt will ultimately be “inflated away” or that default is inevitable. Interest rates would then rise, making the fiscal problem worse and potentially killing the recovery; debt maturities would shorten; and refinancing crises could occur. These concerns would be especially severe where perceived risks of currency depreciation are high.

Consensus forecasts and market indicators of expectations derived from inflation-indexed bonds in major advanced countries suggest that inflation is expected to remain low over the next decade. And, while interest rates on government paper have been on the rise for some months, they also remain low. Markets, however, often react late and suddenly, so the benign market response to date does not provide firm reassurance for the future.

Some commentators have suggested that inflation—which could occur if central banks are unable to shrink their balance sheets and tighten monetary policy fast enough when the recovery begins—could play a helpful role in reducing the debt burden. However, high inflation gives rise to sizable distortions of its own and may be costly to bring down again. And inflation in the single digits would not make much of a dent in the real value of the debt, especially if higher inflation expectations are reflected in higher interest rates when governments refinance themselves in the years ahead. In short, price stability, in the form of low inflation, is a critical public good. It is important to preserve it to support sustained economic growth.

### Central banks acted decisively

Decisive central bank action to provide liquidity and other financial support helped to prevent financial sector collapse

and damaging deflation. Central banks substantially lowered policy rates. In their liquidity provision operations, they lengthened maturities and widened the range of collateral and the group of counterparties to ensure a smooth flow of reserve money into the system.

## “Policies will have to foster strong and sustainable economic growth by restoring private sector control of the financial and other sectors to allow competition.”

Central banks also engaged in various asset-driven and often unconventional operations, both to deal with short-term interest rates that were close to zero in some cases and to combat severe market disruptions, especially when bank demand for reserve balances rose sharply following the Lehman Brothers collapse in September 2008. Notably, unconventional instruments have involved quantitative and credit easing. *Quantitative easing* in this crisis has consisted of purchases of government securities to reduce longer-term interest rates, while *credit easing* has involved purchases of private sector assets to counter the widening of credit spreads in specific markets (becoming the buyer of last resort in a moribund commercial paper market, for example). In some countries, the combined impact of quantitative and credit easing on central bank balance sheets has been very large. For example, by end-June 2009, the balance sheet of the U.S. Federal Reserve more than doubled and that of the Bank of England nearly tripled from the onset of the crisis two years earlier, in both cases to some 15 percent of GDP. The Eurosystem balance sheet expanded by some 50 percent to reach 20 percent of GDP.

### Monetary policy faces unusual issues

Central banks may face tensions between the risks of rising inflationary pressures—whether from domestic demand, commodity prices, or a feed-through from exchange rate movements—and financial stability concerns during continued weak economic performance.

The extensive use of unconventional instruments has complicated both the setting of policy and communication of that policy. Normally, a single instrument—the short-term interest rate, usually an interbank rate—is used to signal a change in a central bank’s policy stance. But the unconventional operations central banks have employed make it considerably more difficult to assess the overall stance of monetary policy. This difficulty might persist in the early stages of recovery if inflationary pressures reemerge in some countries before markets have been fully restored, so that some use of unconventional instruments could continue even as interest rates rise.

So central banks could face important challenges in several related areas: determining the timing and extent of reversing

policy easing; deciding what their future balance sheet should look like; coordinating with fiscal authorities and other central banks; and communicating strategy to the public. Beyond this, although price stability should remain the primary goal of monetary policy, there is a vital debate about the proper role of the central bank in ensuring financial stability.

### Returning to normalcy

As economies recover, it will be important to return to normalcy—not only in government debt and central bank balance sheet positions but in institutional responsibilities as well. To reduce the likelihood of a future crisis, fiscal adjustment—including pension and health care reforms—must take place as soon as the recovery is safely under way. Unwinding the central bank’s interventions, while compensating for any related losses in the government’s budget, will preserve the ability of the central bank to keep inflation under control.

### Greater fiscal discipline needed

The magnitude of fiscal adjustment needed in the next couple of decades is almost unprecedented, especially for countries with the highest debt. A study by the IMF’s Fiscal Affairs Department suggests that advanced countries with higher debt (over 60 percent of GDP in 2014) would have to maintain an average primary surplus (revenue less expenditure before interest payments) of 4½ percent beginning in 2014 to reduce the debt to 60 percent of GDP by 2030 (Horton, Kumar, and Mauro, 2009).

Fiscal adjustment will require reform of pension and health entitlements—the key source of spending pressures over the coming decades. The net present value of future spending due to aging is more than 10 times as large as the fiscal cost of the crisis. Policy measures in this area are politically difficult and will require further technical groundwork, but are necessary. Measures such as raising the retirement age can make a sizable dent in the net present value of future public spending without undermining the effects of the fiscal stimulus on aggregate demand.

Still, fiscal adjustment will have to extend beyond pensions and health care, to revenues and expenditures more generally. Differences in circumstances and policy preferences will lead to different choices across countries, but there will be a few common themes. On the *spending side*, fiscal stimulus measures must not become permanent. On the *revenue side*, broadening the tax base will be the first step, but changes to the tax structure are likely to become more important than before. In this regard, externality-correcting taxes (such as carbon taxation) would be among the main priorities. To buttress the fiscal adjustment, institutional arrangements such as medium-term fiscal frameworks, fiscal responsibility laws, fiscal rules, and fiscal councils may play a helpful role, depending on country circumstances.

Policies should also ensure adequate recovery of the value of assets acquired during the crisis. Country authorities may occasionally face trade-offs between rapidly selling assets to the private sector as soon as acquired banks or companies return to profitability and a more gradual approach that might ultimately yield larger gains to the government’s budget.

Economic growth should be a top priority, given its power to improve a country’s debt position. A 1 percentage point increase in economic growth for 10 years (holding spending constant and assuming a 40 percent tax rate) lowers

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public debt by 24 percentage points of GDP. And if growth over the coming decade averages the same as over the past two decades, balanced budgets—while a challenging objective—would be sufficient to cut a country’s debt ratio from 100 percent of GDP to 60 percent. However, economic growth over the next decade or so is by no means guaranteed. The crisis could result in lower potential growth than in past decades and adverse demographic developments may also constrain growth. Thus, reforms to enhance potential growth are essential.

On the plus side, the basic arithmetic of debt dynamics means that, regardless of where it starts, the debt-to-GDP ratio converges to a level that depends only on growth and the deficit-to-GDP ratio. So efforts to boost growth and to contain the deficit can pay off even if debt positions are high now.

### Challenges to monetary policy

The ability of central banks to preserve price stability will be critical to the strong economic growth that is desirable in itself and is also needed to ensure debt sustainability. While deflation would have pernicious effects and exacerbate the recession, inflation rates higher than those consistent with price stability could also harm economic growth.

Stabilizing the financial sector and the real economy are critical in the short term. But as the crisis abates, the ability of central banks to maintain price stability could be compromised by expanded balance sheets that contain impaired assets:

- Large excess reserves might result in rapid credit growth and inflationary pressures.
- Certain assets could be hard to use for monetary policy and liquidity management.
- A reliance on quantitative tools would make it difficult to judge the stance of monetary policy.
- Losses and quasi-fiscal operations can lead to political pressures that undermine central bank independence.

### Elements of a strategy

The key elements of a central bank exit strategy are, in order of priority: limiting and unwinding unconventional operations; restructuring balance sheets; preparing instruments for

monetary tightening; and defining and communicating policies to anchor expectations.

**Unconventional operations.** Some unconventional operations—justified only by the crisis—will be unwound as financial conditions normalize, and demand for excess reserve balances will automatically fall. Other balance sheet positions will require more active management and policy.

Purchases of government securities under quantitative easing were made to reduce long-term interest rates. Outright sales could increase government borrowing costs, so the timing of these sales is crucial. While government securities could be used in open market operations to drain excess liquidity, there is no pressing need to sell, because holding long-term securities is normal for many central banks.

Credit-easing programs (buying private sector assets to counteract credit spreads) are mostly time limited. As with quantitative easing, a running down of substantial credit-easing operations may imply an effective tightening of monetary policy. Here again, the timing needs to reflect an overall assessment of economic conditions.

The most difficult issues arising from credit easing will be related to holdings by the central bank of often illiquid private sector securities whose value is uncertain. These assets may not be usable in normal open market operations and may thus create a drag on efforts to drain liquidity when inflationary pressures reemerge. Moreover, these assets could be a prime source of central bank losses.

**Restructuring balance sheets.** The large unconventional asset positions now held by some central banks give rise to both market and credit risk. The associated losses on these positions may result in a negative net capital position for some central banks. Credit risk—whether taken on through credit easing or riskier collateral—may materialize. Market risk, mainly from longer-term assets purchased at low yields, could cause assets to lose value when interest rates rise.

The appropriate response for each central bank will depend on the structure of its balance sheet. If capital is still positive and operations show an overall profit, then over time the balance sheet should strengthen. But if credit losses are large, the government will have to transfer funds to the central bank to recapitalize it. A financially weak central bank would otherwise be more subject to political pressures, and more reluctant to take necessary actions, with serious repercussions for price stability.

**Preparing to tighten monetary policy.** Central banks must regain control of liquidity and reestablish the short-term policy rate as the key tool for setting the monetary policy stance, so that they are prepared to tighten when the time comes.

As the economy emerges from the crisis, banks may still be holding substantial excess liquidity, which must be reabsorbed to keep credit growth and inflation in check. Central banks can use many instruments and measures to this end, including reverse repos (selling government securities on their books that they agree to buy back later), issuing central bank bills, and raising remuneration on bank reserves held at the central bank.

Increasing the remuneration for reserves will be important, but reliance on this type of standing deposit facility risks weakening incentives for interbank trading. Because central

banks generally use an interbank lending rate as the policy rate, a smaller interbank market would affect the transmission of interest rate changes to the wider economy, and this must be taken into account in setting monetary policy.

Central banks that have engaged substantially in credit easing may hold long-term assets that cannot be used in open market operations, and will have to use term deposits or central bank bills to reabsorb liquidity.

Finally, tightening collateral policy may be important for some central banks, to reduce the risk of future losses and avoid market distortions. This will require careful planning to avoid sudden shocks to the market.

## Communication

It is still too soon to tighten fiscal and monetary policy, but not too early for governments to anchor expectations by defining and communicating their strategies and proposed measures to ensure fiscal solvency. Markets must be reassured that longer-term concerns will be addressed, and that fiscal policy will be tightened when the economy recovers. Moreover, some actions that have no risk of a negative impact on aggregate demand could be implemented now, such as institutional reforms to enhance fiscal transparency and medium-term fiscal frameworks (for example, credible commitments to cut the fiscal deficit in the medium term).

Markets will also react positively to monetary policy actions that reassure them of the commitment to keeping inflation in check. At the start of the crisis, markets were at times confused about the monetary policy stance, which was sometimes obscured by the extraordinary measures being used to ensure financial stability or to ease liquidity conditions. Avoiding such confusion in the exit will require clear communication by central banks. Drawing a distinction between the policy stance and the measures taken to implement it will be key. The use of a common terminology by central banks would assist the process.

## International coordination key to successful exit

International cooperation is necessary to ensure consistency across countries' fiscal and monetary policy during the exit process, building on and extending the experience during the crisis thus far. The almost simultaneous onset of the crisis in advanced economies helped facilitate coordination of the introduction of the unprecedented policy measures. However, recoveries may be less synchronized. As a result, ensuring international consistency of macroeconomic policies may be more difficult, with country-specific circumstances playing a greater role in governments' deliberations regarding their policy stances. ■

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### Reference:

Horton, Mark, Manmohan Kumar, and Paolo Mauro, 2009, "The State of Public Finances: A Cross-Country Fiscal Monitor," IMF Staff Position Note 09/21 (Washington: International Monetary Fund).