



Fiscal policy and its implications for monetary and financial stability

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Roadmap

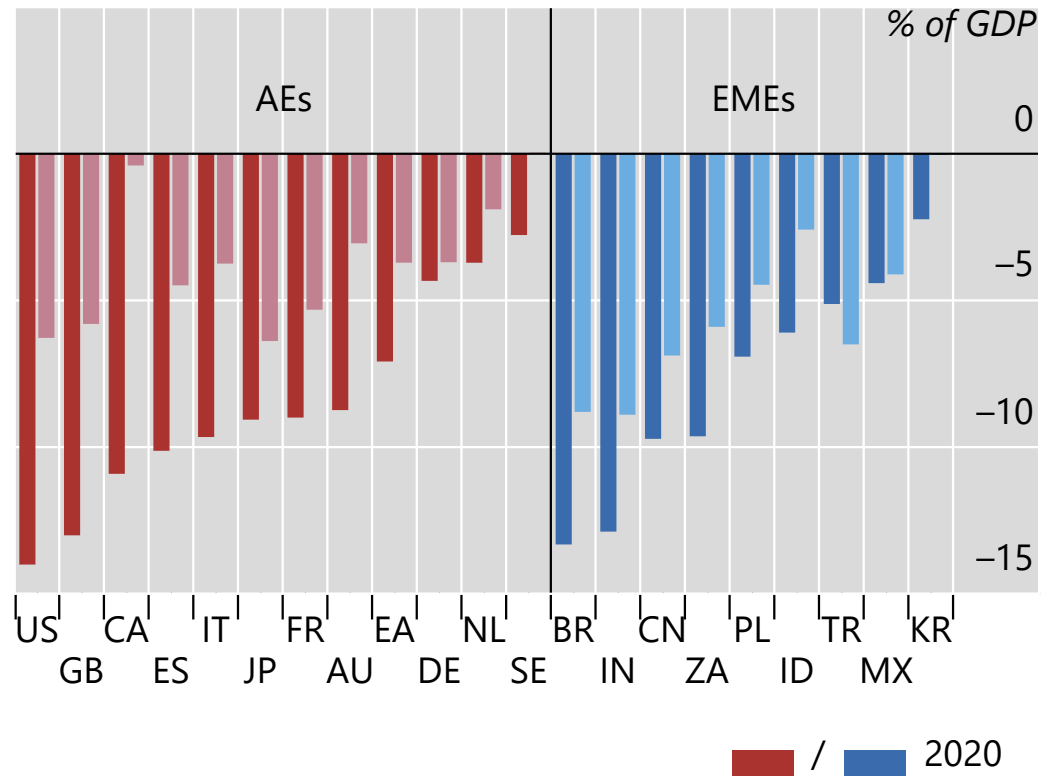
- The current fiscal situation
- Risks to price stability
- Risks to the financial system
- Needed adjustments to policies (to ensure they stay within the “Region of Stability”)



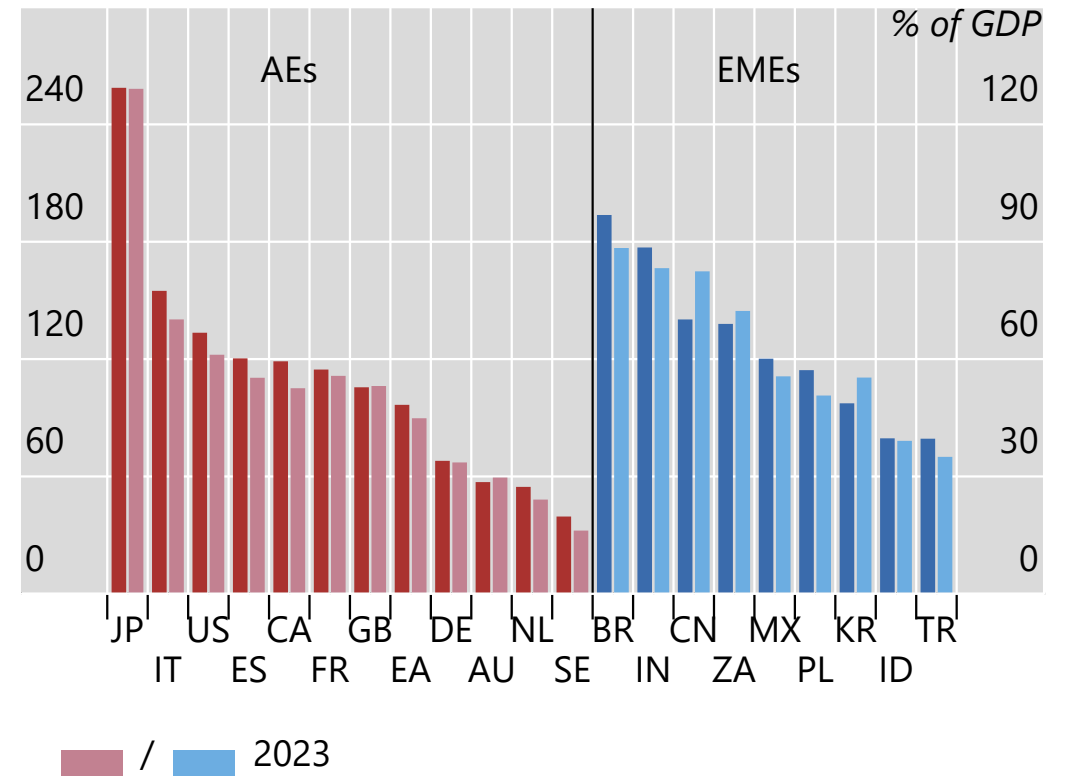
The fiscal situation

The short-term fiscal outlook

Headline fiscal balance

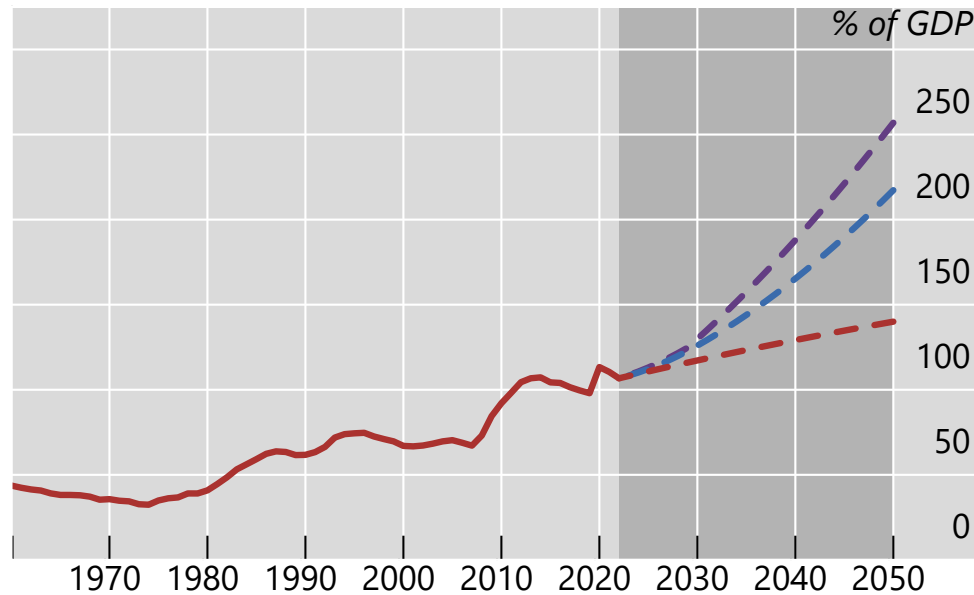


Public debt



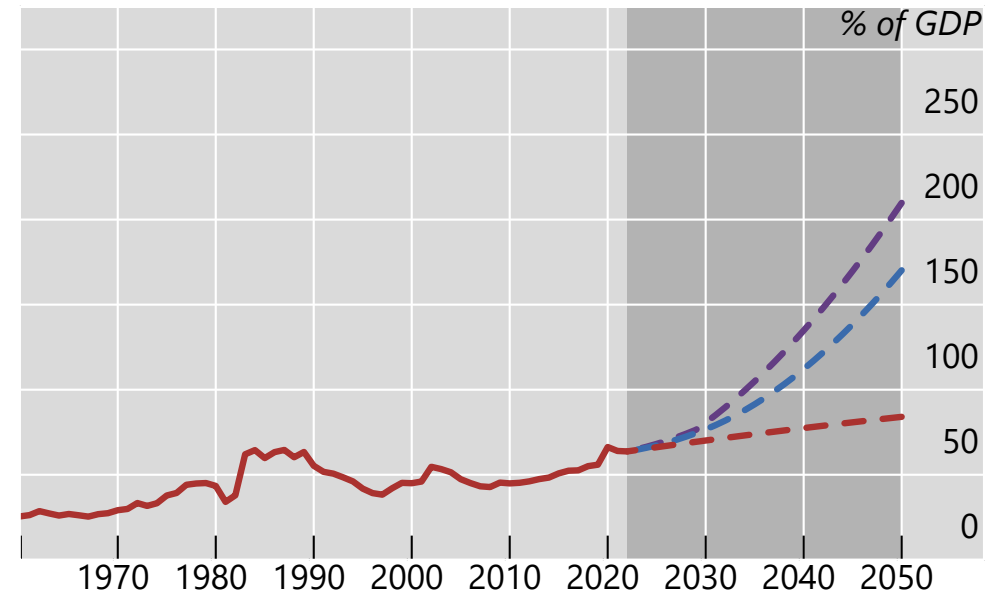
Worrying public debt projections

Advanced economies



- Baseline (constant primary deficits)
- Adding age-related spending increases
- Additional spending increase (2% of GDP)

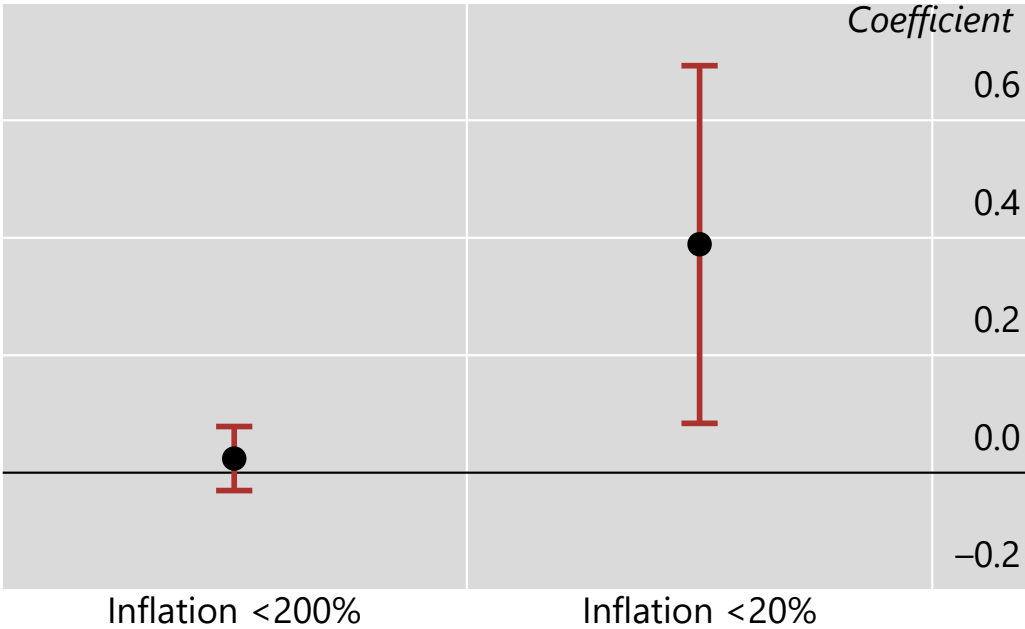
Emerging market economies



- Projections, not forecasts: they show what happens absent fiscal consolidation
- Debt levels trending up: debt likely to stabilise at higher levels in the future
- See 2023 BIS AER Ch II; see also Cecchetti, Mohanty and Zampolli (2010).

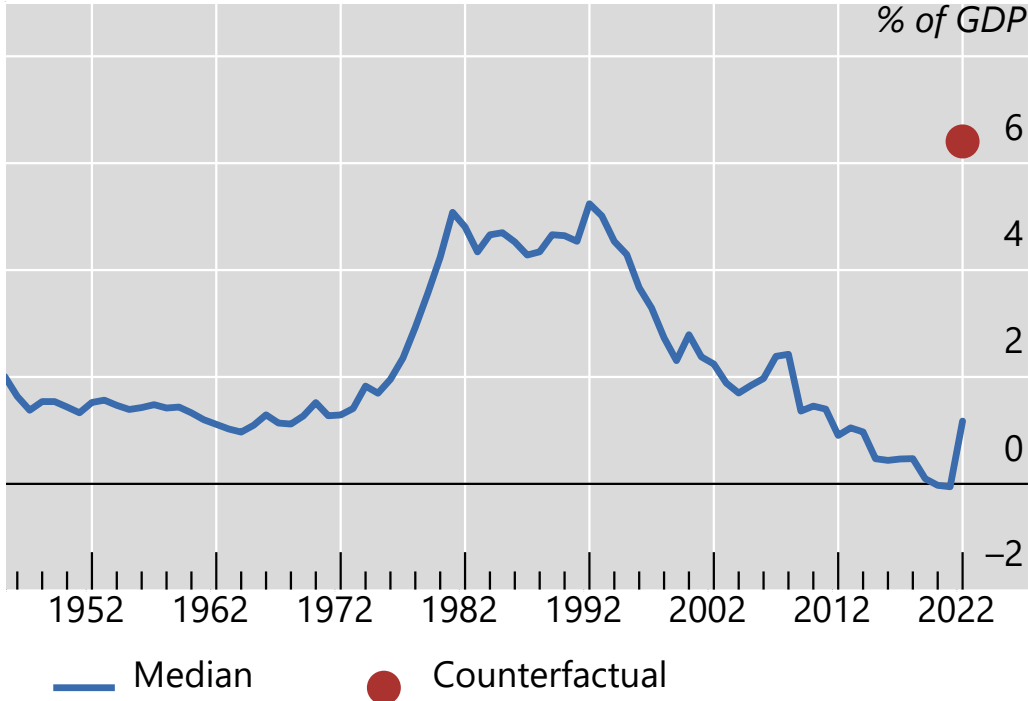
Inflation and the interest-growth differential

Higher inflation does not improve government finances



- Association between a 1% increase in inflation and the five-year-ahead change in debt-to-GDP ratio
- 90% confidence interval

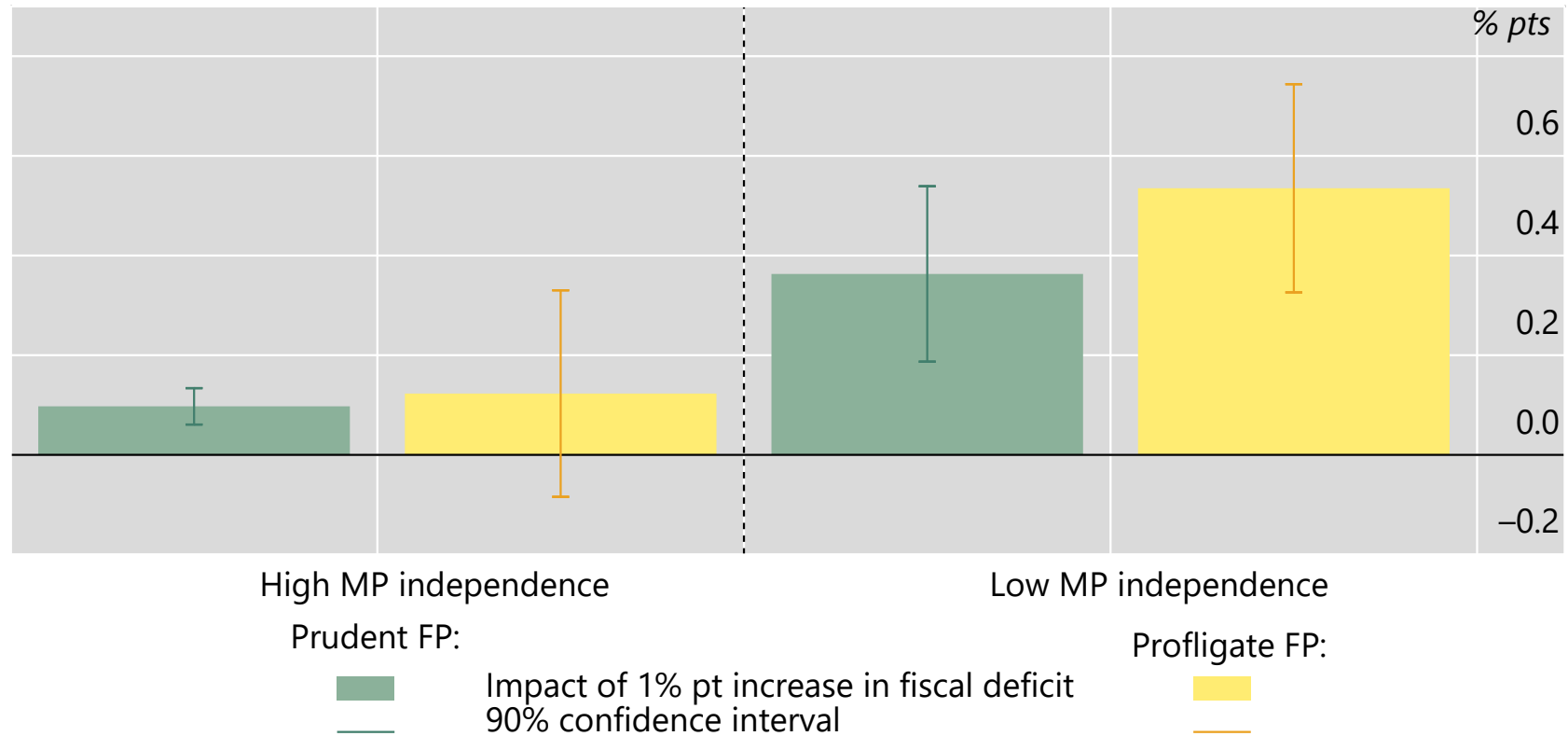
Debt service cost





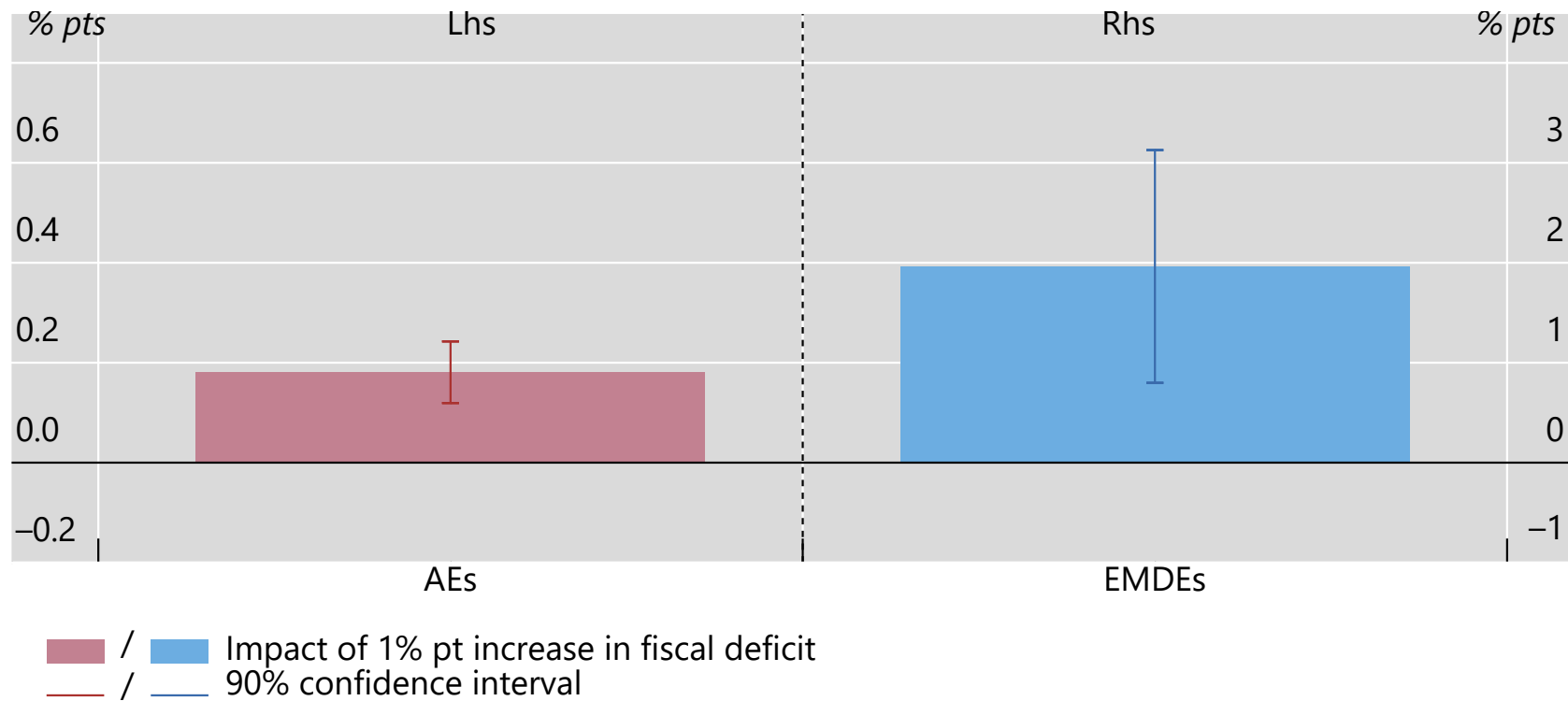
Risks to price stability

Inflationary effects of fiscal stimulus – across regimes



- Inflationary effect depends on the degree of central bank independence and how prudent the government is in ensuring fiscal sustainability.
- Banerjee, Boctor, Mehrotra and Zampolli (2022)

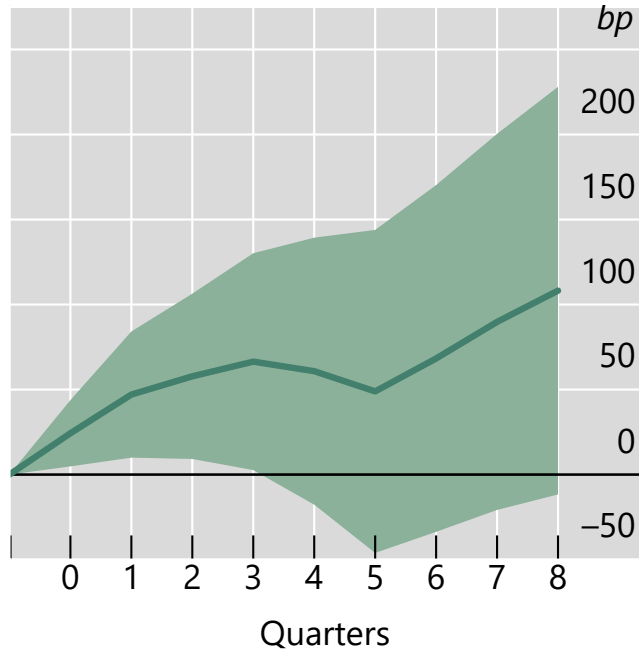
Inflationary effects of fiscal stimulus – across regions



- Banerjee, Boctor, Mehrotra and Zampolli (2023)

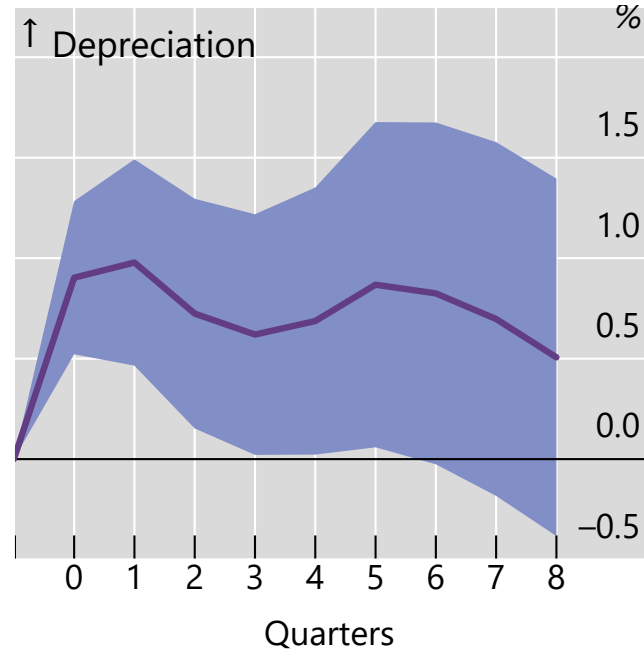
Fiscal risks and inflation in EMEs: the role of the exchange rate

Fiscal deficits raise sovereign risk



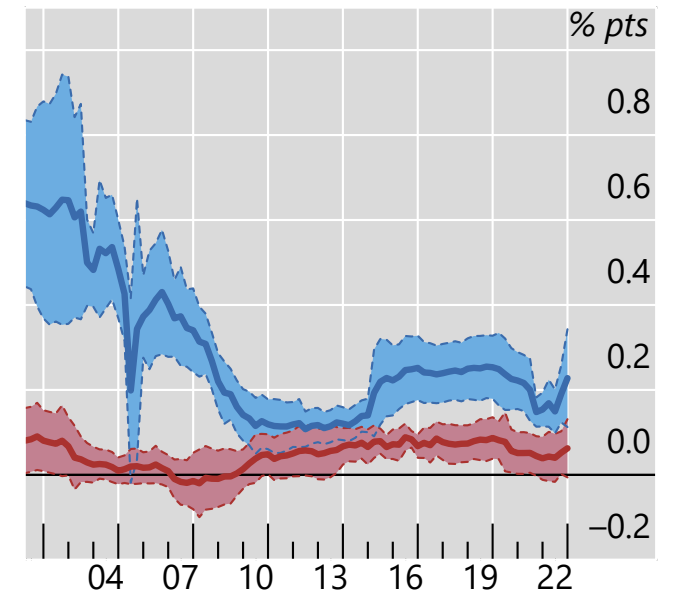
— Response of 5y CDS spreads to one std dev increase in primary deficit
 ■ 90% confidence interval

Risk weakens exchange rates



— Response of exchange rate to 100 bp increase in 5y CDS spreads
 ■ 90% confidence interval

Exchange rate pass-through



AEs: — Inflation response to exchange rate depreciation
 ■ 90% confidence interval
 EMEs: — Inflation response to exchange rate depreciation
 ■ 90% confidence interval

- See 2023 BIS AER and Aguilar, Cantú and Guerra (2023)

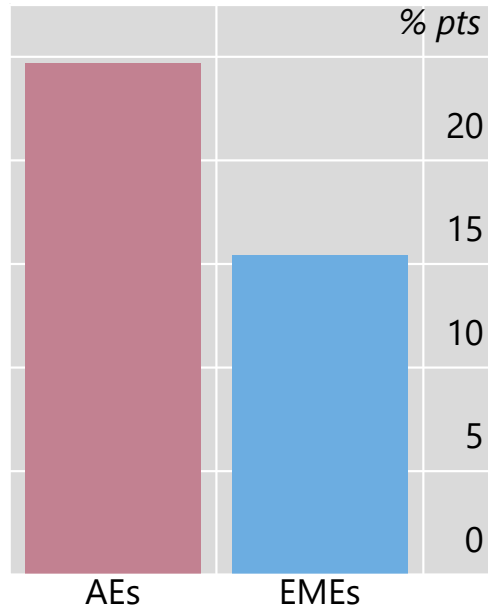
Fiscal risks and inflation in EMEs: non-linearity and debt composition

- In Banerjee, Boctor, Mehrotra and Zampolli (2023) we show that:
 - The inflation effects of fiscal deficits are larger and non-linear in EMDEs (unlike in AEs)
 - ie larger effects on upside tail risks than average inflation
 - Fiscal deficits raises the risk of future currency depreciation (also non-linearly)
 - This channel is closely related to sovereign risk and depends on debt composition
 - stronger when the share of FX or non-resident debt is large
 - The channel is strongly attenuated under inflation targeting

Financial stability risks

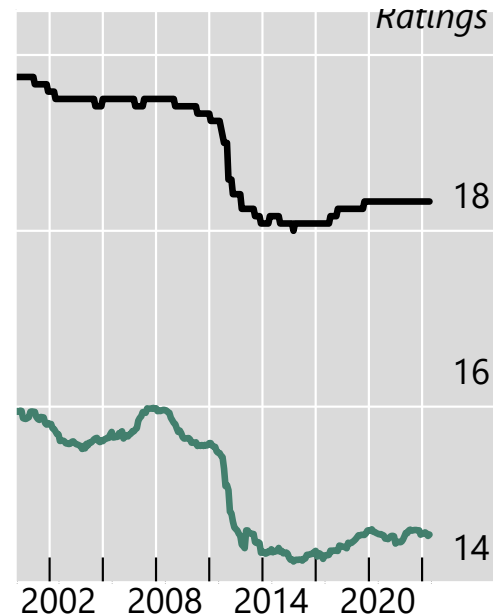
Two-way causality between fiscal policy and financial instability

Increase in public debt



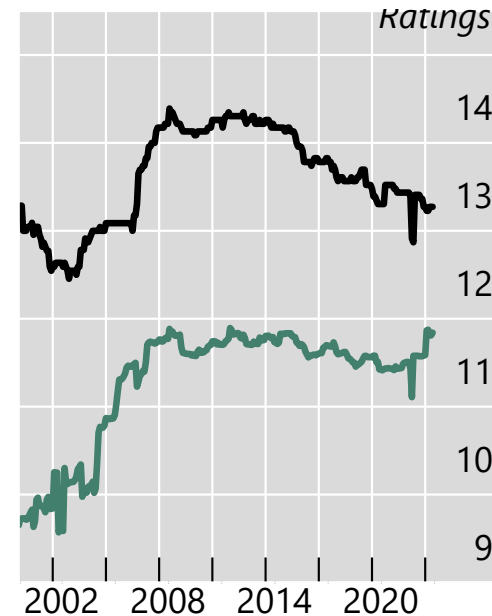
■ / ■ Increase in public debt in the 5-year following a banking crisis

Credit ratings in AEs



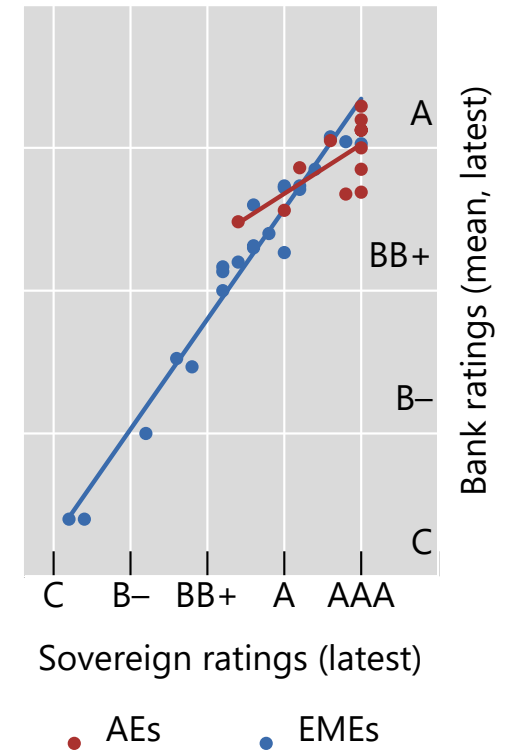
— Sovereign

Credit ratings in EMEs



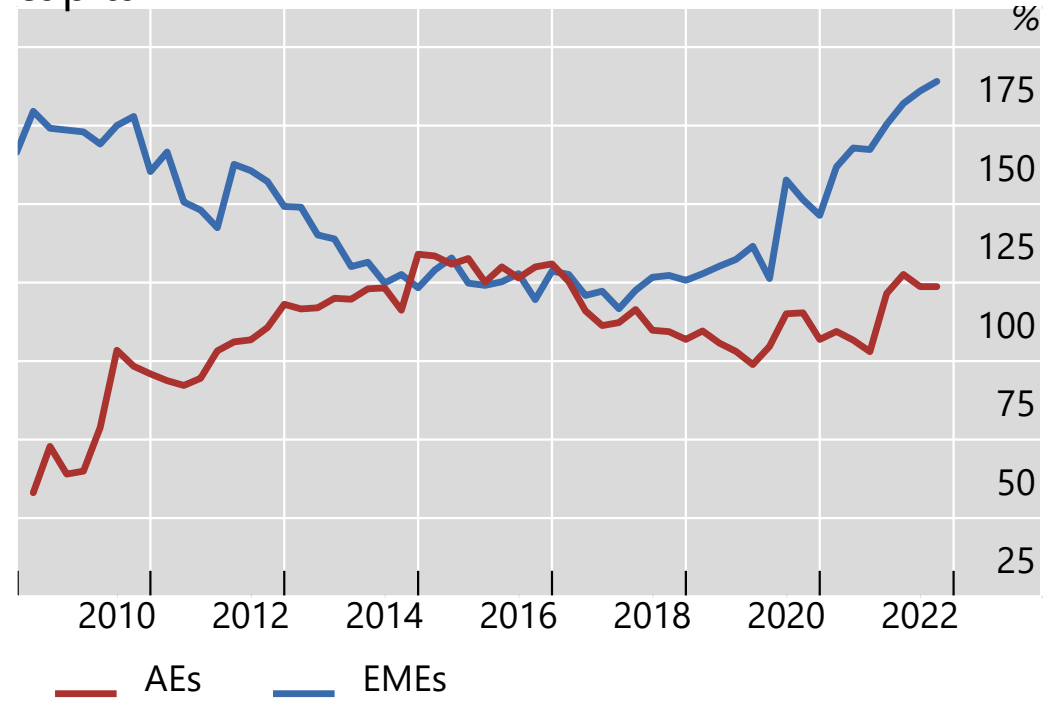
— Bank

Bank vs sovereign ratings

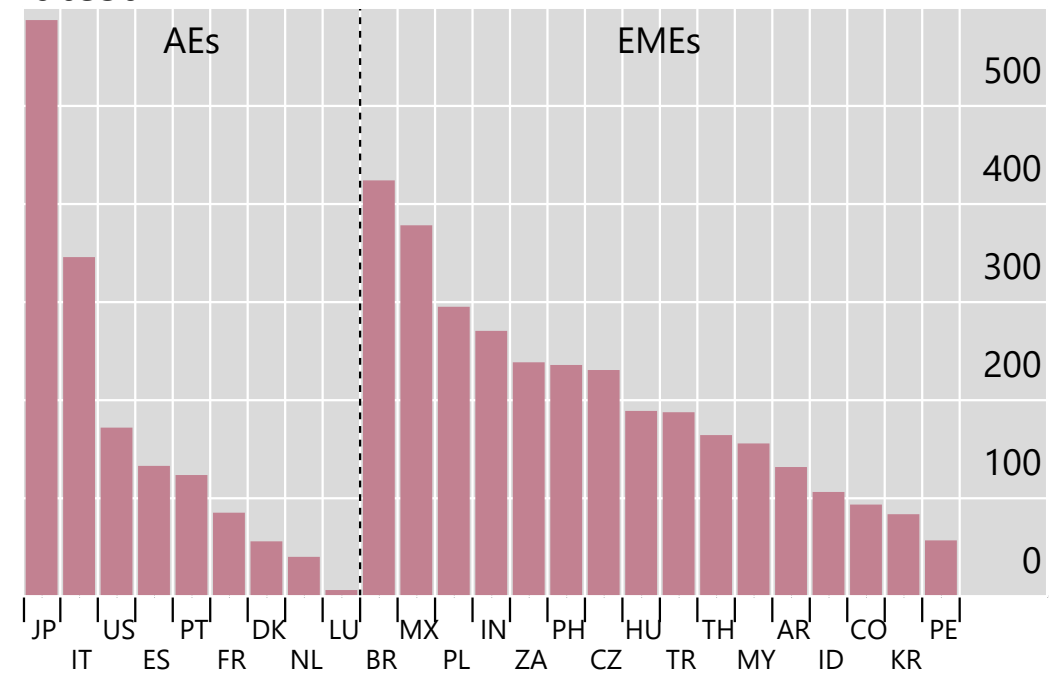


Increasing exposure to sovereign debt

Banks' sovereign debt exposure as ratio to capital

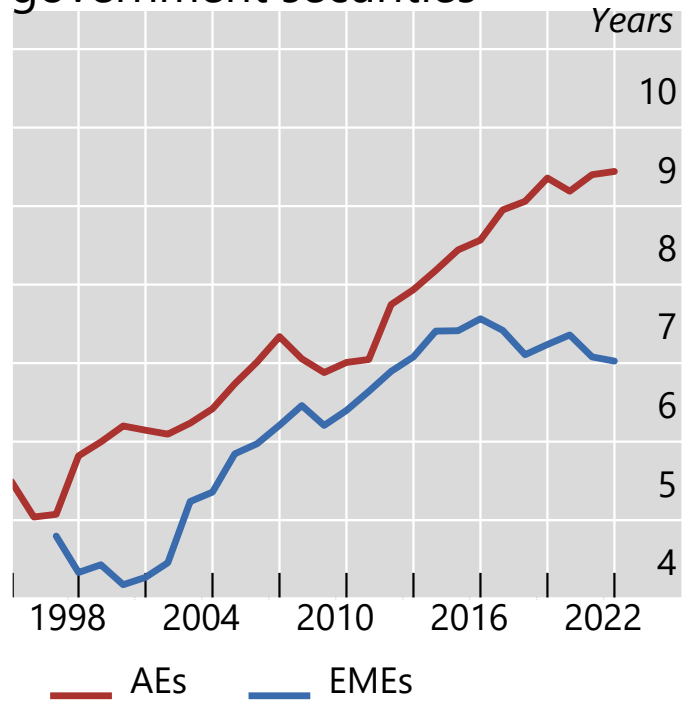


Banks' sovereign debt exposure as ratio to capital: latest

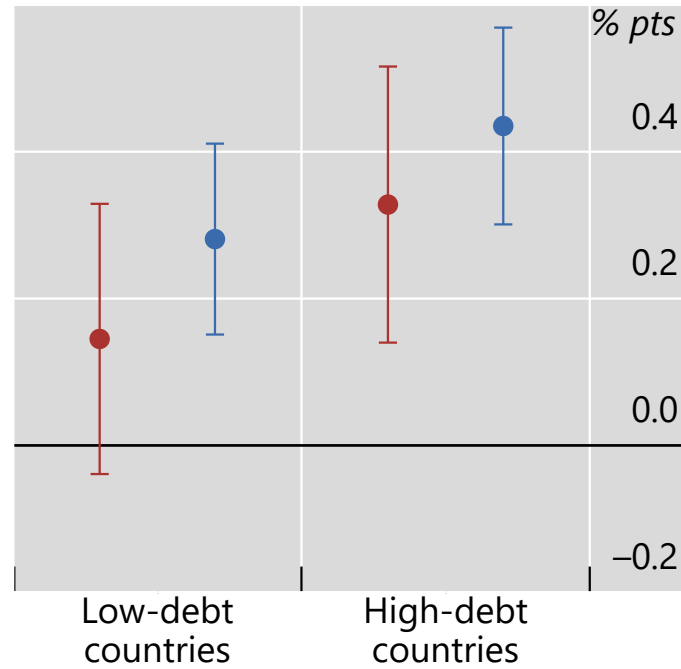


Elevated interest rate risk

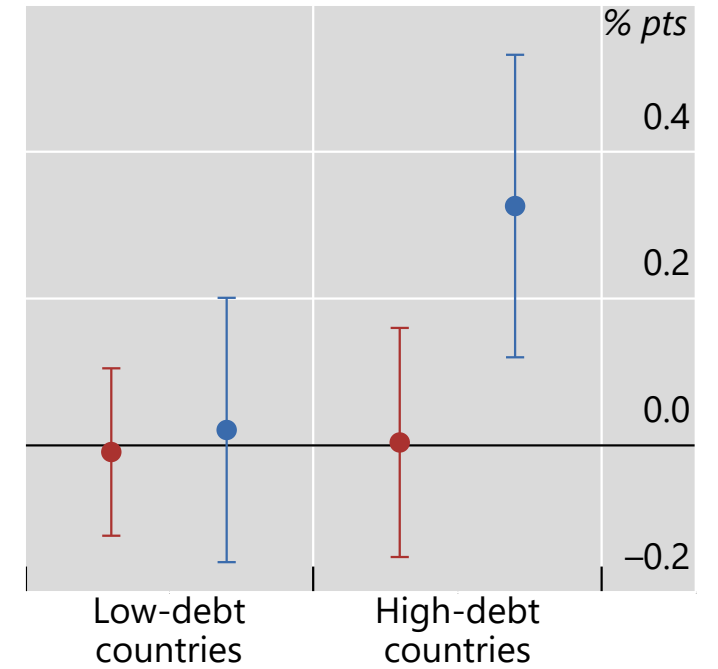
Average remaining maturity of government securities



Yield response to policy rate hike



CDS response to policy rate hike



AEs:
 ● Response to a 100 bp policy rate hike
 — +/- 2 std dev

EMEs:
 ●
 —

Policy

Fiscal policy

- Ensure that debt evolves on a sustainable path
- Pay greater attention to financial factors
 - Adjusting fiscal balances for the financial cycle (eg Borio, Lombardi & Zampolli (2017))
 - Contingent liabilities estimates (eg Borio, Contreras and Zampolli (2020))
- Give more bite to fiscal councils and fiscal rules

Monetary policy

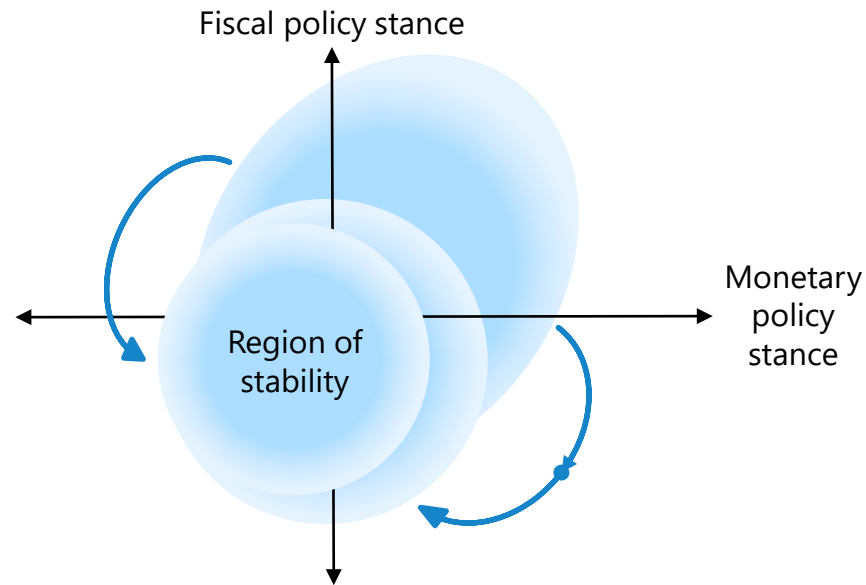
- Ensure price stability with due attention to financial stability
- Exploit self-stabilising properties of low-inflation regimes (Borio, Lombardi, Yetman and Zakrajšek (2023))
- Safeguard central bank independence

Other policies

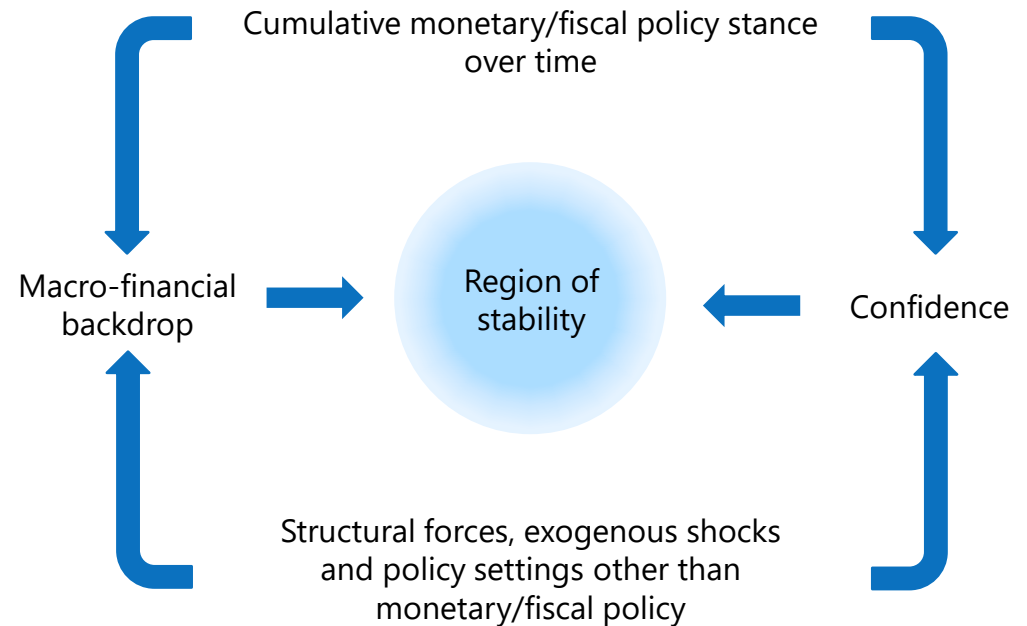
- Prudential policy
 - First line of defence against financial instability
- Structural policy
 - Higher *sustainable* growth achievable only by improving the supply side

The concept of “Region of Stability” (BIS 2023 AER)

The evolving nature of the region of stability



Factors influencing the region of stability



- It cannot be summed up in simple metrics
- Inter-temporal trade-offs are key
- It is affected by structural forces, exogenous shocks and other policy settings
- Future research work should focus on mapping the region

Conclusions

To sum up

- Public debt might be higher in the future
- Higher public debt may translate into risks to inflation and financial stability
- Prudent fiscal policy and independent monetary policy are needed to prevent a bad situation from getting worse
- Only structural policy can raise economic growth sustainably



Thank you for your attention!

Some BIS papers (in reverse chronological order)

- BIS (2023): "Monetary and fiscal policy: safeguarding stability and trust", 2023 Annual Economic Report, Chapter II.
- Banerjee, Boctor, Mehrotra and Zampolli (2023): "Fiscal sources of inflation risk in EMDEs: the role of the external channel", BIS Working Papers, no 1110.
- Borio, Farag and Zampolli (2023): "Tackling the fiscal policy-financial stability nexus", BIS Working Papers, no 1090.
- Borio, Farag and Zampolli (2023): "Fiscal policy and financial stability: revisiting the nexus", Ch 9 in Fiscal Policy in a Turbulent Era (edited by E Alberola), Edward Elgar, forthcoming in February 2024.
- Borio, Lombardi, Yetman and Zakrajšek (2023): "The two-regime view of inflation", BIS Papers. No 133.
- Aguilar, Cantú and Guerra (2023): "Fiscal and monetary policy in emerging market economies: what are the risks and the trade-offs?", BIS Bulletin, no 71.
- Banerjee, Boctor, Mehrotra and Zampolli (2022): "Fiscal deficits and inflation risks: the role of fiscal and monetary policy regimes", BIS Working Papers, no 1028.
- Borio, Contreras and Zampolli (2020): "Assessing the fiscal implications of banking crises", BIS Working papers, no 893.
- Borio, Lombardi and Zampolli (2017): "Fiscal sustainability and the financial cycle", in Rethinking fiscal policy after the crisis (ed by L Ódor), Cambridge University Press.
- Cecchetti, Mohanty and Zampolli (2011): "The future of public debt: Prospects and implications", in Challenges to Central Banking in the Context of Financial Crisis: The International Research Experience, Academic Foundation.
- Cecchetti, Mohanty and Zampolli (2010): "The real effects of debt", Economic Symposium Conference Proceedings, Jackson Hole, pp 145-196.