# Do We Need a New Conceptual Framework for Government Debt Management?

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# Outline presentation: Do we need a New Conceptual Framework for Government Debt management ?

**Addressing this fundamental question requires discussing the following issues:**

- ❑ **What is the influence of the "new (normal) macroeconomic environment or policy setting" on the standard approach to public debt management (PDM)?**
- ❑ **UMP and PDM**
- ❑ **Why minimizing fiscal risks?**
- ❑ **Financial Stability and PDM**
- ❑ **Broader mandate PDM needed (PDM part of macro triangle)?**
- ❑ **Is the standard or micro portfolio approach to PDM still appropriate?**
- ❑ **Why (and when) do we need a SALM approach?**
- ❑ **Policy conclusions/implications**

# The (normal)macro environment or policy setting before the global crisis

- **Before the global financial crisis (GFC), the characteristics of this new (normal) environment were to an important degree shaped by the dominant role of the so-called New Classical Macroeconomic (NCM) policy models that embodied (a) rational intertemporal behaviour and (b) perfect asset substitutability**
- **This set-up implied that economists used the Ricardian equivalence (RE) principle to design economic/financial policies**

# Fundamental flaws in the pre-crisis macro environment or policy setting

- **RE implies that any purchase or sale of assets by central banks would lead to offsetting changes in private demands (with no influence on prices)**
- **If RE holds, then both PDM (maturity structure of debt) and deficit spending are irrelevant!**
- **However, the logic that underpins NCM and RE are fundamentally flawed (See Blommestein (2009) for a critical methodological overview.)**

# Failure of New Classical Macroeconomic (NCM) policy models and the Ricardian equivalence (RE) principle

- **For example, QE has *lowered* long-term interest rates**
- **This is prima facie evidence that NCM was wrong in rejecting the idea of portfolio rebalancing effects**
- **This undermines therefore the RE benchmark**

# Implications of the new (normal)macro environment or policy setting for PDM (1)

- **Since 2008, the separation between PDM and MP has been blurred**
- **This is problematic for the traditional policy set-up because *before* the GFC it was reasoned that potential policy conflicts between monetary policy and sovereign debt management could be avoided by following two "separability principles" (Blommestein and Turner (2014)) :**
  a) **Central banks should not operate in the markets for long-dated government debt, but should limit their operations to the bills market.**
  b) **Government debt managers should be guided by a micro portfolio approach based on cost-minimisation mandates, while keeping the issuance of short-dated debt to a prudent level.**

# Implications of the new (normal)macro environment or policy setting for PDM (2)

- **No separation between PDM and MP : Conflict between MP and PDM?**
- **Portfolio channel of QE together with segmented markets supports the logic of <u>lowering</u> the average maturity of the debt (i.e. conserving on the term premium)**
- **Four competing policy objectives?**

1. **Financing government at lowest cost (micro)**
2. **Minimising (limiting) fiscal risk (micro/macro)**
3. **Managing aggregate demand (macro)**
4. **Supporting financial stability (macro)**

# Implications of the new (normal)macro environment or policy setting for PDM (3)

- **QE operations could easily be contradicted by Treasury financing decisions**
- **The US Treasury has increased the average maturity of its outstanding debt**
- **This is (by itself) difficult to square with the rationale of QE, which aims to shorten the maturity of bonds held by the public**
- **It is therefore essential to examine QE in conjunction with debt management policies**

# Assessing UMP (QE) jointly with PDM

- **QE means swapping long-term Treasuries for short-term interest-bearing reserves**
- **The decline in the term premium is expected to lower LT interest rates**
- **US Treasury policy was at one point focused on lengthening the maturity of its issuance**
- **In general, a debt manager may alter its issuance policy to take advantage of a change in market conditions induced by central bank action**
- **For example, by moving quickly to attain a maturity-extending objective**

# Why minimizing fiscal risk?

- Minimising fiscal risk has different perspectives
- The cost of servicing public debt should not be too volatile (DM)
- Smoothing taxes (by insulating the budget  from refinancing risk)
- Rolling over " too much" short-term debt might make government vulnerable to "bank-run-like" problems
- Is the traditional PDM mandate adequate enough?

1. Financing government at lowest cost (micro)
2. Minimising (limiting) fiscal risk (micro/macro)

- The domain of fiscal risk is a source of conflict between DMOs/Treasuries and CBs

# Financial stability (FS) and PDM

- **FS and PDM have traditonally been separate policy areas**
- **Since the GFC, a regulatory dimension has been added to PDM**
- **PDM aimed at FS implies going for a shorter-term maturity**
- **PDM has advantages over the direct regulation of short-term private liabilities**

# Should PDM be part of the macro-economic triangle?

- **PDM should be an *explicit* part of the macro-economic triangle: fiscal policy, monetary control (including financial stability) and debt management strategy (including supporting aggregate demand and maintaining orderly government debt markets)?**
- **A major stumbling block to change the triangle and associated policies is the lack of a generally accepted theory of the macroeconomics of government debt management**

# Is a broader (macro) mandate for PDM needed?

- **Blurring of lines between PDM and MP (e.g. DMO at short-end and CB at long-end)**
- **Different mandates sometimes in conflict**
- **Mandates of both DMOs and CBs have become more complex and, as a result, (somewhat) less clear**
- **In addition, there is the fundamental argument to question or challenge the micro approach to PDM, including the removal or weakening of the *risk-free asset condition*, and the high degree of *imperfect substitutability.***

# Are the underlying technical assumptions micro portfolio approach (still) valid?

- **See Blommestein and Hubig (2013) for a detailed and critical analytical appraisal of the key underlying assumptions of the micro portfolio approach**
- **Asumptions underlying modern portfolio theory are similar to those associated with the micro portfolio approach to PDM:**

**(1) This implies that actions of the sovereign have no impact on the term structure of interest rates (price-taker condition resulting from modern portfolio theory )**

**(2) Budgetary position and debt position are statistically independent of each other**

## Key conclusion: micro portfolio approach is nested within a broader framework

**Rule 1**: Minimise “burden” of debt portfolio via choice of funding strategy

| Net fiscal position | |
|---|---|
| Cash flows of the debt portfolio | Cash flows primary borrowing requirements (primary budget balance) |

**Micro portfolio approach**

(no interactions with the budget)

**General framework**

(allowing for interactions with the budget)

**Rule 2**: Minimise cash-flow based borrowing costs

Minimise effective borrowing costs (associated with net fiscal position)

# Why is a SALM approach needed?

- **The suggested macro (public finance) approach to PDM implies broader DM objectives than those embedded in the micro portfolio approach**
- **It encompasses the SALM approach where the interactions between the debt position and the budgetary position are explicitly taken into account**

# SALM and crisis situations

- **A SALM approach is vital during crisis periods characterized by highly volatile bond markets, fiscal dominance, and a sovereign balance sheet vulnerable to large shocks (e.g. via toxic links associated with banking crisis)**
- **By using a SALM approach, funding policies can be identified to insulate the fiscal/budgetary position against macro shocks**
- **SALM is closely related to the macroeconomic objectives of tax smoothing and budget stabilisation**

# Policy conclusions/implications (1)

1. **Macro-objectives of PDM? Is a new policy framework needed?**
2. **New division of  labour between CB and Treasury?**
3. **How to co-ordinate between CB and Treasury?**

# Policy conclusions/implications (2)

4. **What are the implications of (1), (2) and (3) for mandates of DMs?**
5. **Explicit links of PDM to MP or FS objectives?**
6. **Articulating an explicit link between PDM and medium-term fiscal policy objectives**
7. **During times of extreme market stress, the minimisation of borrowing costs objective should be (temporary) subordinate to financial stability considerations**

# Policy conclusions/implications (3)

8. **Do we need a policy framework for all official actions that affect the maturity structure of government debt for macroeconomic objectives?**
9. **Is it important that debt managers, central bankers, and also fiscal policymakers, seek a better common understanding of the objectives, functions and institutional arrangements for co-operation and co-ordination?**

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