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 lowering 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 traditionally 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

• Assumptions 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

<table>
<thead>
<tr>
<th>Net fiscal position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flows of the debt portfolio</td>
</tr>
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</table>

**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?
Selected references (1)


Selected references (2)