Closer coordination between debt policy and monetary policy?

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Points of reference

- One reason to avoid the zero lower bound in monetary policy – although not the foremost – is that the dividing line to debt policy tends to be blurred
  - When engaging in quantitative easing central banks do things that debt managers also can do

- One reason to avoid a debt level that puts sustainability in doubt – although not the foremost – is that monetary policy can be compromised and lose its ability to control inflation
  - Not convinced that fiscal dominance problems can be remedied by debt policy (defined as decisions on the composition of the debt)

- Will focus on issues related to the zero-lower bound and debt policy
The zero lower bound

- Monetary policy is conducted by setting the short-term interest rate at a level deemed consistent with price stability.
- Central banks (CBs) use this rate because they have a monopoly as the only provider of means of final payments.
- Quantities do not enter the decision – CBs (passively) provide the quantities needed to hit the interest rate target.
- But when deflation becomes a threat the desired real interest rate may be negative and the CB only controls the nominal short rate, which cannot fall (much) below zero.
- A responsible CB will then look for other instruments.
Additional monetary policy instrument

• A policy rate at zero need not translate into equally low medium- and long-term rates: What can be done?

• **Change expectations**: Signal future policy by presenting a time path with a very low policy (“forward guidance”)

• **Change quantities (“QE”)**:  
  • Lend to banks for longer periods at the current policy rate (ECB)  
  • Buy securities directly in the secondary market (Fed and BoE)

• The CB buys assets that it funds by borrowing the same amount from the private sector => **CB lending is sterilized**

• The effects of quantitative measures – if any – come from maturity or credit risk transformation
QE in government debt instrument

• When a CB buys bonds, they are replaced in private sector portfolios by short-term claims on the central bank

• Changes the maturity structure in the private agents’ claims on the government sector

• If private agents require a premium to hold long-term debt, a lower supply will lower long-term rates

• A lower yield on government bonds makes other assets look more attractive and other long-term interest rates are also lowered

• This stimulates demand and reduces deflationary tendencies – “Mission accomplished!” (we hope)
Enter the Debt Manager …

• Will debt management undo or mitigate the effects of QE so that the whole framework of debt policy must be revised?

• Theoretically it could, but as debt management is practiced it is not likely to be an issue

• One cause for concern is that when trying to affect long-term rates, the CB is not a monopolist – debt policy decisions influence the structure of the private sector’s claims on the government

• The key issue is whether this matters in practice
Enter the Debt Manager …

• The basis for concern is the perception that the standard cost minimization objective will make debt managers offset the effects of QE by issuing more long-term debt when rates are lowered.

• This perception is based on the view that debt managers behave like active asset managers, always on the lookout for favorable opportunities.

• But debt managers are much more boring!
Enter the Debt Manager …

• We may use a portfolio framework to assess fundamental cost and risk trade-offs in quantitative and qualitative terms.

• Such analyses inform decisions on the broad structure of the debt portfolio in terms of composition and maturities.

• For example, Sweden currently has these guidelines:

<table>
<thead>
<tr>
<th>Debt category</th>
<th>Debt share</th>
<th>Average maturity*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal debt</td>
<td>60 percent</td>
<td>2.7–3.2 years</td>
</tr>
<tr>
<td>Inflation-linked debt</td>
<td>25 percent</td>
<td>7–10 years</td>
</tr>
<tr>
<td>Foreign currency debt</td>
<td>15 percent</td>
<td>0.125 years</td>
</tr>
</tbody>
</table>

* Measured as average time to refixing

• Guidelines are decided annually by the Government, but changes are typically small.
Enter the Debt Manager …

• When it comes to actual borrowing decisions, the true key words are “Transparency” and “Predictability” (not cost minimization)

• Promotes bond issuance according to fixed patterns

• If the borrowing needs increase unexpectedly, issuance of short-term debt will rise, because it takes time to adjust bond issuance – not solely a response to lower short rates

• If the rise in the debt stock proves to be lasting, bond issuance will be increased to reduce refixing and refinancing risk – not solely a response to QE
The case against coordination

• If the debt managers is forced to abstain from increasing long-term debt, refixing and refinancing risks increase – not prudent:
  • Who takes responsibility if the downturn deepens and the state ends up in to a financing crisis?
  • What happens to the CB’s control of its balance sheet then? Will it be forced to finance the government directly to avoid default?

• Separation in the interest of the debt manager and the CB:
  • The debt manager can take responsibility for debt policy decisions, treating the CB as an investor among others
  • The CB decides independently on how much of the government debt it wants to have on its balance sheet based on its policy objective(s)
Targeting the long-term rate

• The CB controls the short-term rate by its ability to supply (or withdraw) any amount of reserves, i.e., claims on itself

• To target the long-term rate, the CB (or the debt manager) would similarly have to stand ready to buy (or sell) unlimited amounts of long-term debt instrument – is this feasible?

• Long rates could be targeted in Sweden in the early 1980s:
  • No bond market – government and mortgage bonds forced onto banks via quantitative regulation
  • Binding foreign exchange controls

• Not so today – no coincidence that QE measures are expressed in quantities, not in terms of interest rates
Conclusions

• Current economic and fiscal imbalances create tensions in many policy areas, but do not give grounds for a complete revision of the frameworks for monetary and debt policy, especially not in countries with stable public finances.

• What an alternative would look like remains unclear, but recall that all policy frameworks are second-best solutions.

• Will public debt problems bring back the era of quantitative monetary policy regulations?
  • The tendency to introduce special rules for sovereign debt in financial market regulations is a worrying sign.
  • Quantitative controls is a form of hidden taxation – at most a third-best outcome.