WORKSHOP 1- Is the crisis a call for closer coordination among monetary policy, fiscal policy and debt management?

International sound practice, summarized in the Guidelines for Public Debt Management, has always included coordination of debt management with monetary and fiscal policy. Such coordination recognizes the interdependencies between different policy instruments and the need for a consistent policy mix. While some argue that there is an approach to debt management in which funding decisions could be made solely on the basis of cost and risk considerations, in line with portfolio theory, in practice, debt managers usually coordinate with fiscal and monetary policy makers.

The Guidelines for Public Debt Management state, “Debt managers, fiscal policy advisors, and central bankers should share an understanding of the objectives of debt management, fiscal, and monetary policies given the interdependencies between their different policy instruments”. By understanding the way different policy instruments operate, policymakers can see their potential to reinforce one another, and also how policy tensions can arise. For instance, prudent debt management, fiscal and monetary policies can reinforce one another in helping to lower the risk premia in the structure of long-term interest rates. Conflicts can arise when central banks express their preferences for the use of foreign currency debt to bolster the credibility of monetary policy, while debt managers believe that this action introduces greater risk onto the government’s balance sheet. For this reason, the Guidelines recommend that coordination take place in the context of a clear macroeconomic framework.

With different policy objectives and different policy instruments, the Guidelines for Public Debt Management support the separation of debt management and monetary policy objectives and accountabilities. This separation helps clarify the roles and objectives for debt management and monetary policy, minimizing potential conflicts such as the perception that debt management decisions are influenced by inside information on interest rate decisions. In addition, separation of debt management and monetary policy objectives and accountabilities reduces the chances that a goal set by debt managers to minimize cost (given a prudent level of risk) could be viewed as a mandate to reduce interest rates by relaxing domestic monetary conditions.

Coordination among monetary policy, fiscal policy and debt management, according to the Guidelines, has policy and operational dimensions. The policy dimension refers to the objectives of each policy, the instruments used and the policy stance, as described above. The operational angle refers to information sharing, particularly on the government’s financing needs and debt service transactions. The former will become the debt manager’s funding target while the latter can have an impact on the government balances in the central bank and thus on the liquidity in the financial system. Operational coordination may also be required to ensure that the monetary authority and debt managers are not both operating in the same market segment at
The 2009 financial crisis presented challenges to the coordination of monetary policy and debt management. This came about as the monetary authority in some of the more advanced economies switched from operating in the front end of the yield curve to longer tenors, and in doing so, altered the composition of the government securities placed with the market which no longer reflected the targets of a debt management strategy. After the financial crisis, central banks faced the challenge of finding a transmission mechanism for expansionary monetary policies that could stimulate the pace of economic activity. With short-term interest rates already close to zero and a financial system unwilling or unable to lend to companies and households, some central banks intervened in the markets, buying long-term government securities to drive down long-term interest rates.

This session explored the relationship between debt management and monetary policy in a crisis environment. Philip Turner argues that this relationship should be reformulated and that central banks need to play an active role in the selection of the government funding programs because of monetary policy and financial stability reasons. For Mr. Horngren, the current framework laid out in the Guidelines is sufficiently robust to withstand the different approaches the monetary authority may take to fight deflationary forces.

For Mr. Turner, the market disturbances experienced after 2008 impaired the transmission channels of “conventional” monetary policy, forcing some central banks to intervene in the bond market. The limited ability to lower short-term rates combined with the reduced substitutability between short and long-term paper (as a result of market disturbances) led central banks to intervene and hold down long-term rates. Central banks had no other way to implement a monetary policy that could effectively stimulate economic activity and reverse a deflationary process.

The need for intervention will remain when economies recover and central banks move to tighten monetary policy. At that point, central banks might be unable to sell a substantial volume of bonds as this might cause a steep drop in bond prices, inflicting heavy losses on banks, pension funds and insurance companies. In this case, it could be argued that emergency bond purchases to calm markets could preserve financial stability.

Both situations question the rationale of an issuance policy that is designed independently from monetary policy. In effect, the government flooded the market with long-term paper in the first place, limiting the ability of the central bank to conduct monetary policy (which would have been more effective with a smaller stock of long-term bonds). This can be interpreted as a call for the central bank to “intervene” in the issuance program and the setting of long-term rates.

For Mr. Horngren, there is no need for “special” coordination between debt management and monetary policy during the contractionary part of the business cycle. The central bank is free to
use Quantitative Easing (QE) as a response to the zero lower bound problem, and no coordination is needed for deciding how much or what government bonds to buy. The central bank decision responds to a price stability objective. For their part, debt managers could continue handling their business as usual, taking care of refinancing risk and continuous access to funding markets more broadly. Given the capacity of the central banks to quickly expand their balance sheets there is no reason why the government issuance policy could be considered an obstacle for the central bank to attain its price stability objectives.

In addition, there is no reason for coordination during the exit phase of QE. Once the threat of deflation has disappeared and the central bank starts tightening policy, it will do so by raising the short-term policy rate. No central bank would start easing policy by engaging in QE while keeping the policy rate unchanged. Also, once the recovery is on course, public finances will improve, making it possible for the debt manager to accommodate a gradual reduction of the central bank’s bond holdings, either by outright sales of bonds or by just holding them to maturity.

Finally, another argument against the idea of the central bank setting the long term rate is that pegging a long-term interest rate could be unsustainable. Pegging the long-term rate above the prevailing market level could result in significant asset accumulation for the government (and/or the central bank).