

## GETTING FISCAL POLICY IN SHAPE TO SWING WITH MONETARY POLICY<sup>1</sup>



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### ABSTRACT

Since the outbreak and global spread of COVID-19, central banks and governments worldwide have provided massive stimulus to the economy. Looking ahead, however, the question rises whether monetary policy by central banks and fiscal policy by governments will be able to respond with the same vigour and effectiveness to future crises, given structurally low interest rates and higher government debt. This article takes a closer look at the different options to build back fiscal buffers. Do countries need forceful consolidation, can countries grow out of debt or should central banks simply cancel the debts? The analysis is two-fold. The first part empirically assesses the potential of some traditional avenues to bring public debt dynamics in Belgium under control. The second part is more conceptual, critically evaluating the rather heterodox proposal of cancelling government debt on the central bank balance sheet.

**When monetary policy is constrained, fiscal policy is likely to be more often called upon to actively support the economy**

If structural forces are to keep interest rates low, monetary policy's capacity to stimulate the economy through conventional and unconventional instruments appears limited going forward. This implies that – especially in the presence of large, negative shocks – fiscal policy may be more often called upon to aid monetary policy in macro-economic stabilization. Therefore, it is key that governments have sufficient buffers (i.e., fiscal space) to be able to implement countercyclical fiscal expansions when needed. While this does not seem to be a problem for countries with low public debt levels, countries with high and rising public debt ratios may run into debt (and consequently stimulus) constraints.

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<sup>1</sup> An extended version of the article was published in the June Economic Review of the NBB: [ecorevi2021\\_h3.pdf \(nbb.be\)](https://www.nbb.be/~/media/Files/Publications/Economic_Review/2021/06/06_corevi2021_h3.pdf).



As a result of the coronavirus crisis, debt-to-GDP ratios in all euro area countries have significantly increased, including in those where debt levels were already high. For instance, in seven Member States government debt exceeded 100% of GDP by the end of 2020, with Cyprus, Greece, Italy and Spain registering surges of between 21 and 25 percentage points. In Belgium, government debt jumped by 16 percentage points to 114% of GDP. Moreover, in some high debt countries, such as Belgium, upward debt dynamics are expected to persist also after the crisis. For high-debt countries, the potential to use countercyclical fiscal measures will to a large extent depend on their commitment to put government debt again on a downward trajectory going forward.

How can fiscal buffers be restored? We explore different options. We first evaluate the potential of low interest rates, higher economic growth rates, somewhat higher inflation and fiscal consolidation, respectively, to bring debt dynamics under control. Note that for all simulations Belgian data are used. In a final section we also critically assess whether the monetary authority could help a hand in reducing public debt by cancelling (part of) the public debt it holds on its balance sheet. In contrast to the Belgian debt dynamic simulations, the analysis here is conceptual. It uses simplified balance sheets to bring stylised insights, making abstraction of the complex institutional setting in the euro area as well as of specific accounting rules (the focus here is on the economic reasoning). In addition, the central bank explicitly enters the picture, forming, together with the government, the official sector

### **Debt dynamic simulations for Belgium**

Exploring the different options for restoring fiscal space requires a thorough understanding of the relevant parameters that impact the debt dynamics. In general, one can distinguish two broad factors behind the change in the ratio of debt over GDP in a given year: (i) the primary balance, and (ii) the 'interest-rate-growth differential'.

The primary balance is the difference between government revenues and primary expenditures (i.e., excluding interest payments), both expressed as a share of GDP. It is quite straightforward that a primary surplus has a downward impact on debt and hence on the debt to GDP ratio.

On the other hand, the impact of the interest-rate-growth differential on debt dynamics (also called the snowball effect) depends on the difference between the implicit interest rate on public debt and the nominal growth rate of GDP. This factor is favourable to debt dynamics if the implicit interest rate is lower than the nominal growth rate of the economy, as is currently the case. In that case the debt ratio automatically falls unless it is undone by relatively high primary deficits.



To explore the options for debt stabilisation and reduction, we develop a series of narrative scenarios for Belgian debt over the 2021-2030 horizon. We do this by mechanically changing the values of the variables determining the debt dynamics equation (the primary balance, the real GDP growth rate, the real implicit interest rate and inflation, respectively).

### **Is fiscal consolidation needed to stabilise the debt ratio? And if so, how much?**

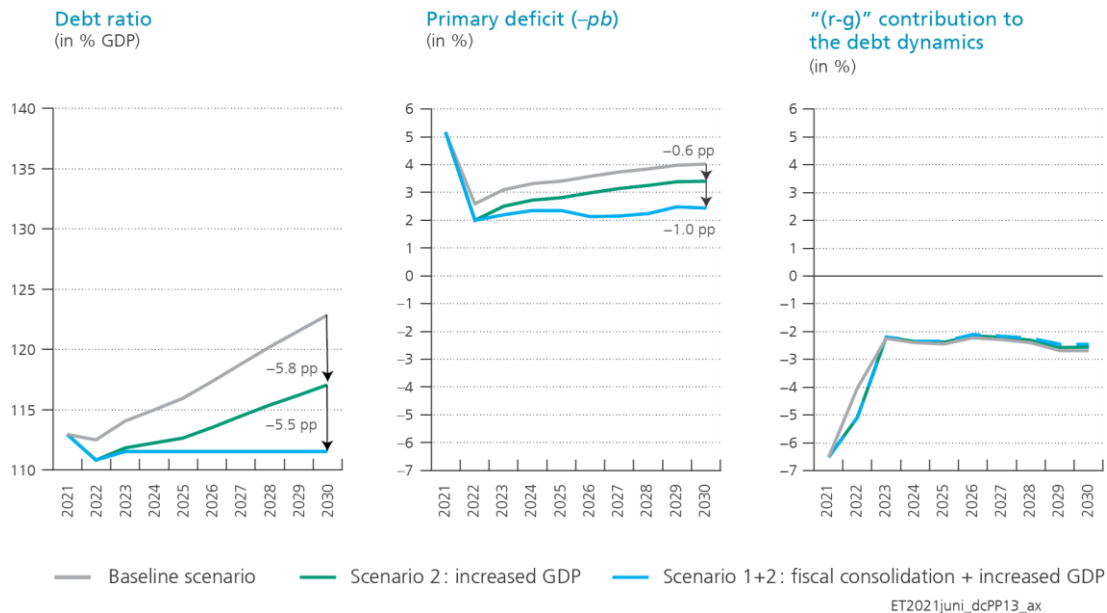
Our baseline scenario is based on the June 2021 NBB macroeconomic projections (published in the June issue of the NBB's Economic Review) which cover the period up to 2023. For the subsequent period, the baseline factors in population ageing costs and GDP developments as estimated in the Study Committee on Ageing's July 2020 report. This scenario is characterised by a very favourable interest-rate-growth differential that is more than compensated by large primary deficits, such that the government debt ratio would steadily rise to 123% of GDP by 2030<sup>2</sup> (see grey line in chart 1). The baseline scenario thus illustrates that despite the historically favourable interest-rate-growth differential, at unchanged policy, the Belgian government fails in bringing down or even stabilising the debt ratio.

A first scenario investigates how much the primary balance needs to improve, compared to the baseline, to stabilise the debt ratio from 2023 onwards. It shows that a consolidation effort of at least 1.5% of GDP is required just to stop the Belgian debt ratio from rising. This scenario of debt stabilisation can be considered as a minimum condition for keeping debt sustainability under control.

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<sup>2</sup> The baseline scenario is described in more detail in the article.

**Chart 1 - Fiscal consolidation is needed to stabilise the debt ratio, increased economic activity can help to alleviate the budgetary effort.**



Source: NBB.

Of course, the reduction in the debt ratio can also be facilitated by the macro-economic environment.

In a second scenario, we therefore assess to what extent an exogenous increase in Belgian economic activity could help alleviate the consolidation effort necessary to stabilise the debt ratio. Note that a higher GDP level would have a downward impact on the debt ratio via a temporary improvement in the interest-rate-growth differential, and via the permanent downward shift of the primary deficit. In our mechanical model a permanent increase in the level of economic output by one percentage point in 2022 compared to the baseline translates into a permanent improvement of the primary balance of 0.62% of GDP. Under these macroeconomic conditions, the consolidation effort required to stabilise debt is reduced by more than one third compared to the first scenario. Indeed, structural policies that increase economic activity, either by raising labour market participation or propping up productivity, also play an important role for debt sustainability.

### What if financial markets question sovereign debt sustainability?

The third scenario tests the implications for Belgian public debt if financial markets lose confidence in public finances. It assumes an exogenous increase in the risk premium of three percentage points from 2022 onwards compared to the baseline<sup>3</sup> (see orange line in chart 2). In this setting, the favourable interest-rate-growth differential fades, and the reverse snowball comes to a halt little by little. Note that the increase in the implicit interest rate occurs only very gradually, compared to the sudden rise in the market interest rate. This is because of the relatively long average maturity of public debt in Belgium, which currently stands at around ten years. This implies that, on average, only one tenth of public debt is re-financed every year at the new market conditions.

This scenario demonstrates the importance of keeping the trust of financial markets and illustrates the adverse consequences of not shoring up public finances with structural measures. It also shows that thanks to the lengthening of the debt maturity in Belgium (from six years on average in 2009 to ten years now), the financing implications of a sudden increase in risk premia would be buffered, giving the government additional time to take necessary action. At the same time, this scenario also indicates what would happen if the historically favourable financing conditions disappear. Note that the mechanical debt simulation should be seen as a lower bound of the likely impact of a higher risk premium, because other spillovers are not considered. For instance, a sharp increase in the risk premium would have negative implications for the real economy because of the loss of confidence among economic agents and tightening credit conditions. This would further aggravate the situation.

### Can higher inflation bring public debt back onto a sustainable path?

A fourth scenario analyses the impact of inflation on debt sustainability (green line in chart 2). As increased inflation reduces the real value of outstanding debt, it is often seen as one of the factors that can contribute to the alleviation of debt sustainability concerns. In a high-inflation scenario we assume inflation to rise to 2.5% from 2024 onwards, which would allow to steadily make up for the low inflation in the recent past. This contrasts with the baseline scenario where inflation remains at 2% as of 2024.

A crucial issue in this scenario is what happens to the nominal – and consequently real – interest rate. We assume in both scenario's that the real market interest rate is kept constant compared to the baseline scenario, meaning that the change in inflation is fully

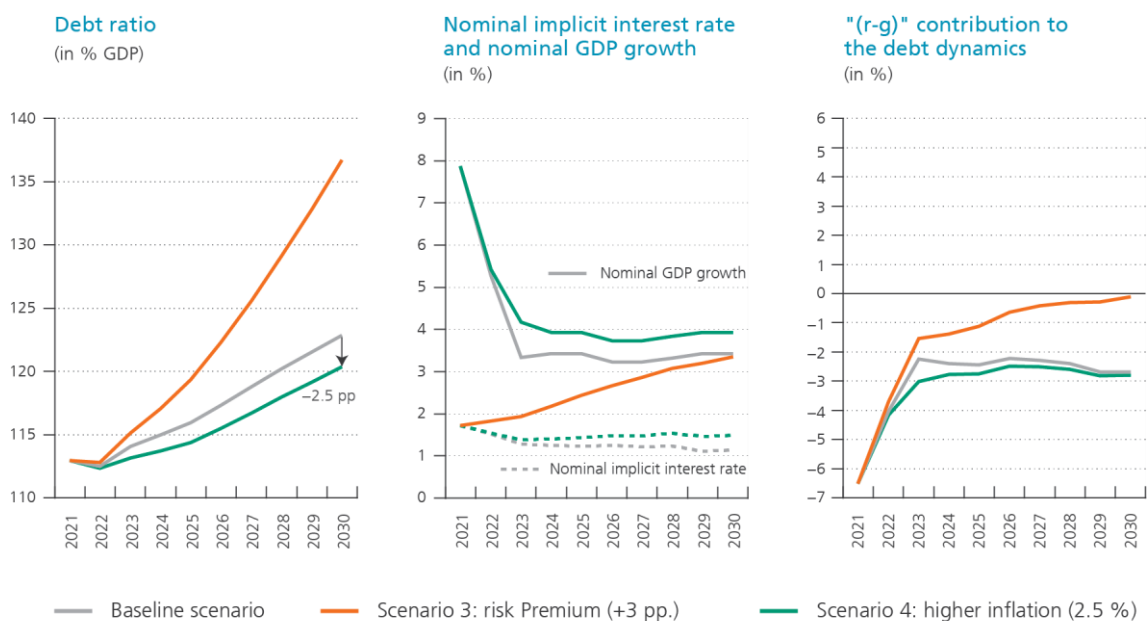
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<sup>3</sup> The three percentage points corresponds to the spread of Belgian ten-year linear bonds vis-à-vis the German Bund end November 2011, in the midst of the sovereign debt crisis.

translated into a change in the nominal market interest rate. Further, we hypothesize that the inflation shock is exogenous (i.e. it does not stem from a change in GDP growth or the output gap vis-à-vis the baseline), and is euro area wide, which warrants a monetary policy reaction by the ECB.

The favourable debt dynamics in the high-inflation scenario originate from a temporary improvement in the interest-rate-growth differential: the nominal growth rate increases immediately due to the higher inflation whereas the nominal implicit interest rate is only gradually affected, as public debt is refinanced little by little over the simulation horizon. All in all, the effect seems limited and not large enough to significantly reverse the unfavourable debt dynamics, though.

**Chart 2 - Public debt is highly sensitive to financial markets evaluation of debt sustainability. Higher inflation can help to slow down the increase in the public debt ratio.**



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Source: NBB.

Note that in our simulation market interest rates react one-to-one to inflation. Where monetary policy to be more accommodative, market interest rates would increase by less than the increase in inflation, and the debt-reducing impact would be higher. The opposite would hold if monetary policy were more restrictive than in the baseline. Moreover, the

debt-reducing impact of higher inflation is greater, the longer the average maturity of public debt. With an average maturity of ten years in Belgium, it takes on average ten years until the increased market interest rate fully translates in the implicit interest rate.

### Can debt cancellation by the central bank create fiscal space faster?

The simulations above illustrated that to bring debt structurally on a sustainable path, fiscal consolidation efforts and/or structural reforms that increase economic activity are key. Both options probably require difficult political choices. Another proposal that has recently gained momentum sees an easier way out: the central bank can immediately, drastically and supposedly painlessly solve the problem, namely by cancelling the government bonds that ended upon its balance sheet via asset purchase programmes<sup>4</sup>. Upon closer examination, the proposal does not appear to be a promising option to pursue, though.

To see this, it is useful to take a step back, to when the central bank acquired the government debt. Under its asset purchase programmes (panel B in chart 3), the central bank buys government bonds from the private sector and finances these purchases by issuing central bank reserves<sup>5</sup>. The private sector now holds longer-term government bonds and short-term central bank reserves and earns interest on both. The central bank also receives interest on the government bonds it holds but it transfers its profits (i.e., the difference between interest earned on assets and interest paid on liabilities in our simple example) back to the government.<sup>6</sup>

As asset purchases are a temporary policy, they will – at some point in the future, depending upon the economic recovery and, in particular, the inflation outlook – come to a halt and be followed by a phasing out of the reinvestment of matured bonds. Panel C depicts the end result of what in practice will be a very slow process: the unwinding of asset purchases. In

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<sup>4</sup> See the open letter “Cancel the public debt held by the ECB and “take back control” of our destiny” published on 5 February 2021 in several newspapers.

<sup>5</sup> In practice, the Eurosystem buys government bonds from the banking sector – which sells the bonds it has on its balance sheet or acts as an intermediary selling the bonds of its clients – and issues central bank reserves in return, which can only be held by the banking sector.

<sup>6</sup> Two refinements should be added here, though. First, the central bank might reserve part of its profits before distributing them to the government. That is because the central bank risks incurring losses on these bonds, which could threaten its financial independence. The recycling of interest payments is thus not perfect from the point of view of the government, but it is when considering the official sector as a whole. Note that the lower central bank dividends are offset by a larger central bank capital base which benefits the shareholders, most often the government. However, and secondly, some central banks, including the NBB, also have private shareholders, which entails that the recycling of interest payments will not be perfect.



the example, the government repays the maturing bonds on the central bank balance sheet through refinancing, with the new bonds being bought by the private sector. Consequently, the government bonds on the central bank's assets side disappear as do the central bank reserves on the liabilities side, because the government extracts resources from the private sector to finance its debt rollover. As a result, each agent's balance sheet has returned to the situation prior to the central bank buying assets (panel A = panel C). The private sector again only holds government bonds and no central bank reserves.

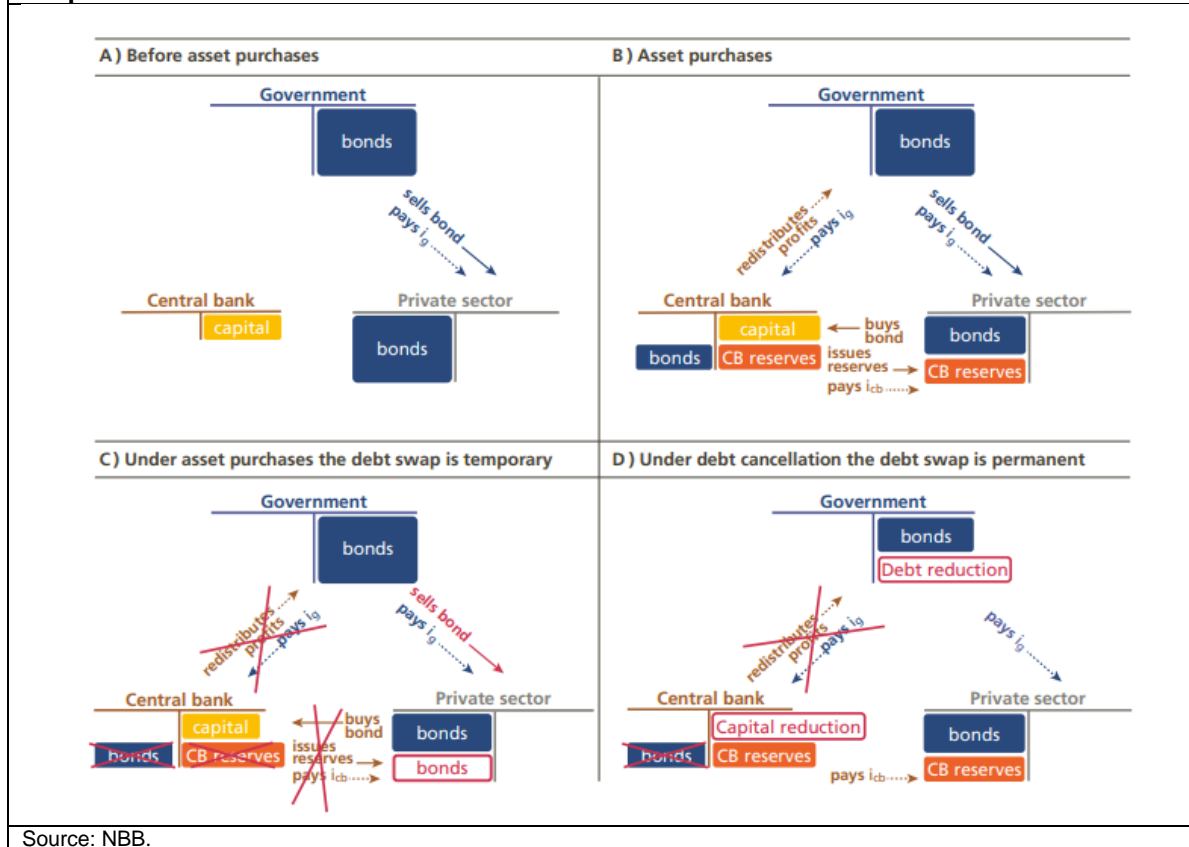
Under debt cancellation (panel D), the repayment to the central bank never happens and the swap of long-term government debt for short-term central bank debt will be permanent. Importantly, compared to central bank asset purchases, debt cancellation does not bring additional financial gains, as it leaves unchanged the stock and maturity structure of interest-bearing official debt in private hands, and hence interest payments to the private sector.

Indeed, debt cancellation does not reduce the stock of interest-bearing debt of the official sector (covering both the government and the central bank) held by the private sector. When the central bank cancels the government bonds on its balance sheet, government debt indeed falls, but the central bank reserves that were issued to finance the purchase of government bonds do not. At the same time, the capital position of the central bank deteriorates.

In addition, from a financial flow perspective, central bank asset purchases already lower debt servicing costs of the official sector; debt cancellation does not bring additional interest cost savings. Under central bank asset purchases, higher-yielding long-term government bonds are swapped for lower-yielding short-term central bank debt (i.e. reserves), lowering the official sector's interest payments to the private sector. The steeper the yield curve, the more significant the interest cost savings are. Under debt cancellation, the circular payments of interests and dividends within the official sector would be halted but this yields little benefits for the official sector as a whole. The central bank would keep paying the interest on central bank reserves to the private sector while no longer receiving interest on government bonds. Hence, the government is likely to receive lower profits from a central bank (that is also restoring its capital position), compensating any benefits from no longer having to service government bonds. Permanently financing a part of the official debt at the interest rate on central bank reserves instead of at the interest rate on government bonds, yields little benefits when the yield curve is flat (as currently is the case). Note that the larger share of short-term funding in the official funding mix, makes official debt more sensitive to central bank interest rate increases.



**Chart 3 - Central bank asset purchases versus debt cancellation: an illustration using simplified balance sheets.**



There are also other counterarguments such as the illegality of debt cancellation, the lack of urgency for an immediate and drastic reduction in government debt in the current economic environment, and the risk that debt cancellation damages the credibility of the official sector. Taking into account the lack of economic benefits and the many risks, the debt cancellation proposal does thus not appear to be a promising option to pursue.

**All in all, a combination of orthodox policies will be needed to bring high public debt ratios on a sustainable path**

Once the crisis mode is behind us, it is important to restore stretched policy space implying that the fiscal authority focuses on debt sustainability, allowing monetary policy to continue focusing on its mandate of price stability. By credibly committing to their respective objectives, monetary and fiscal policies will be best equipped to tackle future challenges that may emerge in bad times (consider, for instance, extreme shocks hitting the economy in a



lower bound environment) as well as in good times (consider, for instance, normalizing policy rates in a high debt environment).

The article has focused on restoring fiscal space in countries with high and rising government debt levels. The simulations for Belgium illustrated that current monetary policy – in pursuing its price stability mandate – contributes positively to government debt dynamics. More specifically, the current low interest rate policy creates favourable conditions for stabilizing debt dynamics while an inflation rate closer to the price stability objective would further benefit fiscal positions. However, they do not suffice to bring Belgian public debt on a downward trajectory. Moreover, current financing conditions may (suddenly) turn and the gains from increased inflation are to be considered as only temporary within the central bank's mandate. Consequently, a structural healing of public finances calls for fiscal efforts and economic reforms by the government. In contrast, resorting to magic tricks, like cancelling the government debt on the central bank balance sheet, is not necessary nor useful.