EDITORIAL

QE FOREVER: ON THE SLIPPERY SLOPE TOWARDS FISCAL DOMINANCE?

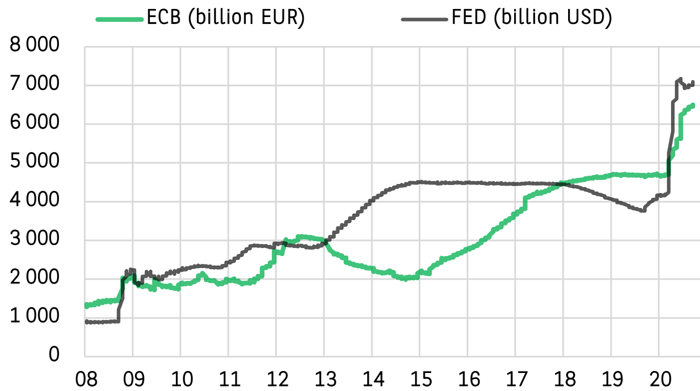
Declining effectiveness of monetary policy and increased fiscal policy space make the case for increased public debt issuance in combination with quantitative easing to boost growth. There is concern that such policy coordination would lead to fiscal dominance whereby monetary policy is dictated by considerations in terms of public finances to maintain public debt sustainability. Once the pandemic will be behind us, governments will have the responsibility to improve their public finances. Inaction in this respect would put the burden on the ECB when fighting future downturns. It would be a different type of fiscal dominance.

Considering that policy rates are close to or, in some cases even below, zero, asset purchase programmes, commonly called quantitative easing, have become a crucial instrument in the toolkit of central banks. It will probably remain like that for many years to come because it seems unlikely that inflation would reach a sufficient level in a sustained way so as to move official interest rates far away from zero. Another reason is of course the low level of the natural rate of interest, the real short-term rate whereby inflation is stable and in line with the central bank's target. There is a concern though that the effect of additional asset purchases on activity and demand declines over time and simply ends up creating excess liquidity in the economy[1]. Low interest rates have another consequence. They create fiscal space, i.e. the possibility for governments to boost growth considering that the cost of borrowing has become very low and has dropped below the expected nominal growth rate of GDP[2]. Declining effectiveness of monetary policy and increased fiscal policy space make the case for increased public debt issuance in combination with quantitative easing to boost growth. In doing so, it also increases the chances that the central bank will reach its inflation target.

Although appealing in theory, there is concern that such policy coordination puts us on the slippery slope towards fiscal dominance. This refers to a situation whereby the conduct of monetary policy is dictated by considerations in terms of public finances to maintain public debt sustainability. Some argue that interest rate hikes, deemed necessary based on inflation developments, would be postponed because they would increase the borrowing cost of the public sector and cause mark-to-market losses on the government bonds on the central bank's balance sheet. Fiscal dominance would imply that the central bank loses its credibility and, de facto, its independence.

Recent speeches have poured cold water on this view that we are moving towards fiscal dominance. Ben Broadbent, deputy governor monetary policy at the Bank of England, argues that, in reacting to the pandemic, monetary and fiscal policy have reacted in parallel by respectively addressing the disinflationary pressure and the blow suffered by households and companies[3]. In the euro area, fiscal dominance concerns come in two guises. The first is the inflationary consequences of QE. The fear is that QE would be continued for too long, to facilitate the financing of budget deficits. However, given its mandate, the definition of its inflation objective and the policy guidance[4], the fear

CENTRAL BANK BALANCE SHEET



SOURCE: ECB, FEDERAL RESERVE, BNP PARIBAS

1. Excess liquidity refers to the build-up of excess reserves of the banking system. Under a QE programme, a central bank buys assets from the banking system, which acts as an intermediary between the central bank and the end investors. The accounts of the banking system with the central bank are credited –giving rise to the creation of excess reserves- and the bank accounts of investors who have sold their assets to the central bank are credited with the equivalent amount.

2. In the policy debate, this is often referred to as a situation whereby $r < g$ with r = average nominal interest rate on the stock of government debt and g = nominal GDP growth. When $r < g$, governments can run a primary deficit –the budget imbalance excluding interest charges- whilst the public debt/GDP ratio would be stable or even decline

3. *"Government debt and inflation"*, speech given by Ben Broadbent, Deputy Governor Monetary Policy, 2020 Annual Meeting of the Central Bank Research Association, 2 September 2020

4. *"Net purchases under our asset purchase programme (APP) will continue at a monthly pace of €20 billion, together with the purchases under the additional €120 billion temporary envelope until the end of the year. We continue to expect monthly net asset purchases under the APP to run for as long as necessary to reinforce the accommodative impact of our policy rates, and to end shortly before we start raising the key ECB interest rates."* (Source: ECB, Introductory statement to the press conference of Christine Lagarde and Luis de Guindos, 10 September 2020).

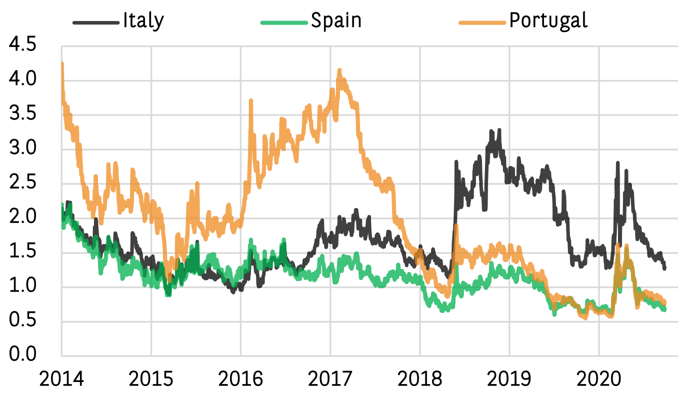
Once the pandemic will be behind us, governments will have the responsibility to improve their public finances. Inaction in this respect would put the burden on the ECB when fighting future downturns. It would be a different type of fiscal dominance.

that QE would continue when it is no longer warranted for monetary reasons, is without ground.

Moreover, should the ECB create a surprise by extending QE whilst inflation has moved beyond target, bond yields would rise anyhow. There is little that the central bank could do to avoid this. The second worry is that purchases of government securities would reduce fiscal discipline, in particular of highly-indebted euro area countries. Thanks to the asset purchase programme and the pandemic emergency purchase programme, spreads have narrowed. However, these interventions serve a monetary purpose by creating an environment that maximises the likelihood that inflation converges to the target. Avoiding market dysfunctioning is key in this respect. This point was emphasised in a recent speech of Isabel Schnabel[5] : *"when yields are largely reflections of panic rather than fundamental factors, risks of moral hazard are negligible and should not prevent the central bank from acting forcefully"*. On the other hand, her comment that *"debt levels remaining too high for too long will hurt growth and make the euro area more vulnerable"* reflect a concern that future recessions could lead to renewed market turbulence and force intervention by the ECB. Once the pandemic will be behind us, governments will have the responsibility to improve their public finances. It will provide them with policy leeway when economic conditions are difficult. Inaction in this respect would put the burden on the ECB when fighting future downturns. It would be a different type of fiscal dominance.

William De Vijlder

GOVERNMENT BOND, 10-YEAR SPREAD VS BUND, %



SOURCE: REFINITIV, BNP PARIBAS

5. *"The shadow of fiscal dominance: Misconceptions, perceptions and perspectives"*, Speech by Isabel Schnabel, Member of the Executive Board of the ECB, at the Centre for European Reform and the Eurofi Financial Forum on *"Is the current ECB monetary policy doing more harm than good and what are the alternatives?"*, Berlin, 11 September 2020