THE NEXUS BETWEEN PRICE STABILITY, FINANCIAL STABILITY AND FISCAL SUSTAINABILITY (PART 1).

Price stability, financial stability and fiscal sustainability are part of the necessary conditions for the balanced development of an economy in the longer run. They can be considered as pillars on which the 'economic house' is built. Weakness or fragility of one pillar -e.g. inflation well above target, overvalued asset prices or a high and rising public debt ratio - may impact the solidity of the other pillars and weaken the overall structure. This gives rise to a debate about the nexus between these three conditions. Given these interactions, it is important that each policy -monetary, fiscal, financial stability oriented- is conducted in a way that takes into account its influence on the other objectives. This should enhance overall economic stability.

Price stability, financial stability and fiscal sustainability are part of the necessary conditions for the balanced development of an economy in the longer run[1].

Price stability corresponds to a rate of inflation that on a sustained basis is in line with the objective of the central bank. The definition of financial stability is more complex. According to the IMF, it refers to the ability of the financial system to perform three tasks. Firstly, facilitating an *"efficient allocation of economic resources –both spatially and especially intertemporally– and the effectiveness of other economic processes (such as wealth accumulation, economic growth, and ultimately social prosperity)"*. Secondly, assessing, pricing, allocating and managing financial risks. Thirdly, maintaining *"its ability to perform these key functions –even when affected by external shocks or by a buildup of imbalances– primarily through self-corrective mechanisms."*[2]

Finally, fiscal sustainability can be associated with a stable public debt-to-GDP ratio. However, other aspects should also be taken into account: the ratio of debt service to fiscal revenues, the foreign currency share of foreign debt, the sensitivity of debt dynamics to interest rate and growth shocks, the expected impact of population ageing on health care expenditures and pension payments, etc.[3]

Price stability, financial stability and fiscal sustainability can be considered as pillars on which the 'economic house' is built. Continuing with this metaphor, weakness or fragility of one pillar -e.g. inflation well above target, overvalued asset prices or a high and rising public debt ratio- may impact the solidity of the other pillars and weaken the overall structure. This gives rise to a debate about the nexus between these three conditions (*see exhibit*).

The recent events that have impacted a limited number of small and midsized regional banks in the United States have fueled the debate whether central banks are facing a tradeoff between the pursuit of price stability and safeguarding financial stability.

PRICE STABILITY, FINANCIAL STABILITY AND FISCAL SUSTAINABILITY

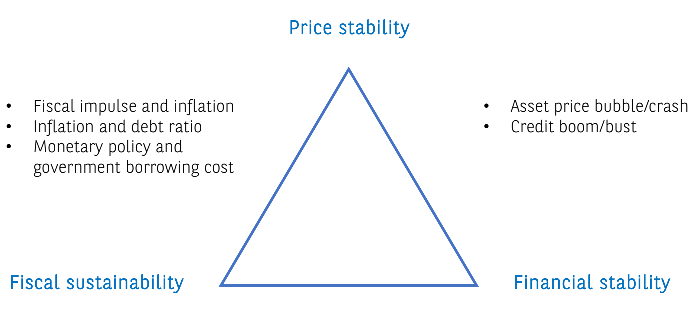

EXHIBIT 1

SOURCE : BNP PARIBAS

The argument of a tradeoff states that a very accommodative monetary policy eventually causes financial imbalances such as excessive borrowing to finance projects, the use of leverage for financial investments, the compression of risk premia, expensive valuations and financial markets being 'priced for perfection'. When monetary policy becomes restrictive, certain projects may become unprofitable and financial markets generally enter a phase of decompression of risk premia.

Such developments are an integral part of monetary transmission, but they nevertheless give rise to concern that, in the end, the adjustment could become disorderly, which is why both the Federal Reserve and the ECB have recently insisted on the data-dependent nature of their monetary policy and on the fact that they have specific tools -liquidity provision- should the risk of financial instability increase.

1 The list of conditions is longer and includes full employment, a sustainable balance of payments, inclusive growth, growth that is sustainable from an environmental perspective, etc. In this respect, one should also refer to the United Nations' sustainable development goals.
2 Source: IMF, Defining financial stability, working paper 04/187, 2004.
3 In this respect, see: Eduardo Levy Yeyati and Federico Sturzenegger, A balance sheet approach to fiscal sustainability, VoxEU column, 24 March 2023.

When the conduct of each policy -monetary, fiscal, macroprudential- takes into account the stance of the other policies and its influence on the other objectives, overall economic stability should benefit.

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Moreover, they argue that these tools can be deployed without interfering with the conduct of monetary policy.[4]

Turning to the nexus between price stability and fiscal sustainability, an ill-timed fiscal expansion can complicate the central bank's task of reaching price stability. The other way around, monetary policy can make reaching fiscal sustainability easier or more difficult depending on whether policy is accommodative or restrictive.

Finally, fiscal sustainability and financial stability are also tied to each other. On the one hand, mounting concerns about the risk of a deterioration of government finances can impact the economy via financial markets -rising government bond yields, which pull along the cost of financing of the private sector- and the bank credit channel.[5] On the other hand, financial instability can necessitate government intervention -e.g. through deposit insurance, measures to support the economy in general, etc.- that causes a deterioration in public finances.[6]

Given the interactions between the three 'pillars', it is important that the conduct of each policy -monetary, fiscal, macroprudential[7]- takes into account the stance of the other policies and its influence on the other objectives. To illustrate this point, the transmission of monetary tightening will be different during an asset price and/or credit boom, which may reflect excessively optimistic expectations about the growth outlook. Initially this may limit the effect of rate hikes but when the expectations turn gloomy, the reaction of economic agents may be very strong.

The central bank will need to take this into account when hiking its policy rate. Likewise, fiscal policy decisions will be influenced by the interest rate environment and outlook. By adopting this broader perspective, overall economic stability should benefit.

William De Vijlder

4 For a more detailed analysis, see Hélène Baudchon and William De Vijlder, A tool for each target, or how to reconcile price stability and financial stability, EcoPerspectives, BNP Paribas, 4 April 2023.
5 Rising sovereign yields may increase the cost of funding of banks. Worsening public finances may directly or indirectly influence the lending policy of banks.
6 For a detailed discussion, see Claudio Borio, Marc Farag and Fabrizio Zampolli, Tackling the fiscal policy-financial stability nexus, BIS Working Papers, No 1090, April 2023..
7 Financial stability is primarily pursued through macroprudential policy (source: The role of financial stability in the ECB's new monetary policy strategy, Financial Stability Review, November 2021).