The risky game of "chicken" between Eurozone governments and the ECB

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What's the proper exit strategy from the crisis? This column says the key question is how to coordinate the withdrawal of fiscal stimulus and accommodative monetary policy. It recommends that Eurozone governments commit to future spending cuts so that they do not undermine the efforts of the European Central Bank.

The discussion on whether exit strategies should be coordinated has so far considered the exit from fiscal stimulus programmes. Should each country go on its own, or is it worth coordinating?

This is not the interesting question. Fiscal coordination was important during the crisis, when countries had the incentive to do nothing and wait for the demand spillovers produced by the stimulus programmes of their neighbours – and some, like Italy, did just that. But the way back will be infinitely slower – not a matter of weeks, as it was last year when the stimulus programmes were being put in place, but a matter of years. When the horizon lengthens, spillovers become less important.

The real coordination needed: Eurozone fiscal and monetary policy authorities

There is a need for coordination, but not amongst countries. The importance of coordination is urgent when it comes to fiscal and monetary authorities, especially in the Eurozone. It is obvious that at some point both monetary and fiscal policy should be reined in, but the issue is one of sequencing. Should central banks start thinking about rescinding their exceptional monetary accommodation, or should governments start cutting deficits?

I mention the Eurozone because this is where the issues have been tabled first. The ECB has explicitly linked fiscal retrenchment and its exit from the recent extraordinary monetary accommodation. ECB Board member Lorenzo Bini Smaghi said on 11 September 2009:

"The more delayed the fiscal exit, *ceteris paribus*, the more the monetary policy exit might have to be brought forward. Indeed, given the level of the debt accumulated in most advanced economies, any delay in the fiscal exit is likely to have an effect on inflation expectations, and may even disanchor them. This is a risk that monetary policy cannot take, as it would undermine its overall strategy." (Bini Smaghi 2009).

Incentives to postpone

Both governments and central banks have good arguments for postponement. The balance sheets of financial institutions are far from being fully repaired. Nobody really knows what would happen if the floodgates were closed and liquidity stopped flowing – and central banks certainly don't want to find out by running an experiment. Moreover, banks, flush with cash but still unwilling to lend, are taking advantage of the yield curve to borrow short and lend long, especially to governments. An abrupt increase in long-term rates risks turning these carry trades sour. On the other front, we don't know to what extent the recovery that seems to have started is simply the result of the stimulus programmes starting to kick in. This makes governments understandably reluctant to cut spending or raise taxes.

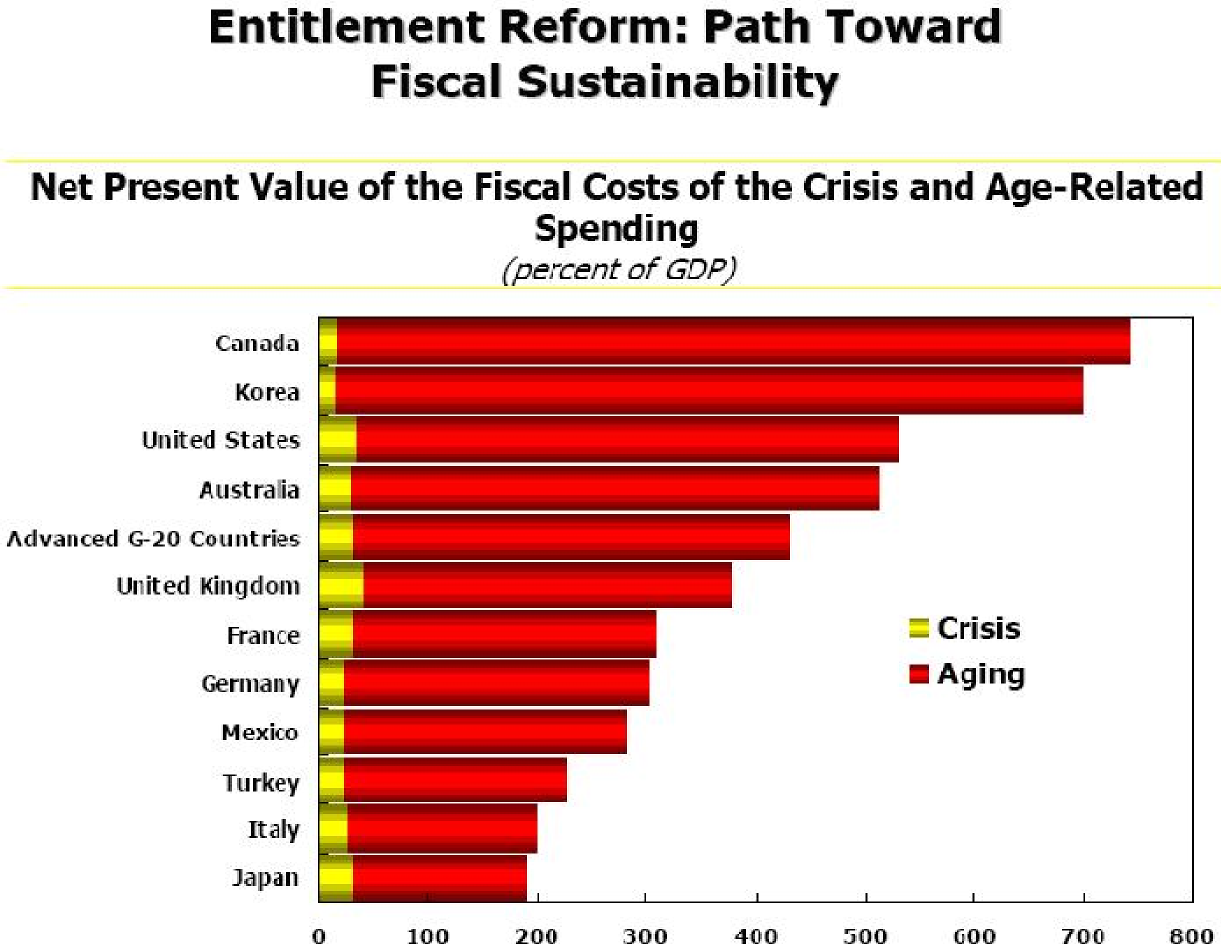
Game of chicken

In the classic game of chicken, one possibility is that neither player yields to the other, resulting in the worst outcome for both. In the case at hand, this would entail an increase in long-term interest rates resulting from a combination of fear of persistent deficits creating large debts, fear of inflation from persistent monetary accommodation, or simply from the anticipation that central banks will move first and rather early. This is a sure way to kill the recovery. Is there a way out?

The answer is an irrevocable commitment by governments to cut spending in the future. Such a commitment would stabilise expectations and allow central banks to wait longer before they remove their monetary accommodation. At the same time, it would avoid the demand risks that an immediate removal of the fiscal stimulus would impose.

Although such commitment may be difficult to achieve, there are arguably means of making spending reversals credible *ex ante*. The prime examples can be found in the area of ageing-related spending. *The 2009 Ageing Report* issued by the European Commission shows that in some EU countries the budgetary effects of the projected demographic trends are much larger than the cost of any stimulus package. The estimated increase in ageing-related spending over the next 15 years amounts to 7% of GDP per year in Holland, 5% in Spain, 3.5% in Germany, and 3.3% in the EU27. The fact that the budgetary effects of ageing are several orders of magnitude larger than the fiscal cost of the crisis is another reason to start addressing the problem now.

Figure 1. The fiscal costs of the crisis compared to age-related spending



Source: IMF

Conclusions

While feasible, such reforms need to be carefully planned and require time to be approved; work should thus start now – also bearing in mind that ageing-related fiscal adjustment is necessary regardless of the current conditions. (This is also the suggestion that comes from the IMF (2009): "successful fiscal adjustment to ensure that debt returns to sustainable positions will hinge on measures to contain aging-related spending, for countries with looming demographic pressures.")

Thus monetary and fiscal authorities face the choice from where to start. Should monetary accommodation be removed first, or should we start from fiscal policy? Absent a credible fiscal exit strategy, long rates could soon increase as financial markets start anticipating the response of central banks to the lack of action on the fiscal front. The increase in long rates would depress consumption and investment and prevent internal rebalancing. A clear commitment to future spending cuts is a smart way to allow central banks to maintain an accommodative policy for some more time.

References

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