Discuss the interactions between Public Debt Management and Monetary Policy

Focus on specific approach:
- Fiscal Insurance Theory

Two case studies:
- Interaction between debt denomination and monetary regime.
- Potential policy conflicts between monetary policy and the Fiscal insurance approach to PDM in different regimes.
The Fiscal Insurance Approach

- **Fiscal Insurance Approach**
  The debt should be structured to provide insurance against shocks to the budget: Pay low returns when government needs are unexpectedly high because of high spending or low output.

**Macroeconomics Goals:**
- Minimize tax distortions
- Stabilize the debt and prevent crises
- Favor countercyclical fiscal policy
- Take risk away from taxpayers
The macroeconomics of PDM

- PDM is inseparable from fiscal policy and should not be confined to micro portfolio optimization

Questions:
- How does PDM interact with monetary policy?
- Do conflicts arise with monetary policy?

To answer, think of what Gov’ts should issue:
- Domestic currency debt
- Long maturity debt (see below)
- ? Conventional vs. inflation-indexed bonds
The choice of the monetary regime: An example of interaction

Foreign currency debt – Fixed exchange regime

- Debt in foreign currencies is worst
- Though cheaper, it is the riskiest: Sudden stops and crises are characterized by devaluations and output contractions.
- No need for models: There is substantial evidence and huge literature
Interaction with monetary policy

Conventional wisdom:
- FC debt is cheap $\rightarrow$ issue more $\rightarrow$
  $\rightarrow$ ‘fear of floating’ $\rightarrow$ fixed exchange rate

But also:
Issuing domestic currency debt undermines the credibility of the peg:
- Fixed exchange rate $\rightarrow$ more FC debt

FC debt and Fixed exchange regime are the outcome of a bad equilibrium
Redemption from original sin

- Redemption from original sin – i.e. issuance of domestic-currency debt – requires:
  - Development of domestic markets;
  - Inflation targeting;
  - CB independence.

Progress has been substantial over the past 15 years
Some OECD countries faced a similar problem in the 1980s

- A few countries featured short-term debt and non-independent CB as part of same equilibrium
PDM and monetary interaction

- PDM does interact with monetary policy.
- Potential conflicts are heightened by ‘activism’ in debt management to minimize cost.
- Fiscal insurance argues for an hedging debt structure to minimize budget risk subject to acceptable costs.
- PDM should pursue this objective irrespective of market conditions.
- Potential conflicts with monetary policy are minimized.
DMOs should not react to market conditions and minimize costs.

- DMOs should not try to beat the market:
  - No better information than the market.
  - Otherwise, you turn the market against yourself (a reason for separation from Monetary Policy).

- DMOs should not react to perverse incentives due to evaluation based on national accounts – interests
  - Issuing short-term debt with upward sloping yield curves increases vulnerability to future shocks.
  - Unconventional swaps are fraud and lower transparency may result in higher premia asked by investors.
DMOs should not issue instruments with lower risk premia

- DMOs should not exploit lower risk premia if high risk premia reflect a fair price for insurance
  - Insurance to debt holders is either undone by higher taxes in bad times or shifts risk to taxpayers or to future generations.

- Cost minimization is however justified in cases of
  - Liquidity premia – e.g. GDP-indexed bonds
  - Credibility problems – e.g. expected inflation
  - Mispricing
The argument in the Fiscal insurance literature:

- Long-term debt is a hedge against government spending shocks: as interest rates rise the value of debt falls and the more so the longer its maturity. (Long is also better for energy-price and wage supply shocks if the CB reacts with high rates.)

Though procyclical interest rates (e.g. productivity shocks) favor short-term debt.
Why long maturity is better

- Interest rates display strong international co-movements; they are determined by international ‘appetite’ for risk, global fiscal factors or default risk.

This suggests **more relevant reasons for a long maturity structure:**

- Immunizes budget from interest-rate shocks;
- Reduces the risk of crises and risk of default;
- Enhances financial stability (a sustainable debt is crucial to enable the gov’t stand a banking crisis).
Does a long maturity debt interfere with monetary policy?

- **No conflict in normal times**

Long-term debt makes:

- Fiscal position more resilient to supply shocks and changes in monetary policy rates;
- Better transmission of monetary policy impulses along the yield curve;
- Monetary contractions more effective (wealth effect, lower banks’ liquidity, interest payments)
PDM - MP interaction at times of high debt and financial instability

At times of high debt and financial instability with ‘monetary dominance’ – high interest rates:

- A long and balanced maturity structure is crucial to avoid default;
- Long-term debt enhances financial stability
  - makes the debt sustainable;
  - leaves some fiscal space to stand a banking crisis;
  - can be shortened to help the banking sector.
PDM - MP interaction at times of high debt and financial instability

With ‘fiscal dominance’ – low interest rates –
Long-term conventional debt:
- can be inflated away;
- allows to smooth inflation over a longer horizon – (Fiscal theory of the price level);
- can be purchased by CB in quantitative easing and ‘operation twist’ policies and….. a potential conflict between PDM and MP can arise…..
The DMO’s objective of attaining a given ‘long’ maturity structure may conflict with Central Bank efforts to keep long-term interest rates low.

**BUT the risk of conflict is minimized if:**

- The maturity of debt including CB holdings is targeted;
- Debt management is not active, i.e. the DMO does not react to a low long-term rate to minimize costs.
Conclusions

- With Fiscal insurance approach, characterized by:
  - Budgetary risk minimization subject to acceptable costs
  - No cost minimization, Non-active debt management

- Separation between PDM and MP can work reasonably well.

By contrast:

- A PDM that aims to minimize costs interferes with MP and heightens the risk of conflicts.