Economic policy mix in a low interest rate environment

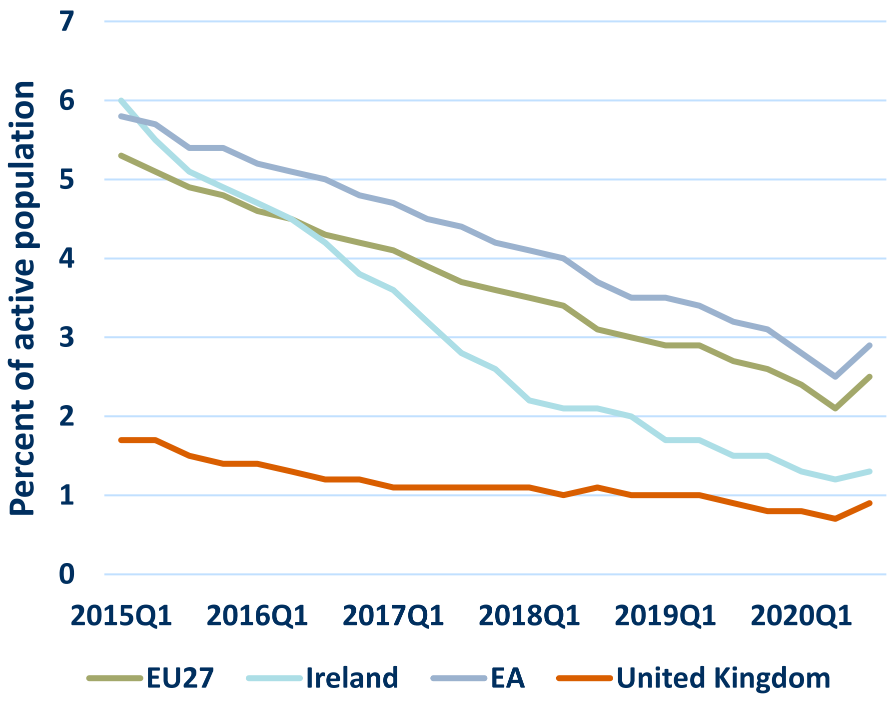
Path for the public finances conference 2021
Irish Fiscal Advisory Council
Karolina Ekholm, 8 February 2021

Stockholms universitet

Is there a need for active stimulus to recover from the corona crisis?

- A need over and above the obvious need to deal with the ongoing crisis.
- There could be a full recovery without stimulus as soon as the spread of covid-19 is brought under control.
- But may be difficult to close output gaps without active measures.
  - Long-term unemployment on the rise.

Long term unemployment (≥12 months), 20-64 years, seasonally adjusted



Source: Eurostat

Should stimulus come from fiscal or monetary policy (or both)?

- **Monetary policy**
  - Conventional policy constrained by the effective lower bound.
  - Unconventional policy – in particular QE – may be expanded.
    - But possibly undesirable side effects.
- **Fiscal policy**
  - Current need to deal with the corona crisis adds to in many cases already high debt levels.
  - Active measures to stimulate once the pandemic is under control will be constrained by high debt ratios, but these constraints will be mitigated by:
    - Currently low level of interest rates.
    - QE in the form of large-scale purchases of government bonds that pushes down long-term rates.

Long-term risks associated with stimulus from *unconventional monetary policy*

- Large-scale purchases of government bonds expose central banks to the risk of finding it difficult to tighten monetary policy if inflation exceeds target.
  - May be a choice between accelerating inflation and a sovereign debt crisis.
- Large-scale purchases of riskier assets distort prices in financial markets and expose central banks to credit risk.
  - Such measures influence credit allocation and have consequences for public finances – more fiscal than monetary policy.

Long-term risks associated with stimulus from *fiscal policy*

- Inflation takes hold and the central bank tightens monetary policy so that interest rates rise.
  - May create uncertainty regarding the long-run sustainability of public finances, which may push up risk premia on government debt.
- Breakdown of fiscal policy rules.
  - Getting back to MTO may be difficult if stimulus involve unfunded permanent measures and deviation becomes very large.
    - Active fiscal tightening is politically difficult and with passive tightening it may take a long time depending on the strength of the recovery.

In summary…

- Active fiscal stimulus is likely to be important for recovery, but so is continued monetary stimulus in the form of low policy rates and purchases of governments bonds.
- QE in the form of large-scale purchases of risky assets entails long-term risks for central bank credibility and ultimately their independence.
- Fiscal stimulus to facilitate recovery should be either temporary or funded in order to maintain sound public finances.

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