



ECB Forum 2020

Fiscal & Financial Dominance

2nd Pillar: Trap Analysis

Panel 2

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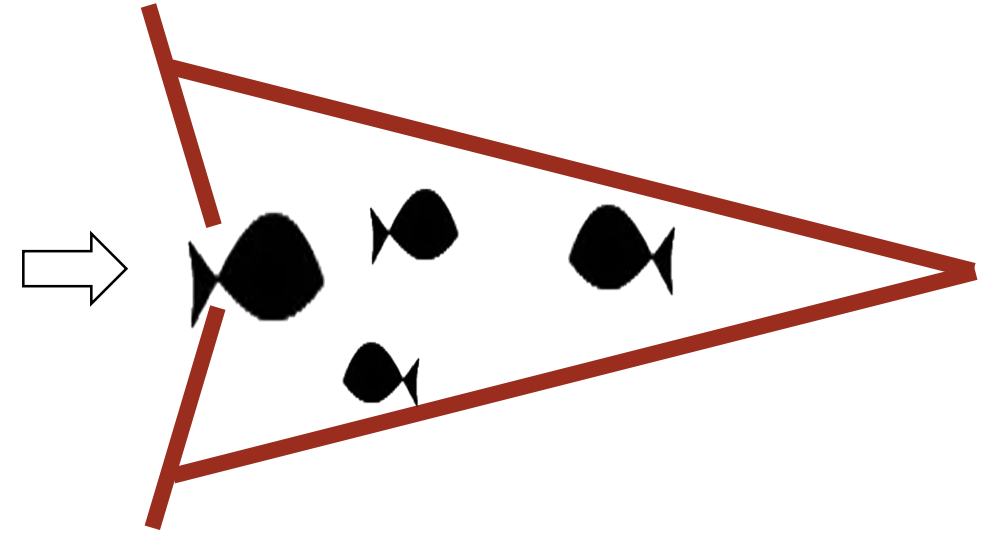
||| Challenges

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 - High public debt level, wave of corporate defaults, Digital Money, ...

||| **Narrow Corridor** between two **Traps**

- **Challenges**

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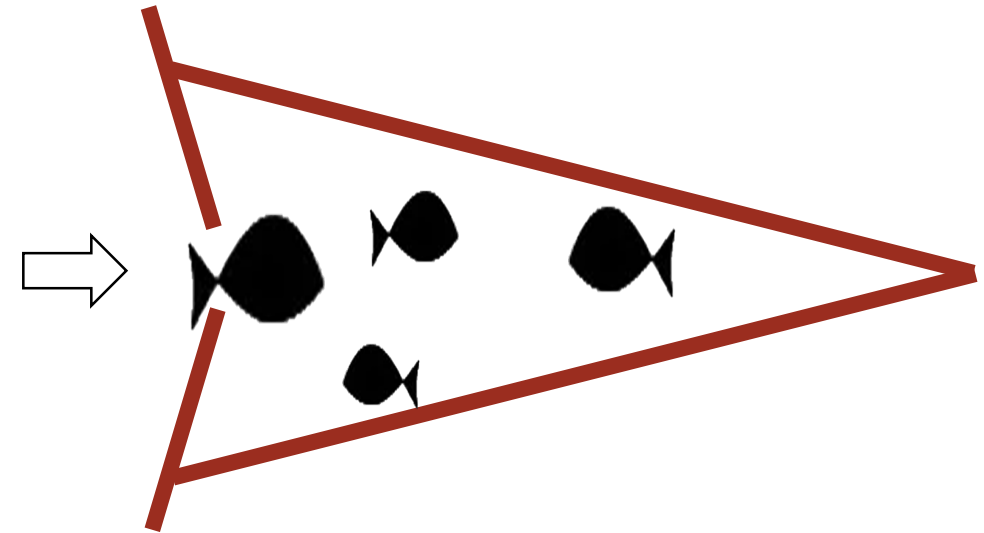
||| Narrow Corridor between two **Traps**

■ Challenges

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1. **Deflation trap** (Liquidity trap)

- Precautionary savings, flight to safety
- Policy rate close to **Reversal Rate** (ELB)



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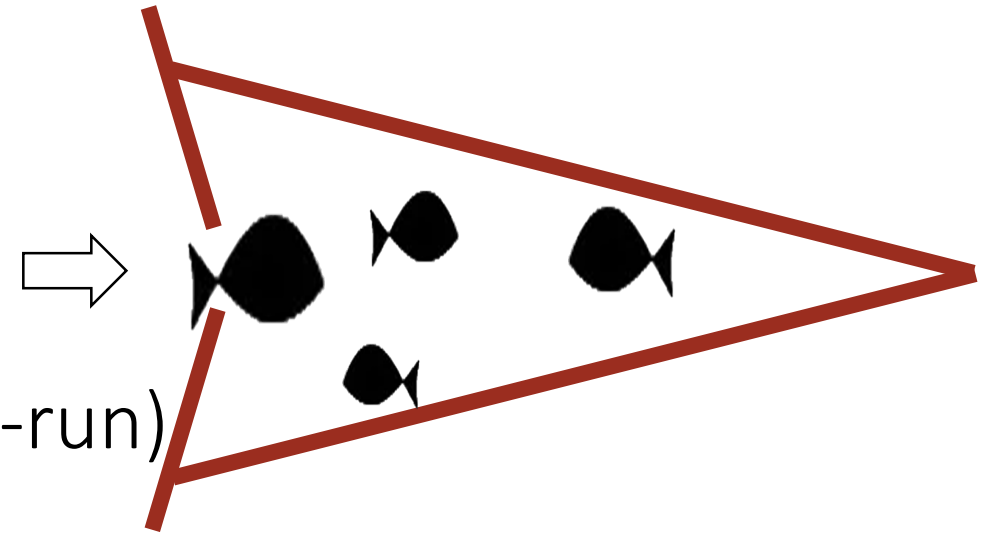
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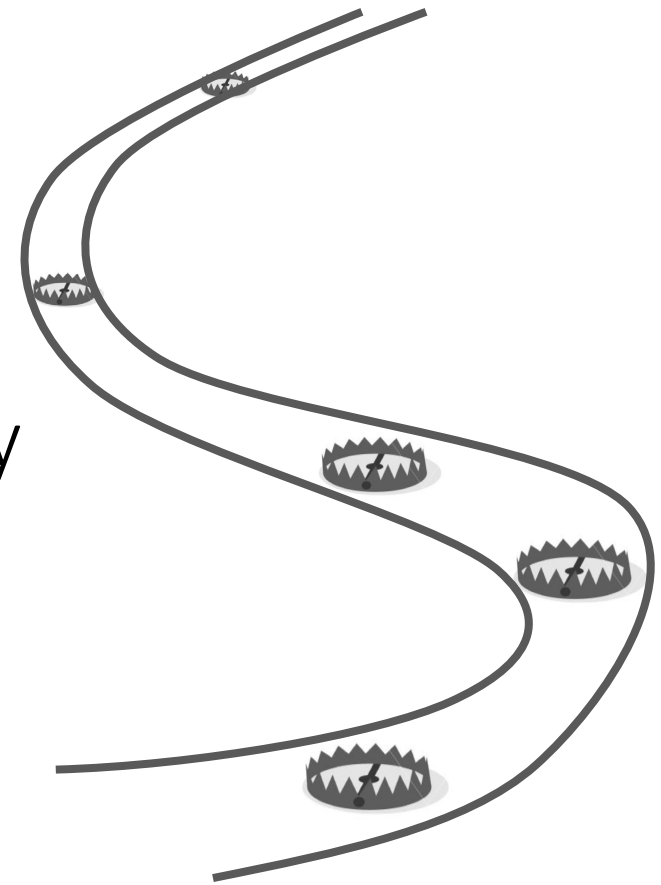
2. **Inflation trap** (inflation like a bank-run)

- Run into consumption, supply shock
 - Run in **other** safe asset/foreign currency (digital) \Rightarrow import cost push shock
 - Wage pressure
- High public debt, solvency concern inhibit necessary monetary policy steps
 - Fiscal sector **Fiscal dominance** \Rightarrow threatens **independence**
 - Financial sector **Financial dominance**



|| 2nd Pillar: ~~Monetary~~ **Trap** Analysis

- Focus on **Tail Risks of Being Trapped (TRiBTed)**
- Robustness: avoid relying on a single model/theory
 - Include heterogenous thinking... avoid group think
- Cross-checking
- Analogy: Chief Risk Officer
- 2nd pillar includes
 - Effectiveness of transmission mechanism + Financial stability +
 - Independence: Fiscal spillovers
 - Quantities of “digital” money + CBDC



|| Tail Risk: “Inflation Whipsaw”

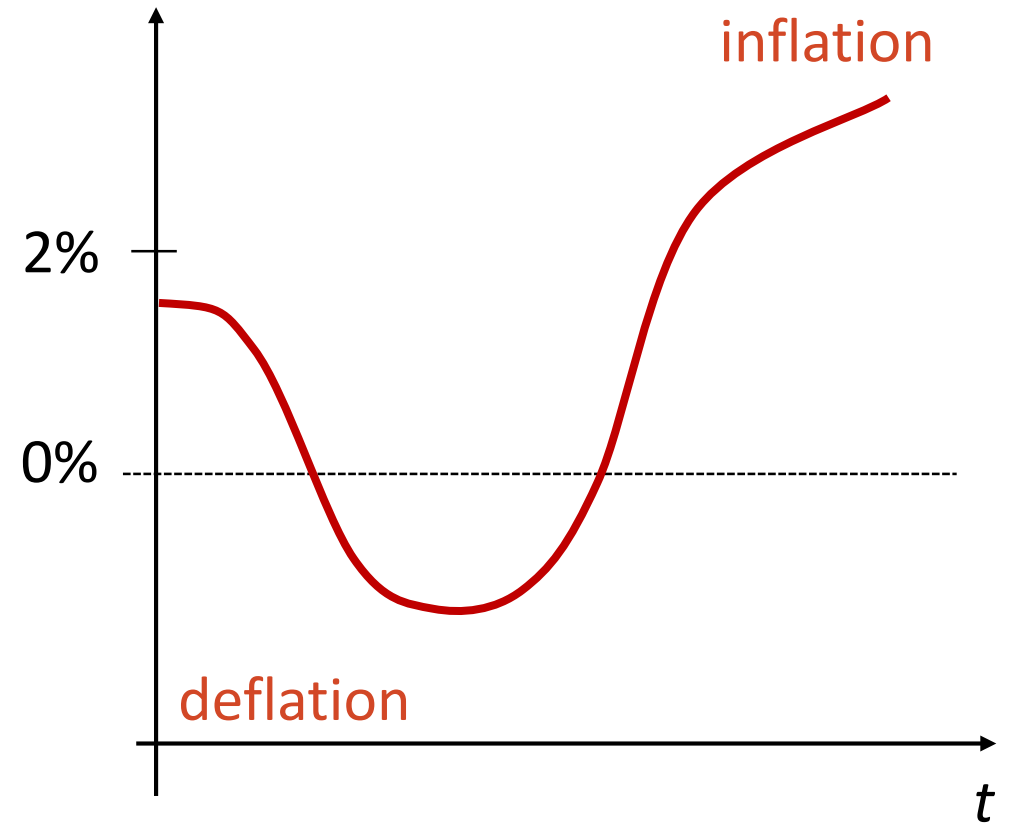
■ Trap analysis

■ Deflation trap (Liquidity trap)

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■ Inflation trap

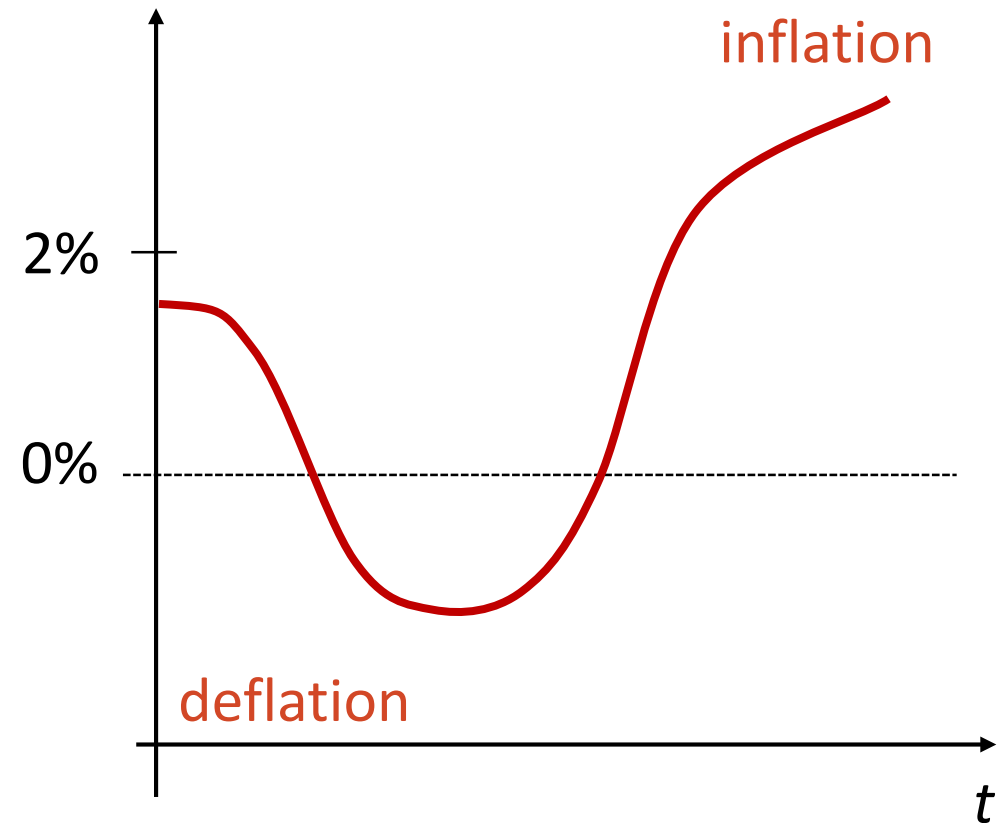
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■ Inflation/deflation pressures

- Forced savings
- Risk
- + capital misallocation
- + (re)-distribution
- + government commitment
- + Pent-up demand
- /+ Lending policy
- + Margin for large firms
- Weak financial sector



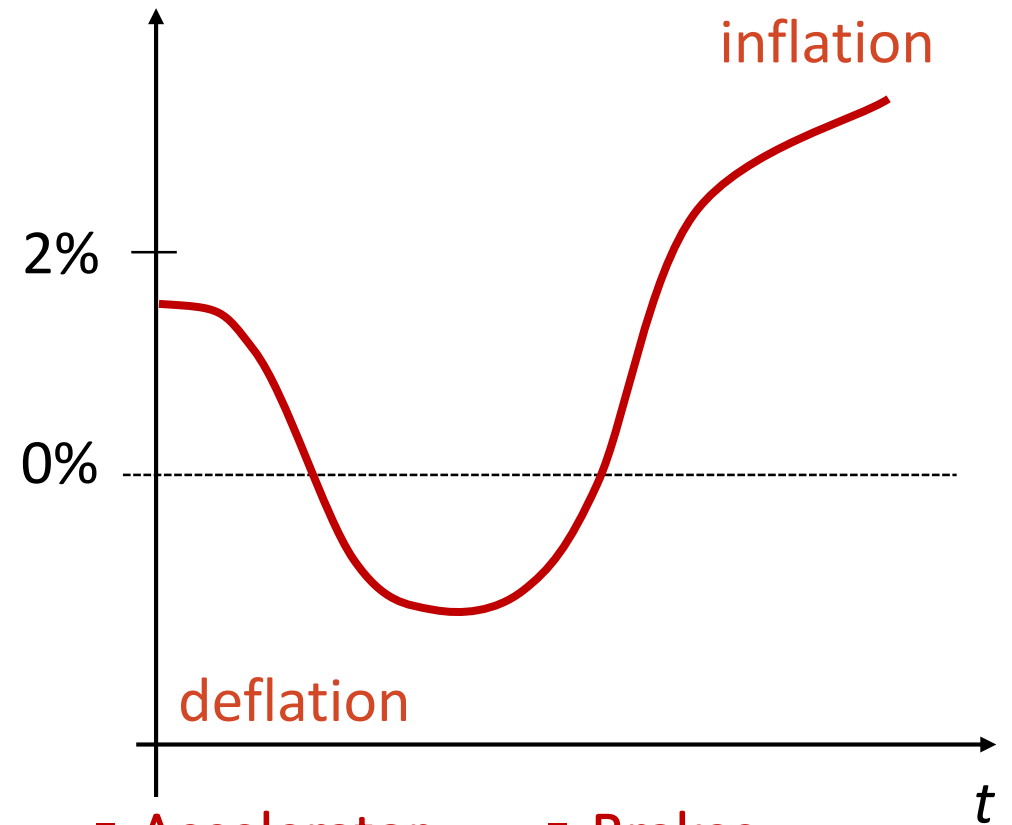
Brunnermeier, Merkel, Payne, Sannikov (2020)

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Brunnermeier, Merkel, Payne, Sannikov (2020)



■ Accelerator



■ Brakes

- CB independence avoid **fiscal dominance**
- Prudential regulation avoid **financial dominance**

||| Fiscal Dominance

- **Game of Chicken** btw. Fiscal authority vs. monetary authority



- Inability or unwillingness of fiscal authorities to control long-run expenditure/GDP ratio
- Limits monetary authority to raise interest rates

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- **Risk management approach**
 - VaR (fiscal debt-servicing costs/GDP | fiscal capacity) instead of Debt/GDP
 - Flight to safety: Loss of safe asset status of government debt (endogenous risk)
 - Danger is relative to other safe assets

Financial Dominance

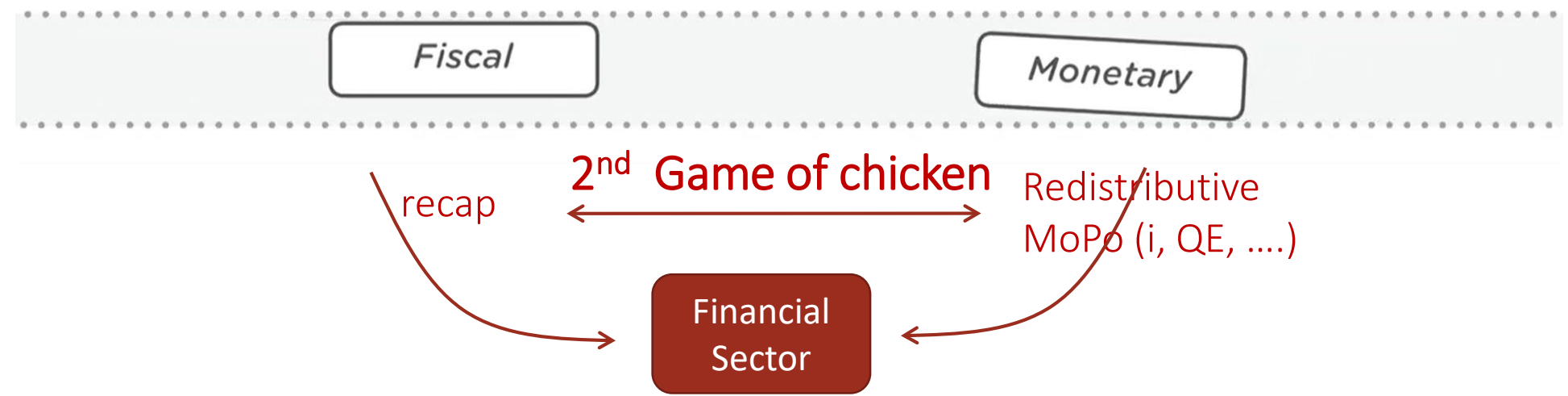
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- **Policy Implication:** Strengthen Independence by raising ECB's equity

Financial Dominance

- Inability or unwillingness of financial sector to absorb losses



■ Policy Implications for Asset Purchase Program: PEPP, ...

- Buy **only** corporate bonds from firms which
 - lowered dividend payment
 - Increased equity

Policy would make equity issuance cheaper

Don't subsidize higher leverage!

Holistic Strategy: Rules

- So far: Strategy
 - a. Interest rate rule: i = function of: (i) “excess” inflation, (ii) output gap
 - b. Make-up strategies

Taylor Rule

- Future:

- $$\begin{pmatrix} i \\ \text{price of risks,} \\ \text{term spreads,} \\ \text{balance sheet quantities/growth} \end{pmatrix} = f \begin{pmatrix} \text{excess inflation} \\ \text{output gap} \\ \text{VaR (fiscal debt-servicing costs/GDP | ESM)} \\ \text{financial risks} \\ \dots \dots \end{pmatrix}$$

- Dynamic risk management approach
 - Risk-transfer and wealth transfer to reduce endogenous (non-linear) risk
 - Risk-premia = price of risk * (exogenous risk + endogenous risk)

- Independence: **Recapitalize ECB** (€100B equity is small)
- MoPo + **Climate change** (see policy brief with Jean-Pierre Landau)