SUERF Policy Brief
No 957, August 2024

Why national independent fiscal institutions need a macro-prudential thrust in their work

By Daniel Dăianu
(Romanian Fiscal Council)

Keywords: central banks, deficits, debts, fiscal-structural plans, financial stability, inflation, macroprudential policy, national IFIs, systemic risks

JEL codes: E61, E62, F15, F33, F36, H6, O52

The longer term and intricate policy challenges and their fiscal implications are, the more an approach that considers systemic risks which impact the overall stability of an economy is required. This is why a macro-prudential dimension in national IFI's work makes sense. There should, however, be caution when European authorities attempt to broaden national IFIs' tasks, as many of the latter have limited resources and risk being overburdened. At the same time, getting involved in policy-making (eg: fiscal structural plans) presents pitfalls. This said, however, a perceptive eye for understanding systemic risks that impact public budgets is a must, and this implies having cognizance, being informed, of a wide range of policy issues and trade-offs. The issue is to have national IFIs' develop a mindset that processes a broad range of relevant information and considers proliferating systemic risks. As some say, national IFIs should be both watchdogs and "advocates" of good practices/policies.

The big crisis that erupted in 2008 showed glaringly that very large borrowing and poor regulations can put economies into a tailspin, while public budgets had to take over private debts in the US and Europe in order to avert a financial collapse. Consequently, macro-prudential measures have become a major feature of central banks' activity.

Elsewhere[1], I argued that national independent fiscal institutions (national IFIs), too, would be wise to have a macro-prudential thrust in their activity. The longer term and intricate are policy challenges and their fiscal implications, the more an approach that considers systemic risks makes sense. Nonetheless, I suggested caution on the part of European authorities when they tend to broaden national IFIs' remits, as many of them have limited resources and risk being overburdened. Likewise, getting involved in policy-making (eg: fiscal structural plans) is very tricky and involves an institutional conflict of interest. Having said that, though, a perceptive eye for understanding systemic risks that impact public budgets is a must, and this implies having cognizance of a wide range of policy issues. As some experts like to say[2], national IFIs should be both watchdogs and "advocates" of good practices/policies.

Monetary and stability policies

Should national IFIs pay attention to monetary policies and stability policies? Arguably, they should. Less well calibrated monetary policies and precarious macroprudential rules may enhance financial fragilities and invite crises that can have severe fiscal consequences –the crisis erupted in 2008 is an obvious example in this respect.

QE programmes should be examined as they may entail central banks losses from large scale asset purchases[3], although the benefits of QEs outweigh their costs when a very severe crisis is avoided[4]. That QEs could have nefarious effects in terms of resource allocation over the longer term[5] may also be true, but a complete financial meltdown is a reason for central bank intervention.

If inflation is not under control, this may force a drastic rise in policy rates which would reverberate across markets and increase debts servicing significantly. National IFIs, which are supposed to assess long term debt sustainability, could try to figure out (as central banks do) the natural interest rate, R*, as a reference value for longer term policy rates, and the financial (in)stability rate, R**[6] -- the latter would reconcile price stability with financial stability. R** is increasingly paid attention by central banks, and fiscal authorities/fiscal watchdogs should arguably do the same.

Shadow banking has not been adequately regulated for years now, and tremors in that sector can trigger contagion in financial markets. Markets are deeply interconnected and the argument that shadow banking does not require strict regulation is fallacious. Elisabeth Caul, a member of the ECB supervisory board, says that the massive growth of private funds and other sources of finance outside regulated banks is the biggest threat to the

[1] Daniel Daianu, "National IFIs need to be stronger, but they should do what they can deliver effectively", SUERF Policy Brief, No 532 23 Feb. 2023, and "National IFIs need to be stronger to perform effectively", *Intereconomics*, 2 (March), 2024

[2] This was underlined at the OECD meeting of national IFIs and public budget offices, Athens, 16-17 June, 2024

[3] Stephen Cechetti and Jens Hilscher see QEs as a form of fiscal policy (Fiscal consequences of central bank losses, Voxeu, 26 June, 2024.

[4] Not a few central bankers would argue that central banks can issue base money (liquidity) limitlessly, and this would not dent their ability to create liquidity. But this is not an unquestionable thesis.

[5] Claudio Borio, "The Financial cycle and macroeconomics: what have we learned and what are policy implications", *BIS Working Papers,* no.395, December

[6] Akinci, O. et al , "The financial "(in)stability" policy rate", NYFR, no.946 (2020 (revised May2023))

stability of the euroarea' s financial system[7]; she sounds an argument made by Andrew Haldane[8], then chief economist of the Bank of England, in the wake of the financial crisis, in which he highlighted the great perils posed by deep interconnectedness and poor regulation. Others espouse a similar line of reasoning and this view can be heard in various debates, at ESRB and ESMA meetings. It is noteworthy in this respect the letter sent to G20 finance ministers and central bank governors (for the meeting in Brazil) by the chief of the Financial Stability Board, Klaas Knot, the president of the Dutch central bank.

It is hard to accept so much lethargy in regulating shadow banking properly[9]. Under dire circumstance, central banks may have to resort to elements of QEs, that have fiscal consequences; they may have to act as "market-makers" (as they already did in the money market funds crisis in the US a while ago and in other episodes), when liquidity seizes up and market dysfunctions are deep.

Demographic policies

Demographics cause more and more headaches for long term forecasts of debt sustainability. As Larch and Busse notice,[10] debt sustainability analysis, comes with an inescapable drawback: uncertainties are higher the longer term is the perspective considered. And this challenge can weaken the effectiveness of net expenditure control for fiscal sustainability. As a matter of fact, large uncertainties concern GDP dynamics too, as well as the balance between saving and investment, the longer term the perspective is.

Demographic analysis may be a too complex task for not a few national IFIs, but the issue is clear and cannot be avoided in assessments of debt/fiscal sustainability. National IFIs should collaborate with specialized entities that focus on demographic analysis.

Climate change

Climate change is hard to capture in models. In addition, its effects can be devastating for economy and society unless proper measures are timely enacted. Geography and development level differentiate among societies when it comes to the severity of policy trade-offs among competing and interrelated goals: inexpensive and reliable energy, clean air and damage control from climate change. But climate change is a huge global challenge.[11] Public and private sectors need to have buffers; public budgets need to have fiscal space to deals with emergencies, "radical uncertainties".

Central banks have created a network that focuses on climate change. The network of national IFIs should have a regular working group that considers this enormously important challenge. Seminars that spread information and knowledge among national IFIs on capturing the impact of climate change in modelling and assessments have taken place in recent years and this is more than commendable.

---

[7] Elisabeth McCaul, "ECB's McCaul warns of systemic shadow bank risks", *The Banker*, 10 July, 2024 and "ECB board member flags rising risk from shadow banking", Financial Times, 11 July, 2024

[8] Andrew Haldane, "Rethinking the financial network", speech at the financial student association, Amsterdam, 2009, and A. Haldane and R. May, "Systemic risks in banking ecosystems", Nature, 469, pp.351-355

[9] This reflects the lobby power of this industry

[10] Martin Larch, Mathias Busse, "Europe's demographic winter and the new fiscal rules", VoxEu, 28 June, 2024

[11] See also Michael Geenstone, "The economics of the global energy challenge", American Economic Review, AEA distinguished lecture, AEA Papers and Proceedings, 2024, 114, pp.1-30

Artificial intelligence (AI)

AI is seen as both a boon and curse. Some even consider it an existential threat (an AI Armaggedon) unless it is properly regulated. AI is likely to have a huge impact on the economy, the financial sector[12]; AI can prompt and exacerbate financial crises, and national IFIs should monitor its evolution.

The recent global tech outage is a harbinger of what can go wrong unless economic (financial systems) have back -ups. It is ironic that the debacle of Friday, July 19, this year, was triggered by a technical failure (a "software update") at CrowdStrike, which is a cybersecurity company. It is worthy to highlight that at this year's ECB annual conference at Sintra (Portugal), Jerome Powell, the FED chair, singled out cyber risks as the most threatening for the financial system.

As in the case of climate change, it would be useful for the national IFIs network to have a working group and organise regular seminars on this topic.

Industrial policies

The US adopted the *Inflation reduction act*, that epitomizes a strong return of industrial policies across the Atlantic. The EU, too, has adopted industrial policy measures that attempt to bolster its competitive advantages and restore its credentials as a global competitor (which has been heavily hit by the energy crisis and other shocks).

Industrial policies can entail protectionist trade policies, in the framework of an *inward-looking syndrome* that is spreading in advanced economies. This could easily entail higher costs, inflationary pressures. One should be reminded that de-globalization, fragmentation of the world economy, has been underway for years now, a process that is enhanced by security considerations.

But industrial policies and trade policies may succeed, or not. Moreover, they can incur costs for public budgets, that may be substantial. National IFIs have to pay attention to such policies.

The functioning of the euro area

An evaluation by the EFB of the overall fiscal policy stance of the euro area does make sense, but it cannot be done separately from examining the macro-prudential policy stance in the euro area, as private sector deficits can harm the euro area as much as public sector deficits. Such an evaluation must consider the functioning of the global financial system as well, in which a dominant role is played by the monetary policy of the Fed.[13] It is, therefore, justified for the EFB to consider overall systemic risks, which go beyond the remit of judging fiscal policies.

[12] See also I. Aldasoro et.al, "Intelligent financial system: how AI is transforming finance", BIS Working Papers, no.1194, June 2024

[13] As Helene Rey says, the trilemma is a dilemma for most emerging economies and capital flows controls can be useful ("International channels of transmission of monetary policy and the Mundellian trilemma", IMF Economic Review, vol 1, no.64, 2016, 6-35).

National IFIs may have to judge national macro-prudential policy stances as the latter influence external imbalance and can make economies more fragile. National IFIs should be concerned about the rise in private debts, that, in worst case scenarios, may force again national governments (and central banks) to step in and took over some of those debts; it is not sufficient to have only the EFB voice concerns in this respect.

There should be instruments available to discourage excessive private debts, which should complement what central banks do with their macro-prudential instruments.[14] Would governments interfere with the functioning of free markets? Yes, but this is not necessarily bad in an environment in which speculative behaviour is rampant and there is little productive investment. Rating agencies have always played a role in this regard, but, as the financial crisis and various scandals have shown, they are ridden with conflicts of interest and their judgements are not faultless, may be biased. Finance ministries should be deeply worried about rising private debts and speculative conduct.

Heads of national IFIs could attend (some of them already do) the meetings of national supervisory bodies that deal with overall systemic risks. In this context, national IFIs could judge the appropriateness of budget/fiscal policies related to overall systemic risks.

It should be noted that the European Systemic Risk Board (ESRB) and the ECB examine how macro-prudential regulations operate, and, increasingly, this is extended to the non-bank financial sector.

Last but not least, national IFIs should not shun having a voice in examining the functioning of the euro area, on sensitive issues as well –such as a joint fiscal capacity, EDIS, a safe asset, etc. The network of national IFS should encourage position/policy papers on these issues, even if they do not converge. The battle of ideas is to be fostered.

Conclusion

The longer term and intricate policy challenges and their fiscal implications are, the more an approach that considers systemic risks which impact the overall stability of an economy makes sense. This is why a macro-prudential dimension of national IFI's work be good to exist.

There should, however, be caution when European authorities tend to broaden national IFIs' tasks, as many of the latter have limited resources and risk being overburdened. At the same time, getting involved in policy-making (eg: fiscal structural plans) presents pitfalls.

This said, nonetheless, a perceptive eye for understanding systemic risks that impact public budgets is a must, and this implies having cognizance, being informed, of a wide range of policy issues and trade-offs.

To sum up, the issue is not to aim at enlarging national IFIs' mandates in an arbitrary way, but to have them adopt a mindset that processes a broad range of relevant information and considers proliferating systemic risks.

[14] As banks are asked to have adequate capital and liquidity reserves, similar requirements could operate for companies that pose systemic risks. Then, the question is who should be in charge of imposing such requirements. Rating agencies do play a role in judging companies' performances, but their history of conflicts of interest and scandals should make us cautious about non interference by public authorities. Banks can also restrain over-borrowing when they perform due dilligence to grants credits. But banks played a nefarious role in the years preceding the financial crisis. There seem to be a role for governments (other agencies) in this respect.

About the author

Daniel Dăianu is President of the Romanian Fiscal Council and professor of economics at the National School of Political and Administrative Studies in Bucharest; he is a member of the Romanian Academy, a former member of the Board of the National Bank of Romania, a former MEP and a former minister of finance of Romania.