Monetary and Fiscal Policy Interactions: the Experience of EMU

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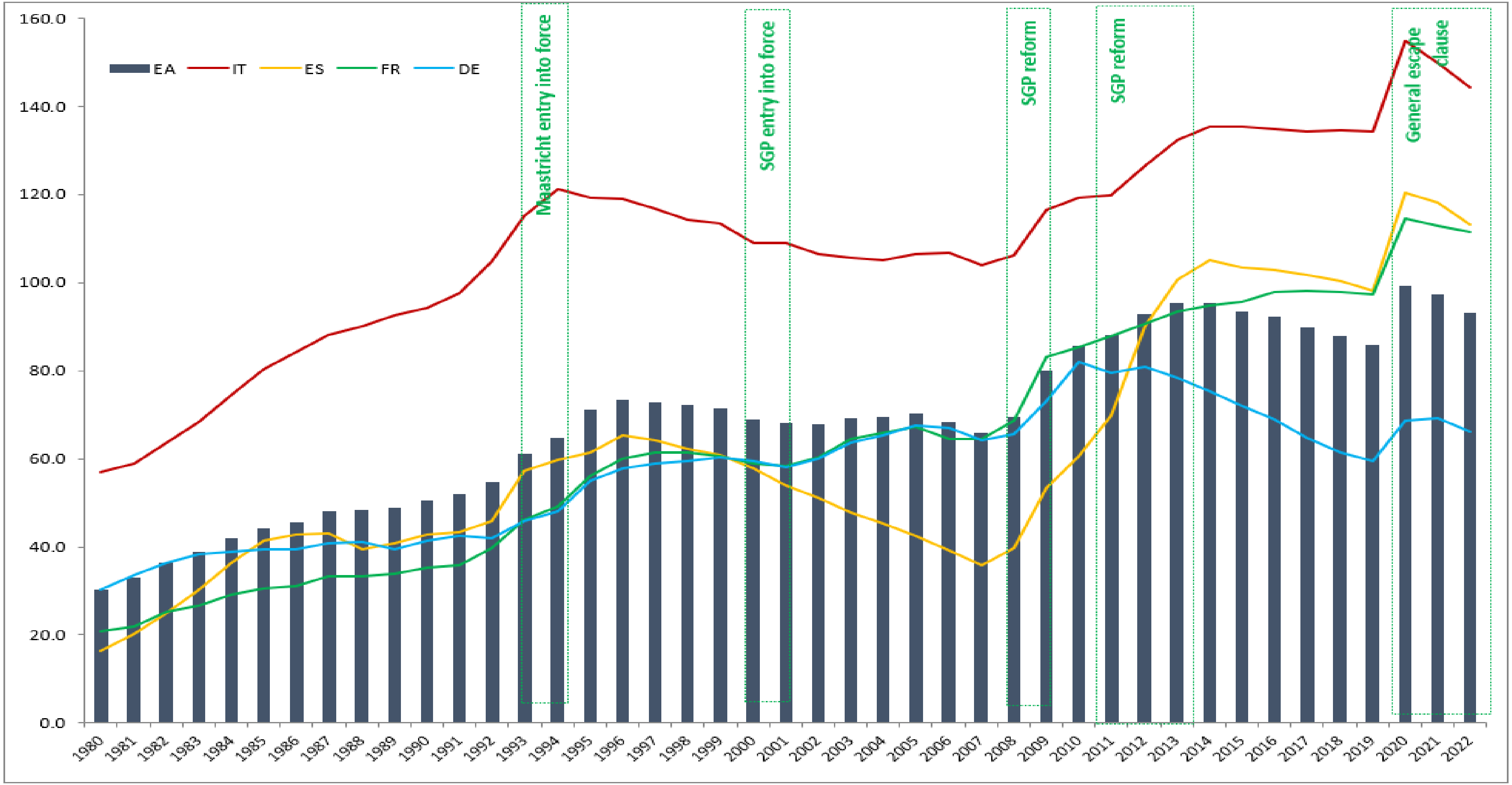
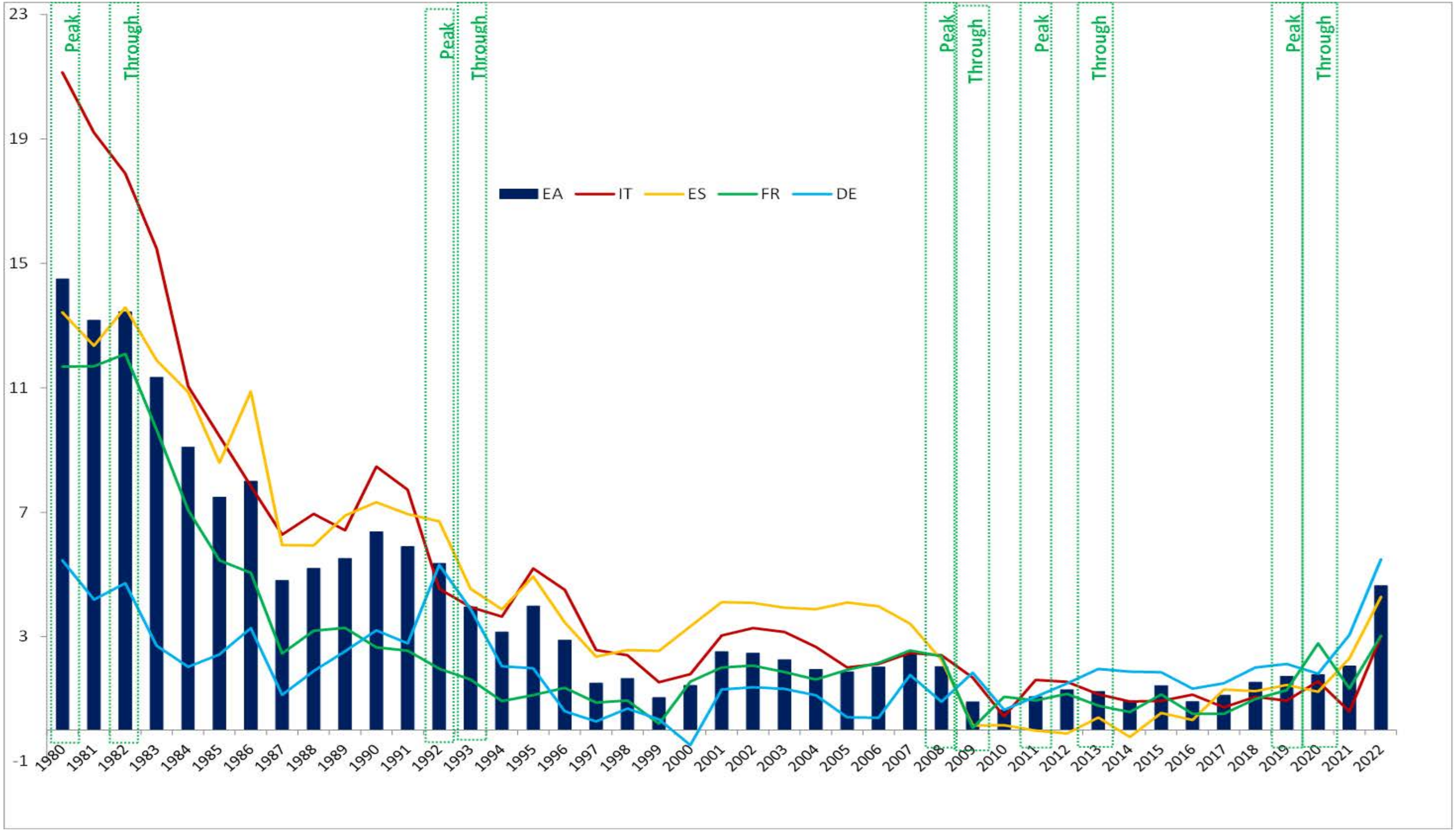
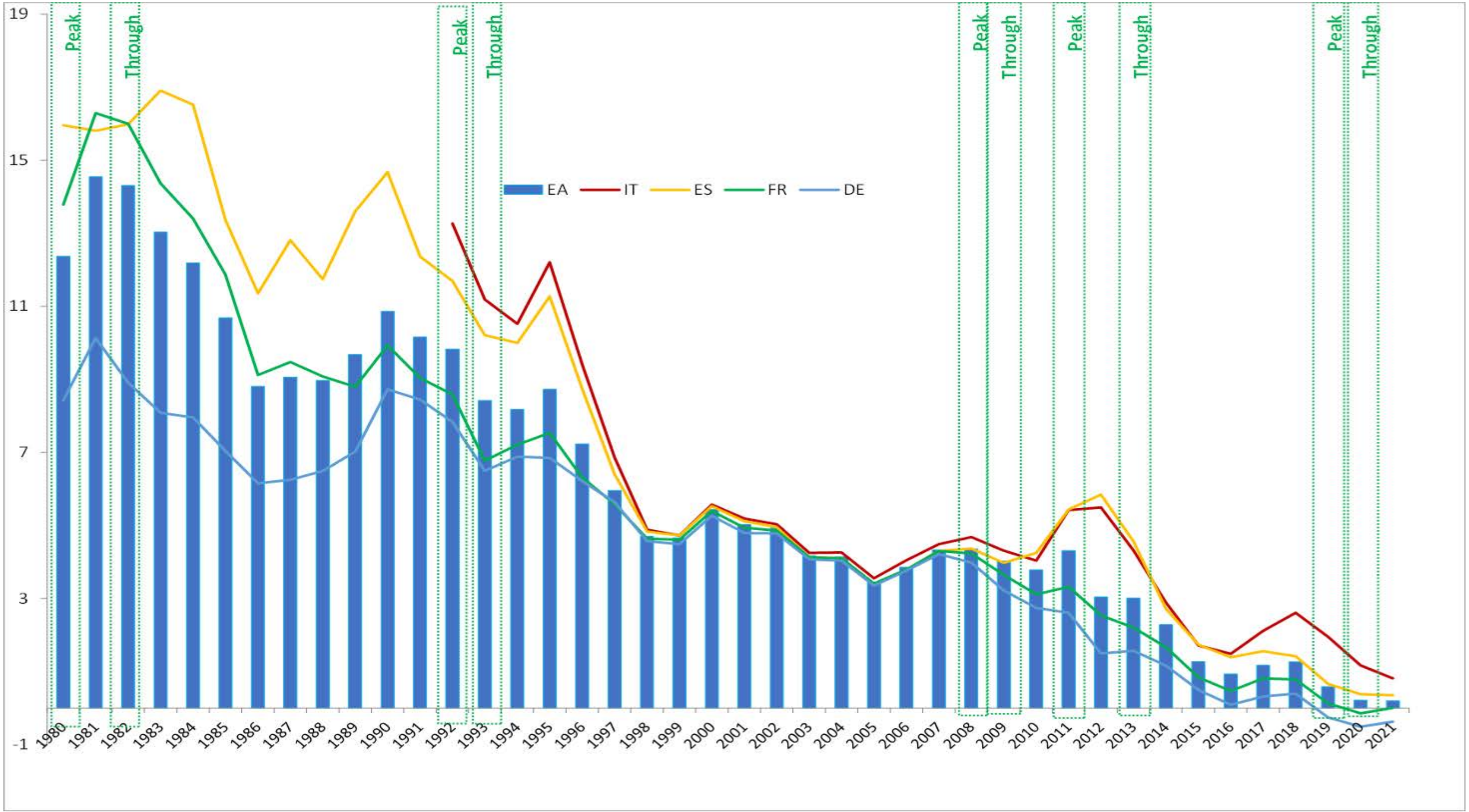
Public debt in the euro area and its main countries



Inflation in the euro area and its main countries

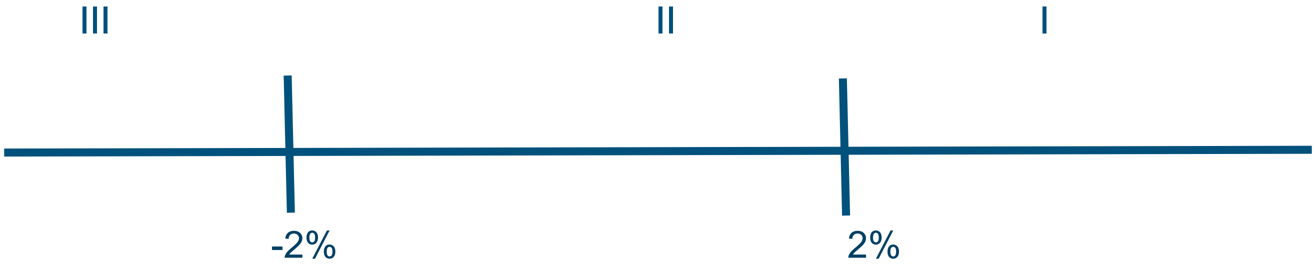


Interest rates in the euro area and its main countries



Three regimes for monetary fiscal policy interactions (*à la* Blanchard (2022)) (1)

$r^* \ (y^* = 2, \pi \stackrel{\wedge}{=} \pi^* = 2)$



ZLB: MIN $r \leq r^*$

$r^* \geq y^*$

Secular stagnation
Monetary policy permanently constrained

New normal
Monetary policy at recurrent risk of being constrained

Old normal
Monetary policy unlikely to be constrained

Three regimes for monetary fiscal policy interactions (*à la* Blanchard (2022)) (2)

'Old normal'

- Monetary policy: ZLB not binding ⇒ set policy rate r so that r = r* and Y=Y*
- Fiscal policy: assume that Y = Y* and r = r*, ensure public debt stabilisation

Clear division of labour and **no need for coordination between monetary and fiscal policy (other than 'proscribing' rules on fiscal policy)** : monetary policy in charge of macroeconomic stabilisation, fiscal policy in charge of debt stabilisation (allocation and distribution), with macroeconomic stabilisation role limited to automatic stabilisers.

'New Normal'

- Monetary policy: ZLB occasionally binding ⇒ not always able to set policy rate r so that r = r* and Y=Y*
- Fiscal policy: need to support monetary policy when ZLB binding, otherwise assume that Y = Y* and r = r*

Need for **occasional coordination between monetary and fiscal policy** to stabilise at ZLB

r *< y* ⇒ lower fiscal and economic cost of public debt ⇒ higher public debt level more likely ⇒ monetary policy more likely to be occasional buyer of last resort of public debt

Three regimes for monetary fiscal policy interactions (*à la* Blanchard (2022)) (3)

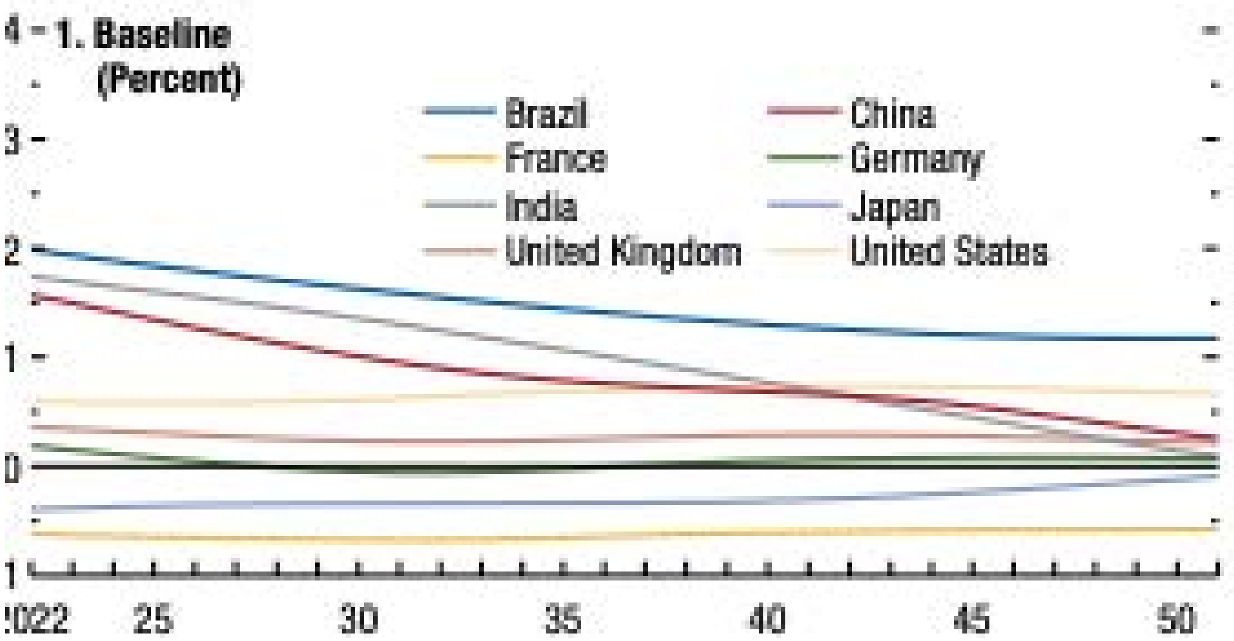
'Secular stagnation'

- Monetary policy: ZLB normally binding ⇒ not able to set policy rate r so that r = r* and Y=Y*
- Fiscal policy: need to be normally active to close otherwise persistent output gap (Y < Y* given that r < r*)

Need for **permanent active coordination between monetary and fiscal policy**. How to characterise the corresponding policy regime: fiscally-led regime with monetary policy financing deficits and refinancing public debt? 'Credible irresponsible' monetary policy shifting inflationary expectations sufficiently to exit ZLB Krugman (2022)? Regime compatible with stable inflation expectations (in theory / practice) ?
Can secular stagnation be a permanent state of the economy (*quid* eventual crowding out, loss of convenience premium of public debt?)
Both r *< y* *and* ZLB ⇒ higher public debt level including debt permanently held by central bank

Regime switching and regime uncertainty
Regime change can be induced by change in r*, but for the same r* one can have different policy regimes (e.g., fiscal dominance in the `70s followed by monetary dominance in the '80s). Excluding permanent secular stagnation, **temporary regime switching can be welfare-increasing** (e.g., temporary fiscal dominance generating temporary inflation allowing exiting ZLB). Protracted uncertainty about policy regime (conflict between monetary and fiscal policy) resulting in 'worst of both worlds': stagflation (Bianchi and Melosi (2022)).

Which regime of monetary fiscal policy interactions can be expected to prevail in the future?



Natural interest rate expected to be close to zero in the long term for all advanced economy, particularly in Europe (IMF 2023a). Expectation consistent **'new normal' regime with need for occasional switch to 'fiscal dominance'**.

How does EMU experience compare with different regimes ?

Economic and Monetary Union (EMU) created as quintessential policy regime for the ‘old normal’:

- Instrument- and objective- independent European central bank (ECB) insulated from pressures from other policies, especially fiscal policy ban on monetary financing; no bail out; ‘ban’ on excessive deficits):
- Active coordination of monetary and fiscal policy seen as impractical (one central bank vs many governments) , unnecessary (monetary policy sufficient to stabilise the economy) and probably welfare-decreasing (potential for conflict between monetary and fiscal policy)

EMU gradually (stealthily?) transitioning from ‘old normal’ to ‘new normal :

- **ECB actions** with marked fiscal implications (OMT (2012); QE (2014); TPI (2022) effectively amounting to **ex post and ex ante risk sharing arrangements backed by central bank balance sheet**;
- Limited effectiveness of common fiscal rules.

COVID-19 crisis and its aftermath example of **active coordination of monetary and fiscal policy**:

- Monetary policy redoubling QE (PEPP) (2020-22);;
- Fiscal rules effectively suspended (2020-23) through recourse to General Escape Clause;
- State-contingent common fiscal capacity set up (Recovery and Resilience Facility (2021-26)

Active coordination meant to be temporary and exceptional regime switch.

Summing up: the experience so far

Framework for monetary and fiscal policy interactions in EMU fraught with particular difficulties outside of 'old normal' regime assigning price stability objective to monetary policy and public finance sustainability to fiscal policy:

- Single monetary policy-maker facing multiple fiscal policy-makers with different starting conditions and preferences.
- Monetary policy effectively centralised but fiscal policy only putatively constrained by common fiscal rules.

Adaptation to 'new normal' regime occurring through implicit backing for fiscal policies of countries facing sustainability-stabilisation dilemma through balance sheet of the central bank with common fiscal rules not being effectively applied.

COVID-19 and its aftermath arguably representing breakthrough in monetary-fiscal policy coordination:

- Explicit backing of fiscal policy by monetary policy;
- Explicit suspension of fiscal rules;
- Explicit deficit-spending of EU level flanking national policies

Proposals for reform of EU fiscal framework aiming at ensuring monetary dominance consistent with:

- greater national ownership (medium-term plans) and cross-country differentiation (according to risks to debt sustainability);
- temporary regime switch' through recourse to escape clauses.

Summing up: some conclusions and challenges for future

Some conclusions:

- **EMU set-up inherently not conducive to active coordination of momentary and fiscal policy other than through exception** to the ordinary policy regime of rule-based coordination.
- Central expectation of **persistently low natural interest rate not incompatible with EMU set-up** provided buy-in of new differentiated rule-based fiscal framework is ensured
- Correct application of new framework should ensure that **neither inflation nor deflation should be problem in the medium-to-long term**: fiscal policy backing for monetary policy normally ensured in turn allowing for monetary policy backing for temporary regime switch.
- **Contribution fiscal policy to (dis-)inflation in the short term not really a matter for EMU set-up**, as "policy choices on what budget items to cut and which to protect or expand" (IMF 2023b)remain with individual Member States.

Challenge: ensuring a common proper understanding of:

- **COVID-19 experiment as *temporary* regime switch**?
- Proposals for **revised fiscal framework** as attempt at **confirming monetary dominance with possibility of temporary regime switch**?

If not, **risk of stagflation** (or deflation, if possibility of temporary regime switch effectively negated)

References

Bianchi, F. and L. Melosi (2022). Inlfationa s a Fiscal Limit. FRB of Chicago Working Paper No. 2022-37.

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Annex

A represetation of monetary fiscal policy interactions *à la* Blanchard

Following Blanchard (2022) the interaction between fiscal between monetary and fiscal policy can be graphically represented under the simplified assumption of potential growth and inflation at target of 2% (i.e., disregarding deviations from the inflation target as secondary in the long term: downward deviations being assumed to be secondary due to downward price rigidity and upward deviations being assumed to be always susceptible of being controlled by raising the policy interest rate) as falling one of three regimes depending on the level of the natural interest rate (from the right to the left of the graph):

I) $r^* \geq y^*(= \pi^* = 2)$ ('old normal'): the natural interest rate is high enough to allow for the policy interest rate (in real terms) to be brought sufficiently below enough the natural rate to stabilise the economy in the event of recession in most cases (i.e., no ZLB). Moreover maintaining a primary surplus is needed to stabilise public debt.

II) $r^* \geq y^*(= \pi^* = 2)$ ('old normal'): the natural interest rate is high enough to allow for the policy interest rate (in real terms) to be brought sufficiently below enough the natural rate to stabilise the economy in the event of recession in most cases (i.e., no ZLB). Moreover maintaining a primary surplus is needed to stabilise public debt.

III) $r^* \leq -2\ (= -\pi^* = y^*)$ ('secular stagnation)': the natural interest rate is so low that the policy interest rate cannot be brought below it (i.e., ZLB is permanently binding). Large primary deficit can be maintained consistent with debt stabilisation.

How does EMU experience compare with different regimes ? (1)
‘old normal’

Economic and Monetary Union (EMU) created as quintessential policy regime for the ‘old normal’:

- Instrument- and objective- independent European central bank (ECB) insulated from pressures from other policies, especially fiscal policy:
  - -Ban on monetary financing of government deficits;
  - - No bail-out clause.
- Fiscal policy-making left with national government but expected to follow rules (3% deficit threshold, close-to-balance-or-in-surplus medium-term budgetary objective).

Active coordination of monetary and fiscal policy impractical (one central bank vs many governments) , unnecessary (monetary policy sufficient to stabilise the economy) and probably welfare-decreasing (potential for conflict between monetary and fiscal policy)

‘Old normal’ persisting as reference for economic policy-making in EMU through Great Financial Crisis: in-built obstacles to active monetary-fiscal policy coordination resulting in over-reliance on monetary policy at the same time as attempts being made at increasing restraints on fiscal policy (Fiscal Compact (2012)).

How does EMU experience compare with different regimes ? (2) ‘new normal’

EMU gradually transitioning from ‘old normal’ to ‘new normal’ mainly through ECB actions with marked fiscal implications:

- Outright monetary transactions (OMT) announcement (2012) providing monetary backing for country at risk losing access to market for its conditional on adjustment programme with European Stability mechanism (ESM).
- Quantitative easing (QE) (from 2014) mainly affecting bond yield spreads of countries with potential debt sustainability problems relative to Germany;
- Transmission protection instrument (TPI) (2022) providing backing for country suffering ‘unwarranted’ rise of debt yields based on assessment of compliance with EU fiscal rules and debt sustainability analysis.

ECB actions effectively amounting to ex post and ex ante risk sharing arrangements backed by central bank balance sheet.

Fiscal policy-making evidencing marked differences across countries with countries with potential debt sustainability problems having more difficulty in respecting fiscal rules

How does EMU experience compare with different regimes ? (3) COVID-19 crisis and its aftermath

COVID-19 crisis and its aftermath arguably providing example of active coordination of monetary n and fiscal policy:

- Monetary policy redoubling QE (PEPP) (2020-22);;
- Fiscal rules effectively suspended (2020-23) through recourse to General Escape Clause;
- State-contingent common fiscal capacity set up (Recovery and Resilience Facility (2021-26)) allowing for the first-time for deficit-spending at EU level (total 5% of GDP with large cross-country differences).

Active coordination presented as temporary and exceptional regime switch *not* affecting monetary dominance

Proposals for reform of EU fiscal framework (2023) aiming at restoring monetary dominance consistent with greater country differentiation based on risk to debt sustainibility:

- Countries to submit medium-term structural fiscal plans (at least 4 y up to 7 y) setting out adjustment path ensuring converging of debt to prudent levels;
- Debt Sustainability Analysis (DSA) main tool for assessing ex ante compliance with new framework;
- Expenditure rule main indicator for assessing ex post compliance with new framework.
- Institutionalisation of general and country-specific escape clauses.

Government deficits and debts development in the before the COVID-19 crisis