

Achieving the right fiscal-monetary mix (in the context of the economic governance review)

Compilation of papers



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Monetary Dialogue September 2023

Abstract

Alignment of monetary and fiscal policies has proven to be decisive for the euro area's ability to withstand successive crises over the years. Today, the European Central Bank (ECB) continues its fight against inflation by implementing a monetary policy tightening unprecedented in pace and scale. At the same time, after allowing for some deviations from regular budgetary rules with the activation of the general escape clause in 2020, the EU is set to reapply its fiscal rules fully from 2024. In addition, co-legislators are currently discussing the proposed legislation by the European Commission for the reform of the economic governance framework. Five papers were prepared by the ECON Committee's Monetary Expert Panel, discussing the interaction between monetary and fiscal policies in the euro area.

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Abstract

This paper analyses how the fiscal framework proposed by the European Commission in April 2023 might affect the interplay between fiscal and monetary policies, from three perspectives: its impact on the medium-term fiscal stance in the euro area, its design, and its implications for the ECB's Transmission Protection Instrument (TPI). It concludes with recommendations for amending both the fiscal governance proposal and the TPI.

This document was provided by the Economic Governance and EMU Scrutiny Unit at the request of the Committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 25 September 2023.

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LIST OF ABBREVIATIONS

| | |
|-------------|---------------------------------------|
| CFC | Central fiscal capacity |
| DSA | Data sustainability analysis |
| EC | European Commission |
| ECB | European Central Bank |
| EFB | European Fiscal Board |
| EGR | Economic governance review |
| ESCB | The European System of Central Banks |
| ESM | European Stability Mechanism |
| EU | European Union |
| GDP | Gross domestic product |
| IFIs | Independent fiscal institutions |
| MS | Member states of the European Union |
| MTO | Medium-term objective |
| NRRP | National recovery and resilience plan |
| OMT | Outright Monetary Transactions |
| TPI | Transmission protection instrument |
| QE | Quantitative easing |

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EXECUTIVE SUMMARY

- **Fiscal and monetary policies interact through multiple channels and interfere with (or support) each others' objectives.** The interplay between monetary and fiscal policy is hence important for economic welfare. This paper analyses how the fiscal framework proposed by the European Commission in April 2023 might affect this interplay, from three perspectives: (1) its impact on the medium-term fiscal stance; (2) its capacity to reconcile debt sustainability and flexibility; and (3) its implications for the European Central Bank (ECB)'s Transmission Protection Instrument (TPI).
- **The proposed framework would lead to substantial tightening in the medium term.** In the short term, tighter fiscal policy supports disinflation. But if the ECB's inflation target is reached by 2025, as both ECB and International Monetary Fund expect, then continued fiscal consolidation under the new fiscal framework might result in an overly tight fiscal stance, requiring the ECB to offset it.
- **The proposed new fiscal framework is broadly balanced between the objectives of ensuring debt sustainability and preserving flexibility, but with room for improvement.** We recommend strengthening the requirement that seeks to prevent excessive 'backloading' of fiscal adjustment, while the requirement that debt falls within the first four years of the application of the framework should be removed or modified substantially, as should the minimum adjustment requirement of 0.5% of GDP for countries with deficits above 3%. We also recommend a review of the Commission's debt sustainability analysis methodology, and a role for independent fiscal councils in the process of activating the framework's escape clauses.
- **While the proposed fiscal framework would not complicate the activation of the Transmission Protection Instrument (TPI) compared to the current framework, we recommend amending one of its eligibility conditions.** The ECB has delegated the assessment of three of the four TPI eligibility conditions to the Council and the Commission. Since these conditions will continue to be evaluated by the Council and the Commission under the proposed framework, their application under the TPI does not change. One eligibility condition, however – whether a country's debt is sustainable – has not been delegated by the ECB. We argue that since debt sustainability is a necessary condition for compliance with the proposed framework, this condition is either redundant, or there should be a presumption that the ECB will follow the Council and Commission when it decides on debt sustainability. This would not reduce the ECB's independence, since the decision on whether activation of the TPI is required remains at the discretion of the ECB.

1. INTRODUCTION*

Monetary and fiscal policy pursue different objectives. Monetary policy in the euro area has only one primary mandate, price stability¹. Fiscal policy, in contrast, has many objectives: provision and financing of public goods, output stabilisation, redistribution, intergenerational equity and improvements in economic allocation. Unlike monetary policy, which is centralised in the hands of the ECB, fiscal policy in the euro area remains in the hands of national governments.

While they have different objectives, fiscal and monetary policies interact through multiple channels. Monetary policy influences both inflation and real output, and thus fiscal revenues directly, and fiscal expenditure indirectly. Monetary policy operates in part by influencing real interest rates, which impact government borrowing cost. Fiscal policy influences the price level both through aggregate demand and through its impact on the supply side (via labour supply and public investment, and potentially muting the transmission of supply shocks, such as commodity price shock). It also influences measured inflation through changes in excise and VAT tax rates. Finally, unsustainable fiscal policy can threaten price stability, either through the dislocations induced by a debt crisis, or by leading to pressures for debt monetisation to stave off the crisis. Such fiscal-monetary interactions were important considerations in the creation of EU-wide fiscal rules before the euro was launched.

The potential to interfere with (or support) each others' objectives implies that the interplay ("mix") between monetary and fiscal policies is important. Fiscal policy that gets in the way of monetary policy objectives, and vice versa, can generate welfare costs. For example, if fiscal policy seeks to raise real output above potential, it may raise inflation, forcing monetary policy to tighten. The result will not be higher output, but rather higher real interest rates, which raise the cost of borrowing and reduce fiscal space. Another example applies to a setting in which interest rates are close to their effective lower bound and inflation is below the central bank's target. In this case, reaching price stability without compromising financial stability may require support from (expansionary) fiscal policy.

By influencing fiscal policy, the EU-level fiscal governance framework will have an influence on the interplay between fiscal and monetary policies. The purpose of this paper is to analyse how the framework proposed by European Commission in April 2023 (EC, 2023a,b) might affect this interplay. We tackle this question from three angles.

First, by quantifying the potential impact of the framework on the fiscal stance in the next five years. Inflation in the euro area is running high, and underlying inflation has proved to be persistent. A frequently voiced view is that fiscal policy should be tighter in support of the disinflation process (see, e.g., IMF, 2023). Fiscal policy is in fact projected to tighten this year, and next, before the proposed fiscal framework would come into effect. The question is how the proposed framework might influence the fiscal stance from 2025 onward if it were to become law next year.

Second, from a design perspective. We assume that fiscal policy makers are disciplined by elections, but also subject to incentives that could result in overborrowing and in some cases in a bias toward current spending. The purpose of fiscal frameworks is to ensure debt sustainability and ideally to protect public investment, while otherwise providing flexibility to fiscal policy, allowing the fiscal authorities to pursue their many objectives. Frameworks that achieve these objectives are also in the

* The authors thank Marco Buti, Grégory Claeys, Maria Demertzis, Francesco Papadia, Lucio Pench, Lucrezia Reichlin, André Sapir, Armin Steinbach, and Stavros Zenios for valuable comments, and Lennard Wleslau for preparing Figure 1.

¹ The objectives of the European System of Central Banks (ESCB) are defined in the Treaty on the Functioning of the European Union as: "the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union."

interest of the central bank. Debt sustainability reduces the risk of fiscal dominance and disruptive crises that threaten price stability². Fiscal policy that is friendly to public investment and raises potential output will lower inflation pressure for a given level of demand. Flexibility is important because it allows the fiscal authorities to pursue their various objectives and to deploy policy in support of the central bank's price stability objective. We analyse the trade-off between debt sustainability and flexibility under the proposed framework.

Third, from the perspective of a specific ECB instrument, the "transmission protection instrument" (TPI) was created in July 2022 to maintain orderly debt market conditions in the face of sharply higher interest rates. While the TPI is not the only ECB instrument at the intersection of monetary and fiscal policy,³ it is the only one whose eligibility criteria include compliance with the fiscal framework, as well as debt sustainability. We answer the question whether the changes in the framework would have an impact on the operation of the TPI, and whether the TPI should be modified to better "fit" the new framework.

The remainder of this paper is structured in line with these three perspectives. Section 2 analyses the implications of the proposed framework for the fiscal stance over the coming 5 years. Drawing on the empirical findings of Section 2, Section 3 takes a view on the design of the proposed fiscal governance framework from the perspective of the interplay between monetary and fiscal policy. Finally, Section 4 analyses the relationship between the proposed framework and the TPI. Section 5 concludes.

² Fiscal dominance describes a situation in which large government debt and deficit prevent the central bank from controlling inflation. In such a situation, a central bank interest rate increase to tame inflation might result in market pressure on government bond markets, and the government might become insolvent without central bank financing.

³ Other instruments include Outright Monetary Transactions (OMT) and all instruments that operate through bond purchases in secondary markets (which are often called quantitative easing – QE).

2. IMPLICATIONS OF THE PROPOSED FISCAL GOVERNANCE FRAMEWORK FOR THE FISCAL STANCE IN THE EU

The European Commission (EC)'s April 2023 proposal to replace the current EU fiscal framework⁴ requires Member States (MS) to develop medium term fiscal-structural plans, following discussions with the Commission, that meet two main requirements. Both must "hold in the absence of any further budgetary measures over a period of 10 years" (EC, 2023a, Article 15) following the end of a 4-7-year adjustment period:

- (a) public debt as a share of GDP must be "put or kept on a plausibly downward path (...) or stay at prudent levels".
- (b) the government deficit must be maintained or brought below the 3% of GDP reference value.⁵

Annex V of EC (2023a) defines debt that is "put or kept on a plausibly downward path (...) or stay at prudent levels" as a debt path that slopes downward (or remains below 60% of GDP if it already meets the 60% benchmark) *both* with sufficiently high probability for 5 years after the adjustment period, as assessed by the stochastic debt sustainability analysis (DSA) of the Commission; *and* under the deterministic stress scenarios described in the Commission's 2022 Debt Sustainability Monitor (EC, 2023c).

In addition, the proposal commits the Commission to several additional conditions both in formulating a "technical trajectory" that it must put forward as a basis for discussion with MS with debt or deficits above the Treaty benchmarks of 60% and 3% of GDP, and in its assessment of MS medium-term fiscal-structural plans. Specifically, it must check: "whether the fiscal adjustment effort over the period of the national medium-term fiscal-structural plan is at least proportional to the total effort over the entire adjustment period" (no-backloading safeguard); "whether the public debt ratio at the end of the planning horizon is below the public debt ratio in the year before the start of the technical trajectory" (debt safeguard), "whether for the years that the Member State concerned is expected to have a deficit above the 3% of GDP reference value, and the excess is not close and temporary", the fiscal adjustment is at least 0.5% of GDP (excessive deficit safeguard⁶), and whether "national net expenditure growth remains below medium-term output growth, on average, as a rule over the horizon of the plan" (net

⁴ The proposal consists of two proposed regulations and one directive. The main reforms are contained in a "Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97" (EC, 2023a) which would replace the "preventive arm" of the current Stability and Growth Pact. In addition, a "Proposal for a Council regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure" (EC, 2023b) would abolish the "1/20th rule" which required MS with debt above 60% of GDP to reduce their debts by at least 1/20th of the difference between its debt ratio and 60% per year, and refocus the existing "debt-based excessive deficit procedure" on departures from the fiscal path agreed with the Council under the regulation replacing the preventive arm. However, the "deficit-based excessive deficit procedure" (EDP) would remain largely unchanged, requiring that "for the years when the general government deficit is expected to exceed the reference value, the corrective net expenditure path shall be consistent with a minimum annual adjustment of at least 0,5% of GDP as a benchmark." Finally, a "Proposal for a Council directive amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States" (EC, 2023c) aims at strengthening national-level independent fiscal institutions and medium-term budgetary frameworks.

⁵ See Articles 6, 12, and 15 as well as Annex I and V of EC (2023a).

⁶ We interpret "a minimum annual adjustment of at least 0,5% of GDP as a benchmark" wording of the draft regulation on the excessive deficit procedure (EC 2023b) as at least half percent adjustment. In our numerical calculations, we assume exactly half percent when otherwise adjustment would be less than half percent. However, Pench (2023) argues that the adjustment requirement can be less than half percent, because this safeguard, as well as the debt reduction safeguard, could be given a subordinated role relative to the sustainability criterion when the Commission and the Council make an overall assessment of the medium-term plans.

expenditure growth safeguard, which we interpret as ruling out a decline in the structural primary balance over the first four years of the adjustment period)

In Darvas, Welslau and Zettelmeyer (2023), we compute the fiscal adjustment implications of these conditions for all MS with 2024 projected debts or deficits above the reference values (on the assumption that the first adjustment year under the framework would be in 2025), based on a replication of the Commission's DSA methodology, using EC forecasts for growth, market-based interest rate and inflation expectations, as well as some ancillary assumptions to enable us to apply the safeguards.⁷

Table 1 summarises the main results. Positive numbers mean an increase in the structural primary balance, i.e. a fiscal tightening, expressed in percent of GDP. Countries are listed in a declining order of the fiscal balance forecast by the European Commission for 2024 (column 2). EC projections for fiscal adjustment in 2023 and 2024 are shown in columns (3) and (4)⁸. These indicate that the Commission expects sizeable fiscal consolidation in most EU countries, partly reflecting the withdrawal of COVID-19 and energy crisis support measures, albeit with exceptions (Belgium, Bulgaria, Croatia, Finland, and Slovakia). The GDP-weighted aggregate impact of this tightening for the euro area countries shown in the table is close to 0.8% of GDP in 2023 and 0.7% in 2024 (see bottom row).⁹

Columns (5)-(12) show the annual average fiscal adjustment that would be required for the 2025-27 period if the Commission's proposed framework was enacted in 2024. This depends on the adjustment period, which is normally four years, but could be extended to seven years for countries undertaking growth-enhancing structural reforms, including in the context of National Recovery and Resilience Plans (NRRPs).¹⁰ The table is laid out in a way that makes it clear which of the requirements of the framework are driving the results: Columns (5) and (6) show the average annual adjustment for 2025-28 that would be required by conditions (a) and (b) of the proposed framework, that is, to (a) put or keep debt on a sustainable downward path, and (b) to lower the deficit to less than 3% of GDP by the end of the adjustment period and keep it there for at least 10 years. Columns (7) to (12) show the annual adjustment, separately for the years 2025, 2026 and 2027, which the proposed framework would require once the safeguards are additionally applied. The need to show each year separately comes from the excessive deficit safeguard, which applies only in years in which the deficit is still above 3%¹¹. Countries and years for which this safeguard is binding are highlighted in orange, countries for which the debt safeguard is binding in yellow, and countries for which the net expenditure growth safeguard

⁷ The main assumption is that the "planning horizon" referred to in the debt safeguard, which is not defined in the proposed regulation, is four years. In addition, we assume that the total adjustment requirement over the 4-7-year adjustment horizon is broken down into equal adjustment steps, in structural primary balance terms. This assumption implies that the net expenditure paths automatically satisfy the no-backloading safeguard; indeed, they go further, as the no-backloading safeguard as currently drafted does not restrict backloading within either the four-year adjustment period or the first four years and the last three years of the seven-year adjustment period. See Darvas, Welslau and Zettelmeyer (2023) and Pench (2023) for a discussion.

⁸ The source is European Commission (2023d).

⁹ Including the remaining euro area countries in the average would somewhat reduce the impact in 2023, to 0.6% of GDP, mainly due to projected fiscal easing in the Netherlands (-1.9%) and Luxembourg (-1.5%), but leave the 2024 impact unchanged.

¹⁰ The calculations underlying Table 1 use the same growth forecasts to compute fiscal adjustment under the four and seven year adjustment periods. To the extent that the extension to seven years is determined by the strength of MS plans to raise growth, this could moderately bias up the adjustment results for the seven-year period shown in the table. However, Article 13 of the draft regulation (EC 2023a) says that "During the lifetime of the Recovery and Resilience Facility (...) commitments included in the approved Recovery and Resilience Plan of the Member State concerned can be taken into account for an extension of the adjustment period." Given that NRRP investments and reforms qualify for the extension, and Member States have difficulties even in implementing NRRPs, at least until the end of 2026, it is unlikely that countries would propose new investments and reforms to obtain an extension. NRRP investments and reforms, however, are already incorporated into the official growth projections on which the table is based.

¹¹ In Table 1, this makes a difference only for Poland in 2027.

is binding in light green. Finally, column (13) shows the average annual adjustment that would be required, in structural primary balance terms, if the current fiscal framework based on a “Medium Term Objective” (MTO) were reapplied after 2024.

The main results are as follows.

1. The proposed framework would require continued fiscal adjustment from 2025 until the end of the four-year planning horizon in 2028, from almost all MS (the only exceptions are Cyprus and Greece, whose 2024 structural primary balances are projected to already be above the 2028 values prescribed by the framework).
2. As indicated by the highlights (and by comparing columns (5)-(6) and columns (7)-(12)), the fiscal adjustment requirements of the proposed frameworks are mostly driven by conditions (a) and (b) above – that is, the debt sustainability requirement and the requirement that the deficit be reduced to and remain below 3% of GDP by the end of the adjustment period. There are three exceptions:
 - First, for a few countries with projected excessive deficits in 2024, the annual fiscal adjustment prescribed by conditions (a) and (b) falls short of the 0.5% of GDP required by the excessive deficit safeguard (Poland and Malta, and additionally Italy, Spain, Hungary and Romania for the 7-year adjustment period which lowers the average annual adjustment required by conditions (a) and (b)).
 - Second, the debt safeguard is binding for two countries, France and Bulgaria, in both the 4-year and 7-year adjustment periods, and for three additional countries, Belgium, Romania and Slovakia, in the 7-year adjustment period only. For France, the annual required adjustment during 2024-28 goes up from 0.8% of GDP (4-year adjustment period) or 0.4% of GDP (7-year adjustment period) to 1.1% of GDP. For Belgium, the increase is 0.3% of GDP (7-year adjustment period only).
 - Third, the net expenditure safeguard is binding for Greece and Cyprus. In the absence of this safeguard, these countries would have been able to *lower* their structural primary balances from their high projected levels in 2024 without running afoul of either conditions (a) and (b) not any of the other safeguards.
3. While the proposed system prescribes a significant fiscal tightening, this is not as large as would be required under the current fiscal rules, if these were to be reapplied from 2025 onward. A comparison between column (13) and columns (7)-(12) shows that the fiscal adjustment requirement under the proposed system would be at least 0.2% of GDP per year lower than under the current system for Cyprus, Greece, Finland, Spain, Italy, Malta, Belgium, and Slovakia. For Portugal, Germany, Austria, France and Slovenia, it does not make much of a difference (+/- 0.1% of GDP). Only for Bulgaria would the proposed system require much higher fiscal adjustment than the current one, on account of the debt safeguard. The difference comes mainly from the fact that in the current system, higher debt raises the MTO via an ad-hoc formula, while fiscal adjustment under the proposed system is based on a set of deterministic and stochastic debt projections (with some ad hoc corrections via the safeguards, as discussed above).

Table 1: Fiscal adjustment based on European Commission forecasts (2023-24), proposed framework (2025-28), and current framework (2025-28)
(in structural primary balance terms, expressed in percent of GDP)

| Country | GDP weight in euro area, 2024 (%) | 2024 fiscal balance (EC forecast) | EC adjustment <i>forecast</i> | | 2025-28 average adjustment required by conds. a&b of <i>proposed</i> framework | | Adjustment required by <i>proposed</i> framework, including safeguards | | | | | | 2025-28 average annual adjust. required by <i>current</i> framework |
|-----------------------|-----------------------------------|-----------------------------------|-------------------------------|------|--------------------------------------------------------------------------------|--------------------|------------------------------------------------------------------------|--------------------|--------------------|--------------------|--------------------|--------------------|---------------------------------------------------------------------|
| | | | 2023 | 2024 | | | 2025 | | 2026 | | 2027 | | |
| | | | | | 4-year adj. period | 7-year adj. period | 4-year adj. period | 7-year adj. period | 4-year adj. period | 7-year adj. period | 4-year adj. period | 7-year adj. period | |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) | (12) | (13) |
| Cyprus | 0.2 | 2.1 | 0.0 | 0.4 | -0.7 | -0.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | -0.3 |
| Portugal | 1.8 | -0.1 | 0.2 | 0.6 | 0.2 | 0.1 | 0.2 | 0.1 | 0.2 | 0.1 | 0.2 | 0.1 | 0.1 |
| Greece | 1.6 | -0.6 | 1.6 | 0.4 | -0.1 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.6 |
| Germany | 28.7 | -1.2 | 0.4 | 1.0 | 0.3 | 0.1 | 0.3 | 0.1 | 0.3 | 0.1 | 0.3 | 0.1 | 0.3 |
| Austria | 3.4 | -1.3 | 1.5 | 1.1 | 0.3 | 0.2 | 0.3 | 0.2 | 0.3 | 0.2 | 0.3 | 0.2 | 0.3 |
| Croatia | 0.5 | -1.3 | -0.5 | -0.6 | 0.2 | 0.1 | 0.2 | 0.1 | 0.2 | 0.1 | 0.2 | 0.1 | 0.4 |
| Finland | 1.9 | -2.6 | -0.9 | 0.3 | 0.3 | 0.1 | 0.3 | 0.1 | 0.3 | 0.1 | 0.3 | 0.1 | 0.5 |
| Slovenia | 0.5 | -2.9 | 0.2 | 1.4 | 1.0 | 0.6 | 1.0 | 0.6 | 1.0 | 0.6 | 1.0 | 0.6 | 1.1 |
| Spain | 10.0 | -3.3 | 0.3 | 0.5 | 0.6 | 0.4 | 0.6 | 0.5 | 0.6 | 0.5 | 0.6 | 0.5 | 1.0 |
| Italy | 14.3 | -3.7 | 2.9 | 1.0 | 0.9 | 0.4 | 0.9 | 0.5 | 0.9 | 0.5 | 0.9 | 0.5 | 1.4 |
| Poland | | -3.7 | 1.0 | 1.6 | 0.1 | 0.1 | 0.5 | 0.5 | 0.5 | 0.5 | -0.2 | -0.1 | 0.6 |
| France | 19.7 | -4.3 | 0.4 | 0.2 | 0.8 | 0.4 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.2 |
| Hungary | | -4.4 | 4.2 | -0.2 | 0.7 | 0.5 | 0.7 | 0.5 | 0.7 | 0.5 | 0.7 | 0.5 | 0.8 |
| Romania | | -4.4 | 2.1 | 0.2 | 0.8 | 0.5 | 0.8 | 0.6 | 0.8 | 0.6 | 0.8 | 0.6 | 1.0 |
| Malta | 0.1 | -4.5 | 1.2 | 1.0 | 0.4 | 0.3 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 1.0 |
| Belgium | 4.0 | -4.7 | -0.5 | 0.6 | 1.1 | 0.6 | 1.1 | 0.9 | 1.1 | 0.9 | 1.1 | 0.9 | 1.5 |
| Slovakia | 0.9 | -4.8 | -3.8 | 1.4 | 1.1 | 0.7 | 1.1 | 0.8 | 1.1 | 0.8 | 1.1 | 0.8 | 1.3 |
| Bulgaria | | -4.8 | -1.7 | 0.0 | 0.9 | 0.6 | 1.9 | 1.9 | 1.9 | 1.9 | 1.9 | 1.9 | 1.1 |
| EA14 weighted average | | -2.7 | 0.76 | 0.73 | 0.58 | 0.31 | 0.65 | 0.51 | 0.65 | 0.51 | 0.65 | 0.51 | 0.83 |

Source: authors' calculations based on Darvas, Welslau and Zettelmeyer (2023), economic growth projections from the European Commission's May 2023 forecast, and market-based interest rate and inflation forecasts.

Note: Countries and years for which excessive deficit safeguard is binding are highlighted orange, countries for which the debt safeguard is binding are highlighted yellow, and countries for which the net expenditure safeguard is binding in light green.

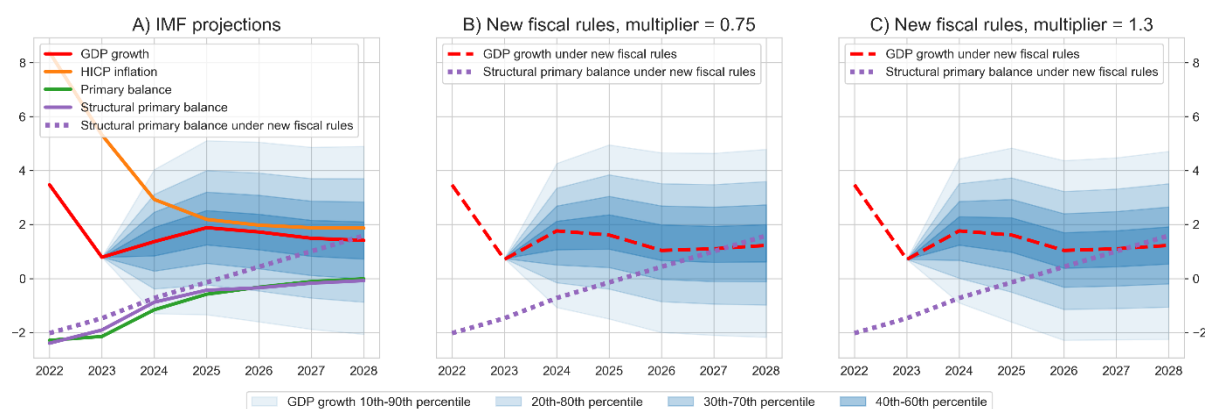
The last line of the table shows the aggregate implications for the euro area fiscal stance, based on the 14 euro-area countries included (88% of the euro area in GDP terms). This implies that the consolidation forecast by the Commission for 2023 and 2024 would continue during 2025-28, albeit at a slightly slower pace. The Commission's DSA and the need to reduce the deficit below 3% imply a tightening between 0.58% and 0.31% of GDP per year, depending on whether countries are given 4 or 7 years respectively to adjust (columns 5 and 6). The application of the safeguards bumps this adjustment up by a notch, to 0.65% and 0.51% percent of GDP, mostly on account of the much higher adjustment for France (columns 7-12).

The question is whether this fiscal adjustment path would support the achievement of the ECB's price stability objective. Most private forecasts and all major official forecasts – by the ECB, the European Commission, the IMF and the OECD – predict a return to the inflation target in the medium term. However, these forecasts typically assume that the central bank will do whatever it takes to achieve its inflation target and thus do not answer the question of whether fiscal policy could contribute either by accelerating the process or lowering the output costs of disinflation. To take a stab at that question, it is necessary to look at inflation forecasts together with forecasts for output and the fiscal stance.

The only institution that provides a set of consistent forecasts of these variables over the medium term (until 2028) is the IMF in the World Economic Outlook. While these forecasts are somewhat dated (April

2023)¹², it is worth asking what they imply if taken at face value. The IMF expects euro-area inflation to return to very close to the 2% ECB target by 2025 and stay close to the target until the end of the forecast horizon (Figure 1, Panel A). It also expects the euro area to avoid a recession; indeed, it projects a recovery of growth by 2025. This said, there is high uncertainty around these projections, indicated by the shaded confidence bands, which imply a recession probability of 25% in 2026.¹³ Finally, as regards fiscal adjustment, the IMF expects an adjustment similar to the European Commission in total in 2023 and 2024, followed by much slower adjustment over the medium term, with the structural primary balance gradually converging to zero after 2025. Panel A of Figure 1 also shows how fiscal adjustment presented in Table 1 would differ from that projected by the IMF. Until 2025, the two fiscal paths more or less coincide. After 2025, however, the fiscal path required by the proposed framework is dramatically tighter (purple broken line).

Figure 1: IMF projections for the euro area, and adjusted growth projections corresponding to the proposed new fiscal rules, 2022-2028



Source: IMF World Economic Outlook database and Bruegel calculations.

Note: Structural primary balance is our calculation using IMF data on primary balance and output gap, and the average euro-area budget balance semi-elasticity to the output gap from Table I.3 (p. 41) of Mourre, G. et al. (2019). We calculated the euro-area average elasticity as a weighted average of the elasticities of euro-area countries. We did not exclude possible one-off expenditure and revenue items when calculating the structural balance. "Structural primary balance under new fiscal rules" correspond to European Commission May 2023 forecast for 2022-2024 and our calculations for 2025-2028 by averaging the annual adjustment requirement under the 4-year and under the 7-year horizons (since some countries might opt for a 4-year plan, others for a 7-year plan). In Panels B and C, "GDP growth under new fiscal rules" is our calculation by adjusting the IMF GDP growth projections with the impact of the difference between the changes in IMF structural primary balance estimate and the change in our "Structural primary balance under new fiscal rules" estimate, assuming either the 0.75 fiscal multiplier parameter that the Commission uses (Panel B), or a fiscal multiplier of 1.3 (Panel C). In line with the Commission, it is assumed that the impact of fiscal consolidation on the output gap gradually diminishes in three years. Percentiles are calculated by us based on IMF historical forecast errors.

Panels B and C of Figure 1 show how GDP forecasts would be affected by faster fiscal consolidation under the proposed new fiscal rules, using either the (relatively low) fiscal multiplier assumptions of the European Commission (Panel B), or a somewhat larger fiscal multiplier (see table note). The consequence would be a somewhat lower output path than that projected by the IMF. At the same time, the probability of a recession in 2026 rises from 25% in panel A to 30% in panel B and 34% in panel C. These probabilities are somewhat smaller than the recession probabilities presented in the most recent ECB forecast, based on ECB growth forecast errors, which are in the order 40% by end-2025 (see ECB, 2023a, Chart 1).

We see two main takeaways in this analysis.

¹² The IMF published an [Update](#) to its World Economic Outlook in July 2023, which, however, only provides forecasts for 2023 and 2024.

¹³ Confidence bands were calculated using historical IMF growth forecast errors.

First, by any measure – whether one believes the European Commission or the IMF’s forecasts – the time where monetary policy and fiscal policy were pushing in opposite directions is over. Fiscal and monetary policy are now moving in tandem and expected to do so until 2025, by when both the ECB and the IMF expects that euro-area inflation will return close to the ECB’s 2% target.

Second, if fiscal balances evolve in line with the proposed economic governance reform, monetary and fiscal policy may well drift apart again from in a few years from now, but in opposite directions compared to where they were in 2022. If inflation indeed falls back close to 2% by 2025, the ECB will stop tightening and might even cut interest rates (either in 2025, or perhaps even earlier), while fiscal policy would continue on a tightening path for several years. This will imply a significant demand drag on the euro area economy. To the extent that it translates into a drop of inflation below 2 %, monetary policy will ease, thereby supporting output and avoiding a recession. But if the preceding monetary and fiscal tightening has already created weaker economic conditions than predicted in the IMF’s baseline scenario, a recession may ensue. Recent signs of economic weakening in the EU, with downward revision to growth in both 2023 and 2024 in the European Commission’s September 2023 forecast (European Commission 2023e) relative to its May forecast European Commission 2023d), suggest that this risk is growing.

Hence the answer to the question of whether the proposed framework would support price stability objectives over the horizon of its first application is as follows. In the short run, it would not make much of a difference. But over the medium term, there is a risk that it would induce a fiscal stance that is too tight from a conjunctural perspective, and requires the monetary authority to offset it. Not surprisingly, this risk depends on the length of the adjustment period: as the seven-year adjustment period would spread out fiscal adjustment over more years, and the fiscal drag on growth over the first four years would be substantially less.¹⁴

¹⁴ In addition, the total required adjustment might be lower as a result of the growth-inducing reforms that are required to qualify for the three year extension to the adjustment period. For the reasons explained in footnote 10, this effect is not considered in the Table 1 estimates.

3. DOES THE PROPOSED FRAMEWORK OPTIMALLY TRADE-OFF FISCAL SUSTAINABILITY AND FLEXIBILITY?

As argued in the introduction, fiscal frameworks should seek to ensure debt sustainability while also giving policy makers flexibility to pursue other objectives. This is both in the general public interest and in the interest of monetary policy makers, who may require the help of fiscal policy makers in meeting their price stability objective¹⁵.

Importantly, however, there can be a trade-off between the two objectives. This could arise from the fact that fiscal authorities may have incentives to overspend, in light of short election horizons, or perhaps in light of the fact that the electorate itself does not fully internalise the welfare of future generations. In this case, ensuring debt sustainability may require restricting the flexibility of the fiscal authority. This is the standard argument for fiscal rules (see, for example, Alesina and Tabellini, 1990). For similar reasons, governments may prefer current spending to investment spending, since the latter only partly benefits current voters. Fiscal rules could attempt to correct this bias.

A monetary union with sovereign fiscal policy at the level of Member States complicates this trade-off, in two respects.

On the one hand, it strengthens the argument for rules that constrain overly expansionary fiscal policies. Overborrowing by members of a monetary union has stronger negative externalities for other members than across countries that are integrated only through trade and financial relationships. This is true not only because financial linkages are tighter in a monetary union, but because a messy default and/or exit from the currency area can threaten the credibility of the currency union as a whole (the July 2015 crisis in Greece is a case in point). As a result, fiscal crises will lead to pressure for a bailout through financial assistance, and possibly pressure for debt monetisation, endangering price stability in all currency union member countries (Darvas et al, 2018, Bénassy-Quéré et al, 2018, Gourinchas et al, 2023).

On the other hand, membership in a currency union also strengthens the possibility of a positive externality associated with expansionary fiscal policy. The central bank may need help in increasing aggregate demand, as was the case in the euro area between 2013 and 2020, but national policy makers may not internalise the impact of fiscal policy on the euro area as a whole. As sovereign countries cannot be forced to incur debt beyond the level that can be justified to national citizens, this problem can only be solved through a central fiscal capacity (CFC), which can adjust the euro area fiscal stance to the collectively optimal level.

From the perspective of monetary-fiscal coordination, one obvious problem of the proposed fiscal framework is the lack of such a capacity. Leaving aside this problem, the question is whether the framework ensures debt sustainability at minimum cost to restricting the possibility of expansionary national fiscal policy when this is needed for price (and output) stability reasons. An important corollary of this requirement is that the framework should not generate rules or incentives that induce procyclical fiscal contractions in response to a negative output shock.

To answer the question, we need to briefly take stock of the design features that attempt to ensuring debt sustainability on the one hand while preserving flexibility on the other.

¹⁵ For example, in her 27 July 2023 monetary policy statement, President Lagarde stressed: "As the energy crisis fades, governments should roll back the related support measures promptly and in a concerted manner. This is essential to avoid driving up medium-term inflationary pressures, which would otherwise call for a stronger monetary policy response." <https://1/www.ecb.europa.eu/press/pressconf/shared/pdf/ecb.ds230727~9e147b657d.en.pdf>

To ensure debt sustainability, the framework relies on a plethora of commitment devices:

- The main *ex ante* commitment device is the medium-term fiscal structural plan, which results in a net expenditure path. This must satisfy not only criterion (a), the debt sustainability criterion per se, but also criterion (b), the deficit criterion, which is conceptually irrelevant for debt sustainability, but required by the treaty, and may be effective in disciplining policy makers in practice (Caselli and Wingender, 2021). Furthermore, the European Commission is supposed to assess whether the plan also meets three additional safeguards described above — designed to prevent “backloading”, achieve debt reduction by the end of the planning horizon, and require a minimum speed of adjustment of 0.5% of GDP per year for countries whose deficits exceed 3% — and base its recommendation to the Council on this assessment.
- *Ex post*, the framework envisages four devices (lines of defense, so to speak) to make sure that fiscal adjustment happens as planned. First, the agreed net expenditure path must be written into law in every country, resulting in binding medium-term net expenditure ceilings. Second, if the country violates these ceilings, it might be subject to a disciplining procedure (the “debt-based” excessive deficit procedure). Third, even if the country does not violate the ceilings, it could be subject to higher-than planned minimum adjustment if the conditions of the “deficit based” EDP apply, namely, if its deficit exceeds 3% when its planned adjustment is less than 0.5% of GDP¹⁶. Even if the net expenditure path was designed to prevent this, this could happen *ex post* as a result of a bad shock (lower nominal output or higher interest rates). And fourth, fines for excessive deficit would be imposed at an earlier stage, and initially in smaller amounts, than in the current system.

The framework also embodies three elements that seek to preserve flexibility, promote reforms and investment, and avoid procyclical fiscal adjustment:

- First, the possibility to extend the adjustment period by three years for countries that put forward growth-enhancing public investment and reforms. From the perspective of the ECB, this is desirable because it raises equilibrium interest rates (“ r^* ”), making it less likely that the economy will return to a regime in which monetary policy is constrained by the zero lower bound on interest rates.
- Second, the fact that the main commitment device is a *net expenditure* path, not a deficit path. Net expenditures exclude items that the fiscal authorities cannot control, including interest spending, as well as the cyclical drivers of the deficit (revenue and cyclical expenditure categories such as unemployment benefits). In principle, this means that if the country is hit by a bad shock, it should not be required to tighten;
- Finally, two “escape clauses”: a general escape clause in which the Council “may adopt a recommendation allowing Member States to deviate from their net expenditure path, in the event of a severe economic downturn in the euro area or the Union as a whole, provided it does not endanger fiscal sustainability”, and a “country-specific escape clause”, where it may do the same “where exceptional circumstances outside the control of the Member State lead to a major impact on the public finances of the Member State concerned, provided it does not endanger fiscal sustainability.”

The question is whether the benefits of the restrictions introduced for the sake of ensuring debt sustainability justify the costs that they impose on flexibility, and vice versa for the devices that are

¹⁶ See footnote 6 about the ambiguity of whether the minimum half percent adjustment requirement is a hard constraint or not.

there to protect flexibility. Drawing on the analysis of Darvas, Welslau and Zettelmeyer (2023) and the results of the last section, we answer this question as follows.

Aside from the lack of a CFC, the main elements of the proposed framework are sound: asking countries to develop a medium-term fiscal-structural plans consistent with debt sustainability, creating incentives for reform and public investment, requiring them to write the plan into national law in the form of a net expenditure path; requiring corrective measures if the plan is violated; and letting countries off the hook in the event of a major downturn that cannot be addressed through automatic stabilisers alone.¹⁷ We also see a rationale for a (properly designed) “no backloading safeguard” that constrains the net expenditure path beyond what would be required by debt sustainability analysis alone. The reason is that debt sustainability analysis alone may not put enough structure on the adjustment path, giving a pass to adjustment proposals that are not time-consistent in light of the political process. We therefore agree with imposing a no-backloading condition, which rules out net expenditure paths that seek to leave most adjustments to the last minute.

Second, given its central role, there is a case for reviewing the European Commission’s DSA methodology, in a way that involves Member States rather than just the Commission alone. While the methodology is generally both reasonable and rigorous, there is scope for improving it with relatively little effort (see Darvas, Welslau and Zettelmeyer 2023 for details)¹⁸. Furthermore, MS are unlikely to comply with the implications of the methodology for fiscal adjustment unless they understand it and agree with it. To make the review as objective as possible, we recommend the establishment of an independent expert group to conduct the technical review, seeking the views of Commission staff, Members States, the ECB, the ESM, and the European Fiscal Board (EFB), and submitting a report to the Council recommending changes. This DSA review will take some time, while the economic governance review (EGR) should be adopted in the next few months; otherwise, the existing fiscal rules will be reinstated in 2024. We, therefore, recommend approving the EGR as soon as possible with a clause requiring the revision of the DSA methodology before the end of 2024, making 2024 a transition year, and launching the full implementation of the new fiscal framework from the beginning of 2025, based on the new DSA methodology.

Third, there are several design flaws with the proposed safeguards which should be addressed before the proposal goes into effect.

- i. As currently drafted, the no-backloading safeguard is almost empty, in the sense that it would not prevent the most common forms of backloading. This is because it requires that “the fiscal adjustment effort over the period of the national medium-term fiscal-structural plan is at least proportional to the total effort over the entire adjustment period.” If the “period of the plan” is four years, this formulation would only ensure that the average adjustment in the last three years of a seven-year adjustment is not smaller than the average adjustment in the first four years, but not prevent backloading within the four-year adjustment period, nor within the first four years and last three years of the seven-year adjustment period.
- ii. Both the debt safeguard and the excessive deficit safeguard impose significant additional restrictions on fiscal policy that cannot be justified with debt sustainability objectives

¹⁷ We have (separately) been arguing for this type of architecture for some time. See Claeys, Darvas and Leandro (2016), Bénassy-Quéré et al (2018), Darvas, Martin and Ragot (2018), Blanchard, Leandro and Zettelmeyer (2021), Arnold et al (2022).

¹⁸ Technical issues are related to the maturity structure of debt; the interpolation of inflation; not differentiating between the GDP deflator and harmonised index of consumer prices (HICP); using euro-area inflation expectations for Bulgaria, Czechia, Denmark, and Sweden; disregarding the sensitivity of interest rates to alternative debt paths; assuming no uncertainty during the adjustment period in the stochastic analysis; assuming normal distribution of shocks in the stochastic analysis; and a number of other simplifying assumptions. There are a number of other assumptions as well, which are reasonable, but could be re-examined.

(particularly if the no-backloading safeguard is fixed). These are particularly apparent in the case of the seven-year adjustment period. These safeguards prevent the countries to whom they apply from benefitting from the extension of the adjustment period, namely, to lower the annual adjustment requirement in exchange for growth enhancing reform or investment. By doing that, they undermine the intended purpose of the extension of the adjustment period. The effects can be large. For example, the application of the debt safeguard raises the annual adjustment requirement for France from 0.8% of GDP with four-year adjustment, or 0.4% of GDP with seven-year adjustment, to 1.1% of GDP. The impact of the debt safeguard on Bulgaria's adjustment requirement is even larger, which is ironic since Bulgaria has one of the lowest debt ratios in the euro area. The excessive deficit safeguard has smaller effects, but they apply to more countries. Both safeguards should be abolished or fundamentally redesigned.¹⁹ If the reason for inserting the safeguards was the lack of trust in the DSA by some Member States, then a better solution would be the joint review of the DSA methodology by the Commission and the Member States and codification of the methodology in the Code of Conduct of the Stability and Growth Pact, as recommended in Darvas, Welslau and Zettelmeyer (2023).²⁰

- iii. Consistent with abolishing or redesigning the excessive deficit safeguard, the deficit-based excessive deficit procedure requires a redesign, because it can induce procyclical adjustment. Member States that are in compliance with the net expenditure path agreed with the Council should not be required to undertake a higher adjustment in the face of a shock that puts their deficit above 3%, so long as the agreed path continues to satisfy the DSA-based requirements (condition (a)).

Finally, we would have liked to see a greater role of independent fiscal institutions in the process of activating the escape clauses. If this process becomes political, it could seriously undermine the discipline that the framework is meant to impart. The participation of independent fiscal institutions could reduce that risk.

Note that these proposals cut both ways. The recommendations to review the Commission's DSA methodology has nothing to do with shifting the weights that the proposal assigns to discipline and flexibility in one direction or the other; rather, it is about making the framework more efficient in the sense of increasing its capacity to predict unsustainable debt. Among our three recommendations on safeguards, the first would make the framework tougher (at an acceptable cost to flexibility) while the two others would make it more flexible (at acceptable costs to its disciplining function). Finally, the recommendation on involving fiscal councils is again about increasing the efficiency and the credibility of the new framework, at no or acceptable cost to flexibility and its disciplining function.

¹⁹ A fundamental redesign would mean (1) defining the safeguards so they do not block an extension of the adjustment period from translating into lower adjustment requirements (for example, by changing the language such that the debt safeguard applies to the adjustment period, not the "planning horizon"; (2) introducing an exception for EU-endorsed public investments into the safeguards. In addition, the debt safeguard should not apply to countries with debt below 60% of GDP.

²⁰ See also Blanchard and Zettelmeyer (2023)

4. REEXAMINING THE TRANSMISSION PROTECTION INSTRUMENT IN LIGHT OF THE PROPOSED FRAMEWORK

In July 2022, the ECB Governing Council approved the Transmission Protection Instrument (TPI), which allows Eurosystem secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals, provided certain criteria are fulfilled. The declared aim of the new tool is to “ensure that the monetary policy stance is transmitted smoothly across all euro area countries”, a precondition for the ECB to deliver on its price stability mandate.

Stripped from ECB terminology, the objective of the TPI is to maintain orderly market conditions in sovereign debt markets without undermining fiscal discipline and without giving rise to transfers from the monetary authority (as might arise if the ECB were to purchase sovereign bonds of an insolvent country). To achieve this, the July 2022 ECB decision set four criteria for the eligibility to the TPI, as follows²¹:

- (1) *compliance with the EU fiscal framework: not being subject to an excessive deficit procedure (EDP), or not being assessed as having failed to take effective action in response to an EU Council recommendation under Article 126(7) of the Treaty on the Functioning of the European Union (TFEU);*
- (2) *absence of severe macroeconomic imbalances: not being subject to an excessive imbalance procedure (EIP) or not being assessed as having failed to take the recommended corrective action related to a Council recommendation under Article 121(4) TFEU;*
- (3) *fiscal sustainability: in ascertaining that the trajectory of public debt is sustainable, the Governing Council will take into account, where available, the debt sustainability analyses by the European Commission, the European Stability Mechanism, the International Monetary Fund and other institutions, together with the ECB’s internal analysis;*
- (4) *sound and sustainable macroeconomic policies: complying with the commitments submitted in the recovery and resilience plans for the Recovery and Resilience Facility and with the European Commission’s country-specific recommendations in the fiscal sphere under the European Semester.*

These are necessary criteria for eligibility. When these criteria are fulfilled, the ECB will independently decide whether to conduct TPI operations, by assessing whether “unwarranted, disorderly market dynamics” arose, following a “comprehensive assessment of market and transmission indicators, an evaluation of the eligibility criteria and a judgement that the activation of purchases under the TPI is proportionate to the achievement of the ECB’s primary objective”.

All four eligibility criteria are related to the economic governance review. In this section, we focus on the aspects most closely related to the reform of the fiscal framework, (1) and (3), and address two questions. First, would the proposed framework pose any difficulties in applying the two conditions, relative to the current framework? Second, does the proposed framework create opportunities for improving the TPI? The answers are no, and yes, respectively.

²¹ Source: <https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr220721~973e6e7273.en.html>

4.1. Would the proposed framework complicate the application of the TPI?

The short answer is no. Under the proposed framework, condition (1) will continue to be determined by the Council as before, while condition (3) could be evaluated by the ECB exactly as before, as all the debt sustainability analysis of the institutions named will continue to be available. Indeed, the DSA of the Commission may be publicly available with greater frequency than under the status quo (when it is published once a year), as it plays a critical role in the excessive deficit procedure (see below). Hence checking (1) and (3) will be no harder, as a result of the proposed fiscal governance reform, than it was before.

To see how the assessment of condition (1) would work in practice, is it nonetheless worth summarising how the proposed regulation envisages the opening of an EDP, and whether there is clarity on the interpretation of “effective action” once a country is under an EDP.

According the proposed “Council regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure” (EC 2023b), two circumstances could lead to the launch of an EDP:

- The deficit-based EDP remains unchanged from the current framework. An excessive deficit exists if the deficit exceeds the 3% reference value, unless the deviation is small and temporary or caused by exceptional circumstances beyond the control of the government.
- The debt-based EDP is revised. For countries with public debt ratios above 60% of GDP, deviations from the Council-endorsed net expenditure path will be evaluated. Within this group, a differentiation is made for countries with “substantial public debt challenges”²² and the remaining countries. For the former, a deviation from the agreed net expenditure path will by default lead to the opening of an EDP, while for the latter, other factors will be considered too.

The new debt-based EDP condition can be assessed only after some years the new framework will have entered into force, so at the possible start of the new framework in 2024, only the conditions for a deficit-based EDP will be assessed. Table 1 reports European Commission deficit forecast for 2024 and shows that ten EU countries, of which six are members of the euro area, are expected to have more than 3% budget deficit in 2024. Among the euro-area countries that suffered high spreads during the euro crisis in the early 2010s, Italy and Spain are in this group and thus will likely enter an EDP in 2024.

Once in an EDP, a country would remain eligible for the TPI if it takes “effective action” in response to the Council recommendation. Per Article 126(8) of the TFEU, it is for the Council to establish whether effective action has been taken. Under the new framework, (Article 3, paragraph 4 of EC 2023b), the Council would ask the MS to “implement a corrective net expenditure path” that meets the following criteria.

- It meets condition (a), i.e. “puts the debt ratio on a plausibly downward path or keep it at a prudent level” as defined by the regulation replacing the preventive arm;
- It ensures that the average annual fiscal adjustment effort in the first three years is at least as high as the average annual fiscal effort of the total adjustment period.

²² As explained in the most recent debt sustainability monitor (EC 2023c, p. 11), these are countries which based on the Commission’s debt sustainability methodology, are assessed as having high fiscal sustainability risks over the medium term. In 2022, this group included Belgium, Greece, Spain, France, Croatia, Italy, Hungary, Portugal and Slovakia.

- “For the years when the general government deficit is expected to exceed the reference value, the corrective net expenditure path shall be consistent with a minimum annual adjustment of at least 0.5% of GDP as a benchmark.”

Hence, implementation of the requested corrective net expenditure path would constitute effective action.²³

In addition, an amendment to Article 8 of the regulation (EC 2023b) lays out the conditions under which the Council would “abrogate” (end) the EDP, namely “where budgetary forecasts as provided by the Commission indicate that the deficit has been brought durably below the reference value and, where the excessive deficit procedure was opened on the basis of the debt criterion, the Member State concerned respected the corrective net expenditure path set by the Council (...) over the previous 2 years and is projected to continue to do so in the current year on the basis of the Commission forecast.”

Our reading of the proposed regulation is hence that it defines the conditions for compliance with the EU fiscal framework at least as clearly as the regulation that it replaces. The Council will continue to decide on the existence of an excessive deficit, and on whether countries in and EDP are taking effective action. And the criteria for doing so are well described in the regulation, creating predictability.

4.2. Does the proposed framework offer an opportunity for improving the TPI?

There is an important asymmetry between conditions (1) and (3). In condition (1) (as well as as conditions (2) and (4)), the ECB delegates the assessment of whether the condition is satisfied to the Council and the Commission. In condition (3), however, the decision whether a country’s debt is sustainable is not delegated. While the ECB Governing Council “takes into account” the DSA of the European Commission (as well as that of the European Stability Mechanism, the International Monetary Fund and others) as well as the ECB’s internal analysis, it reserves the right to decide any way it wants.

The question is whether there may a case for removing this asymmetry, in either direction. If the ECB Governing Council gives itself discretionary power to decide on debt sustainability, might it also make sense to give itself discretionary power to in deciding whether the country’s fiscal policy is appropriate? Conversely, if the ECB delegates the assessment of all criteria but (3) to Council and Commission, might it also makes sense to delegate the assessment of debt sustainability?

To begin with the first question, the potential attraction of placing some decision-making power related to condition (1) into the hands of the ECB is that this might undo some of the less useful, rigidity-inducing features of the proposed system, such as counterproductive safeguards. In principle, the ECB might take a narrower view of both the inappropriate fiscal behavior and “effective action” than the Council, namely, one that is focused only on adherence to a net expenditure path consistent with debt sustainability (criterion a) while disregarding minimum adjustment of 0.5% when this is inappropriate in the eyes of the ECB.

The problem of this approach, of course is that it would be highly confrontational. Furthermore, the ECB’s official opinion on the proposed framework (ECB, 2023b) takes a kinder view of the proposed safeguards than we have taken in this paper. Hence, the idea that the ECB might use the enormous power of the TPI to in effect fix some of the problems of the proposed framework is a pipe dream. We conclude that condition (1) should remain as currently drafted.

²³ That is, it is a sufficient condition for effective action. It may not be a necessary condition, if the Council considers the implementation to be close enough to the requested corrective path. The proposed regulations do not provide any guidance in this respect.

Consider now the second question, on whether condition (3) should be aligned with the remaining conditions in the sense that, rather than taking a discretionary decision on debt sustainability based on various inputs, it defers to the DSA of the Council and Commission, as implemented under the proposed framework.

As argued by Claey's and Demertzis (2022), this could be attractive for two reasons. First, the TPI potentially involves fiscal transfers across euro-area countries. In the absence of a genuine fiscal union, a decision with large potential fiscal consequences should involve considerable deference to the fiscal representatives of euro-area Member States, like the Eurogroup (the euro-area finance ministers from the ECOFIN Council). Second, piggybacking on the Council's/Commission's DSA would avoid noise that could destabilise the debt markets. Markets would know that countries whose debt is found sustainable by the Commission/Council, and meet the remaining conditions (all of which are observable), will have access to the TPI. By contrast, under the current system, there will always be doubt whether the ECB Governing Council ultimately agrees with the Commission's/Council's DSA or not.

From the perspective of July 2022, it is understandable why the ECB did not go this route. First, there was no mechanism for the Council/Eurogroup to assess the fiscal sustainability of Member States (except when financial assistance is requested from the European Stability Mechanism, but this is not a condition for the TPI). The Commission's DSA analysis did not have a prominent role in the EU governance framework, and the Commission DSA results were not endorsed by the Council. Second, the Commission's methodology was relatively obscure, and – while reasonable – embodied some doubtful features (see Darvas, Welslau and Zettelmeyer 2023 for details).

In light of the economic governance legislative proposal, these arguments may no longer apply. First, the status of the DSA methodology has in effect been upgraded: its results will be endorsed by the Council. Furthermore, in Darvas, Welslau, and Zettelmeyer (2023) and the previous section, we recommended that there should be a review and approval of the Commission's DSA methodology jointly by the Commission and all Member States and that the technicalities of the DSA methodology should be codified in a document approved by Member States, possibly in the Code of Conduct of the SGP. The ECB should be given a chance to comment and contribute to the review at the technical level.

Assuming the future fiscal framework encompasses debt sustainability as a necessary condition for compliance with the fiscal framework and the DSA methodology is collectively reviewed, we would therefore recommend a revision of the TPI conditions to give greater deference to the future, Council-endorsed DSA. Specifically, we see two options, the first of which would take an incremental step, and while second one would be more radical.

The incremental approach would be to change the language of condition 3 in a way that creates the expectation that the ECB would normally defer to the Council/Commission DSA, without delegating the debt sustainability decision entirely. For example, condition 3 could read (our addition to the existing text is in bold):

fiscal sustainability: in ascertaining that the trajectory of public debt is sustainable, the Governing Council will **normally adopt the conclusions of the Council-endorsed debt sustainability analysis conducted in the context of the implementation of the EU fiscal framework. In addition, it may** take into account, where available, the debt sustainability analyses by the European Stability Mechanism, the International Monetary Fund and other institutions, together with the ECB's internal analysis.

The radical approach would be to either delete condition (3) altogether – since debt sustainability as per the Council-endorsed DSA is automatically satisfied when a MS complies with the fiscal framework

– or maintain condition (3) but link the debt sustainability assessment fully to the Council/Commission DSA.

The two approaches have different pros and cons.

- The main advantage of the radical approach compared to the incremental one is that it excludes the possibility of market turmoil linked to the possibility that the Commission/Council DSA might be rejected by the ECB.
- Against that, there may be a risk associated with the radical approach, namely the possibility that the Commission/DSA might actually get it wrong.

It is important to emphasise that the independence of the ECB would not be compromised if it delegates the DSA finding to Council and Commission, since the final decision to activate the TPI remains entirely in the discretion of the ECB (this decision does not just depend on the four eligibility conditions, but on the assessment of whether market conditions are justified by fundamentals and whether the activation of the TPI is proportionate to the achievement of the ECB's primary objective, which the ECB does not delegate).²⁴ Moreover, if a government introduces fiscal measures unfavourable to fiscal sustainability after the Council endorsed the national fiscal plan and thereby risks a deviation from the agreed fiscal path, the ECB will continue to have full discretion in assessing whether the increased interest rate spread of this country is in line with fundamentals or caused by *"unwarranted, disorderly market dynamics"*.

For the same reason, the ECB would not be "stuck" if it were to find flaw with the DSA of the Commission/Council. While formally deferring to the Council/Commission (i.e. calling debt sustainable when the Council/Commission does), it could decide not to activate the TPI on the grounds that secondary market spreads are sufficiently close to fundamentals. This would likely create less market turmoil than to conclude that, contrary to the views of Commission and Council, the public debt of a country is not sustainable.

²⁴ Furthermore, there are several precedents for the delegation of eligibility criteria that address credit risk by the ECB. Under the OMT, the ECB implicitly delegates the debt sustainability assessment to the European Stability Mechanism (ESM). Under its normal collateral framework, it delegates to private rating agencies.

5. CONCLUSION

This paper analysed how the interplay between monetary and fiscal policy might be affected by the proposed reform to the EU's fiscal governance framework, and whether the TPI should be redrafted in this light. We conclude as follows.

First, from the perspective of its main features, the proposed framework is mostly good news for the fiscal-monetary policy mix in the euro area. With one notable exception – the lack of a central fiscal capacity – the basic design elements of the framework are helpful to monetary policy. These include its focus on debt sustainability; the use of a net expenditure rule to avoid procyclical adjustment in response to shocks, allowing some flexibility on the timing of adjustment, creating incentives for growth inducing reforms and investment, and two escape clauses that provide fiscal policy makers with flexibility to react to large shocks.

Second, the new framework embodies several design features that imply that it is some way off from striking the optimal compromise between debt sustainability and flexibility.

We propose five amendments:

- The first would strengthen the discipline of the proposal at acceptable cost to flexibility: **review the drafting of the “no-backloading safeguard”** to make it more meaningful (that is, give it more teeth).
- We also offer two amendments that would increase flexibility at acceptable cost to the framework's discipline (particularly if our proposal on the no-backloading condition is taken): (1) **abolish or fundamentally review the drafting of the debt safeguard** requiring debt to decline within the planning horizon; (2) **abolish or fundamentally review the excessive deficit safeguard**, as well as the definition of effective action under the revised excessive deficit procedure. The latter should not require a minimum annual adjustment of countries following a net expenditure path consistent with debt sustainability and the return to 3% by the end of the adjustment period.
- Finally, we offer two amendments that would improve the effectiveness and efficiency of the proposed system without necessarily changing the weights that it places on discipline and flexibility. First, we argue for **a review of the Commission's DSA methodology, to be conducted by an independent expert group based on inputs from the Commission, Member States, ECB, ESM, and EFB**, with the objective of fixing obvious weaknesses and turning it into a methodology that is “owned” and can be implemented by all Member States rather than just the Commission. Since the DSA methodology review will take some time, we recommend making 2024 a transition year and launching the full implementation of the new fiscal framework from the beginning of 2025. Second, we recommend **involving independent fiscal institutions (IFIs) in the decision whether to activate the escape clauses**, hence helping to de-politicise these decisions.

Third, we are concerned about the impact of the new framework on the medium-term fiscal stance during its first application cycle. Given that many euro area countries are starting from high debt and deficits, the framework will require a large, protracted fiscal tightening. While fiscal tightening is welcome while inflation is too high, the main impact of the framework will come at a time when inflation is already expected to be back at target (2025) and the economic cycle may well be much weaker as a result of the lagged effects of the preceding monetary tightening as well as fiscal tightening projected for 2023 and 2024. Once in effect, the new framework will require continued tightening in most euro area member countries, albeit at a somewhat slower pace than both projected in 2023 and

2024 and required under the current framework. The medium term drag on demand, which should persist at least until 2028, could complicate monetary policy from 2025 onward, potentially requiring a return to very low policy rates.

Fourth, the adoption of the new framework represents an opportunity to simplify the eligibility criteria of TPI. Under the proposal, debt sustainability will become a necessary condition for compliance with the EU fiscal framework. Furthermore, a review and approval of the Commission's DSA methodology jointly by the Commission and Member States, in which the ECB is given the opportunity to comment and give technical input, should increase the ECB's confidence in the methodology used to assess debt sustainability. Once this has happened, the ECB could either remove debt sustainability as an eligibility condition that must be independently verified (as it is implied by compliance with the fiscal framework) or delegate the debt sustainability assessment to the Council and Commission. This would increase the predictability and hence effectiveness of the TPI by eliminating fears that the ECB Governing Council may not agree with the Commission's/Council's assessment of debt sustainability. Once the eligibility criteria are met, the ECB would independently decide on the activation of the TPI.

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Monetary-fiscal interaction: achieving the right monetary-fiscal policy mix in the euro area

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Abstract

Achieving a balanced monetary-fiscal policy mix in the euro area is crucial to ensure that monetary policy is able to fulfil its primary price stability objective. This paper outlines, from an economic and legal perspective, the interaction between monetary and fiscal policy in light of the current monetary and fiscal stance and, in particular, the “quasi-fiscal” effects of some unconventional monetary policy measures. Since sustainable public finances are a prerequisite for a price-stability-oriented single monetary policy, the paper also analyses the EU economic governance review proposals.

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LIST OF ABBREVIATIONS

| | |
|--------------|-------------------------------------------------------------------------------------|
| APP | Asset Purchase Programme |
| BIS | Bank for International Settlements |
| ECB | European Central Bank |
| ECJ | European Court of Justice |
| DSA | Debt Sustainability Analysis |
| ELA | Emergency Liquidity Assistance |
| EMU | Economic and Monetary Union |
| EP | European Parliament |
| ESCB | European System of Central Banks |
| EU | European Union |
| GDP | Gross Domestic Product |
| HICP | Harmonised Index of Consumer Prices |
| LOLR | Lender of Last Resort |
| MIP | Macroeconomic Imbalance Procedure |
| OMT | Outright Monetary Transactions |
| PEPP | Pandemic Emergency Purchase Programme |
| TLTRO | Targeted Longer-Term Refinancing Operations |
| TEU | Treaty on European Union |
| TFEU | Treaty on the Functioning of the European Union |
| TPI | Transmission Protection Instrument |
| TSCG | Treaty on Stability, Coordination and Governance in the Economic and Monetary Union |
| USD | US Dollar |
| ZLB | Zero lower bound |

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EXECUTIVE SUMMARY

- While the jurisdictional domains of monetary and fiscal policy are separated – the former within the exclusive competence of the European Union (with the European Central Bank (ECB) as the institution entrusted with the conduct of the single monetary policy) and the latter within the Member States' competences – **monetary and fiscal policies are highly interdependent, interacting in various ways.**
- Though there have been tensions throughout the life of the Economic and Monetary Union (EMU), **monetary and fiscal policies have been broadly aligned and mutually supportive** at key episodes in its history. This was also the case during the COVID-19 pandemic.
- **However, with the return of inflation in 2021, there is renewed and high level of tension in the monetary-fiscal policy mix.** While monetary policy is tightening, discretionary fiscal support in the euro area to counter rising energy costs has been substantial in 2022 and remains significant in 2023. Some of these measures have had a direct dampening effect on energy prices (e.g. indirect tax cuts or price caps). However, once they expire, inflation is likely to rise again, which could hamper the ECB's disinflationary efforts.
- **Some of the ECB interventions, especially large-scale asset purchase programmes, have relevant fiscal implications.** These “quasi-fiscal” monetary policy measures are characterised by the fact they materially impact on the fiscal accounts and/or affect other aspects of fiscal policy such as tax, spending or financing.
- **“Quasi-fiscal” monetary policy measures are problematic from a legal point of view** since they partly over-stretch the mandate of the ECB. This could also be the case of the announced, but not yet activated, new sovereign bond purchase programme, the Transmission Protection Instrument (TPI).
- **The proposal for a new EU economic governance framework aims to strengthen national ownership of fiscal rules.** This is an important step to ensure that public finances in the euro area are sound and do not have to be indirectly addressed by monetary policy measures.
- While the current reform proposal addresses many of the shortcomings identified, **too much discretion remains** in the interpretation of the rules by both the European Commission and the Member States. **This might lessen the fiscal discipline and fiscal homogeneity necessary for a price-stability oriented monetary policy.**
- In the current inflationary environment, **a reduction in fiscal stimulus or more targeted fiscal support could reduce inflationary pressures.** This could allow for a more gradual and moderate tightening of monetary policy, thereby **reducing financial stability and fragmentation risks** and making the use of the controversial TPI less necessary for the ECB.
- **The ECB should only resort to “quasi-fiscal” monetary policy measures in exceptional cases,** such as when the interest rate level has reached the zero lower bound or when there are divergences in government bond yields between Member States resulting from market speculation that jeopardise a single monetary policy.

1. INTRODUCTION

The Maastricht Treaty established a division of competences between monetary policy and fiscal policy, with the former centralised and the latter decentralised. Notwithstanding the formal separation, the Treaty envisaged some basic forms of coordination (positive integration) as well as some forms of negative integration or prohibitions (with regard to monetary financing, excessive deficits, bail-out policies and others).²⁵ Although there have been tensions throughout the life of the Economic and Monetary Union (EMU), monetary and fiscal policies have been aligned during periods in its history. This was the case during the COVID-19 pandemic. However, with the return of inflation in 2021, tension in the monetary-fiscal policy mix reappeared. Monetary policy is tackling rising inflation (the primary objective of the European Central Bank - ECB) by boldly raising interest rates to their highest level in 22 years and by phasing out the Asset Purchase Programme (APP). The ECB also announced a new bond buying programme - the Transaction Protection Instrument (TPI) - which could be activated at any time to counter unwarranted, disorderly bond market dynamics as we discussed in our earlier paper.²⁶ In addition, there is the risk that sharply rising interest rates could trigger a systemic banking crisis, as the recent turmoil in Switzerland and the US in the spring of 2023 vividly demonstrated.

Meanwhile, public debt levels in several euro area Member States remain very high. Debt reduction is at the top of the agenda of euro area policymakers in order to create sufficient fiscal room for future manoeuvring. However, the COVID-19 crisis, the energy price shock resulting from the war in Ukraine and the rise in the cost of living have prompted euro area Member States to adopt supportive discretionary fiscal measures.²⁷ Several member countries, such as France and Spain, have taken measures that have had a direct dampening effect on energy price increases. However, once these measures expire, inflation is likely to rise again in these countries, which could hamper the ECB's disinflationary efforts.

The ECB cannot solve the current challenges and potential risks alone. Rather, in such an environment, monetary and fiscal policy must work together in a coordinated manner.²⁸ The European Commission is embarking on a reform of the economic governance framework in the EMU, including a more country-specific approach within such a regime. The objectives of the proposals²⁹ are stronger national ownership, simpler rules taking account of different fiscal challenges, facilitating reforms and investments for EU priorities, and providing for effective enforcement.³⁰

This paper starts by briefly outlining the legal framework of EMU, which established the separation of fiscal and monetary competences. Second, we examine the complex interaction between fiscal and monetary policy in light of the current economic stance. Third, we discuss the “quasi-fiscal” implications of the ECB's unconventional monetary policy measures, in particular its large-scale asset-purchase programmes, also known as Quantitative Easing (QE). We go into more detail on their legal basis and shed light on the Transaction Protection Instrument (TPI) announced in July 2022. Fourth, we consider

²⁵ See Lastra (2015), pp. 293 ff.

²⁶ See Bernoth et al. (2022).

²⁷ For an overview, see Sgaravatti et al. (2021).

²⁸ It should be noted that also financial supervision and macroprudential policy are important players to manage the challenges ahead. But this is not subject of this paper.

²⁹ These proposals would amend both (i) the preventive arm a new Stability and Growth Pact, (ii) the corrective arm to speed up and clarify the implementation of the excessive deficit procedure and (iii) the Directive on the requirements for national budgetary frameworks. See also footnote 6.

³⁰ Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97, COM/2023/240 final (so called preventive arm regulation); Proposal for a Council regulation amending Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, COM/2023/241 final (so called corrective arm regulation); Proposal for a Council directive amending Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member states, COM/2023/242 final (so called budgetary frameworks directive).

the new proposals to reform the EU economic governance rules and their expected effect on monetary policy. And finally we conclude.

2. THE JURISDICTIONAL DOMAIN OF MONETARY AND FISCAL POLICY

The legal framework of EMU, as laid out in the European Treaties (Treaty on European Union (TEU) and Treaty on the Functioning of the European Union (TFEU)), demarcates the mandate of the ECB and the separation and different jurisdictional domains between monetary policy and fiscal policy.

2.1. The price stability mandate of the ECB

Monetary policy in the euro area is one and indivisible. It is governed by the Treaty framework, which clearly establishes the primacy of price stability in the conduct of monetary policy.³¹ As a contributory task, the ECB should support financial stability.³²

Fiscal considerations within the broader scope of economic policies may not be targeted as such by monetary policy, which ought to remain uninfluenced by the fiscal objectives of the individual Member States. While fiscal policy is still decentralised, monetary policy is the exclusive competence of the ECB. In order to protect the primacy of price stability in the conduct of monetary policy and to shield it from political instruction (including fiscal policy considerations), the Treaty grants strong independence to the ECB.³³

The Treaties remain silent on a definition or further explanation of what is meant by price stability. The academic literature has discussed in-depth what was meant by the Treaty founders and resorted, inter alia, to economic theory (of the time) and the Maastricht-criteria for accession to the euro area to determine what precisely the term "price stability" entails. In this regard, price stability was interpreted as aiming at an inflation of close to, but below 2% until 2021; in July 2021 the ECB amended this interpretation as part of its monetary policy strategy review. On 8 July 2021, the ECB Governing Council adopted a symmetric 2% inflation target over the medium term, thereby diverging from its previous interpretation (ECB, 2021a).

2.2. Fiscal policies within the responsibility of the Member States

As stated above, while monetary policy is centralised at Union level and constitutes an exclusive competence,³⁴ fiscal policies (as part of the economic policies) remain the competence of the Member States. Hence, the jurisdictional domains of monetary and fiscal policy are separated in the Union legal framework.³⁵ Thus, the monetary union and the ECB's monetary policy rests on, and interacts with, heterogeneous economies and fiscal policies of the 27 Member States.

TFEU provides for some coordination of economic policies and sets requirements regarding the fiscal situation of the Member States to ensure a minimum level of economic convergence.³⁶ In practice, however, the incompleteness of the EMU - also described as an asymmetry underlying the EMU with centralised monetary policy at Union level and decentralised economic policy at Member State level -

³¹ Art. 127 (1) 1, 282 (2) TFEU and Article 2 of the Statute of the European System of Central Banks (ESCB Statute) lay out the ECB's primary objective to maintain price stability. Only "[w]ithout prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union" according to Art. 127 (1) 2 TFEU.

³² Art. 127 (5) TFEU.

³³ Art. 130, 282 TFEU and other provisions.

³⁴ Art. 3 (1) (c) TFEU.

³⁵ See Lastra and Louis (2013), pp. 35 ff.

³⁶ See in detail 5.1. of this paper and Lastra and Louis (2013), pp. 20 ff.

has been criticised as flawed since the beginning of the EMU.³⁷ The insufficient enforcement of the existing ruleset is also the subject of considerable criticism.³⁸

³⁷ See Hetges (2015), pp. 32 ff.; on the discussion see for example Seidel (2000), pp. 866 f.; Horn (2011), p. 1399; Siekmann (2013), marginal notes 24 ff.; Lastra (2015), pp. 291 f.; Lastra and Louis (2013), pp. 4 ff.

³⁸ See Degenhart (2013), pp. 88 ff.; Ohler (2019), pp. 13 ff.; Thiele (2013), pp. 3 ff. with further references; Konrad et al. (2010), pp. 143–171; Antpöhler (2012), p. 355. In detail on the different forms of economic imbalances between Eurosystem members Smets (2012), pp. 41 ff.; Lastra and Louis (2013), pp. 35 ff.

3. INTERACTIONS BETWEEN MONETARY AND FISCAL POLICY

While monetary and fiscal policies reside in different jurisdictional domains, they are highly interdependent, interacting with each other (see Chapter 3.1.). These interactions should be ideally mutually supportive and in line with the respective goals and mandate of monetary and fiscal policy. However, the current monetary and fiscal stance results into a complex monetary-fiscal policy mix (see Chapter 3.2.).

3.1. Interdependencies and interaction of (conventional) monetary and fiscal policy

Monetary and fiscal policies use different instruments to influence the economy and achieve their objectives. Monetary policy instruments can be broadly divided into conventional and unconventional instruments. In this section we will briefly discuss the interaction of conventional monetary policy instruments with fiscal policy. In Chapter 4, we focus instead on unconventional monetary policy instruments and their interaction with fiscal policy, which is why they are also referred to as “quasi-fiscal policy measures”.

The main conventional monetary policy instrument is the steering of short-term interest rates. By adjusting interest rates, central banks aim to influence borrowing costs spending and investment decisions of households and firms, and, ultimately, the price level and inflation, the ECB's primary objective.

Fiscal policy involves government decisions on taxation and government spending. Through these instruments, governments influence the level of demand and supply in the economy and allocate resources to different sectors with the aim to stabilise the business cycle and redistribute income and wealth. the business cycle and redistribute income and wealth.

Since both monetary and fiscal policies affect the real economy, they inevitably interact. For example, if the central bank adjusts interest rates to cool or stimulate the economy in order to achieve its price stability objective, this will also have an impact on the government's debt servicing costs, thusly affecting fiscal sustainability and the room for manoeuvring. Conversely, the level of government borrowing affects the demand for credit and, hence, the level of interest rates, thus interacting with the main instrument of monetary policy. Moreover, public investment and consumption affects aggregate demand and, therefore, ultimately also the price level. In this way, monetary and fiscal policies can support or disrupt each other in stabilising the economy and pursuing price stability.

In times of economic contraction and low inflation, coordination of monetary and fiscal policy is not too difficult. Monetary policy could be accommodating by keeping interest rates low to avoid burdening governments with high debt servicing costs. At the same time, governments could take advantage of cheap financing and use fiscal stimulus measures, such as tax cuts and increased government spending, to boost the economy.³⁹

However, it is more difficult to coordinate fiscal and monetary policy in times of economic contractions when inflation is high, as is currently the case. An inflation-targeting central bank, as the ECB, must tighten monetary policy by raising interest rates and phasing out asset purchase programmes. These measures raise the cost of servicing government debt, thus discouraging the issuance of new government debt. Moreover, government deficits increase as maturing debt has to be rolled over. At

³⁹ Several studies show that the effectiveness of fiscal stimulus is also dependent on the monetary policy stance. For instance, the fiscal multiplier turns out to be higher when monetary policy is accommodative or when interest rates have hit the zero lower bound (Klein and Winkler, 2021).

the same time, government spending rises as automatic stabilisers operate. If the fiscal room for manoeuvring is already constrained by high public debt levels, as it is the case in several euro area Member States, governments may be prevented from further supporting monetary policy through the use of expansionary fiscal measures. In case financial markets cast serious doubts on the solvency of governments, governments may even resort to pro-cyclical fiscal policy by cutting government spending, which would counteract an expansionary monetary policy. Thus, fiscal policy would be constrained by monetary policy. The awareness that interest rate hikes worsen the debt sustainability of governments could also lead central banks to be reluctant to raise interest rates further or to do so by less than necessary - a situation referred to as “fiscal dominance”. In this case, monetary policy would be constrained by fiscal policy.

When an economy is affected by an economic downturn or an inflation shock in only some sectors, as was the case with the pandemic and during the current energy crisis, effective monetary and fiscal policy coordination is particularly important. Monetary policy instruments can be viewed as relatively blunt tools that affect the economy as a whole, including the general price level. In case of transitory and sectoral shocks, fiscal policy is better suited to stimulate and support specific sectors and to support the most affected households and firms (Woodford, 2022). In this case, monetary policy may best support fiscal policy by keeping general inflation expectations low through a high degree of credibility.

Thus, these examples illustrate the need for sound and solid public finances and sufficient fiscal room to manoeuvre in order to ensure effective monetary and fiscal policy coordination and the use of counter-cyclical fiscal measures as a stabilisation instrument. The EU legal framework does not provide intensive *ex-ante* or *ad-hoc* coordination of monetary and fiscal decision making (see Dall’Orto et al., 2020; Manzke, 2015). Rather, the Treaties only allow for limited coordination and cooperation (and the forms of positive and negative integration mentioned in the introduction).⁴⁰ This inter-institutional cooperation is based on rights of participation, rights to be consulted, and democratic accountability duties⁴¹. In addition, the ECB has a consultative role.⁴² These forms of coordination institutionalise the exchange of information necessary to conduct monetary and fiscal policies based on a profound understanding of each other (see e.g. Bodea and Huemer, 2010; Bini Smaghi and Casini, 2002; von Hagen and Mundschenk, 2002; Beukers, 2013). The Bank for International Settlements (BIS) Annual Report 2023 considers “the perennial but elusive search for consistency between fiscal and monetary policy” and talks about the need for a “region of stability”: “the region that maps the constellation of the two policies that foster sustainable macroeconomic and financial stability, keeping the inevitable tensions between the policies manageable.”

3.2. The current monetary and fiscal stance

For more than a year and a half now, inflation in the euro area has been well above the ECB's inflation target. Accordingly, monetary policy in the euro area has switched to a clear restrictive course. The interest rates on the deposit facility, the main refinancing operations and on the marginal lending facility have been gradually increased to 4.00%, 4.50% and 4.75% respectively, and quantitative tightening has been initiated. Despite the current decline in headline inflation, the core inflation rate remains stably too high and does not yet show any downward tendencies. Therefore, the ECB will probably remain on a restrictive course for quite some time. There is the risk that sharply rising interest

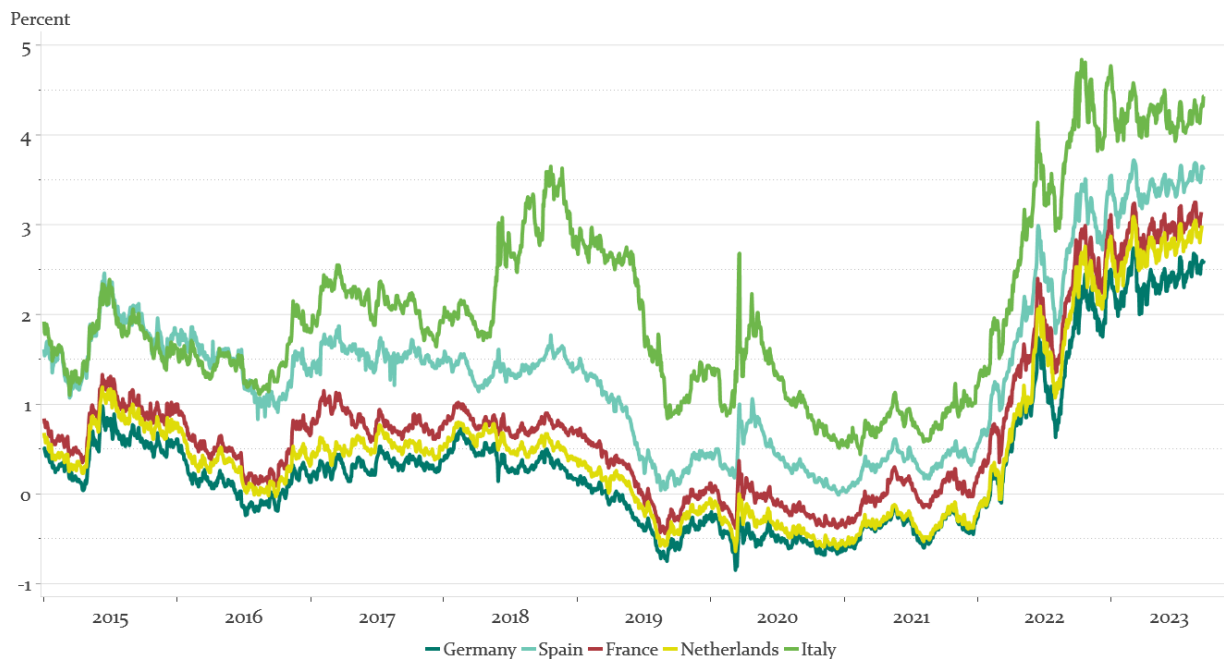
⁴⁰ See No. 12 Resolution of the European Council of 13 December 1997 on economic policy coordination in stage 3 of EMU and on Treaty Articles 109 and 109b of the EC Treaty, OJ C 35, 2.2.1998, pp. 1–4; see also ECB (2003), pp. 37 ff.; Beukers (2013), p. 1582.

⁴¹ Art. 284 TFEU.

⁴² Art. 282 (5), Art. 127 (4) TFEU and Art. 4 ESCB-Statute.

rates could trigger a systemic banking crisis, as the turmoil in Switzerland and the US demonstrated in the spring of 2023.

Figure 1: Government benchmarks, 10-year, yield



Source: Eurostat.

Note: Germany, France, Italy, Spain, Netherlands are represented as the largest economies in the euro area, as measured by their 2021 GDP in US-dollars.

It is important to consider that this monetary tightening has very different regional effects, as interest rates and risk premiums react differently due to the very heterogeneous public debt levels; they typically rise more strongly and non-linearly in the highly indebted countries (Bernoth, 2012). Between 2020 and 2021, ten-year nominal government bond yields reached historic lows and were even negative in the Netherlands and Germany. At the beginning of 2022, even before the ECB's first interest rate hike in July 2022, yields in the main euro area economies rose sharply at the same time, reflecting market expectations of ECB intervention (Figure 1). At the end of August 2023, bond yields in individual countries ranged from 2.48% (Germany) to 4.13% (Italy), remaining relatively stable since the end of 2022. Although long-term government bond yield spreads widened slightly compared to Germany at the beginning of 2022, risk premiums currently appear to have little impact on bond yields. This is mainly due to the announcement of the TPI in July 2022. As a result of these rate hikes, the interest-related costs of public debt servicing have risen since the sharp increase in the key interest rate.

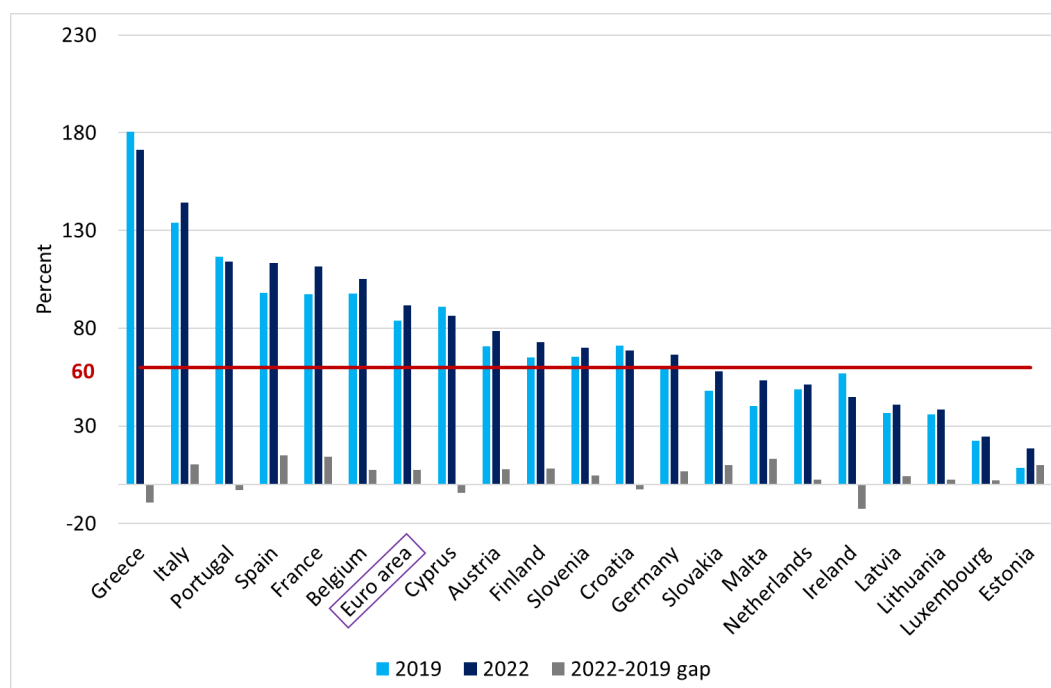
Moreover, the extraordinary fiscal measures implemented by governments to cushion the economic effects of the COVID-19 crisis have led to a sharp increase in public deficits and a record level of sovereign debt in most euro area Member States in 2020.⁴³ Thus, the public debt in the euro area reached 97.2% of gross domestic product (GDP) in 2020 before decreasing slightly to 91.5% in 2022.

While all euro area countries saw a rebound in their public debt in 2020, recent developments are highlighting growing debt disparities within the euro area (Figure 2). Where Estonia's debt-to-GDP ratio reached just 18.4% in 2022 (up by around 10 percentage points since 2019), Greece's now stands at 171.3% (down by more than 9 percentage points since 2019). In total, in 2022, only eight countries

⁴³ Only Germany, Ireland, Latvia, Malta, Netherlands, Austria, and Slovenia did not reach an historic high in their debt-to-GDP ratio in 2020.

have public debt ratios below 60% and five countries have reduced their debt ratios compared with 2019 despite the significant economic impact of the COVID-19 crisis (Croatia, Cyprus, Greece, Ireland, and Portugal). The Debt Sustainability Monitor 2022 (European Commission, 2023b), which gives an insight into fiscal sustainability risk encountered by EU Member States, estimated the fiscal risk to be overall low in the short-term, before becoming high or medium for most countries in the medium- and long-term. Especially in an environment of higher inflation, this situation poses the risk of “fiscal dominance” emerging, compromising the ability of single monetary policy to adequately fulfil its primary price stability objective.

Figure 2: General gross debt in % of GDP



Source: Eurostat.

Note: The horizontal line of 60% of GDP indicates the reference value for government debt as specified in the Maastricht Treaty.

To strengthen the efficiency of tightening monetary policy and to avoid adding upward inflationary pressures, the euro area fiscal stance has becoming more restrictive since 2023, although there are significant disparities between countries, as highlighted in the Eurogroup statement of 13 July 2023, on the fiscal stance for the euro area for 2024 (European Council, 2023). While the emergency fiscal response measures adopted during the COVID-19 pandemic have already largely expired, falling energy prices should allow euro area governments to progressively phase out the support measures implemented to counteract the economic effects of the war in Ukraine (especially high energy costs, supply chain disruptions).

The upcoming contractionary fiscal impulse in the euro area is warranted to ensure a gradual decline in deficits and high public debt over time. Both remain well above their pre-pandemic levels, while rising interest rates will – although only progressively – weigh on the cost of servicing public debts. Thus, the fiscal strategy of Member States should restore fiscal buffers to secure debt sustainability.

At the same time, fiscal policy measures aimed at increasing economic growth over the medium term by boosting the supply side of the economy are being implemented in most euro area countries. These fiscal policies are supported in part by private and public funds but also through the NextGenerationEU programme, via its core element: the Recovery and Resilience Facility. With this temporary instrument,

the European Union is providing financial support to Member States to foster investments in ecological and digital transformation over the 2021-2026 period.⁴⁴

The relation between fiscal policy and inflation is not straightforward. Indeed, the impact of fiscal measures on inflation depends on various factors, notably the type and the size of the fiscal impulse (change in government spending or tax rates, discretionary fiscal policies - targeted or not, side effect on government deficit, demand- or supply-side measures), specific national features (level of debt, position in the business cycle), the global economic and geopolitical context, and the monetary policy stance.⁴⁵ Some of the temporary discretionary fiscal measures taken in the euro area at the beginning of the war in Ukraine to cushion rising energy costs, such as indirect tax cuts or price caps, are estimated to have contributed to reducing inflationary pressures in 2022 and 2023, although the effect is mitigated by the discontinuation in 2022 of the subsidies to households and businesses intended to counter the impact of the health crisis (Bankowski, 2023). However, these direct energy support measures should increase inflation in 2024 and 2025 as most of them expire in 2023. In addition, direct measures to support household income adopted by several euro area governments, such as public sector wage rises, indexation of social benefits to inflation, and cash transfers, will weigh on inflation with some delay as they are gradually transmitted to households' nominal disposable income and, therefore, increase aggregate demand.⁴⁶ Although the implementation of the structural supply-side reforms at the EU level has a stimulating effect on the economy by increasing public expenditure, the overall impact on inflation in the euro area is likely to be limited in the medium term.⁴⁷ However, given the complexity and size of the fiscal measures adopted, the ECB needs to closely monitor their impact on inflation and take them into account in its decision-making.

⁴⁴ See Bönke and al. (2023), pp. 296-297 for more details on the NextGenerationEU programme.

⁴⁵ See Checherita-Westphal and al. (2023), pp. 15 ff.; See ECB (2021), box 6 entitled "Fiscal policy and inflation in the euro area: a VAR-based analysis"; See IMF (2023), Chapter 2.

⁴⁶ See ECB (2023), box 9 entitled "Update on euro area fiscal policy responses to the energy crisis and high inflation".

⁴⁷ See Bankowski (2022), pp. 33 ff.

4. ECB “QUASI-FISCAL” MEASURES

The interaction between monetary and fiscal policies is particularly relevant in the discussion of the ECB's unconventional monetary policy measures, primarily the large-scale asset purchases also called Quantitative Easing (QE) given their “quasi-fiscal” effects. A central bank activity can be considered to have a “quasi-fiscal” component or effect if it has a significant impact on the government accounts and/or affects other aspects of fiscal policy (taxes, spending, financing), either immediately or in the future. This includes, for example, activities that result in financial losses for the central bank, which ultimately must be borne by governments in the form of lower dividends or loss compensation. Central bank activities can also impact fiscal policy if they affect the allocation of resources in the economy and create distortions, or if they change the structure of government debt or the market for government securities, thereby reducing the effectiveness of government debt management (Hooley et al., 2023).

During the Great Financial Crisis and the COVID-19 pandemic, the ECB applied a number of unconventional monetary policy tools to address deflationary tendencies. This involved an unprecedented expansion of central bank assets with quasi-fiscal characteristics:

- In 2010, the Securities Markets Programme (SMP), replaced by the Outright Monetary Transactions (OMT) in 2012, was introduced to ease credit conditions by purchasing bonds on the secondary market.
- The Targeted Longer-Term Refinancing Operations (TLTRO) announced in 2014 (TLTRO I), 2016 (TLTRO II) and 2019 (TLTRO III) provided banks with extended funding opportunities at favourable conditions linked to the granting of loans to non-financial corporations and households.
- Since October 2014, massive asset purchase programmes (APPs) have increased the size of the ECB's balance sheet (Figure 2). In 2020, the ECB implemented another round of quantitative easing with the Pandemic Emergency Purchase Programme (PEPP) to counter the effects of the COVID-19 crisis.⁴⁸

On the whole, the unconventional measures were effective at stabilising financial and economic conditions, easing financial market stress, and, thereby, also smoothing monetary policy transmission (Cour-Thimann, 2013; Beckmann, 2020; BIS, 2019). Combined with negative interest rates, large APPs lowered both interest rates and the cost of borrowing, stimulated bank lending to businesses and households, and encouraged consumption and economic activity (though the unintended effects of APPs require further study). The real economy has also been supported through the exchange rate channel, as currency depreciation induced by the expansion of the monetary base has improved the competitiveness of businesses and fostered export recovery. In total, unconventional monetary policies from 2014 boosted annual GDP growth in the euro area by 0.6 pp. and inflation by 0.4 pp., on average, over the period 2015-2020 (Altavilla, 2021).⁴⁹

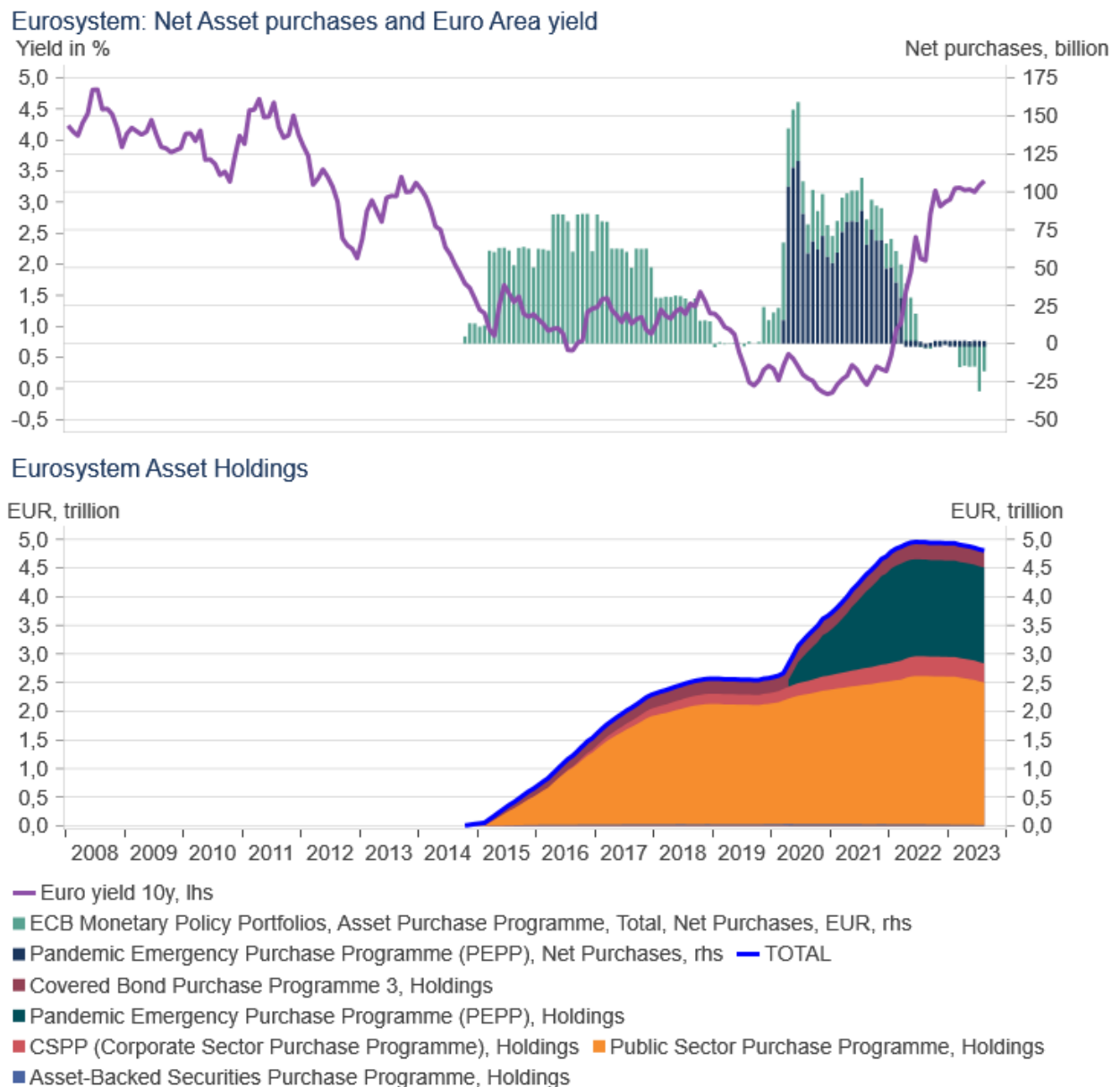
However, ECB unconventional monetary policy measures have increased financial risks on the Eurosystem's balance sheet (which has expanded significantly with QE), that may result in financial losses for the ECB and the national central banks and, ultimately, the Member States' governments and taxpayers. Moreover, these monetary policy measures have relevant distributional effects which are traditionally limited to, and characteristic of, fiscal policy (Dossche et al., 2021; Becker et al., 2015; European Parliament, 2015). Yet, the ECB has complete operational autonomy in the implementation

⁴⁸ See the European Central Bank website for more details on the different monetary policy instruments. <https://www.ecb.europa.eu/mopo/implement/html/index.en.html>

⁴⁹ See Beckmann et al. (2020), pp. 14-15, for an overview of the range of estimated effects of unconventional monetary policy on GDP growth and inflation in the euro area from various studies.

of unconventional monetary policies and there is no involvement of the fiscal authority in their design and implementation. Thus, in order to minimise these effects, unconventional monetary policy instruments should only be used for limited periods of time.

Figure 3: Introduction of quantitative easing from 2014 by the European Central Bank



Source: European Central Bank.

Note: The euro area government bond yield benchmarks are calculated on the basis of national bond yields weighted by outstanding amounts of government debt in each maturity bucket.

4.1. Legal analysis of ECB “quasi fiscal” measures

From a legal point of view, “quasi-fiscal” monetary policy measures are problematic in terms of: (a) competence, (b) principles underlying the monetary policy legal framework, and (c) financial and institutional independence.

First, monetary policy measures are characterised by their primary objective to maintain price stability. However, the fiscal condition/state of Member States (economic and financial imbalances and sovereign debt ratios) influence the transmission of monetary policy measures. This notwithstanding,

the ECB's price stability mandate does not provide the ECB with a competence to address disruptions of monetary policy transmission that are rooted in the fiscal and economic situation of Member States and which rest within their jurisdictional domain. While any economic and financial imbalances as well as sovereign debt ratios inevitably affect monetary policy transmission, the ECB is not competent to address any causes that directly or indirectly impede its price stability mandate. These causes partly relate to issues that are firmly rooted in the fiscal and economic situations and within the competence of the Member States. The ECB only has a secondary or contributory competence to support the economic policies of the Member States, i.e. the ECB can only support the policies pursued by other actors and institutions.⁵⁰

Second, while distributional effects of monetary policy measures are inherent to any policy measure, for example, traditional interest rate policy, selective measures that directly privilege specific market participants, certain Member States, or certain financial or non-financial institutions, are generally not foreseen within the EU monetary policy framework. Such measures with highly distributional effects are only allowed in very narrowly defined cases that rely on monetary reasons and not on economic, social, or other preferences.

The EU monetary policy framework also rests on the principle that the ECB may only conduct monetary policy operations with solvent counterparties and on the basis of adequate collateral. Even in crisis situations, when national central banks act as lender of last resort (LOLR), it is a basic principle that they can only lend money to credit institutions that are solvent, but experience liquidity problems and only against sufficient collateral. These preconditions respond to two purposes: (i) to distinguish monetary policy measures from fiscal measures, since it is the task and the competence of fiscal authorities to inject capital into insolvent institutions, resulting in direct distribution of resources; and (ii) to safeguard the ECB from incurring losses, which is important with regard to the ECB's financial and institutional independence (see also Rogoff, 2021).

The third aspect to consider is that the independence of the ECB cannot be compromised by fiscal and financial considerations. In a situation of so called "fiscal dominance" and/or "financial dominance", the ECB might depart from a monetary policy strategy that might be adequate in terms of price stability.

4.2. TPI and its role in preventing future fragmentation of sovereign bond markets

In reaction to the fragmentation of the sovereign bond markets in the euro area, the ECB Governing Council announced its new anti-fragmentation tool, named the Transmission Protection Instrument (TPI) on 21 July 2022. The TPI aims to ease potential bond market fragmentation with secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals. According to the press release, the TPI aims to support the effective transmission of monetary policy in the case of "unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area" by selective sovereign bond purchases (ECB, 2022).

The TPI faces some legal and economic challenges with regard to its conformity with the ECB mandate and its monetary policy competence, which we analysed in depth in a previous paper.⁵¹ While the aim of TPI – ensuring an "effective transmission of monetary policy" – is no doubt a necessary prerequisite in the pursuit of a price stability-oriented monetary policy, this alone does not suffice to prove that the

⁵⁰ Art.127 (1) 2 TFEU states: "Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union (...)".

⁵¹ See in detail Bernoth et al. (2022).

measure falls within the ECB's price stability mandate. Currently, with surging inflation, the ECB is trying to curb surging inflation by increasing interest rates. This puts a heightened burden of justification on the ECB to explain how further asset purchases – an expansionary monetary policy – would fit within the overall monetary policy stance of fighting inflation, should TPI be activated. It is only if market failures are identified as the cause for the financial fragmentation of sovereign bond yield spreads that the ECB allowed to take such selective and targeted measures to address these causes.

Fiscal support for highly-indebted Member States that struggle with higher, yet justified, risk premia is not a task for the ECB and not within the monetary policy domain. It rather falls within the fiscal domain and within the remit of the competence of the Member States according to the respective democratic processes in place. Such a decision should be subject to political and public scrutiny. As the ECB stated with regard to the TPI, the deterioration in financing conditions potentially hampering monetary policy transmission, which TPI might be able to address, may "not [be] warranted by country-specific fundamentals" (ECB, 2022). This is in line with the European Court of Justice (ECJ)'s ruling on OMT, where it made clear that "the programme in question cannot be implemented in a way which would bring about a harmonisation of the interest rates applied to the government bonds of the Member States of the euro area regardless of the differences arising from their macroeconomic or budgetary situation."⁵²

Moreover, activation of the TPI requires sound and sustainable budgetary and economic policies, as stated in the eligibility criteria explained in the press release (ECB, 2022). However, as outlined also in Bernoth et al. (2022), the institutional structure of the ECB is not well suited to assessing these criteria. The monitoring of compliance with fiscal rules and the ultimate discretionary decision on whether a Member State sufficiently fulfils the requirements of sound and sustainable fiscal and economic policies may expose the ECB to political pressure and threaten its independence. The decision as to whether the ECB should carry out such an assessment itself or whether this should be the responsibility of external bodies (e.g. the European Stabilisation Mechanism and the International Monetary Fund) therefore remains an important question to be clarified.

The ECB has not yet disclosed the method, benchmarks and criteria it will use to assess, whether bond yield developments are "not warranted by country-specific fundamentals". The provisions on how the Governing Council will use the listed eligibility criteria as input to its decision-making process are very non-specific and non-transparent and therefore allow for a certain degree of discretion.

The potential quasi-fiscal components of TPI and the corresponding legal challenges also become apparent when considering the balance sheet implications. TPI interventions, if activated, would lead to a further increase in the size of the Eurosystem's balance sheet if they are not sterilised by the sale of other assets. If the Member State were not able to pay back its debt, the central bank would incur losses on its balance sheet.

⁵² ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, Gauweiler et al., ECLI:EU:C:2015:400, para. 113

5. THE NEW EU ECONOMIC GOVERNANCE ARCHITECTURE

Sustainable public finances are considered a prerequisite for a single monetary policy in the euro area to be able to focus on its primary mandate of price stability, as well as for monetary and fiscal policy to mutually support each other in their stabilisation function. An adequate governance structure in the EU should create these conditions.

5.1. Legal foundations of the EU economic governance architecture

The EU economic governance framework, as laid out in the Treaties, provides a system of institutions and procedures to coordinate economic policies of the Member States (see Art. 120f. TFEU) and aims to monitor, prevent, and correct problematic economic trends that could weaken national economies or negatively affect other EU countries. This framework has evolved over time, being and been refined and reinforced.⁵³

The legal framework relies on the TFEU (Art. 120ff., 126 TFEU)⁵⁴, the Stability and Growth Pact⁵⁵ (see below), the European Semester (an annual cycle of economic, fiscal, employment and social policy coordination) and the so-called six-pack and two-pack legislative reforms (additional secondary legislation to strengthen the Stability and Growth Pact).⁵⁶ The European Commission monitors the economic development in the euro area in order to detect potential problems and risks for economic stability and competitiveness. To do this, it conducts regular assessments and forecasts, while also producing an Annual Sustainable Growth Survey and the Alert Mechanism Report.

Prevention is a key pillar within EU economic governance as it aims to address economic problems early on and prevent spill-over effects to other Member States. The Stability and Growth Pact (SGP) plays an important role within the EU's prevention mechanism and requires the Member States to pursue sound national fiscal policies by setting budgetary targets. The Macroeconomic Imbalance Procedure (MIP), introduced in 2011 as part of the so called "six-pack" reform of the economic governance, foresees, in the case of excessive imbalances in the economies of a Member State, that said Member State is subject to enhanced monitoring and might even face sanctions. In addition, the Treaty on Stability, Coordination and Governance (TSCG or the 'fiscal compact') sets standards for fiscal policies by limiting the size of the structural deficit that a government may incur to 0.5% of GDP per year and requires the establishment of automatic policies to correct significant transgressions.⁵⁷

Correction of economic imbalances and enforcement of the existing ruleset with the Excessive Deficit Procedure (EDP) and the Excessive Imbalance Procedure (EIP) are a crucial part within the EU economic governance framework.⁵⁸ Under EDP, if a national budget deficit exceeds 3% of GDP or if it fails to reduce its excessive debts (i.e. is still above 60% of GDP), the Member State must commit to targets to bring its excessive deficit or debt back down. The EU can also impose sanctions, such as fines that can reach 0.2% of their GDP, if a Member State persistently fails to take adequate action.

Similarly, under the EIP of the EU's MIP, a Member State experiencing excessive imbalances can be required to submit Corrective Action Plans to address its situation and might likewise face fines if they fail to sufficiently impose corrective measures.

⁵³ See Lastra and Louis (2013), pp. 35 ff.

⁵⁴ See Lastra (2015), pp. 293 ff.

⁵⁵ See Lastra (2015), pp. 301 ff.; Lastra and Louis (2013), pp. 55 ff. with further references.

⁵⁶ See Lastra and Louis (2013), pp. 66 ff., 144.

⁵⁷ See Lastra and Louis (2013), pp. 144 ff.

⁵⁸ See Lastra (2015), pp. 293, 298 ff., see also 231 ff.

5.2. Proposal to reform the EU economic governance rules

The EU fiscal framework has been criticised for being too rigid on the one hand and for not promoting sufficient convergence on the other, with the result that several EU Member States lack the fiscal capacity to ensure effective coordination in times of economic downturn. In response to the inadequacies and complexities of the current economic governance architecture, the Commission in April this year presented its new package of proposals to reform the EU's economic governance rules.

The proposed new economic governance architecture aims to strengthen public debt sustainability while promoting progress towards a green, digital, inclusive and resilient economy and making the EU more competitive.⁵⁹ The cornerstones of the proposal are stronger national ownership, simpler rules taking into account different fiscal challenges, facilitating reforms and investments for EU common priorities, and providing for effective enforcement.

The EU economic governance reform consists of three legislative proposals: (i) a proposal to create a new regime for the SGP with regard to its preventive aspects (the so called preventive arm regulation)⁶⁰, (ii) a proposal to strengthen the corrective elements of the SGP (the so called corrective arm regulation)⁶¹ and (iii) amendments regarding the requirements for the budgetary frameworks of the Member States.⁶²

In particular, the proposal on the preventive arm allows Member States to set their multi-annual net expenditure path on the basis of reform and investment commitments that they would detail in their medium-term fiscal-structural plan. For Member States whose government debt is above the 60% of GDP reference value or whose government deficit is above the 3% of GDP reference value, the Commission would propose “technical trajectory for net expenditure covering a minimum adjustment period of 4 years of the national medium-term fiscal-structural plan, and its possible extension by a maximum of 3 years [...]” as guidance for the multi-annual trajectory for net expenditure⁶³ with a view of maintaining debt levels on a downward path. The extension of fiscal adjustment by a maximum of 3 years would allow for a more gradual adjustment path if countries undertake reforms and investments commitments in line with EU priorities.

The proposal responds to the long-standing criticism that the current fiscal surveillance indicators are based on numerical variables that are very difficult to measure in real time, in particular, the structural balance and potential output variables. This has resulted in the fiscal policy being often pro-cyclical when it should have been counter-cyclical according to the information available to policy makers in real time (Bernoth, 2015). Steering on the expenditure side is more transparent and less susceptible to manipulation (Anderson and Minarik, 2006). Moreover, focusing on a medium-term approach rather than year-to-year monitoring gives governments more flexibility to respond to unforeseen events and cyclical fluctuations in public expenditure.

⁵⁹ Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97, COM/2023/240 final; Proposal for a Council regulation amending Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, COM/2023/241 final; proposal for a Council directive amending Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member states, COM/2023/242 final.

⁶⁰ Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97, COM/2023/240 final (so called preventive arm regulation).

⁶¹ Proposal for a Council regulation amending Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, COM/2023/241 final (so called corrective arm regulation).

⁶² Proposal for a Council directive amending Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member states, COM/2023/242 final (so called budgetary frameworks directive).

⁶³ Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97, COM/2023/240 final, Art. 5.

Moreover, the new proposal foresees that independent national financial institutions should be given a stronger role in monitoring the implementation by Member States of their national medium-term fiscal-structural plans.⁶⁴

The proposals allow Member States to have more control over the design of their medium-term plans, but also foresee a more stringent enforcement regime to ensure Member States deliver on the commitments undertaken in their medium-term fiscal-structural plans. The excessive deficit procedure for breaches of the 60% of GDP reference value is strengthened. For a Member State facing substantial public debt problems, the degree of debt challenge will be considered a relevant factor for the initiation of an excessive deficit procedure upon departure from the agreed net expenditure path.⁶⁵

⁶⁴ Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97, COM/2023/240 final, Art. 22.

⁶⁵ Proposal for a Council regulation amending Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, COM/2023/241 final (so called corrective arm regulation).

6. IMPLICATIONS OF THE ECONOMIC GOVERNANCE REVIEW FOR MONETARY POLICY

The economic governance review bears overall positive implications for the ECB's price-stability-oriented monetary policy from an economic and legal perspective, as expressed in an official Opinion by the ECB of 5 July 2023.⁶⁶ The proposed review establishes rules that monitor and restrict, where necessary, fiscal deficits and helps to ensure that Member State's fiscal and economic situations can, at least to a certain degree, converge, thus representing a precondition for a single monetary policy. Likewise, it is important that national ownership of the framework, by setting national medium-term fiscal structural plans, is strengthened to avoid situations where – due to a lack of fiscal capacity at the Union level – the ECB might be *de facto* forced to address fiscal and economic imbalances in Member States by means of monetary policy measures, which are outside of its mandate.

In general, rules that help delineate the responsibility of the ECB for ensuring price stability on the one hand and the responsibility of the Member States for their fiscal and economic situation on the other are essential for ensuring that monetary policy measures do not have “quasi-fiscal” effects of such a scale and manner that they actually substitute fiscal measures. Therefore, the Governing Council's decision to phase out unconventional monetary policy measures of a “quasi-fiscal” nature is welcome and will help to reduce risks and increase transparency. It will protect the Eurosystem from interest rate risks on large holdings of securities as policy normalises and will help reduce distortionary effects on public and private sector assets. This will also reduce reputational risk for the ECB. However, it is worth noting that the recent process of quantitative tightening has been very gradual and will continue for several years to avoid market disruption. The ECB therefore faces a difficult trade-off.

This delineation and the avoidance of the wrong type of monetary-fiscal policy mix is not only important to ensure that the ECB stays within its mandate, as laid down in Art. 127 TFEU, but also to ensure that the ECB keeps its institutional and financial independence. Economic and fiscal measures must be taken by the competent and democratically accountable institutions and actors, as they bear an important social dimension. The existing forms of coordination between the ECB and economic and fiscal policy makers are important to ensure an adequate level of information and better understanding between both policy fields.

The current reform of the EU governance framework provides an opportunity to address the shortcomings that have emerged over the past decades, leading to a situation where optimal coordination of fiscal and monetary policies has been hampered. A well-functioning EU governance framework that leads to effective fiscal consolidation and gradual debt reduction in the years ahead, especially in the highly indebted countries, facilitates the ECB's monetary policy in several respects. In the current high-inflation environment, a reduction in fiscal stimulus or fiscal support targeted at only individual sectors in need reduces inflationary pressures (Beyer et al., 2023). This would allow for a more gradual and moderate monetary tightening, thereby reducing financial stability risks posed by a rapid and widespread increase in interest rates. Furthermore, fragmentation risks of European bond yields (and spreads) would be mitigated, making the use of the controversial TPI less necessary for the ECB.

A closer look, however, shows that the current reform proposal, while eliminating many of the identified shortcomings (see sub-chapter 4.2), still lacks transparency and leaves too much room for discretion, which may once again open the door to clientelism and endless discussions. For instance, the proposal says that “The national medium-term fiscal-structural plan shall ensure the fiscal

⁶⁶ Opinion of the European Central Bank of 5 July 2023 on a proposal for economic governance reform in the Union (CON/2023/20), OJ C 290, 18.8.2023, pp. 17–25.

adjustment necessary to put or keep public debt on a plausibly downward path by the end of the adjustment period at the latest, or remain at prudent levels, and to bring and maintain the government deficit below the 3% of GDP reference value over the medium term"⁶⁷ How exactly is the "plausible downward path" defined and how long is the "medium term"?

Moreover, the governments' medium-term fiscal-structural plans, and also the Commission's fiscal trajectories, are based on medium-term projections of public debt. While the proposal says that the Commission must disclose the underlying framework for these projections and its results, there is always a degree of discretion in the assumptions underlying a projection model and its design. The proposal states that "when Member States use assumptions in their medium-term fiscal-structural plan that differ from the Commission's standard medium-term debt projection framework, they should explain and duly justify the differences in a transparent manner and based on sound economic arguments. In particular, the debt projections at unchanged policy to be included in the plan should be consistent and comparable with the Commission projections."⁶⁸ But no one can say with certainty which model is the right one, and the question is why the Commission does not impose one from the outset to avoid discussion.

In contrast to the previous governance structure, which was mainly based on negotiations between Member States, the new proposal places more emphasis on negotiations between the European Commission and each individual Member State. Whether this vertical structure will improve compliance, however, is an open question. As Fuest (2023) argues, if countries do not want to comply with the European Commission's requirements, it will be easy for them to argue, for example, that the Commission is a technocratic institution with less democratic legitimacy than their national parliaments.

There is still time to remedy these deficiencies in the coming months, and this should be used to put EMU on a more stable position in the long term, able to exploit the synergistic effects between monetary and fiscal policy.

⁶⁷ See Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97, COM/2023/240 final, Art. 6 and 12.

⁶⁸ Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97, COM/2023/240 final, p. 14.

7. CONCLUSION

The EU Treaties establish a formal separation of competences between a centralised monetary policy and decentralised fiscal policies. Despite their different jurisdictional domains, fiscal and monetary policy are highly interdependent. While this close interaction has led to tensions in the past, monetary and fiscal policy have been largely aligned and mutually supportive during the COVID-19 crisis.

Since 2021 with the return of inflation, tensions are again visible in the monetary-fiscal policy mix. Indeed, while the ECB started tightening monetary policy in 2022, with the aim of bringing inflation down to close to 2% in the medium term, most Member States have adopted supportive fiscal measures designed to reduce the impact of rising energy costs on households and businesses. This massive fiscal support is expected to lead to inflationary pressures over the next two years (Bankowski, 2023), partly as a result of the withdrawal of fiscal measures with direct dampening effect on energy prices as indirect tax cuts, but also due to the lagged upward effect on inflation of household income support measures. On the other hand, the “quasi-fiscal” monetary measures implemented by the ECB in recent years, especially the large-scale asset purchase programmes, including the announced, but not yet activated, TPI, have, by definition, a significant impact on the government accounts and/or affect other aspects of fiscal policy (taxes, spending, financing), either directly or in the future. “Quasi-fiscal” monetary policy measures are also problematic from a legal point of view since they partly overstretch the mandate of the ECB.

The Commission has presented a proposal to reform the EU economic governance framework. The proposed new framework aims to ensure greater national ownership and simpler rules that account for the different fiscal challenges, thereby facilitating reforms and investment for EU priorities. While the proposal addresses many of shortcomings identified, too much discretion is still left to the Commission and Member States in interpreting the rules.

In the coming years, it will be crucial to re-establish better coordination between monetary and fiscal policy. This requires sound public finances to provide sufficient fiscal room for manoeuvring. Moreover, the ECB should only resort to “quasi-fiscal” monetary policy measures in exceptional cases, such as when the interest rate level has reached the zero lower bound or when there are divergences in government bond yields between Member States resulting from market excesses that jeopardise a single monetary policy. The current reduction in the balance sheet of the Eurosystem through the gradual phasing out of the bond purchase programmes and the TLTROs is therefore to be welcomed.

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Big central banks and big public debts: The next challenges

Charles WYPLOSZ



Abstract

Like most advanced economies, the euro area emerges from a series of historical shocks with larger public debts, a sizeable increase in the already large balance sheets of the Eurosystem central banks, and intensified links between fiscal and monetary policies. The governments and the ECB must now undo what they did. Corrective action must not wait, if only because other shocks may again unexpectedly occur. The paper also presents a procedure to cut public debts.

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LIST OF ABBREVIATIONS

| | |
|-------------|---------------------------------------|
| APP | Asset purchase programme |
| ECB | European Central Bank |
| EU | European Union |
| EMU | Economic and Monetary Union |
| GDP | Gross domestic product |
| HICP | Harmonised index of consumer prices |
| PEPP | Pandemic emergency purchase programme |
| QE | Quantitative easing |
| QT | Quantitative tightening |
| TPI | Transmission protection instrument |
| UK | United Kingdom |
| US | United States |

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EXECUTIVE SUMMARY

- Like most advanced economies, the euro area emerges from a series of historical shocks with larger public debts, a sizeable increase in the already large balance sheets of the Eurosystem central banks, and intensified links between fiscal and monetary policies. **The governments and the ECB must now undo what they did as they dealt with the shocks.**
- **As most other central banks, the ECB has failed to manage inflation twice since 2009. First inflation was too low, now it is too high.** The main reason is that central banks did not recognise the lack of accuracy of their forecasts and of their estimates of the neutral interest rate.
- **Inflation targeting remains the right strategy, but its implementation must be amended.** This includes the use of quantitative easing (QE) and quantitative tightening (QT), and the acceptance that inflation forecasts can become unreliable. This calls for a revision of the monetary policy strategy, which the ECB has announced for 2025.
- **Sustained use of QE over many years has not delivered on its macroeconomic objectives.** Liquidity injections stabilise financial markets when they are hit by crisis and can be used pre-emptively. This does justify sustained QE, which amplifies the quasi-fiscal aspects of monetary policy and strongly affects the behaviour of financial institutions.
- **QT must be implemented without delay once financial stability has been restored.** Delaying QT for fear of financial instability is a case of both fiscal and financial dominance. If financial instability returns during QT, temporary liquidity injections can be used without abandoning QT.
- **The interactions between monetary and fiscal policy are well established but have been overlooked.** In particular, the inflationary impact of strongly expansionary fiscal policies has contributed to the inflation surge of 2021. In general, the respective responsibilities of governments and central banks must be clarified and central banks ought to recognise the quasi-fiscal aspects of monetary policy as they reformulate their strategies.
- **The remuneration of commercial bank deposits at central banks is a legacy of sustained QE.** Central banks have not signalled whether they intend to retain the abundance of liquidity as a permanent feature of the interbank markets or whether to re-establish the previous regime of scarcity. At stake are transfers of income to commercial banks, which ought to be a fiscal decision.
- **Large public debts are a source of fragility.** The conventional strategy is to pare debts down through sustained primary budget surpluses. The experience shows that governments are most unlikely to deliver and that, in any case, it will take decades to achieve the required debt reductions.
- **Within the euro area, the existence of very large public debts hampers the transmission of monetary policy and represent a serious threat.** The conventional strategy must be rethought accordingly.
- **Public debts can be reduced by keeping forever the holdings of Treasury bonds on the books of central banks.** This calls for changing how central banks intervene on the interbank markets. Instead of using Treasury bonds, the central banks can trade in their own bond instruments. This process is not inflationary and does not entail inter-country transfers. The independent Eurosystem can guarantee that this procedure is not abused by member governments.

1. INTRODUCTION

This paper deals with two specific developments. First, central banks have become too large, in many ways. They have expanded their mission. Beyond price stability, they have accepted to protect financial instability, not just in response to crises but also in preventing potential volatility. To that effects they have experimented with new tools. They have kept their interest rates 'low for long', including setting their policy rates at negative levels. They have massively expanded their balance sheets, abandoning the previous tradition of enforcing monetary scarcity. They have also intervened in support of banks and public debts on an unprecedented scale. Second, governments too have become larger. They have extended subsidies to households and firms as never before in peace time. They have intervened in specific markets to manage scarcities. Like the central banks, they have accepted many new responsibilities, including to deal with climate change and to insulate the labour markets from economic shocks. To that effect, they have used tools like imposing lockdowns, supporting work from home or not working at all while remaining employed. As a result, they have allowed their public debts to rise further, reaching levels that are a source of fragility in numerous countries.

Central banks have started to normalise their policies. They have raised their policy interest rates and started to shrink their balance sheets. In so doing, they exert pressure on highly indebted governments, which they previously financed indirectly through low interest rates and quantitative easing (QE). Most governments have started to cut their budget deficits, which had remained large for long, possibly feeding the inflation surge that started in 2021. The planned reduction of budget deficits may help central banks as they seek to bring inflation rates back to target, but it makes monetary policy more difficult to fine tune. These two-way influences raise a number of difficult issues. In most countries, governments and central banks may cooperate in this kind of situation. Within the Economic and Monetary Union (EMU), cooperation is difficult because the European Central Bank (ECB) cannot make arrangements with the governments of 20 member states and also because economic conditions differ among the member countries (Beetsma et al, 2001; de Grauwe and Yi, 2015).

The next section focuses on the short run in the advanced economies. The next couple of years will be defined by the fight against inflation and subsequent reduction of the big central bank balance sheets. While central banks naturally stand at the front, fiscal policies must be adjusted. Governments must stop feeding price pressure and they need to sustain efforts at stopping the debt build-up in an unfavourable environment where major new needs have emerged. Looking at the longer run, Section 3 argues that the monetary policy strategy need to be amended. Inflation targeting remains a valid bedrock, but its implementation has to be corrected. QE has been heralded as a new instrument that operates as a substitute for interest rates when they reach their lower bounds. It has not worked that way. QE is an important tool to quell bouts of financial stability, which means that it should not be used for years on end. Quantitative tightening (QT), the undoing of QE, is necessary, but fraught with risks. A key risk is its impact on government budgets. Section 4 focuses on challenges specific to the euro area. The differences in national public debts distort the transmission of monetary policy and, once again, threaten the financial stability of the monetary union. Large debts are most unlikely to be significantly reduced in the coming years. This is an issue that is studiously ignored by policymakers. The paper offers suggestions to tackle that issue.

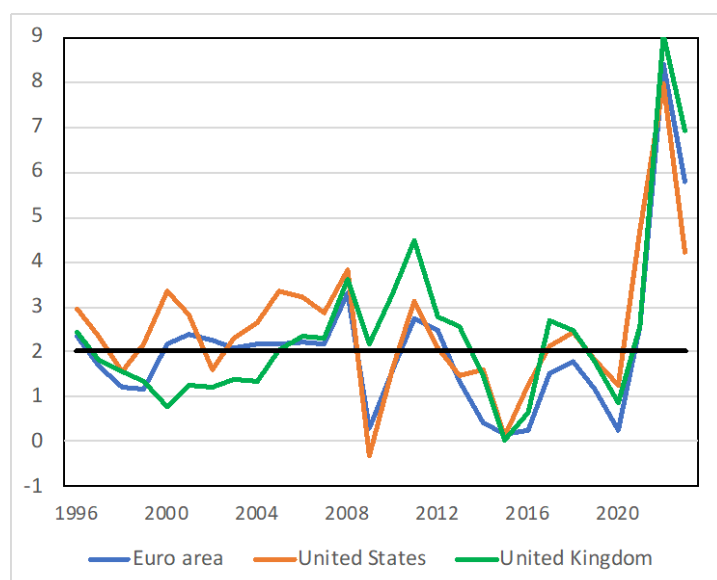
2. MACROECONOMIC POLICIES IN THE SHORTER RUN

2.1. What went wrong at central banks?

In most advanced economies, central banks have good reasons to feel under pressure. They have become very large but failed to bring inflation up when it was too low. They further failed to detect the inflation surge when it took off, so they were late to react. Their reaction was standard in the face of non-standard shocks. Of course, inflation is coming down, but central banks are now different from what they used to be before the global financial crisis, and they need to adapt or revert.

Up until the global financial crisis, most central banks had adopted the inflation targeting strategy. In a nutshell, the strategy calls for adjusting the policy interest rate whenever inflation expectations diverge from the target. For a while, it worked well, but not after 2008 when, as Figure 1 shows, inflation dipped below target. When interest rates hit the lower bound, QE was invented. A large literature has tried to explain this ‘inflation puzzle’, producing a long list of potential reasons (e.g. demographic change, a flat or non-linear Phillips curve, technological change, a very low equilibrium interest rate, globalisation, and more).⁶⁹ Much the same happened when the pandemic hit and, this time, inflation surged. This second failure, on top of the first one, represents a serious challenge.

Figure 1: Headline inflation rates (% per year)



Source: OECD.

A natural conclusion would seem to be that we lack a proper understanding of the inflation phenomenon. A number of commentators have rushed to this conclusion. Adherents of the monetarist tradition see the inflation surge as a consequence of QE during the pandemic (Issing, 2021). But this does not explain why QE did not create inflation in 2010s. Others have proclaimed the Phillips curve to be not just flatter or nonlinear,⁷⁰ or even dead (Cochrane, 2019), but this is not confirmed by a large amount of empirical work. As recently argued by Bernanke and Blanchard (2023), a textbook summary of macroeconomic theory provides a convincing explanation of the events of the last quarter century.

⁶⁹ Some of the many surveys are Ciccarelli and Osbat (2017), Sánchez and Kim (2018) and Yellen (2019).

⁷⁰ If the Phillips curve is flat, economic conditions (the output or the unemployment gaps) do not affect inflation. If it is nonlinear, the effects of economic conditions become stronger as the gap becomes smaller.

Central banks have failed for two main technical reasons.⁷¹ First, their forecasts have not been accurate. The dynamic stochastic general equilibrium (DSGE) models, which capture the current conventional wisdom, are unable to account for both the impairment of financial markets that followed the 2008 crisis and for the pattern of household savings triggered by the lockdowns enforced during the pandemic (Cochrane, 2023). Second, as explained by Gros and Shamsfakhr (2022), these models require their users to make the crucial assumption of what inflation will be in the medium term? They have assumed that, by then, inflation would have returned to its target level, which amounted to decide that the surge would be temporary. They quoted widespread support from private forecasts of professionals, whose views were shaped by those of the central banks themselves. However, Coibion et al. (2020) have shown that households and firms, which bargain over wages and set prices accordingly, hold very different expectations from those of professionals. The inflation targeting is not to be blamed.

2.2. The fight against inflation

As they realised that their forecasts were seriously misleading because of high uncertainty and changed circumstances, central banks have suspended forward guidance, the practice of signalling their intentions over the coming couple of years in order to shape expectations. The shift to rely on observed/incoming data to make policy decisions undermines inflation targeting, even though inflation targeting based on misleading forecasts is even worse. Given that monetary policy affects actual inflation with a long and variable delay, this shift all but guarantees that the anti-inflation stance will last for too long.

The immediate costs will include a period of below-target inflation and of longer than needed slow growth, possibly negative growth, along with rising unemployment. Central banks are fully conscious of this consequence and rightfully argue that it is better to err in this direction than to allow inflation to remain too high. About a year and a half after policy started to tighten, headline inflation is unsurprisingly declining and the tightening cycle is visibly coming to its end.

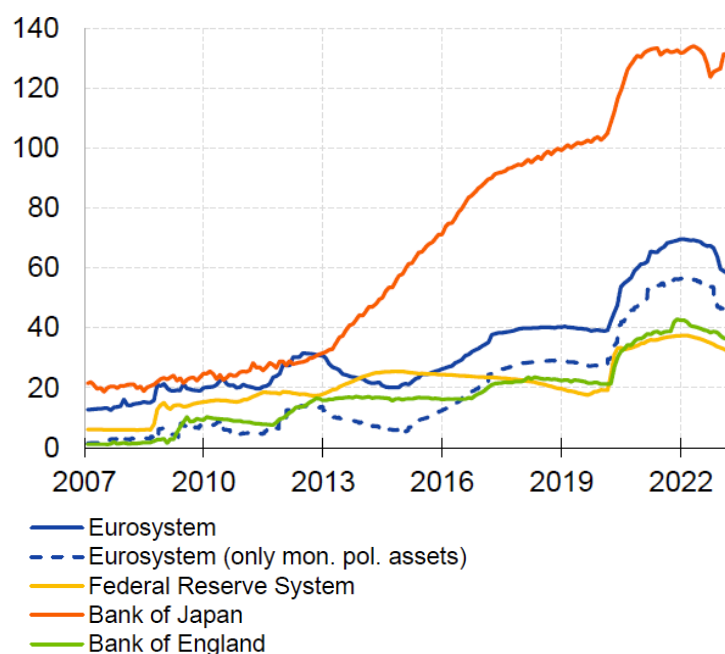
That does not mean that central banks should declare victory. They still face the challenge of coming to terms with the reasons why they failed to achieve their targets since 2008. In the near term, they stand to face three main issues:

- They will eventually have to cut their interest rates. Until recently, the conventional wisdom was that the neutral interest rate – the rate at which monetary policy is neither expansionary nor contractionary – is about 2 to 3% when inflation is at its 2% target. Like much of the pre-existing conventional wisdom, there is surprisingly little support for this assertion.
- In addition, if inflation undershoots its target, central banks may have to go below the neutral rate. That means that there is considerable uncertainty on how far down, and how fast, central banks will have to bring their interest rates. A debate will soon emerge, fed by this uncertainty and by the fiscal considerations presented in Section 2.3.

Most central banks have started to reduce the size of their balance sheets (quantitative tightening, QT). As Figure 2 shows, QT is proceeding relatively slowly. If, as they argued during the QE period, varying the size of balance sheets has a significant effect on inflation, we could have expected them to combine interest rate increases and QT, perhaps raising the interest rates more slowly and proceeding faster with QT, as explained in Wyplosz (2023a). The doctrine on QE and QT needs to be clarified.

⁷¹ President Lagarde has recognised these shortcomings in her speech at the Jackson Hole Symposium on 25 August 2023.

Figure 2: Central bank balance sheets (% of GDP)



Source: Schnabel (2023).

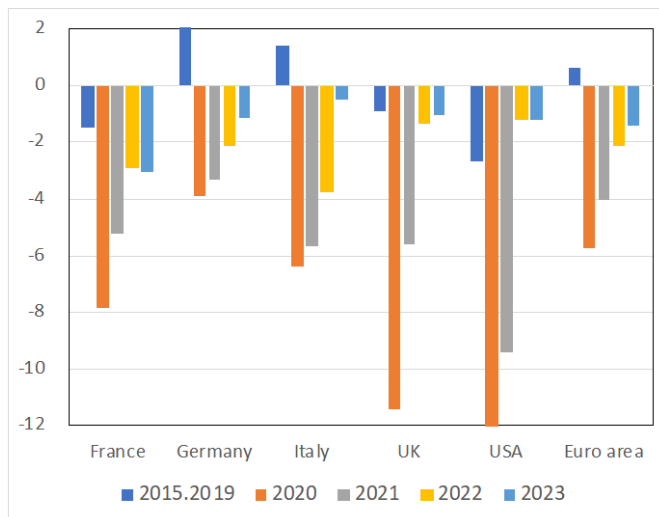
One possibility is that central banks are concerned with financial (in)stability at a time when rising interest rates risks stressing banks and financial institutions. Some relevant events have occurred in the UK, the US and Switzerland but they could be dealt with modest and temporary reversals of QT. Another concern is that QT involves selling public debt instruments, which makes it more difficult for government to finance budget deficits and to serve debt. The delicate relationship between monetary and fiscal policies is examined in Section 2.4 below.

2.3. Fiscal policies

Fiscal policy expansions have been historically strong throughout most of the advanced economies since 2019, and they are slowly being reversed. This is clearly visible in Figure 3, which displays the cyclically-adjusted primary budget balances of large OECD countries and the euro area.⁷² The figure compares the average balance over the pre-Covid period with what happened in the following years. Although the retrenchment in 2022 and 2023 is large, all the balances are expected by the OECD to remain in deficit in 2023. There were good reasons for all countries to adopt emergency measures, although the deficits would have been contained had the measures been carefully targeted toward the intended beneficiaries. Moreover, when growth strongly resumed after the lockdowns, the deficits remained large as governments were anxious not to undercut the budding recovery. Yet, the recovery was brisk, largely because non-targeted subsidies led households to accumulate large savings that started to be spent once lockdowns ended and the pandemic became less severe.

⁷² The purpose of the cyclical adjustment is to measure the discretionary actions of governments since it nets out the automatic effects of cyclical fluctuations and pre-committed interest payments on the existing debt.

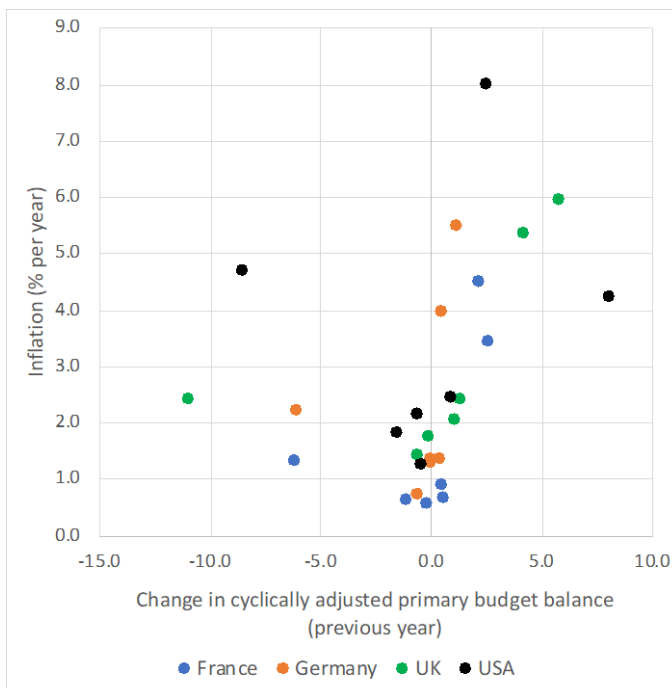
Figure 3: Cyclically adjusted primary budget balances (% of GDP)



Source: *Economic Outlook*, OECD.

The role of fiscal policies in contributing to the inflation surge is not always acknowledged, even though the ECB has repeatedly voiced concern. A good measure of the effect of fiscal policy on the macroeconomy – aggregate demand and, subsequently, inflation – is the change in the cyclically adjusted primary deficit. This change represents how much the government voluntarily adds to, or subtracts from aggregate demand. For each year from 2017 to 2023, Figure 4 plots inflation against the change in the cyclically adjusted primary deficit, lagged by one year to account for the delayed impact. Because fiscal policy is but one of the sources of inflation, the link is not tight, yet it is present. More formal evidence can be found in Bankowski et al. (2023) for the euro area and in Demirel and Wilson (2023) in the US.

Figure 4: Inflation and the cyclically adjusted primary budget balances (% of GDP)



Source: *Economic Outlook*, OECD.

Note: The budget measure corresponds to the previous year.

2.4. Interactions between monetary and fiscal policies

In principle, the separation of tasks between governments and central banks is clear. Central banks are in charge of inflation. Dealing with the impact of the pandemic and subsequent shocks on households and firms is the responsibility of governments. Together governments and central banks are responsible for financial stability. However, these macroeconomic policies are interdependent, a fact that has long been recognised. It is surprising, therefore, that this interdependence has not been taken into account to a greater extent by both central banks and governments.

Fiscal expansions were enacted in 2020 during the acute phase of the pandemic. As Figure 3 shows, the cyclically adjusted primary budgets were pushed into large deficits, with changes ranging from 6% to 11% of gross domestic product (GDP). The impact on GDP growth was bound to be sizeable, even though the lockdowns and other health policy measures worked in the opposite direction. With hindsight, we now know that GDP growth rebounded forcefully in 2020-21, which contributed to the inflation surge. At the time, there were debates about the impact of the Covid shock, which reduced both demand and supply, with an uncertain overall effect. Uncertainty also concerned the duration of the shock and, therefore, the timing and vigour of the eventual recovery. As previously noted, most, if not all forecasting models were unable to clarify the situation and most central banks did not try to counteract the impact of the unusually large fiscal expansions.

Clearly, the central banks were facing considerable uncertainty. In such a situation, however, risks must be balanced. And indeed, there were several risks:

- A clear concern, which central banks shared with governments, was not to undermine the recovery once the pandemic became less threatening. By early 2021, however, vaccines became widely available in the advanced countries and the importance of newly-accumulated household savings suggested the possibility of a strong recovery (Wyplosz, 2021). That, alone, should have alerted central banks to the need of keeping inflation at the top of their list of priorities.
- There were widespread fears of lasting “scarring effects” from the pandemic, due to withdrawals of labour market participations and shifts in consumer behaviours. These effects could harm the recovery, but since they would mostly contributed to a decline in potential GDP, they could be inflationary. Dealing with scars and changing behaviour was a responsibility of governments while central banks had to deal with the inflationary impact.
- Financial stability was another concern. Central banks had learned to quickly inject large amounts of liquidity. Until the end of 2022, though, there was no sign of instability and they kept QE going. Then, they gradually stopped QE and started to shrink the amount of liquidity, which may lead to instability.
- Without a better understanding of why inflation had been too low, central banks in the developed economies were worried of missing a chance of escaping the liquidity trap.

Indeed, several central bankers suggested that they were willing to overshoot the inflation target as a way of exiting the too-low inflation period. Thus, it was a calculated risk, but did it consider the inflationary impact of highly expansionary fiscal policies? No such risk was mentioned as late as November 2021, when the ECB stated that:

“To support the recovery, ambitious, targeted and coordinated fiscal policy should continue to complement monetary policy.” (*Economic Bulletin* 7/2021, ECB, p.3.)

while noting that:

“Inflation is expected to rise further this autumn, but to decline next year. The current increase in inflation is expected to be largely temporary, mainly reflecting the strong increase in oil prices since around the middle of last year, the reversal of the temporary VAT reduction in Germany, delayed

summer sales in 2020 and cost pressures that stem from temporary shortages of materials and equipment. In the course of 2022 these factors should ease or will fall out of the year-on-year inflation calculation. Underlying inflation pressures have edged up. As the economy recovers further, and supported by the Governing Council's monetary policy measures, underlying inflation is expected to rise over the medium term." (*Economic Bulletin* 7/2021, ECB, p.4.)

Note that the inflationary impact of fiscal expansions is not mentioned. It is only after it started to raise the policy rates that the ECB stated in August 2022 that:

"Economic activity continues to benefit from the reopening of the economy, a strong labour market and fiscal policy support. [...] Fiscal policy is helping to cushion the impact of the war in Ukraine for those bearing the brunt of higher energy prices. Temporary and targeted measures should be tailored so as to limit the risk of fuelling inflationary pressures. Fiscal policies in all countries should aim at preserving debt sustainability." (*Economic Bulletin* 5/2022, ECB, p.3.)

The coordination between monetary and fiscal policies is traditionally difficult to organise because the agendas of central banks and governments are rarely aligned. Since 2020, however, the objectives of both authorities were the same. Both acted forcefully, as if they were alone, and they often failed to recognise that many of the required actions were of a fiscal policy nature. In the euro area, the existence of 19 governments⁷³ made coordination even more difficult.

⁷³ Croatia only joined the euro area in 2023.

3. NEW MONETARY POLICIES

3.1. Quantitative easing: when it makes sense and when it does not

QE was introduced as a response to having reached the effective lower bound of the key policy interest rates. Having lost their standard instrument to conduct expansionary policies, central banks hoped that cash injections would be a substitute instrument. QE worked in two ways. First, on the credit supply side, it was thought that abundant liquidity would lead to increases in bank lending through a relaxation of credit conditions at unchanged interest rates. The assumption was that commercial banks would be eager to find lucrative uses for their abundant deposits at central banks. Second, on the credit demand side, it was believed that, by absorbing large amounts of public debts at varied maturities, QE would lower the whole yield curve, thereby encouraging more borrowings by the private sector. Credit conditions were relaxed and the yield curves became flatter, indeed, but the demand for credit did not rise enough to generate sufficient growth to raise inflation, the ultimate objective of QE. In the event, banks found new ways of using their abundant liquidities in other ways than by supplying more credit. Acharya and Rajan (2022) and Rajan (2023) argue that QE had made some financial institutions “liquidity dependent”, so that continuing QE during a quiet period may have planted the seeds of future difficulties:

- Injecting liquidity serves another purpose. It stabilises financial markets during a crisis. However, if the outcome of QE is to create “liquidity dependence”, the liquidity injections are not achieving their aim of increasing the resilience of banks.
- Before QE, commercial bank reserves were close to the minimum that they wished – or needed – to hold. The scarcity of reserves made it possible for central banks to not remunerate bank deposits. When bank deposits exceed what is desired, central banks must offer remuneration, close to the policy interest rate in order to pin the interbank interest rate at the policy rate chosen by the central bank. Section 3.2 examines the quasi-fiscal implication of QE.
- QT is challenging. After successive waves of QE, liquidity is excessive and must be reduced. However, this process can destabilise banks and other financial institutions. They not only stand to gradually face tighter availability of liquidity but they may become seriously constrained inasmuch as they had become “liquidity dependent”. The larger QE has been, the further QT has to proceed, and the more difficult it becomes.
- Public debts are under pressure. As central banks hold a significant portion of public debts, QT competes with new debt issuance, be it to finance ongoing budget deficits or to roll over maturing debt instruments (next section).

The upshot is that the ability of QE to affect aggregate demand is very much in doubt and that liquidity injections are a powerful tool to deal with financial stability during a crisis. Long lasting QE is largely useless, and potentially detrimental. “Brief QE” in the form of pre-emptive or emergency liquidity injections is a key instrument.

3.2. Fiscal implications of quantitative easing

Monetary policy is supposed to be neutral in the sense that it affects only the nominal economy (all variables expressed in value) not the real economy (all variables expressed in volumes). In practice, this is not the case, at least in the shorter run when prices and wages are not flexible. For instance, raising the interest rate does not reduce inflation quickly. It first reduces private spending, it also typically results in an exchange rate appreciation that reduces exports. The resulting lower aggregate demand is meant to influence price and wage setters as they contemplate weakening sales and higher

unemployment. These real effects, however, are expected to gradually disappear as inflation declines and central banks stop pulling the brakes. Over a business cycle, real interest rates, relative prices and real wages usually settle back to their long-run trends.

During a liquidity crisis, central banks act as lender of last resort. The well-established practice stands to encourage financial institutions to take excessive risks if they are certain to receive help in case of a crisis. This moral hazard is taken seriously by central banks which customarily state that liquidity injections are a possibility, not a commitment. Financial regulation is also designed to make these events rare and costly for institutions when they receive support. However, when it is not a particular institution that becomes illiquid but the whole market, the central bank has no choice but intervene. These interventions, which can be seen as one-off QEs, distort financial markets but their fiscal implications are minimal because, by design, they are rare and temporary, and can be reversed once financial stability is restored. Furthermore, governments can and often do intervene along central banks with their own subsidies.

Sustained QE, on the other hand, is not neutral. It creates lasting and disturbing links with fiscal policy, as explained in Hooley et al. (2023).

The most notable effects are:

- By acquiring large amounts of long-term assets, central banks **flatten the yield curve**, as previously mentioned. By reducing term premia, this is a distorting subsidy and therefore an action that belongs to the fiscal authorities. It encourages long-term risk-taking.
- At the same time, the returns from private assets have become significantly higher than the returns from public debts. This has been explained by investors' heightened search for safe assets. **By providing investors with large amounts of liquidity through purchases of public debts, central banks support the safety of the debts and make it possible for governments to borrow at a discount** (Reis, 2021).
- QE typically involves purchases of public debts. **In the euro area, the ECB holds some 30% of outstanding debts** (see Figure 6 below). **This lightens the borrowing and debt burdens.** Everything else remaining equal, it encourages deficit spending. While help from central banks to governments may be welcome at times – in 2020-21, the ECB indirectly financed almost all the member states' deficits – it should be strictly limited to exceptional situations. QT is a condition for avoiding fiscal dominance.
- In some countries, as in the euro area, **the central bank may also purchase private assets, typically those that are highly rated. This is another source of distortion.** It typically favours large firms from the industrial sector, with no obvious justification.
- In the euro area, **QE benefits more the countries with large public debts.** The ECB argues that it is needed to prevent the kind of segmentation that was observed during the debt crisis over 2010-2012 and thus to maintain the transmission of monetary policy throughout the whole area. Special programmes such the Pandemic Emergency Purchase Programme (PEEP) and Transmission Protection Instrument (TPI) reinforce this aspect. Here again, these distortions may be highly desirable in specific situations, but QT should undo them when the need is no longer justified.
- **QE reduces the maturity of debts of the overall public sector.** Combining balance sheets of the central bank and the government into an overall public sector balance sheet, QE can be seen as replacing some long-term debt instruments with very short-term liabilities of the central bank. Under normal conditions, it is the responsibility of the fiscal authorities to determine the maturity structure of their debts.

- **The abundance of liquidity forces central banks to offer interest on bank deposits, as already noted. Relative to the previous situation, this amounts to transfers to banks.** Whether bank deposits should be remunerated or not is controversial but, in the end, decisions on transfers should belong to the fiscal authorities, if only because they receive the central bank profits and therefore end up bearing the costs of interest payments to banks.
- **Central banks take on board risky assets, including public debts, all of which are not safe.** While central banks are uniquely apt at absorbing risk (since they can always create money as needed to guarantee debt service), this is another distortion. Furthermore, if risks materialise and central banks create money to absorb them, this opens up the risk of inflation, which is their key responsibility.

3.3. Policy implications

The main message is that the distortionary effects of classic monetary policy wash out over a cycle as the effects from periods of tightening are compensated by the opposite effects from periods of loosening. Occasional liquidity injections are not neutral but the effects are limited, while sustained QE creates a large number of distortions and takes over significant fiscal characteristics. QE of past years has also left central banks with large balance sheets. Barring any new major shock – a hope more than a presumption – it is time to envisage the next steps. Two of them, making central banks and public debts smaller, deserve more attention than they currently attract.

As noted above, prompt QT is the necessary counterpart to emergency QE. According to Figure 2, QT is proceeding quite slowly, however.

One reason is the fear that it could usher in financial instability, but QT does not prevent occasional injections of liquidity when needed.⁷⁴ Another reason is financial dominance. Financial institutions have adapted to the abundance of liquidity and shares are currently highly valued, although the rapid rise in interest rates have a depressing effect on share prices. In addition, since banks receive interest on their central bank deposits, the abundant liquidity can be seen as a subsidy to the whole financial sector, which naturally wishes that liquidity remains abundant. Governments also benefit from compressed yield curves, a case of fiscal dominance. All these explicit or implicit subsidies are difficult to withdraw, especially when they have been in place for a long time.

However, the certainty of QT is crucial to minimise the quasi-fiscal aspects of QE presented in Section 3.2. QT should not be an option to be exercised whenever it seems convenient. This concerns both the timing and the quantitative objective. Most central banks have now announced a QT schedule in the form of monthly withdrawals of liquidity over periods of several months. This is an important commitment, but it leaves out two essential questions: what is the destination, and when can we expect the destination to be reached? In particular, will the monetary regime remain characterised by excess liquidity and, therefore, will bank deposits continue to be remunerated at the policy rate? In order to minimise the risk of instability, financial markets need to know the answers to these questions ahead of time to make adequate preparations. These are difficult questions, and central banks may not be able to provide definitive answers. Yet, before the inflation surge, several of them have formulated monetary policy strategies that now need to be updated. These issues clearly belong to the formulation of the next monetary policy strategy.

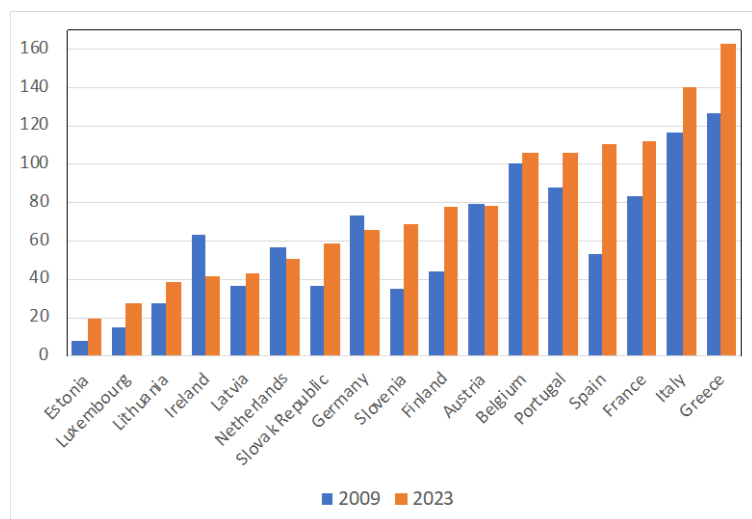
⁷⁴ Indeed, occasional and temporary liquidity injections merely slow down the trend of liquidity absorption.

4. THE EURO AREA IS SPECIAL

4.1. The public debt issue

As can be seen from Figure 5, the gross public debts of several euro area member governments are large, exceeding 100% of GDP in six cases, higher than before the sovereign debt crisis. The debt ratio has declined in only four countries (Ireland, the Netherlands, Germany and Austria), even though interest rates have been close or below zero during much of the intervening period.

Figure 5: Public debts (% of GDP)



Source: *Economic Outlook*, OECD.

The debt increases are partly explained by the shocks of the 2020s, when the general escape clause of the Stability and Growth Pact was activated. However, an effective debt discipline framework would have led to debt reductions during the good years 2012-19, thus making room for the exceptional deficits warranted by the recent shocks. This is what happened in the four countries where debts are lower than in 2009 and in the countries where debts are less than 60% of GDP. These are countries where debt discipline is practiced, quite independently of the Stability and Growth Pact.

The existence of large differences in public debts directly affects monetary policy. Interest rates on public debts tend to reflect indebtedness, which affect private borrowing rates. As a result, the single policy rate set by the ECB does not result in similar borrowing rates across the euro area. Put differently, the transmission of monetary policy is not uniform across member countries. At worst, as it has been the case during the debt crisis, suspicions of debt sustainability can lead to very high interest rates for both the sovereign and the private sector.

This, in turn, translates in divergent national views about the conduct of monetary policy. In the current situation of rapid increases of the policy rates, some governments have started to complain, while others may find that stronger action is needed. Thus, the Italian Prime Minister has warned the ECB against further interest rate increases (*Financial Times*, 28 June 2023), as did Ministers from Portugal and Spain (*Le Monde*, 4 July 2023). In response, the President of the Bundesbank declared that “the image of nearing the interest rate peak is actually wrong” (Speech at the Frankfurt Euro Finance Summit, 3 July 2023).

4.2. The conventional strategy

Can something be done to directly deal with the public debt situation? The conventional answer is that sustained primary budget surpluses is the way to bring public debts down and this is the *raison d'être* of the Stability and Growth Pact. Unfortunately, this logic is most unlikely to deliver significant debt reductions. In a recent survey of the historical evidence, Arslanalp and Eichengreen (2023) make two points:

- Reducing debts through primary surpluses takes considerable times. The evolution of public debts depends on two factors: 1) the primary budget balance; 2) the difference between the interest rate and growth, often referred to as $r-g$. There is considerable uncertainty about the long-run values of r and g , let alone the sign of $r-g$. For the sake of illustration, assume that $r-g=0$. With primary surpluses continuously at 5% of GDP, bringing the debt from 100% of GDP to 60% would take 8 years. For surpluses at 3% of GDP it would take 14 years, and it would take 40 years for surpluses of 1%.
- The experience of the last half-century is that sustained, large primary surpluses are very rarely observed. In modern advanced economies, government budgets are large and include a welfare state with many entitlements, which create political conditions not conducive to the conventional strategy.

Table 1 tallies the evolution of primary surpluses over more than eighty years in OECD countries. No country exhibits an average surplus exceeding 1% of GDP, with two exceptions: Denmark (barely) and Norway, which is an outlier because of its large income for North Sea gas. Surpluses in excess of 3% or 5% of GDP are very rare. Surpluses in excess of 1% would need to be sustained over decades to seriously cut debts in highly indebted countries. The last column indicates the largest spans of consecutive surpluses above 1%. In several cases, they extend over long periods, but never for twenty years or more, except for Norway and for Belgium.⁷⁵

This evidence confirms the conclusion of Arslanalp and Eichengreen (2023) that large debts are here to stay. For the euro area, it means a continuing fragility of some public debts, with an underlying risk of crisis. It also means that the ECB will continue to face contradictory constraints and a challenging policy transmission process. Slow growth may also characterise countries whose governments are fiscally constrained. It may also harm progress on climate change, on health policies, on defence and investment in technological research and development.

The mistaken belief that sustained fiscal retrenchment is the solution means that there is no intention to directly tackle the debt problem. This is the responsibility of governments, not the ECB. But it directly affects the ECB in many ways, as previously explained. The following section sketches an explicit procedure to cut public debts.

⁷⁵ Belgium maintained a surplus in excess of 1% for 21 years, from 1987 to 2008. During that time, its debt went from 142% to 103% of GDP. Today it stands at 105%.

Table 1: Primary surpluses in the OECD area (1960-2023)

| | Number of observations | Average balance (% of GDP) | Number of years above 1% of GDP | Number of years above 3% of GDP | Number of years above 5% of GDP | Longest period above 1% (years) |
|-------------|------------------------|----------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
| Australia | 35 | -0.5 | 12 | 2 | 0 | 6 |
| Austria | 64 | -0.5 | 13 | 0 | 0 | 5 |
| Belgium | 54 | 0.3 | 23 | 17 | 6 | 22 |
| Canada | 54 | -0.9 | 14 | 5 | 2 | 12 |
| Denmark | 53 | 1.3 | 30 | 17 | 6 | 13 |
| Finland | 64 | 0.9 | 36 | 19 | 4 | 16 |
| France | 46 | -1.5 | 3 | 0 | 0 | 3 |
| Germany | 33 | -0.1 | 12 | 0 | 0 | 9 |
| Greece | 29 | -1.5 | 9 | 4 | 0 | 5 |
| Iceland | 44 | 0.3 | 18 | 9 | 3 | 6 |
| Ireland | 34 | -0.1 | 22 | 11 | 3 | 12 |
| Israel | 24 | -0.1 | 8 | 3 | 0 | 5 |
| Italy | 64 | -0.9 | 22 | 7 | 1 | 12 |
| Japan | 64 | -3.1 | 6 | 1 | 0 | 6 |
| Korea | 54 | 0.3 | 23 | 2 | 0 | 7 |
| Luxembourg | 34 | 0.9 | 18 | 3 | 0 | 8 |
| Netherlands | 55 | -0.1 | 19 | 2 | 0 | 6 |
| New Zealand | 38 | 1.1 | 22 | 12 | 4 | 16 |
| Norway | 46 | 5.8 | 37 | 31 | 25 | 25 |
| Portugal | 47 | -1.3 | 8 | 0 | 0 | 2 |
| Spain | 60 | -2.1 | 10 | 1 | 0 | 10 |
| Sweden | 64 | 0.8 | 33 | 22 | 2 | 17 |
| Switzerland | 34 | 0.1 | 9 | 0 | 0 | 3 |
| UK | 54 | -1.1 | 9 | 3 | 1 | 4 |
| USA | 64 | -1.9 | 5 | 1 | 0 | 4 |

Source: Economic Outlook, OECD.

Note: Sample periods vary across countries. The central and east European countries are excluded.

4.3. How to reduce public debts⁷⁶

4.3.1. The idea

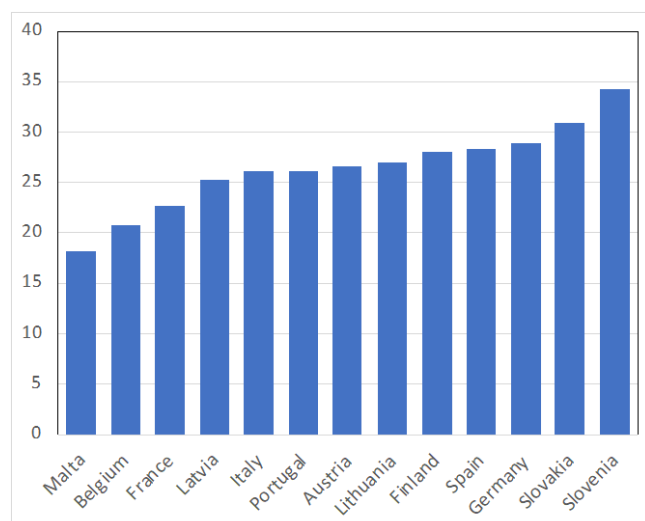
The national central banks of the Eurosystem currently hold a significant share of their respective central government debts. According to Figure 6, the share is usually ranges between 25% and 30% of total debt. Debt service on these shares is zero for the consolidated public sector since interest payments by governments to central banks are returned to governments as profits. In addition, the debt held by central banks is removed from the financial markets, which reduces their exposure to market instability and makes the debts safer. “Effective debts”, therefore, are generally 70%-75% of the corresponding gross debt numbers shown in Figure 5. For example, Italy’s “effective public debt” is 109% of GDP instead of 141%.

The problem is that there is no guarantee that the national central banks will keep forever existing debts on their books, which implies that the concept of “effective debt” as defined above is misleading,

⁷⁶ This is an updated version of the plan presented in Pàris and Wyplosz (2014).

but so is the commonly used concept of actual debt, which ignores the economic effect of holdings of Treasury bonds⁷⁷ by central banks. Behind this confusing situation lies uncertainty about the evolution of future holdings. QT will certainly reduce debt holdings by central banks, but we do not know how far it will proceed. Removing this uncertainty may provide a solution of the large debt problem.

Figure 6: Central bank holdings of central government debts – end 2022 (% of total debt)



Source: ECB.

Note: Data for some countries are not available. Not reported countries with very low numbers (Croatia, Cyprus).

If the Eurosystem central banks were to keep the existing amounts of debts on their books forever, this would be equivalent to a debt restructuring, whereby the correct measure of indebtedness would be the “efficient debt”. How this can be done requires looking into how central banks routinely manage the money supply through the interbank market.

For decades, central banks have created money by taking on board (through outright purchases or repurchase agreements) public debt instruments.⁷⁸ The main reason for using this instrument is that Treasury bonds are deemed safe. Under this assumption, central banks do not take any risk. In so doing, the central banks indirectly finance a fraction of the budget but, until QE, in most countries, the fractions were small. Effective debts were close to actual debts, and the fiscal impact of standard monetary policymaking was irrelevant.

The link between liquidity provision by central banks and public debt financing can be avoided. As central banks provide liquidity to commercial banks (by increasing bank deposits), they must be paid in return. The standard procedure is for the commercial banks to cede Treasury bonds. In other words, the central banks purchase Treasury bonds. The procedure can be changed, however. Instead of purchasing Treasury bond, central banks could buy back their previously issued own bonds held by the commercial banks. Central bank bonds are at least as safe as public debts, both are liabilities of the overall public sector. Were central banks to adopt this procedure, they could conduct routine monetary policy operations while keeping the existing public debts on their balance sheets. Promising to keep existing holdings of Treasury bonds forever would effectively reduce the public debts of governments, replacing them with central bank debts. It would not change the level of indebtedness of the

⁷⁷ This paper does not get into the differences between bonds and bills, using instead the generic term bonds.

⁷⁸ The ECB also acquires private assets, which raises another set of questions that go beyond the purpose of this paper.

consolidated public sector, only its composition, with no impact on the money supply. The interbank market would use central bank bonds as it presently uses Treasury bonds.

4.3.2. How to replace Treasury bonds with central bank bonds

The problem is that, currently, commercial banks do not hold central bank bonds, which they would need to hold in sufficient quantity to trade with central banks on the interbank markets. Somehow, the pump must be primed. Two procedures are possible:

- First, the central bank could buy from commercial banks more Treasury bonds in exchange for newly issued central bank bonds. This would not affect commercial bank deposits. In order to separate the procedure from monetary policy through the impact on the yield curve, the central bank bonds should be of equal maturity as the Treasury bonds that are being swapped.
- Second, the central bank could take advantage of QT, which aims at reducing bank reserves. This could be achieved by issuing central bank bonds to be paid for by commercial banks with reserves, without affecting their holdings of treasury bonds.

An objection to the first procedure is that it would increase debt holdings by central banks, which may be considered as too large. This is a policy choice, which must be agreed upon by the central bank and its government. An objection to the second procedure is that, for the interest rate on the interbank market to be equal to the policy rate, central bank bonds will have to serve the same interest as they offer on bank deposits. Consequently, the banks will consider their deposits and the central bank bonds as equivalent, just different forms of reserves, and QT will not achieve its aim. A solution is for the newly issued central bank bonds to have longer maturities than the deposits which are redeemable on demand. In the end, a combination of both procedures can achieve the desired amount of implicit debt write-off.

4.3.3. Objections and answers

Neutralising a part of existing public debts by placing them on the books of the central banks is bound to generate a number of objections. Furthermore, the specifics of the new procedure must be examined in detail. Some of these questions are dealt with as follows.

a. An inflationary financing of budget deficits?

When a central bank absorbs public debts, it amounts to an ex-post financing of past deficit and the monetary financing of deficits is normally thought of as a source of inflation. The link is more subtle. The constant expansion of the money supply to pay for deficits is certainly inflationary because the reserves of the commercial banks rise, which allows them to keep lending and thus support ever more demand. In the present case, it is a one-off operation that does not increase bank deposits. If needed, the existing excessive deposits can be reduced through QT, with central banks issuing their own bonds.

b. Deposits and bonds

Both commercial bank deposits and central bank bonds are liabilities of the central bank and, as already explained, they must be remunerated at the same rate as the policy interest rate. If they are seen by the commercial banks as equivalent financial instruments, which constitute their reserves, open market operations where one instrument is swapped against the other would have no effect at all. As noted above, the central bank bonds could be of longer maturity than the deposits. Another solution would be that the required reserve requirements, which cap the lending capacity of banks, exclude central bank bonds from being counted as reserves.

c. Inter-country transfers

Within the monetary union, low-debt countries sternly oppose any procedure that could imply transfers to high-debt countries. This is not an issue here since monetary policies are carried out by national central banks, which hold Treasury bonds issued by their own governments. Replacing national Treasury debt with national central bank debt would occur exclusively at the national level, thus preventing any transfer between countries.

d. Moral hazard

If it is easy for a central bank to reduce the “effective debt” of the government, it would seem to create a major source of moral hazard. Since both Treasury and central bank bonds are a liability of the consolidated government, there is indeed a risk that some governments will keep running budget deficits and raise their debts, with the procedure being repeated again and again. This calls for solid safeguards, which already exist. Within the euro area, national central banks operate under the control of the ECB. For that reason, their interbank interventions are carried out on behalf of the ECB and they cannot monetise the debt unless they are instructed to. The ECB will have the authority to determine the size of the initial debt write-downs and any other increase of national Treasury bond holding by the national central banks. It is worth recalling that the Treaty on the Functioning of the European Union requires that the ECB and all national central banks be independent, which forbids them from taking orders from governments.

5. CONCLUSIONS

The euro area emerges from a series of historical shocks with 1) much larger public debts, 2) increased central bank balance sheets of the Eurosystem central banks, and 3) intensified links between fiscal and monetary policies. While the actions that led to this situation are justified by the urgent needs to deal with the shocks, their legacy is a source of undesirable economic and political distortions. The governments and the ECB must now work toward facing these consequences. Public debts must be reduced where they are dangerously large – as seen in Figure 5 - and the ECB must promptly reverse QE. Moving in this direction will go a long way toward minimising the quasi-fiscal implications of monetary policy. Corrective action must not wait, if only because other shocks may again unexpectedly occur.

The need to shrink central bank balance sheets is well understood and indeed QT is underway. However, the strategy has not been spelled out in detail and the speed is not well adapted to a deep retrenchment. Monetary policy has shifted from bank reserves being intentionally kept scarce to abundant. Beyond consequences on the functioning of the financial system and, perhaps, the overvaluation of various assets, abundant bank reserves must now be remunerated, which is a quasi-fiscal issue. Is this new *modus operandi* destined to be permanent or does the ECB, and other major central banks, intend to return to reserves scarcity? The answer to this question should determine the speed of QT, which currently seems to be calibrated by fears of financial instability.

Much of the QE of the 2010s had not been significantly undone by the time the new shocks of the 2020s hit. Similarly, the already large levels of indebtedness of some governments have not been reduced generally by the time they had to be raised again. The idea that fiscal discipline, prompted by the Stability and Growth Pact, will bring the large debts down to safe level assumes that the process can be spread out over a very long time, to be measured in decades. Time, however, is a constraint that need to be recognised. The European authorities, the ECB and national governments, must find a way of quickly cutting public debts down. This paper suggests changing the time-honoured monetary policy practice of dealing on the interbank markets with Treasury bonds. Instead, national banks can issue their own debt instruments and keep the public debt that they currently hold on their balance sheets for ever. In this way, the amounts of public debts held by the private sector can be reduced significantly.

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An effective policy mix for the EU's post-pandemic challenges

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Abstract

The geopolitical and economic shocks, due to the Covid-19 pandemic and the war in Ukraine, represent a structural shift for the European Union (EU) economy. The euro area needs to deal with an ongoing inflation process and the EU needs to radically transform its production model to avoid a lasting decline. An expansionary centralised fiscal capacity, grounded on the production of public goods, and a related common industrial policy are required to allow for this structural change. In the meantime, it is necessary to bring the excessive inflation process under control. These two contrasting problems create a policy dilemma. A restrictive monetary policy backed by national fiscal actions and a temporary central fiscal initiative are inadequate to overcome this dilemma. Hence, we propose an innovative policy mix to address the problem.

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LIST OF ABBREVIATIONS

| | |
|--------------|----------------------------------------|
| APPs | Asset Purchase Programmes |
| CFC | Central Fiscal Capacity |
| ECB | European Central Bank |
| EPGs | European Public Goods |
| EU | European Union |
| GDP | Gross domestic product |
| NATO | North Atlantic Treaty Organization |
| NGEU | Next Generation EU |
| NRRPs | National Recovery and Resilience Plans |
| RRF | Recovery and Resilience Facility |
| SGP | Stability and Growth Pact |
| USSR | Union of Soviet Socialist Republics |

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EXECUTIVE SUMMARY

- The impact of the recent geopolitical and economic shocks implies a **structural shift** for the European Union (EU). The euro area must deal with an **ongoing inflation** process and the EU should transform its production process to improve convergence within the area and strengthen its international role.
- European institutions must therefore solve two problems that, at first sight, have contrasting policy implications: an **expansionary centralised fiscal policy** grounded on European public goods (EPGs), and a common industrial policy to achieve a structural change; and a **restrictive monetary policy backed by appropriate national fiscal actions** to bring the excessive inflation process under control. This leads to a policy dilemma that requires a solution.
- A conventional monetary strategy views excessive inflation rates as the primary short-term problem. As a result, **restrictive monetary and national fiscal policies** are currently needed, whereas an expansionary centralised fiscal capacity would tend to interfere with this restrictive policy stance. Hence, the centralised fiscal policy should be deferred to a medium to long-term horizon when inflation rate is stabilised at its 2% target.
- The solution for the policy dilemma cannot be the overcoming of the excessive inflation, first, and then the implementation of structural changes. Addressing excessive inflation is essential, but the EU should **not delay modernising its production model** while waiting for inflation to stabilise. Prompt modernisation policies are essential due to the changing global landscape and the EU's consequent high risk of becoming a follower in the transition.
- To identify a better solution, we suggest **an innovative strategy to manage the policy mix that does not mainly rely on monetary policy**. The main features of this innovative strategy emerge from a comparison with the conventional policy strategy, illustrated above.
- An innovative strategy does not deny that centralised fiscal policies can have an undesired short-term inflationary impact. However, it stresses the costs of postponing structural changes. Hence, it suggests a policy mix based on **moderately restrictive monetary and national fiscal policies and an expansionary centralised fiscal capacity** focused on the production of EPGs to increase the supply side more than the demand side.
- This innovative policy mix would decrease the recession risk and would allow the EU to reshape its production model; moreover, it would overcome the excessive inflation rates even if at the cost of postponing the inflation adjustment required to hit the European Central Bank's (ECB) target. **This short-term cost can be more than compensated by the positive 'real' outcomes.**
- This policy mix can be **effectively implemented within a supportive economic governance framework**. Hence, the interplay between this policy mix, the role of the ECB, and fiscal regulatory reform should not be underestimated.

1. INTRODUCTION

The era of great moderation has long ended, ushering in a period of repeated shocks and profound changes in which economic areas unable to positively react are at risk of losing their positions in the international markets. This risk specifically applies to the European Union (EU), which suffered a second long recession (2011-2013) after the international financial crisis ('double dip'), recorded a moderate recovery in the period 2014-2018, and was severely hit by the pandemic shock (2020-2021) after having entered a phase of stagnation (2018-2019). Unlike the pro-cyclical response to the 2007-2009 crisis, the EU's economic policy reaction to the pandemic shock was effective and allowed its member states to overcome the worst depression of the last two centuries in just a few quarters. However, the bottlenecks on the supply side, due to the persistent post-pandemic breaks in the global value chains, and the geopolitical and economic shocks triggered by the Russian invasion of Ukraine have determined structural shifts, bringing the EU to a crossroads. The EU must address the economic and social consequences of the ongoing excessive inflation and stagnation by implementing a long-term transformation. The change of its considerable but mature production model is at stake (see Buti and Messori, 2023). This change is necessary for the EU's economic and social system to avoid the decline of its role in the international markets and for the EU member states to avoid increasing divergences among them.

This structural challenge implies that the EU policymakers are facing a dilemma in the short term. On the one hand, if the European Central Bank (ECB) takes full responsibility for bringing the excessive inflation rate under control in the euro area, freezing aggregate demand through restrictive monetary policies backed by national fiscal restrictions will be unavoidable.⁷⁹ On the other hand, to cope with the needed structural changes, it is urgent to implement fiscal policies that support innovations and the restructuring of the EU production model. The apparent conflict between the battle against inflation and the supply of new monetary resources for an economic transformation cannot be solved by postponing the modernisation of the EU economic model and waiting for the stabilisation of inflation rates to the 2% target. In a progressing world, the choice to wait would imply that the EU economy is transitioning from a leading to a follower position. Hence, designing a policy mix apt to meet the EU specificities becomes necessary. This policy mix should be able to combine a gradual but effective reduction of excessive inflation, on the one hand, and an economically innovative and 'green' transition based on an expansionary central fiscal capacity (CFC) and a new European industrial policy, on the other hand.

Our paper aims to clarify the complexity of this policy mix, showing that it can be effective to combine fiscal and monetary policies characterised by different stances. Specifically, the reduction of excessive inflation rates in the euro area can be harmonised with financial support to innovations and restructuring of production activities, if two conditions are met. First, it is necessary that the CFC has a more significant expansionary impact on aggregate supply than on aggregate demand. Second, monetary policy should become moderately restrictive, and the national fiscal policies gradually adjust their main imbalances. The implementation of this policy mix represents, however, a challenge.

The ECB is concerned that the combined stances of the fiscal policies hinder the effectiveness of monetary policy in curbing excessive inflation in the euro area because of their possible expansionary

⁷⁹ These national fiscal restrictions are not only aimed at supporting the monetary policy stance but, at least in the EU countries with high public debt, they are also imposed by the phase-out of the previous safety net for the allocation of public bonds in the financial markets. This safety net was, in fact, based on the ECB's asset purchase programmes (APPs).

effects on aggregate demand.⁸⁰ This position is understandable, but it is partial because it neglects the origins of the current euro area inflation process: a negative supply shock due to bottlenecks in the availability of raw materials and other crucial inputs of production. A restrictive monetary policy that is left alone can control this inflation process through its standard action: a reduction in aggregate demand to match the constrained aggregate supply. This impact has an unpleasant side-effect in the EU, that is it dramatically increases the probability of a recession. Conversely, as recently stressed by Draghi (2023) and recognised by ECB President Christine Lagarde herself (2023b), an expansionary CFC acting on the supply side more than on the demand side should supplement and partly replace the monetary policy's restrictive measures, thus mitigating the recession risks. In the meantime, such a European fiscal policy should support innovative changes in the EU production model.

Lagarde's original concerns should not be overlooked. However, if it is recognised that policy coordination does not require uniform policy stances, it will follow that a compelling policy mix can utilise different tools in different ways to achieve multiple objectives. In the case under examination, an expansionary CFC and the related new EU industrial policy can promote innovation, green transition, and labour productivity; moreover, these policies can help restrictive monetary and national fiscal policies to contrast excessive inflation rates and make national public debts sustainable. Hence, a heterogeneous policy mix can reduce economic instability and enhance sustainable long-term development.

The rest of the paper elaborates on the last statements. Section 2 examines the shifts in the EU's recent policy mix. Section 3 provides a concise theoretical outline of our approach. Section 4 focuses on the policy conditions that ensure sustainability within a restricted fiscal scope for implementing the transformation of the EU production model. Section 5 concludes the paper.

⁸⁰ In this respect, the President of the ECB (see for instance: Lagarde, 2022) has reiterated that: "Euro-area member states should back the ECB's monetary policy by adjusting their increased public balance disequilibria."

2. RECENT EVOLUTION OF THE EU POLICY MIX

The pandemic shock has caused a break in the EU's combination of monetary and fiscal policies. In the previous period (2011-2018), monetary policy in the euro area was the only tool to contrast the economic recession (2011-2013), overcome the risk of deflation (2013-2014), and support a moderate expansion (2015-18). Throughout the entire 2011-2018 period national fiscal policies were restrictive or neutral, mainly due to the severe and pro-cyclical revision of the Stability and Growth Pact (SGP) at the recession's peak in the euro area (2011-2013). Moreover, after the Commission's initiative to introduce some flexibility in the new SGP (mid-January 2015), the stances of the national fiscal policies followed divergent paths and became even more distortionary. Euro area countries characterised by a high public debt to Gross Domestic Product (GDP) ratio, such as Italy and France, implemented expansionary fiscal policies centred on current spending, whereas countries with a low public debt to GDP ratio (such as Germany) continued implementing restrictive fiscal policies. The result was an ineffective policy mix that stimulated the ECB to play a substitute role for fiscal policies. In El Erian's brilliant expression, monetary policy became "the only game in town."

It could be maintained that, in taking such actions, the ECB exceeded the boundaries of monetary policy and adopted quasi-fiscal measures. This interpretation would be inconsistent with the *ex-post* legitimisation of the Outright Monetary Transaction and the Asset Purchase Programmes (APPs) by the European Court of Justice. Nonetheless, even if the ECB acted within its mandate, it should be acknowledged that monetary policy became the only anti-cyclical policy tool due to an ineffective policy mix implemented in the EU, and specifically in the euro area, from 2011 to 2019 (see Bartsch *et al.*, 2021; and Buti and Messori, 2021a).

The EU's response to the pandemic shock led to a new policy mix. This shock resulted in a temporary yet dramatic break of many macroeconomic activities, leading – in the first half of 2020 – to the worst depression of the past two centuries. Consequently, the search for economic stability and recovery required a mix of expansionary policy tools in the EU and euro area, both at centralised and national levels. The ECB's monetary policy became ultra-expansionary by strengthening the APPs through emergency programmes and increasing the amount of liquidity pumped into the economic system through the banking channels. These monetary initiatives built a safety net for the allocation of public bonds in the financial markets, thus allowing for expansionary national fiscal policies even in euro area countries with high public debt stocks. The result was a massive transfer of public resources to households and firms to offset the fall in income and widespread bankruptcy in 'real' and financial activities. Moreover, in the summer of 2020, temporary centralised fiscal policies were agreed by EU leaders, notably Next Generation EU (NGEU) and—mainly—its principal economic programme: the Recovery and Resilience Facility (RRF).

The implementation of the RRF via the National Recovery and Resilience Plans (NRRPs) began in the second half of 2021 and will continue until mid-2026. Let us assume that the NRRPs meet their quantitative and qualitative targets. Thus, centralised fiscal policies will remain expansionary over the next three years, especially for EU countries with more significant NRRPs in terms of their fund allocations, such as Italy. Moreover, in February 2022, another dramatic exogenous shock hit the EU: Russia invaded Ukraine. The unexpected war at the eastern borders of the EU, the consequent energy crisis, and the dramatic acceleration of the technological and geopolitical conflicts between the United States and China have required substantial public transfers to households and firms.

In the same period, the euro area recorded an acceleration of the inflationary process that had already started at the beginning of 2021 and of the excessive inflation rates that became persistent since July

2021.⁸¹ The average headline inflation rate soared above 10% in October 2022 and remains significantly over 2% even in September 2023. Given its primary objective and target, the ECB was constrained to curb excessive and persistent inflation rates by implementing a restrictive monetary policy. The monetary tightening in the euro area started in March 2022, intensified from July 2022 to April 2023, and is still currently being pursued (September 2023). This restrictive monetary stance has also led to a gradual reduction in the safety net provided by the ECB to national fiscal policies by a reduction of its balance sheet.

The previous description shows that, from March 2022 to September 2023, the ECB's monetary policy tightening and its gradually restrictive impact on national fiscal policies have been – at least – partially counterbalanced by an expansionary CFC due to the progressive implementation of NRRPs, and by new national fiscal transfers to households and firms due to the war emergency and its medium-term impact. The evidence in the euro area shows that core inflation has still not been significantly reduced in several member states. In contrast, since the last quarter of 2022, Germany and other euro area countries have been experiencing a recession or stagnation (see Eurostat, 2023). The most credible forecast is that, despite the short-lived resurgence of traditional services (notably tourism), either stagnation or recession will affect the remaining part of the euro area in the second half of this year and the early part of 2024 (see European Commission, 2023). Hence, the economic perspectives in the euro area are gloomy: a persistent excessive inflation rate and a recession that is a high risk of stagflation.

At first sight, this situation implies that economic policy faces an unsolvable puzzle. If left alone to bring the excessive inflation under control, the ECB must continue the implementation of a restrictive monetary policy. On the contrary, fiscal policies should strengthen their expansionary stance to reduce the probability of a recession or persistent stagnation in the EU. Hence, taken separately, monetary policy and fiscal policies interfere with each other. Thus, there is a high probability that both these policies become ineffective in the achievement of their specific goals, worsening the serious problems characterising the EU economy.

This dramatic puzzle could have a positive solution if a compelling policy mix were adopted. It appears as a dead end only because European institutions have failed to learn the lessons from the policy response to the pandemic shock. However, this methodological lesson should not be oversimplified in two ways. First, it does not imply that the interplay between monetary and fiscal policies should always be expansionary regardless of the economic cycle's phase. Second, as we mentioned above, it does not mean that a compelling policy mix necessitates a uniform stance across various policy tools. The methodological break, which allowed an appropriate policy response to the pandemic shock, conveys a more instructive and complex message: an effective policy mix should integrate various policy tools targeting different goals and promoting sustainable economic development over the medium to long term.

To assess the implementation of this methodology, a preliminary analysis of the macroeconomic situation and its main determinants is required. In the case of the euro area, the excessive inflationary process was triggered by supply bottlenecks coming from the breaks in the global value chains due to the pandemic shock (e.g., Canofari *et al.*, 2022). When the peak of the pandemic was overcome, and aggregate demand recorded a partial rebound thanks to the availability of generous public transfers at the beginning of 2021, the supply constraints led to increases in EU prices. Then, the Russian invasion of Ukraine exacerbated supply shortages in several strategic sectors (typically energy, food, and raw

⁸¹ Here, we take for granted that the ECB cannot redefine its quantitative target (an inflation rate equal to 2%) for its primary objective of price stability. A discussion on the recent redefinition of this target is offered in Benigno *et al.* (2023a).

materials for innovative productions). Hence, even if some of the global value chain disruptions were gradually reabsorbed and inflation spread throughout the euro area economy (recall the current downward stickiness of the core inflation), it remains true that excessive inflation originates from a negative gap between aggregate supply and aggregate demand triggered by binding constraints in the former.

It is well known that the ECB's mandate is to pursue price stability, and that monetary policy can directly influence only the demand side. In other words, an anti-inflationary monetary policy must reduce aggregate demand. However, this strategy is not compliant with the new methodology of the policy mix defined as a response to the pandemic. In this last perspective, price stability should not be pursued by worsening production stability and compromising medium-term economic development. In the case of the current euro area inflation process, a more effective possibility, compliant with the new methodology of the pandemic policy mix, could be exploited. We are referring to a combination of policies able to produce a positive supply counter-shock and harmonise aggregate demand with the consequent less constrained and less stagnating aggregate supply.

In principle, designing such an appropriate combination of policies is easy. A positive supply counter-shock should be based on a CFC aimed at expanding the EU activities through the production of European Public Goods (EPGs) without immediately supporting the corresponding aggregate demand. EPGs must be financed and produced at the EU level (Buti *et al.*, 2023). The recourse to a subset of EPGs, such as the production and utilisation of centralised energy storages in partial substitution of the national race to buying up new flows of energy (as happened in the summer of 2022), would weaken the EU's supply bottlenecks even in the short run.

From a more general point of view, the same result would apply to the outcomes of a new EU industrial policy aimed at supporting the green transition and innovative trajectories in digital and artificial intelligence. In this setting, even national initiatives financed by the RRF could contribute to overcome supply bottlenecks at least in the medium term. Moreover, national fiscal policies could gradually adjust the disequilibria in the public balance sheets without increasing the risk of recession. However, it is worth emphasising that a positive supply shock created by centralised fiscal policies could suffer from severe lags. A subset of EPGs can support the supply side more than the demand side in the short term; however, the production of other EPGs can have a short-term inflationary impact because innovations require restructuring processes that support aggregate demand and decrease "old" activities in the short term, thus increasing aggregate supply and labour productivity only in the medium term.

The difficulties in the practical implementation of an effective policy mix could be mitigated if this set of policies were able to anchor at least short-term inflation expectations to the medium-term target thanks to its announced and credible medium-term impact on the supply side.⁸² In any case, appropriate EPGs and a new centralised industrial policy can build a policy mix in the current phase of the euro area aimed at controlling the excessive inflation rate without putting all the burden on monetary policy and hindering medium-term sustainable growth. Combining an efficient and expansionary CFC that supports the net expansion of the supply side, a monetary policy with a moderately restrictive stance, and national fiscal policies aimed at gradually adjusting the main public imbalances could decrease inflation rates without causing stagflation or recession in the EU economy.

⁸² See Section 4.3.

The appropriate methodology of this new policy mix could be specified by describing the different subsets of EPGs and the strong relations between EPGs and the EU's industrial policy.⁸³ Here, we do not follow these complex paths, which would be only indirectly related to the main topic of this paper. It is sufficient to stress two further points that strengthen the interaction between EPGs and centralised industrial policy as crucial components of the new policy mix apt to implement the transformation of the EU production model.

1. The EU's main economic disequilibria (including an excessive inflation rate) are structural and depend on the obsolescence of the EU production model, characterised by an export-oriented manufacturing sector and widespread low-quality services confined to ancillary duties. The EU's medium-to-long term economic growth cannot be based on the current specialisation in mature technologies and driven by the external demand. The production of appropriate EPGs and the implementation of an efficient centralised industrial policy are required to change this old production model through green and technological transitions. These innovative improvements are necessary for the EU to reduce its gaps with the United States and China in the digital sector and artificial intelligence, but also to keep the EU's comparative advantages in terms of regulation and low environmental impact.
2. The allocation of European industrial policy resources should result from a complex and dynamic combination of centralised options, market signals, and widespread guidance. Consequently, the production of EPGs and a centralised industrial policy could also play a role of guidance for corporate innovations and reorganisations, facilitating the creation of transnational companies in the EU's single market. The existence of genuinely European productions would weaken nationalistic debris and facilitate the balance between such signals and centralised options.⁸⁴

It is worth underlining that the change in the EU production model cannot be postponed. If the EU delayed the modernisation of its production model, it would become a follower rather than a leader in the new economic landscape, in which other economic areas have initiated their radical transformations.

⁸³ Let us just mention that the EU might not be able to bridge the technological gaps with the other main international players solely through public and private investments and R&D incentives, partially financed at a central level. Centralised efforts, based on market signals (see below), to establish global businesses in high-tech activities are also essential; and this is the duty of an effective European industrial policy.

⁸⁴ In this perspective, a centralised industrial policy includes initiatives to improve competition in the EU markets. The lack of robust evidence weakens the statement that the current excessive inflation rates in the euro area are mainly due to widespread increases in firms' profit margins. However, we believe that more competition would contribute to overcoming some of the supply constraints and to limiting price increases. This topic will be partially addressed in Section 4.3.

3. ONE DISEASE AND TWO REMEDIES: A SIMPLE GRAPHICAL ILLUSTRATION

The considerations developed in the previous section suggest that a compelling EU policy mix, based on a CFC and—mainly—on the production of EPGs, can support a transition to a new EU production model through green investments and digital innovations and, at the same time, bring the euro area's excessive and persistent inflation rates under control (see Buti and Messori, 2022b and 2023). Various economists have criticised this statement (e.g., Schnabel 2023). Hence, further specification is needed to fill the possible gap between our previous theoretical outline and its efficient implementation.

This section illustrates some issues concerning the current phase in the euro area and the EU at large, as depicted above. Specifically, we analyse the feasible alternative 'policy mix' allowing the transition to innovative production changes in the context of high inflation rates (see also: Buti and Messori, 2022a). To simplify the matter, we consider two contrasting policy strategies:

1. A conventional or **standard strategy** views excessive inflation rates as the primary short-term problem. Hence, the current euro-area economic phase requires a strong demand contraction led by restrictive fiscal and monetary policies. An expansionary CFC to support supply should be deferred to a medium-to-long term horizon when excessive inflation is expected to be brought under control.
2. An **innovative strategy** instead does not defer the expansionary CFC to support supply to a medium-to-long term horizon and calls for less restrictive fiscal and monetary policies in the short run. Combining a moderately restrictive monetary policy, consequent national fiscal policies and an expansionary CFC can smooth the inflationary process and decrease the recession risk at the cost of suffering a temporary increase in inflation rates.

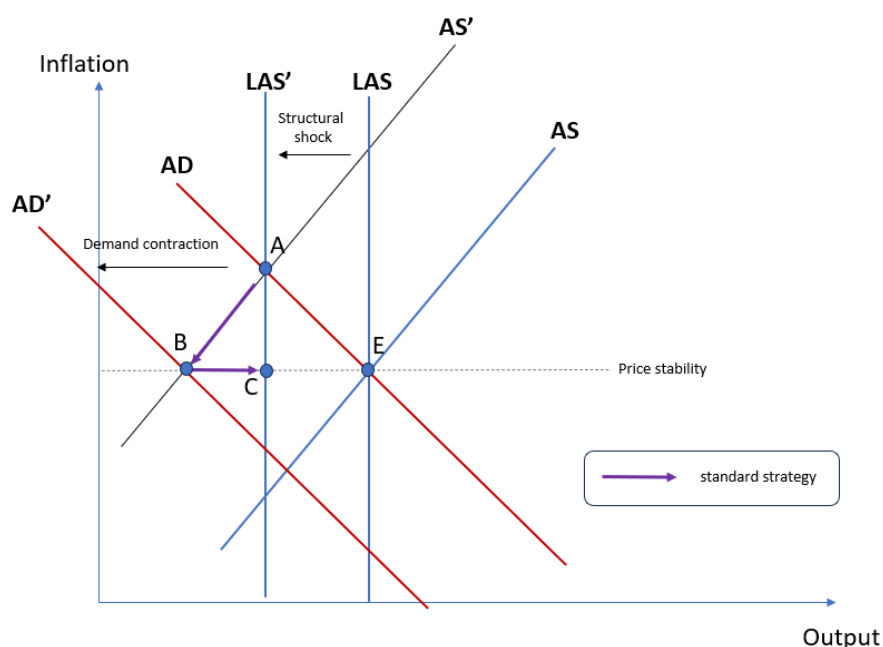
In the following, we elaborate on the two strategies. It is worth noting that the standard strategy emphasises that expansionary centralised fiscal policies, aimed at supporting the supply more than the demand side, achieve the opposite result. In the short term, these policies imply a production restructuring and a decrease in the economic activity, thus increasing the negative gaps between aggregate supply and aggregate demand and strengthening inflationary pressure. The innovative strategy maintains, instead, that expansionary centralised fiscal policies can achieve the desired result even in the short term. If supply-side fiscal policies were immediately effective, they would lead to a costless reduction of inflation.⁸⁵ The considerations, developed in Section 2, state that our preferred strategy is the innovative one. However, the relative effectiveness of these two strategies can be better appreciated if we exclude the case where the short-term counter-supply effects of the EPGs are positive. Hence, in what follows, we maintain that the reallocation due to the production of EPGs can reduce the aggregate supply in the short term, leading to an undesired short-term inflationary increase.

The comparison of the two distinct strategies can be analysed using a simple Aggregate Demand–Aggregate Supply (AD-AS) representation. Figure 1 shows the impact of the standard disinflationary approach, while Figure 2 depicts the impact of the innovative strategy. In both figures, we assume a structural and permanent negative supply shock, which shifts Long-run Aggregate Supply (LAS) and the short-term Aggregate Supply (AS) leftwards, moving the equilibrium of the economy from point E to point A. The permanent supply shock combines geopolitical and economic changes. The latter include the irreversible components of the energy crisis triggered by Russia's aggression and the structural impact of the pandemic crisis on global value chains.

⁸⁵ This is the benchmark case analysed by Buti and Messori (2022a).

Let us start by exploring the disinflationary strategy illustrated in Figure 1. In point A, the economy experiences high inflation. The standard strategy attributes priority importance to price stability. Hence, in the short term, it implements a stringent monetary policy and constrains domestic fiscal policies to adjust their main imbalances, keeping any potential CFC unchanged. The consequent severe restriction in the policy stance leads to a downward shift in the aggregate demand (from AD to AD'). This policy mix swiftly brings prices back under control but at the cost of exacerbating the recession (point B).

Figure 1: The standard strategy



Source: Authors' elaboration.

These textbook effects have been extensively studied and examined in concrete cases. Following a painful disinflation phase, the economy gradually returns to its long-term equilibrium (point C). However, in point B, the primary goal (price stability) of the conventional strategy has been met. Hence, it becomes possible to start the long-term implementation of a supply-side counter-shock via an expansionary CFC to ease economic recovery. In our previous reading of the EU's economic problems, the medium-term delay is enough to make the CFC ineffective in boosting the long-run aggregate supply determined by the structural shock. The economy is trapped at point C, which remains on the left of the original long-term equilibrium (point E).⁸⁶ In this perspective, the EU economy risks being constrained in a follower role compared to areas that have already transitioned to a new production model.

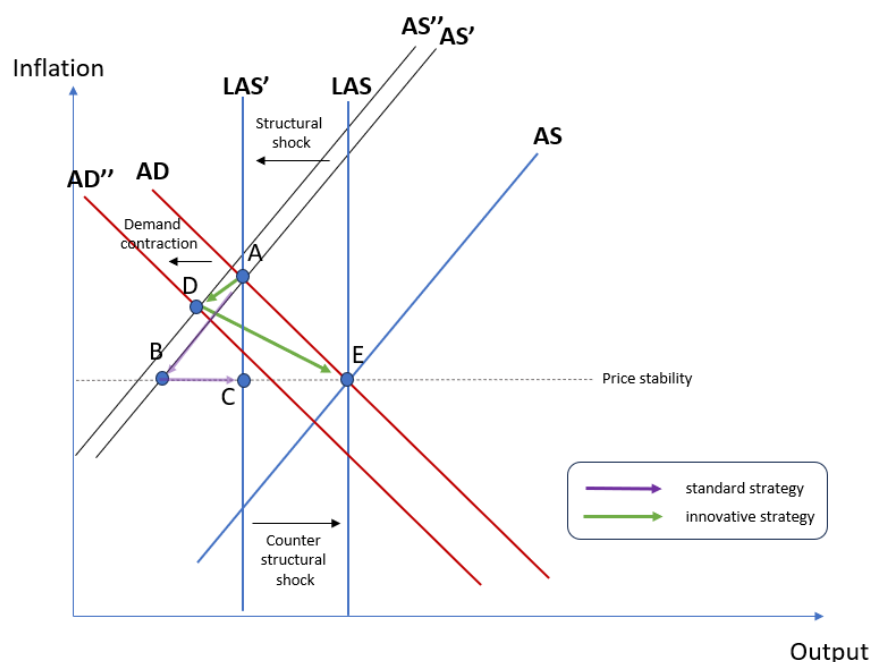
We now look at the innovative strategy, represented by Figure 2. This strategy responds to the initial negative supply-side shock by implementing an expansionary CFC based on the production of EPGs as well as on restrictions of the monetary policy and of the related national fiscal policies that are more moderate than those associated with the standard strategy. These initiatives have two consequences:

⁸⁶ Although delayed, the medium-term beginning of a supply counter-shock could determine a downward shift of AS' crossing a demand curve between AD and AD' at the right of point C. However, this more realistic but complex representation would not substantially change our interpretation.

1. The original leftward shift in the aggregate supply (from AS to AS') is worsened by a further short-term leftward shift to AS'' due to the cost of implementing sectorial reallocations to produce EPGs;
2. The downward shift in the aggregate demand is such that AD'' is moderate compared to the previous case (AD' in Figure 1).

Thus, the innovative policy mix leads to a short-term economic equilibrium represented by point D (in Figure 2), which remains on the right of point B in Figure 1.⁸⁷ This means that point D attenuates the recession with respect to the conventional strategy; however, D will be incompatible with price stability, even if it mitigates the inflation rate relative to point A thanks to the restrictions of monetary and national fiscal policies.

Figure 2: The innovative strategy



Source: Authors' elaboration.

As long as the production of EPGs proves effective in enhancing a positive counter-shock in the aggregate supply, there is a medium-term rightward shift of AS'' and the LAS' shifts to LAS. Moreover, the aggregate demand gradually returns to its long-term equilibrium. Hence, if the counter-shock were sufficiently important for absorbing the initial structural shock through the implementation of restructured productions, the innovative policy mix would move the economic equilibrium to the right until reaching point E of Figure 2. At this point, the new production model meets its long-term equilibrium.⁸⁸

⁸⁷ To ease the comparison, point B – as determined in Figure 1 – is reported in Figure 2.

⁸⁸ It is worth noting that the new long-term equilibrium could be also met at the right or the left of point E. The long-term equilibrium of the innovative policy strategy would be in a point at the right of E, if the production of EPGs and the related industrial policy led to an innovative production model characterised by higher labour productivity with positive medium-term impact on the aggregate demand. However, this same equilibrium could also be in a point at the left of E because the positive supply counter-shock was not able to fully compensate the initial structural shock despite productivity improvements. In Figure 2, for the sake of simplicity, we assume a perfect compensation (enhanced productivity included).

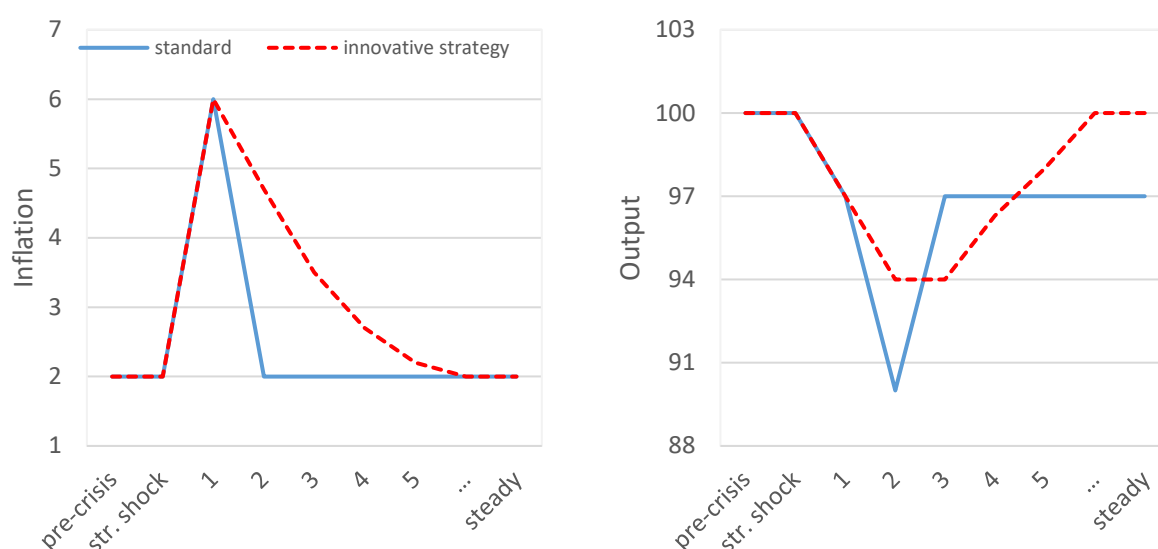
At least two caveats regarding the innovative strategy deserve close attention.

First, the fiscal policies associated with CFC must be thoughtfully designed and efficiently executed, because they should contend with the concurrent innovations implemented in other international areas. The challenge lies in ensuring that the related policy mix is effective with respect to the EU's internal goals as well as to the evolution of international competitiveness.

Second, national fiscal policymakers should avoid the temptation of utilising an appropriate CFC to hide the expansion of their domestic fiscal policies. Maintaining an efficient relation between these two levels of fiscal policies is crucial. The production of EPGs is envisaged as an instrument to drive innovation and structural changes, while domestic fiscal policies are critical to pursuing fiscal sustainability. The innovative policy mix will be effective if there is a balance between the stances of the different policies. As our analysis points out, the current phase of the EU economy requires that the stance of the national fiscal policies (mainly, in countries with high public debt) is harmonised with that of the monetary policy, so that the pressure on sovereign debts is not exacerbated and the expected impact of the ECB policy is not distorted.

The preceding pedagogical illustration of the two policy strategies is static and could be extended by considering the different dynamics implied. Without going into complex analytical details, we offer a rough comparison of the dynamic impacts that characterise the conventional and the innovative strategy, respectively, using Figure 3. Panel (a) of this figure illustrates the evolving trend of the inflation process that derives from each of the two strategies. Panel (b) compares, instead, the different results with respect to output. The conventional approach leads to a more rapid decline in the inflation rate, which reaches its target in the short-to-medium term; however, the cost of this adjustment is a more severe recession and a recovery that is quite rapid but largely insufficient to reach the original long-term equilibrium path. The innovative strategy implies that the average inflation rate takes more time to stabilise, and the economy takes more time to reach its long-term equilibrium; however, the short-term economic recession is milder, and the long-term equilibrium path matches the original potential output.

Figure 3: Dynamic comparison between the two strategies



Source: Authors' elaboration.

Note: The figure is clearly evocative to drive the reader into the adjustment dynamics. The word 'steady' stands for the long-run equilibrium in Figures 1 and 2, i.e., the steady state.

Figure 3 offers qualitative indications with a more precise quantitative assessment expected from the models.⁸⁹ Nonetheless, this figure is sufficient to highlight that the two policy strategies have different trajectories that lead to different results. The comparison of these respective results is not easy to do. How can we compare the cost of a slower recovery to that of a deeper recession? How can we compare the cost of a more persistent excessive inflation to that of long-term growth below the potential? Different EU policymakers do not share a common preference ordering relative to the pros and cons of economic growth, recession, excess inflation, and so on.

Here, we do not directly address these questions, which need – as a preliminary step – quantifications based on a common unit of measure. However, two points should be made. The first is that the quantifications should consider the different horizons (short and long term) of the relative economic and social variables. The second is that the quantifications should consider the different risks involved in the two policy strategies. On the one hand, the standard strategy has a more predictable impact, whereas the innovative one has higher risks; on the other hand, the innovative strategy can allocate a significant part of these risks to the EU, whereas the standard one is based on more traditional tools.

Our analysis cannot state that one of the two strategies dominates the other in the EU. However, an uncontroversial hierarchy between the two strategies arises if we adopt a specific perspective. The deep recession and low potential growth do not ease changes in the EU production model. If the ECB is left alone in facing an excessive inflation rate in the short term, its increase in policy interest rates and its reduction of liquidity supply will make the financing of public and private investments as well as the green and digital transitions more costly and their implementation more difficult (Lane, 2023). These constraints will become even more binding if two additional aspects relating to expectations are considered. First, the restructuring of production processes and innovative choices, required by the transitions, become riskier in a recessionary setting due to worsening expectations. Second, as stressed above (see Section 2), the policy mix designed by the innovative strategy can strengthen the anchorage of inflation expectations to the medium-term target thanks to its announced and credible medium-term impact on the supply side. Hence, in our setting, the innovative policy strategy dominates the conventional one.

⁸⁹ In the next section, we will offer additional qualitative considerations. A quantitative assessment is, however, beyond the scope of the present paper.

4. THE FISCAL NEEDS: SHOULD THE EU WAIT FOR ITS TRANSITION?

4.1. Towards a new EU production model

The euro area has experienced a significant slowdown in productivity growth since the international financial and ‘real’ crises (2007-2009).⁹⁰ The underlying causes of this sluggish performance can be traced back to different factors, some with long-standing structural roots. Here, referring to a few main determinants linked to the euro area’s policy mix will suffice.

Unlike the expansionary policy reaction in the United States, the European institutions responded to the 2007-2009 crisis by adopting a swinging monetary policy and strengthening the central fiscal rules. The aim was to constrain those EU member states with a high public debt-to-GDP ratio and harmful imbalances in their current accounts to adjust their internal and external disequilibria. To pursue these goals, the euro area’s weakest member states had to implement restrictive, and hence pro-cyclical, fiscal policies implying a dramatic compression of wages and internal aggregate demand. On the one hand, this policy mix led to sovereign debt and banking crises in the euro area, which flowed into a new economic recession (2011-2013) and a high risk of deflation (2013-2014).⁹¹ On the other hand, this policy improved the area’s short-term competitiveness in international markets without increasing long-term labour productivity.⁹² Then, from mid-2015 to the end of 2018, the euro area recorded a weak recovery due to an unconventional and expansionary monetary policy and a more flexible definition of central fiscal rules (see Rostagno *et al.*, 2021). In any case, even in that last period the monetary policy remained the main responsible for the anti-cyclical initiatives. Hence, differently from the United States and China, euro area economies were unable to lead critical innovative trajectories, and their productivity dynamics continued unsurprisingly to be weak.

The new expansionary policies implemented in response to the pandemic crisis in the spring of 2020 resulted in further exceptional monetary and fiscal measures, including a temporary CFC. This new policy mix was able to confine the worst depression of the last two centuries to the first half of 2020. However, due to the binding supply bottlenecks and the need to support the income of firms and households hit by the economic lockdown, it did not aim at relaunching the EU medium to long-term economic growth. This relaunch became the main objective of the EU policy mix since mid-2021, when the NGEU started the implementation phase through its main programme (the RRF) and the related NRRPs.

The three pillars of the RRF (the green and digital transitions and social inclusion) showed that the EU economy had a relatively strong position in terms of environmental impact and social welfare but was suffering technological gaps with the United States and China (see Buti and Messori, 2021b, Figures 3 and 4, and Table 1). These gaps were so significant that they hindered the reproduction of the strong points. Energy-intensive and export-driven productions have characterised the EU economy model centred on solid but mature technologies in its most competitive sector, i.e., manufacturing. The services sector has become large but with broad pockets of inefficiency and an ancillary position with respect to industry. The consequent lack of innovation in the EU economy has increased its risk of

⁹⁰ The decline in productivity dynamics is evident across various measurements, including output per work hour (a proxy of Marginal Labour Productivity) and Total Factor Productivity.

⁹¹ The ‘doom-loop’ between banking and the sovereign debt crisis in the euro area has been analysed by several authors (for instance: De Grauwe and Ji, 2013; Sapir *et al.*, 2014). An assessment of the risk of deflation is offered by Canofari and Messori (2015).

⁹² See Esposito and Messori (2018). It should be recalled that Ireland is an exception. This country utilised the European aid program, required to handle the impact of the ‘doom-loop’, to implement innovative investments and to structurally increase its labour productivity.

falling short of the evolving international technological frontiers. The programme proposed by the new Commission at the end of 2019 that focused on green and digital investments was the first attempt to upgrade the EU production model.

The implementation of the RRF since 2021 and its three pillars have put in motion a “growing machine” for the relaunch of the EU economy in the long term (Padoan, 2023). However, only the unexpected persistence of supply bottlenecks and the Russian invasion of Ukraine with the consequent energy crisis have made it evident that the EU’s economy was losing its international competitiveness and needed a new and innovative production model and not just an upgrade (see Buti and Messori, 2023). This acknowledgment has highlighted that the green and digital transitions and improvement in social inclusion can be achieved in a time largely beyond the end of the RRF (mid-2026) and that radical economic changes cannot be supported only by a temporary, even if significant, CFC. The construction of a new EU production model requires an innovative industrial policy, centralised at the EU level and aimed at incentivising efficient public and private investments. Here, it would be inappropriate to go into the details of the possible features of this new European industrial policy. It suffices to emphasise that public and private investments should be financed by a permanent and significant CFC and by mobilising vast private financial wealth.

In such a framework, the centralised fiscal policy should be expansionary, and the liquidity in circulation should be abundant. Implementing these policies would have been highly ambitious at the beginning of 2021, when the euro area economy was in a low-inflation and starting-recovery phase. It has become a dramatic challenge today. As showed in Benigno *et al.* (2023b) and mentioned in the previous sections, the price index started to pick up in the euro area during the first quarter of 2021 and the inflation rate has exceeded the 2% target since July 2021. The ECB changed the stance of its monetary policy in March 2022 and implemented a dramatic sequence of policy interest rate increases from July 2022 to September 2023 accompanied by a more gradual but severe reduction in liquidity supply. At mid-September 2023, there is a high probability that these monetary policy decisions will lead to an economic recession in a euro area already in stagnation (see European Commission, 2023).

In the current framework, it is understandable that the ECB is concerned about again being “the only game in town” able to bring the excessive inflation rate under control. The considerable risk of a persistent recession in the euro area weakens the willingness of many national policymakers to reverse the stance of their expansionary fiscal policies implemented in the post-pandemic phase. Specifically, in countries with high public debt stocks, the attempt is to use the RRF resources to overcome the lack of space in the national fiscal policies due to the restrictive monetary policy implemented by the ECB.

4.2. The role of European public goods

EPGs are pivotal for implementing the triple transition (green, digital, and social) as the way to change the EU production model, to increase sustainable growth within the area, and to enhance European competitiveness in international markets. Being centralised projects with common funding, the EPGs are a specific component of the CFC; however, they offer a less controversial option due to their potential to weaken the “net balance” narrative among EU countries and to reduce tensions between creditors and debtors (Buti *et al.*, 2023.) The vital role played by the EPGs in the EU evolution has become clear in the economic aftermath of the Russian invasion of Ukraine. However, the importance of their production was already raised when the RRF’s potentials were hampered by the national utilisation of the EU funds.

Buti *et al.* (2023; see also: Fuest and Pisany-Ferry, 2019) identify six priority areas for EPGs: digital transition, green transition and energy, social transition, raw materials, security and defence, and health. These areas address crucial EU challenges such as the aims of achieving climate neutrality, reducing technological gaps, enhancing education and re-skilling, and bolstering open strategic

autonomy. It follows that a moderate stance is necessary to finance, produce, and deliver adequate EPGs in a period characterised by a restrictive monetary policy. As already stressed, the implementation of EPGs also requires a permanent CFC and appropriate European technical vehicles. As Buti *et al.* (2023) point out, the intrinsic links between a permanent CFC, effective European vehicles, and the availability of EPGs raise legal, technical, and institutional problems. It is sufficient to recall that the current European Treaties do not leave an adequate space for centralised fiscal policies. Consequently, European institutions face difficulty in planning increases of “own resources” to strengthen the production of EPGs. Moreover, EU programmes such as the Connecting Europe Facility, InvestEU, and the Innovation Fund can ease the delivery of EPGs, but they require significant improvement and redesigning.

Here, we briefly examine three key sectors in which the availability of EPGs is clearly required for implementing innovations that – in their turn – are essential parts of the new EU production model, and for strengthening the social cohesion within the area. These sectors are defence (entirely reliant on public spending), climate transition (where resources come from the public and private sectors at roughly a one-third/two-thirds ratio), and digital transition (primarily private-driven, yet involving important public resources).

Let us address at some length the financial aspects of the green transition. The European Commission’s central scenario suggests that achieving a 55 per cent reduction in greenhouse gas emissions by 2030 would require about €360 billion in total investments (both public and private) for energy and transportation (European Commission, 2020a). These financial resources are equivalent to around 2 per cent of the EU’s GDP per annum. Moreover, additional and significant investments and related financial resources will be required beyond 2030 to achieve net-zero emissions by 2050. Finally, additional expenses derive from eliminating any dependence on Russian fossil fuels by 2027. According to the REPowerEU Communication (see European Commission, 2022), the EU’s geographical reallocation of its demand for fossil fuel will require substantial investments.

European and national regulations, centralised and decentralised taxation policies, carbon pricing, subsidies and non-pecuniary incentives for private investments can help reduce the burden for the public sector. However, in various cases (for instance, energy-network externalities and informational inefficiencies), private investment cannot integrate the public one. Current projections suggest that the contribution of the public sector to the EU’s overall climate investments should amount to about one-third, with additional investments of around 0.6 to 1.8 per cent of EU’s GDP needed and still not covered.⁹³ The EU’s multiannual financial framework and NGEU fail to address this funding gap; and the declining private investments are largely insufficient to solve or even to mitigate the problem.

The implication is that addressing the impact of climate change in the EU will lead to heavy consequences in terms of CFC and national debt sustainability. As Zenios (2021) outlines, there will be a need for dramatic improvements in public investments. To avoid unsustainable increases of public expenditures and borrowing costs in the most fragile EU member states with negative consequences in terms of economic stability and growth, the production of appropriate EPGs will become crucial. The latter could fill a large part of the gap. Leaving aside the other difficulties that hinder this production and delivery, two necessary conditions directly relate to our topic: an effective policy mix and an accommodating monetary policy. In this respect, the innovative policy strategy discussed in Section 3 becomes fundamental.

Let us now outline some problems relating to digital transition by focusing again on the funding gap. The European Commission has calculated an investment gap for digital transformation of €125 billion,

⁹³ The reference is to Eurostat (2021)

equivalent to 0.9 per cent of GDP per annum (European Commission, 2020a). A large portion of this funding requirement should be met by the public sector. In this respect, it must be recalled that, according to the EU Digital Compass 4 strategy, the EU's goal is to achieve the 100 per cent online provision of essential public services by 2030 (European Commission, 2023a). Moreover, the involvement of the public sector is crucial in enhancing digital skills, promoting digital inclusion, and facilitating the digitalisation of small- and medium-sized firms. Finally, several EU countries with substantial public debt exhibit subpar performance in digital public services and digital skills. This picture is worsened by the fact that the NGEU programmes are planning to cover a small fraction of these investment and financial gaps (Darvas and Wolff, 2021.) Hence, even in this case, the EPGs and – consequently – an effective policy mix and an accommodating monetary policy should play a substantial role. In this respect, the innovative policy strategy is again crucial.

As far as defence is concerned, it is necessary to recall that in 2006 the defence ministers of the North Atlantic Treaty Organization (NATO) committed to allocating a minimum of 2% of their respective countries' GDP to defence spending. In 2014, Russia's annexation of Crimea and the Middle East turmoil prompted a new engagement: countries falling below the 2 per cent threshold pledged to reach this target within a decade. As of 2021, Eurostat data reveals that the average defence spending in the EU stood at 1.3 per cent of GDP, with only Greece, Latvia, and Estonia meeting the 2 per cent requirement.⁹⁴ NATO's data (NATO, 2023) slightly varies from Eurostat's, indicating that even Poland surpassed the 2 per cent mark in 2021. However, the crucial factor is that the more recent and partial data (2022), as well as the announced ambitious national plans, indicate that defence spending in the EU continues to grow. The persistent war at the eastern borders of the EU implies that this growing trend will further strengthen in the near future. Hence, it is urgent to start the centralisation of European defence to effectively allocate the growing public spending. In this respect, EPGs should play a fundamental role.

Despite the ongoing challenges and difficulties, the transformative potential of EPGs to shape EU economic dynamics underscores their importance for EU institutional evolution. As shown in the previous Sections, the policy mix and monetary policy have the decisive duty to support the production of EPGs, and, in this respect, the innovative policy strategy appears to be the dominant strategy.

4.3. The policy mix and social cohesion⁹⁵

The rise in energy and import goods prices has adversely impacted real incomes, leading to recent bargaining between firms and employees about a fair distribution of the losses. Firms are inclined to raise their prices to safeguard their profit margins, while workers consider higher wage claims to offset the erosion of their purchasing power. These dynamics can play a role in driving inflation. If each party unilaterally tried to compensate for their specific income losses, the interconnectedness of expanding profit margins, increasing nominal wages, and surging prices could fuel a continuous price hike. The ECB President has warned against the potential risk of the above-described “tit-for-tat” game between firms and workers, as this interaction would interfere with the ECB's 2% inflation target.⁹⁶ Lagarde emphasised that this risk justifies a long-term monetary tightening strategy to maintain economic equilibrium during downturns and anchor expectations.

⁹⁴ See Darvas and Wolff (2022); and Baccianti (2022).

⁹⁵ This section is largely based on Ciccarone and Di Bartolomeo (2023).

⁹⁶ Lagarde (2023b).

The risk of escalating social disputes, particularly against the backdrop of increasing income inequality, is substantial.⁹⁷ Due to differences in production methods, labour market setups, and industry strategies among EU countries, these disputes could have varying national impacts and cause further strain on EU integration. The potential monetary tightening threatened by Lagarde could be less effective or even distortionary in this setting. Anchoring expectations is a necessary but insufficient condition to ensure monetary stability. Social agreement on income distribution grounded on income policies is also required. Hence, it is crucial to understand that the ECB's stabilisation strategy fundamentally depends on a consensus about income distribution. In the presence of inflation, income distribution is altered between those who can and those who cannot adjust the price of their goods or services upward. The assignment of the concept of ensuring monetary stability to central banks arises precisely from the desire to prevent income redistribution 'through inflation', not determined by elected public authorities. With zero inflation, in the absence of such government measures, the distribution is maintained only if there is consensus on it; otherwise, price-wage spirals are triggered.

In this context, Ciccarone and Di Bartolomeo (2023) recently revisited Tarantelli and Modigliani's proposal for managing inflation during the 1980s. Tarantelli and Modigliani were aware of the link between 'programmed inflation' as an anchor of expectation and the social conflict related to income distribution. In fact, according to Ciccarone and Di Bartolomeo (2023), the most ground-breaking facet of their proposal was not merely the predetermination of inflation or the portrayal of unions as proactive economic agents. Instead, it was the visionary realisation that steering inflation toward a predetermined target requires a coordination mechanism fundamentally distinct from those subsequently identified by theoretical frameworks incorporating rational expectations.⁹⁸ Tarantelli and Modigliani's proposal suggests that coordination elements⁹⁹ can skilfully guide expectations in systems where the assumption of rational expectations cannot be invoked.¹⁰⁰ This idea aligns with the Keynesian perspective that institutions, conventions, and social agreements can act as tools to orchestrate the choices of economic actors, even when they might be unstable. When paired with businesses setting prices based on forecasted inflation, this coordination ensures that actual inflation matches the target.

In contemporary economies, the central bank's inflation target has taken on a role akin to the one Tarantelli and Modigliani assigned to the predetermined inflation rate agreed upon by social partners and the government. However, this substitution will be robust only if it is supplemented by an income distribution agreement. For an extended period, the concept of inflation targeting excluded the possibility of incorporating social agreements to manage inflation. We posit that the significant fluctuations in current inflation rates (unprecedented in the euro area) and disparities in income distribution could trigger dynamics that monetary policy alone cannot handle. In the euro area, the unique monetary policy has asymmetric impacts because countries vary in production structure and labour relation types.

⁹⁷ Some firms attempted to push profit margins beyond what increased costs should justify, aiming to offset past losses (from events such as the pandemic). However, while firms can adjust prices quickly, in euro area countries wage changes often require lengthy negotiations. During inflationary periods, this mismatch can initially cause a steep drop in real wages, potentially prompting workers to seek hefty wage raises later.

⁹⁸ These frameworks underpin the anti-inflationary monetary policies anchored to rigid rules, central bank transparency, reputation, and similar tenets, progressively applied globally since the 1980s. Especially within inflation targeting regimes, an optimally devised monetary policy poses a credible threat to the private sector, compelling it to endure high interest rates, engendering unemployment and adverse production gaps until the expectations of both workers and firms align with the target.

⁹⁹ Such as planned (low) inflation and negotiated (low) wages.

¹⁰⁰ Either due to the absence of objective probability distributions concerning significant events (Knight, 1921; Keynes, 1921) or owing to their non-stationarity over time.

It is paramount to recognise that the current economic landscape significantly diverges from that observed by Tarantelli and Modigliani.¹⁰¹ In addressing inflation and income distribution conflicts, a policy adaptation of Tarantelli and Modigliani's approach should have supported a social agreement aligning wage moderation with improved public services and workers' involvement in policy decisions. Nonetheless, their proposition could still hold pertinence within the present circumstances. Today, a policy adaptation of their approach could be based on the production of specific EPGs and appropriate and centralised social protection during the transition to a new EU production model. Even in this case, the aim would be to prevent wage-price spirals and favour more stable economic conditions. However, these new income distribution agreements also have consequences for selecting an effective policy mix and monetary policy strategy.

It is increasingly acknowledged that the unavoidable one-size-fits-all approach of the ECB's monetary policy tends to favour euro area countries with more flexible labour markets. However, a well-structured social agreement could counteract this conclusion. Let us assume that the main results of the social agreement are an additional production of EPGs and stronger social inclusion during the green and technological transitions in exchange for wage moderation. These results would lead to at least three achievements in terms of an effective policy mix: they can incentivise CFC and protect low income, thus mitigating the positive supply counter-shock, bringing under control the possible source of inflationary pressure, and supporting the implementation of the EU production model; they can reduce national policymakers' aversion to adjusting the disequilibria in their public balance sheets; they can avoid excessive monetary policy restrictions because the ECB would not be left alone in handling an excessive inflationary process.

In short, the previous analysis shows that introducing a social coordination mechanism in the policy mix strengthens the dominance of the innovative policy strategy over the conventional one.

¹⁰¹ Their socio-economic context was that of the mid-1980s. At that time, the objective to keep inflation low to bolster the competitiveness of domestic production clashed with two opposite positions: the endeavours of trade unions to uphold workers' purchasing power by increasing nominal wages and businesses' efforts to determine prices ensuring profit margins congruent with those of their international competitors.

5. CONCLUSION

The structural shift of the EU economy, driven by the geopolitical and economic shocks triggered by the war in Ukraine, requires the attention of the EU institutions. A strategic approach is essential as the EU faces ongoing inflation and the necessity of transforming its production model to prevent a prolonged decline and avoid social contrasts in the context of increasing inequalities within and between generations. This task calls for an expansionary centralised fiscal policy coupled with a common industrial strategy, while addressing inflation concerns through moderate restrictive monetary measures and fiscal interventions. In the present paper, we have presented an innovative policy mix to navigate the complex landscape created by this challenge.

Our innovative perspective acknowledges the potential short-term inflationary effects of centralised fiscal policies but highlights the capacity for producing specific EPGs to affect aggregate supply, even in the short run. Additionally, in cases where the CFC and production of EPGs drive transformative restructuring accompanied by temporary reductions in the activity level for green and digital transitions, the medium-term outcome will still be an expanded aggregate supply. Combining a moderately restrictive monetary policy, gradual national fiscal adjustments and an expansionary CFC makes it possible to mitigate inflationary pressures, reduce recession risks, manage the side effects of a temporary inflation surge, and support long-term sustainable growth.

In conclusion, the imperative to reshape the EU production model underscores the need for a well-balanced policy mix. It is crucial not to rely solely on monetary policy. This justifies our preference for the innovative policy strategy outlined above. The resulting policy mix, focusing on EPG production, moderately restrictive monetary measures, and tailored national fiscal adjustments can be effectively implemented only within a supportive economic governance framework. The interplay between this policy mix, the role of the ECB, and the impact of fiscal regulatory reform should not be underestimated, though specific details are beyond the scope of this paper.

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Fiscal adjustment supports the fight against sticky inflation

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Abstract

Fiscal policy becomes less potent in affecting output in an inflationary environment. As the economy nears full employment an increasing part of any fiscal stimulus either crowds out other expenditure or leads to higher prices. This reinforces the case for an accelerated reduction in deficits, especially through the termination of energy subsidies that are no longer appropriate as energy prices have returned to pre-war levels.

An unintended (but predictable) consequence of the past bond buying schemes of the ECB (PSPP and PEPP) is that the net income of the Eurosystem is likely to fall by about EUR 70–80 billion, or 0.5–0.6 % of GDP, making the fiscal adjustment harder.

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LIST OF ABBREVIATIONS

| | |
|--------------|---------------------------------------------|
| ECB | European Central Bank |
| EMU | Economic and monetary union |
| PEPP | Pandemic emergency purchase programme |
| PSPP | Public sector purchase programme |
| SGP | Stability and Growth Pact |
| TLTRO | Targeted longer-term refinancing operations |
| QE | Quantitative easing |

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EXECUTIVE SUMMARY

- **Fiscal policy in the euro area is still projected to be slightly expansionary, with the structural primary balance remaining in deficit (1 % of GDP in 2023 and projected to be 1.5 % in 2024).** This is about 2 percentage points below the surplus of 1 % of GDP in 2018.
- **The pre-pandemic benchmark is approximately equivalent to the requirement to put debt levels on a sufficiently declining path, as required by the proposed new governance rules.**
- **Accelerating the move towards this benchmark would make a material contribution to bringing inflation back under control.**
- **Fiscal policy adjustment should be less costly in terms of lost output or higher unemployment than during the period of low inflation, because any increase in demand will lead to higher interest rates, which will crowd out other expenditure.**
- **Moreover, a key economic parameter, the Phillips curve, is likely to have become steeper, implying that any small reduction in output might lead to a large reduction in inflation.**
- **Lowering inflation is not the primary aim of fiscal policy, but at the present junction fiscal retrenchment will support monetary policy. An acceleration of the primary balance reduction planned for 2024 would thus be appropriate.**
- **The ECB's quasi-fiscal operations (i.e. the public sector purchase programme and the pandemic emergency purchase programme) are now having unintended fiscal consequences, as the Eurosystem is likely to incur considerable losses that will ultimately have to be borne by national treasuries, creating a substantial fiscal headwind.**
- **The sharp increase in the volatility of interest rates over the last few years, which is likely to continue, suggests that it will not be sufficient to set a path for net primary expenditure to reliably achieve the desired reduction in debt ratios.** This uncertainty about the path for the debt ratio is particularly high for highly indebted countries, i.e. those for which a reduction in the debt ratio is most important.

1. INTRODUCTION

The ongoing discussion about reforms to the economic governance framework coincides with the emergence from a double crisis and a sea change in the conditions under which fiscal policy impacts the economy.

Fiscal policy has been in crisis-related challenges since 2020, with the rules of the Stability and Growth Pact (SGP) suspended first because of the COVID-19 crisis and then because of a sharp peak in the energy crisis following Russia's invasion of Ukraine. With energy prices back to pre-war levels and the economy having recovered from the COVID-19 recession, one can no longer argue that extraordinary circumstances require large deficits. As Thygesen et al. (2023) argue, 'it is time to put the fiscal toothpaste back in the tube'¹⁰².

Of course, the average deficit numbers hide large differences across member countries and a return to the status quo ante is not necessarily the main argument for why the present level of deficits is not appropriate. Under the existing rules, Member States would have to start reducing debt levels in 2024 by one twentieth of the distance to the 60 % of GDP reference value. Under the proposed new rules, the required adjustment still be substantial for at least some cases. The Commission has not published the parameters it would suggest to individual Member States under its own proposal, but existing simulations (Zettelmayer et al., 2023) indicate that just to stabilise the debt ratio, highly indebted countries like Italy and Spain would have to improve the primary balance over and above the value planned for 2024 by over 1 point of GDP. The more relevant comparison for macroeconomic policy is with the 2023 value. If the aim is to reduce the debt ratio by at least 1 percentage point annually, the required adjustment relative to 2023 would rise to over 3 percentage points for Italy and Spain. Even Germany would then have to reduce its primary deficit by about 1% of GDP¹⁰³.

Debt levels have diverged over the past decade, with approximately half of all euro area countries keeping their debt-to-GDP ratios below or close to the 60 % reference value. These countries would not be required to reduce their deficits, but many of them are doing so anyway. The result is that the average fiscal contraction of the euro area as a whole would still amount to close to 2 % of GDP, close to what it was in the years immediately before the COVID-19 period.¹⁰⁴

These adjustments will not be required immediately. Under the proposed new fiscal rules, the overall adjustment is likely to be spread over several years.

But the environment for fiscal policy is now very different from the pre-COVID-19 period. The gradual adjustment rules of the past (about a 0.5 percentage point annual reduction in the deficit) may thus no longer be appropriate. There are two related reasons why the trade-offs facing fiscal policy have changed.

First of all, interest rates are no longer glued to the lower bound. In the standard IS-LM framework used to analyse the effectiveness of fiscal policy, this implies that the impact of a fiscal adjustment on output should be smaller because it will be partially offset by the negative impact of higher interest rates on investment and other interest-sensitive expenditure.

Second, there is evidence that the relationship between unemployment and inflation has changed. Some researchers find that the slope of the Phillips curve has increased, implying that even a relatively small impact of a fiscal retrenchment might have a significant impact on inflation.

¹⁰² See <https://cepr.org/voxeu/columns/putting-fiscal-toothpaste-back-tube-its-time-normalise-euro-area-fiscal-stance-2024>

¹⁰³ See <https://www.bruegel.org/policy-brief/longer-term-fiscal-challenges-facing-european-union>

¹⁰⁴ https://www.consilium.europa.eu/media/65609/2023-06-21-efb-assessment-of-euro-area-fiscal-stance-final_0.pdf

Taken together, these two effects imply that the output cost of the fiscal adjustment required to return to the pre-COVID-19 stance, which had put the debt ratio on a slowly declining path, should be relatively small, but could still have a significant impact on inflation.

It follows that fiscal and monetary policy should now move in the same direction. However, the required fiscal adjustment may be larger than appears at first sight because of the unintended costs of the ECB's past quasi-fiscal operations of the ECB (the public sector purchase programme (PSPP) and pandemic emergency purchase programme (PEPP)).

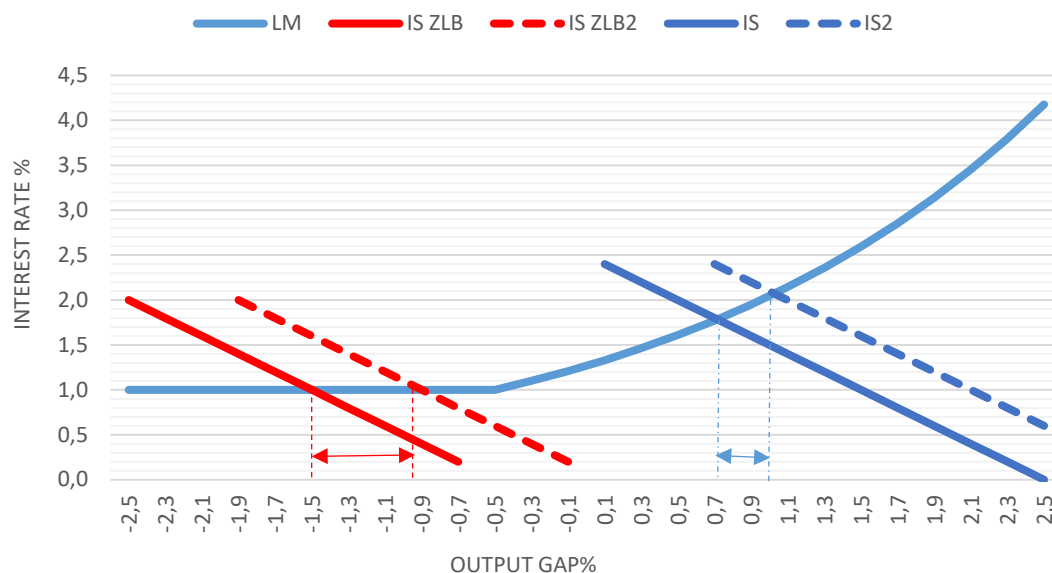
The remainder of this contribution is organised as follows: Section 2 shows why the transition away from a 'low-for-long' period should reduce the multipliers, i.e. reduce the potential output cost of a fiscal adjustment. Section 3 discusses the recent evidence that the Phillips curve has become steeper. Section 4 provides some illustrative calculations of the fiscal cost of the ECB's past bond buying in the new environment of normalised interest rates. Section 5 concludes.

2. FISCAL POLICY AWAY FROM THE LOWER BOUND

2.1. A simple framework

During the low-for-long period, when interest rates were stuck at the lower or zero bound, fiscal policy seemed to have become the main countercyclical instrument. The usual argument that a higher deficit leads to higher interest rates, which then crowd out other expenditure, no longer seemed to hold. In the standard, if dated, IS-LM framework that economists often use to describe the impacts of fiscal and monetary policy, this corresponds to the situation depicted below, a very flat (horizontal) LM curve. Figure 1 illustrates this using an LM curve that is horizontal for large negative values of the output gap.

Figure 1. IS LM illustration



Source: Authors' own elaboration.

Note: Output gap is the difference between actual GDP and potential GDP. The arrows illustrate the change in the output gap after IS curve shift, from IS ZLB to IS ZLB2, and from IS to IS2.

A fiscal expansion, i.e. a higher deficit, would shift the IS curve to the right. It is apparent that when the economy is at or close to the zero/lower bound, a fiscal expansion has a greater impact on output than when the economy is far away from the zero lower bound (ZLB). This is shown in Figure 1, which depicts a (horizontal) shift in the IS curve of the same amount for these two cases.

2.2. Empirical estimates of changing multipliers

There have been extensive efforts to estimate the size of fiscal multipliers in different circumstances (see de Rugy and Salmon (2022) for an exhaustive survey of multiplier estimates over the last two decades). Some contributions distinguish between the multiplier effect of different fiscal instruments such as government spending, taxes and transfers (Forni et al., 2009; Eggertsson, 2009; Coenen et al., 2012, Barrell et al., 2012). Several studies have investigated the cyclical variation of fiscal multipliers (Berge et al., 2021).

Following the prolonged period of low interest rates, a large body of literature has discussed the impact of fiscal policy during episodes of zero/lower bound nominal interest rates. Consistent with theories, many find a larger value of the government spending multiplier with interest rates at the zero/lower bound than in normal times (to name a few, see Christiano et al., 2010; Klein and Roland Winkler, 2019; Di Serio et al., 2020).

The use of asset purchases and other non-standard policy instruments led to a situation (mostly in advanced economies, including the euro area) that has been called a persistent ‘liquidity trap’, where the further monetary expansion no longer stimulated the economy and fiscal policy became the main countercyclical instrument (Gopinath, 2020).

More recent analyses based on state-of-the-art macroeconomic models confirm the higher effectiveness of fiscal spending in boosting economic activity in a liquidity trap (Michau, 2019; Lemoine and Lindé, 2023). During the COVID-19 pandemic, interest rates remained at the lower bound (and central banks intensified the use of expansionary non-standard policies, but the massive fiscal stimulus packages deployed by governments did not seem to have a major effect on output. This was to be expected given the sectoral nature of the COVID-19 recession and recovery (Capolongo and Gros, 2020)¹⁰⁵.

¹⁰⁵ See https://www.europarl.europa.eu/cmsdata/211390/2_CEPS%20final.pdf

3. A STEEPER PHILLIPS CURVE?

The Phillips curve theory suggests a trade-off between the rate of change of wages (and prices) and the employment level. The theory was first introduced by William Phillips in 1958 based on empirical observations of wages and unemployment in the UK, where he identified an inverse relationship between the two variables. The underlying intuition is that when the economy is experiencing a period of strong growth and there is a high demand for labour (unemployment is very low), wages tend to be bid upward rather rapidly, pushing firms to increase prices, and vice versa (Phillips, 1958).

The occurrence of stagflation in the 1970s, with high levels of both inflation and unemployment, however challenged the validity of the original Phillips curve concept and motivated the refinement of the theory over time. Lucas (1972) proposed the new classical version of the Phillips curve incorporating the role of rational expectations into the analysis. Keynesian economists of the 1960s exploited the concept of the Phillips curve, reasoning that policymakers could reduce unemployment by accepting higher inflation or vice versa. Lucas argued that if policymakers attempt to exploit the Phillips curve trade-off by creating surprise inflation, individuals would adjust their behaviour and factor in the expected inflation. As a result, any short-term reduction in unemployment achieved through surprise inflation would be temporary, leading to higher inflation expectations and no long-term reduction in unemployment, resulting in a breakdown of the Phillips curve relationship.

The relationship between inflation and unemployment has become more complex over time in view of the strength of the labour market. Historically low unemployment, and core inflation remaining persistently below the target preceding the COVID-19 crisis led to a discussion about whether the link between output or unemployment and inflation had disappeared. Mishkin et al. (2019) thus asked whether the Phillips curve was dead¹⁰⁶. In the euro area, the ECB examined over 500 specifications of the Phillips curve in 2019 using different measures of inflation (wages, core, headline, etc.) and different slack measures (output gap, unemployment, etc.) and arrived at the conclusion that the Phillips curve was alive¹⁰⁷.

Using regional data from the US, Mishkin et al. (2019) reported that in tight labour markets the Phillips curve may be subject to important nonlinearities. Also, Hooper et al. (2020) suggested an emergence of nonlinear dynamics in the Phillips curve. This implies that the relationship between inflation and unemployment may not be a simple linear trade-off, as suggested by the original Phillips curve theory (Hooper et al., 2020).

3.1. The renaissance of the Phillips curve

The pandemic entailing significant supply and demand shocks with the corresponding unprecedented monetary and fiscal policy responses – introduced new dynamics and challenges to the applicability and predictability of the traditional Phillips curve, as a consequence of higher inflation expectations, supply shocks and structural changes (Ari et al., 2023). So the linear Phillips curve with anchored expectations failed to predict the surge in inflation following the pandemic (Gopinath, 2022).

The key issue for the ECB at present is not so much whether a fiscal adjustment would have a large impact on output, but whether it would have a large impact on inflation. This in turn depends on the

¹⁰⁶ See <https://cepr.org/voxeu/columns/phillips-curve-dead-or-alive#:~:text=Figures%201%20and%202%20show,inflation%20to%20tight%20labour%20markets>

¹⁰⁷ See https://www.ecb.europa.eu/pub/economic-bulletin/articles/2019/html/ecb.ebart201904_02~d438b3e4d4.en.html#toc5

relationship between output or employment and wages (Schanbel, 2023). A key question is whether the slope of the Phillips curve has increased (again) over recent years.

The present combination of high inflation and low unemployment suggests that the Phillips curve is not dead (Baba et al., 2023). Moreover, unemployment has declined only marginally over the last year, while inflation has shot up and remained high despite now-falling energy prices. This suggests that the slope of the Phillips curve may have increased, implying that even a relatively small change in demand could have a significant impact on inflation. Even a small negative impact of fiscal adjustment on demand could provide considerable support for the ECB's fight against inflation.

More recently, Chai Dao et al. (2023) present further evidence of nonlinearities in the slope of the Phillips curve. They measure the Phillips curve as the unemployment-inflation trade-off, which is slightly different from the growth-inflation relationships used in the ECB's evaluations. They argue that the slope of the euro area curve has roughly doubled relative to the pre-pandemic years. The increase in the slope of the US curve is even greater. An important aspect of their findings is that one should use the pre-2019 estimates as a benchmark rather than the 2022 estimates.

Chai Dao et al. (2023) report the following results:

“the slope of the US relation is about -0.3 at 8 percent unemployment but steepens to -2 at 3.5 percent unemployment. ... The euro area might have a similarly steep part of the curve, but this remains uncertain as there has not yet been sufficient overheating to reveal it. A further implication is that policy tightening that cools demand can potentially achieve larger inflation reductions in a more overheated economy.”

One important use of the Phillips curve is in forecasting inflation – a key issue for the ECB. Its own analysis (Bańbura and Bobeica, 2020) concludes that some specifications of the Phillips curve could help forecast inflation, potentially also including nonlinear aspects¹⁰⁸.

Taking into account today's probably much larger impact of a slowing economy could be important for the ECB in calibrating its own policy.

3.2. Can fiscal policy shift the curve?

Most modern economic models do not treat the Phillips curve as a simple relationship between some measure of inflation and some measure of economic slack. A key third ingredient is the expected inflation rate. Actual inflation is thus understood as the result of two elements, namely expected inflation and the degree of economic slack (e.g. the unemployment rate). Various models and approaches differ mainly in terms of what determines expectations of inflation. We do not want to enter into this debate of rational versus adaptive, versus static expectations¹⁰⁹.

The evidence presented in the previous subsection on the slope of the Phillips curve referred to the magnitude of the impact of a change in unemployment on inflation, given inflation expectations.

There is also some evidence that fiscal policy may influence inflationary expectations and shift the curve. This could mean that contractionary fiscal measures may reduce the expectations of inflation by firms and households (at any given level of economic slack) and indirectly curb inflationary pressures to a significant extent. Łyziak and Mackiewicz-Łyziak (2020) find that economic agents reduce their inflation expectations in response to a more sustainable fiscal policy. Similarly, Grigoli and Sandri (2023) find that high public debt has stagflationary effects, with weaker economic activity and

¹⁰⁸ See <https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2471~fc87caada8.en.pdf>; for the US see https://www.nber.org/system/files/working_papers/w31197/w31197.pdf

¹⁰⁹ For a very recent discussion, see a long blog post by J. Cochrane <https://johnhcochrane.blogspot.com/> (28 August 2023).

higher inflation. Increasing government spending and higher interest rates on sovereign debt have a similar effect according to Coibion and Weber (2021). The inflation expectations channel and the pass-through from fiscal policy to inflation, have also been documented based on a natural experiment (D'Acunto et al., 2016).

The evidence that in some circumstances a fiscal policy that becomes more sustainable shifts the curve is still tentative. If confirmed, it would provide another argument to accelerate the reduction in deficits.

4. THE FISCAL COST OF CENTRAL BANK BOND BUYING

When inflation and interest rates increase, central banks ordinarily profit because they pay no interest on cash and have investments whose yields rise along with interest rates. This is known as seigniorage income, which ultimately accrues to national treasuries. In recent decades, the ratio of cash holdings to GDP has grown in most countries¹¹⁰, thereby increasing the base for seigniorage. For example, in the euro area, the amount of currency in circulation – almost EUR 1 600 billion¹¹¹ – is now worth about 12 % of GDP. At the present deposit rate, the ECB (the Eurosystem, to be precise) should be earning at least 3.75 % on the assets that are the counterpart of this EUR 1 600 billion. Its seigniorage revenue should therefore be EUR 60 billion, or 0.45 % of GDP. For the US, the theoretical seigniorage revenue is similar as a proportion of GDP because the policy rate is higher, although the cash-to-GDP ratio is somewhat lower at 9 %. On the over USD 2 200 billion outstanding, the Fed should now be earning 5.5 %, resulting in seigniorage revenues of USD 120 billion, or about 0.5 % of GDP¹¹².

But this time is different. Central banks are now taking losses from the large amounts of bonds they have bought over the past nearly 10 years of low inflation. Central banks bought long-term bonds during their various quantitative easing (QE) operations because they wanted to alleviate private investors from the interest rate risks inherent in holding long-term bonds. The stock of bonds on the balance sheets of central banks is generally low yield and long term.

For this part of their balance sheet, the impact of rising rates on central bank accounts is the opposite of that of seigniorage: as policy rates rise, central banks must pay more on their liabilities to banks than they earn on the stock of bonds.¹¹³

When the stock of bonds held under QE is larger than the cash in circulation (which is the case for most large central banks that engaged in QE), these losses are larger than the seigniorage revenues, leading to unprecedented overall losses for the central banks concerned. If one wants to calculate the impact of higher interest rates due to past QE, one should look at the change in the net revenues of central banks.

The deterioration of the profit and loss accounts of the major central banks is impressive.

In the US, the quarterly net income of the Federal Reserve went from a profit of USD 32 billion in Q1 2022 to a loss of USD 28 billion in Q1 2023, a reduction of USD 60 billion per quarter or USD 240 billion annually, which is equivalent to about 1 % of US GDP.¹¹⁴

In the UK, the losses for the Bank of England will be particularly severe because the cash-to-GDP ratio in the UK is only 4 % and the accumulated bond purchases amounted to about 40 % of GDP by the end of 2023. Accordingly, the Bank of England will need transfers from HM Treasury of about GBP 40 billion, or around 2 % of GDP, as long as interest rates remain at their present levels.

The Bank of England also provides an estimate of the total cumulative fiscal cost of its QE operation, including past gains, which of course depends on future interest rates¹¹⁵. The estimates range from

¹¹⁰ As an aside, one should note that this fact is difficult to reconcile with the widely-held proposition that cash is disappearing, which constitutes one of the key arguments for the digital euro project of the ECB.

¹¹¹ https://www.ecb.europa.eu/stats/policy_and_exchange_rates/banknotes+coins/circulation/html/index.en.html

¹¹² Authors own calculations.

¹¹³ Gros (2016) shows that one could consider QE operations as the investment arm of central banks, with all the attendant risks involved.

¹¹⁴ Federal Reserve Banks Combined Quarterly Financial Report, <https://www.federalreserve.gov/aboutthefed/files/quarterly-report-20230818.pdf>

¹¹⁵ For an independent source of the cost of QE, see <https://www.niesr.ac.uk/news/ongoing-costs-quantitative-easing>

over GBP 100 billion to GBP 200 billion, or between 5 % and 10 % of UK GDP. Over the next 3 years, the Bank expects transfers from HM Treasury of GBP 40 billion, or close to 2 % of UK GDP.¹¹⁶

For the euro area, the accounts of the ECB and those of the 20 national central banks that conduct the euro area's monetary policy are too opaque to provide a similarly simple indication of the fiscal cost of (past) bond buying, but the overall numbers lead to a similar result: holding bonds worth close to a third of GDP that yield nearly nothing will lead to a cost of about 1 % of GDP when the ECB has to pay banks 3.75 % to hold their excess reserves (Gros and Shamsfakhr, 2022).

The loss to the Eurosystem as a whole will be smaller than this amount, because 40 % of this loss will be offset by the increased seigniorage revenues mentioned above, but 0.6 % of GDP is still relevant, corresponding to the annual adjustment effort required under the (old) fiscal rules. Furthermore, the ECB has recently lowered the interest it pays on required reserves to zero.¹¹⁷ This will have only a small impact on the losses of the Eurosystem, but shows what steps the ECB is taking to reduce losses.

What is more, the ECB and many national central banks have large reserves that can now be used to offset some of these losses and spread them over time. However, these accounting adjustments do not change the underlying fact that the national central banks in the euro area, which receive the bulk of the so-called monetary income, will have to reduce or even stop their transfers to national treasuries for some time.

Table 1 below shows in the first column the net income, or rather the expected loss, of the three major central banks in 2023. The second column then shows the change in the net income between 2022 and 2023. This difference reveals the loss incurred by the existing stock of low-yielding government debt on the balance sheets of these central banks. As argued above, an increase in inflation should normally lead to higher central bank profits. But massive QE has completely reversed this.

Table 1: Income/losses of QE- major central banks (% GDP)

| | Absolute loss 2023 | Change in income from 2022 level (p.p.) |
|--------------------|--------------------|-----------------------------------------|
| US Federal Reserve | 0.5 | 1.0 |
| Bank of England | 1.9 | 1.9 |
| Eurosystem | 0.7 | 0.6 |

Source: Own calculations based on ECB, BoE and Federal Reserve data.

Note: The forecast for euro area GDP in 2023 is taken from the European Commission.

The losses for the Eurosystem would be even larger had the ECB not made an unprecedented unilateral change to the terms of its long-term lending in late 2022. Back in 2020, the ECB wanted to entice banks to take up its 'targeted long-term operations' (TLTRO) by promising them a rate of minus 1 % if banks expanded their loan books. This seemed aggressive, but barely justifiable, when inflation hovered close to zero and no end seemed in sight for the negative interest rate policy. Yet, by late 2022, with inflation out of control and the ECB needing to raise its own rates quickly, the cost of this promise had become clear. The ECB then simply decided to unilaterally change the terms on the TLTROs, arguing that this "drastic change in circumstances could not have been foreseen".¹¹⁸

¹¹⁶ Asset Purchase Facility Quarterly Report - 2023 Q2, <https://www.bankofengland.co.uk/asset-purchase-facility/2023/2023-q2>

¹¹⁷ <https://www.ecb.europa.eu/press/pr/date/2023/html/ecb.pr230727~7206e9aa48.en.html>

¹¹⁸ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32022D2128>

The cost estimates presented here can only be approximations of the order of magnitude, as the exact details of the holdings are not known. The key point is that, as the stock of PSPP and PEPP holdings will diminish only in homoeopathic doses, these costs are likely to continue for as long as the ECB keeps interest rates at current levels (Gros and Shamsfakhr, 2023).

5. MONETARY POLICY AND THE (NEW?) ECONOMIC GOVERNANCE FRAMEWORK

Before entering into a discussion of the Commission proposals for a new economic governance framework, it is useful to consider the history of the euro area's fiscal rules.

The basis of the Maastricht consensus was that monetary policy would be unified only through EMU and that the ECB would aim solely at price stability as its overarching mandate. The purpose of the fiscal rules first enshrined in the Maastricht Treaty was mainly to prevent "gross errors" and to avoid pressure on the ECB from highly indebted countries. This was also the main reason why the deficit and debt "reference values" were included in the Treaty. These fiscal rules represent the only link between fiscal and monetary policy. Sound public finances facilitate a monetary policy that can pursue price stability without having to fear financial instability arising from the debt problems of individual Member States.

The SGP operationalised the meaning of "reference values" for fiscal policy oversight after the start of EMU in 1999. The Pact specified that Member States should aim for a balanced budget on average over the cycle. The purpose was to allow countercyclical policies in a recession, when the fiscal deficit could move from balance to a maximum of 3% of GDP. The 3% limit, which was lower than the actual value at the time of the negotiations in Maastricht, was chosen because it was thought that it would only be reached in the event of a very deep recession. With an elasticity of the deficit relative to growth of about 0.5, growth would have to fall by 6 percentage points below trend before countries would see the deficit increase above 3% of GDP – provided of course that they started from a balanced budget in cyclically normal times.

In addition, the SGP introduced an escape clause ("exceptional circumstances") that allowed larger deficits in the event of a severe downturn. To ensure compliance with these rules, the Pact created an elaborate "excessive deficit procedure" with a number of escalation stages, finally including fines for Member States that persistently run excessive deficits.

As is well known, the SGP did not survive contact with reality. (Most) Member States did not run balanced budgets in favourable times during the first years of EMU and thus ran into higher deficits when the first downturn came in 2001-2002. In late 2003, the proposal of the Commission to launch an excessive deficit procedure against France and Germany was met by opposition of the three largest EMU Member States. This episode showed the fundamental problem with the enforcement of fiscal rules in the euro area. Member States are always very reluctant to impose harsh measures on their peers because they might need their votes for something else in the future.

Subsequent rounds of reforms confirmed this Achilles heel. In 2005, the Pact was made more "intelligent" by referring more to cyclically adjusted deficits; but it also became more complicated. This was not the last reform. The 2011 reform even attempted to overcome the enforcement problem with the reverse majority voting system, under which a Commission proposal within the excessive deficit procedure could be overruled by Member States only with a two-thirds majority in Council. However, this only shifted the problem on the Commission, which then became more reluctant to propose fines.

During calmer times after the financial and public debt crises of 2007-2012, Member States made little progress in reducing debt levels. Some countries, in the first instance Italy but also Spain (Greece being a special case because it was under a macroeconomic adjustment programme) caused continual frictions with requests for more flexibility under the rules formally in force then. The limits on debts

and deficits were then suspended in 2020, as envisaged by the rules, when COVID-19 led to a severe downturn.

The Commission has since proposed new rules that concentrate squarely on the sustainability of debt levels. In principle, this is exactly the problem identified by Maastricht (and which materialised during the euro debt crisis). At the same time, the new rules would require much less adjustment than the old ones. Moreover, the basis for the new rules should be tailor-made paths for fiscal policy negotiated individually by Member States with the Commission. The Commission maintains that this will create more national ownership, solving the enforcement problem.

The new proposed rules, if adopted, would not require major immediate adjustments in fiscal policy. They would therefore not influence monetary policy, at least not in the short term. The medium- to long-term effect of the new rules all depends on their success in ensuring the sustainability of public finances. Whether this will be the case is impossible to say at present. The main argument put forward by proponents of the new rules is that Member States will be much more likely to follow less demanding adjustment plans negotiated with the Commission than to comply with the more demanding existing rules. There is no objective basis for or against this argument. It remains a hope and only experience will show.

6. CONCLUSION

Fiscal and monetary policy should now work in the same direction.

There is no need for formal coordination. The ECB remains fully responsible for combatting inflation and the overall stance of fiscal policy should mainly be geared towards maintaining sustainable debt ratios and be countercyclical. At present, these two requirements coincide.

The 2024 budgets presented by Member States envisage a reduction in deficits of about 0.5 % of GDP. This gradual path of adjustment should be accelerated, given that at the present juncture a stronger adjustment will also help to reduce inflation. Achieving this acceleration of adjustment will be made harder by the unintended fiscal costs of the PSPP and PEPP.

It is a different question whether the still large stock of government debt held in the Eurosystem influences the level of interest rates and keeps them lower than they otherwise would be.¹¹⁹ The argument made is simply that the sharp increase in interest payments on reserves makes the necessary fiscal adjustment more difficult.

The European Commission has underpinned its reform proposals for economic governance, inter alia, with the assertion that imposing the existing rules in 2024 would require excessive adjustment. Irrespective of the validity of this assertion in normal times, the call for softer fiscal rules comes at a very inopportune time. The present situation of sticky (core) inflation and full employment provides the ideal backdrop for decisive action to put debt on a plausible and sustainable downwards path.

Moreover, the ongoing discussion on the reform of the SGP has created an incentive for (highly indebted) Member States to keep their deficits elevated this year, because this provides a higher watermark from which the adjustment plans that would have to be negotiated/agreed under the proposed governance framework would depart. The 4-7 year time horizon envisaged for the adjustment plans would presumably take as their starting point the debt level at the end of 2023, with little pressure to reduce debt even by 2027 under the 4-year horizon, or by 2030 if the country fulfils the conditions for this extension. It is thus likely that this optimal moment for fiscal adjustment will be missed.

¹¹⁹ <https://www.niesr.ac.uk/news/ongoing-costs-quantitative-easing>

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Alignment of monetary and fiscal policies has proven to be decisive for the euro area's ability to withstand successive crises over the years. Today, the European Central Bank (ECB) continues its fight against inflation by implementing a monetary policy tightening unprecedented in pace and scale. At the same time, after allowing for some deviations from regular budgetary rules with the activation of the general escape clause in 2020, the EU is set to reapply its fiscal rules fully from 2024. In addition, co-legislators are currently discussing the proposed legislation by the European Commission for the reform of the economic governance framework. Five papers were prepared by the ECON Committee's Monetary Expert Panel, discussing the interaction between monetary and fiscal policies in the euro area.

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