

Monetary Dialogue – 19 November 2020

Executive summaries of the papers prepared by the Monetary Expert Panel¹

1. [MONETARY-FISCAL NEXUS AFTER THE CRISIS](#)

Background

The severe economic disruption caused by the COVID-19 pandemic required an urgent, massive and coordinated fiscal and monetary policy response. The fiscal measures will lead to substantially higher public debt-to-GDP levels across the euro area. In order to safeguard the effective transmission of monetary policy, the European Central Bank (ECB) further expanded its asset purchases, in particular of government bonds. This growing nexus between monetary and fiscal policy has raised concerns about possible future policy constraints and trade-offs.

Five papers were prepared by the ECON Committee's Monetary Expert Panel, discussing the implications of such interlinkages between monetary and fiscal policy.

Papers

[Blurred Boundaries Between Monetary and Fiscal Policy](#) by Salomon FIEDLER, Klaus-Jürgen GERN, Ulrich STOLZENBURG (Kiel Institute for the World Economy)

- In the current crisis, there is strong complementarity between monetary and fiscal policy. High borrowing needs of governments are accommodated by low interest rates and asset purchases of the European Central Bank (ECB), ensuring favourable financing conditions.
- While expansive monetary policies are appropriate given downward pressure on inflation at already subdued levels, there are indications that these policies ultimately amount to monetary financing. First, bond purchases of the central bank are sufficiently large to fully cover government net lending. Second, when a sovereign debt crisis was looming in March, the ECB was quick to ensure capital market access for all Member States by announcing the pandemic emergency purchase programme (PEPP). Third, the central bank has become **governments'** single biggest creditor, which creates strong interdependencies: by holding that much public debt, the central bank plays a major role in the financing of governments; ECB involvement in bond markets strongly affects financing conditions of governments; the central bank inevitably takes substantial creditor risks; and interest payments on bonds held by the central bank eventually flow back to government budgets.
- The COVID-19 crisis brought back fears of a possible breakup of the currency union, but this risk was mitigated by a combination of monetary and fiscal policy measures. The swift

¹ Available at <http://www.europarl.europa.eu/committees/en/econ/monetary-dialogue.html>

reaction of the ECB announcing PEPP prevented yield spreads from widening further. Later, the introduction of joint EU debt and net financial transfers between Member States can be associated with a further decline of risk premia.

- Central bank money, which represents a common liability of all Member States, is rapidly increasing. **ECB's purchase programmes** – in which the Eurosystem creates money to buy government bonds – resemble to some extent a mutualisation of debt.
- Fiscal dominance is a valid concern. The determination of the ECB to maintain price stability would be tested if inflation threatened to exceed the target. Then, the ECB would have to choose between maintaining price stability on the one hand and public debt sustainability, financial stability and cohesion of the Economic and Monetary Union (EMU) on the other.
- The ECB faces a particular challenge due to the unique institutional architecture of the euro area. Safeguarding independence of monetary policy requires institutional reforms either in the direction of a more comprehensive and effective fiscal union or in the direction of reviving the principle of fiscal responsibility embedded in the Maastricht Treaty. Remaining stuck in the middle would probably leave problems unsolved and would cement the conditions for fiscal dominance to prevail.
- Governments should use the years ahead to reorganise EU institutions and reduce debt to levels sustainable also in a less benign interest rate environment. While chances are that borrowing costs remain low over the coming years, we cannot expect this to persist forever and should prepare for an eventual rise of interest rates at a later stage. Rather than taking the current period of low borrowing cost as a reason for complacency, we would see it as a window of opportunity, and suggest starting a process of fiscal consolidation as soon as an eventual recovery of the economy from the pandemic allows for it.

[Monetary-Fiscal Interactions in the Euro Area: Assessing the Risks](#) by Karl WHELAN (University College Dublin)

- The COVID-19 global pandemic is leading to large increases in public debt across the world. This is pushing many countries towards unprecedentedly high debt-GDP ratios.
- The crisis is also increasing the inter-linkages between governments and central banks and between monetary and fiscal policies. Central banks are accumulating large amounts of sovereign debt via asset purchase programmes.
- Inter-linkages of various sorts are emerging between fiscal and monetary policies. Low interest rates allow governments to carry higher debt burdens and ownership of sovereign debt by central banks reduces the net burden of the interest on this debt. The potential deployment of the European Central Bank (ECB)'s outright monetary transactions (OMT) programme also acts to stabilise sovereign debt markets in the euro area and reduces the change of a speculation-driven sovereign default.
- Some are concerned that high public debt may pressurise the ECB to pursue overly loose monetary policy. However, this paper argues this is not a major source of risk.
- We are likely to be in a low-interest regime for a long time, so there is little reason to be concerned about debt sustainability in the euro area. Concerns about fiscal debt should not prevent us responding adequately to this crisis.

- The ECB has been clear that its actions are consciously making it easier for governments to pursue active fiscal policies to combat economic weakness and that it supports an active fiscal response. Rather than be concerned about fiscal-monetary interactions, we should welcome that ECB is enabling a strong co-ordinated approach to an unprecedented threat to our economy.
- This approach is also fully consistent with the ECB pursuing its primary objective. Co-ordinated monetary and fiscal policies are the best bet for restoring price stability by returning inflation to its target level.
- **There is a risk that the Treaty's rules on monetary financing** will constrain the ECB in its reaction to the crisis. In particular, the pandemic emergency purchase programme (PEPP) may be ruled to violate the prohibition on monetary financing.
- The European Court of Justice (ECJ) **has, up to now, ruled that the ECB's asset purchase programmes do not violate the Treaty's monetary financing prohibition.** This paper discusses, however, how there are likely to be limits to the ECJ's tolerance of sovereign bond purchases by the Eurosystem and how the PEPP could trigger the ECJ to impose explicit limits on sovereign debt holdings.
- The ECJ may be concerned about the non-temporary nature of asset purchase programmes. **They may also be concerned about the size of the Eurosystem's holdings** and the question of whether the programmes are discouraging sound budgetary policy.
- The ECB may be forced into an uncomfortable choice. It may have to pick between the short-run stimulus provided by its asset purchase programmes and the longer-term existential threats to be addressed by the OMT programme.
- **Re-imposing the EU's fiscal rules from 2022 onwards could harm economic recovery.** These rules should be suspended indefinitely and then replaced with more sensible provisions. A replacement of the monetary financing prohibition with a more flexible approach should also be considered.

[Rethinking Monetary and Fiscal Policy in the Post-COVID Euro Area](#) by Luigi BONATTI, Andrea FRACASSO, Roberto TAMBORINI (University of Trento)

- The pandemic and the measures against the diffusion of the virus have worsened considerably the economic and social fabric of most euro area countries. While the European Central Bank (ECB) has intervened to support financial markets with ample liquidity provisions, the fiscal authorities have implemented a massive fiscal response that will increase the outstanding sovereign debts for many years ahead.
- These circumstances have modified the monetary-fiscal nexus in the euro area so profoundly that the ECB might face various trade-offs in the future. In particular, monetary policy in the euro area risks being dominated by concerns that are at odds with price stability. This risk is most evident in an economic environment characterised by high outstanding debts and large fiscal deficits.
- Three sources of such risks are prominent in the euro area: inflation, financial dominance, and tapering. If inflation will grow, the **ECB's policy reaction may be constrained by the effects of monetary tightening on national debt sustainability.** Financial instability disconnected from

fundamentals may trigger self-enforcing processes of flight to quality that threatens the integrity of the euro area, forcing the ECB to intervene. The reduction of the assets purchased through the asset purchase programme (APP) and pandemic emergency purchase programme (PEPP) may create problems for the highly indebted countries that need to roll over their debts, large fractions of which are held by official holders, thus implicating them into a highly politicised game concerning financial assistance and debt restructuring.

- These risks impinge upon the functional independence of the ECB, and the transition from the phase of monetary-fiscal joint stimuli to a new equilibrium with price and debt stability. Most of them could be reduced by a revision of the euro area governance framework, aimed at breaking the doom loops among sovereign governments, markets and the ECB, and at creating conditions for a careful calibration of tapering on both the monetary and the fiscal side.
- Key to this aim will be the removal of a considerable amount of sovereign assets from the Eurosystem's balance sheet by means of the creation of a peer supranational fiscal authority as aggregator and manager of the EU sovereign debt created for certified pandemic necessities, endowed with political legitimacy and financial capacity.

[The Euro Area After COVID-19](#) by Charles Wyplosz (The Graduate Institute, Geneva)

- The European economy after COVID-19 will be very different from what it used to be. Most obviously, national public debts will have increased by some 15-30% of GDP. A larger proportion of these debts will be held by the ECB than has been the case so far.
- It is very likely that the post-crisis rebound will not be followed automatically by a sustainable recovery. Macroeconomic policies will have to shift seamlessly from containing the impact of the pandemic to putting the economy on to a lasting growth path.
- The ECB will face a complex situation. Now in negative territory, its interest rate instrument is no longer available, at least not enough to make a difference. Instead, it has been using its balance sheet instrument, which implies buying very large amounts of public debts.
- Large holdings of public debts create proximity between the ECB and its member governments. A particular concern is fiscal dominance, whereby monetary policy decisions become heavily influenced by this proximity.
- This paper takes the view that these risks exist but they can be managed if the ECB makes early preparations to that effect. These risks should be a central concern of the strategy review currently under way at the ECB. The existing strategy may remain reasonably well-adapted to normal times, the strategy review must deal with unusual times, most of which are unpredictable.
- The ECB should adopt the average inflation targeting strategy, as recently adopted by the US Federal Reserve. By committing to overshoot its inflation target for about as many years as it previously undershot it, the strategy will allow the ECB to strengthen the post-Covid recovery, it will lift inflation expectations up and provide leeway to bring interest rates into positive territory.
- An additional benefit of the average inflation targeting strategy is that it will allow to continue to indirectly finance the fiscal policy effort without triggering fears of fiscal

dominance. While there is no threat of a loss of formal independence, the appearance of fiscal dominance may sustain the perception that, informally, the ECB is not as independent as it is supposed to be.

- Financial stability is now acknowledged by the ECB as a key policy objective. Having been given the responsibility for banking supervision, its next step is to work out formal arrangements with governments regarding rules of engagement and financing of losses.
- The ECB should also seek to improve relations with member governments. This enhanced form of mutual information should cover the sharing analysis of the situation, exchanges of views regarding planned action and a better understanding by the ECB of national circumstances
- The ECB should issue its own debt instruments. This would make it possible escape the numerous difficulties associated with the use of national debt instruments for standard and nonstandard policy interventions.

[COVID-19 and Economic Policy Toward the New Normal: A Monetary-Fiscal Nexus after the Crisis?](#) by Thomas MARMEFELT (CASE – Center for Social and Economic Research; University of Södertörn)

- The European Union has responded to the COVID-19 crisis with expansionary fiscal and monetary policy. The fiscal policy includes a recovery fund under Next Generation EU, which focuses on the green and digital transitions. The monetary policy includes unconventional policy measures, in particular asset purchases under the pandemic emergency purchase programme and targeted longer-term refinancing operations to support bank lending to businesses and households, but that is consistent with independent central banking.
- A sharp decline in GDP has been met with a growing money supply, raising concerns of future non-performing loans. This can be understood in terms of financial instability and malinvestment due to credit creation, warranting consideration of the production structure.
- A disequilibrium approach to output-inflation dynamics considers monetary-fiscal policy interactions with production as a process in time, involving interactions among heterogeneous agents. Coordination differs among industrial sectors. The supply of credit is not always met by the same demand for credit due to expectations and financialisation. Unconventional monetary policy needs to be combined with fiscal policy for growth. Production occurs in several stages, involving a capital structure based on technological complementarities and an asset structure, involving reshuffling. Structural change matters.
- Experimental studies for monetary-fiscal policy interactions in an evolutionary, complex economy suggest that fiscal rules are destructive to stability and growth and that a dual-mandate monetary policy is preferred. Macroeconomic outcomes emerge out of interactions among heterogeneous agents coordinating through adaptation. One study suggests that unconstrained fiscal policy and a monetary policy targeting both price and employment stability would achieve lower GDP volatility and a lower likelihood of crises without increasing inflation and public debt to GDP.
- The common European fiscal response (Next Generation EU), which aims at green and digital transitions, is crucial to recovery. Next Generation EU is seen as strongly

complementary to the pandemic emergency purchase programme and the targeted longer-term refinancing operations by the European Central Bank. Public investment provides an important instrument for the green and digital transitions, providing suitable infrastructure. National recovery and resilience plans need continual evaluation to avoid public malinvestment.

- The monetary policy measures have injected liquidity into the banking system and supported lending by banks. In contrast to other proposals, such as helicopter money and zero-coupon perpetuities, debt monetisation has been avoided while providing adequate liquidity preventing deflation. Liquidity injections need to be controlled.
- The strong complementarity between monetary and fiscal policy is related to the pandemic, but not a monetary-fiscal nexus threatening central bank independence. Fiscal and monetary policy have responded to COVID-19 and monetary policy has focused on price stability, according to the given mandate. There is no monetary-fiscal nexus threatening central bank independence, but the new normal will have high private and public debt burdens to address through debt restructuring.

2. EFFECTS OF PANDEMIC-INDUCED UNCERTAINTY ON MONETARY POLICY

Background

The COVID-19 pandemic has fuelled a significant or even, according to some measures, unprecedented increase in economic uncertainty. For central banks, such uncertainty makes effective calibration of monetary policy challenging.

Four papers were prepared by the ECON Committee's Monetary Expert Panel, presenting the different measures used as proxies of uncertainty and evaluating the effects of the current pandemic-induced uncertainty on economic outcomes in the euro area, in particular on inflation.

Papers

[Monetary Policy in the Time of COVID-19, or How Uncertainty is Here to Stay](#) by Maria DEMERTZIS, Marta DOMINGUEZ-JIMENEZ (Bruegel)

- Even before the COVID-19 pandemic the European macro-economic environment was **approaching a poorly understood 'new normal'** that the European Central Bank (ECB) sought to navigate with unconventional tools. The pandemic has accelerated some of these trends, pushing real interest rates further into negative territory and moving economies further from equilibrium.
- The unprecedented resulting increase in uncertainty is evident in the different proxies used to measure it: newspaper and Twitter analyses, stock market implied volatility and cross-sectional disagreements in forecaster estimates.
- Moreover, traditional notions of uncertainty depend on the idea that we can measure risks reliably, which is no longer entirely the case. Current circumstances approach fundamental uncertainty: our understanding of both the COVID-19 shock and the new economic equilibrium are incomplete.
- In the shorter term, this uncertainty manifests itself in the effects of immediate ECB policy.
- The pandemic affects inflation through both supply and demand mechanisms. While overall it appears deflationary, inflation risks remain and compound uncertainty, exacerbated by a growing supply of money and soaring debt, and the small possibility of fiscal dominance.
- Unconventional measures, while perhaps necessary to stabilise an exceptional situation, lead to rapid expansion of an already large balance sheet, with uncertain consequences. The subsequent compression of sovereign spreads raises concerns about medium-term debt sustainability and whether the ECB could conceivably come under pressure to continue support beyond the appropriate horizon.
- These aspects combine with more fundamental challenges for monetary policy from the increasing uncertainty about the state of the world.
- Market and econometric estimates both place the equilibrium real interest rate in negative territory, **which is fundamentally 'not normal' and a source of concern about clearing capital markets and central bank ability to manage demand.**

- The design of monetary policy relies on estimates of oft-unobserved variables, yet forecasting has become increasingly inaccurate in the presence of fundamental uncertainty, and thus less useful in informing policy.
- In these circumstances, traditional confidence intervals should be discarded; confidence is provided instead by the range of contingency scenarios considered. The ECB should provide a certain set of predictions based on a range of assumption outcomes.
- Effective communication of these assumptions is key and should focus on what the response will be to a wide range of scenarios if they materialise (as opposed to focusing on what the ECB expects to happen).
- Policy options should then be ranked based on their ability to keep inflation within an acceptable (pre-determined) range for a wide set of assumptions (i.e. in the most extreme scenarios).
- Additionally, redefining the price stability objective to a simple target of 2% would help best manage inflation under uncertainty. Under the theory of focal points, greater clarity improves communication and provides a good signal to the markets that should facilitate the achievement of the target.
- Finally, the establishment of a tolerance band around this target would explicitly set the levels of inflation that are tolerable. Remaining within this range establishes credibility, while the cost of failing to do so is also heightened. The bands should be moderately wide: in times of uncertainty, it is more important for the ECB to be predictable than precise.

[Uncertainty and the Pandemic Shocks](#) by Pierpaolo BENIGNO (University of Bern), Paolo CANOFARI (Università Politecnica delle Marche, Ancona), Giovanni DI BARTOLOMEO (Sapienza Università di Roma), Marcello MESSORI (Luiss Guido Carli, Roma)

- Newspaper-based measures clearly show a sharp increase in uncertainty in 2020 due to the outbreak of COVID-19 at both global and European level.
- Other measures of uncertainty based on volatility in financial markets also show a significant increase in uncertainty after the first pandemic shock but to a lower extent with respect to other recent financial and "real" crises.
- This evidence could be due to the policy reactions implemented by the EU and EMU institutions, which were more rapid in spring and summer of 2020 than during the previous crises.
- Despite this evidence, European policymakers should take into consideration that, even if the current monetary policy implies very low interest rates, some Member States will have to deal with a big amount of government debt after the emergency, thus further increasing the level of uncertainty.
- The possible complex interactions between policies and uncertainty signal that the economic consequences of COVID-19 could be more persistent than the previous shocks.
- Using both newspapers and financial-variables-based uncertainty indexes, we show that higher uncertainty implies declines in GDP, consumption, worked hours, and investment. The

impact on investment is higher than the one on consumption. As uncertainty increases, inflation and policy rates slightly decline.

- These analytical and empirical results show that the ECB's expansionary monetary policy, as well as the national and EU expansionary fiscal policies, should continue in 2021 and the following years in order to respond to the second wave of COVID-19.
- Hence, the combination of short-term national fiscal policies and a plan for the utilisation of resources provided by the European funds is a necessary condition for controlling the persistent level of uncertainty in the EU and the related macroeconomic consequences.
- It is also crucial to incentivise institutional investors to reduce the part of their portfolio allocated in liquid assets and increase that in riskier assets. This is necessary in order to finance innovations and organisational changes in the EU productive system and to be able to improve the economic potential and social development after the pandemic shocks.

[Uncertainty in the Euro Area During the First Wave of the COVID-19 Pandemic](#) by Atanas PEKANOV, Stefan SCHIMAN (Austrian Institute of Economic Research - WIFO)

- Uncertainty – a state in which assessing future conditions by economic agents is hampered – rose sharply during the current pandemic. This is true for all three kinds of uncertainty measures considered: traditional financial-market-based measures of economic uncertainty drawing on the volatility of stock prices; measures based on business expectations of the future economic situation; and measures based on the prevalence of words in newspapers and other media that refer to uncertainty.
- A bout of uncertainty can have similar effects like an adverse demand shock, dampening private consumption, investment and, hence, inflation. Uncertainty about future incomes, e.g. due to a heightened risk of becoming unemployed, may increase precautionary savings and therefore dampen consumption. Uncertainty about future revenues of firms may lead them to postpone costly and potentially irreversible investments and the hiring of new workers. Furthermore, banks may increase risk premia and, hence, credit costs, aggravating the negative effects on consumption and investment. The reduction in aggregate spending due to uncertainty dampens inflation.
- According to our own estimations, however, the pandemic-induced spike of uncertainty has caused little macroeconomic damage so far. After an initial surge, uncertainty levelled off more quickly than during the Global Financial Crisis 2008/09 – not least due to the decisive action of the ECB, in particular the (announcement of) PEPP and other interventions. The current rise in unemployment and the fall of inflation are predominantly due to the slow-down and shut-down of social and economic activities to contain the pandemic, not due to uncertainty shocks per se.
- The introduction of PEPP was a quick and decisive action that stopped uncertainty from rising further and probably contained its adverse economic effects. Another important monetary policy instrument to mitigate uncertainty is forward guidance. Forward guidance can be used to manage the expectations about the future decisions of the central bank, therefore reducing uncertainty and limiting the increase in risk premia. Another monetary policy option to counteract a shortfall of aggregate demand (uncertainty-induced or otherwise) is to further cut interest rates. However, with policy rates already below zero, further rate cuts bear the risk

of adverse effects hindering the transmission of monetary policy. Instead (or additionally), the ECB might embark on a make-up strategy as part of its monetary policy strategy review – as recently adopted by the US Federal Reserve – tolerating higher inflation in the future to compensate for previous inflation shortfalls. Other options include further tiering and the expansion and extension of current TLTRO programs (by further cutting the rate on TLTROs).

- In the current pandemic, credibly stabilising expectations involves an integrated approach that encompasses both epidemiological and economic aspects. While monetary policy and fiscal policy can help, there is a direct and central role for health policy in stabilising expectations by communicating a coherent and credible strategy to tackle the pandemic. This is still challenging, given the changing circumstances and the many unknown aspects and nature of the COVID-19 virus, its spread and the effective measures against it.

[Uncertainty and Monetary Policy in the Euro Area](#) by Christophe BLOT (Sciences Po – OFCE; Université Paris Nanterre), Paul HUBERT (Sciences Po – OFCE), Fabien LABONDANCE (Université de Bourgogne Franche-Comté)

- Academic literature emphasises that uncertainty shocks work as negative demand shocks suggesting that they would amplify the deflationary pressures already at work.
- Uncertainty is a multidimensional concept that can encompass several dimensions – financial, macroeconomic, economic policy. The different types of uncertainty do not have similar dynamics and effects on the economy.
- We show that uncertainty has negative effects on inflation overall. Although financial uncertainty does not transmit to non-energy industrial goods and uncertainty about macroeconomic news is positively correlated with energy prices, the overall effect of all uncertainty metrics on the various components of inflation in the euro area is negative and persistent.
- However, we find no evidence that uncertainty affects the transmission mechanism of monetary policy to inflation. The effectiveness of the European Central Bank (ECB)'s monetary policy on euro area inflation is the same regardless whether uncertainty is high or not.
- The policy implications of such results are that the effectiveness of the policy instruments is not impaired and that monetary policymakers should consider uncertainty in their reaction function in order to fulfil their mandate.