Rethinking Monetary and Fiscal Policy in the Post-COVID Euro Area*

How are Central Banks Dealing with Macroeconomic Consequences of Covid-19 pandemic?
4 November 2021, Central Bank of Bosnia and Herzegovina

* Based on reports prepared for the Committee on Economic and Monetary Affairs of the European Parliament ahead of the Monetary Dialogues with the ECB President.
https://www.europarl.europa.eu/cmsdata/214967/01.TAMBORINI%20final.pdf

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Overview

• The pandemic and the measures against the economic consequences of the virus have modified the monetary-fiscal nexus in the euro area so profoundly that the ECB might face various **critical trade-offs in the future**.

• Three sources of such risks, common worldwide, are prominent in the euro area: **inflation, financial dominance, and tapering**.

• Risks could be reduced by a revision of the euro area governance framework, aimed at
  (i) creating conditions for a **careful calibration of tapering** on both the monetary and the fiscal side.
  (ii) **breaking the doom loops** among sovereign governments, markets and the ECB.

From monetary dominance to fiscal-monetary synergy

Monetary dominance is the doctrine whereby the institutional design of the monetary and the governmental institutions should ensure the **independence of the central bank** in the pursuit of its statutory mandate(s), primarily the mandate of price stability. "*The euro has been built on the principle of monetary dominance*" (Schnabel 2020, p. 1):

- **monetary orthodoxy**: price stability first, no debt monetisation
- **fiscal orthodoxy**: rule-based fiscal discipline, no fiscal transfers, no bail-ou clause

This doctrine presupposes that:

- the economy is largely self-governed around optimal allocation and full employment of resources by free market forces; money and finance are a"veil" behind which market forces work
- there is no (almost never) need of large inter-generational or inter-temporal resource transfers intermediated by public debt
- monetary and fiscal (macro) policies do not have (permanent) effects on the allocation of resources and employment of production factors; in the long run they only affect the price level
- in the event of shocks and "frictions" that call for short-run macroeconomic stabilisation, independent monetary policy provides the best suited tools.

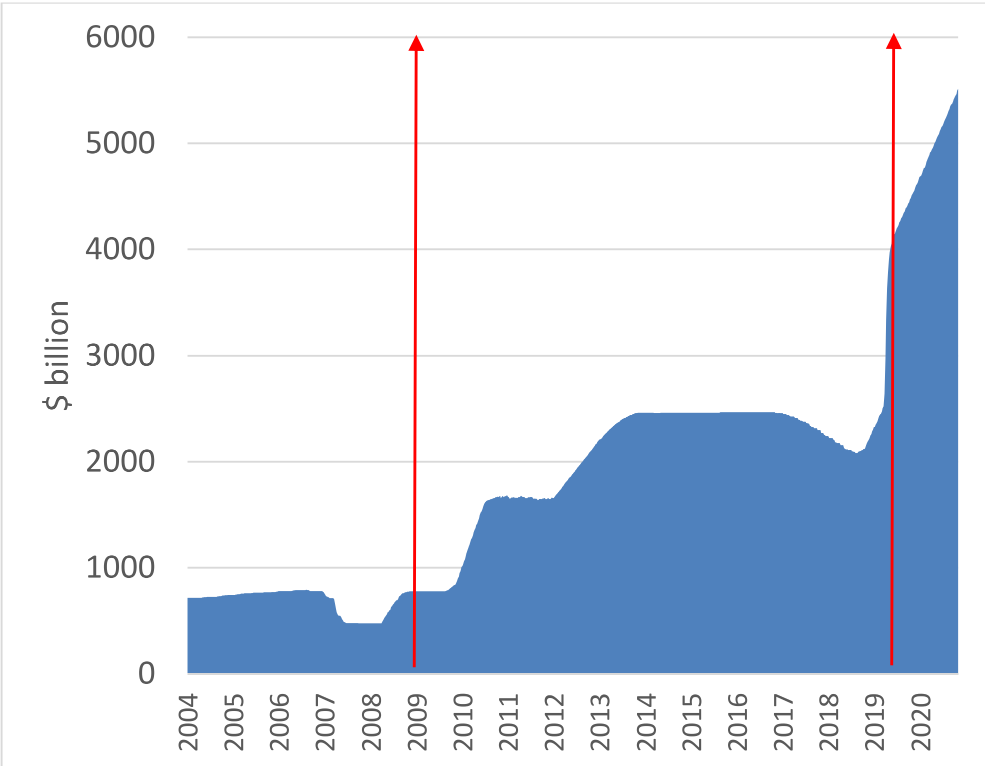
After being dominant since the 1980s, this doctrine has been set aside worldwide by the Global Financial Crisis, the Great Recession, and, in the EMU, by the sovereign-debt crisis and the subsequent stagnation of the 2010s:

- impotency of "conventional" monetary policy *vis-à-vis* depression traps at the "zero lower bound" of interest rates
- radical shock to the doctrine's foundations.

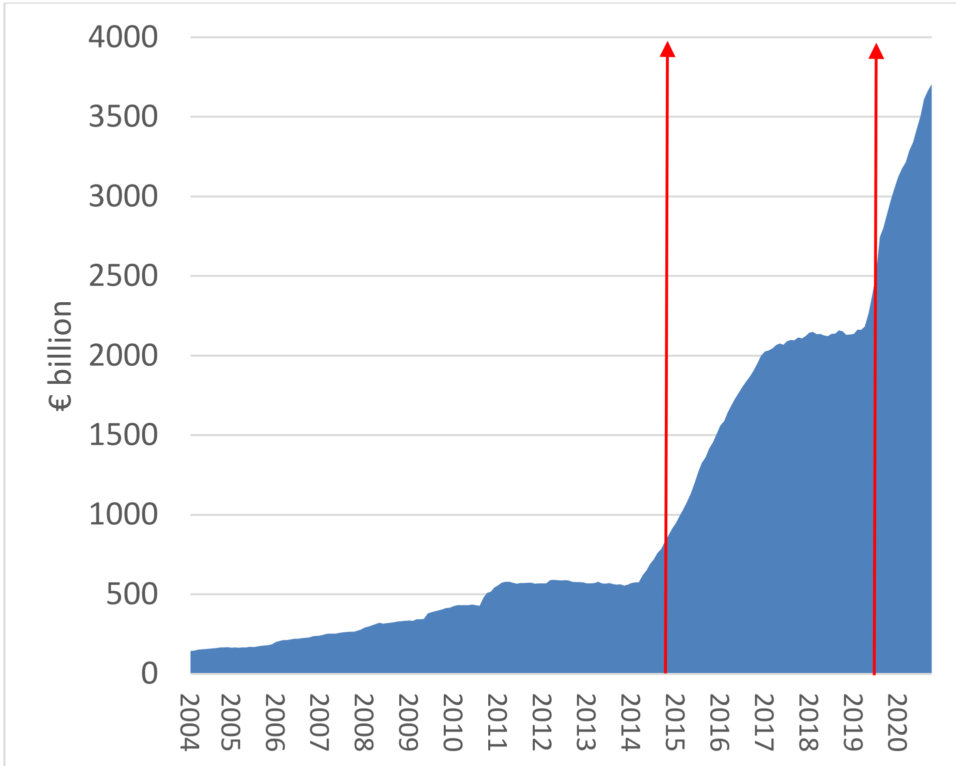
COVID-19 hits a still convalescent world economy, with the shift of policy paradigm towards **fiscal-monetary synergy** under way:

- depression traps need a joint ("unconventional") monetary-fiscal stimulus
- joining the monetary with the fiscal stimulus allows less intensity of each one.

US Fed's (left) and ECB's (right) holdings of govt. securities (e-o-y stocks)



Source: US St. Louis Fed Economic Data



Source: ECB Statistics Warehouse

Great Depression and COVID-19: Two waves of unconventional (QE) monetary policy targeted at purchases of government bonds

Sources of risks and trade-offs

Whereas the assessments about the effectiveness of the new paradigm of fiscal-monetary synergy after the Great Depression remained somewhat controversial, there is wide agreement that no viable alternative was available at the time of the global pandemic.

Nonetheless, three main sources of risks and painful trade-offs may lay ahead. These are common worldwide, but prominent in the euro area: **inflation, financial dominance, and tapering**.

• **If inflation grows out of control**, the ECB's policy reaction may be constrained by the effects of monetary tightening on sovereign debt sustainability ("Volker scenario", with high debt members like developing countries in the 1908s)

– Inflation is on the rise worldwide

– The consensus view remains that no systematic common trends are detectable across sectoral prices and wages, while in some sectors price pressures are present owing to specific demand-supply factors and labour market conditions

– This also makes it harder to curbe inflation

• **Financial markets' expectations** of a Volker scenario may trigger **self-fulfilling** firesales of sovereign bonds threatening financial stability and integrity of the euro area, forcing the ECB to intervene.

– US Treasuries' spikes in Spring

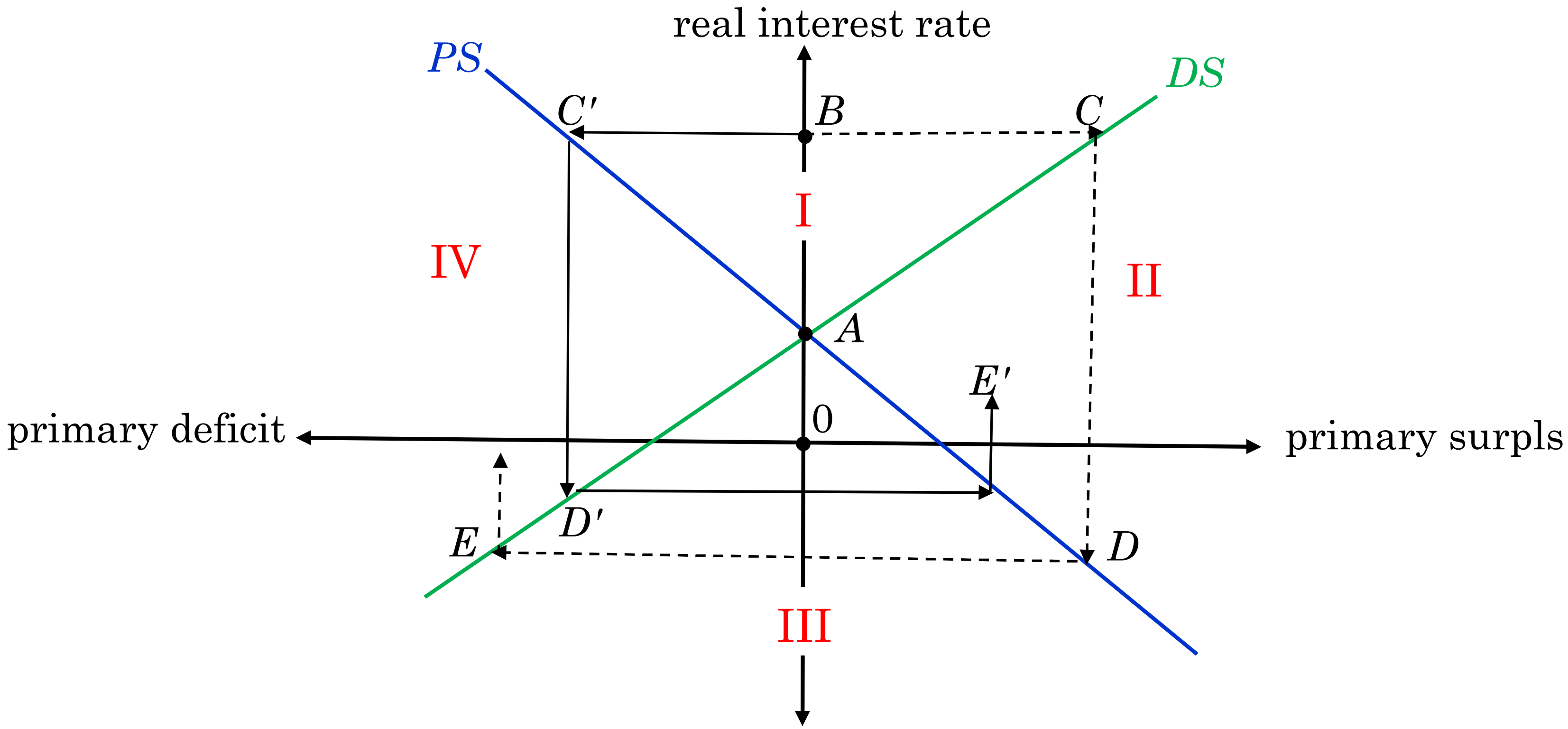
– Some increase in spreads in the EMU

• **The (announcement of) progressive reduction of asset purchases** may create problems for the highly indebted countries that need to roll over their debts.

– "Stop and Go" of tapering over the last years in the US and EMU

■ Four scenarios of fiscal-monetary interaction

Tinbergen's assignment problem in the EMU



I: rising debt, falling inflation

II: falling debt, falling inflation

III: falling debt, rising inflation

IV: rising debt, rising inflation

There is no univocal solution. It depends on i) the **nature and magnitude of the shock**, ii) the **dynamic and interactive** nature of the system, and iii) the **institutional setup** in which the policy authorities operate.

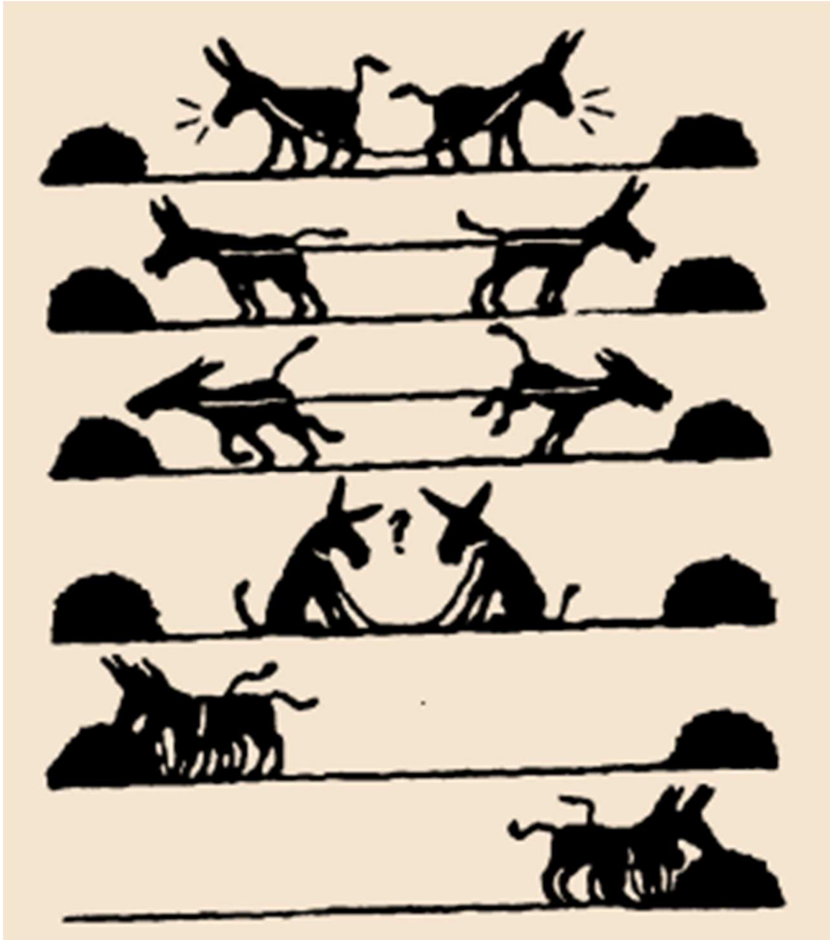
Concluding remarks

In order to address the legacy risks of the pandemic we see **two main avenues**.

- Create conditions for a **careful calibration of tapering** on both the monetary and the fiscal side. This will also require
  - **reformulation of the EMU institutional setup** of monetary and fiscal policy, from uncoordinated monetary dominance to **coordinated mode,** i.e. "solve the problem" of reaching the new equilibrium together and move in tandem
  - **central fiscal authority** able to coordinate national policies with a view to the aggregate fiscal stance of the EMU.

- **Break the doom loops** among sovereign governments, markets and the ECB. The ECB could better preserve its independence and gain more degrees of freedom in the conduct of its monetary policy by gradually **selling some of its stock of pandemic-related sovereign bonds to the ESM**, in accordance with each country's capital key and without any transfer of default risk, which would continue to fall on national central banks.

- These are not merely technical solutions. They require a great deal of **far-sighted political will**.



Thank you for your attention