

FISCAL AND MONETARY INTERACTIONS IN THE EUROPEAN MONETARY UNION

Pablo Hernández de Cos

BANCO CENTRAL DE LA REPÚBLICA DE ARGENTINA
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EMU framework

1. **Single and independent central bank** (the ECB) with the main objective of price stability
 2. **Responsibility for fiscal policies to national governments**
 3. Need for certain **coordination of national fiscal policies**: the fiscal policy of one member affects the rest and the functioning of the union as a whole; market discipline might not be sufficient
 1. **Prohibition of monetary financing** and "**no bailout**" clause.
 2. Member countries should **avoid excessive deficits (3%) and debt levels (60%)**.
 3. The European Commission was tasked with **monitoring** public finances.
 4. Countries that violated these rules would be subject to the **corrective arm** of the Stability and Growth Pact.
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Track record of EMU framework

- Fiscal policy has tended to be **pro-cyclical**.
 - The framework did not prevent a general **increase in public debt levels**.
 - Made it difficult to detect **other financial and current account imbalances**.
 - During the global financial crisis and the **European sovereign debt crisis**, several of these shortcomings became evident .
 - **No supranational fiscal elements** were considered to achieve the adequate policy mix.
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Extraordinary pandemic shock

- **Coordinated fiscal and monetary policy response:**
 - The fiscal response relied on both national and supra-national policy actions (mainly through the Next Generation EU (NGEU) funds) of significant magnitude.
 - Monetary policy ensured that favourable financing conditions were maintained, in particular through non-standard monetary, such as the ECB's pandemic emergency purchase programme.
 - This coordinated fiscal and monetary policy response minimised the potential structural damage to employment, productive capacity and economic growth caused by the crisis, while avoiding deflationary pressures
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Recent very high inflationary episode (I)

- Since the end of 2021, the situation has been characterised by **very high inflation** (mainly stemming from negative supply shocks), subdued activity and high uncertainty.
 - The priority of monetary policy has been to bring inflation back to its medium-term target. The decisive action of the ECB, with the **largest and quickest hiking cycle in the history of the EMU + QT**, has been crucial in keeping inflation expectations anchored.
 - **Fiscal policy** responded with measures to mitigate the impact of the energy and food price shock. These measures helped contain inflationary pressures in the initial phase, although their progressive withdrawal is having counteracting effects.
 - However, **many of these measures were not sufficiently selective or targeted**, resulting in an expansionary impulse that was broader than necessary.
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Recent very high inflationary episode (II)

- The forceful action of the ECB has **not triggered a significant increase in sovereign spreads** between MS.
- Why is that? Higher growth in some of highly indebted countries, significant increase in the average bond maturity, strengthening of the European framework, extraordinary European response during the pandemic, **high risk appetite by investors** in global financial markets.
- Two other factors, linked to ECB policy actions have also played a significant role:
 - The **reduction of the balance sheet** has been done in a **predictable and gradual** way.
 - In July 2022, the ECB announced its **Transmission Protection Instrument(TPI)** :
 - By announcing possible interventions or, if necessary, by carrying out targeted, temporary interventions, the ECB can quickly restore confidence and prevent destabilising rate spirals.
 - Clear **conditions for the purchase of a MS's bonds**: i) the instrument can only be used in countries that pursue sustainable fiscal and macroeconomic policies; ii) the ECB cannot counter persistent tensions that are due to country fundamentals . These conditions **ensure that market discipline for sound fiscal policies is preserved**.
- These two factors have been a **precondition for the ECB to be able to increase rates** to such a large extent and so avoid a deanchoring of inflation expectations and ensure price stability.

New fiscal framework approved in 2024

- Seeks to ensure a **differentiated treatment of national fiscal efforts** according to each country's debt sustainability assessment.
 - Recognises that **structural reforms, growth-enhancing public investment, and fiscal sustainability mutually reinforce each other**.
 - Fix intermediate target **expenditure rule**
 - **Success will depend on its effective implementation** by countries.
 - Its credibility could be endangered if the deadlines for fiscal adjustment are too lengthy or if exceptions from the no-backloading safeguard are frequently sought.
 - The structural reforms and investment commitments that would justify the use of an extended period of adjustment should be strictly analysed ex ante and ex post.
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Implementation of the new fiscal framework

- Given the elevated levels of public debt in many countries, the implementation of this new framework will result in a **restrictive fiscal policy in the euro area in 2025 and subsequent years**, in particular in countries with significant fiscal imbalances.
 - This will happen in a context on which macroeconomic **projections are compatible with the ECB reaching its 2% medium-term inflation target** in a stable manner in 2025.
 - The use of a net expenditures ceiling that excludes interest spending, unemployment benefits and public revenues and the scape clauses means that the new framework should allow for less annual adjustments in case a worst outlook emerges.
 - The composition of the adjustment could also affect the impact on growth and inflation
 - The use of the NGEU funds could counteract in a significant manner the macro impact of the fiscal consolidation requirements.
 - If accompanied with adequate structural reforms, this could also imply higher potential output growth and lower $r-g$.
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Missing elements

- These fiscal adjustment needs will take place at a time when **public investment needs** in areas such as climate change, digitalisation and defence **are significant** (see Draghi report).
 - This should be an additional strong **argument for advocating a common, permanent, European financing instrument**.
 - Essential to have a **central fiscal capacity**, with an adequate size and sufficient and reliable funding, to allow for effective macroeconomic stabilisation at the union level.
 - To ensure that the governance framework mitigates cross-border fragmentation it is crucial to complete the **banking union** and to press ahead with the **capital markets union**.
 - A fundamental element would be the issuance of benchmark pan-European safe assets.
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