



EUROPEAN CENTRAL BANK

EUROSYSTEM

# “A stronger policy mix for the euro area?”

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# 2020/21 Monetary policy strategy review

## Occasional Paper Series

Work stream on monetary-fiscal policy interactions

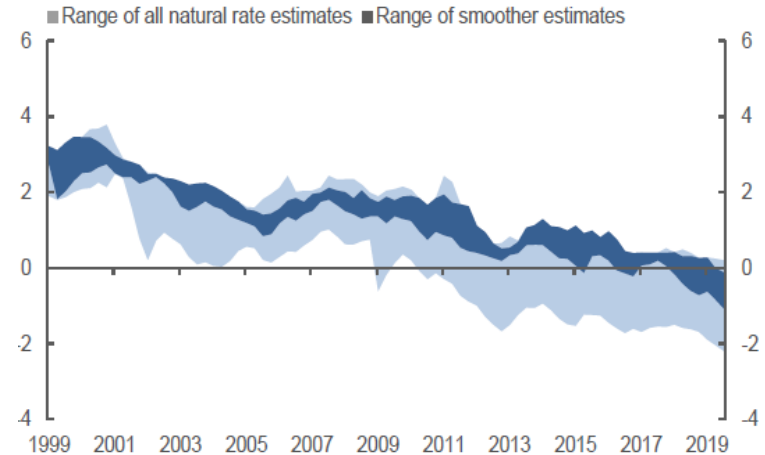
Monetary-fiscal policy interactions in the euro area



# 2020/21 Monetary policy strategy review

**Main motivation:** Pronounced trend decline in the equilibrium real interest rate, which in combination with an effective lower bound on nominal interest rates reduces the space for conventional interest rate policy

Estimates of euro area longer-run equilibrium real interest rate,  $r^*$  (% per annum)



Sources: WGEM Report "The natural rate of interest: estimates, drivers, and challenges to monetary policy", OP, No 217; Ajevskis (2018); Brand, Goy, Lemke (2020); Brand, Mazelis (2019); Fiorentini, Galesi, Pérez-Quirós, Sentana (2018); Geiger and Schupp (2018); Holston, Laubach, Williams (2017); Jarocinski (2017); Johannsen and Mertens (2021).

Notes: Ranges span point estimates across models to reflect model uncertainty and no other source of  $r^*$  uncertainty. The dark shaded area highlights smoother estimates that are statistically less affected by cyclical movements in the real rate of interest. Latest observation: 2019Q4.

# 2020/21 Monetary policy strategy review

**Main motivation:** Pronounced trend decline in the equilibrium real interest rate and effective lower bound reduce space for conventional interest rate policy

**Core outcomes:**

- Simple symmetric 2% inflation target
- Recognition of need for asymmetric reaction function: especially forceful and persistent measures to avoid negative inflation becoming entrenched
- Mainstreaming of alternative policy measures (FG, AP and LTROs)
- Fiscal and other policies are important for macroeconomic stabilisation, especially in the proximity of the ELB

# The EMU architecture

“Traditional” consensus on monetary-fiscal interactions:

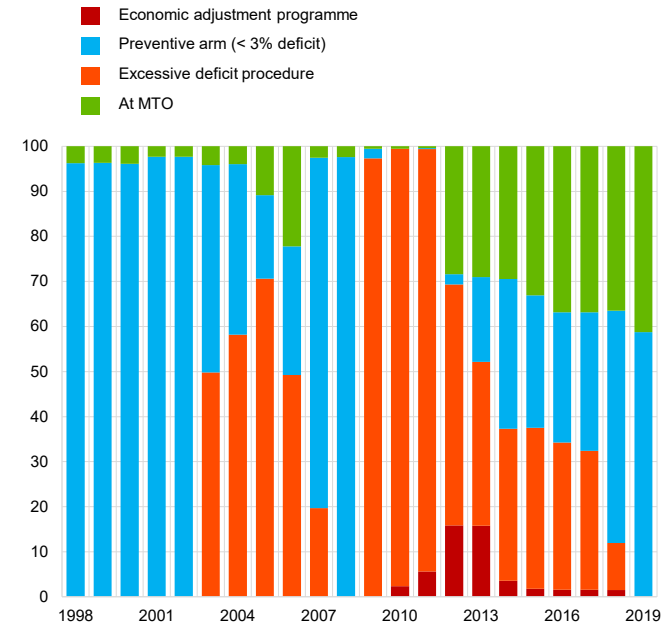
- Independent central bank with medium-term price stability objective
- Sovereign fiscal policies constrained by common fiscal rules (SGP)
- Reliance on automatic fiscal stabilisers, instead of discretionary fiscal policies

→ ***Euro area experience and new insights in a low interest rate environment have challenged some elements of this consensus***

# Insufficiently counter-cyclical fiscal policies

- EMU: 19 sovereigns with heterogenous fiscal positions
- Uneven application of the fiscal rules
- Fiscal policies insufficiently counter-cyclical before the financial crisis
- Response to sovereign debt crisis was “austerity”

**Euro area countries' status under the SGP**  
(countries' share in euro area GDP)

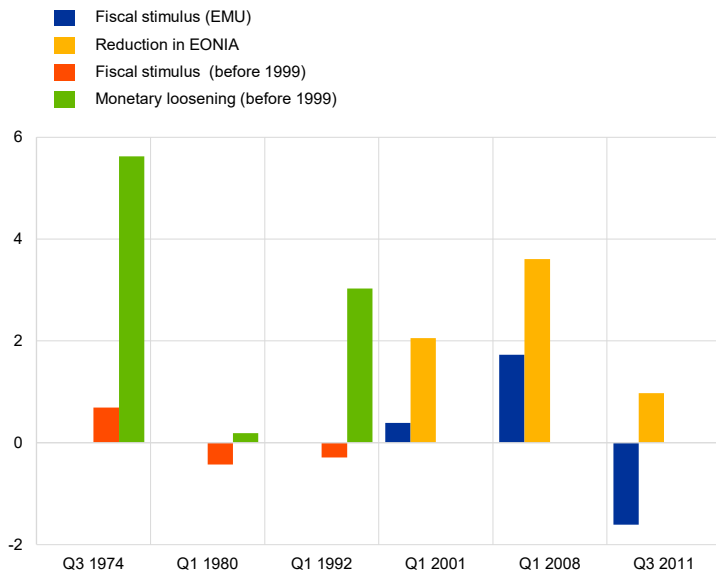


Source: ECB Occasional Paper 273

# Consolidation after the sovereign debt crisis

## Policy mix in euro area recessions

(x-axis: start of euro area recession; y-axis: reduction in overnight interest rate in percentage points; average reduction in underlying budget balance as percentage of GDP)

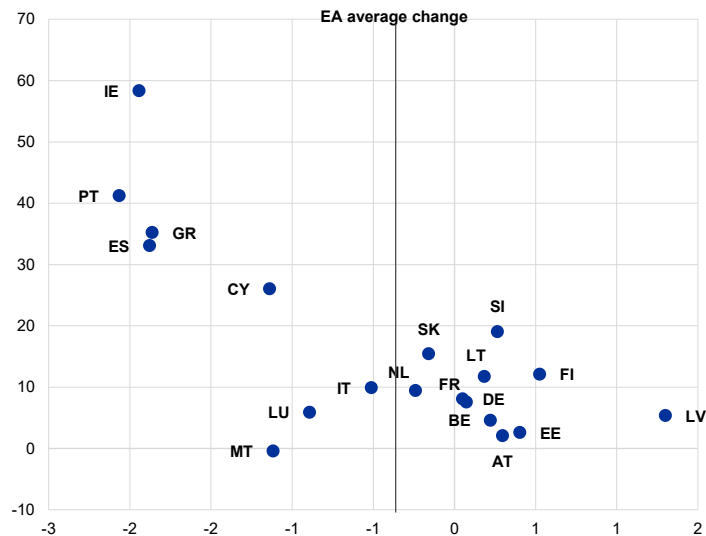


Source: ECB Occasional Paper 273.

Notes: Policy mix two years after start of recession.

## Fall in public investment after the financial and sovereign debt crises

(x-axis: difference between public investment-to-GDP ratio in 2013 and 1999-2008 average, percentage points; y-axis: increase in public debt-to-GDP ratio, 2009-13)



Source: ECB Occasional Paper 273.

# Monetary – fiscal strategic complementarity at ELB

## In low interest rate, low inflation environment

- Lower efficacy of monetary policy, but higher fiscal multipliers
- Favourable  $(r - g)$  creates more fiscal space
- Fiscal and monetary policy can support each other
- This “strategic complementarity” is state-dependent
- Caveat in EMU: fiscal sustainability of 19 sovereigns needs to be ensured

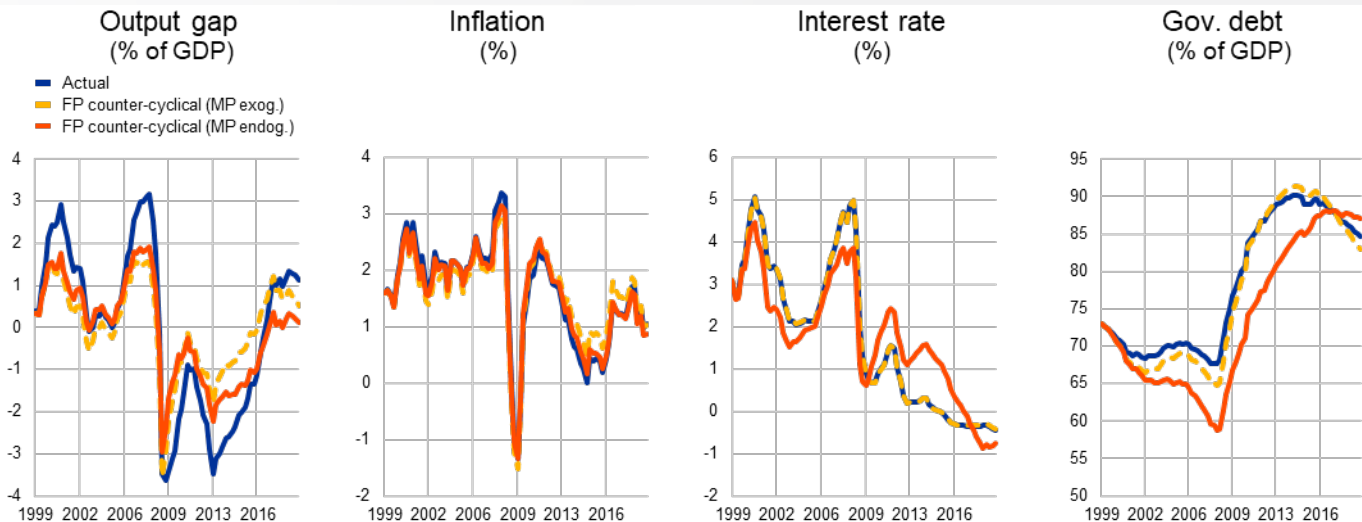


# Scenario analysis

## Model-based analysis (ECB-BASE)

- Interaction of different fiscal and monetary policy rules
  - Backward-looking exercise and forward-looking exercise (until 2030)
  - Baseline based on ESCB Dec 2020 macroeconomic projections
  - Euro area simulations; no changes in country-specific risk premia by assumption
- Compare baseline with:
  - Counter-cyclical fiscal policy
  - “Patient” fiscal policy (i.e. expansionary-for-longer) that takes lags of the output gap into account or incorporates nominal developments
  - “Patient” monetary policy (i.e. lower-for-longer) that maintains rates lower than suggested by a standard Taylor rule

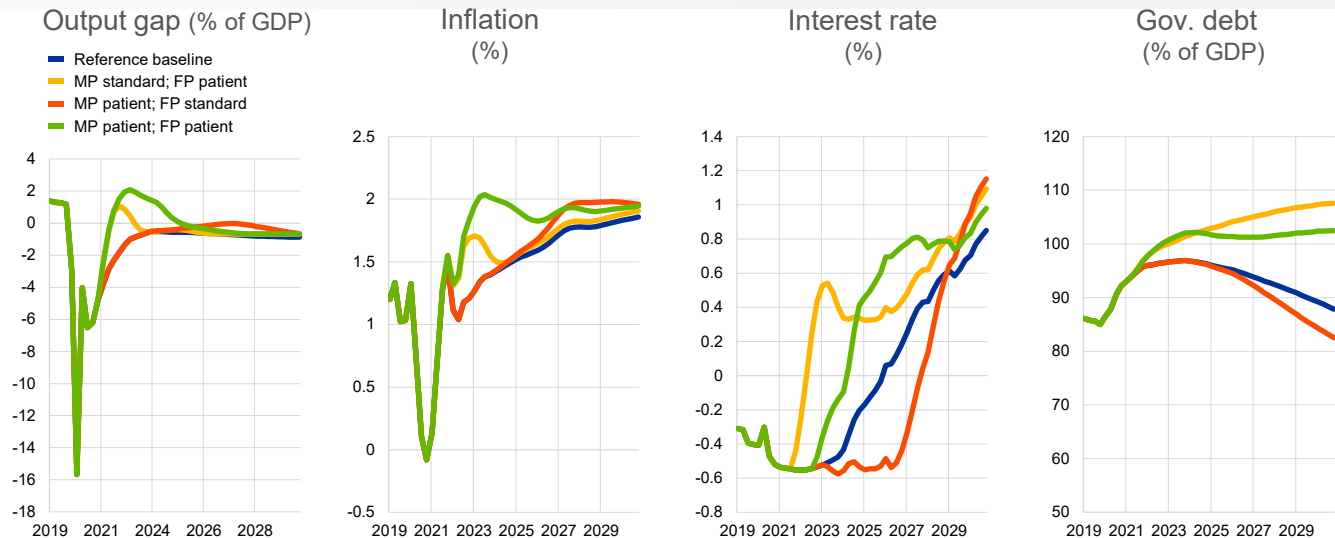
# Backward-looking model simulations: the benefits of more counter-cyclical fiscal policy



Source: ECB staff calculations using ECB-BASE. The output gap is based on the estimates of the European Commission.

- More counter-cyclical fiscal policy would have created a fiscal buffer in good times, used to cushion downturns
- Assuming **unchanged monetary policy**, it would have reduced output gap volatility and lifted inflation in recent years
- With **monetary policy reacting**, there would have been less tightening before 2008 and a longer period of positive interest rates afterwards

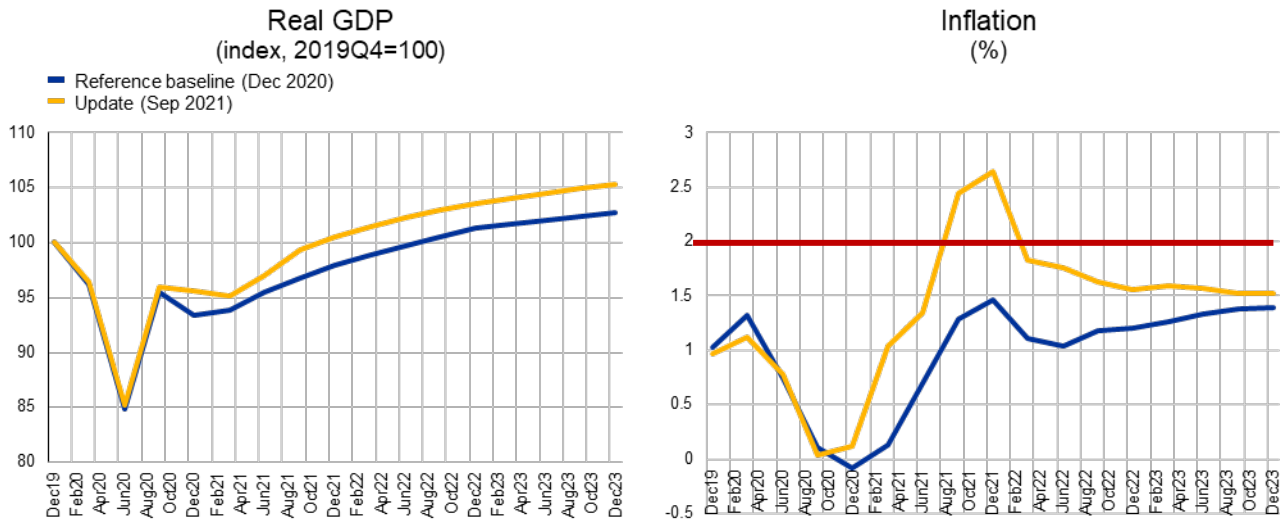
# Forward-looking model simulations: the merits of patience



Source: ECB staff calculations using ECB-BASE. The output gap is based on the potential GDP of the European Commission. The reference baseline is associated with the ESCB Dec 2020 projection exercise.

- Compared to **patient fiscal policy with monetary policy reacting as usual** or **patient monetary policy with pre-pandemic fiscal policy**, the combination of **patient fiscal and monetary policy** brings inflation to the target fastest and recovers more of the output pandemic losses
- By working in tandem, both policies reinforce each other and create space for each other

# Developments after the strategy review: ECB projections



Source: ESCB(ECB) projections. Note: Inflation is based on private consumption deflator.

- Economic outlook improved, with high uncertainties
- Supportive fiscal and monetary successfully worked hand-in-hand
- Inflation is (temporarily) above 2%, with upside risks

# Patience, policy normalization and sequencing

- Fiscal policy challenges in euro area:
  - More targeted fiscal support in light of remaining pandemic uncertainties
  - More growth-friendly fiscal support: Sustained investment (NGEU support)
  - More differentiated fiscal policy: Use nominal growth windfalls for debt reduction in high-debt countries

Helps anchoring market expectations of a gradual medium-term fiscal adjustment
- ECB forward guidance reinforces the monetary policy commitment to avoid premature tightening in the proximity of the ELB: Three conditions
  - Lift-off not “until we see inflation at two per cent well ahead of the end of our projection horizon”, “durably for the rest of the projection horizon” and “progress in underlying inflation is sufficiently advanced”

## SGP reform:

### Eurosystem reply to the Economic Governance Review of the Commission

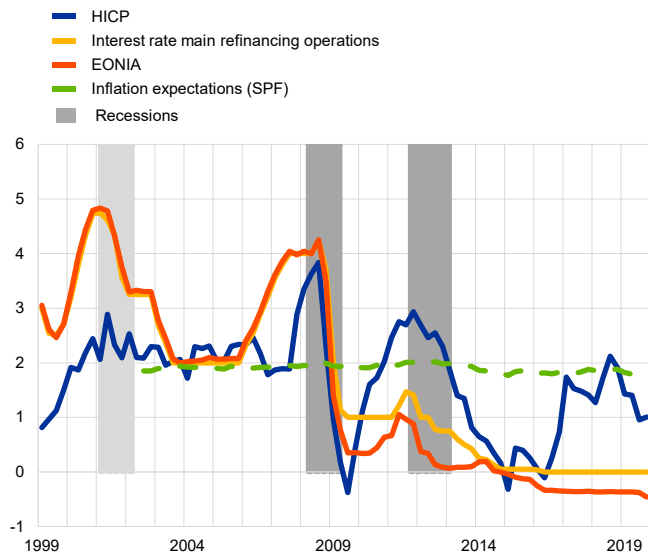
- **Sustainable fiscal positions** are important for price stability and sustainable growth in a smoothly functioning Economic and Monetary Union
- The **stabilising role of fiscal policies** is more important in proximity to the ELB
- Countercyclical fiscal policy requires action during large recessions, but it also crucially requires the **rebuilding of buffers** once the economy is firmly back on track
- Fiscal policy should become more **growth-friendly**
- Framework should be **simpler**, more **transparent** and more **predictable**
- Broadened, fully independent assessment by **independent fiscal institutions** could help
- **Completing EMU**, including banking union and capital markets union, remains essential
- An appropriately designed **permanent central fiscal capacity** could play a key role in enhancing macroeconomic stabilisation and convergence

Thank you for your attention

# Interest rates and balance sheet policies close to ELB

## Inflation (expectations) and interest rates

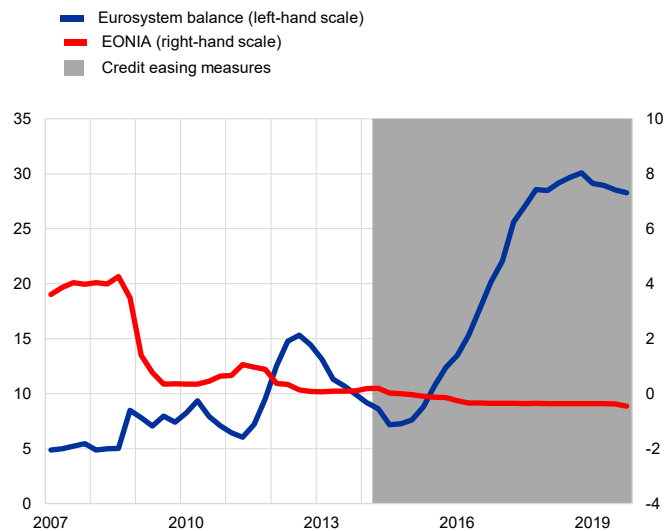
(percentages)



Source: ECB Occasional Paper 273

## ECB balance sheet, HICP and output gap

(left-hand scale: percentage of GDP; right-hand scale: percentage, percentage of potential GDP)



Source: ECB Occasional Paper 273