Macroeconomic stabilization in the euro area

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The euro area has been performing poorly relative to other regions in the world, especially relative to the US, in terms of economic activity and low inflation.

- Monetary policy accommodative, fiscal policy not sufficiently supportive (also relative to other major economies).
  - Five Presidents Report: Appropriate aggregate fiscal stance key to avoid procyclical fiscal policies at all times in the euro area.

As simple as it sounds:

- When the policy rates are at or close to their lower bound, monetary *and* fiscal policy are needed *together* to stabilize the economy.

The issue

Stabilization of **large** adverse shocks:

- Sharp deteriorations of fundamentals and vulnerability to self-fulfilling crisis **strictly interwined:** Market price risk that is largely **endogenous**.
- Policies must be balanced between preventing “liquidity” problems from exacerbating/amplifying adverse shocks, and taking on excessive budget risk and exacerbating “moral hazard”.
- Being wrong on either side of this trade-off not only fails to stabilize the economy, but actually raise the magnitude of the stabilization problem.
- (US, UK, etc) experience suggests that success relies on:
  - ability to ensure credible backstop to bank and sovereigns,
  - consistency across monetary, fiscal, financial and regulatory policies.

This presentation (CDJMS 2016)

How to achieve accommodative monetary and fiscal policy in the EA in response to large adverse shocks?

- Goal: **articulating the question in its key dimensions** (first part), and envision a possible answer (second part).

Outline

- Why achieving an accommodative stance is difficult in the EA
- One way forward: “Macroeconomic Stabilization, Monetary-Fiscal interactions, and Europe’s monetary union”, ECB wp 1988, 2016 by Corsetti Dedola Jarocinski, Mackowiak and Schmidt (henceforth CDJMS 2016,).

Stabilization of large adverse shocks

- When the policy rates are at or close to their lower bound monetary *and* fiscal policy *together* can have a sizable impact on the economy.

  – Through direct effect on disposable income of borrowing constrained households.
  – Through an indirect effect of higher current and expected inflation and lower real rates.
  – By containing household and business idiosyncratic risk and uncertainty (less firm exit/lower unemployment).

- Multipliers of expansion can be large *so long as* fiscal expansion unfolds while rates are at lower bound and monetary policy is accommodative.

Why achieving an accommodative stance is difficult in the EA

- In (incomplete) monetary union (national) fiscal policy is vital to deal with asymmetric shocks.
  - Automatic stabilizers play a larger role in Europe than US.
  - Higher cross-country risk-sharing if governments not borrowing constrained.
- But as long as national debt in member state of the EA is perceived as subject to default and restructuring risk to some degree,

  a member state that raises government spending or cut taxes can expose itself to a self-fulfilling run by creditors.
- Sovereign risk has immediate, large macroeconomic and financial costs.
- Even in countries with a relatively strong fiscal outlook, concerns with sovereign risk motivate precautionary budget policies

Why achieving an accommodative stance is difficult in the EA

- Large and variable risk premia erupted when (around 2010-11) markets realized that (at least for some time) no EA institution was in the condition to provide a backstop to government debt.

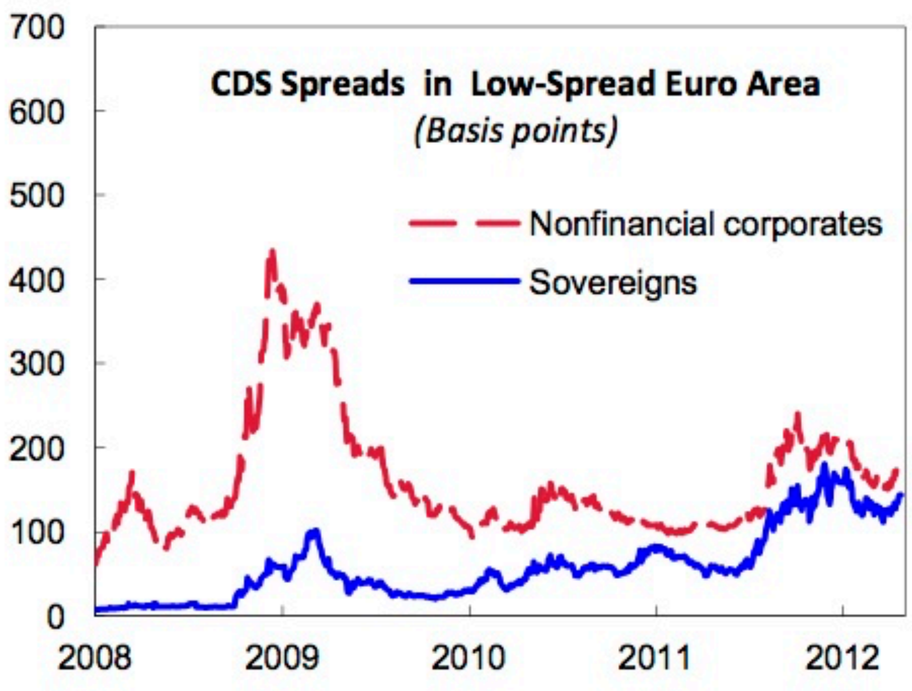
- The incomplete institutional framework and weak political cohesion in the EA did not prevent the emergence of a feedback loop

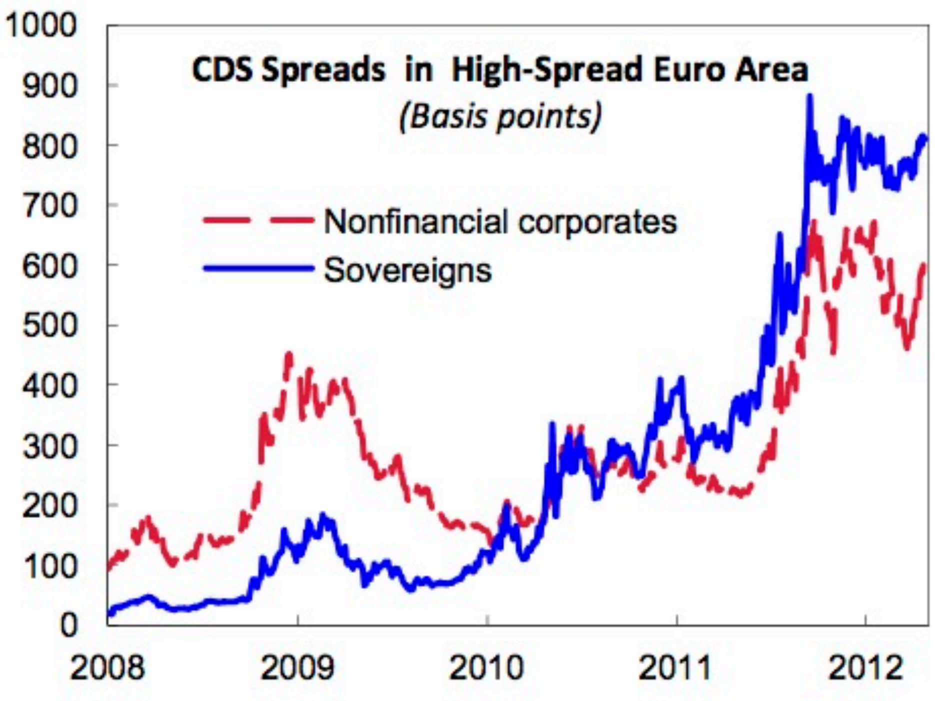
  "sovereigns -- banks -- non-financial firms -- demand -- sovereigns"

  - shock amplification and polarization of country risk
  - fundamental weakness intertwined with self-fulfilling crisis

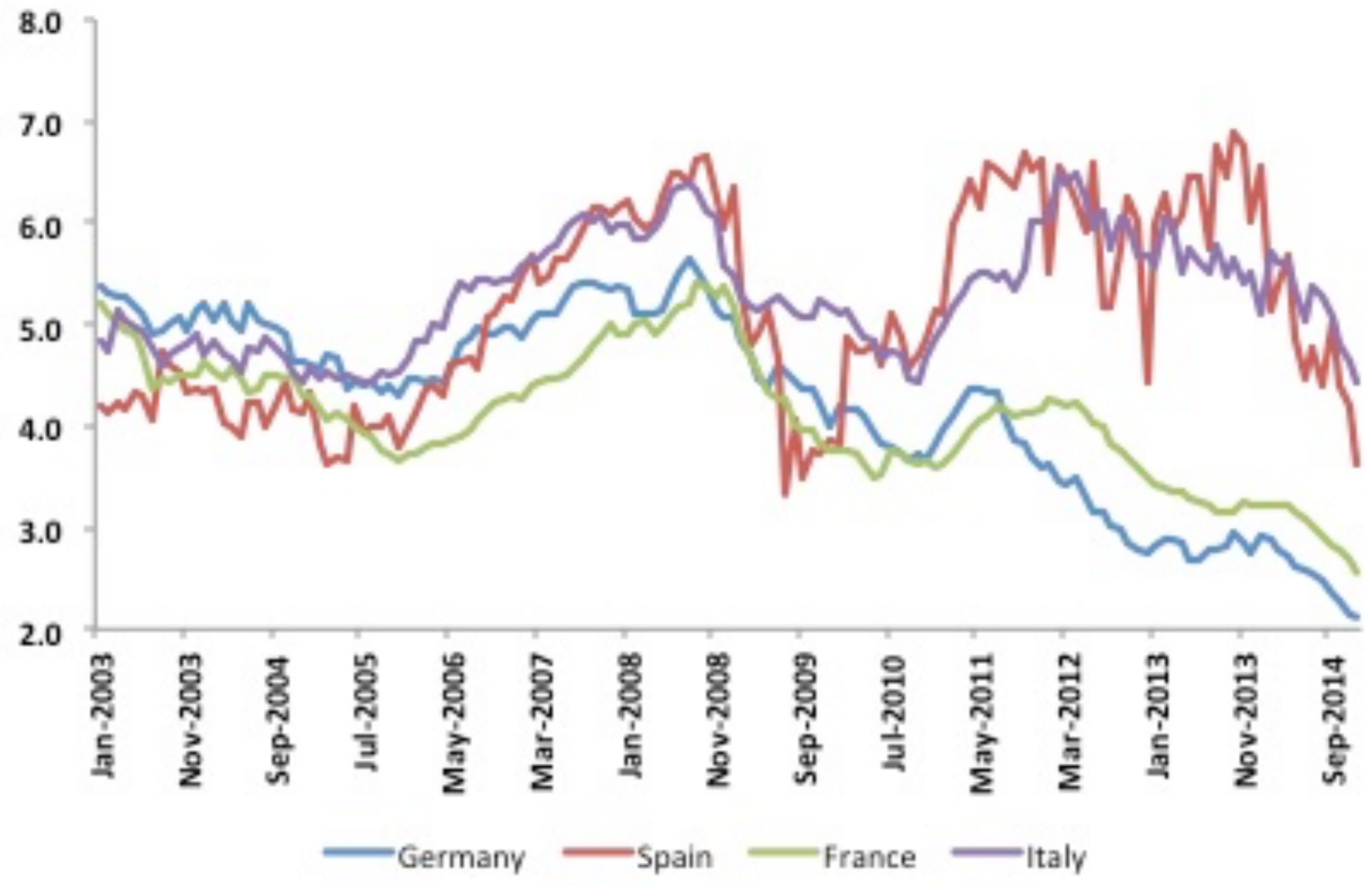
The adverse expectations loop

Corporate borrowing strictly correlated with sovereign (large firms)

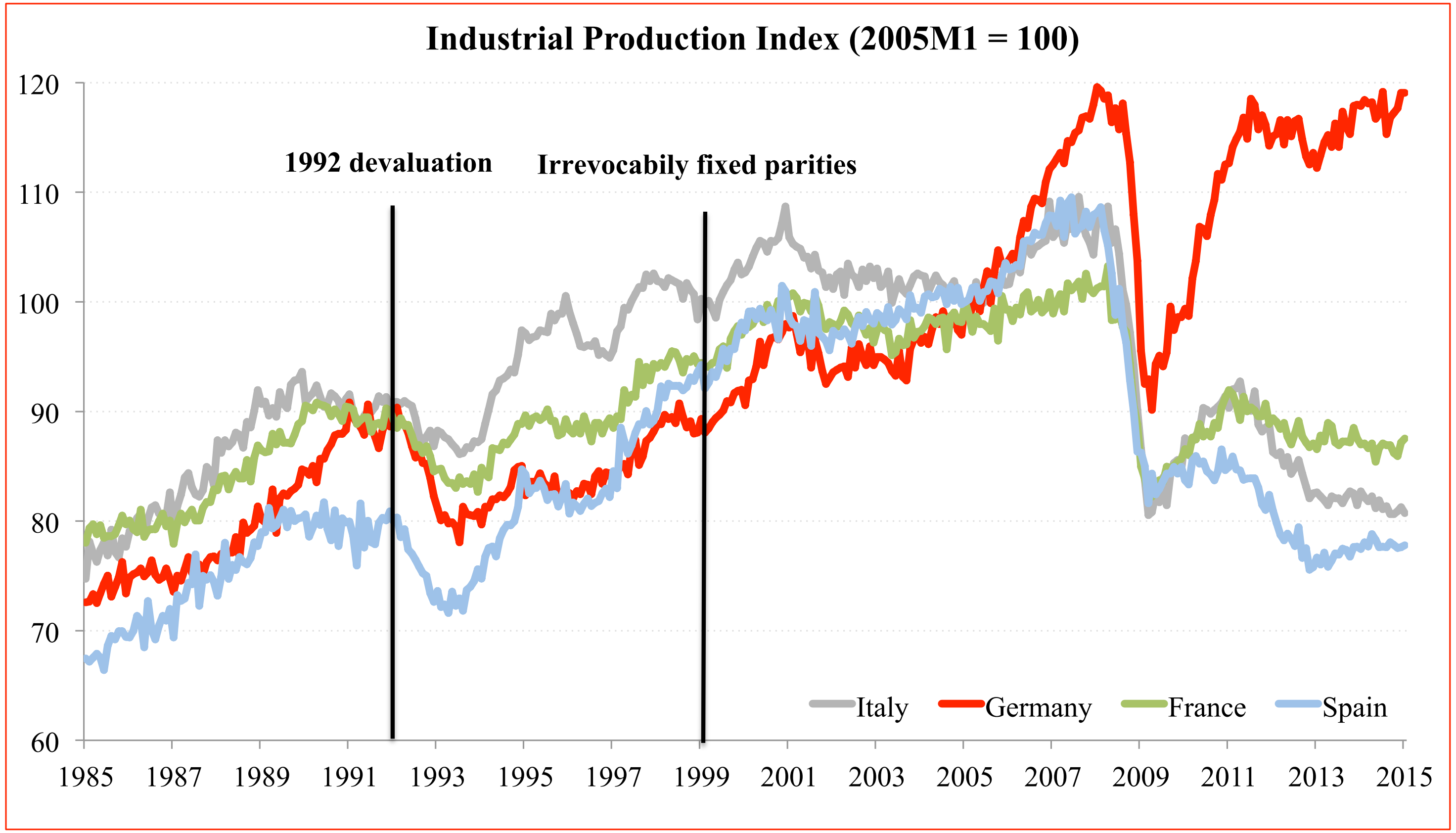




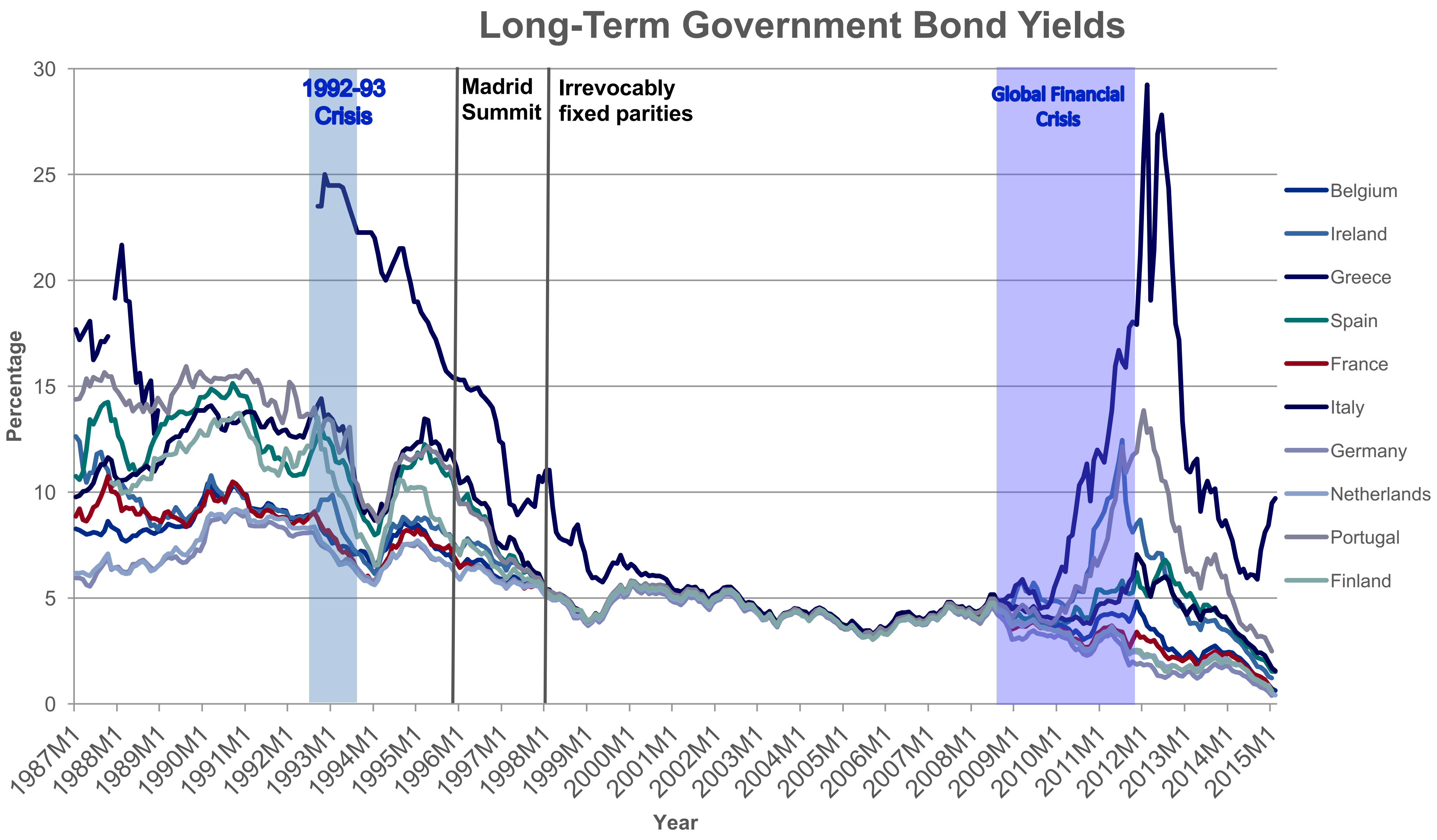
Firms' costs of borrowing from banks



Polarization of economic activity



Present and past polarization crises in Europe



Country risk ⇔ insufficient aggregate demand at EA level

…two sides of the same coin.

Country risk:

1. undermines the monetary transmission mechanism(s)

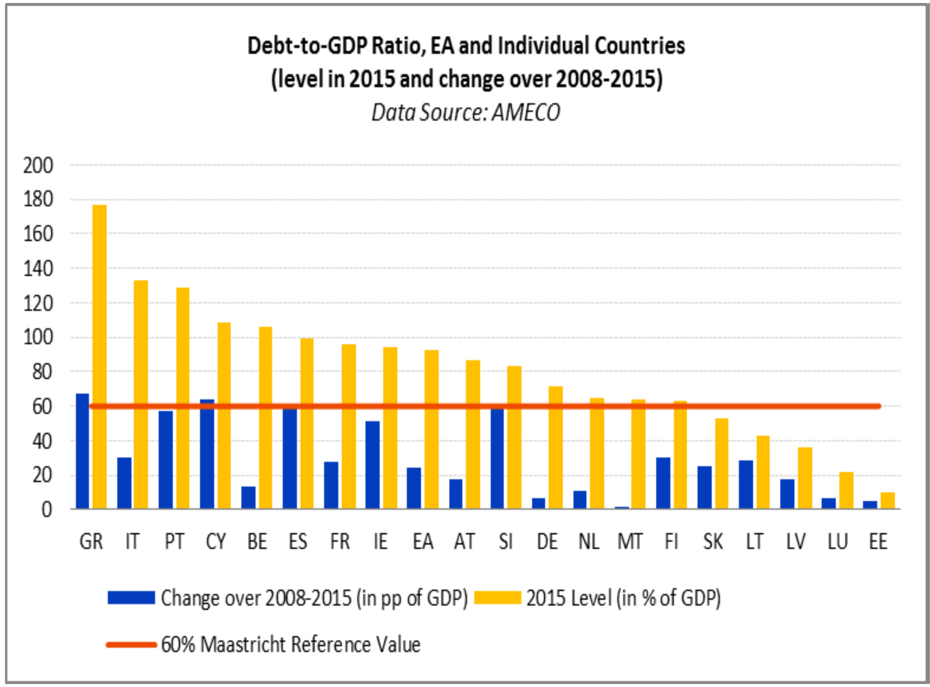
2. motivates contractionary stance in fiscal policy

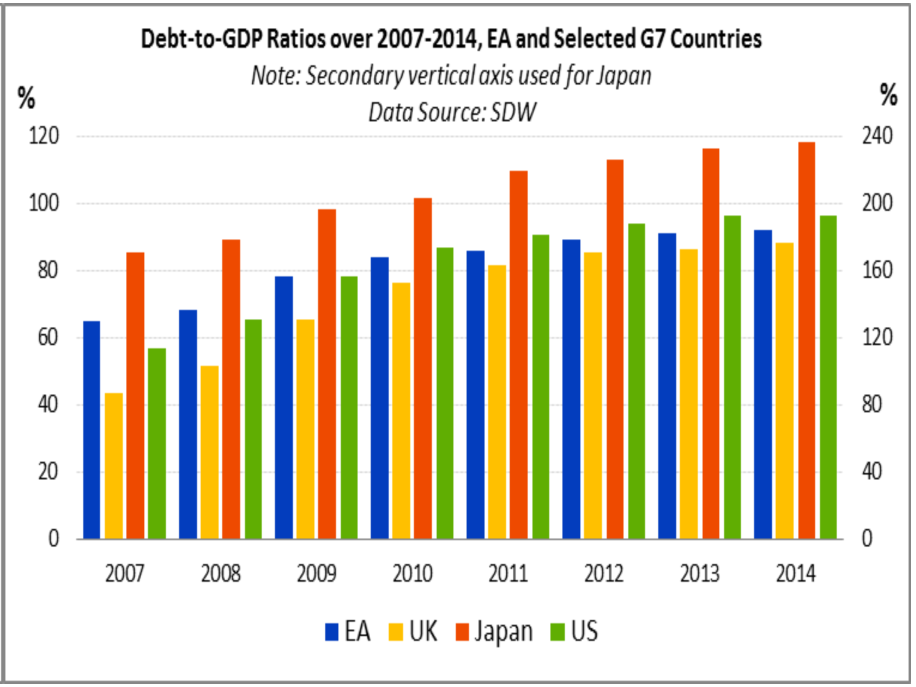
3. feeds policy conflicts on adjustment, undermining cooperation when this is mostly needed:
    - monetary and fiscal stance
    - bank resolution and deposit guarantees
    - debt restructuring mechanism

Consequences of flaws in the fiscal framework of the euro area

- A member state running larger deficit may become vulnerable to self-fulfilling runs by creditors even if fundamentally solvent.
- Endogenous risk crises complicate monetary policy conduct.
  - ECB overburdened with macroeconomic stabilization.
  - Challenge exit strategy from unconventional monetary policy, e.g. if countries' market access depends on it.
  - Blurred boundaries between monetary and fiscal policy.
- EMU fiscal framework needs fixing to regain fiscal policy as a key stabilization tool, while dealing with potential risks from high sovereign debt.

Government debt in the euro area and G4



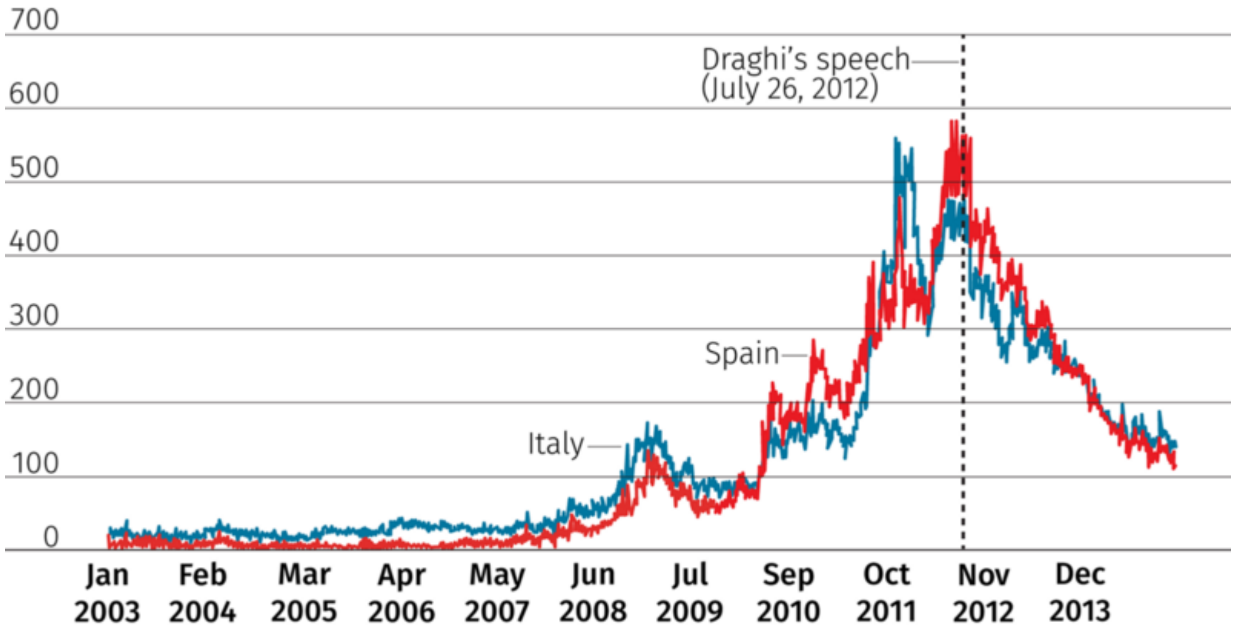


- Lack of fiscal stabilization and risk sharing has been worsened by endogenous emergence of sovereign and country risk.
  - Adverse fundamental shocks and self-fulfilling expectations intertwined.
- Elevated and rising government debt across countries a key hurdle for expansionary aggregate fiscal stance.
  - Feasibility of current stimulus while credibly committing to future adjustment.

2012 as a turning point

- Political consensus reached on European Stability Mechanism (ESM) and Outright Monetary Transactions (OMTs)
- OMTs program has eliminated or reduced the possibility of self-fulfilling runs on debt.

Difference in yield from Germany's 10-year bond, in basis points



Source: Minneapolis Fed

OMTs and aggregate stance

- The program was a key step in bringing the EA institutional framework closer to best practice in the XX and XXI century.
  - Central banks in US, UK, and other countries do act as guardian of financial stability in the national sovereign debt market
- But OMTs per se fall short of creating the conditions for accommodative fiscal policy: as a precondition to access OMTs, a country’s fiscal policy must be approved by the other member states.
  - After the OMTs, the fiscal stance has remained effectively non-accommodative

Not simple solution: if all national public debt in the euro area were made ‘non defaultable’, member states may engage in fiscal accommodation that is excessive from a union-wide perspective.

The ball is on the fiscal side of the equation. The problem has many dimensions.

Dimensions of the problem and way forward and not unique

Desirable reforms should:		
Ensure macroeconomic stabilization.	Strengthen fiscal discipline and debt sustainability.	Prevent self-fulfilling runs on members' sovereign debt.

Dimensions of the problem and way forward and not unique

Desirable reforms should:

Ensure macroeconomic stabilization.	Strengthen fiscal discipline to reduce moral hazard.	Prevent self-fulfilling runs on members' sovereign debt.

Any reform will have to deal with challenges:

Democratic legitimacy and accountability of any centralized institution.	Credibility of fiscal discipline mechanisms.	Sovereign debt restructuring should not jeopardize financial stability/participation in EA.

Dimensions of the problem and way forward and not unique

Desirable reforms should:

Ensure macroeconomic stabilization.	Strengthen fiscal discipline and debt sustainability.	Prevent self-fulfilling runs on members' sovereign debt.

Addressing all these dimensions systematically, with consistent, credible solutions

CDJMS ‘proposal’: Fiscal discipline, stabilization and risk reduction

1. Euro-area fund: issues non defaultable bonds, can buy member state government bonds in the primary market, has sufficient power to tax and weaken fiscal parameters in response to large shocks
   - Democratically accountability
2. Fiscal criteria
   - Regulate access to the fund
   - The fund will be obligated not to purchase bonds issued by countries that violate them
3. Debt restructuring mechanism
   - Minimizing costs of default
   - Maintaining integrity of the euro area
   - Restoring access to the fund

Ruling out sovereign debt runs conditional on fiscal criteria

- Backstop to government bonds of each MS so long as its fiscal policy satisfies fiscal criteria set ex ante.
  - Purchases in primary markets in case of looming liquidity crisis.
  - Criteria should ensure long run debt sustainability, e.g. with fiscal rule as a function of business cycle and debt levels.
  - Debt is non-defaultable when convertible into currency at par at maturity---analogously to a maturing reserve deposit at a central bank.
- If MS violated fiscal criteria, the fund would be forbidden from buying its government bonds.
  - MS would then have to borrow exclusively from markets and, as a last resort, could decide to default/restructure its debt.
  - Restructuring without prejudice to full participation in the EU and the euro, and treating all creditors symmetrically.
- The Fund in charge of signalling that aggregate fiscal accommodation is needed

Fiscal criteria and stabilization

- The criteria would stipulate that in ‘**normal times’** a member state government is to raise its primary surplus in response to an increase in the national public debt-to-GDP ratio.
- If the fund announced that a need for fiscal accommodation had arisen in case of large shocks, member states would be expected to pursue accommodative fiscal policy, consistent with fiscal discipline.
  - The necessary fiscal accommodation might fall outside the limits imposed by the Stability and Growth Pact, in its current version.
- Since the bonds issued by the fund would be non-defaultable:
  - Their yield would be tied by arbitrage to the interest rate on the ECB deposit facility;
  - So long as a member state satisfied the criteria, the yield on the member state’s debt would also be tied by arbitrage to the interest rate on the ECB deposit facility.

Incentives for fiscal discipline

- National fiscal authorities would have an incentive to fulfill the fiscal criteria to avoid high interest rates, borrowing constraints and eventually restructuring/default.
- Difficulty in separating illiquidity and insolvency implies that some conditionality possibly applies when backstop intervenes, to elicit commitment to debt sustainability.
  - E.g., after restructuring, even if MS satisfied fiscal criteria again, backstop could be available in reduced amounts and at a higher interest rate.

Limited pooling of resources

Backstop would be financed with:

- limited tax revenue uniformly from all euro area (e.g., a small VAT surcharge).
  - The PDV of ½ percentage point of euro-area-wide VAT roughly equals 1.5 trillion euros (or 20% of government debt).
  - Share of seigniorage revenues of the Eurosystem could also flow to fund (PDV around 1 trillion).
- non-defaultable (euro)bonds.
  - Non-defaultable maturing debt should be effectively convertible into currency at par, similarly to reserves held at ECB.
  - Accepted as top-quality collateral by ECB.
  - ECB could decide to stop convertibility if backstop mismanaged.

Institutional design and governance

- A key challenge is to ensure backstop independence and accountability:
  <u>Clear mandate and delegation of specific tools</u>.
- The fund would need to be democratically accountable.
  - Because of its power to tax, but also because the fund would make politically sensitive decisions about how to apply the fiscal criteria in individual cases.

Orderly restructuring of national public debt

- If a member state was in violation of the fiscal criteria, the fund would be obligated not to purchase the member state's debt.
  - The member state would then have to borrow exclusively from private creditors and, as a last resort, it could decide to restructure its debt.
  - National public debt restructuring would treat all creditors symmetrically and be without prejudice to full participation in the European Union and the euro.
- Private creditors would demand higher yields and restrict lending in the wake of a restructuring or to account for the possibility of a restructuring in the future.
- National fiscal authorities would have an incentive to fulfill the fiscal criteria in order to avoid credit rationing, interest rate premia, and debt restructuring.

The fund as a backstop

- With access to tax revenue, the fund would be able to backstop:
  - the Single Resolution Mechanism that could wind down any banks insolvent because of national public debt restructuring;
  - the proposed European deposit insurance scheme;
  - the balance sheet of the Eurosystem.

Improving on the status quo without going all the way to fiscal union

	Status quo	Intermediate approach
Ruling out debt runs	OMT works but it does not ensure fiscal stabilization. Threat to ECB balance sheet (insolvency vs illiquidity), independence (accountability).	Common backstop to states whose fiscal policy consistent with ex-ante criteria ensuring debt sustainability. Issue non-defaultable bonds (limited pooling of fiscal resources =>).
Fiscal Discipline	SGP provides little incentives for Commission/Council to enforce sanctions for lack of "political" capital. This makes flexibility difficult to grant.	Role for financial markets: loosing backstop can be quite costly. Orderly sovereign debt restructuring possible for insolvent Member States (MS).
Stabilization	SGP does not ensure appropriate aggregate fiscal stance, nor MSs fiscal space.	Fiscal criteria would allow MSs fiscal space, potentially consistent with aggregate stimulus in deep recessions, with backstop protection.
Legacy debt	Fiscal compact and "convergence" (structural reforms).	More fiscal space and possible orderly sovereign debt restructuring allow to reduce debt overhang. Default without prejudice to euro, EU membership.

A benchmark to think about other proposals for reform

- With this setup, the euro area would be somewhere in between the two polar cases of a deep fiscal union and "fiscal renationalization."
  - Each member state would need to give up some sovereignty,
  - while gaining it in other areas (because the fiscal criteria could be defined in general terms, with specific decisions about fiscal policy and decisions about structural reforms left to individual member states).
- A deep fiscal union is neither a necessary nor a sufficient condition for effective stabilization policy.
  - A deep fiscal union committed to a balance budget rule would aggravate, rather than smooth out, the business cycles.
- National fiscal policies forced to tighten in a downturn – a pattern likely to arise under fiscal renationalization – would aggravate the business cycles.

Conclusions

- How to fix fiscal framework is ultimately a political decision, but alternative solutions must be consistent. Economics can offer guidelines.
  - Intermediate solutions may be politically more acceptable and still achieve objectives.
- Flaws in the fiscal framework of the euro area complicate the conduct of monetary policy.
  - All burden of macroeconomic stabilization in the face of large shocks on ECB.
  - A policy mix consisting of the ECB purchases of sovereign bonds *together* with fiscal accommodation would have sizable effects: what the conditions for making it possible
- The ECB the only institution that now could backstop national debt in the face of self-fulfilling runs.
  - ECB participation in sovereign debt restructuring remains highly controversial.
  - ECB not subject to the kind of democratic accountability that is a desirable counterpart of such backstop.