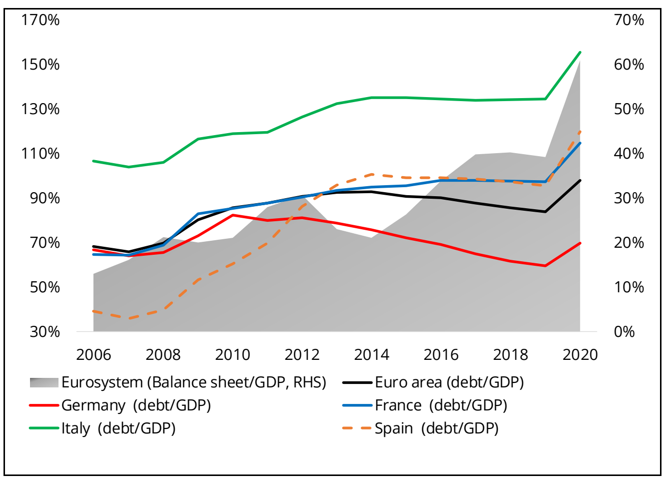
Monetary-fiscal policy interactions: the post-pandemic challenges

By Jean Barthélemy, Katja Schmidt and Giulia Sestieri

Both monetary and fiscal expansions have been needed during the past recent period in the euro area to sustain demand and inflation, mitigate the costs of the pandemic crisis and ensure a robust recovery. Conflicts of objectives between the two policies could, however, arise again in the future, in particular as a result of the ongoing accumulation of public debts and the large expansion of the Eurosystem's balance sheet. Building on the work done during the recent ECB strategy review, this blog recalls the recent monetary and fiscal actions and presents some of the trade-offs for the post-pandemic period.

Chart 1. Public debt to GDP ratio in the euro area and for its largest countries (left hand side axis) and evolution of the Eurosystem balance sheet over GDP (right hand size axis)



Source: Eurostat, National accounts, Eurosystem data. Authors' calculation.

Monetary and fiscal policies are the two main economic policies for ensuring macroeconomic stabilisation. They have different objectives, operate through different channels and are generally delegated to and implemented by different authorities. The outlook for inflation, output, employment and other macroeconomic variables depends, among other things, on how these two policies are deployed and interact with each other. The massive monetary and fiscal measures implemented to address the Covid crisis raise several challenges for the interaction between monetary and fiscal policies in the post-pandemic period. This interaction was therefore examined in the recent ECB Strategy Review by an ECB Occasional Paper "*Monetary-fiscal policy interactions in the euro area*".

The complementarity between monetary and fiscal policy was evident in the response to the Covid-19 crisis

In the euro area, the response of public authorities to the Covid shock was rapid and massive. This was justified by the severity of the shock and managed to prevent the Covid crisis from turning into an even deeper economic or financial crisis and to ensure a quick recovery once the health situation improved.

This response has rested on three pillars. First, a fiscal response at the national level, through sizeable and targeted support to households and firms, using several instruments, such as short-term working schemes, emergency aid for enterprises, tax deferrals and state guaranteed loans. Second, a monetary policy response by the ECB, centred around two main instruments: i) asset purchases, with additional net purchases through its existing programme (APP) and the launch of a new pandemic emergency purchase programme (PEPP); ii) an easing and extension of its targeted longer-term refinancing operations (TLTROs). A detailed explanation of the monetary action during the Covid crisis is given here and here. The third pillar consists of a coordinated response at the EU level, which supplements national fiscal measures. The activation of the general escape clause of the Stability and Growth Pact (SGP) was one of the key immediate initiatives. Another important component of the EU response is the establishment of NGEU, the EUR 750 billion temporary instrument to support the post-pandemic economic recovery, most notably in the Member States hit most severely by the Covid pandemic.

Such sizable measures by public authorities went hand in hand with a sharp increase in public debt levels of member countries and in the Eurosystem's balance sheet, as depicted in Chart 1. This raises questions on the future interaction of monetary and fiscal policies.

Monetary and fiscal objectives remain aligned as long as inflation perspectives are too low

The policy action during the Covid pandemic has further reinforced already existing challenges for the interaction of monetary and fiscal policy in the euro area. The 2008 global financial crisis and the euro area debt crisis had revealed significant shortcomings in the architecture of Economic and Monetary Union (EMU). Fiscal policy played an insufficient role in macroeconomic stabilisation in the euro area at times, leading to an overburden of monetary policy. In addition, years of persistently low inflation and a declining real rate of interest have challenged aspects of the pre-crisis consensus on how monetary and fiscal policy should interact. Notably, at the effective lower bound (ELB) with too low inflation, monetary policy and fiscal policies can mutually reinforce each other: (i) monetary policy is unlikely to counteract a fiscal stimulus by raising interest rates and low rates create fiscal space reducing the costs of fiscal stimulus, and (ii) monetary policy can benefit from supportive fiscal policy to achieve the inflation target. This situation, where both policies create policy space for each other, might however raise fears of "fiscal dominance", a situation where the central bank is bound to keep rates low to ensure fiscal sustainability, thus jeopardising its price stability mandate (e.g. Barthélemy et al. 2021).

In the recent past, the risk of fiscal dominance was not an issue as inflation prospects in the euro area were persistently and significantly below target.

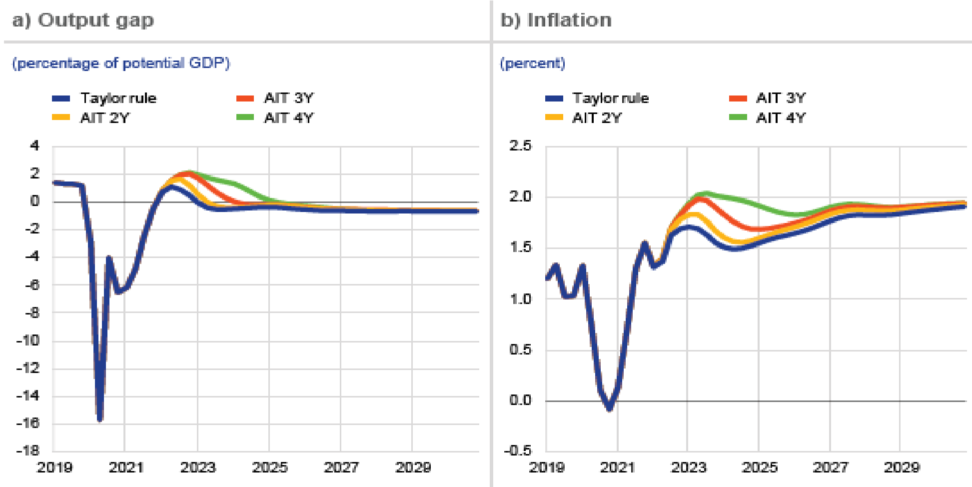
A certain degree of persistence in both policies is needed in the early stage of the recovery

The ECB paper cited above presents several illustrative quantitative simulations using the ECB-BASE model (for details see also Angelini et al, 2019), showing the interaction of different fiscal and monetary policy rules for the euro area. On the fiscal side, it compares an estimated fiscal reaction for the euro area as a whole, in line with pre-Covid regularities, with alternative fiscal reaction functions. One strongly countercyclical (implying a stronger reaction than in the past to actual output variations) and others allowing for "patience" through an additional reaction to past output losses, which could be activated at the ELB. On the monetary side, it compares a standard Taylor rule reaction function augmented with non-standard measures near the lower bound to "patient" monetary rules with make-up features, i.e. reacting to cumulated past inflation gaps. The main conclusions of the simulations are:

- In the event of a major recession, during which monetary policy may be constrained at the ELB, it is conceivable that fiscal policy might react more forcefully and or longer through a well-designed countercyclical reaction, which would indirectly support inflation through demand-side channels.
- A faster and prolonged attainment of the inflation objective might be achieved through a "patient" monetary policy rule, which enhances the effectiveness of fiscal policy support. Qualitatively, in the simulations carried out, this result holds true for any of the fiscal rules under consideration but the effects are most pronounced when a "patient" monetary policy rule receives support from a "patient" fiscal rule (see Chart 2).

These scenarios show that in the early stage of the exit from a severe recession, both authorities can gain in the achievement of their objective from a well-designed policy support from both sides.

Chart 2. Effect on the euro area output gap and inflation from the interaction of "patient" monetary and fiscal policy rules based on simulations from the ECB-BASE model



Source: ECB Occasional Paper No 273/September 2021 "Monetary-fiscal policy interactions in the euro area".
Note: the left (right) panel chart displays the dynamics of the output gap (inflation respectively) under different policy mixes. The blue line shows the dynamics from the combination of a patient fiscal policy and a standard monetary rule (augmented Taylor rule); the yellow, red and green lines show the combinations of a patient fiscal policy with alternative patient monetary policy rules (AIT stands for average inflation targeting over 2, 3 and 4 years).

Beyond the pandemic period, each authority should be guided by and stick to its mandate

However, the alignment of policy objectives and the benefits for more patient fiscal and monetary policies are not permanent features. Inflation in the euro area rose rapidly in the second half of 2021 due to a combination of several factors (see here for an analysis of France's case), which are expected to last for several quarters. Although inflation is expected to return to levels slightly below the 2% target in 2023 according to the ECB's December projections, possible conflicts of interest between fiscal and monetary policies could arise if inflation rises over the medium-term beyond the current "inflation hump".

This implies that both authorities should continue to act independently, in line with their mandates. The central bank should be able to roll back adopted measures if the inflation outlook increases durably or risks of the de-anchoring of inflation expectations materialise. Fiscal authorities must ensure that public debt remains sustainable in the medium-term even if interest rates increase. In order to ensure this, a return to a credible and coherent medium-term fiscal framework is important. There is little doubt that, if inflation developments call in the future for a normalisation of the ECB's monetary policy, the requirements for sound fiscal positions in euro area Member States will gradually become more stringent, in line with the objectives set out in the European Treaty.