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Monetary and fiscal stability – a post-crisis view on a complex relationship

It is with good reason that a conference dealing with the first and the next 20 years of EMU devotes a session on the relationship between monetary and fiscal stability. To begin with, it is common knowledge that in a heterogeneous monetary union like the euro area, fiscal policy is needed to cushion asymmetric economic shocks in the various euro area countries which cannot be dealt with by the single monetary policy. This is to say, fiscal policy should be designed in a way that countercyclical fiscal policy at the national level – at least through the working of automatic stabilizers, if appropriate also through active discretionary measures – is feasible, without endangering fiscal sustainability. The experience of the first 20 years of EMU has shown that this fundamental aim has not been achieved: fiscal policy was at various stages procyclical during economic upturns, implying that the opportunity to build buffers for downturns was not (fully) used. In turn, fiscal policy had to be restrictive during downturns and in several countries even during the crisis because of serious threats of fiscal crises and even state bankruptcies. So, it seems fair to say that fiscal policy has not consistently supported macroeconomic and financial stability during the first two decades of EMU. Did this come as a surprise? Yes and no.

Yes, in the sense that the EU Treaty legislator would not have knowingly and on purpose have designed a euro area policy set up that could be expected not to work. And in principle, the framework could have worked (and could still) if only all players consistently adhered to the agreed rules. And indeed, during the first 10 years of EMU, while not perfect, EMU seemed to function quite smoothly.

No, in the sense that already during the negotiations for the Maastricht Treaty, many well-renowned economists and policy makers had warned to set up a currency union without a political union. Given the lack of readiness for political union by most Member States (even during the Maastricht negotiations in the late 1980s/early 1990s, prior to the EU's „Scandinavian" and „Eastern" enlargement rounds), the compromise that emerged was a framework that sought to provide fiscal stability and counter-cyclical room for maneuver through preventive mechanisms that should ensure deficit and debt levels in normal times.

Economic history is full of examples where fiscal instability was the source of financial and currency crises. Thus, the concern that fiscal latitude might endanger the euro's price stability was at the root of various provisions in the EU Treaty aiming to ensure that the fiscal policies of individual Member States should be „sound". On the one hand, various provisions (prohibition of monetary financing, prohibition of privileged access, inclusion of government bond interest risk premium in the converge criteria for EMU participation) aimed to strengthen market discipline. On the other hand, the Excessive Deficit Procedure, which was enhanced by various vintages of the Stability and Growth Pact (SGP), aiming at creating the leeway for countercyclical policies, if need be, and at preventing fiscal crises by setting rules that constrain national governments' fiscal policies.

The first 20 years of EMU have shown that market forces alone, while in principle seemingly useful, in practice work late and then very abruptly, thus missing to provide a reliable disciplinary force on governments' policies during

calm times, while exacerbating fiscal and financial fragility in crises situations. Hence, fiscal rules are an indispensable complement to market discipline. At the same time, the track record so far has also shown the limits to fiscal rules. EU governments and even EU institutions at times seem not to fully identify with them. The preventive arm of the SGP failed on various occasions to prevent breaching of the quantitative deficit and debt levels. The mechanisms to ensure corrective action at times create tensions between countries threatened with sanctions and the EU Commission and other Member States. In fact, recent experience may suggest that in the event of non-compliance with the fiscal rules, it may in turn be rising risk premiums (and thus market mechanisms) that ultimately prompt governments to take corrective action. So, it might be a combination of market forces and fiscal rules that work best to avoid gross fiscal mistakes.

At the same time, the experience since the global financial crisis, the Great Recession and the European Debt Crisis has also shown that even the combination of market forces and fiscal rules may not prevent fiscal crises – ultimately even threatening the euro itself – if only the shocks affecting countries' banking and economic systems are sufficiently destructive. Besides some other refinements in fiscal rules, the main response taken by EU authorities has been to create new mechanisms for mutual assistance between the euro area Member States. The European Stability Mechanisms (ESM) has over time developed into the main instrument to provide such assistance, and is currently in the process of developing its portfolio of roles in this respect (see Chapters 39 and 40 in ESM, 2019). Various measures to install „shock absorption mechanisms" and „fiscal stabilisation mechnanisms" among euro area countries are currently being discussed (see Katterl and Köhler-Töglhofer, 2018; Prammer and Reiss, 2018). The idea to create Eurobonds, European Safe Bonds (ESBies) or Sovereign Bond Backed Securities (SBBS), which are fully or partly issued jointly by euro area governments, and numerous variations therof, have been debated for several years. Finally, there is also the idea to create a „central European fiscal capacity", in other words to pool a much larger fraction than the current EU budget's 1% of Member States' GDP in a central euro area budget, with a „European Minister of Finance" being in charge (Juncker et al., 2015).

All these proposals have so far found their limits in the tradeoff between effectiveness and relevance in terms of orders of magnitude, on the one hand, and incentives for moral hazard and lack of willingness for (additional) fiscal centralization and fiscal transfers (particularly permanent ones) between euro area Member States, on the other hand. It is not clear at this point, how far such initiatives for "euro area fiscal deepening" will lead, and within which time horizon.

Against this background, for practical purposes, attention might usefully focus on how fiscal policy, within the existing frameworks, can contribute to macroeconomic and monetary stability, while supporting potential growth as best as possible. This would imply that the SGP's prescription to safeguard balanced structural fiscal balances should be taken seriously by all Member States. This would create fiscal space for downturns. Procyclical policies during booms and pre-election periods would be avoided. Debt to GDP ratios would gradually be wound down in countries that exceed the Maaastricht rules substantially, thus preserving market confidence. Asset price booms in those Member States in which monetary conditions resulting from the single monetary policy may be (too) easy would be contained by macroprudential policies, which may also include some fiscal measures. The structure of fiscal revenues and expenditures would be adjusted to support potential growth and environmental sustainability, while not losing sight of social acceptance. Fair compensatory mechanisms to cushion costs for reform losers would help to extend policy reform space.

The recent years have seen a marked improvement in euro area countries' fiscal positions, which was partly due to sizable fiscal savings, partly facilitated by an extended and broad-based economic recovery, and not least strongly aided by ultra-low long-term interest rates due to the Eurosystem's unconventional monetary policies. Nevertheless, debt to GDP levels in most euro area countries have not declined noticeably. This raises several questions and concerns with regard to future fiscal sustainability:

- First, how should Member States' fiscal policies respond to an economic cooling off, if it turned into a recession? How much fiscal space do various euro area countries actually have before concerns about fiscal sustainability resurface?
- Should the use of fiscal space be coordinated within the euro area, implying that countries with balanced budgets or surpluses should be „encouraged" to run deficits, while countries with a fragile fiscal position should refrain from stretching their fiscal space even further?
- How should the above questions be assessed given that euro area monetary policy already is operating at or close to the effective lower bound for interest rates? Particularly, as in such a situation fiscal policy is in principle more effective (as long as it is considered sustainable by markets).
- How to assess the interplay between (unconventional) monetary policy (in particular sovereign bond purchases) and fiscal space? Is it a mere side effect that central banks' sovereign bond purchases, besides their aim to loosen financing conditions for the economy at large, ease governments' budget constraints through lowering debt servicing costs and by absorbing a substantial fraction of new bond issuance and outstanding stocks? Or have we slipped into a regime where, faced with the effective lower bound on interest rates, monetary policy operates through extending governments' fiscal space? If this was the case, what could the long-run consequences for macroeconomic and price stability be?
- Finally, once inflation moved back to target, could a normalization of monetary policies (hike in official interest rates, melting down of central banks' sovereign debt holdings) threaten fiscal sustainability? In other words: how to prepare public finances for monetary policy normalization?

This introduction only touched upon some issues, with many more being neglected. The two presentations in this session pick out two themes. First, Ludger Schuknecht addresses one aspect

of the complex fiscal-financial stability nexus, which has been highlighted by the financial and sovereign debt crisis, namely how to mitigate fiscal risks from the financial sector. The second contribution by Gottfried Haber explores a topic briefly mentioned above, namely potential tensions between fiscal discipline and economic stabilization, an issue which has been with the EU's fiscal stability framework from the start and will remain relevant also in the years to come.

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