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Monetary policy and central fiscal capacity in the euro area

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1. Introduction

The new inflationary peaks reached in the Euro Area (EA) last summer have led the European Central Bank (ECB) to strengthen the restrictive measures it has taken since March 2022. The ECB complemented the end of its net asset purchase programmes by increasing the policy interest rates by 125 basis points in the last two meetings, those of July and September. Also, the ECB signalled that its restrictive policy stance is bound to continue. In her speech at Jackson Hole in August, Isabel Schnabel (2022b), member of the ECB's Executive Committee, stated that the policy interest rates should be increased until price stability (i.e. an inflation rate equal to 2%) is restored, independently of the growing probability of a recession in the EA. A similar statement was reiterated by the ECB's President a month later (see Lagarde, 2022c).

2. Changes in the ECB monetary policy stance

The ECB's recent measures are justified by its mandate, which is centred on price stability. However, in the current economic context this assessment should be complemented by considering a specific issue. Differently from the inflationary process in the United States, which is due mostly to an over-heated economy and to a related excess in aggregate demand, the main roots of the EA's high price dynamics are found in the supply-side bottlenecks caused by the unexpected persistence of the pandemic breaks in the global value chains and by the dramatic impact of Russia's war in Ukraine on the price of energy, other raw materials, and food (see Pasimeni, 2022). The increases in aggregate demand, triggered by government support for firms and households during the pandemic and recorded from spring 2021 to mid-2022 in various member states, have only strengthened the inflationary pressure caused by the fall in aggregate supply. The ECB thus faces a dilemma. Its monetary tools cannot directly handle the supply-side problems; they can only reduce aggregate demand with the aim of bringing down the demand level to the reduced level of aggregate supply. This implies that the ECB's control of inflation inevitably increases the risk of a new recession, which is already expected due to the legacy of the pandemic's impact and the war's economic shock.

This dilemma likely explains the hesitancy in the EA's monetary policy from the fall of 2021 to the summer of 2022. In the second half of 2021 and in the first months of 2022, various members of the ECB's Executive Committee (see

[1] This policy brief is the result of a continuous discussion with Marco Buti and draws several concepts from a recent joint column published in VoxEu and a longer article published as a *Discussion Paper* at CEPR (see the bibliography below). Moreover, the fundamental intuition for the construction of Figure 2, which is included in Section 4 below, should be attributed to Marco Buti. I wrote the different drafts of this policy brief, and I am solely responsible for the assessments of the ECB's monetary policy and the EU's fiscal policy. Needless to say, I warmly thank Marco Buti for his invaluable support. I also thank Alberto Zazzaro for his stimulating comments on an earlier version of the paper.

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for example: Lagarde, 2022a; Lane, 2022; and Schnabel, 2022a) interpreted the supply-side roots of the EA's surge in inflation as evidence that the accelerated price dynamics were a temporary phenomenon. Hence, despite the increase in the EA's average inflation rates from 2.2% in July 2021 to 5.9% in February 2022, the prevailing recommendation of the ECB's Governing Council was to continue a moderate expansionary stance in monetary policy, given that the implementation of a gradual restriction would have negatively affected the economic phase without addressing the consequences of the supply-side bottlenecks. Evidence of this is that the end of the emergency asset purchase programme (the PEPP), announced in mid-December 2021 and implemented in March 2022, was accompanied by a temporary strengthening of the other asset purchase programme (the APP). Only in late spring of 2022 did the ECB unambiguously state that the EA's excessive inflation was not a contingent phenomenon. At this point, consistent with its analytical approach, the ECB affirmed that monetary policy should become restrictive independently of the source of the inflation spike.

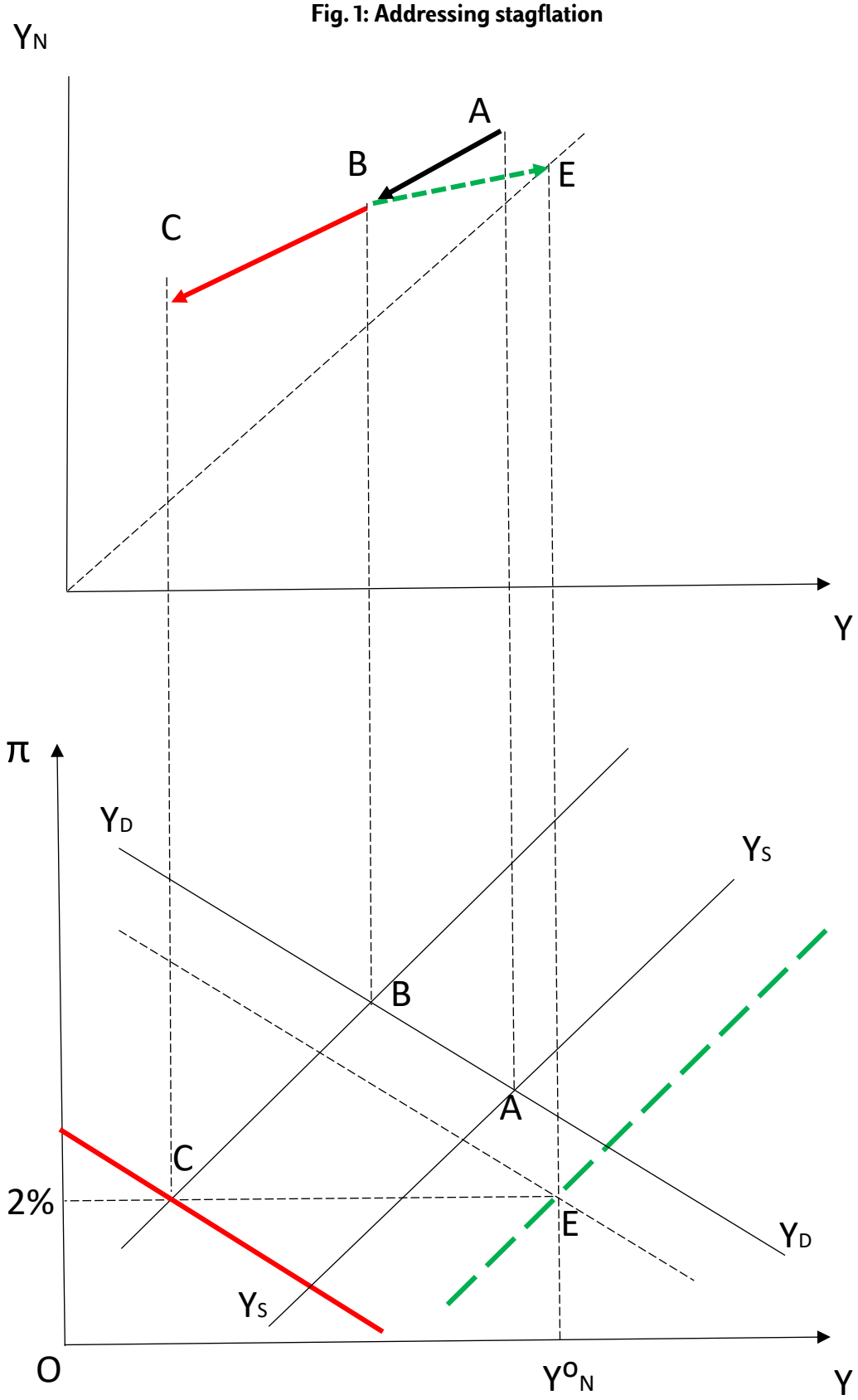
The last consideration needs to be elaborated. On the one hand, in the Q&A session of the ECB's last September meeting, Lagarde (2022b) restated that monetary tools cannot directly manage the supply-side problems that affect prices in the EA. On the other hand, as mentioned above, at Jackson Hole Schnabel (2022b) maintained that the ECB's institutional duty is to put price dynamics under control independently of the supply-side or the demand-side causes of excessive inflation. These two authoritative statements will not be at odds, only if the restriction in the ECB's monetary policy is conceived as a tool to decrease the aggregate demand for an amount capable of compensating the previous exogenous reduction in the aggregate supply (see Lagarde, 2022c). Unfortunately, given that the supply fall has been severe in most of the EA's member states, this is equivalent to affirming that the restriction of monetary policy must be large enough to lead to the EA's recession.

3. Mustering the price effects of a negative supply shock

A stylised representation of the analysis outlined in the previous section is offered by Figure 1, drawn from Buti and Messori (2022a). With reference to mid-2021, the EA's equilibrium is represented by point A in the lower part of the figure. In the absence of shocks, this point can be defined as a short-medium term equilibrium because the current inflation rate is above, but not significantly, 2% and the negative output gap is not overly pronounced.[3] However, in the last months of 2021 and in the first half of 2022, the combination of the old and persistent supply bottlenecks and the unexpected shock from the war shifted the aggregate supply curve leftward and led to point B. This latter point does not represent a short-medium term equilibrium because the B-intersection between the aggregate demand and the left-shifted supply curve is determined by price increases that are incompatible with the ECB's target. Moreover, as shown in the upper part of Figure 1, point B leads to a significant negative output gap. Hence, the temporary equalisation of demand and supply based on an upward shift along the aggregate demand curve requires further adjustments in the short term too.

[3] Central banks relate their policy decisions to the expected and not to the current inflation rates. Hence, strictly speaking, the short-medium term stability of the equilibrium in point A can be questioned; however, the assumption of "absence of shocks" mitigates the simplification. The statement that an inflation rate above 2% is compatible with the new quantitative target, which was adopted by the ECB in 2021 and which specifies that the inflation rate should neither exceed nor remain below 2%, can appear inappropriate; however, as shown by Benigno *et al.* (2021), in special circumstances the ECB may tolerate an inflation rate above the 2% target for some time. Finally, the short-medium term equilibrium cannot be identified with a long-term equilibrium because the output gap remains negative.

Fig. 1: Addressing stagflation



A: mid-2021
B: Covid + war

C: ECB' current strategy
E: Supply counter-shock

Even if the central bank is the policymaker in charge of keeping inflation under control, monetary policy restrictions can interact with appropriate fiscal policies that mitigate the macroeconomic impact of these restrictions without feeding price increases. Currently, in the EA, the ECB's measures are leading to severe downward shifts in the aggregate demand curve by means of implemented and announced increases in the policy interest rates; and the end of the ECB's net asset purchase programmes is constraining the fiscal space of the member states with high public debt/GDP ratios. In the simplified framework illustrated in Figure 1, the ECB's restrictive monetary policy and its binding impact on national fiscal policies gradually lead to the red demand curve and to a new equalisation of aggregate demand and supply in point C. The latter point can satisfy an inflation target of 2% (see the lower part of the figure) but at the cost of a large negative output gap (see the upper part of the figure). The ECB's current monetary policy is leading to a recessionary equilibrium without any mitigation concerning the fiscal policies.

It would be interesting to see if even point C was incompatible with a short-medium term equilibrium due to the high risk of hysteresis. The downward shift in the aggregate demand curve triggered by the restrictive stance of the ECB's monetary policy could exceed the adjustments required to equalise demand and supply. In this case, there would be further decreases in aggregate supply feeding a vicious circle capable of dominating the positive impact of price stability.[4] Anyway, point C depicts a new recession in the EA.

4. The risk of stagflation in an open economy

The conclusion reached at the end of the previous section will be reinforced if we consider that the EA is an open economy that accumulated positive imbalances in its current accounts from the end of 2009 to 2021. More recently, these positive imbalances have been almost eliminated due to the dramatic rise in the prices of various EA imported goods (energy, other raw materials, food), whose price elasticity of demand is low. Moreover, the restrictive stance of the ECB's monetary policy was not enough to avoid a substantial depreciation of the euro with respect to the US dollar because the Federal Reserve started increasing its policy interest rates four months before the ECB and at a faster pace. The impact of the euro's depreciation on the price of the EA's imported goods has become a significant component of the EA's inflation rate.

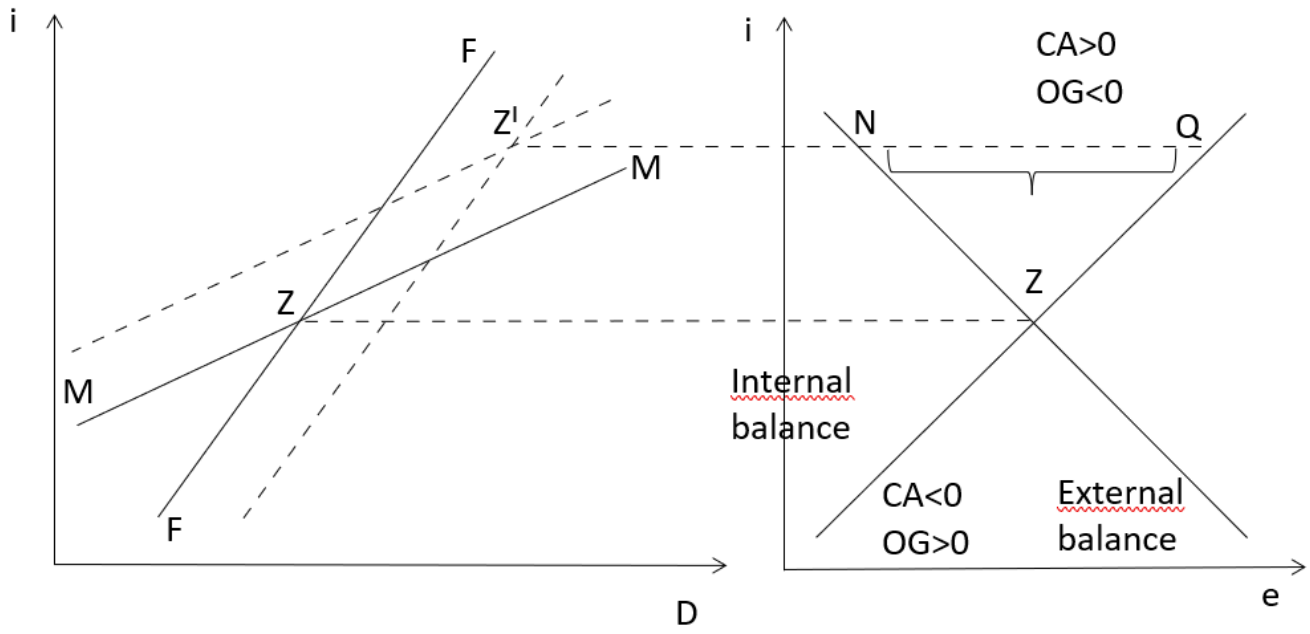
In an open economy, the objective to attain the internal long-term equilibrium, defined as a zero-output gap and price stability, should go hand in hand with the external equilibrium defined as a broadly balanced current account. Figure 2 illustrates the search for such a double equilibrium under a negative supply shock in the EA. The left side of this figure translates the shift from equilibrium A to point B and – then – to point C illustrated in Figure 1, into the instruments' space defined by the structural public deficit (D) in the EA and the ECB's policy interest rate (i) (see Buti and Messori, 2021 and 2022b). *M-M* and *F-F* represent the monetary reaction function and the fiscal reaction function, respectively. Due to the negative supply shock under examination, the intersection between *F-F* and *M-M* shifts from Z to Z' because the restriction in the ECB's monetary policy in response to the fall in aggregate supply and the related excess in the inflation rate generate an upward shift in the monetary reaction

[4] To measure the relative impacts of this vicious circle and of price rebalancing in terms of a final equilibrium would require a complex model that goes largely beyond the scope of this policy brief. Hence, the risk of hysteresis will be neglected even if its examination could buttress my analysis by pointing out that the negative output gap is so important that it makes point C unstable.

function. In turn, the fiscal reaction function shifts to the right due to the increase of the national public deficits aimed at partially absorbing the impact of the price rises on firms' balance sheets and household incomes. However, as already mentioned, the restrictive stance of the ECB's monetary policy hinders the implementation of a large national fiscal expansion. The new equilibrium, Z', is characterised by a substantial increase in the policy interest rates and by a moderate increase in the structural public deficit.

The right side of Figure 2 depicts the possible impact of the described adjustments in the two reaction functions on the EA's internal and external balances in the space defined by the euro effective exchange rate, *e*, and the ECB's policy interest rate, *i*. Let assume that the original equilibrium, Z, is at the intersection of the curve of the external balance, which represents – as already said – the locus of points $\{e, i\}$ satisfying the equilibrium of the EA's current account, and the curve of the EA's internal balance, which represents the locus of points $\{e, i\}$ satisfying the equality of the current and natural outputs.[5]

Figure 2: The external constraint



As the equilibrium shifts from Z to Z' on the left side of Figure 2, *ceteris paribus* the ECB's higher policy interest rates should determine a decrease in the EA's aggregate demand, and an average appreciation of the euro (that is, a decrease of *e*) sufficient to safeguard the equilibrium of the EA's external balance on the right side of this same figure. Point N, lying on the external balance curve, would remain at the left of the curve of the EA's internal

[5] Buti and Messori (2022b) shows that, in the absence of shocks, Z lies on the curve of the internal balance. Conversely, the assumption that Z also lies on the curve of the external balance is here arbitrary. Its justification would require the analysis of the counteractions from the right-side to the left-side of Figure 2, thus defining the monetary and fiscal reaction functions in an open and not a closed economy. This further step, which goes beyond the purpose of the current policy brief, would be even more important to justify the imbalances due to a shock. Hence my examination of the adjustments on the right side of Figure 2, due to the shift from Z to Z' on the left side of this same figure, should be interpreted as a rough and partial intuition of a more complex problem.

balance (negative output gap). However, in the EA's current situation, the clause of *ceteris paribus* does not apply because the increases in the ECB's policy interest rate are lagging behind those of the Federal Reserve and other central banks. Hence, as confirmed by the recent experience, there will be an average depreciation of the euro (that is, an increase of *e*) leading to a point between N and Q on the right side of Figure 2. At its peak, this depreciation could lead to point Q lying on the curve of the EA's internal balance but at the right of the external balance curve. Excluding the boundaries, the interval (segment) *NQ* represents the locus of points characterised by the coexistence of surpluses in the current accounts, negative output gaps, and excessive inflation. These points imply that the EA is in stagflation.

5. An alternative equilibrium

The probability of an EA stagflation in the last quarter of the current year and in the first half of 2023 remains very high, even if the reference to the open economy is neglected. As shown in the upper part of Figure 1, point C would imply a substantial worsening of the negative output gap with respect to point B and – *a fortiori* – to the original equilibrium in point A. Being placed at the end of a fifteen-year sequence of negative events, the C-recession would impose unsustainable economic and social costs on European households and firms and would threaten the long-term potentials of the EU's economic growth. If the restrictive stance of the monetary policy triggered the gradual transition of the EA's economy to point C, some of the intermediate points lying on the leftward supply curve and belonging to the segment *BC* could equalise aggregate demand and supply. However, in these points the EA's economy would be characterised by a stagflation.

These considerations highlight a crucial policy problem in the EA's current economic setting: is it possible to prevent the incoming stagflation from becoming the severe recession represented by point C?[6] In the lower part of Figure 1, a different intersection (point E) between a new aggregate demand curve (see the decreasing dotted line) and a new aggregate supply curve (see the green dotted line) is depicted. Point E would be compliant with price stability in the EA as well as with the zeroing of the negative output gap (see corresponding point E in the upper part of the same figure). Hence, point E represents a positive benchmark that is easy to characterise. It is the main result of a strong rightward shift in the aggregate supply curve. The question thus becomes: how is it possible to (over)compensate the leftward shift of the original aggregate supply curve Ys-Ys, that is, to get a net rightward shift of the latter?[7]

Buti and Messori (2022a and 2022b) maintain that this counter-shift and the consequent internal and external equilibria can be obtained, in the short-medium term, through the strengthening of an expansionary central fiscal capacity (CFC) based on specific forms of public and private investments and – mainly – on the production of a large typology of European Public Goods (EPGs). Those investments and EPGs should be capable of directly increasing aggregate supply without immediately stimulating aggregate demand. Examples are offered by some

[6] The reference to an open economy would make this policy problem even more important. Under reasonable assumptions, the disequilibria in the EA's current account would shift point C to the left in Figure 1 so that the price stability would require an even more severe economic recession.

[7] The previous footnote implies that the rightward shift of the aggregate supply curve should be even stronger if the EA was considered an open economy.

of the investments at the core of the National Recovery and Resilience Plans (NRRPs),[8] and, mainly, by the centralised productions of EPGs such as energy goods and semiconductors (also thanks to the Chips Act launched by the European Commission) and by the transformation of the rare earths (as signalled in the recent State of the Union address).

The implementation of these specific CFC forms is hindered by various technical and political problems. The main difficulty is to overcome a temporal inconsistency: the production of new EPGs takes time, whereas the high risk of stagflation is around the corner. To fill this time gap, the successful achievement of the targets and milestones characterising the various NRRPs would be very helpful.

5. Conclusions

The previous analysis can be summarised in four points:

First, to prevent the current economic phase from leading to a heavy recession in the EA, an adequate policy mix is needed. Monetary policy should be complemented by a CFC at the EU level.
Second, the specific CFC forms that can currently build an effective policy mix are those forms capable of supporting rightward shifts in aggregate supply without immediately increasing aggregate demand; hence, EU countries should concentrate their efforts on the implementation of their NRRPs and – mainly – make progress in the joint production of EPGs.
Third, to prevent the weakening of the exchange rate, which would make it harder to control inflation, the CFC should focus on those EPGs that strengthen the strategic autonomy of the EU. I have provided some examples of such types of EPGs.
Fourth, the EU member states with a high public debt/GDP ratio should further contribute to the implementation of this effective policy mix by reducing their budget deficits and putting their debt on a gradually downward trajectory. In this perspective, the adoption of the "RRF methodology" to design the new fiscal rules would be highly beneficial (see Amato *et al.*, 2021).

[8] The reference to the national plans brings into play the 'Recovery and Resilience Facility', that is, the main programme of Next Generation–EU (NGEU).

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