Luis de Guindos: Improving macroeconomic stabilisation in the euro area

Remarks by Luis de Guindos, Vice-President of the European Central Bank, at the Global Interdependence Center Central Banking Series conference, Madrid, 3 October 2019.

* * *

Introduction

A decade after the global financial crisis, the level of economic activity in the euro area remains disappointingly low. It took nine years for real per capita GDP to surpass its 2007 level. Likewise, euro area inflation has stubbornly remained below the ECB's aim for much of the past decade.

Throughout this period, the ECB has acted decisively to support euro area demand and raise inflation onto a sustainable path towards our aim of below, but close to, 2% over the medium term. This has included lowering the key ECB rates to record low levels and adopting a wide range of non-standard monetary policy measures.

By contrast, the contribution from fiscal policy to macroeconomic stabilisation in the post-crisis period has been muted at best. From 2010 to 2012, economies representing around one-third of euro area GDP carried out procyclical fiscal tightening to restore confidence in their public debt, which significantly contributed to the second recession in that period. Since then, fiscal policy has been broadly neutral.

At our last meeting, the Governing Council responded to the continued shortfall of inflation with respect to our aim. Recent economic data point to a more protracted weakness in the euro area economy. Prominent downside risks remain and inflationary pressures are muted. We introduced a package of measures designed to support the euro area expansion, the ongoing build-up of domestic price pressures and, thus, the sustained convergence of inflation to our medium-term aim.

We also noted the need for countries with fiscal space to act in a timely and effective manner and for all countries to reinforce their efforts to achieve a more growth-friendly composition of public finances.

In my remarks today, I will focus on the roles of monetary and fiscal policy in supporting macroeconomic stabilisation in the euro area. In particular, I will explain why now is a particularly appropriate time for fiscal stimulus. I will also offer some thoughts on how to improve the current fiscal framework.

Macroeconomic stabilisation in a monetary union

The literature on optimal currency areas points to the need to counter two types of shocks: those that are common to all countries, and asymmetric ones that affect a subset of countries.

For common shocks, monetary policy can act to stabilise the economy.

But for idiosyncratic shocks, stabilisation becomes trickier. Monetary policy cannot target individual countries, and those affected can no longer adjust their exchange rate to help cushion the effects of the shock. Hence the literature emphasises the need for economic cycles to converge, so that common shocks generally dominate. For asymmetric shocks, stabilisation comes ex ante from greater cross-border risk-sharing to improve resilience, and ex post from fiscal policy.

But in the light of recent experience, it is worth revisiting this classic separation between using

monetary policy for common shocks and fiscal policy for asymmetric shocks. Fiscal policy at a national level in the euro area was unable to fully counter asymmetric shocks during the crisis. And at an aggregate level, stabilisation may benefit from monetary and fiscal policy working in tandem given the current environment of low interest rates.

Nominal interest rates have been declining in advanced economies since the 1980s. In large part, this decline is attributable to the decline in average inflation over that period. Investors require lower compensation for expected future inflation, and the fall in inflation volatility has also reduced the inflation risk premium. The decline is also a result of a secular fall in the natural rate of interest, which is the rate that balances desired saving and investment in the economy. While the natural rate cannot be precisely measured, a range of estimates point to its decline.

There are a number of contributing factors to this decline, principal among which is lower potential growth. Lower potential growth reduces the expected rate of return on capital, so reduces the rate at which firms are prepared to borrow to invest.

Other factors that are believed to have further weighed on the natural rate of interest include the ageing population in Europe, the role of income distribution, increased saving in emerging markets and a general rise in risk aversion.

This fall in the natural rate of interest has important implications for the optimal policy mix in the euro area. The interest rate at which monetary policy becomes accommodative falls directly in line with the natural rate, so the effective lower bound on nominal rates has become a much greater consideration when setting policy. Before the crisis, it was estimated that interest rates in the euro area would be likely to hit zero only once every 50 years.[1] At the current natural rate, rates of zero or below are likely to be a much more frequent occurrence.

As the experience of the past decade has shown, the decline of the natural rate is not an impediment to monetary policy providing accommodation to the economy. But it does mean that monetary policy has to remain accommodative for longer and make greater use of unconventional measures. Those factors carry with them an increased risk of undesired side effects.

In such a situation, economic theory tells us that fiscal policy should play a much more substantive role in business cycle stabilisation than it usually would.[2] The reason for this is straightforward.

In normal times, when output is close to potential and inflation is close to its objective, a fiscal expansion threatens to push inflation above the central bank's aim. Central banks respond by raising their policy rates, and the increase in interest rates partially crowds out private sector demand. However, when the economy operates below potential the central bank has no reason to fight a fiscal expansion. Policy rates would not increase and private sector demand would be crowded in, leading to a much larger positive effect on aggregate demand and inflation.

In other words, when policy rates are close to the lower bound, fiscal policy becomes more effective in stimulating aggregate demand.[3]

Moreover, while monetary policy must take the natural rate of interest as given, fiscal policy – if enacted appropriately – can help raise it, in turn making monetary policy more powerful. Policies to encourage more people, especially older workers, to participate in the labour force can help raise rates. Increasing spending on education and public investment can support productivity and lift both potential growth and *private* investment.[4]

Every policy implies trade-offs, of course. The side effects of very accommodative monetary policy may become unduly tangible when the economy operates below potential for a long time. In fact, while we believe that, overall, the benefits outweigh the costs, we acknowledge the

challenges that a sustained low interest rate environment poses for banks.

Reforming the fiscal framework

So there is a role for fiscal policy to play in helping to counter common shocks at the European level. To the extent that Member States have created fiscal space, it would therefore be desirable for fiscal policy in the euro area to support business cycle stabilisation more actively. Our current assessment is that the fiscal stance is only mildly expansionary at the aggregate level.

But the current institutional framework is insufficient to deliver that required stimulus.

Fiscal policy remains a national responsibility in Economic and Monetary Union (EMU), with some common rules applicable to individual countries. In its first incarnation, the Stability and Growth Pact focused almost exclusively on fiscal sustainability, with little emphasis on fiscal stabilisation.[5] In recent years it has undergone several reforms, some of them with the explicit aim of providing greater prominence to stabilisation considerations, both at the country level and at the euro area level. The result has been rules which are now viewed as complex and opaque, with little evidence that they have delivered a more countercyclical fiscal policy stance in the euro area.[6]

The Stability and Growth Pact has limited flexibility and does not lend itself to incorporating area-wide stabilisation elements. National fiscal rules, with a focus on domestic issues, tend to neglect positive cross-border spillovers. They fail to recognise the benefits of cross-country risk-sharing and the vital role played by the public sector in underpinning it.

In other words, rules based purely at a national level, or even rules that coordinate a fiscal stance across countries, are not enough by themselves. Empirical evidence suggests that spillovers from a fiscal expansion in one euro area country to others are positive, but small. So while it is important for those countries with available fiscal space to use it domestically to support overall stabilisation, a central fiscal capacity with the ability to allocate expenditure across countries would be more powerful.

A dedicated centralised fiscal capacity would not interfere with domestic policy. By focusing on common area-wide stabilisation it need not affect national fiscal space but rather provide an additional layer. This focus would also help ensure that areas of expenditure that are vital for long-run growth are not cut during a downturn, helping to preserve future fiscal space and support real interest rates over the long term.

A central fiscal capacity of this sort would clearly need to be carefully designed to mitigate any risk of moral hazard. But, crucially, it should have sufficient firepower to effectively contribute to macroeconomic stabilisation. It needs to be sizeable and agile enough to react rapidly to emerging threats.

But macroeconomic stabilisation in the euro area can only function properly when other EMU features and institutions are adequately designed and operational.

First, the banking union needs to be completed. Unified banking supervision and the Single Resolution Fund (SRF) have provided greater confidence that banks operating in other euro area countries face the same conditions as in their home market. But the banking union will remain incomplete until a common deposit insurance scheme has been introduced and the fiscal backstop for the SRF has increased in size. While there is political agreement about the SRF backstop and its terms of reference, there is not yet agreement on the European deposit insurance scheme.

Second, it is imperative to accelerate progress on the capital markets union. This is ambitious. It entails streamlining core aspects of national policies, such as taxation and insolvency regimes,

which are essential for integrating the legal underpinnings of cross-border markets. Capital markets can smooth country-specific shocks by providing a larger pool of financial assets that can be shared across borders. This helps to decouple wealth and income – and hence consumption – from output.

Conclusion

Let me conclude.

The euro area risk outlook is again tilted to the downside. This is a conjunctural concern. The global decline in the natural rate of interest over the past quarter of a century, however, poses structural challenges. Policy rates will likely remain low, by historical standards, and may hit their lower bounds more frequently than in the past.[7] We have learned from the experience in Japan that it is possible to get caught in a vicious cycle of declining inflation expectations, falling inflation and a binding lower bound on nominal interest rates from which it is difficult to escape.

It is thus of utmost importance that we enhance the firepower of euro area stabilisation policy by means of a policy mix that, while continuing to make full use of monetary policy, assigns a more substantive role to fiscal stabilisation policy. Laying the institutional foundations for a European fiscal capacity would be an important step in this direction.

---

[1] See Coenen, G. (2003), "Zero lower bound: is it a problem in the euro area?", *Working Paper Series*, No 269, ECB, September.

[2] Schmidt, S. (2013), "Optimal Monetary and Fiscal Policy with a Zero Bound on Nominal Interest Rates", *Journal of Money, Credit and Banking*, Vol. 45, No 7, pp. 1335–1350; and Werning, I. (2012), "Managing a Liquidity Trap: Monetary and Fiscal Policy", *NBER Working Paper Series*, No 17344, National Bureau of Economic Research.

[3] Eggertsson, G. (2011), "What Fiscal Policy Is Effective at Zero Interest Rates?", in Acemoglu, D. and Woodford, M. (eds.), *NBER Macroeconomics Annual 2010*, Vol. 25, University of Chicago Press, pp. 59–112; and Christiano, L., Eichenbaum, M. and Rebelo, S. (2011), "When Is the Government Spending Multiplier Large?", *Journal of Political Economy*, Vol. 119, No 1, pp. 78–121.

[4] De Jong, J., Ferdinandusse, M., Funda, J. and Vetlov, I. (2017), "The effect of public investment in Europe: a model-based assessment", *Working Paper Series*, No 2021, ECB, February.

[5] There was an exemption clause for the deficit limits in the event of a severe recession.

[6] European Fiscal Board (2019), *Assessment of EU fiscal rules with a focus on the six and two-pack legislation*, 11 September.

[7] Kiley, M. and Roberts, J. (2017), "Monetary Policy in a Low Interest Rate World", *Brookings Papers on Economic Activity*.