## Gabriel Makhlouf: Understanding your lane, managing turning points

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In the summer of 2012, with bond markets pricing in a chance of a euro breakup, Mario Draghi pledged to do "whatever it takes" to preserve the currency union. It worked: spreads fell, though the programme behind the pledge, Outright Monetary Transactions (OMT), was never used. Despite having no formal relationship with national fiscal authorities, the central bank stepped in because markets had doubts about some governments' solvency, and this threatened the monetary union's existence.

We are familiar with Sargent and Wallace's "unpleasant monetarist arithmetic," and Leeper's "active/passive" monetary/fiscal, where fiscal authorities prioritise debt sustainability and monetary authorities price stability. However, the original theory did not anticipate the euro area: one monetary policy with twenty-one fiscal policies. The missing piece is not so much coordination, as it is clear mandates, communicated well. Price stability is not negotiable, but it requires credible fiscal commitment to debt stabilisation.

"Whatever it takes" showed what happens when that fiscal commitment looks fragile. Barred by treaty, the ECB was never going to fund a deficit directly. Instead OMT was designed to make it irrational for markets to bet on a eurozone government losing access to funding. We saw fragmentation risk twice more, during the pandemic – leading to the pandemic emergency purchase programme (PEPP) – and when rates rose rapidly during 2022 – leading to the Transmission Protection Instrument (TPI). None of these instruments finance a deficit in the sense of Sargent and Wallace. They are a softer version of the problem: sovereign market disruptions reshape what the central bank must do to keep monetary policy working across the monetary union.

The EU has tackled the problem through a rules-based approach. The 2024 reform of the Stability and Growth Pact aimed to achieve credible national fiscal commitments. With Excessive Deficit Procedures in place for several Member States, the litmus test will be whether country-specific consolidation paths can be achieved.

Inevitably, the opposite version of this problem gets less attention, because it looks like good news rather than a crisis. When a Member State is running a surplus – which may or may not be built on solid foundations – it may feel relatively unconstrained in its spending plans. Such a scenario has obvious implications for price stability, particularly if the economy has little slack.

I say all of this as someone who has sat on both sides of this relationship: from 2011 to 2019 I ran the New Zealand Treasury and I now sit on the ECB's Governing Council. What looks like a coordination problem from the outside looks quite different from within each institution. New Zealand operated "consensus assignment," where monetary policy took the primary stabilisation role and fiscal policy focused on sustainability and building buffers. This was not formally coordinated. Each institution was clear about its own role,  avoided working at cross-purposes, and was independent enough not to be called upon to do the other's job. It was held together by clarity of mandate and institutional memory of what happens when that clarity breaks down.

In a speech just over 8 years ago, reflecting on lessons from the Global Financial Crisis, I wondered whether "better coordination of fiscal, monetary and financial stability policy [would] help lift the economy's performance over the cycle as well as help lift the economy's sustainable growth rate".  Eight years on, a clear answer is that coordination is not always bad. For large shocks, some alignment of fiscal and monetary policy is appropriate. I saw this from the fiscal side when the Christchurch earthquake struck in February 2011, which was followed by a large fiscal mobilisation with comparatively little monetary policy response. During the pandemic, I watched the same dynamic from the other side of the table, as both fiscal and monetary policy moved in the same direction. So, crisis-alignment can be the right call, depending on circumstances. But the lesson is that this type of coordination must not become a standing expectation of fiscal support, thereby undermining central bank credibility and its ability to meet its price stability mandate.

Credibility must be actively maintained. I am not just talking about achieving the mandate, but also clearly communicating your actions and the reasons for them. Central banks have spent three decades building public understanding of why price stability matters, through transparent frameworks, plain language, and consistent accountability. Fiscal authorities need the same discipline. The challenge is that the costs of undisciplined public finances are diffuse and delayed, while the benefits of spending are immediate and visible. Making the case for fiscal rules to the citizens who determine whether governments hold to them is itself part of what credibility means. Commitment that lacks public legitimacy will not long survive contact with a political cycle, however firmly it is written into law.

To conclude, coordination in the sense of a standing, negotiated division of roles is not credible in the euro area. For large shocks, some alignment is desirable, but grounded in each institution's mandate, not according to some moveable boundary agreed in advance. The rest of the time, the euro needs twenty-one fiscal authorities that can stick to credible commitments through good times and bad. In this way, the ECB will never have to choose between its mandate and other goals.  Of course, a centralised fiscal capacity – underpinned by a single safe asset – would help but that's another topic altogether.