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Rethinking Monetary and Fiscal Policy in the Post-COVID Euro Area

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
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Abstract

In the post-COVID environment, the ECB might face many and related trade-offs associated with the risk of being dominated by policy concerns other than price stability. Most of these risks could be reduced by a revision of the euro area governance framework, the creation of a new mechanism to provide financial assistance, and the implementation of a one-off intervention to reduce the exposure of the Eurosystem towards the euro area sovereign debts.

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LIST OF ABBREVIATIONS

APP	Asset purchase programme
ECB	European Central Bank
ESCB	European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
IMF	International Monetary Fund
NGEU	Next Generation EU
OMT	Outright monetary transactions
PEPP	Pandemic emergency purchase programme
SGP	Stability and Growth Pact
ZLB	Zero lower bound

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EXECUTIVE SUMMARY

- The pandemic and the measures against the diffusion of the virus have worsened considerably the economic and social fabric of most euro area countries. While the European Central Bank (ECB) has intervened to support financial markets with ample liquidity provisions, the fiscal authorities have implemented a massive fiscal response that will increase the outstanding sovereign debts for many years ahead.
- **These circumstances have modified the monetary-fiscal nexus in the euro area so profoundly that the ECB might face various trade-offs in the future**. In particular, monetary policy in the euro area risks being dominated by concerns that are at odds with price stability. This risk is most evident in an economic environment characterised by high outstanding debts and large fiscal deficits.
- **Three sources of such risks are prominent in the euro area: inflation, financial dominance, and tapering.** If inflation will grow, the ECB's policy reaction may be constrained by the effects of monetary tightening on national debt sustainability. Financial instability disconnected from fundamentals may trigger self-enforcing processes of flight to quality that threatens the integrity of the euro area, forcing the ECB to intervene. The reduction of the assets purchased through the asset purchase programme (APP) and pandemic emergency purchase programme (PEPP) may create problems for the highly indebted countries that need to roll over their debts, large fractions of which are held by official holders, thus implicating them into a highly politicised game concerning financial assistance and debt restructuring.
- **These risks impinge upon the functional independence of the ECB, and the transition from the phase of monetary-fiscal joint stimuli to a new equilibrium with price and debt stability.** Most of them could be reduced by a **revision of the euro area governance framework**, aimed at breaking the doom loops among sovereign governments, markets and the ECB, and at creating conditions for a careful calibration of tapering on both the monetary and the fiscal side.
- **Key to this aim will be the removal of a considerable amount of sovereign assets from the Eurosystem's balance sheet** by means of the creation of a peer supranational fiscal authority as aggregator and manager of the EU sovereign debt created for certified pandemic necessities, endowed with political legitimacy and financial capacity.

1. INTRODUCTION

In a recent interview, the President of the European Central Bank (ECB), Christine Lagarde, stressed that "*we should guard against the premature withdrawal of these support measures*" (Lagarde, 2020a), referring to the pandemic emergency purchase programme (PEPP) and to the substantial easing of the conditions under which banks can obtain liquidity under the ECB's targeted longer-term refinancing operations. Philip Lane, member of the ECB's Executive Board, further specified that "*net asset purchases will continue until at least the end of June 2021 and, in any case, until the Governing Council judges that the coronavirus crisis phase is over; reinvestment will be maintained until at least the end of 2022 and, in any case, the future roll-off of the PEPP portfolio will be managed to avoid interference with the appropriate monetary policy stance*" (Lane, 2020c).

The resurgence in infection rates that is going on in Europe since the end of summer, with the consequent effect that this is having on the continent's economies, is reinforcing the expectation that, in the euro area, the "divine coincidence"[1] between sustaining economic activity and preserving price stability that is holding in the current environment will be preserved for quite a long time. Indeed, "*Especially in an environment of low inflation and low interest rates, monetary and fiscal policies have the potential to reinforce each other. In particular, in relation to the price stability mandate, the scale of the monetary policy adjustment required to neutralise the negative pandemic shock to inflation dynamics and sustain the subsequent convergence to the inflation aim depends on the extent of the fiscal support for the economic recovery*" (Lagarde, 2020a). Such expansionary conduct has received indirect support by the International Monetary Fund (IMF) which, in its latest Fiscal Monitor report, called governments not to withdraw lifelines too rapidly and scale up public investment, thereby exploiting favourable financing conditions ensured by the central banks' liquidity provision and asset purchases (IMF, 2020b).

Probably, the expectation that Europe's new COVID flare up will soon induce the ECB to implement further measures to support the euro area economy, and possibly announce a prolongation of the extraordinary programmes underway, has played some role in steadying the reduction of interest rate spreads between high-debt countries' sovereigns in the euro area and the German bund that was triggered by the announcements of the PEPP and the Next Generation EU (NGEU) plan.

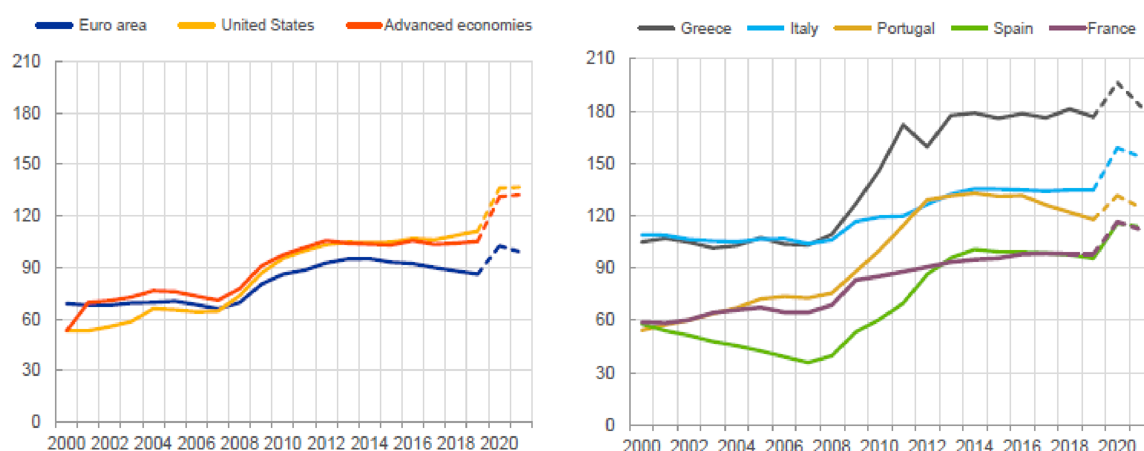
This notwithstanding, some scholars (e.g. Lengwiler and Orphanides, 2020) have argued that the ECB is too slow and prudent in adjusting its inflation target to the new environment created by COVID-19, especially after the Fed has announced last August at the Jackson Hole Symposium that it will allow inflation to overshoot its target temporarily, so as to make up for shortfalls and ensure that it averages 2% over the long term. The ECB's stance has contributed, according to its critics, to anchor medium-term inflation expectations for the euro area to an unacceptably low 1.3% and to cause an appreciation of the euro (almost 8% against the dollar in the six months following the outbreak of the pandemic in Europe at the end of February 2020, and more than 6% against the yuan in the same period), which is not justified by relative growth fundamentals (IMF's growth projections for 2020 are -8.3% for the euro area, -4.3% for the US and +1.9% for China) and does not facilitate the recovery of the euro area. Apparently, indeed, markets have not been particularly impressed by Mr Lane's remarks pointing out that the ECB intends to regain momentum to inflation dynamics, in order to accelerate the convergence towards the higher path along which expected inflation was moving before the pandemic shock (see Lane, 2020b). And also the recent statements by President Lagarde did not dissipate the impression that, in its strategy review, the ECB will not go as far as the Fed to indicate that its new target will be inflation at 2% only as a long-run average; rather, the ECB might limit itself to

[1] The introduction of this expression in this context is usually attributed to Blanchard and Galí (2007).

restate its "medium term" orientation with limited room for temporary overshooting and catching-up: "*the* ***horizon over which price stability should be achieved*** [emphasis in the text]…*is captured by the ECB's "medium term" orientation. This forward-looking orientation reflects traditional and well-established principles of prudent monetary policy, which is consistent with the notion that monetary policy works with a lag and can influence inflation over the medium term rather than the near term. But within the ECB's framework, the medium-term orientation has also been a way for the Governing Council to take into account what is happening in the real economy, including employment. We have a hierarchical mandate with price stability at the top. But the medium term, which is a flexible concept, allows us to avoid unnecessarily constricting jobs and growth in the event of a supply shock which temporarily pushes up inflation and generates an economic slump*" (Lagarde, 2020b).

ECB officials are well aware that the post-pandemic environment will be a world of possibly permanently higher levels of public debt, with the euro area public debt-to-GDP ratio that is projected by the IMF (2020a) to reach 101.1% in 2020 (from 84.0% in 2019) and then to decline to 94.3% in 2025, and with growing disparities in public debt levels across euro area countries (see Figure 1): Germany's public debt-to-GDP ratio, for instance, is projected to reach 73.3% in 2020 (from 59.5% in 2019) and to fall again to 59.5% in 2025, while Italy's public debt-to-GDP ratio is projected to climb to 161.8% in 2020 (from 134.8% in 2019) and to decline to 152.6% in 2025. Isabel Schnabel, member of the ECB's Executive Board, recently wondered whether higher government debt ratios with substantial heterogeneity across euro area countries may lead to fiscal dominance – defined as a situation in which monetary policy is conditioned by governments' financial needs – and therefore jeopardise central bank independence. A concept, Schnabel clarified, that for the ECB means its ability to pursue "*its monetary policy objectives, as defined by its mandate in the European Treaties, without being constrained by other considerations*" (Schnabel, 2020). Referring to the evidence concerning the recent past, she concludes that the surge in debt after the global financial crisis, as well as during the current COVID-19 crisis, has not deviated the ECB from pursuing price stability, so much so that "*too low rather than too high inflation remains the main predicament of our times*" (Schnabel, 2020).

Figure 1: General government gross debt (% of GDP)



Source: Schnabel (2020).

Hence, according to Ms Schnabel, the concern that high debt in some euro area countries could induce the ECB to divert from its mandate of price stability is substantially groundless. This is consistent with the conviction expressed by Blanchard (2019) and Blanchard et al. (2020) on the eve of the pandemic that, in times of very low interest rates, the space for conducting expansionary fiscal policies is wider,

while the probability of a debt crisis gets smaller, thus reducing the risk that the ECB could be subject to pressures in order to monetise the debt of the countries in trouble. However, the legacy of the pandemic, both in terms of the long and painful process of restructuring of the real economy and of the large private and public debt overhang, can make some euro area countries very vulnerable, with the possibility of severe negative spillovers for the other euro area countries and for the integrity of the euro area as a whole. In such circumstances, the ECB would face serious dilemmas as its actions (and lack thereof) would have profound consequences for the stability and integrity of the monetary union, and not simply for the future path of inflation: concerns of this kind, clearly, go well beyond what a technocratic institution is supposed to address, as they have fundamental implications on the euro area governance framework and on the very existence of the monetary union (see Bonatti et al., 2020). In our view, this calls for political decisions on the part of the euro area Member States to strengthen the resilience of the area and to shield the ECB from responsibilities that, *sic stantibus rebus*, are outside its mandate.

The remaining of the paper proceeds as follows. In section 2, we address the monetary-fiscal nexus in the euro area after the anti-pandemic measures recalled above, with an emphasis on the trade-off that the ECB might face once inflation will return to higher levels, due to the **risks of fiscal dominance** in an economic environment characterised by high outstanding debts and large fiscal deficits. section 3 is devoted to the discussion of an additional trade-off associated with a different form of dominance, that we dub "**financial dominance**" for the sake of simplicity; we argue that the ECB may be expected to intervene massively in the markets every time that endogenous self-enforcing expectations create massive portfolio rebalancing effects and "flight to safety" phenomena, in turn generating divergent developments in sovereign credit spreads not motivated by fundamentals, capable to threaten the integrity of the euro area. Subsequently, in section 4, we offer our insights on the direction in which to go for strengthening the euro area and the EU as a whole. We argue that the right time for **building a more solid safety net** to protect the euro is now, when the COVID-19 emergency helps smooth the differences in interests and visions across the various countries, which are bound to become more acute once this crisis will be over. In any case, the political compromises that are needed to build such a net are made problematic by the fact that no actor here can negotiate under the veil of ignorance. The awareness that, without a more steady foundation, the euro can be soon seriously at risk may help reaching these compromises.

2. MONETARY-FISCAL INTERACTIONS AND THE EURO AREA: A CONCEPTUAL FRAMEWORK

2.1. The surge of monetary policy dilemmas and the crisis of narrow mandates

Monetary and fiscal policy, the two main arms of macroeconomic policy, belong to the same body, the State. Nevertheless, in advanced democratic countries, they are assigned to different institutions. Fiscal policy is directly enacted by governments expressed by elected representatives of popular will, whereas monetary policy is delegated to an independent authority managed by a techno-structure. This institutional separation between the fiscal and the monetary domain that we observe nowadays is the outcome of a long history of "trials and errors", and of the advent of economic doctrines advocating the subtraction of "money", namely the preservation of its purchasing power, from the direct control of political power.[2] In this perspective, legal independence is fundamental, though *"legal central-bank independence does not confer functional independence"* (Canzoneri et al., 2002), i.e. its ability to pursue its priority mandate when due. However tight the institutional separation may be, monetary and fiscal policy remain deeply intertwined because they exert reciprocal side effects. Even conceptually, let alone down to the ground, it is hard to draw a clear-cut dividing line (or wall).

On the one hand, the central bank does need a solvent fiscal authority to achieve its objectives, as it would not manage to stir interest rates and manage liquidity, and ultimately affect price developments, could it not count on well-functioning markets, safe assets and a fiscal backup for the commercial banking system. On the other hand, fiscal policy can be jeopardised during liquidity and banking crises, as well as in the face of vicious loops of self-fulfilling expectations, could it not count on a lender of last resort for commercial banks and a market stabiliser endowed with potentially unlimited resources. Even in normal times, fiscal and monetary policy affect each other, directly and indirectly, the former having potential consequences on central bank independence, and the latter exhibiting non-negligible quasi-fiscal effects.

The euro area presents further layers of complexity. First, the euro is "money without a State". The single central monetary authority faces nineteen fiscal sovereigns, whereas these cannot issue their own fiat money – a distinctive sign of national power. Second, by statute, the ECB can only aim at aggregate euro area targets, in the first place the inflation rate of "close to but below 2% per year", but no equivalent euro area fiscal authority exists. Third, as regards business cycles stabilisation, the division of labour between central bank (common monetary policy) and Member States' governments (national fiscal policies), wants the former committed to accommodating euro area-wide "symmetric" shocks, and the latter taking care of local "asymmetric" shocks. However, as a consequence of structural differences among member countries, monetary policy inevitably suffers from the "one-size-does-not-fit-all" problem, thus becoming itself a source of asymmetric shocks. Fourth, the theory of "optimal currency areas" also prescribes that governments should enjoy as much fiscal space as necessary. By contrast, the euro area legal framework sets limits to governments' fiscal space, both in terms of yearly borrowing and of debt accumulation, in addition to exposing them to market discipline with no safety net. Thus, *de facto*, as the ECB assigns high priority to the euro area inflation target, governments are pressed to assign high priority to national debt stability (if not reduction) (Corsetti et al., 2017; Jarocinski and Mackowiak, 2017; Losada, 2020).

[2] Indeed, this idea goes back to the XIX century, or even earlier, when it was put forward by tying money supply to the reserve of gold.

This arrangement of the monetary-fiscal nexus in the euro area owes much to the economic, political, and doctrinarian climate at its conception. In the early 1990s, the western world was entering in the long wave later dubbed Great Moderation (Stock and Watson, 2002). In this perspective, where price stability and sound public finances were seen as the sole effective contributions that public (macro)policies could give to growth and employment (e.g. ECB, 1999, pp. 39-ff.; Lucas, 2003),[3] the majority of scholars was convergent to conclude that the euro area setup appeared anomalous for the good, since it seemed apt to grant ultra-protection to central bank independence and "dominance" in pursuing inflation targeting in a context of limited activism on the fiscal side (see e.g. Beetsma and Giuliodori, 2010, for the review of the relevant literature). "*The euro has been built on the principle of monetary dominance*" (Schnabel, 2020, p. 1). However, doubts and criticisms were continuously raised, with particular regard to risks of procyclical national fiscal policies, endemic inability to counteract recessions, and eventually threats to the integrity of the euro area.

When the euro was born at the turn of the century, the age of Great Moderation was fading away. The 9/11 2001 terrorist attack in New York threw the world into a recession with significant repercussions on the euro area economies, paving the way to the first open breach, and call for reform, of the Stability and Growth Pact (SGP) by France and Germany. The result was a technical complexification of the Pact with a view to depurate budgetary figures from cyclical components, and grant governments larger fiscal space in downturns. Sovereign debt levels received limited attention in the reform of the SGP (Canzoneri et al., 2002), probably because outstanding debts were taken as a legacy from the pre-euro periods that economic growth and fiscal discipline (whether induced by rules or market pressure) would have gradually reabsorbed.

However, the "climate change" was much deeper than it appeared. By the end of the decade, the Great Moderation turned into the Great Recession, the worst global crisis ever since 1929. Greece's failure to abide by the fiscal rules after admission to the euro area, and the turmoil in global financial markets, brought debt sustainability at the centre of attention. This led, amid the crisis, to another reform of the SGP to strengthen the rules regarding sovereign debt and to address macroeconomic imbalances and needed structural reforms. Yet, the results of such reforms were not entirely convincing with respect to previous criticism (European Fiscal Board, 2019; Eyraud et al., 2017; Pisani-Ferry, 2019). One decade later, COVID-19 caught the world, and the euro area in particular, still muddling through the consequences of the previous crisis, again with countries exhibiting high levels of public debts and poor growth prospects, and a background of low inflation and negative interest rates on the few financial assets considered as safe. The consensus *agenda* of policymaking – in the Latin meaning of "what has to be done" – changed profoundly, first under the pressure of events and then in their systematisation within a new conceptual framework (see e.g. Blanchard et al., 2010, among many others). The latter now seeks to accommodate the following stylised facts.

Large crises, though relatively infrequent, are possible. They do not necessarily erupt because of political misdoings, and they may be rapidly magnified by self-enforcing and self-fulfilling expectations fed, in the euro area, by the recognition of the incomplete and politically contentious framework of economic governance. In these events, conventional monetary policy (i.e. management of the money market rates) may quickly become ineffective as the policy rate falls to its zero lower bound (ZLB) with little relief for the economy. Next come "unconventional" monetary policies, an array of tools that, by and large i) increase liquidity supply to the banking sector and, indirectly or directly, to the private sector, and ii) contain the risks of overshooting in financial markets due to self-fulfilling expectations. Going further, re-activation of the fiscal arm, possibly in coordination with the monetary one, is

[3] A complementary contribution might be necessary at the "micro" or "structural" level in order to bring markets as close as possible to the free competition ideal.

contemplated, particularly because of the low interest rate environment (Christiano et al., 2011; Bonam et al., 2020; Galì, 2020; Miyamoto et al., 2018; Roulleau-Pasdeloup, 2018).

Coordination between the two arms of economic policy has two dimensions. One is due to the fact that in deep recessions, in particular when demand-driven, monetary and fiscal policy are synergic: activation of both reduces the extent of use of each. The other is that, in order to maximise synergy, the public sector is eligible as recipient of quantitative easing measures of the central bank, which in practice means monetary financing of budgetary deficits and refinancing of maturing debt at very favourable terms. Notably, the reasons that in the previous age warned against trespassing the threshold of conventional monetary policy have not been forgotten. Yet, they are now set in a broader framework and weighed against the urgency, need and benefit of restoring economic activity first.[4] As mentioned, in the end, no "pure" monetary policy can be conducted when the economy is in shutters, sovereign solvency is at jeopardy because of the size of the economic recession, and the very concerns for an inactive monetary policy exacerbate the financial turmoil.

In the aftermath of the Great Recession, major advanced countries such as the United States, the United Kingdom and Japan saw their policy authorities swiftly covering all the way from conventional monetary policy to monetary-fiscal coordination. This was not the case with the euro area, where the ECB engaged itself in some unconventional programmes only after 2012 and in quantitative easing in 2015, while the frame of national fiscal policies was tightened and tilted towards debt consolidation first. Some scholars argue that this divarication of the policy *agenda* in the euro area from the evolution undertaken in the other countries is to some extent responsible for the divarication in its macroeconomic performance too (e.g. (De Grauwe, 2015; Corsetti et al., 2017; Jarocinski and Mackowiak, 2017). "*Precisely at a time when the central bank's policy rates are expected to stay at or close to the lower bound for an extended period of time, monetary and fiscal policy* together *can have a sizeable impact on the economy. [….] Achieving and maintaining an accommodative fiscal policy stance has proved difficult in the EA, in the current institutional arrangements*" Corsetti et al., 2017, pp. 4, 7).[5] Notwithstanding such consensus, "the battle of ideas" (Brunnermeier et al., 2016) was not over, as a number of scholars raised concerns that the ECB's sovereign bond purchase programme and the creation of the European Stability Mechanism (ESM) could risk removing the incentives for national authorities to undertake the structural reforms needed to restart growth, especially in the vulnerable countries (Benassy-Quere et al., 2018; Sinn, 2018). As pointed out by Coeuré (2017), "*convergence is also a political prerequisite to engage in a discussion on any new public risk-sharing mechanisms*".

A first, more tangible, turn of the euro area monetary-fiscal policy setup towards the new consensus outlined above is now taking place under the scourge of COVID-19, with a new wave of asset purchasing programmes by the ECB (APP and PEPP), the temporary suspension of the national budgetary rules, and the creation of an entirely new, truly common fiscal arm with the NGEU (as to the relationship between the pandemic and these policy measures see Bonatti et al., 2020). These extraordinary measures aim at addressing several concerns: allowing the national fiscal authorities to finance the large current deficits necessary to stabilise the economy, while preserving debt sustainability and preventing self-defeating capital flights within the euro area; fostering structural reforms and economic growth in the medium term; ensuring the transmission of the monetary stimulus to all economic agents and jurisdictions. Clearly, in this setting, the sustainability of the

[4] An example of this balancing exercise for the euro area is provided by our previous Monetary Dialogue paper, Bonatti et al. (2020).

[5] Such a position gained consensus also because of the strong backing of several economists at the IMF (IMF, 2017; Cottarelli, 2016). Berger et al. (2018), for instance, argued that the weak credibility of the no bailout rule was due to a time-consistency problem that greater fiscal risk sharing could ameliorate, if accompanied by regulatory reforms aimed to avoid sovereign-bank spirals (Mody and Sandri, 2012; Obstfeld, 2013).

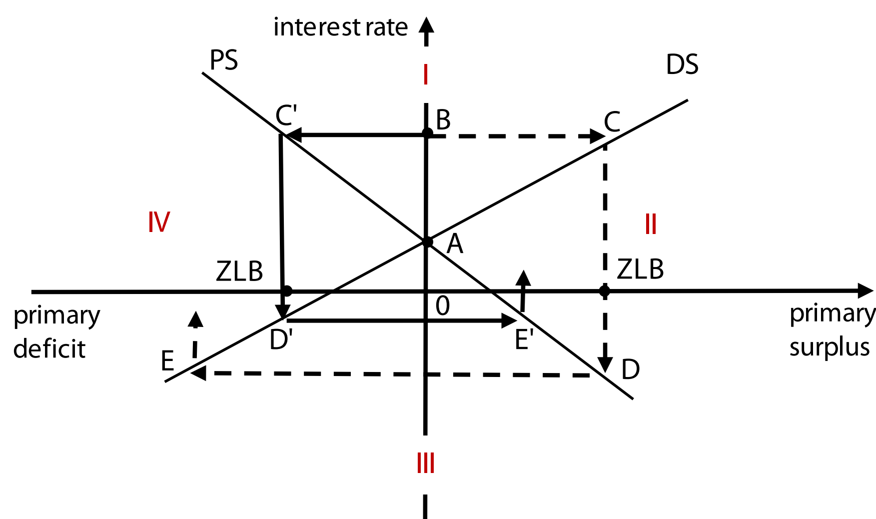
sovereign debt becomes an *ex ante* condition for effective fiscal and monetary stimuli, more than an *ex post* evaluation in an exercise of multilateral surveillance, such as the European Semester and the IMF consultations. If debt sustainability becomes a constraint for effective policymaking, it indirectly becomes, especially in bad times, one of the objectives to achieve with all the instruments and tools at hand, monetary as well, when fiscal consolidation is impossible and counter-productive (McManus et al., 2019).

Before focusing on the actual and prospective monetary-fiscal interactions in this new economic and political context, it may be useful to provide some simple conceptual tools.

2.2. A guide to monetary-fiscal interactions

As said above, the essential policy challenge of the euro area after the legacies of the crisis of the 2010s, and to a greater extent of the pandemic, can be seen in securing both **price stability** and **debt stability** (European Parliament, 2020). While little disagreement exists that both are important for welfare, problems arise when pursuing one goal is in conflict with the other, that is when the so-called **policy trade-offs** arise. In general, this is due to the fact that each policy affects both objectives creating **negative spillovers**, i.e. what is good for one objective may be bad for the other. Ignoring this fact may lead to largely suboptimal outcomes. How can these situations be addressed? What is the best solution, if any? What role has to be played by the policymakers?

Figure 2: Four scenarios of monetary-fiscal interactions around price stability (PS) and debt stability (DS)



Source: authors' elaborations on Mason and Jayadev (2018).

Note: Fiscal variables are expressed as GDP ratios. Scenarios: I) rising debt and falling inflation; II) falling debt and falling inflation; III) falling debt and rising inflation; and IV) rising debt and rising inflation.

In order to organise ideas, let us first think about the euro area as a single sovereign country, whereas its peculiarities will be addressed subsequently.[6] The central bank sets the monetary interest rate, and the government is responsible for the budget of the public sector or, more precisely, the primary budget net of interest payments on outstanding debt, which are taken as given by the government.

[6] One may think of the ECB *vis-à-vis* identical Member States aggregated in a single representative unit.

Monetary-fiscal policy interactions are reproduced diagrammatically in Figure 2, where the fiscal variables are thought of as ratios to GDP (our re-elaboration drawn on Mason and Jayadev, 2018).

According to basic macroeconomic principles, the interest rate set by the central bank ("the" interest rate for short), providing the risk-free floor on which the whole array of market interest rates is based, affects the inflation rate through its influence on interest-sensitive aggregate demand, for a given production capacity, as well as the interest payments in the public budget. At the same time, public budget imbalances affect the evolution of public debt as well as aggregate demand, and hence also the inflation rate. Consequently, a fiscal stimulus (a primary budget deficit) may boost aggregate demand above GDP potential (or the level consistent with the central bank's inflation target), so that the central bank reacts with a monetary restriction (an increase in the interest rate) to realign inflation to the target. Hence the goal of price stability entails a **negative relationship** between the two policy tools (the PS schedule in Figure 2). On the other hand, as the central bank increases the interest rate to control inflation with respect to its target, the debt service increases, too, so that the government should create a primary surplus to keep debt under control. Thus, the goal of debt stability creates a **positive relationship** between the two policy tools (the DS schedule in Figure 2). The two policy tools *may* meet at an ideal equilibrium of the economy where the primary budget is in balance and the interest rate is at the level consistent with the inflation target – or "neutral" interest rate - implying that also GDP is at its potential level (point *A* in Figure 2). What is then the best policy conduct in order to realise both objectives when the economy is out the ideal equilibrium?

There are no univocal and once-and-for-all answers to these questions. The best solution depends on i) the **nature and magnitude of the shock**, ii) the **dynamic and interactive** nature of the system, and iii) the **institutional setup** in which the policy authorities operate.

As can be seen in our diagram, the economy may lie in four scenarios when cast away from the ideal equilibrium (in clockwise order): I) *rising debt and falling inflation*, II) *falling debt and falling inflation*, III) *falling debt and rising inflation*, and IV) *rising debt and rising inflation*. The path subsequently taken by the economy depends on the institutional design of the policy authorities, their mandates and scope of action. As remarked by Claudio Borio, "*purchasing government securities is part and parcel of standard monetary policy implementation. The meaningful economic dividing line between monetary and non-monetary financing has to do with who is in control and the reasons for the actions taken*" (Borio, 2020, p.10). There are two objectives and two tools available, which is a well-known necessary condition for a solution to exist (Tinbergen, 1952), but since both tools affect both objectives, a preliminary step is the so-called **policy assignment** - or who takes care of what. In the second place, the two policymakers may interact in **independent,** or **non-coordinated**, mode, i.e. each pursues its own objective upon taking the action of the other as given. Alternatively, they may operate in **coordinated** mode, i.e. they "solve the problem" of reaching the new equilibrium together and move in tandem.[7] As we shall see, these features of the institutional design may or may not be conducive to reaching the new equilibrium, depending on specific conditions.

Now let us consider a real shock, or a real-financial compound shock, so that the economy finds itself in scenario I, with rising debt and falling inflation (point *B*), which fits well the consequences of the 2008-09 recession as well as of the current pandemic. The euro area "orthodox" policy assignment

[7] The earlier strand of literature mentioned at the beginning focused on the additional problem that may arise when the policy authorities disagree about the ideal equilibrium point. At the centre of analysis was the classic conflict between a "hawkish" central bank aiming at a low inflation equilibrium (with higher unemployment than desired by the government), and a "dovish" government aiming at a low unemployment equilibrium (with higher inflation than desired by the central bank). In consideration of this problem, as said above the consensus was sceptical, if not adverse, towards policy coordination, and in favour of "monetary dominance" as embedded into the euro area institutional design (Dixit, 2001 and Dixit and Lambertini, 2001, are paradigmatic examples).

recalled above wants a) monetary policy targeted to price stability, and fiscal policy targeted to debt stability, with b) the two authorities acting independently. This means (follow the dotted arrows in Figure 2) that the government takes the initial interest rate as given and creates the primary surplus necessary to stabilise debt (point *C*). This move, however, worsens output and deflation. To close these gaps, the central bank should cut the interest rate (point *D*). This move grants more fiscal space to the government, which may relax its primary surplus.[8]

As said above, the magnitude of the shock (the vertical shift from point *A*) is also critical. Suppose, as in Figure 2, that the shock is so large that point *D* would require a **negative interest rate**.[9] The consequence is the well-known problem of the ZLB, owing to which the central bank is unable to regain the target inflation rate, with the economy settling down in scenario II (debt is falling thanks to the lower interest rate, but inflation (with GDP) is still deviating from target). Thus, the diagram offers an intuitive explanation why the pursuit of price stability by the central bank may necessitate direct quantitative stimulus of economic activity.[10] To the extent that this stimulus flows into the government budget, the pursuit of debt stability will allow for a relaxation of the fiscal stance as explained above.

Looking at the euro area, it is suggestive to compare the path from *B* to *C* with the early post-recession phase 2010-12, with monetary policy substantially passive and the national fiscal policies engaged in debt consolidation. The path from *C* to *D* (down to the ZLB) is instead resembling the activation of the subsequent accommodative monetary policy, with quantitative easing and asset purchases after 2015. Apart from these historical analogies, the general question now is whether the "orthodox" policy assignment is conducive to restoring the economy at its desired equilibrium *A*.

Note that, at this junction, the system moves into scenario III, where inflation picks up and hence the debt/GDP ratio falls further. This phase is critical for two reasons. The first one is that the central bank should tolerate the right quantum of inflation acceleration in order to converge to the target. The second is that the government may be tempted to exploit its larger fiscal space (debt is *below* target), i.e. from primary surplus to deficit (point *E*), creating too much inflationary pressure.[11] This, in turn, would trigger a monetary restriction (up to the target on the PS schedule). Therefore, the monetary-fiscal interaction would take the form of a spiral with both debt and inflation on the rise (scenario IV). Will the economy converge to the new equilibrium (point *A*)?

Mason and Jayadev (2018) show that the answer is affirmative (provided that the ZLB is not binding) if the initial (target) debt-to-GDP stock is *below* a certain critical threshold.[12] Of course, this is an empirical matter, but the message is that the "orthodox" policy assignment seems appropriate as long as national debts are not too high. This sounds consistent with the general conception of the euro area rules. However, the shock makes national debts higher (point *B*) to begin with, and they may remain higher for a considerable time. The euro area average debt-to-GDP ratio was 65.9% in 2007 and 86% in 2019.[13]

[8] This alternate sequence of moves mimics the notion of un-coordinated policies.

[9] An even worse problem, that we do not consider here, is that the new equilibrium A has fallen below zero, which means a negative neutral rate. This is a phenomenon largely discussed in the macroeconomic literature after the Great Recession (with regard to the euro area see e.g. Lane, 2020, and Bonatti et al. 2020, sec. 5).

[10] Geometrically, the extent of the quantitative stimulus is the "missing" segment between the ZLB and point D.

[11] Notably this scenario did not materialise in the euro area, where monetary quantitative easing was followed by a relaxation of the primary fiscal stances by several governments, without, however, generalised rushes to deficits. The structural primary balance of the whole euro area remained in positive territory, from the peak at 1.6% of GDP in 2014 to 0.55% in 2019 (with only Estonia, France, Spain, Latvia and Slovakia going into deficit by more than 1% of GDP). On the price front, inflation remained steadily below its target.

[12] Convergence to point A depends on the dynamic properties of the system. Basically, whether the PS schedule is flatter (convergence) or steeper (divergence) than the DS schedule. Figure 1 exemplifies the case when PS is steeper so that the system diverges from point A.

[13] In a similar exercise, Jarociński and Kackowiak (2017) argue that a larger and quicker reabsorption of the 2008-09 shock would have required the introduction of a share of non-defaultable euro debt. The same idea is endorsed and developed by Corsetti et al. (2017).

Now let us examine the alternative assignment, the one where fiscal policy targets (output and) price stability[14] and monetary policy targets debt stability (follow the solid arrows in Figure 2 starting again at point *B*). Therefore, the government runs a primary deficit to stabilise output and prices (point *C'*). In order to keep the debt stable, the central bank responds by lowering the interest rate (point *D'*).[15] According to the Mason and Jayadev model, this path is *always* convergent (provided that the ZLB is not binding), and it is certainly appropriate when the debt is high. However, as in the previous case, Figure 2 shows that the adjustment path may be interrupted by the ZLB of the interest rate. As already explained, the missing adjustment should be engineered by means of unconventional tools. A resemblance may be seen here with the course of actions undertaken in the Great Recession by major sovereign countries in the world (though debt stocks were relatively small, except in Japan). A similarity may also be seen with the euro area today, where the anti-pandemic joint packages of NGEU + more fiscal space to governments aim at restoring the economies, and the ECB's extended purchases of assets aim at stabilising the sovereign debt market.

If this analogy is broadly correct, the conceptual framework encapsulated in the diagram of Figure 2 prompts some further considerations. Once the debt is stabilised and the economy is being sustained by the joint monetary and fiscal stimuli (point *D'*), the final transition to the new equilibrium is critical, as largely discussed in the current literature (e.g. European Parliament, 2020). The suggestion of our analysis is that the path that will be taken has an **institutional determinant**, in the sense of what task is assigned to each policy actor. If they remain in un-coordinated mode, and fiscal policy remains in charge of price stability, *to the extent that* the economy is accelerating the government(s) may be willing to engage in fiscal retrenchment (from point *D'* to *E'*). This move will add momentum to push debt below target, allowing "monetary space" for the central bank to raise the interest rate while maintaining debt on target. As in the previous assignment, the adjustment path is a (counter-clockwise) spiral around the new equilibrium, with the difference that, according to Mason and Jayadev (2018), this path is convergent to equilibrium regardless of the level of debt.

An alternative is to switch the assignment back to "orthodoxy". The central bank will therefore move first by raising the interest rate to achieve price stability (from *D'* to *C'*), debt will be destabilised, and government(s) will be forced to consolidate (from *C'* to *C*). Luk and Vines (2015) show that, when debt is high, this fiscal restriction is a necessary component on the way towards equilibrium, but, as already said, if debt is high, this (clockwise) path may not lead to equilibrium at all (as exemplified in Figure 2).

Finally, a third institutional option is the **coordination mode**, where the unwinding of the monetary and fiscal stimuli proceeds in tandem along the "knife edge" path of debt stability conditions up to the achievement of price stability too (see also Codogno and Corsetti, 2020).[16] Essential is that timing and pace of adjustment be tuned carefully so that debt does remain stable and economic activity is not cooled down too much, too early. With independent fiscal sovereigns and no central fiscal authority, with possibly asymmetric macroeconomic positions across countries, the coordinated transition to the new equilibrium would also require coordination of national fiscal policies.[17] In this perspective, the (re)activation of the balanced-budget rule may help coordination. Yet, more ambitious forms of coordination may turn out to be desirable, like the repeated quest for a central fiscal "visible hand" capable of directing national fiscal policies towards a **common fiscal stance** of the euro area as a whole

[14] Governments are typically portrayed as being more concerned with economic activity than with price stability, but we are in a scenario in which the variables move in tandem and there is no conflict between the two objectives.

[15] This move may include, and generally it does, monetary financing of the budget deficit.

[16] The "knife edge" path is exemplified in Figure 2 by the movement from point *D'* along the DS schedule up to point *A*.

[17] For instance, Saraceno and Tamborini (2019) treat this point in a two-country model of monetary union with quantitative easing by the central bank. See also Landmann (2020).

vis-à-vis the ECB's monetary stance (Draghi 2014a, 2014b; Boone and Buti, 2019), if not a full-fledged "Economic and Finance Minister" endowed with own resources and powers (see e.g. Asatryan et al., 2018, for a recent discussion of the issue).

Of course, our diagram is too simple a guide to the choice of the right solution, and many important empirical "details" ought to be considered. Nevertheless, it may be argued that the establishment of a new framework for monetary-fiscal policy coordination in the euro area may be desirable as a complement to the innovative anti-pandemic measures under way, being aware that the **political economy of the euro area** is not conducive to policy coordination, and it has proved resistant to modifications in the course of the crisis of 2010s.

The foregoing reasoning does not entail that, even in a context of improved coordination between fiscal and monetary authorities, any degree of greater fiscal activism can be supported. Barthelemy et al. (2019), for instance, show that, in the face of a large negative fiscal shock, and a large demand for safe assets, the central bank’s ability not to be dominated by the fiscal authority while this latter “relaxes” its intertemporal budget constraint ultimately depends on the private demand for the central bank's liabilities (i.e. currency and reserves). Government debt, in other words, can be expanded thanks to the support of an accommodative monetary policy without triggering serious problems of fiscal dominance to the extent that the private demand for public liquidity is sufficiently high and stable. The credibility of the overall system of economic governance, thus, remains of fundamental importance and the independence of the central bank remains an essential ingredient of any successful coordination effort. Again, the current framework of coordination in the multicountry euro area, whereby different viewpoints among the Members States hinder the adoption of clear-cut common decisions, does not seem to contribute in this direction. As we shall argue again in section 4, fixing the euro area’s institutional framework may thus strengthen the independence and the credibility of the ECB, paradoxically exactly when it coordinates with the fiscal authorities and deliberately supports their activism.

3. SOVEREIGN RISK PREMIA, FINANCIAL STABILITY, AND MONETARY-FISCAL POLICY COORDINATION

The discussion in section 2 deliberately neglects two important aspects: one characterises any economy and one only the euro area. The first aspect to consider is the possibility that the actual interest rates differ from the risk-free policy rates that the monetary authorities manipulate to contribute to economic stabilisation. Private investors may demand **large and volatile credit premia** to finance and refinance the sovereign, thereby creating a wedge between the policy and the market interest rates. This aspect broadens that spectrum of monetary policy "secondary" concerns and trade-offs from public debt stability to financial stability at large.[18] Second, specific to the euro area is the existence of **large differentials in such premia across the Member States.** These latter reflect the differences in the outstanding level and structure of public debts, the current borrowing needs of each country, the expected rates of GDP growth in the future, the health conditions of the domestic banking sector, the features of macroeconomic imbalances, the risk appetite of the international investors, and the perceived political ability of the authorities to carry out stabilisation and consolidation policies, respectively, in bad and in good times. It is worth noticing that while central banks can exploit their independence to commit to their future conduct, governments lack such commitment over future policies: investors may be sceptical that, after raising new debt, they will not eventually decide to default (Cole and Kehoe, 2000).

Panic in financial markets may thus lead the sovereign yields to stray from what would be consistent with the fundamentals (Bocola and Dovis, 2019). In the first case, it is possible to end up in a bad equilibrium, whereby the very expectations of insolvency create the premises for an unsustainable situation. In such circumstances, debt consolidation is incompatible with socially acceptable conditions, whereas countercyclical expansionary fiscal policies cannot be undertaken due to the refinancing problems.[19]

Although distinguishing self-fulfilling debt crises from fundamental-driven debt dynamics is difficult, common wisdom is that unless all evidence points to debt unsustainability, the central bank (as well as international institutions, such as the IMF, and individual foreign countries) may help the sovereign to overcome liquidity crises and paroxysmal market reactions. However, the central bank cannot be the ultimate unconditional guarantor of the national fiscal authorities: in such a case, it would be entirely dominated and would lose both independence and credibility. This implies a sort of special form of coordination among the authorities, whereby the central bank provides only conditional and temporary liquidity support in the secondary markets when and if non-fundamental related crises emerge.

While the discussion in section 2 shows that, under certain conditions, there exists a case for an explicit and transparent form of fiscal and monetary coordination with a view to dampening the fluctuations of prices and output around the optimal targets, further considerations in this section reveal that debt sustainability concerns and investors' expectations may further exacerbate the trade-off between credible pursuit of price stability when due, and preservation of financial market conditions that are consistent with the fundamentals, conducive to a smooth functioning of the economy, and enabling the effective transmission of the economic policy stimuli. This has not much to do with the fiscal and

[18] This is indeed a long standing issue dating back, to say the least, to the 1990s when "narrow" objective functions of central banks became recommended. The early consensus against financial stability as a target (e.g. Bernanke and Gertler, 2001) was substantially impaired in the run-up of global financial imbalances leading to the 2007-08 collapse: Borio and Lowe (2002); White (2006)

[19] Lorenzoni and Werning (2013), Tamborini (2015) and Ayres et al. (2018) show how multiple equilibria can arise when a change in investors' beliefs may increase borrowing costs for the government and move the economy on a path of debt accumulation that raises the risk of a default, thus validating the initial change in beliefs.

monetary coordination directed to stabilisation goals that we outlined in section 2, but it represents an additional venue of the multifaceted monetary-fiscal nexus. In sum, if *financial* stability becomes *de facto* an additional secondary objective of central banks and the sovereign debt represents the main source of uncertainty and risks in the financial markets, the life of central banks and fiscal authorities can become very complicated in several respects.

A further issue to notice is associated with central banks' sovereign bond purchasing programmes to control the yield curve in times of financial distress, and it has to do with the **long-term consequences of the stocks of sovereign assets** acquired during the programme. First, there exists a level of stocks beyond which the financial implications of a domestic sovereign default may wipe out the capital of the central bank, which would paradoxically need a capital injection from the very fiscal authorities the bank is trying to support.[20] Second, central banks appear to struggle, when they try to unwind previous quantitative easing programmes (i.e., the so-called tapering) once the economic and financial conditions improve, because financial markets react in a disorderly manner to the announcements of such policy switches. Central banks' temporary purchase programmes may, to a certain extent, lock them in also in the future. It follows that the independence of a central bank from the domestic fiscal authorities could then be *de facto* reduced by the reluctance of the investors to reabsorb risky sovereign debt, and this would be more likely the larger the share and the level of sovereign debt held by the central bank. The ability of the central bank to preserve its independence in the long term, thus, depends on its ability to avoid being locked-in by, on the one hand, the investors' unwillingness to take on sovereign risks and, on the other, the unabated need of support by the government. An equilibrium that may set the limit of where the monetary-fiscal policy nexus can feasibly go. Such a situation would be particularly difficult if the economy, once the crisis will be over, will be characterised by low growth and high inflation. As suggested by Charles Goodhart (2020): "*Only when indebtedness has been restored to viable levels can an assault on inflation be mounted*".

What is important to notice for our purposes, at this point, is that all these considerations are particularly controversial in a currency union among sovereign states that lacks a common fiscal authority. On the one hand, the ECB should act as the central bank of a sovereign state for the reasons explained in section 2 and for the reasons above, but on the other hand, it holds an allegiance with more than one country: unless the interests of each Member State are perfectly aligned with those of the others, the ECB has to reach consensus through negotiations. Let us consider the case of a non-fundamental-related increase in sovereign yields. The monetary and fiscal authorities in the monetary union have to decide, both at the technical and political level, whether the turmoil is due to some wrongdoings by certain fiscal authorities, who will ultimately bear the possible costs of temporary financial assistance, and what is the probability that the provision of liquidity and temporary support may undermine, rather than increase, the sustainability of the assisted countries' sovereign debt. Evaluations and negotiations require time and may raise serious political controversies, whose ultimate impact, even in the rosiest scenario, bears heavily on the effectiveness and the adequacy of the measures. In the heart of the European debt crisis, a massive sell-off of peripheral bonds risked jeopardising the integrity of the euro area until the then President of the ECB, Mario Draghi, addressed the market with the famous "whatever it takes" commitment. This has happened again with the diffusion of COVID-19, but the ECB's engagement was not enough: this time both the fiscal authorities and the ECB had to make simultaneous commitments to support the economies of the euro area, and

[20] Since central banks do not have liabilities except fiat money that they can issue freely, the relevance of capital losses for central banks is a matter of debate. See e.g. De Grauwe and Ji (2013); Sinn (2018).

in particular those considered as most vulnerable to the virus and to possible excesses in financial markets (see Bonatti et al. 2020).

Ultimately, this represents the very reason why, in the past, European governments decided to externalise the provision of financial assistance to sovereign states to the European Stability Mechanism (ESM), imposing *ex post* conditionality, and running a debt sustainability exercise before deciding upon conceding loans to a sovereign. Yet, the current COVID-19 crisis has shown that, as the ultimate motives of disagreement among the Member States have not been solved, the ESM has been so far redundant and the burden of intervention has shifted again on the ECB. A burden that, as we shall discuss in section 4, can be alleviated only by a fundamental reform of the framework for financial assistance in the euro area; until then, the ECB will likely face trade-offs connected with this sort of "financial dominance".

4. BUTTRESSING THE EUROPEAN UNION AND ITS MONETARY INSTITUTIONS

4.1. Tapering shocks, political risks and monetary policy

By June 2021, the Eurosystem is projected to own assets close to 40% of the euro area GDP as a result of purchases made under the PEPP and its other asset purchase programmes. Although – as seen above with regard to the PEPP – "*reinvestment will be maintained until at least the end of 2022*", one cannot rule out that, in the future, the monetary policy stance judged appropriate by the ECB will require not only the reduction of its net purchase of assets but even the reduction of the size of the Eurosystem balance sheet. As shown in section 2, the transition from the (successful) phase of monetary-fiscal joint stimuli to a new equilibrium with price and debt stability, and ordinary policy conditions, will require a careful calibration of "tapering" on both sides. Otherwise, this "**tapering shock**" might destabilise the high-debt countries. In section 3, we have pointed out a number of euro area-specific features that may dramatize this trade-off thus *de facto* restricting the ECB's policy options.

In order to have a wider view of the conditions within which the ECB will operate, and devise appropriate interventions to buttress the euro area and its monetary institutions, we now wish to draw attention to two important **political-economic facets**, already emerged in the EU during the last decade. What we are going to consider projects the post-pandemic challenges beyond the competences and boundaries of the ECB, and even of the euro area, to reach out to the EU itself.

The first consideration, a consequence of the growing fraction of government debts that is held by official holder, is that any future financial market tensions, due to concerns about Member States' debt sustainability, is going to have, more than in the past, immediate **repercussions on the relationships among governments and EU institutions**. Conversely, political developments and events (e.g. elections) across EU countries will have a greater impact on market assessments of government securities. Moreover, as noticed by Bulow and Rogoff (2015), "*because private creditors care strictly about getting their money and official creditors have broader goals, countries are better off when official creditors hold their debts*". Geo-political factors, for instance, can condition negotiations among official entities and governments to restructure the sovereign debts of countries in troubles, or to obtain new loans and grants to their benefits, generally providing them with additional levers for achieving better terms, as recently happened with the approval of the NGEU (see Bonatti and Fracasso, 2020). Selective (partial) default may become an issue, with the possible attempts by debtor countries to extract debt relief concessions in one form or another from EU institutions and creditor countries, without undermining their access to private capital markets. Under these circumstances, it is difficult to think that the ECB, as the holder – directly or indirectly through national central banks – of a substantial chunk of the euro area countries' debt, will not be involved in this intrinsically political game.

The second facet to be considered is the growing influence in many EU countries of the so-called **sovereigntists/euro-sceptics (or populists)**. In the so-called euro area core countries, sovereigntists tendentially oppose any risk sharing and intercountry transfers in favour of the so-called peripheral countries, and symmetrically their counterparts operating in the latter ask – when they are not openly in favour of leaving the euro area – for complete risk mutualisation and unconditional ECB support for their country's debt, while pretending to keep full national sovereignty over fiscal policy. What unites core countries' sovereigntists and their peripheral counterparts is their common hostility towards the EU establishment. In the period preceding the COVID-19 pandemic, tensions associated with the growing sovereigntist influence has been at the origin of many episodes in which sovereign bond yield spreads widened in the euro area, especially in the case of the spikes in Italy's sovereign spreads, which

were closely linked to the confrontational attitude displayed by Italian populists towards EU institutions and major EU Member States.[21] As a matter of fact, in that period neither financial shocks nor shocks to economic fundamentals have been the main drivers of the volatility of high-debt countries' sovereign yields in the EU, but rather the doubts concerning the willingness of these countries' political elites to preserve public debt sustainability, and thus remain in the euro, in a context of anaemic growth.

In the environment described above, the government of a very high-debt country whose economy is hit by a recessionary shock, or simply tends to stagnate, may prefer to redirect resources toward spending or to cut taxes rather than repaying debt held by official entities or foreign investors. A lower debt level could make this outcome less likely (thus reinforcing the argument in favour of a substantial reduction of the national debts by transferring them to the ESM). This conclusion is consistent with the recent literature on sovereign default.[22] Such literature accounts for the fact that, in a monetary union, the costs incurred by a country to exit the union are extremely high and larger than the costs associated with a default on its debt, thus making partial default without leaving the monetary union more realistic. Furthermore, it shows that, if the collateral costs (due to contagion and other negative spillovers) that a country's default inflicts on its partners are large enough, it is rational for the latter to bail out the former. It follows in this case that any strict no bail-out rule ends up being time-inconsistent, and therefore it is not credible. Finally, to avert the default, fiscal transfers in favour of the high-debt country on the part of its partners are more efficient than debt monetisation on the part of the Union's central bank because of the distortionary cost associated with higher inflation. However, in the euro area it is envisaged that the ECB can buy the bonds of a country in trouble through the outright monetary transactions (OMT) programme, avoiding any inflation cost by sterilising these purchases through the sales of some other assets.

Although, according to the literature mentioned above, it is rational for countries that incur serious losses in case of default of their EU partners to make fiscal transfers in favour of them in order to avoid their default, it is far from sure that this solution would be politically viable in case of need once the COVID-19 emergency will be over. The insistence whereby political leaders of Germany and the so-called "Frugal Four" stressed the temporary and exceptional nature of the NGEU seems to rule out this possibility. At the same time, the political and social climate of the most vulnerable EMU countries – Italy in particular – raises doubts about the acceptance by these countries of the typical mix of fiscal consolidation and structural reforms that would be required to get financial assistance under the OMT programme. In this post-pandemic scenario, the ECB would be forced to make politically sensitive choices, in the presence of opposite pressures such as those pushing for a quick return to a strict adherence to the capital key in the purchases of sovereign assets, on the one hand, and those calling the ECB to act unconditionally as lender of last resort in favour of the countries in trouble, on the other hand. Hence, the ECB would implicitly assume political responsibilities that are not appropriate for a technocratic institution, and its credibility and independence would be questioned.

Making this scenario less likely and the euro area less fragile entails not only the reduction of government debt that will be discussed below, but also the rapid completion of the Banking Union, with the creation of a European deposit insurance and the final approval of the ESM reform, whose elements were agreed in principle by the Eurogroup in December 2019. In particular, completion of the Banking Union is urgent to prevent the possible repetition of the "doom loop" between sovereign risk and bank risk that took place in the euro area periphery in 2011-12.

[21] The contribution of redenomination risk in the determination of Italy's sovereign spreads is quantified by Gros (2018) and Minenna (2019).

[22] See Aguiar et al. (2015); de Ferra and Romei (2018); Bianchi and Mondragon (2018); Bianchi et al. (2019); Gourinchas et al. (2020).

However, it is exactly the large holdings of domestic government bonds by the southern European banks that raises the perplexities of the euro area core countries towards the completion of the Banking Union, revealing in particular their strong doubts about the will of the Italian political class to pursue a responsible fiscal policy and avoid a debt crisis that would have immediate consequences for its domestic banks. Actually, southern European populists seem to validate these fears, for instance by their aggressive opposition to the ESM reform, in particular to the extent that in the event of a crisis it facilitates an orderly restructuring of the debt in the hands of the private sector.[23] In fact, this opposition signals to the market, as well as to other countries, that, if in power, they will not give priority to debt sustainability, since – in case of crisis – they will seek to offload a substantial part of its costs on the taxpayers of the rest of Europe, while safeguarding domestic private holders of national debt.

Therefore, it is necessary to create the conditions for a courageous political compromise among the countries of the euro area, overcoming their mutual mistrust and proceeding quickly on the path of a concomitant risk reduction and risk sharing, so as to create a solid safety net to protect the EU, the integrity of the euro area, and of its central bank.

4.2. Breaking the doom loops between sovereigns, markets and the ECB

Some proposals have been put forward that aim at the goal indicated above. They share two key ideas that, taking stock of the innovation represented by the financial engineering of the NGEU programme, differentiate them from the past unfruitful debate about the mutualisation of *existing* sovereign debts. The first idea is that the preservation of a sound ECB requires a **peer supranational fiscal authority** (see also section 2.2 above). For the purposes at stake here, the new institution's mandate is to manage sovereign debt(s), endowed with political legitimacy and financial capacity. The second idea is that the sovereign debt eligible to be entrusted to this authority is not the whole of past sovereign debts, marked by past national responsibilities, but the debts newly created for the certified pandemic necessities, such as the debt purchased by the Eurosystem under the PEPP.[24]

Before the pandemic, Corsetti et al. (2017, pp. 10-ff.) envisaged, as a means to enhance the joint monetary-fiscal stabilisation capacity of the euro area, the creation of "**undefaultable bonds**" issued directly by the ESM or a similar institution, in addition to being ready to purchase sovereign debts making them undefaultable too.[25] Key to this instrument is the principle of conditional eligibility, mentioned above, according to which the activation of the mechanism in either form would be the result of a collective green light of Member States.

At the outbreak of the pandemic, drawing on the war finance analogy, Giavazzi and Tabellini (2020) have advocated the issuance of **irredeemable bonds**, either by single sovereigns or by some EU institution (see also Boitani and Tamborini, 2020). In their original idea, these "consols" should be backed by the ECB thus enjoying very low interest rate and the status of (almost) risk-free asset.

[23] The reform of the ESM has been quite controversial in Italy, even among economists that are not close to the populist parties (see Galli, 2020). Their main objection makes reference to the violent market reactions that followed the so-called "Deauville walk", namely the agreement between Chancellor Merkel and President Sarkozy according to which, in the future, sovereign bailouts from the ESM would require that losses be imposed on private creditors. However, market reactions were violent because market participants were surprised by that announcement, since before it the equal treatment of all euro area sovereigns envisaged by the ECB collateral rules and the prudential provisions for banks and asset management companies had convinced them of the safe status of all sovereigns. This will not be the case when the ESM reform will be implemented: the possibility of losses in case of default of a bond will be priced by the markets from the instant of its issuance. Moreover, there is no mechanism of automatic debt restructuring for the countries that ask for financial assistance from the ESM.

[24] One reason that underpins the eligibility of this newly created debt to be considered a "collective liability" is that granting each country a fiscal "whatever it takes" to fight the pandemic and sustain the economy generates positive spillovers for all (while too strict fiscal constraints would do the opposite).

[25] "*By 'non-defaultable' we mean that the fund and the ECB would ensure that maturing Eurobonds would be convertible into currency at par, analogously to maturing reserve deposits at the ECB*" (Corsetti et al., 2017, p.10).

According to Micossi (2020), however, the ECB could gain more degrees of freedom in the conduct of its monetary policy by gradually selling some of its stock of sovereign bonds to the ESM, in accordance with each country's capital key and without any transfer of default risk, which would continue to fall on national central banks. The ESM could go on buying these sovereigns up to 20% of the euro area's GDP. By rolling over the securities purchased from the Eurosystem "*rather than seeking reimbursement from the issuers, the ESM would make them equivalent to irredeemable bonds*" (Micossi, 2020). In its turn, the ESM could finance these purchases by issuing its own securities in capital markets. Together with the bonds that the EU is going to issue to finance NGEU and the other EU programmes, these ESM securities could be the risk-free instruments comparable to US government securities that Europe would strongly need to underpin a fully integrated capital market.

Micossi, like Corsetti et al. (2017), does not motivate his proposal as a way to relieve the ECB from the constraint represented by the need to roll over the government assets of the high-debt countries, but rather as a way to protect the latter from the consequences of a financial shock. Indeed, as recalled in section 3, when a country's public debt exceeds a certain threshold, there may exist multiple fiscal equilibria, one being a "bad" equilibrium that materialises if investors are convinced that there is a significant probability that the government will default on its debt. A financial shock may push the economy towards the bad equilibrium, thus spreading contagion to other Member States and exerting pressure on the ECB to bail out the countries in trouble.

One may also think that this substantial transformation of government securities into ESM irredeemable-undefaultable bonds, for an amount that is close to what the member governments have to spend for tackling the COVID-19 emergency, should not arouse the political opposition of those who are usually concerned with the moral hazard implications of debt mutualisation.

While these are certainly not the only available solutions, they have the merit of making it clear the relationship between the risks of financial, not only fiscal, dominance for the ECB and the necessity to develop a new governance framework capable of dealing with the legacy of the two decades of profound economic crises. As similar reforms to this framework would be anyway necessary to create a credible and resilient European Banking Union, there exists a window of opportunity to strengthen the euro area banking and financial systems, while restoring greater independence of the ECB from market instability.

5. CONCLUSION

The pandemic and the measures against the diffusion of the virus have worsened considerably the economic and social fabric of most euro area countries. While the ECB has intervened to support financial markets with ample liquidity provisions, the Member States have implemented a massive fiscal response that will increase the outstanding sovereign debts for many years ahead.

These circumstances have modified the monetary-fiscal nexus in the euro area so profoundly that the ECB might face various trade-offs in the future. In particular, monetary policy in the euro area risks being dominated by concerns that are at odds with price stability. This is most evident in an economic environment characterised by high outstanding debts and large fiscal deficits. We have shown that three sources of such risks are prominent in the euro area: **inflation, financial dominance, and tapering**.

If inflation will grow, the ECB's policy reaction may be constrained by the effects of monetary tightening on national debts sustainability. A different, though connected, trade-off unique to the euro area is associated with what we have called "financial dominance". Indeed, the expectation that some Member States choose to default on their debts and/or exit the EMU (the two scenarios might not be equivalent) can create massive portfolio rebalancing and "flight to safety" phenomena within the euro area. When such expectations are not motivated by fundamentals and trigger a self-enforcing process that threatens the integrity of the euro area, the ECB must intervene. At some point of normalisation, the monetary policy stance judged appropriate by the ECB will require the reduction of the assets purchased through the APP and PEPP programmes. This tapering can create problems for the highly indebted countries that need to roll over their government debts. Moreover, in a post-COVID environment where a large fraction of government debts will be held by official holders (the Eurosystem and other EU institutions), the threat of selective partial defaults could be used by the highly indebted countries to extract concessions from EU institutions and partner countries, thus implicating the ECB into a highly politicised game concerning financial assistance and debt restructuring.

These risks impinge upon the functional independence of the ECB, and the transition from the phase of monetary-fiscal joint stimuli to a new equilibrium with price and debt stability, and ordinary policy conditions. Most of them could be reduced by a **revision of the euro area governance framework**, aimed at breaking the doom loops among sovereign governments, markets and the ECB, and at creating conditions for careful calibration of tapering on both the monetary and fiscal side. Key to this aim will be the removal of a considerable amount of sovereign assets from the Eurosystem's balance sheet by means of the creation of a **peer supranational fiscal authority** as aggregator and manager of the EU sovereign debt created for certified pandemic necessities, endowed with political legitimacy and financial capacity.

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In the post-COVID environment, the ECB might face many and related trade-offs associated with the risk of being dominated by policy concerns other than price stability. Most of these risks could be reduced by a revision of the euro area governance framework, the creation of a new mechanism to provide financial assistance, and the implementation of a one-off intervention to reduce the exposure of the Eurosystem towards the euro area sovereign debts.

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