Monetary and Fiscal Interactions

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Right time to discuss policy mix

- Policy mix in EZ is key issue in face of simultaneous negative supply shock and uncertainty shock
- Challenges with new war situation but resonate with more structural issues already present before COVID and before Ukraine
  - Lack of coordination between monetary and fiscal policies
  - Debt sustainability and fiscal rules

Persistent inflation and uncertainty shock

- COVID shock on supply chains is not over (see China)
- Energy transition will accelerate and add price pressures
- War in Ukraine with potential full embargo next step ?
- Huge uncertainty on size and nature of the war shock: simultaneous supply but also confidence and demand shock

Policy Response in reaction to shocks:

- First mover: ECB with acceleration of monetary normalization/tightening
- Fiscal side response ? Not clear at this point:
  - What fiscal reaction of national governments ?
  - What fiscal reaction at EU level ?
- Gradual monetary normalization if coordinated with fiscal absorption of shocks makes sense with high inflation and risk of de-anchoring of expectations

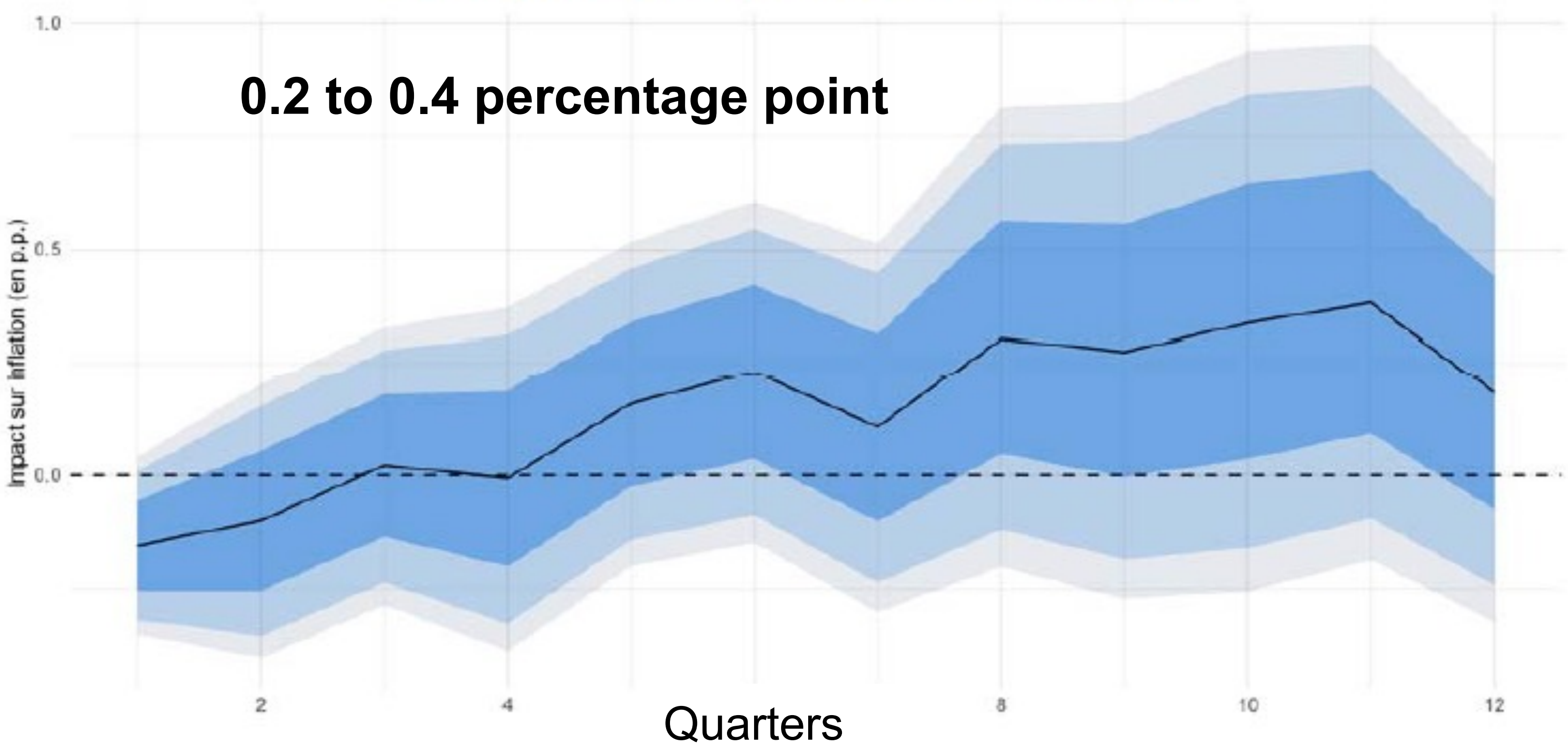
Absence of policy coordination in EZ

- Structural issue: strict disconnect of fiscal and monetary policies has not passed the test of time
- Implicit coordination during COVID : ECB intervenes and lowers cost of borrowing for governments to absorb shock
- Need for more explicit coordination (see Bartsch et al. 2020)
- Independence of ECB must not be infringed (no binding commitments by the ECB)
- Soft coordination arrangements: dedicated board or European Semester process

Fiscal policy: targeted fiscal transfers

- Excess saving during COVID in France (CEA, based on 300 000 Bank accounts): aggregate is large 6-7% of GDP
  - continues to increase for top decile households
  - reduced modestly for median households
  - entirely spent for bottom decile
- High income households can use accumulated saving
- Low income households require targeted transfers : in France lump sum transfers and price freeze too wide, too expensive and too inefficient
- Do transfers to households generate inflation ?
- Moderate impact of tax cuts on households: see Renault, Savatier, 2021 (CEE) extended narrative data on Germany by Hayo and Uhl (2014)

Figure 1. Effect of an exogenous tax cut of 1 GDP point on inflation over a 12-quarter horizon in Germany



Renault, Savatier, 2021 (CAE) based on German data by Hayo and Uhl (2014).

Fiscal policy: targeted fiscal transfers

- More controversial : Potential targeted rebates on energy bills for low income households + households with energy intensive equipment
- Financed by exceptional tax on energy groups profits ?
- Targeted price rebates may have an impact on inflation and inflation expectations
- Is there a tradeoff between efficiency losses (triangles) and macro-economic externalities ?

Fiscal policy: large public investments to come

- Military
- Energy, renewables, resilience…: pressure to accelerate ⇒ supply side
- How to manage well and finance these investments ?
- Structural issue of fiscal framework needs reform in this new "high investment" phase: See Maduro et al. (2021) and Martin et al. (2021)

Fiscal rules:

Martin, Pisani-Ferry and Ragot (2021)

- Country specific assessment of debt sustainability to define a country-specific 5-year debt target
- Country-specific debt sustainability depends on:
  - sustainable primary surplus
  - $r - g$ difference: nominal interest rates, growth rates and inflation
  - take into account time profile of climate investments (avoid creating incentives to postpone climate investments) + supply investment + reforms (pensions)

Financial fragmentation risk

- Risk of financial fragmentation through self-fulfilling debt crises
- Difficult to differentiate between a 1) spreads crisis due to redenomination risk + multiple equilibria and 2) spreads crisis due to fundamentals
- ECB should only intervene in 1) and not 2)
- Fiscal monetary channel (see Martin and Philippon, 2017) : High cost of borrowing (increased spreads) because of too tight monetary policy in 2010-12 pushed towards fiscal austerity
- Lessons learnt from past ECB mistakes