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The European Central Bank as the Only Game in Town: How Could Fiscal Policy Makers Play Along?

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Abstract

The Maastricht Treaty clearly separated the domains of the single monetary policy and the national fiscal policies. This article examines what national fiscal policy-makers could do together to more actively support the ECB in maintaining price stability for the eurozone when the monetary policy rate reaches the effective lower bound, while keeping their sovereignty. The appropriate euro area fiscal stance is constrained by the need for member countries to find a balance between their budgetary contribution to macroeconomic stabilisation and requirements for achieving and maintaining fiscal sustainability. Euro area countries could nevertheless strengthen fiscal and structural policy coordination in the Eurogroup and establish a central fiscal capacity subject to common decision-making with the objective to provide for a growth-friendly economic policy mix for the euro area.

Die Europäische Zentralbank als einziges Spiel in der Stadt: Wie könnten die Fiskalpolitiker mitspielen?

Zusammenfassung

Der Maastrichter Vertrag hat die Aufgabenbereiche der einzelne Geldpolitik und der nationalen Fiskalpolitik deutlich abgegrenzt. Dieser Aufsatz untersucht, wie die nationalen Fiskalpolitiker zusammen die EZB bei der Aufrechterhaltung der Preisstabilität für die Eurozone aktiver unterstützen könnten wenn der geldpolitische Zins die effektive Untergrenze erreicht, unter Beibehaltung ihrer Souveränität. Eine angemessene Finanzpolitische Ausrichtung auf Euro-Ebene wird dadurch eingeschränkt, dass die Mitgliedstaaten ein Gleichgewicht finden müssen zwischen ihren budgetären Beitrag zur makroökonomischen Stabilisierung und Anforderungen zur Erreichung und Aufrechterhaltung ihrer Schuldentragfähigkeit. Die Euro-Länder könnten dennoch ihre Fiskal und Struk-

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turmaßnahmen in der Eurogruppe enger abstimmen und einen Zentralen Budgetkapazität aufbauen über deren Anwendung sie gemeinsam entscheiden mit dem Ziel einen wachstumsfreundliche wirtschaftspolitischen Mix für die Eurozone zu unterstützen.

Keywords: new central banking, active fiscal policy, euro area policy mix

JEL Classification: E5, E63, H63, H7

I. Introduction

The past decade has seen the emergence in many advanced economies of a new style of central banking – similar to that of Japan – to escape from a secular stagnation characterised by a very low equilibrium or neutral real interest rate. As monetary policy rates reached the effective lower bound, close to zero or just below, the major central banks applied unconventional tools such as quantitative easing in order to provide the additional monetary stimulus necessary to achieve their price stability objective while calling upon fiscal policy-makers to add their weight in fighting the prolonged recession.

During the sustained low inflation episode of 2014–17 the ECB similarly faced a limit on lowering its key interest rates and added a large balance sheet expansion with the aim to further relax credit conditions and bring euro area inflation durably back in line with price stability. These non-standard monetary easing measures drew criticism for the adverse side-effects of ultra-low interest rates, such as creating incentives for excessive risk-taking (*van Riet* 2017c). Arguably, a budgetary expansion at the euro area level could in these circumstances relieve the burden on the ECB to restore macroeconomic equilibrium and help to maintain financial stability.

However, the Maastricht Treaty conceived of the ECB as the ‘only game in town’ for actively stabilising the euro area economy (*Praet* 2017). A euro area treasury that could add discretionary fiscal support when the monetary policy rate stands at the effective lower bound is missing, reflecting the ECB’s ‘institutional loneliness’ at the supranational level (*Padoa-Schioppa* 2000; *Draghi* 2014). The Stability and Growth Pact focuses on maintaining sound and sustainable national public finances and the need for fiscal austerity in many member countries complicated the ECB’s fight against low inflation. The Economic and Monetary Union (EMU) therefore needed more effective macroeconomic stabilisation tools, especially to address a secular stagnation resulting from a prolonged demand deficiency and persistent supply-side weaknesses.

The academic literature has long argued in favour of a fiscal counterpart to the ECB. This article on the euro area macroeconomic policy mix argues that the particular challenges arising for the single monetary policy when the scope for lowering key interest rates is exhausted strengthen the case for further budgetary integration. Also without a euro area treasury, the 19 national governments could act together as the 'joint sovereign' behind the euro (*Hoeksma/Schoenmaker* 2011; *van Riet* 2016) and align their aggregate fiscal policy orientation with the ECB's monetary policy stance to play a more active role in managing the business cycle, especially when the euro area economy is depressed. As 'subsidiary governments' facing continuous market scrutiny of their creditworthiness, they could deploy a conventional fiscal stimulus only when their debt sustainability is secured and it does not derail their own economy. But they could also implement so-called unconventional fiscal policies through budget-neutral tax and subsidy measures that directly help to ease domestic credit conditions when ECB interest rate policy is constrained. Other than that, euro area countries could improve the quality of public finances, speed up balance sheet repair in the private sector and strengthen supply-side conditions as a precondition for the effectiveness of euro area macroeconomic stabilisation measures. Achieving the objective of a growth-friendly economic policy mix among sovereign nation states requires stronger coordination in the Eurogroup and would be easier to accomplish if it was supported by a central fiscal capacity subject to common decision-making.

This article is organised as follows. Section 2 reviews the new era of central banking and the related call for a more active fiscal policy to alleviate the burden on monetary policy. Section 3 summarises the ECB's monetary policy during 2014–17. Sections 4 and 5 discuss the constraints on national fiscal policies and how governments could join forces to assist the ECB with a growth-supportive economic policy mix for the euro area. Section 6 concludes.

II. The Changing Relationship Between Monetary and Fiscal Policies

Nominal and real interest rates in the advanced economies have steadily declined over the past few decades. *Summers* (2014) argues that the downward trend in inflation-adjusted interest rates represents a decreasing equilibrium or neutral real interest rate (which some authors refer to as the natural real rate), reflecting a prolonged disturbance in the balance between desired savings and planned investments. The corresponding shortfall in aggregate demand was due to persistent factors driving secular stagnation, such as the demographic transition and declining productivity growth. *Del Negro* et al. (2017) note that US treasury bonds are increasingly valued for their safety and liquidity and identify the rising premium that investors are willing to pay for these special attributes (the convenience yield) as another key driver of the downward trend in the natural real interest rate on sovereign bonds.

Estimates suggest that in recent years the natural real interest rate has fallen to a level close to zero, or even below in the case of the euro area (*Holston* et al. 2017). Conventional monetary policy in this situation is constrained in its ability to set the real interest rate below this benchmark. As a result, the post-crisis shortfall in aggregate demand remains unresolved and output growth is lower than necessary to achieve full employment. To escape from this 'secular stagnation trap', central banks gave forward guidance on their policy rates and actively expanded their balance sheets in order to reduce longer-term interest rates, create positive wealth effects and relax financing conditions as usual. Their deep dive in the monetary policy toolbox, employing a variety of conventional and unconventional monetary instruments, marked a 'new era of central banking' (*Santor/Suchanek* 2016). The new style of monetary policy appeared successful in reviving the economy, albeit with decreasing returns to scale and growing risks for financial stability the longer it was pursued. Another danger was that the large distributional consequences could undermine the acceptance of central bank independence (*de Haan/Eijffinger* 2016).

As regards fiscal policy, the pre-crisis view was that business cycle fluctuations could be addressed most efficiently and effectively by monetary policy, implemented by an independent central bank, leaving the government budget a countercyclical role as automatic shock-absorber (*Taylor* 2000). Discretionary fiscal policies attempting to fine tune the economy were hard to implement in a timely, targeted and temporary manner (ECB 2008). According to the Ricardian view, an increase in public debt to stimulate aggregate demand would be ineffective when private agents increased their savings in anticipation of the higher taxes that would be necessary to service the higher debt. This risk was most pronounced for countries with overstretched public finances. Governments should instead use their budget to strengthen the supply side of the economy.

Faced with a demand-driven secular stagnation the old view of fiscal policy gave way to a new view, in which governments are expected to return to a more active role (*Furman* 2016; *Ubide* 2016). To reduce the burden on monetary policy at the effective lower bound several central banks called upon their own government to provide a fiscal stimulus in support of aggregate demand and private debt deleveraging. A conventional budgetary expansion could in this case benefit from larger multiplier effects because the implied increase in expected inflation at near-zero nominal interest rates reduces the real interest rate, which promotes private spending and 'fills the output gap' (*Woodford* 2011). Since many households and firms were liquidity-constrained, this fiscal expansion would hardly be offset by additional private savings. The extra supply of safe sovereign bonds would moreover lead to a higher market-clearing interest rate and/or a lower convenience yield, both of which had the effect of increasing the neutral real interest rate that constrained conventional monetary policy (*Kocherlakota* 2015).

Governments could furthermore deploy unconventional fiscal policies in a quasi-monetary way (*Correia* 2016). Carefully designed tax measures could push up consumer price inflation and lower real market interest rates while credit subsidies could narrow the spread between bank lending and deposit rates and relax financing conditions. Even when budget-neutral, these fiscal actions could generate a significant macroeconomic impulse equivalent to a monetary accommodation and were easy to reverse again in a cyclical upturn.

III. The Special Case of EMU

The case of EMU is much more complicated. The construction of the eurozone as a monetary union without a fiscal union makes the ECB by definition the only game in town for macroeconomic stabilisation at the supranational level (*Praet* 2017). Governments are required to coordinate their national economic policies as a matter of common concern, meaning that they must ensure sound and sustainable public finances and competitive market-based open economies, which taken together also supports price stability and a stable euro (*van Riet* 2016). When member countries maintained a healthy budgetary position they could let automatic fiscal stabilisers absorb national shocks and further rely on favourable spill-over effects from their eurozone partners.

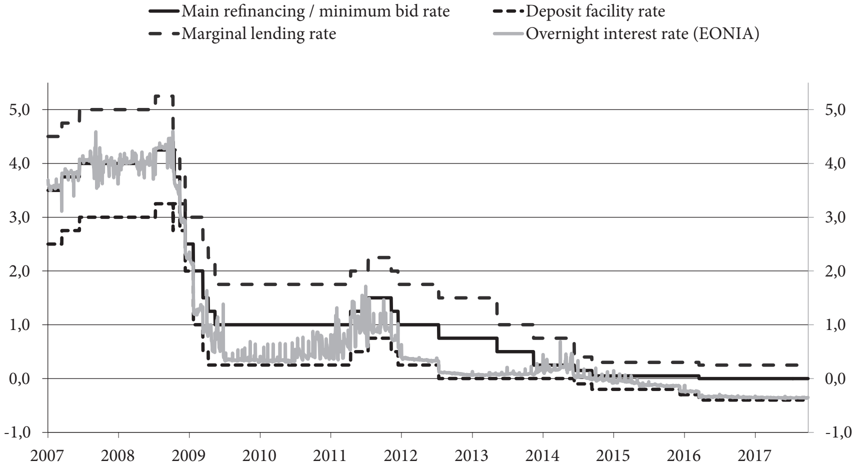
This lack of attention for the euro area macroeconomic policy mix was criticised early on in the academic literature. *Lamfalussy* (1989) concluded already in the Delors Report that fiscal policy coordination was vital and EMU needed to make the transition to a union-wide fiscal policy. Only having the single monetary policy as a tool for macroeconomic stabilisation in the face of common shocks was in his view 'an unappealing prospect'. *Sims* (1999) believed that when a euro area deflation pushed the interest rate towards zero a continued adherence to the Maastricht fiscal rules stood in the way of organising an adequate fiscal expansion. According to *Buiter* (2004), when the short-term interest rate touched zero, the ECB had to engage in generalised open-market purchases which required cooperation with the national fiscal authorities. Since these were all subject to particular constraints and preferences, reaching agreement on an appropriate response was a 'logistic challenge'. *De Grauwe* (2016) consistently argued that an incomplete EMU was fragile and resolving this vulnerability required budgetary integration embedded in a political union.

The EU and national authorities judged the strict separation between the monetary and fiscal policy domains as appropriate in a time when there were upside inflation risks and high government debt raised fears that the ECB might be forced to deviate from its primary objective of price stability in order to support fiscal sustainability. However, the EMU macroeconomic policy framework, as laid down in the Maastricht Treaty, was not designed for the recent episode of economic stagnation characterised by deflationary pressures and very low interest rates. Since there was no euro area treasury with its own fiscal capacity, the

ECB missed a sovereign counterpart which could have assisted in reviving the euro area economy, thereby shortening the period of ultra-low interest rates and mitigating unintended side-effects. Although in the early-2000s the ECB examined the possibility that the short-term interest rate might reach the zero lower bound, with price stability defined as a medium-term rate of inflation below but close to 2% the probability of this scenario was assessed to be low (*Coenen* 2003). The EU and national authorities in any case dismissed the potential relevance of the zero lower bound as a valid argument for advancing budgetary integration.

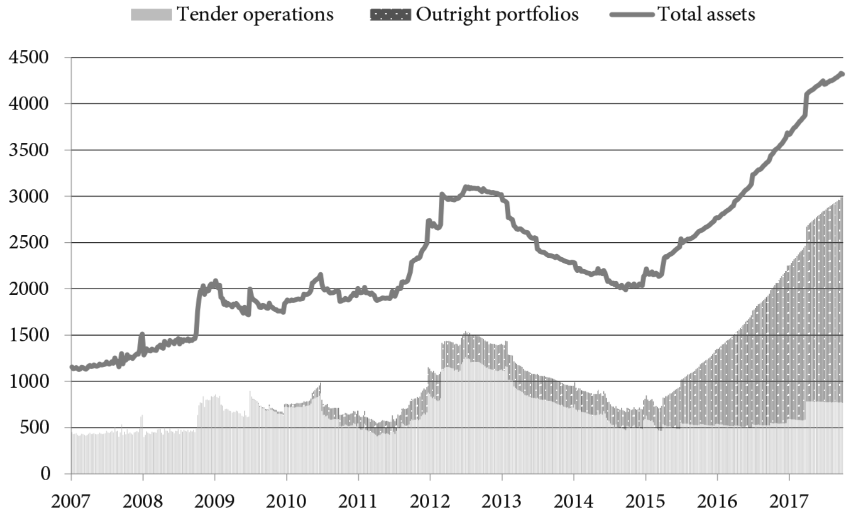
IV. A New Era of Central Banking for the ECB

Since the introduction of the euro in 1999, the ECB had conducted monetary policy mainly by adjusting its three policy interest rates (Figure 1) and using regular credit operations to provide short-term liquidity against adequate collateral to the euro area banking sector. Through this standard operational framework it directly steered the overnight interest rate, which was instrumental in influencing the yield curve and asset prices. The appropriate monetary stance was determined by the medium-term outlook for price stability as derived from cross-checking economic and monetary developments according to its two-pillar monetary policy strategy. The euro area governments on their part were (only) expected to contribute with stability-oriented national economic policies.



Source: ECB, Thomson Reuters. Latest ECB key interest rates: MLR = 0.25%; MRO = 0.0%; DFR = –0.4%.

Figure 1: ECB Key Interest Rates and the Euro Overnight Interest Rate (January 2007 to September 2017, Percentages per Annum)



Source: ECB. Tender operations include lending to euro area credit institutions in euro against eligible collateral. Outright portfolios include public and private sector securities bought directly in the market for monetary policy purposes.

Figure 2: Assets on the Eurosystem Balance Sheet
(January 2007 to September 2017, € Billions)

The 2008 global financial crisis raised serious questions about the appropriate response and the traditional division of labour between the single monetary policy and national fiscal policies in EMU. The strategic interactions could turn into a 'game of chicken' between the fiscal authorities trying to force the central bank into a range of quasi-fiscal actions and the monetary authority wishing to pursue price stability but also caring for financial stability (*Buiter* 2010).

The ECB entered a new era for monetary policymaking in which it had to dig much deeper into its monetary policy toolkit – just as other major central banks – to provide sufficient monetary accommodation while contributing to financial stability (*van Riet* 2017b). The standard approach of lowering the policy rates was combined with various non-standard interventions to provide ample reserves to a liquidity-constrained banking system and revive dysfunctional securities markets where monetary transmission was impaired. The mix of monetary measures with traditional and uncommon features in response to crisis conditions changed the composition and increased the size of the Eurosystem's balance sheet (Figure 2).

Meanwhile, EU countries with budgetary room for manoeuvre took fiscal stimulus measures as part of the European Economic Recovery Plan that was launched in November 2008 (*van Riet* 2010, editor). This coordinated action re-

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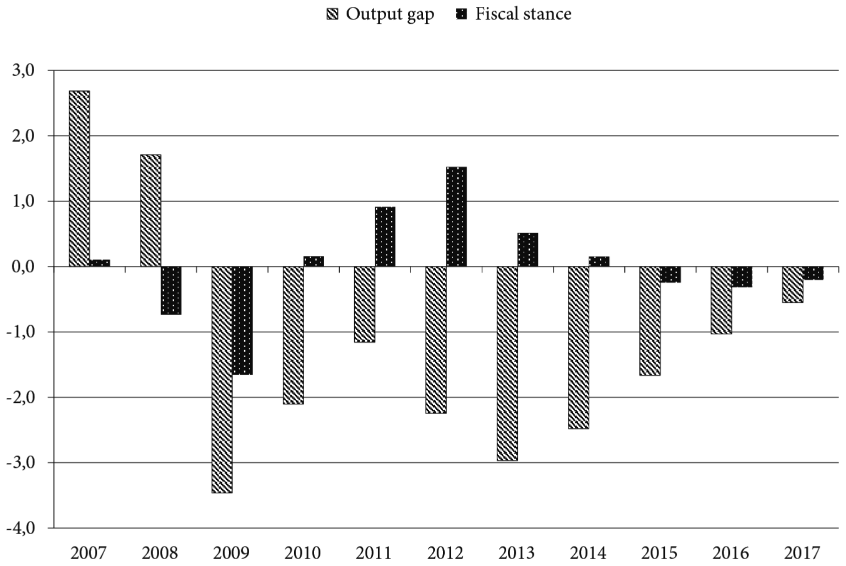
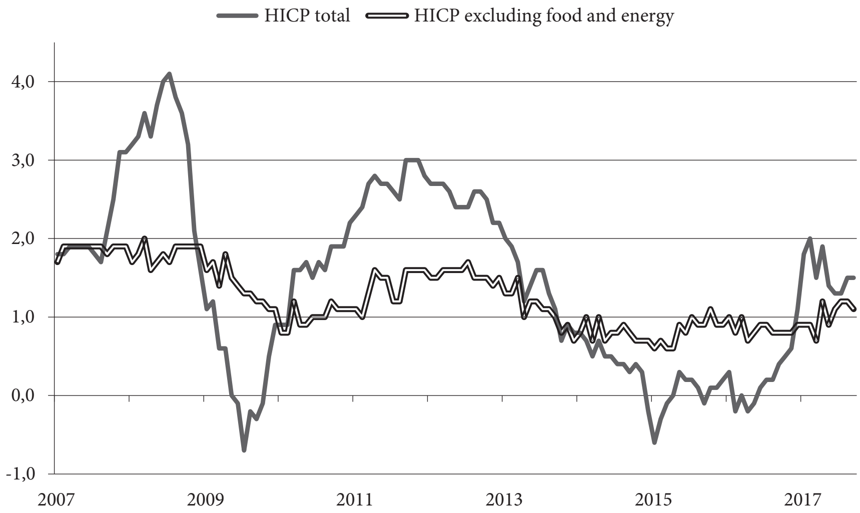


Source: European Commission Economic Forecasts, Spring 2014 and Winter 2017.

Figure 3: The Euro Area Fiscal Stance and the Output Gap (2007 to 2017, Percentage Points and Percent of Potential GDP Respectively)

sulted in an expansionary euro area fiscal stance during 2008–10, supporting the ECB in fighting a deep euro area recession (Figure 3).[1] When the sovereign debt crisis broke out, in early 2010, many euro area countries changed to fiscal consolidation in order to maintain or restore public debt sustainability while some governments also initiated structural reforms to revive economic dynamism. The crisis-hit countries had to comply with their EU/IMF adjustment programmes and the others needed to observe the EU economic governance rules. This policy response was vital to strengthen market confidence in their status as a trustworthy debtor. Hence, the euro area fiscal stance turned contractionary in 2011–13, contributing to the broad-based weakness of the euro area economy in a period when the private sector was also engaged in a protracted debt deleveraging.

[1] The fiscal stance is defined as the change in the structural primary balance, which shows the impact of discretionary fiscal measures on the budget balance corrected for the business cycle, interest payments and non-permanent measures but is also affected by non-policy factors. The concept of fiscal space stands for a country's budgetary capacity to undertake a demand stimulus subject to the constraint of preserving fiscal soundness (ECB 2017).



Sources: Eurostat, ECB calculations. HICP = Harmonised Index of Consumer Prices.

Figure 4: Consumer Price Inflation in the Euro Area (January 2007 to September 2017, Annual Percentage Changes)

The ECB's interventions during these years were successful in stabilising financial markets and containing inflation. However, a steady fall in consumer price inflation in 2013 to well below the upper benchmark of 2.0 % put the objective of price stability at risk (Figure 4). Starting in July 2013, when there was little room left for further cutting the policy rates, the ECB gave forward guidance on the expected monetary stance. From June 2014 to December 2016 the ECB took a series of mutually supportive non-standard monetary stimulus measures to restore price stability on a sustained basis (*van Riet* 2017c). A negative deposit facility rate was combined with targeted longer-term credit operations and large-scale public and private sector asset purchases which were reinvested as they matured. Taken together, this comprehensive package steadily expanded the size of the Eurosystem's balance sheet (Figure 2) and was effective in lowering borrowing costs and relaxing credit conditions.

Considering the contribution of national fiscal policies, the euro area fiscal stance became almost neutral in 2014 and turned marginally expansionary in 2015–16 (Figure 3). Without explicit coordination, however, the country composition was suboptimal; some governments contributed less to euro area business cycle stabilisation than was feasible, whereas others lacked the fiscal space and still postponed necessary austerity measures.

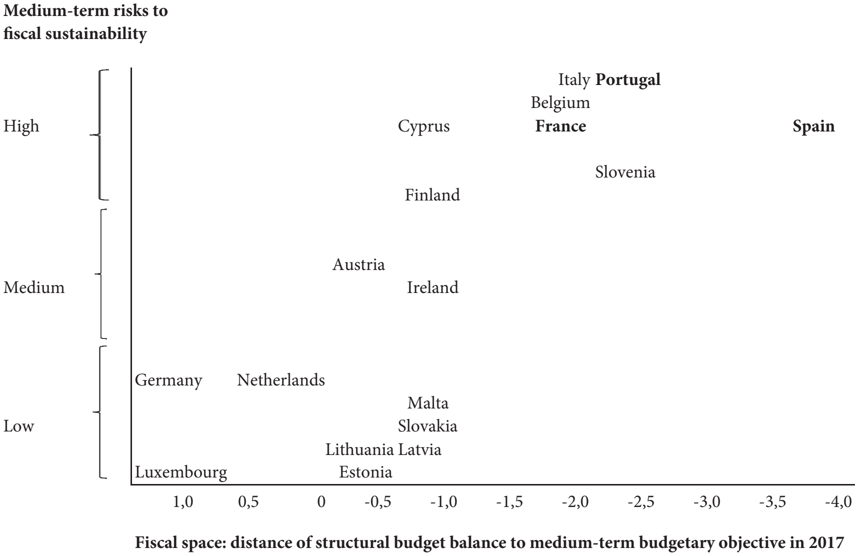
After falling well below zero in early 2015, headline inflation picked up again, moving to the range 1.3–2.0 % in the first nine months of 2017 (Figure 4), accompanied by a broadening economic recovery and solid job creation. Underlying inflation, measured as the headline rate excluding food and energy prices, stayed around 1.0 %, which justified a continuation of the ECB's non-standard monetary accommodation.

Looking back, the low inflation environment turned out to be persistent. The backdrop of a low neutral real interest rate and constraints imposed by the effective lower bound on its key interest rates compelled the ECB to take exceptional monetary policy measures, also because the euro area fiscal stance offered little if any counter-cyclical support. The challenge facing the ECB during this episode was to provide sufficient monetary accommodation while seeking to monitor, manage and, where possible, to minimise potential negative side-effects of record-low interest rates (*Draghi* 2015). The question is whether and how national governments could more effectively enter the game in these circumstances and together realise an aggregate economic policy mix that is consistent with the orientation of monetary policy.

V. The Game Played by National Fiscal Policy Makers

The EU fiscal surveillance framework as laid down in the Stability and Growth Pact (SGP) is asymmetric in its implications for discretionary fiscal policies. Countries that have achieved their medium-term budgetary objective could only be expected to make a voluntary contribution to a joint fiscal stimulus and will be careful to avoid an overheating of their own economy. By contrast, the SGP requires governments with fiscal consolidation needs to restore sound and sustainable public finances, albeit with some flexibility in the pace of adjustment. A temporary deviation from their fiscal adjustment path is only possible in case of a severe economic downturn for the euro area as a whole, provided that this delay does not endanger fiscal sustainability in the medium term. Accordingly, the appropriate euro area fiscal stance is constrained by the need for governments to find a balance between national fiscal contributions to short-term macroeconomic stabilisation and SGP requirements for achieving and preserving medium-term fiscal sustainability (*Bańkowski/Ferdinandusse* 2017).

For 2017, the draft budgetary plans of the member countries implied a broadly neutral euro area fiscal stance (Figure 3). To complement the monetary accommodation of the ECB and reduce the still negative euro area output gap, the European Commission (2016) called in November 2016 for a 'positive' euro area fiscal stance, both in terms of a fiscal stimulus to support the fragile recovery and high-quality public budgets that could help to resolve supply-side deficiencies. The Commission proposed a collective fiscal expansion of 0.5 % of euro



Source: ECB (2017), based on the European Commission's Debt Sustainability Monitor 2016 and Economic Forecast Winter 2017. Countries in bold were subject to the Excessive Deficit Procedure in early 2017, the chart excludes Greece.

Figure 5: Fiscal Space Versus Risks to Fiscal Sustainability (Fiscal Space in % of GDP)

area GDP in 2017. The national fiscal contributions would have to be differentiated across countries according their budgetary position and take account of favourable spill-over effects. Germany, the Netherlands and Luxembourg had fiscal space in combination with low risks to fiscal sustainability and could arrange a budgetary expansion in the common interest. Other euro area countries, however, were subject to the Excessive Deficit Procedure of the SGP and/or faced high or medium risks to their fiscal sustainability (Figure 5). The Eurogroup (2016) of finance ministers – recalling its earlier view that a broadly neutral aggregate fiscal stance was broadly appropriate for 2017 – underlined that the member countries are in very different situations. The euro area fiscal stance should therefore 'strike an appropriate balance' between the need to support investment to strengthen the fragile recovery and the need to continue consolidation to ensure fiscal sustainability.

During the European Semester of spring 2017 the newly established European Fiscal Board (2017) gave its first assessment of the prospective fiscal stance for the euro area to inform the national preparation of draft budgetary plans for 2018. As the output gap was projected to close, a neutral euro area fiscal stance appeared appropriate in its view. The question was how to implement it at the national level: relatively favourable cyclical conditions in some countries with fiscal space did not warrant a fiscal expansion, while those countries where the economy could benefit from it had to meet their SGP requirements. This 'formidable dilemma' highlighted the tensions between the national and euro area macroeconomic perspectives in an EU fiscal governance framework that targets sustainable national public finances and pays little regard to area-wide business cycle needs.

The apparent risk is that countries will try to resolve this dilemma by pursuing sub-optimal fiscal policies. The fiscal over-achievers could feel obliged to increase public spending at any rate, without making a proper cost-benefit analysis. Countries in need of fiscal adjustment might decide to stretch the flexibility of the SGP and prioritise near-term output growth. Lacking adequate fiscal buffers, they could then (again) be forced to change abruptly into austerity mode when interest rates rise or in the next recession. Overall, the experience of 2017 suggests that the availability of a central fiscal capacity could have been more conducive to achieving aggregate macroeconomic stabilisation goals while preserving national budgetary discipline.

VI. Limits and Opportunities for National Fiscal Policies

The priority that most euro area countries must give to public debt reduction over a fiscal expansion in the common interest can be understood from three perspectives.

First, the 'subsidiary governments' of the eurozone are unable to issue debt in a currency under their own monetary control. Without an effective monetary backstop with fiscal backing, their status as safe borrowers is in principle fragile and vulnerable to negative shocks that cause a shift in market perceptions (*Corsetti/Dedola* 2013; *De Grauwe* 2016; *van Riet* 2017a). Moreover, contagion by vulnerable member countries remains an ever-present danger. The permanent market scrutiny of a sovereign's creditworthiness makes its semi-safe debt less suitable as a fiscal stabilisation tool.

Most euro area countries face a post-crisis debt overhang and because investors may (again) suddenly decide to shift their holdings to safer destinations abroad, their governments have to prioritise public debt reduction over a fiscal stimulus so as to reclaim the status of their bonds as a relatively safe asset. When successful, investors will be willing again to accept a lower convenience yield on their government bond holdings and thereby lift the equilibrium real interest rate and offer more scope for adjusting the monetary policy rate.

By contrast, a fiscal expansion financed with semi-safe debt securities may trigger concerns among citizens about the extra future tax burden and weaken the expected macroeconomic benefits. Furthermore, a need for credit institutions to fund a higher public sector deficit could crowd out the supply of loans to the private sector, in particular in the case of undercapitalised banks with limited financial resources, which would further reduce the favourable fiscal multiplier effects (*van der Kwaak/van Wijnbergen* 2017). Still, when more households and firms are credit- and/or liquidity-constrained, the fiscal stimulus will likely translate into higher private spending instead of being saved. The market-clearing interest rate will in any case have to rise in order to absorb a larger supply of semi-safe government bonds with investors also demanding a higher convenience yield on safe government bonds in view of their greater relative scarcity.[2] Alternatively, this interest cost may be avoided with a front-loaded fiscal consolidation to achieve a faster stabilisation of the government debt-to-GDP ratio, which appears feasible even when the fiscal multiplier is rather large (*Warmedinger* et al. 2015).

Moreover, the country-specific credit risks associated with political upheavals, high public debt and bank failures caution against (further) increasing the exposure of banks, pension funds, and insurance companies to a semi-safe sovereign. The sovereign-bank feedback loops that turned vicious during the euro area crisis have yet to be fully broken. This negative interaction could emerge again in turbulent times and undermine financial stability. Although the steps taken towards a European Banking Union mitigate this concern, in some countries the need to deal with unviable non-systemic banks still has significant fiscal implications.

Second, the ECB's monetary policy of record-low interest rates has translated into significant budgetary advantages (*van Riet* 2017c). The successful monetary efforts to prevent deflation avoided an undue rise in the real value of public debt. Furthermore, the lower interest payments on public debt and the higher nominal GDP growth rates saved budget outlays and raised tax revenues. The Eurosystem now also holds a substantial amount of public sector bonds. Most of the interest paid on these securities will return to governments as dividend, after subtracting the (negative) interest costs on the enlarged central bank reserve accounts of the banking sector.

At some point, the ECB will reverse its monetary expansion and withdraw from the capital markets, bringing the episode of cheap funding for semi-safe sovereigns to a close. Governments are therefore well-advised to use the exceptional benefits from very low interest rates for more rapidly reducing their budget deficits and the fiscal space from central bank remittances for building up rainy day funds. Although few countries actually heeded this advice, realis-

[2] Note that the Eurosystem's public sector bond purchases extract credit, liquidity and duration risk from the capital market and in return inject risk-free overnight central bank liquidity into the economy. This increase in the net supply of safe and liquid assets lowers the convenience yield on scarce government bonds of high quality and stimulates investors to take on more risk. Both effects reduce government bond yields.

ing a stronger fiscal position could ease the trade-off between macroeconomic stabilisation and fiscal sustainability in the next recession.

Third, some of the caveats associated with a fiscal policy of promoting aggregate demand also apply at the effective lower bound. Doubts remain whether the state of the economy can be identified with sufficient certainty in real time and a discretionary fiscal stimulus will meet the success criteria, i.e. can be modulated to reach the economy at the right point in time, targeted at a productive allocation of resources, and restricted to be temporary. When these success criteria are not met, fiscal activism (whether at national or euro area level) could in practice turn out to be harmful (*Kamps* et al. 2017).

Governments could instead also relieve the burden on the ECB by together adopting unconventional fiscal policies that mimic a monetary easing with benefits accruing to all member countries (*Correia* 2016). For example, increasing consumption taxes – counteracted by lower labour and capital taxes to stabilise demand – would trigger consumer price inflation and could temporarily lower the inflation-adjusted interest rate when the effective lower bound for the monetary policy rate is binding. Countries could also introduce tax-financed credit subsidies to lower bank borrowing costs. Or they may offer state guarantees to facilitate public-private financing of investment projects where it is clear that benefits exceed the costs. When member countries properly coordinate these budget-neutral fiscal measures and comply with EU state aid restrictions, they could engineer a quasi-monetary expansion for the euro area as a whole and/or target it more specifically at credit-constrained borrowers, and reverse this course when the economic recovery has taken hold.[3]

Separately, they could focus on increasing public investment and tax efficiency to enhance the quality of public finances and free up fiscal space, harmonise the enforcement of financial contracts in bankruptcy law to deepen financial integration and improve access to credit, and remove regulatory barriers in product and labour markets to strengthen the supply-side of the economy and promote job creation. These broad-based structural reforms are vital for each country to reverse the declining trend of productivity growth, raise the longer-term return on capital and thereby increase the equilibrium real interest rate. This would offer more room for standard ECB interest rate cuts above the effective lower bound, enhance the monetary transmission mechanism and improve the overall efficacy of monetary policy (*van Riet* 2006).

Finally, sovereign nation states participating in the euro have a common responsibility for the proper functioning of the eurozone. To fully enjoy the ben-

[3] The effectiveness of shifting the composition of taxes and subsidies for stabilising the business cycle is open to debate. Lessons may be drawn in this respect from using fiscal instruments as macro-prudential tools for managing the financial cycle.

efits from EMU membership they will need both to share the risks from common shocks and to reduce the risks of national derailment. For a long time EMU participation consisted of countries adhering to the EU economic governance framework for risk reduction at the national level and relying on the single market, the single currency and the single monetary policy for risk sharing at the euro area level (*Schelkle* 2017). The challenge ahead is to establish complementary economic risk-sharing institutions that both promote coherent national policies where this is in the common interest and allow more freedom in other fields (*Pisany-Ferry* 2015).

Acting as the 'joint sovereign', euro area leaders could charge the President of the Eurogroup with the task to act as euro area finance minister and coordinate the fiscal and structural policies of the member countries as well as their compliance with the EU economic governance framework. The political constraints in pairing euro area macroeconomic stabilisation goals with national economic policy requirements could be partly overcome with a central fiscal capacity subject to common decision-making on its deployment. Following up on the views expressed in the Five Presidents' Report (*Juncker* 2015), the European Commission (2017) presented three fiscal options for cushioning an economic downturn: a European investment protection scheme that enables the continuation of national public investments, a European unemployment reinsurance scheme that relieves the burden from rising unemployment on national budgets, and a rainy day fund which makes disbursements in case of a large adverse shock. A euro area budget for cyclical stabilisation purposes was regarded as a goal for the longer term.

While the modalities of these and other options are still under debate, stronger coordination combined with a central fiscal capacity could make the aggregate economic policy mix more consistent with the monetary policy stance, as freely determined by the ECB. Work by *Hetting/Müller* (2017) on currency unions indicates that national policy-makers coordinating on a positive common fiscal stance when monetary policy is constrained by the effective lower bound are able to stabilise area-wide output and inflation and avoid adverse consequences for their own economy. Moreover, the favourable cross-border spillover effects on economic activity are higher (*Boussard/Campagne* 2017).

VII. Concluding Remarks

From 2014 to 2017 the ECB needed to design a monetary stimulus that was strong enough to prevent a too prolonged period of low inflation taking hold. This resulted in a combination of standard and non-standard monetary policy interventions and forward guidance on the intended monetary stance. The exceptional monetary accommodation generated a broad-based economic recovery and underpinned a return to medium-term price stability. The ECB as the only game in town at the eurozone level could have benefited from national fiscal policy-makers playing along through stronger coordinated action within the Eurogroup. Euro area countries needed to be cautious towards participating in a joint fiscal stimulus before their own legacy of high public debt was resolved. Acting as the 'joint sovereign' behind the euro, national governments nevertheless have various options to support the ECB – in particular in an economic stagnation with persistent low inflation and very low interest rates – and thereby reduce the need for monetary policy to advance in unknown territory.

First, each government could contribute to an aggregate fiscal expansion according to its fiscal space under the condition that public finances are sustainable and national economic stability is preserved. Second, countries could in any case target budget-neutral tax and subsidy measures at an easing of financing conditions. Third, governments could speed up balance sheet repair in the private sector to support financial stability and enhance the transmission of monetary and fiscal stimulus measures. Fourth, member countries could make public sector budgets more growth-friendly and undertake structural reforms with the aim to raise potential growth, thereby helping to increase the equilibrium interest rate that functions as a benchmark for monetary policy. Finally, they could establish a central fiscal capacity subject to common decision-making within the Eurogroup. This complementary tool for euro area macroeconomic stabilisation could be employed in particular when the ECB's standard monetary policy actions are constrained by the effective lower bound on interest rates.

The result of a euro area economic policy mix consistent with the single monetary policy could fill the gap between desired savings and planned investments, promote a sustainable higher growth path, a faster return of low inflation to price stability and limit the need for an extended period of record-low interest rates. When the economy is firmly back on track, coordinated action could reverse the earlier stimulus measures and ease the challenge of the ECB's exit from unconventional monetary policy. The necessary modest steps of budgetary integration while preserving national sovereignty could pave the way for a euro area treasury which would resolve the institutional loneliness of the Eurosystem.

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