Deepening of EMU: how to improve macroeconomic stabilisation using fiscal policy at the euro area level?

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The Blackrock Proposal

1. Helicopter Money not in its purest form, nor in the form of QE, but…

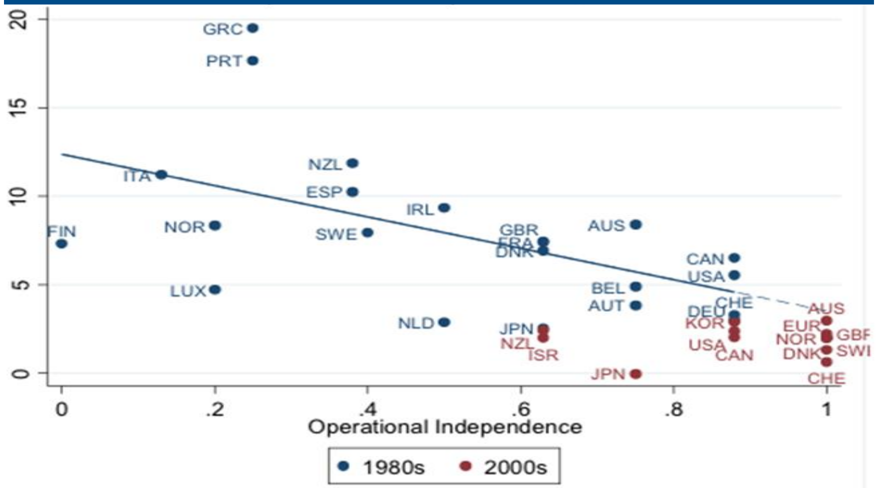
2. ..via Coordination of Monetary and Fiscal Policy

- A standing emergency fiscal facility (SEFF) to operate on top of automatic stabilisers and discretionary spending, with the explicit objective of bringing the price-level back to target.
- The central bank would activate the SEFF when interest rates cannot be lowered and a significant inflation miss is expected over the policy horizon.
- The central bank would determine the size of the SEFF based on its estimates of what is needed to get the medium-term trend price level back to target and would determine ex ante the exit point.
- Monetary policy would operate similar to yield curve control, holding yields at zero while fiscal spending ramps up.

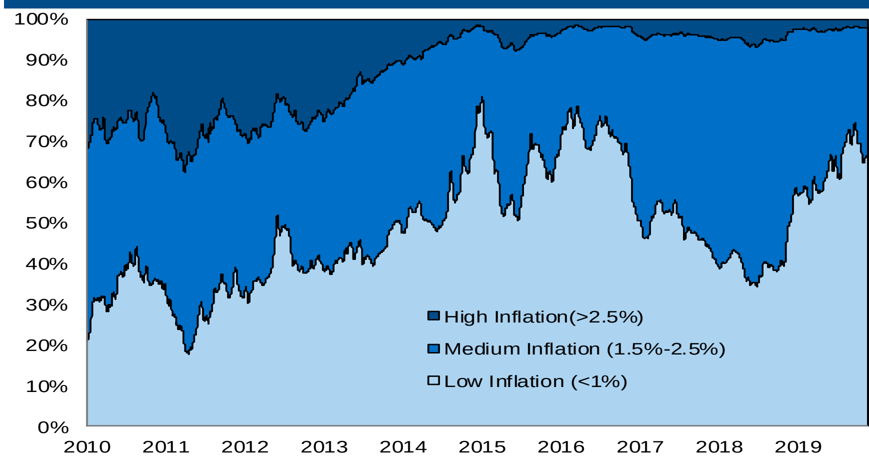
Source: Blackrock Investment Institute, Global Macro Outlook, Dealing with the next downturn: From unconventional monetary policy to unprecedented policy coordination, Elga Bartsch, Jean Boivin, Stanley Fischer, Philipp Hildebrand, August 2019

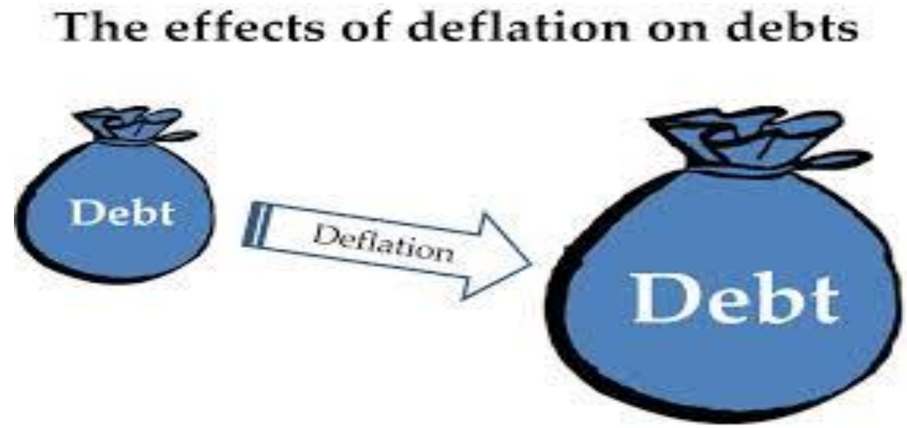
The Risks

1. Inflation and operational independence, 1980s and 2000s



2. Euro Area Inflation Expectations, 5-year average

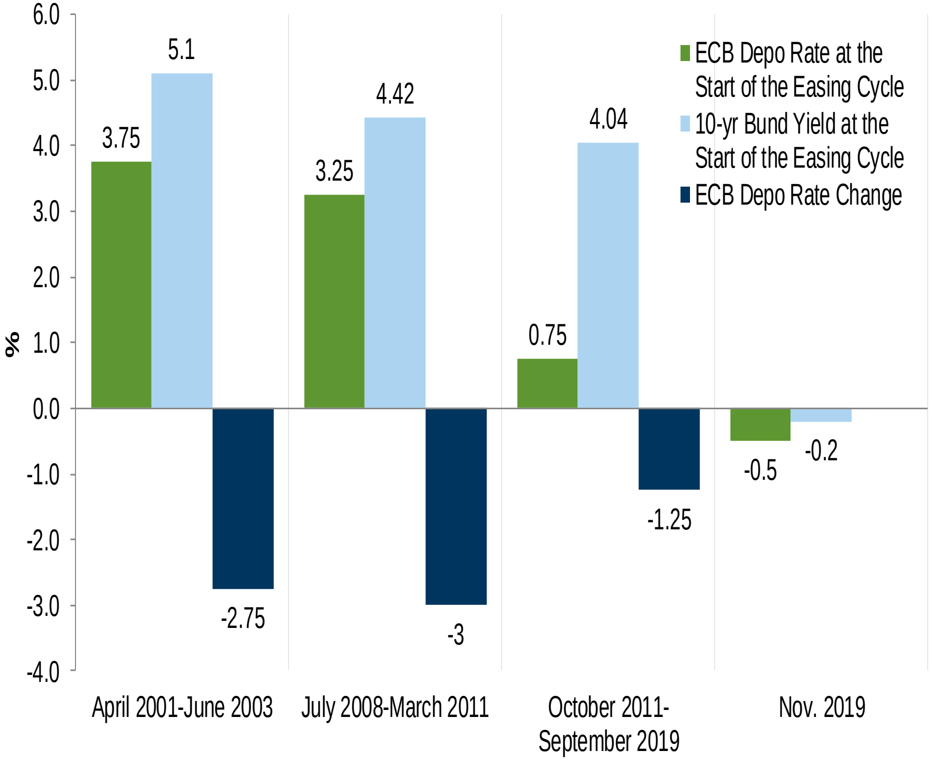




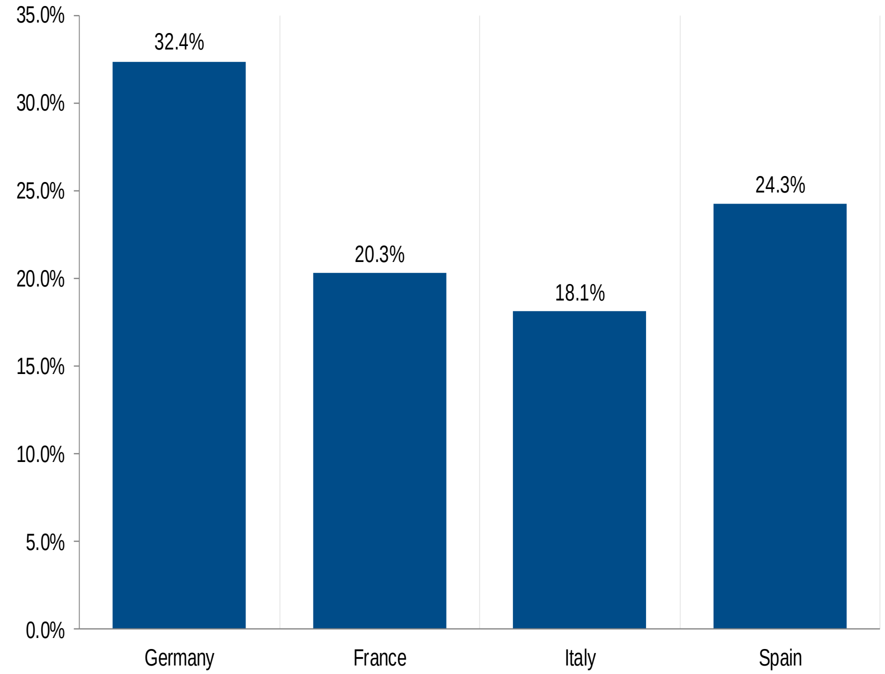
Source: Goldman Sachs Investment Strategy Group, "Twenty years on: Is there still a case for Bank of England independence?" Ed Balls, Anna Stansbury, VovEU, 01 May 2017.

The Rationale: (1) Lack of Monetary Policy Space

1. ECB Monetary Easing Cycles



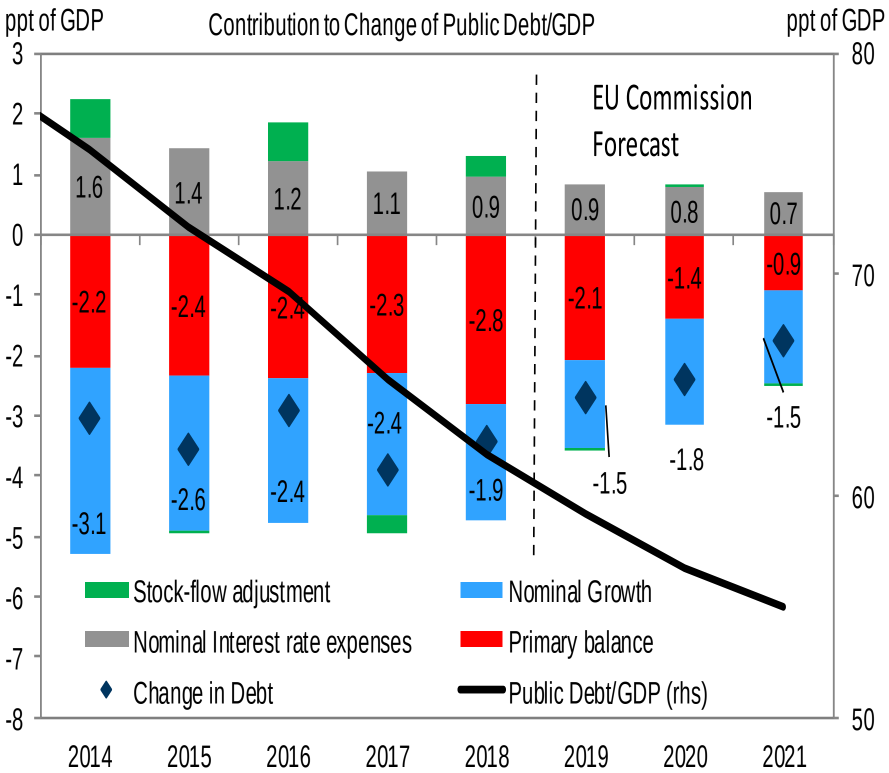
2. ECB Holdings of Securities in PSPP as a % of General Government Securities Outstanding



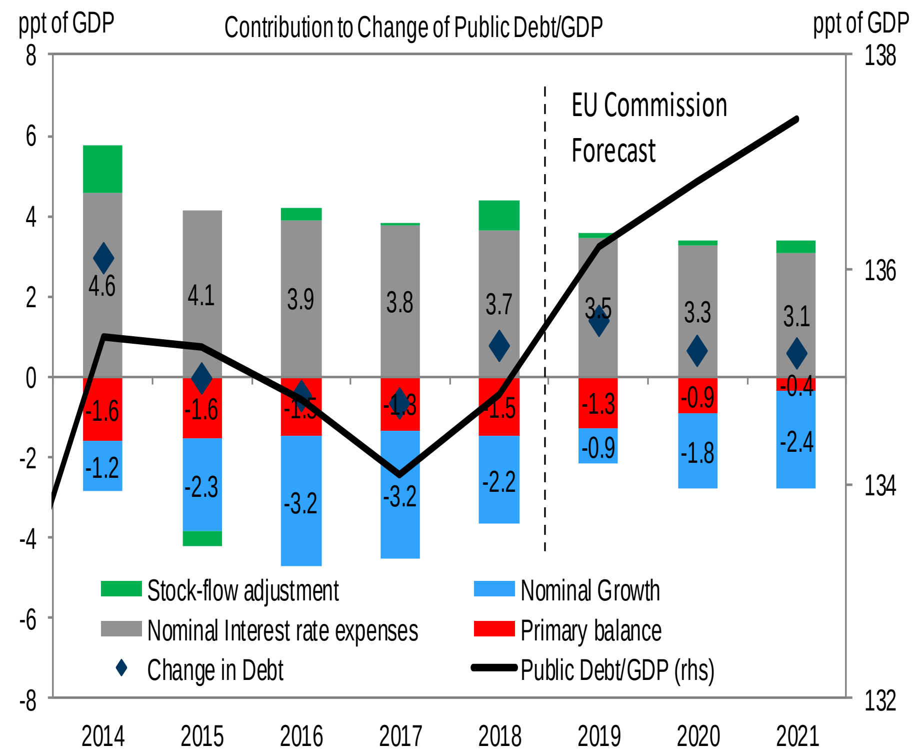
Sources: Investment Strategy Group, European Central Bank, Haver Analytics.

The Rationale: (2) Limited Fiscal Space

1. Germany's government debt dynamics



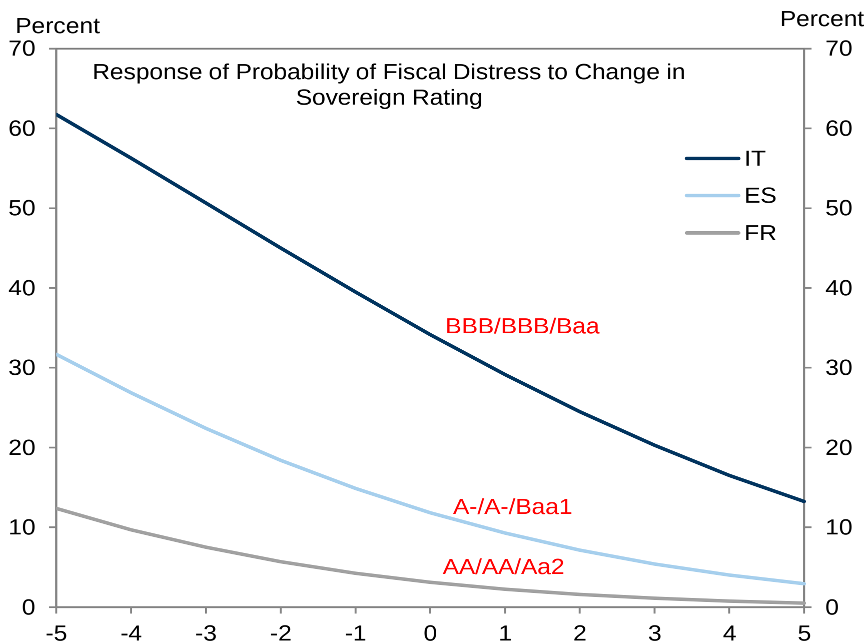
2. Italy's government debt dynamics



Source: Investment Strategy Group, European Commission, Eurostat, Haver Analytics.

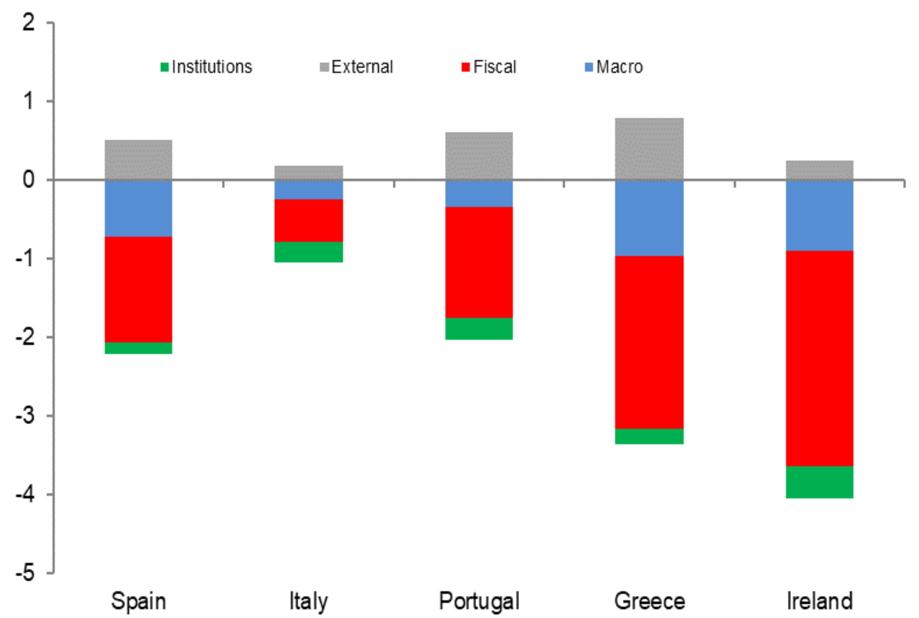
The Rationale: (2) Limited Fiscal Space

1. Fiscal Space for Countries with Different Sovereign Credit Ratings



Note: The current value of ratings is denoted in red next to the curve of the respective country

2. Fiscal Factors and Ratings Agencies' Downgrades in 2008-2012

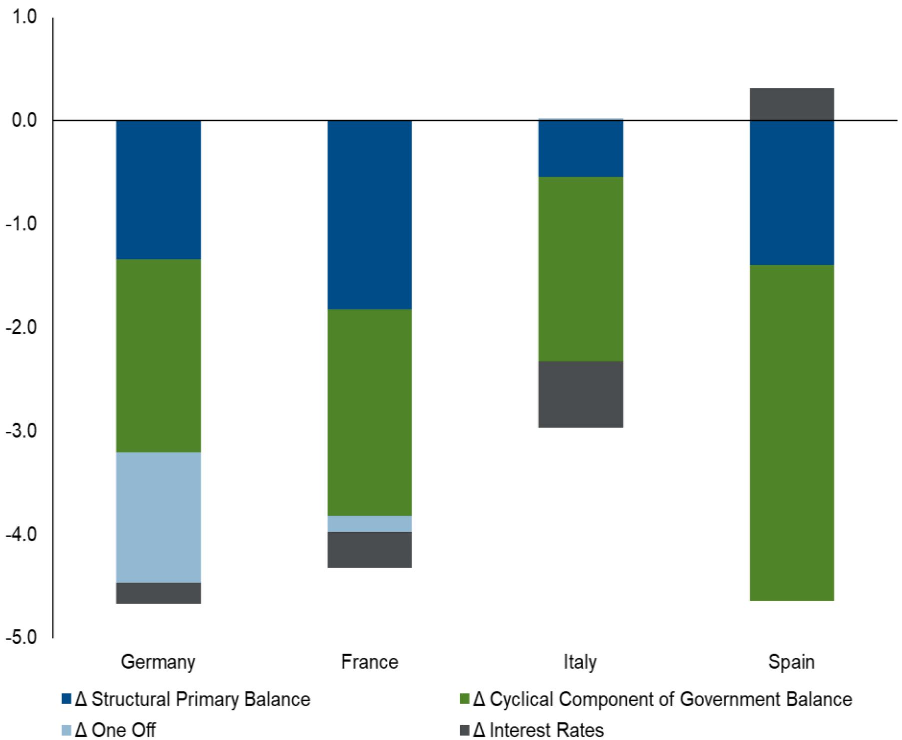


Sources: Investment Strategy Group, Haver Analytics.

The Rationale: (2) Limited Fiscal Space

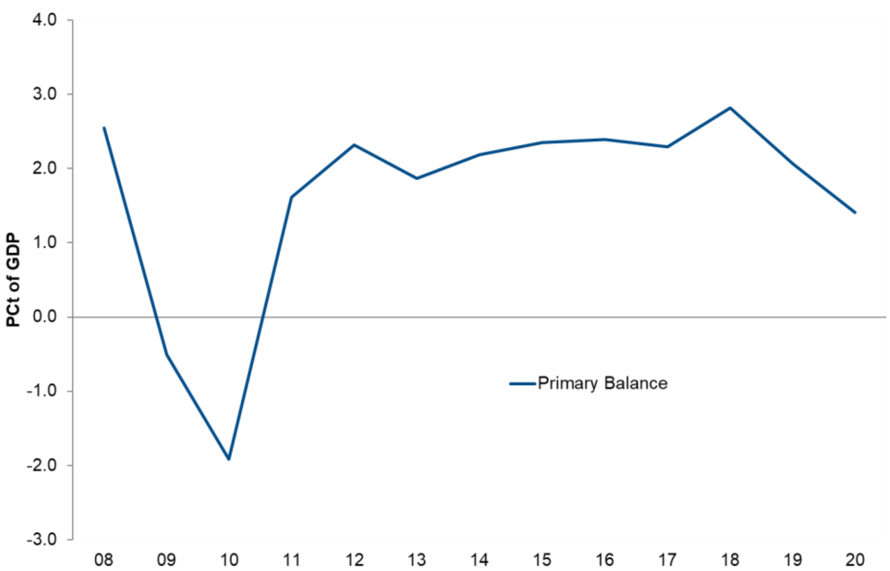
1. Fiscal Easing in 2009-2010

Cumulative Fiscal Easing 2009-2010



Key Questions:

- How Large Should Fiscal Easing in Germany Be to Make a Difference for the Entire Euro area? Is It Feasible? Would It Be Sufficient?



Source: Investment Strategy Group, European Commission, Eurostat, Haver Analytics.

Deepening of EMU: how to improve macroeconomic stabilisation using fiscal policy at the euro area level?

- **A 'Package'** = Central fiscal stabilization mechanism as a complement to national fiscal policies + strong monetary and fiscal coordination + a Euro safe asset

- A **central fiscal capacity** to activate when common shock hits the Euro area or to support the ECB in achieving its inflation mandate.
  - Instrument choice: consider multiplier/impact on growth and inflation and time lags. Governance: an independent fiscal body – mimic the appointment rules of the ECB?.
  - Complementary to (i) national fiscal policy used to respond to an idiosyncratic country level shock, redistribute resources within country according to national preferences; (ii) Euro area budget for competitiveness and convergence, (iii) ESM loans/programme + OMT for speculative attack on a country.
  - Easier to sell politically?: no legacy, no mutualisation of previous liabilities, independence of Euro area fiscal body safeguard against national political influence, moral hazard
  - No further burden for national budgets in a slowdown: help preventing rating downgrades and fiscal crisis and perhaps also easy some governments' resistance to fiscal expansions

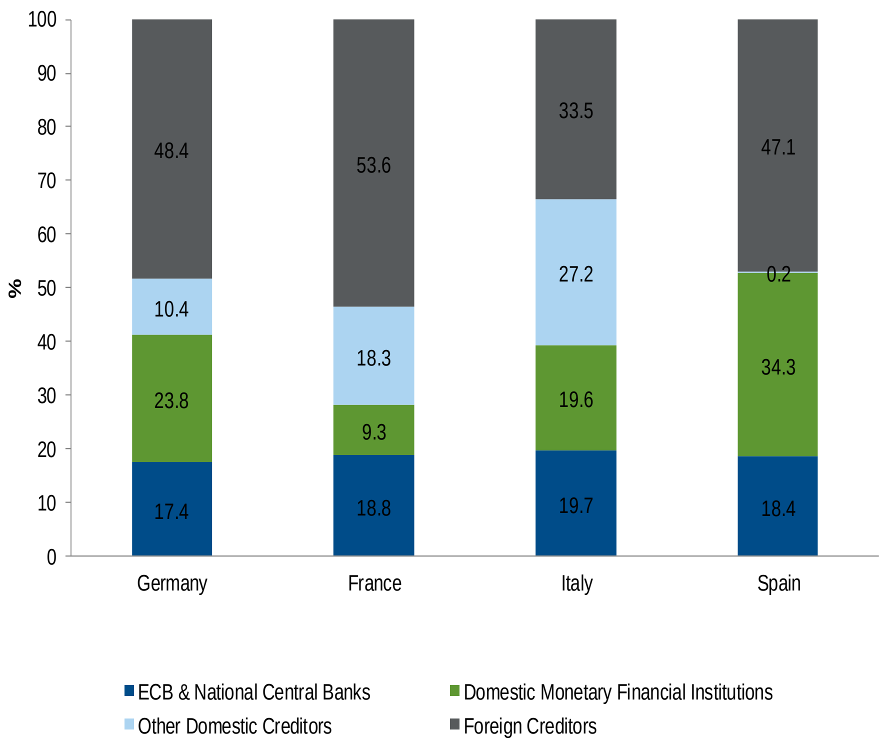
- **Coordination** between monetary and fiscal body to activate the fiscal facility.

- **Issuance of a safe asset** to fund the fiscal facility – e.g.: ESM bonds to be bought by ECB

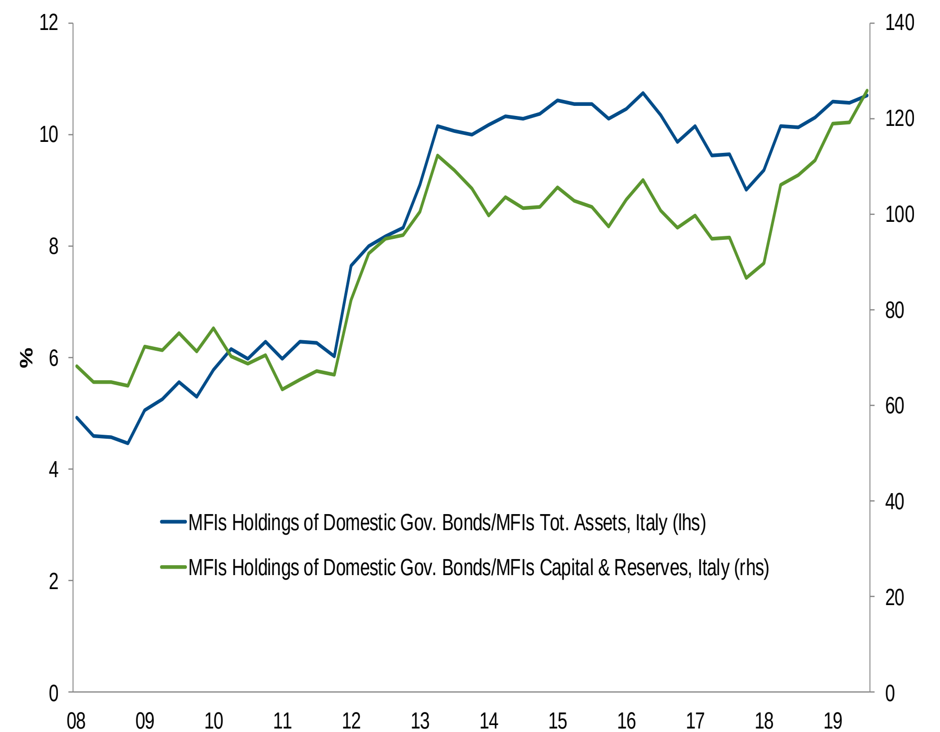
Source: Goldman Sachs Investment Strategy Group.

A Safe Asset To Break the Bank-Sovereign Doom-Loop

1. EMU4 Banks-Sovereigns Loop: Ownership of Sovereign Bonds



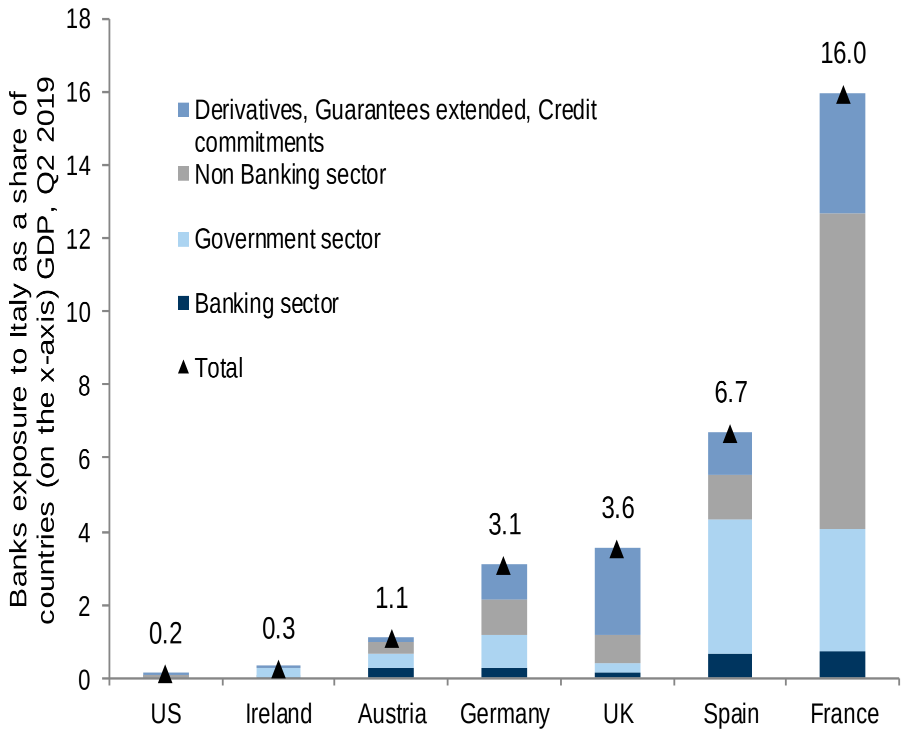
1. Italy's Banks-Sovereign Loop



Sources: Investment Strategy Group, Eurostat, Haver Analytics.

A Safe Asset To Break the Bank-Sovereign Doom-Loop

1. Mind Spill-Over Effects From Impairing Sovereign Market Access



2. Key Issues for Markets

- Threshold Above Which Concentration Charges Are Applied
- Size of National Public Debt vs Size of Euro Area Safe Asset
- Seniority Structure of National vs Supranational Debt

3. The Carrot and The Stick

- A Maastricht Treaty for Conversion of Government Securities
- A Truly Federal Fiscal System

Source: Investment Strategy Group, Haver Analytics.

Consumer and Investment Management Division

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Period	Gross Return	Net Return	Differential
1 year	6.17%	4.61%	1.56%
2 years	12.72%	9.43%	3.29%
10 years	81.94%	56.89%	25.05%

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