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The 2023 Economic Governance Review – Considerations on fiscal-monetary interactions

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Economic governance review and the monetary-fiscal policy mix

Economic governance review proposals (26 April 2023)

Policy mix
- Euro area
- Member states

Fiscal policies
- Fiscal sustainability
- Growth ST/LT
- Fairness and strategic objectives

Structural reforms
- Growth LT
- Fairness and strategic objectives

Monetary policy
- Price stability
- Financial stability
The key objective of the reform is to strengthen **debt sustainability** and promote **sustainable and inclusive growth**

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The fiscal stance and the debt anchor

- **Fiscal path** should ensure that **debt is put on a downward path, or stays at prudent levels** (after 4 or 7 years) with sufficient certainty (“plausibly”) and that the deficit is brought and maintained below 3% of GDP over the medium term.

- The debt dynamic is driven by few key variables: the initial debt level, the current/projected ‘r-g’ differential, the current/projected primary balance (including costs of ageing) and stock-flow adjustments.

\[
\Delta D_t = D_{t-1} \cdot \frac{(r_t-g_t)}{(1+g_t)} - PB_t + \Delta CoA_t + SFA_t
\]

=> These requirements would result in an estimated **average annual improvement in the SPB across the EA between -0.35 and -0.55 % GDP** based on current r-g projections and depending on 4 or 7 year adjustment.
Implication of EGR for macro-policy mix
Contractionary EA fiscal stance (except under GEC)
Two recent cases under GEC: COVID shock
Low-inflation context

The COVID crisis pushes output and medium-term price pressures down and starts in a disinflationary context with inflation undershooting. Starting from a no-policy scenario 1, fiscal and monetary policy move in tandem (pushing demand the economy from point 1 to 3). Output stabilisation and price stability in same direction.
Two recent cases under GEC: energy supply shock
Inflationary context

1. The supply shock shifts the supply curve from $S_0$ to $S_{\text{shock}}$ with lower output and higher prices and price pressures above the ECB's objectives.

2. Fiscal policy would shift the demand curve to $D_{\text{fiscal}}$ and fuel price pressures further while achieving little output benefit.

3. Monetary policy needs to reduce demand to $D_{\text{monetary}}$ to reduce price pressures and anchor inflation. Monetary policy will counter fiscal expansion effects resulting in a bad policy mix with high interest rates and fiscal sustainability risks.

Price developments consistent with ECB price stability objective.
Fiscal policy working in tandem with monetary policy towards price stability

• In 2023 and 2024, fiscal space created by the phasing out of energy measures should be used to reduce deficits and thus support monetary policy in pursuing price stability.

• Any future support measures for households and firms (if necessary) should be better targeted to the most vulnerable.

• Swift agreement on reform of the economic governance framework would help anchor expectations on predictable fiscal policy, investments and reforms, and debt sustainability.

• In case of severe shocks and general escape clause, the appropriate fiscal stance and measures should seek complementarities with the monetary policy objectives.
Some considerations on the Transmission Protection Instrument (TPI)

- Announcement of TPI reassured investors.
- Impact on r-g and DSA appears substantial.
- Assessment criteria for TPI eligibility may provide additional incentives for compliance efforts with the EU framework.
- To ensure predictable and transparent EU governance, and clear signals to markets, timely agreement and implementation of the new framework is essential.

Sovereign spreads depending on the level of the 10-year EA safe benchmark before and after the announcement of the TPI by the ECB
Thank you!