



EUROPEAN CENTRAL BANK

EUROSYSTEM

Some reflections on the  
interaction between monetary  
and fiscal policy and  $r^*$

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SUERF workshop

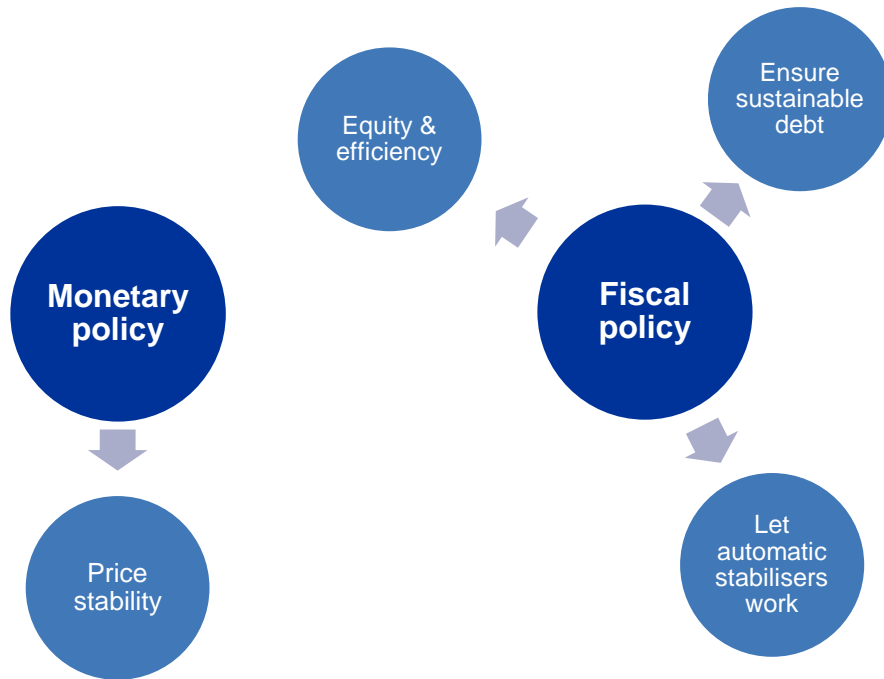
15 September 2021



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The views expressed here are those of the presenter and do not necessarily reflect those of the ECB

# Monetary and fiscal policy interactions when $r^* \gg 0$



Clear division of labour between monetary and fiscal policy:

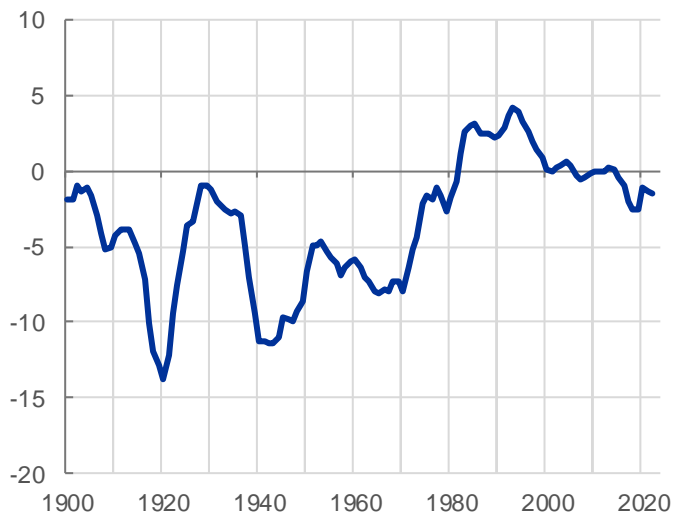
- Independent central bank with monetary dominance over the price level
- Fiscal policy to provide automatic stabilisers, focus on other objective while ensuring that debt remains sustainable

Monetary union set-up adds complexities

- Many fiscal policies at country level
- Need for a fiscal framework: focus on debt externality

# New economic environment: $r-g < 0$ and $i \leq 0$

**Interest-growth differential across advanced economies** (percent; 5-year moving average)



Sources: Global Financial data and Haver Analytics

Notes: The countries included in the sample shown here are Australia, Austria, Germany, Denmark, Finland, France, Spain, Canada, UK, Ireland, Italy, Japan, the Netherlands, Norway, New Zealand, Portugal, Sweden and the US. Projections for 2021-2022 from AMECO. Last observation: 2022 (annual data)

**Policy rates across advanced economies** (percent)

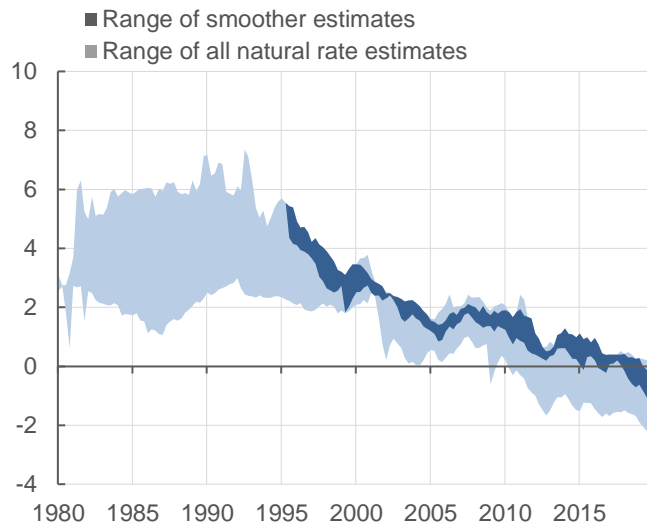


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Notes: The countries included in the sample shown here are: Australia, Austria, Belgium, Switzerland, Germany, Denmark, Spain, Finland, France, UK, Greece, Ireland, Italy, Japan, Netherlands, Norway, New Zealand, Portugal, Sweden and the US. Last observation: 2020 (annual data)

# How did we get there?

## Estimates of euro area longer-run level of the equilibrium real interest rate $r^*$ (% per annum)



Sources: WGEM Report "The natural rate of interest: estimates, drivers, and challenges to monetary policy", OP, No 217; Ajevskis (2018); Brand, Goy, Lemke (2020); Brand, Mazelis (2019); Fiorentini, Galesi, Pérez-Quirós, Sentana (2018); Geiger and Schupp (2018); Holston, Laubach, Williams (2017); Jarocinski (2017); Johannsen and Mertens (forthcoming). Notes: Ranges span point estimates across models to reflect model uncertainty and no other source of  $r^*$  uncertainty. The dark shaded area highlights smoother  $r^*$  estimates that are statistically less affected by cyclical movements in the real rate of interest. Latest observation: 2019Q4.

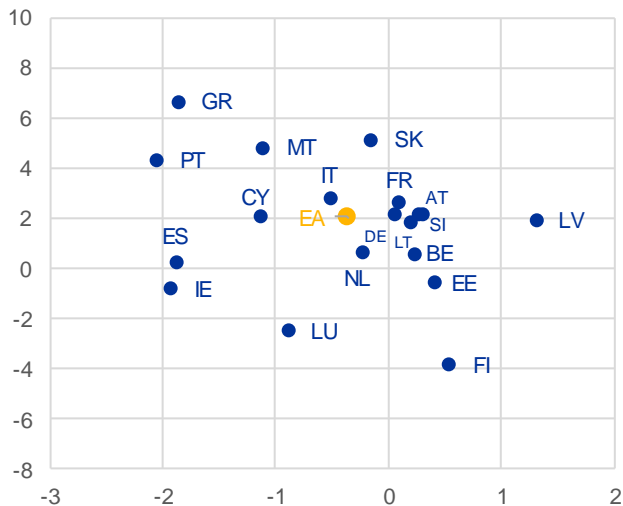
## Since 1980s, decline in $r^*$

- Declining trend growth
- Demographic change
- In addition, since the global financial crisis:
  - Rise in risk aversion
  - Increase in flight to safety
  - Fiscal consolidation, including composition, likely to have exacerbated the decline in  $r^*$  and contributed to on-set of low inflation period

# Quality of public finances worsened

## Fall in public investment and pre crisis deficits

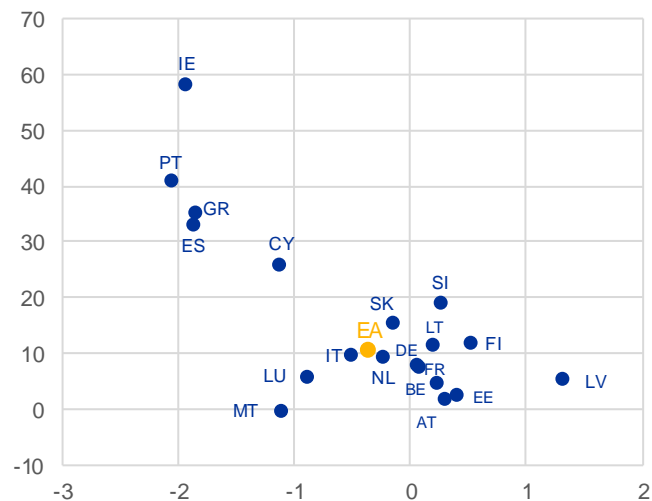
(number of years between 1999-2008 with deficit > 3%; difference between public investment-to-GDP ratio in 2013 and the 1999-2008 average in pp)



Sources: Workstream report on Monetary and Fiscal Policy interactions (ECB calculations).

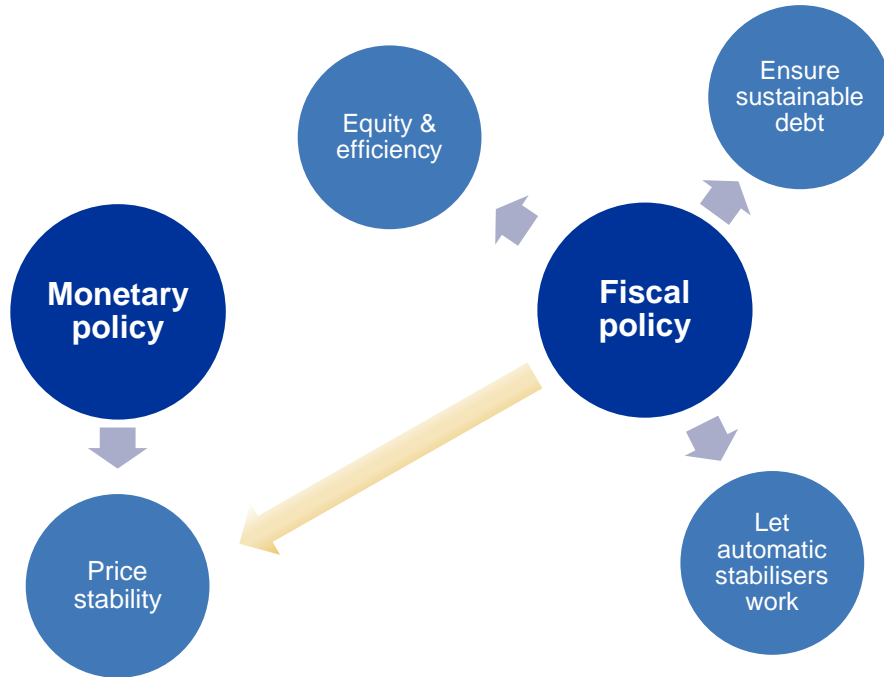
## Fall in public investment and debt increase

(increase in debt-to-GDP ratio 2009-2013; difference between public investment-to-GDP ratio in 2013 and the 1999-2008 average, in pp)



Sources: Workstream report on Monetary and Fiscal Policy interactions (ECB calculations).

# Implications for the monetary-fiscal interaction



## Interaction becomes complementary:

- Fiscal policy becomes relevant for macroeconomic stabilisation; larger fiscal multipliers and larger spillovers
- Fiscal and monetary policy need to work together to the regime....

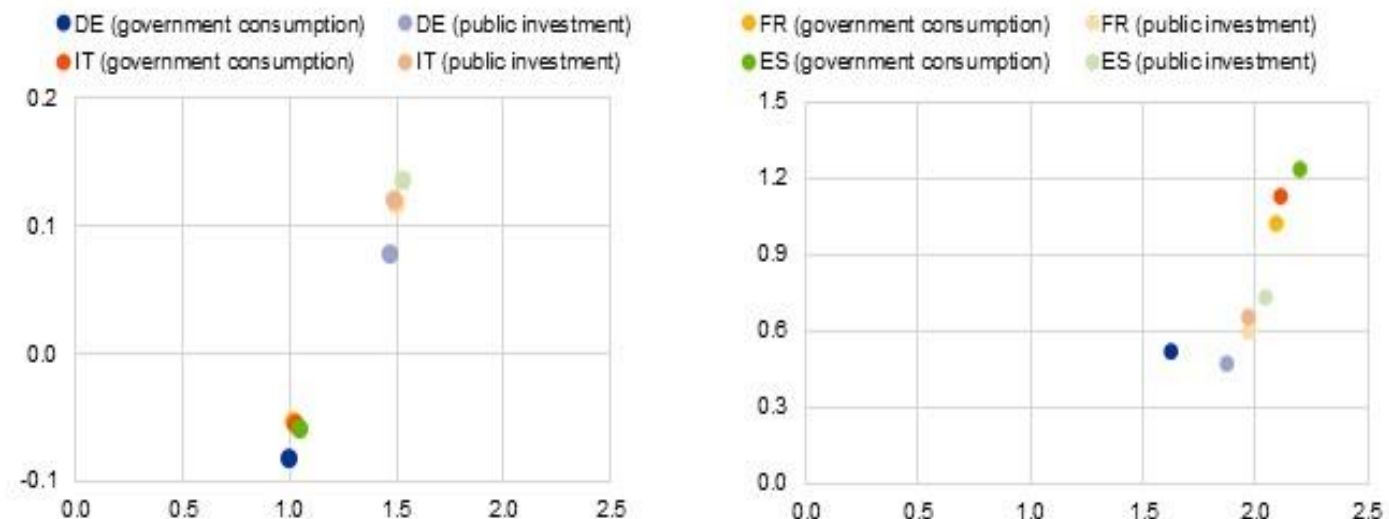
## Interactions becomes more complex:

- New role of fiscal brings to the fore a difficult trade off between stabilisation & sustainability
- Monetary policy to deploy “unconventional” tools leads to more complex interactions with fiscal
- Increased complexity even more the case in the monetary union

Endogeneity: Fiscal policy can help lift  $r^*$

# Fiscal spillovers increase at the lower bound

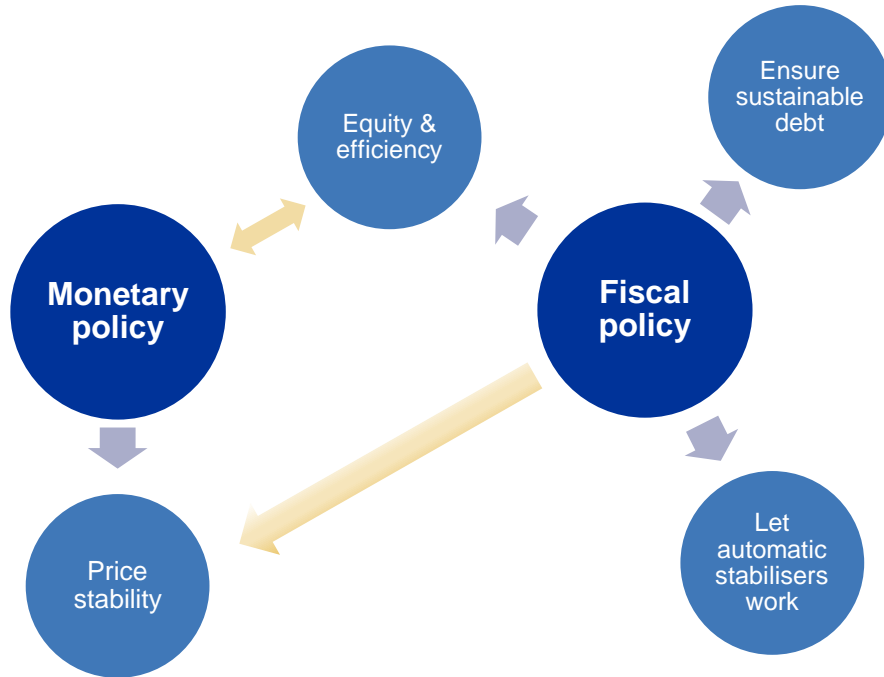
**Destination spillovers, with reactive interest rates (left panel) and non-reactive interest rates (right)**  
(x-axis: two-year average percentage change in GDP in countries propagating the fiscal stimulus; y-axis: two-year average percentage change in GDP in recipient country)



Source: EAGLE model.

Notes: The left-hand panels shows destination spillover, i.e. the impact of a simultaneous increase in government consumption or public investment by 1% of GDP for two years in all but one country on the countries' domestic output (x-axis) and the country receiving the spillovers (y-axis).

# Implications for the monetary-fiscal interaction



Interaction becomes complementary:

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- Fiscal and monetary policy need to work together to exit the regime

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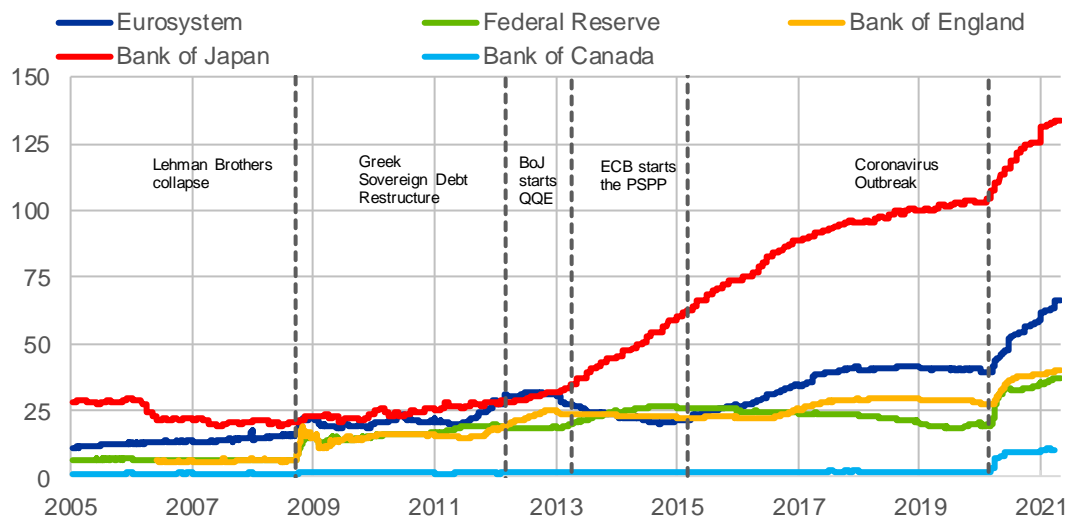
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# Central bank balance sheets

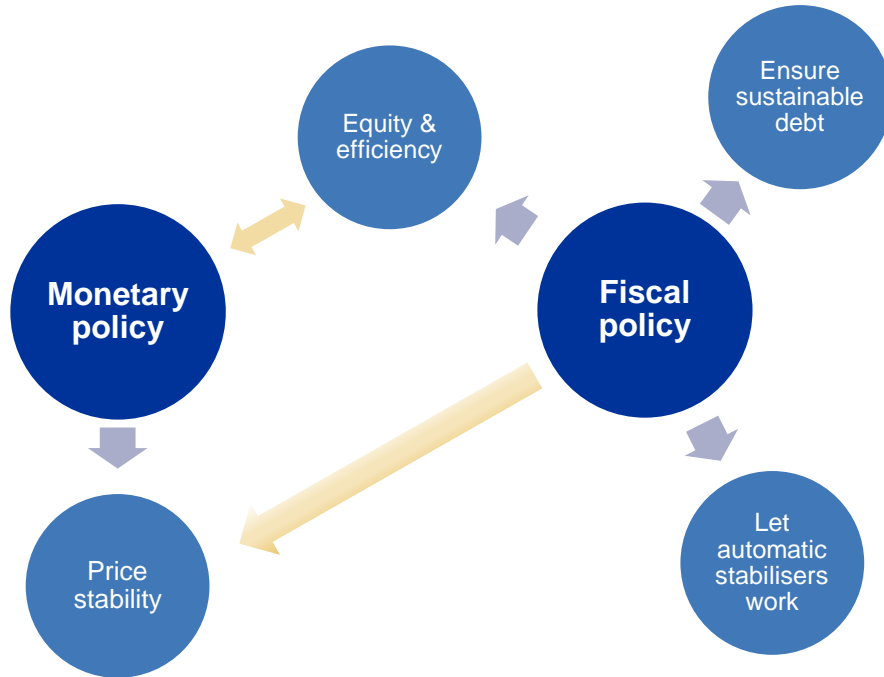
Evolution of central bank balance sheets in G7 countries since 2005  
(in % of GDP)



Source: ECB, Federal Reserve, Bank of England, Bank of Japan, Bank of Canada, Eurostat and Bank for International Settlements.

Notes: The BoE balance sheet is approximated after the 24 September 2014 since the institution only discloses 90% of its consolidated balance sheet after this date. Latest observation: 30 April 2021 (ECB, Federal Reserve, Bank of England) and Bank of Japan) and 31 March (Bank of Canada).

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Thank you!