Recovery, price stability and debt sustainability : ménage à trois or trilemma ?

Xavier Debrun| Strasbourg | 4th ERMEES Macroeconomics Workshop

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BanqueNationaleBank
DE BELGIQUE VAN BELGIË
Eurosystem

Disclaimer

The views and opinions expressed here are my own and do not necessarily reflect those of the National Bank of Belgium or the European Fiscal Board.

I wish I was physically there… blame it on δ and o !

01 Before the crisis: scarce macro policy space

02 The return of the policy mix…

03 COVID-19: Ménage à trois

04 The trilemma is back

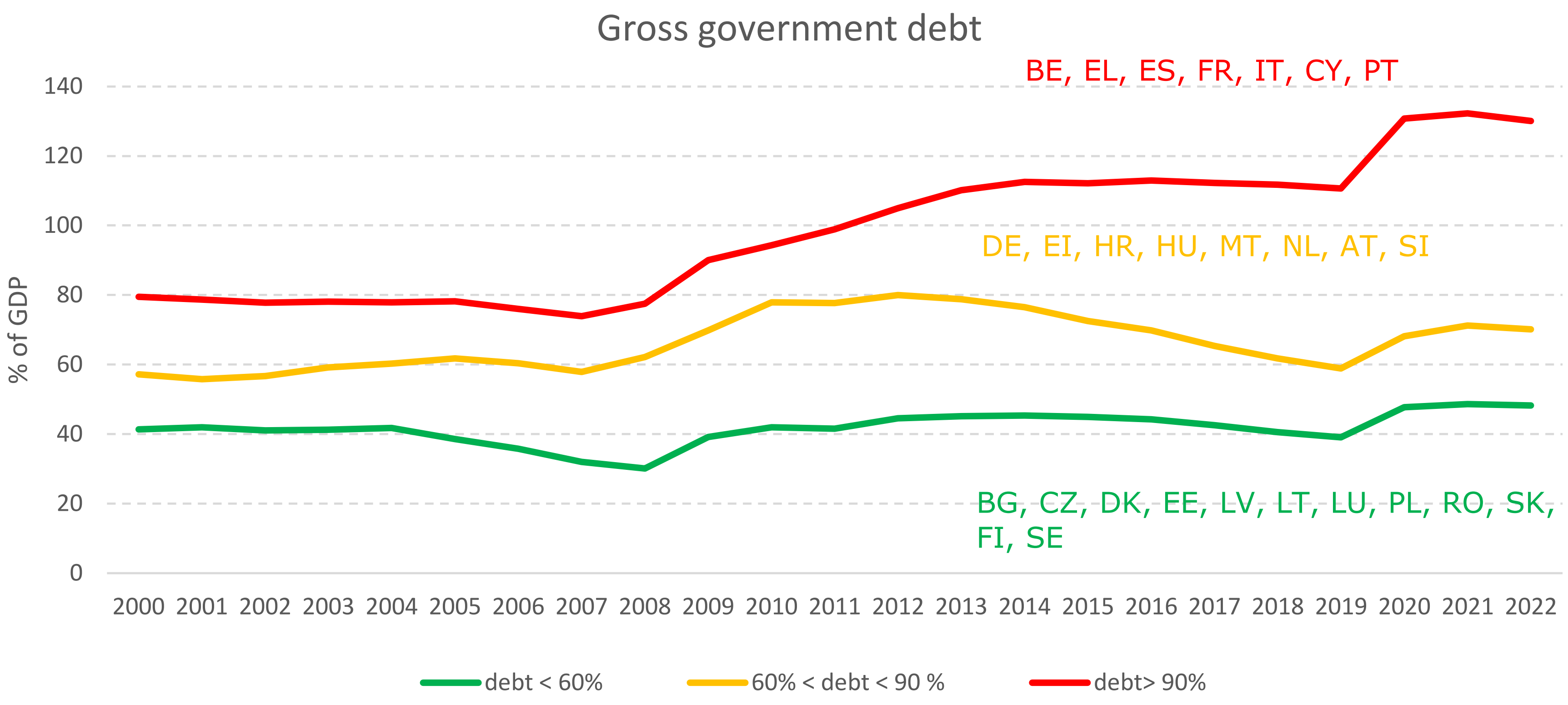
05 Get a (fiscal) framework!

Before the crisis: shrinking macro policy space

- Monetary policy: constraints to accommodation
  - Lower bound on nominal interest rates + stubbornly low inflation → lower bound on r → $\underline{r}$
  - A sinking natural real interest rate: r^* ↓ (demographics, inequality,…)
  - Conventional monetary policy space shrinks faster than the polar ice sheet: $r^* - \underline{r}$ ↓

Before the crisis: shrinking macro policy space

- On the fiscal side: high public debts
  - Too few countries rebuilt fiscal buffers when possible and needed.



Note: Countries are grouped based on their average debt levels in 2011-2019.

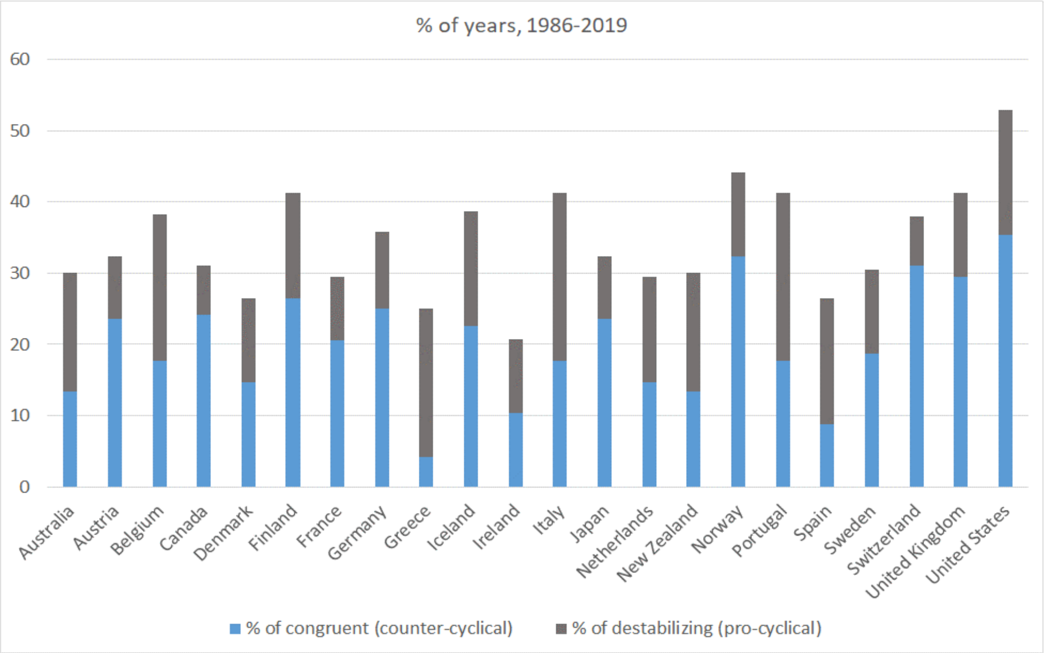
Sources: AMECO and EFB calculations

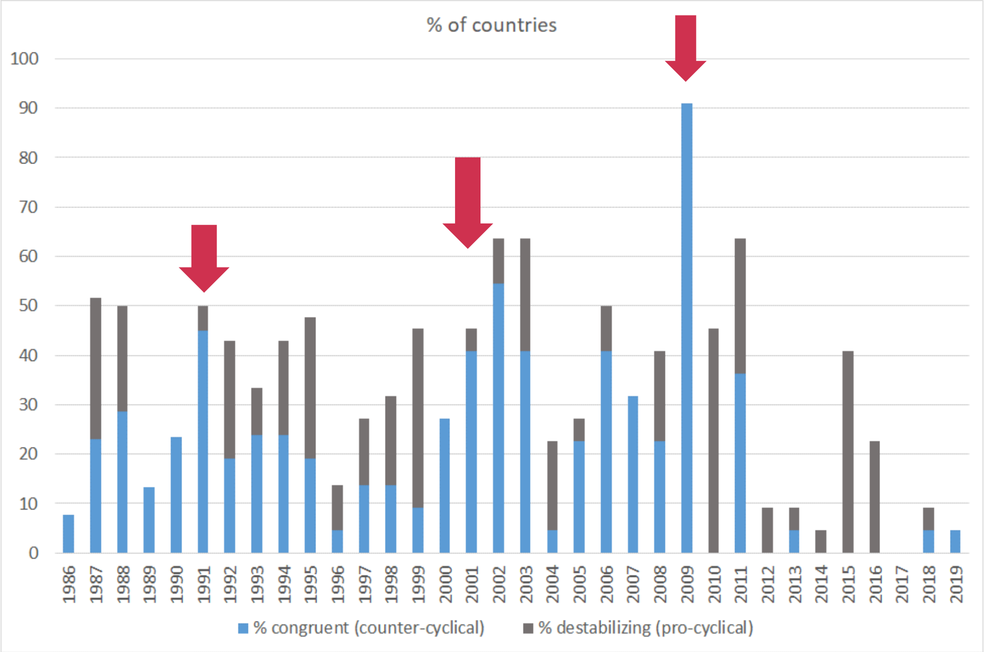
A little help from my friends: the return of the policy mix?

- MP and FP are *technical* complements:
  - Influence aggregate demand,
  - MP creates fiscal space through lower borrowing costs and risk premium compression.
- MP and FP are *strategic* substitutes:
  - MP in charge of macro stabilization (in normal times: "divine coincidence“ – closing the gap stabilizes prices)
  - FP in charge of efficiency and redistribution, but often procyclical → MP often offsets demand effect of FP.
- Popularity of "secular stagnation“ narrative:
  - Too much saving chasing too little investissement : fall in r^*, limits MP's ability rebalance S and I at π^*.
  - Structural demand shortage → deploy all instruments → return of the policy mix.
- Exploit M-F complementarity to bring back S and I at levels consistent with π^* and $r^* > 0$
  - MP and FP pull demand together → congruent policy mix.

Policy mix congruence is rare

- The policy mix is congruent less frequently than every 3-4 years for most countries (LHS chart).
- Too often, MP and FP go in the same destabilizing direction: both are procyclical (grey bars).
- Congruence is more widespread across countries during global slowdowns or crises (RHS chart).



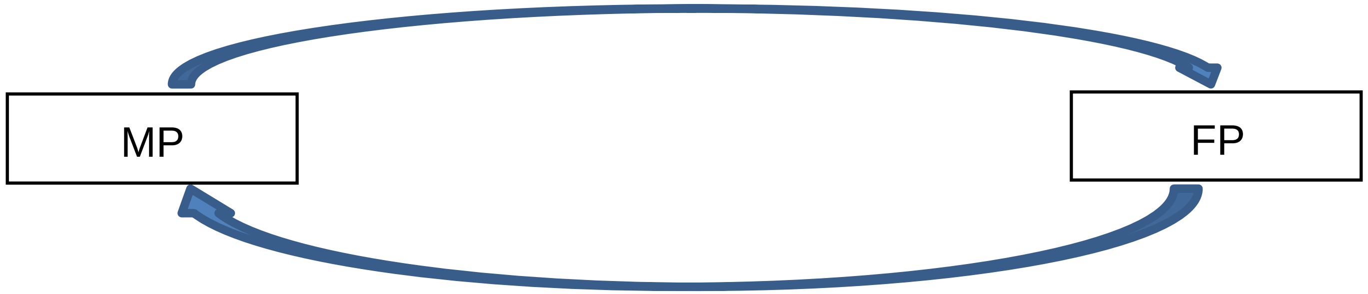


Source: Bartsch, Bénassy-Quéré, Corsetti et Debrun (2020), CEPR Geneva Report N°23.

COVID-19: congruence triggered by large shock and lack of macro space

- Global tail shock:
  - Lockdowns suddenly suppress demand and constrain supply (but less so) → risk of deflationary spiral.
  - Global but heterogeneous shock (countries, sectors, income categories).
- Economy in artificial coma means stimulus cannot work → protect livelihoods as much as lives → the state as the insurer of last resort and CB as the enabler of last resort:
  - With little fiscal space, congruence was a must → MP et FP became *strategic* complements!

MP creates fiscal space: implicit backstop of public debt

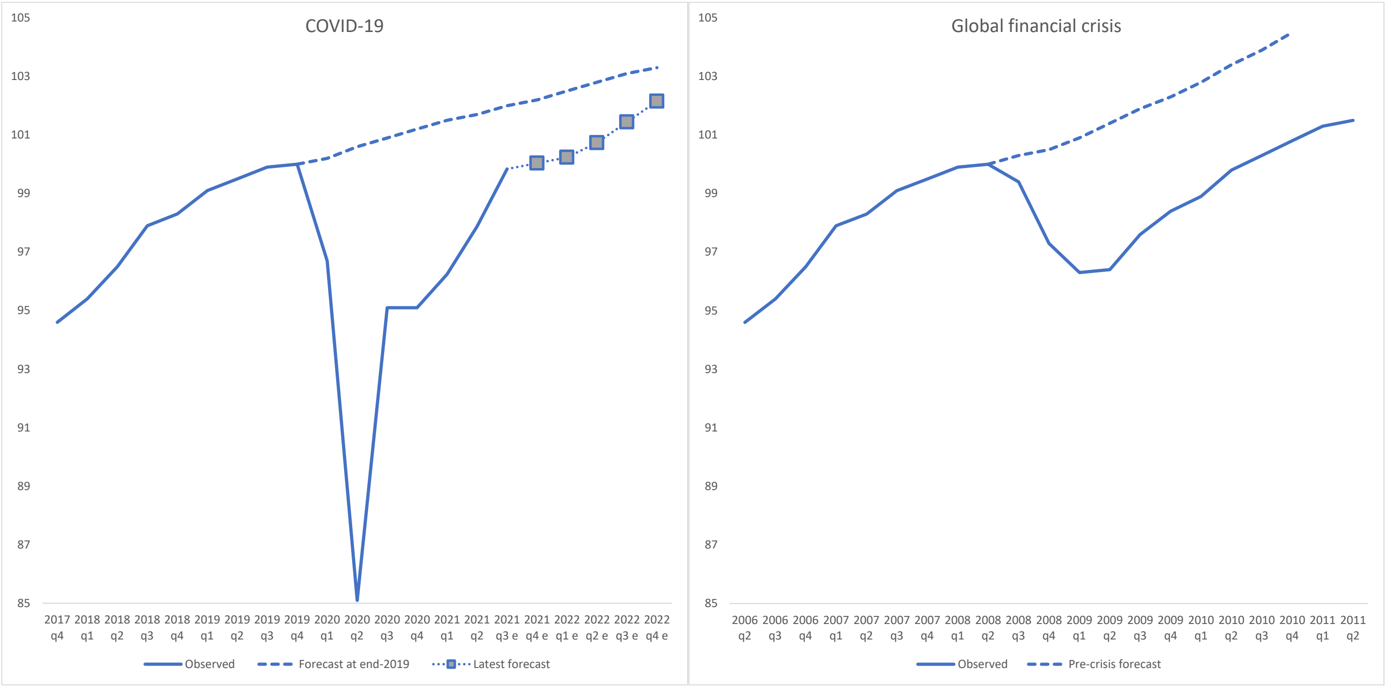


FP plays its insurance role through public debt accumulation, setting the scene for a swift recovery of demand as soon as coma ends.

Strategic complementarity @ work

- Theoretical distinction matters: CB and Treasury act within their remit. But it is in their best interest to help each other:
  - No explicit coordination of MP and FP, no fiscal dominance, no printing press, no monetization,…
  - Temporary ménage à trois: divine coïncidence on steroids (including public debt sustainability).
- Successful wake up from coma! Sharp contrast with global financial crisis → beware of lessons from GFC.

Belgium: COVID vs GFC



Exiting the crisis (not yet the pandemic…)

- Ménage à trois for the time of the crisis?
  - Little space on both sides of the policy mix.
  - Economic crisis like no other: man-made, acute, complex… and temporary.
- Recovery like no other (its' not 2010-15 « redux »):
  - Sudden bounce back in demand (instant back to normal + some revenge buying),
  - Persistent supply constraints: bottlenecks, commodities, peculiar labor market dynamics (reallocations,…),
  - Inflation is back: temporary or not? → Huge uncertainty… but Fed's chair made up his mind (not temporary)
- Non-temporary drivers?
  - Pricing power is back: end of conservative price setting behaviors aimed at keeping market shares.
  - Labor markets seem tight: increase in labor power → wage pressures setting stage for quick 2^{nd} round effects?
  - Persistent changes in consumption habits / accelerating trends (digitalization,…) → value chains must adapt… it takes time to invest.
  - Trends: carbon prices and eventual reshoring; China's aging rapidly (end of global labor supply shock hitting a fast growing capital stock).

The end of easy choices…

- MP and FP must be agile without adding to already high uncertainty:
  - Remain accommodative as long as price dynamics remain contained (risk-management approach) → patience
    - Cost of premature exit > cost of late exit.
  - Communicate clearly conditions for exiting supportive policies: no time-bound commitments, state-contingent ones.
  - React as and when needed. Remember: this is neither 2011 nor 1979!
- Slippery roads require steady hands on the wheel. Credibility/confidence is your most valuable asset:
  - For FP: set up transparent and enforceable rules anchoring public finances in a sustainable debt trajectory. Urgent to clarify fiscal governance in the euro area…
  - For MP: transparency under the new MP strategy (symmetric π^*). Historically, ECB has a difficult relationship with transparent communication; hope for the best.
- Normalizing the policy mix? M-F complementarity can help too.
  - Fiscal consolidation less painful when nominal growth is strong and MP remains accommodative: the time to start rebuilding fiscal buffers is now → this should be gradual but steady. Markets will be patient only if you are credible.
  - If FP normalizes first, then MP tightening can be more gradual, which in turn makes fiscal consolidation stress-free.

Face it: the trilemma is back, so are hard choices

- Between deficit-financed recovery (A), price stability (B) and debt sustainability (C), MP and FP can only achieve two of them simultaneously (recall Tinbergen?). Outcome can be:
  - **Ugly**: A+B = Deficit-financed recovery further feeds inflation and forces accelerated monetary tightening → brutal repricing of sovereign risk… → « Hello Luxembourg? Hello Washington? We have a problem. »
  - **Bad**: A+C = MP must keep backstopping public debt unconditionnally, and therefore give up on π^* → fiscal dominance (regime change with one predictable outcome: the end of the euro as we know it).
  - **Good**: B+C = what any sensible macro textbook tells you. Does that mean we cannot have a supportive FP full of green and other productivity-enhancing investment? No of course. But the name of the game is called making choices to **upgrade** our future, not to **tax** it. Governments spending more than 50 percent of GDP cannot claim not being able to make space for 2-3 percent of high-quality outlays.

- In the end, …

In the end, we need…

- …**sound fiscal frameworks clearing policy uncertainty.** Good rules are simple, flexible and enforceable; they do exist; and they can work. What lacks is political will. Do we really need to wait for a disorderly repricing of sovereign risks and a new round of existential threats to the euro for political leadership to get its acts together?
- …to stop the secular habit of kicking the can down the road: there are only so many more crises and slowdowns that public debt can take.
- …to accept that we are navigating exceptionally uncertain waters. The supply side is currently an enigma wrapped in mystery hidden in dense fog: be patient but nimble, no time-bound forward guidance, nurture transparency and in particular do not claim you know where we are going when you don't.