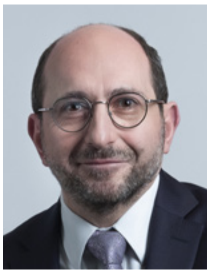
THEMATIC GLOBAL VIEWS

Only innovation in fiscal and monetary rules will make the euro zone viable

As crises unfold, structural and governance issues tend to become more and more important. And the objectives of economic policy are increasingly ambitious, both on the fiscal and monetary fronts. The governments and the ECB are in an impossible situation. The "old rules", be it the Taylor rule for the ECB or the rules of the Stability and Growth Pact are outdated. That said, the absence of rules can lead to increased financial and macroeconomic volatility. Only "new rules", which have yet to be invented, will enable monetary and fiscal policy to meet the new challenges. It is up to the EU Member States to define, as a priority and in a concerted manner, the major strategic orientations.



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Structural and governance issues have become increasingly prominent from one crisis to the next. One of the thorniest issues in the Eurozone is fiscal policy, which remains the Achilles' heel of the European construction. The Eurozone is an incomplete monetary union, with a notoriously inefficient combination of a single monetary policy with independent fiscal policies that are too often left uncoordinated. And it is precisely during crises that we see just how inefficient the institutional framework is.

Meanwhile, public policy objectives are increasingly ambitious. We expect governments to fund the energy transition, to provide investment in infrastructures, education and healthcare, and to play a stabilising role during recessions. And we expect central banks not just to ensure price and financial stability but also to rein in financial fragmentation, while contributing to the energy transition.

This is like squaring a circle, with too many intertwined objectives for too few instruments, along with increasingly tough constraints (price stability and debt sustainability) for both governments and central banks. A combination of exogenous supply-side shocks and "uncertainty shocks" is clouding the economic prospects of the Eurozone, which, moreover and for the first time in its history, must deal with stagflationary pressures.

On the monetary front, a broad consensus has emerged in recent decades around pre-set rules. Taylor's rule has gradually taken hold but looks unsuited or inadequate. There's no point in (aggressively) raising interest rates to dampen inflationary pressures that result from a supply-side shock, unless it is being assumed that such pressures will spill over into wages and the general price level.

On the fiscal front, the rules of the Stability and Growth Pact are outdated. It makes little sense to impose a single figure on each country in terms of debt (60% of GDP) and the deficit (3% of GDP). Such rules have turned out to be pro-cyclical in the past. And sanctions have not worked.

Even so, this doesn't mean that purely discretionary action produces the best public-policy decisions. For a lack of rules could stoke financial and macroeconomic volatility. It is still essential to anchor market expectations. But how? Monetary normalisation is possible only through a coordinated approach to fiscal policy (to absorb the shocks). Strict separation between fiscal rules and monetary rules doesn't work. There was a "lucky" period of implicit coordination during the Covid crisis, when disinflation allowed the ECB to ease its monetary policy. This lowered the cost of borrowing and allowed fiscal policy to absorb the shock. It is now essential to explore how coordination can be made more explicit.

There are no quick fixes, but some avenues are worth exploring. The ECB's independence, naturally, is inviolable. But nothing keeps it from re-interpreting its mandate. First, it could take into consideration more explicitly the origin of the inflationary shock (i.e., supply- or demand-side) in following an "enhanced" Taylor rule. And, second and more importantly, the ECB should agree to separate its bond-buying programme from its key rate policy.

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But to do so, the Stability and Growth pact will first have to be re-interpreted. In an initial stage, EU countries could agree on some key (existential) objectives and on the fact that they have more to lose collectively by not achieving them than from raising debt at European level. To determine the effort required to ensure national debt sustainability, it is essential to examine primary balances, debt burdens, initial debt levels, and ratios of government expenditure to GDP. This means that rules that are specific to each country would ultimately be more suitable (and more binding) than a single, deficit-based rule. There is also a need for multi-annual spending plans at the national level that commit governments to keeping recurrent expenditure growth below real GDP growth, while protecting capital expenditure. The focus must be on aggregates that governments control and that are measured explicitly. Governments and the ECB will only be able to meet these challenges through a pragmatic, coordinated and innovative approach.

Finalised on 20 May 2022

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June 2022 #06

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Date of first use: 1 June 2022

Document issued by Amundi Asset Management, "société par actions simplifiée"- SAS with a capital of €1,143,615,555 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90-93 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris – www.amundi.com

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