Jordi Gual

Chairman, CaixaBank

The specter of fiscal dominance

The struggle to contain the epidemic has immersed the global economy in a recession of unprecedented scale. The response needs to be bold, everywhere and by everyone. Everywhere because there is a need for a synchronized recovery –otherwise, weak external demand will lead to a slower and incomplete rebound. And by everyone because all policymakers, both monetary and fiscal, need to act forcefully.

There is little doubt that they have risen to the challenge. Monetary policy has done what was necessary thus far. In the eurozone, the ECB has not only supported the economy but also –and crucially– preserved an effective policy transmission and swiftly placated any signs of financial fragmentation. On the fiscal front, the response has also been commensurate to the crisis. In the European Union, not only at a national level but also at the Union level with the agreement on the Next Generation European Union (NGEU) package. A consequence of this necessary fiscal boldness, however, will be a staggering increase in public debt levels. This is not without risks.

An easy monetary policy and a fiscal expansion will reinforce each other and make the overall response more effective and efficient. Policy coordination, however, must be the result of independent institutions acting within their respective mandates. This is a fundamental cornerstone of every prosperous economy and cannot be taken for granted. It could easily be compromised by the simple fact that every monetary policy action has fiscal consequences, more so in the age of quantitative easing.

High budget deficits and public debt levels raise the specter of fiscal dominance, especially if the central bank holds a significant portion of domestic public debt on its balance sheet. Under these conditions, there is a serious risk that the decisions of a central bank end up geared toward guaranteeing the sustainability of public debt rather than achieving a certain level of inflation. Fiscal authorities may also take advantage of this bias and delay the necessary fiscal adjustments when economic conditions improve.

The coordination problem is even more complex in the case of several sovereigns sharing a central bank, such as in the euro area. A robust institutional architecture is absolutely key to surmount these challenges anywhere but even more in a monetary union that remains incomplete and where fiscal rules do not have a successful implementation track record.

This is why NGEU –funded by common debt issuance and including grants– is a very welcome step. With its €750bn firepower, it will meaningfully add to macroeconomic stabilization efforts, easing an excessive reliance on monetary policy, and can spur reforms and investments that increase potential economic growth. The issuance of EU debt in large quantities will also enable the creation of a European safe asset that increases the effectiveness of monetary policy, improves financial integration and mitigates the bank-sovereign doom loop.

But more will need to be done. For instance, European fiscal rules need to be reviewed with a view to simplifying them, moving away from the use of imprecise estimates of unobservables like the output gap. Instead, simple spending rules may be easier to monitor and implement. The Banking and Capital Market Unions also need to be finalized.

Robust institutions are key to allow fiscal and monetary policies to work hand in hand when their joint action is needed. But also, to allow them to part ways when the time comes to do so. ●