Agnès Bénassy-Quéré: Towards an extended policy mix

Speech by Ms Agnès Bénassy-Quéré, Second Deputy Governor of the Bank of France, at the European University Institute, Robert Schumann Centre, Economic and Monetary Union Lab Seminar, Florence, 22 March 2024.

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It is a great pleasure for me to be here in Florence, and I would like to thank Marco Buti and Giancarlo Corsetti for giving me the opportunity to share some thoughts about the policy mix – a topic they know very well.

Since we are here to celebrate the EMU Lab, I will focus on the European policy mix. I will first review how it has actually worked since the inception of the Economic and Monetary Union (I); then, I will discuss the complexification but also enrichment of the policy mix over time (II). I would like to convince you that the policy mix is more than what you think.

I. The policy mix since Maastricht

As you all know, the euro area's policy mix was born in Maastricht, Netherlands, in 1992. Hence it was maybe not a coincidence that the Maastricht treaty de facto endorsed the instructions of a Dutch economist, Jan Tinbergen. "One objective, one instrument": the single monetary policy was put in place to ensure price stability at the level of the euro area, while fiscal policies were assigned to output stabilisation at the level of each Member State.

This framework implicitly assumed the absence of supply shocks. With only demand shocks, there would be no trade-off between price stability and output stability, whether at the euro area or at the Member State level.

The set-up was clear, simple and straightforward. It was assumed that during economic booms, governments would accumulate buffers that they would subsequently spend to cushion inevitable crises. In this way, they would stabilise their economies while avoiding running excessive deficits.

As argued by my co-authors Elga Bartsch, Giancarlo Corsetti, Xavier Debrun and myself in a Geneva Report in 2020,[i] the credibility of fiscal policy reinforces that of monetary policy, and vice versa. Indeed, fiscal discipline enhances the effectiveness of monetary policy by reinforcing the independence of the European Central Bank. And reciprocally, a credible central bank delivers price stability at low levels of real interest rates, reducing the risks of snowball effects for sovereign debts

On several occasions, the policy mix has served us pretty well, for instance in 2009 in response to financial crises, or in 2020 in response to the Covid crisis. In both cases, monetary and fiscal policies were clearly counter-cyclical in the euro area.

From 2014 to 2019, a few cracks appeared in the simple, Maastrichtian distribution of tasks, as the Eurosystem was struggling to lift the inflation rate while the aggregate

fiscal stance in the euro area was flat. Some doubts appeared as to the ability of monetary policy alone to reach the 2% inflation target. At the zero lower bound, monetary policy had become relatively less powerful whereas fiscal policy benefited from the lack of crowding out effect, hence becoming more effective. In his speech at Jackson Hole, in August 2014, Mario Draghi explicitly called for a coordination of monetary and fiscal policy, declaring that "it would be helpful for the overall stance of policy if fiscal policy could play a greater role alongside monetary policy". [ii]

But the real shock to the policy mix came with the energy crisis, in 2022. Following its mandate of stable inflation, the Eurosystem raised its interest rates ten times between July 2022 and September 2023, with a total increase of 450 basis points. Simultaneously, though, the post-covid adjustment of fiscal balances was slowed down by the introduction of costly measures to protect households and firms from a sudden and temporary rise in energy prices. Some of these fiscal measures had the same goal as monetary policy, i.e. stabilising inflation.

According to IMF estimates,[iii] these measures reduced inflation by 2.2 percentage points in 2022, at a budgetary cost of 3.3% of GDP in the euro area. In a New Keynesian model, a standard fiscal stimulus of the same magnitude would rather lead to an *increase* in inflation of between 0.3 and 1 percentage point. Smoothing price increases may have helped the real economy to adjust and limited the price-wage spiral. The fact that the shock on energy prices was only temporary has validated this strategy ex post, although at a relatively high fiscal cost.

This episode reminds us of the existence of cost-push shocks and the need for governments to monitor not only the output gap but also the inflation rate at the country level. Jean-Claude Trichet was famous for brandishing graphs showing cumulated divergence of unit labour costs across the euro area. Such divergence was a key ingredient of the subsequent sovereign debt crisis. We should never forget that this crisis severely hit countries such as Ireland and Spain, which had been following prudent fiscal policies.

II. What's next?

Let me refer once more to our Geneva report, which itself was quoting Arthur Okun and James Tobin. According to them, the task for the policy mix today would be to come back to the "middle of the road" in order to recover room for manoeuvre and to navigate in better-charted territory. This means reducing both the size of the ECB's balance sheet and the debt-to-GDP ratios of governments – which will take time.

Meanwhile, we need to reconsider our toolbox. The good news is that since 2010 we have had a new stabilisation instrument in our toolbox, namely macroprudential policy. Macroprudential policies were introduced in the euro area as a response to the global financial crisis, in order to mitigate financial instability, and above all to reduce the vulnerability of the economy to financial cycles and instability.

Today, most European countries have a counter-cyclical capital buffer (CCyB) of at least 1%. This means that, in the event of a credit crunch, macroprudential authorities can suddenly increase banks' capacity to lend, by simply lowering the CCyB. Even more importantly, borrower-based measures were imposed on mortgages during the

era of loose monetary policy. Today, this reduces the scope for a negative feedback loop between higher interest rates, declining house prices, credit defaults and the economy. In a sense, macroprudential policies are alleviating today's constraints on monetary and fiscal policies.

The fact that we have not suffered a financial crisis over the last decade, even after the turmoil in the United States and in Switzerland a year ago, also validates the impressive efforts carried out over this period to re-regulate and reinforce capital and liquidity buffers in euro area banking system. It is never easy to prove why a crisis did not happen. It is even more difficult to share such great achievement with the general public, but we should not be too modest. .

We have been less successful in terms of completing the Banking Union and progress on the Capital Markets Union (CMU), yet research has shown that capital mobility is a powerful tool for macroeconomic risk sharing in the United States, even more so than the federal budget.[iv]

Today, with the huge financing needs stemming from the ageing population, the digital transformation and, above all, the green transition, the CMU re-emerges not so much as a stabilisation tool than as a key allocation policy, as recently noted by the Governor of Banque de France.[v] In a sense, the CMU becomes a "no-regret policy": its usefulness for stabilisation purposes is conditional on future asymmetric shocks; but its usefulness for minimising the cost of the transitions is not contingent, hence it should be a no-brainer.

The climate and energy transformation is probably the most pressing structural challenge that we are now facing. The Banque de France has undertaken scenario-based analyses regarding transition risks.[vi]

The key takeaway is that we cannot preclude that the transition will be inflationary, however it is not certain yet, and it will crucially depend on the mix of instruments that will be used to mitigate greenhouse gas emissions. For instance, a balanced-budget policy aiming at incentivising green private investment would be inflation-neutral during the first years, and then lead to lower inflation.

As regards physical risks, another piece of research carried out at Banque de France has focused on French overseas territories. This research suggests that more frequent climate events will likely increase the volatility of prices – rather than increase the inflation rate.[vii]

However, both physical risks and transition risks could weigh on productivity growth, hence indirectly on inflation. The risk of "greenflation" should reinforce our determination to revive productivity growth in our economies, and more specifically in services sectors that form the "core of the core" of inflation.

More efficiency in services will help keep headline inflation on track. I mention services for three reasons.

- First, because this is where the single market remains largely incomplete, hence there is room for efficiency gains.
- Second, the new technology revolution, with the arrival of artificial intelligence, provides an opportunity for the integration of services markets, in the single regulatory environment provided by the AI Act.
- Third, the completion of the single market for services is a complement to the completion of the CMU. Indeed, the combination of the two will offer European tech companies the scope they need for their development both in terms of market and funding.

In turn, productivity growth will simultaneously mitigate possible greenflation and provide fiscal room for manoeuvre. Hence, a credible growth policy will undoubtedly raise the capacity of monetary and fiscal policies to fulfil their stabilisation mandates.

To conclude, I would like to encourage the EMU Lab to work on a broader concept of policy mix that would encapsulate not only monetary and fiscal policies, but also macroprudential policies and the dimensions of the single market that will make the euro area more resilient to a wide range of shocks, and stabilisation policies more effective. Thirty-two years after the Maastrichtian policy mix, let's build the Florentine policy mix!

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[i] Bartsch (E.), Bénassy-Quéré (A.), Corsetti (G.) and Debrun (X.), *It's all in the mix : how monetary and fiscal policies can work or fail together*, *Geneva Report on the World Economy*, 15 December 2020

[ii] Draghi (M.), *Le chômage dans la zone euro*, speech, Annual central bank symposium in Jackson Hole, 22 August 2014

[iii] Dao (M.), Dizioli (A.), Jackson (C.), Gourinchas (P.-O.), Leigh (D.), *Unconventional fiscal policy in times of high inflation*, *IMF Working Papers*, September 2023

[iv] Furceri (D.) et Zdzienicka (A.), *The Euro Area Crisis: Need for a Supranational Fiscal Risk Sharing Mechanism?*, *Open Economies Review*, 26, 683–710, 2015.

[v] François Villeroy de Galhau, *From a Capital Markets Union to a genuine Financing Union for Transition*, Speech given at Eurofi, Ghent, 23 February 2024

[vi] Allen (T.), Boullot (M.), Dees (S.), De Gaye (A.), Lisack (N.), Thubin (C.) and Wegner (O.), *Climate transition scenarios: short-term economic effects*, *Banque de France Eco Notepad, 8 December* 2023

[vii] Gautier (E.), Grosse Steffen (C.), Marx (M.) and Vertier (Paul), *Decomposing the inflation response to weather-related disasters*, Banque de France Working Paper, December 2023