A Sword of *Damocles* Hangs Over Monetary Union

Models aren't working.

BY OTMAR ISSING

During the Great Moderation, a long period of low and stable inflation, continuous growth, and moderate unemployment, the risk of higher inflation was off the radar, even in central bank circles. And since inflation started to rise well above the 2 percent target in 2021, quite a number of central banks have been in the "transitory" camp, expecting inflation to return to prior low levels via self-correction, so to speak, mainly due to energy prices ceasing to rise any further, then falling again and global potential output significantly improving.

As recently as February of this year, the European Central Bank's Philip Lane argued that "since bottlenecks will eventually be resolved, price pressures should abate and inflation return to its trend without a need for a significant adjustment in monetary policy." As a consequence, central banks saw no need for action to counter the risk of higher inflation. Until the end of last year, the ECB even went so far as to communicate that sooner rather than later it would once again face a situation of too-low inflation by projecting inflation rates to fall below its target of 2 percent.

This was probably one of the biggest inflation forecast errors since the 1970s. Even before the Russian attack on Ukraine, the ECB had to continuously revise its inflation assessment upwards. Any forecast of inflation is based on assumptions about various exogenous variables, with oil and other energy prices playing an important role. This is the reason why the ECB uses the term

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projections—signalling that the staff bases its work on assumptions.

The problem of the ECB's severe underestimation of inflation since mid-2021 has a deeper source. It has largely ignored how the traditional models, including those to estimate potential output, were unable to take the substantial structural changes into account. The pandemic, as a combination of supply and demand shocks, entails a persistent negative shock on the output potential and is a major source of structural problems which had to be addressed by targeted and temporary measures of fiscal policy. Especially the U.S. Federal Reserve, but to some extent also the ECB, have underestimated the inflationary impact of expansionary fiscal policies via boosting domestic and global demand for goods and energy.

A major, deep structural change is taking place on the global level. In an important 2020 book, Charles Goodhart and Manoj Pradhan analyzed the main factors which will bring a change in the international environment from a disinflationary impact to a world where inflationary influences will dominate. Demographics is a major factor, but also the rise of protectionism. The Russian war and concerns about future tensions with China will strengthen the intention in all countries to reduce dependency on foreign sources of energy as well as other essential products.

What are the consequences of these and other developments for the monetary policy of the ECB? It is hard to understand why the ECB has been remaining in the crisis mode it adopted after the financial crisis in 2007–2008 and the sovereign debt crisis in 2010–2012. Zero or even negative interest rates and still net purchases of bonds—quantitative easing—were no longer appropriate in a period when the economy was improving and unemployment was at its lowest level since the start of the euro.

Now, with inflation rates not seen during the existence of the euro, the ECB has just started a very late exit from the monetary policy crisis mode. It is true that monetary policy cannot control energy prices and should look beyond temporary price shocks. Its role is to prevent inflation expectations from losing their anchor and wages and profits starting an upward trend. The pandemic, war-induced military spending and other geopolitical crises, aging populations, and not least climate policy will contribute to higher public spending. This implies a strong risk that public debts, having already reached historically high levels, will increase further, with consequences for the sustainability and credibility of public finances in a number of countries. Efforts to weaken fiscal rules could further undermine fiscal discipline and contribute to inflationary pressure.

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The Russian war as a negative supply and wealth shock indicates the risk that the euro area is heading towards a stagflationary environment with inflation still well above 2 percent. Plotting a way out of the crisis mode under such circumstances is a big challenge for central bankers. But as the experience of stagflation in the 1970s demonstrates, letting inflation rise unchecked is no appropriate option for a central bank with the mandate priority for price stability.

THE NEW TRANSMISSION PROTECTION INSTRUMENT

In mid-June, when spreads on Italian bonds rose to around 250 basis points, the ECB felt it necessary to hold a special Governing Council meeting announcing accelerated work on the completion of the design of a new Anti-Fragmentation Instrument (AFI). In her speech in Sintra, ECB President Christine Lagarde said: "…in order to

Mistake Prone

ECB chief economist
Philip Lane

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preserve the orderly transmission of our policy stance throughout the euro area, we need to ensure that this repricing is not exacerbated and distorted by destabilizing market dynamics leading to a fragmentation of our original policy impulse."

To combat the risk of fragmentation, the ECB "…will use flexibility in reinvesting redemptions coming due under the pandemic emergency purchase programme (PEPP) to preserve the functioning of the monetary policy transmission mechanism. In other words, those redemptions can, as appropriate, be invested within the Eurosystem in bond markets of jurisdictions where orderly transmission is at risk."

This new TPI raises a number of questions.

For one thing, it is very ambitious and risky for any public institution undertaking to discern the extent to which spreads reflect differences in underlying fundamentals or, beyond that, unjustified destabilizing market dynamics. For all scientifically objective approaches, there will always be a major political element to this distinction, which will be tested by the market and will inevitably lead to a tendency for the central bank to intervene more strongly than justified by the economic and financial fundamentals of the country concerned. An assessment of whether or not existing risk premia in markets are justified by fundamentals in the end boils down to a political judgement by the Governing Council about the quality and soundness of future economic, financial, and social policies decided by a national parliament and government. For example, the ECB will have to judge how likely it is that a political crisis in a country may lead to a new government or how likely it is that a new government or parliament will conduct sound policies or will run high public deficits and policies which will endanger debt sustainability. It is not the task of an independent central bank to make far-reaching judgements about future government policies with fundamental political consequences.

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The new instrument will strongly enhance the political role the ECB is already playing, for which it has no mandate as an independent central bank. The comparison with outright monetary transactions comes to mind. My basic objection to OMTs has not changed: ensuring the cohesion of the euro area is primarily a question for national politics, which

French Fantasy

OFFICIAL WHITE HOUSE PHOTO BY ANDREA HANKS

French President
Emmanuel Macron

As France's influence has grown over the years, a clear shift in economic policy orientation has become apparent. In his speech at the Sorbonne in 2017 on the future of Europe, French President Emmanuel Macron put forward the traditional notion of a state-dominated and controlled economy in all its breadth. He made it clear that an agricultural policy based on supply autonomy and a state-led industrial policy are crucial elements of a "sovereign" Europe.

The French president can count on the unconditional support of a number of member states in this regard. Arguably, none of these states has distinguished itself to date with a particularly successful economic model.

It can hardly be maintained that the French model is worthy of imitation on account of its successes. France's large and growing public debt and still high youth unemployment cast enough doubt on this claim. A European industrial policy secured by protectionism and subsidies does not hold out the promise of a model for long-term success. Looking at the current political landscape, the gap between aspiration and reality could hardly be wider.

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is responsible for the compliance of its measures with the conditions of a monetary union. Ensuring cohesion in the crisis is the task of the community of member states, not of the central bank. However, considering the new program, OMT in my judgement has fundamental advantages.

This raises the question of the conditionality of the ECB's intervention. A comparison with the conditions for the use of OMT is almost inevitable. In the European Parliament, ECB President Lagarde has already made clear that the ECB was not thinking to just apply OMT.

Rather than offering my own assessment, I will quote former ECB President Mario Draghi. In his speech on May 6, 2013, he gave the following remarks on OMTs:

> *The bond-issuing governments which request an activation of the OMTs agree, in conjunction with the European authorities and, if possible, with the International Monetary Fund, on a recovery programme to address macroeconomics and structural weakness. This is a necessary, but not sufficient condition...*

He continued:

> *The conditionality associated with the programme to which governments and the European authorities agree is a crucial element in being able to preserve monetary policy independence. It is important in providing the ECB with adequate assurance that interventions supporting sovereign debt bond prices do not mutate into financial subsidies for unsustainable national policies in the medium term.*

And finally:

> *...the ECB cannot and does not intend to provide financial support to Governments which reinstate solvency conditions which have not already been approved* ex ante.

I have nothing to add to this. As far as can be seen at this stage, the requirements for the use of AFI fall far short of the conditions formulated by Draghi for the use of OMTs. However, the more the ECB decides at its discretion on the requirements for the use of AFI, the stronger its presumption of a role reserved in any democracy for governments and parliaments at large, and the greater the expectation in markets and member states with high public debt that the resources used will allow the continuation of a fiscal policy that leads to further debt accumulation without a substantial increase in risk premia and thus interest rate spreads.

The ECB's reaction to the moderate rise in spreads without any evidence that such spreads were not in line with current and expected fundamentals, which is by no means threatening, prompts fears of trouble ahead. The convening of a special meeting already points in this direction. As is well known, the ECB took a long time to react to the threatening rise in inflation and needed a meeting of the Governing Council to announce a small interest rate hike for the next meeting.

The press release on TPI declares: "The Governing Council will consider a cumulative list of criteria to assess whether the jurisdictions in which the Eurosystem may conduct purchases under the TPI pursue sound and sustainable fiscal and macroeconomic policies." At first glance, one may think that such criteria bring TPI close to OMT. In a deeper assessment, however, there is a major and worrying gap between OMT and TPI.

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Under OMT, an ESM program with "strict and effective conditionality" (at least in the form of an Enhanced Conditions Credit Line) was a necessary condition. Such a program would have had to include detailed fiscal and structural policy commitments by the respective member state and a commitment by the other member states for financial assistance loans provided via the ESM. The ESM and the Commission would sign the memorandum of understanding detailing the adjustment program. All this would have implied "skin in the game"—both reputational and financial—from all member states, the ESM, and the Commission.

Under OMT, fiscal and economic policy assessment and design would be under the responsibility of member states and the Commission.

With TPI, however, no ESM adjustment program will be designed and therefore all other players—the country with high spreads, the other member states, and the Commission—do not have any major skin in the game and thus the ECB in the end is burdened with much higher reputational and financial risks than under OMT.

> *Increasing transfers—not between rich and poor member states, but between those with more solid public finances and those with high debts—along with undemocratic, non-transparent procedures undermine the consent of citizens to participate in the European Union and put wind in the sails of extreme parties.*

Given that debt levels are now much higher and longer-term prospects often worse than ten years ago when OMT was adopted, I fail to see how replacing OMT with TPI and its much weaker conditionality can be justified.

The new TPI risks dismantling two crucial achievements of the last decade which drew proper lessons from the crises and helped to strengthen the institutional framework of European monetary union: the ESM as the key institution to deal with fiscal problems in individual member states, and the OMT, which required an ESM program and thus clear skin in the game by all member states.

ON THE SITUATION OF THE EUROPEAN UNION

In the early days of the European Economic Community, there were fierce disputes between French ideas of planification and the competition-based model of the social market economy. Despite considerable resistance in the Commission, but also with significant support from the case law of the European Court of Justice at the time, the competition-based approach prevailed. The great economic successes of the European Union, whose attractiveness was also revealed in the numerous applications for membership, are based on this fundamental decision.

As France's influence has grown over the years, a clear shift in economic policy orientation has become apparent. In his speech at the Sorbonne in 2017 on the future of Europe, French President Emmanuel Macron put forward the traditional notion of a state-dominated and controlled economy in all its breadth. He made it clear that an agricultural policy based on supply autonomy and a state-led industrial policy are crucial elements of a "sovereign" Europe.

The French president can count on the unconditional support of a number of member states in this regard. Arguably, none of these states has distinguished itself to date with a particularly successful economic model. The responsible French commissioner has just presented an industrial policy program involving the deployment of massive subsidies. On this matter, he has the President of the Commission on his side.

The previous German economy minister has made no secret of his affinity for an industrial policy *à la française.* Besides, German economic policy has moved further and further away from the original concept of the social market economy and lends itself less and less as a successful model for Europe.

There is no reason to object to a reorientation of the European economic order; it would even be welcome if it came with the prospect of greater welfare, more growth and employment, better climate protection, and social security. However, robust arguments for this are lacking. It can hardly be maintained that the French model is worthy of imitation on account of its successes. France's large and growing public debt and still high youth unemployment cast enough doubt on this claim. A European industrial policy secured by protectionism and subsidies does not hold out the promise of a model for long-term success. Looking at the current political landscape, the gap between aspiration and reality could hardly be wider.

With the program of the reconstruction fund adopted in 2021, member states with high national debt in particular will receive substantial financial resources, as gifts to some extent, aimed at orienting their economies toward more growth, employment, and environmental sustainability. At the same time, the member states have taken on considerable risks. It fits into the image of a Commission that hardly imposes any limits on debt-making that the liabilities incurred in this context by the member states do not show up in any statistics. Incidentally, voices have long been raised, including that of the previous German finance minister, that the fundamental ban on borrowing at the European level enshrined in the Treaty should not be seen as a one-off act, but as an entry into fiscal union. In climate protection, a prime candidate for the next borrowing program is already waiting in the wings. It is notable that the democratically essential condition of political union is no longer ever mentioned in this context.

As a sword of Damocles hanging over the monetary union, the high and growing debt of individual member states threatens its success and stability. Increasing transfers—not between rich and poor member states, but between those with more solid public finances and those with high debts—along with undemocratic, non-transparent procedures undermine the consent of citizens to participate in the European Union and put wind in the sails of extreme parties.

These brief observations are limited to economic aspects. Yet the conception of a political union should center on issues of foreign policy and security policy. It is both essentially misguided and a telling sign if political union is sought primarily through the complex and highly contentious domain of public finances. The development I have outlined will not lead to a democratically legitimized federal state. On the contrary: as it runs its course, the danger of a fragmented and divided Europe looms. The demand for “more Europe” as a continuation of the previous misguided development is therefore a thrust in the wrong direction. There is no getting around it: as sovereign states, the EU countries have primary responsibility for their own economic and financial policies. Rules and measures at the European level should support national reform efforts, but under no circumstances should they also fuel national aberrations. Despite all the difficulties, one should not forget: the European Union is a community that lives in peace and freedom, and a huge internal market. These achievements should not be jeopardized by further ambitions. Anyone who cares about the future of Europe, and certainly anyone who wants to uphold the vision of a European federal state, can only issue a strong warning against setting a misguided course. ◆

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