Avoiding the Japanification of Europe

BOLOGNA — As monetary and fiscal authorities have acted aggressively to blunt the COVID-19 pandemic's economic impact, public debt and central-bank balance sheets have swelled rapidly. In the European Union, this trend is compounded by a new 750 billion euros ($886 billion) COVID-19 recovery fund, which includes the issuance of so-called "recovery bonds" guaranteed by the EU's multiyear budget and, possibly, by Europe-wide taxation.

This is a whole new world for all advanced countries except one: Japan. It is not the "nice" world of the 1990s, characterized by stable inflation, steady output, fiscal prudence, and a narrow central-bank focus on manipulating short-term interest rates to meet inflation targets. But nor does our turbulent world resemble that of the 1970s, marked by high inflation, volatile output, fiscal profligacy, and excessively accommodative monetary policy.

In today's world, inflation is very low and is expected to remain so, and monetary authorities enjoy significant credibility, much more than in the past. Advanced countries are headed for a situation in which the distinction between monetary and fiscal policy is merely academic, and debt consolidation is unrealistic.

This has long been the case in Japan, with its very low inflation, negative interest rates, and a public debt-to-GDP ratio of 200 percent, 70 percent of which is held by the central bank. But most countries are not used to facing these problems. Addressing them, and avoiding a deflationary spiral, will require a creative and coordinated approach to monetary and fiscal policy.

The challenge will be particularly profound in the eurozone, which has a common monetary policy but lacks a shared budgetary policy, notwithstanding the new recovery fund. Overcoming it will require an institutional setup that is very different from the one established in the Maastricht Treaty. Europe's leaders must urgently begin discussing what that setup must be, and how to get there.

The European Central Bank's (ECB) current strategy review provides an opportunity to address some of the issues at stake. For example, the ECB could update the definition of price stability, so that it has the flexibility to overshoot the inflation target in the short term, thereby compensating for years of undershooting. This would help to prevent long-term inflation expectations from stabilizing at too low a level, resulting in real interest rates that are incompatible with full employment.

One solution could be to adopt nominal GDP targeting. That way, in responding to supply shocks that drive up prices and depress output, the ECB would weigh the two target variables equally. This would discourage policymakers from taking an excessively hawkish stance at a time when a range of factors, from climate change to pandemics to financial crises, threaten to produce many more supply shocks.

But such a change would go only so far. The vital issue, which will most likely demand some new piece of legislation and a departure from the Maastricht Treaty, is the relationship between monetary and fiscal policy. In a unitary state like the United States or the United Kingdom, monetary- and fiscal policy coordination is possible in service of an agreed target, for example, in terms of nominal GDP.

For example, in circumstances when fiscal policy is more effective than monetary policy, such as when interest rates reach their effective lower bound, debt-financed tax cuts could be pursued, with the central bank acting as a buyer of government debt. The shared target, meanwhile, would ensure the credibility of the monetary authority, protecting it from so-called “fiscal dominance”.

In a monetary union, the dynamic is more complicated, making a formal structure for coordination all the more important. Monetary and fiscal policymakers should be working in concert to achieve the right combination of inflation, output, interest rates, and sovereign risk. But such coordination would affect, among other things, the ECB’s bond-buying programme, including how much risk it assumes and the geographical mix of the bonds it purchases.

Should the ECB now be purchasing relatively safe recovery bonds, or leaving those to the market, while directing its purchasing programme toward riskier assets? This is a monetary-policy decision with fiscal consequences. It should not be left to the central bank alone.

What institutional changes could resolve this problem? To begin, the EU must consider the desirability of an independent fiscal authority with which the ECB could coordinate policy. The two bodies would meet regularly to set relevant targets, relating to deficits, interest rates, and prices, and to evaluate whether national policies are aligned with those targets.

The pandemic has upended many existing rules and institutional guidelines. For example, the EU has suspended its limits on fiscal deficits, which most economists think should not be reintroduced any time soon, especially not in their current form. If EU leaders take this as an opportunity to pursue radical, forward-looking change, the COVID-19 upheaval could move the bloc to a better place. Otherwise, conditions could become much worse. Just ask the Japanese.

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