From friends to foes?

Monetary and fiscal policy interactions in the eurozone

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- After years of alignment, fiscal and monetary policy are now starting to pull in the opposite direction in the eurozone
- In the near-term, more fiscal support could allow the ECB to focus more on inflation and normalise policy faster...
- ...but a prolonged tug of war could lead to output volatility, uncertainty in the markets, and debt sustainability concerns

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From maximum coordination...

Since the onset of the pandemic, the talk of the town has been the need for monetary and fiscal policy to work together. The eurozone has been one of the best examples. Monetary policy has been highly accommodative. Even with policy rates pretty much at their lower bound, it still created room for an expansionary fiscal policy through the PEPP. This combination helped the economy recover fast and with hardly any scarring. Then, as restrictions were lifted, the fiscal support was (almost automatically) unwound which, thanks also to strong nominal growth, led to a rapid reduction of the deficits. This helped the ECB to exit QE without causing too much pressure on the spreads.

...to a possible tug of war?

The Ukraine conflict poses a tougher challenge for European policy-makers. With all-time high inflation, the ECB is keen to tighten policy, but is being held back by recession fears. Fiscal policy is coming to the rescue again but this time without the umbrella of QE. In the near-term, things could work out just fine. Outright cuts to energy taxes and price caps could help reduce inflation, but also allow the ECB to move faster down the policy normalisation path as they take care of recession risks.

But monetary and fiscal policy pulling in opposite directions poses risks further out. With supply chain constraints and energy shortages limiting output, fiscal support could push demand further beyond supply raising near-term inflationary pressures. This reinforces the need for well-targeted fiscal measures, as ECB Board Member Isabel Schnabel noted. But that's easier said than done. As Europe goes through a tough energy transition beyond the war, energy price pressures could be long lasting, making it hard for governments to unwind support. The ECB could be pushed to be even more aggressive in tightening policy, to which fiscal authorities could respond with even bigger fiscal expansions. This tug-of-war could increase output and market volatility. And with fiscal deficits rising again, we could see debt sustainability and fragmentation risks re-emerging, which the ECB might find hard to counteract.

Against this background, a gradual approach by the ECB to tackle inflation might be warranted, effectively extending the time horizon when the 2% target is met. Fiscal support should be combined with a commitment to medium-term consolidation and swift re-introduction of EU fiscal rules to make it credible. Fiscal measures lowering energy prices might be preferable to transfers, reducing the risk of second round effects. Even then, the risk of the eurozone getting stuck in a bad equilibrium is high.

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Monetary and fiscal policy interactions

Going hand in hand during the pandemic

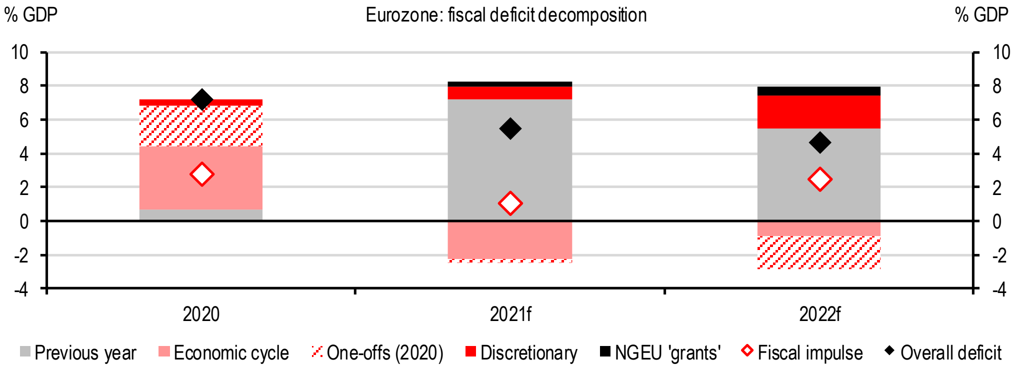
The coordination between monetary and fiscal policy has been a key ingredient in the response to the pandemic shock, at the global level and also in the eurozone. Even though ECB policy rates were basically at their lower bound, with rates already negative (-0.5%) entering the crisis, it still introduced additional stimulus measures, most notably a new QE programme, the Pandemic Emergency Purchase Programme (PEPP), which ended in March after having bought almost EUR1.7bn of assets, and making Targeted Longer-term Refinancing Operations (TLTROs) even more generous, with banks able to borrow money at -100bps (the additional 50bps discount will expire in June).

PEPP created the space for fiscal authorities to intervene

Meanwhile, fiscal policy did the heavy lifting of cushioning the blow to households and firms hit by the lockdowns, by creating the conditions for a swift economic recovery once the pandemic-related restrictions were lifted. PEPP, by effectively absorbing all the net sovereign bond issuance in 2020 and 2021, created the fiscal space needed for governments – particularly high-debt ones – to provide such fiscal support while limiting the risks of rising borrowing costs. And there was even some joint response at the EU level, particularly with the EUR750bn Next Generation EU (NGEU) fund which contained a component ('grants') of mutualised debt.

The strong coordination of monetary and fiscal policy is in our view one of the key reasons while the GDP recovery was much swifter than we (and most) had initially anticipated, with hardly any economic scarring, at least until supply-chain constraints and surging energy prices started to bite towards the end of last year, and the Ukraine war more recently which exacerbated some of these issues.

1. Fiscal policy has been highly expansionary in the eurozone since the pandemic



Source: HSBC calculations based on European Commission, Ministries of Finance.

Well targeted fiscal support and relatively easy to unwind...

Due to the nature of the crisis and the fiscal measures, as the restrictions were lifted, the support was also unwound

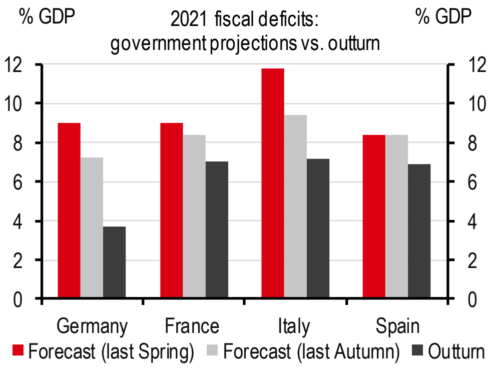
The fiscal support measures during the pandemic also had some features, partly due to the unique nature of the crisis, which made them relatively easy to unwind. The bulk of them were targeted at individuals and firms hit by the lockdowns and restrictions to economic activity. They included short-time work compensation schemes and transfers to firms to compensate them for the foregone revenues while they were kept shut. So as the restrictions were gradually lifted, these measures were almost automatically unwound, without any need for active consolidation, which is always politically difficult. This is why we have referred to those interventions in the past as super-cyclical, rather than structural, measures. The swift economic recovery did the rest in terms of boosting government tax revenues. And with even stronger-than-expected nominal growth as inflation picked up from the second half of last year, the fiscal deficits fell much faster than even the – usually optimistic – government forecasts anticipated (Chart 2).

...likely also facilitated the ECB exit strategy

Shrinking fiscal deficit likely played a role in allowing the ECB to exit QE without causing too much disruption

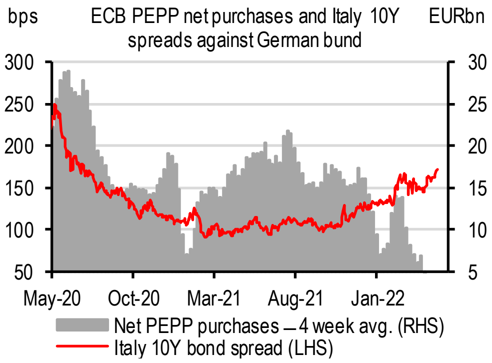
In turn, this likely facilitated the process of monetary policy normalisation by the ECB. We had flagged earlier on during the pandemic that the ECB faced a narrow exit path from the monetary stimulus, and that winding down QE in particular might have proven hard if fiscal deficits remained stubbornly high. So the faster reduction of the deficits likely helped the ECB to wrap-up the PEPP programme quickly, and without much pressure on periphery spreads, at least so far, as also noted in the minutes of the March ECB meeting.

2. Deficit fell much faster than governments expected last year...



Source: Ministries of Finance, HSBC.

3. ...which likely helped reduce pressures on the spread as PEPP was unwound



Source: Bloomberg, ECB, HSBC.

From friends to foes?

A more challenging environment for policy coordination

The surge in energy prices seen since the second half of last year, exacerbated by the war in Ukraine (and adding a few more, from food to supply chains), have created a more challenging environment for the coordination of monetary and fiscal policy in the eurozone.

The energy transition which Europe is facing creates some clear inflationary pressures for the eurozone, as stressed recently by ECB Board Member Isabel Schnabel in her speech "*A new age of energy inflation: climateflation, fossilflation and greenflation*" (17 March 2022). On top of that, the intrinsically inflationary nature of the Ukraine war increases the challenges facing the ECB.

All-time high inflation and increasing risk of second-round effects to wages means the ECB is keen to tighten policy, but it has its hands tied by the fear of causing – or possibly exacerbating – a possible recession. As Board Member Fabio Panetta recently put it, "asking monetary policy alone to bring down short-term inflation while inflation expectations remain well anchored would be extremely costly" and "a monetary-policy tightening would not directly affect imported energy and food prices [...] we would instead have to massively suppress domestic demand to bring down inflation." (Reuters, 6 April).

> **"Asking monetary policy alone to bring down short-term inflation while inflation expectations remain well anchored would be extremely costly**
>
> **Fabio Panetta, ECB Board Member, 6 April**

Let fiscal do the work

So far, the response has been for fiscal policy to step in, while monetary policy continues to move down – albeit very slowly – a policy normalisation path. In recent months we have seen first fiscal transfers to households and (to a lesser extent) firms being implemented first, and more recently direct interventions (tax cuts and subsidies) to curb energy prices (Table 4).

4. Main measure to tackle the energy crisis in the Big 4

Measure	Detail
Germany	The German government followed up on its first energy relief package in late February, worth roughly EUR9bn including the complete abolishment of the renewable energy apportionment from July 2022, which alone would save German consumers EUR6.6bn, with a second relief package on 23 March. The second package is even larger in fiscal terms, costing up to EUR18bn according to our estimates. Though the exact timing for the implementation of the contained measures has not yet been announced, they include a EUR300 cash bonus for all income tax payers, additional transfer payments for social security beneficiaries and families as well as a temporary cut of the energy tax on fuels, which could lower gasoline prices by up to 15% for the 3-month period it will be applied (we expect it from June). The finance ministry also implemented liquidity support measures for businesses via loans from the KfW and federal guarantee schemes on 8 April. These will be followed by other support measures, which could include grants to energy intensive business sectors as well as the acquisition of stakes by the public in the coming weeks.
France	The main measures to tackle rising energy costs so far amount to EUR30bn of which about EUR20bn is to curb the increase in energy prices for households and firms and the rest in household support measures. A subsidy on petrol pump prices (18c per litre) is in place from 1 April for four months (cost of the measure is estimated at EUR2bn). The government also unveiled on 16 March a new 'resilience plan' of EUR4bn to help corporates facing higher energy prices. It includes targeted subsidies and support for corporates very dependent on energy imports and for some sectors (building, agriculture, transport). Other measures already announced before were: a freeze on regulated gas prices (to October 2021 levels) until the end of 2022 (EUR10bn), a cap on the rise in regulated electricity prices at 4% in 2022 (EUR8bn), a one-off payment of EUR100 for low and middle income households (EUR4.4bn) and higher tax deductions for people who use their cars a lot (EUR0.4bn).
Italy	The government introduced EUR10bn of measures last year to offset the rising energy costs for households and firms (VAT cuts, income support measures for poorer households). Another EUR8bn package was agreed at the end of February of which EUR6.5bn is to cushion the impact of rising energy prices on households and firms. Of those, EUR3bn is to further reduce all taxes on gas, EUR3bn of tax credits for firms. For April-June, the government has reduced the VAT (to 5%) charged on gas and other taxes which led to a c10% reduction in electricity and gas prices in April. From 22 March until 2 May (postponed from an initial deadline of 21 April), the VAT on fuel and gas for transport has been cut, resulting in a discount of EUR30.5c/litre for fuel and EUR10.4c/kg for LPG. An extra EUR6bn is available within the 5.6% of GDP deficit target for additional support measures.
Spain	So far, the main measures in Spain to tackle the energy crisis have been a reduction to 10% of the VAT on energy bills for households consuming less than 10kW and a discount of 60-70% of the S&P energy bill for the household beneficiaries of the "electricity social bonus" (recently extended until 10 June). A special electricity tax was reduced to 0.5% until 30 April while a 7% further tax on electricity production will remain suspended until 31 March. On 2 March, PM Sànchez announced new measures to tackle the energy crisis, focussing on reducing Spain's dependence on energy (EUR 0.6bn) and strengthening the plan to increase renewable energy production (EUR1bn). On 28 March, the government agreed an additional EUR16bn plan to tackle the energy crisis. EUR6bn is in direct fiscal measures (0.5% of GDP), which include a 20c/litre subsidy for fuel with 15c paid by the government and 5c by energy firms. The other EUR10bn is a new line of state guaranteed loans for the firms facing difficulties.

Source: HSBC, Ministries of Finance.

In the near term, things could work out well...

More fiscal support can allow the ECB to focus more on hitting its inflation target

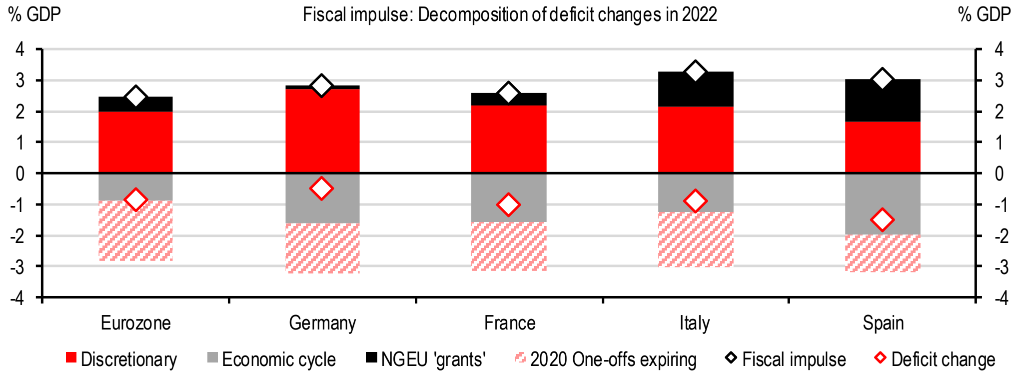
So it seems that we have moved from a paradigm of monetary and fiscal policy coordination, to one in which the two pull in opposite directions (even if the ECB has been treading very carefully so far). That needs not be a problem. By reducing inflation outright, the more recent interventions aimed at curbing energy prices should even help the ECB directly reduce the risk of second round effects from inflation to wages. At the same time, with inflationary pressures already broadening out, it should allow the ECB to focus on its primary objective, hitting the 2% inflation target, and therefore be a little more aggressive in terms of policy normalisation.

...but there might be troubles further out

Fiscal support is going to be very substantial this year...

The latest fiscal support measures come on top of what was already planned, so we are now looking at a very expansionary fiscal policy this year, with a net stimulus (including the NGEU 'grants') amounting to around 2% of GDP (Chart 5). Italy and Spain stand out in terms of additional support, thanks to the NGEU payments (the Spanish government expects NGEU spending to push public investment to a post-Global Financial Crisis high of EUR40bn or nearly 3.5% of GDP). The new German government is also showing more willingness to spend fresh money to tackle the energy crisis as well. And more fiscal support might still be coming, including following the French presidential election, which saw an all-time high support for a far-right leader in the second round.

5. Italy and Spain should top the Big 4 this year in terms of additional fiscal stimulus



Source: HSBC calculations based on Ministries of Finance.

...and the latest measures might be harder to unwind than those implemented during the pandemic

Furthermore, unless energy prices fall sharply – which seems unlikely, at least in the near term – it might be tough for governments to unwind the latest tax cuts or subsidies to curb energy prices, particularly with elections looming in several eurozone countries next year (Italy, Spain, Greece). Unlike the pandemic, the shock is not so clear to identify and offset. Granted, the Ukraine war added greatly to the energy prices, but as mentioned earlier, some of the inflation pressure pre-date the war and reflect wider, more structural factors (e.g. the broader energy transition challenge facing Europe). So they might not necessarily fade even if the conflict situation is resolved.

Against this backdrop, it might be harder for governments to unwind the latest measures relative to those implemented during the pandemic, when the unwinding was fairly automatic. At the same time, some of the windfall gains in terms of deficit reduction from higher inflation could fade, as pressure rises to increase at least certain spending items (e.g. salaries, social benefits) in line with inflation.

> **“ But fiscal support should be targeted so as not to add to medium-term price pressures at a time when the economy itself is expected to generate sustained inflation and Europe’s ambition to achieve strategic autonomy will already necessitate significant public investment spending**
>
> **Isabel Schnabel, ECB Board Member, 2 April 2022**

Further fiscal support could add to the near-term inflationary pressures

At the same time, with the supply side of the economy constrained, further fiscal support pushing demand further beyond supply could add to the near-term inflationary pressures, as stressed recently by Ms Schnabel (2 April). This could push the ECB to be even more aggressive in terms of raising rates. In turn, fiscal authorities could respond with even more expansionary policy to support activity levels. This could lead to a vicious cycle of more monetary tightening and even more expansionary fiscal policy. From the academic literature, similar tug-of-war situations tend to lead to greater output volatility, particularly in situations where the output gap is uncertain,[1] and could also lead to more volatility in the markets.

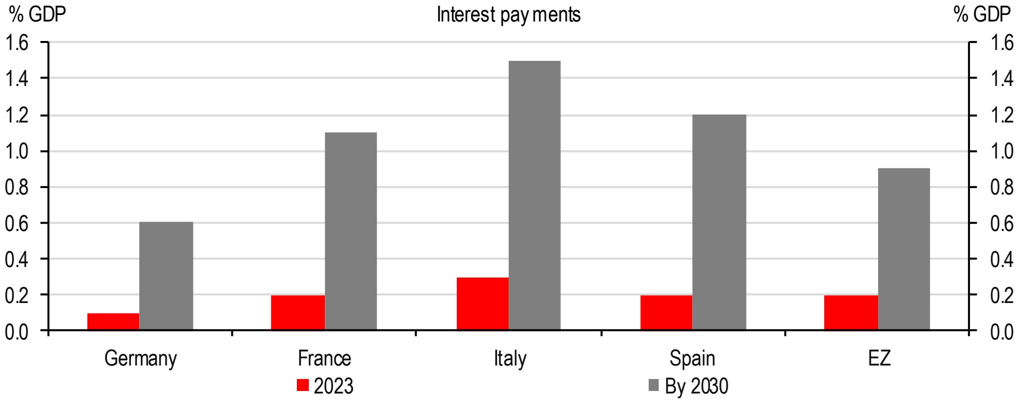
Possible debt sustainability concerns and market fragmentation risks

That might not be the end of the story. Fiscal deficits are still high in absolute terms following the pandemic even though they have been falling faster than governments anticipated. More pressure on them arising from tighter monetary policy could lead to broader debt concerns.

Higher deficits combiner with more aggressive tightening of monetary policy could put debt sustainability at risk

The higher debt levels after the pandemic increase the roll-over risk and leave Europe's economies highly vulnerable to small changes in interest rates. We estimate that a 1pp shift up in European yield curves could increase interest costs by around 0.2% of GDP next year. For the eurozone as a whole, that's around EUR25bn. If sustained, it would cost around 0.9% of GDP by 2030, likely more due to a large chunk of bonds that are already held by the national central banks and which imply lower transfers back to the Treasuries as rates starts to go up. High-debt countries such as Italy would see their borrowing costs rise even more (Chart 6). If, on top of that, fiscal deficits were to widen further – and in a structural manner – as a result of the energy crisis, concerns around debt sustainability for some countries might resurface in the markets, leading to possible renewed pressure on periphery spreads and market fragmentation risks.

6. Higher debt burdens leave countries highly sensitive to interest rate changes



Source: HSBC calculations based on European Commission. Note: This does not account for the reduce profits and lower transfers back from the national central banks to their respective Treasuries resulting from higher rates.

ECB could have its hands tied

Granted, the ECB could step in to address possible market fragmentation risks. The ECB recently added to its initial statement the possibility to "incorporate flexibility if warranted." This could potentially allow the ECB to go beyond the limits of the existing tools to contain market fragmentation, such as the OMTs, which have policy conditionality, or the PEPP reinvestment flexibility, which only applies to PEPP and "pandemic-related market fragmentation".

[1] Buti, Marco, Larch, Martin and Balboni, Fabio, *ECB vs. Council vs. Commission: Monetary and Fiscal Policy Interactions in the EMU When Cyclical Conditions are Uncertain* (April 1, 2007). Empirica, Journal of Applied Economics and Economic Policy, 2009

With wider deficits, politically it might be even harder for the ECB to implement any such backstop facility

But the ECB also faces many legal and technical constraints when it comes to its ability to purchase sovereign bonds, arising from the Treaty requirement to avoid monetary financing of the deficit. So, it remains to be seen whether investors will find the pledge of a possible new instrument credible enough, or might want to test the ECB in the coming weeks and months. And in any case, with wider deficits, politically it might be even harder for the ECB to implement any such backstop facility.

Graduality and commitment

A gradual approach by the ECB to tighten policy seems warranted

Against this background, we draw the following conclusions. First, a gradual approach by the ECB to tighten policy seems warranted. This has also been flagged by most ECB policy makers (including several hawks). In practice, that would mean pushing further out the time horizon when the 2% target is met, possibly until enough progress has made under the energy transition to reduce some of the price pressures. This would not necessarily mean, however, formally extending the horizon, or pushing back against increasingly hawkish market expectations. Indeed, maintaining a relatively hawkish narrative is key to reduce risk of possible second round effects, particular with limited other tools at its disposal. But when it comes to delivering on those rate rises, we think that the ECB will move more slowly than currently priced in by the markets (some 200bps by the end of next year).

More investment should be undertaken – ideally jointly – to speed up the energy transition

At the same time, interventions will have to be put in place by the member states to speed up the energy transition process and reduce some of the inflationary pressures stemming from it. The European Commission has recently rolled out a plan (REPowerEU) to cut Russian energy dependency already starting from this year,[2] but this is likely to require significant investment in the coming months. Ideally, to avoid putting too much pressure on the individual countries' finances, at least some of the additional spending could be mutualised.

Fiscal support should be combined by commitment to medium-term consolidation and re-introduction of EU rules

Finally, in terms of the specific government interventions to tackle the energy crisis, we would argue that the latest measures which reduce energy prices outright seem preferable to fiscal transfers, as by reducing inflation they also lower the risk of second round effects on wages. However, as also argued in this note, they also come with a higher risk of being harder to unwind. Therefore, we think such fiscal support should be combined with a strong commitment by governments to medium-term consolidation. EU member states have recently agreed that EU fiscal rules will – de facto – remain suspended also next year. While this is understandable given rising recession risks, to us a swift re-introduction of – possibly slightly different – rules focussing more on medium-term consolidation plans and curbing spending would be important.

Finally, it is worth bearing in mind that even if all these things were implemented, there are plenty of risks along the path. For one, if inflation expectations do end up getting de-anchored as the eurozone navigates this difficult energy transition challenge, the risks of the block getting stuck in a stagflation-type scenario would increase, making the coordination of monetary and fiscal policy even harder.

[2] https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1511.

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