

# Who Is Afraid of Eurobonds?

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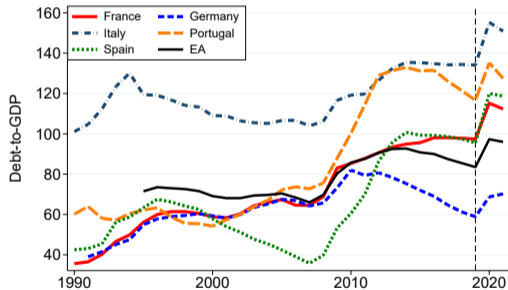
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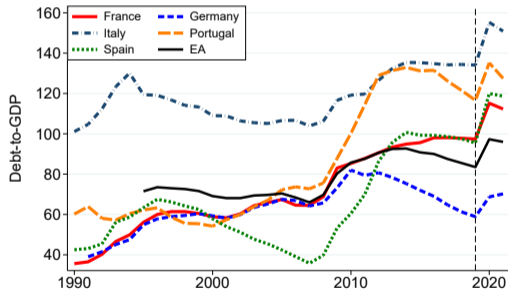
# Where does the euro area stand?

- More countries in EA now have elevated sovereign debt



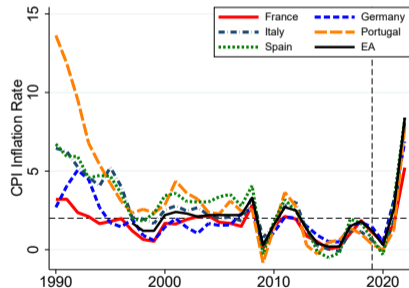
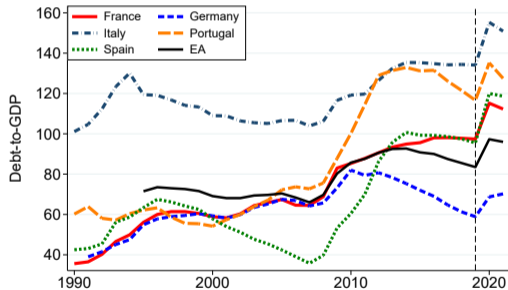
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- Large fiscal adjustments required especially in low-growth countries



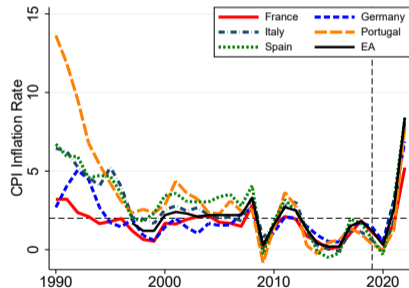
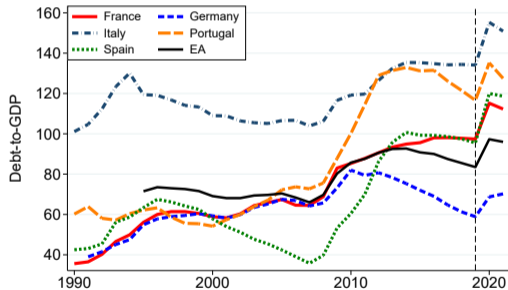
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- In the 90s **fiscal rules** introduced and there was convergence across euro area countries



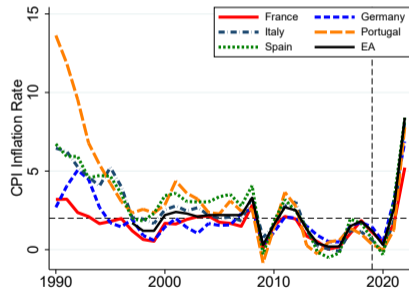
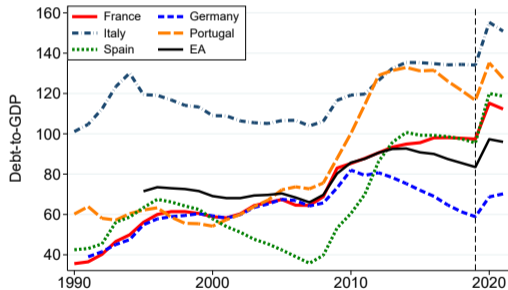
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- Indeed we observe macroeconomic convergence in the 2000s...



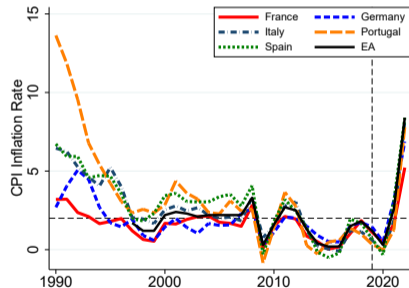
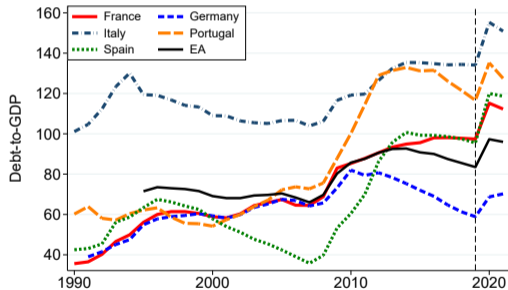
# Where does the euro area stand?

- ...but when Great Recession and sovereign debt crisis hit, **sovereign debt** rose significantly



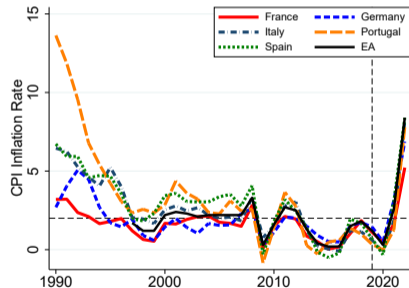
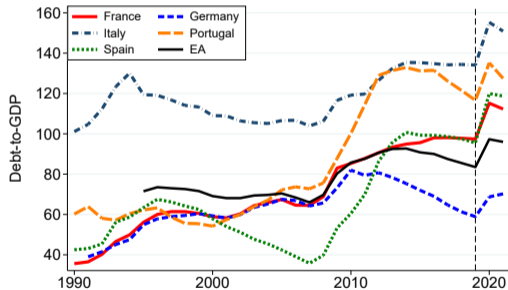
# Where does the euro area stand?

- The EA experienced low inflation, slow growth and zero/negative interest rates



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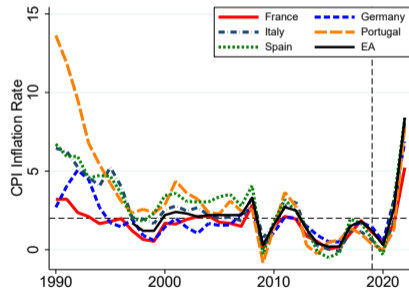
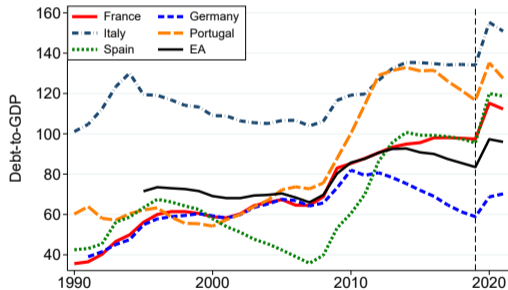
- The Pandemic set off a massive coordinated monetary/fiscal response





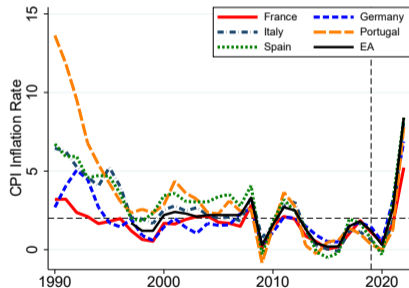
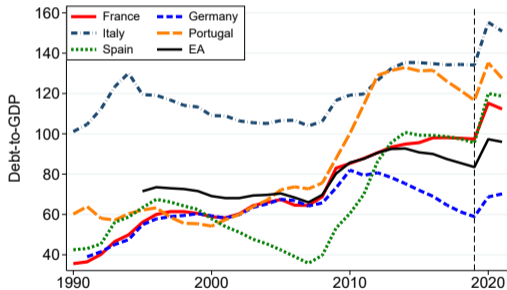
# Where does the euro area stand?

- As fiscal rules were temporarily suspended sovereign debts rose



# Where does the euro area stand?

- Later on, sovereign debts marginally improved as inflation surged quickly



# A Key Trade-off for the Euro Area

# Trade-off and risks

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# A two-country monetary union model with no fiscal union

- Backbone: Medium scale NK model
  - + Households consume both domestic and imported goods
  - + Two types of households: savers and hand-to-mouth
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- Central bank of the union follows Taylor rule subject to the ZLB constraint

# Fiscal discipline in the monetary union

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## + The monetary authority is credibly committed to stabilize inflation

- The Taylor principle is always satisfied
- The ZLB constraint occasionally curtails monetary accommodation

# Recession scenario

## + Recession induced by a large demand (risk-premium) shock

- Persistence: Match average EABCN peak-to-trough
- Volatility: Match output volatility over 1999Q1-2019Q4

## + Calibration of national fiscal imbalances:

- High-debt country (Italy): pre-recession debt-to-GDP 134.8%
- Low-debt country (Germany): pre-recession debt-to-GDP 61.9%



# A model-based assessment of the EA risks

Compare:

## **Case 1. Fiscal Discipline is maintained**

- + Both fiscal authorities follow the fiscal rules and begin reducing their deficits
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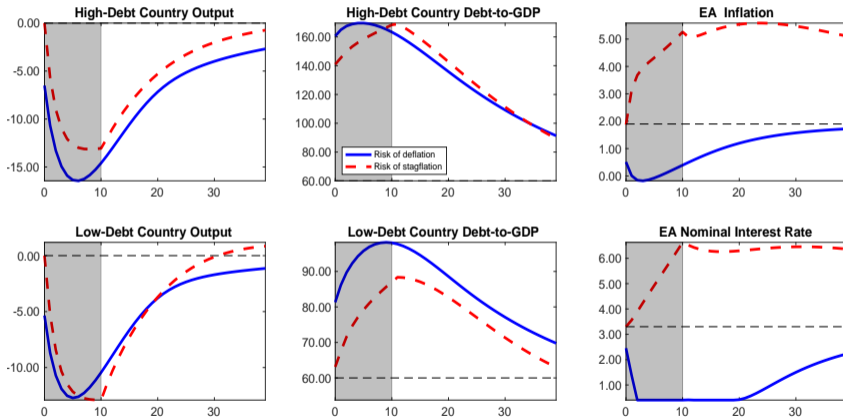
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## **Case 2. One country deviates from Fiscal Discipline (Fiscal Dominance)**

- + The high-debt country refuses to comply with the fiscal rules
- + The low-debt country keeps adhering to the fiscal rules
- + Monetary authority keeps stabilising inflation (for a while)

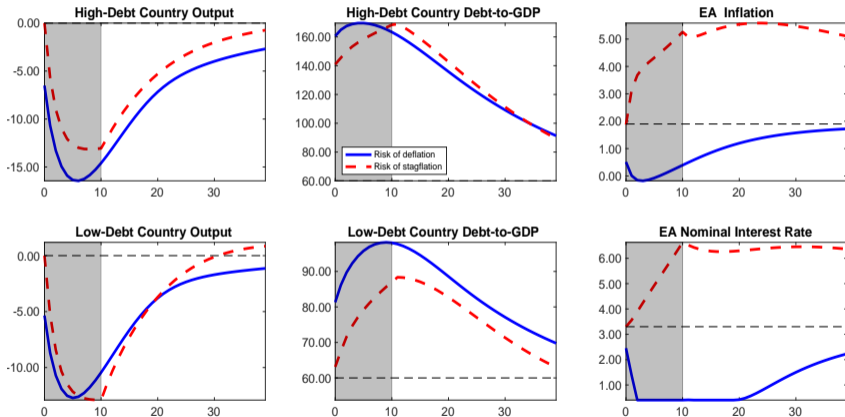
# A model-based assessment of the EA risks

- Fiscal Discipline coupled with a binding ZLB  $\Rightarrow$  Deflation and deep recession



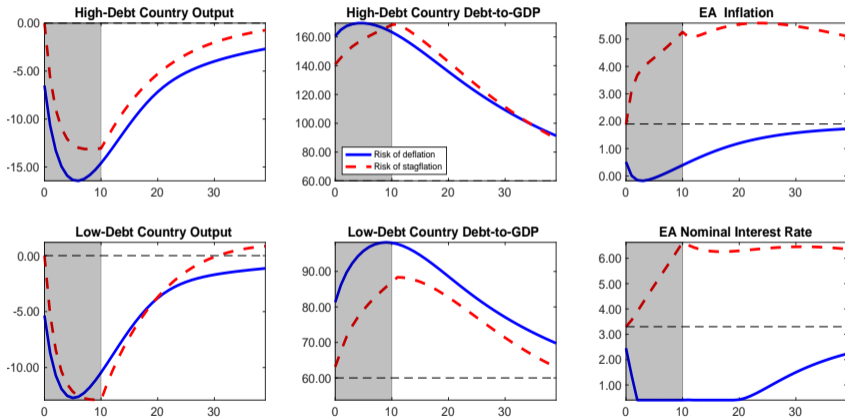
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- Suspend rules & high-debt country refuses to revert to them → **Fiscal Dominance**



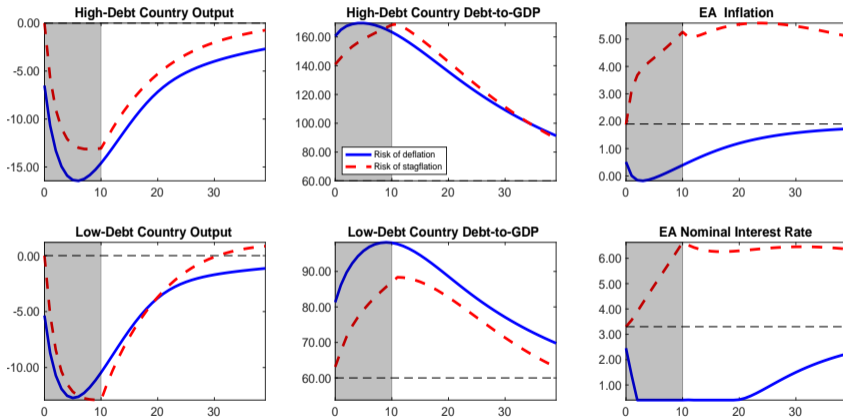
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- Monetary tightening deteriorates the fiscal position of the high-debt country



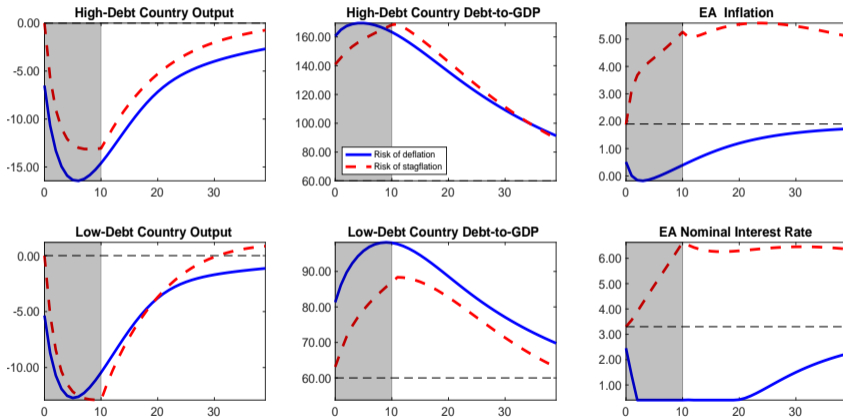
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- Spiral of growing inflation, deep recession, and debt accumulation



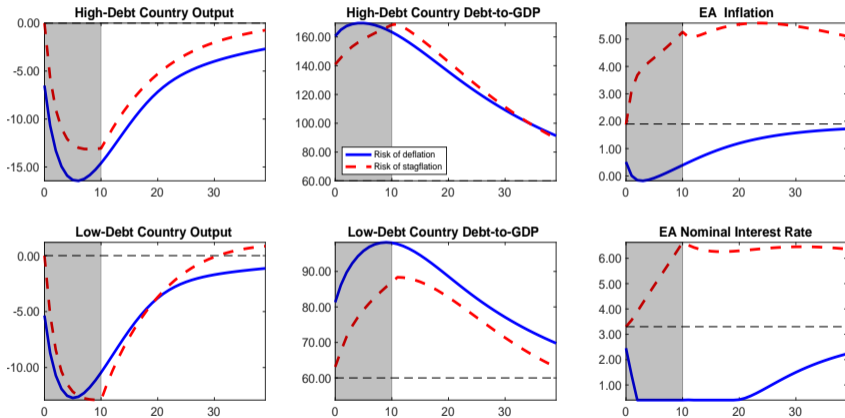
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- High-debt country abandons Fiscal Discipline to better stabilize its economy



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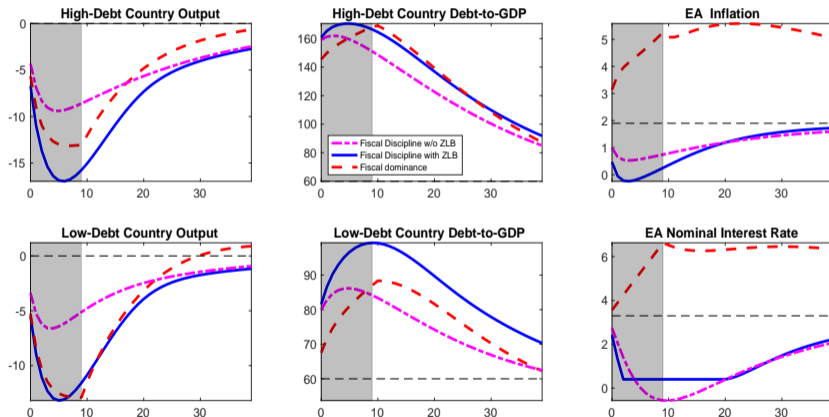
- But higher inflation for every country in the monetary union





# A model-based assessment of the EA risks

- If the ZLB does not bind, lower incentive to deviate from Fiscal Discipline



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With current fiscal/monetary framework, policy coordination in the EA is difficult to achieve:

- + Hard to implement quick fiscal interventions for stabilisation purposes
- + Hard to guarantee long-run fiscal sustainability

We study a fiscal/monetary framework to allow the EA to sidestep both risks

# A centralized fiscal authority for the EA?

- + A **EA budget** to pursue supranational objectives:
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- + **Fiscal rules** are maintained **at national level**
- + Countries are fully accountable for their national debt

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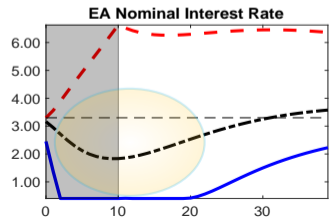
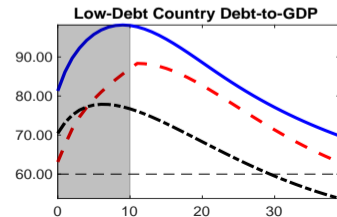
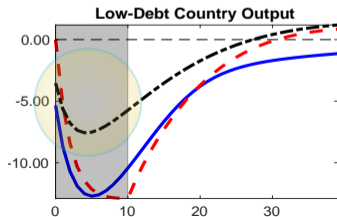
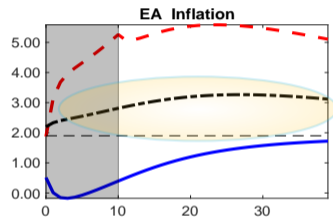
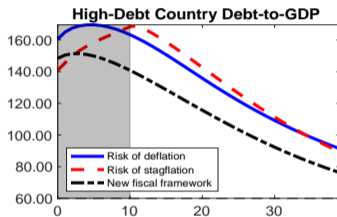
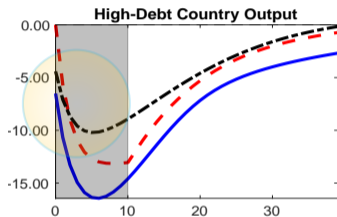
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⇒ Stabilization policies separated from long-run fiscal sustainability  
⇒ Ability to coordinate to avoid ZLB and deflation without sparking high inflation

# New policy framework: controlled reflation

- **New policy framework** based on **EA debt** eliminates risks of deflation and fiscal dominance

# New policy framework: controlled reflation

- No ZLB, milder recession, contained increase in inflation



# EA monetary and fiscal coordination

A recession scenario to show that:

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  - Milder recession → lower EA debt → smaller expected fiscal adjustments
- + Only a **moderate** increase in **inflation** because of GE effects
  - Milder recession → less debt accumulation → less inflation to stabilize the EA debt
  - Fiscal discipline preserved at national level



## Monetary and fiscal coordination at EA level is Pareto improving

Volatilities	Fiscal Discipline	EA Budget
Euro Area Output	16.797	11.707
Euro Area Inflation	0.617	0.427
High-Debt Country Output	18.103	12.273
High-Debt Country Inflation	0.640	0.426
Low-Debt Country Output	15.516	11.147
Low-Debt Country Inflation	0.640	0.426
ZLB Frequency	0.210	0.089

**Table:** Volatilities of Output and Inflation for 1000 simulations of 40 periods under *Fiscal Discipline* and *EA Budget*.

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  - Facilitate separation between macroeconomic stabilisation and long-run fiscal sustainability, reducing the risk of fiscal dominance
  - Be Pareto improving, i.e. every country would benefit from it