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PRESS RELEASE

Monetary and fiscal policy in the euro area: independent but connected
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Pre-crisis, monetary and fiscal policies tended to be analysed and implemented separately.
Against the background of some bad experiences in the past, interactions between monetary and fiscal policies are often reduced to the danger of governments urging central banks to resort to monetary financing of their debt. The resultant risk of rising inflation can jeopardise macroeconomic stability and prosperity. Hence, in the 1990s, a new consensus began to emerge that good macroeconomic policy requires central banks to be independent. Being insulated from political pressure, they are able to guarantee stable inflation and make a major contribution to macroeconomic stability in the broad sense. Moreover, to make sure that governments do not disrupt the stabilising capacity of the central bank, some countries have imposed binding fiscal rules. In the euro area, the Stability and Growth Pact (SGP) thus sets explicit limits for the EU Member States’ budget deficits and debt ratios.

The crisis calls the conventional view into question.
The economic and financial crisis that started in 2007 threw up new challenges to conventional thinking and the European institutional architecture, which strictly separate monetary and fiscal policies. Governments proved to be sensitive to shocks likely to turn liquidity problems into solvency problems, which justifies the central bank acting as a backstop. When it comes to maintaining price stability, monetary policy has encountered limits, which has raised the question whether fiscal policy should be assigned a bigger role in evening out the macroeconomic imbalance between savings and investment. Effective policy recommendations thus turned out to be more complex than the 'keep your own house in order' view that prevailed before the crisis and was considered to be sufficient.

Joint analysis of these two policy areas is gaining ground.
So the crisis triggered some serious rethinking about the consensus view, whereby, especially in exceptional situations, positive synergies between these two policy domains are given more room to play. The importance of a more holistic analysis of monetary and fiscal policies is, however, not a new insight; the idea had already been floated in the 1990s with the monetary-fiscal theory (in its narrow definition better known as the fiscal theory of the price level). Since it allows a wider spectrum of monetary and fiscal policy behaviour, this school of thought has come to the conclusion that macroeconomic and budgetary stability always requires an appropriate – be it sometimes implicit – interplay of these two policy areas. These insights are also being translated into specific policy measures, taken by the ECB for example, and into changes to the European institutional set-up.

This article takes a look at some of the interactions between monetary and fiscal policies in the euro area that emerged during the crisis, both from the conventional view and the alternative monetary-fiscal theory. More specifically, it analyses the role the ECB played in preventing a sovereign debt crisis, whether fiscal policy could inject strong impetus into the economic recovery, and thus also contribute to bringing inflation back in line with its target, and to what extent the fiscal policy framework, given its asymmetry and its national dimension, results in a fiscal stance that is appropriate for the Monetary Union as a whole.

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