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Euro area policy mix: From horizontal to vertical coordination[1]

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1 Introduction

During the past 13 years, the EU has undergone two major 'existential' crises: the Great Recession that reached its peak after the bankruptcy of Lehman Brothers in September 2008 and culminated with the sovereign debt crisis of 2011–12; and the Covid-19 crisis, which erupted in the spring of 2020. It is now largely acknowledged that the responses of the EU and its member states have been radically different between the two crises. During the Great Recession, after an initial monetary and fiscal expansion, the focus quickly turned to government debt sustainability and fiscal prudence to reassure the markets, so that the onus of sustaining the economy fell mainly on the shoulders of the ECB. Instead, during the pandemic a much more forceful monetary and fiscal response was enacted. The ECB adopted the Pandemic Emergency Purchase Programme (PEPP) and strengthened its utilisation of other monetary tools, and national fiscal authorities implemented sizeable fiscal expansions on the back of the suspension of the Stability and Growth Pact (SGP)'s adjustment requirements via the General Escape Clause (GEC) and the temporary state aid framework.

It is important to stress that, for the first time, in 2020 the EU rules-based framework has been complemented by direct policy support at the central level. The Union agreed on a number of measures, including most notably the support to short-time work schemes (SURE). Most importantly, the Union agreed on a programme of direct support via the EU multiannual balance, Next Generation EU (NGEU), with at its core the Recovery and Resilience Facility (RRF). The different nature of the shock, the learning from the financial crises and new insights from macroeconomic theory help explain the different policy stances during the two crises (Buti 2020, Buti and Papacostantinou 2021). Most EU member states have put forward National Recovery and Resilience Plans (NRRPs), the majority of which have been adopted by the Council

1 The authors are writing in their personal capacity and their views should not be attributed to the European Commission or to other institutions. We thank, without implicating, Lucio Pench, Ernesto Reitano, Alessandra Cepparulo, Sven Langedijk, Simon O'Connor and Roberta Torre for their useful comments on an earlier draft of this Policy Insight. An Italian version of the paper will be published in "Astrid Rassegna".

based on a positive recommendation by the Commission. During August 2021, the Commission released the first transfers under the RRF, corresponding to the initial payment of 13% of the member states RRF envelope.

The combination of national and EU budgets, coupled with the rapid and determined ECB measures, have led to a more expansionary policy stance compared to previous crisis episodes. This forceful policy response was instrumental in maintaining the financial cohesion of the euro area (Hartmann et al. 2021) and favouring a strong bouncing back of its economy in the current year.

The purpose of this Policy Insight is to provide a simple unifying framework to analyse the evolution of the monetary-fiscal policy mix in the euro area since its inception, and to outline some options for the post-pandemic period. In Section 2 we show that euro area policymakers had to confront a policy mix trilemma. We then analyse the monetary-fiscal interactions in the euro area, and revisit their implications for monetary and fiscal dominance. Sections 3 and 4 examine how the trilemma was tackled during three different phases: the euro area's first decade, the global financial crisis, and the pandemic. The measures taken during the Covid-19 crisis could pave the way for the post-pandemic solution of this trilemma through a robust policy mix entailing horizontal and vertical coordination (Section 5). In Section 6, we discuss the options for future coordination between EU-level and national fiscal policies, notably the setting up of a central fiscal capacity. The final section sketches out some policy orientations for the future.

2 The euro area policy mix trilemma

Conceptually, in any currency area, policymakers need to supply an 'adequate' amount of cyclical stabilisation, either via the common monetary policy, via fiscal policy at central or decentralised level or, most likely, via a combination of these different policies. Within the Maastricht framework, policy authorities face what can be dubbed the 'euro area policy mix trilemma': one cannot have, at the same time, (a) asymmetric fiscal rules of the Maastricht type, (b) monetary policy constrained by the effective lower bound (ELB), and (c) no central fiscal capacity.[2] The trilemma is represented in Figure 1.

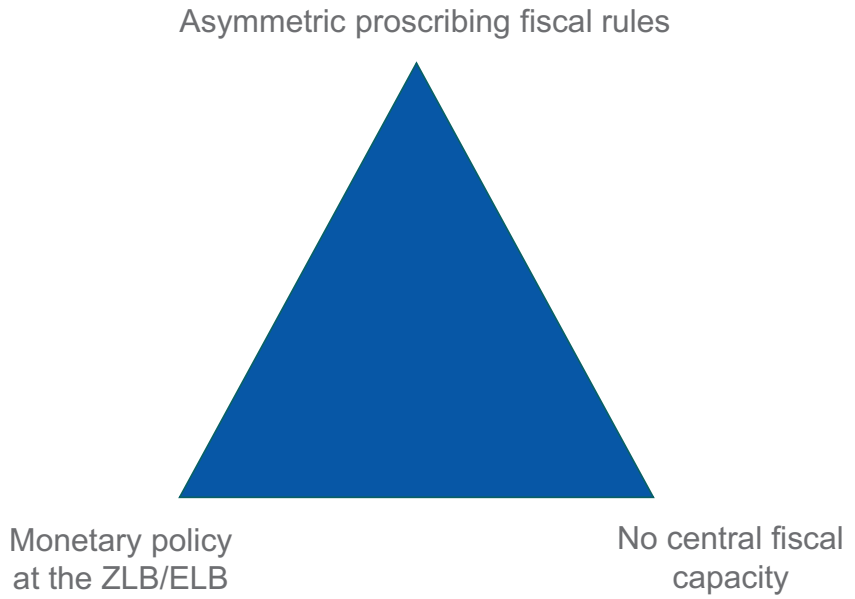
The Maastricht Treaty and, *a fortiori*, the SGP are fundamentally asymmetric in their call to avoid excessive government deficits without any constraint on the corresponding balance surpluses: the rules 'proscribe' excessive government deficit even if this entails a pro-cyclical fiscal behaviour, but do not have any 'prescribing' power over policies by countries with fiscal space. This asymmetry reflected the 'Brussels-Frankfurt consensus' prevailing at the time of the negotiations of Maastricht Treaty and of the SGP; the focus was on the risk of a government deficit bias aggravated by the common pool problem (Buti and Sapir 1998, Buti and Gaspar 2021).

For the European Commission and the Council to credibly enforce the Excessive Deficit Procedure in the absence of a central fiscal capacity, monetary policy should have unconstrained space to respond to shocks. This means that monetary policy cannot be limited by an ELB on interest rates. Should the latter not be the case, the fiscal stabilisation would have to be necessarily supplied either by the violation of the Maastricht fiscal requirements or by the setting up of a central fiscal response. In principle, the integrity of the Maastricht assignment can thus be preserved, if the

2 We are grateful to Lucio Pench, Director for Macroeconomic policies at the European Commission, for having spelled out the trilemma to us. He is in no way responsible, obviously, for the use we will make of this trilemma in the present paper.

fiscal rules are coupled with a monetary policy not constrained by the ELB and/or with a central fiscal capacity that can supplement the national fiscal policies (Buti 2020).

Figure 1 The euro area's policy mix trilemma



Source: own elaboration.

A related implication of the Maastricht fiscal constitution is that the *proscribing* (as opposed to *prescribing*) nature of fiscal rules makes it exceedingly difficult to achieve the right fiscal stance for the euro area solely via 'horizontal' coordination of national fiscal policies. The experiences of the last decade before the pandemic shock have shown that either the euro area fiscal stance has not been adequate, or the achievement of a satisfactory fiscal stance has taken place, most of the time, via a wrong distribution of national fiscal positions – i.e. too restrictive in countries with fiscal space and too relaxed in countries with high government deficits and debts.

3 Monetary and fiscal dominance revisited: How the euro area's policy mix trilemma was handled in the first two decades

This section provides a bird's eye view of the interactions between monetary and fiscal policies in the first two decades of the euro area's life.

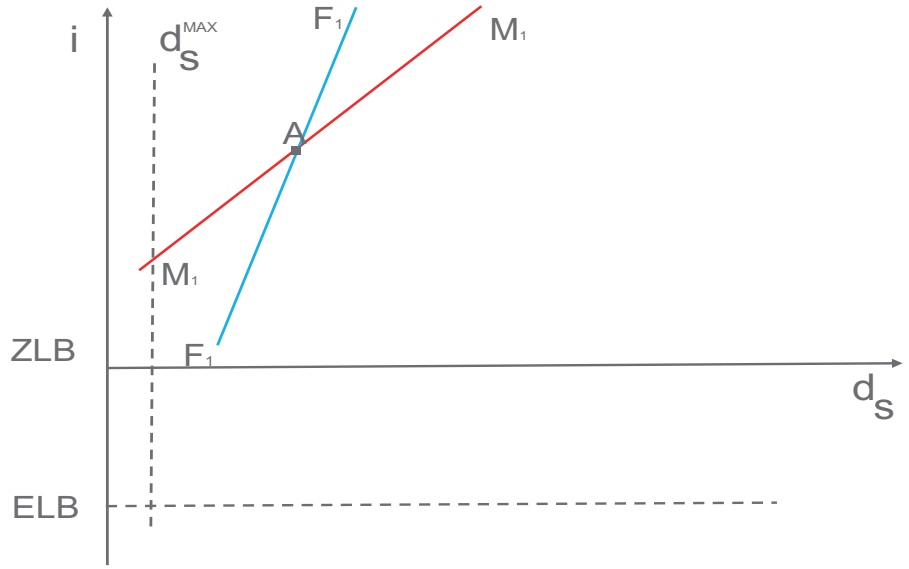
In the first decade (1999–2007), the temporary solution of the trilemma took place mainly via the monetary policy corner. The ECB had sufficient ammunition to deliver on the goal of taming inflation and keeping the European economy close to its potential: from 1999 to 2007, real GDP growth and inflation rate in the euro area averaged 2.3% and 2.1%, respectively. At that time, the economic thinking subscribed to Blanchard and Galì's 'divine coincidence': by delivering on the inflation target, the central bank would also help keeping output close to potential (Blanchard and Galì 2007).

The euro area's first decade was a period of what one might dub 'weak monetary dominance'. Monetary authorities pursued their primary goal of price stability, then defined as close to but lower than 2%, whilst fiscal authorities kept reducing headline government deficits and gradually bringing down public debt ratios. Fiscal policies, however, benefitted from the relatively strong economic growth and the 'convergence

bonus': the impact of automatic stabilisers and the lower interests burden helped comply with the deficit ceiling with relatively modest structural efforts. This underpins the 'weak' qualification added to 'monetary dominance'.

The relations between monetary and fiscal authorities during the years 1999–2007 are summarised in Figure 2, which shows the interactions between monetary and fiscal policies in the policy instrument space. The horizontal axis shows the structural government deficit, d_s, and the vertical axis the policy interest rate, i. The figure depicts the reaction functions of the two authorities in a simple demand-and-supply macroeconomic model.[3] The reaction functions are derived under the assumption that the fiscal authorities aim at keeping output close to potential, without deviating from the structural balance target that can be interpreted as the medium-term objective (MTO) of close-to-balance or in surplus of the SGP (d_s^{MAX} in Figure 2). In parallel, the monetary authority pursues its inflation target, but faces a cost in changing its policy interest rate. Point A in Figure 2 represents the Nash equilibrium at the end of the euro area's first decade.

Figure 2 Monetary-fiscal reaction functions at the end of the first decade in the euro area



Source: own elaboration.

This equilibrium indicates that, after the nominal convergence to qualify for euro area participation, national fiscal authorities kept reducing the government deficits. On average, the reductions in the structural deficit were not enough to comply with the MTO (the d_s^{MAX} line).[4] In the meantime, the ECB was able to keep inflation in check by setting positive interest rates, well above the zero lower bond (ZLB) and, a fortiori, the recent ELB.

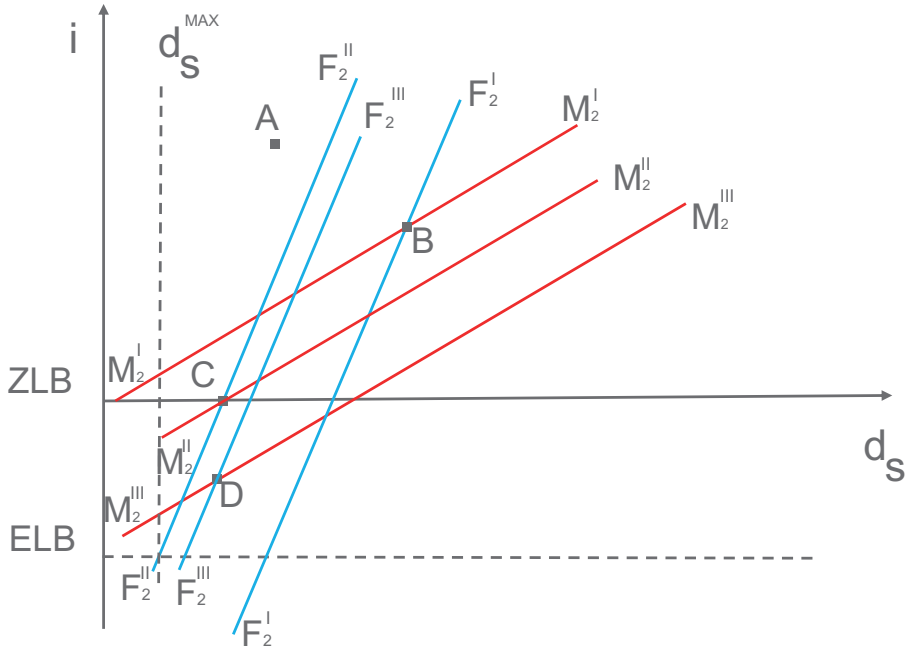
3 See Buti et al. (2001). It should be noted that the positive slopes of both the reaction functions reflect the fact that when interest rates go up, fiscal policy is relaxed to offset the impact on output, and vice versa. The quoted paper shows that the relative steepness is a condition for the stability of the model. It ensures that a positive (negative) fiscal shock leads to a rise (fall) in the interest rate. Let us add that we do not investigate further possible changes in the slopes of the two functions during the different periods of the euro area. This investigation would require an analytical apparatus that goes beyond the purpose of the present paper. Our qualitative conclusions, however, are robust to possible changes of the slopes of the monetary and fiscal reaction functions. Another simplifying assumption is the representation of national fiscal policies via the aggregate structural balance.

4 In 2006 and 2007, the average government deficit-to-GDP ratio in the euro area was equal to 1.5 % and 0.6 %, respectively. Twelve out of 13 countries were compliant with the 3% fiscal rule in 2007, that is, 92% of the euro area's member states at that time. Greece was the only country recording a deficit above 3% of GDP in 2007 (6.7%), but in the spring of 2008 it reduced this deficit to 2.8% of GDP. Let us recall that Eurostat expressed reservations on the latter number.

The benign initial years of the euro area were interrupted by the global financial crisis that came into full display after the bankruptcy of Lehman Brothers in September 2008. From the standpoint of the interplay between monetary and fiscal authorities, one can distinguish three sub-periods: end of 2008–2010, characterised by complementary, simultaneous fiscal and monetary expansion (the structural deficit increased by almost 2% over the two years); 2011–2014, dominated by the sovereign debt crisis and the strategic substitutability between monetary and fiscal policies, when the structural deficit was reduced by 4% of GDP compared to its 2010 level; and 2015–2019, when the overburdening of monetary policy went hand-in-hand with a flexible application of the fiscal rules resulting in a broadly neutral fiscal stance at the euro area level.

The monetary-fiscal interactions during these three sub-periods are depicted in Figure 3.

Figure 3 Monetary-fiscal reaction functions during the second decade in the euro area



Source: own elaboration.

Note: The reaction functions in the first sub-period are denoted by apex ^{I}, those in the second sub-period by apex ^{II}, and those in the third sub-period by apex ^{III}.

In the initial sub-period, the policy mix turned expansionary: ECB policy rates were reduced (reversing the increase decided shortly before the Lehman bankruptcy), open market operations were strengthened, and national fiscal policies loosened following the Commission proposal of a discretionary fiscal expansion of 1½% of GDP in 2009 with a further smaller loosening in 2010. In Figure 3, these policy reactions are shown by the equilibrium moving from A to B.

In 2011, however, both policies turned restrictive as the recovery that started at the end of 2009 and continued unevenly in the 2010 was, mistakenly, deemed self-sustaining. European governments 'declared victory' on the international crisis, and the worries shifted from stabilisation to public debt sustainability.[5] The euro area entered a vicious circle where institutional flaws, such as the lack of a 'lender of last resort' for

5 Buti (2020) recalls the debate and the decisions at the G20 Toronto summit, where the goal moved from supporting the economy to regaining fiscal sustainability. This shift was supported by Germany and Canada, whilst the US remained more reserved.

solvable sovereigns, and doubts on the integrity of the area triggered the sovereign debt and banking crises fuelling each other. The result was financial fragmentation and a double-dip recession.

After the two rises in the policy interest rates in the spring and summer of 2011 – that is, immediately before the peak in the sovereign debt crisis – monetary policy changed course and loosened substantially via various policy decisions. Let us recall the two Longer-Term Refinancing Operations (LTRO) in the beginning of December 2011 and end of February 2012; the "whatever it takes" statement by President Draghi in July 2012 and the related announcement of the Outright Monetary Transactions (OMT) in September 2012; and crucially the launch of unconventional monetary policies: (the Targeted LTRO, T-LTRO) in the late summer of 2014, the quantitative easing (QE) in the autumn of 2014, and the announcement of the extension of QE through the Asset Purchase Programmes (APPs) in the winter of 2014 (Messori 2021). Moreover, by mid-2014, policy interest rates hit the ZLB. On the fiscal side, the formal tightening of the fiscal rules (the Six Pack and the announcement of the Two Pack), which culminated with the adoption of the Fiscal Compact, led to a pro-cyclical fiscal stance going beyond the adjustment requirements of the SGP. This double shift is captured in Figure 3 by the shift from point B to point C.

During the third sub-period of the second decade of the euro area's life (2015–2019), monetary policy continued to provide substantial support via the strengthening of the APP and the effective combination between APP and a new T-LTRO (since April 2016), which set negative interest rates on bank's refinancing and government bonds (Benigno et al. 2020). As shown in Figure 3, the result was policy interest rates approaching the ELB (point D). At the same time, on average, national fiscal policies turned broadly neutral, helped by a more flexible interpretation of the central fiscal rules, as proposed by the newly installed Juncker Commission in early 2015 (European Commission 2015). This resulted in a broadly neutral fiscal stance for the euro area as a whole. However, the neutrality was attained via the wrong distribution of national fiscal positions. In France and Italy, notwithstanding the high public debt, fiscal adjustments first stalled and then were reversed. This came back to haunt policy authorities who found themselves with little fiscal space when the global economy weakened in 2019, well ahead the pandemic crisis (Boone and Buti 2019, Messori 2020).

What does the evolution of the policy mix imply for fiscal and monetary dominance? During most of the global financial crisis, the interplay between monetary and fiscal policies was dominated by strategic considerations. A tightening of the fiscal rules and pro-cyclical fiscal policies going beyond the adjustment requirements of the SGP were instrumental in gaining acceptance for a more active role of expansionary monetary policy and for establishing the European Stability Mechanism (March 2012) as the euro area's crisis management institution.

During the years 2012–2014, fiscal dominance reasserted itself and, then, characterised the whole sub-period. However, this form of fiscal dominance was not usually discussed in the literature. The overburdening of monetary policy in sustaining European economic activity in the face of fiscal retrenchment, and the need to ensure the integrity of the euro area in the absence of an unequivocal commitment on the part of leading governments,[6] led to *de facto* '*sui generis* fiscal dominance'. As argued by Buti (2020) and Messori (2021), the 'unpleasant monetarist arithmetic' of Sargent and Wallace (1981) was turned on its head: fiscal dominance emerged out of excessive fiscal prudence, especially in euro area member states with large fiscal space that were not under pressure from financial markets to adjust their balances. This specific

6 It is enough to recall the dramatic events that were threatening the exit of Greece from the euro area in mid-2015.

'fiscal dominance' continued in the years 2015–2018. As shown in Figure 3, in the face of a large demand shock, the pro-cyclical fiscal restriction pushed the monetary policy through the ZLB and eventually towards the ELB.

4 The policy mix during the pandemic: The search for congruence

In the Maastricht constitution, the policy assignment aims at preventing fiscal dominance. Strong institutional safeguards of central bank independence and central constraints on national fiscal policies are designed to avoid an excessive accumulation of public debt, itself made worse by the common pool problem deriving from the interplay between a single monetary authority and several fiscal authorities. In such a construct, whilst fiscal constraints would tackle the government deficit bias, a 'conservative' central bank would avoid the inflation bias. As discussed above, fiscal dominance was not always eschewed, even if it took forms not envisaged in the original Maastricht set up. Whilst the Maastricht assignment had a strong focus on preserving stability, it was also believed to ensure an adequate degree of cyclical stabilisation. In such a system:

a) Monetary policy would take care of symmetric shocks. According to the 'divine coincidence' view mentioned above, by keeping inflation close to target, monetary authorities would also deliver a level of output close to potential.

b) Given uncertain leads and lags, discretionary fiscal policies would be unlikely to be successful. The negative supply-side effects of volatility in tax rates and, more generally, the scepticism over discretionary fiscal policies lead to the preference for tax smoothing (Barro 1979). Moreover, given the extensive tax and benefit systems in the EU, reliance on the working of automatic stabilisers was believed to provide a sufficient degree of shock absorption at the national level. Finally, portfolio reallocation and capital movements would ensure an adequate degree of private risk sharing.

c) To the extent that EU countries pursued sound fiscal positions in normal times, sufficient room for manoeuvre to let automatic stabilisers respond to asymmetric shocks would be ensured without breaching the 3% deficit ceiling (Artis and Buti 2000).

The provisions of the SGP to attain a structural budget of 'close to balance or in surplus' legally codifies such line of thinking. In this setting, 'negative coordination' amongst national fiscal authorities and between the latter and the ECB would suffice (Buti and Sapir 1998).

The global financial crisis of 2007-2009 showed that such a model was partial at best. Three aspects can be recalled in this respect.

First, it is now clear that the ELB is an important constraint over the conduct of monetary policy. When monetary policy is operating under the shadow of the ELB, there are significant negative spillovers associated with deficient demand. Inflation can undershoot the price stability norm for long periods, so that monetary policy may need support from expansionary fiscal policy to deliver price stability in a timely manner. This is a substantial departure from the Maastricht framework. This point cannot be over-emphasised: in 1990, ten years into disinflation, the concern with 'too low inflation for long' was not an issue for Maastricht negotiators.

Second, fiscal policy is now seen as a powerful tool for stability and stabilisation. It is generally recognised that discretionary fiscal policy can play an important role in managing divergent growth trends in a currency union, especially after exceptionally large shocks such as the Covid-19 pandemic. Fiscal policy can be timely and act decisively in extreme cases. This was not envisaged at the time of the Maastricht Treaty, and not at this scale even later. Public stabilisers are key in situations of stress because, in these circumstances, private stabilisers tend to fail: the sovereign and banking crises in the euro area have shown financial integration fragmenting over stress. The link between national treasuries and national banking sectors created a doom loop that served as an amplification mechanism of underlying stress instead of smoothing the initial shock.

Third, in the face of large demand shocks, the combined effect of the negative output gap and tax-rich elasticities leads to sizeable swings in the national balances, pushing government deficits over the 3% of GDP deficit limit even starting from sound fiscal positions.

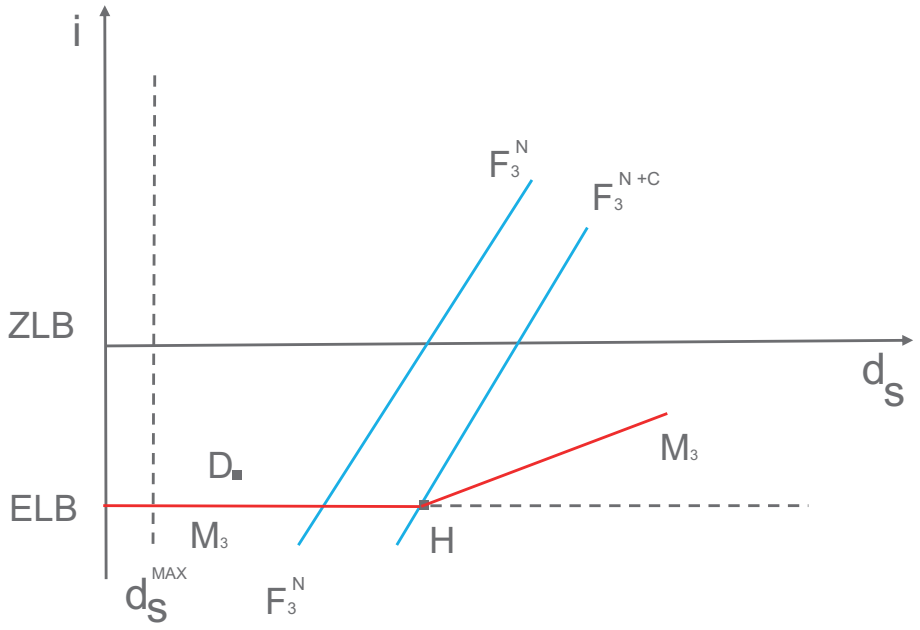
The limits of the Maastricht framework came fully to the fore when the pandemic hit the European and the global economies. The European policy response was a combination of further loosening of the fiscal rules via the triggering of the GEC, the establishment of a central fiscal response via the NGEU and the other measures adopted by the Eurogroup, and fast and radical ECB measures aimed at increasing the liquidity pumped into the economic system through the banking channel (T-LTRO III) and at temporarily removing the market constraints to national fiscal policies (strengthened APP and the Pandemic Emergency Purchase Program, or PEPP), even in the euro area's over-indebted countries (Benigno et al. 2021). Contrary to the strategic substitutability between the monetary and fiscal policies prevailing during most of the financial crisis, a congruent policy mix was implemented in the euro area as an effective response to the pandemic.[7] Figure 4 captures such policy responses.

For the first time, the horizontal coordination of national fiscal policies (in Figure 4 indicated as F^N) was complemented by vertical coordination between national balances and the EU fiscal initiatives (in the same figure, the resulting 'aggregate' reaction function is indicated as F^{N+C}, where C stands for 'centralised'). The double shift to the right of the fiscal reaction function, with monetary policy hitting the ELB, brings the European equilibrium from D to H. The result was a very aggressive relaxation of the macroeconomic policy stance.

Figure 5 sums up the evolution of the monetary-fiscal interactions in the euro area at the end of the first decade (point A), at the end of the European double-dip recession and the pre-pandemic recovery (point D), and at the possible end of the Covid-19 emergency (point H). Leaving aside the period of 'weak' monetary dominance and the initial years of the international crisis, the European fiscal policies were – at first – characterised by a recessionary and pro-cyclical stance and were progressively relaxed since 2016. However, the manners and timing of this relaxation were not consistent with the achievement of efficient equilibria in the years preceding the pandemic. Monetary policy gradually lost its room for manoeuvre and was eventually constrained by fiscal dominance and pushed towards the ELB before the pandemic shock. The current policy mix, leading to point H, is based on an equilibrium which is still unstable because it can fall again prey of fiscal dominance. The next section discusses how to escape such a sub-optimal equilibrium.

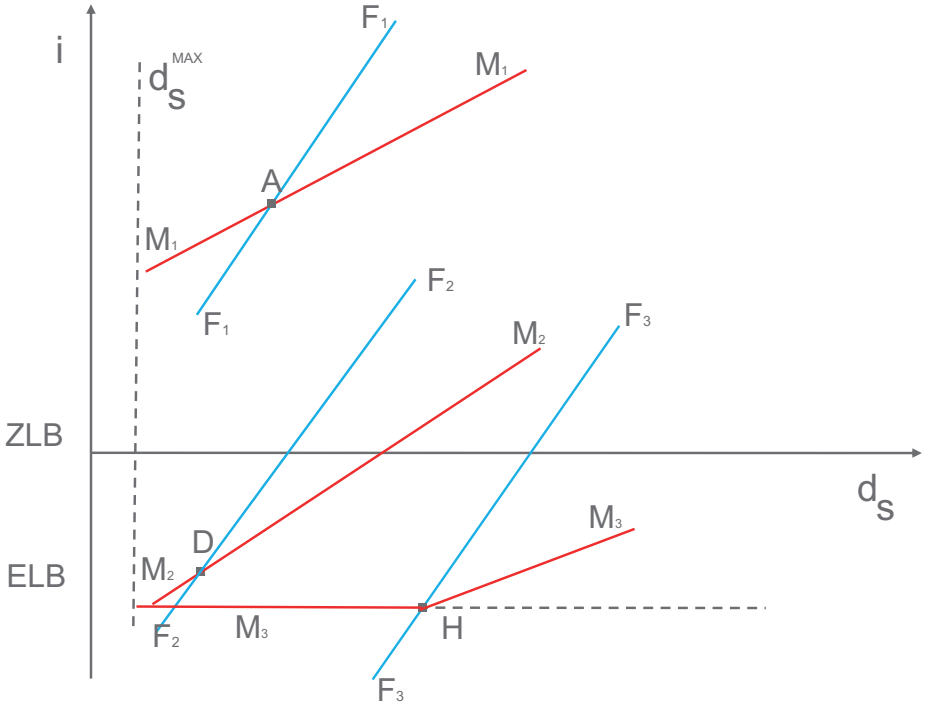
7 For a thorough analysis of the debate on the policy mix in the euro area and beyond, see Bartsch et al. (2020).

Figure 4 Monetary-fiscal reaction functions after the peak of the pandemic crisis in the euro area



Source: own elaboration.

Figure 5 Summing up: The three equilibria in the euro area



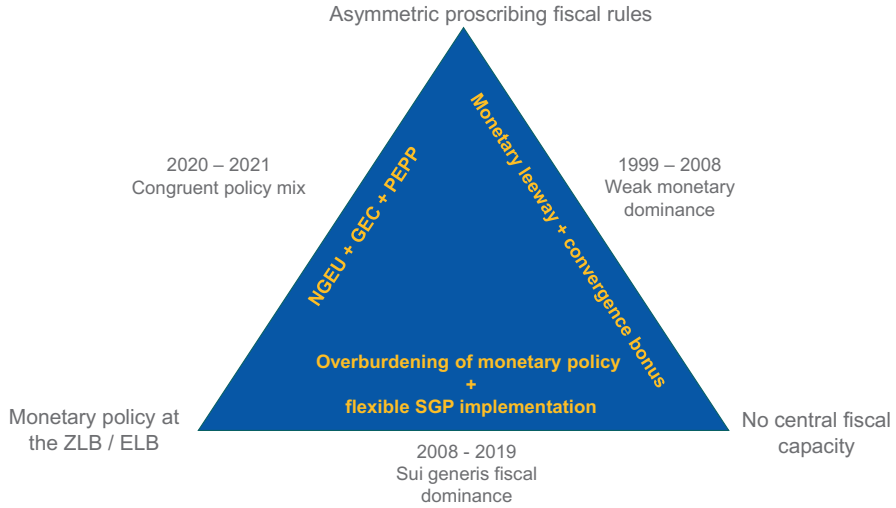
Source: own elaboration.

5 Post-pandemic policy mix: Revisiting the Maastricht policy assignment

In the previous sections, we have reviewed how the monetary and fiscal policy legs have interacted during the various phases of the euro area's lifetime. Figure 6 summarises the impacts of these different policy mixes on the trilemma that we sketched out in Section 2. In each of the three phases analysed above, the specific policy impact led to temporary solutions of the trilemma, with varying degrees of effectiveness.

We already emphasised that, after a period of *weak monetary dominance* during the euro area's first decade and a short episode of coordinated expansion at the outset of the financial crisis, *sui generis fiscal dominance* prevailed during and after the sovereign debt crisis. In that period, monetary policy became 'the only game in town' (El-Erian 2016). During the pandemic, instead, the trilemma was resolved at the two corners characterised, respectively, by the ECB's attainment of the ELB and by a strong fiscal response at the EU level. The latter was complemented by the suspension of the SGP adjustment requirements via the triggering of the GEC. The combination between these initiatives, the strengthening of unconventional monetary policies (most notably the PEPP), and the action at the EU level that showed vigorous solidarity among member states (SURE, NGEU), favoured the adoption of strong expansionary fiscal policies even in euro area countries without fiscal space. This exceptional policy response entailed a more congruent policy mix. However, given the one-off nature of NGEU and the large accumulation of government bonds on the ECB's balance sheet, even this solution of the trilemma is temporary and does not ensure stable equilibria going forward.

Figure 6 How the trilemma has been solved so far

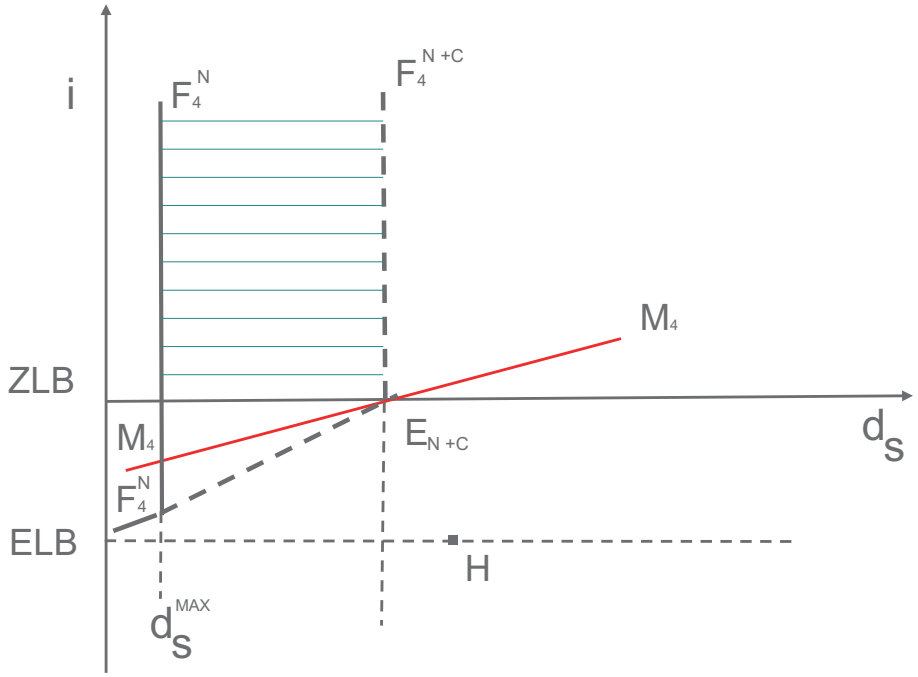


Source: own elaboration.

Supplementing national fiscal policies with a permanent central fiscal capacity would allow to attain an adequate fiscal stance and a more balanced policy mix that would overcome any kind of fiscal dominance. This model of vertical coordination is sketched out in Figure 7.

If supplemented by a central fiscal capacity, the national fiscal reaction function F_4^N could shift towards d_s^{MAX} without leading to a recessionary fiscal stance. In fact, this shift would be compensated by a centralised fiscal expansion which brings the aggregate fiscal stance to F_4^{N+C}. This stronger role of fiscal policies would allow monetary policy to escape the ELB. Hence, the post-pandemic equilibrium would become E_{N+C}.

Figure 7 Monetary-fiscal reaction functions in the euro area's post pandemic



Source: own elaboration.

It is worth noting that this latter equilibrium can be attained through varying combinations between national and centralised fiscal policies. This flexible combination between F_4^{N+C} and F_4^N, which can be dubbed the 'vertical coordination space', would make the post-pandemic equilibrium much more robust than that attained during the pandemic. In the steady state, one could see national fiscal policies become compliant with the MTO (d_s^{MAX}) and the central fiscal capacity to amount to ($E_{N+C} - F_4^N$). During the transition, the central fiscal capacity would likely be smaller and the national fiscal policies would approach d_s^{MAX} only gradually. This implies that, with respect to the steady state equilibrium, F_4^N would be shifted to the right but would remain to the left of E_{N+C}. The appropriate overall fiscal stance would be achieved by allowing flexibility vis-a-vis the MTO and a complementary gradualness in implementing central fiscal policies.

Importantly, in this new policy mix with vertical fiscal coordination, the unconventional monetary policy would not be constrained to supporting the sustainability of national fiscal policies and, thus, it would not fall again into a distortionary fiscal dominance condition. This would ease the gradual winding down of the government bonds accumulated on the ECB's balance sheet, when required by a well-balanced monetary policy.[8] The result is that the ECB should escape the ELB as well as a distortionary and unsustainable composition of its assets.

8 As recalled in Buti (2020), in 2019 Mario Draghi called for a monetary policy satisfying three 'Ps': patience, persistence and prudence.

6 The EU's vertical fiscal coordination in practice

We have argued above that a 'vertical' fiscal coordination between the national and the EU-level policies appears the appropriate way forward if one does not want to continue relying on the monetary arm, with the high risk of pushing the ECB beyond its mandate. This coordination requires building a central fiscal capacity within a coherent 'European budgetary system'.[9] The EU's current governance is far from this solution. As recalled above, faced with the dramatic economic fallout from the pandemic, vertical coordination has taken the form of setting up NGEU, with the RRF at its core. Many observers, including the German Finance Minister, Olaf Scholz, have hailed the building of NGEU as Europe's Hamiltonian moment. A number of observers are (explicitly or implicitly) calling to make the new central fiscal capacity a permanent feature of the post-pandemic EU fiscal architecture. However, NGEU and its main programmes were explicitly conceived as a 'large one-off',[10] whereas an effective central fiscal capacity requires a permanent and stable institutional design.

The Commission has called in the past for setting up a central fiscal capacity (European Commission 2017). What form could such capacity take? There are, in principle, three non-mutually exclusive options:

a) creating a central stabilisation function;

b) increasing the supply of EU public goods; or

c) setting up conditional transfers from the EU budget.

Table 1 provides a qualitative assessment of these three options along institutional, political, and economic dimensions.

Table 1 Assessing the three options

	Legal/ institutional compatibility	Political feasibility	Incentive structure	Technical design
Central stabilisation capacity	Complement of single monetary policy	Interplay with SGP reform	Moral hazard concerns	Automaticity, eligibility
Supply of EU public goods	Topping up of EU budget	Low in ST High in MT	Interplay EU/national budgets	Identification problem
Keep RRF in normal times	Reviving 'contractual arrangements' proposal	One-off nature of RFF	Acceptance of strong role of EU institutions	Use existing RFF infrastructure

Source: own elaboration.

9 Sapir et al. (2004) and Buti and Nava (2003) examined in a different setting how the vertical coordination between the EU budget and national balances could be designed.

10 The RRF is established according to art. 122 of the EU Treaty which provides the EU with the possibility of establishing measures, decided in a spirit of solidarity, appropriate to the economic situation. Such an article would not allow a permanent central fiscal capacity to be legitimised.

The first option – that is, creating a central stabilisation capacity – would be the most rational one for the completion of the EU economic governance, but probably also the most contentious politically. In 2018, the Commission proposed an embryo of a stabilisation capacity based on loans – the European Investment Stabilisation Function (EISF) (European Commission 2018). The discussions amongst the member states and within the Council proved very difficult and led to a substantial weakening of the ambition of the Commission proposal. Eventually, as the pandemic hit Europe, it was superseded by NGEU.

The most cumbersome issue of this option might be the 'moral hazard' risks characterising the implicit contract under imperfect information between the European fiscal supervisors and national governments. If the national governments anticipated the support of a central fiscal instrument in case of negative shocks or negative cyclical phases, they would have fewer incentives to create national fiscal room for manoeuvre in periods of strong growth. This is what allegedly occurred during the euro area's 'good times'. As the economic literature proved long ago (e.g. Hirshleifer and Riley 1992, Kreps 1990), such concerns could be alleviated via appropriate incentives and eligibility requirements. However, in the European debate, this perspective has not been fully recognised or pursued. A reason is that the reference to moral hazard often hides deep mistrust between member states dressed up as concerns about institutional legitimacy. This implies that the political feasibility of the first option will remain untested until there is an improvement in cooperation (and trust) between member states.

The second option – that is, increasing the supply of EU public goods – would be the response to the criticism towards NGEU for relying excessively on transfers to member states (via the RRF) and, as such, not being sufficiently 'European' (Pisani-Ferry 2020). As we pointed out in an earlier paper, the agreement at the European Council in July 2020 increased the share of the RRF and reduced the non-allocated part of NGEU, which provided truly European public goods (Buti and Messori 2020).[11] This was a signal that, particularly during an emergency and the subsequent recovery, the second option appears not easy to agree upon. Moreover, it would require a topping up of the EU budget and an increase in own resources of the EU balance. However, even if this option is not likely in the short to medium term, it may turn out to be compelling in the longer term. Whilst not always straightforward from a fiscal federalism standpoint, its incentive structure and technical design appear solvable, building on the numerous proposals on how to reorient the EU budget in the light of the evolving EU priorities in the economic, environmental, and geopolitical spheres (Buti and Messori 2021).

The final option – that is, setting up conditional transfers to national budgets – would be akin to a *de facto* revival of the proposal of 'Contractual Arrangements' made by Herman van Rompuy in mid-2013 when he was at the helm of the European Council. Contractual Arrangements were rejected by the majority of member states through a spurious coalition between 'core' countries, concerned by the permanent transfers, and fragile countries, concerned by the risk of excessive conditionality. Despite this weakness, the option would have the advantage of building on the institutional infrastructure set up under the RRF.[12] For the stated reasons, the actual recourse to Contractual Arrangements should overcome political difficulties. In fact, the EU's 'core' countries should accept the principle of recurrent conditional grants, and the EU's high-public-debt countries should accept an intrusive role of European

11 The Commission attempted to recreate the space for EU public goods from the bottom up by focusing on seven flagship initiatives (three in the domain of ecological transition, three in the digital transition, and one in social policy), and by pushing member states to present transnational projects within their RRPs. The attempt, however, was not fully successful.

12 However, it would not be possible to utilise the NGEU's legal basis (art. 122), which allows community action under emergency.

institutions in their national fiscal policies. Should this option be pursued, a more structured coordination between programmes would have to be put in place to internalise spillovers and optimise synergies.

7 Conclusion

The interactions between the single monetary policy and the fiscal policies of the member states are central elements of economic policies in the euro area. Politics and institutions – national and supranational – are key for fiscal practices and performance. Thus, a stability-oriented economic policy regime requires not only rules and procedures but also institutions delivering sustainable and resilient fiscal policies, and an adequate policy mix.

Whilst the monetary-fiscal framework of the EU has proved to be resilient in the face of massive emergencies, it is widely acknowledged that the policy mix has been suboptimal most of the time. 'Horizontal coordination' has often failed because it has put a disproportionate burden on monetary policy in bad times, and it has created insufficient fiscal room for manoeuvre in good times. 'Vertical coordination' between the national and EU level has occurred only in the extreme circumstances created by the pandemic.

The relaunch of the "Review of the economic governance framework" this autumn (2021) will need to discuss how EU fiscal rules allow reining in burgeoning debt levels, tackling the pro-cyclical bias of fiscal rules, and making the rules consistent with the green and digital transitions. The analysis in this Policy Insight points to the need to consider the 'vertical coordination' between national balances and the EU budget as an essential element to attain an adequate fiscal stance and to contribute to a balanced policy mix.

NGEU has provided an effective central response under duress and allowed a balanced fiscal-monetary policy mix to be attained. More lasting innovations require stronger mutual trust between member states. Success in the implementation of the RRPs, and hence in the implementation of NRRPs, will be key to creating this trust as a condition for allowing any more lasting option for a central fiscal capacity. In the long run, as the example of other currency unions shows, there is no alternative to a central budget supplying EU public goods and supplementing national stabilisation programmes.

The establishment of a permanent fiscal capacity is likely to materialise only in the longer term. During the transition period, we will need to set the compass in the 'vertical coordination space' between national fiscal stance and central fiscal support. The closer the 'needle' remains to the national fiscal responsibility, the more the fiscal rules will have to foresee flexibility to allow the necessary room for manoeuvre at the national level. The closer we get to a more substantive role of the central budget, the stricter the respect of the EU requirements will have to be; any consideration of a central fiscal capacity will need to go hand-in-hand with further sharing of national fiscal sovereignty. This interaction is likely to evolve over time. As such, the forthcoming reconsiderations of the EU fiscal rules following the "Review of the economic governance framework" will need to be robust to the future evolution of vertical fiscal coordination. Adding this policy dimension may help avoid the zero-sum game that has often marred the discussions on EU fiscal rules.

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