

**Comments on**  
**The Fiscal-Monetary Policy Mix in the Euro Area:**  
**Challenges at the Zero Lower Bound**

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The global financial crisis of 2008-09, and the subsequent European debt crisis of 2010-2012 revealed the fragility of the Eurozone architecture, and posed a serious threat to its survival. In this paper, Athanasios Orphanides, a former member of the European Central Bank (ECB) Governing Council from 2008 to 2012, reviews some key episodes of the crisis, arguing that some fiscal and monetary policy decisions had destabilizing effects for the Euro area as a whole, exacerbating the costs of the crisis for some its member countries, to the benefit of other countries.

The primary focus of the paper is on early decisions of the ECB Governing about the treatment of sovereign debt. Since 2005 the ECB decided to rely on the assessment of private rating agencies to determine whether the government debt of its member countries could be eligible as collateral for its monetary operations. A similar criterion was also adopted in 2015-2018 for the implementation of the quantitative easing (QE) program. These decisions were “discretionary”, since the ECB could have made different choices within the boundaries imposed by the existing EU Treaties. Using the author’s words, the “ECB reliance on private credit ratings facilitated the compromising of the safe asset status of the euro area sovereign debt”, and reflected the “ECB unwillingness to serve as a backstop to government debt”, with the consequent destabilizing effects for the Euro area as a whole.

The author argues that these decisions had major distributional consequences among its member countries. The rationale is that, at the onset of the debt crisis, financial investors feared that the sovereign debt of a euro area member could be downgraded by rating agencies, and fall out of the ECB shield. Thus, investors shifted away from countries perceived to be “weak” (like Italy), towards countries perceived to be “strong” (like Germany). Countries perceived to be “weak” were facing increasingly higher costs of financing, while “strong” countries were able to borrow at lower (even negative) rates. In other words, the credit premium generated by the ECB discretionary choices constituted an indirect fiscal transfer from Italy to Germany.

Looking forward, Orphanides suggests that the ECB should take actions to restore the safe-asset status of euro area sovereign debt, with an equitable treatment of its member countries considered in “good standing”. In practice, he urges the ECB to abandon the reliance on private credit agencies, and let the EU highest political bodies to determine

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whether a member country lost its good standing status. Importantly, from a practical viewpoint, some of the proposed corrective actions do not require a change of existing EU Treaties, and are thus of more immediate applicability relatively to more ambitious proposals.

In what follows I consider two main questions. First, the main argument of the paper is that the large spread in the government bond yields (e.g. Italy vs. Germany) observed over the past decade is mainly the consequence of ECB “discretionary” decisions. How persuasive is this argument? Are there other possible explanations? Second, the paper provides suggestive evidence about the distributional effects of QE policies. Are there more tangible distributional effects looking both at financial and macroeconomic indicators?

On the first question, as an illustrative example, the author highlights that the Italian debt stopped to be considered safe in 2010-2011, despite the fact that its fiscal fundamentals (debt/GDP ratio and primary balance) looked solid, and comparable to those of other countries which were not facing any pressure in the financial markets. It is then clear that financial market expectations have played a key role. But it is always hard to know which factors drive market expectations: weak “fundamental” factors or pessimistic “sentiments”?

It is not implausible to think that in 2010-11 the credit premium on Italian sovereign debt was related to some fundamental weaknesses of the Italian economy, such as the low growth prospects, the volatile political situation, the anti-European positions of some political forces, among other factors. These features clearly distinguished Italy from other economies, both within and outside the Euro area. A similar argument can be made for the 2015-2018 period, when the ECB implemented its QE program. In this respect, Figure 1 shows the evolution of the spread between the Italian and German 10-year sovereign yields over that period. As it is visible in the figure, the spread rises almost exclusively in correspondence to Italian political events, such as the resignation of Prime Minister Renzi in Dec. 2016, and the victory of the populist parties Lega and Five Star movement (M5S) in the Apr. 2017 elections. These considerations suggest that the large spreads in sovereign yields, and their redistributive consequences, are not necessarily related to the ECB decisions.<sup>2</sup>

But let’s take as granted the view that the European debt crisis was primarily driven by pessimistic market “sentiments”. The key question is to what extent this situation arose because of “discretionary” choices of the ECB, or because of more fundamental fragilities of the Eurozone architecture. As acknowledged in the paper, it is ambiguous, and subject

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<sup>2</sup> Along this line, see Baldwin and Giavazzi (2015) for a comprehensive view of the causes of the Eurozone crisis.

to interpretation of the EU Treaties, whether the ECB could legitimately serve as a lender-of-last-resort for government debt. This ambiguity is likely the main reason behind the pessimistic “sentiments” that triggered the crisis. Another problem is related to the hierarchical mandate of the ECB. According to its mandate, the ECB should abstain to preserve financial stability in one or more of its member countries, if that objective conflicts with its primary objective of maintaining price stability. And this is not just a theoretical possibility. For most part of 2011, headline and core HICP inflation in the Euro-zone remained well above the 2% target, and this might partly explain why the ECB hesitated to intervene in the bond markets, injecting liquidity at some moments, but withdrawing it at others. Looking forward, it seems unlikely that adopting an alternative collateral framework would suffice to dissipate the doubts about the legitimacy of the ECB to serve as a lender of last resort for sovereign debt. Unless these fundamental fragilities are resolved, the risk of sentiments-driven crisis is bound to remain.<sup>3</sup>

On the second question, the article provides only suggestive evidence about the effects of QE, mainly looking at the behavior of sovereign yields relatively to the Overnight Indexed Swaps (OIS) rate. One problem with this approach is that it is not possible to determine whether fluctuations in sovereign yields are driven by the QE policies, or other factors. In this respect, recent results by Altavilla et. al. (2019), who use high-frequency surprises to identify the effects of monetary policy shocks, suggest that QE has narrowed spreads in the Eurozone, which contradict the view that QE lead to a redistribution against “weak” countries. It is also instructive to investigate whether the implementation of QE led to divergence in macroeconomic conditions among the member countries. While a formal econometric analysis is beyond the scope of this discussion, Table 1 provides some simple evidence in that regard. The table reports the estimates from an ordinary least squares (OLS) regression of the absolute value of the difference of between Italy and Germany in some macroeconomic indicators (GDP growth, and three measures of inflation), on a constant, a time trend, and a dummy variable for the QE implementation period. Together with the point estimates, the table reports the corresponding standard errors (Newey-West estimator). The effects of QE should be captured by the coefficient on the QE dummy. The estimates reported in Table 1 (second column) indicate that there is no evidence of divergence between Italy and Germany during the implementation of QE, for any of the variables considered. All the coefficient estimates are negative, suggesting that if anything convergence between the two countries, and insignificant. To summarize, there is no robust evidence about the redistributive effects of QE among the countries of the Eurozone.

To conclude, the Euro was launched 20 years ago as an incomplete project, and is still under construction. This paper offers a frank illustration of some critical flaws in the

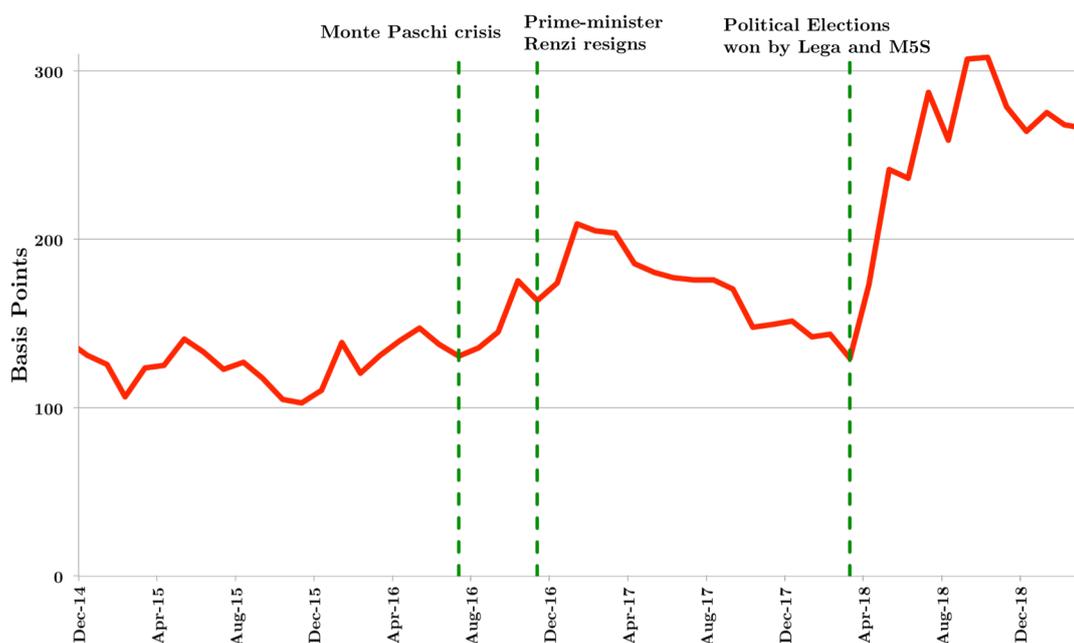
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<sup>3</sup> See e.g. the insightful analyses of De Grauwe (2013) and Corsetti and Dedola (2016).

conduct of monetary policy in the Eurozone, with a pragmatic proposal for corrective actions. More research is needed to assess the actual effects of past ECB “discretionary” decisions, but the key message of the current paper remains unaltered. Learning from recent experiences, and given the unprecedented challenges posed by the current economic situation, it is of primary importance and urgency to promote the creation of a common safe-asset (without mutualizing sovereign-risk), and to clarify once-and-for-all that the ECB is legitimated and willing to serve as a backstop to avoid liquidity crises in the sovereign debt market.

## References

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**Figure 1.** Spread between the 10-yrs sovereign yields of Italy and Germany (Dec. 2014 – Apr. 2019).

**Table 1**

The Distributional Effects of QE on Italy and Germany

	CONST	QE	time trend
GDP growth	0.62* (0.11)	-0.21 (0.12)	-0.005 (0.01)
GDP deflator	0.57* (0.06)	-0.03 (0.07)	-0.01 (0.004)
HICP inflation	0.26* (0.09)	-0.06 (0.11)	0.002 (0.001)
Core HICP inflation	0.32* (0.11)	-0.02 (0.15)	0.004* (0.001)

Note: For each variable, the table reports the estimated coefficients from an ordinary least square regression of the absolute value of the differences between Italy and Germany  $|x_t^{ITA} - x_t^{GER}|$  on a constant, and linear time-trend, and a dummy for the QE period (2014:Q4 – 2018:Q4). The sample period is 1996:Q1–2019:Q4. Data at quarterly frequency are used for GDP growth and GDP deflator, and at monthly frequency for HICP and Core HICP inflation (HICP inflation minus energy, food, alcohol and tobacco). Standard errors obtained using a Newey-West estimator (4 lags). \* denotes statistical significance at the 5% level.