

## EUROZONE: THE MANY FACES OF PROPORTIONALITY IN ECONOMIC POLICY

Following the judgment of the German Constitutional Court on 5 May, the ECB Governing Council needs to demonstrate that the monetary policy objectives of its PSPP are not disproportionate to the economic and fiscal policy effects resulting from the programme. In most cases, monetary, economic and fiscal policies are mutually reinforcing. When assessing whether monetary policy is appropriate, one should take into account the stance of economic and fiscal policy. The necessity to have adequate transmission to all jurisdictions as well as the likelihood and extent of tail risks due to insufficient policy action also play a role in the assessment.

It is an ironic coincidence that the publication on 5 May of the judgment of the German Federal Constitutional Court on the Public Sector Purchase Programme (PSPP) of the European Central Bank (ECB)<sup>1</sup> was followed the next day by the European Commission's spring forecast. The former concluded that the review undertaken back in 2018 by the European Court of Justice (ECJ) of the PSPP is "not comprehensible", considering that in assessing PSPP's proportionality, the ECJ had completely disregarded all economic policy effects arising from the programme<sup>2</sup>. This reflects a view that the pursuit of an inflation mandate could have unwanted economic and fiscal policy effects, e.g. by creating an environment providing cheap financing to companies with weak balance sheets and highly-indebted countries. In this line of thinking, monetary policy is disproportionate when in pursuing its objective – inflation rates below, but close to 2% – it ignores economic and fiscal effects. In reality, the effects of monetary, economic and fiscal policies are difficult to separate. More importantly, in most cases, these policies are mutually reinforcing, rather than conflictual. A fiscal expansion has a bigger impact when monetary policy is very accommodative because it avoids that rising interest rates act as a headwind. Inaction in terms of structural adjustment – a point which was emphasized by Mario Draghi as ECB President in every single press conference during his mandate – increases the burden on monetary policy. Likewise, insufficient fiscal stimulus during a downturn puts the entire burden on monetary policy. This implies that the proportionality of monetary policy needs to be assessed taking into consideration the stance of economic and fiscal policy.

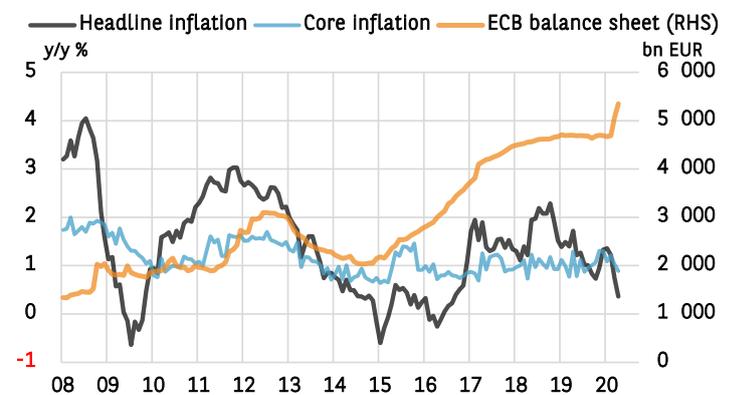
Another factor to be taking into account is the risk of non-linear developments. This is top of mind when a central bank wants to preserve its inflation targeting credentials: throwing in the towel could put us into deflation, with detrimental economic consequences. Another example

is maintaining adequate market functioning, including for governments. This is a key objective of the Pandemic Emergency Purchase Programme<sup>3</sup>. The relationship between policy effort and risk was clearly emphasized by ECB President Lagarde in last week's press conference: "That some self-imposed limits might hamper action that the ECB is required to take in order to fulfil its mandate, the Governing Council will consider revising them to the extent necessary to make its action proportionate to the risks that we face."<sup>4</sup>

3. The judgment of the German Constitutional Court did not concern the PEPP. The Court explicitly stated that the decision "does not concern any financial assistance measures taken by the European Union of the ECB in the context of the current coronavirus crisis."

4. Source: ECB, Press conference, Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 30 April 2020

### EUROZONE: INFLATION AND ECB BALANCE SHEET



SOURCE: EUROSTAT, ECB, BNP PARIBAS

1. Source: Bundesverfassungsgericht, ECB decisions on the Public Sector Purchase Programme exceed EU competences, Press Release No. 32/2020 of 05 May 2020

2. As a consequence, "the Bundesbank may thus no longer participate in the implementation and execution of the ECB decisions at issue, unless the ECB Governing Council adopts a new decision that demonstrates in a comprehensible and substantiated manner that the monetary policy objectives pursued by the PSPP are not disproportionate to the economic and fiscal policy effects resulting from the programme."

The assessment whether monetary policy in pursuing its inflation objective is proportionate needs to take into account the stance of economic and fiscal policy, the necessity to have adequate transmission to all jurisdictions as well as the likelihood and extent of tail risks due to insufficient policy action.



Following the publication of the judgment, the spread between Italy and Germany widened somewhat, but, all in all, the reaction was muted. Investors must have considered that countless press conferences, meeting accounts, speeches and working papers should make it an easy task for the ECB to demonstrate that its PSPP is proportionate. In reaction, the ECB issued a press release in which it took note of the ruling adding it remains fully committed to its mandate to ensure *“that the monetary policy action taken in pursuit of the objective of maintaining price stability is transmitted to all parts of the economy and to all jurisdictions of the euro area.”* The emphasis on ‘all jurisdictions’ is no coincidence and is a subtle reminder that the large geographic remit is another factor to take into account what is proportionate and what is not.

Whereas the Constitutional Court’s judgment could raise concerns that the interpretation of the ECB’s mandate could be narrowed, thereby weighing on the effectiveness of monetary policy, the spring forecast of the European Commission emphasized the downside risks to its bleak assessment of the outlook and underlined once again to do more and act collectively. It mentions the risk of a revival of concerns about debt sustainability –which supports the necessity of the PEPP– but also the importance of sufficient coordination of national policy responses. The common EU response could be too limited *“or be inadequate to compensate for the lack of sufficient policy space in those euro area Member States that are also hardest hit.”* This last point brings another aspect of proportionality into the picture: in a monetary union, a condition for fiscal policy in a given country or at the union-wide level to be proportionate is that it takes into account whether it sufficiently compensates for the absence of policy leeway in certain member states. To conclude, the assessment whether monetary policy in pursuing its inflation objective is proportionate needs to take into account the stance of economic and fiscal policy, the necessity to have adequate transmission to all jurisdictions as well as the likelihood and extent of tail risks due to insufficient policy action. In addition it seems useful to apply such an assessment to fiscal policy in the context of a monetary union.

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