Speaking notes

Slide 1.
Pleasure to be here.

Slide 2.
Teresa gave me 12-15 minutes for my presentation, so that I must be very selective on what I will cover.
I understand the topic assigned to me is to explore the foreseeable consequences of the ongoing revision of the GSP on the possible action of the ECB as backstop to fiscal policy.

This general question can be split in two:

- **Will the new GSP reduce the risk of "gross errors" in the conduct of fiscal policy, reducing the risk that the ECB is called again, like in the past, to intervene to remedy fiscally wrong policies?** The symmetric issue, of governments recapitalizing central banks that are losing money because of the sharp increase of interest rates, decreasing the value of their huge bond holdings, is not in my assignment.
- If the ECB will again have to act as a backstop, **will the new GSP help manage this unfortunate development?**

Given the specific topic I must address, I will not cover other, very important issues. The entire issue of an "**optimal" fiscal policy is excluded:**

- Anticyclical function of fiscal policy.
- Provision of EU public goods.
- Help from fiscal policy to control inflation.

Another important limit of my presentation is that I will consider the new GSP as proposed by the EU Commission, with only limited references to the discussions that followed it.

Slide 3. If you think of it in terms of distribution of fiscal policies, I will cover only the tails of the distribution, i.e. the gross errors I just mentioned: **will the new GSP make the tails thinner?**

Slide 4. Let me now come to what I **will** indeed cover:

I. I will briefly look at the past experience of the ECB acting as a fiscal back-stop.
II. Borrowing the terminology of climate policy, I will then look at the ability of the new GSP to **mitigate** the risk that the ECB must again backstop fiscal policy. I was tempted to use the term "preventive", which is indeed in the current GSP for this part, but I find the distinction between that and the "corrective" part, also in the current GSP, confusing.
III. I will look at **adaptation.** If, notwithstanding the new GSP, the ECB is called again to act as a backstop, will the GSP facilitate this task?
IV. Finally, I will give my summary conclusions.

Slide 5. My reading of the experience of the actions of the ECB as fiscal backstop is that this was clearly undesirable. It pushed the ECB to the limit of its responsibilities, blurring the line with fiscal policy and forcing it to enter political issues. Still, it was, in my view, inevitable. Jean Claude Trichet was very fond of quoting Weber's distinction between the ethics of conviction and the ethics or responsibility. I don't believe a policy maker has the luxury to only work with the ethics of conviction: awareness of the actual consequences of policy decisions must guide her choices. According to this conclusion, the ECB was right in backstopping critical fiscal developments. A related issue is whether these actions led to fiscal dominance. Equivalently, one can ask whether they were consistent with the ECB statute. My answer to these two questions is respectively an uneasy no and yes. Letting the entire euro project unravel or just being unable of controlling inflation in some parts of the euro area because of the fragmentation effects caused by a fiscal crisis would have been inconsistent with the main objective of the ECB to pursue price stability. And backstopping did not, in the specific conditions prevailing during the financial crisis, negatively impact price stability in the euro-area overall. Analytically, the justification for backstopping can be found in the multiple equilibria model of Diamond and Dybvig. When the move from a good to a bad equilibrium is caused by a change of expectations, external action bringing the economy back towards its good equilibrium is justified. The existence of multiple equilibria does not excuse, however, imprudent fiscal policies. Some countries made themselves vulnerable to a change of expectations because they had put themselves in a vulnerable situation, specifically in precarious fiscal conditions. The immediate cause of the crisis was a change of expectations, but this could only arise in unbalanced underlying conditions. The multiple equilibrium model also has three practical implications:

1. Backstopping should be priced lower than the market price prevailing in the bad equilibrium, but higher than the price that would prevail in a good equilibrium (Remember Bagehot penalizing cost for LOLR).
2. As in insurance contracts, backstopping should foresee deductibles. In backstopping, deductibles should mostly understood as tight macroeconomic conditionality.
3. It makes sense to have a gradual backstopping, coinciding with a gradually tighter macroeconomic conditionality. The progression in the ECB framework between calibrated purchases in PEPP, TPI and OMT looks right in this respect.

Slide 6. On mitigation, as I already said, **the first basic question** I want to address is whether the new GSP will reduce the risk of government debt becoming unsustainable in one or the other country of the euro-area. If that was the case, the GSP would lessen the risk of putting the ECB in an acute dilemma situation in which it would be confronted between tightening monetary policy, to pursue price stability, while easing it to pursue the kind of financial instability that follows sudden capital stops and inordinate yield spreads between member countries of the euro-area. **The second, symmetric question** is whether, as claimed by the Commission in presenting its proposal for the new GSP, it will reduce the risk of fiscal dominance.

Slide 7. There are 7 elements in the new GSP that lead to a favourable answer to the two questions above:

1. The differentiation of countries between high, medium and low sustainability risk.
2. An intertemporal approach, whereby public debt is projected forward, instead of looking at instantaneous fiscal conditions (the "magic number" approach, as my colleagues at Bruegel called it).
3. The adjustment path is operationalized in terms of net primary expenditure leading to a "plausibly and continuously declining path", clearly identifying a variable under the control of the government.
4. There is more role for discretion, abandoning the illusion that adding more and more clauses one can achieve a complete contract.
5. Great effort is made to achieve national ownership of the plan.

6. The importance of growth, through reform and investment, for the sustainability of debt receives adequate attention.
7. Connecting the plan to the Macroeconomic Imbalance Procedure helps achieving a comprehensive approach to ensure debt sustainability.

The ECB president in her latest Press Conference, while not entering into details, showed appreciation for the Commission proposal.

Slide 8. Yet there are doubts about the effectiveness of the new GSP in achieving sustainable debt in all member countries and thus reducing the risk that the ECB will have to backstop unsustainable fiscal situations. While the overall design is right (as my colleagues at Bruegel have argued – Blanchard, Sapir and Zettelmeyer, Zsolt) the problem is in the implementation. I regard as particularly difficult to agree on a DSA methodology that all countries will accept in all circumstances. My doubt also derives from the experience from the use of cyclically adjusted figures in the old GSP. In principle, it made a lot of sense to use these figures instead of raw ones. But, even after having thought that an agreement on the methodology was reached, difficult questions emerged on the appropriate estimates.

More fundamentally, I see a lack of trust among euro-area countries as the source of difficulties. Let me put it in a somewhat rough fashion: Germans seem obsessed by the fear that someone could expropriate their deserved savings, Italians seem to believe that the only way to restore growth and soundness to their economy is to get a sufficient amount of EU money or, at least, to run their fiscal policy in full freedom, as they did with big problems in the 1970s and 1980s. And the two attitudes mutually reinforce themselves. I see the proposal of Germany to plug a strong quantitative parameter into the DSA analysis, which could make it practically irrelevant, as another manifestation of this problem (Blanchard and Zettelmeyer). I see the Italian reaction to the revised Commission proposal, claiming it to be too restrictive, as further confirmation of my fear.

Slide 9. There are another three, interrelated, issues, albeit of less importance, which could affect the effectiveness of the new GSP.

The first one is the link between the fiscal plan and the "common safeguards", minimum fiscal adjustment of 0.5% of GDP proposed by the Commission, to ensure debt sustainability if either of the two benchmarks of 3% for the deficit and 60% for the debt are not respected. Beyond the lack of clarity about the exact definition of the variable subject to the 0.5% reduction (Darvas) there is the issue of the possible procyclicality of the reduction and, more generally, the issue of consistency with the DSA plans. In a way, this is a general issue of which German insistence for a strong quantitative constraint is a specific case.

The second issue is the role of the EU Commission. As my colleagues at Bruegel have shown, the role that the Commission has designed for itself in the new GSP is excessive. Not only because it is not proportionate to the institutional role of the Commission, which is not a fully-fledged government, but also because it makes some countries fear that it will not be thorough enough, being prone to political influences from governments subject to the correction programs.

The third issue is that it remains to be seen whether the Commission proposal will fully exploit the role of the European Fiscal Board and of the National Fiscal Policy Councils. The power and independence of these bodies still needs testing, but the right approach is to reinforce both.

Slide 10.

The other area in which the new GSP could help, which I call **adaptation**, is in helping the ECB backstop the fiscal situation of one or the other country when this would be, unfortunately, needed:

- The GSP would give a very good basis on which to build the conditionality that must accompany any ECB backstopping beyond the mildest, and temporary, form consisting in the calibration of PSPP purchases.
- The fact that respect of the GSP will be a necessary component of any ECB backstopping will reinforce the incentive to adhere to the plan.
- The new GSP can reinforce the role of "government" authorities, like the Commission and the Council of Ministers, or even the European Council, in designing conditionality. In my view, the ECB put too much weight on its own decision and evaluations, especially as regards the TPI, with respect to that of "political" bodies like the Commission and the Council of Ministers; in a way I see the same mistake as when the ECB participated in the troika, asking the Greek government actions in fields totally outside monetary and financial issues.
- The link between the GSP and the MIP will help take a comprehensive approach to the actions needed to pursue stability and growth-oriented policies.

Slide 11. My conclusions are straightforward:

- A new GSP designed around the lines proposed by the EU Commission has the potential to mitigate the risk that the ECB will again be forced to act again as fiscal backstop.
- The new GSP can also help manage the ECB backstop when, unfortunately, this would again be needed.
- Implementation is the weak point of the GSP and the underlying problem is the lack of trust among member countries.

Slide 12. Advertisement

Slide 13. Thanks