Working Session 1 - Reinforcing the joint impact of monetary and fiscal policies

The Covid-19 pandemic led to decisive monetary and fiscal policy actions, which benefited from a common understanding about the nature of the crisis and awareness about the links between fiscal and monetary policy. This note provides a description of the immediate actions by the monetary and fiscal authorities, also discussing how initiatives taken at the EU level facilitated a coherent policy-mix. It also discusses conditions for effective monetary and fiscal policies in the recovery phase and beyond, highlighting important challenges and desirable further developments to reinforce their effectiveness in the coming years.

Monetary and fiscal policy emergency response to the pandemic shock

The COVID-19 pandemic shock prompted a strong response from both fiscal and monetary policies. Although monetary policy had already been expansionary for years - including a zero interest rate on the main refinancing operations and a negative deposit facility rate - the intervention of the monetary authorities at the onset of the pandemic was remarkable. In the euro area, with the launching of PEPP and recalibration of TLTRO III, the ECB ensured the proper functioning of the financial system in the peak of the crisis and eased market pressures, not only ensuring the transmission mechanism, but also providing additional stimulus, de facto creating fiscal space for governments to act and adopt wide-scope temporary fiscal packages without triggering negative market reactions.

Fiscal policy played an immediate crucial role in responding to the health emergency and supporting households and firms. Euro area governments swiftly implemented an unprecedented fiscal response, strongly reinforcing the functioning of automatic stabilisers through decisive discretionary measures, showing that, given the right conditions, fiscal policy can react (almost) automatically and support monetary policy in stabilising the economy.

Initiatives at the EU level complemented the national emergency fiscal response. While unconventional monetary policy laid favourable conditions for fiscal authorities to respond to the pandemic shock, immediate pressure was further reduced by the activation of the general escape clause in the context of the EU fiscal surveillance framework. The SURE instrument, the Coronavirus Response Investment Initiative (CRII) and the CRII+, as well as financing provided by the EIB and the ESM Pandemic Crisis Support Instrument created leeway for national fiscal authorities to mitigate the fallout from the pandemic, while also providing effective risk sharing. This was further reinforced by the approval of the Next Generation EU (NGEU) instruments, including the RRF. Together with the core Multi Annual EU Budget, the NGEU is the biggest financial package ever approved, with a volume of up to €1.8 trillion.

The alignment of monetary and fiscal policies in the response to the pandemic does not alleviate deeper issues related to the complexity of the euro area policy-mix. A common monetary policy, combined with decentralised and insufficiently countercyclical fiscal policies, have often resulted in the past in undesirable dissonant policies (notably during the sovereign debt crisis). The persistently low inflation environment and the uncertainty surrounding the unfolding of the pandemic crisis still call for continued effort, as monetary and fiscal policies may reinforce each other in supporting the economy in the recovery process. However, the significant challenges posed by the high levels of public and private debt should also be acknowledged and monitored closely.

Medium- to long-term challenges: devising a sustainable recovery

While the challenges brought about by the pandemic are unprecedented, the crisis proved that monetary and fiscal policies – while operating independently - can mutually reinforce each other and deliver an effective response to adverse shocks. The NGEU instruments and the activation of the SGP general escape clause create particularly supportive conditions for a coherent policy-mix. Under the current low inflation environment, the monetary policy stance reinforces NGEU's role in alleviating the trade-off between fiscal support for the economic recovery and long-term sustainability. On the other hand, the fiscal impulse may also be helpful to stimulate demand, minimising additional downward risks on inflation in the short-run.

Monetary policy is expected to remain accommodative in view of its price stability objective. Forward guidance points to policy interest rates remaining at low levels and the maintenance of unconventional instruments in the foreseeable future. Financing costs are thus likely to remain low in the period ahead, at least while inflation remains low.

Further challenges may also arise from the significant risks inherent in the increased size and composition of the central banks' balance sheets. Concerns over the central banks' credibility could arise if certain risks would materialise. However, central banks apply risk management frameworks that are designed to ensure the effectiveness and efficiency of its policies, and at the same time protect their balance sheets.

Looking ahead, the conduct of fiscal policy in the recovery phase will also face the crucial challenge of managing a high level of debt, in spite of the support from the RRF. Governments will likely continue to face large financing requirements in the near future, stemming from the need to maintain support to the most vulnerable sectors and mitigate potential scarring effects of the pandemic. Moreover, the possible materialisation of contingent liabilities accumulated during the pandemic is an additional source of risk. Tensions between the need to support the recovery and ensure fiscal sustainability may re-emerge, especially if there is some reversal of the interest-growth differential (in spite of the lengthening of public debt maturity in the past few years and the resulting lock-in of low financing costs). Funding provided through ReactEU may alleviate short-term budgetary pressures, as it continues to support crisis repair measures. Importantly, by focusing on productive investment and strengthening long-term growth, the RRF framework should increase the growth potential and resilience of the euro area, improving debt sustainability while also addressing the transition to greener and more digital economies.

The continued application of the SGP's general escape clause in 2022, conditional on the state of the economy, should allow for a proper interaction of monetary and fiscal policies. A premature shift towards fiscal strictness could harm long-term growth. In the near future, the discussion on the existing EU fiscal rules and potential reforms should be resumed, including to assess whether the framework remains fit for the post-COVID European economy.

Further improvements to the EMU architecture may also be warranted, especially given elevated vulnerabilities in the financial sector. A common resolution framework may not be sufficient to minimise the burden on public finances and, in this regard, efforts should be put on the completion of the banking union. A review of the crisis management and deposit guarantee frameworks should be considered, as a revival of the highly detrimental bank-sovereign doom-loop should be avoided.

Questions for discussion

1. In your opinion, what are the main challenges ahead? Do you see scope to improve the effectiveness of the monetary and fiscal policies and their joint impact? If so, which changes could be considered?

2. How should the current low interest rate environment be incorporated in the way we look at the role of fiscal policy and its interaction with monetary policy?