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# Euro Area fiscal policies and capacity in post-pandemic times



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#### Abstract

The economic policy response to the Covid crisis avoided a euro area financial crisis. Looking ahead, in the short run, the key issue is the pace of withdrawal of fiscal stimulus. The right approach seems to follow a state-contingent strategy, guided by unemployment, inflation and output gap data.

Over the medium term, the reforms supported by the NGEU remain critical. To succeed, adequate country ownership, rather than the pure conditionality mechanisms, is necessary. Reducing public debt ratios over the medium term at a sufficient speed will require that the growth of primary spending remain below the (higher) potential growth rate, to be achieved through the reform process.

Over the longer term, the priorities are the creation of a central fiscal capacity, the strengthening in the enforcement of fiscal rules in good times and the completion of banking and capital market unions.

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# LIST OF ABBREVIATIONS

ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
EU	European Union
EURI	European Union Recovery Instrument
FRED	Federal Reserve Economic Data
GDP	Gross domestic product
IMF	International Monetary Fund
NGEU	Next Generation European Union
PEPP	Pandemic Emergency Purchase Program
QE	Quantitative easing
QT	Quantitative tightening
RRF	Recovery and Resilience Facility
RRPs	Recovery and Resilience Plans
SGP	Stability and Growth Pact
SURE	Support to mitigate Unemployment Risks in an Emergency
US	United States
WEO	World Economic Outlook

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### **EXECUTIVE SUMMARY**

The economic policy response in the euro area to the Covid crisis was stronger than in previous crises: the main success was to avoid that the health emergency and the direct and indirect impact of the lockdowns on GDP would be compounded by a euro area financial crisis. Yet, differences in economic and fiscal performance of member countries further increased during 2020-21. The decline in GDP was generally stronger in Southern European countries, as these were hit more severely by the Covid pandemic, with respect to Northern European countries; the deterioration of the fiscal accounts also differed markedly across the area, with, again, stronger negative consequences for Southern Europe. This leaves the euro area divided between a North, where inflationary pressure may arise earlier and where an increase in interest rates may be welcome at an earlier stage, and a South, where an early rise in interest rates, as well as an early withdrawal of fiscal stimulus, would have severe consequences for economic and financial stability. Against this background, the priorities are to resume the growth process in the short run and to raise potential growth rates over the medium term, particularly in Southern European countries.

Assessing the appropriate pace of withdrawal of fiscal stimulus is particularly challenging, given the high uncertainty related to the exit from the Covid crisis. In the baseline scenario, where financing conditions remain easy (low interest rates), the main policy prescription is to return to deficit levels similar to those existing in 2019 only once the output gap/unemployment has also returned to similar levels. Exceptions can be made in case a looser fiscal stance is deemed necessary to implement long-delayed investment and reforms that would boost potential output growth. In a higher inflation/higher interest rate scenario, a faster pace of fiscal consolidation may be needed. In such a scenario, consideration should be given to implement the necessary monetary tightening in a way that avoids the need to reduce the amount of higher risk government debt acquired during the 2020-21 period. This may require freezing, through an extraordinary reserve requirement for banks, the excess liquidity created in this period.

Over the medium term, the reforms supported by the NGEU remain critical. Whether the NGEU succeeds in boosting economic growth will depend primarily on the existence of sufficient ownership of the required reforms by member countries, as we cannot rely much on standard conditionality mechanisms when it comes to structural reforms. Whether it succeeds in strengthening the fiscal accounts will depend on whether fiscal rules and euro area surveillance will be able to ensure that the growth of primary spending remains below the (higher) potential growth rate that should be achieved through structural reforms and investments.

Finally, over the longer run, the process to strengthen institutions and governance in the euro area should continue. This would require creating a central fiscal capacity, strengthening the enforcement of fiscal rules in good times, possibly through an increased role for the independent European Fiscal Board, and completing the banking and capital market unions.

## **1. INTRODUCTION**

Economic policies in the euro area responded to the economic crisis causes by the Covid medical emergency better than in previous crises. The medical crisis and the inevitable decline in GDP due to the direct and indirect effects of the lock downs were not compounded by a financial crisis that would have been disastrous not only for countries more exposed to adverse market reaction, but also for the whole area. This said, the crisis caused a further sharp increase in public debt ratios and deepened the already large difference between debt ratios in Northern and Southern European countries. Lowering debt ratios and fostering fiscal convergence will be important over the coming years, but monetary and fiscal policies will need to be managed carefully to avoid an unnecessary delay in the economic recovery. Moreover, the crisis has been addressed through *ad hoc* solutions, albeit innovative ones, such as the Next Generation European Union (NGEU) program. This raises the question of which institutional and governance changes would be appropriate over the medium term to strengthen the ability of the euro area to enhance its resilience and confront new crises more easily on a permanent basis.

This paper is organised as follows. Section 2 discusses the most relevant macroeconomic and fiscal developments during 2020-21 as a basis for the following policy discussion. Section 3 looks at how fiscal policies should be managed to support the economic recovery over the next few years, while allowing a reduction of fiscal imbalances and fostering cross-country convergence. Section 4 focuses on the role and the key challenges faced by the Recovery and Resilience Facility (RRF) and by the other tools set up by the European Union to improve the area's medium-term growth performance. Section 5 discusses medium term institutional issues, such as the role of a central fiscal capacity, the enforcement of fiscal rules and the importance of banking and capital market unions. Section 6 presents some concluding remarks.

# 2. STAGE SETTING: KEY MACROECONOMIC DEVELOPMENTS DURING THE COVID PANDEMIC

Discussing future euro area fiscal policies requires considering the deep changes that have characterised macroeconomic trends since the beginning of the Covid pandemic.

All euro area members suffered in 2020-21 an economic shock of a magnitude unprecedented since the Second World War. However, the macroeconomic impact of the shock varied significantly across countries. So far, three features have stood out with respect to macroeconomic developments in the euro area:

- The decline in GDP was generally stronger in Southern European countries than in Northern European countries, as the former were generally hit harder by the Covid pandemic.
- The deterioration of the fiscal accounts also differed markedly across euro area member countries, with, again, stronger negative consequences for Southern Europe.
- In contrast, differences in accessing financial markets, as measured by the movement in interest rate spreads, declined.

Let us review these three developments, focusing also on the issue of their persistence over time once the Covid pandemic is overcome.

The different impact on economic activity of the pandemic can be assessed by looking at: (i) the percentage decline in GDP levels in 2020 with respect to 2019; (ii) the decline in the GDP growth rate in 2020, also with respect to 2019. The results do not differ significantly. According to both metrics, euro area members that can be classified generally as "Southern European" (or "Latin" countries) suffered more than "Northern European" and "Eastern European" countries. The first six places in the tragic backward race of GDP levels in 2020 are all taken by Southern European countries (Spain, Italy, Greece, France, Portugal and Malta), Cyprus being the only Southern European country that fared relatively well (Table 1).

Countries	GDP growth
	rate
Spain	-10,8
Italy	-8,9
Greece	-8,2
France	-8,1
Portugal	-7,6
Malta	-7,0
Austria	-6,6
Belgium	-6,3
Slovenia	-5,5
Slovak Republic	-4,8
Cyprus	-5,1
Germany	-4,9
Netherlands	-3,7
Latvia	-3,6
Estonia	-2,9
Finland	-2,8
Luxembourg	-1,3
Ireland	3,4
Lithuania	-0,9

Table	1: Real GDP	arowth	rate in	2020 ir	the Euro	Area (%	)
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Source: European Commission, European Economic Forecast, spring 2021

The same six countries are also at the top of the list if we look at the fall in the GDP growth rate with respect to 2019 (a better indicator of the deviation of GDP from the most recent GDP trend), although the ordering of these six countries changes, and Cyprus moves up in the eighth position (Table 2).

Countries	Growth rate 2019 (A)	Growth rate 2020 (B)	Delta (B)-(A)
Spain	2,0	-10,8	-12,8
Malta	5,5	-7,0	-12,5
Greece	1,9	-8,2	-10,1
Portugal	2,5	-7,6	-10,1
France	1,5	-8,1	-9,6
Italy	0,3	-8,9	-9,2
Slovenia	3,2	-5,5	-8,7
Cyprus	3,1	-5,1	-8,2
Belgium	1,8	-6,3	-8,1
Austria	1,4	-6,6	-8,0
Estonia	5,0	-2,9	-7,9
Slovak Republic	2,5	-4,8	-7,3
Latvia	2,0	-3,6	-5,6
Germany	0,6	-4,9	-5,5
Netherlands	1,7	-3,7	-5,4
Lithuania	4,3	-0,9	-5,2
Finland	1,3	-2,8	-4,1
Luxembourg	2,3	-1,3	-3,6
Ireland	5,6	3,4	-2,2

Table 2: Decline in real GDP growth rates (%)

Source: European Commission, European Economic Forecast, spring 2021

The increase in fiscal deficits and public debt was also stronger in Southern European countries. Five of the six countries that suffered a larger GDP loss appear in the first six positions in terms of the level of the fiscal deficit in 2020 (Table 3).

Countries	2019 (A)	2020 (B)	Delta (B)-(A)
Spain	-2,9	-11,0	-8,1
Malta	0,4	-10,1	-10,5
Greece	1,1	-9,7	-10,8
Italy	-1,6	-9,5	-7,9
Belgium	-1,9	-9,4	-7,5
France	-3,1	-9,2	-6,1
Austria	0,6	-8,9	-9,5
Slovenia	0,4	-8,4	-8,8
Lithuania	0,5	-7,4	-7,9
Slovak Republic	-1,3	-6,2	-4,9
Portugal	0,1	-5,7	-5,8
Cyprus	1,5	-5,7	-7,2
Finland	-0,9	-5,4	-4,5
Ireland	0,5	-5,0	-5,5
Estonia	0,1	-4,9	-5,0
Latvia	-0,6	-4,5	-3,9
Netherlands	1,8	-4,3	-6,1
Germany	-1,9	-4,2	-2,3
Luxembourg	2,4	-4,1	-6,5

#### Table 3: Deficit-to-GDP ratios in the Euro Area (%)

Source: European Commission, European Economic Forecast, spring 2021

The exception is, in this case, Belgium that is in fifth position concerning the fiscal deficit level, but that also suffered a sizable decline in GDP (Table 1). The relationship is not as tight if we look at the increase in the fiscal deficit between 2019 and 2020 (Table 3, third column), rather than at its level, but, again, Southern countries show, in general, a stronger deterioration in the fiscal balance than Northern and Eastern European countries.

Altogether, the story that emerges from these data seems clear. Countries that were hit harder by the pandemic crisis presented in general a stronger deterioration in the fiscal accounts (Figures 1 and 3).



#### Figure 1: GDP growth and fiscal deficit in 2020

Unfortunately, the countries that suffered a larger GDP loss and where fiscal deficits reached higher levels were also countries that had larger public debt-to-GDP ratios at the end of 2019. Indeed, with fiscal policies already almost pre-determined in 2021, it is worth focusing on the relationship between the pre-Covid public debt-to-GDP ratio and the projected increase in the debt ratio in 2020-21 (Figure 2). The correlation is impressive. Countries that started with a debt ratio close to or higher than 100 per cent (Greece, Italy Spain, Cyprus, Belgium, France) suffered an increase in debt ratios of 20-25 percentage points GDP, Portugal being a partial exception, with an increase limited to 10 percentage points. Lower debt countries registered much smaller increases (as low as 5 percentage points for Luxemburg and Ireland).<sup>1</sup>

<sup>&</sup>lt;sup>1</sup> It should be underscored that the larger increases in debt ratios for high debt countries is partly due to the fact that, for a given decline in GDP, debt ratios increase more for higher debt countries, as illustrated by the standard debt dynamics equation:  $\Delta d_t = -pb_t + \frac{(i-g)}{(1+g)}d_{t-1}$ .



Figure 2: Public debt (2019) and its increase in 2020-21

The implication of these developments in public debt-to-GDP ratios is that the differences between GDP levels of euro area members have further deepened. It is in this respect revealing to look at the differential in debt levels between Italy and Germany and France and Germany. The differentials have in both cases reached levels unprecedented, not only since the birth of the euro, but also since the Second World War (Figure 3).



Figure 3: Difference in the public debt-to-GDP ratio (1950-2020)

In contrast with these divergent trends in output and public debt, interest rates have tended to converge. In spite of some recent increases, interest rates spreads between Italy, Spain and Portugal, on the one hand, and Germany, on the other hand, are currently much lower than they were at end-2019, and indeed are at their lowest level in five years (Figure 4).





These developments are somewhat puzzling: differences in public debt levels are at record heights while spreads are at record lows. The puzzle, however, can be easily resolved by recalling the massive purchases of government bonds by the ECB that have taken place since the beginning of the pandemic. Indeed, the timing in the decline of spreads broadly matches the announcement of the Pandemic Emergency Purchase Program in mid-March 2021. While these purchases were undertaken for monetary policy reasons and they involve all euro area member countries, they probably reduced perceived default risks much more significantly in high debt countries than in lower debt countries (where those risks were already perceived to be trivial). Note that the impact of these ECB purchases on long-term interest rates is twofold. First, they reduce directly the supply of government bonds that needs to be absorbed by financial markets, thus reducing interest rate spreads between risky bonds and other assets.<sup>2</sup> Second, they improve the fiscal accounts, and thus perceived risk, as they imply that deficits are financed through seigniorage revenues, as ECB and national bank profits are ultimately returned, almost entirely, to governments as central bank profit distribution. Again, this is likely to benefit more governments issuing risky government bonds than those that issue risk-free bonds.<sup>3</sup> Indeed, as long as the bonds purchased by the ECB during the Covid period remain in the ECB portfolio, the corresponding deficits have, defacto, been financed by "printing money", i.e. through seigniorage, without an impact on the sustainability of fiscal positions of higher debt-higher risk euro area members.

Moreover, the financing schemes proposed by the European Commission and later approved by the Council (the SURE facility and the European Union Recovery Instrument), while so far dwarfed by the ECB interventions, have probably, in a forward looking perspective, also affected interest rate spreads on high debt countries, given their favourable financing terms and their grant component.

How long will these trends in debt levels and interest rate spreads persist? According to the projections included in the April 2021 IMF Fiscal Monitor, the differences in public debt trends between Northern and Southern Europe are going to be long lasting and, in some cases, are expected to widen. For example, the differential in the public debt-to-GDP ratio between Italy and Germany is projected to rise by another 7 percentage points of GDP between 2021 and 2026.<sup>4</sup> As to spreads, what will remain critical is the behavior of the ECB, which, in turn, depends on inflation trends (see below).

<sup>&</sup>lt;sup>2</sup> Basic means-variance analysis implies that spreads between assets that are not perfect substitutes (including because of differences in perceived risk) depend on their relative supply. As the ECB purchased bonds of all euro area countries, this did not altered the relative supply or risky and risk-free euro area bonds, but did alter the relative supply of risky government bonds and the total supply of risk-free assets (including risk-free euro area government bonds). It follows that those purchases did affect the spread between risky and risk-free euro area bonds.

<sup>&</sup>lt;sup>3</sup> Under the PEPP, as well as other ECB quantitative easing programs, the bulk of the purchases of government securities is undertaken by national central banks, not by the ECB.

<sup>&</sup>lt;sup>4</sup> See <u>https://www.imf.org/en/Publications/FM/Issues/2021/03/29/fiscal-monitor-april-2021#Full%20Report</u> .

# 3. POLICIES TO SUPPORT THE SMOOTH RECOVERY, THE SUSTAINABILITY OF PUBLIC FINANCES AND ECONOMIC RESILIENCE

In the absence of a central fiscal capacity, the issue of the appropriate fiscal policy stance in supporting the economic recovery after the pandemic needs necessarily to be discussed, as in the past, by considering the policies implemented by the various member countries. Common borrowing tools (in particular of the NGEU) have been introduced (albeit temporarily), and will alleviate financial market pressures for high-debt countries. However, the calibration of the fiscal policy stance, as well as fiscal policy implementation, remain squarely a responsibility of Member States (see section 5 for a discussion of how, ideally, fiscal capacity should be enhanced in the euro area).

The issue of the appropriate fiscal policy stance for euro area member countries is discussed below under two scenarios, as required by the highly uncertain macroeconomic situation characterizing the exit from the Covid pandemic:

- In scenario (a), financial market conditions remain relatively easy, or, in other terms, increases in interest rates in world financial markets, as well as in spreads, remain contained and gradual.
- In scenario (b), pressures for tighter monetary policies arise in the context, for example, of a surge in inflation (or, possibly, the need to avoid excessive risk taking and financial market bubbles).

These two scenarios are discussed in turn in the rest of this section.

#### a. First scenario: contained interest rate pressure

Let us start with the first scenario. It stands to reason that, in assessing how rapidly fiscal stimulus should be withdrawn as economic activity recovers, the following principle should be followed: with the return of macroeconomic activity to more normal levels, fiscal policy should normalise, i.e. the level of fiscal deficits should return to pre-crisis levels. We do not know how fast this normalisation will occur. The experience of past pandemic shocks and simulations of pandemic crises undertaken in the past with macroeconomic models suggest that, once the health emergency has been overcome, the recovery can be rapid, indeed more rapid than recoveries following financial market crises.<sup>5</sup> The April 2021 IMF World Economic Outlook (WEO) also takes the view that economic "scarring" after pandemics is likely to be less severe than after financial crises. However, the WEO is more concerned that, given the magnitude of the Covid crisis, the return to more normal output conditions may take quite a long time and, as a consequence it calls for prudence in withdrawing fiscal stimulus, influenced perhaps by the widespread belief that the exit from fiscal stimulus after the 2008-09 global financial crisis was premature.

Be this as it may, the unusual circumstances that the world economy is facing suggest to adopt a flexible state-contingent fiscal policy strategy favoring fiscal support programs that can be more easily reversed in case the recovery picks up faster than expected. This includes, for example, direct support to economic sectors that are still suffering from closures and, in general, one off spending initiatives, rather than structural spending increases involving, for example, a rise in public sector employment and wages (unless these spending increases are financed by permanent revenue measures).

<sup>&</sup>lt;sup>5</sup> For simulations of recoveries after pandemic crises see European Commission (2006), McKibbin and Sidorenko, A. (2006) and Verikios et al. (2011). In these papers, however, the impact of the pandemic crisis on GDP was much smaller than the impact caused by Covid.

The above principle (to have deficits returned to "normal levels" when economic activity returns also to "normal levels") needs to be discussed in more specific terms. What does "normal levels" mean exactly? There are two basic options:

- The first one is to target the return of the deficit-to-GDP ratio to its 2019 (i.e. pre-Covid) level once GDP has returned to its 2019 level.
- The second one is to target the return of the deficit-to-GDP ratio to its 2019 level once the output gap has returned to its pre-Covid level. This means waiting to return to pre-Covid deficit levels until GDP has returned to its pre-Covid trend (corrected for any output gap that existed in 2019) under the assumption that potential output growth was not affected by the crisis, or, more likely, to the new post-crisis trend, whatever that is.<sup>6</sup>

The first approach has the attractiveness of simplicity, as current GDP levels can be observed. The problem is that this approach makes sense only if we assume that potential output has not increased at all since 2019 and that, therefore, the return of GDP to the 2019 level implies the return of the output gap to the 2019 level or even to a more positive (or less negative) output gap. This appears to be an excessively restrictive approach.

The second approach requires estimating potential output growth, knowing very well that current estimation methods may be unfortunately very sensitive to large temporary falls in GDP growth. Nevertheless, this approach, in spite of this imperfection, seems to be preferable, as long as the current estimation of potential output growth does not give rise to extreme results, such as concluding that potential output levels declined permanently as a result of the crisis. In this respect, consideration should be given to either focusing just on the level of unemployment as a yardstick to assess whether economic conditions have returned to the 2919 levels, or, anyway, to increase the role of unemployment data with respect to the current one in the process of calculating the output gap.<sup>7</sup>

It may be argued that the surge in public debt ratios observed during 2020-21 would actually call for returning to a somewhat tighter fiscal position than the one observed in 2019, once the same level of the output gap is achieved. This is because the crisis will leave a legacy of higher public debt (especially, and regrettably, in countries where public debt was already higher): in the average of the euro area, the public debt-to-GDP ratio has reached record levels for the post World War Two period and, in some key cases, unprecedented levels.<sup>8</sup> A tighter fiscal stance would therefore be justified by the need to return to pre-crisis debt ratios, or at least to finance the increased interestrate burden. However, under

<sup>&</sup>lt;sup>6</sup> We are of course assuming that in 2019 the output gap was also close to zero.

<sup>&</sup>lt;sup>7</sup> The most recent stability programs, presented in April 2021 by the various countries, seem to envisage a more gradual exit from the fiscal stimulus with respect to the policy prescription under scenario 2 (and, a fortiori, under scenario 1). For example, Germany was running a structural surplus of 1.3 percent of potential GDP in 2019, while it is planning to run a deficit of 2.8 percent in 2022, when the output gap is projected to return to its 2019 level. This would imply a deterioration of 4 percentage points in the fiscal balance for the same level of the output gap. This may, however, be partly justified by the fact that Germany's surplus was in 2019 well above Germany's SGP medium-term objective (a deficit of 0.5 percent of GDP). Moreover, Germany's structural deficit is planned to decline in 2023 to 1 1/4 percent. A more interesting case is Italy, which is planning to run a structural deficit of 4.4 percent of potential GDP in 2023 against a structural deficit of 1.7 percent of GDP in 2023, when the output gap is expected to be closed (as it was in 2019). In 2019, Italy's deficit was far weaker than its SGP medium-term objecting (a surplus of ½ percent of GDP). Nevertheless, Italy is planning to have a deficit that, for the same close-to-zero output gap, is 2.7 percentage points of GDP higher than in 2019 (and 4.9 percentage points away from its medium-term objective, at least assuming that the latter remain unchanged in the Commission's view).

<sup>&</sup>lt;sup>8</sup> The IMF Fiscal Monitor projects that at end 2021 the debt ratio for the euro area will reach 98 percent, five percentage points above the previous peak (93 percent in 2014), which was reached after the euro area debt crisis. The Italian authorities project Italy's public debt at end-2021 to approach 160 percent, the highest level since Italy became a unitary state in 1861.

normal market conditions, the extra debt that countries are currently facing should be reduced gradually over time.

Two factors reduce the urgency of lowering debt ratios in the scenario discussed in this section. The first one is the trend decline in real interest rates and in the differential between the average interest rate on public debt and the GDP growth rate observed over the last decades, usually associated to the theory of the secular stagnation.<sup>9</sup> It is still premature to conclude that low real rates and differentials will persist over time, but these low levels cannot be ignored: in a Bayesian sense, the evidence of a persistently low level of real interest rates should lead us to conclude that the likelihood that the secular stagnation theory is correct has increased. The second factor is that fiscal deficits in 2020-21 in the euro area have been financed largely through seigniorage, as discussed above, i.e. by "printing money" rather than through the issuance of debt purchased by the private sector. As long as this financing through seigniorage is permanent (see below for a scenario in which seigniorage revenues decline over time), the increase in public debt observed since 2019 is, to a large extent, irrelevant. Indeed, if sovereign debt were monitored statistically for the "public sector" (which includes a country's central bank) rather than for the "general government", as commonly done including by Eurostat, public debt would not have increased nearly as muchin 2020-21, and in some euro area countries would not have even increased at all.<sup>10</sup> For example, the holdings of "securities issued by Italian residents" (almost entirely government bonds) in the Bank of Italy balance sheet increased by 187 billion euro in 2020, while the Italian general government debt increased by 160 billion (see Banca d'Italia (2021)), with a likely decline in the gross debt of the consolidated government/central bank balance sheet.

These developments would not at all justify the "cancellation" of government securities issued by member countries held by the ECB, as suggested recently by some observers. Such cancellation would be problematic because it would create an obstacle to the management of monetary policy by the ECB, should the need arise to mop up the liquidity injected into the economy during 2020-21 (see below). However, the surge in public debt does not involve a net interest payment by the government if the purchases are made by the Eurosystem, nor does it involve the usual roll over risks (short of reasons related to the monetary policy needs discussed below) and all this alleviates the risks related to the recent rise in general government debt.

Altogether, in a scenario in which pressures to raise interest rates remain contained, the most appropriate policy seems to be to return to 2019 levels of the fiscal deficit only once the output gap (and not the GDP level) has returned to where it was in 2019. Deviations from this principle should be justified on the basis on country-specific reasons, such as the recognition that the 2019 deficit levels were unnecessarily tight, or taking for example into account structural reform needs requiring temporarily high deficits. They may also be justified by more general priorities, such as the need to implement green investment, even at the cost of accepting somewhat higher fiscal risks. But, as noted, these deviations from the general principle need to be motivated.

#### b. Second scenario: stronger upward pressures on interest rates

<sup>&</sup>lt;sup>9</sup> The theory of secular stagnation argues that the surge in world saving experienced over the last decade as a result of the entrance in the world economy of countries (like China) where households have a large propensity has caused a fall in the global equilibrium real interest rate.

<sup>&</sup>lt;sup>10</sup> Fiscal data in the euro area are monitored at the general government level, thus including the central government as well as local government (and the social insurance systems?). Standard definitions of the "public sector" include also other public entities, in particular the central bank. The fact that the ECB is independent does not imply that, from an economic perspective, seigniorage should not be regarded as a relevant source of financing of fiscal deficits. As long as central bank profits are transferred to governments, as they routinely are in the euro area, governments still benefit from seigniorage.

Let us now consider how monetary and fiscal policies should be managed in a second scenario, in which upward pressure on interestrates arise because of an increase in inflation. Inflation has remained low in recent years and international institutions continue to regard it as subdued in the foreseeable future (see International Monetary Fund (2021)). This said, in both the United States and the euro area, inflation has increased over the last few months and it cannot be ruled out that the combination of continued expansionary and fiscal policies at the global level may indeed result in a faster than currently expected rise in inflation.

A sharp rise in interest rates, connected to the monetary tightening that the ECB would have to implement (short of radical changes in its inflation targeting framework) to cool inflationary pressure, would have very different effects, in principle, between Northern and Southern European countries, on account of their very different public debt levels. Northern European countries may welcome such an increase, not only because of perhaps stronger dislike for inflation, but also because excessively low (indeed negative) interest rates for a prolonged period undermine the working of their pension systems that rely more than those of Southern European countries on private saving as a source of pension income. In contrast, a sharp increase in interest rates would have severe implications for the sustainability of the fiscal position of Southern European countries, because of their higher debt levels.<sup>11</sup> Indeed, as noted, the divide between the North and the South of the euro area in terms of debt levels, which was anyway sizable even before the Covid crisis, has further increased during 2020-21.

In the immediate future, the impact of the higher level of public debt ratios in Southern countries on their vulnerability to interest rate increases will be reduced by the fact that, as noted, the increase in public debt in 2020-21 has consisted, to a large extent, of purchases of government bonds by the ECB.<sup>12</sup> The new securities purchased by the ECB at higher interest rates will simply mean higher profit transfers from the ECB and national central banks to governments. However, for this mechanism to work, it will be critical that the ECB continues to roll over the government securities purchased so far. Only in this case will seigniorage revenues remain high. If, instead, for monetary policy reasons, the ECB balance sheet needs to be reduced by not rolling over the government bonds acquired in the last two years, seigniorage revenues will decline. The impact of such a decline on government accounts will by higher, the higher will be the level of interest rates. So, the question is: under what circumstances will the ECB have to reduce the stock of government bonds in its portfolio? Would it be possible for the ECB to continue rolling over the government so far, even if inflation picks up?

Faced with an increase in inflation, the ECB would normally respond with an increase in policy interest rates. However, as long as bank liquidity (that is commercial banks' deposits at the ECB) remain large, the increase in policy rates may have a more limited impact on bank lending and aggregate demand, particularly in the context of higher expected inflation. It is in this context that the need to mop up the liquidity created during 2020—21 to support economic activity may arise. In other words, if during the last two years the ECB has been undertaking quantitative easing (QE) operations to raise bank liquidity

<sup>&</sup>lt;sup>11</sup> If the increase in interest rates were caused by higher inflation, rather than by a rise in global real interest rates, its impact on public finances may be muffled by the erosion of public debt caused by inflation (the inflation tax). However, as recent data confirm, inflationary pressures in Northern countries are stronger than in Southern countries, while the ECB monetary policy is common in the euro area. Thus, real interest rates would rise more for Southern than for Northern countries. Moreover, as discussed below, the monetary tightening may involve the sale of public debt issued by high-debt countries by the ECB, with an impact on interest rate spreads.

<sup>&</sup>lt;sup>12</sup> To clarify, the term ECB is here used with reference to its balance sheet, as referring to the balance sheet of all central banks that are part of the European System of Central Banks. As noted earlier, the government securities purchased as a result of quantitative easing operations are actually held in the portfolio of national central banks.

and inflation, it may be necessary to do the opposite (quantitative tightening or QT) to stem inflationary pressures.

QT would imply not rolling over the government securities that come to maturity or even selling on the secondary market the government securities currently held in the ECB portfolio before they expire. Downloading on financial markets large amounts of government securities would, however, have devastating effects on the sustainability of public finances in high debt countries: the weight of that high debt, no longer supported by central banks (i.e. by seigniorage), would fall entirely on financial markets. Spreads within the euro area would rise and the situation may get out of hand. This would put the ECB in the very difficult position of having to choose between sticking to its primary mandate of targeting inflation and the risk of having to deal with a new sovereign debt crisis.

Is there an alternative to reducing bank liquidity to cool severe inflationary pressure? One possibility would be to freeze the liquidity created during 2020-21 through a special zero interest rate reserve requirement: in other words, instead of mopping up the excess liquidity, that liquidity could be made unavailable to support the expansion of bank loans by freezing it through a reserve requirement. Some comments are needed to clarify the implications of this operation:

- Freezing excess bank liquidity through a reserve requirement would imply that the ECB could continue to roll over a corresponding amount of government securities that, *de facto*, would become irrelevant in terms of fiscal sustainability. There would be no need to cancel those securities, though, a step that seems anyway to be impossible from a legal standpoint.
- Freezing part of banks' liquidity would have a tightening effect and lead to an increase in interest rates. However, the impact on interest rate spreads and the risk of a debt crisis would be much smaller than in case of QT operations that would dump high-risk government securities in financial markets.
- Reserve requirements have always been part of central banks' arsenal. They have been disregarded in recent years perhaps because they represent a tax on the banking system (banks would be forced to hold a zero yield asset at times of rising market interestrates) and may led to bank disintermediation in favor of less regulated financial intermediaries. The problem would, however, be alleviated by the fact that the reserve requirement would be limited in terms of magnitude, as it would apply only to the amount of liquidity created during the Covid period. It would be an extreme solution taken to face an extreme situation (the Covid crisis).

Similar approaches are of course possible, such as intervening with macro prudential regulations (aimed, for example, at re-building macroprudential buffers that were allowed to be eroded during the Covid pandemic to support the economy) to slow down the growth of bank lending. They would all share one feature with the reserve requirement solution: they would be forms of financial repression and, like all financial repression tools, would have unpleasant side effects (like, as mentioned, risks of disintermediation of the official banking system). However, the costs of these side effects would be smaller than those arising from the sale of large amounts of government bonds in financial markets. This said, it would have to be made clear that the imposition of a reserve requirement to freeze the bank liquidity created in 2020-21 would be a one-off event, reflecting the exceptionality of the Covid crisis.

In this scenario, characterised by higher inflationary pressures, the pace of fiscal adjustment would have to be accelerated with respect to that recommended in the first scenario. In the same way in which, during the downturn, the task of supporting aggregate demand could not be left just to the ECB, but had to involve also fiscal policy, in a higher inflation scenario fiscal policy will need to support monetary policy in moderating aggregate demand and inflationary pressures.

# 4. THE EFFECTS OF THE ESTABLISHMENT AND USE OF EURI/RRF ON NATIONAL PUBLIC FINANCES

The establishment of temporary facilities at the central level (i.e. supranational level) that would transfer resources to EU member countries (i.e. national level) to help them to face the economic consequences of the pandemic was necessary because of the absence of a central fiscal capacity, i.e. of a central budget that serve a macroeconomic stabilisation role. While having such a central capacity remains the first best (see section 5), the Recovery and Resilience Facility and other instruments set in place recently were based on a key principle that made them politically feasible: resources are borrowed together and spending decisions are taken together. In a central capacity/budget, this principle would take the form of spending initiatives managed by the center. In the support tools set up in 2020-21, following that principle has involved either constraining the use of the borrowed funds (as in the case of the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency and of the Pandemic Crisis Support Instrument introduced by the ESM) or the conditionality process (centered on targets and milestones) required by the RRF. It is worth stressing that the securities issued to finance these facilities are very different from the Eurobonds proposed some 10 year ago as a way to mutualise the public debt of euro area members. Those involved the mutualisation of past debt that had been created as a result of decisions taken by individual countries. In the current case, the securities are issued to finance spending programs that have been mutually agreed, as it would happened with a central fiscal capacity.

The RRF and other facilities are supporting the fiscal response to the crisis in 2020-21, even if, in terms of magnitude of disbursement in these two years, they are dwarfed by the ECB QE operations. First, their direct effect on borrowing costs was helpful, given their grant component and the lower interest rates for the loan component with respect to those paid by some Southern and Eastern European countries.<sup>13</sup> Second, the announcement that the European Union would make resources available fostered the belief that the current crisis would be faced through solidarity among EU countries, thus lowering borrowing costs from financial markets.<sup>14</sup> Third, the conditionality related to the RRF is expected to ensure the adoption and the implementation of reforms and investments that will both facilitate the recovery over the medium term and make countries more resilient, thus perhaps avoiding the need of future common support to respond to shocks.

The achievement of higher and more stable GDP growth rates will be also critical for future development in medium-term fiscal sustainability, particularly for high debt countries. However, whether the RRF succeeds in boosting medium-term growth and in strengthening public finances depends on two conditions that are discussed in the rest of this section.

#### a. The effectiveness of the conditionality mechanism

European institutions, like the ESM, have been familiar with conditionality mechanisms for years, following the 2010-12 euro area crisis. The conditionality foreseen for the RRF has, however, some specific features that makes it more challenging in terms of implementation. First, the time period involved is very long (five years, almost twice as long as standard medium-term fiscal adjustment programs). Second, it is more than usually biased towards structural goals, reforms and investments,

<sup>&</sup>lt;sup>13</sup> However, only a few countries (Italy being the main one) seem to be interested in using the RRF loan component.

<sup>&</sup>lt;sup>14</sup> The spread between ten year government securities issued by Italy and Germany declined by about 80 basis points between mid-May 2020 and July 2020, in the absence of new major monetary policy announcements, as the prospects for the Next Generation European Union became concrete (Figure 4).

rather than deficit and debt targets, which are not existent. The result is that the management of the related conditionality will become more complex and that the related assessment of whether conditions for disbursement have been met will require more subjective judgement than what is normally experienced in macroeconomic adjustment programs.Let us see why.

The complexity of the RRF conditionality is already evidenced by the amount of material that member countries are submitting to the European Commission.<sup>15</sup> While complete detailed information is not yet available, many of the 27 programs submitted by EU members are likely to involve hundreds of conditions distributed over a five-year period.<sup>16</sup> The key issue, however, is not only the number of conditions, but their nature. As it often happens with structural conditionality, and in contrast with macroeconomic conditionality that focuses on standard definitions of a few variables (e.g. fiscal deficits and public debt), some structural conditions will require specific definitions to make them applicable in practice, thus complicating matters. Others, and this is crucial, will have instead to be defined in general terms. This is particularly true for the so-called "milestones" (more qualitative conditions than the targets), referring often to critical structural reform (for example the reform of the justice system in the case of Italy). Unfortunately, the laws required to implement these reforms will necessarily be complex and assessing whether the letter and the spirit of the law is consistent with the agreed conditions will be a complex exercise, requiring a high degree of subjectivity. Of course, this sort of problems emerges also for standard macroeconomic adjustment programs, but the number of occurrences in which these complexity and subjectivity problems are likely to arise in the context of RRF conditionality is likely to be much higher.

The consequence of all this is the risk that political influences and considerations become much more important in assessing whether conditions have been met or not. We have already seen in the past that European Institutions have difficulties in enforcing rules. Emblematic is the example of the SGP fiscal rules, already discussed in section 2. These enforcement problems are going to be magnified in the context of the complex and vaguely specified conditions that are going to be frequent in Recovery and Resilience Plans (RRPs).

There is also another problem related to structural conditionality, not so much in terms of deciding whether the resources should be released or not, but in terms of whether the programs will lead to actual structural changes. Whether some measures were effective or not in actually achieving the goals of RRPs will be clear only after a long time, as it is usually the case for structural reforms. The latter do not just involve adopting pieces of legislation, implementation is critical and can last several years.

All this boils down to a conclusion that is well known to those that are familiar with complex and structural conditionality: ownership by the country implementing the program will be critical in achieving its goals, especially in terms of raising the medium-term growth rate and its resiliency to shocks. Unfortunately, whether the public opinion of the various countries does own the programs will emerge only over time and will also depend, possibly, on how strongly the public opinion was involved in preparing (designing) the plans and in its implementation.

#### b. Fiscal sustainability and growth

Even assuming that RRF investment and reform programs are implemented and manage to raise medium-term GDP growth, one cannot take for granted that this will lead to a decline in public debtto-GDP ratios at a sufficient speed. It has become common to argue that the debt problem can be

<sup>&</sup>lt;sup>15</sup> For example, Italy's RRF program is reported by the media to have required the submission of 2500 pages of material illustrating the program's actions and related target and milestones.

<sup>&</sup>lt;sup>16</sup> For example, the plan submitted by the Italian government includes as many as 419 targets and milestones.

addressed through the "denominator effect", i.e. through a faster growth in GDP. While not wrong, this is a rather simplistic view: of course, what the debt ratio does depends also on what the numerator of the ratio (public debt) does, not just on the denominator, and the behavior of the numerator depends on the development of deficits.

To illustrate the point through a simulation, consider a country that, in the baseline, has a constant public debt-to-GDP ratio of (say) 160 per cent of GDP (the level that the debt ratio it projected to be reached in Italy by the Italian government at end-2021). Assuming a baseline nominal GDP growth rate of 1,5 percent, this would imply a baseline constant deficit of 2,4 percent of GDP. <sup>17</sup> What would happen to the debt ratio if, simply through structural reforms that do not involve any exogenous increase in public spending or cuts in tax rates, the country manages to raise the GDP growth rate by one percentage point? What will be the impact on the debt ratio after, say, 15 years? Two extreme scenarios illustrate an interesting point:

- In the first scenario, the country keeps primary spending at the same level (in national currency) as in the baseline. This means that all additional revenues coming from the higher growth rate are saved. Assuming a revenue-to-GDP ratio of 42 per cent (as in Italy), and taking into account the decline in interest payments as public debt declines below the baseline levels, the debt ratio after 15 years would have declined by 69 percentage points (Figure 5), a very sizable decline.<sup>18</sup>
- In the second scenario, instead, primary spending rises in line with GDP. In this case, the decline in the debt ratio is limited to only 23 percentage points, one third of the decline in the first scenario.

It is of course unlikely that a country experiencing a faster growth rate would leave unchanged spending for fifteen years, with respect to any alternative baseline with lower growth, as the budget balance would eventually start showing sizable and rising surpluses.<sup>19</sup> The sharp difference between the two scenarios, however, illustrates a point. A key component of a strategy to reduce debt ratios based on faster GDP growth must include the containment of public spending below the (higher) GDP growth rate, with a related improvement in the primary balance.<sup>20</sup>

<sup>&</sup>lt;sup>17</sup> This is based on the formula for the debt stabilising deficit is  $df = \frac{g}{1+g}d_{-1}$  where g is the nominal GDP growth rate.

<sup>&</sup>lt;sup>18</sup> In these two scenarios, interest rates are, for simplicity, assumed to be the same as in the baseline).

<sup>&</sup>lt;sup>19</sup> In scenario 1, the budget balance would move from a deficit of 2.4 percent of GDP to a surplus of 4.7 percent of GDP.

<sup>&</sup>lt;sup>20</sup> In this respect, it is significant that Italy's 2021 Stability Program states that (my translation) "It is important to be aware that ... in due course, the fruits of higher growth will have to contribute to the strengthening of public finances." (see <a href="https://ec.europa.eu/info/sites/default/files/2021-italy-stability-programme\_it.pdf">https://ec.europa.eu/info/sites/default/files/2021-italy-stability-programme\_it.pdf</a>, p.12). Indeed, advanced economies that during the 1970-2000 period managed to lower their public debt ratios by large amounts did so while maintaining sizable primary surpluses, in the context of fairly high growth rates. See Bernardini et al (2019).





*A fortiori*, if raising the growth rate of the economy were considered to require a rise in public spending (or tax reforms involving lower revenues), the decline in the debt ratio that could be achieved through faster growth would be even lower.<sup>21</sup>

The policy implication of all this is that the evolution of public spending will need to be kept under close scrutiny (unless compensating measures are taken on the spending side) as part of a strategy to lower public debt ratios through growth. The post-Covid rebounding of economic activity starting from a situation of depressed economic activity will of course imply a decline in the primary spending-to-GDP ratio, the usual effect of letting the automatic stabilisers operate during a recovery phase. The point is that the same must occur for an increase in the potential growth rate of the economy related to RRF reforms if the goal is to bring down the debt ratio. The decline in the spending ratio would not imply a cut in the absolute level of spending in the context of faster growth, which should make it politically more acceptable. Moreover, lower growth rate of primary spending-to-GDP ratio can return to higher levels (as the deficit ratio needs to be more compressed only during the period of public debt reduction). However, letting the automatic stabilisers operate in the standard sense would not be enough. Containing public spending growth below the faster potential growth rate of GDP for some years will be necessary to compensate the asymmetric effect of large economic shocks like the

<sup>&</sup>lt;sup>21</sup> It is indeed unlikely that an increase in public spending may cause a decline in the debt-to-GDP ratio even when it does raise the GDP growth rate, except under very special circumstances. This may occur, for example, when the higher growth rate leads to a faster closing of the output gap and to higher inflation (Gaspar ed al., 2016), an effect that is in any case likely to be of a temporary nature.

one caused by Covid. Indeed, those shocks tend always to be negative and therefore must be offset by containing public spending during expansions even when faster growth reflects increases in potential GDP growth.<sup>22</sup>

## 5. PRIORITIES IN THE EMU GOVERNANCE REFORM

The joint policy response in Europe to the recent crisis has been much more effective than during the previous euro area crisis in 2010-12. The monetary policy actions and the "common borrowing" tools created by the European Union averted the risk of compounding the medical and "lock down" crises with a financial crisis caused by market pressures that would have otherwise hit high debt countries, with major negative implication also for other member countries.

Yet, the response was clearly *ad hoc* and revealed some persistent problems in facing large unanticipated shocks. In particular:

- The fiscal policy response was, again, left to individual member countries, albeit, this time, with the support of the new common financing tools (e.g. SURE and RRF) and by the intervention of the ECB.
- The common borrowing tools were introduced only after a long time (the ratification process has just been completed) and, explicitly, as a one off event.
- Some countries (among them Italy, the third largest) would have been unable to stand the crisis on their own, given their limited possibility to access financial markets. This resulted from lack of adequate fiscal and economic convergence in good times.

In light of these shortcomings, what are the key areas of improvement regarding economic policy governance in the euro area?

a. A central fiscal capacity

The main difference in the fiscal policy response to the crisis in the United States and in Europe is its full decentralisation in the latter and its quasi-centralisation in the former. In Europe, this time, the financing of decentralised fiscal policies was partially centralised, but the design of fiscal policies (subject to the RRF conditionality process, which however will affect primarily the post- crisis period) and their implementation was left to Member States, in line with the current architecture of the euro area. This decentralisation certainly has advantages, as it allows a better tailoring of policies to local needs, a key principle of fiscal federalism. At the same time, the complete absence of a central fiscal capacity implied that countries whose debt was not considered as risk free by financial markets could respond through fiscal policy to the crisis only because of the ECB intervention and, most likely, with some delay due to uncertainty regarding future ECB actions. This put more pressure than would have been optimal on monetary policy, which is one of the reasons why eventually the NGEU was put in place. While the mere announcement of the NGEU was helpful in restoring financial market confidence on the resilience of the euro area to the Covid shock, Member States will start receiving NGEU funds towards the end of 2021, when the deepest phase of the economic crisis will be (hopefully) overcome. Indeed, the NGEU will play primarily the role of a tool to support investment and reforms over the medium term, certainly a very useful role, but definitely not a counter-cyclical role.

All these points, once more, to the usefulness of a central fiscal capacity, advocated also by the European Commission before the crisis (see, for example, European Commission, 2018). A central fiscal capacity would involve the possibility of some centrally managed discretionary counter-cyclical

<sup>&</sup>lt;sup>22</sup> The asymmetric nature of large recessions in their effect on public finances is made by Gaspar and Escolano (2016).

policies. This, should, in principle, also lead to the statutory centralisation of some spending and taxation responsibilities, which may also lead to some centralisation of the automatic stabilisers (through the centralisation of spending and revenues that are sensitive to the economic cycle). Moreover, such centralisation would foster the harmonisation of products and factor markets.<sup>23</sup>

It is sometimes argued that a stronger fiscal capacity can be replaced by the working of financial markets. Indeed, it is also argued, in the United States counter cyclical financing flows are provided more by financial markets than by the federal budget (see, for example, Heijedra et al. (2018)). However, the comparison with the United States is totally misplaced for a very simple reason: in the United States the possible unwillingness of financial markets to provide financing to US states hit by economic shocks would never lead to the belief that those states would eventually leave the Union and the dollar. EMU is still too new, and not backed up by a political union, and this implies that the so-called redenomination risks are still very present in the minds of financial markets' agents. Thus, a heavy economic shock is likely to revive those redenomination risks and prevent financial markets from playing the role that is played in the United States in providing market-based risk sharing forms.

b. Convergence of national debt levels in good times

As discussed in section 2, public debt ratios have further diverged during 2020-21 between Northern and Southern Europe. This follows a period of relative faster GDP growth after 2012, when debt also diverged or, at least, failed to converge. The persistence of large (indeed larger) differences in public debt levels is a key vulnerability in the euro area, as it implies, as discussed, a potentially very different response to increase in interest rates across the area. The problem is more acute in the absence of a central fiscal capacity (as well as of a full banking and capital market union; see below), but would exist anyway, as long as large part of fiscal policy remains decentralised. This implies that, once fiscal rules are reactivated, they must become effective in fostering fiscal convergence in good times, that is in the context of higher growth, something that has not been achieved so far.

The purpose of this paper is not to discuss the specific forms that new fiscal rules should take. However, two points are worth making.

The first one is that, given the previous discussion of the features of a growth-based debt reduction strategy, fiscal rules should be focused on spending ceilings leading to saving a good part of the revenues coming from additional potential growth, until the desired country-specific medium-term objective are achieved.

The second point refers to a specific governance issue: peer pressure for complying with fiscal rules in the euro area has been generally weak. Indeed, member countries and EU institutions, in the context of EU surveillance, have usually preferred either simply to turn a blind eye or to change the rules through increased flexibility, to avoid putting pressure on member countries to achieve public debt convergence in good times. The Commission itself, in the fiscal as well as other areas, seems to have been, at least sometimes, constrained by political considerations with Commissioners playing the role of their home country representatives rather than of neutral representatives of a supranational institution.

Addressing this issue is not easy. Substituting or complementing external pressure for strengthening fiscal performance in good times with internal one has not really worked: even the constitutional amendments introduced in some countries have not really worked, as national parliaments have been

<sup>&</sup>lt;sup>23</sup> For example, a European unemployment benefit scheme would foster the convergence in the working of labor markets and may facilitate the introduction of harmonized labor market legislation. On the effect of centralised spending and tax policies on the convergence of product and factor markets see Cottarelli (2016).

more than willing to regularly state the existence of exceptional circumstances (the "escape clauses" inevitably included in such amendments) to suspend balanced budget rules. Moreover, national fiscal councils—also mandatorily introduced in EU countries during the last ten years—have had different effectiveness depending on country's circumstances. One possibility would be to strengthen the resources, the role and the responsibility of the independent European Fiscal Board. These responsibilities may include expressing formal and public views on the Stability and Convergence Programmes presented by individual member countries and on their implementation, including the possibility of recommending to the European Commission, or perhaps even directly to the Council, the opening of excessive deficit procedures and their termination.

c. Banking and Capital Market Unions

The completion of the banking and capital market unions remains important, with the former being a key priority. The most important element to complete the banking union is the introduction of the European Deposit Insurance Scheme (EDIS), proposed by the Commission almost six years ago. If it had been in place, the EDIS would have probably reduced the tensions arising within the euro area at the beginning of the Covid crisis, tensions that were resolved only through the massive intervention of the ECB. Thus, an EDIS would also reduce the burden of addressing economic and financial crisis that now fall in good part of the ECB.

As to the capital market union, its completion would facilitate to some extent the financing of countries relatively hit more heavily by economic shocks, but this is subject to the caveats discussed above about the limits of capital markets to replace a fiscal central capacity in a still new monetary union, not backed up by political unity. The completion of the capital market union would, however, have another, and important, advantage: it would facilitate the mobilization of private capital needed to accelerate economic growth over the medium term in the euro area. As discussed, it is in the context of faster growth, especially in Southern Europe, that the necessary reduction in public debt ratios and in the cross-country debt ratio dispersion can take place more easily.

# 6. CONCLUDING REMARKS

The monetary policy actions undertaken by the ECB and the willingness by EU Member States to set in place innovative common financing mechanisms allowed the euro area to contain the economic damage caused by the Covid crisis. Financing remained available for all countries at favourable terms, contrary to the experience during the global financial crisis of 2008-09 and the euro area debt crisis of 2010-11.

Yet, the crisis revealed once more some persistent shortcomings in the working of euro area policy making and governance:

- There was not enough economic and fiscal convergence in the relatively good times before the crisis.
- The absence of a central fiscal capacity implied that too much burden was put on the ECB in avoiding a financial crisis.
- It also implied the need to set up *ad hoc* common borrowing tools, which is being implemented with a delay.
- The crisis has been accompanied by a rise in differences in public debt to unprecedented levels, leaving Northern and Southern euro area countries exposed to very different levels of risk with respect to a possible increase in interest rates.

The priority is now to restore growth, also as a way to facilitate the medium-term decline in public debt ratios, particularly in high debt countries. Fiscal policy support should be withdrawn gradually, as the output gap returns to more normal levels and structural reforms need to strengthen potential growth

rates, particularly in Southern European countries. RRF conditionality can help in this respect, although it faces unusual challenges related to the structural nature of the actions that member countries will have to undertake over a prolonged period. Moreover, EU surveillance and fiscal rules should insure that at least part of the revenue coming from higher potential growth are actually saved, otherwise the decline in debt ratios would occur at an insufficient pace.

Most important for the future development of the euro area will be to further centralise fiscal policy institution and decisions, particularly with the creation of a central fiscal capacity and the completion of the banking and capital market unions.

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The euro area response to the Covid crisis avoided a financial crisis. In the short term, the withdrawal of fiscal stimulus should be guided by unemployment, output gap and inflation data. Over the medium term, reducing public debt ratios will require maintaining the growth of primary spending below the (higher) GDP growth rate to be achieved through structural reforms. Over the longer term, creating a central fiscal capacity, strengthening the enforcement of fiscal rules in good times and completing the banking and capital market unions remain priorities.

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