OVER-PUBLIC INDEBTEDNESS CHALLENGES FOR GROWTH AND STABILITY

SYLVIE GOULARD
Second Deputy Governor
Banque de France

Cinderella and the Covid crisis

Coming (slowly) out of the sanitary crisis, it is difficult to identify what the "new normal" could be. Compared to the management of the previous crisis the response to the COVID choc was definitely quicker, of a larger magnitude, and more coherent.

In March 2020, the ECB decided to intervene in a massive way to preserve financial stability and avoid the collapse of European economies. The Pandemic Emergency Purchase program consisted of an unprecedented injection of liquidity (1,8 trillion euros). Access to liquidity was secured for private banks. Prudential buffers were released.

On the fiscal side an unprecedented expansionary policy mix was implemented. This support helped economies to go through brutal lockdowns, kept companies alive, saved jobs and supported purchasing power. In July 2021, EU Member States agreed to a common debt issuance to finance the recovery; the 800 billion € recovery fund is intended to help relieve the economic pain due to the crisis. NGEU disbursements will amount to around 0.8% of Eurozone GDP per year in 2021 and 2022. Two new features, NGEU conditionality and assessment process led by the Commission, should contribute to increased efficiency in national reforms and mutual trust.

All these decisions took place in an exceptional context, where the stability and growth pact rules were suspended as well as state aid rules. And now? Like Cinderella, we may face another situation when the night is over... Several issues are at stake:

- **rising inflation:** in the Eurozone, the annual inflation rate was estimated at 5% in December 2021 when, since the strategic review, the new inflation target of the Eurosystem is a symmetric 2 %. According to the ECB previsions, inflation is expected to fall slightly below 2% by the end of 2022 (1.8% in 2023);
- **accumulation of public debt:** at global level, public debt-to-GDP ratio increased on average by 15 pp between 2019 and 2020; for the Euro area, it is estimated to reach 100% in 2021, however with great disparities;
- pre-existing structural vulnerabilities: economic performances of euro area countries are heterogeneous. Though the creation of the "macro imbalances procedure" in the revised Stablity and Growth Pact (SGP) in 2011 meant to give the Commission a monitoring power, spill overs between states still exist.
- **new long-term challenges:** all EU countries are committed to net zero which requires huge investment (estimated at €360 billion per year for the three coming decades); digitalisation is also key and costly, without even considering the possible need for more military spending in a troubled geopolitical environment.

Should inflation be more persistent and higher than anticipated, the ECB will act according to its mandate. Higher interest rates could both affect the European Union's recovery and increase the interest burden of public debt. Fiscal authorities will have to include the risk of higher nominal interest rates in their budget plans.

The Commission has launched a consultation on the current EMU rules. As long as states remain in charge of economic and social policies and the ECB of a unique monetary policy, this "social contract" is key.

EU fiscal rules are often considered too complex and even not applicable. It is true that the revised SGP and the "fiscal compact" (TSCG treaty) were adopted in a short period of time (end of 2011 / 2012), in a context of very high spreads and mutual distrust. To revise these rules, it is not enough to criticize their complexity, their insufficient counter cyclicality or limited enforcement. These are the consequences of remaining cultural divergences, which need to be worked upon in depth. Whatever the outcome of the current revision, reduction of debt will require effort, in particular in countries used to high levels of debt, long before Covid.

Cinderella holds her fate in her own hands.

New rules are not a silver bullet nor will they create convergence if governments and public opinions are not convince that these efforts, accompanied by well designed productive investments, are in their interests. Some ideas currently discussed such as the exclusion of some expenditures in the calculation of the deficit and debt, were also already envisaged in the past, with little success.

A common EU central fiscal capacity should be investigated, as part of a optimal currency area, and to cover the financing needs of the green transition while ensuring convergence across Members-States on the transition path. However, the best method to get such a budget one day is to make the best possible use of the NGEU.

Any future "budget" dedicated to common priorities driven investments and growth-friendly public spending requires not only the revision of rules but other behaviours. Cinderella holds her fate in her own hands.

EDWARD SCICLUNA

Governor - Central Bank of Malta and Member of the Governing Council of the ECB

One instrument for one objective

Nobody needs to explain why high inflation is undesirable. It robs people on fixed incomes. It starts the dog chases tail wage-price spiral between unions and employers. And yet, nobody would like inflation to return to negative territory, where interest rates can get stuck at very low levels for long periods.

Hence the accepted 2% inflation rate target, which gives adequate elbow room to monetary policy makers to keep the ship steady and allow economic growth to flourish. Hence too the symmetry principle which the ECB has embraced for the future.

That said we are presently faced with relatively high rates of inflation which were last experienced more than a decade ago. Indeed, the rates in the European Union countries and elsewhere, notably in the US and Canada, are exceptionally high.

The knee-jerk reaction response from media to raise interest rates is understandable. But proper evaluation needs to enquire about the source of this inflation, and how it has been in hibernation for so long and after proven itself unresponsive to the barrage of monetary instruments over the last decade, appears all of a sudden.

Of course, it has to do with the pandemic. No doubt the pandemic has upset persons, institutions, and whole economies. Many people stayed at home for various reasons. Like a war period both supply and consumption were seriously interrupted. Like war it has interrupted the modes of work, encouraged persons especially the elderly to withdraw from the labour force, affected heavily people's wellbeing and self-worth, while making others to rethink their life-plans and undertake a reset as well.

The aftermath of the pandemic found the economy with previously pent-up demand pouring out and finding supply short. Industry found much of their staff missing due to sickness imposed quarantine, absences to look after children whose schools were closed, or even inadequate vaccination.

The logistic problems affecting cargo shipping, combined with the tight oil production and ensuing energy prices affected the prices of a wide range of goods, including food and housing cost. Each price surge is explainable, has a beginning, and an end. In short, the price burst is not expected to be permanent. Inflation is transitory.

Many questions arise. What do we mean by transitory? What about the reactions of firms, unions and consumers in the face of such price increases? Will they react? Inflationary expectations are of material interest to the medium term anchoring of the inflation rate.

... an agreement on a renewed fiscal pact for the sake of containing inflationary expectations.

In all this we cannot ignore the fiscal side. In this pandemic, government support took a central role and may be described as the elephant in the room. Definitely more so in the US where no less than a 3 trillion US dollar stimulus package was laid out.

On this side of the Atlantic the pandemic-related public expenditure was likewise justifiably generous, though not as much as in the US. But judging by the increasing deficits and debts which averaged over 13 percentage points for the euro area it was indeed significant and without precedent.

This public assistance was intended to ensure some element of continuity which was missing during the 2008 financial crises and its aftermath. Wage supplements and business support schemes were meant to provide liquidity to revenue- starved firms and ensure the labour force would remain on the firms' payroll. This was supplemented at the EU level by various schemes with the largest being the RRF. Definitely, one cannot overlook this as a potential source of inflationary pressure.

In comparing the global financial crisis to the pandemic crises another difference stands out. The aftermath of the former crisis was marked by stringent EU wide fiscal rules and relentless consolidation where EU governments saw a marked reduction of their deficits and their debts. In the current situation the fiscal rules had to be suspended and a new fiscal framework is still being discussed. Its future is not yet clear. It is expected that deficits will come down but definitely slower than before.

What is relevant for inflationary expectations is whether consumers, firms and unions believe that governments are really committed to bring down the crisis related deficits and debts. If that is the case then indeed inflationary expectations would be eased accordingly.

If on the other hand the taxpayers believe this will not happen, inflationary expectations may not become anchored at the required rate for price stability. They will argue that since governments do not do their part to see the debt burden falling to pre-pandemic levels through growth and fiscal rectitude then inflation will be left to reduce the debt burden through its known taxing method.

The principle of using one instrument for one objective here applies. That part of inflation which is caused by fiscal largesse must be mainly addressed by fiscal means. For now it is imperative for MS to reach an agreement on a renewed fiscal pact for the sake of containing inflationary expectations.

DECLAN COSTELLO

Deputy Director-General, Coordination of Economic Policies of Member States - DG for Economic and Financial Affairs - European Commission

Europe's recovery from the crisis: facing new headwinds

The EU economy is rebounding from the recession caused by the COVID-19 pandemic faster than previously expected. Thanks to a successful vaccination campaign and a forceful and coordinated policy response, most Member States returned to its pre-pandemic output level by the end of 2021, according to the Commission's latest economic forecast of November 2021. The Commission projects GDP growth in the EU at 4.3% in 2022, in line with strong domestic demand dynamics and a positive labour market outlook. The economic expansion is set to continue, with GDP growth expected at 2.5% in 2023.

The uncertainty around these projections is high and headwinds to the economic outlook are mounting. Whilst recent developments are positive in Europe, new waves of infections and containment measures remain a downside risk to the outlook. More pressingly, we also see that the supply side is struggling to keep up with buoyant demand as supply chain disruptions and shortages of raw materials and intermediate inputs hamper production, while pockets of labour shortages emerging. In addition, a sharp spike in energy prices fuels inflationary pressures.

Whilst our economies have coped better than expected and worst potential impacts in terms of scarring have been avoided to date, vulnerabilities over the medium and long-term have increased. Highly valued equity markets and the recent surge in house prices, to levels above their fundamental value in many Member States, carry the risk of sudden corrections. At the same time, high corporate and public debt levels accumulated during the crisis imply additional exposure to changing financial conditions. While the substantial liquidity support, public loan guarantees and debt repayment moratoria have helped keeping businesses afloat during the pandemic, the overall low insolvency rates suggests that bankruptcies are due to catch-up to some degree, with possible ramifications on public finances.

In this challenging macro-economic environment, the right policies and effective economic policy coordination will be crucial to support a broad-based recovery that is consistent with the green and digital transition while ensuring macroeconomic stability.

Whilst our economies have coped better than expected, vulnerabilities have increased.

With the Recovery and Resilience Facility (RRF), the EU has created a once-in-a-generation opportunity to transform our economies in light of an unprecedented crisis. By providing large-scale financial support to high-quality investments and enabling reforms in the Member States, the RRF will help lift their growth potential and thus support the sustainability of public debt.

Now is the time to turn the Member States' ambitious recovery and resilience plans into tangible results on the ground. We should see it as a strong and positive signal that the euro area Member States with high deficits and debt levels are frontrunners in the implementation. Spain has already received its first disbursement under the RRF based on the successful implementation of the first milestones of its plan, and France is expected to follow suit soon. Greece, Italy and Portugal have formally submitted payment requires which are under active consideration by the Commission.

Beyond the swift implementation of the RRF, we need to reach a swift agreement on the direction of our economic governance. The reform of the fiscal rules should help put fiscal policy on a credible medium-term path that strikes the right balance between macroeconomic stabilisation and fiscal sustainability. A credible anchor for fiscal policy will foster market confidence and support the ECB in ensuring that the monetary policy stance remains consistent with inflation stabilising at the target rate over the medium-term, in line with an eventual normalisation of interest rates.

Finally, and as part of this debate, economic governance should pay attention to the quality of the budgets and protect public investments that are crucial for the green and digital twin transition. The EU has chosen to be a frontrunner and to embrace the opportunities found in environmental protection and the fight against climate change, which is the biggest challenge we collectively face. In addition, the pandemic has further accelerated the digital transition. Supporting the development and uptake of digital technologies and equipping the workforce with the right digital skills will be key to lift the growth potential of our economies.

The fiscal rules should take due account of these objectives. In this regard, the RRF grants will help to adjust to the structural changes underway without jeopardising fiscal sustainability.

SARAH CARLSON
Senior Vice President
Sovereign Group -
Moody's Investors Service

Next Gen EU offers opportunity for debt-laden countries to address challenges

In Moody's view, the Next Generation EU (NGEU) economic recovery programme is a once-in-a-generation opportunity for some of the EU's most indebted countries because of its size and the way in which it links disbursement of its funds to the enactment of structural economic reforms that could address root causes of weak growth potential.

Four South European countries — Greece, Italy, Portugal, and Spain — will receive almost half of all grants and loans available under the NGEU's Recovery and Resilience Facility (RRF). The European Commission has stated that if fully utilized, the funds available for all EU countries would total €806.9 billion in current prices, or around 4% of EU GDP, over the 2021-26 programme period. In the case of Italy and Spain, the RRF funds are several times the size of what these countries receive under the regular multi-year EU budget.

In all, EU funds from the RRF and the current EU budgeting cycle will effectively double public investment in these four countries over the next five years. Public investment spending in these countries has been falling since the euro area sovereign debt crisis and was among the lowest in the EU in 2019. Since 2015, the four countries had accumulated a public investment gap—in other words, the investment needed to maintain the stock of public assets net of depreciation—that averaged 2.4% of GDP, with Portugal and Italy having accumulated the largest investment needs.

The NGEU recovery funds give recipient countries the space to reduce pandemic-era deficits while supporting economic growth. Moody's estimates that this funding, if fully absorbed, could add 0.7 percentage point to real GDP growth in these countries between 2021 and 2027, which in turn could help to activate positive debt dynamics. If these funds mobilise further private investment, this could have additional benefits for economic growth.

Moody's views the structural reform component of the NGEU programme as being at least as important as the investment funds themselves in boosting longer-term growth potential, and in many cases the reforms and investment priorities are mutually reinforcing. For example, substantial funds that are being channelled toward digitalization will aid reform of the public administration. If implemented effectively, this could generate significant efficiency gains and ease spending pressures in areas such as healthcare, which will be under pressure in the coming decades because of population ageing.

The NGEU recovery funds give recipient countries the space to reduce pandemic-era deficits.

In fact, subdued investment spending is only one key driver of weak growth in the EU's most-indebted countries. The most acute challenges vary by country, but relatively low productivity growth, low labour force participation, and slowing population growth have often played an important role, too, in driving the low level of economic growth in Europe's most indebted countries. Among the advanced economies, Europe is not unique in facing growth challenges—for example, South Korea also faces significant demographic challenges and the US has difficulties with productivity growth, weaker participation rates for some segments of the labour force, and high levels of income inequality. However, in both South Korea and the US, high levels of technical innovation mitigate these challenges to a greater degree than in Europe. This contributes to keeping their growth potential higher.

Many challenges remain for the EU, but if they can be overcome there is further upside potential to Moody's growth expectations, which if realized would be credit positive for the countries concerned. One key area of uncertainty is whether the large recipient countries can absorb large amounts of investment funds in such a short time frame and use these funds effectively to support the process of structural reform. This has been a challenge in the past, and if previous absorption rates were to be applied here, Moody's estimates that the growth impact of the recovery funds would, on average, be 0.2 percentage point lower each year. Whereas the incentives that the NGEU's governance process has created are a strength of the programme, it will be difficult for governments to maintain political momentum around the structural reform process. It could also be challenging for the European Commission to enforce commitments to deliver on reforms.

Nevertheless, NGEU has the potential to mark not just an institutional milestone for the EU, but also an important step towards addressing the twin challenges of low growth and high debt that many of the EU's most-indebted member states are confronting.

If NGEU can realise its potential, this would increase the resilience of the entire monetary union, with meaningful benefits for the stronger member states as well.

PIER CARLO PADOAN

Chairman of the Board of Directors - UniCredit S.p.A.

The need to create fiscal capacity and a true capital market in Europe

The US economy is probably the best reference for a comparison on EU growth, while China has a completely different structure. In 2010-19, per-capita GDP growth in the EU underperformed the US by an average of 1pp a year, due to an unfavorable mix of demographic factors and slower productivity. This was exacerbated by the fact that the EMU remains an incomplete project, with lack of fiscal integration and slow progress on the banking union.

Consequently, before COVID-19, the euro area was not adequately equipped to counter cyclical shocks via fiscal policy and placed an excessive burden on monetary policy as a stabilization tool. After the Great Recession, austerity that was intended to reassure financial markets backfired, leading to tighter conditions and severe recessions in the weakest eurozone countries, ultimately leaving the responsibility of sustaining the economy entirely on the ECB.

Against this background, the main reform priorities for European policymakers are the creation of a central fiscal capacity and establishing a true European capital market.

European policymakers need to create a common fiscal capacity to attain a more adequate aggregate fiscal stance than what a coordination of national policies has managed to achieve before the pandemic. NGEU has been a major step forward. Several European leaders have recently expressed their support in favor of the set-up of a permanent fund to increase common investments in strategic areas (such as defense, research, infrastructure, and digitization) and the proposal is expected to be discussed in March on the initiative of French presidency of the Council of the EU.

The need of more investment in "common goods" is highlighted by the weakness in public investment over the last decade. In the eurozone, public investment fell from 3.5% in 2010 to 2.8% of GDP just before the COVID-19 crisis, with Italy and especially Spain recording large declines. In fact, the debate on the reform of fiscal rules and the discussion on a central fiscal capacity should be seen as complementary and mutually reinforcing in strengthening Europe's resilience to shocks and place the recovery on a fairer and more sustainable path. Driving the rules' reform proposals is the aim of encouraging growth-friendly expenditure, such as green and digital investment, and enabling member states to pursue a gradual and realistic reduction in debt to avoid stifling the recovery.

Creation of a central fiscal capacity and establishing a true European capital market.

Policymakers need to step up efforts toward integrating European capital markets and thereby channeling towards investment the large pool of European private savings (whose stock exceeded EUR 4tr last year) irrespective of home-country considerations. This is particularly important as the COVID-19 crisis risks increasing economic divergences within the euro area. Increasing cross-border ownership of stocks and debt securities and cross-border business financing would be an important way of sharing risks and by this means stabilizing the real economy over time. It would also be critical to achieve the substantial investments in digital and green infrastructure that are needed to meet the bloc's medium to longer term objectives. The goal to cut greenhouse gas emissions by at least 55% before the end of the decade will on itself require about EUR 500bn per year in additional investment, compared to the previous decade. And the bulk of these additional funds will have to come from the private sector.

The implications of above-target inflation will depend on the causes of high inflation and the response of monetary policy. If high inflation mainly reflects an improvement of economic fundamentals, namely activity exceeding the pre-pandemic trend-line sooner than expected, a closing of the output gap and stronger labor markets and wage developments, big negative consequences for financial stability are unlikely. The ECB would stop net asset purchases and, probably, lift interest rates out of negative territory. However, the increase in market rates would feed through to the average cost of debt over a number of years, while public debt/GDP ratios would continue to decline thanks to sustained nominal growth.

The situation would be different if high inflation were to mainly reflect supply bottlenecks and persistently high energy costs. In this context, economic activity would suffer because the inflationary shock would erode the purchasing power of households, with negative consequences not only for consumption, but also for investment and intra-area exports. However if inflation expectations remain well-behaved, the ECB should refrain from tightening monetary policy and this would help stabilize market sentiment.

A more challenging situation would arise if the recovery of eurozone countries proceeds at markedly different speeds with highly indebted countries lagging behind. In this environment, the ECB would probably need to tighten policy to some extent, which might lead to wider sovereign spreads and a higher risk of renewed financial fragmentation.