Ensuring EU growth and financial stability with over public indebtedness

Even before the Covid crisis, global debt was at a record since the 1950s also due to accommodative monetary policies in advanced countries over the past 20 years. The debt situation has been worsening with the Covid crisis.

Several points emerged from this discussion: Firstly, in the current environment characterised by the return of inflation, the continuation of a monetary policy of very low interest rates in the euro area would intensify its negative consequences on growth, employment and financial stability. Secondly, effective macroprudential policy is essential for financial stability and ensures that monetary and fiscal policy can play their respective roles. Thirdly, the increase in public debt and unlimited money creation can result in a dangerous spiral for our economies. Increasing public spending and debt in highly indebted European economies can lead to economic underperformance. Structural issues can only be resolved by structural policies and economic growth.

1. Lasting ultra-loose monetary policies discourage productive investment and growth in Europe

1.1 Persistent zero interest rates damage productive investment

An expert stated that low interest rates or negative interest rates have not fostered productive investment. For the last 20 years there has been a lower capital base in terms of productive investment. Productive investment has receded and decreased over the last 20 years. In advanced economies the level of growth of non-residential investment in tangible assets has declined significantly over the past two decades, from 14.1% of gross domestic product (GDP) in 2000 to 11.5% in 2019. One of the reasons is the liquidity trap. If interest rates are zero or even negative, then the rational reaction of a saver is to keep their money in liquid forms. If the evolution of household financial assets is observed over the last 20 years there has been a steep increase in the share of liquid instruments held by households.

1.2 Loose monetary policy coupled with expected low returns on earnings drive a preference for liquidity

An expert explained that the liquidity trap is a major phenomenon which is never analysed in the reports of big institutions and central banks, but it is absolutely central. The more someone has a propensity to hold assets in liquid forms the less they can have long-term investments. The inconveniences and the drawbacks of a policy of zero or negative interest rates are absolutely enormous. If a company has to choose between a risky project over 20 or 30 years or one in order to buy back their shares, in an environment of zero interest rates it is going to do the latter.

1.3 Remuneration is a key driver for contributing to sustainable growth

An expert added that remuneration is important in contributing to growth. Someone does not choose an investment project only because of the return they are going to get on it, but if they know that the return is going to be zero or even negative then they are not going to do it. Inflation is worse than forecast, and now is the time to act on it.

1.4 Persistent loose monetary policies have led to negative economic and financial consequences

1.4.1 Lasting zero or even negative interest rates have been a disincentive for many Member States to undertake structural reforms

An expert underlined that one of the big drawbacks of too easy a monetary policy is that it allows governments to delay structural actions. Europe has reached some limits on the easy borrowing policy that it has been pursuing in recent years because of inflation and high fiscal deficits and will have to move towards structural policies. These policies cover labour markets, research, development, the inequality problem, and energy policy. Energy policy is going to have to significantly change. Europe will need much more electricity, which is a significant investment. That investment will be done by the public and private sectors. If Europe wants the private sector to invest in those types of investments it is going to have to give it remuneration, which monetary policy with zero interest rates is not going to be able to do.

1.4.2 Persistent loose monetary policies may lead to negative economic and financial consequences

A Central Bank official highlighted the importance of acknowledging the problem with negative interest rates. It is necessary to incentivise risk-taking by a positive real return on investment. If this is not achieved, then the result will be low investment. The savings of households and non-financial companies will be channelled towards liquid and non risky assets, thus leading to companies being highly liquid but are not investing. When looking at the overall picture the inequalities are increasing. Indeed, lasting low interest rates and unconventional monetary policy instruments have tended to increase asset prices which have benefited the wealthiest segment of society. So, Europe is trying to be kind but is actually being unkind towards people on low incomes.

The Chair thanked the Central Bank official for referring to the inequalities as the side effects of a large amount of liquidity put in the market.

An industry representative added that inequalities will be a key credit driver in future years. It links to the theme of

structural reforms because some of the lack of structural reform is coming because of insiders trying to protect their position, often to the detriment of outsiders. It is extremely important to keep older workers in the labour force.

2. Macroprudential policy protects both monetary and fiscal policy from financial dominance

Effective macroprudential policy is essential for financial stability, which is vital for price stability. It ensures that monetary and fiscal policy can play their respective roles.

2.1 Macroprudential policy is needed to prevent financial stability risks from emerging

A Central Bank official stated that the joint responsibility is to make sure that Europe has a stable financial system, stable public finances, and stable prices. The economy is facing structural change. This requires a resilient financial system – especially as it is also undergoing structural change, e.g. due to digitalization. During the pandemic, the financial system functioned quite well in providing liquidity to the real economy. Still, vulnerabilities have continued to build up over this period, e.g. in the form of a higher NFC leverage in some market segments. Macroprudential policy is the first line of defence against financial stability risks. It is particularly important in a monetary union and essential for making sure that fiscal and monetary policy can focus on their main mandates.

A Central Bank official added that resilience of the financial system is fundamental for the resilience of the real economy, financing investment and growth. Many challenges lie ahead. Finding answers to problems posed by digitalisation and climate change have been added to central banks' tasks. Geopolitical risks and their effects on structural change are adding additional uncertainty. To manage all these challenges, a resilient financial system is needed. Three elements are important: adequately financing the transition, awareness of the emerging risks, and an efficient framework for the entry and exit of financial firms into financial system.

2.2 Macroprudential risks should not be underestimated

A Central Bank official highlighted that the fiscal measures for the real economy also indirectly protected the financial system during the Covid crisis. In that sense it was different from the global financial crisis, where there was targeted support to financial institutions. But vulnerabilities have increased in the financial sector. Indeed, banks have increased exposure to interest rate risk and assets are potentially over-valued. There is a concern notably that macro risks are currently being underestimated by financial institutions. In past decades there was usually an increase in corporate insolvencies during a recession. However, in the past two recessions, caused the global financial crisis and the pandemic, corporate insolvencies in some countries did not increase by much or even decreased even though GDP sharply declined. Looking ahead, correlations between credit risk and macro risks could return to their previous patterns, leaving financial institutions with too little risk provisions if they take low default rates (enabled by ample fiscal support) for granted. To ensure that fiscal policy can focus on its tasks, we need strong macroprudential policies and appropriate buffers in the financial system to strengthen resilience against macroeconomic risks.

2.3 Effective macroprudential policy ensures the stability-oriented financial sector policies and monetary policy are aligned

A Central Bank official added that Stability and Growth Pact is an essential instrument for aligning stability oriented fiscal and monetary policies. Without it, fiscal policy could be overly expansionary, eventually leading to fiscal dominance: A necessary monetary tightening may be delayed if it raises concerns about the sustainability of public debt. The macroprudential policy framework complements the Stability and Growth Pact (SGP) by disincentivising excessive private borrowing which may lead to "financial dominance", in which a necessary monetary tightening may be delayed if it puts the stability of financial institutions at risk. Hence, macroprudential policy is not just a topic relevant for technocrats, supervisory institutions and central banks, but for the entire society.

3. The fiscal policy response to the pandemic was appropriate, but increasing public spending and debt in over-indebted countries would lead to lower economic performance

3.1 Significant fiscal deficits were necessary during the Covid crisis

A Central Bank official noted that in this pandemic government support took a central role. The accommodative monetary policy was accommodating governments in increasing their deficits and debts, all for a justified reason. The financial crisis was a big shock which too required governments to give their all, which meant higher deficits, to be followed by a debt crisis. The pandemic then hit. Governments wanted to give the economy its full support. So one can say there is always good cause to spend, especially when monetary policies are accommodative. When there are no fiscal governance regulations any cause gives governments a blank cheque to spend on whatever they require.

A Central Bank official agreed that the fiscal policy response to the pandemic was well targeted and necessary. With the large decline in GDP that Europe saw due to the pandemic and the associated lockdown measures it was important to protect the real economy.

A policy-maker stated, from a personal capacity, that regarding the appropriateness of the fiscal policy response to the Covid crisis, while it is never easy to respond to crises, the response to the Covid crisis should be assessed very positively. In particular, if the fiscal policy response for the Covid crisis is compared to the

one for the financial crisis, then most people would agree that Europe got it badly wrong in some respects for the first crisis and did a much better job for the second crisis. A simple illustration of this is provided by the fact that the deficit increase has been higher in this crisis than the great financial crisis, but the increase in the debt to GDP ratio has been lower. The reason is that the damage to growth has ben contained in the case of the Covid crisis, while it has been persisting in the case of the financial crisis, in particular in the euro area.

Supporting the real economy and the financial system during the Covid crisis did not raise moral hazard concerns. A Central Bank official observed that the moral hazard effects were more acute in the global financial crisis than in the Covid crisis. The pandemic was an unexpected global shock that -contrary to the financial crisis- was not the result of wrong incentives and a build-up of debt and risks in some sector, as in the financial system before the global financial crisis. On the contrary, during the pandemic fiscal policy measures helped prevent spillovers from a distressed real economy to the financial system. They protected firms and households against losses in income and therefore shielded the financial system from macroeconomic risk.

3.2 Sustainable fiscal policies are required to deliver a flexible and competitive economy

3.2.1 The divergence in public debt levels across EU member states is a concern

The Chair noted that earlier at Eurofi an expert stated that one of the ideas for the future of the SGP is to examine what countries do in a more tailor-made approach with an Article 4 IMF.

The Chair asked a policy-maker what a significant change to NextGenerationEU (NGEU) means from inside the European Commission, as for the first time Europe has both the money to invest and a strong incentive for structural reform, and technical support for states that want to receive support.

This policy-maker remarked that, while, as noted, the level of debt has increased less than it could have done if the policy response had been botched, the level of public debt is significant and cause for concern. One could have questions. The first question is whether the level of debt is too high for the Euro area as a whole or if it is too high for Euro area countries. The Euro area as a whole does not stand out among developed economies for its high level of debt. The second and most important question is the one of divergence of this public debt across Member States. This is probably the most serious concern, given the incompleteness of Economic and Monetary Union. A downward trajectory in the next few years for public debt in the EU due to high(er) inflation is a very uncertain prospect.

3.2.2 Fiscal rules are needed in a Monetary Union; the economic governance of the EU needs to be strengthened

A policy-maker added that there is clearly a problem of divergences in debt and debt levels that are too high in some countries, which leads to the issue of the fiscal framework. Fiscal rules are necessary, especially in the monetary union, as only relying on the market will not work. It is important to recognise the dilemma of supranational fiscal rule, and that imposing fiscal rule on fiscal sovereigns is a potential intractable problem.

An industry representative stated that the Covid crisis has highlighted that the economic governance of the European Union and Eurozone was insufficient and needed reform. The first moves that were taken by the authorities once the Covid crisis broke out were to suspend the SGP and introduce NGEU. Europe needs to be very careful not to lose the opportunity to rethink economic governance once the impact of the Covid crisis is over.

3.2.3 Addressing the tensions between EU fiscal rules and national fiscal policies

A policy-maker was of the view that Europe may have been too ambitious about what can be achieved with supranational fiscal rules, as the rationale for supranational as opposed to national fiscal rules is essentially to deal with EU wide externalities. Much of the work of those who have been reflecting on fiscal rules has been about coming up with some clever formulas for debt reduction, where it is now recognized that the current one is too harsh. There is a temptation among specialists to create some kind of algorithm and deduct from this algorithm a certain pace of fiscal adjustment. There are doubts that this may work.

More respect for national preferences in exchange for a more binding orientation of fiscal policy at national level could be a way forward. One question about the working of fiscal rules is whether EU fiscal rules have an effect on national fiscal policy or whether the fact that countries respect fiscal rules, or don't, reflects other variables such as cultural variables in the broad sense. The 3% seems to have an effect: it has become a sort 'Schelling coordination point' for fiscal policy. The other solution is to potentially give a greater role on sustainability analysis to set the band of what is permissible to countries depending on their fiscal position, or to shorten their level of debt.

3.2.4 Efficient fiscal policies must be incentivised at each and every public administration level

A Central Bank official explained that it is important to have EU rules and to deal with externalities, but the incentives to have appropriate public policies and efficient spending policies have to start at the national level. Apart from the important SGP macro narrative, it is also important to think about what incentives exist at the national or regional level. The European Commission plays an important role in establishing frameworks for dealing with public policies and public finances.

4. Only domestic supply-side-oriented reforms can foster productivity and growth

4.1 Europe is not unique in facing growth challenges

An industry representative stated that slowing long-term growth rates are taking place across the advanced economies. Differences in the levels are because of

geographic location. If a country is close to a fast-growing country, then it is easier if they are a major trading partner. There is a very different risk appetite across countries, which has an impact on long-term structural growth trends. Europe is not alone. A 2021 International Monetary Fund (IMF) paper discussed South Korea and the challenges that it faces with slower growth going forward.

4.1.1 The most acute investment challenges vary by country

An industry representative highlighted that Moody's thinks that Canada has a long-term structural growth rate of about 1.9%. In a European context that would be on the high side. Sweden has growth potential in excess of 2%; one of the reasons that Moody's thinks that Sweden is able to grow more quickly is also because the labour force participation rate is high, including among older workers. The industry representative added that the chart that Moody's and other market participants use thinking about the divergence in total factor productivity growth between the US and Europe in the years following the global financial crisis is striking. One of the driving factors behind that divergence in total factor productivity (TFP) growth lies with structural reform.

4.1.2 Facing the secular stagnation

An industry representative noted that there are questions about the fact that investment is simply not enough. This is a huge problem, and the European answer is unclear. A lot of evidence has recently been produced about the R-Star story and secular stagnation. Issues causing the more superficial macroeconomic dynamics are driven by long-term drivers such as demography, distributional elements, and a fall in productivity in major sectors. The structural agenda needs serious consideration, as well as asking what the right policy mix is. There is a tendency towards secular stagnation, which by itself represents a limitation to policy space and monetary policy. Therefore, that constraint needs to be lifted in terms of getting an R-Star, which is higher in the longer-term. There is a great deal of structural measures to implement in order to unleash policy space for monetary policy and other policies.

4.2 Highly indebted countries need structural reforms

An industry representative added that higher and sustained growth are needed to remove the debt trap. There are several ways in theory to get rid of debt, but only one can be recommended. The only one that is left is more growth. Structural reforms are needed in order to get more growth. The question then turns into why Europe does not have enough structural reforms.

A Central Bank official noted that governments always try to use just causes to spend more. High debts and big deficits are opposed because they remove the restraint on governments to go into productive investment. The quality of expenditure turns poor because there is a lack of discipline. Highly indebted countries need structural reforms. Europe has a problem with the withdrawal of senior people and immigrants from the labour force due to the pandemic. Europe needs regulations and the SGP for productivity. Governments have to be pushed towards undertaking structural reforms. The benefit of the NGEU fund is not in spending more. The NGEU is an appropriate contribution for the digitalisation and climate change challenges and to incentivise structural reforms.

A Central Bank official (Claudia Buch) stated that if structural reforms are going to succeed, firms with an unsustainable business model should not be protected but rather leave the market. The pandemic has shown that Europe's insolvency frameworks might not be ideal. Of course, workers need be supported and enabled to migrate to new businesses. For a long time there a higher labour-market turnover in the US than in Europe.

4.3 Labour market reforms are critical to boost productivity and reskill workers

An industry representative underlined that younger workers need to be included in labour market reforms. Structural reform can help to address the duality in the labour market. The number of permanent contracts issued in France has dramatically changed in recent few years following the labour market reforms. An important area of a younger worker's productivity gains is learning by doing. The data is clear that investment in training and development of staff on temporary contracts is not the same as for permanent contracts.

4.4 Improving the incentives for domestic structural reforms

An industry representative stated that when looking at the structural reform story, eventually the problem becomes the unavailability of the private sector or the public sector to launch a structural reform programme that is serious. The political incentives for structural reforms are weak. Benefits from structural reforms only come to the medium and long term, immediately showing the lack of incentive for a policy-maker to enquire into something which usually brings costs up front and benefits in the future where they cannot be exchanged for political benefit. It is important to ask what can be done in order to improve the incentives for structural action. One answer is the NGEU, which links the structural reform agenda with the investment agenda and to the resources available for that agenda.

An industry representative added that there is a lot that the private financial sector can do. The amount of private money needed to implement the strategic actions to invest in digital and sustainable growth is much larger than the amount of money that the public side can put on the table. The financial system comes in when thinking about how to mobilise private money to do that. The main purpose of the financial system is to link savings to investment, which are very high, especially in Europe. It is vital to direct that to investment needed to complete the transformation.

4.5 The structural reforms agenda in Italy is up to the challenges

An industry representative noted that the list of reforms is very long, so priorities need to be chosen. The current list that the Italian government is working on includes civil justice, public administration, competition policy, and an addition of measures to boost innovation. The requirements agreed with the Commission have been

met. This is important for Europe, because it would show that a European system of governance, of which NGEU is part, can work.

4.6 NGEU offers opportunity for debt laden countries to address structural reform challenges

An industry representative stated that structural reforms are one of the essential elements of the NGEU. When talking about NGEU for the largest recipient countries in southern Europe it is thought about as being a once in a generation opportunity due to the structural reforms that are contingent on receiving the funds. Debt matters. If debt is left to one side there are four ways a country can reduce debt: inflation, growth, fiscal consolidation, and interest rates. That is where structural reform can potentially come in. When thinking about structural reform or government debt, the difficult time is during the good times, not in times of crisis.

The Chair noted that the success of the NGEU in Italy is a precondition of any decision to make a permanent fiscal capacity. It is important to show that it works. It is also important to note that when transferring the money between countries it is impossible to have completely different tax systems and completely different retirement ages.

Sylvie Goulard invited all panellists to read the Monetary Scoreboard published by Eurofi. EU fiscal rules are needed within the EU. One of the difficult issues for monitoring an economic union is that Europe has excluded the Court of Justice, which has never been the case for the single market.