EU fiscal policy response in times of crisis - speech by Rolf Strauch

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(*Please check against delivery*)

Good afternoon,

It is a great pleasure to be here and talk to you about fiscal policies in times of crisis.

Crises are crunch times. Crises are abnormal times. Crises often allow us to look at the barebones of economics. They teach us lessons that normal times don't do. During my time at the European Stability Mechanism, I have lived through four crises – the great financial crisis, the sovereign debt crisis, the pandemic, and now the energy crisis.

Today, I will talk mainly about the last two – they are a tale of fundamentally two very different stories. [slide 2] The pandemic led to broad-based monetary and fiscal intervention. Fiscal policy complemented monetary policy. They reinforced each other. Policies were designed to support income, mitigate fragmentation and to promote long-term structural change.

The situation is more complex during the current energy crisis, sparked by the Russian invasion of Ukraine. Monetary policy is focused on fighting inflation and fiscal policy faces a number of trade-offs. Fragmentation this time around runs along different lines than during the pandemic.

I will draw some lessons from the tale of these two crises for the policy challenges ahead – the creation of more resilient European and euro area institutions.

The response during the pandemic [slide 3]

We entered the pandemic in a relatively strong economic position compared to the great financial and the euro crises.

[slide 4]

We could actually reap the benefits of many of the reforms taken over the past decade.

Macroeconomic imbalances which had led to the sovereign debt crisis were addressed.

Also, the banking sector entered the crisis with much stronger balance sheets. Banks were not part of the problem anymore. They became part of the solution.

We also created a more robust institutional infrastructure – importantly with the European Stability Mechanism as crisis resolution mechanism, as well as the first two pillars of banking union.

When the pandemic hit, the ECB reacted immediately. [slide 5] The ECB lowered the cost of borrowing. It extended the capacity of banks to lend. And it ensured proper market functioning. The new pandemic asset purchase programme was crucial for financial stability. It benefitted all member states.

Similarly, Danmarks Nationalbank (DN) launched an extraordinary lending facility and followed its usual reaction function. It was mimicking changes in the ECB's policy interest rates, supplemented by foreign-exchange interventions and policy interest spread adjustments if needed.

Fiscal policy geared up to crisis fighting also instantaneously. The EU abolished temporarily the application of the common fiscal rules, invoking the "general escape clause". This clause, which can suspend the enforcement of fiscal rules in exceptional times.

[slide 6]

Governments provided immediate support to firms and households. Fiscal support was more sizeable than during the great financial crisis – both in terms of public spending and guarantees. It actually matched the size of the output gap which had emerged. In this sense, it fully compensated for the economic loss that was incurred. Still, limitations of fiscal policy became also apparent.

First, the fiscal support provided reflected the fiscal space available at national level and in some cases only partially tackled the severity of the pandemic's impact on the real economy. Fragmentation of the single market emerged.

Second, fiscal measures were supposed to be temporary, but they partly became permanent and continued beyond the downturn. And it was difficult to fine-tune fiscal support in an uncertain and rapidly changing environment. With hindsight, the additional fiscal impulse provided in 2021 appears somewhat pro-cyclical and some measures could have been withdrawn earlier.

European schemes were derived to overcome the emerging fragmentation and provide support – first for liquidity and then to embark on structural change and strengthen potential growth across countries.

[slide 7]

The immediate safety net introduced in May 2020 was provided by the European Stability Mechanism, the European Commission and the European Investment Bank. This emergency package of €540 billion was designed to support firms, households and governments.

[slide 8]

The Next Generation EU initiative which followed during the summer of 2020 amounts to €750 billion and has a deliberate redistributive setup. It promotes the digital and sustainable transformation of our economies with a multi-year investment programme. Disbursements are also linked to milestones and structural reforms.

[slide 9] The fiscal and financial packages were successful. Contrary to earlier crises, labour and capital did not suffer unduly. Employment was maintained and the extension of credit allowed companies to survive. Liquidity shortages did not turn into insolvencies and a massive destruction of capital could be avoided.

[slide 10] The euro area economy recovered much faster from the pandemic than from the great financial and the sovereign debt crisis. This is inherent to the deep, yet short-lived nature of the shock. But it is also a consequence of the support provided.

Protecting jobs and leveraging public balance sheets contributed to a quick recovery. In fact, many companies and firms left the pandemic downturn with excess savings. But this came at the cost of higher public indebtedness and fiscal vulnerability.

Russian invasion and the energy crisis

[slide 11]

Let me now turn to the Russian invasion of Ukraine and the energy crisis.

[slide 12]

The energy shock hitting Europe represents a terms of trade shock. It leads to transfers of income and wealth abroad. This matters more for the euro area than other global regions. In the US, terms of trade improved. It means the US imports additional income. For Europe, the immediate impact of the current energy crisis is worse than the oil crisis of the 1970s.

[slide 13]

The impact of the energy crisis also hinges on the economic dependence on Russian gas. Different frictions emerged compared to the pandemic. This year many of the southern countries were doing well – thanks to the revival of tourism as an export of services. Countries in central Europe and the Baltics suffered from very high energy import prices and weakening export demand.

[slide 14]

The war in Ukraine has been exacerbating inflationary pressures. About 40% of the excessively high inflation we see is driven by energy. Food-related inflation has become more important. Unfortunately, it tends to be more persistent. And core inflation has gone up. This is a massive cost-push shock happening when the output gap is still negative.

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Monetary policy has to tighten. The ECB increased its policy rate in three major steps by 200 bps. The Danish central bank followed suit. The ECB is now also reducing its exposure by cutting back on special refinancing operations, called TLTRO. In addition, the ECB broadened its toolbox to ensure the equal transmission of monetary policy across jurisdictions. It already deploys a flexible reinvestment policy for its pandemic--related purchase programme (PEPP) to contain a widening in sovereign spreads. Its new transmission protection instrument (TPI) is envisaged to prevent speculative market spiralling.

There are various macro conditions for countries to apply this tool. Among others the ECB will ask for the ESM’s debt sustainability analysis.

Finally, outright monetary transactions (OMT) is available when a country shows imbalances and signs up to an ESM facility entailing conditionality.

[slide 16]

Fiscal policy has reacted equally strongly. The aggregate euro area fiscal impulse remains neutral. But here the picture is more diverse than during the pandemic.

All countries have taken measures to address the energy crisis. In some countries these measures do not yet outpace the budget savings from the end of temporary pandemic support. In other countries, they led to an additional fiscal impulse or may do so in 2023.

European initiatives so far mainly relate to the functioning of energy markets, energy saving agreements and the redirection of NGEU funds toward energy independence. Additional financing is limited, but overall there could be a focus on more energy-intensive economies.

[slide 17]

The use of fiscal policies as crisis support also shows some constraints.

First, a broad range of fiscal measures has been employed – each one facing its own policy trade-off. There is a general consensus that fiscal policies should be temporary and targeted towards the most vulnerable. But this marks “the smallest common denominator”. De facto, many countries have adopted more broad-based price measures. Those tend to reduce inflation in the short term. But they are fiscally expensive and just lead to more income transferred to energy exporters if they increase energy demand.

[slide 18]

Second, policy measures have a spill-over effect across countries. Both on the demand and the supply side. Take the German “Doppel-Wumms”. It clearly supports demand, not only in Germany, which is more strongly impacted by the energy crisis than other countries. It also affects supply in terms of goods and commodities available to other countries. Big countries “showcase” policies, increasing the pressure on others to follow the example. But it also risks distorting the single market.

[slide 19]

Finally, policies this year have consumed already the windfall in revenues created by inflation and better than expected growth in the first half of 2022. Governments are not using this windfall to build up buffers for the downturn that is now expected. This pattern has already led to a deterioration of the budget balance for this year. And some of the spending impact is yet to be seen. Overall, it seems too early to take stock of the overall success of these measures in mitigating the impact of the energy crisis without adding to inflationary pressures.

Way forward [slide 20, 21]

Effectively, there are a number of challenges going forward. We can expect the economy to weaken in the course of the next year, and the shape of the recovery from this slowdown is still highly uncertain. Geopolitically, the key driver will be how Russia's war against Ukraine further affects the supply of energy and other commodities. But not only that. Trade relationships with China and the US will also play a role. Increased global fragmentation poses threats to the growth of the euro area economy. These global changes will affect prices, economic strength, and the speed at which the European economy needs to transform.

[slide 22]

Getting back to effective rules-based fiscal guidance will support policy coordination and instil market trust. The escape clause will be in place until the end of 2023. Then the fiscal rules are expected to be applied again unless severe downside risks materialise. Increasingly, investors are asking us how fiscal policy will be run in the years ahead and how expansionary it may be. Returning to the application of fiscal rules is a necessary step.

We need to re-think the current rules to make them more effective. There is consensus on the three following elements in a number of proposals put forward:

First, fiscal rules need to be more operational. The past two crises have underlined the problem of having unobservable variables as guidance and benchmark. Expenditure-based rules could have provided better guidance than cyclically-adjusted measures in navigating through the past crises. The 3% deficit rule has now become engrained as a focal point of the fiscal regime and can be kept as a benchmark.

Second, a credible debt anchor is necessary. What matters here is that there is a credible adjustment path for debt. The 1/20 rule implies an overly harsh adjustment that entails unwarranted economic costs. We have argued that the debt limit could be moved to 100%. But we also understand that there is much resistance to such a proposal, as this may be seen as sending the wrong signal.

Countries with high debt levels should clearly commit to a debt reduction path, and should be held accountable for it. At the same time, these consolidation paths need to be realistic and economically doable.

Third, effective rules require ownership and enforcement. The key issue is how much European guidance and enforcement should be kept and where national institutions play a role – particularly national fiscal boards. A more important role for national fiscal boards could indeed increase ownership. But it needs guidance from the European level and the role of the European Commission has to be preserved in line with the current Treaty.

Focusing on “gross errors” and having a staged approach to incentivise corrections may also help. There has been reluctance to apply sanctions in the past. A staged approach – ranging from public statements to financially material access to funds – may support effectiveness.

The European Commission will present its proposal soon. I would expect it to also address these points. I hope that discussions will be productive and that Member States can converge fairly soon on effective solutions. Rules that could not be enforced and would require recurrent waivers would not be credible and not instil market trust.

[slide 23]

But rethinking only fiscal rules is not enough. The past two crises point to the usefulness of a central fiscal stabilisation instrument – particularly for the euro area. Having such a tool operating on the basis of clearly defined criteria can support an effective role of fiscal policy in complementing monetary policy.

Without this instrument, there will be repeated calls for ad-hoc solutions. A permanent solution is needed. It can be designed to incentivise good fiscal policy through eligibility and disbursement criteria. A central fiscal capacity geared to idiosyncratic shocks would bolster resilience.

There were calls for a fiscal stabilisation tool buffering aggregate shocks when monetary policy was constrained by the zero-lower bound. But, the experience of the energy crisis shows that this seems to hold mainly for demand and not cost-push shocks. Focusing on the differential country impact and pre-empting fragmentation is warranted in either case.

Beyond this, a broader discussion is needed on how to provide European public goods. This clearly requires a longer-term perspective, although some challenges are immediate. I see three broad areas where such European public goods could benefit from the pooling of resources.

First, the fight against climate change and the need for energy transition. Single country action is ineffective to curb climate change. In turn, the single market requires that no country is left behind when affected by this global threat. Some countries will be more impacted by physical climate risks than others. We should not leave them behind.

Second, strategic independence. Organising the support to Ukraine is the most immediate concern. Common defence may be another. The need to take common action in support of Europe’s strategic interests will be necessary in a more fragmented international political order and can also be extended to other regions and issues.

Third, common infrastructure, which is partly related to the previous two issues. Effective energy grids are one example. Another is the development of common IT infrastructure, such as super computers and innovation centres.

Private sector financing has to play an important role in all these areas. No doubt. This makes more market integration and proper regulation a necessary condition for success.

But in many areas, a commonly financed public contribution seems necessary. Leaving this to bilateral and multilateral agreements, including small subsets of member states, will not achieve the necessary scale effects to stay at par with the US and China.

Conclusion

The euro area has been hit by four crises over the last 15 years. It has shown great resilience in coping with the first three and will also manage the current energy crisis. There is reason to be proud of this achievement.

At the same time, the tale of the two stories emerging from the past two crises shows that more progress is needed. Revising the fiscal rulebook and moving from ad-hocery solutions to a permanent stabilisation facility are two priorities in the short term. I hope we will have a productive debate on these and the broader strategic aspects, where we need common initiatives to reach good solutions.

Thank you.

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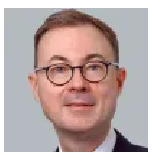

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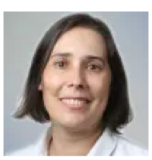

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