EUROFI VIEWS MAGAZINE - BERLIN SEPTEMBER 2020

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European-level response can guard against risks to debt sustainability

In light of the Covid-19 pandemic, we – policy makers – seem to have learned our lesson following the previous crisis episodes: this time, fiscal and monetary policies have been carefully coordinated to deliver a consistent economic response to the ongoing crisis. To help the European economy survive the severe disruption and to support the rebound afterwards, the European Central Bank (ECB) has strengthened already highly accommodative monetary policy, while national governments have implemented a large number of wide-ranging fiscal measures, reinforced by pan-European efforts.

On the flip side, economic contraction and the unprecedented fiscal policy response will inevitably cause public deficits and debt ratios to rise sharply in 2020. However, the current low interest rate environment helps alleviate the sovereign debt burden as necessary fiscal measures are being implemented. It is estimated that even with rising debt-to-GDP ratios the debt position should remain sustainable over the medium-term across the EU.

Fiscal and monetary support will remain vital in the foreseeable future, especially in view of high uncertainty regarding the course of the pandemic, as well as the partial and rather fragile recovery expected for 2021. Fiscal support at the national level throughout the next year should be continued, as withdrawing fiscal accommodation prematurely could weigh on the recovery and increase the risk of long-term scarring effects. Of course, considering a longer time horizon, delivering an appropriate fiscal stance remains a balancing act. Once countries return to a path of sustainable growth, fiscal policies should aim to achieve prudent medium-term fiscal positions.

Focusing on the euro area, due to a number of factors the policy response among euro area countries has differed in terms of size and composition – despite the overall strength of the fiscal action on the aggregate level. This has raised the risk of fragmentation within the single currency union. Asymmetric growth outcomes could increase economic divergence among countries and impair the transmission of the ECB monetary policy, while, at the same time, render it more difficult to calibrate an appropriate euro area-wide policy stance.

In this vein, I would like to recall a phrase that was popular in the central banking community prior to the current crisis: monetary policy cannot be the only game in town. Or, rather, it cannot once again become the only game in town. In a currency union, this is all the more true when the economy-wide shock – which affects all jurisdictions – is not overcome to the same level of success in all countries. We cannot rule out the possibility that diverging fundamentals – which would also induce financial fragmentation – may ultimately pose new challenges to long-term debt sustainability in certain Member States. At the end of the day, the solution to this issue lies not in euro area-wide monetary accommodation but in fiscal policy and structural reforms, combined with proactive use of the macroprudential tools.

To propel the European recovery and increase convergence, sizeable fiscal support – at least in some parts of Europe – will be required beyond that already provided at the national level. In fact, the recent initiative on the temporary recovery instrument Next Generation EU is a step in a right direction. Complementing national efforts to support structural reforms and public investment, Next Generation EU will provide sizeable fiscal transfers to the most affected European countries.

Nonetheless, moving forward a permanent solution must be developed: the Next Generation EU could serve as basis for a centralized fiscal instrument with a substantial common borrowing capacity. If appropriately designed, a permanent fiscal capacity would provide macroeconomic stabilisation and help counteract asymmetric shocks, thereby contributing to the overall resilience of the Economic and Monetary Union and supporting the single euro area-wide monetary policy. ●