



Mário Centeno

Governor, Banco de Portugal

The pandemic crisis: sustainability, role of monetary policy and the need for long-term growth

The COVID-19 pandemic induced a severe downturn in the economic activity that has been unbalanced across sectors, with harsher consequences in some Member States. The downturn triggered a coordinated and swift response from policy makers. The general escape clause was activated, within the rules of the Stability and Growth Pact. In ten days, the Eurogroup agreed upon three key safety nets for workers, businesses and sovereigns. And last June an extraordinary meeting of the Heads of State or Government agreed upon a recovery package and an European budget.

The speed and scale of the response were unprecedented. The strength of this response goes beyond the financial support. It reinforces solidarity and policy coordination. Some concrete elements will facilitate further steps towards financial integration. The financing of the Recovery Fund is one of them. The Commission is expected to issue debt worth 750 billion euros over the next years; that's an issuer twice as large as the traditional European supranational peers. The EU bonds are not a substitute for a European safe asset, but they will provide a preview which impact on the financial markets should not be underestimated.

The role of the ECB has been critical in the policy response to the pandemic in the euro area. Monetary policy response was strong, stabilizing the financial markets and providing abundant liquidity to economic agents, in a timely manner. The highly accommodative stance of monetary policy – in a regime of low interest rates – will certainly not be reverted for some time. In general, a central bank can assist the government's policy effort not only by reinforcing its lending to the financial system and by lending directly to firms, but also by strengthening its role as a backstop for government funding. As a backstop, the central bank can avoid expectations-driven debt crises without further budgetary implications.

However, if a policy of debt purchases by the central bank reduces interest rate spreads that are due to fundamentals, then it has budgetary implications, eventually translating into inflation and into currency devaluation. Monetary and fiscal policy responses to the pandemic crisis have been decisive and complementary. Central banks ensured ample liquidity provision with favourable conditions, decreased interest rates when policy space was available and reinforced asset purchase programs. As referred, the fiscal response was extensive, leading to soaring public debt in the euro area and elsewhere that may still be

impacted by implicit guarantees. Even if public debt is sustainable, the uncertainty and the existent risks on the sovereign debt of the euro area countries should be monitored as to prevent an abrupt increase in spreads over a longer horizon.

Monetary dominance has to be preserved. Otherwise, inflation would likely increase, leading to a depletion of the value of debt. Inflation that is not rooted in the reputation of an independent central bank may be uncontrollable. Furthermore, once the reputation of a central bank is lost, it may be hard to regain it. The euro is an international reserve currency and this status depends crucially on the independence of the central bank.

Against this, it is necessary to guarantee credible fiscal discipline at the country and at the European Union level, which may benefit from a reflection of the existent fiscal rules and improved quality of public expenditures. This is critical as it has to be made compatible with the existent and future investment needs. It is also important to strength the resilience and stability of our financial system putting in place the missing pieces of the Banking Union and, also, of the Capital Markets Union.

Finally, I recall that in a context of low inflation, even with the support of very low interest rates, strong GDP growth also emerges as a necessary condition for fiscal sustainability and for the improvement of social conditions. It is important that the allocation of funds of the recovery plan promote converge in the European Union and, in particular, the ones allocated to the Euro Area member states are used in a way consistent with the monetary union, helping to prevent the build-up of imbalances. ●