WORKING SESSION I - Interaction of fiscal and monetary policy in the face of current and future challenges

Saturday, 16 September. 10:00 – 11:30

Plenary hall. Museo Centro Gaias. Cidade da Cultura

Policymakers are navigating a context where high uncertainty and structural change have become the "new normal". The succession of momentous shocks during the past two decades[1] make economic models less able to properly reflect reality and forecasting less reliable.

The ongoing structural transformation of EU economies and tectonic shifts in the global economic and political order call for reviewing fiscal and monetary toolkits and reconsidering their interaction, devising strategies that are robust to uncertainty. In this environment, policymakers face incomplete knowledge on the duration and frequency of shocks, the direct and indirect impact of their policies and the likelihood of tail events. Textbooks are being re-written as new measures and public policies are deployed[2], in search of a comprehensive and robust policy-mix providing effectiveness, flexibility to adjust to an evolving environment, and a medium-term perspective to ensure resilience and avoid long-term scarring.

Measures undertaken by governments and central banks in response to the pandemic stand as a perfect example of such robust strategies, as they were instrumental in preserving economic and social stability and cohesion, while setting the stage for a strong recovery.[3] In the face of sheer uncertainty, Governments protected citizens and supported workers and viable business via a broad range of policies, ranging from health care spending to job protection schemes and public guarantees on loans, at the cost of increasing their debt levels. National emergency and support measures in 2020 and 2021 reached a combined EUR 680 billion mark (4.7% of EU GDP) and the EUR 540 billion were provided at EU level. The ECB, in turn, ensured financial stability and prevented a tightening of financial conditions both for public and private sector by extending a 1,850 billion € temporary pandemic emergency asset purchase programme and providing extended cheap liquidity to banks.

Furthermore, an ambitious reform and investment programme is underway to drive the twin green and digital transitions in Europe, leading technological innovation and the fight against climate change at global level. In order to help countries recover from the pandemic and modernise their economies, the EU established the Recovery and Resilience facility, with an additional EUR 672.5 billion to support structural reforms and investments.

All in all, this time it really was different. Fiscal and monetary policy provided an unprecedented countercyclical impulse, reinforcing each other, avoiding worst-case scenarios and preventing hysteresis in the labour market and scarring in the productive tissue.[4]

The policy-mix adjusted course during 2022 to respond to increasing inflationary pressures. The strong rebound in economic activity since 2021 was hampered by supply-side restrictions, such as bottlenecks in global supply chains, scarcity in raw materials and, ultimately by the surge in energy costs and other commodities due to the Russian war against Ukraine. In the face of what initially seemed transitory shocks to prices and with inflation expectations well anchored, fiscal authorities started phasing-out generalised pandemic support and gradually moving to targeted and temporary measures, enhancing investment and safeguarding medium-term sustainability.[5] The ECB started the rapid normalisation of its monetary policy stance adopting a fast increase of interest rates, by 425 basis points in 12 months.

In this context, the challenge of ensuring policy-mix consistency can only grow as trade-offs between different policy objectives become more prominent. As the war drags on, leading to the largest terms-of-trade shock in a generation with its toll on growth, headline inflation has come off its peak, albeit with broadening price pressures and the strengthening of its underlying component. As a result, the policy-toolkit must address various challenges and reach conflicting objectives at least in the short term. Monetary policy must ensure that inflation continues its downward trend and returns to its medium-term target. As for fiscal policy, it should aim at buttressing the recovery, supporting the most vulnerable in a context of falling buying power and boosting private investment to increase productivity, competitiveness, and strategic autonomy in an extremely complex geopolitical context. This should be done ensuring fiscal sustainability, which proves even more demanding in a context of higher debt levels and higher interest rates due to tighter monetary policy, combined with signs of decelerated economic growth.

Looking ahead, structural change and uncertainty are part of the baseline scenario and will continue to test our economies and our policymaking. Beyond cyclical developments, the inter-play of long-term trends will determine potential growth and the natural rate of interest. Economic policies are thus shifting to take account of key drivers such as the green transition, technological change or reorganisation of global value-chains, speeding up the energy transition.[6] Making the most of digitalisation as well as boosting our defence capabilities will be critical for our joint long term security, competitiveness and strategic autonomy.

A medium-term perspective is warranted as well as a deep understanding of the trade-offs and the time dimension of policy decisions to ensure system-wide coherence and robustness. As a consequence of the growing number of objectives and the persistence of uncertainty, the synergies that an optimal policy mix must exploit become more apparent. For instance, measures to contain prices, such as tax reductions, may enable a fast reduction of inflation preserving consumption and growth, with a limited impact on public revenues and fiscal balances. Lower financing costs for green and digital investments can add to aggregate demand and lead to higher costs and prices in the short term. However, in the medium term, the necessary investments in greening and digitalization of the EU should be disinflationary, increasing productivity and potential growth, reducing uncertainty and crowding-in additional investments, thus improving long term fiscal sustainability and fostering EU strategic autonomy.

Key issues for our institutional framework:

- **The ECB is committed to setting key interest rates at sufficiently restrictive levels for as long as necessary to achieve a timely return of inflation to the two per cent medium-term target.** The ECB will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. So far, ECB interest rate decisions have been guided by an assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission.[7]

- **Fiscal policy must strike the right balance to ensure long term sustainability and generating the necessary fiscal space to accommodate the unprecedented levels of investment and reforms that will be needed over the next decade.** The ongoing economic governance review should be completed, leading to new rules that help Member States ensure the sustainability of public finances, promoting sustainable economic growth, supported by growth- and resilience-enhancing reforms[8]. Beyond national fiscal capacities, common investments are needed to drive the EU green and digital agendas, among other shared objectives. Their public-good nature calls for continuing investment efforts beyond NextGenerationEU and pressing ahead with the design of additional own resources to complement the EU budget.
- **The completion of the Banking Union, as well as the development of deeper and more integrated capital and energy markets in the EU will be of the essence to mobilise substantial private investments** covering the financing gap (for instance, the European Commission estimates that EUR 600 billion annually until 2030 will be needed for the EU's green transition). The funding challenge will come along with the complex task of maximizing absorption capacity in Member States and producing a regular pipeline of transformative projects.

Questions for discussion:

1. *How to reconcile short term policy objectives aiming at a soft-landing scenario, where taming inflation is compatible with continued growth and strong labour market performance?*
2. *What are the views of Ministers and Governors on how to define the monetary-fiscal policy mix in order to achieve common policy priorities?*

References

1. As highlighted by Bloom and coauthors' Uncertainty Index: https://cepr.org/voxeu/columns/tracking-uncertainty-rapidly-changing-global-economic-outlook
2. "There is no pre-existing playbook for the situation we are facing today – and so our task is to draw up a new one," Christine Lagarde (August 2023) Jackson Hole speech, https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230825~77711105fe.en.html
3. For a thorough analysis of robust strategies and the proxies for robustness, see Ben-Haim et al. (2021), "Robust Policy in Times of Pandemic", *Intereconomics,* Volume 56, Number 2, pp. 108-112.
4. For an comparison of the fiscal reaction function during the pandemic vs. previous episodes, see Bökemeiera and Wolski (2022), "This time is different: Fiscal response to the COVID-19 pandemic among EU countries", *International Economics,* vol. 172, pp 217-226.
5. See Eurogroup Statement on the Draft Budgetary Plans for 2022, https://www.consilium.europa.eu/en/press/press-releases/2021/12/06/eurogroup-statement-on-the-draft-budgetary-plans-for-2022/
6. In line with the speech by given by the President of the ECB at the annual Economic Policy Symposium "Structural Shifts in the Global Economy" organised by Federal Reserve Bank of Kansas City in Jackson Hole, Policymaking in an age of shifts and breaks (europa.eu)
7. As per the Monetary ECB's Monetary Policy Statement, March 16th, 2023, Combined monetary policy decisions and statement - 16 March 2023 (europa.eu)
8. See Council Conclusions on "Orientations for a reform of the EU economic governance framework" for the ECOFIN Council meeting on 14 March 2023, pdf (europa.eu)