Klaas Knot: Monetary-fiscal policy mix in the euro area - lessons learnt and the way forward

Introductory remarks by Mr Klaas Knot, President of the Netherlands Bank, at the European Central Bank policy panel at the annual congress of the European Economic Association, Rotterdam, 27 August 2024.

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Thank you very much for inviting me. This panel touches upon a topic that I believe will always lie at the forefront of policy discussions, especially in the light of our experiences from the recent past. I will start my remarks by recalling the policy responses to the global financial crisis and the Covid pandemic. Because I think these events have taught us important lessons not only about the appropriate monetary/fiscal policy mix, but also about the fiscal policy design both at the national and at the union level.

When the euro was introduced, the common belief was that national fiscal policy should focus on stabilising national business cycles and that monetary policy was the appropriate instrument for stabilisation at the euro area level. This thinking changed when interest rates fell for an extended period and were approaching their effective lower bound, thereby limiting the effectiveness of monetary policy. This increased the importance of fiscal coordination among member states. This came to the fore for the first time during the global financial crisis.

During the global financial crisis and the subsequent debt crisis in the euro area. The monetary/fiscal policy mix was suboptimal, both at the national and the European level. Monetary policy was quite accommodative throughout that period, there is little doubt about that. Its intended stimulus could have been reinforced by a countercyclical fiscal stance. That would potentially have allowed a faster economic recovery without having to rely so excessively on loose monetary policy. However, this is not what happened. Throughout most of the debt crisis, most governments pursued tight fiscal policies. This reflected choices that are understandable at the national level, as some countries had little choice but to undergo fiscal consolidation, but it was not conducive to economic recovery at the European level.

Had monetary and fiscal policy moved in tandem, the recovery could have been quicker. But this would only have been possible if public finances had been on a sound footing throughout the euro area. Unsustainable debt levels and fiscal deficits spinning out of control make it difficult to implement the right monetary/fiscal policy mix.

The monetary/fiscal policy mix was more effective during the pandemic. Again, the ECB conducted a very accommodative monetary policy. But this time, it was accompanied by an expansionary fiscal stance. The general escape clause in the Stability and Growth Pact was activated for that specific purpose. Monetary expansion created the necessary fiscal space for governments to increase public expenditures in order to prevent a collapse in economy activity. Of course, a key difference with the global financial crisis was that the pandemic hit all member states simultaneously. This made

it easier to align national fiscal responses. Also, many of the member states that were previously fiscally burdened were in a somewhat healthier fiscal position at the onset of the pandemic.

Lately, however, monetary and fiscal policy have gotten mixed up again, although with both policies now having traded places. The recent energy crisis and its impact on inflation led to a monetary tightening, while fiscal policy continued to be very loose. This monetary/fiscal policy mix is equally undesirable. Interest rate hikes put upward pressure on debt servicing costs which should have been compensated by higher primary fiscal balances. Also, most of the burden of bringing inflation down was placed on the ECB. Here too we see that an inappropriate fiscal stance can hamper the efficacy of monetary policy. In this case, a more restrictive fiscal policy would have been desirable.

In the past, economists have been critical of the EU fiscal framework. A major weakness was the lack of flexibility. The existing rules were inspired by the need to reduce fiscal deficits in the early years of the monetary union. However, they were not suitable for dealing with the kind of crises we have seen since 2008. This is mainly because the rules were not flexible enough to allow automatic fiscal stabilisation to do its work in an economic downturn. Had this been the case, and had fiscal consolidation been allowed to proceed more gradually, the monetary/fiscal policy mix would probably have been less damaging to economic growth.

The good news is that the new European fiscal framework has been in place since the 1st of May. The new rules provide more room for automatic stabilisation and decrease the risk of fiscal tightening in bad economic times. Also, the new rules are more country-specific and offer incentives for long-term investment and reform. This increases the long-term growth potential of member states, especially those with substantial levels of debt.

But flexibility has its limits, also under the new framework. That's because the room for countercyclical fiscal policy is limited by the need for national fiscal discipline. If markets perceive that national debt is on an unsustainable path, spreads will widen and financial stability in the union will be threatened. So the increased flexibility under the new rules to allow for expansionary fiscal policy in economic downturns is definitely an improvement. But it will only work if national governments reduce their debt during upturns. Whether this happens will largely depend on compliance and enforcement of the rules. In this regard, the new EU fiscal framework will immediately have to prove itself.

In view of national fiscal constraints, some form of supranational fiscal spending could be helpful in dealing with a large euro area wide shock. A good example of this is the Next Generation EU recovery fund, which was introduced during the Covid pandemic. The introduction of Next Generation EU had a calming effect on financial markets and prevented the spreads from widening. And the conditionality attached provides an incentive for economic reform. Having said this, more spending at the central level should not lead one-for-one to more public debt or higher taxes in the euro area. After all, the national and European taxpayer is ultimately one and the same person. More fiscal space at the European level should therefore go hand in hand with less fiscal space at the national level.

And on that rather sobering note, I give the floor back to you, Leonardo.