

IN-DEPTH ANALYSIS

Requested by the ECON committee

Monetary Dialogue Papers, November 2020



# Blurred Boundaries Between Monetary and Fiscal Policy

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Policy Department for Economic, Scientific and Quality of Life Policies  
Directorate-General for Internal Policies  
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## **Abstract**

The paper argues that the monetary policy response to the COVID-19 crisis has been appropriate in terms of the ECB's primary objective. The concern over fiscal dominance is, however, valid as in a situation of rising inflationary pressure the ECB would have to choose between maintaining price stability on the one hand and public debt sustainability, financial stability and cohesion of the EMU on the other hand. Reform of the euro area institutional framework could mitigate this risk, either in the direction of a fiscal union or in the direction of full fiscal self-responsibility.

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## LIST OF ABBREVIATIONS

<b>APP</b>	Asset purchase programme
<b>ECB</b>	European Central Bank
<b>EIB</b>	European Investment Bank
<b>EMU</b>	Economic and Monetary Union
<b>EP</b>	European Parliament
<b>ESM</b>	European Stability Mechanism
<b>EU</b>	European Union
<b>GDP</b>	Gross domestic product
<b>HICP</b>	Harmonised Index of Consumer Prices
<b>NGEU</b>	Next Generation EU
<b>OMT</b>	Outright monetary transactions
<b>PEPP</b>	Pandemic emergency purchase programme
<b>PSPP</b>	Public sector purchase programme
<b>SURE</b>	Support mitigating Unemployment Risks in Emergency

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## EXECUTIVE SUMMARY

- **In the current crisis, there is strong complementarity between monetary and fiscal policy.** High borrowing needs of governments are accommodated by low interest rates and asset purchases of the European Central Bank (ECB), ensuring favourable financing conditions.
- **While expansive monetary policies are appropriate given downward pressure on inflation at already subdued levels, there are indications that these policies ultimately amount to monetary financing.** First, bond purchases of the central bank are sufficiently large to fully cover government net lending. Second, when a sovereign debt crisis was looming in March, the ECB was quick to ensure capital market access for all Member States by announcing the pandemic emergency purchase programme (PEPP). Third, the central bank has become governments' single biggest creditor, which creates strong interdependencies: by holding that much public debt, the central bank plays a major role in the financing of governments; ECB involvement in bond markets strongly affects financing conditions of governments; the central bank inevitably takes substantial creditor risks; and interest payments on bonds held by the central bank eventually flow back to government budgets.
- **The COVID-19 crisis brought back fears of a possible breakup of the currency union, but this risk was mitigated by a combination of monetary and fiscal policy measures.** The swift reaction of the ECB announcing PEPP prevented yield spreads from widening further. Later, the introduction of joint EU debt and net financial transfers between Member States can be associated with a further decline of risk premia.
- **Central bank money, which represents a common liability of all Member States, is rapidly increasing.** ECB's purchase programmes – in which the Eurosystem creates money to buy government bonds – resemble to some extent a mutualisation of debt.
- **Fiscal dominance is a valid concern.** The determination of the ECB to maintain price stability would be tested if inflation threatened to exceed the target. Then, the ECB would have to choose between maintaining price stability on the one hand and public debt sustainability, financial stability and cohesion of the Economic and Monetary Union (EMU) on the other.
- **The ECB faces a particular challenge due to the unique institutional architecture of the euro area.** Safeguarding independence of monetary policy requires institutional reforms either in the direction of a more comprehensive and effective fiscal union or in the direction of reviving the principle of fiscal responsibility embedded in the Maastricht Treaty. Remaining stuck in the middle would probably leave problems unsolved and would cement the conditions for fiscal dominance to prevail.
- **Governments should use the years ahead to reorganise EU institutions and reduce debt to levels sustainable also in a less benign interest rate environment.** While chances are that borrowing costs remain low over the coming years, we cannot expect this to persist forever and should prepare for an eventual rise of interest rates at a later stage. Rather than taking the current period of low borrowing cost as a reason for complacency, we would see it as a window of opportunity, and suggest starting a process of fiscal consolidation as soon as an eventual recovery of the economy from the pandemic allows for it.



## 1. INTRODUCTION

**The COVID-19 pandemic called for a multitude of fiscal and monetary policy measures to reduce damage, stabilise output and calm financial markets.** National governments found themselves in the urgent need to act decisively in order to mitigate the social and economic consequences incurred by measures to contain the virus and by changes in behaviour to avoid infection. Inevitably, the enormous magnitude of the fiscal response will lift public debt levels substantially, in some cases from already elevated levels, and the strain on fiscal resources could be aggravated if this exceptional crisis incurred permanent damage on potential output compared to pre-crisis expectations. Simultaneously, the central bank played a prominent role in calming financial markets. In March, increasing spreads on returns of government bonds threatened to constrain the fiscal capacity of some Member States to mitigate the crisis, and a sovereign debt crisis was looming at the most inopportune time. The European Central Bank (ECB) was forced to act swiftly – much faster than a joint fiscal policy response could have been agreed upon – in order to prevent further repercussions from tensions and turmoil on financial markets. As central bank policy was already constrained at the zero lower bound, the ECB primarily relied on further large-scale asset purchases.

**Over the course of the crisis, there has been a strong complementarity between monetary and fiscal policy.** Elevated borrowing needs of governments were accommodated by low interest rates and asset purchases of the ECB, guaranteeing favourable financing conditions. As consumer price inflation decreased from already subdued levels, and with currently no indication for upcoming inflationary pressures, expansionary monetary policies that effectively accommodate fiscal policy responses are not at odds with achieving price stability. Conversely, a strong fiscal response plays an important role in stabilising output, thereby reducing downward pressure on prices, which contributes to the central bank's main objective – price stability. Moreover, the impact of expansionary fiscal policies on output is probably more effective than usually, because the offsetting monetary policy reaction will be absent as long as the central bank is constrained at the zero lower bound. Overall, the recent interplay of monetary and fiscal policy appears like a coordinated crisis response of mutual benefit.

**Looking forward, however, unpleasant trade-offs may emerge that endanger central bank independence.** With already elevated public debt levels increasing further, government finances are becoming even more vulnerable to pressure from financial markets. As long as interest rates remain exceptionally low, high debt is indeed not a particular concern. If inflation threatened to exceed the central bank target, however, the ECB might face delicate trade-offs. In that situation, a decisive tightening of monetary policy may be required to maintain price stability, but this would probably put too much pressure on government budgets and create unbearable consequences, thus endangering central bank independence.

**This paper discusses selected aspects of the monetary-fiscal nexus.** Section 2 investigates the recent interplay between monetary and fiscal policy. We find several indications nurturing the suspicion that some sort of monetary financing is actually already in the making (2.1). The development of interest rate spreads between euro area Member States over the course of 2020 is investigated closely, as recent measures of monetary and fiscal authorities may have reduced the probability of a breakup of the currency union (2.2). Section 2.3 discusses the role of vastly increasing central bank money as a common liability. In Section 3 we describe trade-offs the ECB may face in a scenario of rising inflationary pressures, which might put central bank independence into question and result in a regime of fiscal dominance in the monetary union. Section 4 considers avenues improve conditions for central

bank independence in the years ahead, focusing on the role of the institutional framework of the monetary union. Section 5 concludes.

## 2. RECENT INTERPLAY OF MONETARY AND FISCAL POLICY

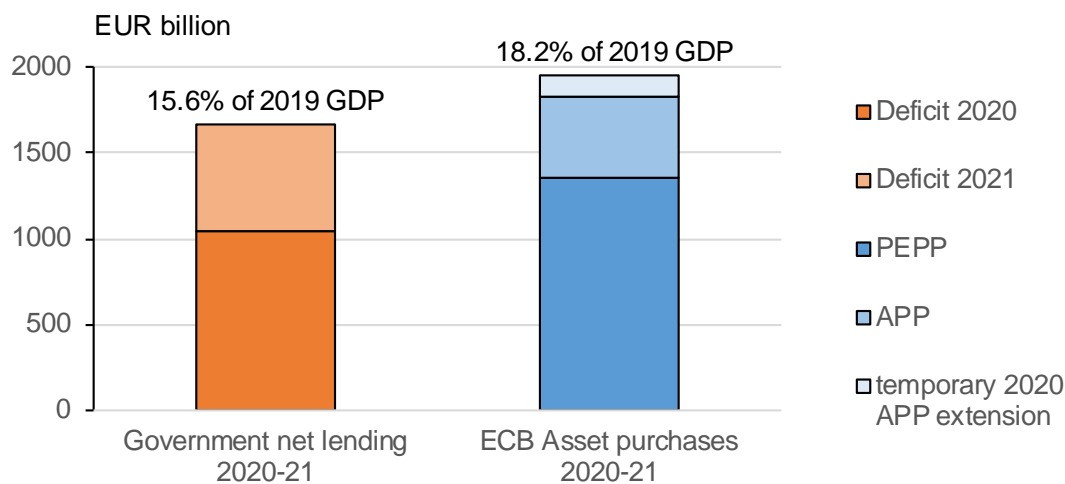
### 2.1. Implicit monetary financing

**In the current crisis, the central bank effectively took measures to support and sustain public finances.** This contributed to the impression that, at least implicitly, the ECB might already be violating the ban on monetary financing laid down in the Maastricht treaty. That said, the ECB is clearly able to explain and justify its actions and programmes within its mandate, e.g. as measures to ensure transmission of monetary policy and to promote financial stability. Still, there are some indications that nurture the suspicion that monetary financing is de-facto already implemented – although unofficially.

#### 2.1.1. Government budget deficits financed by the ECB

**The ECB has announced sizable bond purchases in 2020 and 2021.** The asset purchases under the pandemic emergency purchase programme (PEPP) – introduced in March and expanded in June – are currently planned to amount to EUR 1.35 trillion by June 2021. Moreover, at the current pace of monthly purchases of EUR 20 billion under its “regular” asset purchase programme (APP), together with EUR 120 billion of asset purchases on a temporary envelope in 2020, the Eurosystem will add another EUR 600 billion to its balance sheet within two years. Combined, these asset purchases amount to almost EUR 2 trillion until the end of 2021, most of which are government bonds (Figure 1).

Figure 1: Government net lending and ECB asset purchases during the COVID-19 crisis



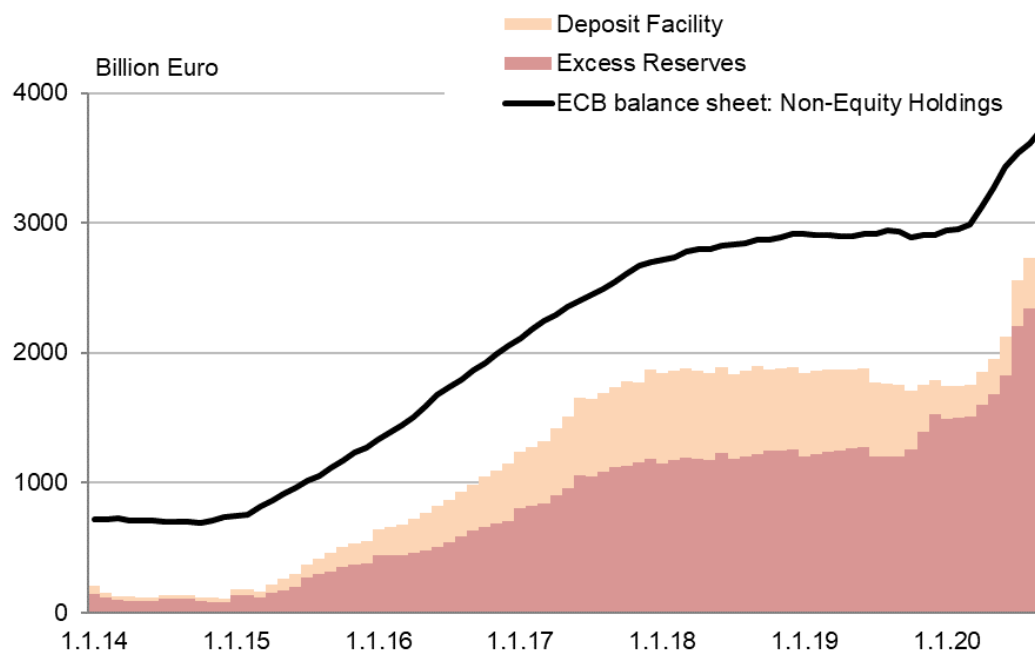
Source: ECB, Consensus (2020), Eurostat, own calculations.

**Government net lending in the euro area will probably be of similar size as the bond purchases of the central bank.** According to the October survey of Consensus Economics, the median expected government budget deficit in the euro area will be EUR 1.046 trillion in 2020 and EUR 622 billion in 2021, amounting to almost EUR 1.7 trillion within two years (Consensus 2020, p.19).

**The ECB provides sufficient funding to effectively fully finance government deficits.** Governments in the euro area issue additional bonds of immense volumes (on primary markets), and the Eurosystem simultaneously purchases bonds of almost the same volume and duration (though on secondary markets). What follows is that, in some sense, monetary financing is effectively carried out already, even though it is not called so officially, and even if the actions can convincingly be explained

and justified by central bank communication with different reasons and arguments, e.g. "... to effectively stave off risks to the smooth transmission of monetary policy." (ECB 2020a).

Figure 2: Excess liquidity in the monetary system and ECB asset purchases, 2014-2020



Source: ECB, own calculations.

Note: The black line represents assets on the Eurosystem balance sheet, while excess reserves and the deposit facility represent liabilities of the Eurosystem that are part of the monetary base and that grow in tandem with asset purchases.

**A by-product of central bank bond purchases is the ever-increasing stock of excess reserves in the monetary system.** The interplay between a central bank that prints (electronic) money and governments that issue new bonds may have no serious immediate consequences, as long as prices remain stable. However, the newly created central bank money certainly shows up and remains in existence within the monetary system on reserve accounts, though neither used nor needed by monetary financial institutions (Figure 2). Textbook theory of the “money multiplier” suggests that these reserves could in principle trigger a huge credit expansion, as soon as other – in the current situation obviously more binding – limitations to credit creation dissipate. It remains to be seen if and when this huge amount of excess liquidity will have to be withdrawn from the monetary system at a later point in time.

### 2.1.2. Like it or not: the ECB is here to close spreads

**An independent central bank like the ECB is not responsible to ensure favorable refinancing conditions to governments, yet in practice this position is soon to be abandoned.** At the height of the sovereign debt crisis in 2012, the ECB stepped in to reassure markets of solvency of certain Member States, when there was doubt that the resources of the fiscal rescue mechanism, the European Stability Mechanism (ESM) – offering financial assistance to ailing Member States – were sufficient to rescue larger economies like Italy or Spain. The outright monetary transactions (OMT) program was announced at a time when fear in financial markets that countries’ fiscal positions might drift towards

debt unsustainability with deteriorating financing conditions threatened to be self-defeating (multiple interest equilibria). The powerful statements by previous ECB president Draghi (“Whatever it takes to preserve the Euro” – “and believe me, it will be sufficient”) underlined the central bank’s willingness to suppress self-fulfilling sovereign debt crises once and for all. Furthermore, quantitative easing programs were set up in the following years, starting in 2015, and have significantly improved financing conditions for governments, thereby reducing the burden of existing high levels of public debt. No matter if by accident or by choice, the ECB is clearly involved in safeguarding sustainability of public finances.

**In the early phase of the COVID-19 crisis, a resurgence of the sovereign debt crisis of 2012 was suddenly looming.** Escalating risk premia in government bond markets of a number of countries with high government debt levels were not welcome at a time, when all attention of decision makers was dearly needed to contain the pandemic. When the COVID-19 crisis unfolded in its full magnitude in spring, the ECB had to back-pedal on its initial signals sent to financial markets. During the press conference following the Governing Council meeting on 12 March, ECB president Lagarde had uttered the view that the ECB “is not here to close spreads” (ECB 2020b). While this may have expressed the idealistic self-conception of an independent central bank, market observers took it as evidence for a lack of commitment to preserve cohesion of the monetary union. Without “side protection” by the central bank, and in the absence of another potent lender of last resort – as ESM support was not regarded a valid option for Italy – intra-euro area risk spreads exploded. Only a few days later, on 18 March, the ECB announced the PEPP (ECB 2020c). Now, Lagarde assured via Twitter that “there are no limits to our commitment to the euro.” The ECB is indeed here to close spreads.

**The ECB had to forcefully convince financial markets once more that public debt is not going to default soon.** The PEPP comprises additional asset purchases of about EUR 100 billion per month. Importantly, the ECB did not rule out to deviate temporarily from its capital key when allocating bond purchases, to frontload planned purchases on the timeline, and to extend the programme if necessary. The programme can be interpreted as OMT but without the precondition of asking for ESM support and consequently, without macroeconomic adjustment programmes. Whenever pressure increased on bond yields of a particular country, the ECB would be able to purchase as many bonds as needed to push down yields, thereby ruling out self-fulfilling sovereign debt crises. In any case, the announcement of PEPP was sufficient to calm down market fears and to stabilise government bond yields. Once more, the central bank was forced to take decisive actions to assist governments in preserving access to market financing.

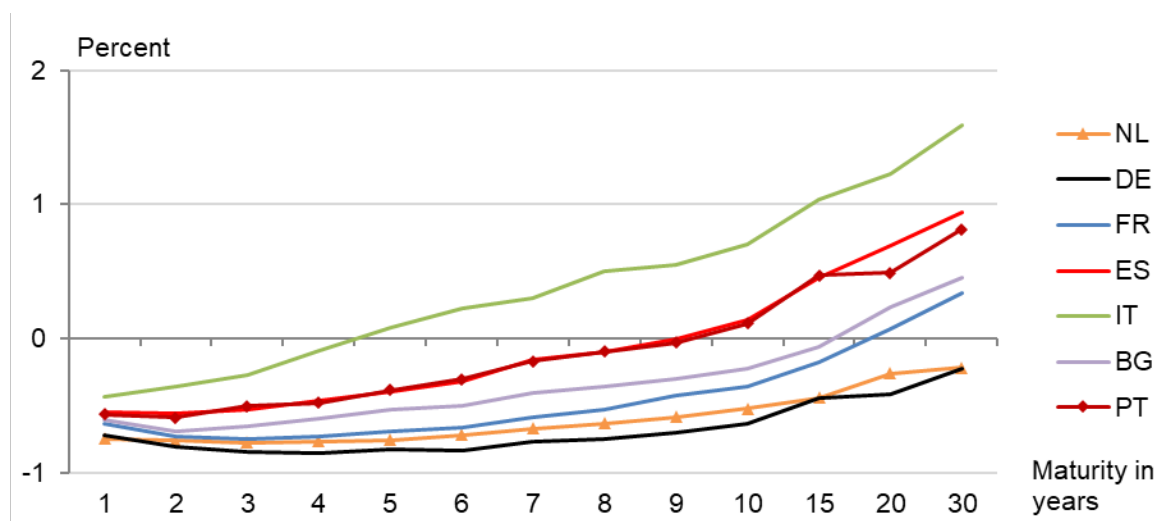
### 2.1.3. The central bank as major creditor to governments

**By the end of 2020, government bond holdings of the Eurosystem amount to more than 20% of euro area GDP.** As the ECB capital key is the primary benchmark to allocate the volume of asset purchases on Member States, this GDP share of asset holdings does not deviate too much by individual countries (except for Greece, as its bonds were not eligible in the public sector purchase programme [PSPP]). Not surprisingly, the central bank has become the single biggest creditor to governments.

**Apparently, there is a strong interdependence between government budgets and their biggest creditor.** First, by holding that much public debt, the central bank obviously plays a major role in the financing of governments – as a matter of fact. Second, as the Eurosystem holds large parts of issued bonds, this clearly has an impact on financing conditions. Looking at current yield curves, these conditions are quite favorable for all Member States from a historical perspective (Figure 3). Although debt levels are set to increase strongly due to the current crisis, countries like Portugal and Spain can issue bonds at below zero interest with up to nine years maturity, France and Belgium with up to 15

years maturity, and Germany and the Netherlands even with 30 years maturity. Even if the ECB policy may not directly be guided by the wish to lower the debt burden of governments (Schnabel 2020), the effect is the same.

Figure 3: Yield curves of selected Member States, October 2020

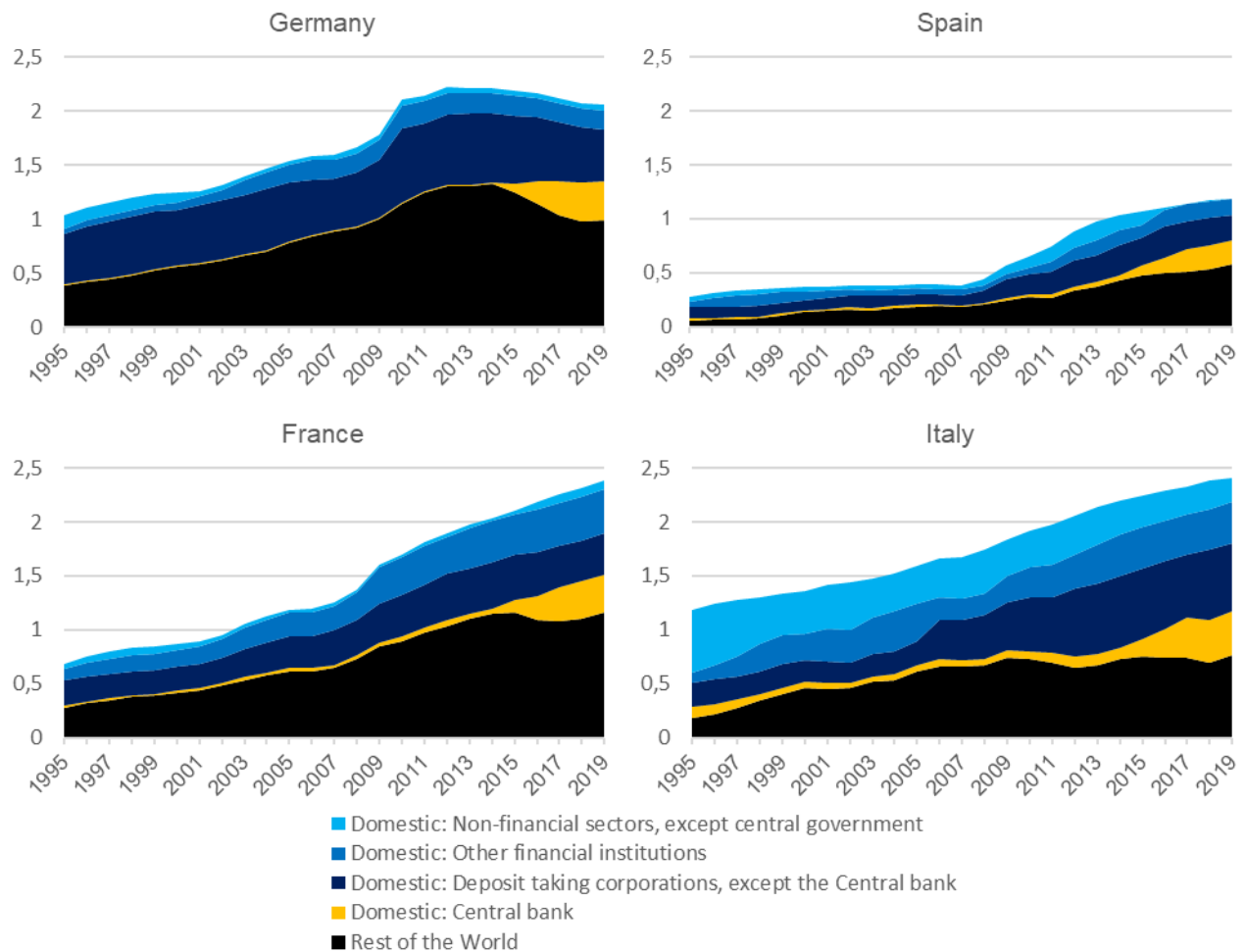


Source: Thomson Reuters Eikon.

**Debt held by the central bank does not weigh on government budgets.** Interest payments on sovereign bonds held by the Eurosystem will show up as profit of national central banks and will eventually be transferred back as revenue into respective government budgets, much like a zero-sum game without net interest flows. Those government bonds that are permanently held by the central bank do actually not strain government budgets. This raises the question whether public debt of, say, 100% in relation to GDP actually requires debt service to mere 80% of the debt – the part that is actually held by non-central bank market participants. Apparently, this reasoning will only be valid as long as the ECB does not have to reduce its investment position on sovereign debt, e.g. to withdraw excessive liquidity from the monetary system.

**Meanwhile, the central bank takes substantial creditor risk, in particular default risk and interest-change risk.** If, for example, inflationary pressures required the ECB to substantially increase the interest rate level at some point in time, sovereign bonds with high residual maturity would suddenly lose much of their present value. Suppose the Bank of Spain purchases Spanish government bonds today at a volume of EUR 10 billion, 10 years maturity and zero interest rate. If the nominal interest rate would rise to 4%, the present value of these bonds would shrink to less than 70%, so the respective assets of the Bank of Spain would shrink by more than 30% in their market value. This, in turn, could in principle result in negative equity for some central banks, and usually the domestic government would have to step in and recapitalise the national central bank. As a consequence, the creditor risk taken by the national central bank is de-facto also an implicit risk to government budgets.

Figure 4: Government debt by holder in EUR trillion, 1995-2019



Source: ECB (Government Finance Statistics: Gross consolidated government debt - by holder).

**The central bank grows in importance in the holder structure of circulating bonds.** To this end, consider the distribution of nominal bond volumes held by different types of investors (Figure 4). Moreover, this tendency accelerated sharply in 2020 (not shown here), when the ECB launched PEPP. Besides that, there are some notable differences between Member States. For example, while France and Italy exhibit an unbroken trend of increasing debt levels, there was substantial fiscal consolidation going on in Germany between the last financial crisis and the COVID-19 crisis. Moreover, Italy also shows a much higher share of domestic creditors than Germany. In all countries, particularly in Spain and France, domestic banks reduced their holdings of government bonds disproportionately over the same period.

## 2.2. Mitigation of euro area breakup risk

**The COVID-19 crisis brought back fears of a possible breakup of the currency union.** Italy, which was hit first and quite substantially by the first wave of the pandemic in late February, was soon considered a question mark in its ability to manage a crisis of this magnitude on its own. Moreover, for political considerations it appeared unlikely that Italy would request financial assistance from fellow governments via the rescue mechanism ESM and would agree on a macroeconomic adjustment programme linked to that. Against this backdrop there was a growing nervousness in financial markets, manifesting in soaring spreads on the returns of Italian government bonds in early March. Noteworthy,

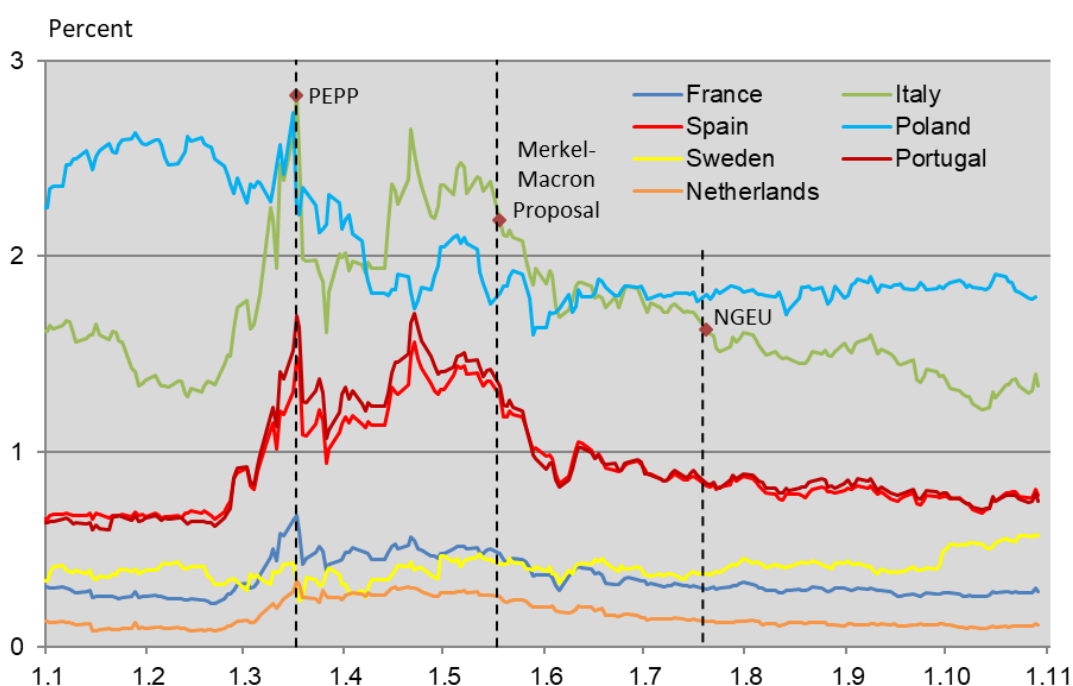


intra-euro area spreads generally increased at that time, not only for Italian bonds, but also for countries deemed invulnerable like France and the Netherlands (Figure 5). This points to a common risk factor among euro area Member States, which was absent for non-euro area EU members like Poland and Sweden. The common risk factor can be interpreted as breakup risk of the currency union.

**The swift reaction of the ECB in mid-March prevented risk spreads from widening further.** As the ECB back-pedalled on its former signals to markets, according to which the central bank is not actively involved in controlling risk spreads, it took only a few days and nights to design and announce a huge “pandemic emergency purchasing program” (PEPP). This program was sufficiently reassuring to markets so that intra-euro area risk spreads stabilised in the time after. Once again, the central bank was the main actor on stage which was capable of a swift and decisive action in due time, even though accompanied by discussions and legal interpretations whether or not the ECB acted within its mandate. On the contrary, a joint fiscal response requires substantial preparation and negotiation between heads of state, as well as legitimisation by national parliaments. Consequently, in the wake of the COVID-19 crisis, the ECB had to act as “fire brigade” once again, whereas joint and unanimous decisions by heads of state require patience, particularly if they involve huge volumes of taxpayer money.

**In the course of the COVID-19 crisis, considerable political pressure emerged and eventually brought about the conviction that a joint fiscal response on EU level was needed.** In early April, governments agreed on a loan programme worth EUR 540 billion as a first step, comprising three elements: First, EUR 240 billion were made available at the ESM to provide “pandemic crisis support” (PCS) if needed, unconditional on the requirement of close fiscal surveillance and without a macroeconomic adjustment programme. Second, a EUR 100 billion loan programme – built on guarantees – was put in place to finance short-time work or furlough schemes in Member States called “Support mitigating Unemployment Risks in Emergency” (SURE). Third, the European Investment Bank (EIB) offered a total of EUR 200 billion of loans to small and medium-sized enterprises. Despite this early loan programme, the pressure persisted to come up with a more dedicated, more generous financial assistance on EU level to cope with the crisis.

Figure 5: Spreads of 10-year government bond yields vs. Germany



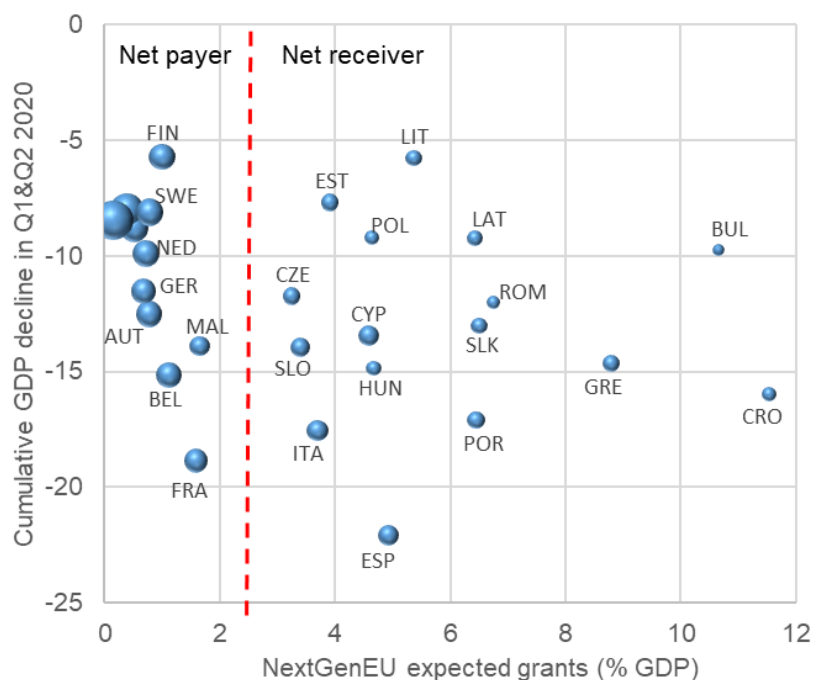
Source: Thomson ReutersEikon.



**The Merkel-Macron proposal to issue joint EU debt and to distribute grants to Member States eventually became known as a programme called “Next Generation EU”.** On 18 May, German chancellor Merkel and French president Macron came up with the proposal to set up a program that involves joint debt issuance worth EUR 500 billion and net financial transfers between Member States of the EU. Building on that, the EU Commission added EUR 250 billion of loans from joint debt and prepared a proposal for a full-fledged programme called “Next Generation EU” (NGEU), designed to complement the 7-year multiannual financial framework 2021-2027. In late July, after several days and nights of negotiation, the programme was adopted with EUR 390 billion of grants and EUR 360 billion of loans. For the first time in history, the EU would issue joint debt that is not directly accompanied by claims against the receivers of funds (as in the case of EIB loans). Respective assets will exist at least until 2058, when repayment is supposed to be accomplished.

**The NGEU programme can be criticised for various reasons.** First, loans and grants from NGEU will be distributed largely between 2022 and 2026, when the acute crisis is likely long gone. Second, vulnerabilities like high and further increasing levels of public debt beyond 100% or even 150% in relation to GDP will hardly be solved by grants of merely 2-3% of GDP on average (and these are gross flows). Third, under the assumption that Member States contribute to the repayment of joint debt at a later point in time according to their current EU budget contributions (or alternatively that EU tax payers eventually repay the debt proportionate to the GDP share), there will be net payers and net receivers of NGEU. Countries that receive grants of more than 2.5% in relation to GDP will likely be net receivers. However, if we compare expected grants from NGEU programme with the GDP loss that occurred over the first half of 2020, we see that the correlation is very weak (Figure 6). Although the rationale for a joint fiscal response were directly related to the exceptional burden of the pandemic, the economic damage incurred by the COVID-19 crisis so far plays only a minor role for the expected allocation of funds. Instead, key macroeconomic indicators of the pre-crisis years (unemployment, per-capita-income) primarily determine net financial flows (Bundesbank, 2020).

Figure 6: The relationship between GDP decline in 2020 and expected NGEU grants



Source: Eurostat, European Commission (2020), Own calculations.

Note: Bubble size represents per capita GDP in 2018.

**The introduction of joint debt and net financial transfers between Member States probably led to a decline in the perceived likelihood of Economic and Monetary Union (EMU) breakup.** Once the Merkel-Macron proposal was announced, it was clear that major players in the political game – in particular in the German ministry of finance – were changing their previous position and became willing to accept “quasi-Eurobonds” and net transfers of substantial magnitude. Looking forward, after the contested instruments are put in place, they can be used again if deemed appropriate, including to roll over further parts of national public debt with jointly issued bonds, implying additional debt mutualisation. “Financial markets” probably interpret the NGEU agreement as a major first step towards an ever-closer fiscal integration. By this, the probability of a sovereign default of a Member State declined, and therefore a breakup of the currency union was perceived less likely. As a consequence, risk spreads within the euro area took a downward trajectory (Figure 5).

### 2.3. Central bank liabilities as part of consolidated sovereign debt

**The measurement of a sovereign’s debt is not a trivial task.** A common approach is to look at government gross debt – the sum of sovereign bonds and loans to the government. The consolidated gross sovereign debt of a country is then determined by netting out any intra-governmental loans between different fiscal entities, such as local, state, and central governments, and social security schemes. Also, in many cases, fiscal strength will depend more on net debt (gross debt minus assets): if a sovereign holds substantial assets (for example in the form of a sovereign wealth fund), a given amount of gross debt will be less daunting.

**A full accounting needs to include a country’s central bank.** In a typical country outside the euro area, the inclusion of the central bank might be relatively simple: it issues a liability of the sovereign (namely central bank money in the form of cash and reserves), thus increasing gross debt. It may also, for example due to purchase programmes, hold government bonds, which would decrease gross consolidated debt. Finally, it holds other assets, such as loans to commercial banks, which reduces net sovereign debt. So as long as assets and liabilities of such a central bank develop roughly in line with each other, the sovereign’s net debt should not change much.

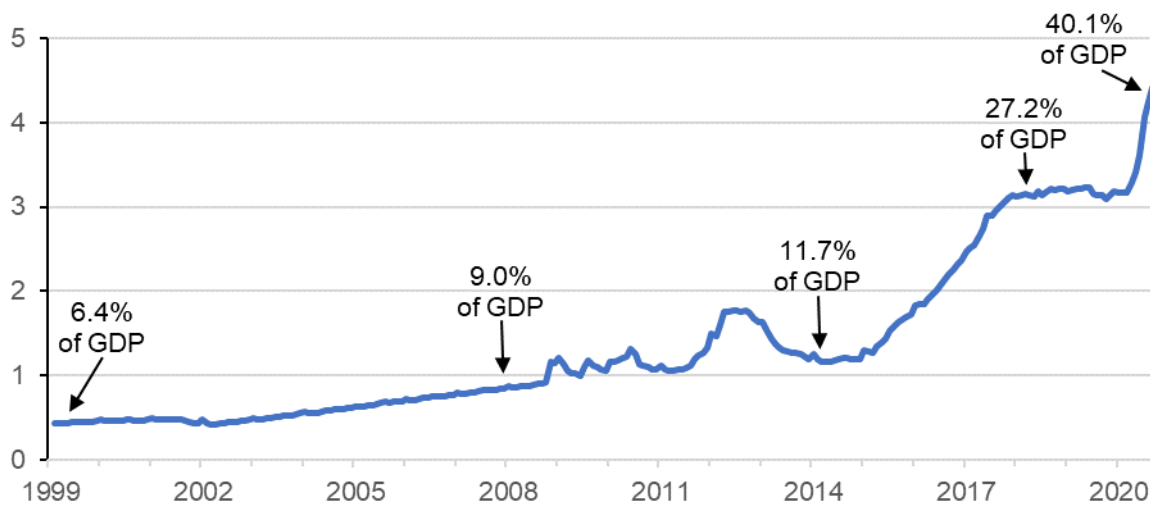
**Central bank policy affects not only the level, but also the term structure of sovereign debt.** The term structure of the debt is important because to the degree that a sovereign is funded through long-term liabilities it will be insulated from sudden changes in interest rates, leaving more time for necessary budget adjustments. At the same time, as long as term premia are positive – meaning that creditors find long-term bonds more risky than short-term ones – the overall interest burden for a sovereign will increase in the degree to which it uses long-term liabilities. This suggests there is a trade-off that must be resolved by policy makers to determine the optimal term structure of sovereign debt. In this regard, central bank money is an interesting case. On the one hand, it has properties of a perpetuity: there is no specific point in time when it absolutely has to be redeemed by the government. Further, cash does not even provide interest payments. On the other hand, for a responsible government, central bank money might be the liability most exposed to short-term developments. Central bank operations determining the amount of money in circulation are conducted every day. If the demand for money should fall, maybe even precipitously, the central bank would have the choice to either decrease the amount of money to the same extent or let inflation run out of control.

**The Eurosystem acts as a common central bank for Member States which conduct individual fiscal policies.** The Eurosystem issues central bank money that is a liability for all Member States – that is, central bank money functions like a Eurobond. It also holds a variety of assets, including loans to commercial banks and government bonds. Some of these assets are held by the national central banks in their individual accounts, while others are held jointly. There are also claims that the individual

central banks have with respect to each other (cf. TARGET2 balances). However, these claims are generally not callable and not remunerated. It is unclear to which degree the Eurosystem would be able and willing to insist that an individual Member State recapitalise its national central bank to compensate for losses in its portfolio of loans and bonds. The treatment of claims within the Eurosystem is ultimately a political act, so as long as there is no binding legal clarification on these issues, it will remain impossible to reliably determine the net contribution of euro area membership to individual Member States' (net consolidated) sovereign debt levels.

**The extraordinary monetary policies of the Eurosystem since the sovereign debt crisis have increased its fiscal involvement substantially.** Due to its nature as a common liability of all Member States, the issuing of euro central bank money always carried a certain degree of ultimately fiscal consequences. However, in the past, the outstanding amount of central bank money was generally relatively small. Extraordinary monetary policies such as large-scale asset purchase programmes changed that (Figure 7). In September 2020, the Eurosystem's outstanding base money exceeded EUR 4.4 trillion and it is set to further increase substantially.

Figure 7: Euro area base money in EUR trillion

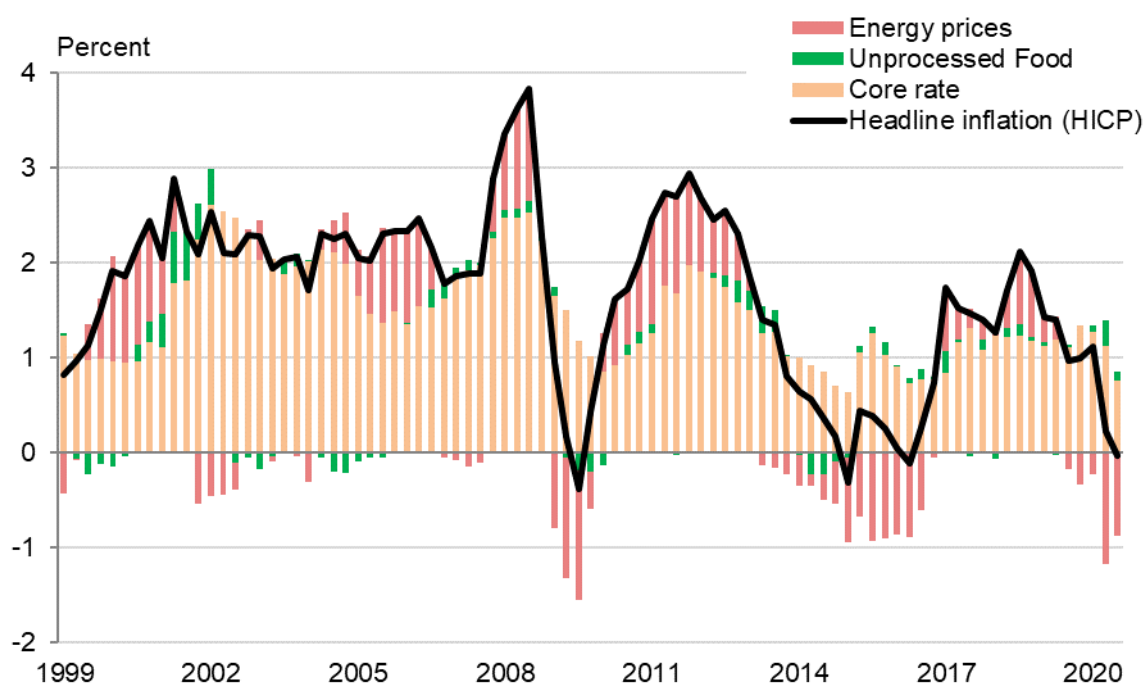


Source: ECB, own calculations.

### 3. FISCAL DOMINANCE

**Fiscal dominance refers to a situation where the central bank neglects its objective of maintaining price stability in order to support government spending.** Historically, there have been numerous examples where high government debt was eventually resolved through inflation (Schnabel 2020). An extreme form of fiscal dominance would be a government deficit that directly determined the increase in the money supply, such that fiscal profligacy would be accommodated by newly printed money and finally paid for by society with higher inflation. The ECB and the euro by contrast were designed on the principle of monetary dominance, meaning that the pursuit of price stability must not be constrained by other considerations. Clearly, there can be grey scales of fiscal dominance, and monetary dominance. While there is some indication that ECB policy actions may already be driven to some extent by requirements of public finances, it is fair to say that these have not been at odds with maintaining price stability thus far.

Figure 8: Consumer price inflation (HICP), 1999 - 2020



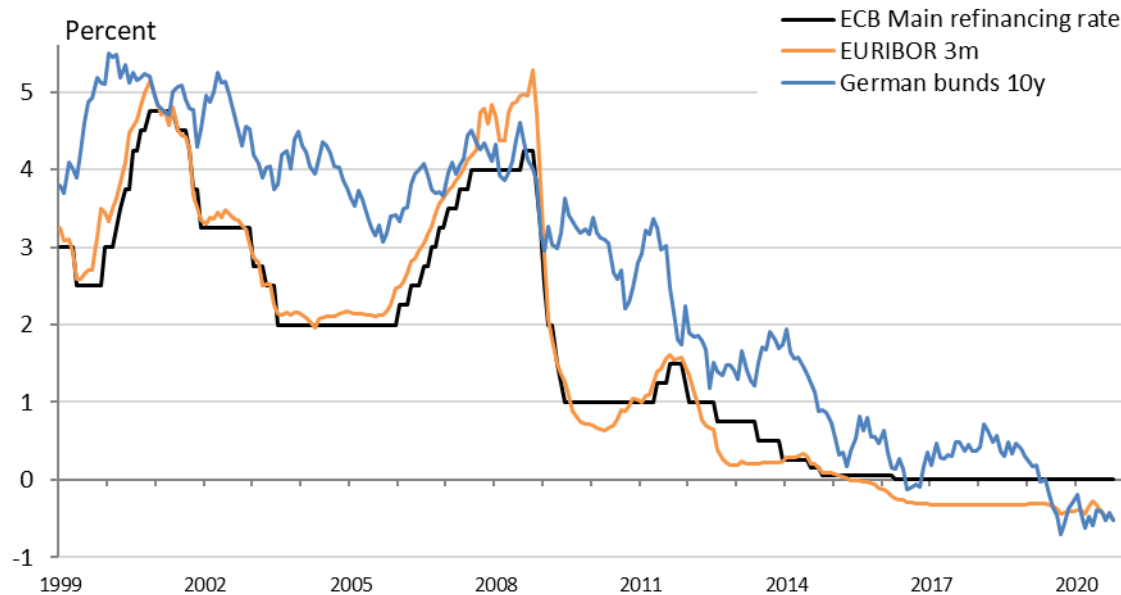
Source: ECB.

Note: Quarterly data, latest data point: Q3 2020.

**The development of consumer price inflation gives no indication that the goal of price stability in the euro area has been abandoned in any way.** In the first ten years since the onset of the currency union, consumer price inflation on average was slightly above 2% (Figure 8). Since then, underlying price pressures have eased, and over the past years inflation was below 2% most of the time. As a consequence, similar to other major central banks, the ECB was struggling to bring inflation back to its target of inflation of close to, but below 2% in the medium term. In the wake of the COVID-19 crisis, inflation decreased again markedly with headline inflation even falling into negative territory and core inflation, which excludes volatile price components like energy and unprocessed food and is regarded a more accurate measure of underlying price pressures, down to 0.4%. In this environment of subdued inflation, low interest rates and extraordinary measures such as asset purchases, which improve conditions on capital markets for governments to finance their debt, can be easily justified from a

monetary policy point of view as part of the policies to lift inflation back to target. For example, an inadequate fiscal response to the crisis resulting from problems to finance budgets would even increase downward pressure on prices, therefore neglected support to government finances might impede the ECBs ability to deliver on its main objective – price stability. From this perspective, admittedly, even undisguised monetary financing can be justified as long as inflation is too low.

Figure 9: Interest rates, 1999 - 2020



Source: ECB, Thomson Reuters Eikon.

**The determination of the ECB to maintain price stability could be tested if and only if inflation threatened to exceed the target.** Textbook theory of monetary policy rules suggests that rising inflation requires an increase of the real interest rate, and to achieve this nominal interest rates would have to rise over-proportionately (Taylor, 1993). In the first ten years of the euro between 1999 and 2008, when inflation was broadly on target, the main refinancing rate has been averaging at about 3% (Figure 9). Although markets currently expect inflation to remain low for a sustained period of time, a substantial increase of price pressures can hardly be ruled out. For example, if availability of a vaccine eventually brings an end to the pandemic, excess savings from the crisis months could suddenly spur a post-crisis boom (exceptionally high demand), while many companies may have gone bankrupt in the meantime (lower supply). Now, if underlying (core) inflation was on a rising trend and surpassed 2%, the upper limit of the ECB definition of price stability, monetary policy would have to be tightened considerably.

**A normalisation of the interest rate level would impose considerable pressure on government finances.** With higher inflation, nominal output growth would increase which – other things being equal – would support governments in their aim for fiscal sustainability. However, this effect is likely to be over-compensated by increasing pressure on sovereigns. Suppose the main refinancing rate were set at 3% as in the early years of the monetary union. At that time, German government bonds with 10 years maturity had returns approximately 1 percentage point higher than the main refinancing rate, so they averaged at about 4%. Now suppose this historical pattern re-emerged in the near future, and Italian government bonds would carry the same risk spread of 1.4 percentage points as today. Then the return on Italian government bonds with 10 years maturity, which is a proxy for the refinancing costs for public debt over all maturities, would climb to 5.4%. Considering that the debt level can be expected

to increase beyond 150% in relation to GDP as a result of the current crisis, this implies a long-run interest rate burden of about 8% of GDP, compared to 3.4% in 2019. In that scenario, the Italian government would need to reduce primary expenditures or increase revenues for many years in order to maintain a fiscal position in accordance with the European fiscal rules.

**A sudden stop or reversal of ECB asset purchases would add to concerns over public debt sustainability.** According to forward guidance, the ECB intends to purchase assets as long as interest rates remain low, which implies that the Eurosystem will stop buying bonds with the first interest rate hike. Moreover, as there still is a huge amount of excess reserves in the monetary system, the ECB might also consider to withdraw this unused liquidity (Figure 2). In order to do that, the Eurosystem would probably have to sell government bonds, as this is the channel by which excessive liquidity was emitted in the first place. Governments would not only lose a big market player that currently purchases their bonds like a vacuum cleaner, but the big pile of government bonds currently on the Eurosystem balance sheet could be thrown back on the carpet. Most likely, this would have dire consequences for risk spreads and the ability of some governments to refinance. Furthermore, if inflation would actually surpass the target level, the ECB would have to counteract by increasing the interest rate level over-proportionately, which would impose even higher refinancing costs on governments. Government financing at elevated debt levels would become much more difficult than it is today, and debt sustainability might be in doubt for some countries.

**The market value of financial assets would decline, including those on the balance sheet of central banks.** An increase in the interest rate level would reduce the present value – and therefore the market value – of financial assets considerably, in particular for assets with long duration. The valuation risk from a change in interest rates is particularly pronounced for longer-term government bonds issued at very low rates – for example, an increase of 1 percentage point in the reference interest rate will cut almost 10% from the market value of a recent bond with 10 years remaining maturity and near-zero coupon. Once markets expect a sustained normalisation of monetary policy, bond markets will probably come under significant pressure immediately. The surge in Treasury bond yield in 2013 known as “Taper tantrum”, when the Federal Reserve announced to reduce bond purchases initiated during the financial crisis, illustrates this point. The pressure on sovereign bonds would likely be aggravated if the ECB simultaneously tried to sell off assets on its balance sheet in order to withdraw liquidity from the monetary system. Overall, a substantial reduction in the market value of bonds and other assets would tear deep holes in the balance sheets of private market participants, including banks and pension funds, thereby potentially putting financial stability at risk. Yet also the central banks’ balance sheets would be strongly affected with negative equity as a possible result.

**The central bank could be left with delicate trade-offs.** The central bank would have to shoot in its own foot if monetary policy normalisation implied assets on the Eurosystem balance sheet to melt away, thereby obliterating its equity position. Even worse, the ECB might have to choose between maintaining price stability on the one hand and public debt sustainability, financial stability and cohesion of the EMU on the other hand. If inflationary pressures require a determined response of monetary policy at some point in the future, fiscal dominance becomes a valid risk that might hinder the ECB to deliver on its main objective.

**The monetary expansion of the past years resembles a one-way street with a dead end.** Going down that road was straightforward and sometimes even convenient, and we came here without a reasonable alternative. Unfortunately, the way back appears to be a difficult route. It is an open question if and when normalisation of monetary policy can be achieved without jeopardising public debt sustainability and financial stability.



## 4. SAFEGUARDING CENTRAL BANK INDEPENDENCE

**Central banks around the world have seen expansions in their roles and instruments after the global financial crisis, but the ECB faces a particular challenge due to the unique institutional architecture of the euro area.** In the aftermath of the global financial crisis, the role of major central banks around the world was stretched with respect to their roles in crisis management and as lender of last resort (Dall’Orto Mas et al. 2020). The ECB’s position is particularly complicated. The European sovereign debt crisis that followed on the Great Recession has revealed problems in the architecture of the euro area with its combination of centralised monetary policy and decentralised fiscal policies. The current crisis will increase debt levels strongly, in many countries from already elevated levels, in some cases to extreme heights. High debt makes governments vulnerable to multiple interest rate equilibria. In the current situation of an almost symmetric shock to the euro area economies, aggressive monetary easing and extensive purchases of government bonds from all Member States may be an appropriate response. However, the situation will be different if a future shock is asymmetric, and risk premia could easily rise again. This might put the ECB into a delicate situation, if the euro area outlook for inflation would not warrant an across the board monetary easing. Against this backdrop, institutional reforms are key to release the ECB from its current position as effective fiscal backstop for governments with shaky fiscal foundations.

**Two paradigms struggle to dominate the political debate for institutional reforms in the euro area.** In order to make substantial progress with regard to reforming the institutional architecture, a consensus on monetary and fiscal affairs among euro area Member States is necessary. The two competing approaches can be labelled as (1) Fiscal Union and (2) Maastricht 2.0. The Fiscal Union approach builds on harmonisation and deepening, in particular via common fiscal mechanisms on the euro area level. Maastricht 2.0 denotes the original Maastricht concept, enlarged by more emphasis on financial stability, and includes a re-establishment of the no-bailout rule of the Maastricht Treaty. These two concepts follow different monetary traditions that in the past (prior to the establishment of the euro) have coincided side by side on national levels, but need to be reconciled in the euro area.

### 4.1. Further steps towards a Fiscal Union

**The Next Generation EU programme is a step into the direction of a fiscal union, but it is not consistent, of temporary nature and modest size.** The COVID-19 crisis has triggered a significant fiscal response at the EU level (see section 2.2). Following an initial response consisting of various programmes providing loans from the ESM, from a newly established facility to support financing temporary unemployment (SURE), and from the EIB, the European Council came up with a proposal that consists not only of loans but includes also a substantial share of grants. However, several caveats exist: the NGEU programme, which still has to be enacted by the European Parliament and the Member States, does not disburse funds in the acute crisis; the volume of EUR 750 billion over 5 years is modest in comparison to EU GDP (around 1%); while the programme was motivated by the COVID-19 crisis, redistribution within the programme is only loosely correlated with the COVID-19-induced economic damage or idiosyncratic economic shocks and thus no systematic instrument to share fiscal risk. The probably most significant innovation is that the programme will to a large part be financed by issuance of joint European debt, an instrument Member States so far were not able to agree upon.

**Numerous ways to implement fiscal risk sharing have been proposed implying steps in the direction of a fiscal union, but all of them need to be designed carefully in order to keep the incentives to employ prudent policies that help preventing a crisis in the first place.** In a number of countries, fiscal space turned out to be insufficient to smooth out large fluctuations in activity and deal with macroeconomic shocks appropriately. This occasionally led to liquidity runs and steep rises

in yield spreads reflecting solvency risks that threatened to be self-fulfilling. With the introduction of the ESM, a safety net for fiscally distressed countries has been introduced, and the need for completing the Banking Union is widely acknowledged to help cut through the sovereign-bank nexus at the national level. However, additional elements of fiscal risk sharing are discussed, including a meaningful euro area budget, a rainy-day fund, an area-wide basic unemployment insurance scheme, or joint debt instruments at the European level (Gern et al., 2019). A general concern with respect to fiscal risk sharing is moral hazard: a system that effectively reduces economic pain in a country in the case of a crisis may also reduce the incentive to employ prudent policies that help preventing a crisis in the first place or to seek fiscal space in normal times to be capable of managing a crisis on its own. While many proposals try to reduce inherent problems of moral hazard by introducing specific rules and conditions, these tend to increase complexity and to have technical issues, e.g. related to the separation of cyclical from structural developments. A rainy-day fund that would give one-off fiscal support in times of substantial economic trouble (see e.g. Bénassy-Quéré et al., 2018) can provide some mitigation of idiosyncratic shocks, but entails the risk of political issues in the process of execution and results in persistent transfers. A larger central budget would be stabilising over the cycle, but the political foundations for such a fiscal union are missing, and the willingness to simultaneously shift competences to the supranational level is also lacking, which would be necessary to respect the principle of unity of liability and control. Shifting expenditures from the national to the European level may be appropriate in fields such as defence or public investment, but centralisation of policies lacks political support at the national level. There is also the problem that the EU budget is not confined to the currency union and thus not well-suited to deal with euro area problems.

## 4.2. Maastricht 2.0

**The original Maastricht idea of fiscal self-responsibility needs firm foundations with respect to financial stability.** The concept of Maastricht 2.0 perceives diversity and competition as strengths of the euro area. Institutional reforms along these lines would honour the principle of subsidiarity and re-establish a strict no-bailout rule, thus enforcing fiscal discipline via capital markets, including the possibility of sovereign defaults and public debt restructuring. Fiscal stabilisation would be conducted at the Member State level. The concept would not allow for any form of monetary government financing, and foresee reliable bail-in instruments to shield commercial banks from fiscal turmoil.

**Re-establishing the no-bailout rule is central and requires that sovereign default of a Member State must no longer trigger a currency crisis.** In a union of Member States with sovereign fiscal authority, each country would ideally be allowed to take its own fiscal policy decisions. If decisions turn out to be bad policies that ultimately lead to unsustainable public debt, there is, however, the risk of severe financial spillovers to other EU countries up to the point that financial integrity of the currency union as a whole is at stake. Preventing this externality of irresponsible fiscal policies is the rationale for the system of fiscal rules and surveillance in place. Fiscal surveillance has not, however, prevented that solvency of some countries is occasionally questioned in financial markets and the set of fiscal rules has arguably become overly complex over the years. How could the no-bailout rule credibly be re-established? First, a debt restructuring mechanism is required. Instead of bailing out creditors in advance by tax payers, actual solvency crises need to be distinguished from mere liquidity crises, and in the former case unsustainable debt must be restructured in an orderly fashion (Andritzky et al. 2016). Second, banking regulation needs to incentivise a diversification of risk, in particular to reduce the home bias in bank's bond portfolio and to reduce the vulnerability of banks to their own sovereign (Benassy-Quéré et al 2018). Third, the home government must not be responsible to stabilise the domestic financial sector, but there has to be a financial backstop on supranational level that prevents systemic crises from escalating, particularly if the respective government is in financial trouble itself. If,



as a result, the domestic financial sector becomes sufficiently resilient to deal with a default of their home government, the vulnerability of the euro area would be substantially reduced, and the no-bailout rule could regain credibility.

### 4.3. Stuck in the middle: muddling through

**In the current institutional arrangement, monetary policy is held hostage by its position as a fiscal backstop.** Since 2010, the Eurosystem has been operating in crisis mode. It responded to the global financial crisis and the subsequent European sovereign bond crisis by steering interest rates into negative territory and by engaging in large-scale asset purchases. The massive purchases of government debt have been justified as an instrument to bring back inflation closer to its target, but it has also been understood as a way to “buy time” for governments to implement structural reforms in order to strengthen growth and consolidate public finances. The ECB has communicated over and over again that monetary policy cannot replace structural reforms. However, low financing costs for governments not only render reform programmes easier to handle, they also make it less costly in the short-term not to reform. Debt levels have not significantly decreased in the euro area during the recovery after the crises, and as a result many countries entered the COVID-19 crisis with debt levels (and sometimes deficits) still elevated. In this situation, there are two ways to combat spiralling risk premia and the development of an uncontrolled debt crisis. Either the central bank remains in its current position and prevents bad interest rate equilibria as lender of last resort also for governments, or public debt has to be reduced to an amount where multiple interest rate equilibria are unlikely. As long as monetary policy can be relied upon to step in in the case financial markets lose confidence, incentives to bring down government debt sufficiently will be undermined. Therefore, appropriate fiscal rules and a strict and effective fiscal monitoring would be needed.

**Strengthening fiscal rules and conditional fiscal support risk reducing the political fabric of the Union – ownership is key.** In the past years the European system of macroeconomic monitoring and fiscal supervision has been extended and has become increasingly complex. Most proposals for introducing further elements of fiscal risk sharing also include strengthening or amending fiscal rules in order to reduce moral hazard. At the same time, compliance with the rules and implementation of country-specific recommendations seems to have declined over the years. A further tightening of rules and the introduction of ever more control and interference into national fiscal affairs could ultimately severely damage popular support for the European project. Policies such as fiscal consolidation or structural reforms on goods and labour markets to increase the growth potential can be expected to be more successful if there is ownership for these reforms with national decision makers and their voters.

## 5. CONCLUSION

### **In the current crisis, there is a strong complementarity between monetary and fiscal policies.**

Elevated borrowing needs of governments in their quest to cushion the negative impact of behavioural responses and government restrictions on economic activity are accommodated by low interest rates and asset purchases of the ECB, thus guaranteeing favourable financing conditions. While expansive monetary policies are appropriate given downward pressure on inflation at already subdued levels, there are indications that these policies ultimately amount to monetary financing.

**Fiscal dominance is a valid concern.** The determination of the ECB to maintain price stability would be tested if inflation threatened to exceed the target. A substantial increase in key interest rates and a reversal of asset purchases would impose considerable pressure on government finances, potentially leading to a renewed surge in risk premia on government bonds of highly indebted countries, and with the risk of triggering turmoil in the financial sector. Then, the ECB would have to choose between maintaining price stability on the one hand and public debt sustainability, financial stability and cohesion of the EMU on the other hand.

### **A continuation of the ultra-low interest rate regime appears likely according to market expectations, so that debt sustainability concerns would lose significance – but there is only probability, not certainty.**

The good news is that there appears to be no sustained increase in underlying inflation in the cards for the next couple of years, and from the yield curve (or forward swaps) it can be inferred that investors expect interest rates to remain low over the next ten years. Therefore, chances are that borrowing costs remain low relative to growth for the foreseeable future. With low interest rates much higher debt-to-GDP ratios are sustainable and that primary government deficits are feasible without jeopardising fiscal sustainability, compared to a situation with higher levels of interest rates like those prevailing before the global financial crisis and that are implicitly built into the European fiscal rules (Blanchard et al., 2020). However, we cannot be sure that this scenario actually unfolds, i.e. that interest rates remain that low for a sustained period of time. Given progressive demographic aging in increasing parts of the world, there are sound arguments to expect upward pressure on interest rates from declining savings in the not too distant future.

### **Governments should use the coming years to reorganise EU institutions and reduce debt to levels that appear sustainable also in a less benign interest rate environment.**

We suggest that the upcoming years of low interest rates should be seen as a window of opportunity, where fiscal space should be used to put the house in order. A process of fiscal consolidation should be initiated as soon as an eventual recovery of the economy from the pandemic allows for it. At the same time, the institutional set-up of the monetary union should be reformed. This could either be in the direction of a more comprehensive and effective fiscal union or in the direction of reviving the principle of fiscal self-responsibility embedded in the Maastricht Treaty. Both approaches are demanding as their consistent implementation requires a consensus on how economic policy in the EU should work, a consensus that is apparently difficult to establish. Remaining stuck in the middle would probably leave problems and vulnerabilities unresolved and would cement the conditions for fiscal dominance to prevail.

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The paper argues that the monetary policy response to the COVID-19 crisis has been appropriate in terms of the ECB's primary objective. The concern over fiscal dominance is, however, valid as in a situation of rising inflationary pressure the ECB would have to choose between maintaining price stability on the one hand and public debt sustainability, financial stability and cohesion of the EMU on the other hand. Reform of the euro area institutional framework could mitigate this risk, either in the direction of a fiscal union or in the direction of full fiscal self-responsibility.

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