"Fiscal Policy and Monetary Policy Normalisation in the Euro Area" - article in Eurofi Magazine

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25/04/2018
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Fiscal Policy and Monetary Normalisation in the Euro Area

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European Stability Mechanism

The euro area has entered the expansionary phase of the business cycle. Growth is above potential and there are good prospects that it will remain strong in the near future. Last year, euro area GDP grew at 2.3% and the vast majority of forecasters project GDP growth above two percent for this year. In the medium-term, growth will slow down and move towards the long-term potential. All euro area economies are expanding – and several countries have caught up after the double-dip recession, thanks to the structural reforms implemented in the context of ESM programmes. At the same time, major external imbalances existing at the start of the crisis have been overcome. In view of these encouraging prospects, inflation is expected to increase in the medium-term.

Against that background, the ECB reduced the pace of its asset purchases in January, and is expected to take further steps towards monetary policy normalisation in the near term. For the moment, net purchases will run until the end of September, or continue beyond that moment if the ECB’s Governing Council deems it necessary. Interest rate moves are expected only “well past the horizon of the net asset purchases”. Financial markets are adjusting to this setting with moderate increases in long-term rates and an exchange rate appreciation.

European institutions project the aggregate fiscal stance of the euro area to be broadly neutral across countries over the coming years, and debt levels are expected to drop further. Given the growth performance and debt structure, policy normalisation does not pose an immediate sustainability risk for any euro area country. Many countries have used the past years of low interest rates to extend the maturity of their debt. Therefore, changes in monetary policy will only slowly feed into higher interest rate costs. In the case of Greece, ESM lending ensures that the sovereign will face low average interest rates and manageable financing needs over the years to come.

Yet, there is a need to learn from the past and create the necessary policy space to handle periods of weaker growth in the future. Countries with high debt levels, low long-term growth potential, and small economies experiencing high output volatility need to create fiscal buffers to avoid pro-cyclical fiscal tightening in future downturns. Indeed, low private and public savings in the early 2000s were factors in causing the most recent European crisis. From that perspective, all countries need to make an effort to live up to the requirements of the European fiscal framework, including the debt rule. This is even more important considering that the room for manoeuvre of monetary policy to react to any future downturn may be limited at the current level of interest rates.

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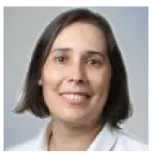

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