IN-DEPTH ANALYSIS

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The Euro Area After COVID-19

Policy Department for Economic, Scientific and Quality of Life Policies
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Abstract

The COVID-19 pandemic will leave the euro area economy quite weak. It will be essential that both fiscal and monetary policies remain mobilised to achieve a sustainable recovery. Having indirectly financed a large share of new public debts, the ECB will have to tread a fine line between its price stability mandate and the need to avoid disrupting debt markets. The solution for the ECB is to use its announced strategy review to provide more clarity, both to its objectives and to its procedures. This includes adopting average inflation targeting, a formal relationship with member governments and the issuance of its own debt instruments.

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LIST OF ABBREVIATIONS

AIT	Average inflation targeting
APP	Asset purchase programme
ECB	European Central Bank
EP	European Parliament
EU	European Union
GDP	Gross domestic product
HICP	Harmonised Index of Consumer Prices
LTRO	Long term refinancing operation
PEPP	Pandemic emergency purchase programme
QE	Quantitative easing

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EXECUTIVE SUMMARY

- **The European economy after COVID-19 will be very different from what it used to be.** Most obviously, national public debts will have increased by some 15-30% of GDP. A larger proportion of these debts will be held by the ECB than has been the case so far.
- **It is very likely that the post-crisis rebound will not be followed automatically by a sustainable recovery.** Macroeconomic policies will have to shift seamlessly from containing the impact of the pandemic to putting the economy on to a lasting growth path.
- **The ECB will face a complex situation.** Now in negative territory, its interest rate instrument is no longer available, at least not enough to make a difference. Instead, it has been using its balance sheet instrument, which implies buying very large amounts of public debts.
- **Large holdings of public debts create proximity between the ECB and its member governments**. A particular concern is fiscal dominance, whereby monetary policy decisions become heavily influenced by this proximity.
- **This paper takes the view that these risks exist but they can be managed if the ECB makes early preparations to that effect.** These risks should be a central concern of the strategy review currently under way at the ECB. The existing strategy may remain reasonably well-adapted to normal times, the strategy review must deal with unusual times, most of which are unpredictable.
- **The ECB should adopt the average inflation targeting strategy, as recently adopted by the US Federal Reserve.** By committing to overshoot its inflation target for about as many years as it previously undershot it, the strategy will allow the ECB to strengthen the post-Covid recovery, it will lift inflation expectations up and provide leeway to bring interest rates into positive territory.
- **An additional benefit of the average inflation targeting strategy is that it will allow to continue to indirectly finance the fiscal policy effort without triggering fears of fiscal dominance.** While there is no threat of a loss of formal independence, the appearance of fiscal dominance may sustain the perception that, informally, the ECB is not as independent as it is supposed to be.
- **Financial stability is now acknowledged by the ECB as a key policy objective.** Having been given the responsibility for banking supervision, its next step is to work out formal arrangements with governments regarding rules of engagement and financing of losses.
- **The ECB should also seek to improve relations with member governments.** This enhanced form of mutual information should cover the sharing analysis of the situation, exchanges of views regarding planned action and a better understanding by the ECB of national circumstances
- **The ECB should issue its own debt instruments.** This would make it possible escape the numerous difficulties associated with the use of national debt instruments for standard and nonstandard policy interventions.

1. INTRODUCTION AND PREVIEW

The European economy after COVID-19 will be very different from what it used to be. Most obviously, national public debts will have increased by some 15-30% of GDP. A larger proportion of these debts will be held by the European Central Bank (ECB) than has been the case so far. Most, if not all, countries will have seen a number of firms leave business and unemployment will be higher. Some financial institutions may be weak. All of that suggests that it is very likely that the post-crisis rebound will not be followed automatically by a sustainable recovery. Macroeconomic policies will have to shift seamlessly from containing the impact of the pandemic to putting the economy on to a lasting growth path.

Unfortunately, the scars of the crisis that we are currently undergoing will create a daunting challenge. Public debts are increasing fast, the interest rate is at, or very close to, its effective lower bound, unemployment currently kept in check by fiscal support will build up fast, myriads of firms will have gone into bankruptcies. In addition, fighting climate change is likely to emerge as the new priority. It will require deep transformations that will eat into growth as we replace exclusive emphasis on economic efficiency with carbon mitigation objectives.

Meeting these challenges cannot be entirely delegated to the central bank. Much as governments and the ECB have joined forces during the pandemic, they will have to continue doing so in post-COVID times. In normal times, fiscal-monetary coordination is rare, in fact more the exception than the rule.[1] In crisis times, it is even more needed but not guaranteed, as we saw during the European debt crisis. It is therefore very important to start the discussion now.

The ECB will face a complex situation. Now in negative territory, its interest rate instrument is no longer available, at least not enough to make a difference. Instead, it has been using its balance sheet instrument (longer-term refinancing operations [LTRO], asset purchase programme [APP], pandemic emergency purchase programme [PEPP]), which implies buying very large amounts of public debts. But large holdings of public debts create proximity between the ECB and its member governments, which generates a host of questions. In particular, are we witnessing a case of fiscal dominance, whereby monetary policy decisions become heavily influenced by this proximity? Will the ECB be able to pursue its core mandate of price stability if doing so stands to fragilize public debts?

This paper takes the view that these risks exist but they can be managed if the ECB makes early preparations to that effect. These risks should be a central concern of the strategy review currently under way at the ECB. The previous strategy was set in the late 1990s, and marginally adjusted during the previous review in 2003. Already, the debt crisis revealed the limits of this strategy, essentially built for quiet times, moderate public debt levels and positive interest rates. The historical situation created by COVID-19 lies even further out from the logic of the 1990s. The existing strategy may remain reasonably well-adapted to normal times, the strategy review must deal with unusual times, most of which are unpredictable.

In order to confront its inability to raise inflation to its target for about a decade, the ECB should adopt the average inflation targeting strategy, as recently adopted by the US Federal Reserve. By committing to overshoot its inflation target for about as many years as it previously undershot it, the strategy will allow the ECB to strengthen the post-COVID recovery, it will lift up inflation expectations and provide leeway to bring interest rates into positive territory.

[1] For recent evidence, see Bartsch et al. (2021).

An additional benefit of the average inflation targeting strategy is that it will allow to continue to indirectly finance the fiscal policy effort without triggering fears of fiscal dominance. While there is no threat of a loss of formal independence, the appearance of fiscal dominance may sustain the perception that, informally, the ECB is not as independent as it is supposed to be.

Financial stability is now acknowledged by the ECB as a key policy objective. For a long time, the ECB has resisted taking on this responsibility but the Great Financial Crisis has made it clear that it is unavoidable. Yet, this task is fraught with difficulties, including the risks that it implies and the division of tasks between the ECB and its member governments. Having been given the responsibility for banking supervision, its next step is work out formal arrangements with governments regarding rules of engagement and financing of losses.

The ECB, now a mature central bank, is also in a better position to improve its relations with member governments. Formal contacts at the highest level, which would supplement ample contacts at the technical levels, stand to improve the functioning of the euro area. This enhanced form of mutual information should cover the sharing analysis of the situation, exchanges of views regarding planned action and a better understanding by the ECB of national circumstances.

Finally, the ECB should escape the numerous difficulties associated with using national debt instruments for its standard and nonstandard policy interventions. The solution is to issue its own debt instruments, which would progressively replace on its balance sheet national instruments.

2. THE ECONOMIC LEGACY OF COVID-19

As we are currently discovering with the second wave of the pandemic that swirls through all of Europe, it is far too early to take stock of the situation. Economic forecasts have flourished in large numbers over the last few months, only to be deeply revised soon after being produced. The current level of uncertainty in the face of a historical event is unprecedented. Yet it is possible to envisage some key characteristics of the legacy of the pandemic.

The first source of uncertainty is when the pandemic will end. The optimistic view is that some vaccines will be validated around the end of 2020 and early 2021. It will then take about one year to vaccinate enough people around the world to achieve herd immunity, hopefully by late 2021. More pessimistic views would push out the date. The next uncertainty concerns the number of waves yet to come, along with the need to repeatedly impose again strong distancing measures that disturb the economic activity and require fiscal support.

The second source of uncertainty is the economic impact of one wave of pandemic. Table 1 shows the Commission forecasts as of July 2020, i.e. after the first wave. GDP growth in the euro area was then expected to decline by 10% in 2020 relative to 2019 (9.8% for the EU). With the second wave, the outcome is likely to much worse, even though the Q3 recovery seems to have been stronger than expected. It is possible that we learnt how to better deal with a wave following the first one so, in the following, I optimistically assume that the cost of one further wave is a decline of 5% to 8% of GDP. If we assume that there will be three waves before a vaccine is widely adopted by end of 2021, this would imply a cumulative GDP decline of 14% to 22%. With four waves, the range is 18% to 28%. These are guesses, of course, but they clearly indicate that the crisis is massive proportions.

Table 1: GDP growth forecasts (% per year)

	Summer 2020			Spring 2020		
	2019	2020	2021	2019	2020	2021
Euro Area	1.3	-8.7	6.1	1.2	-7.7	6.3
EU	1.5	-8.3	5.8	1.5	-7.4	6.1

Source: European Commission, Interim 2020 Summer Forecasts.

According to the Commission (AMECO online), presumably due to the first wave and its follow-up, the total of public debts of euro area member countries is expected to increase by close to 12% over 2020, raising the debt/GDP ratio by 16% of GDP.[2] Three waves would imply a 48% increase in the debt/GDP ratio, to about 134% of the euro area GDP. Of course, national evolutions are likely to be very different, an issue taken up below in Section 3.3.

The image that emerges from these rough and uncertain calculations shows a euro area in deep depression. This is not what the public is, and will be, seeing, though. Massive public policy interventions have largely preserved incomes of much of the population and made it possible for most firms to survive and to avoid resorting to large-scale labour dismissals. As a whole, the euro area will have been borrowing its way out of the depression. High borrowing, in turn, is made possible by large scale purchases of public debt by the ECB and, in the case of previously largely indebted countries by

[2] This is not quite consistent with the forecasts in Table 1, but I ignore this issue.

the creation of the European Recovery Fund. This combined effort is creating a virtuous cycle, which prevents the considerably worse deterioration that would have occurred in the presence of large dismissals and deep income losses.

At the same time, the ECB is likely to indirectly finance a large share of newly issued public debts through its quantitative easing (QE) programs. Through the public sector section of the asset purchase program (APP), the ECB plans to acquire about EUR 420 billion of debts through December 2021. Under the pandemic emergency purchase programme (PEPP), until at least June 2021, the ECB is committed to spend EUR 1,350 billion on public and private assets, with the bulk concerning public debts. The numbers shown in Table 2 are not exactly comparable since the debt issued by member governments is a forecast to end of 2020 while the announced ECB numbers concern purchases that will extend to 2021. With the second wave under way, it is now clear that public debts will increase in 2020 by more than indicated and it is quite plausible that they will continue to rise in 2021 at a similar rhythm. But the ECB is also expected to raise its asset purchase programmes. Still, it seems safe to interpret Table 2 as indicating that the ECB intends to indirectly acquire the bulk, or even more, of newly issued public debts.

Table 2: Forecasts of new public debt and ECB purchases (EUR billion)

Newly issued public debt in 2020	ECB purchases under PEPP (2020-21)	ECB purchases under APP (2020-21)
1,200	1,220*	420**

Sources: Debt: European Commission (AMECO online); ECB purchases: ECB and author's calculation.

Notes: (*) PEEP purchases, to a total of EUR 1,350 billion concern public sector and private securities. As off end of September 2020, 90% of purchases concerned public securities, hence the EUR 1,220 billion estimate.

** In September 2019 the ECB restarted APP with net monthly purchases of EUR 20 billion. In March, it decided an additional envelope of EUR 120 billion for 2020, hence a total of EUR 600 billion for 2020-21. With about 70% of these purchases concerning public sector assets, APP will purchase about EUR 420 billion worth of such assets.

3. POST COVID-19 CHALLENGES

3.1. The central issue: sustainable recovery

The previous section suggests that, by end 2021 when the coronavirus could have been contained, the euro area will be in a historically bad economic shape. While any forecast is impossible, a plausible view is that GDP will have declined by some 20% to 25% relative to the 2019 level. The debt/GDP ratio indebtedness will have risen by some 50% of GDP. Again, the situation will differ from country to country.

Thanks to the measures taken by the governments and the ECB, most citizens and businesses will not feel a pain that corresponds to these dramatic numbers. Public borrowing will have sustained standards of living. Corporate borrowing, some of which is guaranteed by governments, will permit most firms to survive. Public debts, while nominally much larger, will be safely parked in the Eurosystem's balance sheet, away from financial markets. This is how it should be. Time-honoured principles indicate that borrowing is the best way to face unexpected adverse shocks[3] and that the government should borrow on behalf of those who cannot[4]. In a way, public policies during the pandemic are straightforward and, indeed, it is striking that all governments in the euro area have adopted broadly similar actions.

The hard part will come afterwards, after the pandemic. The recovery must then start without delay, for several reasons:

- As the pandemic support programmes are removed, numerous firms are likely to face bankruptcies and unemployment stands to soar.
- Many bankruptcies will concern viable firms. Bankruptcies are costly as they destroy know-how, commercial assets and some physical capital.
- Similarly, lasting spells of unemployment destroy human capital and create social pain, with dangerous political implications.
- Bankruptcies and unemployment result in non-reimbursed borrowings, which fragilizes the financial sector and can trigger a financial crisis.

Will the recovery start spontaneously? Mechanically, it will, but only partly. The end of distancing measures, which prevent normal economic activity, will play an important role. Both consumers and producers will be eager to return to normality. But the new normal will be different. Once overall consumption rises, productive investment will have to play a crucial role to keep the economy going in a sustainable way. A new uncertainty, however, will set in: after nearly two years during which public policies have frozen the pre-existing situation, the changes that did not take place will come into play. Several industries are likely to never return to their previous levels of activity. In addition, exchange rates with trading partners will have changed, reflecting different experiences with the pandemic, further changing the landscape. All of this may well slow productive investment down.

3.2. The good news

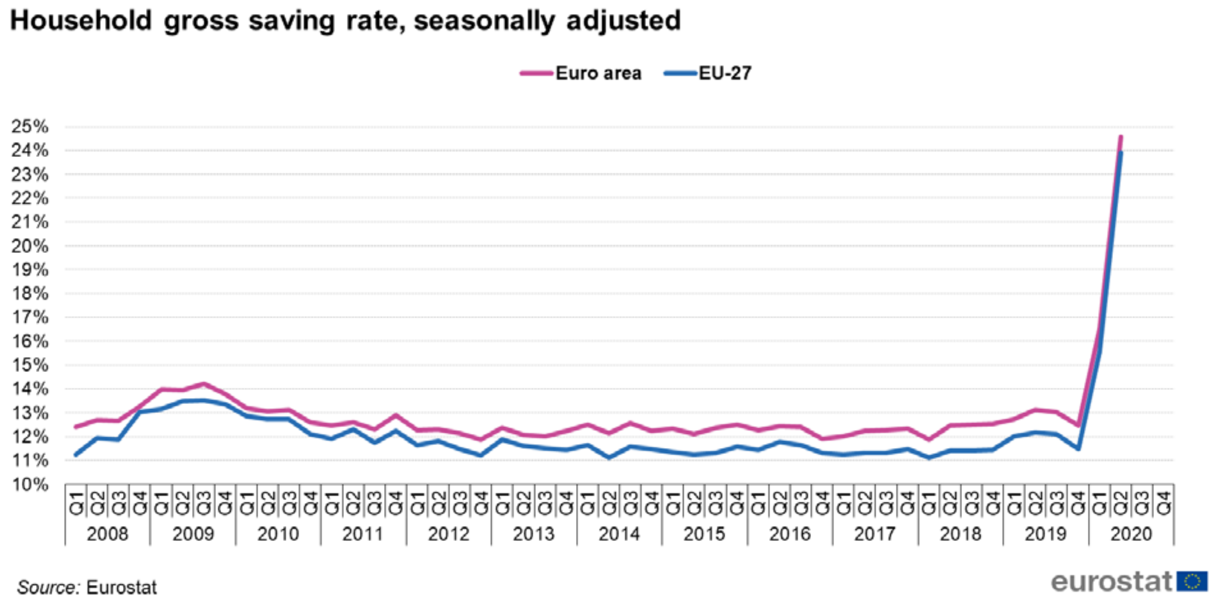
During the first lockdown period, European households have more than doubled their savings rate, as shown in Figure 1. (The 12% of GDP cut in spending fits well with a GDP fall of some 8% given

3 This principle goes back at least to Milton Friedman's permanent income hypothesis (Friedman, 1957).

4 A classic reference is Blanchard and Gali (2005).

expansionary fiscal policies.) Available information[5] is that these savings have started to be run down after the lockdown, fuelling a sharp economic growth rebound. Much the same is likely to happen again after the next waves. This is the automatic part of the recovery.

Figure 1: Household saving rates (% of GDP)



Source: Eurostat

3.3. The bad news

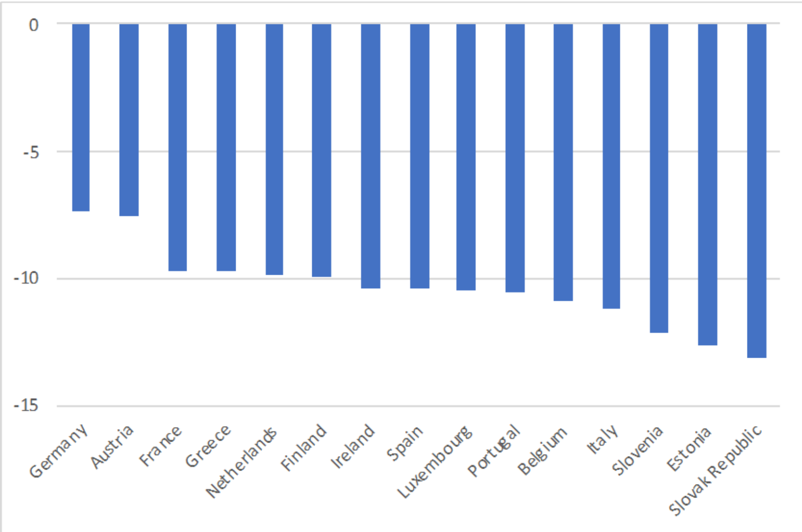
The overhang of the pandemic, described in Section 3.1, predicts that the recovery will be partial and weak, unless something is done about that. This is the first bad news.

A second bad news is the second wave, which makes the possibility of further waves in 2021 quite plausible.

A third source of concern is the disparity of effects within the euro area. So far, this paper has looked at the overall euro area. Figure 2 looks at growth rates in individual member countries. It is based on estimates produced by the Organisation for Economic Co-operation and Development (OECD) in June 2020. Interestingly, the OECD has looked at the impact of a second wave at end-2020. The figure plots the estimated growth rates for 2020. The impact ranges for a 7.3% decline in Germany to 13.1% in the Slovak Republic. Such a difference, or asymmetry, stands to complicate the recovery in several ways. First, it will call for much more policy support in some countries. This concerns fiscal policies, and therefore public borrowing, but also the common monetary policy, which is ill-adapted to asymmetric shocks.

[5] The latest data displayed in Figure 1 are from 28 October 2020.

Figure 2: OECD estimates of GDP growth in 2020 in the euro area (double-hit scenario)

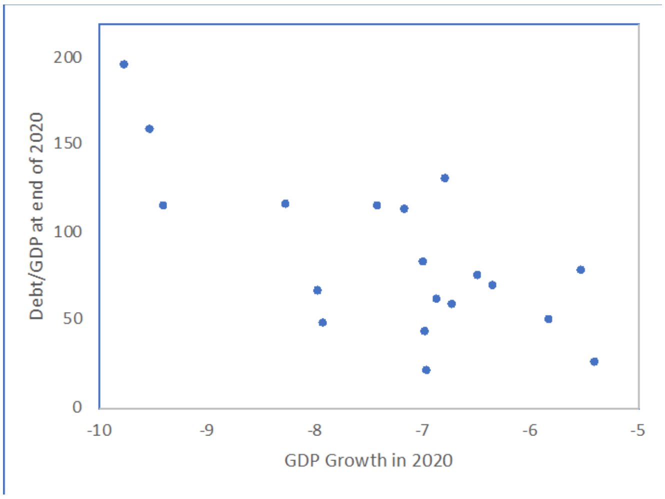


Source: OECD Economic Outlook No. 107, June 2020, and author's calculation.

Note: The OECD assumes a "double-hit" scenario whereby a second wave occurs in October-November, but a weaker one than the first wave. It also assumes that there is no further wave.

Regarding fiscal policies, Figure 3 compares the growth declines over 2020 in individual countries and their public debts at the end of that same year. The forecasts are those of the European Commission as available from AMECO online. In contrast to the OECD, they have not yet factored a second wave, so they differ from those presented in Figure 2. The figure strongly suggests that the countries worst hit by the pandemic typically are also those where public debts are highest. The Recovery Fund is meant to address this double asymmetry, but the orders of magnitude are not commensurate with the asymmetry displayed in this figure.

Figure 3: Growth and public debts in the euro area at the end of 2020



Source: European Commission, AMECO online.

3.4. Three big policy issues

3.4.1. No premature retrenchment of fiscal policies

Saddled with significantly higher debts, many governments will be tempted to declare victory once the pandemic is under control and quickly bring their large budget deficits down. This would be a major policy mistake, an echo of what happened after the Great Financial Crisis a decade ago. Indeed, the previous analysis argues that the quick resumption of growth made possible by large accumulated household savings will not last due to several headwinds. Fiscal policy will have to remain expansionary, probably for a couple of years, until the recovery is broad-based and driven by corporate investment, which will only occur when private consumption is strong.

The downside of continuing fiscal policy support will be the further accumulation of public debts following the large increases during the pandemic period. To make matters worse, Figure 3 shows that the continuing debt build-up will likely be larger among the initially highly indebted countries. It is easy to foresee increasing pressure to cut deficits and indeed aim at bringing debts down. This is where the ECB enters the picture.

The reason why fiscal policy will have to bear the brunt of post-COVID expansionary macroeconomic policies is that, despite its oft-repeated assertions, the ECB has all but exhausted its ability to raise the activity level on its own. It may, however, play a crucial supporting role. In fact, this is what it has been doing since the breakout of the pandemic. As shown in Table 2, the ECB has been indirectly financing a large part of new debt issues by its member governments and it will have to do so until expansionary fiscal policies are not needed anymore.

3.4.2. Monetary financing of budget deficits

One major reason for this indirect financing of budget deficits to continue is to alleviate justified fears about these deficits. Such fears can be based on principles, namely that lasting deficits are bad per se. This view is not valid at times of economic hardship. Indeed, governments and the Commission deserve praise for having discarded such a view at the outset of the pandemic. Another reason to fear continuously large deficits is that the financial markets stand to be spooked by high and rising public debts. After all, in 2010-11 several euro area countries were drawn into crisis at debt levels much lower than those that are likely to be reached by end of 2021 (as the calculations in Section 2 suggest). The ECB can go a long way to quelling these fears. It did so in 2012 with the celebrated “whatever it takes” statement by its President. It did so again earlier this year with the announcements of its asset purchase programmes (APP and PEPP)[6].

Monetary financing of budget deficits, in turn, raises another fear that it unavoidably leads to high inflation. This has been historically the case, but under different situations, when money created by a central bank quickly ended up in consumer hands. This has not been the case since the Great Financial Crisis and, indeed, the massive amounts of money created by QE have been met by lower, not higher inflation.

3.4.3. Raising inflation

In fact, since 2008, many central banks have continuously undershot their inflation targets. It not yet fully understood why, even though many potential explanations have been advanced. Among them is the presence of a vicious circle: low inflation becomes entrenched when it lasts, because expectations

[6] The early misstatement of the President, that she was not responsible for interest spreads, is another proof, *a contrario* this time, of the power of the ECB in this matter.

that it will continue result in slower wage and price adjustments. Central banks have tried to raise expectations through communication, but statements that are not followed by results soon lack credibility. When inflationary expectations remain low, nominal interest rates decline and can hit the effective lower bound at zero or below. At that stage, the central bank loses its classic tool, the interest rate, and resorts to nonstandard instruments, mostly QE, which have not been powerful enough to raise inflation. Arguably, this circle has played a role in the euro area.

Another reason for stubbornly low inflation is that economic fluctuations now have limited effects on the inflation rate. This is often defined as a flattening of the Phillips curve, which describes this effect. There is indeed evidence that the Phillips curve has become flatter, but not absolutely flat.[7] This means that a strong enough increase in the level of activity will eventually raise inflation, and therefore inflationary expectations. Under this interpretation, inflation has been too low in the euro area because growth has been subdued, in spite of ECB's best efforts, because fiscal policy has been too restrictive, shifting from austerity to neutrality.

Since the pandemic outbreak, fiscal and monetary policies have been both expansionary. This rare policy alignment has so far succeeded in preventing an economic collapse. Inflation has declined, but not much in view of the negative growth rates, which is likely to also be the result of the alignment of fiscal and monetary policies. This observation further strengthens the argumentation in favour of a continuation of this alignment throughout the recovery phase. It will not only firm the recovery up but also make it possible to finally raise the inflation rate to its target.

[7] For recent evidence and a review of research, see Del Negro (2020).

4. FISCAL DOMINANCE AND CENTRAL BANK INDEPENDENCE

4.1. Is fiscal dominance a threat to central bank independence?

Fiscal dominance is usually seen as the main threat to central bank independence. Fiscal dominance occurs when a government, formally or informally, forces the central bank to finance its deficits. When this occurs, monetary policy is hijacked: the interest rate and money creation are driven by budgetary needs, not by the usual commitment to price stability. This arrangement initially makes deficits painless, which creates an incentive for governments to provide ever more public goods and services without raising taxes, or even while lowering taxes. This is indeed what lies behind all hyperinflation episodes, and even more moderate inflation episodes. These episodes only come to an end when the central bank is given formal independence along with a clear mandate to achieve price stability.

This lesson from history lies at the heart of the Maastricht Treaty. The ECB is formally very independent and its mandate sets price stability as its overriding objective. Any change to either independence or the mandate would require a Treaty change, which must be approved by all member countries. It is most unlikely that such a change will ever be agreed upon. The independence of the ECB is seen as rock-solid.

Why then is the issue surfacing at this stage? The reason lies in the distinction between formal and informal arrangements. The previous section has argued that, once the pandemic is over, fiscal policies will have to remain strongly expansionary and the ECB should keep indirectly financing the resulting budget deficits for as long as needed. This is not a statement about formal independence, but it can be seen as a signal of fiscal dominance as the ECB goes along on its own free will. The result would be that a strongly independent ECB accepts to act in a way that looks like the much-feared fiscal dominance, informally giving up its independence. It would seem easy to reject this possibility, but it is not quite the case.

First, consider the case against any informal threat to independence. The argument for joint expansionary fiscal and monetary policies rests on the need to lift the euro area economy after it emerges deeply wounded from the pandemic, unable to achieve a sustainable recovery without strong policy support. An independent ECB will always be able to continuously evaluate the relevance of this argument. When it considers that the argument is no longer relevant, it will be perfectly free to change its policy stance. In particular, it will be driven by its price stability mandate when it determines that the policy stance contradicts that mandate. For a while, it might look like it has abandoned its price stability mandate but this can only last as long as inflation is below target. In effect, all along, the ECB will remain in full control of its policy stance, even if that means generously financing indirectly the budget deficits of its member countries.

Things are subtler, however. Imagine the case when some countries need to pursue their expansionary fiscal policies for longer than initially expected. Again, Figure 3 suggests that it will be the case of the most highly indebted countries, while the others may already have achieved a sustainable recovery. Inflation will still be subdued in the high-debt level countries but rising in the low-debt countries. As the overall euro area inflation rises, the ECB will want to raise the interest rate and to discontinue its asset purchase programs. This would have two dangerous effects on the high-debt countries. A higher interest rate will raise their borrowing costs and debt service, and the latter would deepen their budget deficits. In this increasingly fragile situation, the end of indirect deficit financing could well trigger a new debt crisis and endanger the stability of the financial system. Even though it is fully independent, the ECB might conclude that a debt crisis would lead to yet another recession, which would reduce inflation. Or, as in 2012, it could fear a breakup of the euro area, nimbly called a risk of currency redenomination. Both prospects could very well lead the ECB to keep interest rates low and to continue to indirectly finance budget deficits. If it successfully manages to prevent a new debt crisis, inflation will rise in the low-debt countries, quite possibly bringing the overall euro area rate above target. In effect, the ECB would become hostage to the high-debt, large-deficit countries. Whether it is a formal or an informal hostage makes little difference. The ECB would be formally independent but informally dependent and subject to fiscal dominance.

This example shows that fiscal dominance cannot be ruled out, even for a central bank that is formally highly independent. Yet, an independent central bank can always carry out its chosen policies. In the example, the ECB has the choice between carrying out a policy that looks like driven by fiscal dominance – keep supporting fiscal policies that are in need for support – or refusing to appear as such and adopt a policy that is risky, possibly opposite to what it prefers – take the risk of a debt crisis.

A safe conclusion is that an independent central bank can take the risk of appearing subject to fiscal dominance. Yet, appearances matter in monetary policy matters. It shapes expectations of future policies, crucially regarding inflation and financial stability. The next section considers what the ECB can do to shape expectations in a stabilising way.

4.2. The ECB needs to update its strategy

The relationship with member governments should be a central concern of the strategy review currently under way at the ECB. The previous strategy was adopted in the late 1990s, and marginally adjusted during the previous review in 2003. The debt crisis has revealed the limits of this strategy, essentially built for quiet times, moderate public debt levels and positive interest rates. The historical situation created by COVID-19 lies even further away from the logic of the 1990s. The existing strategy may remain reasonably well-adapted to normal times, but the strategy review must also deal with unusual times, most of which are unpredictable.

Understandably, political sensitivities have prevented a precise discussion of the ECB's relationship with member governments. Yet, the ECB is unique in that it faces several governments, which it cannot simply follow other central banks' experience. In practice, the ECB has vowed to not look at individual countries, even if some are in crisis, focusing instead at overall euro area information. In order to avoid the appearance of fiscal dominance, it has shunned formal exchanges with member governments and, until the pandemic, it has continuously made statements that call for lower deficits.

Ideally, governments and central banks should coordinate their macroeconomics to achieve their goals. In practice, they rarely do so for all sorts of reasons (Bartsch et al, 2021). It is incumbent on the ECB to adopt a strategy that is reasonable, transparent and widely understandable. Here are a few suggestions.

4.2.1. The inflation target

The "close to but below two" inflation rate target has been criticised over and again for being vague, asymmetric, narrow and too frequently unmet. Hopefully, this definition of price stability will be changed to alleviate these concerns. The debt and pandemic crises raise more complex issues, though.

The crises have shown that it is important for a central bank to be able to use its interest rate instrument, which is more potent that the new nonstandard ones. The effective lower bound, which disables the interest rate instrument, is likely to be reached more often when the inflation rate is low in non-crisis times. There have been proposals to raise the inflation target to modest levels such as 3% or 4%. Central banks have nearly rejected these proposals for good and bad reasons.

Recently, the Federal Reserve has adopted an average inflation targeting (AIT) strategy. The Fed will now aim to reach its target not year after year but on average over several years. Thus, periods of inflation above target will alternate with periods below target.[8] The new Fed strategy reflects concerns about the current situation. Like the ECB and several other central banks, in recent years the Fed has failed to achieve its target and, after the outbreak, it has brought its interest rate to zero. It has indicated that it does not intend to prematurely withdraw its currently accommodating stance, including the indirect financing of federal budget deficits, as suggested in Section 3.4. This is precisely a situation where it might appear to be subject to fiscal dominance. The adoption of the AIT strategy aims at several objectives:

- Bring inflation up. Since inflation has been below target for a while, it now will have to keep it above target for a substantial period of time.
- This, in turn, should make it possible to raise the interest rate away from the lower bound.
- All along, avoid the appearance of fiscal dominance since the strategy does not refer to fiscal policy.

The announced AIT has been criticised for being too vague (in particular, it does not specify over which period the average is to be met) and poorly communicated. As a novel experiment, it stands to be refined and improved, but its objectives well match both normal times and the current crisis situation. The ECB could be well inspired to adopt its own variant of AIT. It would put to rest decades-old criticisms of its target definition and allow it to deal with recovery period.

4.2.2. Financial stability

It has taken some time for the ECB to accept responsibility for financial (markets and banks) stability. Yet, this is an unavoidable responsibility because, when crises erupt, the central bank is the only institution that can instantly mobilise virtually infinite resources by creating money. The ECB has been reluctant to get there for many reasons:

- It does not want financial institutions to bet on being saved from excessive risk taking.
- Inasmuch as institutions from different countries may face different risks, its interventions may end up concerning more some countries than others, which would raise questions of fairness and incentives.
- Since these interventions are inherently risky, the ECB may occasionally suffer deep losses. Indeed, some countries have seen their central banks lose all their capital during dramatic events. How to react to such deep losses and how to recapitalise the central bank would be decided by governments, which could hurt the ECB's independence. Equally concerning is the possibility that the losses would be the result of one country's difficulties and yet they would end up being financed by the other countries.

In many countries, there exist formal agreements between the government and its central bank. These agreements usually set the rules for interventions in financial markets during periods of turmoil, including the terms designed to not encourage risk taking by financial institutions, the respective responsibilities of the government and of the central bank and who will bear potential losses. Such agreements do not limit the central bank independence and they remove the risk of fiscal dominance.

During the financial crisis, in the absence of such an agreement, the ECB did not intervene, leaving the task instead to governments, which had to hurriedly borrow vast sums of money. This has led directly

[8] AIT has long been debated. A recent contribution is Budianto (2020).

to the debt crisis in Cyprus, Ireland and Spain. The fact that there exist more than one government in the euro area does not prevent such a formal agreement, even though it could be more difficult to design. Yet, it is a natural next step after the transfer of the responsibility of bank supervision to the ECB. Such an agreement could take the form of an improvement of the existing bank resolution regime and of the financial market oversight framework.

4.2.3. Relationship with member governments

Even if coordination between fiscal and monetary policies is unlikely to be reached, there is much to be gained from exchanges of information between the ECB and its member governments. It concerns sharing analyses of the economic situation at the highest level (there already are many exchanges at technical levels) and exchange of views on impending policy choices. In the past, the ECB has been reluctant to hold formal meetings with governments for fear that it would be seen a limit to its independence. Two decades down the road, the ECB has established its independence and such fears are no longer warranted.

It is already the case that the ECB President frequently attends high level meetings with governments. Undoubtedly, they must discuss several issues, but these exchanges are informal. Formal meetings (composition, frequency, agendas are not discussed here) have several advantages:

- Difficult issues are not ignored when they are inconvenient, which means when they are important.
- While no policy decisions should be made during such consultations, if only to preserve the independence of the ECB, future decisions can be evaluated with a view of improving them.
- They require detailed preparation at technical and political levels, thus ensuring that all parties have evaluated all issues of collective importance.
- They would allow the ECB to gain a better understanding of national circumstances.

4.3. The ECB needs to issue its own debt instruments

For its monetary operations, standard and nonstandard alike, the ECB buys or sells high-quality assets against money in exchanges with financial institutions. These assets can be government or private debt instruments, but public assets represent the largest part of trades. There are a number of problems associated with ECB purchases of public debt instruments:

- The fact that the ECB stands ready to purchase large quantities of these instruments has long eliminated spreads among debts issued by different countries, irrespective of the riskiness of these debts. After the financial crisis, spreads have started to emerge, leading to the debt crisis. Various interventions by the ECB have followed to eliminate what it called the currency denomination risk. In this way, the ECB has been drawn into specific countries debt risks, opening up the issue of fiscal dominance.
- In order to avoid supporting some country debts more than others, the ECB buys (via the national central banks) country debt instruments in the proportion of each country's share ownership of the ECB. Since national debts considerably vary in size, it is conceivable that the ECB faces the possibility that some countries' instruments are in short supply. This is a serious possibility for the PEPP programme.
- By holding public debts, the ECB faces the risk that a government could default. In that case, as shareholders of the ECB, all other member countries would suffer losses. This consideration has long hampered the management of the Greek crisis.

A simple way-out is for the ECB is to refrain from using national public debt instruments. A solution is for the ECB to issue its own debt instruments, which would become truly European safe assets. It would remove any potential aspect of fiscal dominance and any risk of losses due to national fiscal policies.[9] The down side of this substitution is that the ECB would forfeit its ability to indirectly finance budget deficits, a procedure that has played a significant stabilising role over recent crises. The creation of the Recovery Fund, which allows for the collective mutual support of member governments, is an alternative arrangement, which has the merit of breaking, again, the risk of fiscal dominance. Emergency financing of the Recovery Fund by the ECB could be included in the financial stability agreement suggested above.

Replacing public debt instruments with the ECB's own debt can only be a long-drawn-out process. Indeed, rapid sales of public debt instruments could depress their values, possibly even threatening financial stability. In addition, this is not the time to do it while the ECB is conducting large scale purchases of public debts. Yet, the strategy review is a good time to evaluate this possibility, which would be phased in gradually when normalcy will have returned.

[9] Eichengreen and Gros (2020) make a similar proposal.

5. CONCLUSIONS

The COVID-19 pandemic will leave the euro area economy quite weak. It will be essential that both fiscal and monetary policies remain mobilised to achieve a sustainable recovery. The risk is that governments feel the need to promptly reduce their indebtedness and, maybe, that the ECB quickly attempts to return to normalcy, ending its asset purchases programmes and lifting its interest rate from negative territory, and bringing the inflation rate to its target.

The ECB will have to confront some implications of its very active and welcome actions during the pandemic. Having indirectly financed a large share of new public debts by its member governments, it will have to tread a fine line between its price stability mandate and the need to avoid disrupting debt markets, which could lead to fiscal dominance and, some fear, a loss of independence.

The solution for the ECB is to use its announced strategy review to provide more clarity, both to its objectives and to its procedures. Average inflation targeting stands to help out, particularly at this juncture but in normal times as well. Other proposals concern the need to develop its relationship with member governments and the issuance of its own debt instruments.

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The Covid-19 pandemic will leave the euro area economy quite weak. It will be essential that both fiscal and monetary policies remain mobilized to achieve a sustainable recovery. Having indirectly financed a large share of new public debts, the ECB will have to tread a fine line between its price stability mandate and the need to avoid disrupting debt markets. The solution for the ECB is to use its announced strategy review to provide more clarity, both to its objectives and to its procedures. This includes adopting average inflation targeting, a formal relationship with member governments and the issuance of its own debt instruments.

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