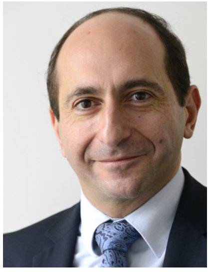
THEMATIC GLOBAL VIEWS

The Eurozone Gordian knot: how to reform the fiscal framework without abandoning fiscal discipline?



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Reforming the European fiscal framework would improve the resilience of the Eurozone...provided that fiscal discipline is not abandoned.

The fiscal rules of the Stability and Growth Pact were temporarily suspended in March 2020 to allow Eurozone states to implement stabilisation policies. They are scheduled to be reactivated in 2023.

For the vast majority of economists, the Stability and Growth Pact framework is obsolete. Let's recall that keeping identical numerical thresholds for each country in terms of debt (60% of GDP) and deficit (3% of GDP) has no theoretical basis. The fixed-debt threshold is a target that has become too far removed from reality for many countries.

The current rules have proven to be pro-cyclical and therefore counterproductive, especially after the sovereign debt crisis. The deficit rule is based on estimates of structural (i.e. cyclically adjusted) deficits, which are by nature unobservable. Different methods are used to assess them, but none of them is unanimously accepted, provoking endless debate. And methodological problems are exacerbated by major recessions.

Even before the Covid-19 crisis, the effectiveness of the fiscal rules had already been questioned and many economists had called for reform[1].

The reactivation of the fiscal rules as they stand – scheduled for 2023 – would lead economies still weakened by the crisis to implement restrictive policies, ultimately proving counterproductive to the sustainability of their debt (with, as a consequence, a further increase in the debt-to-GDP ratio).

In a monetary union, fiscal coordination is necessary...

In a monetary union, it is necessary to coordinate fiscal policies in order to avoid the negative consequences associated with excessively loose fiscal policies by members of the union. If one-size-fits-all rules are no longer appropriate, **a new credible and coherent fiscal framework must therefore be found.** Since the Maastricht Treaty, the European fiscal rules have been amended several times without significant treaty changes. There is therefore no institutional obstacle[2].

- The Covid crisis led countries to implement stabilisation policies that increased their public debt. Ironically, it was the countries with the highest debt levels before the Covid crisis that experienced the most significant increase in public debt.
- **Countries do not face the same macroeconomic constraints.** It is therefore neither desirable nor credible to maintain a single rule.
- **The central issue has become the sustainability of public debt.** Debt sustainability depends fundamentally on the gap between bond yields and GDP growth and on the capacity of a government to maintain a sufficient primary surplus. This type of analysis is by nature country-specific. The analytical framework must be enriched by taking into account a battery of indicators: the primary deficit, the level of the debt-to-GDP ratio, the debt maturity, the interest rates/debt burden, the potential growth.

Too many objectives are assigned to fiscal policy alone

... but the link between monetary and fiscal policy must be rethought when interest rates can no longer be reduced

- **Unconventional monetary policies implicitly call for unconventional fiscal policies.** The current low interest rates (much lower than GDP growth) naturally give governments more room for manoeuvre to implement stabilisation policies or public investment programmes. This is all the more necessary as monetary policy is less effective when interest rates are close to zero.
- **However, Europe cannot abandon fiscal discipline just because interest rates are low.** Interest rates could eventually rise and put the most indebted countries in serious difficulty. The Eurozone member states cannot take this risk. Let us remember that the monetisation of public debt is not compatible with the functioning of the European monetary union, and that it increases the risks of financial instability in the medium term (through the impact on financial and real asset prices).

[1] *Bénassy-Quéré et al. 2018, Darvas et al. 2018, Feld et al. 2018, Thygesen et al. 2018. And more recently, Martin, Pisani-Ferry, Ragot (2021).*

[2] *In practice, states will have to rewrite the core provisions of the Treaty on the Functioning of the European Union (TFEU). In particular article 126 ("Member States shall avoid excessive government deficits").*

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Rethinking the European fiscal framework: abandoning uniform numerical targets without abandoning fiscal discipline

- **The Covid crisis has clearly shown that the fiscal framework was inappropriate.** The new framework will have to provide for aid to states in difficulty in exceptional circumstances (in response to an exogenous shock that does not present a moral hazard).
- **With the NGEU, the Eurozone has taken a significant step towards debt mutualisation.** The appetite for securities issued by the NGEU shows that investors welcome this move. But it should be remembered that this mechanism is temporary. The common debt could certainly be mobilised again in the future in exceptional circumstances. But this assumes that the States continue with structural reforms and do not abandon fiscal discipline.
- **However, too many objectives are currently assigned to fiscal policy alone:** energy transition, financing infrastructure and education investments, cyclical stabilisation.
- Furthermore, the need to distinguish between operating and capital expenditure is often emphasised. Governments cannot avoid the issue of the "quality" of spending. Fiscal discipline must first and foremost focus on "unproductive spending". Investment expenditures must be protected.
- **The establishment of a new fiscal framework requires unanimous agreement.** In order to convince the most virtuous countries, the countries with high debts (Italy, Spain, France) will have to commit to reducing their operating expenses (by committing, for example, to keeping the growth of those expenses below that of GDP).
- **The fiscal framework will need to be sufficiently credible** to ensure that debt sustainability does not rely on the ECB.
- **In practice, it would thus be necessary to delegate to an independent body the analysis of the public finances of each state and the «recommendations» made to governments**. Since sanctions have never been applied, a system of appropriate incentives will have to be found to ensure that these recommendations are applied (e.g. some solidarity mechanisms could be conditional).

Reform needs unanimity, and unanimity is out of reach in the short term

These subjects are by their very nature politically sensitive. The debate has only just begun and rapid agreement is highly unlikely. The current rules are highly symbolic, especially for the least indebted countries, which believe they already made enough concessions when the NGEU recovery fund was set up. A complete break with the Stability Pact and the old rules is therefore not realistic. But European governments can possibly agree to set aside the current rules while a new framework is negotiated.

The next coalition in Germany, probably dominated by the SPD and the Greens, might agree to move in this direction. But the FDP liberals will only agree to give up the current framework if the new fiscal framework ensures a certain discipline. **France, which will take over the EU Council in H1 2022, will probably take the opportunity to put this issue on the table.**

The adoption of a new fiscal framework would improve the resilience of the Eurozone in the event of an asymmetric external shock, thereby enhancing the credibility – and hence the attractiveness – of the Eurozone. **Investors will be more sensitive to the definition of a coherent fiscal framework than to the maintenance of numerical targets which have never been met in practice.** This should encourage governments to reach an agreement, as the credibility of the union is a prerequisite for the internationalisation of the euro, which is an objective shared by all..

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