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Towards a new set of fiscal rules in Europe: an investor view

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Towards a new set of fiscal rules in Europe – an investor view

In the current high-inflation regime, the use of fiscal space must: (1) be rule-based; and (2) preserve the possibility of a cooperative game between monetary and budgetary policies. This use of fiscal space should also help manage investors' expectations, in order to minimise the risk of 'sunspot equilibria', where investors' beliefs cause prices to diverge from fundamentals. We propose a practical roadmap of market-friendly and pragmatic changes to EU fiscal rules that move away from the obvious limits of the one-size-fits-all (or at least overly rigid) old framework. We end with a brief discussion of the potential implications of such new rules for investors.

Part 1: EU fiscal rules before COVID – a journey towards a dead end

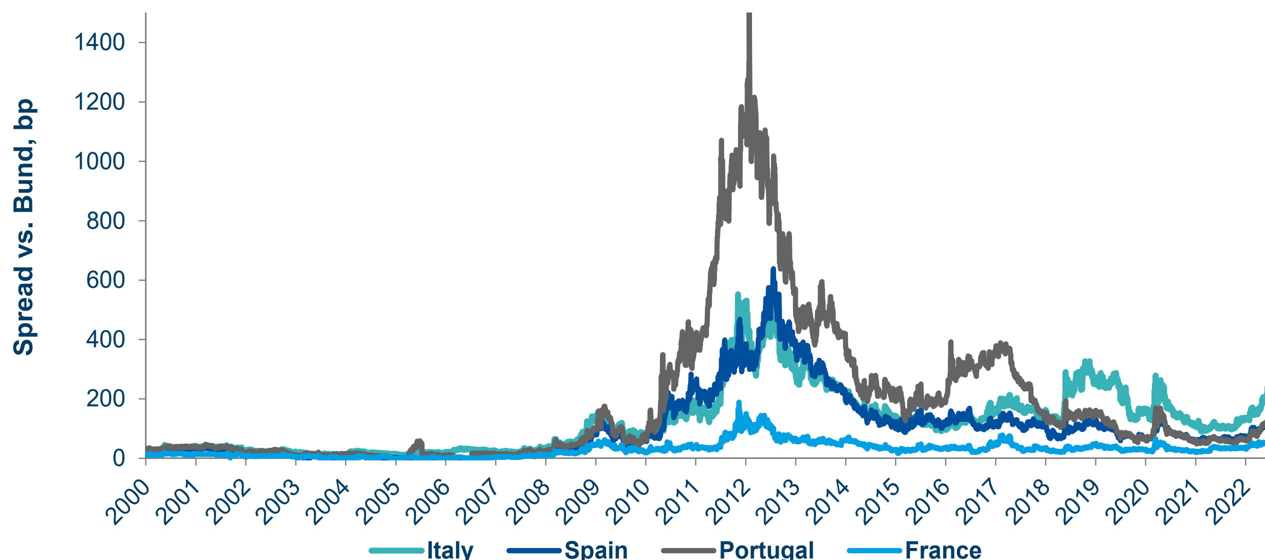
During the first two decades of the euro, investors' mindsets regarding euro sovereign debt rested on at least three series of beliefs. The first (at least at the beginning of the period) was the convergence, over time, of the public debt and deficit situations of member countries. Second, investors also trusted that EU institutions would provide an emergency safety net in extreme situations, as was the case when Greece was on the brink of exiting the Union. Third, investors expected that the ECB would stand ready to compress excessive spreads (as it did through its announced, yet not deployed OMT programme, followed by its effectively launched PSPP and PEPP asset purchase programmes) and act as a lender of last resort, while the union could also move towards jointly issued debt (the Eurobond theme, followed by effective joint issuances within the NGEU framework).

This mindset and investors' corresponding risk-adjusted expectations led to specific market behaviour patterns. Most of the time, sovereign and corporate bonds (and also equities) enjoyed a minimal redenomination risk premium as the probability that a country would exit the union was seen as low. This containment of risk premia led to a preference for relative value strategies over bets on directional market movements. Co-movement and co-integration across member countries' sovereign bonds was strong. Investors arbitraged relative value (notably between BTPs and Bunds) around a perceived equilibrium. The key to such strategies was estimating the maximum yields and spreads that the ECB would tolerate before intervening. They also focused on additional fiscal metrics, notably the primary surplus, as this was a key target assigned to countries for receiving EU bailout funds.

The key to the evolution of each country's spread vs. the Bund was a powerful market-led narrative redrawing the region into core, peripheral and later (specifically for France) semi-core countries. By the mid-2010s, this taxonomy had replaced the former PIIGS (Portugal, Ireland, Italy, Greece and Spain) narrative of the 2011-12 Eurozone sovereign crisis and supplemented the simple North/South distinction.

Moreover, expectations regarding the appropriate policy mix diverged gradually, yet significantly, from those that had inspired the initial fiscal rules. The exhaustion of traditional monetary policy tools (due to policy rates reaching the zero lower bound), against a backdrop of low inflation (and even fears of deflation), led to a growing reliance on fiscal policy, for which debt monetisation and, later, joint debt issuance created new space. Several rounds of different crises (the GFC followed by the European sovereign crisis) also gave way to new political priorities and the definition of new public goods (beyond price stability and fiscal sustainability). These included, first and foremost, the greening of the economy, yet also a reduction in social inequalities and, after COVID and the Russian invasion of Ukraine, a growing preoccupation on European sovereignty under various criteria (such as medical supplies or energy independence, food security or defence).

Figure 1: Ten-year bond spreads vs. the Bund



Source: Amundi Institute on Bloomberg data, as of 4 July 2022.

Part 2: The post-COVID, more inflationary regime creates new challenges

Investors now need to adapt to a new regime of high inflation and uncertain long-term growth prospects, where the de facto cooperative game between monetary and fiscal policy can no longer be taken for granted. This new regime marks the end of the great coincidence of the previous decade, where at least the first two of the three points of the price stability/financial stability/convergence triangle (the three structural targets of the EU policy mix) showed little incompatibility. Indeed, public debt monetisation by the ECB did not carry (at least over the short to medium term) a risk of fuelling intolerable inflationary pressure. On the contrary, so called 'anti-fragmentation' fiscal and monetary tools to compress peripheral yield spreads, and therefore tame financial stress, even helped prop up the value of the euro, further limiting inflation. However, now that inflation has returned, investors must brace themselves for the possibility of several less cooperative combinations of monetary and fiscal mix. There are risks related to the emergence of two, opposite, sunspot equilibria: markets could either expect a new Volckerian moment of extreme monetary tightening to stop inflation rising beyond control, or, on the contrary, they could believe in a 'back to the 70s' scenario, where central banks let inflation (and inflation expectations) run away. Against this backdrop, what will become of the currently suspended EU Stability and Growth Pact (SGP) has become a further cause of uncertainty. While no longer a 'free lunch'[1], significant fiscal space remains. Its use requires rules, yet new ones.

Under this new regime the current SGP rules appear even more suboptimal, both in economic and political terms. From an economic standpoint, the focus on deficits has long been a problematic built-in pro-cyclical feature. Most governments' attitudes towards the rules have become hypocritical, as they hope they will not be fully reinstated for fear this could cause new recessions (even though there is now less of a case that it could trigger deflation). Moreover, repeated rule breaches have damaged the framework's credibility. These failures have exacerbated the ambiguity in their very objective: while they are a tool intended to provide both convergence and financial stability, they achieve neither. As of today, the very pursuit of convergence (the third point of the triangle of the objectives of the monetary and fiscal policy mix) is being questioned as a target. Indeed, several episodes of social tensions and the rise in Eurosceptic political forces have moved the political

[1] *See 'The myth of the fiscal free lunch: beware of the trap. An investor's viewpoint'. Pascal Blanqué, Amundi Discussion Paper, No.53, June 2022.*

pendulum more in favour of national collective preferences, implying that rules need to be more country-specific.

The alternative references adopted by investors have become stronger than ever. While investors had long factored in the presence of QE and the ECB safety net, the Covid support programmes led them one step further in considering public debt issuances and inventories net of ECB purchases and holdings (therefore focusing on the part of the debt that markets need to absorb). The risk of default has therefore become an EU institutional risk, concerning the resolve of the ECB and other EU institutions to safeguard the union, starting with its Germany, France and Italy core. Through this process, financial stability, initially the second objective of the ECB, has been perceived, at least until recently, as its first priority (over price stability) when periphery vs. core spreads were widening too much or too fast. The memories of such expectations gradually formed by investors (and the practices they led to) now constitute a legacy policymakers should build on when designing new rules.

Part 3: Towards new rules

The topic of how to revamp EU fiscal rules has been well researched, both before and after the Covid crisis. Strong ideas have emerged to build a consensus on proposed changes, both in the investor community and in wider society.

Before moving on to the recommendations, a few caveats need to be highlighted regarding debt sustainability and fiscal rules.

Caveat 1: Public debt sustainability is a probabilistic outcome, better assessed using country-specific stochastic analyses. While the standard debt sustainability equation is straightforward ($D_{n+1} = D_n\ (1+r)/(1+g) - ps$)[2], the linkages between its variables are dynamic and complex, including through policy reaction functions that are heavily influenced by each country's political preferences. Notably, the ps component may strongly react to changes in D. Several equilibria are possible and, under some assumptions regarding ps and r-g, practically any debt could become sustainable or unsustainable. A country-specific stochastic analysis, forecasting the probability of various outcomes under different conditions (possibly including stress tests analogous to those conducted in the private financial sector) is the right approach. Indeed, while existing debt and deficit rules are too simplistic, no fixed set of rules would be elaborate enough to guarantee debt sustainability, or even a high probability thereof, under all credible scenarios[3].

Caveat 2: Rules remain necessary. Despite the flaws and lack of credibility of the current rules, the very principle of rules remains an important reference from which investors have gradually built the aforementioned narratives and expectations. It would be challenging for investors, if constrained to forget all old references, to develop new, consistent expectations from scratch. Moreover, abandoning the rule-based framework altogether could lead investors to immediately question the durability of whatever may replace it.

Caveat 3: Rules are preferable to a standards-based framework. A well-known proposal suggests we simply drop all ex-ante quantitative rules in favour of 'standards'[4]. These are defined as statements of general objectives of debt sustainability, qualitative prescriptions that leave room for judgment, and a codified process to decide if the standards are met (including the use of country-specific stochastic debt sustainability analyses). If they are not, countries should then follow adjustment recommendations that would become ex-post legal content. However, this approach has been widely criticised as opening the door to too much flexibility and moral hazard. Moreover, it appears impossible to sell to Northern European countries, even more so within a compromise that would also make room for specific fiscal space to be devoted to the pursuit of European public goods, be they environmental, social or related to sovereignty.

[2] *Where D_{n+1} and D_n are the debt/GDP ratios of two subsequent years, r is the nominal interest rate on the debt inventory, g is the nominal growth rate of GDP and ps is the primary surplus to GDP ratio.*

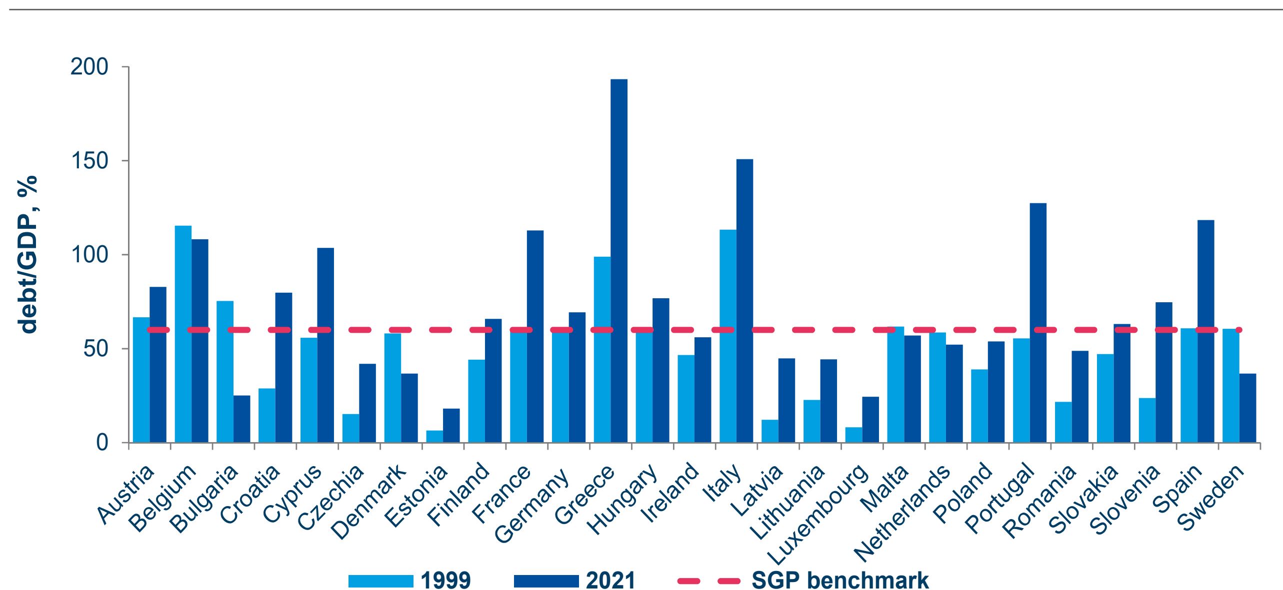
[3] *Such an approach has been extensively described and justified in 'Redesigning EU Fiscal Rules: From Rules to Standards', Olivier Blanchard, Álvaro Leandro, and Jeromin Zettelmeyer, Peterson Institute Working Paper, No.21-1, February 2021.*

[4] *Ibid.*

Caveat 4: Fiscal rules need to be part of a political, institutional and cultural deal, both across countries and within them. Much more than monetary policy, fiscal policy choices, and how they are perceived, have a determining role on many aspects of citizens' lives, and on what they expect regarding their future. Therefore, they should be understandable to the wider public and, to some extent, country-specific.

Caveat 5: Fiscal rules must be politically workable. Specifically, against the current European backdrop, the bar is much higher for changing the TFEU (Treaty on the Functioning of the European Union: the 'primary' legislation) than for changing the legislation governing how rules and procedures provided for by the TFEU have to be implemented (the 'secondary' legislation).

Figure 2: Evolution of EU-27 debt burdens against SGP benchmark



Source: Amundi Institute on Eurostat data, as of 4 July 2022

Factoring these important caveats in, we believe that the EU fiscal surveillance framework could and should be amended in terms of the following rules.

Rule R0: Preserve the existing 'primary' legislation rules. It is essentially the 3% deficit/GDP and 60% debt/GDP rules that are annexed to the TFEU (Protocol 12 on Art.126 defining the excessive deficit procedure) that would be difficult to change. However, they could be retained and interpreted as long-term references only. On the other hand, the 'secondary' legislation (Stability Pact, *Six-Pack, Two-Pack*, and associated regulatory texts), added over the course of the last two decades either to tighten the process or to include flexibility through 'escape clauses', could be modified.

Rule R1: Focus on a spending rule ensuring that public spending does not rise faster than potential GDP growth, and at a slower pace in case adjustment is needed. Such a spending rule would eliminate many of the flaws of the current deficit-based rules[5]. First and foremost, unlike a headline deficit rule, a spending rule based on potential growth is not pro-cyclical. It is also much easier to communicate, and even more so in contrast to those deficit rules that are based on the unobservable and frequently disputed structural deficit metric[6]. In contrast to the aforementioned pure 'standards' approach, a spending rule would also be more politically palatable to Northern countries as it would present a much stronger safeguard against the moral hazard of fiscal profligacy.

[5] *A spending rule is one of the key proposals formulated in the following papers, 'Reforming the European Fiscal Framework', Philippe Martin, Jean Pisani-Ferry and Xavier Ragot, Les notes du CAE, N.63, April 2021. and 'Reconciling risk sharing with market discipline: A constructive approach to euro area reform', Agnès Bénassy-Quéré et al., CEPR Policy Insight, N.91, January 2018.*

[6] *While potential GDP growth, on which a spending rule would be based, is also an unobservable variable, it tends to be less prone to disputes and large revisions than structural deficit metrics.*

Rule R2: The spending rule should be used in combination with country-specific stochastic debt sustainability analyses determining a medium term optimal debt level and, if needed, an adjustment trajectory. Should no adjustment be required (meaning generally that the long-term primary balance has a strong probability of exceeding long-term r-g), public spending, net of automatic stabilisers (notably non-discretionary unemployment benefit) and net of discretionary tax changes, should not rise more than potential growth. This spending rule could also make room for an adjustment account that would capture limited deviations, and could be drawn or paid down in subsequent years.

Rule R3: Though challenging, excluding some investment in public goods from the spending rule is feasible and should take place. There is a strong case that due to its different implications for the future (as it is assumed to lead to higher output and taxes over the medium to long term), investment spending should be treated differently from current spending, and possibly exempted from fiscal rules applying to the latter[7].

However, it cannot be denied that such a distinction would open the door to major moral hazard, as governments could claim that many, if not all, forms of public spending (including social benefits and various recurrent, non-discretionary public consumption items) are necessary for a better future.

Moreover, to be successful, a public investment strategy usually needs to overcome many more challenges (notably those related to decision-making, such as the choice of projects, sectoral lobbying or the opposition of some vested interests) than just financing constraints. It would be overly simplistic to consider that spending considerable sums on public capital formation could, by itself, be a panacea for increasing productivity, greening the economy or reaching social equality or sovereignty goals.

Yet, notably through the experience of the NGEU, the EU is gradually improving its processes and acquiring experience that should help it better target such funds and tightly monitor their use.

Additionally, through various mechanisms, exemption clauses for public investment could be tied to supply-side reform commitments. Indeed, this is the other indispensable leg (together with investment) of productivity enhancement or public goods-oriented strategies, an imperative for trust between Northern and Southern euro countries, and a necessity for sovereigns to be credible in the view of investors if a monetary or intra-EU fiscal transfer safety net is not to be permanently factored in. Such a process involving reforms could be built upon the one that already exists within the escape clauses from current fiscal rules and the NGEU[8].

In any case, to what extent investment spending should benefit from fiscal rule exemptions would also largely depend on the magnitude of future EU-scale investment schemes, if any, which would already be financing some of the union's long-term policies.

Finally, although more ambitious and raising complex challenges, a solution involving several types of debt at the national level could also be explored, with debt issued to finance EU-approved investment projects enjoying either a senior status or mutual EU guarantees, or both of these features (one possible application of a two-yield curve system for each country).

[7] *A well-known proposal for a Green fiscal pact is outlined in 'A green fiscal pact: climate investment in times of budget consolidation', Zsolt Darvas and Guntram Wolf, Bruegel Policy Contribution, No.18/21, September 2021.*

[8] *The possibility of effective monitoring allowing for exempting some forms of investment from fiscal rules has been described in 'Revising the European Fiscal Framework', Francesco Giavazzi, Veronica Guerrieri, Guido Lorenzoni, Charles-Henri Weymuller, December 23, 2021.*

Enforcement of the aforementioned 'general' rules could be then strengthened through the following control, execution and governance 'additional' rules.

Enforcement rule r1: Strengthen the role of national Independent Fiscal Institutions under EU supervision. The current, though never enforced, sanction process has lost credibility and is largely considered as counterproductive. Indeed, if enforced, sanctions would raise tensions among member states against a backdrop where the sanctioned country would probably already be in a dire economic and financial straits, exacerbating the risk of extreme politicisation of the topic. However, within the surveillance process, there is room to transfer more power, including that of rejecting the budget (at least temporarily) to Independent Fiscal Institutions (IFIs, or 'fiscal watchdogs', already exist yet could be given more teeth) supervised by an EU or EZ institution that would define common methods and processes[9]. A harsher change, which would imply giving the ECJ jurisdiction over breaches of fiscal rules (which is not currently the case) is, on the other hand, not appropriate. Indeed, as a sovereign default or the the need for a very large fiscal adjustment by one country could have major spillovers on others, an intragovernmental process should have the final word.

Enforcement rule r2: EU funds and a two-tier debt system could bring more productive incentives than sanctions. First, a positive incentive could be built by offering fiscally compliant countries privileged access to various (NGEU-like or other) European funding schemes. Second, while it does raise complex issues and requires careful further studies, an elaborate 'blue debt/red debt' principle[10] (another application investigated at the beginning of the 2010s, of a two-yield curve system for each country) could bring major advantages. Under such a framework, debt issued by a country in accordance with EU rules (essentially the debt up to 60% of GDP) would be senior (possibly with some guarantees from the rest of the EU, with room for conditionality and the opt-out of some EU members), while debt issued in excess of these rules would be junior. This would create an ex-ante, built-in and, importantly, non-politicised de facto sanction system. The non-compliant country would automatically be sanctioned by having to pay high interest rates, yet this would be determined by the market and without the need for any ex-post decision by the rest of the EU. In order to avoid increasing the risk of banking crises, disincentives would be created to minimise the holding of junior sovereign debt by the banking system (notably heavy capital requirements and ineligibility as collateral to the ECB's financing operations). Moreover, junior debt would need to be ineligible to ECB QE purchases in order not to cancel out the built-in sanction mechanism.

Enforcement rule r3: An orderly sovereign default process should be set up, notably to bring more freedom to monetary policy. Indeed, accepting and preparing for the possibility of default would go a long way towards limiting how far monetary policy would remain constrained by fiscal dominance, so that it could focus on its primary objective of price stability. An orderly default regime (which, in the case of the aforementioned two-tier debt system, if associated with EU guarantees on senior debt, would only be the case for the junior debt) would also further reduce moral hazard in terms of public spending. This potential change is, however, very related to the broader topics of capital markets union, (notably the bank-sovereign nexus, the reduction of implicit financial repression and the cross-country and cross-sector diversification of portfolio flows), as a large, euro-wide investor base for each country's sovereign debt would help absorb and mitigate the consequences of a default. We note that the two topics of fiscal surveillance and the capital markets union are also related through other channels, such as the necessity to build a more fluid, EU-wide investor pool that could mobilise a maximum of savings if public spending on some forms of investment is to be exempt from the spending rule and must be financed by the private sector.

[9] *On the strengthening of the role of IFIs, see the already mentioned 'Reforming the European Fiscal Framework' paper.*

[10] *Such a scheme has been proposed in 'The Blue Bond Proposal', Jacques Delpla and Jakob von Weizsäcker, Bruegel Policy Brief, No.2010/03, May 2010.*

Enforcement rule r4: The fiscal and macroeconomic surveillance processes should be brought closer together. Fiscal rules are not macro-independent. They have significant linkages with major macroeconomic imbalances that must be checked to ensure the monetary union's viability[11]. Thus, the fiscal and macroeconomic surveillance processes should not be considered separately. As of today, the EU's Macroeconomic Imbalance Procedure is a much less robust process than fiscal surveillance. It has also been heavily criticised for focusing too much on imbalances at country level, and for using standard tools that do not factor in the specific architecture of the monetary union. Notably, a country's current accounts are considered vis-à-vis the rest of the world (euro and non-euro countries added together), while the threshold on REER changes can be hit due to fluctuations of the euro on which individual countries have no control, and therefore this does not help monitor changes in an EU member's relative competitiveness. These tools are therefore unable to address the core (and toxic) problem of the creditor/debtor status that euro countries build over time with each other. Since fiscal adjustment recommendations are likely to have implications for current accounts and (through inflation divergences) relative competitiveness within the euro area, the two processes should be better integrated. For instance, there may be cases where the recommendations for fiscal adjustment should be toned down (or even dropped) in case they increase an already oversized bilateral current account surplus vis-à-vis other euro area member states.

Part 4: Implications for investors – positive for euro assets, through several channels

Not all of the aforementioned changes could easily be made. The focus on a spending rule rather than deficit rules in the way the fiscal surveillance process is effectively conducted (as long as 3% and 60% remain in the Treaties to be considered as long-term targets), as well as a larger use of stochastic debt sustainability analyses seem realistic outcomes when EU fiscal rules are reinstated. In terms of governance, a stronger role for Independent Fiscal Institutions, some positive incentives in terms of access to EU funds for compliant countries, more distinction (one way or another) between current and investment spending, and progress towards a better interaction of fiscal surveillance with the Macroeconomic Imbalance Procedure could probably also be agreed over a one-to two-year horizon. On the other hand, an orderly sovereign default process and a blue debt/red debt system would be more demanding transformations, with many issues to resolve in terms of governance, treatment of legacy debt (a large portion of which is above the 60% threshold in most member countries) and their interaction with other EU schemes (including NGEU debt and the modalities of any future ECB QE programme). Thus, they are unlikely to happen as fast, and may appear as necessary instruments only after another crisis (the usual accelerator of EU or Eurozone integration) demonstrates the need for further architectural resilience building.

Nonetheless, even limited reforms to EU fiscal rules could have implications on the way investors consider the region, in terms of risk premium, the perception of the most likely policy mix and return expectations. First, new rules that would be both more credible and less pro-cyclical should contribute, at least to a limited extent, to reducing the specific risk premium that European assets (public, yet also private sector assets) carry, in comparison to the equivalent assets of other regions, due to the perceived complexity and fragility of EU institutions. Second, by reducing fiscal dominance, and allowing monetary policy to focus on price stability (with some room for counter-cyclical stimulus in bad as well as good times), revamped rules would pave the way for more balanced (even though not necessarily always cooperative) interactions between fiscal and monetary policies. Investors would probably retain, at least for some time, the memory of the old regime, meaning that they would continue to factor in the ECB's safety net function when betting on maximum yield divergence. However, this should gradually fade in favour of a more classic mindset, where they focus again on sovereign issuers' specific economic and financial characteristics. Restoring credibility in the rule-based framework would also reduce the risk that investors generate sunspot equilibria, based on misguided or unstable expectations regarding the EU's response to new episodes of economic or financial stress. Finally, rules allowing an increase

[11] *This view is notably expressed in 'Règles budgétaires européennes: comment atterrir?' Agnès Bénassy-Quéré, DG Trésor, February 2022, which refers to this analysis of the MIP 'The Macroeconomic Imbalance Procedure at the Heart of EU Economic Governance Reform', Willi Koll, Andrew Watt, Intereconomics: Review of European Economic Policy, 57(1), pp.56-62.*

in investment spending, conditioned by reforms, should also, over time, have positive spillover effects on economic growth expectations, and investors' perception thereof in terms of return expectations. From a sectoral standpoint, assets related to new EU public goods and the targets of investment programmes (such as the environment, sovereignty and defence) should also benefit.

Overall, while a revamping of fiscal rules would likely take time to negotiate, probably along the usual North/South dividing line with each side starting from a hard stance, solutions do exist for productive compromises. Such compromises should move away from simplistic views, such as those that defend an outright exemption of investment from fiscal rules, or an outright return to rules as they were. Rather, while avoiding excessive complexity and bearing in mind communication issues, new fiscal rules and surveillance processes should be able to offer a lesser focus on deficits alone, room for country-specific assessment, carefully crafted incentives for member states in all situations (including those where the risk of politicisation of the fiscal issue is high) and the inclusion of the fiscal topic in a more comprehensive macroeconomic surveillance process adapted to the specificities of a monetary union. More ambitious reforms, such as the possibility of orderly default or even a blue debt/red debt system for each country, may also, if very carefully designed, change participants' incentives in ways that would greatly benefit the economic and financial resilience of the region. Agreement on such complex reforms, however, is likely to take a lot more time.

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