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Another attempt to change the eurozone’s fiscal rules

Later today, the European Commission will officially start the consultation process for the discussion on whether and how to reform the eurozone's fiscal rules. Despite all current shortages in the global economy, there is clearly no shortage of ideas and proposals of how to improve the fiscal rules

(L-R) German Minister of Finance Olaf Scholz, President of European Central Bank Christine Lagarde, European Commissioner in charge of Economy Paolo Gentiloni and French Economy Minister Bruno Le Maire

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Over the past 20 years the Stability and Growth Pact (SGP) has been one of the most contentious pillars of the monetary union. When he was president of the European Commission, in 2002 Romano Prodi even declared "I know very well that the stability pact is stupid, like all decisions which are rigid." Since then, fiscal surveillance has undergone many changes, but the SGP is still far from optimal: the annual report of the European Fiscal Board stated in 2020 that the fiscal framework should be reformed without delay.

The eurozone’s economic policy framework was created in the early 1990s, when neutral (real) interest rates were positive, the main risk was excessive inflation and member states of the newly created monetary union possibly running too loose fiscal policies. The construction of the eurozone's framework followed the idea of a strict separation of fiscal and monetary policy, with fiscal policy mainly focusing on solid public finances and monetary policy on cyclical stabilisation. While the debt criterion of 60% of GDP hardly ever proved to be useful or applied, the 3% GDP deficit criterion had become a powerful policy anchor; at least in economic 'normal' times.

With interest rates at zero or even in negative territory, potential economic growth clearly lower than in the early 1990s and structural high investment needs for all governments to finance the green transition, the heat is once again on for the eurozone's fiscal rules. There have been many changes, additions and adoptions of the fiscal rules since the start of the monetary union and much more discussions and proposals on how to do these changes. However, until now, the right balance between longer-term debt sustainability, sufficient fiscal breathing power for unprecedented investment projects as well as rules that are easy to understand and to implement has still not been found.

European Commission will present first ideas for changes (or just a less spectacular start of the consulation procedure)

Later today, the European Commission will present possible ways forward for the SGP and will start a so-called public consultation process. This process will follow the principles of the ECB's public consultations as part of the strategy review.

When talking and discussing about reforms, it is important to keep in mind that some reforms could be implemented without Treaty changes while others can't. In short, changing the 3% deficit and 60% debt criteria would require Treaty changes, while changes to the start or general application of the sanction procedures (the so-called Excessive Deficit Procedure) or agreement on other targets could be implemented without Treaty changes.

Why a reform of the fiscal rules is needed now

At the outset of the pandemic the General Escape Clause, has been activated, allowing member states to deviate from the medium-term budgetary objective or from the appropriate adjustment path towards this medium-term objective, during both the assessment and the implementation of Stability or Convergence Programmes. In 2020 and 2021, this meant that no single country was put in an Excessive Deficit Procedure despite fiscal deficits breaching the 3% limits and government debt exceeding 60% of GDP. This General Escape Clause still applies for 2022, but budgets for 2023 should normally abide again by the rules of the SGP.

Public finances of European countries have strongly deteriorated during the pandemic on the back of the fiscal support measures. If the normal SGP rules are reinstalled, the excessive deficit and elevated debt levels would imply a forceful fiscal tightening in 2023. This would bring back memories of the self-defeating fiscal tightening after the financial crisis, where countries tightening fiscal policy the most saw in fact their debt-to-GDP ratio increase. As such the SGP could be seen as pro-cyclical, while at the same time weighing on public investment, thereby jeopardizing future potential growth and undermining any attempts to finance the green transition.

Reforming the Stability and Growth Pact does not necessarily *imply that fiscal consolidation should be delayed eternally*

However, reforming the SGP does not necessarily imply that fiscal consolidation should be delayed eternally – especially since all European countries will be confronted with structurally higher ageing-related expenditures in the future. Also, the current low interest rate environment, which has greatly helped the servicing of the growing debt burdens, cannot be taken for granted forever. The IMF is therefore pleading for a robust fiscal framework that guarantee debt sustainability and economic stabilisation. Last year, former IMF chief economist Olivier Blanchard and two other economists proposed to replace the fiscal rules in the eurozone by a set of fiscal standards. This should basically allow the eurozone to better balance between debt sustainability, economic stabilisation and increasing investment needs.

Others (like Brussels-based thinktank Bruegel or the European Fiscal Board) came up with proposals to focus more on the public expenditure side; either as a kind of golden rule excluding certain expenditures (for example for the green transition) or by introducing a strict path and threshold for government expenditures.

Another more extreme option would be to simply scrap the SGP, stick to the no-bailout clause and have the ECB only purchase bonds of countries with debt levels below a certain threshold.

What we expect to happen

As member states will have to submit their Stability and Convergence Programs in April, some guidance on how the SGP will be applied will be badly needed. If not, the Excessive Deficit Procedures are likely to be set in motion again. However, it will take time to find a compromise on a new set of rules. On top of that the political situation in a number of countries doesn't help: there is still no new government in the Netherlands and Germany, while there will be presidential elections in [CB1] April in France at a time that the country is holding the EU presidency.

However, the above scenario without new guidance and the start of Excessive Deficit Procedures does not necessarily have to be a bad thing. It could actually give a foretaste of how the entire discussion on the eurozone's fiscal rules will evolve: with a fudge, giving the European Commission gradually more surveillance power. A leading example here is the European Recovery Fund, for which member states had to hand in their national plans which were then assessed (and also guided) by the European Commission. Giving the European Commission more discretionary power to assess which investments can be counted as green investments or growth-oriented investments and which as pure consumption, would solve any disagreement between countries on the right definition. Currently, once a country is subject to the Excessive Deficit Procedure, the European Commission has already a much bigger say in what the country should and shouldn't do. The only problem would be EDPs for highly indebted countries as this would basically mean that these countries will never exit the tighter surveillance by the European Commission. But there it looks as if the emphasis will be on the 3% deficit target, while the 60% debt criterion might be considered less relevant, as suggested by Klaus Regling, the managing director of the ESM.

In any case, as much as an overhaul of the eurozone fiscal rules would currently make sense, any quick agreement amongst member states looks highly unlikely. The current positions are simply too different. In a good European tradition, this normally means that the can will be kicked further down the road by extending the GEC for another year or simply doing as if it would be extended.

With or without official changes to the fiscal rules, expect fiscal policies in the eurozone to remain accommodative for some years to come.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

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