OVER-INDEBTEDNESS: WAY FORWARD

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The reform of the SGP must focus on simplicity and strict enforcement

The Stability and Growth Pact (SGP) is one of the critical elements of economic governance within the European Union. The SGP's purpose is to ensure sound public finances in all Member States in order to guarantee a solid foundation to the Single Currency. Despite ambitious reforms following the sovereign debt crisis, the past years have shown, that even the reformed SGP did not live up to expectations. On the one hand, the interpretation of the SGP continued to be a point of contention between the Commission and Member States. On the other hand, the SGP failed to prevent the build-up of excessive debt levels in many Member States. Even during a relatively benign macroeconomic environment, the debt-to-GDP ratio continued to climb in many Member States during the 2012-2019 period.

The fallout of the Covid-19 crisis has significantly increased already elevated debt levels. The debt-to-GDP ratio in the Eurozone is expected to surpass 100% this year, which is simply unsustainable. While the European Commission has temporary suspended the EU's fiscal framework for the time of the Covid-19 crisis, there can be no doubt that in the medium-term the EU's fiscal framework must be revised.

How could an effective revision of the EU's fiscal rules could look like? To identify what we need to improve, we should look at the most obvious shortcomings of the current framework. Right now, the Stability and Growth Pact is excessively complex and suffers from poor enforcement. A successful reform of the fiscal rules must address these two issues.

The Stability and Growth Pact has become more and more complex over the years. By now, the official handbook on the application of the SGP has grown to an impressive length of 108 pages. This level of complexity makes the application of the SGP unnecessarily complicated and opaque to outside observers. Furthermore, the plethora of exemptions and interpretations provides the European Commission with excessive discretion and has often lead to disagreements with Member States.

When it comes to the EU's fiscal rules, there is value in simplicity.

When it comes to the EU's fiscal rules, there is value in simplicity. Instead of going for a specific rule for every conceivable situation, the SGP needs to focus on a few core principles that are easily understood by everyone involved. Such a streamlined process also implies to refrain from introducing new exemptions (e.g. preferential treatment for sustainable investments).

Currently, the analysis underpinning the stability and growth pact relies heavily on metrics that either have to be estimated (such as the output gap or potential GDP growth rate), cannot be entirely influenced by policymakers (such as the annual deficit as a percentage of the GDP) or are prone to frequent revisions (GDP growth). As result, the process often looks more like art than like an exact science. This causes the decision making to be somewhat opaque and prone to manipulation. Building on the proposals by the European Fiscal Board (EFB), we should therefore move towards a system that focusses on variables that are easily observable and under full control by policy makers. Expenditure growth could therefore serve as the central variable. If the expenditure grows slower than a country's gross domestic product, that Member State should gradually grow out of its debts.

One of the key shortcomings of the EU's fiscal framework is poor enforcement. Despite the fact that there were numerous violations of the reference values - sometimes justified, sometimes less so - the European Commission has never proposed meaningful sanctions. An effective enforcement of the fiscal rules requires a capable and impartial referee though. A Commission that considers itself to be first and foremost a political actor, cannot credibly take that role. Therefore, a comprehensive review of the SGP must not stop at the rules itself, but also look at the institutional framework.

For the fiscal rules to be credible, they must be applied in a fair, objective and equal manner to all Member States. During the past years, the European Fiscal Board has built up a considerable expertise and has proven that it can provide fair and independent fiscal analysis. Therefore, the important task of fiscal surveillance should be progressively entrusted to the EFB, which needs complete political independence for that purpose. To ensure political accountability, the final decision in relation to possible sanctions should remain at the level of EU finance ministers.

Implementing such reforms would result in a significantly more robust and effective fiscal framework.

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Rethinking debt in the current low-interest rate environment

The EU response to the COVID-19 crisis proved that a coherent fiscal and monetary policy coordination can effectively lift the European economy out of a state of emergency. Looking forward, the main challenge is to ensure that these policies continue to reinforce each other in the post-pandemic period, as the premature withdrawal of policy support could hold back the recovery and increase the risk of long-term scarring effects.

To help the European economy survive the pandemic-induced disruption, the European Central Bank (ECB) undertook extraordinary measures to ensure highly accommodative financing conditions, while national governments rolled out a number of fiscal initiatives, complemented by a comprehensive and coordinated European-level response. The unprecedented policy action to counter economic downturn had an impact on public finances – government deficit and public debt ratios increased sharply across the board: the euro area debt-to-GDP ratio is forecasted to peak at 102 % this year before decreasing slightly in 2022.

Despite elevated debt levels, there is a strong case to maintain an overall supportive fiscal policy stance in 2022, in line with the European Commission recommendations. The current low-interest rate environment and the new ECB symmetric inflation-rate targeting strategy enables fiscal policy to act more effectively, as fiscal multipliers are assessed to be greater when monetary policy is constrained by the effective lower bound. In such an environment, fiscal expansion can even improve debt sustainability. If spent in a targeted and prudent manner, the additional fiscal support can contribute to long-term economic growth and competitiveness, thus eventually raising the GDP more than the debt level. A return to the sustainable growth path would also imply smoother fiscal consolidation which will be needed to rebuild fiscal capacities once the European Commission deactivates the General Escape Clause of the Stability and Growth Pact.

The "Next Generation EU" instruments, and most notably the Recovery and Resilience Facility, provide an excellent opportunity for Member States to reinforce growth-enhancing policies and necessary reforms without affecting the sustainability of public finances in the medium term. Targeted use of European Union funds can propel the green and digital transformation, as well as increase convergence among Member States.

Growth enhancing public investment should not be undermined by over-fixation on debt.

Finally, fiscal policy is an important tool, along with structural reforms, that affect conditions shaping the current low real equilibrium interest rate environment. A stronger counter-cyclical fiscal stimulus would not only support employment and income but would help reverse the trend in the equilibrium interest rate and lift the inflation trajectory that has been lagging behind the central bank target for many years. This, in turn, would increase monetary policy space in the future.

Looking forward, efforts to achieve better synergies between fiscal and monetary policies should be encompassed in a revision of the European fiscal framework. The Stability and Growth Pact (SGP) – a cornerstone of the EU fiscal framework – should be more cognisant of the diversity of national public finances, especially given the current debt levels. Over-fixation on debt might be damaging, as the rigid 60 % debt rule could potentially undermine productive public investment to promote future growth. The SGP reform should ensure sufficient flexibility on public investment linked to long-term growth and employment, in particular related to climate change and digitalization.

Furthermore, the SGP should better fit the macro stabilization function of fiscal policy during economic downturns, especially when monetary policy is near the effective lower bound. In the current framework, public spending is constrained by the estimates of structural balance, which has tended to be pro-cyclical. Thus, to increase counter-cyclicality, the expenditure rule may be considered as the main operational target. Once included in the SGP, the stabilization clause would make the EU fiscal policy more effective and counter-cyclical which, in turn, would contribute to a less constrained monetary policy.

The review of the SGP is expected to be resumed by the end of the year and it will offer policy-makers an opportunity to take into account the new reality in which monetary and fiscal policies interact.

We have learnt many lessons from the current crisis, and we must recognize them in order to better prepare for challenges that the future might hold.

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Macro-prudential policy lacks common EU approach

In Nordic countries and elsewhere in Europe, authorities have expressed concern about increasing household indebtedness. We fully share the objective of curbing excessive indebtedness and to be well-prepared for an eventual increase in interest rates. While consumer loan growth has recently reduced, Covid-19 has boosted housing loans as households have cut back spending and become more interested in their own dwellings.

Macro-prudential instruments have taken increasing role in public policies aimed at preventing excessive lending growth and indebtedness. While micro-prudential supervision has been subject to strong integration via the creation of the Single Rulebook and SSM supervision, macro-prudential policies are still largely national. Macro-prudential measures are regulated in the EU via Directives rather than Regulation, leaving room for national discretion, and there is only coordination and consultation at the EU level.

Lack of a unified European approach has created uneven playing field for banks and obstacles to cross-border consolidation, while risking effective macro-prudential policy in the Single Market.

Macro-prudential instruments have been applied at greatly different levels when it comes to anti-cyclical or even structural systemic risk measures, while the differences are not obviously explained by the characteristics of the national financial markets. Unlevel playing field in capital requirements causes differences in the actual capitalisation levels of banks, thus interfering with effective allocation of capital across banks in Europe. Furthermore, when applied from a domestic perspective, macro-prudential policies may not be well-coordinated across national designated authorities, or with micro-prudential authorities, causing overlaps or underlaps in capital requirements.

Coordination between micro- and macro-prudential tools is already well laid out in the EU framework (CRD). Notably, authorities should ensure before applying macro-prudential measures that none of the existing micro- or macro-prudential measures is sufficient to address the identified risk. One risk should be covered by only one prudential requirement and the priority should start from the Pillar 1 requirements, moving then to Pillar 2 and the various capital buffer requirements. Avoiding overlaps is difficult when supervisors have adopted different requirements on Pillar 1 capital models (such as the SSM TRIM), or when the approaches to macro-prudential measures are different.

Lack of a unified European approach has created uneven playing field for banks.

When macro-prudential measures are, for instance, based on lending volumes they easily overlap with Pillar 1 requirements. Also macro-prudential requirements often grow automatically when Risk-Weighted-Assets increase. Achieving a truly level-playing-field would require stronger macro-prudential powers at the EU level. It would also prevent the risk of a 'race to bottom' by national authorities. As authorities exit the Covid-19 relaxations in capital requirements, effective European coordination will become even more topical.

Another important development has been the welcome strengthening of consumer protection standards. These measures, aimed at safeguarding sufficient repayment capacity and remaining income for household expenditures, also limit the possibility of excessive indebtedness. Over-indebted households can have negative implications for the overall economic development as well as they may need to cut spending sharply when becoming unemployed, or when interest rates increase. Consumer protection standards also help safeguarding sound lending practices across banks and non-bank lenders. We have a fully aligned mutual interest with authorities in keeping sound debt-to-service and LTV levels in place in household lending.

In this area too, European harmonisation and coordination would be usefully strengthened. For instance, stress testing clients' debt servicing capability to withstand increases in interest rates is not formally required in all countries, and many practical aspects of the client interaction are not harmonised regarding e.g. 'money at disposal' and income verification requirements. Further, not all countries yet have established credit registries that greatly assist banks in making sure that the overall level of indebtedness of their clients remains in check, taking into account the amount of borrowing from all different sources.

Nordic authorities have tended to be frontrunners in applying the new tools in order to reduce the risk of uncontrolled increase in household indebtedness. This has already been effective in maintaining strong economic and banking sector stability.

At the same time, issues arising from the differing Euro Area/EU/EEA regimes and differences in practices across the Single Market have become visible, supporting stronger European level harmonisation of both macro-prudential and consumer protection standards.

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Regaining fiscal strength post Covid will require sustained higher growth and proactive fiscal policy

One legacy of the Covid pandemic will be the significant increase in debt for sovereigns globally, with most EU countries likely to carry higher debt burdens for years to come. Together with demands for greater social equity and investments to finance the transition to net-zero carbon emissions and a more sustainable economy, higher government debt will shape policies. A combination of robust growth and proactive fiscal policy that unwinds the COVID-related widening of deficits can bring down debt burdens. The key will be achieving these outcomes ahead of the next economic and financial shock, which will invariably come.

Government debt in the EU has jumped by nearly 15% of GDP on average since 2019. By 2025, Moody's expects most EU countries to still carry a higher debt burden than pre-pandemic – with debt levels materially higher for some. And just like before the shock, debt prospects will vary greatly among countries. While Moody's expects that nearly half of the EU members will carry debt burdens below 60% of GDP in 2025, six will likely still have debt levels that exceed 100% of GDP by that time.

Monetary policy will help keep debt manageable by preserving price stability. Already, the average cost of government debt across the EU is around 1.5%. By refinancing at low interest rates, governments will see that cost fall somewhat. However, the monetary policy stance will not drive EU fiscal balances and debt dynamics. Instead, a material and prolonged expansion of QE would probably happen for negative reasons, namely that the economic recovery and, with it, inflation prospects, are much weaker than currently expected. And expanding or even maintaining QE beyond what is warranted to ensure price stability would quickly undermine the credibility of monetary policy, prompting a sharp adverse market response, with a highly negative impact on governments' finances.

Moody's expects that fully unwinding asset purchase programmes will become increasingly challenging, leaving central banks holding a higher share of government debt from one cycle to another. However, deciding outright to either monetise deficits and/or write off some of that debt would blur the respective responsibilities and objectives of policymaking institutions, jeopardising their credibility.

Robust growth and proactive fiscal policy can bring down debt burdens; the key will be to achieve this ahead of the next shock.

Fiscal policy that proactively narrows primary deficits will contribute to bringing down debt burdens. However, a rapid tightening of fiscal policy does not seem to be on EU governments' agenda so far. Rather, political economy and social considerations suggest that primary balances will remain lower than they were pre-pandemic and, for a number of EU countries, lower than the levels that would stabilise debt.

In particular, some of the spending that began or was extended during the pandemic will likely remain in place for years, especially for initiatives that aim to mitigate the income and wealth inequality that COVID has highlighted. Raising taxes is not entirely off the agenda, as indicated by a few noteworthy points of agreement between global leaders, such as the proposal to set a 15% minimum effective tax rate and the G-20's endorsement of carbon taxes as a policy tool. However, none of the more detailed policy agendas of EU governments for the next several years indicate that they will attempt to raise more than a few percent of GDP over a number of years from new or extended taxes.

That leaves higher growth as the primary means to reduce debt burdens. In the years before the COVID pandemic, the role of growth in determining debt dynamics became clear, with a close correlation between changes in debt-to-GDP ratios and real GDP growth. Achieving strong growth will likely involve a clear impulse from governments in the form of public investment.

The EU offers numerous investment opportunities that would facilitate the transition to net zero, strengthen climate resilience and develop a world-class digital economy, for instance. But public investment can be a double-edged sword. As the IMF has shown, sound project selection and execution can deliver growth benefits and multipliers that activate positive debt dynamics.

The opposite – poorly designed and implemented investments – leaves governments and populations worse off financially, economically and socially.

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Fiscal discipline is essential in Europe's Monetary Union

The Covid crisis has prompted governments to roll out unprecedented fiscal initiatives to protect economies and societies. However public debt has increased between 2007 and 2019 at the EU level at a time when the level of public debt was already worrying. In the euro area, the aggregate government debt-to-GDP ratio in the same period rose from 65,9 % to 85,9% - one-third more debt compared to the pre-crisis level. In France, the public debt ratio compared to GDP has increased even more from 64,5 to 98,1% of GDP between 2007 and 2019. In Italy the public debt ratio has grown from 99,8% to 134,7% and in Spain from 35,6% to 97%. However, by contrast, in Germany public debt has decreased from 63,7% in 2007 to 59% in 2019.

We have come to this situation for two main reasons: the ECB's monetary policy has always been ultra-accommodating and the Stability and Growth Pact has not been enforced most of the time over the last two decades. The continuation of very low interest rates during the past two decades has pushed many countries to implement active fiscal policies and economics agents to borrow more. Moreover, negative interest rates have been disincentivizing fiscal discipline and the implementation of structural reforms.

The economic and social consequences of the current Covid-19 crisis are worsening the situation and increasing the heterogeneity of fiscal performance across euro area member states. In the euro area, the ratio of public debt to GDP is now forecast to peak at 102% in 2021 and the fiscal divergences are projected to increase further this year in terms of public-debt-to-GDP ratio. Indeed, seven EU Member States should have their public debt exceeding 110% of GDP in 2021: Greece (208,8%), Italy (156,6%), Portugal (127,2%), Spain (116,9%), France (116,4%), Belgium (115,3%) and Cyprus (112,2%). By contrast, sixteen EU countries will keep their ratio at or below 75% of GDP in 2021. Among them, Germany, the Netherlands and Finland will see their public debt compared to GDP hovering respectively at 72,1% of GDP, 56,8% and 71% in 2021.

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As long as it is not sufficiently understood, notably in indebted countries (France, Italy, Spain etc), that excessive debt is a source of under competitiveness, the economic situation in these countries will continue to deteriorate. Only domestic structural reforms can resolve structural issues and increase productivity and growth. It is an illusion to try to solve the structural problems of our economies by prolonged increases in public or private debt or by using money creation. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that will inevitably pose systemic risks to financial stability and therefore to future growth.

Furthermore, fiscal discipline is essential in Europe's monetary union. The reason stems from the fact that the European Union is not a state and that negative externalities - stemming from questionable national policies - should be considered and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy. Therefore, the need for fiscal coordination and the involvement of a monetary policy of fiscal policies.

Some may think that fiscal discipline is no more indispensable because of low interest rates. This is a profound misconception: interest rates will not stay at zero level for ever and the markets are already showing this. And to base a fiscal framework on the assumption of indefinite low interest rates and monetization of public debt is not consistent with the functioning of our monetary union.

In such a context, the following guidelines could inspire the reform of the Stability and Growth Pact:

- Instead of uniform quantitative fiscal rules, each Member State should outline a specific path for reducing its public debt which would take account of specific local parameters (level of savings, economic potential...) but it should be up to the EU Institutions to discuss and formally validate these plans.

- When the percentage of GDP devoted to public expenditure is too high, it must be reduced and brought closer to the average of the eurozone if we want to achieve a degree of homogeneity in budgetary performance, which is essential for the proper functioning of any monetary union.

- For countries with debt levels of 100% or more, it is essential to maintain their ratings, which requires that public debt be stabilised. The way to do this is to achieve a primary surplus (without taking into account the interest on the public debt) as a number of European countries such as Italy understood before the crisis.

- The quality of public spending should be an important criterion for assessing fiscal policies. Countries that tend to perpetuate very high ratios of public spending to GDP should be discouraged from doing so, and these Member States should be encouraged to maintain investment spending for the future.

- Early warning mechanisms should be put in place to prevent unsustainable public finance trajectories.

If the revised Stability and Growth Pact is not implemented, the result would be an inevitable new crisis of the euro zone...