OVER-INDEBTEDNESS: WAY FORWARD

A Central Bank official compared the discussion of over public indebtedness to when people want to lose weight and try to find the 'magic diet'. In reality, it is about effort and eating less. There was an awareness 10 years ago that the EU fiscal rules may be too complex and consideration of which independent body could enforce states' commitments.

The following three points emerged from this session. First, fiscal discipline is essential in the Economic and Monetary Union (EMU), but the fiscal rules of the Stability and Growth Pact (SGP) have not been obeyed and growth is the only way to repay the debt. Second, the reform of the SGP must focus on simplicity and enforcement and should improve the composition of public finances. Third, a tailor-made system and better internalising of the European framework in domestic systems is essential to achieve an effective EU fiscal framework.

1. Fiscal discipline is essential in the Economic and Monetary Union, but the fiscal rules of the Stability and Growth Pact have not been obeyed; growth is the only way to repay the debt

All speakers agreed that fiscal discipline is essential in the EU monetary union, that the SGP failed to prevent the build-up of excessive debt levels in many Member States and that growth is the only way to repay debt.

1.1 Why do we need fiscal discipline in the Economic and Monetary Union?

An expert stated that there is in Europe a monetary union without a fiscal responsibility at the helm of the system, so some form of fiscal cooperation is needed. If each member does exactly what it wants, the big danger is anarchy, moral hazard and smart spending ones taking advantage of the virtuous economising others. Basing a fiscal framework on the assumption of indefinite low interest rates and monetisation of public debt is not realistic nor consistent with the functioning of the monetary union.

An industry representative emphasised the importance of strong fiscal discipline. Market discipline is slightly forgotten in this discussion. When there is European-level debt, there might not be so much market discipline in relation to the national sovereign debt. But credible debt restructuring might be needed.

1.2 Public debt has increased at the EU level between 2007 and 2019, at a time when the level of public debt was already worrying

An expert commented that the SGP has not been enforced for the majority of the time over the last two decades. The aggregate government debt ratio between 2007 and 2019 rose from 65.0% to 85.9%, one third more debt compared to the pre-crisis level. Eurofi's macroeconomics scoreboard demonstrates that over-indebtedness in several countries over 20 years has led to a reduction in competitiveness and a slowdown in productivity. Governor Knot also demonstrated this during his earlier speech. In addition, the economic and social consequences of the pandemic are increasing the heterogeneity of fiscal performance across euro area member states. if this heterogeneity is not corrected, the existence of the euro would be called into question.

1.3 Growth will be the only way to repay the debt, but the liquidity trap, which is a consequence of persistent very low interest rates, is an obstacle for relaunching sustainable investment

An expert stated that improvements in growth are needed to address this exceptional debt and avoid economic consequences. Growth will be the only way to repay the debt, over a gradual and planned period. The focus on growth and productivity is all the more important given the risk of inflation. When inflation starts, it is very difficult to stop. In the meantime, greenwashing bias is very widespread in the market. Promotion of the green economy relies on public spending and private actors. If low interest rates and too-accommodative policies persist for too long, savers and corporates will fall into the liquidity trap, where savers are encouraged to keep their savings in liquid and non-risky assets and sustainable investment is not relaunched. Persistent low interest rates do not incentivise entrepreneurs and private investors to launch productive investment despite the needs of the climate and digital transition.

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

The key will be achieving a combination of these outcomes ahead of the next economic and financial shock, which will inevitably come. An industry representative stated that governance capacity should be discussed in the context of the next shock. Considering plausible expectations for inflation, interest rates, and fiscal stance, as well as growth, most governments will have a higher debt burden than pre-pandemic by the middle of the decade. Which options are likely to be more successful or politically palatable in the face of the next shock should be considered. Higher inflation would help. There does not seem to be a consensus across Europe to move towards higher inflation as a steady state, in particular because it would harm savers or voters.

An industry representative (Marie Diron) stated that the political economy is not yet tackling expenditure or revenue, instead addressing the health and economic impact of the pandemic, which falls back onto growth. It is surprising how much growth has been put on the EU agenda, combining objectives of creating or reinforcing a green, digitised economy with structural reforms. Reforms in Finland or in other countries in Europe have managed to increase growth on a state-to-state basis. The credit differentiation is likely to come in governments' capacity to channel these resources towards higher growth state to state.

1.5 The Recovery and Resilience Facility: a potential game changer

A policy-maker emphasised the importance of the Recovery and Resilience Facility as the first instrument of macroeconomic scale to combine reforms and investments. Many reforms included in the national recovery and resilience plans can make direct contributions to fiscal sustainability. These include making tax administration and collection more efficient, making public procurement more centralised and professionalised, and reforms to public financial management, particularly in local and regional government.

1.6 A permanent EU fiscal policy would contribute to closing the investment gap with the US

An industry representative emphasised the necessity of sustainable growth to address public debt. Normalisation of inflation is also needed. The EU should be congratulated for its very good handling of the COVID crisis on all policy fronts and the issuance of the joint public debt and the NextGenerationEU (NGEU) programme. The strong EU industrial policy dimension ensures that the money is used for productive, transformational investment in climate topics and digitalisation. The use of the funds in productive investments supporting sustainable growth is the key.

An industry representative commented that it is important to have Nordic buy-in for this EU angle in fiscal policies. More fiscal capacity may be needed at the EU level to ensure the money is used for these productive, transformational investments. A more centralised European fiscal capacity, focused on research and development, closing the gap with the US, and maybe larger EU budgets and common taxes, would be appropriate. Gert Jan Koopman noted that the EU bonds have been very well received and coexist with national bonds. Mutual debt could be used to finance EU-level public goods and investments.

1.7 There is a strong case to maintain a supportive fiscal policy stance in 2022

A Central Bank official advised that, when countries return to a path of sustainable growth, fiscal policies should aim to achieve prudent fiscal positions in the long term. Currently, fiscal and monetary policies are working together to deliver a strong, consistent economic response to the ongoing crisis. When a monetary policy is at its low effective bound, fiscal multipliers play a greater role. Fiscal stimuluses should be spent in a focused, prudent and efficient manner to reduce the indebtedness level.

2. The reform of the Stability and Growth Pact (SGP) must focus on simplicity and enforcement

Presently, the SGP is excessively complex and suffers from poor enforcement. The reform of the fiscal rules must address these two issues.

2.1 Simplicity

An official commented that the rules are complex because they govern a difficult conceptual issue. Fiscal rules in general are difficult in a euro-area context and more so in an EU context. Simplification is necessary and overdue. There are problems around enforcement and governance. The International Monetary Fund (IMF) is in favour of a single debt rule and a single operational rule, favouring an expenditure rule and a single debt anchor. The IMF has not given an opinion on what the debt anchor is, how it relates to the Maastricht or the 60% debt, and whether the 3% deficit is still appropriate or not. if we can move in the direction of simplification with these two rules or two criteria, that would be very substantial progress.

A Central Bank official commented that, in relation to the Chair's metaphor of a diet, there is no perfect form of diet. The problem is probably that the individual is overweight and has an issue. The current European fiscal rules are too complex and rigid. The reason for this is often forgotten and the situation is considered as it is.

2.2 Enforcement

2.2.1 A perennial issue for Europe

An official stated that, despite its imperfections and complexity, the SGP has been beneficial in the context of fiscal outcomes. Not every country has abided each year by the exact criteria of the rules, but the situation would have been worse in the absence of rules. There was excessive austerity at times. A collective judgment of what debt levels are sustainable was not advisable. Going forward, a move to simplicity is vital because it is challenging to understand the rules in their entirety.

2.2.2 Understanding the main shortcomings of the poor enforcement of the SGP

An expert stated that a minimum amount of fiscal normality in the system is critical. Otherwise, the negative externalities will kill the whole exercise. In the past, the fiscal rules of the SGP have not been observed by the large or smaller powers. It is possible that the norms were too simplified and that member countries did not believe in the legitimacy of those norms, perceiving them as artificial, global, and too arithmetic, and therefore did not perceive that they belonged to the system and the rules.

2.2.3 It will not be possible to improve enforcement without a simpler, less complex system

A policy-maker stated that a much simpler fiscal framework is needed to improve enforcement. Whatever fiscal framework emerges in the future must be applied and implemented by all member states all of the time. An agreement on a new and better economic governance framework is needed. The full and proper implementation of the Recovery and Resilience Facility will be crucial. Currently, member states, particularly the member states with the most economic difficulties, have significant funds and transfers to finance the necessary reforms and investments. If these reforms and investments do not proceed now, it is uncertain when they will and how confidence can be built in this area.

2.3 Regarding debt sustainability issue, the sovereign bank loop must still be addressed and a common EU approach for macroprudential policy is required

An industry representative noted that banks hold a great deal of their own sovereign debt. The link between the sovereigns and the banks has still not been addressed, for instance by putting some restrictions on holdings of national debt. The Banking Union aimed to break this link between the banks and the sovereigns. Now that there is also the EU-level debt, breaking this link can be explored. The perception of central bankers is that asset price inflation or the indebtedness issues cannot be addressed through monetary policy, but there are the macroprudential instruments. As Andrea Enria noted, European integration or harmonisation in that field is lacking.

3. The reform of the SGP should improve the composition of public finances

The revised common framework should ensure a composition of public finance that is both growth friendly and sustainable. More importance should be placed on the quality of public spending, rather than its quantity. The question of a special treatment for growth-enhancing public expenditure was also discussed.

3.1 The quality of public spending should be a criterion for assessing fiscal policies

An expert noted that public spending is very important in many economies, and it therefore must be treated with care. It is one of the future rules of the Commission's economic and financial package. 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 a degree of homogeneity in budgetary performance is the aim. Public support is needed for some very-long-term investments in the green economy. The lack of a real EU energy policy or common strategy is regrettable. In such a challenging context, 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.

3.2 Encouraging public investment in all Member States

A Central Bank official noted a Eurofi article for the panel that underlined that investment is only 4% of public spending. There is a margin of improvement to invest more and better, with the quality of investment being key. A huge amount of money is spent for consumption or not growth-enhancing debt.

A policy-maker commented that the previous crisis demonstrated that the first source of fiscal consolidation is public investment. The level of public investment in virtually all Member States is below what is needed to sustain the level of the public capital stock. The level of the public capital stock is being decreased at the time that it should be increased. The fiscal rules are not the source of the problem; they are a choice to be made.

3.3 Certain types of investment could be exempted from the fiscal deficit rule

An official suggested that certain types of investment could, in principle be exempted from the fiscal deficit limit, given the European agenda on climate change and the need for more green investment. But this will not over come fiscal space constraints in some countries. So, in practice governments will need to acknowledge a trade-off between more public investment and current expenditure and prioritize public investment in line with national needs.

A Central Bank official commented that the rules are difficult to understand for the wider public and policy-makers. Growth-enhancing public investments should not be undermined by over-fixation on debt level. A reformed SGP should ensure sufficient flexibility on public investment linked to long-term growth and employment. If this is connected to an important topic such as fighting climate change, digitalisation, or transformation of economies, a green clause could be included. Safeguards would be needed to avoid abuses. The SGP should better fit the macro-stabilisation function of fiscal policy during downturns, especially when the monetary policy is near its effective lower bound. The current framework of fiscal policy tends to be too procyclical. More countercyclicality should be introduced. An appropriately designed expenditure rule could assist in this.

An industry representative commented that whether the reform of the fiscal rules will be effective is not yet known. An alternative would be to try to move towards a more principles based approach, with a common agreement on the principles to apply to a fiscal policy.

4. A tailor-made system and better internalising the European framework in domestic systems is essential to achieve an effective EU fiscal framework

The revised framework should define, on a state-by-state basis and from a medium-term perspective, the budgetary guidelines that best reflect the specific national and Community interests. Finding ways for countries to better internalise the revised fiscal framework in their domestic systems is essential. From this perspective, building a constructive fiscal dialogue between member states and an EU fiscal independent authority that is also in charge of surveillance makes sense. Political difficulties could interfere there, but, if political factors make comprehensive fiscal action at the level of the Union impossible, the problem is a lack of belief in a true European Union.

4.1 An adapted framework for a common discipline

An expert commented that a tailor-made system is needed. This will be more complex than a one-size-fits-all system because the reality of the economic challenges of each country must be understood and accommodated. Each Member State should define a specific path for reducing its public debt and a politically independent EU institution should discuss and validate these plans. A dialogue will be needed between the economists of this impartial EU institution and the national authorities. If the country understands that the measures are reasonable, enacting those prescriptions becomes easier. Increased confidence and trust between the economists in charge of this supervision and the national authorities will improve enactment and application of the system. A fiscal authority, comprised of economists of good economic and academic backgrounds, would add credibility.

A Central Bank official suggested that this independent, honest, trustful body could be the European Commission.

4.2 Domestic fiscal choices are domestic and political issues, which complicates action at the EU level in this area

A policy-maker commented that an independent fiscal board can play an important role in critical elements of a fiscal survey for ensuring fiscal sustainability. However, the critical choices around the composition of public expenditure, the designed tax system and distribution are fundamentally political. There is a role for independent fiscal authorities in certain aspects of the fiscal surveillance, but, ultimately, many of these choices are political. Consensus and trust in bodies like the European Commission and the European Fiscal Board (EFB) is very important. Member states need to have confidence that their counterparts are going to adhere to the commitments that they entered into.

An official emphasised the importance of the political aspect. The IMF's record in Europe, or elsewhere, of persuading countries to pursue structural reforms for growth, sustainability and such is not stellar. The IMF works very closely with the Commission on its country-specific reform recommendations, and its experience is similar. The issues are largely political. Debt levels have been very high in many industrial countries across the world from the 1950s onwards. Debt came down from these high levels because of growth, not because of austerity, fiscal consolidation, belt tightening, or extreme diets. And higher growth requires countries to pursue reforms more consistently.

An industry representative suggested that an economic reform board might also be needed. This body would dispassionately outline the conflicts of interest, namely on reforms, and demonstrate with examples what could be done, considering the political constraints. The board would aim to be transparent about the social and political hurdles to reforms.

An industry representative agreed with other speakers that there is a very bad track record in public spending expenditure and not generating productive investments. A European fiscal authority might be too ambitious an approach at the present time. Instead, industrial policy could be coordinated, while retaining the national debt and coexisting policies.

4.3 If it is stated that political factors make a comprehensive fiscal action at the level of the Union impossible, there is a lack of belief in a true European Union

An expert commented that, if political factors are blamed and considered as impossible for making a comprehensive fiscal action at the level of the Union, there is a lack of belief in a true European Union. The reactions of the panel to the very modest proposals around a fiscal board and an adapted framework are disappointing.