WHAT ECONOMIC GOVERNANCE IN THE EURO AREA

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The reform of the EU fiscal rules: time is of the essence

Over the past 15 years, the euro area has been confronted with several crises. Unwavering determination, new tools, institutional reforms, and an increasing degree of solidarity have helped the euro area overcome these crises and become more resilient.

Following the severe pandemic-induced recession, the euro area experienced a strong economic rebound before waking up to the horrors of war at its doorstep. Beyond the unbearable human toll it has been engendering, the war on Ukraine has also significantly exacerbated inflationary pressures that had emerged during the COVID-19 crisis. Despite this new shock, the euro area narrowly escaped a new recession.

Even so, challenges remain. While headline inflation is receding, it remains elevated and core inflation has remained uncomfortably sticky. Both the pandemic and the energy crisis have required substantive fiscal stimulus, thereby augmenting public debt. In the short-term, this increase doesn't pose an imminent risk, as governments have been able to lock in their refinancing at very low rates during an extended period. However, as interest rates go up, vulnerabilities will increase over time.

While economic policies did reinforce each other during the pandemic, the current economic context necessitates a new alignment between monetary and fiscal policies. Government spending needs to remain in check to avoid undermining the effective transmission of monetary policy. In the same vein, prudent fiscal policies are imperative to safeguard debt sustainability over the medium-term.

Against this backdrop, the ongoing reform of the EU fiscal rules is crucial. With the general escape clause phasing out by the end of this year, time is of the essence. Reverting completely to the old set of rules would entail a clear risk: imposing an overly ambitious consolidation path on countries with higher debt level and thereby confronting them with unwarranted economic hardship. This would not only weaken these member states, but also the euro area as a whole.

The future fiscal framework will need to include several features so it can better serve its purpose:

- First, it will have to be transparent. Making rules less complex automatically leads to increased transparency. In this regard, setting targets in the form of simple and observable variables that are under the direct control of governments would help considerably.
- Second, the framework needs to gain in credibility. Once agreed, all parties will have to abide by the rules. If not, trust in the system will be undermined and fail to send reliable signals to the markets.
- Third, the reformed framework should be based on the clear tenet that any debt consolidation path should reconcile both stability and growth. Both should go hand in hand. This would foster ownership and generate superior outcomes.
- Finally, the emphasis should be on "sustainable" growth, as sustainable growth constitutes a strong foundation for stability.

The European Commission's communication on orientations for a reform of the EU economic governance provides a good basis for discussion. The proposal incorporates many of the features that policymakers, academics and analysts have been calling for in recent years. It represents a welcome step forward with its medium-term orientation and the move toward observable fiscal variables.

The consideration of members states' different starting points and the possibility to lengthen adjustment paths by up to three years to implement reforms and make investments are also welcome. Yet, such reforms and investments should be well-planned and growth-enhancing to justify longer adjustment paths.

This reform is critical from the standpoint of the ESM because it has several implications for its work.

First, debt sustainability, which is central to the Commission's proposal, is at the core of the ESM's work. Unsustainable public debts put at risk financial stability, the safeguard of which is the ESM's primary mandate. Furthermore, access to ESM financial assistance, particularly its precautionary credit lines, is tightly linked to criteria related to EU fiscal rules. Finally, the ability of the ESM to track countries' ability to repay their ESM loans – the so-called early warning system – is inextricably linked to post-programme surveillance, which is also addressed in the Commission's communication.

Agreeing on a reformed fiscal framework that strikes the right balance between sustainable growth and stability is key to make the euro area prosper and become even more resilient. The coming months present a unique window of opportunity to do so.

VINCENT VAN PETEGHEM
Minister of Finance, Belgium

Towards a tripartite framework: with debt reduction, investments, and reforms

The European budgetary rules have been temporarily put on hold due to the severe energy and purchasing power crises, allowing Member States to support households and companies. But starting in 2024, we will again fall under this EU framework.

Thirty years ago, the Maastricht Treaty created those debt and deficit rules. Because a monetary union without a full-fledged budgetary capacity, requires at least some stringent budgetary coordination.

But up to now, those European debt rules have not been a great success. The major starting point of those rules was its countercyclical nature: building up buffers in good economic times that can be used during economic downturn. However, recent decades do not show this in practice. In periods of economic prosperity, we did not build up sufficient buffers. And after the 2008 financial crisis Member States put in place austerity measures, that additionally caused a drop in public investment rates.

So the existing European budgetary rules did not work in the past, and would not do so in the future. Because these rules do not take into account the different foundations on which our economies are built. They do not recognize the heterogeneity of economic and fiscal performance between euro area countries. One-size clearly does not fit all, when it comes to debt reduction trajectories. Moreover, the budgetary rules are not adapted to the current macro-economic environment. The average public debt ratio of euro area countries has been close to 100% of GDP over the last years.

The European fiscal framework sets the pace (1/20th rule) at which Member States must reduce their debt levels to the 60% benchmark (the average when the rules were created in 1992). For many Member States, that pace is far too high, making compliance unachievable. In order for the rules to be applied, they should at least be realistic.

Therefore, more than ever, a thorough reform of those rules is needed.

Of course, the starting point of the European fiscal rules remains unchanged: we need sustainable debt ratios in the medium and long term. This should ensure the smooth functioning of our monetary union, and ensure governments find funds on financial markets at reasonable rates.

But the current rules did not manage to keep debt ratios under control. The current focus is too one-sided. In addition to a healthy budget, we also need a strong economy. Productivity and future economic growth - through investments and reforms - must also have their place. Because those also have a positive effect on future debt levels.

In order to incorporate reforms and investments into the European fiscal framework, I plead for a commitment-based approach which could be based on the RRF mechanism. Member States could set up a package of investments and reforms according to their country-specific needs. This could create more ex-ante flexibility, by giving governments the possibility to extend their debt reduction trajectory, in exchange for this package of investments and reforms. But ex-post, this RRF mechanism will also enhance compliance, due to strict control of this package.

We need a tripartite budgetary framework with a focus on debt reduction, investments and reforms.

The eligible investments allowing for a prolonged debt trajectory need to be of high-quality and should be growth-enhancing. This requires a clear labelling of investment, preferably by independent EU institutions such as for example the European Fiscal Board. Moreover, those 'labelled' investments would need approval by the Member States. This more country-specific approach will not only create more ownership for Members States, it will also encourage Member States to see debt reduction, investments, and reforms as one package for increasing the resilience of their economies.

Therefore, our future budgetary framework should shift away from the one-sided focus on debt reduction, towards a tripartite European budgetary framework with a focus on ánd debt reduction ánd investments ánd reforms.

GINTARĖ SKAISTĖ
Minister of Finance
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The new fiscal framework should help overcome EU's challenges

In today's environment, marked with russia's unjustified war against Ukraine, ensuing inflationary pressures, lasting negative effects of the pandemic, risks stemming from climate change and other challenges, review of EU fiscal framework may seem as a rather technical issue. Yet it could not be further from truth. Revision of the European fiscal ruleset could and should become part of the solution to these numerous challenges – enabling governments' response in terms of enhancing resilience and growth potential of our economies, while safeguarding the overarching objective of fiscal sustainability.

With the challenging landscape, there is room for optimism. We see that in principle agreement on key pillars of the economic governance review proposal put forward by the Commission is emerging. The proposed new framework is rightly focused on a risk-based approach, with the central aim to boost domestic ownership. It also outlines a delicate balance between incentives to implement growth-enhancing reforms or investments, and commitment to credible debt reduction paths in high debt Member States. The fine line between tailored country-specific solutions and multilateral character of the fiscal framework still needs to be drawn, but the direction of travel is overall appropriate.

In this regard, a key issue is to ensure that the reviewed framework does not leave low debt Member States beyond the radar screen. A strong preventative element is needed in the system, in order to prevent unwarranted build-up of debt levels. Otherwise we face a risk that in several years' time the currently low risk countries may jump into the medium or high risk basket. This would not be the envisaged outcome of the economic governance review. Having said this, it is important to ensure that national Governments retain the right to decide on concrete policy instruments and their design, as long as the agreed fiscal targets are met.

Furthermore, a differentiated framework brings risks to transparency and equal treatment of Member States. To mitigate these risks, transparency is key, as it helps build trust. Especially, given that the new system would likely be based on debt sustainability analysis (DSA) as its key pillar. It is crucial to ensure that the underlying DSA assumptions are clear and agreed upon in advance, with the exercise itself replicable. In this regard, a stronger role for the European Fiscal Board should be explored. For instance, it could provide an independent verification of the DSA, which would form the basis of Member State's fiscal path.

No matter how well designed rules are on paper, if we do not implement them in practice, we will not reach the envisaged effect – be it increasing long-term fiscal sustainability or enhancing resilience and growth potential of our economies.

In this respect, effective enforcement is critical. We need to de-stigmatise financial sanctions and not be afraid to use them. Also, a higher degree of automaticity in applying the sanctions is necessary – especially if a Member State deviates from the approved (extended) fiscal adjustment path or fails to implement the agreed reforms.

Guarding against an existential threat cannot be lost in scrutiny of debt sustainability.

Finally, while providing de facto more room for growth-enhancing and green investments, we must not forget about the current geopolitical context, which dictates the need to invest heavily in boosting our defence capacities. Guarding against an existential threat cannot be lost in scrutiny of debt sustainability. This new reality must be reflected appropriately in the new framework.

To conclude, we have to aim for transparent and realistically applicable fiscal framework leading to fiscal sustainability, including through growth-enhancing reforms and investment. We are on good track and I see all preconditions to complete this review by the end of this institutional cycle.

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A new economic governance framework: finally playing by the rules

Even before the pandemic crisis, the fiscal position of EU member states was quite heterogeneous. Countries entered the recent difficult years with different levels of government debt and deficit. There was thus very different fiscal room for manoeuvre to cope with some common, but also some quite diverging challenges.

For a long time, financing conditions were favourable due to a low interest rate environment. The window to buy time for reforms and adjustment to enhance resilience and create buffers is now closed again. The ECB cannot raise interest rates as vigorously as it would like in its fight against high inflation because it has to take account of countries with high debt levels. But what is even less feasible is to lower the rates, at it would risk de-anchoring inflation expectations.

Fiscal policy has sometimes relied too much on "low for long", which reminds us that fiscal and monetary policies must always be well coordinated. And the inability to properly co-ordinate on measures to cushion the energy price hike has its roots also in the General Escape Clause.

It shows that a fiscal framework that ensures the sustainability of public finances is a key element of the economic architecture of the EU. Alternative narratives have not passed the reality-check. High deficits did not buy-in voters, nor markets.

With the presentation of the European Commission's ideas for a new EU economic governance framework last November, we have entered into concrete and intensive negotiations on a new Pact, taking into account shortcomings of the current framework. As the ECOFIN Council Conclusions of mid-March say, we still have a lot of work to do and further clarifications and discussions are needed.

And that brings us to what I see as the key points for a possible reform of the Pact and for further clarification:

My first point concerns the agreement already reached by the Council to maintain the 3% deficit and 60% debt reference values. I am very satisfied with this agreement. These two targets are important reference points that are easy to communicate and clarify the direction in which public finances must move.

My second point concerns the proposed possibility of extending the consolidation period if reforms and investments meet certain criteria. It will be important to work out clear criteria to distinguish between productive and sustainable investments and those that are not. We have to take a holistic view, because it is not only the amount of public investment that counts, but also the "right investments" and the institutional environment. We should also focus more on the composition and quality of our budgets and transparency as regards implementation. For structural reforms, that are certainly urgently needed in many countries and areas, it is important to ensure that they are implemented at the beginning of the adjustment period. In a new framework, we should generally adopt the approach of performance first. Not first the reward for a promise that may never be kept.

Third, it has been and remains one of our central demands that we only agree to more flexibility, if enforcement is strengthened at the same time. After all, the weak enforcement of the Stability and Growth Pact in the past is one of the main weaknesses of the current fiscal framework. The design of a fiscal framework is essential for shaping expectations of politicians and market participants. No less important is the actual enforcement of the fiscal requirements. To ensure maximum compliance, the actual Pact is equipped with a sanction mechanism. But so far, no fiscal sanctions have been imposed. We need to define more "effective" sanction rules. I can well imagine that we will reduce the size of the fines to make them politically easier to enforce. And we certainly also need to improve enforcement mechanisms.

We have to play by sound and enforceable rules again. The sooner, the better.

My final message is about the special role of common fiscal rules for the euro area. I am generally in favour of stricter rules for euro area countries, with a focus on those with very high debt ratios. As regards the future of the Economic and Monetary Union and the repeated demand of the ECB and others, namely the establishment of a central fiscal capacity, I am very sceptical that this will solve our problems. If we use the enormous financial resources of the Recovery and Resilience Facility effectively and efficiently, and if all EU countries adhere consistently to the common EU fiscal rules, then we will not need a common borrowing capacity.

In conclusion, I hope that we will soon see concrete progress. It is high time that we start to move out of the vacuum of applied fiscal surveillance that has now existed for several years.