STRENGTHENING THE EMU

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Three lessons from the last decade

The debate over the economic governance is ongoing for long, and the analyses have shifted the judgement pendulum in the direction of a growing anachronism of the existing fiscal rules and the unfeasibility of the restoration of the pre-pandemic status quo. This is not the first time that a debate on the fiscal rules takes place. The first time occurred about almost 20 years ago, because some Member States, as soon as they were under pressure, did not feel bound to common rules or European recommendations. The second time was about 10 years ago, right after the crisis, when we realized that rules failed as substitute for explicit policy coordination because they were designed to control for the negative spillovers of fiscal profligacy, but not for those of fiscal austerity. This is why the recession after the last economic crisis has been deeper and longer in the Union than elsewhere.

It would be not fair to say that nothing has been done in recent years to address this problem. European institutions acknowledged the limits of macroeconomic governance by issuing the well-known Communication of 2015. The effects of this innovation was positive and important. More growth-friendly consolidation has been favored, and this has not been at the expense of the structural reforms that countries have continued to push forward. We must now capitalize on this experience in this review.

Three lessons from the last decade might be useful in defining a new set of rules.

- The first lesson is that an entirely rules-based approach is ineffective because rules are statics and cannot be updated quickly when unforeseen circumstances arise. Rules that apply only in fair weather conditions end up producing uncertainty. In the end, rather than generating stability, they would generate instability, including by destabilizing expectations.
- The second lesson is that drawing up rules capable of taking into account of all potential future events is impossible. Increasing the number of contingencies leads to highly complex rules which are difficult to apply and easier to manipulate and even circumvent.
- The third lesson is that delegating fiscal policy entirely to Member States constrained only by a set of rules which ignore macroeconomic externalities is no longer possible. The era of "do your homework alone" is over. Member States' budgetary policies must be more effectively controlled and - at the same time - coordinated and harmonized to maintain an appropriate Euro area fiscal stance in order to minimize negative spillovers from national budgetary policies onto other Member States.

The Commission's legislative proposals put forward last April seems to move in the right direction. There are many positive elements, but two of them are particularly important. The first is that the focus has shifted from annual budget to medium-term public debt sustainability assessment. This could potentially amend the anti-investment bias embedded in the current economic governance. The second is that the medium-term public debt sustainability assessment and debt-reduction paths should be country specific, therefore eliminating reference to fixed targets valid for all without distinctions. This will allow to better assessing the future evolution of debt, taking into account of the specific features of each Member States with references to growth, population dynamics, interest rates trend, but also current and future budgetary policies. While conducted at the single Member State level, the debt sustainability analysis should also need to pay attention to the cross-country spillovers and the resulting aggregate fiscal stance of the Union as a whole.

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Debt sustainability risks should be balanced against the cost of adjustment in terms of production, with the explicit goal of averting a debt crisis for the individual Member State and the European Monetary Union as a whole. If we returned to fixed parameters that were the same for everyone - perhaps calling "safeguard" what instead represents an actual "constraint" - then this important innovation proposed by the Commission would inevitably be lost.

New rules must be complemented by a system of safeguards to protect the Union's integrity in the event of systemic shocks. This task cannot be delegated again entirely to the ECB, but must be a commitment of the Union as a whole. If the political will for this tool is not there yet, I am afraid that the new rules, in order to be credible and able to work also with unfair weather conditions, will need again to include enough flexibility.

If we do not have the courage to accept this element as an essential part of our future governance, our efforts in recent weeks risk becoming useless.

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A new fiscal framework strengthening EU's debt sustainability and economic resilience

Over the last decade, the successive crises have led to a substantial rise of public debt in the European Union, fuelled by fiscal policy decisions to mitigate the socioeconomic impact of these crises, but also by subdued growth. This rise has created a potential vulnerability for the sustainability of public finance and the stability of our economies. In the meantime, it has highlighted the inability of the Stability and Growth Pact to provide Europe with a fiscal framework adapted to the 21st century. The uniform stringent rules attached to the SGP, such as the 1/20th debt reduction rule, and its procyclical bias have indeed played an important part in depressing economic growth in Europe in the 2010s: while EU and US growth rates were similar at the beginning of the century (1,7 % for the EU between 2000 and 2009 vs. 1,9 % for the US), the gap widened from 2010 (1,7 % for the EU between 2010 and 2019 vs. 2,3 % for the US).

In this context, the starting point of the reform was to find the right balance between 3 objectives: ensuring fiscal sustainability and supporting growth, addressing the shortcomings of the previous fiscal framework, and taking into account the massive investments needs of the European Union facing the twin transitions.

The political agreement reached by the Council of the European Union on December 20th aims to fulfil these multiple objectives: rebuilding fiscal buffers and reducing public debt, together with tackling our massive investments needs, especially towards climate change, strengthening our defence capabilities, and enhancing our strategic autonomy.

How can the new fiscal framework achieve these objectives?

With the aim of strengthening EU's debt sustainability and economic resilience, the reform is based on three main principles supported by France from the beginning of the discussions, that ensure that these fiscal rules are more credible, adapted to our current economic environment and enforceable.

First, the new rules are based on differentiation. The fiscal trajectories will be designed with comprehensive debt sustainability analyses (DSA) that take into account the specific economic situation of each Member State and reflect ambitious goals regarding the reduction of excessive debts and deficits. Minimum standards in terms of budgetary effort are guaranteed by numerical benchmarks on both debt and deficit reductions. These two elements will ensure economic relevance and credibility for fiscal trajectories, while avoiding the procyclical bias of the previous framework.

Second, the rules take into account the major investment needs that the European Union is currently facing. The successive crises have underlined how critical it is to accelerate the ecological and digital transitions. Russia's war of aggression against Ukraine has been a wakeup call to step up our energy independence and strengthen our defence capabilities at both national and EU levels. By allowing Member States to adjust their consolidation pace when they commit to investments and reforms, the new framework incentivizes the realisation of investments that will shape our potential growth and autonomy for the next century, and thus strengthen the EU resilience.

Third, national ownership is at the heart of EGR. Member States will be responsible for the design of their multiannual fiscal trajectories and their investments and reforms commitments, leading to more political accountability. Furthermore, the rules will be more enforceable because they are economically sounder and already take into account the necessity to finance forward-looking investments, making them more credible.

The economic governance review of the European Union is based on three core principles: national ownership, rules adapted to different fiscal challenges and effective enforcement.

Those principles improve substantially the European fiscal rules and will yield better results in terms of fiscal sustainability and economic resilience. Although not necessarily simpler, the new framework has the advantage of being driven by economic logic instead of a one-size-fits-all approach and being forward-looking. In the end, it is not the fiscal framework by itself that will determine the sustainability of public finances in the future, but the willingness of each Member State to abide by its rules and act accordingly. In this respect, reaching a compromise at the Council level in a timely manner has stressed the Member States' willingness to better coordinate their policies, improve the functioning of the monetary union and reach our common strategic goals. Negotiations with the European Parliament are now underway, with the aim conclude a final agreement ahead of the June 2024 elections.

To conclude, it is important to remind that fiscal rules are only one piece of the toolkit to improve the functioning of the European Union. France's view is that more work is required to reflect on additional EU-level instruments to foster the double transition and ensure the transformation of European economies. NextGenerationEU and its main instrument, the Recovery and Resilience Facility, has been a key milestone in this regard. The EU has now the relevant scale to play a key role in coordinating and stimulating productive investments, which must be combined with ambitious strategies to further deepen the single market, to boost economic growth and reap the full benefits of European integration.