Public debate on the review of the EU economic governance

Bundesbank contribution,
22 December 2021

Questions

1 **IMPROVING THE FRAMEWORK** 2
2 **SAFEGUARDING SUSTAINABILITY AND STABILISATION** 4
3 **INCENTIVISING REFORMS AND INVESTMENTS** 6
4 **SIMPLIFICATION AND MORE TRANSPARENT IMPLEMENTATION** 8
5 **FOCUS ON PRESSING POLICY CHALLENGES** 10
6 **LESSONS FROM THE RRF** 11
7 **NATIONAL FISCAL FRAMEWORKS** 12
8 **EFFECTIVE ENFORCEMENT** 13
9 **INTERPLAY BETWEEN THE SGP AND MIP** 14
10 **EURO AREA DIMENSION** 15
11 **NEW CHALLENGES DUE TO THE COVID-19 CRISIS** 17

Attachment: Deutsche Bundesbank, selected articles from Monthly Reports

1 Improving the framework

<u>Question</u>: How can the framework be improved to ensure sustainable public finances in all Member States and to help eliminate existing macroeconomic imbalances and avoid new ones arising?

<u>Answer Bundesbank:</u>

Main takeaways:

- Sound public finances are important for the stability of the monetary union.
- The Treaty relies on rules but also on the disciplining effect of market reactions. Therefore, it is vital that Member States raise their own funding mainly on the capital market. (See Deutsche Bundesbank Monthly Report, April 2019, pp. 78, attached)
- Fiscal rules should set precise and binding quantitative limits that can create confidence in the sustainability of public finances. (See Deutsche Bundesbank Monthly Report, April 2019, pp. 78, attached)
- Mixing the procedures for fiscal policy and for macroeconomic imbalances is not advisable.

Sound public finances are important for the stability of the monetary union. They ensure that the Member States are individually capable of fiscal policy action and safeguard a stability-oriented monetary policy. Monetary policy could come under pressure to assist fiscal policy if confidence in sound public finances was lost. Within the monetary union, Member States decide on their own fiscal policy. The currently very favourable interest growth differential makes it easier for them to shoulder their debt. However, high debt levels remain a risk to the stability of the monetary union, leaving countries less resilient and more vulnerable. It would be risky to view the currently very favourable interest growth differential as permanent and, therefore, to pursue a strategy of higher government debt levels. A worsening of financing conditions might then quickly erode confidence in the soundness of public finances, with adverse effects on individual Member States and the monetary union as a whole.

Jointly agreed fiscal rules are one pillar that can create confidence in the sustainability of public finances. However, the fiscal rules can fulfil their purpose only if countries choose to adhere to them. In the current institutional setting, the European level cannot determine Member States’ fiscal policy in order to enforce compliance with the rules. In addition to the fiscal rules, the Maastricht Treaty also relies on the disciplining effect of market reactions. Monetary financing and fiscal bail-outs are forbidden according to the Treaty. It is therefore vital that Member States raise their own funding on the capital market and are compelled to stake out a convincing fiscal policy path. Hence, potential risk premia are not a deficiency but are a necessary complement to Member States’ fiscal autonomy and support sustainability of public finances by creating incentives for sound government finances. But, both pillars safeguarding sustainability have been weakened. To strengthen the effectiveness of the governance framework, reform is needed.

In the future, the fiscal rules should set out precise quantitative and binding upper limits defining the bounds within which national fiscal policy can operate. Compliance with these limits needs to be monitored in a transparent manner and, as a result, very high debt ratios, in particular, should fall reliably. Contrary to the current approach, exceptions and scope for discretion should be far more limited. However, countries should have room for manoeuvre as long as they stay within the thresholds. The fiscal path and evaluation of adherence to the rules should be rules based and not be subject to political negotiations. Otherwise, neither governments nor the public will see the rules as a binding fiscal benchmark. Clarity also requires separating the fiscal assessment from procedures relating to macroeconomic imbalances. These two procedures should not be mixed.

2 Safeguarding sustainability and stabilisation

Question: How to ensure responsible and sustainable fiscal policies that safeguard long-term sustainability, while allowing for short-term stabilisation?

Answer Bundesbank:

Main takeaways:

- The basic quantitative requirements of the Stability and Growth Pact should be kept in place.
- The rules should define precise yearly adjustment and correction requirements. These requirements could be operationalised by means of an expenditure rule. (See also contribution to Question No 4)
- An adjustment path for the structural balance of 0.5 PP per year until the MTO is reached does not constitute an undue fiscal effort. Yet it would bring about a sufficient reduction of debt. (See Deutsche Bundesbank Monthly Report, April 2019, pp. 78, attached)
- At the same time, it is possible to conduct stabilisation policies via national rainy day funds (See Deutsche Bundesbank Monthly Report, April 2019, pp. 82, attached)

Any reform of the European fiscal rules has to uphold their main objective: safeguarding sound government finances. This includes, in particular, efforts to bring down high debt ratios. The basic quantitative requirements currently enshrined in the Stability and Growth Pact are well suited to this purpose. Yet they have been diluted substantially. Improving them is possible with relatively moderate adjustments. At the same time, the rules could be amended to allow more room for active stabilisation policymaking.

The medium-term objective (MTO) and the adjustment path towards it are key and should remain at the core of the fiscal rules. In specific terms, the basic quantitative requirements are as follows: if the debt ratio is higher than 60%, the structural deficit may not exceed 0.5% of GDP, and if the debt ratio is lower than 60%, the structural deficit may not exceed 1% of GDP. For the adjustment path towards the MTO, the benchmark for structural consolidation is 0.5% of GDP per year. Also, when a country is subject to an excessive deficit procedure, it should reduce its structural deficit by 0.5% of GDP per year as a rule. The basic quantitative requirements should apply without discretion.

Adhering to the MTO and the adjustment path towards it brings down debt ratios and does not call for any undue fiscal effort. The associated debt reduction phases could well be very long. For instance, with an initial debt ratio of 150% and nominal GDP growth of 3%, it would take almost 40 years to reach the reference value of 60% if a structural deficit of 0.5% of GDP is maintained. The rules could spell out more clearly that a country that achieves its MTO or adjusts sufficiently towards it is regarded as complying with the debt criterion.

Broadly, the European Commission implemented adherence to the debt criterion in this vein (while the controversial 1/20 rule was not relevant). Still, countries often failed to meet the quantitative requirements for the structural balance. This was largely due to the way in which the European Commission, in consultation with the European Council, interpreted the rules. Exceptions and scope for discretion enabled countries to deviate significantly from the basic quantitative requirements without being penalised. Furthermore, the implementation of the rules was complex, lacking in transparency, and the outcome has been almost impossible to predict.

In the future, rules should define specific quantitative targets that should be used to determine whether a country is compliant. Basing an expenditure rule on the MTO could be an appropriate option, enabling an annual quantitative requirement for the structural balance to be converted into a more practical ceiling for expenditure growth. Beyond a general escape clause for severe crises, there should be no exemptions (see No 4).

At the same time, national rainy day funds could offer greater scope for stabilisation policies. The quantitative requirements of the European fiscal rules are sometimes criticised for being too narrow. There are often calls to allow greater scope for active stabilisation policymaking, for example. In order to have a buffer even where limits are strict, national rainy day funds could be created and utilised. The basic idea behind this type of fund is to build up a financial buffer in good times in order to prepare for “rainy days” ahead. This could be added to the European fiscal rules without permitting additional debt over and above the target path. To this end, the rules would have to allow the fund to be loaded when the MTO is exceeded. This reserve would then free up room for manoeuvre: a country could fall short of its MTO by the amount that it has in credit in its reserve. Pre-filled rainy day funds help to ensure symmetric counter-cyclical policies, i.e. avoiding a ratcheting-up of sovereign debt.

3 Incentivising reforms and investments

Question: What is the appropriate role for the EU surveillance framework in incentivising Member States to undertake key reforms and investments needed to help tackle today and tomorrow's economic, social, and environmental challenges while preserving safeguards against risks to debt sustainability?

Answer Bundesbank:

Main takeaways:

- It may be politically desired to especially protect investment expenditure. However, this could be achieved within the (existing) fiscal limits. There should be no trade-off between investment, green budgets and sound public finances.
- A capped golden rule, tied to the MTO, would not run counter to sustainability. Consideration may be given to relaxing the MTO for countries with debt below 60% of GDP and positive net investment. (See Deutsche Bundesbank Monthly Report, April 2019, pp. 85, attached)

It is often criticised that countries cut investment expenditure in order to comply with deficit ceilings. This is judged to be in conflict with other political goals and also an obstruction to long-term sustainability. The current rules do not set incentives to consolidate by cutting investment expenditure. However, it might be desirable to especially protect investment spending. Golden rules give investment special treatment, and they come with disadvantages as well as advantages. (See Deutsche Bundesbank Monthly Report, April 2019, pp. 83, attached.)

In order to limit the risks associated with the disadvantages of golden rules, it would be important to link them to net investment. This means that write-downs would have to be deducted from gross investment so that additional debt could only be run up for net investment. A pragmatic approach would be to use net government investment as defined in the national accounts. This should be roughly comparable across the EU.

It would also be crucial to set an upper ceiling up to which net investment may be taken into account ("capped golden rule"). This would ensure that deficits and debt ratios remain limited, thus safeguarding the sustainability of government finances and mitigating any problems associated with defining and measuring net investment.

A capped golden rule could be integrated into the current MTO. For instance, a country with a debt ratio of over 60% could be required to provide a structural balance that is at least balanced as a basis. Only if net investment was correspondingly high would it be possible to have a structural deficit of up to 0.5% of GDP (i. e. a deficit of 0.5% of GDP is only allowed if net investment is equal to or above 0.5% of GDP). This would be in line with the current MTO but would also better protect net investment. The MTO of countries with less debt (a debt ratio of below 60%), too, could be graduated as follows: starting from a deficit ratio of 0.5%,

correspondingly high net investment would allow for an additional deficit of 0.5% of GDP. This would resemble those countries' current MTO. Furthermore, net investment could accordingly be factored into the adjustment path towards the MTO and corrections of excessive deficits. Protection of investment would thus also be in place in the consolidation process.

For relatively safe debt ratios below the reference value of 60%, consideration could be given to the option of easing the MTO. To this end, capped net investment could be taken into account in addition to the existing 1% limit. The overall structural deficit ceiling would then be 1.5% of GDP, instead of 1% of GDP.

4 Simplification and more transparent implementation

<u>Question:</u> How can one simplify the EU framework and improve the transparency of its implementation?

<u>Answer Bundesbank:</u>

Main takeaways:

- An expenditure rule could be the operational fiscal target for the MTO and its corresponding precise yearly adjustment and correction requirements. (See Deutsche Bundesbank Monthly Report, April 2019, pp. 80, attached)
- Abstain from exceptions and discretion – except for an escape clause in crises.
- Implementing a control account could prevent an accumulation of systematic failures. (See Deutsche Bundesbank Monthly Report, April 2019, pp. 81, attached)
- There should be no interferece with fiscal policy choices as long as limits are respected.

A frequent proposal in the current debate on reform is the option of using expenditure rules. The suitability of such rules hinges on the underlying fiscal target to be operationalised via expenditure ceilings. Expenditure rules based on unambitious or unspecific targets are not appropriate. Nor is it advisable to set expenditure ceilings for multiple years. Projections for several years ahead are particularly uncertain and could routinely be overly optimistic. If the underlying pace of revenue, for instance, is systematically overestimated, deficits may end up becoming more and more detached from the anchor target. Large consolidation needs could build up and may eventually be perceived as “too large” to follow up on and in the end excused. Furthermore, if expenditure ceilings apply only on average over several years, there is a risk that necessary consolidation may be postponed, e.g. into the next legislative period.

Basing an expenditure rule on the MTO would be an appropriate option. An annual quantitative requirement for the structural balance could be converted into a more practical ceiling for expenditure growth. Both budget plans and their execution could then be measured in terms of this expenditure growth rate defined ex ante. Exceptions should only be made in times of crisis, and no ad hoc discretionary scope should be granted. The rules would be much simpler if only this one indicator were used to determine compliance. Moreover, weaknesses related to using the structural balance as the operational fiscal limit could be avoided. Revenue windfalls and shortfalls would not be a factor in terms of adherence, and the unobservable and frequently revised output gap would be relied on to a lesser degree. At the same time, this approach delivers an unambiguous medium-term orientation. It is crucial that expenditure limits are calculated based on independent projections first regarding macroeconomic developments and second with a view to the quantitative effects of revenue measures.

Combining an expenditure rule (or any other type of rule) with a control account would be a sensible move. A control account could record the margin by which a country misses its target structural position despite being on schedule with its implementation (positive or negative projection errors) and the extent to which it misses its expenditure ceiling. This does not mean that a country would be expected to respond immediately. Positive and negative deviations may cancel each other out over time. However, if the amount on the control account falls below a negative threshold, this should be corrected over time.

5 Focus on pressing policy challenges

<u>Question:</u> How can surveillance focus on the Member States with more pressing policy challenges and ensure quality dialogue and engagement?

Answer Bundesbank:

Main takeaways:

- Make better use of pre-existing options to differentiate between more and less pressing fiscal situations.
- Consider relaxing the MTO for low debt countries (below 60%) with positive net investment.

The existing rules already offer significant scope for differentiation. i) The MTO is more stringent for highly indebted countries. Under the existing rules, the fiscal target of highly indebted countries is not allowed to be lower than -0.5% of GDP. This is to ensure that the debt ratio declines at a sufficiently swift pace. However, if the debt ratio is already below the reference value of 60%, it is possible to have an MTO of -1% of GDP. Consideration could be given to the idea – in conjunction with a capped golden rule – of relaxing the MTO to -1.5% of GDP given a correspondingly high level of net investment (see contribution to answer No 3). ii) Targets missed by more serious margins can attract a more stringent response than those missed to a less worrying extent. The existing rules provide for more palpable sanctions on highly indebted countries. A country with a low level of debt only faces the prospect of a tangible financial sanction if it deviates considerably from the MTO: with a deficit ratio of more than 3% and a subsequent excessive deficit procedure. A fiscal position of that kind can certainly be considered critical, given that the debt ratio would approach 100% even with nominal growth of 3%. For countries already exhibiting high debt ratios, a less significant deviation from the MTO or its adjustment path can have greater repercussions. They could be subjected to an excessive deficit procedure even if they have not yet breached the 3% ceiling for the deficit ratio. This is appropriate given that high debt ratios will only decline distinctly if a more ambitious fiscal position is pursued.

Greater use should be made of the available scope for differentiation. This will be feasible if the Commission and the Council are willing to open excessive deficit procedures for highly indebted countries. In the past, a lenient interpretation of the rules smoothed out the differentiation enshrined in the pact. Going forward, it should not be possible to take advantage of discretionary scope as a way of excusing deviations from the fundamental fiscal target and its adjustment path. Instead, annual fiscal outturns should be measured against the target specified upfront. (An expenditure rule could be useful in this regard, see No 4). Operational targets should be defined clearly enough that no interpretation is needed to discern whether they have been met or not.

6 Lessons from the RRF

Question: **In what respects can the design, governance and operation of the RRF provide useful insights in terms of economic governance through improved ownership, mutual trust, enforcement and interplay between the economic and fiscal dimensions?**

Answer Bundesbank:

It is still too early to judge whether RRF/NGEU has been a success or not. While the plans often appear to be appropriately ambitious, a proper assessment requires the results becoming visible. Moreover, if it is deemed effective at a later stage, it might serve more as a model for MIP than for fiscal limits.

Regarding fiscal policy, the less detailed the instructions are for the budget, the greater the ownership. This would mean merely setting a precise numerical limit but leaving the manner in which that limit is adhered to to national policymakers.

7 National fiscal frameworks

Question: Is there scope to strengthen national fiscal frameworks and improve their interaction with the EU fiscal framework?

Answer Bundesbank:

Some improvements are necessary before independent fiscal institutions (IFIs) could become more influential. Clear rules and precisely defined yearly fiscal efforts are a prerequisite for making better use of additional decentralised surveillance. If the rules are indistinct and implemented politically, IFIs can only add limited value to surveillance.

8 Effective enforcement

<u>Question</u>: How can the framework ensure effective enforcement? What should be the role of pecuniary sanctions, reputational costs and positive incentives?

<u>Answer Bundesbank:</u>

Main takeaways:

- Both sanctions and rewards work as incentives only if they are credible. Credibility requires fiscal limits and procedures to be unambiguous, non-negotiable and predictable.
- Rewards make rules less binding, as adherence may be viewed as an option not a binding agreement.
- Rewards require delicate distributional decisions on how to finance them.
- Ownership is likely to be greater the less interference there is with national political choices.

In both cases (pecuniary sanctions and rewards), a Member State would forego financial resources if it misses agreed targets. This makes it equally difficult, politically, to either impose a sanction or deprive a reward. Hence, fiscal limits have to be unambiguous, and procedures predictable and non-negotiable. Only then will the risk of foregoing financial resources be credible, thus setting incentives to stay within the limits. Shifting from negative sanctions to rewards would be an unfortunate move. If adherence to agreements and rules is rewarded, their perception may change. Member States could view adherence as an option rather than a contractual obligation. It seems likely that this would reduce the rules' binding force. Rewards require delicate decisions on how to finance them. There is not a single right scheme as distributional choices are required.

Ownership substitutes external enforcement to some degree and is probably greater the less European rules interfere with national choices. This calls for setting precise quantitative limits, yet remaining silent on how countries stay within these limits. This should be a matter for national political choices. Moreover, if limits reflect a common understanding of sustainability needs, respecting the limits would also be in each Member State's own interest.

9 Interplay between the SGP and MIP

Question: In light of the wide-ranging impact of the COVID-19 crisis and the new temporary policy tools that have been launched in response to it, how can the framework – including the Stability and Growth Pact, the Macroeconomic Imbalances Procedure and, more broadly, the European Semester – best ensure an adequate and coordinated policy response at the EU and national levels?

Answer Bundesbank:

Clarity requires separating the fiscal assessment from procedures relating to macroeconomic imbalances. These procedures should not be mixed (see answer to question No 1).

10 Euro area dimension

<u>**Question:**</u> **How should the framework take into consideration the euro area dimension and the agenda towards deepening the Economic and Monetary Union?**

<u>Answer Bundesbank:</u>

Main takeaways:

- The euro area could become more resilient by i) severing the nexus between sovereigns and banks, and ii) installing a mechanism for orderly public debt restructuring. Deepening the banking union in this regard would be recommendable. (See Deutsche Bundesbank Monthly Report, March 2015, pp. 22 and Deutsche Bundesbank Monthly Report, July 2016, pp. 41-62., attached).
- The Bundesbank supports further progress towards a capital markets union.
- Common fiscal capacities are frequently suggested. However, analyses need to show why their stabilisation features would go beyond those of purely national schemes.
- Regular common debt would require Treaty changes.

In addition to more effective fiscal limits, there are other ways in which the euro area can be made more resilient. One notable step is to sever the sovereign-bank nexus as far as possible. This is why shareholders and creditors should indeed be comprehensively bailed in when a bank needs to be recapitalised or resolved. Furthermore, as a preventive measure, the incentives that lead to banks holding excessive concentrations of government bonds should be scaled back. This goal would be achieved if banks have to set aside risk-appropriate capital commensurate with the government bonds in their portfolio and if the large exposure limits also apply to government bonds. It would also be helpful to establish a mechanism for orderly public debt restructuring in a crisis situation. The single-limb CACs agreed as part of the ESM reform are useful in this regard. However, it would make sense to add extra clauses to the terms of government bonds of euro area countries. One such clause could provide for the automatic extension of a bond’s maturity as soon as a Member State agrees on an assistance programme. Bond terms of this kind shield the taxpayer and expose investors more to the risks inherent in their investment decisions. The market responses that will probably be induced by the aforementioned measures, in turn, would create stronger incentives to embrace fiscal prudence.

Enhancing and refining the banking union is another way to strengthen the euro area. What is important here is to significantly reduce the existing risks and do as much as possible to prevent them from flaring up again. This concerns, amongst other things, the still-extensive stocks of non-performing loans in some cases and the substantial nexus in some countries between national government finances and the national banking system (sovereign-bank nexus). It would also be important to strengthen resolution regimes (see above).

The Bundesbank supports further progress towards a capital markets union. A deeper and more integrated financial system is highly desirable from a monetary policy perspective, as

integrated capital markets improve the transmission of the single monetary policy to all parts of the euro area. Furthermore, they allow European firms to benefit from more diverse funding sources and make it easier to switch between them. They would also offer broader investment opportunities to citizens and increase private risk-sharing across countries and actors. While complete harmonisation will not be achievable in some policy fields (e.g. insolvency rules), we welcome any proposals in the action plan on CMU that aim to enhance transparency.

Proposals regarding facilities that are designed to balance out at the European level the cyclical fluctuations of economic activity in Member States, e.g. via element of a common unemployment insurance, have been less than compelling, at least to date. In any case, it would need to be demonstrated why the respective targets cannot also be achieved at the national level, without the need to establish complex European mechanisms.

Given the no-bail out clause, permanent common debt for such facilities would require Treaty changes transferring significant political power to the European level. From an economic point of view, it would be particularly important to ensure that the same political power that decides on how funds are spent is held responsible for servicing the respective debt, i.e. power and liability would have to balanced. This is required in order to avoid negative incentives like moral hazard that would be detrimental to the stability of the EMU.

11 New challenges due to the COVID-19 crisis

<u>Question:</u> Considering how the COVID-19 crisis has reshaped our economies, are there any other challenges that the economic governance framework should factor in beyond those identified so far?

<u>Answer Bundesbank:</u>

Main takeaways:

- European debt for NGEU will have to be serviced by taxpayers in the Member States.
- To ensure that meaningful limits are in place for the fiscal rules, common deficits and debt need to be taken into account in the fiscal rules. Therefore, EU deficits and EU debt should be allocated to the Member States. (See Deutsche Bundesbank Monthly Report, December 2020, pp. 37-46, attached)

New common assistance facilities were created as an exceptional measure during the coronavirus crisis. As part of these facilities, the European level will provide Member States with debt-financed funds up to 2026 (in addition to the regular contribution-funded EU budget), resulting in an accumulation of substantial debt at the European level. This debt is no longer funding just assistance loans but also extensive grants to Member States. As a consequence, notable deficits are being recorded at the European level for the first time.

EU debt and deficits mean that national deficits and debt are initially lower. This is the case because a Member State's expenditure is funded not by national borrowing but by debt-financed EU grants. While this improves the national indicators, Member States' financial positions are not any better overall. This is because European debt – on top of the national debt burden – will need to be serviced by taxpayers in the Member States at some point in the future. Instead of interest and principal payments on national debt, there will be larger contributions or tax payments to the EU budget.

Existing fiscal rules that apply to official national budgetary indicators should not be hollowed out. The quantitative requirements would be undermined if deficits and debts were simply transferred to a greater extent to the European level. For the quantitative limits to retain their force, it is vital, first, for the European Commission to collect statistics on government deficits and debt at the European level and disclose this information in a transparent manner. Second, this information should feed into the fiscal rules. To this end, it would be straightforward to allocate European debt and deficits to the Member States (not in the official national accounts, but separately to ensure that the enhanced national indicators can be used in analyses and in the fiscal rules). This would require establishing a distribution key. A country's share of EU gross national income would appear suitable for this purpose, as this will probably continue to be the key metric for measuring a country's share of financing in the EU budget.