Reform of the EU Stability and Growth Pact: Seeking the Golden Mean

Gikas A. Hardouvelis
Chairman, National Bank of Greece
Professor, Dept. of Finance
University of Piraeus

www.hardouvelis.gr

Conference organized by
Hanns Seidel Stiftung and the
Institute for Democracy "Konstantinos Karamanlis"

Athens. February 21, 2022,
16:00-17:15 CET

Reform of the EU Stability and Growth Pact (SGP)

- **SGP is a substitute for the missing fiscal union in EMU**. It is a set of rules on proper fiscal policy so that monetary policy is not over-burdened
- History shows the **European project keeps improving** over time **in small steps** and with continuous compromise
  - Same holds true for SGP
- **Jumps in policy occur only after crises**
  - The **Greek crisis** led to the beginning of the Banking Union, the establishment of ESM
  - The **pandemic crisis** pushed Europe into new fiscal territory:
    - i. Brought a large fiscal expansion, i.e., the implementation of the escape clause in SGP in the face of a large shock
    - ii. Brought a partial mutualization of debt, something that was discussed but did not materialize during the Greek crisis
    - iii. Opens the possibility of the establishment of a "central adjustment account," previously advocated by academics

SGP: A history of fiscal concerns and political friction

- **1992: Maastricht Treaty** sets the **3% deficit & 60% debt limits**
- **1997: Stability & Growth Pact**
  - Preventive arm (1998), Corrective arm (1999). Preventive arm included Medium Term Budgetary Objectives and Expenditure Benchmarks
- **2005**: Renewed discussions of the ideas of:
  - Medium-Term budgetary Objectives
  - Structural Balance
- **2010: European Semester** as an instrument of coordination & governance
- **2011: Six Pack:** Reduce public deficits and address macro imbalances
- **2012: Fiscal Compact:** Budgetary balance into Member States' constitutions
- **2013: Two Pack:** Prepare budgets with common standards and schedules
- **2015: Communication Flexibility**
  - European Commission describes how it will apply the rules of the SGP to strengthen the link between structural reforms, public investment and fiscal responsibility in support of employment and growth
- **2020:** Stability & Growth Pact **effectively suspended**

A post Greek crisis "consensus"

- By 2015, the emphasis was on the structural deficit, as it is less procyclical than the ordinary deficit. Its size was decided to be smaller than 0.5% GDP (and for countries with low debt, 1% GDP).
- Lots of criticism & arguments on …
  - The complexity of new rules, e.g., frequent ex-post revisions of structural deficits as large as 1% GDP, the proper definition of government expenditures, etc.
  - The time-inconsistency of penalties, advocating incentives in their place
- I can loosely summarize this consensus in the following prescription to a member state:

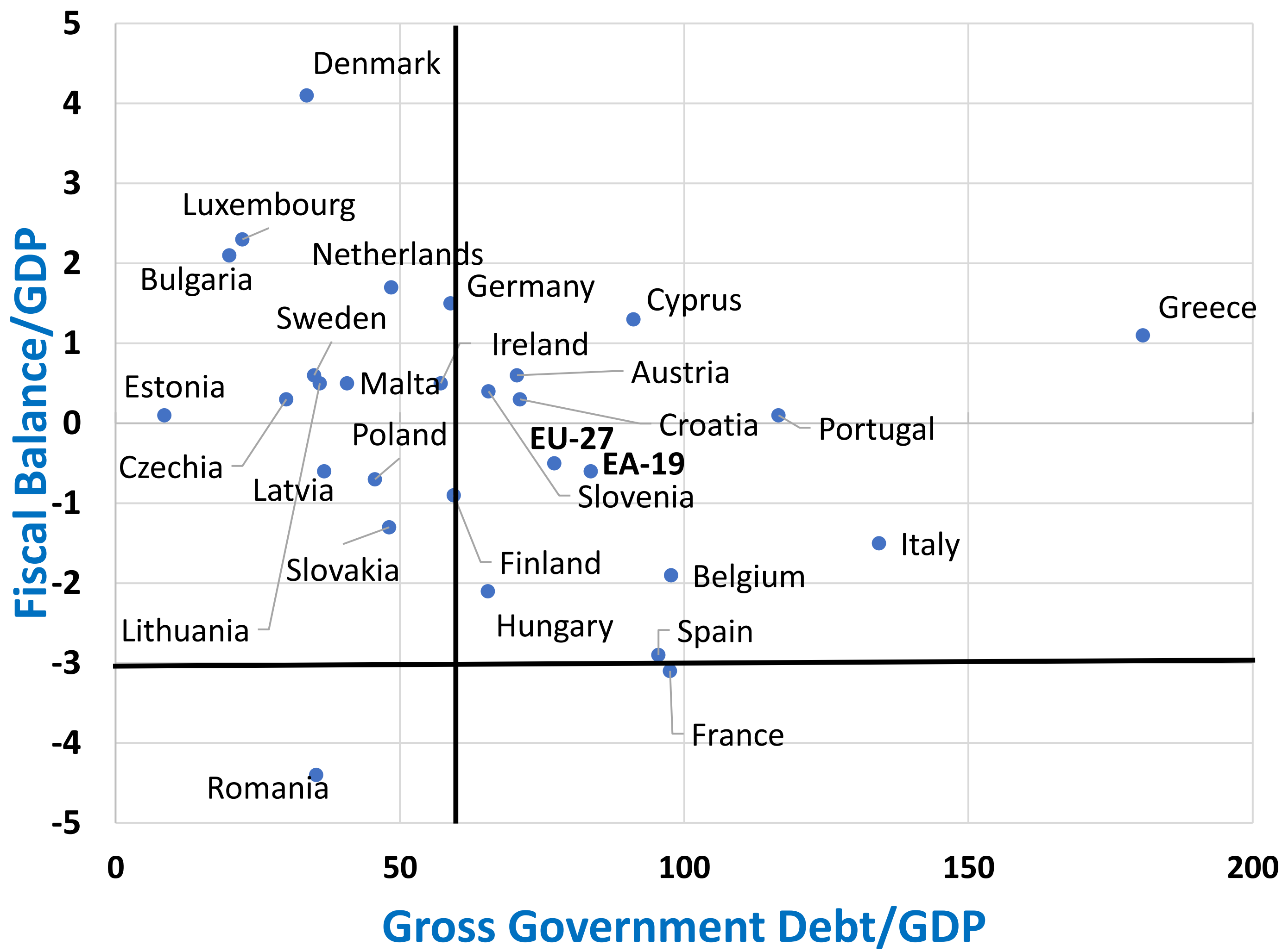
  "Utilize the good times to build a fiscal cushion in order to be able to follow a countercyclical fiscal policy on your own if a negative shock were to occur in the future"

  If the prescription is followed, then there would be no need for a central fiscal mechanism to do the fiscal stabilization, unless the shock is very large

European fiscal picture just before the pandemic

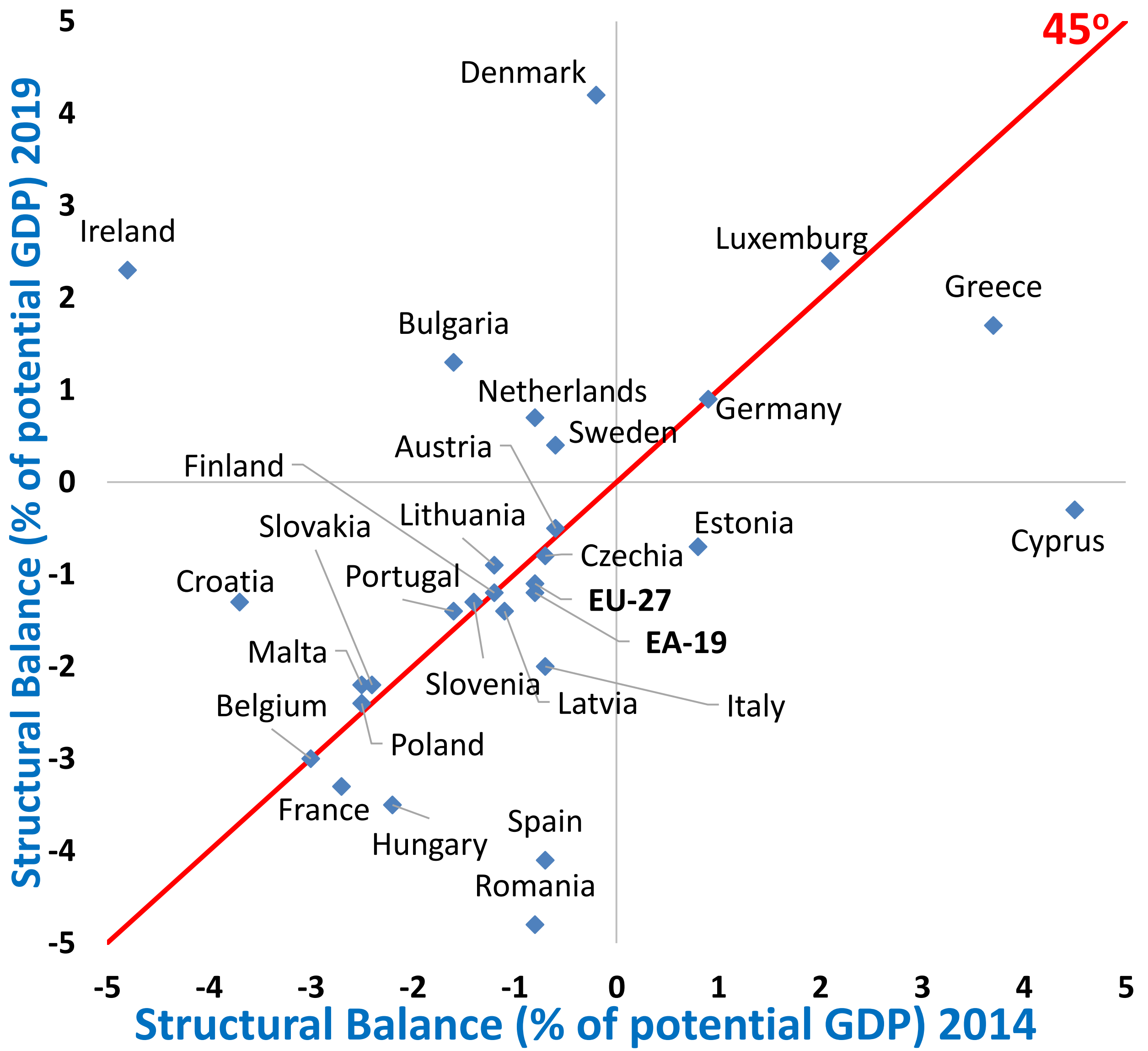
- ❑ In 2019, most countries **observed the Deficit limit**
- ❑ Yet half the countries **above the Debt limit**
- ❑ 2019 was preceded by **a period of growth** in all EU countries
- ❑ Did the countries build fiscal cushions for a future stress?

The Fiscal Picture in 2019

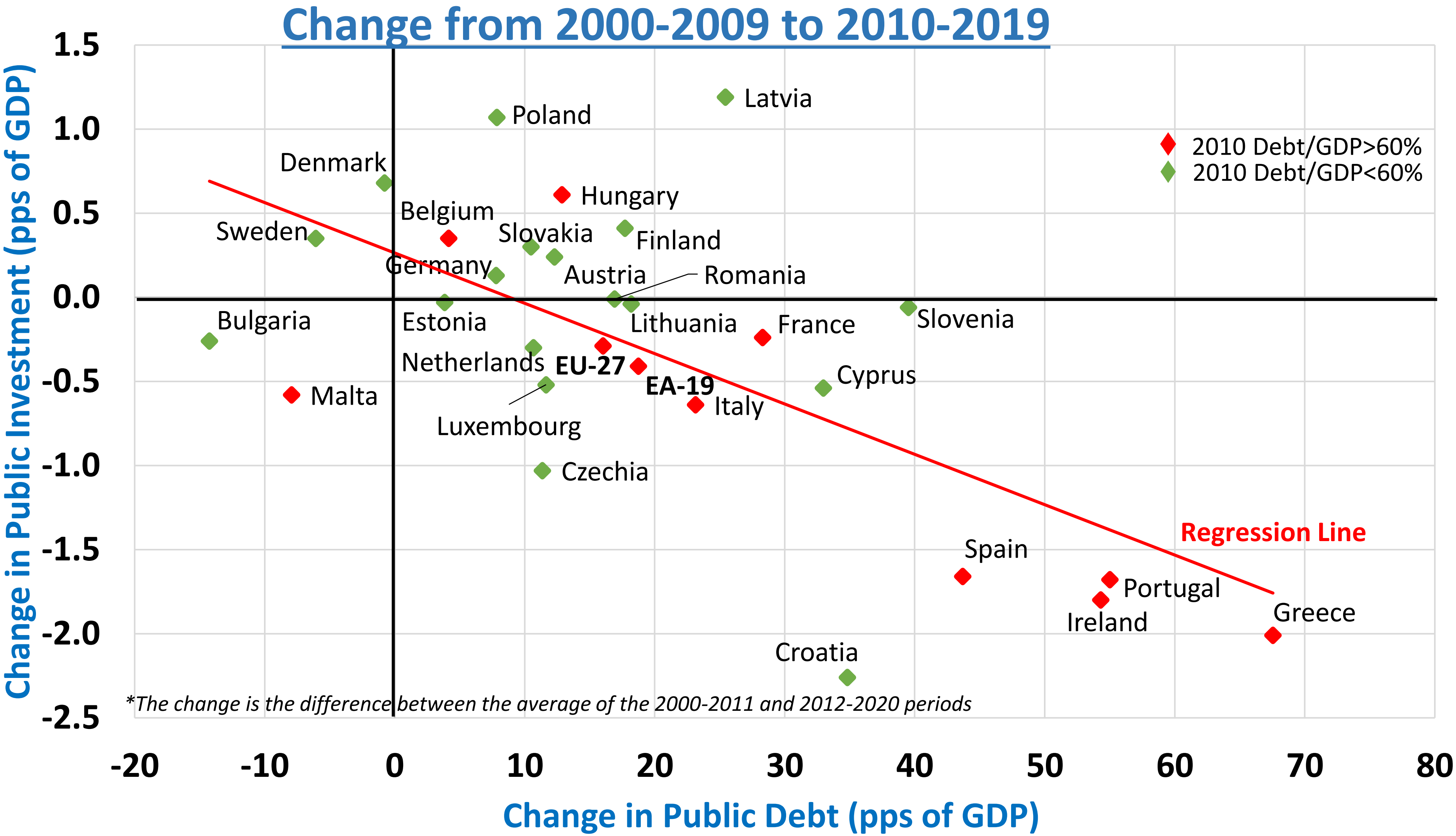


Did the structural balance improve from 2014 to 2019?

- ❑ Was the agreed by 2015 fiscal policy subsequently successful? Namely, did countries **build buffers in good times** for fiscal relaxation in future bad times?
- ❑ **Lower left quadrant raises concerns:** Countries should have relocated to the top left quadrant
- ❑ Yet many are even **below the 45° line**, namely, despite the economy improving, they had a worse structural deficit in 2019



Change in Public Debt & Investment across the Decades



- From decade 1 to decade 2, **Debt/GDP increased** in most countries
- Countries with Δ(Debt/GDP) > 0 are typically the ones with **Δ(Inv./GDP) < 0**

The current debate

Three schools of thought:

1. **Current framework needs little reform**
2. **Fiscal rules need to be adapted, yet within the current framework**
3. **A complete overhaul of the rules; even a replacement of the numerical targets included in the European treaties**

- See recent common position by Finance Ministers of Austria, Czech Republic, Denmark, Finland, Latvia, Netherlands, Slovakia, Sweden. Seems to lie between options (i) and (ii), closer to (i). "*De-activation of the General Escape Clause and the reform of SGP should not be linked*."

- Given the need of unanimity for final decisions and the history of EU policy-making, it is likely that **option (ii) would be followed**. Namely, an adaptation within the existing framework

The current debate

- **EU Fiscal Council proposes**:
  1) Set numerical targets for **debt reduction** in very high debt countries, at a moderate and differentiated pace
  2) Implement an **expenditure benchmark** through a single, observable indicator, with one escape clause invoked on the basis of independent economic analysis
  3) Maintain the 3% threshold for the headline deficit as a **backstop** in containing debt dynamics and as a **trigger** for the EDP for all MS

- **We are likely to see a debate** around the above proposal on items like:
  - Definition of **public expenditure**: **Net of** interest payments, non-discretionary unemployment benefits, discretionary revenue measures, public investment (on an amortized basis?), Green investment
  - Medium-Term Budgetary Objective as a preventive measure, rather than a corrective measure
  - **Central fiscal capacity**, how large? A simple adjustment account or **RRF would transform into** a macroeconomic stabilization mechanism?

Reform of the EU Stability and Growth Pact:
Seeking the Golden Mean

In conclusion:

- I am optimistic this crisis will lead to a better functioning EU and EMU
- The time to reform is now – before the escape clause expires
- Our European moto: The SGP reform ought to …
    - Adjust the traditional dilemma: ***"Rules versus discretion"*** into ***"Rules and discretion*** *within a* ***proper governance framework"*** Namely, utilize both "discipline-improving" and stabilization-improving policies, like academic economists suggest
    - Take into account the pressing challenges of the next decades: climate change, digitalization, investment needs, ageing population

Thank you for your attention!

www.hardouvelis.gr