Back to Square One?

October 2021

_Fiscal rules and political developments in the EU_

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However, this transformation has not yet taken a definitive form or a single direction. Much will depend on the choices in the months ahead and the new German government will carry significant weight in these decisions.

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The European Union (EU) proved to be timely and effective in responding to the pandemic-induced economic crisis. In addition to the monetary policy measures taken by the European Central Bank (ECB), on the fiscal side the Union acted: i) to quickly suspend the Stability and Growth Pact to leave governments the budgetary space needed to take all the necessary measures; and ii) to create a new joint instrument, the Next Generation EU (NGEU) which includes the Recovery and Resilience Facility (RRF), to help countries hard hit by the pandemic recover.

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This programme, and the consequent national recovery and resilience plans, breaks two taboos rooted in the European system: issuing common debt and allowing direct transfers from Brussels to central governments for national policies.

Under the NGEU, a major sovereign issuer was born: the European Commission will borrow up to €150 billion annually on the capital markets between mid-2021 and 2026. So far these measures have been welcomed by strong investor demand and EU has maintained its AAA rating.

However, issues remain, and loose ends hang over Europe’s future, particularly surrounding the economic and monetary union.

After this exceptional period for the breadth of interventions and innovative decisions, it is now time to “come back”. As health restrictions are removed and the economy picks up, stimuli, aid and exceptional measures must be brought back to a sustainable path and the framework in which fiscal policy moves should be normalized.

On the monetary policy side, the ECB, anticipated by the Federal Reserve which is a few weeks ahead in the cycle, will soon act to reshape its exceptional asset purchase programme implemented during the pandemic.

At the September meeting, the ECB Governing Council decided to slow down the pace of net asset purchases under the Pandemic Emergency Purchase Programme (PEPP). We expect more momentous decisions will be made by year end.

As regards fiscal policy, a new framework will have to be reinstated. The Stability and Growth Pact, which famously caps budget deficits at 3% GDP and limits public debt, has been suspended only until 2023.

Consequently, discussions on the architecture of rules that will govern the post-pandemic economic and monetary union are likely to dominate the months ahead.

Some countries, including Austria, the Netherlands, Denmark and the Czech Republic, usually considered more hawkish, have taken a joint stance for maintaining strict rules of fiscal discipline.

On the contrary, in a recent official document the Italian government signalled its intention to maintain a deficit well beyond 3% after 2022. However, real negotiations haven’t started yet. The process intersects with the political calendar of the major countries: the formation of the German government and the French Presidential elections in April 2022.

Therefore, economists and public finance pundits are currently openly discussing possible models and reform proposals.

The widespread opinion among experts is that we cannot return to the Stability and Growth Pact as it was before the suspension, given also several technical aporias that it has shown. However, the views on the range and depth of reforms vary.

Some suggest, as highlighted in a recent paper by Bruegel, to intervene on the existing framework by introducing a “green golden rule” that would exclude green public investments from the rules on deficit and debt.

This could be achieved through interpretative notes by the European Commission, without formally changing the existing rules.

Others, including Stiglitz in a recent FT article, argue the need for a profound reform of the rules, to prevent a repeat of the mistakes made after the great financial crisis. In this sense, several authoritative economists, including Blanchard and Pisani Ferry, suggest moving from the current framework of legal rules that are the same for all, to a mechanism inspired by the macroeconomic principles of public finance sustainability and applied country by country.

1. European Commission, as of October 12, 2021.
2. European Commission as of October 2021.
5. ECOFIN as of 10/11 September 2021. This paper was presented to the informal meeting in Ljubljana. Z. Darvas and G. Wolff, 2021. “A green fiscal pact: climate investment in times of budget Consolidation”, Policy Contribution 18/2021, Bruegel.

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The future of the NGEU and the RRF is intertwined with this debate. In its current form it is a one-off programme destined to run out by 2026. It will be discussed whether and how to shape it as a permanent tool that allows the Commission to raise resources in the capital markets for investments at a national and European level, perhaps in areas such as decarbonization and sustainability.

Obviously, the effectiveness and speed with which these current RRF resources will be spent will weigh on this choice. A few countries, first and foremost Italy, are the real litmus test for the functioning of this tool. In this sense, the responsibility in the implementation of the national recovery and resilience plan that weighs on Italian governments between now and 2026 is critical.

During the German election campaign these issues were concentrated around the theme of the return to the “schwarz null” rule, the German constitutional principle according to which the federal budget must be balanced.

This rule too was suspended due to COVID, allowing Chancellor Merkel to finance in deficit the emergency measures of recent months. The only party that has clearly called for a questioning of this rule are the Greens, who would like to allocate €500 billion to investments for decarbonisation over the next few years. ⁹

The other parties, albeit with different pitches, all seem to favour a return to stricter fiscal discipline. Olaf Scholz, tipped as the next Chancellor, has emphasized the need for social and green investments, but seems reluctant to abandon pre-existing rules, both domestic and European.

To conclude, there is certainly an increasingly robust conceptual framework for not returning to the pre-pandemic status quo. Much attention is focused on introducing flexibility mechanisms for investments that facilitate energy transition and face the climate emergency.

The extent to which this consensus can become a political reality will depend on the political developments in key countries, first and foremost in Germany.

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