THE DEBT ISSUE. EU MACROECONOMIC GOVERNANCE AND THE FISCAL/MONETARY NEXUS

- Fiscal rules in the EU
- Other alternatives: e.g. fiscal sustainability
- Escape clause during the pandemic

Fiscal rules under the EU the Stability and Growth Pact

- EU fiscal rules are based on numerical targets, such as the 3% budget deficit target, the 60% government debt GDP target and the structural budget balance rule over the business cycle.

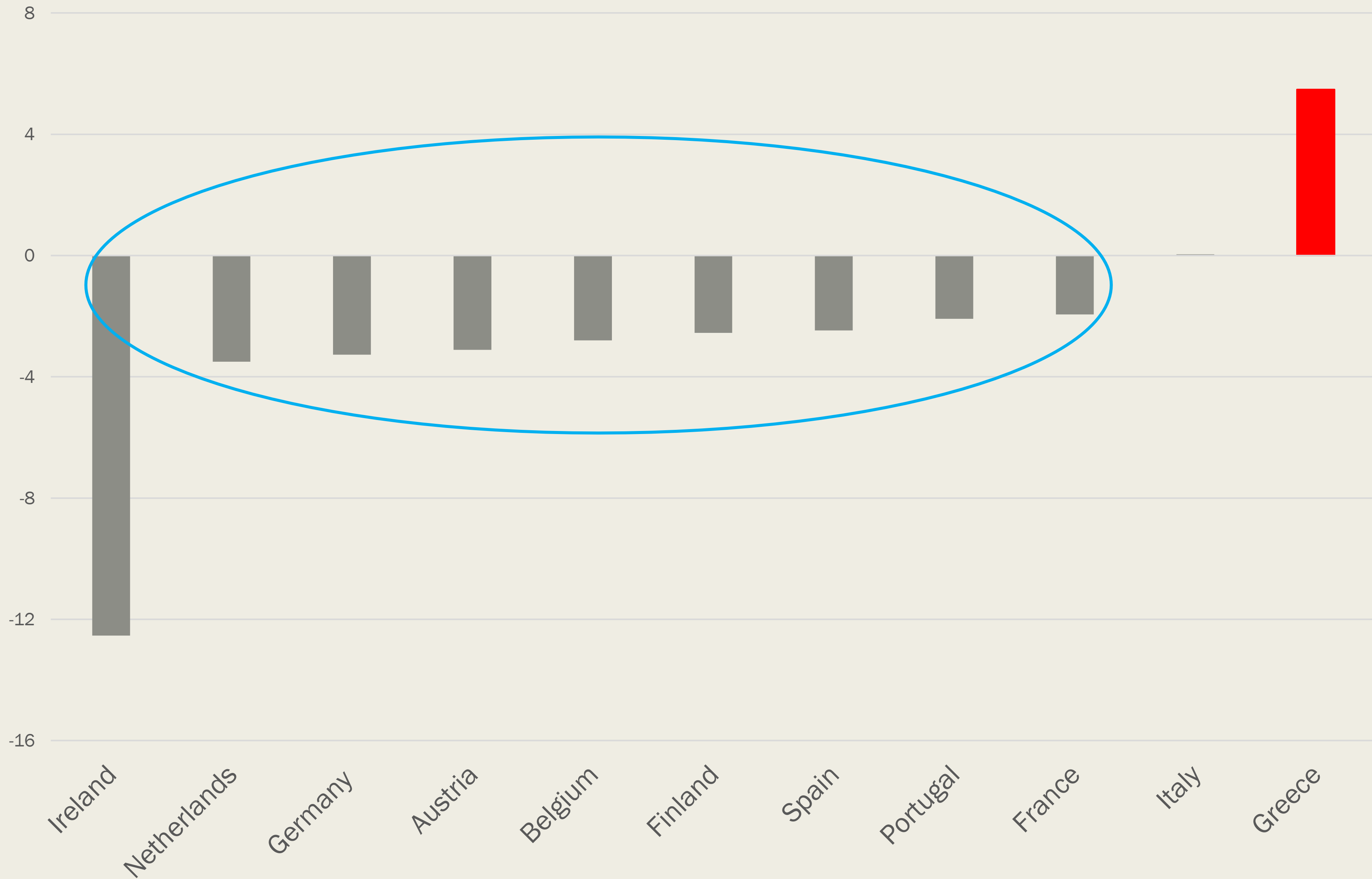
  - *3% budget deficit (or the 60% debt ceiling) may limit national governments to implement fiscal stimulus and stabilize its output. This is the case in particular for large shocks.* For example, during deep recessions, countries may lose their capacity to do output stabilization and may be forced to implement austerity policies that would lead to prolonged recessions and unemployment.

  - *Long term growth: balanced budget rules do not allow government to issue debt to finance public investment…*

  - *The Commission estimation of cyclically adjusted government budget balance is strongly pro-cyclical (technical problem). During a recession, the long-term growth potential of a member state is often adjusted downwards creating underestimation of business cycle component and overestimation of structural component of budget. Policy implications from this estimation is often against stabilization and in favour of structural reforms such as in labour markets.*

New Approach: Fiscal sustainability

- The numerical targets are often not necessary to guarantee sustainability. A growing consensus that the new governance should be based on long-term sustainability analysis of public debt (see Kopits (2004), European Commission (2014), Debrun, et al. (2019), Wyplosz (2019)), De Grauwe (2021)
- Future expected (net) debt levels should be evaluated based on the current forecasts of interest rates, inflation, GDP growth rates and tax capacity.
- Two different regimes (r-g) concerning debt sustainability:
  - *Stable dynamics : when the nominal interest rate is expected to be lower than the growth rate of the economy, the debt to GDP ratio tends to decline automatically. It is then not necessary to push countries into fiscal austerity to achieve a particular numerical target of the debt ratio.*
  - *Unstable dynamics: when the interest rate exceeds the nominal growth of GDP, a government debt ratio of less than 60% will not guarantee debt sustainability.*



Eurozone countries apart from Greece and Italy are in a fiscal sustainable situation without the need to implement any fiscal austerity policies. In fact, these countries should have more fiscal spending in particular public investments.

Make a case for the public investments

- Public investments increase both assets and liabilities in government's balance sheet.
- When the expected return to public investment exceeds the cost of borrowing, the value of the public assets (measured by their capacity to generate additional production) increases faster than the value of its liabilities.
- This implies that these public investments will reduce net debt of the government in the future. No constraints on such debt-financed public investments should be imposed.
- Golden rule: public investment can be financed by borrowing and be kept in capital budget
- Current budget (i.e. other government spending) should be financed by the tax revenue and should follow balanced budget rule over the business cycle

Escape clause during the pandemic

- Flexibility during a big recession such as a pandemic
- €100 billion for the SURE programme to support jobs and keep people in work
- The NextGeneration-EU recovery plan has the capacity to borrow €807 billion and to fund structural reforms and public investments supporting green and digital transitions.
- A novel instrument that finances public investments by the joint issue of common bonds at EU level. It is of great political importance as it can be considered as a first step on the road to a future political and budgetary union.

Problems

- The scale is relatively limited as the spending will be spread out over the period 2021-26, the average yearly stimulus will amount to about 1% of EU-GDP
- Hence, the recovery largely depends on actions from the EU national governments and the ECB. The latter has a pandemic emergency purchase programme (PEPP) amount to a total of €1.3 trillion liquidity
- The escape clause is scheduled to end after 2022. This means that without reforms in the Stability and Growth Pact, EU national governments would be forced to follow the fiscal rules next year. Is this too soon?
- At that time, will ECB continue its government bond purchase programme and provide the necessary liquidity?

References

- Mourre, Gilles, and Aurélien Poissonnier. "What Drives the Responsiveness of the Budget Balance to the Business Cycle in EU Countries?." *Intereconomics* 54, no. 4 (2019): 237-249.
- De Grauwe, P and Yuemei Ji, ‘Rethinking fiscal policy choices in the euro area, October 2019, Vox EU, https://voxeu.org/article/rethinking-fiscal-policy-choices-euro-area
- De Grauwe (2021), IN-DEPTH ANALYSIS requested by the the ECON committee, European parliament https://www.europarl.europa.eu/RegData/etudes/IDAN/2021/651393/IPOL_IDA(2021)651393_EN.pdf
- Kopits, G., (2004), Assessing Fiscal Sustainability under Uncertainty” *Journal of Risk* (Summer).
- European Commission (2014), “Assessing Public Debt Sustainability in EU Member States: A Guide”, ECFIN Occasional Papers No. 200, Brussels.
- Debrun, X, J D Ostry, T Willems and C Wyplosz (2019), “Debt Sustainability”, In A Abbas, A Pienkowski and K Rogoff (eds.), Sovereign Debt: A Guide for Economists and Practitioners, New York: Oxford University Press.