Wide Angle Shot: EU fiscal rules 2.0, more carrot than stick plus greenwashing?

Raiffeisen RESEARCH

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The de facto (almost) guide-less state of affairs in euro/EU fiscal policy in recent years is not to become permanent. The reforming of the Euro Stability Pact is going into the next round. The EU Commission will soon present reform ideas. The guiding principle shall be: less stringent rules, but focus on implementation. In addition, state spending should be divided into "good" and "less good" ... a move that may give rise to "greenwashing" risks.

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EU fiscal rules: The "unloved child" of the EU regulatory framework

Even before the various and existential economic crises of the last few years (COVID-19, Ukraine war) it was clear: the fiscal rules in the euro area are the "unloved child" of the EU economic governance in some parts of the economic bloc. For some, they have become "toothless" after several reforms and the creation of multiple exceptions. For many others, they represent an insubordinate restriction of national fiscal room for manoeuvre, while according to such patterns of thought, no sensible fiscal policy can be pursued on a pan-European scale either. The only consensus is that the fiscal governance rules have become too complex in the years following the euro sovereign debt crisis and need to be simplified. Moreover, even fiscally conservative and more critical countries like Germany seem to have come to terms with the idea that a "one size fits all" public debt reduction is no longer appropriate. But this is clearly the end of the common ground between the different camps, which are once again at odds with each other in the current reform discussion.

Even if in the "competition of ideas" on reforming the Stability Pact not all of Germany's positions are shared by all of the "fiscally like-minded" countries, the following is nevertheless true: as with previous decisions that had a potentially trend-setting character (e.g. NGEU in mid-2020), the (very) **different stability cultures** within the euro area are also coming back to light this time around. The lack of consensus on the fundamental orientation and objectives of national fiscal and economic policy (keyword: industrial policy) is ultimately the **main reason** why the **Stability and Growth Pact never had the desired disciplining effect** and did not promote a common stability culture.

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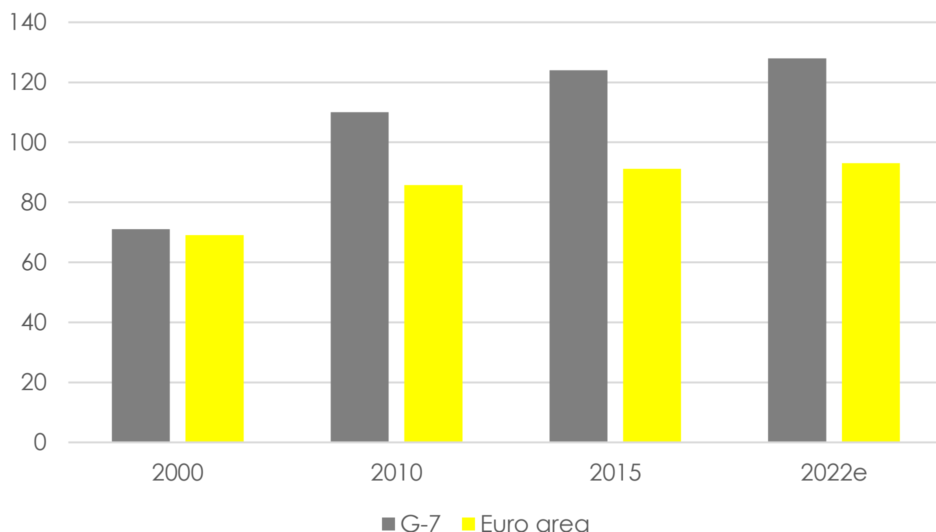
Public debt-to-GDP ratios
in %



Source: IMF, Eurostat, RBI/Raiffeisen Research

Reform process or the "competition of ideas"

The **application of EU fiscal governance rules** has been officially **suspended since 2020** due to the crisis, and in May this "state of emergency" was extended for another year (2023). This is logical. Because even more of an unrealistic scenario than the full implementation of an EU (governance) reform in the year of a full-blown geopolitical and energy policy crisis is a return to the fiscal status quo prior to 2019. Put simply, the **"normative force of the factual"** is also at work here. Although **government debt** in the **euro area** is expected to stabilise at around **90%** of GDP, the three major economies **France, Italy and Spain**, for example, are characterised by public debt-to-GDP ratios of (well) **over 100%** of GDP. Thus, even before 2020, it was generally accepted that there was a need for fundamental change or at least simplification of fiscal governance. However, the pandemic put an abrupt and quick end to the evaluation process that started in February 2020. The second attempt was finally interrupted by the start of the Ukraine war. However, all this did not detract from the necessary **discussion process on the future fiscal architecture of the euro area** and EU. Nevertheless, it is clear to all that the application of fiscal rules is only temporarily suspended, sooner or later fiscal policy will have to be subject to rules again — as long as there is no fully comprehensive and joint financial risk sharing, which is not foreseeable inside the euro area or the EU. But what rules? Against this backdrop, the "competition of ideas" that started in 2021, including the battle for the sovereignty of interpretation, is not surprising.

The competition of fiscal governance ideas will reach a preliminary climax these days. According to (media) reports, **EU Commission** will publish **its ideas for the future design of the European fiscal architecture** on 9 November. The general principles are already known, as long as they follow the ideas presented by EU Monetary Commissioner Paolo Gentiloni in October: On the one hand, **more flexibility and individuality** in fiscal targets as well as more room for (green, digital,...) **investments**, and on the other hand, **stricter rule enforcement**. "Carrot and stick" is likely to be the motto with which a reconciliation of the different views is to be achieved. The considerations and possible thrusts in detail:

Modernization, not abolition of the 60 % criterion

It should be comparatively easy to reach a consensus with regard to the 60% public debt criterion. The current **debt target of 60 % of GDP** is hardly achievable in a realistic period of time (i.e. the coming decade(s). Since the euro debt crisis for some and since 2020 for many euro countries the 60 % criterion seems somewhat **"outdated"**. And that is

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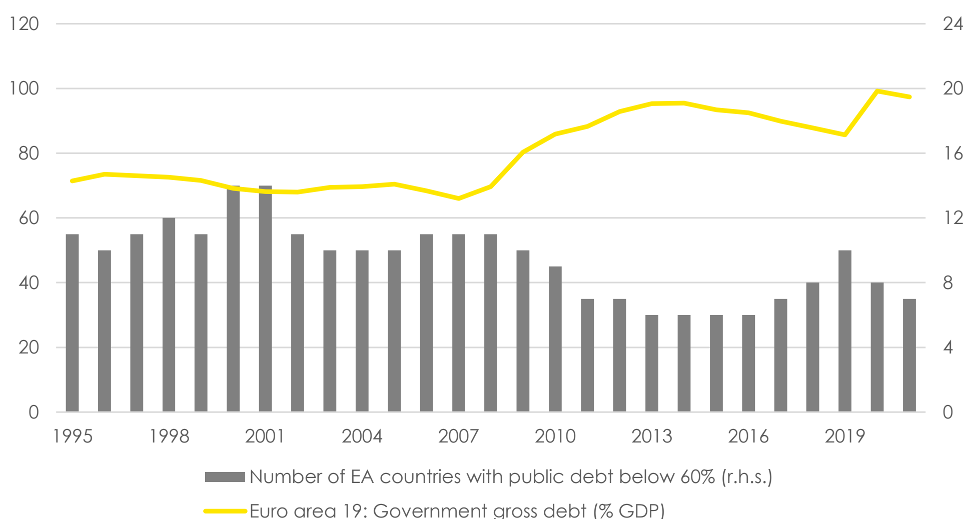
meant quite literally. Moreover, the 60% target value is not per se the result of economic considerations, but rather roughly represented the average public debt of the 11 founding members of the euro in the years before the signing of the Maastricht Treaty in 1992.

That was a long time ago; in the meantime, the 11 founding members, with an average (unweighted) public debt-to-GDP ratio of 88% of GDP (2021), are far from this target value (the same applies to the unweighted average of the current 19 euro countries: 83% of GDP, weighted: 97% of GDP). Even if no one expects countries like Italy to even come close to the 60 % of GDP in the next few years, there are two reasons against a change (=increase). First, such a move would require a **change** to the **EU Treaties**. An EU treaty change could come up in the coming years anyway for other reasons (voting procedure, unanimity), but is not realistic in the short term. And secondly, the **symbolic power of this value**, which is also known to the public, should not be underestimated; an increase could therefore meet with reservations, especially in the "euro core countries". This is especially true in the current phase of tense inflation concerns and elevated inflation expectations among the general population. However, it is important to note: The average public debt of the G-7 economies is currently even higher than that of the euro area (83% or weighted 97% vs. just under 130%). In this respect, the relative perspective must be taken into account and/or relative competitive or consolidation disadvantages must be avoided.

Euro area: Government gross debt (% GDP)



Source: Ameco (Europ. Commission), RBI/Raiffeisen Research

Government Debt: More realistic targets, which are then also met

In view of the increase in public debt levels, a **"modernization" of the 60% criterion seems necessary** — and this is where "flexibility" aspect may come into play. The idea is that the adjustment path towards this level should take greater account of the different starting conditions (debt levels), i.e. an **"individualization" of the adjustment paths**. Currently, debt above 60% of GDP would have to be reduced by **1/20 per year**, which would require overly ambitious consolidation measures from countries with a significantly higher level of government debt. For example, Italy with a debt level of 148% of GDP expected for 2022 according to the EU Commission (spring forecast) would have to reduce its debt level by a good 4% of GDP in 2023, whereas Austria with a projected debt level (also EU Commission spring forecast) of 80% of GDP would only have to reduce it by 1% of GDP. It should therefore be admitted that in many cases the 60% limit cannot be reached within a realistic time frame, **"the path (=adjustment path) is therefore the goal"**. The 60 % limit would thus lose relevance as a realistic target value, but would still represent an important anchor. Admittedly, such a proposal would ultimately amount to countries with an unfavorable fiscal position in particular having to reduce their debt ratios more slowly than under the current set of rules. However, rules that are less

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stringent but set more realistic targets, combined with a strengthening of the sanctions element, could ultimately achieve a faster debt reduction than stricter rules that would only exist on paper due to their lack of practical relevance.

Such a "trade-off" does not seem unrealistic. After all, even the German government showed itself open to it in August in a non-paper. The slogan "more realistic requirements that are adhered to" should therefore be suitable as a compromise formula.

Idea with conflict potential: Commission and member state negotiate debt reduction plans

The Berlin document, however, was less pleased with the EU Commission's idea of leaving it to itself and the respective states to determine the fiscal targets. The **targets** to be met would thus be the **result of negotiations between the EU Commission and the member state**. The rule-based procedure would be replaced by a discretionary process in which the euro country concerned would negotiate its own targets with the Brussels authority. The involvement of national governments is justified with a higher acceptance ("ownership") in the respective member states. In fact, the past has shown that fiscal and reform requirements, whether in the framework of the Stability Pact or the various euro rescue packages, have often been perceived as imposed by Brussels/externally (EU Commission, "Troika"). The implementation accordingly left much to be desired (Greece, Italy). If, on the other hand, the population and thus also the politicians were convinced of the necessity of the measures, they were also implemented much more consistently, see Ireland. Nevertheless, it must be questioned whether an even greater power of the Commission, which in the past has often turned a blind eye to violations of the rules, in combination with a right of co-determination of countries for which the motto "less is more" applies in matters of budget consolidation, is the right way to go. It is not without reason that this idea meets with little approval in Germany and the Netherlands.

ESG trend orientation vs. also "good" investments/debts are repayable debts

Long before the current reform process, ideas were repeatedly floated (especially by France and Italy) to pay more attention to the **"quality of public sector spending"**. What is ultimately meant is that supposedly "good" government spending, such as for green or digital "investments in the future", but also defence spending, should be excluded from the application of fiscal governance rules. The Commission is also thinking along these lines (Gentiloni: *"Reform and investment commitments could allow for a longer fiscal adjustment period"*). The thrust is likely to be: **The more investments and reforms, the more time for debt reduction**.

Even if the need for stronger public sector involvement to cope with the upcoming transformation tasks is shared in principle at the country level, there is no agreement on whether such expenditures should receive "special treatment" in the regulations. Germany has shown itself to be opposed to this. Indeed, the **normative division** of **government expenditure into different categories** and "values" **must be viewed critically** in principle. Experiences with such mechanisms (e.g. investment rule in Germany) lead us to expect that in the political practice of nation states, the (green/ digital) investments to be taken into account will be defined generously. With the prospect of special fiscal treatment, many **government expenditure** items are thus **likely to be given a green coat of paint ("greenwashing")**. There are thus greenwashing risks as in the ESG financial market. That the EU Commission would be particularly strict in its assessment of investments cannot be assumed in view of the lax handling of fiscal rules practised in the past. Apart from the risk of greenwashing, the basic problem with such rules is that government spending can be politically well divided into "good and ESG-compliant" or "bad" spending, but in the sense of mathematical public **debt sustainability money has "no makings"**. Despite a special accounting treatment, **"good" debts are also repayable debts**. The idea of treating desirable

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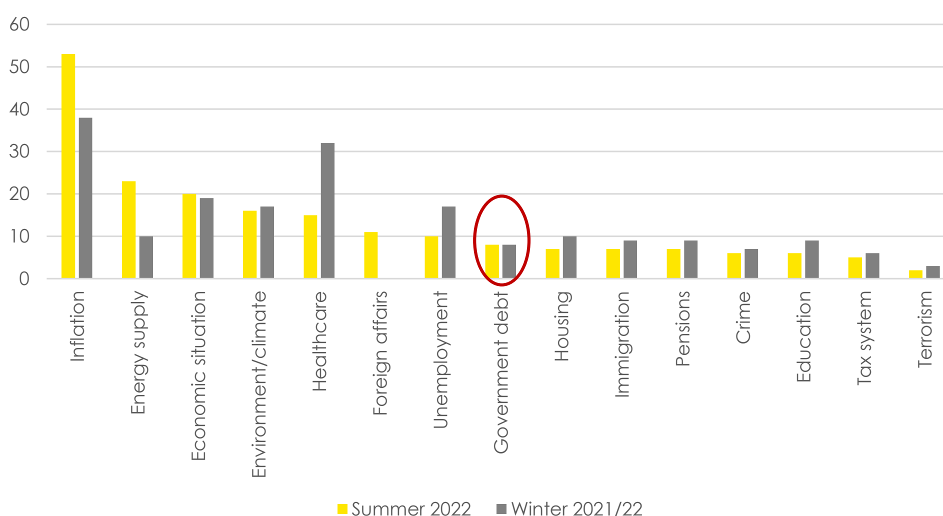
because (supposedly) future-oriented investments separately is therefore based on the notion that there is or must always be room for such expenditures. In countries such as Germany or Austria with comparatively low levels of public debt, such investments may indeed make no difference in the assessment of debt sustainability. In countries with significantly higher debt ratios, on the other hand, it does make a difference, especially if the optimistic assumptions about the long-term growth effects of such investments do not come true. An expansion of green and digital investments is undoubtedly necessary. But this can be done within existing possibilities, necessitating a **re-evaluation of total government spending** and subsequent prioritization. Moreover, a **comprehensive instrument has already been created with NGEU**, which grants comprehensive fiscal transfers to the particularly highly indebted states (Italy, France, Spain) to cope with the upcoming transformation agendas. Here, too, an evaluation of the NGEU instrument would make sense in the coming years.

Population: Energy & inflation in the spotlight - not government debt



** Eurobarometer survey: "What do you think are the most important issues facing (OUR COUNTRY) in the moment?", survey result for total euro area*

Source: European Commission (Eurobarometer), RBI/Raiffeisen Research

Population: Public debt concerns moved into the background

The last few years have been marked by sharply rising debt ratios and further declining interest payments by the states. Even in traditionally more skeptical or fiscally conservative countries such as Germany, a **more lax fiscal policy** is **seen** to a **lesser extent** as a **threat** to the **euro area** as a whole, the euro currency or even to their own prosperity than 10 years ago. The negotiations on the NGEU instrument were also instructive in this respect. Despite its potentially trend-setting character for the euro fiscal architecture, there was no public outcry. This has certainly been helped by the fact that the warnings often voiced during the euro debt crisis that the monetary union would falter due to high and rising debt levels of some euro countries have not come true. The **crossing of (supposed) red lines without the feared consequences** is thus likely to have encouraged a more relaxed attitude towards government debt among the population of the core euro area. This is further fueled by the **expectations** that have been stoked since the pandemic that **fiscal policy must protect the population from all risks** (Corona: "Whatever the cost", energy crisis: "No one is left alone"). Added to this are the energy and security challenges worth billions of euros, which the population attaches greater urgency to than the much less tangible sustainability of public finances.

Timetable: Clarity needed on structural breaks - attractive time window 2025?!

The current environment in which the reform process of EU fiscal governance rules is taking place can be described from a bird's eye view as follows: **Fiscal pressure** to act is **still fairly low** (in terms of interest burden) but on the rise. The impact of the

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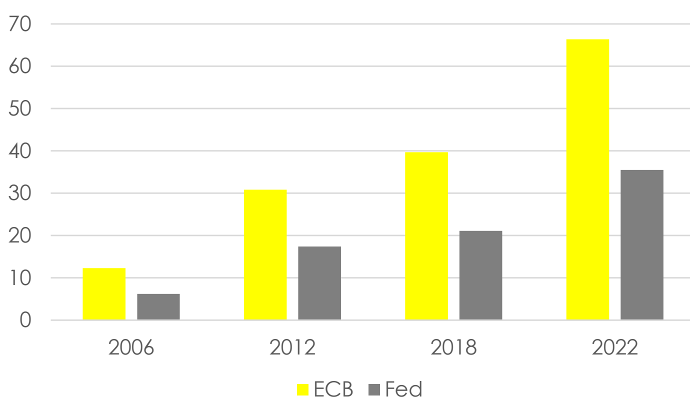
current geopolitical and energy policy challenges on national state finances is likely to be enormous, but can only be roughly estimated at present. The same applies with regard to the Ukraine reconstruction costs for the EU and the financial resources required for this. Added to this is the **general uncertainty** as to what the various upheavals will mean in the medium to long term for **growth, interest rates, inflation** and thus **debt sustainability**. The actual need for consolidation depends not least on this. The effects of the current elevated inflation are massive: Austria's gross public debt-to-GDP ratio will fall by no less than 4 percentage points this year due to inflation (decline from 82% of GDP to 77% of GDP, of which 4 percentage points are due to inflation)!

Despite a noticeable increase in long-term capital market yields over the course of the year, the actual interest burden on governments remains extremely low. The low to negative rates and yield environment seen over the last few years is still having an effect. Therefore, the market pressure on governments to act is still not particularly high, also due to the outlined effect of inflation on public debt ratios. Consequently, there is a **political "risk"** that the current combination of **still low fiscal pressure** to act, moderate market pressure and **high investment requirements** will ultimately **result in less stringent fiscal rules than necessary**.

In this respect, it would be well worth considering brokering first a **transitional solution** for the **next few years** and **subsequently a substantial revision** of the **Stability and Growth Pact** in **times of less uncertainty**, especially since **ECB** has also announced a review of its new monetary policy strategy for **2025**. The interrelationships and interdependencies of monetary and fiscal policy could thus be taken into account to a greater extent. The ECB's **extensive** and **partly market-distorting government bond purchases** and reinvestments, as well as the low interest costs resulting from the extraordinary negative interest rate period, should buy time at least until 2025. And then there should also be **clarity** as to **how long ECB will continue to reinvest government bond holdings**, steer public debt markets and to what extent, or how (quickly) it intends to reduce its overstretched balance sheet. It may also be clearer by 2025 to what extent ECB's monetary policy can stimulate "green" investments, where clarifications are needed in the coming years. It should also be borne in mind that substantial reform windows under the Stability and Growth Pact are likely to open very rarely and that it remains to be seen whether fundamental EU treaty changes will be forthcoming anyway. The latter could also suggest more room for political compromise (beyond the fiscal rulebook). A **reformed set of fiscal governance rules** that **"only" reflects current known unknowns** could seem **"antiquated"** in a **few years** to come. The ECB can tell you a thing or two about this, as its "new strategy" is rather a response to the long-gone era of too-low inflation and inflation expectations.

ECB vs. Fed: Balance sheet (% of GDP)



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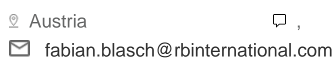

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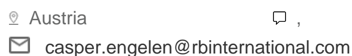

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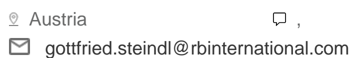

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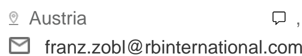

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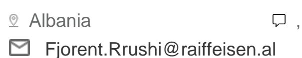

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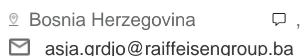

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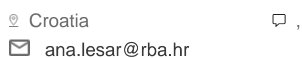

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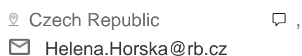

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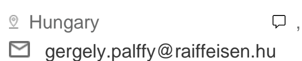

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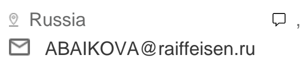

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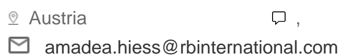

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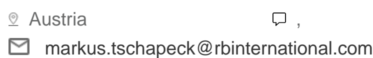

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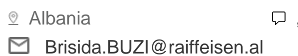

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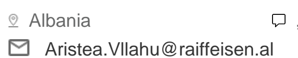

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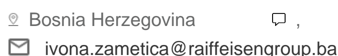

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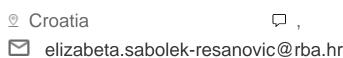

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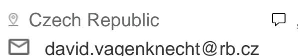

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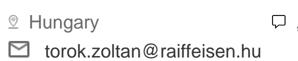

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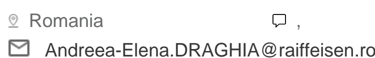

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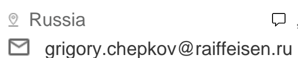

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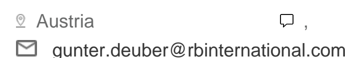

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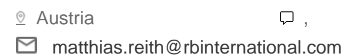

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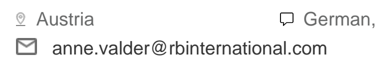

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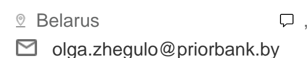

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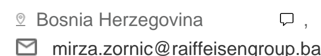

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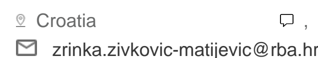

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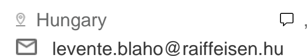

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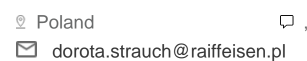

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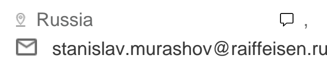

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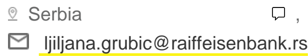

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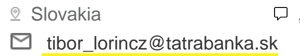

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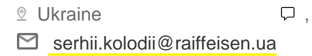

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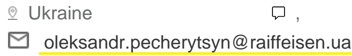

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