Rolf Strauch in Bruegel podcast "Rethinking fiscal policy"

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20/10/2021

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Discussants Maria Demertzis and Zsolt Darvas on 19th October 2021

Bruegel - The Brussels-based Economic Think Tank

Language: English

Publication date: 20 October 2021.

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Transcript:

Maria Demertzis: Welcome to the Sound of Economics, the podcast series of Bruegel, the Brussels-based economic think-tank. In today's episode, we will discuss fiscal policy in the EU, starting with its present, but also looking backwards in order to assess what we need to do in the future. Here with me to discuss these issues, and a lot more, are Rolf Strauch, who is the Chief Economist and Management Board member of the European Stability Mechanism, and Zsolt Darvas, who is my colleague at Bruegel and senior fellow. I am Maria Demertzis, the Deputy Director of Bruegel.

Thank you both for joining me to discuss what is no doubt a topic that we are going to see a lot more of in the coming year. And that is fiscal policy, perhaps to rethink the way that we do fiscal policy in Europe. But before we go there, let's start with the present. I turn to you first, Rolf. We have seen unprecedented fiscal support that was given during the pandemic at the national level, across all EU countries without any exception.

But we have also seen what I would describe as unprecedented architectural innovation, if I may call it this way, in the form of course, of the NextGenerationEU fund, where the EU innovation is common borrowing. Now we still do need to finalise that because we have not put the final lines on how we are going to pay this back. And there, there is also a scope of innovation as well. And I wanted to ask you, what is your take in terms of both the size of the support that was given across the national and supranational levels and the effectiveness of the fiscal response that we're given?

Rolf Strauch: Thank you, Maria. To kick this discussion off, let me make a relatively bold statement by saying that I think we got it right – Europeans got it right in their crisis response. And that is what we can confirm now when we see actually how it works and the economic repercussions. We are in the recovery phase and fully fledged. So, the economy is kind of bouncing back at this stage, and we see much less scars than we had anticipated even not so long ago.

I think, this has to be crucially explained by the policy reaction and by the policy measures taken. I mean, you know the first set of policy measures, broad-based and across the board was to provide liquidity support, provide immediate help. That was central bank measures, national measures and European measures. There was the first package with the European Commission, European Investment Bank and the ESM to provide liquidity support. The second point was, and you already alluded to it, is that we, and Europe actually in the first place, formulated a recovery concept, a recovery vision.

That is why this institutional innovation of NextGenerationEU came into place, and we are now at the start of implementing it. I think it went off for a good start so far, and we may be discussing that in more depth. So, if we look at the economy now against all those measures, we see that firms are doing relatively well, in the sense that we have not seen the amount of bankruptcies that many had expected. And that was, because the liquidity was provided to the firms. We may see more bankruptcies coming forward, but by far not – I think, this is commonly agreed – not the kind of big tsunami that one may have feared to see. We see less friction in the labour market than one may have feared before and certainly less than we saw after the past crisis. So they are performing relatively well. Also, what we see, what I think is very important, is a high degree of popularity of the euro, and that has to do with those measures.

The fact that we come out of this crisis and you see [almost] 80% support for the euro for this common project, for me, is also a consequence of the kind of measures that were taken. This is to say so far, so good. Obviously, there are challenges out now that we have to address and it is not a forgone deal that everything will be working right. That is what you alluded to. So more needs to be decided. More needs to be done in order to really make that recovery work.

Demertzis: Yes, I am sure we will come back to what needs to happen next. But if we can just take stock of where we are now, Zsolt, do you share Rolf's assessment that we got this right? And I think it wasn't quite what Rolf said, but there is a comparison to be made with the previous crisis, the financial crisis, probably we didn't get it right back then. And again, that is not what Rolf said. But what do you think, Zsolt? Did we get it right?

Zsolt Darvas: Thank you, Maria. Compared to the aftermath of the global financial crisis and subsequent euro area crisis, I very much agree that this time European policy-makers and politicians did much better. And Rolf listed the number of positive developments that we are observing now in 2021, even though the last year was really dramatic year. Nevertheless, let me nuance somewhat the developments.

First, if we do a transatlantic comparison, then again, what we see is that the United States is recovering much faster and much stronger than the European economy.

There could be a number of reasons for that, but certainly one reason is the really large-scale fiscal support in the US, initially by President Trump and then subsequently by President Biden, which is certainly almost a magnitude larger than the fiscal support provided in the European Union. Now, the jury is still out how effective the US support was. It is also a different composition, which we could discuss and how effective the European support is or was. But certainly all projections suggest that in the US, there was no reduction compared to the pre-COVID trend line. So basically, if you drew a line for the period, let's say from 2010 to 2019, then the US economy went back to the trend line. Unfortunately, the European economy did not go back to the trend line, and it's persistently below that. So there is a gap which we need to explain and ideally close.

Another comment is on insolvencies, where again, I very much agree with Rolf that they did not expand much. But one reason why it did not happen is that insolvency laws were also amended or suspended in many countries. And when this will come to an end, the jury will come out when this will actually end and then we will see how many companies were able to survive. Nevertheless, I strongly believe that even after that, the current situation will be much better than after the global financial crisis and the euro crisis. Exactly because there was massive state support, liquidity support; companies were supported for unemployment, quite importantly, throughout the European Union. So many companies were able to survive the huge shock of falling demand in the past one and a half years than during and after the euro crisis.

Strauch: Can I briefly come in on this? For this comparison of the different crises, the past crisis in the euro area, and also now for the comparison with the US, which I think is important also to take some considerations into account. Some people say that in the past crisis, what was done was a mistake. Let me also point out that the past crisis had a different character. So some of the recipes that work now with the pandemic crisis did not work in the past because you also had to address different kind of imbalances.

And for the country that we are actually the closest to in terms of ESM relationship, Greece entered this crisis in a very different situation compared to the past one. Also, because of all the reform measures that were taken in the last one. Similarly, you can say that all the measures that were taken in the banking sector to make the banking sector healthier, was obviously a condition also for the banks in this crisis to be in a much better position to support the economy. I do not say that everything that was done in the past was right. But I think we clearly need to recognise the differences in the type of crisis and also that the effect of past reforms actually help us or helped us in this crisis. That is one point.

The second point is, on the comparison with the US, where many people said, “they do it right because they engineer this kind of pressure economy”, I think you can do that under certain circumstances and with a view to the institutional setting in a different country. So with the US, given the exorbitant privilege, given the financial structure that they have financing space, and they use that financing space, and they also compensated for the fact that their social insurance system is less developed and broad than compared to the euro area countries.

In order to give broad income support, in Europe, we took a different way, and I think rightly by focusing on company relationships and employment, because that is where the biggest frictions emerged. And obviously also we used the social insurance system; so that may be less money, so to speak, in order to put the economy under pressure to grow. But I think it is a very effective way of handling it.

And of course, we will now have to see whether we make the final mileage that Zsolt referred to, in also reaching again the trend line. We maybe have not done it as quickly, but I think we have done it in an efficient way, given the European institutional setting.

Demertzis: And I think the comparisons can only go that far, because in all bumps and growth instances, the US is a lot more flexible, we know that. And therefore it may go into deeper troughs, but it's actually quicker to bounce back. So I think this is a feature that is known in the US. The question is the cost, the cost of meeting the crisis, and what is the bill? And how are we going to pay this bill back? Because that's what it comes down to. It depends very much on how we're coming out of the crisis.

Now, as we are beginning to think about removing some of the measures that have artificially sustained the economy, as Rolf said. And I think the next point to discuss is what happens next. So a number of rules were suspended during the almost two years of the crisis. We need to think about going back to some of the rules. There are good reasons why we have these rules and need to go back to them. Is the speed at which we go back is something that is important, and also what do we go back to?

And I think this is the one issue that will be debated here in Brussels – how do we go back to a fiscal coordination framework? And is it the current one that we go back to? Or do we need to rethink that? And I am sure you both have lots to say; Zsolt, you have written a lot on this. But in order to answer that question, and certainly for the benefit of our audience, I would like us to discuss the role of fiscal policy both in the past and in the future, because I think we had two once-in-a-lifetime crises, two in the space of ten years, where fiscal policy had to play a very active role, and we have a fiscal policy regime in the EU.

Do you think that this is fit for purpose in the future? If we can go back and evaluate the fiscal framework that we had, did it serve a good purpose and can it sustain this purpose in the future as we move forward, given the challenges that may come ahead? In fact, next year we will celebrate 30 years of Maastricht. So I think that's kind of a good time to take stock of whether Maastricht has served us well, and if it can serve as well in the future.

Darvas: Maastricht and more generally, the architecture of the euro area was basically built on two main pillars. One is fiscal sustainability and the second one is price stability. Price stability was thought to be achieved by giving the new European Central Bank a strong power to follow the steps of the monetary policy of the German Bundesbank. For fiscal stability, the Maastricht criteria, in particular, the 60% of GDP public debt ratio and the 3% budget deficit limit, were supposed to deliver such stability from that side.

Now, since then we know that these two are not enough. Financial stability is similarly important. But now let me talk and focus more on fiscal policy and on fiscal rules, as you highlighted. Already when this 60% public debt ratio threshold and the 3% budget deficit threshold were decided, already at that time, there were question marks. What is the economic rationale behind these numbers? And since then, we have seen a lot of evolution of the fiscal framework. Most importantly, in the early 2000s, Germany and France were unable to meet the 3% deficit threshold.

And instead of fining these two large countries, a major fiscal framework reform followed, and the rules were made more flexible. Also, after the global financial crisis and in particular, the Greek crisis which started in 2009, in 2011, 2012 and 2013, there were again a lot of new reforms to the European fiscal framework in the so-called Six-Pack, which changed the preventive arm of the Stability and Growth Pact when a county does not have an excessive deficit, and also the corrective arm, when a country has an excessive deficit, how these two major arms should evolve.

A new numerical definition was given or defined for the requirement of reaching the 60% of GDP public debt ratio, which is the so-called 1/20th rule, whereby in each year countries have to reduce the gap between the actual debt level and the 60% threshold by the 1/20th of this gap. And what we have seen after the euro crisis a decade ago is that many, many countries entered an Excessive Deficit Procedure, so they had excessive deficits. Many of them received a lot of flexibility, extended deadlines and a lower pace of fiscal adjustment.

But overall, I think the consensus, and also this is my view, is that fiscal adjustment after the previous crisis was too fast and not just in hard-hit countries, which were either under a programme like Greece, or under severe market pressure like Italy. But also, if you look at, let's say Germany, which even during that time had a very credible fiscal position, did it much faster than it was required by the European fiscal rules and also much faster than what was required by the German national debt break rule.

Demertzis: Zsolt, are you saying that the fiscal rules have implied the fiscal policy has been unnecessary restrictive?

Darvas: What I see is that the fiscal rules were applied in a flexible manner for those countries which were unable to meet them. And also this includes, for example, France and Spain, two countries which received a lot of deadline extensions in extending the deadline for correcting their existing deficits. But for some other countries – and I mentioned Germany, which is certainly the largest country – fiscal consolidation voluntarily, by decision of the German Parliament and government, progressed much faster than what was required by the rules. And this second element, I think, was at least in my assessment, a policy mistake.

Fiscal consolidation should have not progressed that fast after 2010, as it actually happened. Now for the other countries, for the more hard hit countries or countries which faced some market pressure, I think there was not much choice but to do fiscal consolidation, and especially after Mr Juncker became the President of the Commission, a lot of flexibility had been applied in this regard. Flexibility is also reflected, for example, that in this 1/20th action rule that I have just mentioned, it was never applied seriously. So Italy and Belgium frequently violated the rule.

But again, building on the flexibility, which said that, for example, when a country implements a major structural reform, then that deduction rule can be overlooked. So this kind of flexibility mechanism had been used, so actually, that rule was not enforced.

Demertzis: Can I just come in here because the rationale of the Maastricht Treaty, and you said that there was not much agreement on what the actual limits were on the numbers. I think the one thing we can agree about, though, is that the rationale of the Maastricht Treaty is that there is a need for fiscal coordination in the monetary union. I do not think there was a disputed point when the Maastricht Treaty was created. But on the role of fiscal policy, which I think is important in particular, if you are going to say something about the future, back in the 90s, when the book was written, there was no role for fiscal policy, there was no role for discretion of fiscal policy. It was just automatic stabilisers that was textbook fiscal policy, and the Maastricht rationale followed that textbook policy. So the fiscal policy was never there to be used in any other way than just automatic stabilizers. What happened since then, I think, can we look back and say, well, actually, there was space for fiscal policy and it was not used or it was a choice to be used or it was used excessively. How do you see fiscal policy operated in the past 30 years? And let's say start with the first 20 before we come to the last decade.

Strauch: Well, from my perspective, I think Zsolt got it right in saying that the fiscal rules are fundamental. The fiscal regime for monetary union is fundamental, obviously, as a mechanism of trying to control fiscal policies because market mechanisms by themselves do not do it.

I think I would not agree with your formulation that there was no role for discretionary fiscal policies. First, we need to be very conscious that the fiscal rules have a very specific objective, which is debt sustainability. They need to have a limited intrusion into what national governments can do. So they were confined. And yes, then they focused largely on the operation of automatic stabilizers under those rules. But obviously there's a very broad scope of discretionary fiscal policies.

Even in a crisis, I think that is why we have the escape clause [in the Stability and Growth Pact], and we have benefited from the escape clause now, and we benefited from the escape clause in the last crisis. So there is a role of discretionary fiscal policies also in that regime in order to support the economy. I mean, for me, backward looking and forward looking, this is about making the fiscal rules more effective.

So they have worked to some extent in the past, but you would not have had a debt crisis if they had worked perfectly. Zsolt described also that did not work really nicely over the cycle. And above all, the creation of buffers in good times hasn't worked. And that constrained fiscal policies in the bad times. And that is what I think we need to be looking at now. And I hope today, when the Commission will start this kind of public consultation on the fiscal framework, that this will be the objective, making the fiscal rules more effective.

Now, before the crisis, the pandemic, there were already points where we said that we should be looking at this. And they have to do with the complexity, and Zsolt mentioned all the elements that add to it. And the second point had to do with measurement – the output gap, where the consensus on how to measure the appropriate fiscal stance to some extent had broken down. Now, we go through the crisis and come out of it. And then I think that has kind of strengthened the need of looking at the rules and how effective they can be and the additional elements, such as measurement become even more complicated after such a crisis, to measure the output gap.

The second point is that also the situation with the view to debt has changed. Obviously, governments incurred a lot of debt during the crisis, and I think they occasionally did this in order to support the economy. But this makes the achievement of the 60% and the 1/20th rule even more difficult. And maybe in some cases, even economically too costly to get there. So that is something that one has to recognize. Another element is that interest rates are very low and make financing more affordable in that regard. And even though interest rates will increase, debt-carrying capacity is probably still higher nowadays than in the days when the 60% rule was put in place. So I think these are all elements that need to be taken into account. More forward-looking. We see big investment needs - which is why I think it would also make sense to have a fresh look at how we want to handle that in that fiscal framework. And again, in order to try to be effective in the design of fiscal rules.

Demertzis: So effective, I may summarise, because it would be nice to move forward on what to do next. Zsolt, I will come to you in a minute. But just to summarise, the three things that we need to take into consideration as we move forward: low interest rate environment – that is on the

favourable side, because it means the financial needs are lower. But on the unfavourable side, we have huge debts. We have built them up as the legacy of two crises for a number of countries, but also investment needs. And there, if you think about the climate, just one of the investment needs, and Zsolt can tell us a little bit more about those investment needs in a minute. Those investment needs on the public side are going to be huge; on the private side as well. We need to find ways of mixing these two. How should we think about the fiscal framework, or adjusting some of the rules when you have to deal with a huge legacy of debt, and we have probably sizeable investment needs?

Darvas: Let me have a very quick reaction. In fact, I would like to emphasise one very important point that Rolf has said, and he said that in the past, in good times, countries did not accumulate sufficient reserves. And indeed, I think there's a quite general consensus in the literature that fiscal rules did not constrain countries in good times because in good times the housing market, let's say, is booming and there's a lot of tax revenues then it's very difficult to see what is the more fundamental underlying position of public finances.

A number of countries made a mistake that they believed that such booms will continue forever. And unfortunately, fiscal rules were not suitable for containing such a development. Constraining countries in good times, which I think is almost as important, or perhaps even more important than what is allowed discretionary in bad times. But looking to the future, I think the central challenge will be that if and when the current fiscal rules will be reactivated in their current form – and I have to say, I give a very large probability that this will actually happen because in the most likely scenario, the rules should be reactivated starting from January 2023 – the countries will have to prepare the national budgets according to the rules, and they typically plan their preparations in the spring of the previous year. So the national budget will start being prepared from spring 2022, let us say less than half year from now, and I cannot really imagine that within half a year, a major reform of the fiscal rules will be agreed. So my baseline scenario is that rules will restart from 2023 as they are. Now, from that point, countries have to do fiscal consolidation, except very few countries like Luxembourg and Sweden, which have very low debt and very low budget deficits.

But all other countries, including all the big ones, you have to do fiscal consolidation. But as you rightly mentioned, Maria, Europe has very ambitious plans to fight climate change, which will require a lot of investment. And a quite significant share of that investment will have to come from the public sector. So basically, in the years to come, more and more public investment has to be made in the fight against climate change. But at the same time, all countries will have to start fiscal consolidation. And I am afraid that these two things will not happen simultaneously.

If you look back again to the history and look at historical episodes of fiscal consolidation, you see that public investment was actually cut almost everywhere. And again, the reason is relatively straightforward: when a government has to choose, let's say, between cutting spending for building a new bridge or reducing pensions or public sector employment wages or some other current expenditure, then it's much less painful to cut and postpone an investment than cut current spending. And I think this bias, which is well understood also from a political perspective, will always remain with us.

So we will need to do fiscal consolidation and at the same time, we will need not just to maintain the level of public investment and even increase it. And I am really afraid that these two things will not happen. We also hear that in the case of Germany, there are some tricks going on of creating a new special fund in 2022, and the rules are not yet active. So some tricks are perhaps being made in a few countries, but overall, across the European Union, I think this will be the challenge of this decade, how to increase public investment at the same time when fiscal consolidation will have to be made.

Demertzis: A very sober outlook, Zsolt. You are saying that we need to go back to the current set of rules. You also say that the current set of rules are not fit for purpose because we have huge investment. So one of the two needs to be sacrificed. Unfortunately, that will be the investment, right? That is what you say. So we can forget about our climate ambitions, if I read you correctly. Rolf, do you share Zsolt's pessimism?

Strauch: I do not know whether it is pessimism, but my perspective is that first, there will be naturally some consolidation, just by those temporary measures that were taken for the crisis to phase out. That is what we can expect and what we should expect. So then the question is, will there be more consolidation, or should there be more consolidation beyond that? And by what kind of framework is that governed?

So, I do agree with Zsolt that the probability of having new rules in place is not very high at the time of next spring, when the budget is planned. But that does not mean that one could not politically formulate some kind of a transition period, where some support can be maintained. So that, for me, is a political question. And from that I would not deduct that we cannot find an operational framework. And that can still be somewhat different from how the fiscal rules will eventually look like, if we cater for a transition period and how we want to address the long-term challenges.

Now, on the long-term challenges and the link with climate change, I do agree that climate change [related] investment will be an important component, obviously, of future fiscal policies that we have to address. It is broader than that. I think also, convergence is an important issue that we need to have in mind, and we need to have resilience in mind.

Thinking of all of this, it is clear that there cannot be fiscal policies only, but it has to be structural reforms as well, and a big part has to go to the private sector, and the private sector has to deal with it. And we can talk about that later on. So can we secure climate change? Should we secure climate change policies over that period? Yes, I think we should. We should with all the measures that we have, that may mean some reprioritisation of public spending. It may mean that incentivising the private sector to do the right things. And it may mean that maybe taking initiatives at the European level in order to support forward going climate change action beyond what is done currently in NextGenerationEU. At this stage, NextGenerationEU at the European level and implementing it has priority and is probably the best we can do for climate change, and that will carry us through the next couple of years.

And from there we will also learn how we can go forward and can take better informed choices in that regard. So I do not think that what we envisage now is incompatible with adequately dealing with climate change. I do agree that it would be good to have a clear transition regime, if we cannot agree on new fiscal rules. And again, I also said, as I said before, I think it would be good to have a very good discussion on how we can make the fiscal rules more effective.

Demertzis: But can I ask, realistically speaking, and it is not just about the political will to design a transition phase. There are countries that are very heavily indebted. I mean, the fiscal space for some countries, it just is not there. We have legacies that need to be financed. How are those countries going to meet equally ambitious climate needs when there are also

investment needs? Certainly on the public side, of course, on the private side, and we can do things to incentivise the private to be involved more. But without the public contribution there, it would be difficult to still drive that. How do you do that when you have huge legacy debts?

Strauch: Maybe let me take this up straight away – because obviously, as I said before, Greece, having the highest debt in the euro area, is clearly on our mind. And when I say at this stage that I think that public debt is sustainable in euro area countries, I also have Greece in mind. And we have mentioned the factors before, right? That is, low interest rates have tremendously increased debt-carrying capacity. If you think about highly indebted countries, they pay typically much, much lower interest rates today than they did with lower debt levels before. And that is just an indication. And we probably can agree in this round that interest rates are going to increase.

But I think we probably can also agree that they will not increase to an extent as we had seen, maybe prior to the global financial crisis, that we get back to the old regime, at least not for the foreseeable future over the next decade or so. Now, having that in mind that is what allows me to say that I am not overly concerned by having high debt levels per se. What I do say is that it still requires a clear degree of fiscal discipline in the sense that you need to have a credible fiscal path of addressing it, because that is what will sustain market confidence.

So you need to have clarity on how you want to deal with it. But that does not mean that by all means, you need to rapidly reduce debt levels in order to have sustainability. From that perspective, there is discipline required, but not exaggerated consolidation.

Demertzis: I am actually glad you brought the issue of the credible path here because I don't want to get into discussion as to where the interest rates are going to go anytime soon. That is another kind of discussion. We have a different podcast on this. But if the central bank, the ECB, finishes the QE programme, interest rates will go up by themselves, and it will not be through monetary policy. It will be through the financial fragmentation. So the risk associated with the credibility path that still needs to be designed – and interest rates are still going up – is still there, and it's very visible, and it very much depends on what the ECB is doing.

So I still don't know we are going to prevent that from happening and how we're going to ensure that the fiscal needs in the future can be met by country needs only. It is still not clear that we can have equally ambitious climate objectives when the fiscal space is very difficult in countries; it's a circle that I cannot close, if you like. Zsolt, come into the discussion.

Darvas: I very much share, Maria, your risk concerns and risk assessments. Currently, we are all very happy about, at least from the public finance perspective, about the low interest rates. But this might not stay with us forever, partly because the ECB might, as you say, sooner or later, reduce and eventually stop its massive quantitative asset purchases. We also do not know what will happen to inflation. Currently, we see a big spike in inflation. Now, all the central banks argue that this is just a transitory phenomenon. Let us hope they are right. But if not, and in particular, if it starts to spill over into increases in other prices, the low inflation era might be behind us. I mean, we do not know at this moment, which will immediately necessitate higher interest rates, and then that financing cost will increase.

And let me add another factor that when we look at the literature on the impact of climate change on growth and also the impact of public climate or green investment on growth, the results are not really clear-cut. Even the European Commission impact assessment of the transition to the net zero suggested that there are scenarios in which in fact the growth impact will actually be negative. There are also scenarios in which growth impact will be positive, and the Commission uses the New Green Deal as the EU's new growth programme. Nevertheless, if you look at the details and also other analyses, climate change actually can make public debts more difficult to sustain, not least because, for example, due to extreme weather events, which will necessitate more public resources. Overall, if you do the transition fast, then some currently productive activities will have to close down, jobs will be lost.

So overall, whether green investment and climate change in general will increase productivity and output is not that clear-cut. And there are scenarios in which actually all these climate-related issues could actually lower productivity and GDP. And at the same time, if you spend more by the public sector, so public debt is going up while GDP is going down, then the fiscal sustainability challenges can be even more serious. So that's why also in one of our recent papers that I wrote with Guntram Wolff, we discriminated between two sets of countries. We did not say which country belongs where. But we said that there are countries that currently have weaker fiscal positions and countries which still have strong positions. So countries which have weaker fiscal positions, we were very cautious not to suggest a big expansion of spending. But there's also good news, I have to say: that if you look at the distribution of NextGenerationEU funds, the EU recovery money, then we see that to a very large extent, it goes to countries with large public debts like Greece, Italy, Portugal – they will get significantly more than, let's say, Western European countries.

And as we know, that 37% of recovery money has to be spent on climate change. So what we did advocate is that indeed, countries which have a shakier fiscal position for the next, let's say five or six years should rely on the NextGenerationEU for the green public investment. They should not receive special treatment for other additional green investment, and that can be sufficient.

Demertzis: And they will. It is not that they should, but they will.

Darvas: But for countries, let us say, like Germany or even the Netherlands and France and other countries which do not have such debt sustainability constraints, what we suggested is that a good solution would be to exclude the increase in net public investment in green activities from the fiscal rules, because that would create incentives to do more green investment at the same time when the budget will have to be consolidated.

Demertzis: So you are arguing for differentiation of the rules, as it were.

Darvas: Yes, differentiation, depending on the fiscal space.

Demertzis: In fact, I am looking at the time, and there are two things more that I would like to touch and ask you both because I think they are important in this conversation. I do not want us to close this podcast without referring to the NextGenerationEU fund. How do you see that as an innovation - temporary, or permanent, and why? But I would also like to ask you: if you were to make one change to the fiscal rules, what would that be? And I will start with you, Rolf.

Strauch: Thank you for letting us address a bit more broadly the fiscal structure, or the fiscal challenges that we see forward looking. So in this regard, NextGenerationEU, we know it is temporary. I think again, as I said before, we had a very good start. And what we should also consider with this good start is indeed the amount of reforms – structural reforms – that were put into the programmes, and actually now put forward by Member States. Now, of course, the most important part is actually to follow up on this to implement them, and also for that, there are steps and governance in the programmes to try to ensure this.

I think from NextGenerationEU what we can do forward looking and take away, in my view, as positive lessons are two points. The one point is that it creates positive incentive schemes for reforms. And if we look at the country-specific recommendations that are now complied with in Member States and included in the programmes, it is much higher than what we have seen in the past and more comprehensive, more ambitious. So from that perspective, one lesson out of NextGenerationEU forward looking would be this.

The next one, obviously is also with a view to climate change. It is good that it is envisaged to be financed by green taxation, climate-related taxation. So that is also a positive point that one can take forward. What I would like to take forward beyond NextGenerationEU is the question if there will be some kind of a follow-up. We know NextGenerationEU is temporary, but could one, for example, find other means in the EU budget to implement such a scheme to further support green investment?

The other point, an issue that we still need to address is this issue of resilience, also that you mentioned, and of course, with risks being there, we cannot exclude that also forward looking, a crisis may emerge. And therefore, what we think is that a permanent fiscal stabilisation facility that complements national capacity would be helpful. We are a crisis resolution mechanism, so when really it becomes very tough, we step in, but there can be downturns. There can be other situations where such a stabilisation mechanism, a central fiscal capacity could be good, and then there are different ways of organising it. Many proposals have been made on that. I think if we put this together, we get to a more complete fiscal financial infrastructure for the euro area. But again, I can only make the point that I had before - that it cannot be all the public sector. So we need to think about further recovery. We need to think about climate change in the private sector and what we need to do there. The same holds for resilience, holds for risk-sharing. And here just those agendas on banking union and capital markets union are crucial, and we are not discussing it right now. But obviously there's a lot to be said about this, how elementary and fundamental they are in securing future growth and us being able to deal with climate change.

Demertzis: But do you think, Rolf, that the NextGenerationEU fund is a good template for designing such a centralised fiscal capacity?

Strauch: From my perspective, the two are different things. NextGenerationEU is in its very nature more related to convergence and structural change. That is what it wants to achieve. Yes, it is now also used to get out of the crisis, but it is not perceived a stabilisation mechanism. Stabilisation mechanisms, like a rainy day fund, as they are discussed, they come into place in order to really address a crisis in the short term and provide support. And then you can also direct expenses or the support towards investment, but not necessarily so. So I think by nature they are different.

Demertzis: But effectively, what I am asking is that the size of this fiscal stabilisation mechanism is much smaller than the NextGenerationEU from the way that you describe it, right? Do I understand correctly?

Strauch: So the size that is mentioned in the literature is about 1-2% of GDP for a stabilisation fund. Already with 2% you can provide effective support.

Demertzis: Zsolt, your final thoughts? We have heard what you would like to change in the rules – the exclusion of investments for green needs. What is your take on the NextGenerationEU fund?

Darvas: Let me pick up a point from Rolf on possibly using the EU budget more or any other EU facility for financing climate change. And the reason I would like to pick that up is in fact, the NextGenerationEU can be sold as a kind of tool to flout fiscal rules because the EU-wide borrowing will be paid back by Member States. But since this is EU-wide borrowing, and ex-ante we do not know who will pay back how much in the next three decades. That component of NextGenerationEU, which is distributed by grants, will not count as the public debt of Member States.

So basically, the EU borrows about 2.5% of its GDP and redistributes across Member States. But this 2.5% of GDP is not counted anywhere as public debt of European Union countries. The case is different for loans – for direct loans, let's say to Italy, Portugal or Poland and other countries – that will be counted as public debt. But the grant component of NextGenerationEU is not counted as public debt. But it also means that if something similar will be done with the climate expenditures, then this would be a clever way for excluding green public spending from fiscal rules. Because if, let us say, we set up a new EU fund, let the name be “The Future of Climate Fund”, that fund would borrow in the name of the EU. The repayment of that fund would be similar to the NGEU, namely, that Member States would pay that down in three decades from regular contributions. It means that fund would not be counted as national public debt, and the spending from that fund would not be counted as budget deficit. So that could be, I would say, a clever way of circumventing fiscal rules and giving countries fiscal resources for climate investment, which does not count into fiscal rules.

There will be a further additional advantage of that, namely, that all green investments funded by that fund would be approved both by the European Commission and the Council, meaning that national green investments will be fully in line with the European priorities. So in fact, setting up such a fund could be a good way of circumventing fiscal rules. But then comes a very tricky question whether the fund should involve redistribution, as NextGenerationEU does, and also as the general EU budget does, or not, because if there is redistribution, then I think there is no chance that such a fund would be agreed. We need massive climate investment, and we already saw how difficult it was to agree on the redistribution, which is involved in the NextGenerationEU.

So I do not see any political chance for such a fund, but if there is no redistribution, and countries pay back what they get, then the whole beauty of this thing would disappear, because then we would know what each country is paying back, then Eurostat might decide that, look, this fund actually has to be added to national debt. So there are some options for flouting fiscal rules and using a new EU fund for creating more fiscal space for investments. But it is not clear-cut and a lot depends on whether there is redistribution or not.

Strauch: Can I please just add to this very quickly? I think the purpose of neither NextGenerationEU and whatever, if anything may follow, should be to circumvent the fiscal rules. The NextGenerationEU has a fundamental positive purpose of trying to engineer recovery and also do it so that those that lost most are helped more. Forward looking, I think for any such facility, or if you use the EU budget, the point would be to support climate change mitigating policies. That's the positive thing that one wants to achieve. And I personally think also, as I said before, we need to be mindful of convergence and an element of convergence in supporting countries. That consideration of solidarity should also usefully be included in order to fit the purpose. And that would be the objective.

Darvas: I very much agree, Rolf, that the fundamental goal is the fight against climate change. But my major worry is that when we reinstate fiscal rules from 2023, then the conflicting needs of fiscal consolidation and increased public investment will not be satisfied simultaneously. One will be lost and I am really afraid that green investment will be the losing part in this race.

Demertzis: If I may, I was hoping to finish with Rolf's upbeat message, but I cannot help listen to Zsolt very carefully. I think this has been absolutely fascinating. I think there are more questions than answers here, but thank you both for sharing your views on this. I think you both make very important points. I certainly share Rolf's original point that we are now in a much better position than we were ten years ago, architecturally only, but also we've learned from mistakes of the past, and this crisis was managed a lot better than the previous one simply because we had the benefit of insight and that is not to be underestimated, in view also of the challenges that we are going to face in the future.

But with that, I think we are coming up to an hour now and I would like to thank you both for joining me today. That is all from us for today.

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