

Impulses for Growth and Stability in Europe - article by Klaus Regling

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"Impulses for Growth and Stability in Europe"

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John Maynard Keynes is often quoted with these words: "When the facts change, I change my mind. What do you do?"

Very likely, however, the true originator of this quote is not Keynes but Paul Samuelson, another famous economist.

Regardless of its provenance, the sentence contains a rather sensible statement – especially when analysing economic developments. It is not only prudent, but also imperative to take changing economic conditions into account.

Take the discussion about the European Stability and Growth Pact (SGP). The SGP was conceived in the mid-1990s and adopted in July 1997. Since then, several steps have been taken to amend and revise the fiscal rules in this pact, most recently with the entry into force of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) on 1 January 2013.

In the mid-1990s, I was involved in the drafting of the SGP as a staff member of the then Finance Minister Theo Waigel. I remain convinced today that a credible

framework for fiscal policy is essential in our monetary union.

The European Central Bank (ECB) is responsible for monetary policy in the euro area, while fiscal policy is largely decided by national governments and parliaments.

An irresponsible fiscal policy in individual member states, especially if it jeopardises debt sustainability, can become a problem for the entire monetary union. Monetary policy can thus be confronted with an unsolvable task. Avoiding excessive deficits and debt levels is clearly in the common interest of all parties involved.

The original SGP is now 24 years old. By and large, its main goal of limiting budget deficits has been achieved. On average, the fiscal balance of the euro area compares favourably with that of other major economies. Several countries, including Germany and France, broke the rules shortly after the turn of the century. Henceforth, the pact was reformed in several steps, first in 2005 and later in 2011-2012. As a result of these changes, we are now left with a very complicated set of rules that are difficult to explain and therefore not easy to enforce. In addition, important basic economic conditions have changed in the last 30 years. A reform therefore makes sense.

Due to the pandemic and the associated need to support the economy, the rules are suspended until the end of 2022. This is in line with the existing SGP rules, and it is fully justified in this situation. At the same time, it gives us a window of opportunity to modernise the rules before the sanction mechanisms kick in again. We should use this time window.

One particularly notable change in the last 30 years is the interest rate environment. An example: on average, in the 1980s, the yield on 10-year German government bonds was 7.6%. In the 1990s it was 6.6% and in the period 2010-2019, until the start of the pandemic, it was 1.1%. In other euro area countries, this development is even more striking.

This development has to do with structural, demographic, and macroeconomic changes in Europe and other parts of the world. On the one hand, this includes a productivity growth rate that is trending downwards. On the other hand, there is a clear demographic change. Population ageing leads people to save more of their current income. The trend towards a higher savings rate can be observed in many countries, and it is reinforced by the increasing inequality in the distribution of wealth. Higher savings in turn lead to an increased demand for safe and low-risk

assets. These are needed in the financial markets, for example to be used as a capital base for future pensions.

As a consequence, economic theory predicts a decline in the 'real natural interest rate', i.e., the interest rate that ensures an equilibrium between savings and investment. Empirical observations corroborate the theoretical expectation. The factors behind the decline in interest rates are unlikely to change in the foreseeable future. On average, the interest rate level can therefore be expected to remain well below its previous levels. Not as low as it is at present, but significantly lower than 30 years ago. This will be the case, even if a post-pandemic economic recovery should lead to an increase in real interest rates.

Economic policy must take such changes into account. There is a need for action on the SGP, as the pact in its current form does not reflect the changed macroeconomic environment and can therefore lead to conclusions that make little economic sense.

However, such a reform requires not only economic but also political and legal considerations.

In EU law, the SGP provisions are mostly contained in secondary legal acts, in contrast to the EU treaties, which are referred to as primary law.

Historically, a full revision of the EU treaties has proven to be difficult and can take many years. We do not have that much time, and indeed it is not necessary in this case. Instead, we could make use of a solution proposed in a discussion paper by some of my colleagues in the European Stability Mechanism (ESM). The crucial provisions are in a protocol to the EU treaties. This protocol can be amended through a special legislative procedure. The amendments would require unanimity in the Council, as well as a consultation of the ECB and the European Parliament.

In terms of content, there are several proposals on how to simplify the fiscal rules and simultaneously make them more effective and credible. For example, in the aforementioned discussion paper by ESM staff, it is suggested to retain the existing 3% limit for the government budget deficit, while increasing the reference value for total government debt from 60% to 100% of gross domestic product (GDP).

In view of the significantly lower interest rate level, such an increase in the debt reference value is justified. Some observers fear that it would be equivalent to giving a carte blanche to governments that embark on an irresponsible fiscal policy. I do not share this opinion. A debt ratio of 100% implies a much lower interest burden in

today's situation than a debt level of 60% in the mid-1990s.

The proposed change would be combined with guard rails for public spending. For all member states, expenditure growth should generally not exceed the growth trend in real GDP.

Countries with a debt level of more than 100% of GDP would also have to cut the debt overhang by 1/20 every year, through an adjustment of the primary budget (excluding interest payments) – unless the country is in recession or has an investment gap in the public sector, as measured by objective, observable criteria. The latter mainly concerns spending to reduce climate-damaging emissions and growth-friendly infrastructure measures.

This proposal would reduce the complexity of the existing rules, preserve the fundamental orientation of the SGP and integrate objectives that could not have been thought of 30 years ago. The European Fiscal Board – an independent advisory body to the European Commission – already presented a similar proposal two years ago.

The reform of the SGP should leave the fundamental features of the existing rules untouched. It remains crucial for cohesion in the monetary union that countries with relatively high debt ratios adjust their fiscal policies in such a way that the debt remains sustainable.

High government debt should always be reduced when macroeconomic conditions permit. This gives governments the necessary leeway to enable growth-friendly investments and to allow the automatic stabilisers – through the social security and tax systems – to work in the next crisis.

A classic task of fiscal policy is to mitigate cyclical fluctuations. The amplitude of such variations has tended to increase in recent decades. This could be a reason to create European mechanisms to stabilise economic development, support national measures and complement the reform of the SGP.

The European Commission has relaunched public debate on the review of the EU's economic governance framework. This is very welcome, and many stakeholders will be making their proposals in the near future. In the process, we should both draw on the experience of the last 30 years and react resolutely to the current challenges.

It is also a good opportunity to drop archaic and artificial antagonisms, e.g., between 'North' and 'South'. The euro area countries have far more common interests than conflicting ones. This should be emphasised more in the public discussion. Here I also think about issues such as financial stability, and the role of the EU and the euro in a global context.

The European economy is in global competition and must be better prepared for it. Reforming fiscal rules is just one undertaking among many that are critical to our shared success, including:

- the creation of a banking union and a capital markets union;
- the strengthening of the international role of the euro;
- enabling investments in climate-friendly technologies and in digitalisation;
- strengthening convergence in the euro area.

All of this requires a lot of work. But I am confident the next step will be an agreement on pragmatic and purposeful guidelines for fiscal policy.

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