The reform of the EU fiscal rules: time is of the essence

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Over the past 15 years, the euro area has been confronted with several crises. Unwavering determination, new tools, institutional reforms, and an increasing degree of solidarity have helped the euro area overcome these crises and become more resilient.

Following the severe pandemic-induced recession, the euro area experienced a strong economic rebound before waking up to the horrors of war at its doorstep.

Beyond the unbearable human toll it has been engendering, the war on Ukraine has also significantly exacerbated inflationary pressures that had emerged during the COVID-19 crisis. Despite this new shock, the euro area narrowly escaped a new recession.

Even so, challenges remain. While headline inflation is receding, it remains elevated and core inflation has remained uncomfortably sticky. Both the pandemic and the energy crisis have required substantive fiscal stimulus, thereby augmenting public debt. In the short term, this increase doesn’t pose an imminent risk, as governments have been able to lock in their refinancing at very low rates during an extended period. However, as interest rates go up, vulnerabilities will increase over time.

While economic policies did reinforce each other during the pandemic, the current economic context necessitates a new alignment between monetary and fiscal policies. Government spending needs to remain in check to avoid undermining the effective transmission of monetary policy. In the same vein, prudent fiscal policies are imperative to safeguard debt sustainability over the medium term.

Against this backdrop, the ongoing reform of the EU fiscal rules is crucial. With the general escape clause phasing out by the end of this year, time is of the essence. Reverting completely to the old set of rules would entail a clear risk: imposing an overly ambitious consolidation path on countries with higher debt levels and thereby confronting them with unwarranted economic hardship. This would not only weaken these member states, but also the euro area as a whole.

The future fiscal framework will need to include several features so it can better serve its purpose:

- First, it will have to be transparent. Making rules less complex automatically leads to increased transparency. In this regard, setting targets in the form of simple and observable variables that are under the direct control of governments would help considerably.
- Second, the framework needs to gain in credibility. Once agreed, all parties will have to abide by the rules. If not, trust in the system will be undermined and fail to send reliable signals to the markets.
- Third, the reformed framework should be based on the clear tenet that any debt consolidation path should reconcile both stability and growth. Both should go hand in hand. This would foster ownership and generate superior outcomes.

- Finally, the emphasis should be on “sustainable” growth, as sustainable growth constitutes a strong foundation for stability.

The European Commission’s communication on orientations for a reform of the EU economic governance provides a good basis for discussion. The proposal incorporates many of the features that policymakers, academics and analysts have been calling for in recent years. It represents a welcome step forward with its medium-term orientation and the move towards observable fiscal variables.

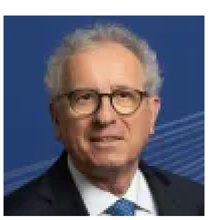
The consideration of members states’ different starting points and the possibility to lengthen adjustment paths by up to three years to implement reforms and make investments are also welcome. Yet, such reforms and investments should be well-planned and growth-enhancing to justify longer adjustment paths.

This reform is critical from the standpoint of the ESM because it has several implications for its work.

First, debt sustainability, which is central to the Commission’s proposal, is at the core of the ESM's work. Unsustainable public debts put at risk financial stability, the safeguard of which is the ESM’s primary mandate. Furthermore, access to ESM financial assistance, particularly its precautionary credit lines, is tightly linked to criteria related to EU fiscal rules. Finally, the ability of the ESM to track countries' ability to repay their ESM loans – the so-called early warning system – is inextricably linked to post-programme surveillance, which is also addressed in the Commission's communication.

Agreeing on a reformed fiscal framework that strikes the right balance between sustainable growth and stability is key to make the euro area prosper and become even more resilient. The coming months present a unique window of opportunity to do so.

Author



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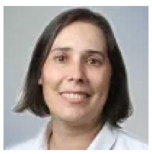

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