CENTRE FOR EUROPEAN
POLICY STUDIES

EU Economic Governance

Past, present and future

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Outline:

- A historical overview of the EU governance framework
  - The original EMU design
  - The post-2010 changes in the E(M)U macroeconomic governance
  - The Economic Governance Review
- The new framework
  - What will change
  - An early assessment
- Conclusions

The original design of the EMU (I)

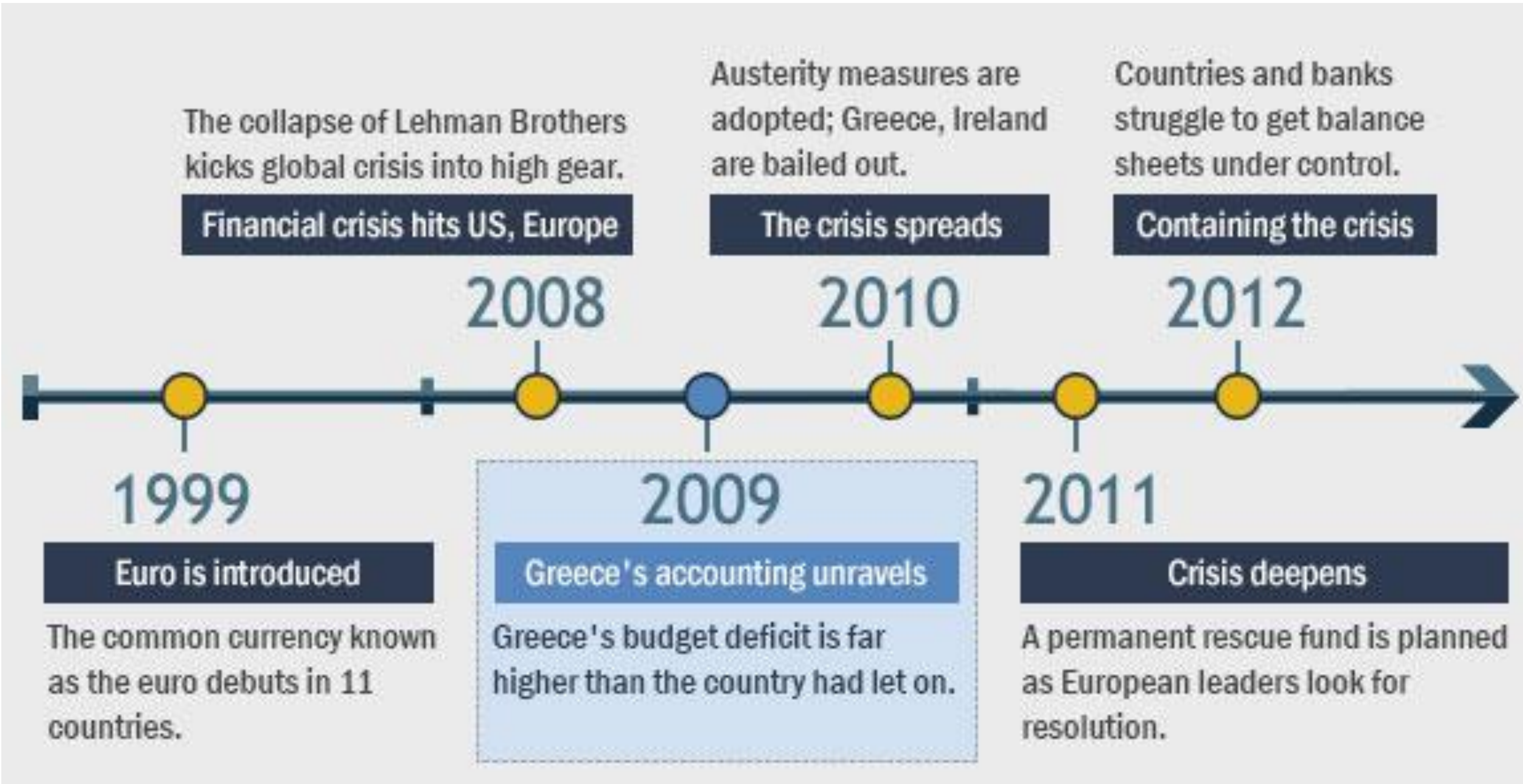
The EMU model was based on three pillars

1. Single monetary policy:
   – Price (and implicit financial) stability
2. A flexible economy
   – Mobility of capital and labour and trade in goods and services (single market)
   – (some) Flexibility in prices (and wages)
3. Fiscal rules to ensure limited action for fiscal policy
   – Fiscal stability ex-ante
   – Focus on budget balance (headline first, cyclically adjusted later on)

The original design of the EMU (II)

1. EMU system was not designed to handle state insolvency
   – Zero-risk weighting on sovereign bonds (financial regulations)
   – No monetary financing
   – No bail-out clause
2. Fiscal rules were originally rather simple
   – 3% deficit and 60% debt benchmarks
   – embedded in the Stability and Growth Pact (SGP): protection from fiscal crises
3. The SGP was first reformed in 2005
   – to introduce a more sophisticated approach to fiscal surveillance built on the concept of “structural balance”

..and then the Euro area crisis came



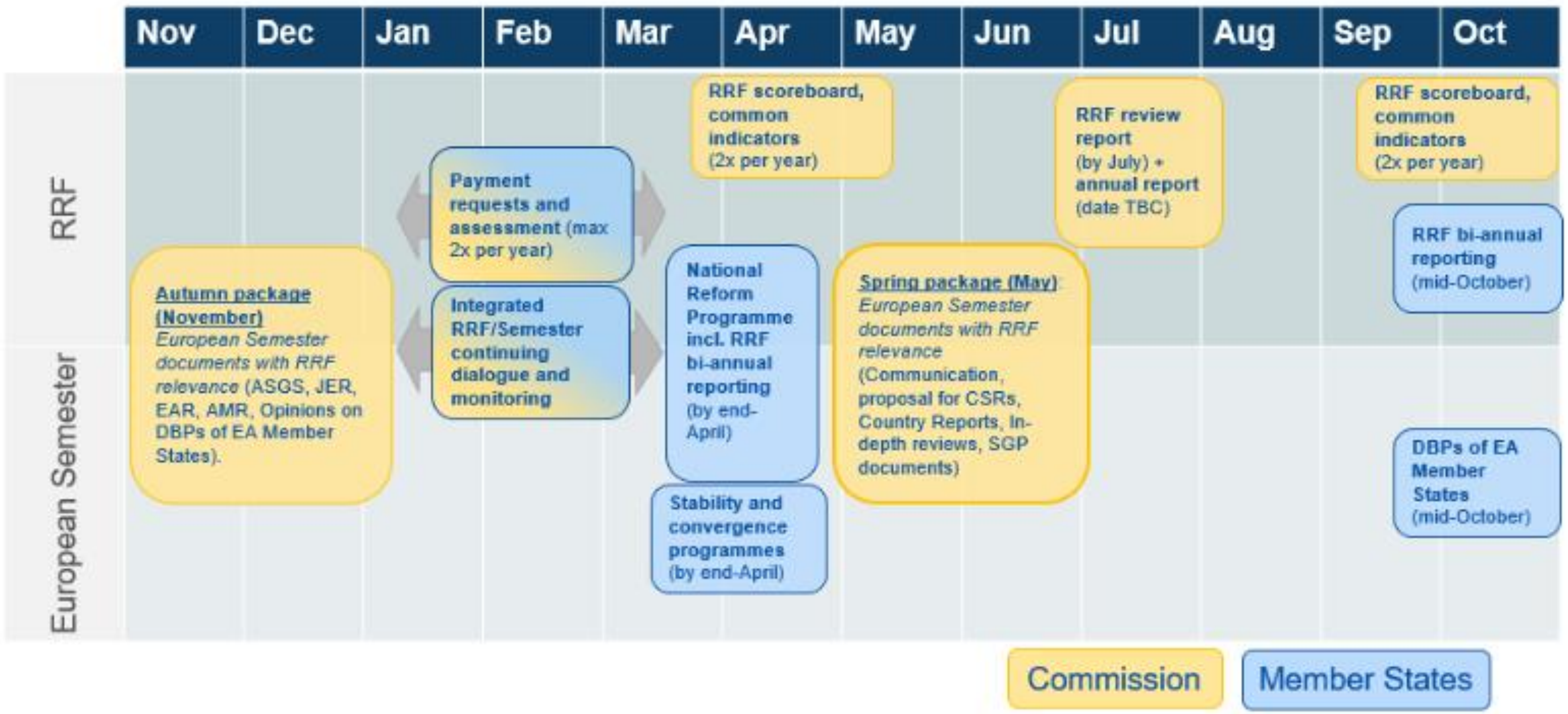
Source: European Commission

The responses to the financial crisis

- The EMU design did not include a safety net for financial crises
  - The EMU did not have tools to deal with a banking crisis.
  - This contributed to making it an existential crisis
- Among the many responses a key one was the reform of the economic (and financial) governance:
  - Underlying idea: fiscal rules did not prevent the crisis
- It led to the establishment of the European semester: A framework for
  - Coordination of economic policies and implementation of the SGP
- Focus mainly on fiscal policy:
  - consistent with Maastricht's view, stronger fiscal rules:
    - New SGP + MIP, Fiscal Compact

The European Semester cycle

(modified to integrate the RRF)



Source: European Commission

The governance reform (2011)

New SGP:

- **The Six-Pack** (5 regulations & 1 directive)
  1. Improve economic and fiscal surveillance (EU semester)
  2. Make rules ‘smarter’: MTOs – expenditure benchmark
  3. Improve enforcement: Sanction procedures (for EA MS) more automatic
  4. Debt is also important not only deficits
  5. Not only fiscal matters but also macroeconomic imbalances
     - Prevent and correct risky macroeconomic developments
- **Two-pack regulations**:
  - common budgetary timeline
  - enhanced monitoring and surveillance for EA MS in case of severe financial instability
    - Before/after adjustment programmes

The fiscal compact

- Fiscal compact or TSCG (Treaty on Stability Coordination and Governance)
- International treaty (2012) - outside the EU Treaties - with 25 signatory countries (+ Croatia)
- Meant to ensure enforcement of EU rules by keeping national sovereignty:
  - Constitutionalization of fiscal rules
- It is a stricter version of the SGP
  - The national budget has to be in balance or surplus:
  - **structural** deficit not exceeding a country-specific MTO and structural deficit below:
    - 0.5% of GDP if debt-to-GDP is above 60%
    - 1.0% of GDP if debt is below 60%.
- The fiscal compact has been integrated into the constitutions, but it is de facto forgotten

The evolution of the SGP

- The reform resulted in increased complexity of the rules and lower predictability
  - Trade-off simplicity vs. smart rule became soon very clear
  - Communication becomes more difficult
- EC sometimes had to take ambiguous positions:
  - Can the EC remain the guardian of the Treaties and exercise discretion typical of the political function?
- Debate about fiscal rules never stopped
  - Main criticisms related to:
    - Pro-cyclicality
    - Lack of enforcement
    - Complexity

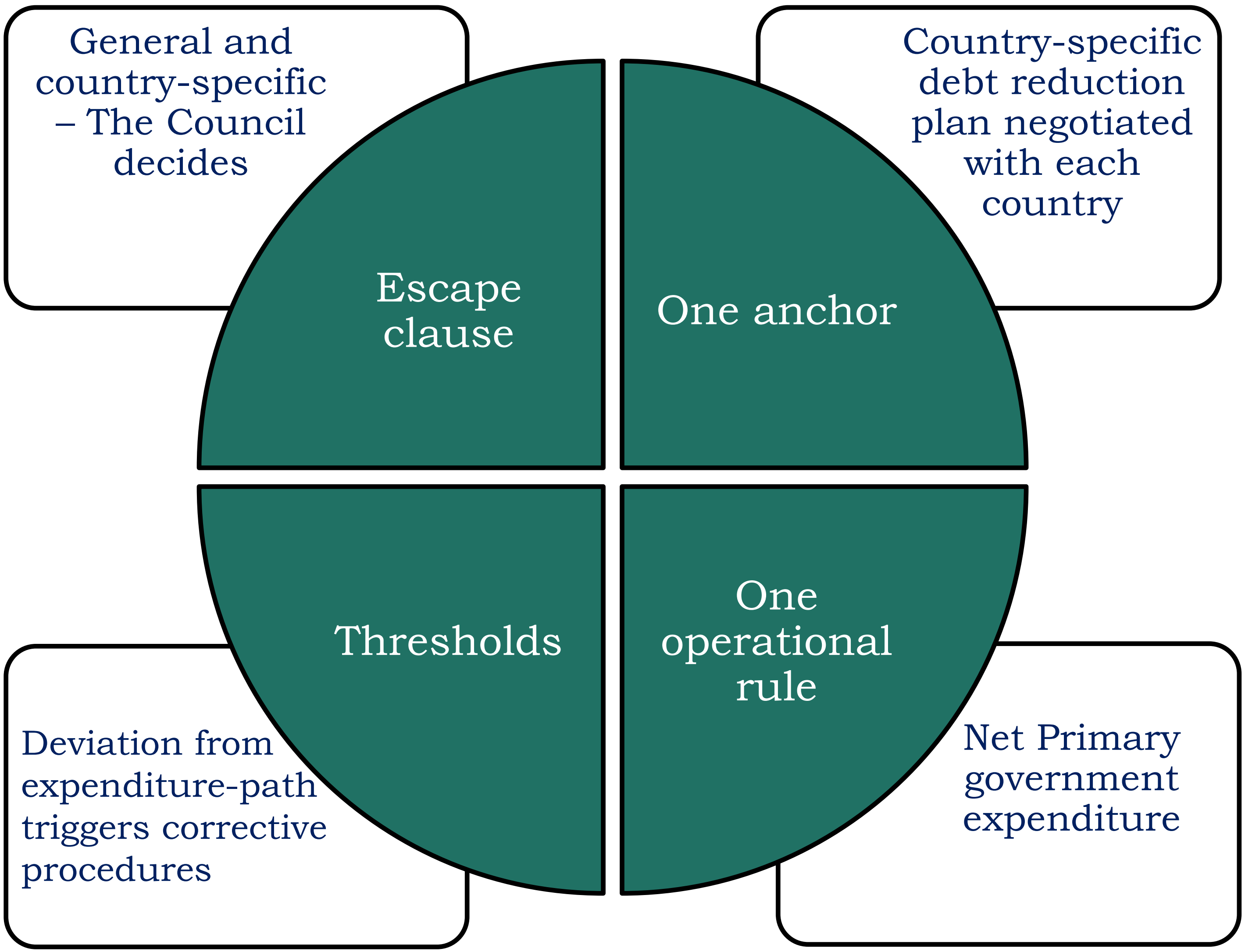
The evolution of the SGP and politics

- At the onset of the EMU: The SGP was thought of as - "a quasi-automatic mechanism to impose sanctions" and grant fiscal discipline – Maastricht's view
- 2002: Prodi calls the Pact "Stupid" and in 2005 the concept of structural balance is introduced
- 2010: the financial crisis reopened the debate of "rules versus discretion" in fiscal policy – but choice was for reinforced rules
- 2014: Juncker qualified his commission as a "political" one and rules can have a flexible interpretation
  - No sanctions applied to France and Italy in 2014
  - No sanction to Spain and Portugal in 2016
  - Italy 2019: sanctions stopped by additional measures
- 2019: von der Leyen qualified her commission as "geopolitical" signalling a complete change in priorities
- What's next with a new Commission coming in the fall?

Another reform…

- In February 2020 the EC launched a process of economic governance review (EGR)
- The process was interrupted by the pandemic.
  - In March 2020, the EC and the Council activated the general escape clause, allowing MS to undertake budgetary measures in exceptional circumstances.
  - The clause was then extended to 2023, in light of the conflict in Ukraine
- The EGR process was reactivated in October 2021
- In April 2023, the EC published a package of three proposals to revise the EU's economic governance framework:
  - a regulation to replace the current preventive arm of the SGP,
  - an amending Council regulation on the corrective arm of the SGP, and
  - an amending Council directive to strengthen the role of independent fiscal institutions
- In December 2023, the Council reached a political agreement on the economic governance proposal
- In February 2024 the EP and the Council reached a political agreement on a comprehensive reform of the EU's economic governance framework

New generation of rules



Key features

Simplification:

- "Structural deficit", a controversial variable, was abandoned in favour of **net primary expenditure**. **However:**
- Structural variables are still present e.g. in the debt sustainability analysis, in the calculation of cyclical unemployment expenditure, and in the minimum deficit reduction and deficit resilience safeguards.

- The safeguards multiply the control variables and reduce simplicity.
- The Commission submits **a 'reference trajectory'** (previously called 'technical trajectory') to MS where government debt exceeds 60% of gross domestic product (GDP) or where the government deficit exceeds 3% of GDP.

Ownership:

- Country-specific plans are meant to increase national ownership through the extension of the time frame and the possibility to set priorities and plan reforms and investment

Key features

Flexibility improved by tailored adjustment plans and their possible extension. However,

- the maintenance of the 3% deficit and 60% debt benchmarks represent a constraint.
- The safeguards directly limit the adjustment paths of countries above such thresholds

Reforms and public investments for sustainability and growth should be reinforced

- MS allowed to ask for an extension of the 4-year fiscal adjustment period up to 7, if they carry out certain reforms and investments that improve resilience and growth potential and support fiscal sustainability and address common priorities of the EU (from green and digital transition to security and defense capabilities)

Credibility and enforcement are possibly fragile, as the likelihood of effective compliance can be jeopardized by several factors.

- Deficit and debt benchmarks and safeguards imply important consolidation effort in several MS (possibly above 0.6% a year for several years)
- Somehow surprisingly national independent fiscal institutions have been relegated to a mere advisory role.
- Similar to the previous framework, the Commission and Council hold the final word (a model that has proven ineffective).

Conclusions

- The approach to the EU fiscal governance has changed substantially over time
  - In 2005, 2011, and now, changes were always driven by a crisis
  - Common to all, the attempt to account for lessons, but each crisis proved very different and so will be the next one
- The focus moved gradually from deficit to debt, from short to longer term. But the benchmarks were not changed
  - Treaty was not changed: 3% and 60% thresholds untouched
- The new framework has the potential to
  - bring back fiscal responsibility into the hands of the national governments, hence improving national ownership of the fiscal path,
- The short-term may prove difficult
  - Given the large deficits and high levels of debt, the rules will be tested soon after their introduction
  - Failure could jeopardise the credibility of the new framework from the start
  - But politics matters…

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