BRIEFING

European Parliament

Thematic Digest: "When and how to deactivate the SGP general escape clause?"

This note presents summaries of four papers on the conditions and timing for the future deactivation of the general escape clause of the Stability and Growth Pact, which is in force since March 2020. The papers, written by external experts, were requested by the ECON Committee of the European Parliament.

At the request of the ECON Committee, four papers were commissioned in September 2020 to external experts on when and how to deactivate the Stability and Growth Pact (SGP) general escape clause. In particular, the experts were asked to:

- Discuss the framework in which the general escape clause could be lifted, taking into account the objectives of the SGP, including the avoidance of pro-cyclical fiscal measures. Such a framework should inter alia refer to the indicators used by the Commission under the SGP, including under its flexibility provisions, and the objective of SGP.
- Assess whether other transitional arrangements could/should be applied, notably how to take into account debt and deficit levels which have sharply increased due to the pandemic.
- Discuss in which terms Commission and Council should recommend Member States to correct excessive deficits or adjust to their updated Medium Term Objectives, once a decision on the deactivation of the general escape clause has been made. Which periods and (transitory) paths for correction/adjustments should be foreseen? Which relevant factors should be considered?

The papers were published between November 2020 and January 2021. Their authors are:

- Erik Jones (Johns Hopkins University SAIS),
- Klaus-Jürgen Gern, Stefan Kooths and Ulrich Stolzenburg (Kiel Institute for the World Economy),
- Luisa Lambertini (École Polytechnique Fédérale de Lausanne) and
- Philippe Martin and Xavier Ragot (Sciences Po, OFCE and Conseil d'Analyse Economique).

Economic Governance Support Unit (EGOV)
Authors: J. Angerer and A. Zoppè
Directorate-General for Internal Policies
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Background:

In March 2020, the Council, based on a proposal by the Commission, activated for the first time the general escape clause under the SGP, in order to provide leeway for Member States to adopt emergency measures with major budgetary consequences. The activated clause allows Member States in the preventive arm to temporarily depart from their respective adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term. If a Member State is in the corrective arm (currently Romania), the clause implies that the Council may decide, on a recommendation from the Commission, to adopt a revised fiscal trajectory. In a nutshell, the general escape clause does not suspend the procedures of the SGP, but allows the Commission and the Council to depart from the budgetary requirements that would normally apply.

On this basis, the Council recommended in July 2020, without providing country specific fiscal targets, that Member States should take all necessary measures to address the pandemic, sustain the economy and support the ensuing recovery and that, when economic conditions allow, they should pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment.

In May 2020, the Commission adopted Excessive Deficit Procedure reports for all Member States (except Bulgaria, since it was not expected to breach the numerical Treaty thresholds on deficit and debt), in which it finds that all Member States do not comply with the deficit criterion (and some with the debt criterion neither). However, the Commission also considered - in light of the pandemic - that at this juncture a decision on whether to place Member States under the EDP should not be taken.

In July 2020, the European Fiscal Board (EFB) stated that a review date and the conditions for an exit from the escape clause have not been indicated and should be discussed and agreed as soon as possible. It also noted that '*In principle, the clause should be deactivated as soon as the severe economic downturn in the EU and the euro area comes to an end. However, there is no commonly accepted or agreed definition of a severe economic downturn. The Commission and the Council may hold different views. Also within the Council views may diverge considerably, especially if the economic impact of the Covid-19 crisis differs across countries: some may soon embark on an upturn, others may experience negative growth for longer.*'

In November 2020, the Commission stated: "*In light of this need and the still high uncertainty about the economic consequences of the pandemic, the general escape clause will remain active in 2021. In spring 2021, taking into account updated macroeconomic projections, the Commission will reassess the situation and take stock of the application of the general escape clause.*"

Recent statements by the IMF

End of December 2020, the IMF stated, inter alia, in an Art. IV staff report on the euro area:

38. ***Activation of the escape clause was warranted and should be extended until the recovery is firmly established.*** *The escape clause suspends the requirements of the fiscal rules with respect to structural fiscal adjustment toward countries' medium-term objectives, providing countries with adequate flexibility to respond to the crisis. But it does not suspend the requirement to open excessive deficit procedures (EDPs) for countries that breach the deficit criterion. All euro area countries will have deficits in excess of 3 percent of GDP this year, and most will exceed that threshold next year, suggesting they could be subject to the EDP. The Commission may find itself in the position of recommending opening EDPs for most euro area countries. There is also a risk that if the rules come into force again in 2022, it could precipitate a shift toward fiscal adjustment sooner than is warranted by economic developments.*

39. ***This could therefore be an opportune time to reform the fiscal rules.*** *Though undoubtedly politically difficult, a fundamental reform of the EU fiscal rules would be desirable. Any reform should simplify the rules and make them easier to communicate and enforce. While the Commission's fiscal rule review that started in early 2020 was delayed by the crisis, it will hopefully conclude in 2021. European leaders should task the review with the ambitious goal of proposing a fundamental reform and simplification of the rules.*

When and how to deactivate the SGP general escape clause?

Klaus-Jürgen GERN, Stefan KOOTHS, Ulrich STOLZENBURG

The paper by Klaus-Jürgen GERN, Stefan KOOTHS and Ulrich STOLZENBURG of the Kiel Institute for the World Economy starts by putting forward arguments on why the EU fiscal rules have become increasingly complex over the years; in a following step, it proves that the record of past compliance with the rules was mixed, at best. Turning to the corona crisis, the authors show that activating the general escape clause enabled a sizeable fiscal response, thereby mitigating the negative economic and social impact of the crisis: automatic stabilisers worked unrestricted and all Member States were able to launch counter-cyclical fiscal policies, although to a differing degree. However, the resulting strong increase of government debt, often from already elevated levels, implies considerable fiscal adjustment needs once the general escape clause will be lifted.

Their analysis concludes that:

- The general escape clause of the SGP should be lifted as soon as epidemiological conditions allow for a sustained normalisation of economic activity. "*This could be the case in 2022, if vaccines are made available to a sufficiently large share of the population in 2021.*"
- Under the current EU fiscal framework, a transitory arrangement should be adopted following the deactivation of the general escape clause, in which all Member States remain under the preventive arm of the SGP. Given the increased uncertainty about the long-term effects of the crisis on the Member States' economies, the corrective arm would remain deactivated for two more years and the Commission should consider pre-crisis estimates of potential output as a benchmark to determine fiscal adjustment needs.
- The current period - under the general escape clause - should be used to redesign the fiscal framework. The authors note that it is a difficult task, since criticism of the current rules has led to numerous reform proposals with quite different approaches. The authors also note that changing the fiscal rules to allow for higher debt ratios or structural deficits amid the current low-interest rate and low-inflation environment will keep high-debt countries vulnerable to changes in perceptions of financial markets and a possible increase in interest rates. Since they assess that focusing on expenditure rules would not eliminate the need for cyclical adjustment and has its own problems, they favour an alternative approach that aims at re-establishing the no-bailout rule laid down in the Maastricht treaty, which would eventually allow to dispose of fiscal surveillance entirely. This favoured solution would however require fundamental reforms, to disentangle the bank-sovereign doom loop and to allow for orderly restructuring of public debts. Therefore, they propose a transitory regime in which refinancing costs of Member States are subsidised - in the case of excessive yield spreads - by transfers provided by a fund that would be financed by all Member States.

When and how to deactivate the SGP general escape clause?

Luisa LAMBERTINI

The paper by Luisa Lambertini of the École Polytechnique Fédérale de Lausanne is based on quantitative analyses, notably of output gaps and fiscal stances. This quantitative approach indicates that output losses in the euro area could have been up to two times larger if the general escape clause had not been activated and if the provisions of the SGP had been fully applied.

The author recommends to avoid pro-cyclical policies, and that the deactivation should take place only once the economies have recovered from the effects of the pandemic. *"Lifting the general escape clause when economies are still in a downturn would prolong the recession, deteriorate public finances and ultimately defeat the purpose of activating the general escape clause*".

Concretely, she recommends that the 2020 output gap or the 2019 level of real GDP as forecast by the Commission in autumn 2019 should be taken as a reference for lifting the general escape clause, since they would adequately benchmark pre-Covid-19 economic conditions. On that data basis, each Member State should revert to the prescriptions of the SGP when its output gap has returned to its pre-Covid-19 level. "*Such Member State-specific return to the SGP can be implemented by deactivating the general escape clause, which is common to all Member States, and invoking the clause for unusual events for the countries that fall short of their pre-Covid-19 economic conditions."* Furthermore, she explains that a deactivation based on an aggregate EA/EU pre-crisis level of GDP, as proposed by the European Fiscal Board, would lead to pro-cyclical fiscal policy for those Member States whose output gaps are still large and negative. *"This scenario is particularly likely if the recovery from the Covid-19 pandemic is uneven across the euro area."*

Given that government debt is increasing considerably during the Covid-19 pandemic, leading to a deterioration of public finances for both low- and high-debt countries, the author suggests that the large shocks caused by the pandemic should be seen as an excellent opportunity for reforming the EU fiscal framework. More specifically, she proposes that Medium-Term Objectives explicitly take into account the country-specific debt-to-GDP ratio and interest rate-growth differential. *"Member States with higher debt levels should be given more time for debt/GDP to return to the reference level of 60%; Member States with higher and possibly positive interest rate-growth differentials need higher MTOs to ensure debt sustainability and should therefore be given longer adjustment periods."*

The author states that political economy considerations play an important role in debt adjustment, since faster debt reduction necessarily implies tighter fiscal policy and larger output losses, and therefore governments have little incentive to front-load the fiscal adjustment. In that respect, the ECB Pandemic Emergency Purchase Programme has contributed significantly to make the cost of new public debt negligible or even negative in most euro area Member States during the pandemic, by keeping sovereign debt yields low. This leads to the final conclusion that maintaining government debt yields at low levels after the pandemic would help public debt sustainability and would attenuate the negative impact of debt reduction on GDP; therefore, especially high-debt Member States should take advantage of periods with low interest rates to reach and maintain their updated Medium-Term Objective and reduce debt.

When and how to deactivate the SGP general escape clause?

Erik JONES

The paper by Erik Jones (Johns Hopkins University SAIS) addresses the topic of the 'severe economic downturn' that justified the activation of the general escape clause and looks at the policy response to the crisis; it considers how much it is possible to mitigate the economic downturn through the use of available fiscal and monetary instruments. The paper presents the divergence in macroeconomic performance across Member States and its consequences for the public finances. Importantly, it outlines those factors that should be taken into account when considering transitionary arrangements.

The author concludes that the deactivation of the general escape clause is contingent in many ways on a solution for the global pandemic and cannot be postponed indefinitely. He argues that the application of the clause is only possible as long as medium-term fiscal sustainability is ensured. The assessment of this sustainability includes a complex evaluation of the interactions between fiscal and monetary policy. *"The longer both macroeconomic instruments remain accommodative, however, the more they tend to distort private and public balance sheets."* The author derives from it that both monetary and fiscal policies must be allowed to unwind their accommodative positions, which is delicate given how the two sets of policy instruments reinforce one-another. *"The longer they remain active, the more challenging this unwinding becomes. Therefore, it is important to begin steps to reset these instruments sooner rather than later."* He underlines, however, that such consolidation should not come at the expense of the economic recovery.

A crucial conclusion of this paper is that finding a balance between a durable recovery and fiscal sustainability explains why it is necessary to have transitional arrangements in place when deactivating the general escape clause. He refers in that context to the "unusual circumstances clause" of the SGP.

He sees three hurdles to be overcome before it is easier to shift from the broad application of the general escape clause to the narrower application of the unusual circumstances clause for those countries most severely affected by the pandemic.

The first is the final adoption of the Recovery and Resilience Facility, coupled with the submission and acceptance of the national recovery and resilience plans:

A second hurdle is to avoid that the economic consequences of the pandemic spread from the real economy into the financial system. The author refers, in that context, to possible very negative impacts of non-performing loans. The author adds that the European Banking Union has instruments to prevent this from devolving into crisis, but they are untested in the face of systemic financial fragility and they remain incomplete. "*National governments still play the main role in any banking recapitalization and the European Commission recently extended its temporary framework for the application state aid rules related to such measures until September 2021.*"

A third hurdle is the continued availability of support from the ECB for monetary accommodation in general and for the pandemic emergency purchase program in particular. The author notes that the current low level of the spread between sovereign debt instruments issued by different Member States rests in large measure on the credibility of the ECB's monetary accommodation.

If these hurdles are overcome, "*the European Commission will have the instruments to enforce Member States' commitment to medium-term objectives and country specific recommendations, and the withdrawal of national fiscal stimulus can be matched with an increase in fiscal spending through European funds. This is a best case scenario that could play out as early as spring 2021, and so allow for a resumption of the normal pattern of macroeconomic policy coordination within the European Semester as early as 2022.*"

When and how to deactivate the SGP general escape clause?

Philippe MARTIN, Xavier RAGOT

Martin and Ragot (Sciences Po, OFCE and Conseil d'Analyse Economique) argue in their paper that one cannot separate the question of the deactivation of the general escape clause from the question of the rules that would be applied and implemented after the deactivation. They state that a clarification on the future design of the fiscal surveillance framework is a necessary condition before the deactivation of the general escape clause. They explain in that context that it is important to anchor the expectations of economic agents on a fiscal stance that does not entail early consolidation. They highlight that the deactivation should be state- not time-dependent and based on simple measurable statistics, unlike the output gap, which suffers from mismeasurements. Their recommendation is that the general escape clause should be exited only when the EU-wide GDP per capita or employment rate has returned to its Q4 2019 level. Once the clause is deactivated, individual countries should apply newly defined fiscal rules only when their national GDP per capita or employment rate have returned to their Q4 2019 level. Before the condition that the GDP per capita or employment level of Q4 2019 is met, the "unusual circumstances clause" should be activated on a country-specific basis, in order to prevent detrimental early fiscal consolidation.

The paper also recommends that during the period of the general escape clause or of the unusual circumstance clause, the transitory country-specific fiscal recommendations should be based on four criteria:

- First, no EDP should be considered. This procedure would only make sense if we were to return to the pre-COVID framework, which should be reformed.
- During the transitory period, country-specific fiscal recommendations should avoid procyclical policies. In other words, no fiscal consolidation should be asked before the deactivation of the general escape clause and the deactivation of the country's unusual event clause.
- The need for a transitory fiscal stimulus should be acknowledged. The fiscal country-specific recommendations should focus on policies with the lowest cost and highest return for the budget.
- As a counterpart to this flexibility, countries should not use this period to permanently increase their structural deficit. Any permanent increase in budget deficit should be motivated by an investment or reform, increasing medium-term growth.

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