IN-DEPTH ANALYSIS

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Euro Area fiscal policies and capacity in post-pandemic times

External author:
Paul DE GRAUWE

Economic Governance Support Unit (EGOV)
Directorate-General for Internal Policies
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Euro Area fiscal policies and capacity in post-pandemic times

Abstract

The Covid-19 pandemic has created huge challenges for policymakers in the whole world. These challenges have to do with both the short run and the long run. In addition, in the euro area, these challenges have dimensions that are peculiar to the fact that the euro area is a monetary union with one monetary authority and nineteen separate budgetary authorities. In this policy brief, the author provides some answer to two questions:

- Which policy mix (national/supranational) supports smooth recovery, sustainability of public finances and resilience of the euro area?
- Which EMU governance reforms should be prioritised so as to improve the functioning of the euro area?

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AUTHORS
Paul DE GRAUWE, London School of Economics

ADMINISTRATOR RESPONSIBLE
Jost ANGERER

EDITORIAL ASSISTANT
Donella BOLDI

LINGUISTIC VERSIONS
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ABOUT THE EDITOR

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To contact Economic Governance Support Unit or to subscribe to its newsletter please write to:
Economic Governance Support Unit
European Parliament
B-1047 Brussels
E-mail: egov@ep.europa.eu

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LIST OF ABBREVIATIONS

APP	Asset Purchase Programme
ECB	European Central Bank
GDP	Gross Domestic Product
NGER	Next Generation EU Recovery plan
OECD	Organization for Economic Cooperation and Development
PEPP	Pandemic Emergency Purchase Programme
PSPP	Public Sector Purchase Programme
RRF	Recovery and Resilience Facility

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INTRODUCTION

The Covid-19 pandemic has created huge challenges for policymakers in the whole world. These challenges have to do with both the short run and the long run. In addition, in the euro area, these challenges have dimensions that are peculiar to the fact that the euro area is a monetary union with one monetary authority and nineteen separate budgetary authorities. In this policy brief, I wish to answer two questions:

- Which policy mix (national/supranational) supports smooth recovery, sustainability of public finances and resilience of the euro area?

- Which EMU governance reforms should be prioritised so as to improve the functioning of the euro area?

1. WHICH POLICY MIX (NATIONAL/SUPRANATIONAL) SUPPORTS THE SMOOTH RECOVERY, SUSTAINABILITY OF PUBLIC FINANCES AND RESILIENCE OF THE EURO AREA

The economic recovery in the euro area countries is likely to come about automatically, as consumers who have drastically increased their savings during 2020 return to the new normal. According to Eurostat (2021), households in the euro area increased their savings rate from 13% in 2019 to 20% at the end of 2020. This is a very large increase in involuntary savings. And given its size, it is a broad-based increase involving large parts of the households. When the perception exists that the pandemic is over and that life can return to normal, it is quite likely that large parts of this excess saving will be unlocked, leading to a strong consumption boom.

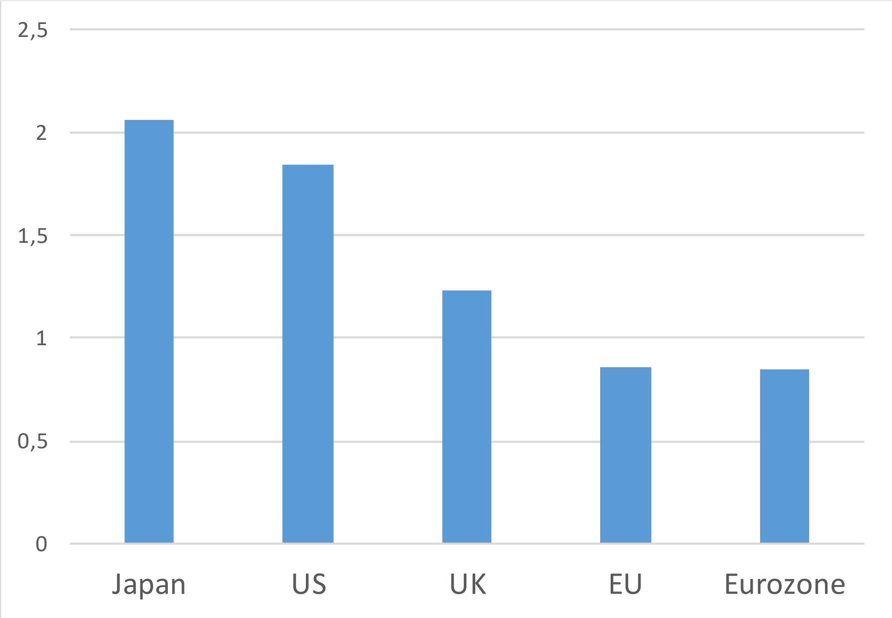
There is of course great uncertainty about the timing and the intensity of such a consumption boom, as it depends crucially on the success of the vaccination programmes. One thing we have learned from this pandemic is that there is no trade-off between health and economics. We have learned that making health compromises (e.g. allowing for more Covid-deaths so as to keep the economy running) does not deliver in terms of economic recovery. On the contrary. Thus, the economic recovery via a consumption boom will materialise only when consumers have become confident that the Coronavirus does not create health hazards anymore. At this point in time, some optimism is warranted, given the acceleration of vaccination programmes observed in the euro area and in the EU as a whole.

The risks involved

(a) insufficient fiscal stimulus

There are a number of risks involved. The euro area countries have been more cautious than other major countries during the pandemic in allowing their budget deficits to increase, so as to reduce the negative impact of the pandemic on production and employment. We show the evidence in Figure 1. This shows the ratio of the change of the budget balances to the changes in GDP-growth rates from 2019 to 2020. When this ratio is above 1, the countries involved allowed the budget deficit to increase (in percentage points) by more than the percentage decline in GDP. We observe that this measure of fiscal activism for the euro area and the EU as a whole is 0.85. This compares with significantly higher ratios in Japan, the US and the UK. In the US, for example, the ratio is 1.84 during the same period. Thus, it appears that the US has been much more active in its policy stance than the euro area and the EU during the pandemic. It allowed its budget deficit to increase by 1.84% as a reaction to a 1% decline in the growth rate of its GDP. The EU appears to have been less than half as reactive. This difference in fiscal policy stance has been noted by others (see Erik Nielsen(2021), IMF, Fiscal Monitor(2021)).

Figure 1: Change budget balance/GDP-growth, 2019-20



Source: Eurostat

If the consumption boom fails to materialise or is postponed because of doubts about the success of the vaccination programmes, there is a risk that the recovery in the euro area will be less intense than in the previously mentioned countries. Therefore, national fiscal policies in the euro area should continue to be sufficiently stimulatory, i.e. contain a discretionary fiscal stimulus aimed at supporting the recovery especially if the consumption boom fails to materialise quickly enough.

In this connection, the NextGeneration-EU recovery plan (NGER) that was instituted during 2020 could provide for a significant additional impetus to the recovery in the EU. The Recovery and Resilience Facility (RRF) in the NGER has the capacity to borrow €672 billion and to fund structural reforms and public investments supporting green and digital transitions. It is a path-breaking instrument that finances public investments by the joint issue of common bonds. As such, it is of great political importance as it can be considered as a first step on the road to a future political and budgetary union.

The question that arises here, however, is whether this programme can act as a strong instrument for the recovery in the European Union. The answer is that this is unlikely to be the case, for two reasons. First, there is the size of the RRF. A spending programme of potentially almost 700 billion is significant, but as the spending will be spread out over the period 2021-26, the average yearly stimulus will amount to barely more than 1% of EU-GDP.

Second, there is the timing. Many public investments take a long lead-time from the decision moment to the actual spending that activates the economy. A large part of the RRF consists of investments and this part will start stimulating the EU-economy years beyond 2021. These public investments are of great importance to increase future potential output, but are not a good anti-cyclical instrument. The conclusion is that, however important the NextGeneration EU programme is for the future of the EU, it is not a powerful instrument to lift the EU-economy out of the pandemic recession soon.

(b) Too early exit from stimulus

There is a second risk. Even if the first risk does not materialise, there is the risk that European policymakers will decide to stop the fiscal stimulus and will want to re-introduce fiscal consolidation too early. Very much like they did in the period 2011-12 during the sovereign debt crisis, which led to a second-dip recession during 2012-13. This risk of too early imposition of fiscal discipline arises from the fact that the national fiscal support programmes instituted during the pandemic, have led to a surge in the government debt levels in the euro area. The fear that these debt levels would become unsustainable if discipline is not quickly restored is at the core of this risk.

Unsustainable government debt levels?

The fear that the government debt levels in the euro area will become unsustainable for a number of member-countries is excessive. The reason is the following. The extra government debt created during the pandemic to sustain collapsing economies has been issued at extraordinarily low interest rates. As a result, the future interest payments on this corona-induced debt, will hardly lead to higher total interest payments for each Member State than those that existed prior to the pandemic. In addition, this extra debt will decline automatically as a percent of GDP, for the simple reason that GDP is likely to increase by at least 2 to 3 percent a year. If anything, inflation is likely to increase and may even surge above 2%, while economic growth is also likely to increase (at least if no new austerity programmes are imposed). Thus, the denominator in the debt to GDP ratio is likely to increase significantly faster than the numerator, leading to a steady decline of the weight (in GDP) of the extra debt incurred during the pandemic. This automatic decline of the burden of the corona-debt will occur without having to impose austerity measures.

We illustrate this phenomenon in in Figure 2. We show the future development of an amount of debt (normalised at 100) issued with 30-year bonds at interest rates shown in the same figure. These were the interest rates prevailing at the end of 2020. Assuming a yearly nominal increase in GDP (inflation + real growth) of 3%, we observe that the ratio of this debt to GDP declines automatically without having to create a surplus on the primary balance.[1]

An objection that is often formulated against the previous analysis is that there is some probability that the interest rates increase in the future. At that moment, the burden of the government debt will increase again and become unsustainable. This argument fails to make a distinction between old and new debt. The old debt is the one that was incurred during the pandemic and before. The interest rate on this debt is fixed for the whole maturity of this debt. This old debt is insulated from the future increase in the long-term interest rates. Only the new debt will become more expensive, but to the extent that the economic recovery will allow governments to profit from automatic declines in budget deficits, the rate at which new debt will be created in the future will decline, thereby limiting the budgetary sensitivity of future higher interest rates.

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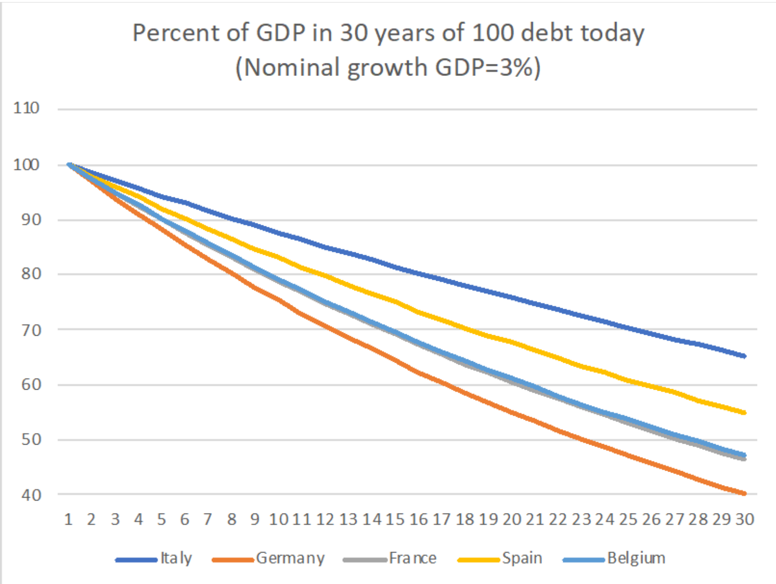
[1] We use the Domar model to make these calculations: $D_t = \left(\frac{1+r}{1+g}\right) D_{t-1} - PB_t$ where r is the interest rate and g the nominal growth rate of GDP; D_t is the government debt to GDP ratio and PB_t is the primary balance as a percent of GDP. We set the latter = 0, i.e. no austerity

Figure 2: Percent of GDP in 30 years of 100 debt today



30-year bond yields (Nov 2020)	
Belgium:	0.37%
Germany:	-0.18%
Italy:	1.51%
France:	0.32%
Spain:	0.90%

Source: own calculations for the chart and the following publication for the box http://www.worldgovernmentbonds.com/bond-historical-data/germany/30-years/

Despite the fact that the "unsustainable-debt-produced-by-covid" argument is weak, the political momentum in a number of countries of the euro area to restore fiscal discipline is strong. This will create a risk that when the fiscal rules (hopefully reformed) that have been temporarily abrogated during the pandemic will be restored, the pressure to impose fiscal discipline aimed at reducing debt-to-GDP ratios will be real.

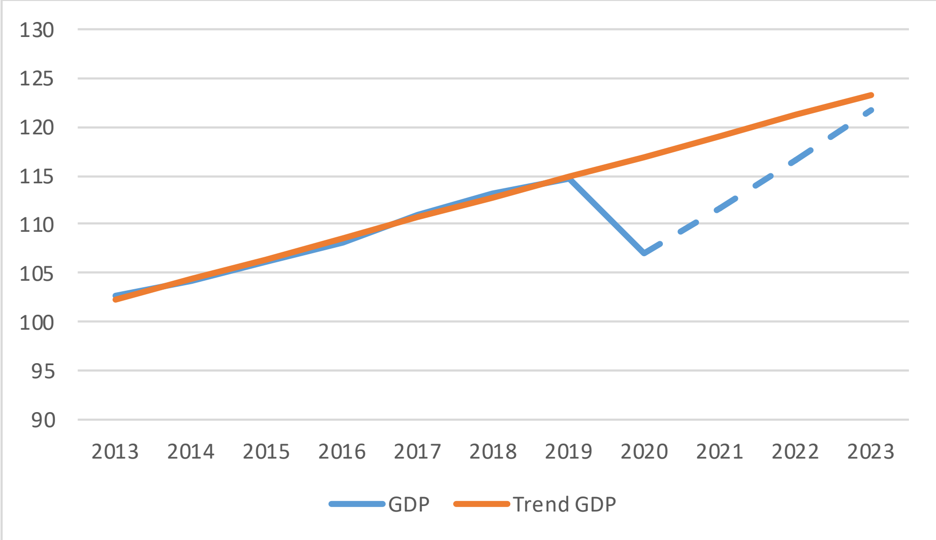
When to impose fiscal discipline?

That's why I propose that the restoration of fiscal rules (albeit reformed, see section 2) should be postponed until the euro area GDP has returned to its pre-pandemic growth path (see similar recent proposals in European Parliament (2021)). In order to find out what this means in practice, I used the forecasts of GDP made by the European Commission in its Spring Forecasts of 2021 (and assuming the forecasted 4.4 percent growth for 2022 extends to 2023) and I computed the trend growth path of GDP starting in 2013, the first year of recovery from the sovereign debt crisis. The results are shown in Figure 3. We observe that the projected increase of GDP (dotted line) will meet the trend line of GDP after 2023, i.e. in 2024. This should be the moment one may consider restoring fiscal discipline.

This conclusion is not time dependent but state dependent, i.e. if GDP growth is below the yearly growth rates that the European Commission is forecasting, the moment of restoration will have to be extended farther into the future. Conversely, if realised growth rates turn out to exceed the Commission growth forecasts, this moment can come earlier.

Note that by assuming a linear trend as our measure of potential output we assume that the pandemic has not created permanent damage to countries' capacity to produce. This can be criticised. For example, Paschal Donohoe, President of the Eurogroup, noted "that the risk of scarring and damage from this pandemic in our societies, for our citizens and on the balance sheets of employers continues to be real". In this view, the pandemic may have had as an effect to permanently reduce potential output. We come back to this point when we compare our estimates to the European Commission's estimate of the output gap.

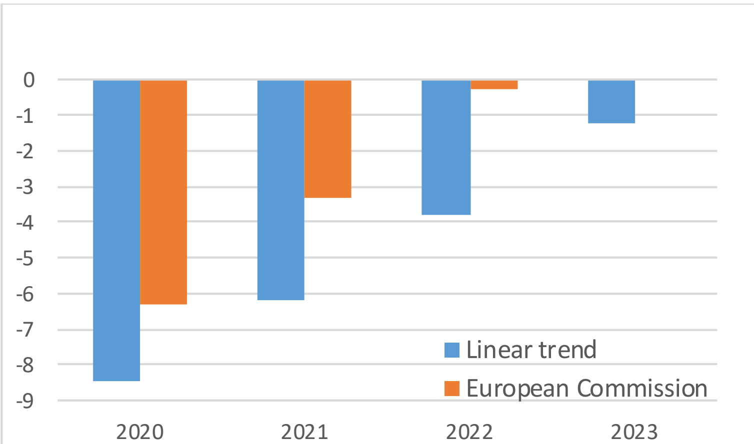
Figure 3: GDP and trend GDP (constant prices), Euro area 2009=100?



Source: Eurostat and own calculations
Note: we use the European Commission Spring Forecast, 2021 for the growth rates of 2021, 2022, 2023

It is important to realise that the numerical exercise done in Figure 3 can be used to derive the output gap. This is defined as the difference between actual GDP and potential GDP expressed as a percent of the latter. We show our estimates of the output gap in which we assume that the potential output follows a linear trend (called "linear trend") and compare these with the European Commission's estimates of the output gap of the euro area in Figure 4. The differences are striking. The European Commission's estimates of the output gap during 2020-22 are systematically lower. They lead to the conclusion that the output gap will have returned to zero by 2022. In other words, in 2022 the euro area will have fully recovered from the pandemic-recession. Quite an optimistic forecast. The implication of this finding is that from 2022 on there is no problem in restoring the fiscal rules and starting a process of fiscal consolidation.

Figure 4: Output gap estimates, Euro area



Source: European Commission, Spring Forecast, 2021 and own calculations

Where does this difference come from? There are two factors playing a role here. First, the Commission estimates are based on a longer period in the past. It includes the period of the Great Recession and the sovereign debt crisis. This has the effect of estimating a low growth of potential output (1.1 percent for the last 10 years) while the trend growth since 2013 amounted to 1.6%. As a result, when translated in the context of Figure 3, it makes the orange trend line flatter than the one I obtain.

Second, it is well-known that the European Commission's estimate of the output gap is pro-cyclical, i.e. when in recession potential output declines (see Heimberger (2020)). According to the latter author's calculations, one additional percentage point in losses of actual output is associated with a loss in potential output of about 0.6 percentage points. This pro-cyclicality has the effect of bending the orange line in Figure 3 downwards in 2020, again producing a lower output gap. In its latest estimate of the output gap, the European Commission takes the view that in 2020 potential output dropped to 0,8% (from 1.2% in 2019). In other words, the European Commission's estimates embody the view that we discussed earlier, i.e. the pandemic has led to a permanent decline in potential output. We note, however, that this decline assumed by the European Commission is quite significant, some may say, excessively so.

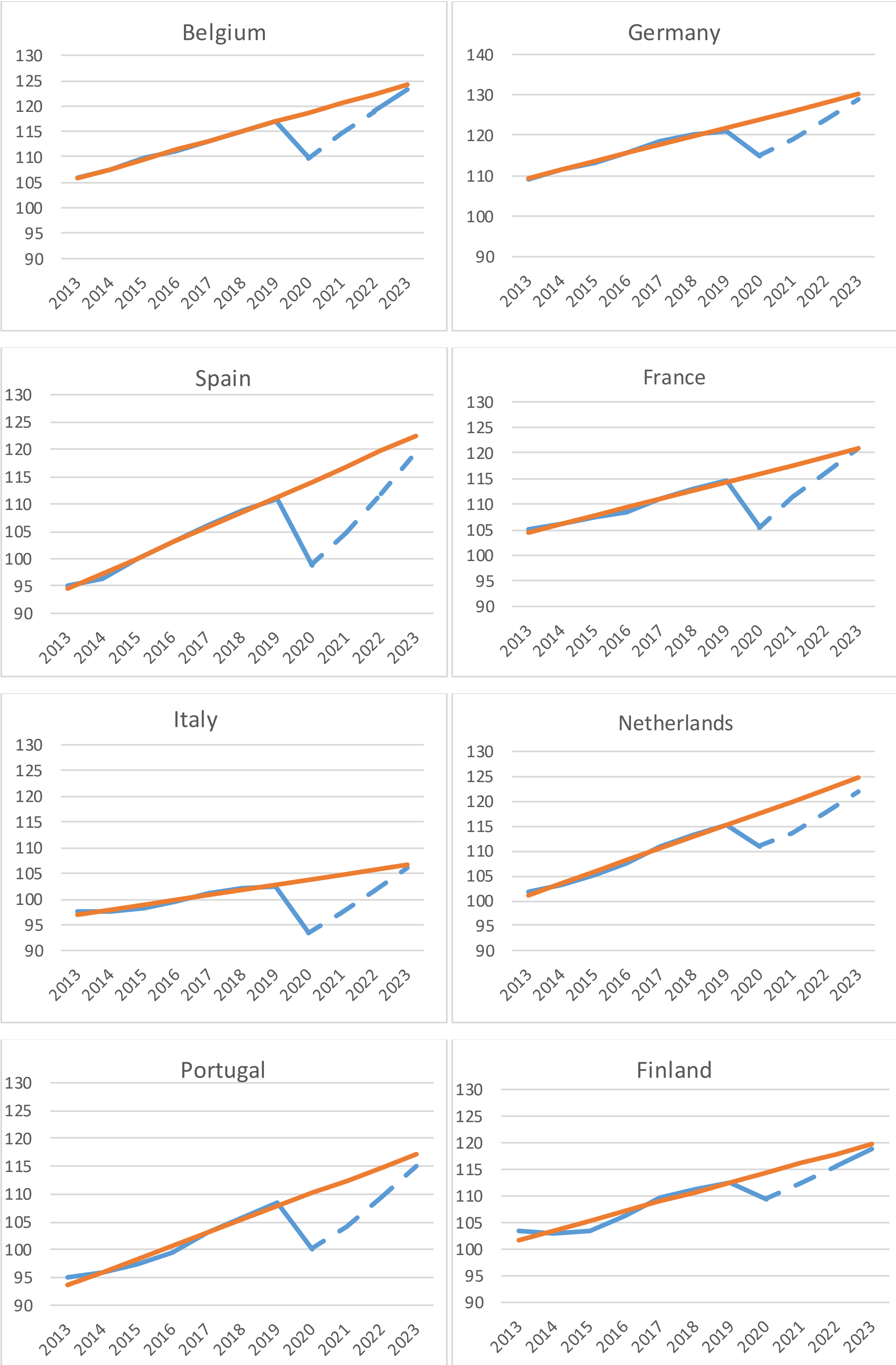
I am not arguing that my estimates of the output gap are necessarily better. They may also hide implicit biases, in particular, they assume that the pandemic will not have permanent effects on potential output. It is important, however, to confront the European Commission's estimates of the output gap that assume a very strong decline in potential output, with other estimates that make a number of reasonable assumptions and that come to very different results from those obtained by the Commission.

The need for flexibility

There is a significant risk that the recovery paths in the different member countries will be different. Some countries are likely to reach the pre-pandemic growth path earlier than other countries. In order to illustrate this, I made the same calculations as in Figure 3. I computed trend-GDP for a number of euro area member countries and I used the Commission's forecasts of each country's GDP growth during 2021-22 (and assuming 2023 would be the same as 2022). The results in Figure 4 show that some countries will reach the pre-pandemic growth path in 2023, others in 2024. This is also to be seen in Figure 5, showing the output gap calculations for the same countries. But note again the contrast with the output gaps as computed by the European Commission. The latter forecasts that in most euro area countries macroeconomic balance (zero output gap) will be reached already in 2022. This implies that fiscal stimulus should then stop in these countries.

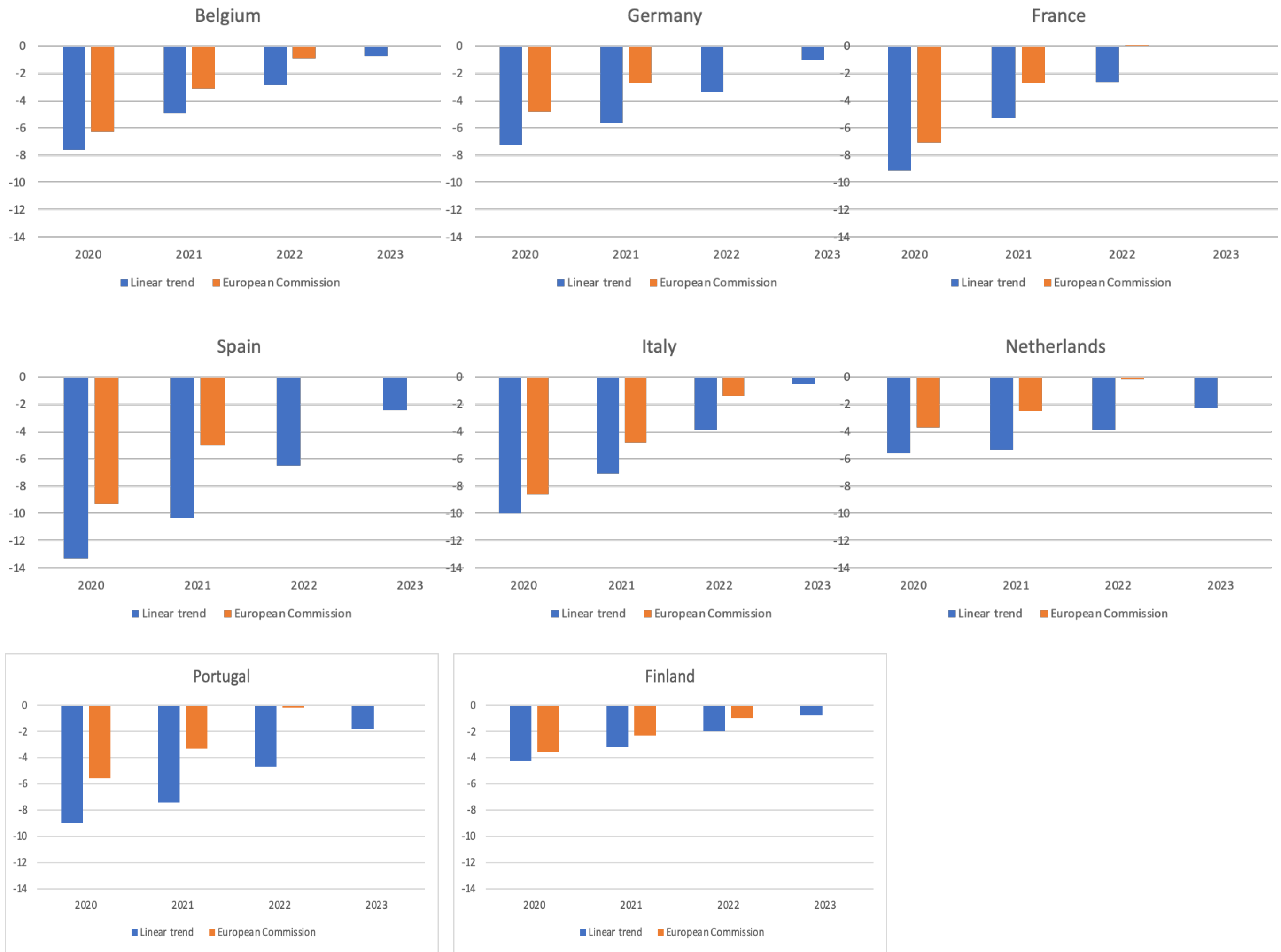
Our results imply that one will need flexibility in imposing future fiscal discipline, allowing some countries to retard the moment of a return to discipline compared to the early movers. In the absence of flexibility in returning to the fiscal rules, the risk is created of repeating past mistakes. It could lead some countries to be forced to apply austerity too soon, as they were forced to do in the aftermath of the sovereign debt crisis.

Figure 5: GDP and trend GDP in Euro area countries (2009 = 100)



Source: Eurostat, EC Spring Forecast, 2021 and own calculations.

Figure 6: Output gap estimates, Euro area countries



Source: Eurostat, EC Spring Forecast, 2021 and own calculations.
Note: the linear trend of France in 2023 = 0.03

The role of the ECB in the recovery

When the pandemic hit the euro area, there was an acute danger of a liquidity crisis. This was provoked by the combined negative supply and demand shocks that left many businesses scrambling for liquidity. The same shocks also threatened the normal functioning of the government bond markets. By announcing its pandemic emergency purchase programme (PEPP), the ECB relieved these liquidity pressures and helped to avoid that the pandemic shocks would lead to a deflationary spiral, in which lower supply leads to lower demand which in turn leads to less supply, etc.

The PEPP is a temporary asset purchase programme of private and public sector securities. The initial envelope announced in March 2020 amounted to €750 billion. This was raised by €600 billion in June 2020 and by another €500 billion in December 2020, for a total of €1,850 billion. All asset categories eligible under the existing asset purchase programme (APP) are also eligible under the PEPP, ECB (2021).

The largest part of the PEPP consists of public sector purchases (PSPP). In principle, the purchases occur according to the capital keys of the national central banks in the ECB. But the ECB has announced that it will apply this rule flexibly based on market conditions so as to support the smooth transmission of monetary policy.

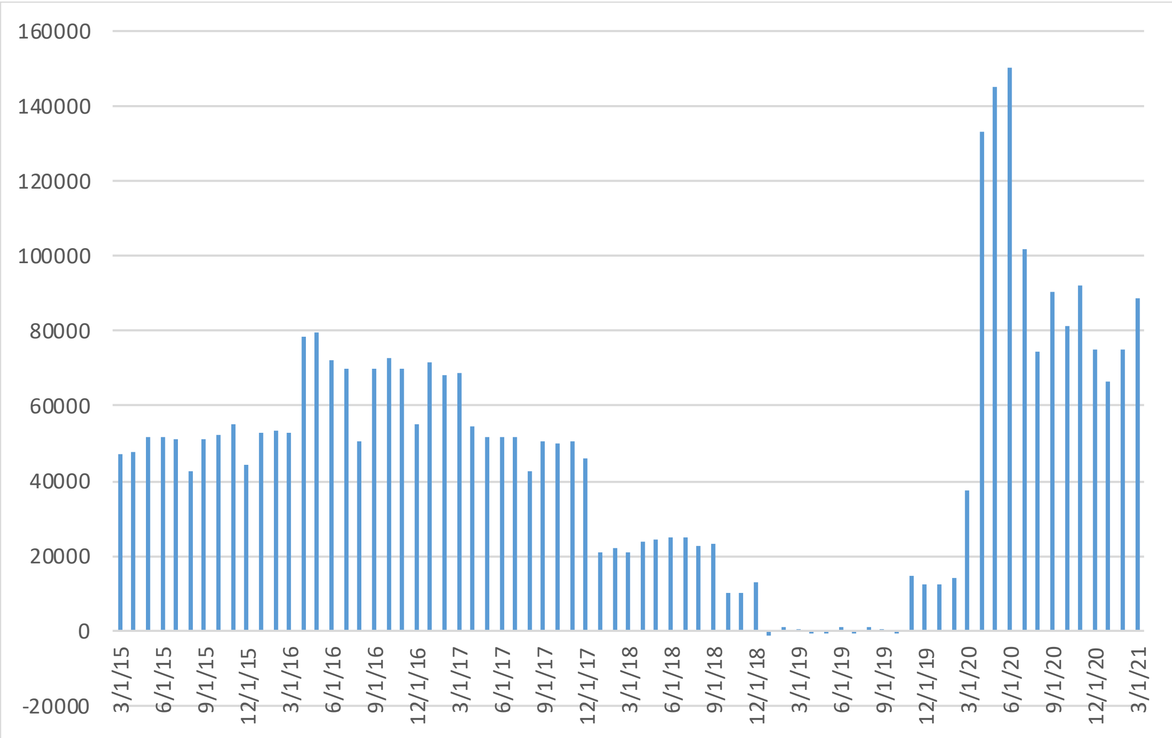
Macroeconomic importance of PEPP

How important have these purchases by the ECB been during the pandemic? Figure 6 gives an answer. It appears that these purchases have been sizable, compared to the purchases that were initiated in 2015 under the Asset Purchase Programme (APP), commonly known as Quantitative Easing. Thus, the ECB acted promptly and in significant amounts to alleviate the liquidity pressures in private and public asset markets.

Compared with the asset purchases made by the US Fed, however, the ECB purchases appear modest (see Figure 7). The Fed bought a total of $2.6 trillion against a total of €1.3 trillion purchases by the ECB. We observe the same phenomenon here as when we discussed the difference in fiscal stimulus between the US and the EU, i.e. a more cautious attitude of the EU authorities.

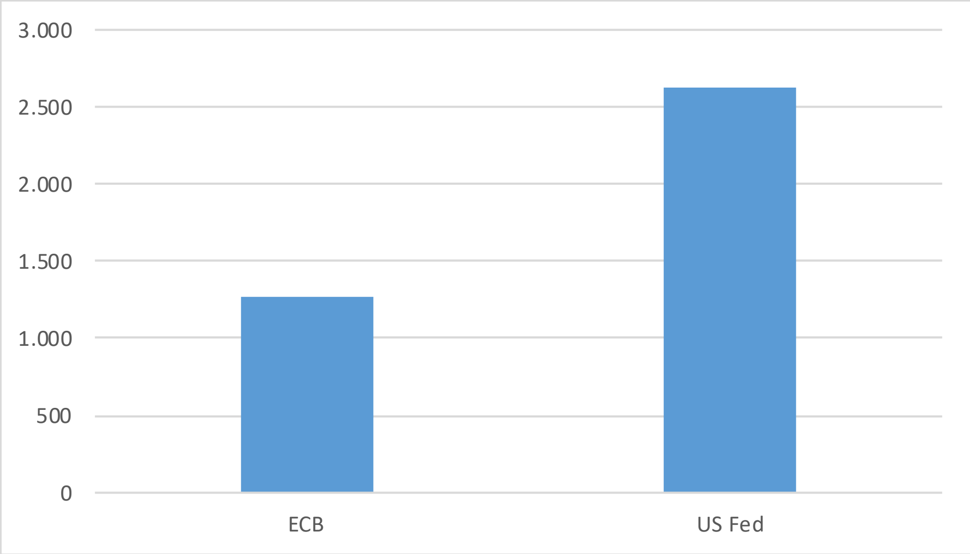
Whether this much higher monetary and fiscal activism of the US authorities will turn out to have been a better choice than the cautious policy stance in Europe remains to be seen. The fact is that the economic recovery in the US at this stage is certainly more impressive than the one observed in the Euro area.

Figure 7: Net monthly APP + PEPP-purchases



Source: ECB, https://www.ecb.europa.eu/mopo/implement/app/html/index.en.html#pspp
Note: the period March 2020-March 2021 is the sum of APP and PEPP purchases

Figure 8: Asset Purchases of ECB ad Fed since Jan 2020 (billion euros or dollars), March 31, 2021



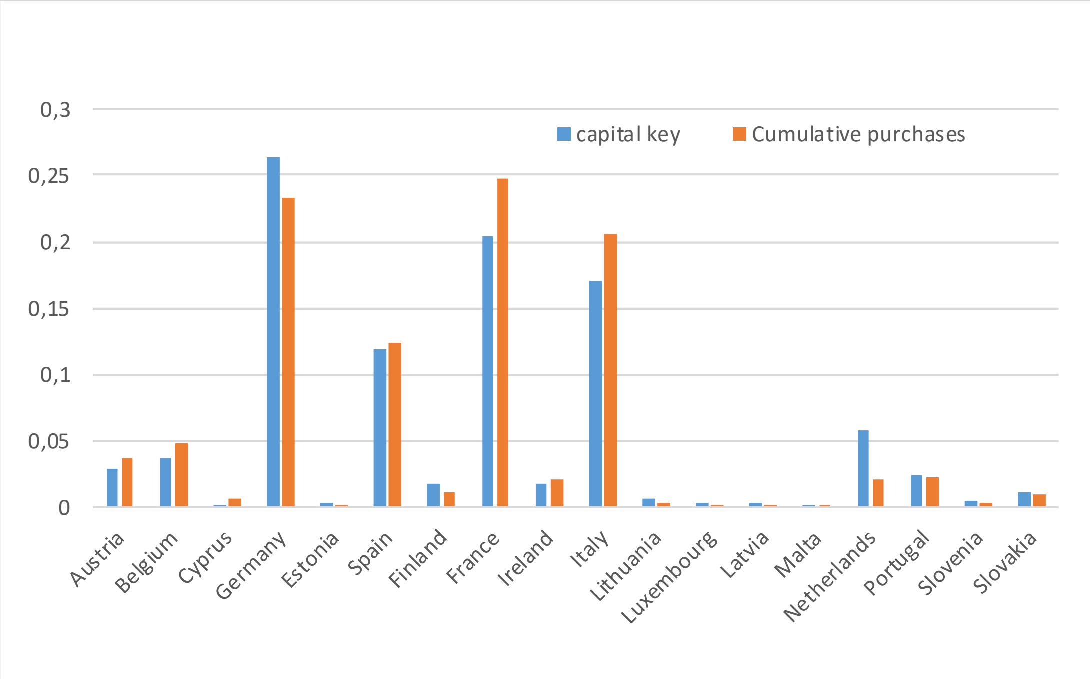
Source: ECB and Federal Reserve *https://www.federalreserve.gov/releases/h41/20200102/*

The need for flexibility: Again

The need for flexibility in reimposing budgetary discipline also applies to monetary policies. This need arises because the pandemic has had divergent effects on the government debt levels of the member countries of the euro area. It is not to be excluded that these divergences trigger new self-fulfilling liquidity crises in the government bond markets (see De Grauwe (2011) and De Grauwe and Ji (2013)). In such liquidity crises, panicky investors sell the bonds of the countries perceived to be risky to buy the bonds of "safe" countries. This can lead to massive capital flows between these countries. In order to stop these capital flows from destabilising the euro area, the ECB will need to be ready. And only the ECB can fulfill this role. As the institution that creates money, there is no limit to the liquidity support that the ECB can grant. This contrasts with the ESM that has limited resources, and therefore, lacks the credibility to provide support during liquidity crises.

The ECB's PSPP programme in principle satisfies this flexibility requirement. However, up to now the ECB has followed the equity keys of its member countries in allocating its government bond purchases rather closely, as shown in Figure 8. As the recovery of the member countries is likely to be differentiated, the ECB may have to increase its bond purchases from member countries that are slower in their recovery paths, to avoid that movements of distrust overwhelm the government bond markets, leading to a second sovereign debt crisis.

Figure 9: Capital key and cumulative PSPP purchases (% of total), 31 March 2021



Source: ECB, https://www.ecb.europa.eu/mopo/implement/app/html/index.en.html#pspp , 31/03/2021

2. WHICH EMU GOVERNANCE REFORMS SHOULD BE PRIORITISED SO AS TO IMPROVE FUNCTIONING OF EURO AREA?

The reform of the fiscal rules has become inevitable. I will formulate two principles that should guide this reform process:

- No numerical targets any longer
- Priority should be given to public investment both at the EU and national levels

2.1. Numerical targets are a thing of the past

The budgetary governance in the euro area has been based on an enforcement program of numerical targets, like the 3% budget target, the 60% government debt target and the balanced structural budget rule (Schwarze Null). It is now clear that this approach has failed. The reason is very simple. Top-down rules that have no scientific basis will not be followed by elected politicians that are under pressure because the economy experiences a major downturn. Which politician can afford to abide by a holy number 3, or a Schwarze Null (balanced budget), when millions of domestic citizens suffer because of a recession that can be made less severe by trespassing these unintelligent rules? Few will subject their citizens to extra suffering to abide by those non-scientific rules.

In its 20-year existence, the euro area has been hit three times by this painful dilemma. And predictably, three times the rules were set aside. In the periods 2002-04, in 2008-09, and more recently during the pandemic years of 2020-21. Surely, this will happen again, and these rules will be set aside again. As a result, these rules have zero credibility.

Another constant in this approach to enforce numerical targets is that after each recession when the rules were suspended, they were also changed. It happened in 2003, when they were relaxed, and after the Great Recession of 2008-09 when inexplicably they were tightened up, leading to a second-dip recession in 2011-12. This time, after the pandemic, they are likely to be changed again[2]. Hopefully by ditching the numerical rules. And each time the fiscal rules change they are made more complex. So much that only few persons outside Brussels understand them. This increasing complexity is built-in into a governance based on numerical targets, as with each negative shock hitting the economy, new exceptions and new rules have to be introduced. In the end, such a governance, like the Soviet system of governance, will collapse under its own weight. It is better not to wait for this to happen and to develop a governance model that ditches the numerical rules.

Our criticism of numerical rules also applies to the expenditure rule made popular by the European Fiscal Board (European Fiscal Board (2018). This rule would prevent the growth of government spending from exceeding the growth rate of potential output. Such a rule dictates that the ratio of government spending to GDP has to remain constant over the business cycle. There is no good economic argument for fixing this ratio. Some countries have low ratios, others have high ratios. Why would these ratios have to be frozen? There might be good reasons why in some countries this ratio should increase, while in others it should decline. Again this is an example of imposing a rule that has no scientific basis. As the other rules, also this one will be set aside by rational governments when they come under pressure because of unfavourable economic conditions.

[2] In February 2020 the European Commission launched a review of the economic governance framework (see European Commission (2020)).

There is now a broad consensus among economists that a new governance of sustainable fiscal policies should be developed without such numerical targets. It is not the intention of this paper to develop a fully worked out proposal of an alternative governance. Many such reform proposals have been made recently (see Beetsma, et al. (2021), Benassy-Quéré, et al. (2018), Blanchard, et al. (2021), Darvas, et al. (2018), Debrun, et al. (2019), Wyplosz (2019)). Instead, I wish to highlight the main principles that should guide this new governance.

The principles that should guide a future reform of the fiscal rules are the following:

- Instead of numerical rules, debt sustainability analysis
- Instead of top-down, bottom-up governance.

Instead of numerical rules we need debt sustainability analyses

There is a growing consensus that the new governance should be based on long-term sustainability analysis of public debt (see Kopits (2004), European Commission (2014), Debrun, et al. (2019), Wyplosz (2019)). This is a scientific tool of analysis that projects the future expected (net) debt levels given the current forecasts about interest rates, inflation, GDP growth rates and tax capacity. The net debt levels refer to the fact that in such extrapolation one should also include public assets that contribute to future debt repayment capacity. We will come back to this point.

Such a sustainability analysis will allow policymakers to focus on the things that really matter, instead of focusing on numerical targets for budget deficits and debt levels. The numerical targets are often not necessary to guarantee sustainability. To give an example: when the nominal interest rate is expected to be lower than the growth rate of the economy, the debt to GDP ratio obeys a stable dynamics , i.e. it tends to decline automatically (see our earlier discussion). It is then not necessary to push countries into austerity to achieve a particular numerical target of the debt ratio. Conversely, when the interest rate exceeds the nominal growth of GDP, a government debt ratio of less than 60% will not guarantee debt sustainability. In this sense, the 60% government debt target is not sufficient to guarantee sustainability.

Obviously, since the analysis is based on forecasts of a number of macroeconomic variables, there is a lot of uncertainty involved in this exercise. That is why such a debt sustainability analysis should be seen as a benchmark to which future debt levels should broadly converge. It also implies that debt sustainability should be performed in a stochastic framework (see Kopits (2004), De Bella (2008) and European Commission (2021)). In addition, a procedure of "name and shame" should be used to explain, when a divergence occurs, which of the underlying assumptions of the sustainability path is responsible for the deviation.

Such an exercise should and is already performed by the European and by some National Fiscal Boards. It is therefore important to strengthen the mandate and the independence of these institutions.

Instead of a top-down, a bottom-up approach is necessary

The budgetary governance based on numerical rules has been a top-down affair where national governments are monitored by the Council upon proposal by the Commission. This model has an obvious weakness, which can be described as follows. In a democracy, the power to spend and to tax is vested in parliaments ("no taxation without representation"). And these parliaments are accountable to national electorates, which can punish the parliament in the next election. In the euro area, the power to spend and to tax is vested mostly in national parliaments. When, then, a supranational institution tries to override decisions made in these parliaments, problems are bound to arise. The major one is that this supranational institution (European Commission cum Council and European Council) does not face the political costs of the budgetary rules it tries to enforce. It is the national government and parliament that face these political costs. This disconnect between those who take decisions and those who suffer the political costs of these decisions is the major weakness of the governance of budgetary rules in the euro area.

Put differently, the political legitimacy of spending and taxation today mainly rests with national parliaments. The interference in this decision-making process by an authority that does not have the political legitimacy necessarily leads to conflicts and makes this governance model unsustainable. Note that I am talking of political legitimacy. This is the legitimacy that arises from the fact that those who take decisions are accountable to the electorate and face sanctions by this electorate. This is the case today for national governments and parliaments. It is not the case for the European Commission nor for the Council when they take decisions concerning one particular country.

One may object to this reasoning by pointing out that the Stability and Growth Pact came about because of an international treaty that gave responsibilities to the European Commission, the Council and the European Council. Thus, in a legal sense, these institutions are legitimate. However, they lack the political legitimacy as defined earlier. It is this lack of political legitimacy that makes the EU governance of national government debts and deficits unworkable, and therefore in need of reform.

There are two ways to solve this problem. The first one consists in transferring a significant part of the power to spend and to tax to European institutions, prominent among which must be the European Parliament and a European government that is accountable to the European Parliament. The NextGeneration-EU programme is a first timid step in this direction. Many more steps, however, will have to be taken to achieve a situation where European institutions have obtained a fiscal space that is large enough to matter.

In the meantime, this problem of a lack of political legitimacy can only be overcome by moving to a bottom-up approach. This has also been called a “renationalisation” of the budgetary governance (Wyplosz (2019)). Such a “renationalisation” should go together with giving a greater degree of independence and authority to national fiscal boards. This also implies that these national fiscal boards should have sufficient resources to perform this task. One way to ensure this is for the National Central Banks to transfer part of their profits to the national fiscal board. In this approach, a peer pressure exerted by other institutions such as the European Fiscal Board can be useful (Kopits (2013)).

2.2. Absolute priority to public investment

The necessity to boost public investment is not contested any longer. There was a time when economists were teaching the crowding-out theory of public investment. This postulated that more investment by the government would raise the interest rate and in so doing would reduce private investment. And since private investment was considered to be more productive than public investment, society would lose when governments engaged in public investment.

It is now realised that public investment is key to overcome the environmental problems we face today and to make economic growth sustainable. It is also realised by more and more economists that the crowding out theory is wrong and that instead public and private investment are complementary. Without public investments in collective goods such as infrastructure, power grids, education, fundamental research, etc., the private sector will also lack the incentives to make the necessary investments that will promote sustainable growth (see Mazzucato (2014)). A massive boost in public investment has acquired an existential dimension.

Unfortunately, the fiscal rules in the euro area are obstacles for such a boost in public investment. As is well-known, the fiscal compact requires member countries of the euro area to have balanced budgets (or ‘close to balance’) in structural terms, i.e. balanced (or ‘close to balanced’) government budgets over the business cycle. This implies that public investments cannot be financed by the issue of debt. The same problem applies to the recently proposed expenditure rule that would dictate government spending to remain constant as a percent of GDP over the business cycle. This rule also implies that if governments wish to increase public investment they have to reduce other spending items. Such a constraint makes no economic sense for at least two reasons.

First, for several years, the cost of borrowing for most euro area member countries has been close to zero and for some even negative. Surely, one can find public investments with a rate of return exceeding zero. As these public investments are key in making economic growth environmentally friendly and thus sustainable, they have an expected return by far exceeding the cost of borrowing. As long as this is the case, no restrictions on borrowing should be imposed. In fact, the only constraint to public investment should be that its expected return exceeds the cost of borrowing.

Another way to put this is the following. When the government makes public investments, it increases both assets and liabilities in its balance sheet. When the expected return to public investment exceeds the cost of borrowing, the value of the public assets (measured by their capacity to generate additional production) increases faster than the value of its liabilities. This implies that these public investments will reduce net-debt of the government in the future. No constraints on such debt-financed public investments should be imposed. A good model for this approach is the Recovery and Resilience Facility embedded in the NextGeneration-EU programme.

This conclusion fits well with our earlier discussion of the necessary reforms of the fiscal rules. We argued that we should move to an analysis of future sustainability of the net debt position of the government. Our discussion now makes clear that lifting the fiscal compact and its requirement of structural balance would actually make it possible to improve the sustainability of public debt. By making debt-financed public investments possible, economic growth could be made more sustainable, thereby generating future tax revenues capable of (more than) servicing the added debt. Thus, the best way to make government debts more sustainable in the euro area would be to abolish the fiscal compact (and the balanced budget rule in the SGP). This compact is the result of poor economic thinking. By constraining public investments, it ensures lower sustainable growth in the future, and therefore lower tax revenues for future governments. In doing so, it actually ensures future debt problems of countries struck in low growth.

There is a second, political economy reason why the (structural) balanced budget rule should be abolished. By forcing politicians to finance public investment through taxation or through spending cuts, it puts all the costs of the public investment on the present generation of voters. These public investments, however, will also generate benefits for future generations. Thus, while the benefits of the public investments are shared by present and future generations, the costs fall squarely on the present generation. This gives the wrong incentives to politicians needing the electoral support of the present generation of voters. They will not be inclined to boost public investment.

Debt-financed public investment is the solution of this political economy problem. It allows the costs of the investment (the interest payments) to be aligned inter-generationally with the benefits of these investments. In doing so, it also gives more incentives to politicians to boost public investments. This requires reliable estimates of the returns of these "public goods" investments and their likely financing costs over time.

To what extent is the obstacle to public investment produced by the fiscal compact resolved by the existence of the NextGeneration-EU programme? The Recovery and Resilience Facility (RRF) in this programme has the capacity to borrow €672 billion and to fund public investments supporting green and digital transitions. Would that not be sufficient to substitute for national debt-financed public investment programmes? The answer is definitely negative. Clearly, the RRF is a significant step forward and as I argued earlier it could be a model for the governance of public investment programmes at the national level. Its macroeconomic impact will remain limited, however, as I argued earlier. On average, the public investments made possible by the RRF will amount to at most 1.1% of euro area GDP during the period 2021-26. This is significant but hardly sufficient to deal with the challenges we face with climate change and environmental crises.

To trigger a boost in public investment, it will therefore also be necessary to use the national governments' capacities to borrow. In fact, since most of the power to tax is still vested in these national governments, the capacity to borrow of these governments is a multiple of the European Commission's capacity to find "own resources" in the context of the RRF.

Thus, the approach should be two-pronged. The European Commission's capacity to borrow should be used to the maximum. Since this capacity is limited, the national governments' capacity to borrow should be used to the fullest extent possible. It makes no economic sense to allow debt-financed public investments in member countries only through the channel of the European Commission and to leave the much higher capacity to borrow of national governments untapped. The need for public investment has acquired an existential dimension and should override the current dogmas that exist in the European Union.

Therefore, the way forward would be to apply the "golden rule" that has been proposed many times in the past by well-known economists (example: Mario Monti (2014)). The approach consists in dividing the government budget in two parts, a current budget and a capital budget. The structural balanced budget rule could then apply to the current budget; the capital budget would record public investments and could be financed by issuing debt. The overall budget would then be subject to the sustainability analysis described earlier.

It is therefore also clear that this sustainability analysis must also involve an analysis of the selection of public investment projects. These should be productive, i.e. they should increase the future sustainability of economic growth. I am aware that this is not an easy task. But it is not impossible. The proof is that up to now the European Commission has had some success in selecting productive investments presented by national governments in the framework of the NextGeneration-EU. Thus one could envisage that national governments make a selection of public investment projects that they present to the European Commission for approval. The Commission would then analyse the expected future returns of these projects. Once approved, national governments can fund these investments by the issue of government bonds. Or put differently, with the fiat of the European Commission, spending associated with the approved public investment projects can be recorded in the capital budget.

2.3. The governance of the government debt levels cannot be dissociated from the ECB's bond purchasing policies

When the central bank buys government bonds, say in the context of the PEPP, it substitutes interest bearing government bonds for monetary liabilities (money base typically taking the form of bank reserves). At that very moment, the central bank creates "seigniorage". This is the monopoly profit arising from the creation of money. This "seigniorage" is transferred to the national government budget in the following way: the government pays interest to the central bank, which now holds the bonds, but the central bank returns this interest revenue to the government. Thus, when the central bank buys the government bonds, *de facto*, the government does not have to pay interests any longer on its outstanding bonds held by the central bank. The central bank's purchase of government bonds is therefore equivalent to debt relief granted to the government.

This is also the case within the euro area. As long as the government bonds are on the balance sheet of the ECB, these bonds do not exist anymore from an economic point of view[3]. This is so because, as I just argued, when a government bond is on the central bank's balance sheet, a circular flow of interest payments is organised from the national treasury to the central bank and back to the treasury. So, the burden of the debt for the national government has become zero. The central bank could cancel that debt (i.e. set the value equal to zero), thereby stopping the circular flow of interest payment. This would not make a difference for the burden of the government debt. Put differently, as long as the government bonds are on the balance sheet of the central bank, they do not exist from an economic point of view. They only exist in the world of the accountants.

This has important implications for our discussion of the sustainability of the government debt. The latter cannot be dissociated from the bond purchases effectuated by the ECB. To be more concrete: according to Eurostat, gross government debt in the euro area increased from €10.2 trillion (85.8% of GDP) in 2019 to €11.3 trillion (100% of GDP) in 2020; an increase of €1.1 trillion of government debt in one year. This has led to the fear that this debt increase may be unsustainable. We discussed these fears earlier. Here we concentrate on the implications of the bond-buying programme by the ECB during 2020.

It appears that the total purchases of government bonds (APP + PEPP) during 2020 amounted to €0.9 trillion. Thus, while the official statistics record an increase of the euro area gross government debt of €1.1 trillion during 2020, from an economic point of view, the government debt in the euro area has increased only by €0.2 trillion (or 2% of euro area GDP). €0.9 trillion is now on the balance sheet of the ECB and has ceased to exist. Instead, the ECB has issued €0.9 trillion of monetary liabilities (money base) that has displaced government bonds in the portfolios of private investors, and that can be considered as a “super-safe” asset. This is important because, as a result of the bond buying programme of the ECB, the total stock of government bonds in the portfolios of private investors has barely increased. And, therefore, the sustainability of the government debt has barely been affected by the pandemic.

The “only” issue that remains concerns the future of the bond buying programmes of the ECB. Will the ECB keep the government bonds on its balance sheet forever? In that case, it will have to buy new bonds in the markets when the old bonds mature. Or will it want to wind these down, e.g. by not replacing the maturing bonds by new purchases? This is a crucial question. For, if the ECB chooses the latter strategy, the national governments will have to issue new bonds to rollover the old ones. In other words, the government bonds that were on the balance sheet of the ECB reappear as liabilities of the national governments and the government debt increases again. If, however, the ECB keeps the amount of government bonds on its balance sheet unchanged, then the debt relief that the ECB initiated when it bought government bonds will be permanent.

It is not entirely clear what the intentions of the ECB are. When the ECB started its QE-programme, it announced that it would keep the stock of the government bonds on its balance sheet unchanged by buying new bonds when the old ones come to maturity. It is unclear how long it will keep this commitment.

The ECB certainly could keep these bonds on its balance sheet indefinitely. If, at some point in the future, it is compelled to fight inflation, it could do this by raising the interest rate without selling government bonds. It could also raise the minimum reserve requirement that banks are subjected to. The ECB made it clear that if inflation increases permanently it will reduce the amount of government

[3] Note that in the euro area each national central bank (NCB) purchases the bonds issued by its national government and puts these on its balance sheet. Thus, technically the government bonds bought in the context of PEPP are on the balance sheets of the NCBs of the euro area.

bonds on its balance sheet. In fact there is no need to do so. The ECB can combat inflation by raising the interest rate (and possibly minimum reserve requirements) without having to dispose of government bonds on its balance sheet.

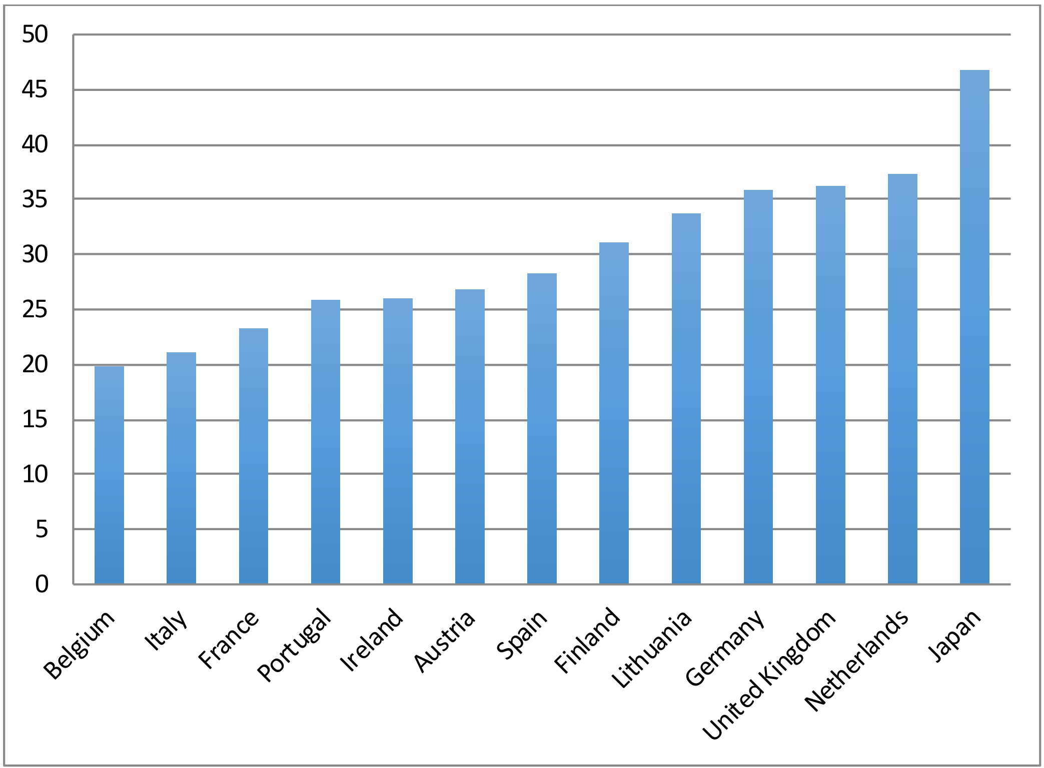
It is sometimes argued that since the central bank remunerates bank reserves, the increase in the interest rate to fight inflation would force the central bank to pay a higher interest rate on these bank reserves. As a result, the central bank would make less profit (seigniorage) to be returned to the government. Thus, government would lose revenue. What it gains by the fact that the bonds are on the central bank's balance sheet, it loses by the fact that it gets less revenue from the central bank.

In this reasoning, there is no fundamental difference between government bonds and the money issued by the central bank (the liabilities of the central bank). Both are remunerated and thus if one substitutes the other (e.g less bonds and more money base) it does not make a difference for the government budget.

This reasoning takes it for granted that the central bank has to remunerate bank reserves. Nothing could be further from the truth. In the old days, these liabilities of the central bank were not remunerated. For about 10 years, however, central banks have fallen victim to the lobbying by the banks and have started to remunerate these banks reserves. Nothing in the statutes of the central banks forces them to do so, and they could quickly reverse this policy. In fact, for a couple of years major central banks, including the ECB, apply negative interest rates on these bank reserves, indicating how easy it is to reverse the remuneration policies.

The point here is that any analysis of the sustainability of the government debt should be done together with an analysis of the bond purchase programme of the ECB, present and future. It makes a big difference to know how much of these government bonds will be kept on the ECB's balance sheet to decide how sustainable government debts are. This is also illustrated by the Japanese experience. The official Japanese government debt has been extremely high in the last 20 years, exceeding 200% today. A large part of this debt, however, has been held by the Bank of Japan for a long time. It looks like the Bank of Japan does not have intentions to reduce its government bond holdings significantly. As a result, the high official Japanese government debt looks unsustainable, but in fact is very much sustainable because almost half of this debt is held by the Bank of Japan and therefore has ceased to exist from an economic point of view (see Figure 10). This figure also shows that the amount of government bonds held by other central banks, although less important than in Japan, is also significant. My forecast is that the ECB, like the Bank of Japan, will want to hold significant amounts of government bonds on its balance sheet for a long time. And this will not endanger price stability.

Figure 10: Percent outstanding government debt



Source : OECD, Economic Outlook, 2020

3. CONCLUSION

The main conclusions of this paper can be summarised as follows.

First, the economic recovery from the pandemic is likely to be driven by a consumption boom originating from the fact that households have set aside extraordinary amounts of excess savings during the pandemic. When the perception exists that the pandemic is over, these involuntary savings are likely to be released, leading to a consumption boom and a strong recovery. There is however much uncertainty about the timing of this optimistic scenario. That is why fiscal stimulus should continue to be exerted.

Second, there is a risk of a too early exit from the fiscal stimulus. This risk is driven by the fear that the surge in public debt during the pandemic will become unsustainable. I argued that this fear is misplaced. Given that the political momentum for restoring fiscal discipline may be difficult to stop, I argued that fiscal discipline should only be considered when observed GDP returns to its pre-pandemic growth path. This is unlikely to happen before 2024.

Third, the reform of the governance of the budgetary process in the euro area should be guided by a number of principles. The first one is that the numerical targets should be abandoned. These have failed and will continue to fail. Instead, the new governance should be based on (net) debt sustainability analyses. This is a procedure that starts from forecasts of future growth rates, inflation, interest rates and tax collections and plots the likely future paths of net government debt. The European and national fiscal councils would have major responsibilities in recommending policies that will guarantee that these future paths are sustainable.

Fourth, absolute priority should be given to public investment. Without a major boost in public investment, the next challenge of climate change will not be met. The current governance (fiscal compact) has erected major obstacles to boost public investment, because it makes it very difficult for national governments to finance public investment by issuing debt. The NextGenerationEU plan is a major step forward. However, it is insufficient. In addition, it makes no economic sense to allow the European Commission, with a low capacity to tax, to finance public investment with debt while forbidding national governments, with a much large capacity to tax, to do so. The need for public investment has acquired an existential dimension and should override the current dogmas that underlie the fiscal rules.

Fifth, the best way to make government debts more sustainable in the euro area would be to abolish the requirement of maintaining budget balance over the business cycle (structural budget balance). This requirement is the result of poor economic thinking. By constraining public investments, it ensures lower sustainable growth in the future, and therefore lower tax revenues for future governments. In doing so, it actually ensures future debt problems of countries struck in low growth.

Sixth, the sustainability of government debt is very much linked to the bond purchasing programmes of the ECB. The pandemic-induced recent surge of government debt in the euro area has almost fully been compensated by the ECB's government bond purchases. As a result, the effective increase in government debt in the euro area during 2020, which officially amounts to €1.1 trillion (15% of GDP), is substantially less burdensome. This should lead to fewer concerns about the sustainability of government debt levels in the euro area.

In this paper, I have focused on fiscal policies and the governance of the fiscal rules. Reforms in the way fiscal policies are conducted and fiscal rules are applied appear to be the most urgent today as the exit from the pandemic is near and new challenges coming from climate change will necessitate large increases in public investment. Clearly, there are other reforms that will be necessary to make the Eurozone sustainable. In particular, capital market union and further progress in the banking union are the next items in the never-ending story of reforms in the Eurozone.

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The Covid-19 pandemic has created huge challenges for policymakers in the whole world. These challenges have to do with both the short run and the long run. In addition, in the euro area, these challenges have dimensions that are peculiar to the fact that the euro area is a monetary union with one monetary authority and nineteen separate budgetary authorities. In this policy brief, the author provides some answer to two questions:

- o Which policy mix (national/supranational) supports smooth recovery, sustainability of public finances and resilience of the euro area?
- o Which EMU governance reforms should be prioritised so as to improve the functioning of the euro area?

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