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The economic governance review and its impact on monetary-fiscal coordination

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The economic governance review and its impact on monetary-fiscal coordination

Abstract

This paper analyses how the fiscal framework proposed by the European Commission in April 2023 might affect the interplay between fiscal and monetary policies, from three perspectives: its impact on the medium-term fiscal stance in the euro area, its design, and its implications for the ECB's Transmission Protection Instrument (TPI). It concludes with recommendations for amending both the fiscal governance proposal and the TPI.

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LIST OF ABBREVIATIONS

CFC	Central fiscal capacity
DSA	Data sustainability analysis
EC	European Commission
ECB	European Central Bank
EFB	European Fiscal Board
EGR	Economic governance review
ESCB	The European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
GDP	Gross domestic product
IFIs	Independent fiscal institutions
MS	Member states of the European Union
MTO	Medium-term objective
NRRP	National recovery and resilience plan
OMT	Outright Monetary Transactions
TPI	Transmission protection instrument
QE	Quantitative easing

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EXECUTIVE SUMMARY

- **Fiscal and monetary policies interact through multiple channels and interfere with (or support) each others' objectives**. The interplay between monetary and fiscal policy is hence important for economic welfare. This paper analyses how the fiscal framework proposed by the European Commission in April 2023 might affect this interplay, from three perspectives: (1) its impact on the medium-term fiscal stance; (2) its capacity to reconcile debt sustainability and flexibility; and (3) its implications for the European Central Bank (ECB)'s Transmission Protection Instrument (TPI).
- **The proposed framework would lead to substantial tightening in the medium term.** In the short term, tighter fiscal policy supports disinflation. But if the ECB's inflation target is reached by 2025, as both ECB and International Monetary Fund expect, then continued fiscal consolidation under the new fiscal framework might result in an overly tight fiscal stance, requiring the ECB to offset it.
- **The proposed new fiscal framework is broadly balanced between the objectives of ensuring debt sustainability and preserving flexibility, but with room for improvement.** We recommend strengthening the requirement that seeks to prevent excessive 'backloading' of fiscal adjustment, while the requirement that debt falls within the first four years of the application of the framework should be removed or modified substantially, as should the minimum adjustment requirement of 0.5% of GDP for countries with deficits above 3%. We also recommend a review of the Commission's debt sustainability analysis methodology, and a role for independent fiscal councils in the process of activating the framework's escape clauses.
- **While the proposed fiscal framework would not complicate the activation of the Transmission Protection Instrument (TPI) compared to the current framework, we recommend amending one of its eligibility conditions.** The ECB has delegated the assessment of three of the four TPI eligibility conditions to the Council and the Commission. Since these conditions will continue to be evaluated by the Council and the Commission under the proposed framework, their application under the TPI does not change. One eligibility condition, however – whether a country's debt is sustainable – has not been delegated by the ECB. We argue that since debt sustainability is a necessary condition for compliance with the proposed framework, this condition is either redundant, or there should be a presumption that the ECB will follow the Council and Commission when it decides on debt sustainability. This would not reduce the ECB's independence, since the decision on whether activation of the TPI is required remains at the discretion of the ECB.

1. INTRODUCTION*

Monetary and fiscal policy pursue different objectives. Monetary policy in the euro area has only one primary mandate, price stability[1]. Fiscal policy, in contrast, has many objectives: provision and financing of public goods, output stabilisation, redistribution, intergenerational equity and improvements in economic allocation. Unlike monetary policy, which is centralised in the hands of the ECB, fiscal policy in the euro area remains in the hands of national governments.

While they have different objectives, fiscal and monetary policies interact through multiple channels. Monetary policy influences both inflation and real output, and thus fiscal revenues directly, and fiscal expenditure indirectly. Monetary policy operates in part by influencing real interest rates, which impact government borrowing cost. Fiscal policy influences the price level both through aggregate demand and through its impact on the supply side (via labour supply and public investment, and potentially muting the transmission of supply shocks, such as commodity price shock). It also influences measured inflation through changes in excise and VAT tax rates. Finally, unsustainable fiscal policy can threaten price stability, either through the dislocations induced by a debt crisis, or by leading to pressures for debt monetisation to stave off the crisis. Such fiscal-monetary interactions were important considerations in the creation of EU-wide fiscal rules before the euro was launched.

The potential to interfere with (or support) each others' objectives implies that the interplay ("mix") between monetary and fiscal policies is important. Fiscal policy that gets in the way of monetary policy objectives, and vice versa, can generate welfare costs. For example, if fiscal policy seeks to raise real output above potential, it may raise inflation, forcing monetary policy to tighten. The result will not be higher output, but rather higher real interest rates, which raise the cost of borrowing and reduce fiscal space. Another example applies to a setting in which interest rates are close to their effective lower bound and inflation is below the central bank's target. In this case, reaching price stability without compromising financial stability may require support from (expansionary) fiscal policy.

By influencing fiscal policy, the EU-level fiscal governance framework will have an influence on the interplay between fiscal and monetary policies. The purpose of this paper is to analyse how the framework proposed by European Commission in April 2023 (EC, 2023a,b) might affect this interplay. We tackle this question from three angles.

First, by quantifying the potential impact of the framework on the fiscal stance in the next five years. Inflation in the euro area is running high, and underlying inflation has proved to be persistent. A frequently voiced view is that fiscal policy should be tighter in support of the disinflation process (see, e.g., IMF, 2023). Fiscal policy is in fact projected to tighten this year, and next, before the proposed fiscal framework would come into effect. The question is how the proposed framework might influence the fiscal stance from 2025 onward if it were to become law next year.

Second, from a design perspective. We assume that fiscal policy makers are disciplined by elections, but also subject to incentives that could result in overborrowing and in some cases in a bias toward current spending. The purpose of fiscal frameworks is to ensure debt sustainability and ideally to

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[1] The objectives of the European System of Central Banks (ESCB) are defined in the Treaty on the Functioning of the European Union as: "*the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.*"

protect public investment, while otherwise providing flexibility to fiscal policy, allowing the fiscal authorities to pursue their many objectives. Frameworks that achieve these objectives are also in the interest of the central bank. Debt sustainability reduces the risk of fiscal dominance and disruptive crises that threaten price stability[2]. Fiscal policy that is friendly to public investment and raises potential output will lower inflation pressure for a given level of demand. Flexibility is important because it allows the fiscal authorities to pursue their various objectives and to deploy policy in support of the central bank's price stability objective. We analyse the trade-off between debt sustainability and flexibility under the proposed framework.

Third, from the perspective of a specific ECB instrument, the "transmission protection instrument" (TPI) wascreated in July 2022 to maintain orderly debt market conditions in the face of sharply higher interest rates. While the TPI is not the only ECB instrument at the intersection of monetary and fiscal policy,[3] it is the only one whose eligibility criteria include compliance with the fiscal framework, as well as debt sustainability. We answer the question whether the changes in the framework would have an impact on the operation of the TPI, and whether the TPI should be modified to better "fit" the new framework.

The remainder of this paper is structured in line with these three perspectives. Section 2 analyses the implications of the proposed framework for the fiscal stance over the coming 5 years. Drawing on the empirical findings of Section 2, Section 3 takes a view on the design of the proposed fiscal governance framework from the perspective of the interplay between monetary and fiscal policy. Finally, Section 4 analyses the relationship between the proposed framework and the TPI. Section 5 concludes.

[2] Fiscal dominance describes a situation in which large government debt and deficit prevent the central bank from controlling inflation. In such a situation, a central bank interest rate increase to tame inflation might result in market pressure on government bond markets, and the government might become insolvent without central bank financing.

[3] Other instruments include Outright Monetary Transactions (OMT) and all instruments that operate through bond purchases in secondary markets (which are often called quantitative easing – QE).

2. IMPLICATIONS OF THE PROPOSED FISCAL GOVERNANCE FRAMEWORK FOR THE FISCAL STANCE IN THE EU

The European Commission (EC)'s April 2023 proposal to replace the current EU fiscal framework[4] requires Member States (MS) to develop medium term fiscal-structural plans, following discussions with the Commission, that meet two main requirements. Both must "hold in the absence of any further budgetary measures over a period of 10 years" (EC, 2023a, Article 15) following the end of a 4-7-year adjustment period:

> (a) public debt as a share of GDP must be "put or kept on a plausibly downward path (…) or stay at prudent levels".
>
> (b) the government deficit must be maintained or brought below the 3% of GDP reference value.[5]

Annex V of EC (2023a) defines debt that is "put or kept on a plausibly downward path (…) or stay at prudent levels" as a debt path that slopes downward (or remains below 60% of GDP if it already meets the 60% benchmark) *both* with sufficiently high probability for 5 years after the adjustment period, as assessed by the stochastic debt sustainability analysis (DSA) of the Commission; *and* under the deterministic stress scenarios described in the Commission's 2022 Debt Sustainability Monitor (EC, 2023c).

In addition, the proposal commits the Commission to several additional conditions both in formulating a "technical trajectory" that it must put forward as a basis for discussion with MS with debt or deficits above the Treaty benchmarks of 60% and 3% of GDP, and in its assessment of MS medium-term fiscal-structural plans. Specifically, it must check: "whether the fiscal adjustment effort over the period of the national medium-term fiscal-structural plan is at least proportional to the total effort over the entire adjustment period" (no-backloading safeguard); "whether the public debt ratio at the end of the planning horizon is below the public debt ratio in the year before the start of the technical trajectory" (debt safeguard), "whether for the years that the Member State concernced is expected to have a deficit above the 3% of GDP reference value, and the excess is not close and temporary", the fiscal adjustment is at least 0.5% of GDP (excessive deficit safeguard[6]), and whether "national net expenditure growth remains below medium-term output growth, on average, as a rule over the horizon of the plan" (net

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[4] The proposal consists of two proposed regulations and one directive. The main reforms are contained in a "Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97" (EC, 2023a) which would replace the "preventive arm" of the current Stability and Growth Pact. In addition, a "Proposal for a Council regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure" (EC, 2023b) would abolish the "1/20th rule" which required MS with debt above 60% of GDP to reduce their debts by at least 1/20th of the difference between its debt ratio and 60% per year, and refocus the existing "debt-based excessive deficit procedure" on departures from the fiscal path agreed with the Council under the regulation replacing the preventive arm. However, the "deficit-based excessive deficit procedure" (EDP) would remain largely unchanged, requiring that "for the years when the general government deficit is expected to exceed the reference value, the corrective net expenditure path shall be consistent with a minimum annual adjustment of at least 0,5% of GDP as a benchmark." Finally, a "Proposal for a Council directive amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States" (EC, 2023c) aims at strengthening national-level independent fiscal institutions and medium-term budgetary frameworks.

[5] See Articles 6, 12, and 15 as well as Annex I and V of EC (2023a).

[6] We interpret "*a minimum annual adjustment of at least 0,5% of GDP as a benchmark*" wording of the draft regulation on the excessive deficit procedure (EC 2023b) as at least half percent adjustment. In our numerical calculations, we assume exactly half percent when otherwise adjustment would be less than half percent. However, Pench (2023) argues that the adjustment requirement can be less than half percent, because this safeguard, as well as the debt reduction safeguard, could be given a subordinated role relative to the sustainability criterion when the Commission and the Council make an overall assessment of the medium-term plans.

expenditure growth safeguard, which we interpret as ruling out a decline in the structural primary balance over the first four years of the adjustment period)

In Darvas, Welslau and Zettelmeyer (2023), we compute the fiscal adjustment implications of these conditions for all MS with 2024 projected debts or deficits above the reference values (on the assumption that the first adjustment year under the framework would be in 2025), based on a replication of the Commission's DSA methodology, using EC forecasts for growth, market-based interest rate and inflation expectations, as well as some ancillary assumptions to enable us to apply the safeguards.[7]

Table 1 summarises the main results. Positive numbers mean an increase in the structural primary balance, i.e. a fiscal tightening, expressed in percent of GDP. Countries are listed in a declining order of the fiscal balance forecast by the European Commission for 2024 (column 2). EC projections for fiscal adjustment in 2023 and 2024 are shown in columns (3) and (4)[8]. These indicate that the Commission expects sizeable fiscal consolidation in most EU countries, partly reflecting the withdrawal of COVID-19 and energy crisis support measures, albeit with exceptions (Belgium, Bulgaria, Croatia, Finland, and Slovakia). The GDP-weighted aggregate impact of this tightening for the euro area countries shown in the table is close to 0.8% of GDP in 2023 and 0.7% in 2024 (see bottom row).[9]

Columns (5)-(12) show the annual average fiscal adjustment that would be required for the 2025-27 period if the Commission's proposed framework was enacted in 2024. This depends on the adjustment period, which is normally four years, but could be extended to seven years for countries undertaking growth-enhancing structural reforms, including in the context of National Recovery and Resilience Plans (NRRPs).[10] The table is laid out in a way that makes it clear which of the requirements of the framework are driving the results: Columns (5) and (6) show the average annual adjustment for 2025-28 that would be required by conditions (a) and (b) of the proposed framework, that is, to (a) put or keep debt on a sustainable downward path, and (b) to lower the deficit to less than 3% of GDP by the end of the adjustment period and keep it there for at least 10 years. Columns (7) to (12) show the annual adjustment, separately for the years 2025, 2026 and 2027, which the proposed framework would require once the safeguards are additionally applied. The need to show each year separately comes from the excessive deficit safeguard, which applies only in years in which the deficit is still above 3%[11]. Countries and years for which this safeguard is binding are highlighted in orange, countries for which the debt safeguard is binding in yellow, and countries for which the net expenditure growth safeguard

[7] The main assumption is that the "planning horizon" referred to in the debt safeguard, which is not defined in the proposed regulation, is four years. In addition, we assume that the total adjustment requirement over the 4-7-year adjustment horizon is broken down into equal adjustment steps, in structural primary balance terms. This assumption implies that the net expenditure paths automatically satisfy the no-backloading safeguard; indeed, they go further, as the no-backloading safeguard as currently drafted does not restrict backloading within either the four-year adjustment period or the first four years and the last three years of the seven-year adjustment period. See Darvas, Welslau and Zettelmeyer (2023) and Pench (2023) for a discussion.

[8] The source is European Commission (2023d).

[9] Including the remaining euro area countries in the average would somewhat reduce the impact in 2023, to 0.6% of GDP, mainly due to projected fiscal easing in the Netherlands (-1.9%) and Luxembourg (-1.5%), but leave the 2024 impact unchanged.

[10] The calculations underlying Table 1 use the same growth forecasts to compute fiscal adjustment under the four and seven year adjustment periods. To the extent that the extension to seven years is determined by the strength of MS plans to raise growth, this could moderately bias up the adjustment results for the seven-year period shown in the table. However, Article 13 of the draft regulation (EC 2023a) says that "*During the lifetime of the Recovery and Resilience Facility (…) commitments included in the approved Recovery and Resilience Plan of the Member State concerned can be taken into account for an extension of the adjustment period.*" Given that NRRP investments and reforms qualify for the extension, and Member States have difficulties even in implementing NRRPs, at least until the end of 2026, it is unlikely that countries would propose new investments and reforms to obtain an extension. NRRP investments and reforms, however, are already incorporated into the official growth projections on which the table is based.

[11] In Table 1, this makes a difference only for Poland in 2027.

is binding in light green. Finally, column (13) shows the average annual adjustment that would be required, in structural primary balance terms, if the current fiscal framework based on a "Medium Term Objective" (MTO) were reapplied after 2024.

The main results are as follows.

1. The proposed framework would require continued fiscal adjustment from 2025 until the end of the four-year planning horizon in 2028, from almost all MS (the only exceptions are Cyprus and Greece, whose 2024 structural primary balances are projected to already be above the 2028 values prescribed by the framework).
2. As indicated by the highlights (and by comparing columns (5)-(6) and columns (7)-(12)), the fiscal adjustment requirements of the proposed frameworks are mostly driven by conditions (a) and (b) above – that is, the debt sustainability requirement and the requirement that the deficit be reduced to and remain below 3% of GDP by the end of the adjustment period. There are three exceptions:
    - First, for a few countries with projected excessive deficits in 2024, the annual fiscal adjustment prescribed by conditions (a) and (b) falls short of the 0.5% of GDP required by the excessive deficit safeguard (Poland and Malta, and additionally Italy, Spain, Hungary and Romania for the 7-year adjustment period which lowers the average annual adjustment required by conditions (a) and (b)).
    - Second, the debt safeguard is binding for two countries, France and Bulgaria, in both the 4-year and 7-year adjustment periods, and for three additional countries, Belgium, Romania and Slovakia, in the 7-year adjustment period only. For France, the annual required adjustment during 2024-28 goes up from 0.8% of GDP (4-year adjustment period) or 0.4% of GDP (7-year adjustment period) to 1.1% of GDP. For Belgium, the increase is 0.3% of GDP (7-year adjustment period only).
    - Third, the net expenditure safeguard is binding for Greece and Cyprus. In the absence of this safeguard, these countries would have been able to *lower* their structural primary balances from their high projected levels in 2024 without running afoul of either conditions (a) and (b) not any of the other safeguards.
3. While the proposed system prescribes a significant fiscal tightening, this is not as large as would be required under the current fiscal rules, if these were to be reapplied from 2025 onward. A comparison between column (13) and columns (7)-(12) shows that the fiscal adjustment requirement under the proposed system would be at least 0.2% of GDP per year lower than under the current system for Cyprus, Greece, Finland, Spain, Italy, Malta, Belgium, and Slovakia. For Portugal, Germany, Austria, France and Slovenia, it does not make much of a difference (+/- 0.1% of GDP). Only for Bulgaria would the proposed system require much higher fiscal adjustment than the current one, on account of the debt safeguard. The difference comes mainly from the fact that in the current system, higher debt raises the MTO via an ad-hoc formula, while fiscal adjustment under the proposed system is based on a set of deterministic and stochastic debt projections (with some ad hoc corrections via the safeguards, as discussed above).

Table 1: Fiscal adjustment based on European Commission forecasts (2023-24), proposed framework (2025-28), and current framework (2025-28)

(in structural primary balance terms, expressed in percent of GDP)

Country	GDP weight in euro area, 2024 (%)	2024 fiscal balance (EC fore-cast)	EC adjustment *forecast*		2025-28 average adjustment required by conds. a&b of ***proposed*** framework		Adjustment required by ***proposed*** framework, including safeguards						2025-28 average annual adjust. required by ***current*** frame-work
							2025		2026		2027		
			2023	2024	4-year adj. period	7-year adj. period	4-year adj. Period	7-year adj. period	4-year adj. period	7-year adj. period	4-year adj. period	7-year adj. period	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Cyprus	0.2	2.1	0.0	0.4	-0.7	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	-0.3
Portugal	1.8	-0.1	0.2	0.6	0.2	0.1	0.2	0.1	0.2	0.1	0.2	0.1	0.1
Greece	1.6	-0.6	1.6	0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.6
Germany	28.7	-1.2	0.4	1.0	0.3	0.1	0.3	0.1	0.3	0.1	0.3	0.1	0.3
Austria	3.4	-1.3	1.5	1.1	0.3	0.2	0.3	0.2	0.3	0.2	0.3	0.2	0.3
Croatia	0.5	-1.3	-0.5	-0.6	0.2	0.1	0.2	0.1	0.2	0.1	0.2	0.1	0.4
Finland	1.9	-2.6	-0.9	0.3	0.3	0.1	0.3	0.1	0.3	0.1	0.3	0.1	0.5
Slovenia	0.5	-2.9	0.2	1.4	1.0	0.6	1.0	0.6	1.0	0.6	1.0	0.6	1.1
Spain	10.0	-3.3	0.3	0.5	0.6	0.4	0.6	0.5	0.6	0.5	0.6	0.5	1.0
Italy	14.3	-3.7	2.9	1.0	0.9	0.4	0.9	0.5	0.9	0.5	0.9	0.5	1.4
Poland		-3.7	1.0	1.6	0.1	0.1	0.5	0.5	0.5	0.5	-0.2	-0.1	0.6
France	19.7	-4.3	0.4	0.2	0.8	0.4	1.1	1.1	1.1	1.1	1.1	1.1	1.2
Hungary		-4.4	4.2	-0.2	0.7	0.5	0.7	0.5	0.7	0.5	0.7	0.5	0.8
Romania		-4.4	2.1	0.2	0.8	0.5	0.8	0.6	0.8	0.6	0.8	0.6	1.0
Malta	0.1	-4.5	1.2	1.0	0.4	0.3	0.5	0.5	0.5	0.5	0.5	0.5	1.0
Belgium	4.0	-4.7	-0.5	0.6	1.1	0.6	1.1	0.9	1.1	0.9	1.1	0.9	1.5
Slovakia	0.9	-4.8	-3.8	1.4	1.1	0.7	1.1	0.8	1.1	0.8	1.1	0.8	1.3
Bulgaria		-4.8	-1.7	0.0	0.9	0.6	1.9	1.9	1.9	1.9	1.9	1.9	1.1
EA14 weighted average		**-2.7**	**0.76**	**0.73**	**0.58**	**0.31**	**0.65**	**0.51**	**0.65**	**0.51**	**0.65**	**0.51**	**0.83**

Source: authors' calculations based on Darvas, Welslau and Zettelmeyer (2023), economic growth projections from the European Commission's May 2023 forecast, and market-based interest rate and inflation forecasts.

Note: Countries and years for which excessive deficit safeguard is binding are highlighted orange, countries for which the debt safeguard is binding are highlighted yellow, and countries for which the net expenditure safeguard is binding in light green.

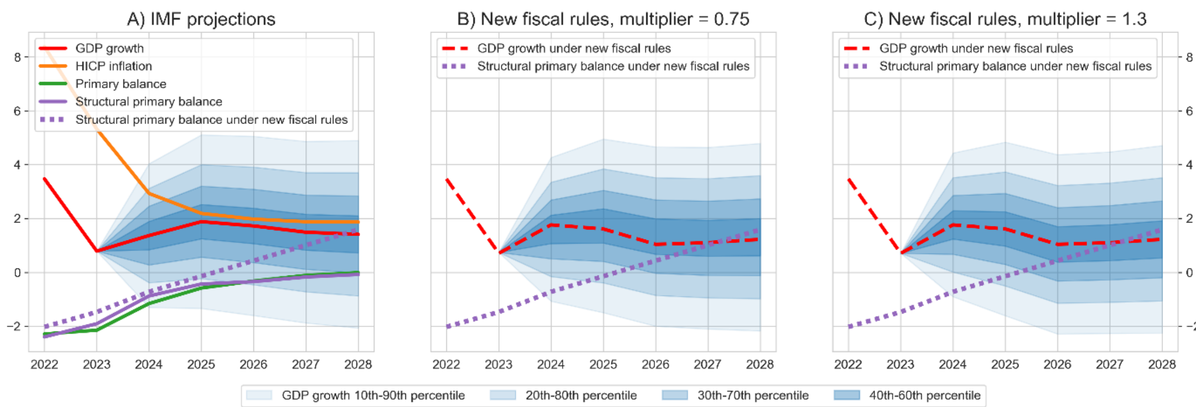
The last line of the table shows the aggregate implications for the euro area fiscal stance, based on the 14 euro-area countries included (88% of the euro area in GDP terms). This implies that the consolidation forecast by the Commission for 2023 and 2024 would continue during 2025-28, albeit at a slightly slower pace. The Commission's DSA and the need to reduce the deficit below 3% imply a tightening between 0.58% and 0.31% of GDP per year, depending on whether countries are given 4 or 7 years respectively to adjust (columns 5 and 6). The application of the safeguards bumps this adjustment up by a notch, to 0.65% and 0.51% percent of GDP, mostly on account of the much higher adjustment for France (columns 7-12).

The question is whether this fiscal adjustment path would support the achievement of the ECB's price stability objective. Most private forecasts and all major official forecasts – by the ECB, the European Commission, the IMF and the OECD – predict a return to the inflation target in the medium term. However, these forecasts typically assume that the central bank will do whatever it takes to achieve its inflation target and thus do not answer the question of whether fiscal policy could contribute either by accelerating the process or lowering the output costs of disinflation. To take a stab at that question, it is necessary to look at inflation forecasts together with forecasts for output and the fiscal stance.

The only institution that provides a set of consistent forecasts of these variables over the medium term (until 2028) is the IMF in the World Economic Outlook. While these forecasts are somewhat dated (April

2023)[12], it is worth asking what they imply if taken at face value. The IMF expects euro-area inflation to return to very close to the 2% ECB target by 2025 and stay close to the target until the end of the forecast horizon (Figure 1, Panel A). It also expects the euro area to avoid a recession; indeed, it projects a recovery of growth by 2025. This said, there is high uncertainty around these projections, indicated by the shaded confidence bands, which imply a recession probability of 25% in 2026.[13] Finally, as regards fiscal adjustment, the IMF expects an adjustment similar to the European Commission in total in 2023 and 2024, followed by much slower adjustment over the medium term, with the structural primary balance gradually converging to zero after 2025. Panel A of Figure 1 also shows how fiscal adjustment presented in Table 1 would differ from that projected by the IMF. Until 2025, the two fiscal paths more or less coincide. After 2025, however, the fiscal path required by the proposed framework is dramatically tighter (purple broken line).

Figure 1: IMF projections for the euro area, and adjusted growth projections corresponding to the proposed new fiscal rules, 2022-2028



Source: IMF World Economic Outlook database and Bruegel calculations.

Note: Structural primary balance is our calculation using IMF data on primary balance and output gap, and the average euro-area budget balance semi-elasticity to the output gap from Table I.3 (p. 41) of Mourre, G. et al. (2019). We calculated the euro-area average elasticity as a weighted average of the elasticities of euro-area countries. We did not exclude possible one-off expenditure and revenue items when calculating the structural balance. “Structural primary balance under new fiscal rules” correspond to European Commission May 2023 forecast for 2022-2024 and our calculations for 2025-2028 by averaging the annual adjustment requirement under the 4-year and under the 7-year horizons (since some countries might opt for a 4-year plan, others for a 7-year plan). In Panels B and C, “GDP growth under new fiscal rules” is our calculation by adjusting the IMF GDP growth projections with the impact of the difference between the changes in IMF structural primary balance estimate and the change in our “Structural primary balance under new fiscal rules” estimate, assuming either the 0.75 fiscal multiplier parameter that the Commission uses (Panel B), or a fiscal multiplier of 1.3 (Panel C). In line with the Commission, it is assumed that the impact of fiscal consolidation on the output gap gradually diminishes in three years. Percentiles are calculated by us based on IMF historical forecast errors.

Panels B and C of Figure 1 show how GDP forecasts would be affected by faster fiscal consolidation under the proposed new fiscal rules, using either the (relatively low) fiscal multiplier assumptions of the European Commission (Panel B), or a somewhat larger fiscal multiplier (see table note). The consequence would be a somewhat lower output path than that projected by the IMF. At the same time, the probability of a recession in 2026 rises from 25% in panel A to 30% in panel B and 34% in panel C. These probabilities are somewhat smaller than the recession probabilities presented in the most recent ECB forecast, based on ECB growth forecast errors, which are in the order 40% by end-2025 (see ECB, 2023a, Chart 1).

We see two main takeaways in this analysis.

[12] The IMF published an Update to its World Economic Outlook in July 2023, which, however, only provides forecasts for 2023 and 2024.

[13] Confidence bands were calculated using historical IMF growth forecast errors.

First, by any measure – whether one believes the European Commission or the IMF's forecasts – the time where monetary policy and fiscal policy were pushing in opposite directions is over. Fiscal and monetary policy are now moving in tandem and expected to do so until 2025, by when both the ECB and the IMF expects that euro-area inflation will return close to the ECB's 2% target.

Second, if fiscal balances evolve in line with the proposed economic governance reform, monetary and fiscal policy may well drift apart again from in a few years from now, but in opposite directions compared to where they were in 2022. If inflation indeed falls back close to 2% by 2025, the ECB will stop tightening and might even cut interest rates (either in 2025, or perhaps even earlier), while fiscal policy would continue on a tightening path for several years. This will imply a significant demand drag on the euro area economy. To the extent that it translates into a drop of inflation below 2 %, monetary policy will ease, thereby supporting output and avoiding a recession. But if the preceding monetary and fiscal tightening has already created weaker economic conditions than predicted in the IMF's baseline scenario, a recession may ensue. Recent signs of economic weakening in the EU, with downward revision to growth in both 2023 and 2024 in the European Commission's September 2023 forecast (European Commission 2023e) relative to its May forecast European Commission 2023d), suggest that this risk is growing.

Hence the answer to the question of whether the proposed framework would support price stability objectives over the horizon of its first application is as follows. In the short run, it would not make much of a difference. But over the medium term, there is a risk that it would induce a fiscal stance that is too tight from a conjunctural perspective, and requires the monetary authority to offset it. Not surprisingly, this risk depends on the length of the adjustment period: as the seven-year adjustment period would spread out fiscal adjustment over more years, and the fiscal drag on growth over the first four years would be substantially less.[14]

[14] In addition, the total required adjustment might be lower as a result of the growth-inducing reforms that are required to qualify for the three year extension to the adjustment period. For the reasons explained in footnote 10, this effect is not considered in the Table 1 estimates.

3. DOES THE PROPOSED FRAMEWORK OPTIMALLY TRADE-OFF FISCAL SUSTAINABILITY AND FLEXIBILITY?

As argued in the introduction, fiscal frameworks should seek to ensure debt sustainability while also giving policy makers flexibility to pursue other objectives. This is both in the general public interest and in the interest of monetary policy makers, who may require the help of fiscal policy makers in meeting their price stability objective[15].

Importantly, however, there can be a trade-off between the two objectives. This could arise from the fact that fiscal authorities may have incentives to overspend, in light of short election horizons, or perhaps in light of the fact that the electorate itself does not fully internalise the welfare of future generations. In this case, ensuring debt sustainability may require restricting the flexibility of the fiscal authority. This is the standard argument for fiscal rules (see, for example, Alesina and Tabellini, 1990). For similar reasons, governments may prefer current spending to investment spending, since the latter only partly benefits current voters. Fiscal rules could attempt to correct this bias.

A monetary union with sovereign fiscal policy at the level of Member States complicates this trade-off, in two respects.

On the one hand, it strengthens the argument for rules that constrain overly expansionary fiscal policies. Overborrowing by members of a monetary union has stronger negative externalities for other members than across countries that are integrated only through trade and financial relationships. This is true not only because financial linkages are tighter in a monetary union, but because a messy default and/or exit from the currency area can threaten the credibility of the currency union as a whole (the July 2015 crisis in Greece is a case in point). As a result, fiscal crises will lead to pressure for a bailout through financial assistance, and possibly pressure for debt monetisation, endangering price stability in all currency union member countries (Darvas et al, 2018, Bénassy-Quéré et al, 2018, Gourinchas et al, 2023).

On the other hand, membership in a currency union also strengthens the possibility of a positive externality associated with expansionary fiscal policy. The central bank may need help in increasing aggregate demand, as was the case in the euro area between 2013 and 2020, but national policy makers may not internalise the impact of fiscal policy on the euro area as a whole. As sovereign countries cannot be forced to incur debt beyond the level that can be justified to national citizens, this problem can only be solved through a central fiscal capacity (CFC), which can adjust the euro area fiscal stance to the collectively optimal level.

From the perspective of monetary-fiscal coordination, one obvious problem of the proposed fiscal framework is the lack of such a capacity. Leaving aside this problem, the question is whether the framework ensures debt sustainability at minimum cost to restricting the possibility of expansionary national fiscal policy when this is needed for price (and output) stability reasons. An important corollary of this requirement is that the framework should not generate rules or incentives that induce procyclical fiscal contractions in response to a negative output shock.

To answer the question, we need to briefly take stock of the design features that attempt to ensuring debt sustainability on the one hand while preserving flexibility on the other.

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[15] For example, in her 27 July 2023 monetary policy statement, President Lagarde stressed: " *As the energy crisis fades, governments should roll back the related support measures promptly and in a concerted manner. This is essential to avoid driving up medium-term inflationary pressures, which would otherwise call for a stronger monetary policy response.*" https:/1/www.ecb.europa.eu/press/pressconf/shared/pdf/ecb.ds230727~9e147b657d.en.pdf

To ensure debt sustainability, the framework relies on a plethora of commitment devices:

- The main *ex ante* commitment device is the medium-term fiscal structural plan, which results in a net expenditure path. This must satisfy not only criterion (a), the debt sustainability criterion per se, but also criterion (b), the deficit criterion, which is conceptually irrelevant for debt sustainability, but required by the treaty, and may be effective in disciplining policy makers in practice (Caselli and Wingender, 2021). Furthermore, the European Commission is supposed to assess whether the plan also meets three additional safeguards described above — designed to prevent "backloading", achieve debt reduction by the end of the planning horizon, and require a minimum speed of adjustment of 0.5%of GDP per year for countries whose deficits exceed 3% — and base its recommendation to the Council on this assessment.
- *Ex post*, the framework envisages four devices (lines of defense, so to speak) to make sure that fiscal adjustment happens as planned. First, the agreed net expenditure path must be written into law in every country, resulting in binding medium-term net expenditure ceilings. Second, if the country violates these ceilings, it might be subject to a disciplining procedure (the "debt-based" excessive deficit procedure). Third, even if the country does not violate the ceilings, it could be subject to higher-than planned minimum adjustment if the conditions of the "deficit based" EDP apply, namely, if its deficit exceeds 3% when its planned adjustment is less than 0.5% of GDP[16]. Even if the net expenditure path was designed to prevent this, this could happen *ex post* as a result of a bad shock (lower nominal output or higher interest rates). And fourth, fines for excessive deficit would be imposed at an earlier stage, and initially in smaller amounts, than in the current system.

The framework also embodies three elements that seek to preserve flexibility, promote reforms and investment, and avoid procyclical fiscal adjustment:

- First, the possibility to extend the adjustment period by three years for countries that put forward growth-enhancing public investment and reforms. From the perspective of the ECB, this is desirable because it raises equilibrium interest rates ("r*"), making it less likely that the economy will return to a regime in which monetary policy is constrained by the zero lower bound on interest rates.
- Second, the fact that the main commitment device is a *net expenditure* path, not a deficit path. Net expenditures exclude items that the fiscal authorities cannot control, including interest spending, as well as the cyclical drivers of the deficit (revenue and cyclical expenditure categories such as unemployment benefits). In principle, this means that if the country is hit by a bad shock, it should not be required to tighten;
- Finally, two "escape clauses": a general escape clause in which the Council "may adopt a recommendation allowing Member States to deviate from their net expenditure path, in the event of a severe economic downturn in the euro area or the Union as a whole, provided it does not endanger fiscal sustainability", and a "country-specific escape clause", where it may do the same "where exceptional circumstances outside the control of the Member State lead to a major impact on the public finances of the Member State concerned, provided it does not endanger fiscal sustainability."

The question is whether the benefits of the restrictions introduced for the sake of ensuring debt sustainability justify the costs that they impose on flexibility, and vice versa for the devices that are

[16] See footnote 6 about the ambiguity of whether the minimum half percent adjustment requirement is a hard constraint or not.

there to protect flexibility. Drawing on the analysis of Darvas, Welslau and Zettelmeyer (2023) and the results of the last section, we answer this question as follows.

Aside from the lack of a CFC, the main elements of the proposed framework are sound: asking countries to develop a medium-term fiscal-structural plans consistent with debt sustainability, creating incentives for reform and public investment, requiring them to write the plan into national law in the form of a net expenditure path; requiring corrective measures if the plan is violated; and letting countries off the hook in the event of a major downturn that cannot be addressed through automatic stabilisers alone.[17] We also see a rationale for a (properly designed) "no backloading safeguard" that constrains the net expenditure path beyond what would be required by debt sustainability analysis alone. The reason is that debt sustainability analysis alone may not put enough structure on the adjustment path, giving a pass to adjustment proposals that are not time-consistent in light of the political process. We therefore agree with imposing a no-backloading condition, which rules out net expenditure paths that seek to leave most adjustments to the last minute.

Second, given its central role, there is a case for reviewing the European Commission's DSA methodology, in a way that involves Member States rather than just the Commission alone. While the methodology is generally both reasonable and rigorous, there is scope for improving it with relatively little effort (see Darvas, Welslau and Zettelmeyer 2023 for details)[18]. Furthermore, MS are unlikely to comply with the implications of the methodology for fiscal adjustment unless they understand it and agree with it. To make the review as objective as possible, we recommend the establishment of an independent expert group to conduct the technical review, seeking the views of Commission staff, Members States, the ECB, the ESM, and the European Fiscal Board (EFB), and submitting a report to the Council recommending changes. This DSA review will take some time, while the economic governance review (EGR) should be adopted in the next few months; otherwise, the existing fiscal rules will be reinstated in 2024. We, therefore, recommend approving the EGR as soon as possible with a clause requiring the revision of the DSA methodology before the end of 2024, making 2024 a transition year, and launching the full implementation of the new fiscal framework from the beginning of 2025, based on the new DSA methodology.

Third, there are several design flaws with the proposed safeguards which should be addressed before the proposal goes into effect.

i. As currently drafted, the no-backloading safeguard is almost empty, in the sense that it would not prevent the most common forms of backloading. This is because it requires that "the fiscal adjustment effort over the period of the national medium-term fiscal-structural plan is at least proportional to the total effort over the entire adjustment period." If the "period of the plan" is four years, this formulation would only ensure that the average adjustment in the last three years of a seven-year adjustment is not smaller than the average adjustment in the first four years, but not prevent backloading within the four-year adjustment period, nor within the first four years and last three years of the seven-year adjustment period.

[17] We have (separately) been arguing for this type of architecture for some time. See Claeys, Darvas and Leandro (2016), Bénassy-Quéré et al (2018), Darvas, Martin and Ragot (2018), Blanchard, Leandro and Zettelmeyer (2021), Arnold et al (2022).

[18] Technical issues are related to the maturity structure of debt; the interpolation of inflation; not differentiating between the GDP deflator and harmonised index of consumer prices (HICP); using euro-area inflation expectations for Bulgaria, Czechia, Denmark, and Sweden; disregarding the sensitivity of interest rates to alternative debt paths; assuming no uncertainty during the adjustment period in the stochastic analysis; assuming normal distribution of shocks in the stochastic analysis; and a number of other simplifying assumptions. There are a number of other assumptions as well, which are reasonable, but could be re-examined.

ii. Both the debt safeguard and the excessive deficit safeguard impose significant additional restrictions on fiscal policy that cannot be justified with debt sustainability objectives (particularly if the no-backoading safeguard is fixed). These are particularly apparent in the case of the seven-year adjustment period. These safeguards prevent the countries to whom they apply from benefitting from the extension of the adjustment period, namely, to lower the annual adjustment requirement in exchange for growth enhancing reform or investment. By doing that, they undermine the intended purpose of the extension of the adjustment period. The effects can be large. For example, the application of the debt safeguard raises the annual adjustment requirement for France from 0.8% of GDP with four-year adjustment, or 0.4% of GDP with seven-year adjustment, to 1.1% of GDP. The impact of the debt safeguard on Bulgaria's adjustment requirement is even larger, which is ironic since Bulgaria has one of the lowest debt ratios in the euro area. The excessive deficit safeguard has smaller effects, but they apply to more countries. Both safeguards should be abolished or fundamentally redesigned.[19] If the reason for inserting the safeguards was the lack of trust in the DSA by some Member States, then a better solution would be the joint review of the DSA methodology by the Commission and the Member States and codification of the methodology in the Code of Conduct of the Stability and Growth Pact, as recommended in Darvas, Welslau and Zettelmeyer (2023).[20]

iii. Consistent with abolishing or redesigning the excessive deficit safeguard, the deficit-based excessive deficit procedure requires a redesign, because it can induce procyclical adjustment. Member States that are in compliance with the net expenditure path agreed with the Council should not be required to undertake a higher adjustment in the face of a shock that puts their deficit above 3%, so long as the agreed path continues to satisfy the DSA-based requirements (condition (a)).

Finally, we would have liked to see a greater role of independent fiscal institutions in the process of activating the escape clauses. If this process becomes political, it could seriously undermine the discipline that the framework is meant to impart. The participation of independent fiscal institutions could reduce that risk.

Note that these proposals cut both ways. The recommendations to review the Commission's DSA methodology has nothing to do with shifting the weights that the proposal assigns to discipline and flexibility in one direction or the other; rather, it is about making the framework more efficient in the sense of increasing its capacity to predict unsustainable debt. Among our three recommendations on safeguards, the first would make the framework tougher (at an acceptable cost to flexibility) while the two others would make it more flexible (at acceptable costs to its disciplining function). Finally, the recommendation on involving fiscal councils is again about increasing the efficiency and the credibility of the new framework, at no or acceptable cost to flexibility and its disciplining function.

[19] A fundamental redesign would mean (1) defining the safeguards so they do not block an extension of the adjustment period from translating into lower adjustment requirements (for example, by changing the language such that the debt safeguard applies to the adjustment period, not the "planning horizon"; (2) introducing an exception for EU-endorsed public investments into the safeguards. In addition, the debt safeguard should not apply to countries with debt below 60% of GDP.

[20] See also Blanchard and Zettelmeyer (2023)

4. REEXAMINING THE TRANSMISSION PROTECTION INSTRUMENT IN LIGHT OF THE PROPOSED FRAMEWORK

In July 2022, the ECB Governing Council approved the Transmission Protection Instrument (TPI), which allows Eurosystem secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals, provided certain criteria are fulfilled. The declared aim of the new tool is to "ensure that the monetary policy stance is transmitted smoothly across all euro area countries", a precondition for the ECB to deliver on its price stability mandate.

Stripped from ECB terminology, the objective of the TPI is to maintain orderly market conditions in sovereign debt markets without undermining fiscal discipline and without giving rise to transfers from the monetary authority (as might arise if the ECB were to purchase sovereign bonds of an insolvent country). To achieve this, the July 2022 ECB decision set four criteria for the eligibility to the TPI, as follows[21]:

(1) compliance with the EU fiscal framework: not being subject to an excessive deficit procedure (EDP), or not being assessed as having failed to take effective action in response to an EU Council recommendation under Article 126(7) of the Treaty on the Functioning of the European Union (TFEU);

(2) absence of severe macroeconomic imbalances: not being subject to an excessive imbalance procedure (EIP) or not being assessed as having failed to take the recommended corrective action related to a Council recommendation under Article 121(4) TFEU;

(3) fiscal sustainability: in ascertaining that the trajectory of public debt is sustainable, the Governing Council will take into account, where available, the debt sustainability analyses by the European Commission, the European Stability Mechanism, the International Monetary Fund and other institutions, together with the ECB's internal analysis;

(4) *sound and sustainable macroeconomic policies: complying with the commitments submitted in the recovery and resilience plans for the Recovery and Resilience Facility and with the European Commission's country-specific recommendations in the fiscal sphere under the European Semester.*

These are necessary criteria for eligibility. When these criteria are fulfilled, the ECB will independently decide whether to conduct TPI operations, by assessing whether "*unwarranted, disorderly market dynamics*" arose, following a "*comprehensive assessment of market and transmission indicators, an evaluation of the eligibility criteria and a judgement that the activation of purchases under the TPI is proportionate to the achievement of the ECB's primary objective*".

All four eligibility criteria are related to the economic governance review. In this section, we focus on the aspects most closely related to the reform of the fiscal framework, (1) and (3), and address two questions. First, would the proposed framework pose any difficulties in applying the two conditions, relative to the current framework? Second, does the proposed framework create opportunities for improving the TPI? The answers are no, and yes, respectively.

[21] Source: https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr220721~973e6e7273.en.html

4.1. Would the proposed framework complicate the application of the TPI?

The short answer is no. Under the proposed framework, condition (1) will continue to be determined by the Council as before, while condition (3) could be evaluated by the ECB exactly as before, as all the debt sustainability analysis of the institutions named will continue to be available. Indeed, the DSA of the Commission may be publicly available with greater frequency than under the status quo (when it is published once a year), as it plays a critical role in the excessive deficit procedure (see below). Hence checking (1) and (3) will be no harder, as a result of the proposed fiscal governance reform, than it was before.

To see how the assessment of condition (1) would work in practice, is it nonetheless worth summarising how the proposed regulation envisages the opening of an EDP, and whether there is clarity on the interpretation of "effective action" once a country is under an EDP.

According the proposed "Council regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure" (EC 2023b), two circumstances could lead to the launch of an EDP:

- The deficit-based EDP remains unchanged from the current framework. An excessive deficit exists if the deficit exceeds the 3% reference value, unless the deviation is small and temporary or caused by exceptional circumstances beyond the control of the government.
- The debt-based EDP is revised. For countries with public debt ratios above 60% of GDP, deviations from the Council-endorsed net expenditure path will be evaluated. Within this group, a differentiation is made for countries with "substantial public debt challenges"[22] and the remaining countries. For the former, a deviation from the agreed net expenditure path will by default lead to the opening of an EDP, while for the latter, other factors will be considered too.

The new debt-based EDP condition can be assessed only after some years the new framework will have entered into force, so at the possible start of the new framework in 2024, only the conditions for a deficit-based EDP will be assessed. Table 1 reports European Commission deficit forecast for 2024 and shows that ten EU countries, of which six are members of the euro area, are expected to have more than 3% budget deficit in 2024. Among the euro-area countries that suffered high spreads during the euro crisis in the early 2010s, Italy and Spain are in this group and thus will likely enter an EDP in 2024.

Once in an EDP, a country would remain eligible for the TPI if it takes *"effective action"* in response to the Council recommendation. Per Article 126(8) of the TFEU, it is for the Council to establish whether effective action has been taken. Under the new framework, (Article 3, paragraph 4 of EC 2023b), the Council would ask the MS to "implement a corrective net expenditure path" that meets the following criteria.

- It meets condition (a), i.e. "puts the debt ratio on a plausibly downward path or keep it at a prudent level" as defined by the regulation replacing the preventive arm;
- It ensures that the average annual fiscal adjustment effort in the first three years is at least as high as the average annual fiscal effort of the total adjustment period.

[22] As explained in the most recent debt sustainability monitor (EC 2023c, p. 11), these are countries which based on the Commission's debt sustainability methodology, are assessed as having high fiscal sustainability risks over the medium term. In 2022, this group included Belgium, Greece, Spain, France, Croatia, Italy, Hungary, Portugal and Slovakia.

- "For the years when the general government deficit is expected to exceed the reference value, the corrective net expenditure path shall be consistent with a minimum annual adjustment of at least 0.5% of GDP as a benchmark."

Hence, implementation of the requested corrective net expenditure path would constitute effective action.[23]

In addition, an amendment to Article 8 of the regulation (EC 2023b) lays out the conditions under which the Council would "abrogate" (end) the EDP, namely "where budgetary forecasts as provided by the Commission indicate that the deficit has been brought durably below the reference value and, where the excessive deficit procedure was opened on the basis of the debt criterion, the Member State concerned respected the corrective net expenditure path set by the Council (…) over the previous 2 years and is projected to continue to do so in the current year on the basis of the Commission forecast."

Our reading of the proposed regulation is hence that it defines the conditions for compliance with the EU fiscal framework at least as clearly as the regulation that it replaces. The Council will continue to decide on the existence of an excessive deficit, and on whether countries in and EDP are taking effective action. And the criteria for doing so are well described in the regulation, creating predictability.

4.2. Does the proposed framework offer an opportunity for improving the TPI?

There is an important asymmetry between conditions (1) and (3). In condition (1) (as well as as conditions (2) and (4)), the ECB delegates the assessment of whether the condition is satisfied to the Council and the Commission. In condition (3), however, the decision whether a country's debt is sustainable is not delegated. While the ECB Governing Council "takes into account" the DSA of the European Commission (as well as that of the European Stability Mechanism, the International Monetary Fund and others) as well as the ECB's internal analysis, it reserves the right to decide any way it wants.

The question is whether there may a case for removing this asymmetry, in either direction. If the ECB Governing Council gives itself discretionary power to decide on debt sustainability, might it also make sense to give itself discretionary power to in deciding whether the country's fiscal policy is appropriate? Conversely, if the ECB delegates the assessment of all criteria but (3) to Council and Commission, might it also makes sense to delegate the assessment of debt sustainability?

To begin with the first question, the potential attraction of placing some decision-making power related to condition (1) into the hands of the ECB is that this might undo some of the less useful, ridigity-inducing features of the proposed system, such as counterproductive safeguards. In principle, the ECB might take a narrower view of both the inappropriate fiscal behavior and "effective action" than the Council, namely, one that is focused only on adherence to a net expenditure path consistent with debt sustainability (criterion a) while disregarding minimum adjustment of 0.5% when this is inappropriate in the eyes of the ECB.

The problem of this approach, of course is that it would be highly confrontational. Furthermore, the ECB's official opinion on the proposed framework (ECB, 2023b) takes a kinder view of the proposed safeguards than we have taken in this paper. Hence, the idea that the ECB might use the enormous power of the TPI to in effect fix some of the problems of the proposed framework is a pipe dream. We conclude that condition (1) should remain as currently drafted.

[23] That is, it is a sufficient condition for effective action. It may not be a necessary condition, if the Council considers the implementation to be close enough to the requested corrective path. The proposed regulations do not provide any guidance in this respect.

Consider now the second question, on whether condition (3) should be aligned with the remaining conditions in the sense that, rather than taking a discretionary decision on debt sustainability based on various inputs, it defers to the DSA of the Council and Commission, as implemented under the proposed framework.

As argued by Claeys and Demertzis (2022), this could be attractive for two reasons. First, the TPI potentially involves fiscal transfers across euro-area countries. In the absence of a genuine fiscal union, a decision with large potential fiscal consequences should involve considerable deference to the fiscal representatives of euro-area Member States, like the Eurogroup (the euro-area finance ministers from the ECOFIN Council). Second, piggybacking on the Council's/Commission's DSA would avoid noise that could destabilise the debt markets. Markets would know that countries whose debt is found sustainable by the Commission/Council, and meet the remaining conditions (all of which are observable), will have access to the TPI. By contrast, under the current system, there will always be doubt whether the ECB Governing Council ultimately agrees with the Commission's/Council's DSA or not.

From the perspective of July 2022, it is understandable why the ECB did not go this route. First, there was no mechanism for the Council/Eurogroup to assess the fiscal sustainability of Member States (except when financial assistance is requested from the European Stability Mechanism, but this is not a condition for the TPI). The Commission's DSA analysis did not have a prominent role in the EU governance framework, and the Commission DSA results were not endorsed by the Council. Second, the Commission's methodology was relatively obscure, and – while reasonable – embodied some doubtful features (see Darvas, Welslau and Zettelmeyer 2023 for details).

In light of the economic governance legislative proposal, these arguments may no longer apply. First, the status of the DSA methodology has in effect been upgraded: its results will be endorsed by the Council. Furthermore, in Darvas, Welslau, and Zettelmeyer (2023) and the previous section, we recommended that there should be a review and approval of the Commission's DSA methodology jointly by the Commission and all Member States and that the technicalities of the DSA methodology should be codified in a document approved by Member States, possibly in the Code of Conduct of the SGP. The ECB should be given a chance to comment and contribute to the review at the technical level.

Assuming the future fiscal framework encompasses debt sustainability as a necessary condition for compliance with the fiscal framework and the DSA methodology is collectively reviewed, we would therefore recommend a revision of the TPI conditions to give greater deference to the future, Council-endorsed DSA. Specifically, we see two options, the first of which would take an incremental step, and while second one would be more radical.

The incremental approach would be to change the language of condition 3 in a way that creates the expectation that the ECB would normally defer to the Council/Commission DSA, without delegating the debt sustainability decision entirely. For example, condition 3 could read (our addition to the existing text is in bold):

> fiscal sustainability: in ascertaining that the trajectory of public debt is sustainable, the Governing Council will **normally adopt the conclusions of the Council-endorsed debt sustainability analysis conducted in the context of the implementation of the EU fiscal framework. In addition, it may** take into account, where available, the debt sustainability analyses by the European Stability Mechanism, the International Monetary Fund and other institutions, together with the ECB's internal analysis.

The radical approach would be to either delete condition (3) altogether – since debt sustainability as per the Council-endorsed DSA is automatically satisfied when a MS complies with the fiscal framework

– or maintain condition (3) but link the debt sustainability assessment fully to the Council/Commission DSA.

The two approaches have different pros and cons.

- The main advantage of the radical approach compared to the incremental one is that it excludes the possibility of market turmoil linked to the possibility that the Commission/Council DSA might be rejected by the ECB.
- Against that, there may be a risk associated with the radical approach, namely the possibility that the Commission/DSA might actually get it wrong.

It is important to emphasise that the independence of the ECB would not be compromised if it delegates the DSA finding to Council and Commission, since the final decision to activate the TPI remains entirely in the discretion of the ECB (this decision does not just depend on the four eligibility conditions, but on the assessment of whether market conditions are justified by fundamentals and whether the activation of the TPI is proportionate to the achievement of the ECB's primary objective, which the ECB does not delegate).[24] Moreover, if a government introduces fiscal measures unfavourable to fiscal sustainability after the Council endorsed the national fiscal plan and thereby risks a deviation from the agreed fiscal path, the ECB will continue to have full discretion in assessing whether the increased interest rate spread of this country is in line with fundamentals or caused by "*unwarranted, disorderly market dynamics*".

For the same reason, the ECB would not be "stuck" if it were to find flaw with the DSA of the Commission/Council. While formally deferring to the Council/Commission (i.e. calling debt sustainable when the Council/Commission does), it could decide not to activate the TPI on the grounds that secondary market spreads are sufficiently close to fundamentals. This would likely create less market turmoil than to conclude that, contrary to the views of Commission and Council, the public debt of a country is not sustainable.

[24] Furthermore, there are several precedents for the delegation of eligibility criteria that address credit risk by the ECB. Under the OMT, the ECB implicitly delegates the debt sustainability assessment to the European Stability Mechanism (ESM). Under its normal collateral framework, it delegates to private rating agencies.

5. CONCLUSION

This paper analysed how the interplay between monetary and fiscal policy might be affected by the proposed reform to the EU's fiscal governance framework, and whether the TPI should be redrafted in this light. We conclude as follows.

First, from the perspective of its main features, the proposed framework is mostly good news for the fiscal-monetary policy mix in the euro area. With one notable exception – the lack of a central fiscal capacity – the basic design elements of the framework are helpful to monetary policy. These include its focus on debt sustainability; the use of a net expenditure rule to avoid procyclical adjustment in response to shocks, allowing some flexibility on the timing of adjustment, creating incentives for growth inducing reforms and investment, and two escape clauses that provide fiscal policy makers with flexibility to react to large shocks.

Second, the new framework embodies several design features that imply that it is some way off from striking the optimal compromise between debt sustainability and flexibility.

We propose five amendments:

- The first would strengthen the discipline of the proposal at acceptable cost to flexibility: **review the drafting of the "no-backloading safeguard"** to make it more meaningful (that is, give it more teeth).
- We also offer two amendments that would increase flexibility at acceptable cost to the framework's discipline (particularly if our proposal on the no-backloading condition is taken): (1) **abolish or fundamentally review the drafting of the debt safeguard** requiring debt to decline within the planning horizon; (2) **abolish or fundamentally review the excessive deficit safeguard**, as well as the definition of effective action under the revised excessive deficit procedure. The latter should not require a minimum annual adjustment of countries following a net expenditure path consistent with debt sustainability and the return to 3% by the end of the adjustment period.
- Finally, we offer two amendments that would improve the effectiveness and efficiency of the proposed system without necessarily changing the weights that it places on discipline and flexibility. First, we argue for **a review of the Commission's DSA methodology, to be conducted by an independent expert group based on inputs from the Commission, Member States, ECB, ESM, and EFB**, with the objective of fixing obvious weaknesses and turning it into a methodology that is "owned" and can be implemented by all Member States rather than just the Commission. Since the DSA methodology review will take some time, we recommend making 2024 a transition year and launching the full implementation of the new fiscal framework from the beginning of 2025. Second, we recommend **involving independent fiscal institutions (IFIs) in the decision whether to activate the escape clauses**, hence helping to de-politicise these decisions.

Third, we are concerned about the impact of the new framework on the medium-term fiscal stance during its first application cycle. Given that many euro area countries are starting from high debt and deficits, the framework will require a large, protracted fiscal tightening. While fiscal tightening is welcome while inflation is too high, the main impact of the framework will come at a time when inflation is already expected to be back at target (2025) and the economic cycle may well be much weaker as a result of the lagged effects of the preceding monetary tightening as well as fiscal tightening projected for 2023 and 2024. Once in effect, the new framework will require continued tightening in most euro area member countries, albeit at a somewhat slower pace than both projected in 2023 and 2024 and required under the current framework. The medium term drag on demand, which should persist at least until 2028, could complicate monetary policy from 2025 onward, potentially requiring a return to very low policy rates.

Fourth, the adoption of the new framework represents an opportunity to simplify the eligibility criteria of TPI. Under the proposal, debt sustainability will become a necessary condition for compliance with the EU fiscal framework. Furthermore, a review and approval of the Commission's DSA methodology jointly by the Commission and Member States, in which the ECB is given the opportunity to comment and give technical input, should increase the ECB's confidence in the methodology used to assess debt sustainability. Once this has happened, the ECB could either remove debt sustainability as an eligibility condition that must be independently verified (as it is implied by compliance with the fiscal framework) or delegate the debt sustainability assessment to the Council and Commission. This would increase the predictability and hence effectiveness of the TPI by eliminating fears that the ECB Governing Council may not agree with the Commission's/Council's assessment of debt sustainability. Once the eligibility criteria are met, the ECB would independently decide on the activation of the TPI.

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This paper analyses how the fiscal framework proposed by the European Commission in April 2023 might affect the interplay between fiscal and monetary policies, from three perspectives: its impact on the medium-term fiscal stance in the euro area, its design, and its implications for the ECB's Transmission Protection Instrument (TPI). It concludes with recommendations for amending both the fiscal governance proposal and the TPI.

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