Euro Area fiscal policies and capacity in post-pandemic times

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Abstract
This paper situates the EU’s fiscal response to the pandemic (suspending the Stability and Growth Pact, creating the SURE and Recovery and Resilience Facility) within longstanding debates on reforming EU fiscal governance and offers recommendations on the way forward, specifically the SGP reforms needed prior to returning to its rules and creating a budget with a stabilisation capacity.

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<tr>
<td>BICC</td>
<td>Budgetary Instrument for Convergence and Competitiveness</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<td>EDP</td>
<td>Excessive Deficit Procedure</td>
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<td>EISF</td>
<td>European Investment Stabilisation Function</td>
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<td>EMU</td>
<td>Economic and Monetary Union</td>
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<td>ERM</td>
<td>Exchange Rate Mechanism</td>
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<td>ESM</td>
<td>European Stability Mechanism</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>MFF</td>
<td>Multiannual Financial Framework</td>
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<td>NGEU</td>
<td>Next Generation EU</td>
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<td>PEPP</td>
<td>Pandemic Emergency Purchase Programme</td>
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<td>PSPP</td>
<td>Public Sector Purchase Programme</td>
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<td>RECOVER</td>
<td>Recovery and Resilience Task Force</td>
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<td>RRF</td>
<td>Recovery and Resilience Facility</td>
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<td>RSP</td>
<td>Reform Support Programme</td>
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<td>SGP</td>
<td>Stability and Growth Pact</td>
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<td>SURE</td>
<td>The European Instrument for temporary Support to mitigate Unemployment Risks in an Emergency</td>
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EXECUTIVE SUMMARY

Background

Since the peak period of the sovereign debt crisis, progress towards the completion of Economic and Monetary Union (EMU) has stalled, despite several institutional reflections on the need for economic, financial, and fiscal union. Numerous studies of the Stability and Growth Pact (SGP) point to problems with its efficacy and legitimacy, as some Member States continued to suffer from high debt levels and the EU was blamed for the austerity imposed on countries in southern Europe. The most promising proposal for fiscal governance reform in recent years was the Budgetary Instrument for Convergence and Competitiveness (BICC)¹, which followed up on the Franco-German proposal for a Eurozone Budgetary Instrument². Internal disagreement on the need for a substantial euro area budget made progress on completing fiscal union difficult, as debates raged on the need for stronger rules versus more solidarity. The Commission also launched a debate on the future of EU economic governance in February 2020³ to review its effectiveness within a changed economic context since fiscal reforms had been introduced during the sovereign debt crisis.

The Covid-19 pandemic upended both plans for the BICC and the economic governance review, as the EU dealt with its sanitary and economic impact. The response of an ambitious Next Generation EU (NGEU) budget financed on capital markets provided a stark contrast to the sovereign debt crisis (Buti 2020). Although these instruments are temporary in nature, they indicate some important shifts to the established logic of EU fiscal cooperation, specifically the need for a fiscal capacity with a stabilisation function.

The purpose of this paper is to look at the future EU fiscal policy, considering the implications of both continuing the current policy and the challenges that would make the budgetary instruments created to combat the economic consequences of the pandemic a permanent feature. The general escape clause of the SGP will be deactivated in 2023, based on current projections of the resumption of economic activity to 2019 levels⁴. While it would be preferable for the planned reforms to occur before returning to the SGP’s rules, at a minimum there should be flexibility in the pace at which Member States reduce their debt levels, which is much higher than originally foreseen by the Treaties. Debt reduction at the pace required by SGP rules could cause the same austerity policies that proved disastrous for economic growth during the sovereign debt crisis.

Second, the paper demonstrates how the NGEU’s Recovery and Resilience Facility (RRF) could form the basis for a revised BICC within the context of previous institutional reflections and the political and legal challenges that arose. The decision to make these changes within a framework involving all the EU Member States (rather than restricting it to the euro area) reveals the declining relevance of the distinction between euro ins and euro outs, and it potentially points the way towards averting some of the difficulties that had been associated with deepening EMU. The political obstacles remain relevant, however, and compromises need to be sought.

Aims of the paper

- The first objective is to examine academic versus institutional notions of fiscal cooperation and fiscal union, particularly within a monetary union;
- The second objective is to analyse the EU’s fiscal response to the Covid-19 pandemic, placing it in the context of ongoing reform discussions;
- The third aim is to provide recommendations for reforming the SGP and developing a permanent fiscal capacity with a stabilisation function.
1. INTRODUCTION

KEY FINDINGS

This paper argues that the EU’s post-pandemic fiscal policy should be based on a far-reaching reform of the SGP. First, the benchmark for debt reduction should account for the post-pandemic levels of debt that are much higher than in 2011 and for a low inflation and low interest rate environment. Returning to the unreformed SGP rules after growth resumes would demand the return to austerity policies and the divisions between northern and southern Europe. Second, a reinforced budgetary instrument similar in size to the RRF, which could form a stabilisation function for the EU, should be considered after the RRF expires. This would require Treaty changes, so trust must be built in the coming years in fulfilling the objectives of the RRF to allow for its replacement by the next budgetary cycle.

The launch of the Economic and Monetary Union (EMU) in 1999 heralded an important step in European integration, with the introduction of a single currency. The UK and Denmark had negotiated opt-outs, but the accession of new Member States in 2004, 2007 and 2013 included the expectation that they would adopt (eventually) the euro. The incomplete nature of EMU was recognised by the EU during the sovereign debt crisis, and various institutional reflections endeavoured to fill in the needed gaps. Debates on the completion of monetary union through economic union, financial (banking and capital markets) union, and fiscal union took place, but progress slowed as the sovereign debt crisis abated. The editors of the Common Market Law Review dismissed the 2017 Commission roadmap for deepening EMU as “tinkering”, and even these limited proposals made limited headway.

The global pandemic caused by Covid-19 is the most severe economic shock in Europe since the Great Depression. Real gross domestic product (GDP) growth in 2020 fell by 6.8 percent in the European Union. Although growth is expected to rise to 4.2 percent in 2021 and 4.4 percent in 2022, it will be spread unevenly across the EU Member States. In contrast to the piecemeal response to the sovereign debt crisis a decade ago, the EU rapidly implemented numerous policy measures. Fiscal measures include the activation of the general escape clause of the Stability and Growth Pact (SGP) and the creation of the European instrument for temporary Support to mitigate Unemployment Risks (SURE) and the Recovery and Resilience Facility (RRF), the latter as part of the Next Generation EU (NGEU) budget. Both the SURE and RRF are being financed by borrowing on capital markets. These new temporary budgetary instruments reflect years of debates and compromises hashed out in the name of a euro area fiscal union, but the new instruments were open to all EU Member States. Brexit had put into question the relevance of the distinction between euro ins and euro outs (as all EU Member States, except Denmark, are obliged to adopt the euro one day). Moreover, the logic used in favour of new budgetary instruments did not rely on the distinction between euro ins and outs. Such arguments had already been losing favour in the Eurogroup (see chapter 3) and the pandemic was viewed as a symmetric shock to the EU and not one specific to the euro area.

The changed economic and political environment provides the EU with new opportunities. Political science theories, like historical institutionalism, emphasize path-dependence and the gradual nature

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of policy changes until a critical juncture arrives (Fioretos, Falletti and Sheingate 2016). Could Covid-19 constitute such a critical juncture (Ladi and Tsarouhas 2020)? This paper considers the implications of continuity and change in EU fiscal policy cooperation, particularly how the fallout from the pandemic increases the dangers of continuing with the status quo and opens a window of opportunity for taking a step towards fiscal union.

Chapter 2 looks at the economic and political logic behind the current fiscal rules and the evolution of the sustainability of EU public finances. It then examines the recent track record of Germany, Spain, and Italy in achieving debt sustainability and the potential impact of reinstating the fiscal rules. The activation of the general escape clause of the SGP7 allows for maximum flexibility for the EU Member States to combat the pandemic. Based on the Commission’s 2021 Spring Economic Forecast, the general escape clause will likely be deactivated in 20238. Although the Commission cautions against the premature withdrawal of support, the pro-cyclical bias of the SGP combined with the elevated debt levels of Member States after the pandemic would make adherence to the current rules impossible without drastic fiscal consolidation. Even if economic activity returns to 2019 levels, the pace of debt reduction must factor in that in some Member States debt to GDP ratio will be double that of 60 percent benchmark and require an exceptionally large primary surplus. The impact on economic growth would have negative political and economic repercussions. Either the EU should delay the deactivation of the general escape clause until after the already-planned SGP reform, or a high amount of discretion should be allowed in evaluating the pace of debt reduction. The former would be preferable, in that the continued non-observance of the EU fiscal framework damages its credibility, both with financial markets and with institutional partners.

Chapter 3 examines the recent changes to fiscal policy, particularly the introduction of the SURE and the RRF that add substantial firepower to the EU’s fiscal capacity. The chapter first explores the justification for a fiscal capacity, originally grounded in the economics literature as part of optimum currency area theory. Substantial disagreements on the need for such a fiscal capacity, and its size and purpose if it were created, led to numerous proposals that would alternatively provide a stabilisation function, enhance competitiveness, and/or promote economic convergence. Although theoretically linked to the need for a monetary union to have a fiscal capacity, restricting it to the euro area posed substantial legal problems and failed to gain sufficient political traction. The SURE and RRF are significant improvements to EU economic governance, and a proposal is made for a permanent fiscal capacity with a stabilisation function for the EU. Chapter 4 concludes.

**2. EU FISCAL COOPERATION: RATIONALE AND EFFECTS**

**2.1. Economic and Political Rationale for the SGP**

The Stability and Growth Pact (SGP) constitutes one of the major pillars of European economic governance. In the context of an economic and monetary union (EMU) without a corresponding political union and accompanying fiscal capacity, the SGP was designed to ensure that government spending remained on a sustainable path, to avoid negative spillovers between Member States. First, the high debt levels could generate higher inflation for the euro area as a whole, which could then increase the interest rates set by the European Central Bank (ECB) for the euro area. Second, the

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sovereign debt crisis revealed how a highly indebted sovereign can weaken its domestic banking sector holding high levels of sovereign debt, and a fragile banking system can similarly weaken the sovereign and the value of sovereign debt, on the expectation of having to rescue banks, thereby further increasing sovereign indebtedness. This ‘vicious circle’9, or doom loop, was meant to be broken by the banking union, which remains incomplete. Third, high debt levels could trigger concerns about a state’s insolvency and the risk it would need to leave the euro area, also known as a redenomination risk. A self-fulfilling liquidity crunch could result from concerns about the integrity of the euro area that could spill over to other countries, as had happened during the sovereign debt crisis (De Grauwe and Ji 2012).

Avoiding these negative spillovers requires that government debt remains sustainable, so that the government can finance expenditures through tax receipts and borrowing. Debt sustainability is widely recognized as “an essential attribute of good macroeconomic policies, but its precise definition is elusive and its assessment is even more challenging” (Wyplosz 2007). Different institutions employ different methodologies for assessment. The SGP originally focused on member state deficit levels (see the Annex for information on the evolution of EU fiscal governance). Fiscal rules apply to both euro area and non-euro area Member States, though the latter would not go through the sanctioning foreseen under the Excessive Deficit Procedure (EDP). Given that fines have yet to be imposed under the EDP, this distinction between euro area and non-euro area Member States appears less significant.

The SGP’s focus on deficits (rather than on debt) and the procyclical nature of its structure (Buti 2006) that would impose (theoretically) a fine on Member States that are likely going through an economic downturn (a common reason for higher deficit levels due to reduced tax receipts) led some to label the SGP as “stupid”, including Commission President Romano Prodi (Le Boucher 2002). The SGP placed greater emphasis on debt over time, particularly with the adoption of the 2011 six-pack reforms10 that placed debt and deficits on equal footing and established a debt reduction benchmark, so that the gap between a member state’s debt level and the 60 percent reference must be reduced by 1/20th annually. Failure to do so could trigger an EDP. The sovereign debt crisis had prompted further interest in monitoring public debt and developing a framework for debt sustainability analysis (Alcidi and Gros 2018).

Politically, the focus on deficits and later debt levels were driven primarily by the interests of Germany, allied with Member States like the Netherlands and Austria. Prior to EMU, these Member States insisted on the need for economic convergence before adopting the euro, while France and Italy assumed that convergence would occur because of further integration. It turned out that both views were incorrect: Germany successfully included in the Treaty a set of convergence criteria (on debt, deficits, inflation, interest rates, and exchange rates) prior to adopting the euro, but it was clear after the first decade that monetary union alone would not drive greater convergence. The Commission noted that “persistent divergences between euro-area Member States…led to accumulated competitiveness losses and large external imbalances”11.

Germany’s longstanding preferences for price stability and fiscal constraints support its own economic model of export-led growth that could be threatened if public debt in other countries led to a spillover of inflation. Euro area governance suits German preference very well in this regard, as its export-led economy benefits from real exchange rate depreciation through domestic wage restraints (Vermeiren 2013). German financial elites and skeptical public opinion reinforced Germany’s consistent efforts to

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9 GEN (europa.eu)
strengthen fiscal discipline at the EU level (Schoeller and Karlsson 2021). State broadcaster ZDF already blasted the headline ‘Fear of Hyperinflation’ on 11 May12. Such concerns affect not only monetary policy and ECB bond-buying, they also would pressure policymakers to reduce fiscal support and potentially demand retrenchment through the return to the SGP’s rules.

German political elites will likely be looking to return to the status quo ante that has served the German economy well. The CDU-CSU election manifesto 13 emphasizes the temporary nature of EU Recovery Fund and a return to the fiscal rules. SPD chancellor candidate (and German Finance Minister) Olaf Scholz indicated that the current rules have demonstrated sufficient flexibility and appears reluctant to engage in major SGP reforms14; despite his suggest of extending Germany’ debt brake suspension to 2023, he insisted that fiscal rules would then be reinstated15. The Greens, however, expressed interest in reforming the SGP and Germany’s debt brake16. If the Greens were to enter into a coalition government, it is not clear how committed they would be to fiscal reforms during coalition bargaining. Finally, Austrian Finance Minister Gernot Blümel is already trying to form an alliance of fiscally responsible states aiming for a quick return to the SGP rules17, indicating continued support for the old rules in certain Member States, regardless of German election outcomes.

2.2. The Cost of Continuity: Debt Sustainability and the SGP Rules

The EU fiscal rules endeavoured to encourage fiscal sustainability by placing limits on EU deficit and debt levels. Fiscally sound Member States presumably would avoid exporting inflation, contributing to a doom loop or threatening the integrity of the euro area through market speculation. Although the EU buttressed its crisis management instruments through the creation of the European Stability Mechanism (ESM), for example, these concerns remain relevant. Various measures exist to assess debt sustainability. The Commission’s 2021 debt sustainability analysis considers real GDP growth rates, inflation, the primary budgetary balance, interest rates, exchange rates (for non-euro area countries) and stock-flow adjustments as the baseline in assessing debt sustainability18. This section will examine some of the indicators for Germany, Spain, and Italy to illustrate the different debt sustainability trajectories and their consequences for continuing with the current fiscal rules.

The primary budget (see Table 1) refers to the government’s spending requirements minus the interest payments it makes on its sovereign debt. When government bond yields increase, so does the ability of the government to reduce its debt stock. For example, in 2019 the Italian government ran a primary surplus of 1.8 percent of GDP, but its deficit level used for SGP reporting was -1.6 percent of GDP, showing the important (and ongoing) impact of its debt servicing requirements. Italy must still pay a high price for the large accumulation of debt that occurred since half a century ago and continues to impede its economic growth. For Germany, its primary deficit exceeded its deficit figures, pointing to the favourable debt servicing terms enjoyed by the German government.

The SGP monitors government deficit trajectories (Table 1). Although Italy and Spain ran deficits throughout the period 2012-2019, Italy remained under the 3 percent SGP target (though its high debt levels demanded an even lower primary deficit to achieve the benchmark of reducing debt above the

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12 https://www.zdf.de/nachrichten/wirtschaft/steigende-rohstoffpreise-baumaterialien-100.html?txor=CS5-62
60 percent reference by 1/20th per year\textsuperscript{19}, and Spain’s deficit was a third of what it was at the start of the period. German balances were in balance or in surplus.

By 2019, the EU could boast that no country’s deficit exceeded the 3 percent threshold. Nevertheless, a Commission staff working document credits “improving macroeconomic conditions that contributed to higher tax receipts and lower expenditures for automatic stabilisers rather than adhering to Commission recommendations”\textsuperscript{20}. Reducing deficits through economic growth would be the preferred path to debt reduction, rather than emphasising spending cuts that harm long-term investment and the more vulnerable members of society.

Table 1: Primary balances and headline balances in Germany, Italy, and Spain, % of GDP, 2012-2019

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<td>1.4</td>
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<td><strong>Italy</strong></td>
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Sources: [https://sdw.ecb.europa.eu/reports.do?node=1000004700](https://sdw.ecb.europa.eu/reports.do?node=1000004700) (for primary deficit figures) and Eurostat

The growth rates of these economies also vary substantially, as seen in Figure 1. Economic growth had resumed in the three countries since the sovereign debt crisis, particularly in Spain. While the pandemic affected all three countries, Germany’s economic growth (-4.9 percent), while negative, was still substantially better than in Italy (-8.9 percent) and Spain (-10.8 percent). The Covid-19 crisis disproportionately affected countries still struggling with debt hangover from the previous crisis. The lower growth rates and the lower tax receipts that come with it influence their debt sustainability.


A third factor affecting debt sustainability, namely sovereign bond yields, reached historically low levels. An extended period of low interest rates has slashed borrowing costs; Austria, Belgium, France, and Germany saw a reduction of interest expenditure as a percentage of GDP of about 50 percent. Despite the sharply rising funding needs and corresponding debt levels following the measures adopted to limit the impact of the COVID-19 crisis, sovereign credit downgrades have not ensued for EU countries. Even Greece posted negative debt yields for 5-year bonds, and currently Italy is the only euro area country with positive yields for 5-year bonds. As seen in Figure 2, German yields are negative. The government debt purchases from the ECB’s Public Sector Purchase Programme (PSPP) and Pandemic Emergency Purchase Programme (PEPP) have played a major role in keeping down bond yields, particularly in southern Europe.

Source: Eurostat. 2019 and 2020 figures are provisional

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22 https://on.ft.com/3cLc982
Prior to the pandemic, the EU Member States had resumed economic growth, enjoyed low bond yields, and had returned to relatively low budget deficits. Can the EU claim success? Not if the objective is debt sustainability. According to the Commission’s 2021 debt sustainability monitor, fewer than half of the EU Member States can be considered at low risk in the medium term, and only five Member States are in the low-risk category for the long-term\textsuperscript{23}. Moreover, the second, third, and fourth largest EU economies, i.e. France, Italy and Spain, are all at high risk in the short-term and medium-term. The IMF forecasts debt levels to be around double (for Spain) or more (for Italy) the SGP debt limits\textsuperscript{24}, as seen in Figure 3.

\textsuperscript{23} https://ec.europa.eu/info/publications/debt-sustainability-monitor-2020_en, p100
\textsuperscript{24} https://www.imf.org/en/Publications/FSM/Issues/2021/03/29/fiscal-monitor-april-2021
In summary, the debt sustainability varies widely across EA Member States. Despite concerted efforts to satisfy EU budget requirements, legacy debt in some countries directs substantial resources towards debt repayment rather than investment. While economic growth resumed by 2014, for Italy it was rather modest, and for all countries this was reversed in 2020. Progress in reducing debt was attributed not to rules, but to the macroeconomic environment and return to economic growth after the sovereign debt crisis. Large-scale government bond purchases by the ECB have become a vital factor in ensuring debt sustainability, making Member States like Italy vulnerable to its withdrawal. Christine Lagarde’s comment that the ECB ‘was not here to close the spreads’\(^25\) between sovereign bond yields of euro area Member States caused a sharp increase in Italian bond yields and a 17 percent drop in the Milan stock exchange. Successive crises have exposed the weakness of the EU fiscal architecture, and the refusal to enact meaningful reforms has concentrated power in the ECB. The EU’s inability to agree on a fiscal union has placed great pressure on ECB policy, and the future of the EU’s Member States debt sustainability requires policies that allow European economies to grow sufficiently so that their debt can be repaid rather than relying on ECB bond purchases.

2.3. **SGP Reform and Deactivating the General Escape Clause**

The general escape clause of the SGP was introduced as part of the six-pack reforms in 2011, specifically in Articles 5(1), 6(3), 9(1) and 10(3) of amended Regulation (EC) 1466/97 and Articles 3(5) and 5(2) of Regulation (EC) 1467/97 that “allow for a coordinated and orderly temporary deviation from the normal requirements for all Member States in a situation of generalised crisis caused by a severe economic downturn of the euro area or the EU as a whole”\(^26\). The Commission proposed activating the SGP’s


General Escape Clause on 20 March 2020, and the Council quickly agreed on 23 March. The Commission’s Communication on 3 March 2021 specified that the general escape clause would be deactivated based on the resumption of pre-crisis economic activity. According to the Spring 2021 Economic Forecast, the general escape clause would be maintained in 2022 and deactivated in 2023. Would this be the appropriate criterion, based on the aforementioned factors related to debt sustainability?

2.3.1. Recommendation: Reform Before Return

On the one hand, debt sustainability requires reducing debt levels, especially after the ECB withdraws its support. Nevertheless, countries should not rush to consolidate their fiscal position as they did during the sovereign debt crisis; a return to the SGP’s rules before reforming it could do more harm. Empirical research shows that “attempts to reduce debt via fiscal consolidations have very likely resulted in a higher debt to GDP ratio through their long-term negative impact on output” (Fátás and Summers 2018). The EU should reduce debt through a strategy based on economic growth rather than on fiscal consolidation, which would be possible by replacing fiscal rules with fiscal standards using qualitative rather than quantitative assessments (Blanchard, Leandro, and Zettelmeyer 2021).

Even before the pandemic, many advocated reforming EU fiscal rules for its lack of efficacy, pro-cyclical bias, and impact on public investment. The European Court of Auditors criticised both the implementation of the SGP as well as the outcome of “very slow, or even absent adjustment in several Member States with high public debt ratio”. The independent members of the European Fiscal Board (EFB) stated that “the EU fiscal framework does not deliver the goods… it should be reformed without delay”. The EFB’s 2019 assessment of EU fiscal rules criticised the ‘persistence of pro-cyclical fiscal policy’ and the need to incentivize spending in public investment, which is apt to get cut during periods of fiscal consolidation. Returning to rules that did not work before the pandemic makes little sense.

On 5 February 2020, the European Commission launched a review of the EU economic governance framework that was put on hold to devote resources to coping with the Covid pandemic. The Commission Communication noted the changed economic environment since the last round of reforms to the SGP, including chronically low inflation rates, low interest rates, the failure of the growth potential of some Member States to return to pre-crisis levels, and reform fatigue. Moreover, “it could be argued that the reformed Pact has not been successful in bringing the level of debt down sufficiently in the most vulnerable Member States.”

The need for a review of the SGP is even greater now in the context of the post-pandemic economic environment. Indeed, the IMF advised that “fiscal policy needs to play an increasingly larger role”, suggesting “additional support to the tune of 3 percent over 2021-22”. ECB Vice-President Luis de Guindos also stated to the European Parliament: “In the short term, all stakeholders, particularly fiscal ones, must keep complementing our accommodative monetary stance. If we want a timely recovery in Europe, we have...
to avoid any cliff effects from the premature scaling back of these policies”\textsuperscript{36}. The Committee of Regions partially blamed the economic governance framework for declining public investment after the euro crisis and for failing to differentiate between current expenditure and investment expenditure, stressing the need for a review: “Once the pandemic will be under control, we cannot go back to the ex-ante status quo nor continue as though nothing happened”, according to rapporteur Elio Di Rupo\textsuperscript{37}.

The elevated debt levels of a country like Italy mean that it would have to run a very steep budgetary surplus of 5 percent to comply with a reduction of 1/20\textsuperscript{th} per year above the 60 percent reference value. The Commission forecasts a ten-year average nominal potential growth rate of 2 percent (before RRF reforms) for Italy\textsuperscript{38}. Spain would need to run a surplus of about 3 percent, due to its debt levels. Using return to the growth rates of 2019 as “the key quantitative criterion…in making its overall assessment of the deactivation or continued application of the general escape clause”\textsuperscript{39} would be an insufficient basis to resume the SGP’s demands. While there have been important discussions on what kind of government spending to privilege, such as those promoting investment and are growth-enhancing\textsuperscript{40}, the size of government debt accumulated by some Member States makes such policy choices illusory given the surplus levels required.

Moreover, it is unclear that high public debt levels pose the threat assumed by the SGP rules in the current low levels of inflation and low interest rate environment (Blanchard 2019)\textsuperscript{41}, making it harder to justify fiscal retrenchment. Euro area Member States paid less in annual debt servicing in 2019 compared to 1995\textsuperscript{42}. French and Italian government officials have indicated the need to rethink EU fiscal rules in a low interest rate environment (OMFIF 2021a).

Concretely, in the short- to medium-term, the EU should not rush to deactivate the general escape clause of the SGP. Reinstating the rules as soon as economic growth resumes could jeopardise economic growth. Recovery of economic growth back to 2019 levels should be considered a first step rather than signal an immediate return to ‘normalcy’. Moreover, former ECB Executive Board member Lorenzo Bini Smaghi notes that “this assumes the years prior to Covid-19 were ‘normal’. They were not. In fact, they weren't even good...not only irregular, but unsustainable”\textsuperscript{43}. Indeed, the EU should also aim to account for the loss in economic output between now and the end of 2023 in order to reclaim the lost economic potential (Blanchard and Pisani-Ferry 2021).

Basing fiscal rules on an outdated set of notions regarding debt sustainability in a low inflation and low interest rate environment would be difficult to justify politically, particularly given the uneven impact of the pandemic across the EU. Much was made of the solidarity shown to the EU Member States who were the hardest hit by the pandemic, a solidarity that was possible because of the lack of moral hazard concerns. This likely contributed to increasing public support for the euro; Eurobarometer data published in 2021 shows the percentage of those viewing having the euro as a good thing rise from 76 percent in October 2019 to 80 percent in March 2021; both figures already contrast sharply with the 66 percent approval during the sovereign debt crisis\textsuperscript{44}. A return to the SGP and the austerity that would accompany following its rules could signal a return to the toxic political environment during the

\textsuperscript{36} https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp210414~4291d0b4db.en.html
\textsuperscript{38} https://ec.europa.eu/info/sites/default/files/economy-finance/com-2021-512-1_en_act_part1_v3.pdf, p6
\textsuperscript{39} https://ec.europa.eu/info/sites/default/files/economy-finance/1_en_act_part1_v9.pdf, p14
\textsuperscript{42} https://www.cer.org.uk/publications/archive/policy-brief/2021/learning-live-debt
\textsuperscript{43} The eurozone must not return to its pre-crisis ‘normality’ | Financial Times (ft.com)
\textsuperscript{44} https://europa.eu/eurobarometer/surveys/detail/2291
previous crisis that pitted the Northern European saints against the Southern European sinners (Matthijs and McNamara 2015).

The deactivation of the general escape clause, therefore, should happen after the rules have been reformed to account for the new environment of high debt, low inflation, and low interest rates. While there is some flexibility that could be used to account for different rates of recovery for EU Member States, the focus on economic output without factoring in the substantially increased post-pandemic debt burdens would leave heavily indebted Member States little choice but to reduce investment and engage in cost-cutting measures that could threaten growth and keep highly indebted Member States within the same fiscal trap as the old rules did. The EU should use this time to reflect on how to deal with the increased debt burden in a way that would allow for economic growth to reduce the debt rather than a short-term focus on investment and expenditure cuts.

A more limited reform could include a differentiated adjustment speed towards the reference anchor to replace the current rule. Measures could be taken to alleviate the procyclicality of the SGP (Hagelstam et al 2019). Even more flexibility in the application of SGP to ease substantially the debt reduction rules could be implemented. Having rules that are not applied over an extended period of time would not be optimal for the credibility of the SGP, but it would not be new.

3. COPING WITH COVID-19 THROUGH AN ENLARGED FISCAL CAPACITY

The euro crisis brought about a reckoning of European economic governance, particularly euro area governance, with various institutional reflections following. Discussions varied and included the feasibility of a fiscal union that included stronger fiscal rules, as well as the development of a fiscal capacity that could: provide a macroeconomic stabilisation function; support structural reforms and competitiveness; and assist in convergence.

Political disagreements continually pushed meaningful reforms to the future. The whittling down of the ambitious proposals for a euro area budget to the Budget Instrument for Competitiveness and Convergence (BICC) reflected these differences. Nevertheless, there were hopes that the creation of the BICC could become the first step towards a budget that could go beyond supporting competitiveness and include the possibility of macroeconomic stabilisation. The SURE and RRF were major steps in this direction, albeit temporary ones.

This chapter makes the economic case and subsequent political rationale for creating a euro area budget. The original justification for a euro area budget with a stabilisation function met political opposition from northern European economies until the pandemic. An unprecedented commitment to supporting EU Member States (not just euro area) during the pandemic raised expectations of what the EU could do in the future, should the new budgetary instruments become permanent. The political and legal challenges to an enlarged fiscal capacity remain, but so does the need for a stabilisation function.

3.1. Enlarging the Budget: Rationale for Euro Area and EU Fiscal Capacity

Plans for a fiscal union to accompany the monetary union have long featured in the academic literature. Optimum currency area theory posits the need for a currency union to be able to offset asymmetric shocks (Mundell 1961, Kenen 1969). For example, the rise of China on the global stage had different economic effects within the euro area. For Germany, it provided a large new market for its exports. For
Italy and Spain, it provided a major competitor that could produce at lower cost, and their competitiveness waned; from 1990-98 Germany and Spain on average ran current account deficits (-0.5 and -1.7 percent, respectively, as a percentage of GDP) and Italy ran a small surplus (0.6 percent), but from 1999-2007, Germany ran a surplus (2.7 percent of GDP) compared to the deficits in Italy (-1.1 percent of GDP) and Spain (-5.5 percent) (Vermeiren 2013, p747; see also Chen et al, 2013). Outside of a currency union, flexible exchange rates could ease adjustment through shock via a currency devaluation, albeit at the price of higher inflation. Inside a currency union, this falls on an internal devaluation, such as the downward pressure on wages, to restore competitiveness, as during the sovereign debt crisis in countries like Greece and Spain. Other mechanisms also could alleviate such imbalances. Labour mobility would allow workers to move from a depressed area to one with more jobs. Private financial transfers would allow for risk sharing across borders and reduce balance of payments problems. Finally, fiscal transfers would allow transfer payments to depressed economic areas to enable economic recovery. Frankel and Rose (1998) famously wrote about the endogeneity of optimum currency areas in which the decision to form a monetary union could lead to a self-fulfilling prophecy through intensified trade flows, financial integration that would encourage insurance mechanisms, and increased labour market flexibility that could ease adjustment (see also De Grauwe 2006). Two decades later, however, the euro area still does not constitute an optimum currency area; Paul Krugman (2012) referred Europe’s sovereign debt crisis as the “revenge of the optimum currency area”.

Various measures developed during the sovereign debt crisis (e.g., banking union, the ESM) brought the euro area closer to such an optimum currency area, but much work remains. The need for a “substantial compensatory public finance mechanism” had already been identified in the 1977 MacDougall Report as being “of great importance…to fuller Community integration”45. Numerous proposals exist for the creation of a central fiscal capacity for the euro area46. Consideration of a euro area budget appears in the institutional reflections on the future of euro area governance, such as the 2012 Four Presidents’ Report47 and the 2015 Five Presidents’ Report48. The Five Presidents’ Report proposed a budget sufficient to “improve the cushioning of large macroeconomic shocks and thereby make EMU overall more resilient” (p14). In this instance, resilience is linked to a stabilisation function, but later discussions on resilience refer to structural reforms. The Five Presidents’ Report emphasised that the new budget be developed as part of the existing EU fiscal framework (i.e., not an intergovernmental agreement), and notably that it should not lead to permanent fiscal transfers between Member States.

On 16 February 2017, the European Parliament resolution on a budgetary capacity for the euro area identified 3 pillars: convergence, absorption of asymmetric shocks, and absorption of symmetric shocks49. This marked a departure from previous arguments focusing on asymmetric shocks. The resolution also proposed a sizable budget in the hundreds of billions of euros. Funding would come from Member States as external assigned revenue, and in time the own resources decision could be amended as described in the Monti report on the future financing of the EU50.

On 31 May 2017, the European Commission published its Reflection paper on the deepening of the Economic and Monetary Union51. On the creation of a macroeconomic stabilisation function for the euro

46 The European Fiscal Board’s 2020 report provides a summary of academic contributions to the debate, https://ec.europa.eu/info/sites/default/files/efb_annual_report_2020_en_0.pdf, p79
area, the Commission advocated that “it should be developed within the EU framework and could be open to all EU Member States” (p25). It proposed three potential avenues to a stabilisation function: investment protection, unemployment reinsurance, and a ‘rainy day’ fund. A euro area budget, however, would constitute a longer-term goal that would include convergence and stabilisation (p26). Competitiveness was mentioned in reference to the use of European Structural and Investment Funds, but no connection was made between a larger budget or fiscal union and competitiveness. Juncker further clarified the Commission’s position in the 2017 State of the European Union address: “We do not need parallel structures: We do not need a budget for the Euro area but a strong Euro area budget line within the EU budget”52.

3.1.1. Macron to Meseberg

Emmanuel Macron attempted to restart the completion of EMU when he assumed the French presidency in 2017, specifically by championing the need for a euro area budget of several percentage points of the euro area GDP, i.e. large enough to perform a stabilisation function that would have its own revenue source53. Euro area GDP was €10.7 trillion in 2016, so the proposed budget would be several hundred billion euros. The March 2018 German coalition agreement54 indicated support for the creation of “specific budgets for economic stabilisation and social convergence and for supporting structural reforms in the euro area”, signalling a possible convergence of preferences between France and Germany on this subject.

The Commission soon followed up in December 2017 with a Communication titled ‘New Budgetary Instruments for a Stable Euro Area within the Union Framework’55. It noted 3 challenges for EU public finances: supporting structural reforms; stabilisation of large asymmetric shocks; and breaking the link between weak banks and fiscally vulnerable sovereigns (the doom loop) that contributed to the sovereign debt crisis. The Commission proposed a Structural Reform Support Programme, a Convergence Facility for Member States looking to euro membership, and a Stabilisation Function that would have a grant component and be at least 1 percent of EU GDP. In other words, the different objectives of stabilisation, convergence and competitiveness would be pursued through different instruments: convergence would be done through a separate budget for Member States acceding to the euro area (not the euro area convergence between euro area Member States), improving competitiveness would be financed through the Structural Reform Support Programme, and a stabilisation budget through the Stabilisation Function that would be substantial but not as significant as most economists indicate.

The separation of functions continued with the May 2018 Commission proposal of a Reform Support Programme (RSP)56 and a regulation for an Investment Stabilisation Function (EISF)57. The former would be open to all Member States, and the latter for the euro area and countries in the ERM II. The RSP would enhance competitiveness and included a Convergence Facility of €2.16 billion to support countries wishing to join the euro. The EISF would establish a stabilisation function to ease the impact of asymmetric shocks and avoid potential negative spillovers. This builds on the 2017 reflection paper, developing the investment protection angle. Up to €30 billion of loans, combined with grants

52 State of the Union Address 2017* (europa.eu)
53 https://euobserver.com/economic/138841
54 https://www.bundesregierung.de/resource/blob/975226/847984/5b8bce2590d4cb2892b31c987ad672b7/2018-03-14-koalitionsvertrag-data.pdf?download=1, p8
55 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52017DC0822
56 The Reform Support Programme and the European Investment Stabilisation Function explained (europa.eu)
57 https://eur-lex.europa.eu/resource.html?uri=cellar:c9301291-64b1-11e8-ab9c-01aa75ed71a1.0001.03/DOC_1&format=PDF
Euro Area fiscal policies and capacity in post-pandemic times

collected through a special vehicle and potentially through additional resources in the future\textsuperscript{58}, could be used by Member States undergoing a large asymmetric shock to support objectives that fall under the Common Provisions Regulation, which is the main legal basis for Cohesion policy. Both the size and loans component contrast with earlier stabilisation proposals (see Table 2), and €30 billion is not a macroeconomically significant budget for a stabilisation fund, especially in the form of loans. Nevertheless, the rationale for a stabilisation fund for asymmetric shocks is consistent with the debate on completing EMU.

On 6 March 2018, finance ministers from Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands, and Sweden shared their “\textit{views and values in the discussion on the architecture of the EMU}”\textsuperscript{59}. This grouping of countries has been dubbed the New Hanseatic League; the permanent representations of these countries even began their own Twitter account (@HansaintheEU). Their first point was to insist on opening discussions to non-euro area countries on equivalent terms, thereby blunting Macron’s initiative\textsuperscript{60} to have a vanguard of Member States involved in deeper integration. In contrast to proposing a budget within the next Multiannual Financial Framework (MFF) for stabilisation, they argued it should be used to promote structural reforms. Dutch Prime Minister Mark Rutte declared, “it’s my firm conviction that we need, in effect, 19 national shock absorption funds in the eurozone”\textsuperscript{61}.

On 19 June 2018, the Franco-German Meseberg declaration included a proposal for a Eurozone budget that would promote convergence, competitiveness and stabilisation\textsuperscript{62}. The proposal did not provide any figures, but Macron’s original proposal would have amounted to several hundred billion euros. Merkel, however, envisaged a budget in the lower tens of euros\textsuperscript{63}. The scope for agreement had narrowed considerably, given the diverging preferences between France and Germany, and the insistence of the fiscally conservative New Hanseatic League on involving non euro area countries made Macron’s proposal look like a pipe dream.

3.1.2. Negotiating the BICC

In November 2018, the Council came back with its proposal. On the creation of a euro area budget (rather than a larger EU budget), “a justifying reason is the need for a higher level of convergence and competitiveness within the Eurozone to ensure stability of the euro area as a whole”\textsuperscript{64}. How convergence and competitiveness contributed to euro area stability, however, was not developed and deviates from the economic logic described above. The proposed budget would be part of the EU budget and financed by external assigned revenues and European resources. Euro area Member States would make regular contributions that would be transferred to the EU budget on the basis of an intergovernmental agreement. Suggested legal bases included Article 175 (3) TFEU (specific actions outside Structural Funds), possibly in conjunction with Article 182 TFEU (research and technological development) and Article 173 TFEU (competitiveness of the industry), depending on the specific design in conjunction with Art 136 (provisions specific to euro area Member States). The following month, the Eurogroup report indicated that discussions of the contributions from the Commission and from Germany and France on creating instruments for competitiveness, convergence and stabilisation were discussed, but

\textsuperscript{59} Shared views and values on the architecture of the EMU | Ministry of Finance of the Republic of Estonia (rahandusministeerium.ee)
\textsuperscript{60} President Macron gives speech on new initiative for Europe | Élysée (elysee.fr)
\textsuperscript{62} Meseberg Declaration (bundesregierung.de)
\textsuperscript{63} Kanzlerin Angela Merkel F.A.S-Interview. „Europa muss handlungsfähig sein“ (faz.net)
\textsuperscript{64} https://www.consilium.europa.eu/media/37011/proposal-on-the-architecture-of-a-eurozone-budget.pdf
they “did not reach a common view on the need and design” of a stabilisation function. The European Council endorsed all elements of the Eurogroup report on 14 December 2018.

On 20 February 2019, the Financial Times reported seeing a 4-page paper from the German Finance Ministry (backed by France) proposing an intergovernmental treaty as the basis for a euro area budget, but the Dutch government threatened to not to sign. On 21 February, France and Germany proposed a Eurozone budgetary instrument to promote convergence and competitiveness by supporting national reforms and financing public investment in areas identified in the European semester. Financing could come from regular contributions from euro area Member States on the basis of an intergovernmental agreement, and possibly through own resources.

The Eurogroup agreed on a term sheet for the BICC in June, and on 9 October the Eurogroup (both times in inclusive format that includes all EU Member States) approved the creation of a BICC that was much more modest than those proposed in the optimum currency area literature or that proposed by Emmanuel Macron’s vision of a euro area budget. The Commission had already drafted a regulation on its governance framework in July as an ‘additional act’ allowing euro area Member States autonomy for the governance framework that would be limited to the euro area. The BICC was to be part of the regular EU budget allocated in the to-be-negotiated 2021-2027 Multiannual Financial Framework (MFF), estimated to be around €17 billion in grants, with the possibility of additional voluntary contributions from Member States, to be negotiated in an intergovernmental agreement. It would enhance competitiveness by supporting structural reforms and investment in euro area and Exchange Rate Mechanism (ERM) II Member States on request, and it would demand national co-financing in order to ensure ownership. Financing would be delivered in tranches and conditional on reaching agreed upon milestones in structural reforms. Eurogroup President Mario Centeno noted in a letter to European Council President Donald Tusk the work done under the Finnish Council Presidency for a Convergence and Reform Instrument, based on the Commission’s proposal, that would support convergence and structural reforms for non-euro area Member States. In April 2020, the European Parliament’s co-rapporteurs of the Budgetary Affairs and Monetary Affairs Committees issued a press release on integrating the BICC with the Commission’s RSP proposal. Dealing with pandemic, however, shifted the focus away from the BICC.

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67 https://www.ft.com/content/bcde49bc-34d2-11e9-bb0c-42459962a812
69 Term sheet on the Budgetary Instrument for Convergence and Competitiveness (europa.eu)
71 Eurogroup, 09/10/2019 - Consilium (europa.eu); see also Term sheet on the budgetary instrument for convergence and competitiveness (BICC) - Consilium (europa.eu)
Table 2: Proposals and rationale for creating a euro area budget or budget line for the euro area

<table>
<thead>
<tr>
<th>Plan</th>
<th>proposed size (if given)</th>
<th>Stabilisation</th>
<th>Convergence</th>
<th>Competitiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012 4 Presidents’ Report 2015 5 Presidents’ Report</td>
<td></td>
<td>X</td>
<td></td>
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<tr>
<td>2017 European Parliament resolution</td>
<td>Several hundred billion euros</td>
<td>X</td>
<td></td>
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<td>2017 Commission reflection paper</td>
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<tr>
<td>2017 Macron</td>
<td>Several hundred billion euros</td>
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<td>X</td>
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<tr>
<td>2017 Commission communication on new budgetary instruments</td>
<td>est. €148 billion</td>
<td></td>
<td>X</td>
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<tr>
<td>2018 Commission proposal for a Reform Support Programme (RSP) (in MFF)</td>
<td></td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>2018 Commission proposal for a European Investment Stabilisation Function (EISF) (in MFF)</td>
<td>€30 billion in loans</td>
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<td>X</td>
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</tr>
<tr>
<td>2018 Joint letter from finance ministers of Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands and Sweden</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
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<tr>
<td>2018 Meseberg Declaration</td>
<td>Est. €17 billion</td>
<td></td>
<td>X</td>
<td>X</td>
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<tr>
<td>2018 Council Proposal on architecture of a Eurozone budget</td>
<td></td>
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<td>2018 Eurogroup report on EMU deepening</td>
<td></td>
<td>X</td>
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<td>X</td>
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<tr>
<td>2019 BICC (in MFF)</td>
<td>Est. €17</td>
<td></td>
<td></td>
<td>X</td>
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</tbody>
</table>

3.1.3. A Euro Area Budget: Rationale versus Reality

Table 2 summarizes the various institutional and member state proposals for some sort of euro area budget, their objectives (stabilisation, convergence, and/or competitiveness), and their size. Optimum currency area theory indicates the need for a currency union to have a budget large enough to deal with asymmetric shocks. The euro crisis made the case for the completion of EMU more compelling, which included insights from optimum currency area theory. Proposals for a euro area budget soon included additional functions like improving economic competitiveness and convergence among Member States. These do not have clear roots in the economics literature on optimum currency areas. Indeed, a budget large enough to counteract asymmetric shocks is useful for a currency union in which participants have lost an adjustment tool, e.g. the exchange rate. The rationale for competitiveness and

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76 The European Parliament resolution was the only proposal containing a response to symmetric shocks, all the others referred to stabilization after asymmetric shocks
convergence is less direct, with the logic being that countries with similar economic structures may be less vulnerable to asymmetric shocks in the first place. This would not eliminate the need for a mechanism to deal with asymmetric shocks, however, which could not be excluded as a possibility.

Several factors account for the very modest conclusion to the talks for a euro area budget. First, the receding economic crisis after the announcement of the ECB’s Outright Monetary Transactions and banking union in 2012 made reform less urgent. Second, the domestic challenges in France, particularly the protests by the *gilets jaunes*, weakened Macron’s domestic position and by extension his European position. His ability to find only a limited compromise with Germany indicated the reduced room for manoeuvre for bold European measures. German preferences for limiting fiscal capacity building remained consistent during these negotiations. When the costs of inaction became too great during the sovereign debt crisis, “pragmatism trumped ordoliberalism”, but during normal times Germany reverted to its longstanding preference for limited fiscal integration (Howarth and Schild 2021).

### 3.2. Symmetric Shock, Asymmetric Consequences

The Covid-19 pandemic shifted the Commission’s focus from the BICC and the economic governance review to dealing with the economic fallout. The lockdowns across the world reversed the economic growth that had resumed in the EU after a long period of economic crisis. Unlike the previous crisis, blame was not assigned for errant behaviour (Matthijs and McNamara 2015). Instead, EU Member States exhibited much greater pragmatism and solidarity in the face of the pandemic. The main fiscal measures relate to activation of the general escape clause of the SGP for the first time, the creation of the temporary Support to mitigate Unemployment Risks in an Emergency (SURE), and the development of the Recovery and Resilience Facility (RRF). While much was made of the unprecedented solidarity shown by the EU, these instruments are the culmination of long-standing discussions on the requirements for a single currency.

Early in the pandemic crisis, some EU actors referenced the BICC as a possible tool to fight the pandemic (see Dias and Zoppè 2020). The BICC’s distinction between euro area and non-euro area Member States, however, held less relevance it did a few years earlier. First, the nature of the emergency that affected all the EU Member States was viewed as a symmetric shock, not the asymmetric shock considered in optimum currency area theory. Second, Brexit eliminated the most likely naysayer to this move. One reason for the distinction between the EU and the euro area had to do with the objections of the UK for further integration. For example, the 2012 Treaty on Stability, Coordination and Governance (also known as the Fiscal Compact) originally was being negotiated within the EU legal framework, until British Prime Minister David Cameron threatened to veto unless he could secure an exemption for British banks from the new banking regulations (Van Rompuy 2014). The remaining objections to the recovery plans did not pit euro area versus non-euro area Member States, and their justifications were not relevant to debates on deepening the euro area. This had already been established during the BICC negotiations that had the Eurogroup meet in inclusive format (thereby not excluding non-euro area Member States) and the shared scepticism of some Member States (euro area and non-euro area) over the need for the euro area to further integrate.

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77 EMU Positions dataset (emuchoices.eu)
78 Report on the comprehensive economic policy response to the COVID-19 pandemic - Consilium (europa.eu)
3.2.1. SURE

The Commission proposal for temporary SURE on 2 April 2020 would provide up to €100 billion in back-to-back loans in order to alleviate negative economic and social consequences of the pandemic by supporting national short-term works schemes that subsidise temporary reductions in work hours that allow employers to keep employees on the payroll with reduced hours instead of laying them off. The Commission raises money on capital markets under the SURE social bond framework, backed by €25 billion in guarantees committed by Member States to the EU budget, thus allowing for leveraging. The governance framework is simpler than the ESM Pandemic Crisis Support facility, requiring only a qualified majority in the Council. It also lacks the stigma that the ESM carries in countries like Italy.

The legal basis is Article 122 TFEU: “the Council, on a proposal from the Commission, may decide, in a spirit of solidarity between Member States, upon the measures appropriate to the economic situation” (Art 122.1), given that the EU Member States were “seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control” (Art.122.2 TFEU). The Council approved SURE on 19 May as Council Regulation 2020/672, and it was activated on 22 September. The first bond issuance on 20 October was oversubscribed over 13 times, indicating strong investor interest. As of 25 May 2021, nearly €90 billion in loans have been provided to 19 Member States, with Italy, Spain, Poland and Belgium benefiting from the largest share of loans.

SURE fits as a variation of the stabilisation functions described by the 2017 Commission Reflection Paper indicating investment protection, unemployment reinsurance, and a ‘rainy day’ fund as potential avenues for stabilisation for EU Member States. But while the European Unemployment Reinsurance Scheme announced by the Commission in January 2020 was a permanent mechanism that targeted the unemployed, SURE is a temporary instrument that benefits employers, employees and the self-employed (Alcidi and Corti 2020). Moreover, it is not large enough to play a stabilisation function for the EU.

3.2.2. RRF

The European Council conclusions from 26 March 2020 invited the Eurogroup to present proposals that “would take into account the unprecedented nature of the Covid-19 shock affecting all our countries”. French Finance Minister Bruno Le Maire indicated a common EU instrument should be created to deal with the pandemic “which would be limited in time with an indebtedness possibility for the long-term response to the crisis”, with an expiration within five or ten years so as to placate the objections of northern European governments. On 9 April, the Eurogroup report on the comprehensive economic policy response to the COVID-19 pandemic agreed to work on “a Recovery Fund to prepare and support the recovery”. Spain issued a non-paper on 19 April for a European recovery strategy that included an ambitious Recovery Fund of €1 to €1.5 trillion for stabilisation (citing expert recommendations) and investing in digital and green sectors. The Franco-German proposal of 18 May surprised many with...
how it differed so strongly from the German response to the sovereign debt crisis and the BICC. In contrast to the emphasis on fiscal consolidation and avoiding moral hazard, the Franco-German proposal contained “an ambitious, temporary and targeted Recovery Fund” of €500 billion geared towards “resilience, convergence and competitiveness”, a similar refrain from previous iterations of discussions regarding a euro area budget. Particular attention would be paid to investing in the digital and green transitions. The proposal did indicate that the money would be directed towards the economic sectors and regions that were most impacted by the pandemic, as southern European economies were hit harder. In this sense, the fund resembled the 2017 European Parliament resolution for a budget that could handle both symmetric and asymmetric shocks\(^\text{86}\). German Finance Minister Olaf Scholz famously hailed the Franco-German plan (on which the RFF was built) as analogous to that of Alexander Hamilton’s plan in the US, with federal government’s assumption of state debts that laid the foundation for the US fiscal union\(^\text{87}\). Figure 2 also shows the impact of the Franco-German plan’s announcement’s on sovereign bond yields, which in Italy and Spain had risen during the first months of the pandemic and reached their peak in May 2020 before moving downwards.

The Franco-German Recovery Fund proposal came just a few weeks after the German Constitutional Court delivered its judgment of the ECB’s PSPP, its quantitative easing programme (BVerfG 2020). The Karlsruhe-based court’s decision had questioned the proportionality of the ECB’s plan and potentially jeopardised the participation of the German Bundesbank in further PSPP operations. By the same logic, it could also have called into question the legality of the ECB’s PEPP announced in March 2020. While none of these worst-case scenarios occurred, the possibility that the EU could no longer rely on the ECB to rescue the euro placed additional pressure for a strong fiscal response. Both the Spanish and Franco-German proposals envisioned financing the grants through issuing common debt.

Some Member States were more sceptical of the Franco-German proposal. The Frugal Four countries (Austria, Denmark, the Netherlands, and Sweden) opposed the grants envisioned, preferring that solidarity take the form of loans that could be made conditional on structural reforms\(^\text{88}\). The Frugal Four is a smaller configuration than the New Hanseatic League that includes euro ins and euro outs with shared views on budgetary matters, particularly limiting the size of the EU budget and continuing to receive their rebates from the MFF.

The Commission proposed the NGEU budget that included a Recovery and Resilience Facility on 27 May 2020\(^\text{89}\), with similar objectives as the Franco-German proposal and similar spending priorities. The main difference was that the Commission proposal included loans in addition to grants. Given the already-low interest rates governments were able to obtain from markets (see Figure 2), the loans component was less compelling. The ESM already had created a Pandemic Crisis Support Instrument on 8 May\(^\text{90}\), based on its Enhanced Conditions Credit Line, offering loans up to 2 percent of a member state’s end-2019 GDP without the onerous conditionality associated with ESM support during the sovereign debt crisis. At this writing, no euro area member state has applied; the stigma of the conditionality applied to the loans made during the sovereign debt crisis lingers still. Recently published research indicated the extent to which austerity is an anathema to the Italian electorate, potentially turning Italy’s pro-euro majority into one favouring exiting the eurozone in case of conditionality (Baccaro, Bremer and Niemanns 2021). Debates between the Member States centred on

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\(^{86}\) Texts adopted - Budgetary capacity for the euro area - Thursday, 16 February 2017 (europa.eu)

\(^{87}\) https://www.ft.com/content/2735a3f1-bc58-477c-9115-98129e12852

\(^{88}\) https://www.tweedekamer.nl/kamerstukken/detail?id=2020D20163&did=2020D20163; see also Franco-German recovery deal meets resistance – POLITICO

\(^{89}\) https://ec.europa.eu/info/files/communication-europes-moment-repair-and-prepare-next-generation_en

the RRF’s size, the proportion of grants and loans, the approval process, oversight over the use of the RRF, and the link to rule of law (Cameron 2020).

After an epic European Council meeting from 17 to 21 July, EU leaders reached an agreement. The RRF would include a substantial grants component, but more emphasis was placed on loans. Reportedly, EU Council President Charles Michel broke the deadlock by proposing that the rebates (in the context of the MFF) the Frugal Four countries enjoyed and wanted to protect be increased. Germany was the only country receiving a rebate that did not receive an increase (Germany would still receive a rebate, however). Moreover, the overall size of the MFF 2021-2027 budget was lowered by €25.7 billion from the proposal from May. On the other hand, the overall size of the RRF increased from the original Commission proposal.

On 11 February 2021, the Council and the European Parliament adopted a regulation setting up the RRF. Member States would submit their recovery and resilience plans in a coherent package of reforms and investments that would incorporate six areas of relevance for the EU: the green transition; the digital transition; smart, sustainable and inclusive jobs and growth; social and territorial cohesion; health and resilience; and policies for the next generation, such as education and skills. The national recovery and resilience plans should also consider the European Semester’s country-specific recommendations and establish control systems that would guard against fraud and corruption. The Commission will assess the recovery and resilience plans and send its recommendation to the Council, which will approve by a qualified majority vote. 70 percent of the whole RFF grants have been allocated among Member States in 2021, and the remaining 30% by 2023. RRF money will be disbursed up until the end of 2026, with repayment completed by 2058. Member states that receive loans will repay them, and the European Council is reforming the own resources system so that the grants repayments can be done through new EU own resources and gross national income-based contributions. The RRF funds are distributed according to income per capita and past unemployment developments for 2021-22. In 2023, the fall in real GDP in 2020-21 will replace the past unemployment criterion. Greece, Spain, and Italy in particular will receive generous support from the RRF.

The rapid progress in the negotiations from the RRF have been attributed to the EU learning lessons from the sovereign debt crisis on the importance of acting quickly in the face of such an economic shock. This speed was also possible because the EU institutions had been discussing the possibility of a larger fiscal capacity for the better part of the last decade. These discussions began from the premise of needing to ‘deepen’ EMU, guided in part by ideas relating to optimum currency area theory and the need to deal with asymmetric shocks, until they were subsumed by more general arguments related to European integration such as the need for increased competitiveness and convergence. Concomitantly, the symmetric nature of the Covid-19 crisis called for a European solution rather than one for the euro area. The hollowing out of the euro area budget debate related to the BICC seemingly ended debate on the need for a budget capable of macroeconomic stabilisation in the euro area. But the previous debates had already resulted in extended reflections on the size and potential functions this could take. Indeed, the size of the grants component of the RRF is comparable to the 2017 Macron proposal.

92 https://www.ft.com/content/4c17389-7918-49ba-a928-79d06612523.
93 https://www.ft.com/content/55f6796e-4a9f-43b2-8d94-da0804d163b.
### Table 3: Comparison of Pandemic Recovery Proposals

<table>
<thead>
<tr>
<th>Proposal</th>
<th>Total size</th>
<th>grants</th>
<th>loans</th>
<th>Aims</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eurogroup Report on the comprehensive economic policy response to the Covid-19 pandemic 9 April</td>
<td>Not defined</td>
<td>Not defined</td>
<td>Not defined</td>
<td>Deal with health emergency needs, to support economic activity and to prepare the ground for the recovery</td>
</tr>
<tr>
<td>Spanish non-paper on European Recovery Strategy 19 April</td>
<td>€1 to €1.5 trillion</td>
<td>€1 to €1.5 trillion</td>
<td>0</td>
<td>Stabilisation</td>
</tr>
<tr>
<td>Franco-German Recovery Fund 18 May</td>
<td>€500 billion</td>
<td>€500 billion</td>
<td>0</td>
<td>Stabilisation and competitiveness</td>
</tr>
<tr>
<td>Commission proposal for Recovery and Resilience Facility 27 May</td>
<td>€560 billion</td>
<td>€310 billion</td>
<td>€250 billion</td>
<td>Stabilisation, convergence and competitiveness</td>
</tr>
<tr>
<td>Final Recovery and Resilience Facility</td>
<td>€672.5 billion</td>
<td>€312.5 billion</td>
<td>€360 billion</td>
<td>Stabilisation, convergence and competitiveness</td>
</tr>
</tbody>
</table>

#### 3.2.3. The Evolution and Revolution of Creating the RRF

The size of the RRF and the speed with which Member States found agreement mark an important moment in European cooperation. It was rightly hailed as “historic” (Commission President Ursula von der Leyen) and “the most innovative plan we have ever had” (Portuguese Prime Minister António Costa)96.

On the other hand, the RRF also represents an evolutionary step that bears the marks of earlier debates. Although at the time of announcement the RRF had been portrayed as a Keynesian stimulus akin to those being pursued by the US, it does not perform a stabilisation function. The nature of its contents (e.g. requiring investments in digital and green transition) and the timing of the disbursement (well over a year after the first lockdown period) and implementation of reforms (by 2026), and the wording of the regulation indicate that it is to support investments and structural reforms rather than provide countercyclical stimulus. In this sense, the BICC has been replaced with a much more ambitious programme, both in size and scope.

The EU response does include support for stabilisation during the pandemic in the SURE programme. Both the RRF and the SURE are temporary measures, however, and the presentation of the European Pillar of Social Rights Action Plan on 4 March 2021 did not include an EU unemployment reinsurance scheme. This omission reflects continued scepticism over having a supranational budget with a stabilisation function that would last beyond the crisis. Indeed, the 2017 press release already noted

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96 Council of the European Union approves Recovery and Resilience Facility (2021 portugal.eu)
that the European Pillar of Social Rights “should serve to re-start the process of convergence within the EMU” without noting how it would perform a stabilisation function. Despite the historical nature of the SURE and RRF, both were agreed upon as temporary measures, and deep-rooted scepticism towards a permanent stabilisation function in Germany and the Frugal Four countries remain.

Finally, the hollowing out of the distinction between euro area and non-euro area member states in the BICC (that was agreed upon in inclusive format) was reinforced by the RRF that applies to all EU Member States. Indeed, the interests of euro ins and outs converged in the Frugal Four grouping. Differentiating between euro area and non-euro area in creating a stabilisation budget would be tricky from a legal perspective (van der Sluis 2019). Article 20 TEU on enhanced cooperation would be an uncertain basis for a euro area budget, and it would need to be open to all EU Member States. Creating a specific euro area budgetary capacity would be more difficult than one for the EU, despite the rhetoric for the former.

3.3. Recommendation: A genuine fiscal capacity

In addition to the institutional reflections presented in section 3.1, other EU bodies have advocated for a fiscal capacity and warmly welcomed the NGEU and the potential it represents. The European Fiscal Board’s 2020 report indicated that for completing EMU, a “crucial element would be a permanent and genuine central fiscal capacity.” The ECB also suggested that the experience of the NGEU should be considered as part of the review of the economic governance framework. The next few years provide an important test of the utility of large-scale transfers and whether they can promote investments and structural reforms supporting the sustainability of public finances, or if the money disappears because of corruption, inefficiency, or lack of administrative capacity. The spending of the RRF is front-loaded over the next few years, giving observers inside and outside the EU the chance to see the fruits of solidarity. The Commission’s Recovery and Resilience Task Force (RECOVER) plays a crucial role, both in evaluating the Member States’ recovery plans and in overseeing their implementation, as the money is doled out in twice-yearly tranches. The framework of the RRF in terms of its structure, function, and governance addresses many of the previous concerns indicated by Member States. Embedding it within the European Semester gives the latter more credibility, by endowing it with carrots in addition to just sticks in the form of EDP and MIP fines (that have never been applied). Indeed, the disbursement of RRF funding and their approval process “creates new dynamics: a technocratic ritual will become a political process,” as the Member States will seek approval for disbursement and the RECOVER will be under pressure to ensure the implementation of the Recovery and Resilience plans. These incentives for reform and implementation contrast with the current system in which ‘neither the Stability and Growth Pact nor the Lisbon Strategy have had a significant beneficial impact on fiscal and economic performance outcomes’ (Ioannou and Stracca 2014, p1). By the time the next MFF negotiations come around, the case for a scaled-up BICC 2.0 that could perform a stabilisation function could be more convincing for sceptics. Although the academic rationale limited this to the euro area, recent experience indicates the utility of a large budget that could deal with symmetric shocks; including non-euro area Member States would have the added advantage of eliminating some of the potential legal obstacles to creating such a fund for only the euro area (van der Sluis 2019).

The SURE and the RFF together combine the three elements that dominated discussions on fiscal union: stabilisation (SURE), competitiveness, and convergence (RRF). Nevertheless, “SURE is not a significant and permanent EU borrowing capacity to be used as a stabilisation tool” (Claeys 2020), given its size. The RFF’s size made it a suitable stabilisation tool, but its objectives were directed towards competitiveness and convergence. The pandemic showed the need for a stabilisation function at the level of the EU, not just the euro area. And by definition, a stabilisation tool needs to be of a substantial size to be macroeconomically significant. The EU’s pandemic response showed that it could deploy funding of an appropriate size in the short-term. It was also able to accommodate asymmetric effects of the pandemic in the allocation of funding and could be targeted towards specific countries (euro area or not), depending on the needs at the time. Could the next step be a true fiscal union?

This would not be an automatic process, as it would require changes in the EU treaties and in the constitutions of the Member States. The creation of the fiscal capacity and its financing through the SURE and RRF were linked to the pandemic and are time limited. Article 125 (the no bailout clause), for example, presented a conundrum during the sovereign debt crisis that was eventually resolved through the intergovernmental treaty creating the ESM, which offered loans under conditionality. While this provides a stabilisation function, its approval requires unanimity among the euro area Member States, making it less automatic and more onerous than a stabilisation fund.

Without a treaty change, according to Article 310(3) TFEU, a binding legal act must precede an expenditure from the Union budget, therefore “a legal basis would have to be sought that corresponds to the aim and content of the proposed instrument” (Crowe 2018, p5). Staying within the current legal framework limits options, as was discovered during earlier debates on a euro area budget. The legal basis for cohesion policies used for the Commission’s European Investment Stabilisation Function (EISF) proposal101 and Reform Support Programme (RSP)102 and for the 2019 Franco-German proposal103 was Article 175(3) TFEU. While the goals of the Commission and Franco-German proposals correspond to promoting territorial, economic and social cohesion (Article 174 TFEU), the stabilisation function would not be accomplished through the existing Structural Funds and needed a new mechanism, thereby satisfying Article 175 (3)TFEU on using existing funds. Indeed, the Franco-German proposal insisted, “this instrument should not be a precedent for the EU’s cohesion policy”. Nevertheless, the extent to which cohesion could be viewed as the primary objective of these proposals is questionable; while existing legal traditions interpret convergence as a market-driven process in achieving EU objectives, cohesion has been seen as offsetting negative effects from markets. The use of Article 175(3) as a legal basis, therefore, would entail a reconsideration of how cohesion policies have been viewed (van der Sluis 2019).

The innovation of the RRF lies not only in its size but its financing. The RRF is the latest example of supporting EU public investment by borrowing on capital markets (Guter-Sandu and Murau 2021). The October 2020 SURE bond issuance received the largest order book ever (€233 billion), setting up the EU as a major player in global bond markets. NGEU has a diversified funding strategy, given its complexity given the size (up to €800 billion by the end of 2026), funding grants alongside loans that are disbursed to multiple users. The Commission, therefore, will undertake a debt management policy akin to those of large sovereigns104. This experience would enable it to undertake a variety of different

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101 https://eur-lex.europa.eu/resource.html?uri=cellarc9301291-64b1-11e8-ab9c-01aa75ed71a1.0001.03/DOC_1&format=PDF  
104 https://ec.europa.eu/info/sites/default/files/about_the_european_commission/eur_budget/gic_slides_08062021.pdf, slide 6
funding strategies if it received the mandate to fund a budget that could perform a stabilisation function.

Funding such a budget on a permanent basis would require a new agreement. The December 2020 Own Resources Decision105 (Council Decision 2020/2053) increased the own resources ceiling from 1.20 percent to 1.40 percent of EU gross national income (GNI). Moreover, a temporary increase of 0.60 percent GNI would finance the NGEU budget, along with national contributions tied to non-recycled plastic packaging waste. Council Decision 2020/2053 Article 5, however, stresses the 'temporary' nature of the budgetary increase and ability to borrow funds. SURE similarly is based on Article 122 TFEU that allows the EU to provide temporary financial assistants to Member States in difficulty "in a spirit of solidarity". Their replication after the Covid crisis would require ratification by national parliaments in most EU Member States.

Indeed, fiscal sovereignty remains a national prerogative, and domestic actors can impede the creation of such a budget. The German constitutional court already has questioned several measures (the creation of the ESM and the ECB’s Outright Monetary Transactions and PSPP) that could be viewed as fiscal operations. No indications have been given from Germany or the Frugal Four countries that their perspectives have changed on the need to create a permanent stabilisation function. Despite the success (so far) of the pandemic response, relations between Member States still exhibit a lack of trust and concern for moral hazard. The primary obstacles to a genuine fiscal capacity are political, not economic. With sufficient political will, the legal obstacles could be overcome.

The succession of crises over the last 15 years has shown the difficulty of anticipating the source of the next economic shock. Creating a stabilisation function would also balance EU economic governance that has relied too heavily on the ECB. In Mario Draghi’s farewell remarks, he explained, "we need a euro area fiscal capacity of adequate size and design: large enough to stabilise the monetary union, but designed not to create excessive moral hazard"106. Nevertheless, such a large step in integration also requires a political choice that includes a treaty change, not a technocratic exercise of integration by stealth. The results from the RRF will play an important role in the rebuilding of trust between Member States and demonstrating the possibilities.

105https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020D2053; see also
4. CONCLUSION

The SGP is due for serious reform. A major review by the Commission had to be postponed due to the Covid-19 pandemic, but until this review occurs, it does not make sense to return to the old rules. Prior to the pandemic, the SGP failed to improve the debt sustainability of the Member States that needed it most, i.e. those that are highly indebted. These same rules cannot be expected to work now that even more debt has been accrued because of the pandemic. Tinkering at the margins of the existing rules would not be suited to the new economic conditions.

The post-pandemic debt levels, low inflation, and the low interest rate environment should be factored in a new fiscal framework. At a minimum, the debt reduction benchmark should not be applied in the foreseeable future, which would require unrealistically high budgetary surpluses. Ideally, a more thorough consideration of the SGP would occur, but this may not be possible politically.

Although the pandemic postponed the review of EU fiscal governance, it also opened a window of opportunity in that it created greater political space to test bold initiatives like the RRF and SURE. They are temporary, but they are the culmination of nearly a decade of debate for the need for a euro area budget. References to economic theory (e.g. optimum currency area theory) have been made when citing the need for a euro area budget, but most of the proposals that followed used such theories rhetorically rather than as the basis for reforms. The need for a fiscal stabilisation mechanism in a monetary union gave way to proposals using a limited budget to promote convergence and competitiveness.

The RRF and the SURE serve as a powerful rejoinder to many of the questions raised during these institutional reflections on a euro area budget. First, the EU demonstrated its willingness and ability to raise a macroeconomically significant budget on capital markets within a short period in response to an emergency. This is a major success, considering the rancour that surrounded the delayed responses to the sovereign debt crisis. The pendulum swung away from austerity of the sovereign debt crisis to more Keynesian solution, at least for the time being.

Second, it points to the financial viability of the EU raising money on capital markets. The success of the SURE and NGEU bond issues indicates a possible path to creating a safe asset for the EU. The financing arrangements for SURE and the NGEU are temporary in nature but provide a template if and when a consensus is reached. The long maturity of the bonds could raise market expectations of their periodic replacement, particularly if these bonds enjoy popularity on the secondary market: “by precedent, and by its very long duration (until 2058), the NGEU will, in practice, ultimately become a permanent structure. With the taboo broken legal limits dissolved, there will be little to stop (the EU from) resorting to similar measures again”107.

Third, SURE and the RRF make more explicit the fading division between the euro area and the rest of the EU, with both open to all Member States. Only 1 member state (Denmark) is not required to adopt the euro. The intention of Bulgaria and Croatia to adopt the euro would shrink further the group of euro outs. The Eurogroup consistently makes use of the inclusive format. While specific institutions for the euro area in monetary policy and banking union will endure, the blurring between the euro ins and outs likely will continue.

A recent article on the effects of the global financial crisis and sovereign debt crisis on economic and financial governance concluded, “the history of the EU is littered with change invoked by crisis” (D’Ermann, Schure, and Verdun 2020, pp267-268). Similar conclusions can be drawn from the EU response to the

107 https://www.ceps.eu/next-generation-eu/
Covid-19 pandemic and, by extension, the future EU fiscal policy. The idea of a currency union having a budget with a stabilisation capacity has been a point of contention since well before the introduction of the euro. But successive crises have brought the EU closer to an optimum currency area than it was before the euro crisis, with the creation of the banking union and the European Stability Mechanism. Neither was viewed as necessary or desirable before the crisis occurred. The pandemic similarly could have longer-ranging effects on EU economic governance beyond the temporary innovations we have seen over the last year.

The EU has delayed completing EMU for nearly a decade. The pandemic has created the political space to find more common ground on risk sharing and solidarity than seemed possible. The EU and its Member States should seize this momentum to ensure the euro’s long-term viability. The obstacles to delaying a return to the SGP until after a reform and the creation of an EU budget with a stabilisation function are more political than economic, and the legal obstacles could be overcome with sufficient political will. Former German Finance Minister Wolfgang Schäuble, who led the opposition to SGP flexibility and the creation of a euro area budget and safe asset, has recently expressed sympathy for reforming the SGP before deactivating the general escape clause. Most telling, when asked about a euro area budget and bonds, he replied, “I know very well that an economic and currency union needs to have them”\(^\text{108}\).
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ANNEX

Evolution of EU fiscal governance

1992 The Maastricht Treaty includes convergence criteria for adopting the euro, including debt levels below 60 percent of gross domestic product (GDP) and deficit levels below 3% of GDP.

1997 The European Council adopts a resolution on the SGP on 17 June 1997, paving the way for Regulation 1466/97 on the surveillance of Member States’ budgetary positions and economic policy coordination and for Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure. These aimed to prevent the break of the deficit criterion of the Maastricht Treaty through a preventive arm and regulated the corrective arm and.

2005 The first reform of the SGP creates country-specific medium-term objectives that include measures to strengthen budgetary surveillance and economic policy coordination (Regulation 1055/2005) and to speed up the Excessive Deficit Procedure (Regulation 1056/2005), both amending the above mentioned SGP Regulations.

2011 Five regulations (1173/2011, 1174/2011, 1175/2011, 1176/2011, 1177/2011) and a directive (2011/85/EU) are passed that would enforce more strictly the deficit and debt limits set by the treaty, create a new expenditure benchmark, establish medium-term budgetary objectives for member states to converge towards SGP debt limits by 0.5 percent per annum as a benchmark, and set up a new Macroeconomic Imbalances Procedure.

2012 The Treaty on Stability, Coordination and Governance is signed that included a Fiscal Compact restating some of the six-pack rules and requiring a balanced budget rule to be transposed into national legal systems.

2013 The two-pack (Regulations 472/2013 and 473/2013) provides for the enhanced monitoring and surveillance of draft budgets of Member States and ensure the correction of excessive deficits.

2015 Commission issues ‘interpretative communication’ emphasizing the inherent flexibility of the SGP, identifying three policy dimensions to consider when applying the SGP: investment; structural reforms; and cyclical conditions. This COM communication was only the starting point of the flexibility interpretations: Afterwards, the EFC made some amendments and the amended version went into the Code of Conduct. See for instance EP Fact-Sheet on EU Fiscal frameworks: The EU framework for fiscal policies | Fact Sheets on the European Union | European Parliament (europa.eu)

2020 Commission begins review of EU economic governance. Due to the coronavirus crisis, the period of public consultation has been extended and the Commission is expected to return to the review exercise once the immediate challenges linked to the pandemic have been addressed.

2021 The EU passes the Regulation 2021/241 establishing the Recovery and Resilience Facility as part of the Next Generation EU.
This paper situates the EU’s fiscal response to the pandemic (suspending the Stability and Growth Pact, creating the SURE and Recovery and Resilience Facility) within longstanding debates on reforming EU fiscal governance and offers recommendations on the way forward, specifically the SGP reforms needed prior to returning to its rules and creating a budget with a stabilisation capacity.

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