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Shaping Europe Pragmatically

A Stability Union or a Debt Union?

A Strategic Decision for Europe

Tim Peter

Europe faces major investments in the future, but also mountains of debt. For this reason, it is crucial to align digital and environmental transformation with a stability-oriented fiscal policy. How is this aspiration reflected in the differing economic traditions of the EU member states? What steps need to be taken to create a stability union rather than a debt union?

Where Do You Stand on Public Debt?

The European Union and its member states are facing major challenges: they have to achieve digital and environmental transformation, they need to enhance their resilience and defence capabilities in response to the Russian war of aggression against Ukraine and last but not least, they must not neglect efforts to promote Europe's competitiveness. All three goals have one thing in common: they require investment.

Where will the necessary funds come from? There are usually three options here:

1. higher taxes and levies,
2. restructuring of the existing budget,
3. borrowing.

Regarding the latter option, the EU currently faces the crucial question: where do you stand on public debt? In particular, all eyes are on the debate surrounding the reform of the Stability and Growth Pact (SGP) – the centrepiece of European debt rules.

In this context, the roles are no longer as clearly assigned as they once were with the "frugal North" on the one hand and the "free-spending South" on the other. The joint initiative to reform EU debt rules undertaken by Spain and the Netherlands is an example of the shift that is happening here. At its core, the question is: which path should Europe pursue in order to achieve its multiple and costly goals – increased debt or a stability-oriented fiscal policy?

Europe's Differing Economic Traditions

Here, the EU member states' differing economic traditions and approaches are revealed. Some are pushing to cut public spending in order to reduce debt, while others argue that public spending should be increased so as to stimulate economic growth, thereby reducing debt through growth.[1] The Brussels think tank Bruegel is among those suggesting the introduction of a "Green Golden Rule" (GGR) for EU debt rules, a concept that goes back to the economists Chichilnisky, Heal and Beltratti.[2] The aim here is to enable more debt-financed public investment in digital and environmental transformation by differentiating between the type of public expenditure, allowing countries with healthy public finances to pursue such investments outside of EU debt rules.[3] Even stability-oriented economists like Thiess Büttner say that debt can make economic sense under certain circumstances. Firstly, it can have a stabilising effect in the event of short-term financial needs, especially in times of crisis. Secondly, the state can usually borrow money on the capital market at better conditions than private actors.[4]

Why Fiscal Rules Are Needed

Nevertheless, Büttner argues that constraints are needed in the form of a debt brake and European fiscal rules. The main reason for this is what is known as time inconsistency. A government will tend to work harder to achieve short-term success with a view to being re-elected, thereby neglecting optimum long-term financial planning. As a result,

Protests in Paris: In May 2023, numerous people took to the streets in protest of the pension reform proposed by the French government. According to economists, however, expensive pension systems are often a central reason for a strained budget. Photo: © Maxime Gruss, Hans Lucas, picture alliance.

it always falls to the successor government to take care of debt reduction. According to Büttner, this has devastating consequences:

1. Uncertain repayment of government debt can burden the economy as a whole, thereby resulting in economic losses.
2. Monetary policy can be used to keep interest rates low for refinancing government debt, which in turn fuels inflation.[5]

The economists Kauder, Matthes and Sultan also argue that a potential debt crisis, that may be caused by a lack of financial sustainability, endangers all the other goals of an economy, including environmental transformation, and that the goal of financial sustainability must therefore be pursued as a matter of priority.[6]

Germany would not have been able to respond so resolutely during the COVID-19 pandemic if it had not ensured that its finances were sound in the preceding years.

Empirically, it is difficult to sustain the argument that debt-financed public spending contributes to an increase in productivity per se and therefore – as a result of increased economic growth – does not burden subsequent generations. In reality, additional funds have tended to be spent less on education and investment and more on consumptive social spending.[7] Moreover, the option of borrowing money is often used to put off necessary structural reforms. One example is the French pension reform. According to the economist Jörg König, the expensive pension systems of southern Europe are in fact among the crucial factors explaining the tight budgetary situation faced by some southern European member states. König further shows that a "negative interest rate growth differential" has failed to materialise in the longer term, especially in Italy. A negative interest rate growth differential describes a situation in which the increased interest costs resulting from borrowing are absorbed by the economic growth thus stimulated. Italy, for example, has not been able

to achieve a single negative differential rate in the first 20 years of monetary union.[8] This also makes it difficult in practice to implement the Green Golden Rule approach, which tends to have negative consequences. Rather than mobilising the necessary investments through difficult but equally necessary budgetary reallocations and structural reforms, it finances them by means of additional debt while maintaining the status quo. The ability to mobilise capital quickly in times of crisis and therefore achieve greater resilience also depends on moderate government debt, as the economist Lars Feld emphasises.[9] For example, Germany would not have been able to respond so resolutely during the COVID-19 pandemic and the energy price shock as a result of the Russian war of aggression against Ukraine if it had not ensured that its finances were sound in the preceding years.

In addition to the incentives for governments to take on debt beyond the economic optimum, there is another component in a monetary union: risk-sharing as an incentive to increase debt. Member states are closely interlinked economically through the common currency and

the single market, so the default of one country would have a significant impact on the others. Consequently, the costs of default are borne not only by that country, but by the entire monetary union. Moreover, unsound fiscal policy pursued by individual member states makes it more difficult for the monetary union as a whole to fight inflation.[10] This is the conclusion arrived at by the economist Jörg König: "Permanently rising debt ratios are either tomorrow's taxes or tomorrow's inflation."[11]

Europe's Mountains of Debt

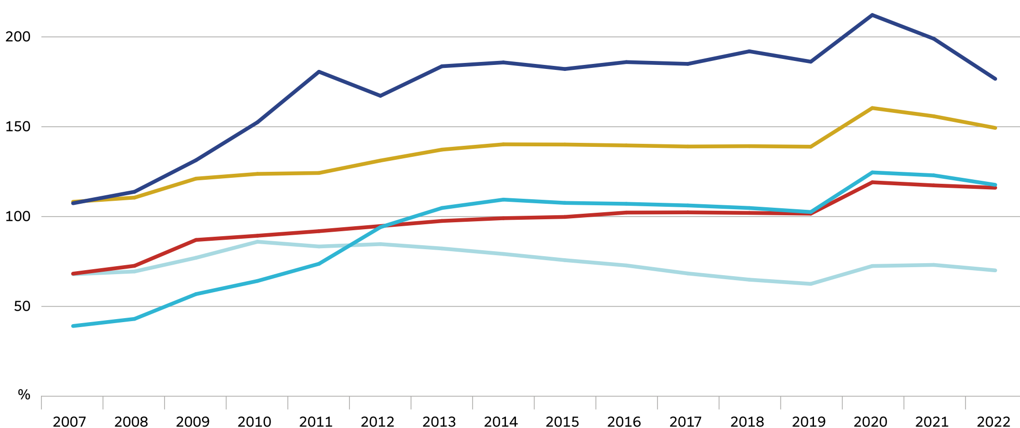
The SGP was adopted in 1997 under the Treaty of Amsterdam with a view to coordinating a common monetary policy and a decentralised fiscal policy more effectively. It incorporates the Maastricht criteria of 1992, which stipulate that the annual public deficit may not exceed three per cent of gross domestic product (GDP) and that the debt level may not exceed 60 per cent of GDP. The SGP was reformed in 2005 and was then supplemented by tighter rules and additional instruments as a result of the euro crisis, including the "Six Pack" adopted in 2011, the European Stability Mechanism (ESM) introduced in 2012 and the Fiscal Compact signed in the same year. These measures were aimed at stabilising the monetary union and making it more resilient. Among other things, the member states[12] made a voluntary commitment under the Fiscal Compact to establish debt brakes at national level.

Nevertheless, the economist Matthias Kullas says that the SGP is "not a success story". Greece, for example, has exceeded the maximum government deficit of three per cent of GDP in 21 years out of 25 since the introduction of the SGP, although there has been recent success in reducing Greek debt levels through structural reforms in the wake of the euro crisis. The figures for the second Maastricht criterion are also sobering: since the introduction of the SGP, twelve of the member states that currently have debt levels above 60 per cent of their GDP have not reduced these debt levels but increased them.[13]

Interest costs are rising, especially for highly indebted states.

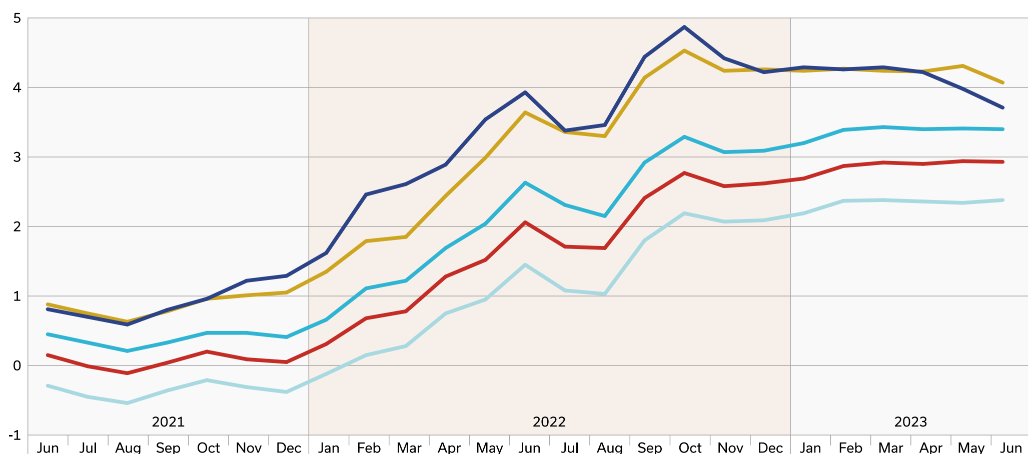
A look at the debt levels of Greece, Italy, Spain and France in Figure 1 shows how far the Maastricht ceiling of 60 per cent of GDP has been exceeded: Greece had a debt level of about 171 per cent of GDP in 2022, Italy about 144 per cent, Spain about 113 per cent and France

Fig. 1: Public Debt in Relation to GDP



Greece Italy Spain France Germany Source: own illustration based on Eurostat 2023: Government Deficit/Surplus, Debt and Associated Data, in: https://ogy.de/oxgr [10 Oct 2023].

Fig. 2: Interest Rates on Ten-year Government Bonds (Interest Rates in Per Cent)



Greece Italy Spain France Germany Source: own illustration based on ECB 2023: Long-term Interest Rate Statistics for EU Member States, in: https://ogy.de/u8ls [10 Oct 2023].

about 112 per cent. In a study by the German Economic Institute, the economists Kauder, Matthes and Sultan used debt sustainability analyses to model developments in several euro countries up to the year 2030. For this purpose, they projected three underlying scenarios: economically optimistic, intermediate and pessimistic. For France, all three scenarios result in an increase in debt level, largely due to the high deficit of the French budget.[14] In view of this, another SGP rule seems increasingly unrealistic: the so-called 1/20 rule stipulates that countries must reduce their debt level back to the 60 per cent mark within 20 years. This would result in rigorous austerity measures for countries like Greece and Italy, probably triggering a recession. As a result of the ensuing economic slump, the debt-to-GDP ratio would then be even higher.[15] It is therefore imperative that this rule should be reformed, albeit without opening the door to a further increase in debt levels.

Difficult Refinancing and the Role of the European Central Bank

Interest costs are also rising, especially for highly indebted states. Italy and France have to refinance about one eighth of their debt each year, in other words replace old government bonds with new ones. Newly issued government bonds are subject to significantly higher interest rates than those issued just a few years ago, as Figure 2 shows. For example, the interest rate for ten-year French government bonds was 0.05 per cent in December 2021, already rising to 2.62 per cent by December 2022. Germany's federal interest expenses have also increased from four billion euros in 2021 to a projected 40 billion in 2023.[16]

The ECB mitigates undesirable developments caused by the euro countries' fiscal policy.

On 21 July 2022, in response to the rise in interest rates, the Governing Council of the European Central Bank (ECB) adopted what is known as the Transmission Protection Instrument (TPI). The aim of this instrument is to allow bonds of individual euro states to be purchased under certain circumstances in order to curb unjustified interest rate premiums on their bonds.[17] According to the economist Jürgen Matthes, the TPI closes a gap in the Economic and Monetary Union. At the same time, it has certain deficits in its current form: due to unclear conditionality, for example, it may reduce the incentive for euro countries to maintain fiscal sustainability.

Moreover, it is not clear how the ECB will distinguish between justified and unjustified interest rate premiums. According to Matthes, one solution would be to integrate the TPI into the ESM.[18] Unlike the ECB, the ESM was created to support over-indebted euro countries: it is methodologically sound in this area, legally secure and democratically legitimised.

The TPI has not yet had to be applied, however, since the announcement of the instrument was probably already enough to calm the markets. There are obvious parallels here with Mario Draghi's "whatever it takes" speech in July 2012 at the height of the European financial and debt crisis: in the same way, it was not subsequently necessary to apply the Outright Monetary Transactions (OMT) programme set up at the time that would have allowed the ECB to purchase unlimited amounts of government bonds.[19] Another reason is that replacement purchases were made under the Pandemic Emergency Purchase Programme (PEPP) established by the ECB during the COVID-19 pandemic. This comprises a potential total of 1.85 trillion euros.[20] In this way, a large number of German government bonds were replaced by Italian government bonds in order to counteract the increased interest rate premiums on the latter.

For some time now, the ECB has been indirectly supporting the budgets of highly indebted euro countries through its bond purchase programmes. In the case of Spain and Italy, for example, the shares of government bonds held by the ECB each amount to almost 50 per cent of national GDP.[21] The problem with the ECB's increasing intervention is that it is moving further away from market neutrality, possibly balancing the goal of fighting inflation against the goal of not overburdening highly indebted euro countries with its key interest rate hikes.[22] On the other hand, the ECB's monetary policy mitigates undesirable developments caused by the fiscal policy of the euro countries. A functioning stability union would not put the ECB in a position to consider major interventions in the first place.

Quantitative, Uniform Fiscal Rules or Qualitative, Individual Negotiations?

Quantitative, uniform fiscal rules are indispensable for a union of stability. However, these are increasingly being called into question in the debate on the reform of the SGP.[23] For example, it is proposed that individual debt reduction plans should be agreed on between the EU Commission and the member states. This would strengthen "national ownership" on the part of member states, it is argued, and would take account of the concrete economic situation. It is difficult to dismiss the argument that the domestic political situation in some more indebted member states, such as France, makes medium-term budget consolidation difficult. Nevertheless, individual agreements do not solve the problem. For example, the economist Matthias Kullas writes that the differing economic traditions in Europe might lead us to expect increasing public spending on the part of some member states as a way of supposedly growing out of debt.[24] In fact, however, unpopular structural reforms are necessary in order to achieve long-term growth and sound finances.

Politically, it is difficult for the Commission to impose further financial burdens on member states that already face financial problems.

Negotiating individual debt reduction paths potentially creates a sense of external control by the EU rather than "national ownership". In practice, it would mean that a new government would first have to renegotiate the national debt reduction path with the EU Commission. This can increase frustration with Brussels, as demonstrated by the Greek sovereign debt crisis.[25] In general, qualitative rules based on a debt sustainability analysis give the Commission too much scope for interpretation, inevitably making it a political arbiter.[26] According to the economist

Friedrich Heinemann, there are also problems with the envisaged time frame of the debt reduction path, which can be extended from four to seven years if certain criteria are met: since it spans a legislative period, the problem of time inconsistency mentioned at the beginning continues to apply, he says, with the result that it always falls to the successor government to take care of savings and reforms.[27]

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Simpler Rules with Efficient Enforcement

Instead, the SGP should be reformed with the aim of establishing simpler rules and more efficient enforcement. The economists Matthes and Sultan recommend that the planned debt reduction paths should introduce a benchmark requiring that net primary expenditure is lower than potential growth by a certain margin, for example. Increases in expenditure would therefore be lower than economic growth on average, normally resulting in a drop in the debt-to-GDP ratio.[28] Another possibility would be not to rely exclusively on financial sanctions in the event of rule violations. Politically speaking, it is difficult for the Commission to impose further financial burdens on member states that already face

The headquarters of the European Central Bank in Frankfurt: The ECB has been providing indirect support for the budgets of highly indebted euro countries with its bond purchase programmes for quite some time now.
Photo: © Florian Gaul, greatif, picture alliance.

financial problems.[29] The European Semester, which is supposed to be used to coordinate economic policy in the EU, could also be awakened from its "long slumber" by being given more binding force, with its economic policy recommendations to the member states no longer remaining mere recommendations.[30]

The Commission's reluctance to enforce fiscal rules is attributed by Kelemen and Pavone to its dual role as an "engine of integration" and "guardian of the treaties". They say that enforcement of the fiscal rules would have led to diminished support for EU integration in the member states concerned, so open violations of the fiscal rules ultimately ended in formulaic compromises.[31] A promising response to this would be the creation of an independent, non-political supervisory body and the automation of EU debt rule application. During his time as German Finance Minister, Theo Waigel called for the creation of a European Stability Council, for example.[32] This is a role that could be taken on by the existing European Fiscal Board if its institutional status were to be enhanced. According to the economist Thiess Büttner, decentralisation of fiscal rules with independent, national fiscal institutions is also a way of achieving more efficient compliance with these rules. The bodies entrusted with this task in Germany are the independent advisory board of the Stability Council, the Joint Economic Forecast Project Group and the German Council of Economic Experts. However, this requires quantitative, uniform rules in order to be able to verify compliance transparently. By contrast, debt reduction paths negotiated between the member states and the Commission would be tantamount to re-centralisation.[33]

Conclusion

Europe faces major investments in the future, but also mountains of debt. Since unsound fiscal policy may potentially lead to a new debt crisis in the medium term, it might jeopardise digital and environmental transformation. For this reason, the goals of transformation must be pursued subject to the condition of sound fiscal policy. In order to achieve this, the focus must be on uniform, quantitative debt rules, an independent supervisory body and greater decentralisation of the monitoring of debt rules by national fiscal institutions. By contrast, the continuation of expansionary monetary and fiscal policy with extensive bond purchase programmes is not a sound growth strategy. This policy, along with other factors, has led to high inflation. In order to grow out of debt sustainably and manage digital and environmental transformation, what is needed instead are structural reforms and prioritisation in the existing budget. It is up to individual member states under their national sovereignty to decide where to apply these measures. It is legitimate to ask whether partial debt financing of southern Europe's expensive pension systems is still sustainable, however, given the lack of investment in digital and environmental transformation, for example. Positive examples of necessary structural reforms are to be seen in Portugal and Greece, which have paved the way for solid growth and a reduction in their debt levels through reform efforts during the euro crisis.

– translated from German –

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