*Clemens Fuest*

# The Reform of the EU Economic Governance Framework, Market Discipline and the Role of the ECB

## KEY MESSAGES

- **Experience with European fiscal rules has shown that European rules cannot prevent member states from accumulating high debt levels if they want to**
- **The fact that the ECB increasingly positions itself as a fiscal bailout mechanism implies that the risk of short-term fiscal crises due to a collapse of confidence in capital market declines. But this comes at the cost of further weakening incentives for fiscal discipline**
- **A reform of economic governance should place emphasis on enhancing fiscal discipline and responsibility**
- **The proposal that an excessive deficit procedure will be opened by default if countries deviate from their agreed fiscal adjustment paths may improve discipline**
- **In contrast, the idea to allow countries to incur more debt if their policies are aligned with EU political priorities will weaken fiscal discipline**

Should the EU reform its economic governance framework? And if so, how? The framework's objective is to promote EU fiscal stability and economic growth. In principle, fiscal and economic policy is primarily a national responsibility. However, economic developments in individual member states significantly affect other member states, as well as economic development throughout the EU and beyond. This clearly calls for policy coordination, which is what the EU governance framework provides.

While EU economic governance encompasses all member states, whether countries belong to the Eurozone plays a key role, since in a monetary union there is a greater need for common governance rules than among countries with national currencies. Unsurprisingly, therefore, the focus of the debate lies on the fiscal rules enshrined in the Treaty of Maastricht, which limit fiscal deficits to a maximum of 3 percent of GDP and public debt to 60 percent of GDP.

European fiscal governance rests on three pillars. First, the fiscal rules limiting deficits and the level of public debt, which are linked to a process of political supervision and coordination. Second, the No-Bailout Rule stipulates that each country is responsible for its debt and stresses the role of market discipline in this regard. Third, the European Central Bank is not allowed to finance the budgets of national governments.

The reform of the economic governance framework currently under discussion focuses on the first element. This paper argues that the reform needs to be considered in the context of all three governance elements. From this perspective, the reform would need a stronger focus on fiscal responsibility and accountability.

## WHAT IS WRONG WITH THE EXISTING EU GOVERNANCE FRAMEWORK?

One recent reason posited as making a reform of the existing EU governance framework necessary is that the fiscal rules have been suspended since 2020, when the Covid-19 pandemic broke out. Now the plan is to reinstate them in 2024, but it seems natural to discuss whether the rules should be changed before they are applied again.

But there are eight other, more fundamental, reasons to consider a reform of the governance framework. First, the fiscal rules are criticized for favoring procyclical fiscal policies: during economic crises, they are seen to offer too little room for fiscal expansion, while during economic booms they fail to encourage fiscal consolidation. Second, the fiscal rules are criticized for being arbitrary. It is indeed difficult to produce a convincing theoretical argument justifying the numerical values of 3 percent and 60 percent for the deficit and the debt levels, respectively. Third, the rules are criticized for paying too little attention to the quality of public spending. Public investment and public consumption have very different implications for economic growth and, hence, for fiscal sustainability.[1]

Fourth, it has been argued that the focus of the EU fiscal governance framework may fail to detect risks to fiscal sustainability that may build up outside the public budget, like, for instance, private debt growth during real estate booms. The fiscal problems of Spain and Ireland during the European debt crisis are cited as examples for this.

Fifth, compliance with the rules has been weak enough for some observers to question the relevance of the governance

[1] Blesse et al. (2023) review research about whether fiscal rules crowd out investment, as is often claimed. The available evidence does not support this view.

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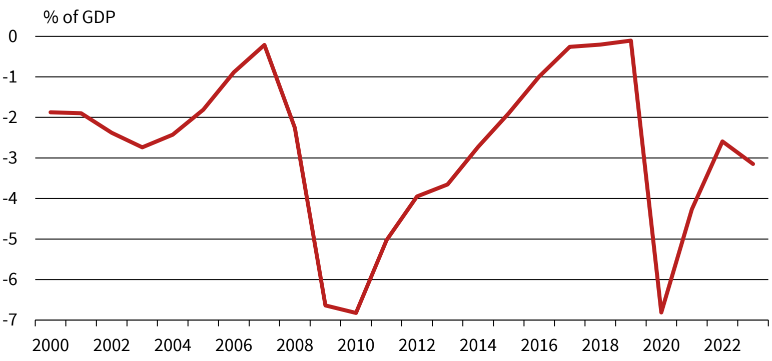
Figure 1
**Average Fiscal Deficit in the Eurozone (20 Countries)**




Source: IMF World Economic Outlook, April 2023. © ifo Institute

framework entirely. For instance, the Stability and Growth Pact originally required countries to make sure that their fiscal balances were approximately balanced in normal times so that the 3 percent deficit rule would leave enough room for fiscal support during economic crises. If anything, the fiscal policy actually pursued by most countries took the 3 percent rule rather as a focal point for normal times (see e.g., Kamps and Leiner-Killinger 2019). Figure 1 illustrates how fiscal deficits evolved between the years 2000 and 2023. The average deficit was 2.7 percent of GDP.

Greece provides one extreme example of failure to comply with the fiscal rules, where the governance framework proved unable to prevent the country from accumulating excessive public debt and ultimately defaulting. Deviations from the rules were widespread across the Eurozone, the heterogeneity of fiscal positions increasing significantly over the years, with some countries accumulating very high debt levels and others managing to keep debt in check (see Figure 2).

Debates about compliance often highlight the role of national ownership of fiscal consolidation plans. Pressure from Brussels for fiscal consolidation and economic policy reforms is often unpopular in the member states because of the lack of "national ownership." Fiscal consolidation is seen as imposed from the outside, on the basis of procedures and decisions perceived to be technocratic and far removed from domestic needs and effective democratic control. More generally, the governance framework is widely considered as too complex and opaque.

Sixth, the role of the governance framework during exceptional crises has been questioned. While it may be justified to offer more room for deficits under extraordinary situations, suspending limits to these deficits entirely is unlikely to be optimal. When rules are suspended and no further limits exist, the door opens to careless behavior and accounting tricks that allow countries to incur high debt levels to finance higher spending or tax cuts even in later years, after the crisis has receded.

Seventh, the 60 percent rule for the level of public debt as a percentage of GDP is deemed increasingly unrealistic in light of the far higher levels debt ratios have reached in many countries (Figure 2). Related to this, the debt reduction rule, which was added later, has been criticized for being overly restrictive and harmful. It requires countries above the 60 percent limit to reduce the gap to 60 percent at a rate of 1/20 per year. For instance, if a country has a debt ratio of 120 percent, it is required to reduce this ratio from one year to the next by 3 percentage points. The problem is that this rule has a bias toward a procyclical fiscal policy, since the debt ratio rises during economic downturns, simply because the denominator shrinks. This implies that the fiscal consolidation effort of the debt reduction rule needs to be larger in times of low growth.

Eighth, there is a controversial debate about the use of structural fiscal deficits as a key indicator in the preventive arm of the Stability and Growth Pact. Structural deficits are notoriously difficult to estimate, and misleading estimates may guide fiscal policy into the wrong direction.

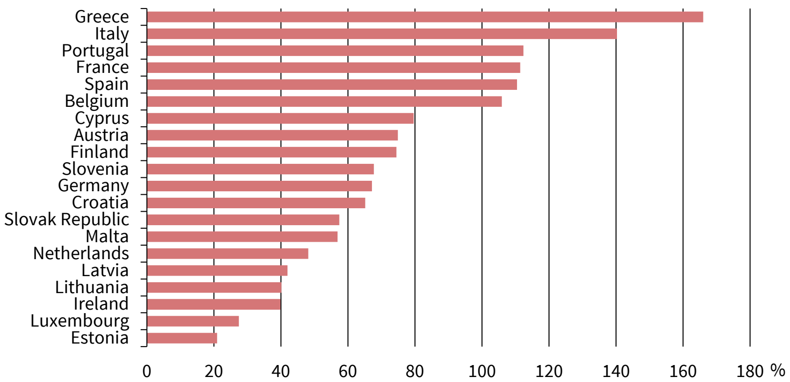
At a more fundamental level, there is a debate pitting political supervision and coordination of fiscal policy at the EU level as one governance model, against market discipline as the other model. Critics of political coordination argue that the member states are responsible for their fiscal policy, democratic control takes place at the national level and that capital markets are most effective in ensuring fiscal discipline. The role of market discipline for EU economic governance will be discussed further below.

## THE REFORM PROPOSAL OF THE EUROPEAN COMMISSION

The European Commission (2022 and 2023) has proposed a reform of the governance framework focused on the following key elements:

1. The reference values for the fiscal deficit and the debt level of 3 percent and 60 percent of GDP will be preserved.

Figure 2
**Debt to GDP Ratios in Eurozone Countries 2023**




Source: IMF World Economic Outlook, April 2023. © ifo Institute

2. All member states will submit plans with fiscal adjustment paths formulated in terms of multi-year expenditure targets.
3. For countries with deficits or debt levels above 3 percent and 60 percent of GDP, respectively, the European Commission will issue a country-specific "technical trajectory" intended to make sure that an annual fiscal adjustment of 0.5 percent of GDP is performed, so that the debt level moves along a downward path.
4. An excessive deficit procedure will be opened "by default" if countries stray from the agreed fiscal adjustment path.
5. General and country-specific escape clauses can be activated, for instance, in the case of an exceptional economic crisis.
6. Countries may be given more time for fiscal adjustments, i.e., more debt will be tolerated, if countries undertake reforms or investments that are in line with EU priorities.

According to the European Commission, this reform aims to simplify the governance framework and make it more transparent, enhance national ownership, focus more on the medium term, and strengthen enforcement.

Three aspects of the reform stand out. First, the opening of an excessive deficit procedure by default if a country deviates from the agreed fiscal adjustment path suggests that enforcement will be stricter, whatever the precise meaning of "by default." At the same time, more emphasis is placed on negotiations between the European Commission and each individual member state. This is likely to extend the influence of the European Commission on the adjustment plans. Previously, the governance structure was geared chiefly towards negotiations among peers. One weakness of this horizontal structure was that larger countries in particular had a tendency to avoid being sanctioned for rule violations. Whether the vertical structure will improve compliance is an open question. If countries do not want to comply with requirements issued by the European Commission, it will be easy for them to argue, for instance, that the EC is a technocratic institution that has less democratic legitimacy than their national parliaments. Thus, there is tension between the concept of European supervision of national fiscal policy and the fact that national parliaments are ultimately responsible for fiscal policy and have direct democratic legitimacy for conducting fiscal policy.

While it is not easy to come up with a reform which increases compliance, it is not impossible to do so. For instance, Fuest and Heinemann (2017) have proposed to use accountability bonds to improve compliance with fiscal rules, among other objectives. Countries whose deficits or debt levels exceed the limits of European fiscal rules would be obliged to finance the overshooting debt with junior bonds. This would make it clear that investors buying this additional debt take a higher risk, which in turn makes the violation of the rules very costly.[2]

Second, more emphasis will be placed on public expenditure. There are good reasons to use expenditure rules in fiscal governance, in particular because the public expenditure path is easier to control than the deficit path. At the same time, expenditure rules are not aimed at determining the level of public spending in a country. Different countries have different preferences for the share of the public sector in the economy. This implies that expenditure rules do allow for an increase in spending, provided that such changes are covered by measures to raise more revenue. While this makes expenditure rules complex and difficult to understand and communicate in public debates, experimenting with expenditure rules in the governance framework is nevertheless useful.

Third, the reform brings a fundamentally new element into the fiscal governance framework. Countries will be allowed to incur more debt if they follow political priorities formulated at the EU level. To some extent this transforms the fiscal governance framework into a tool for steering the economic and fiscal policy of the member states towards EU objectives, which may conflict with the objective of ensuring debt sustainability. Adding an additional objective to the governance framework will certainly reduce its transparency.

## EU FISCAL GOVERNANCE, THE ECB AND MARKET DISCIPLINE

While the economic governance reform tries to tackle weaknesses of the existing fiscal rules and their enforcement, a key question is whether it addresses more fundamental issues of fiscal governance in Europe. These include the interaction between monetary and fiscal policy, the role of market discipline, and the role of the European Central Bank (ECB).

## FISCAL POLICY AND MARKET DISCIPLINE IN A CURRENCY UNION

A currency union of fiscally sovereign member states like the Eurozone faces a fundamental problem that an assemblage of countries without a common currency does not face. Countries belonging to a currency union do not have a national central bank that can act as a lender of last resort to the government. In this regard, they face a similar situation as states belonging to a federation with a national currency like, for instance, the US states. The fact that a national government runs its own fiscal policy but has no control over the central bank has two implications.

First, there is a greater risk that crises lead to a collapse of trust in the ability of the government to

[2] The proposal has also been integrated into the comprehensive reform proposal for Eurozone governance by Bénassy et al. (2018).

service its debt, because a lender of last resort—a role normally played by the national central bank—is missing.

Second, if countries pursue unsustainable fiscal policies or a deep economic crisis overburdens public finances, they face default, which may take the form of a restructuring of public debt.

Governments of countries which do not belong to a currency union are in an entirely different situation. If they face a fiscal crisis but they control the national central bank, they will probably order a bailout using the printing press. If the government faces only a liquidity problem, the central bank acts as a lender of last resort and the problem is solved. However, if the crisis happens because fiscal policy is unsustainable, the monetary bailout leads to high inflation and a destabilization of the national currency, and possibly a devaluation. This may be painful, but advantageous in terms of economic governance. Since the cost of the currency devaluation is primarily borne by the country in question, there are strong incentives for national governments to avoid such a scenario. Creditors will take into account the risk of the country's debt, including the devaluation risk, so that early market reactions may even work towards preventing such a crisis. Of course, this does not mean that a fiscal crisis happening in one country has no consequences for other countries. For instance, if a currency is devalued, trade partners will be affected. But market discipline still works in this case, and most of the cost is borne by the country where the crisis originates, so that incentives are aligned.

In a currency union, things are different. The common central bank could also bail out member states undergoing fiscal difficulties, but the potential cost of doing so, in the form of higher inflation or lower central bank profits, would be spread across the entire currency union. In terms of governance, such an arrangement would imply that the cost of the crisis is not borne by the country where it originates, but by the community of countries constituting the currency union. Since such an arrangement would undermine incentives for sound fiscal policy, the European Central Bank is not allowed to finance government budgets of individual member states. This is a legal safeguard. Whether the ECB respects this legal rule is another matter, which will be discussed further below. If the central bank of the currency union refrains from financing the budgets of individual member states, unsustainable fiscal policy will lead to default, which may take the form of a restructuring of public debt. If such a debt restructuring is possible, investors in capital markets will carefully assess the sustainability of public finances of countries before buying their debt, so that default risk will be reflected in risk premia on such government debt. This is often referred to as market discipline. In this way, market reactions to imprudent fiscal policy create incentives to pursue sound policies. Since such reactions can sometimes be sudden and violent, market discipline prompts government to avoid any sign of financial difficulties and to steer clear of unsustainable fiscal policies.

However, market discipline will only work if investors truly believe that a debt restructuring will take place if countries borrow excessively. If political decision-makers think that debt restructuring will be too costly or too risky, they will avoid such a step and instead bail out the country in question. In the Eurozone, restructuring of public debt can be risky, since European financial sector regulation allows banks to hold large amounts of national government bonds without having to underpin these investments with equity. The reason is that these bonds are seen as riskless assets. But they are actually not riskless in a currency union, as just explained. Thus, if a government bond restructuring is necessary, there is a risk that this restructuring will trigger a banking crisis,[3] an event that usually has a massive negative impact on the rest of the economy.

In this situation, investors will rationally anticipate that highly indebted countries will be bailed out in case of a crisis, which leads to market discipline not working. In the years before the Greek debt crisis, interest rates on Greek government bonds were no higher than the interest rates on bonds of countries with much lower debt levels. This has sometimes been interpreted as evidence that market discipline does not work. The above analysis, however, leads to a different interpretation. Investors knew and anticipated that there would be a bailout. Ultimately Greek government bonds were restructured, but by the time it happened most banks had already got their money back, meaning that the burden of the Greek default was partly borne by taxpayers in the rest of the Eurozone.

What does this imply for fiscal governance? Market discipline can only play a role if the threat is credible that private creditors will lose money if they lend to a country whose debt becomes unsustainable. This threat is credible if and only if a restructuring of debt is feasible without giving rise to prohibitive costs or risks. A key step to assure this is to change financial sector regulation, so that banks no longer hold large quantities of government bonds of the country where they reside, without underpinning these bonds with equity.[4] Although this reform has been debated for a long time, no progress has been made so far.

A second obstacle for market discipline to work is that, during the period of low inflation and zero interest rates, the ECB bought large quantities of national government bonds to stimulate the economy and raise inflation to the two-percent target value. A side effect of this policy is that the ECB has now become a large creditor of the Eurozone member states, a position

[3] The proposal has also been integrated into the comprehensive reform proposal for Eurozone governance by Bénassy et al. (2018).
[4] The Scientific Advisory Board of the German Federal Ministry of Finance (Wissenschaftlicher Beirat beim Bundesministerium der Finanzen 2010) made this point early during the Eurozone crisis.

that further increases the costs of debt restructuring. In principle, national governments could compensate the ECB for possible losses it takes if a debt restructuring occurs, but politically this would be very costly for them, because they would have to explain to their voters why they must shoulder part of costs of the default of other Eurozone countries. This takes us to the role of the ECB for Eurozone governance.

## THE ROLE OF THE EUROPEAN CENTRAL BANK

The framework for economic governance in the Eurozone needs to be seen in the context of how the ECB deals with fiscal difficulties of individual member states. Legally, the ECB is not allowed to finance governments or to engage in fiscal policy. However, drawing the line between monetary and fiscal policy in legal terms is difficult. From an economic perspective, it is natural to ask whether the ECB could and should act as a lender of last resort to national governments. For the reasons explained above, this is more difficult for the central bank of a currency union than for a national central bank. One of the risks involved in acting as a lender of last resort is that it is often difficult to distinguish clearly between situations where countries just need liquidity help, as opposed to situations where their debt is unsustainable.

In 2012, at the peak of the Eurozone Debt Crisis, the ECB effectively decided to position itself as a lender of last resort to governments by introducing the OMT program.[5] The ECB announced it would buy unlimited amounts of government debt of individual countries if necessary, provided that these countries participate in an adjustment program supervised by the European Stability Mechanism (ESM). The underlying idea was that the ESM procedures would make sure that the ECB will not buy government bonds of countries with unsustainable debt levels. Of course, given that the negotiation of an ESM program is a highly political undertaking, it is far from clear whether this safeguard would protect the ECB against being drawn into financing governments with unsustainable debt levels. However, the condition of an ESM program at least increased the cost for individual countries of relying on the ECB for fiscal policy support. Being shielded from market forces came at the cost of signing a program with political obligations in the form of complying with the conditions for a fiscal adjustment and economic reform program supervised by the ESM. The OMT program was never activated, but its existence alone created bailout expectations among investors, further weakening market discipline for fiscal policy.

Recently, the ECB took a further step and introduced the so-called Anti Fragmentation Instrument (AFI). It allows the ECB to buy bonds of individual member states if it thinks that interest rates in capital markets are out of line with economic fundamentals. Determining whether interest rates and risk premia reflect fundamentals is obviously largely arbitrary. But the key difference to the OMT program is that the countries receiving support no longer need to sign an ESM program to receive support. The AFI has therefore been criticized for shielding highly indebted Eurozone member states from both market forces and political obligations (Kronberger Kreis 2022).

Overall, the ECB has increasingly established itself as a fiscal actor in the Eurozone, taking over the role of a lender of last resort for governments with high debt levels.

## POLICY CONCLUSIONS

The economic governance framework in the Eurozone has the function to ensure that the member states pursue sustainable fiscal policies. Experience with European fiscal rules has shown that such rules cannot prevent countries from accumulating more debt if they want to. There is a tension between the idea of European fiscal supervision and the fact that national parliaments are ultimately responsible for fiscal policy.

Poor compliance with European fiscal rules would be less problematic if the costs of unsustainable fiscal policies were borne primarily by the countries pursuing such policies and by their creditors. This is the function of market discipline. But this is made difficult, among other things, by financial regulation that allows banks to hold large amounts of national government bonds. As long as this is the case, a restructuring of public debt will pose a threat to financial stability, undermining the credibility of the No-Bailout Clause and hampering the functioning of market discipline.

For the EU economic governance framework, the fact that the ECB increasingly positions itself as a fiscal bailout mechanism implies that the risk of short-term fiscal crises due to a collapse of confidence in capital market declines, which addresses one of the vulnerabilities of fiscal policy in a currency union. But this comes at the cost of a further weakening of fiscal discipline incentives.

Against this backdrop, a reform of economic governance should place emphasis on enhancing fiscal discipline and responsibility. Some elements of the reform proposal by the European Commission do have the potential to improve compliance with fiscal rules, in particular the idea that an excessive deficit procedure will be opened by default if countries stray from their agreed fiscal adjustment paths. However, other elements are likely to weaken the focus on fiscal sustainability, in particular the idea of allowing countries to incur more debt if their policies are aligned with EU political priorities.

[5] The ECB argued that this was an act of monetary policy intended to protect the transmission mechanism for monetary policy. This was never convincing.

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