NOVA SCHOOL OF BUSINESS & ECONOMICS

# SEMINAR IN EUROPEAN ECONOMICS

## THE STABILITY AND GROWTH PACT: RECENT REFORMS IN FISCAL RULES

### PRACTICAL CLASS 5

**2024-2025 S2**

# THE STABILITY AND GROWTH PACT: RECENT REFORMS IN FISCAL RULES

- Rationale for fiscal policy coordination in a monetary union
- Framework for fiscal policy coordination in the EU
- Assessment of efficacy of existent framework
- Recent reforms

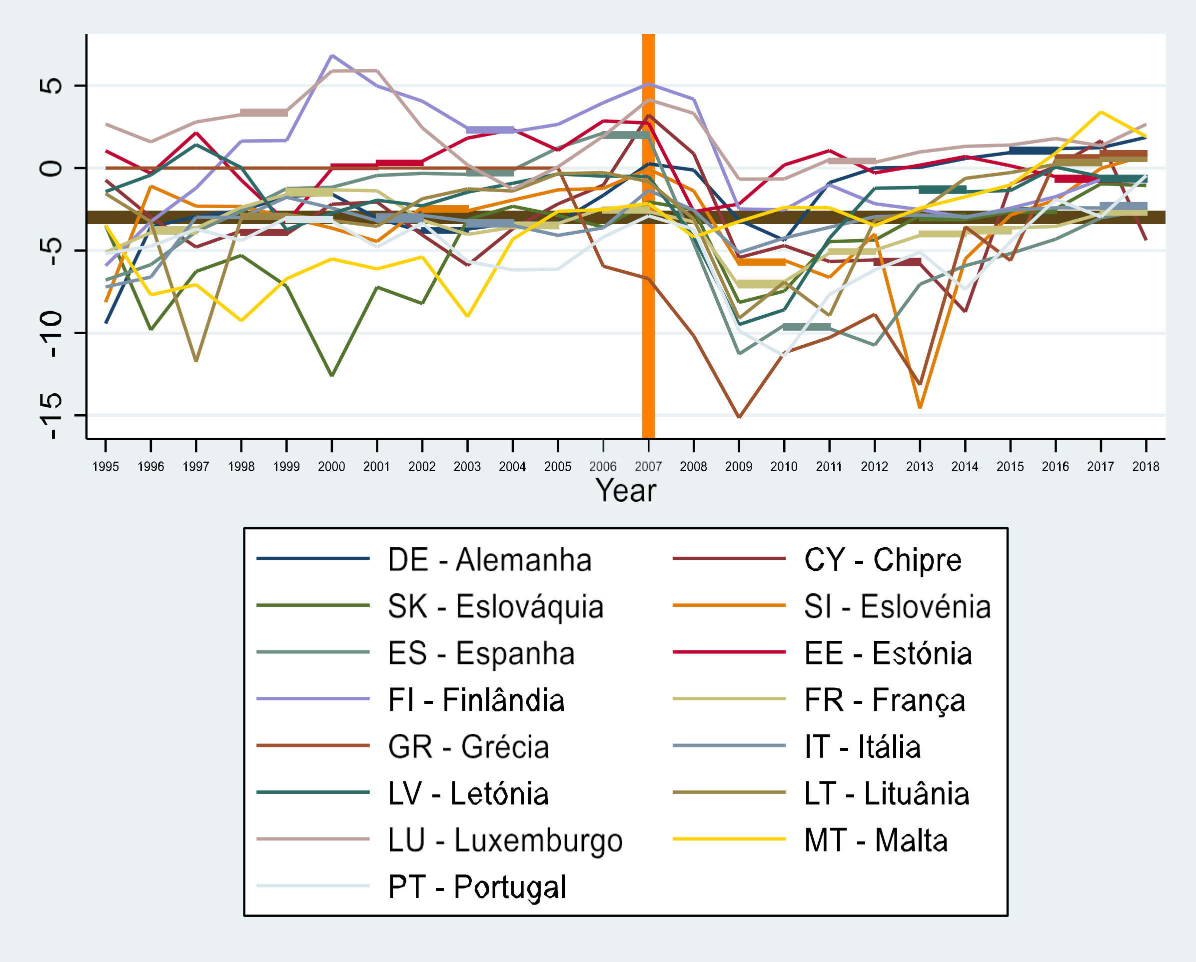
# RATIONALE FOR FISCAL POLICY COORDINATION IN A MONETARY UNION

- **Interaction between monetary and fiscal policy:**

  **Monetary and fiscal policy can interact in several ways:**

  **1) The lack of fiscal discipline can undermine the monetary policy goal of price stability**

  ..thereby, putting pressures on the common interest rate



## Selected fiscal indicators

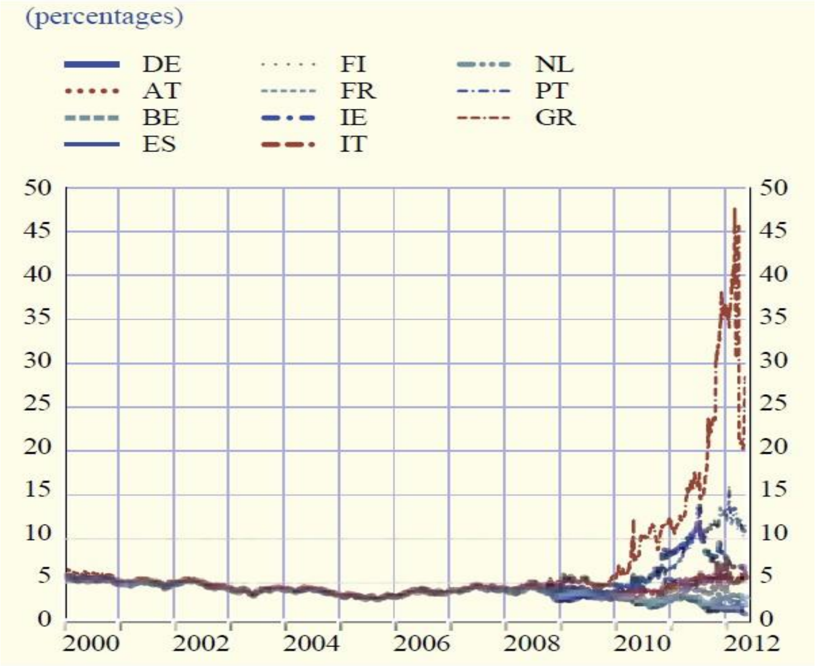
| | Fiscal balance to GDP ratio | | | | Government debt to GDP ratio | | | | Interest payments to GDP ratio | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1998 | Change 1998-2007 | Change 2007-2010 | 2011 | 1998 | Change 1998-2007 | Change 2007-2010 | 2011 | 1998 | Change 1998-2007 | Change 2007-2010 | 2011 |
| Belgium | -0.9 | 0.9 | -3.8 | -3.7 | 117.2 | -33.2 | 12.0 | 98.0 | 7.3 | -3.4 | -0.5 | 3.3 |
| Germany | -2.3 | 2.6 | -4.5 | -1.0 | 60.5 | 4.7 | 17.9 | 81.2 | 3.4 | -0.6 | -0.3 | 2.7 |
| Estonia | -0.7 | 3.1 | -2.1 | 1.0 | 6.0 | -2.3 | 3.0 | 6.0 | 0.5 | -0.4 | 0.0 | 0.1 |
| Ireland | 2.4 | -2.3 | -31.2 | -13.1 | 53.0 | -28.2 | 67.6 | 108.2 | 3.3 | -2.3 | 2.1 | 3.4 |
| Greece | -3.9 | -2.6 | -3.9 | -9.1 | 95.4 | 12.0 | 37.5 | 165.3 | 8.2 | -3.7 | 1.2 | 6.9 |
| Spain | -3.0 | 4.9 | -11.3 | -8.5 | 64.2 | -27.9 | 25.0 | 68.5 | 4.2 | -2.6 | 0.3 | 2.4 |
| France | -2.6 | -0.1 | -4.3 | -5.2 | 59.5 | 4.7 | 18.1 | 85.8 | 3.3 | -0.6 | -0.3 | 2.6 |
| Italy | -2.7 | 1.0 | -3.0 | -3.9 | 114.2 | -11.2 | 15.5 | 120.1 | 7.9 | -2.9 | -0.4 | 4.9 |
| Cyprus | -4.2 | 7.7 | -8.8 | -6.3 | 59.2 | -0.4 | 2.7 | 71.6 | 3.1 | 0.0 | -0.8 | 2.5 |
| Luxemburg | 3.4 | 0.3 | -4.5 | -0.6 | 7.1 | -0.4 | 12.4 | 18.2 | 0.4 | -0.2 | 0.2 | 0.5 |
| Malta | -9.9 | 7.6 | -1.4 | -2.7 | 53.4 | 8.8 | 7.2 | 72.0 | 3.2 | 0.1 | -0.3 | 3.1 |
| Netherlands | -0.9 | 1.1 | -5.3 | -4.7 | 65.7 | -20.4 | 17.6 | 65.2 | 4.7 | -2.5 | -0.2 | 2.0 |
| Austria | -2.4 | 1.5 | -3.6 | -2.6 | 64.4 | -4.2 | 11.7 | 72.2 | 3.6 | -0.8 | -0.1 | 2.6 |
| Portugal | -3.9 | 0.7 | -6.7 | -4.2 | 50.3 | 18.0 | 25.1 | 107.8 | 3.1 | -0.2 | -0.1 | 3.9 |
| Slovenia | -2.4 | 2.3 | -6.0 | -6.4 | 23.1 | -0.1 | 15.7 | 47.6 | 2.2 | -0.9 | 0.4 | 2.0 |
| Slovakia | -5.3 | 3.5 | -5.9 | -4.8 | 34.5 | -4.9 | 11.5 | 43.3 | 2.5 | -1.1 | 0.0 | 1.6 |
| Finland | 1.6 | 3.7 | -7.8 | -0.5 | 48.4 | -13.2 | 13.2 | 48.6 | 3.5 | -2.1 | -0.4 | 1.1 |
| Euro area | -2.3 | 1.6 | -5.6 | -4.1 | 72.8 | -6.5 | 19.2 | 88.0 | 4.5 | -1.6 | -0.2 | 3.1 |

Sources: European Commission and the European Commission's European Economic Forecast – spring 2012.
Notes: 1998 and 2011 levels are expressed as a percentage of GDP. The changes over the periods 1998-2007 and 2007-10 are expressed in percentage points. Regarding changes in the fiscal balance-to-GDP ratio, a positive (negative) figure reflects an improvement (deterioration) in the fiscal balance.

## 2) The lack of fiscal discipline affects sovereign risk and countries' risk premiums

- The lack of a clear framework for crisis management makes it difficult to prevent contagion.

**Chart 3 Yields on ten-year government bonds in selected euro area countries**



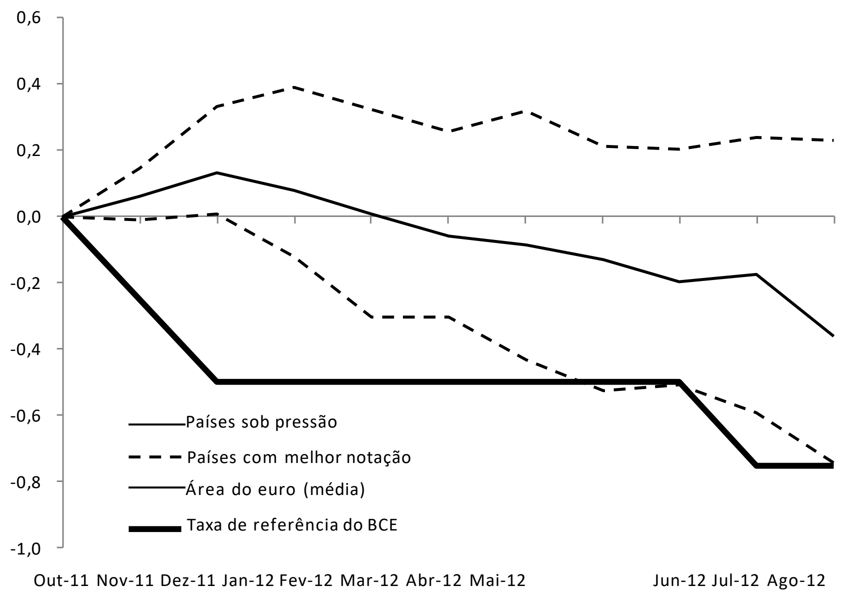

Source: Thomson Reuters Datastream.
Note: The latest observation is for 22 May 2012.

# 3) The lack of fiscal policy affects the management of monetary policy

- Volatile and illiquid sovereign bond market affects the transmission mechanism of monetary policy

- Market segmentation (different risk premia across countries) makes it difficult to target policies to improve financing conditions in more vulnerable countries

Interest rates: ECB interest rate and interest rate to new loans to NFCs




Fontes: BCE e cálculos do Banco de Portugal.

- The different levels of interaction among fiscal and monetary policies and …
- …. the fact that in the monetary union there are several fiscal authorities and only one monetary policy

➢ **creates a rationale for setting a framework for fiscal policy coordination**

# FRAMEWORK FOR FISCAL POLICY COORDINATION IN THE EU

- **Maastricht Treaty**: rules concerning prohibition of direct financing from the ECB to EU member states or pub. administration; Maastricht criteria
- **The Stability and Growth Pact (SGP):** set of rules designed to ensure that countries in the European Union pursue sound public finances and coordinate their fiscal policies.

**Preventive arm**

- The rules of the SGP's 'preventive arm' bind EU governments to their commitments towards sound fiscal policies and coordination.
- 'Stability programme' (euro area)/'Convergence programme' (other EU countries): define budgetary targets and measures to ensure the attainment of these goals. These programmes are assessed by the European Commission

**Corrective arm**

- The Excessive Deficit Procedure (EDP) ensures the correction of excessive budget deficits.
- An excessive budget deficit is defined as one greater than 3 % of GDP.
- If not corrected the EDP can give rise to the payment of sanctions by the country

# ASSESSMENT ON THE EFFICACY OF EXISTING FRAMEWORK

## Framework has been undermined by weak enforcement

- **Lack of automatism of Excessive Deficit Procedures**
  - ❑ Requires assessment by the Commission, taking into account medium term economic scenario, external conditions, evolution of medium term budgetary situation and policies or reforms taken;
  - ❑ Recommendation to correct situation/recommendation to sanction requires approval by the Council – may be compromised by **countries' interests**.

- **Exceptional circumstances can justify the lack of Excessive Deficit Procedures:** exceptional circumstances never clearly specified (recession; temporary character of deficit)

- **Statistics and accounting difficulties** – undermines assessment of deficit

## Reforms since the international financial crisis:

**Fiscal Rules**

- 'Six pack', two pack 'fiscal compact'
- Treaty on the stability, coordination and governance in the Economic and Monetary Union (TSCG)

**European Stability Mechanism** (ESM): an international organisation, to act as a permanent source of financial assistance for member states in financial difficulty. (It replaced two earlier temporary EU funding programmes: the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM).

## Measures under the six-pack

- bring the surveillance of fiscal and economic policies **under the European Semester,** to ensure that the policy advice given to Member States is consistent;
- **introduce an expenditure benchmark, linked to a country's medium-term budgetary objective (MTO), that places a cap on the annual growth of a country's expenditure – based on structural measures;**
- enhance country surveillance, through examining not only countries with current account deficits, **but also those with current account surpluses;**
- permit the excessive deficit procedure to be opened on the **sole basis of the debt criterion (60% of GDP);**
- **introduce a macroeconomic imbalance – go beyond fiscal variables**;
- Impose graduated financial sanctions, which may eventually reach 0.5% of GDP.

# RECENT REFORMS ON FISCAL FRAMEWORK

**Preventive arm**:

- Balanced budget Rule: structural fiscal balance > - 0.5% of GDP(or > - 1% of GDP if Public Debt ratio <60%)
- Medium term objectives (MTO) are defined in structural terms.

**Corrective arm:**

- According to the amended SGP, an EDP is triggered by the deficit criterion or the debt criterion:
  - Deficit criterion: A general government deficit is considered to be excessive if it is higher than the reference value of 3% of GDP at market prices; or
  - Debt criterion: debt is higher than 60% of GDP and the annual debt reduction target of 1/20 of debt differential has not been achieved over the last three years.

- Greater automatism in the correction of departure from MTO (constitution of deposit) and in the imposition of sanctions.
- Council votes by reversed qualified majority (for EDP with respect to deficit)
- Transposition of the balanced budget rule to national law (Constitution level)
- Reinforcement of policy surveillance and coordination

**FOR DISCUSSION**

How do you assess the interplay between fiscal and monetary policies in a monetary union?

- ***Without the possibility to devaluate the currency, fiscal policy is the main corrective measure at the national level***
- ***Expansionary fiscal policies can create inflationary pressures which can undermine the stability of the monetary policy***
- ***Build-up of public debt which cannot be directly financed by the monetary authority***

**FOR DISCUSSION**

It is widely acknowledged that the fiscal policy is an important stabilization tool in any economy but is has proven to be difficult to manage it in the EU.

a) What is currently the setup for the management of fiscal policy for EU member-countries?

- ***There is no common fiscal policy, just a common framework***

- ***The Stability and Growth pact has both a preventive (warning mechanisms for the countries) and corrective arm (penalties when rules are broken) - 3% Deficit and the 60% Debt***

- ***The corrective arm aims that countries adopt certain fiscal policies, particularly trough the Excessive Deficit Procedure***

- ***Reform of the stability and growth pact after the last financial crisis***

## FOR DISCUSSION

b) What have been the problems and which fiscal challenges presently remain?

- ***Many countries violated the rules implied by the SGP, which lead to a debt crisis after the financial crisis***
- ***This increased the risk within the euro area with common monetary policy but without automatic fiscal transfers***
- ***Reforms have been made to SGP – Six pack, Two pack - Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union***
- ***European Stability Mechanism (for discussion next class)***
- ***Although the renewed framework has not yet been sufficiently tested, it does not seem to have a strong enforcement mechanism, thus maintaining initial fragilities.***
- ***Furthermore, EU's fiscal rules were lifted to face the current pandemic crisis.***

**FOR DISCUSSION**

c) Why has the supervision of macroeconomic imbalances in the EU countries enlarged beyond the fiscal aggregates?

- ***High levels of debt and current account deficits beyond the sudden stop lived during the crisis***
- ***It increased the need to look to wider set of variables, not just fiscal ones – to make sure that countries meet their fiscal targets in the medium run***
- ***This resulted in the creation of the Macroeconomic Imbalance Procedure (for discussion next class).***

# RECENT REFORMS IN FISCAL RULES

## Reform's overall objectives:

- reduce debt ratios and deficits in a gradual, realistic, sustained and growth-friendly manner;
- while protecting reforms and investments in strategic areas such as digital, green or defence;
- At the same time, the new framework will provide appropriate room for counter-cyclical policies and help address existing macroeconomic imbalances.

## National medium-term fiscal structural plan:

- Under the new rules, all member states will be asked to prepare a **national medium-term fiscal structural plan** that **spans over 4-5 years**, depending on the length of the national legislature.
- In their plans, member states commit to a multi-year public net expenditure path and explain how they will deliver investments and reforms that respond to the main challenges identified in the context of the European Semester, in particular in the **country-specific recommendations**.
- Ahead of this, the Commission will submit a **'reference trajectory' for net expenditure developments** to member states where government debt exceeds the 60% of gross domestic product (GDP) or where the government deficit exceeds the 3% of GDP.

# RECENT REFORMS IN FISCAL RULES

**Safeguards:**

The new rules contain **two safeguards** that the reference trajectory **must comply with**:

- a debt sustainability safeguard, to ensure a minimum decrease in public debt levels and
- a deficit resilience safeguard, to provide a safety margin below the Treaty public deficit reference value of 3% of GDP, in order to create fiscal buffers.

The member states will incorporate a net expenditure path into their national medium-term fiscal structural plans.