

# Fiscal adjustment supports the fight against sticky inflation





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## **Abstract**

Fiscal policy becomes less potent in affecting output in an inflationary environment. As the economy nears full employment an increasing part of any fiscal stimulus either crowds out other expenditure or leads to higher prices. This reinforces the case for an accelerated reduction in deficits, especially through the termination of energy subsidies that are no longer appropriate as energy prices have returned to pre-war levels.

An unintended (but predictable) consequence of the past bond buying schemes of the ECB (PSPP and PEPP) is that the net income of the Eurosystem is likely to fall by about EUR 70–80 billion, or 0.5–0.6 % of GDP, making the fiscal adjustment harder.

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## LIST OF ABBREVIATIONS

<b>ECB</b>	European Central Bank
<b>EMU</b>	Economic and monetary union
<b>PEPP</b>	Pandemic emergency purchase programme
<b>PSPP</b>	Public sector purchase programme
<b>SGP</b>	Stability and Growth Pact
<b>TLTRO</b>	Targeted longer-term refinancing operations
<b>QE</b>	Quantitative easing

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## EXECUTIVE SUMMARY

- **Fiscal policy in the euro area is still projected to be slightly expansionary, with the structural primary balance remaining in deficit (1 % of GDP in 2023 and projected to be 1.5 % in 2024).** This is about 2 percentage points below the surplus of 1 % of GDP in 2018.
- **The pre-pandemic benchmark is approximately equivalent to the requirement to put debt levels on a sufficiently declining path, as required by the proposed new governance rules.**
- **Accelerating the move towards this benchmark would make a material contribution to bringing inflation back under control.**
- **Fiscal policy adjustment should be less costly in terms of lost output or higher unemployment than during the period of low inflation, because any increase in demand will lead to higher interest rates, which will crowd out other expenditure.**
- **Moreover, a key economic parameter, the Phillips curve, is likely to have become steeper, implying that any small reduction in output might lead to a large reduction in inflation.**
- **Lowering inflation is not the primary aim of fiscal policy, but at the present junction fiscal retrenchment will support monetary policy. An acceleration of the primary balance reduction planned for 2024 would thus be appropriate.**
- **The ECB's quasi-fiscal operations (i.e. the public sector purchase programme and the pandemic emergency purchase programme) are now having unintended fiscal consequences, as the Eurosystem is likely to incur considerable losses that will ultimately have to be borne by national treasuries, creating a substantial fiscal headwind.**
- **The sharp increase in the volatility of interest rates over the last few years, which is likely to continue, suggests that it will not be sufficient to set a path for net primary expenditure to reliably achieve the desired reduction in debt ratios.** This uncertainty about the path for the debt ratio is particularly high for highly indebted countries, i.e. those for which a reduction in the debt ratio is most important.



## 1. INTRODUCTION

The ongoing discussion about reforms to the economic governance framework coincides with the emergence from a double crisis and a sea change in the conditions under which fiscal policy impacts the economy.

Fiscal policy has been in crisis-related challenges since 2020, with the rules of the Stability and Growth Pact (SGP) suspended first because of the COVID-19 crisis and then because of a sharp peak in the energy crisis following Russia's invasion of Ukraine. With energy prices back to pre-war levels and the economy having recovered from the COVID-19 recession, one can no longer argue that extraordinary circumstances require large deficits. As Thygesen et al. (2023) argue, 'it is time to put the fiscal toothpaste back in the tube'<sup>1</sup>.

Of course, the average deficit numbers hide large differences across member countries and a return to the status quo ante is not necessarily the main argument for why the present level of deficits is not appropriate. Under the existing rules, Member States would have to start reducing debt levels in 2024 by one twentieth of the distance to the 60 % of GDP reference value. Under the proposed new rules, the required adjustment still be substantial for at least some cases. The Commission has not published the parameters it would suggest to individual Member States under its own proposal, but existing simulations (Zettelmayer et al., 2023) indicate that just to stabilise the debt ratio, highly indebted countries like Italy and Spain would have to improve the primary balance over and above the value planned for 2024 by over 1 point of GDP. The more relevant comparison for macroeconomic policy is with the 2023 value. If the aim is to reduce the debt ratio by at least 1 percentage point annually, the required adjustment relative to 2023 would rise to over 3 percentage points for Italy and Spain. Even Germany would then have to reduce its primary deficit by about 1% of GDP<sup>2</sup>.

Debt levels have diverged over the past decade, with approximately half of all euro area countries keeping their debt-to-GDP ratios below or close to the 60 % reference value. These countries would not be required to reduce their deficits, but many of them are doing so anyway. The result is that the average fiscal contraction of the euro area as a whole would still amount to close to 2 % of GDP, close to what it was in the years immediately before the COVID-19 period.<sup>3</sup>

These adjustments will not be required immediately. Under the proposed new fiscal rules, the overall adjustment is likely to be spread over several years.

But the environment for fiscal policy is now very different from the pre-COVID-19 period. The gradual adjustment rules of the past (about a 0.5 percentage point annual reduction in the deficit) may thus no longer be appropriate. There are two related reasons why the trade-offs facing fiscal policy have changed.

First of all, interest rates are no longer glued to the lower bound. In the standard IS-LM framework used to analyse the effectiveness of fiscal policy, this implies that the impact of a fiscal adjustment on output should be smaller because it will be partially offset by the negative impact of higher interest rates on investment and other interest-sensitive expenditure.

Second, there is evidence that the relationship between unemployment and inflation has changed. Some researchers find that the slope of the Phillips curve has increased, implying that even a relatively small impact of a fiscal retrenchment might have a significant impact on inflation.

<sup>1</sup> See <https://cepr.org/voxeu/columns/putting-fiscal-toothpaste-back-tube-its-time-normalise-euro-area-fiscal-stance-2024>

<sup>2</sup> See <https://www.bruegel.org/policy-brief/longer-term-fiscal-challenges-facing-european-union>

<sup>3</sup> [https://www.consilium.europa.eu/media/65609/2023-06-21-efb-assessment-of-euro-area-fiscal-stance-final\\_0.pdf](https://www.consilium.europa.eu/media/65609/2023-06-21-efb-assessment-of-euro-area-fiscal-stance-final_0.pdf)

Taken together, these two effects imply that the output cost of the fiscal adjustment required to return to the pre-COVID-19 stance, which had put the debt ratio on a slowly declining path, should be relatively small, but could still have a significant impact on inflation.

It follows that fiscal and monetary policy should now move in the same direction. However, the required fiscal adjustment may be larger than appears at first sight because of the unintended costs of the ECB's past quasi-fiscal operations of the ECB (the public sector purchase programme (PSPP) and pandemic emergency purchase programme (PEPP)).

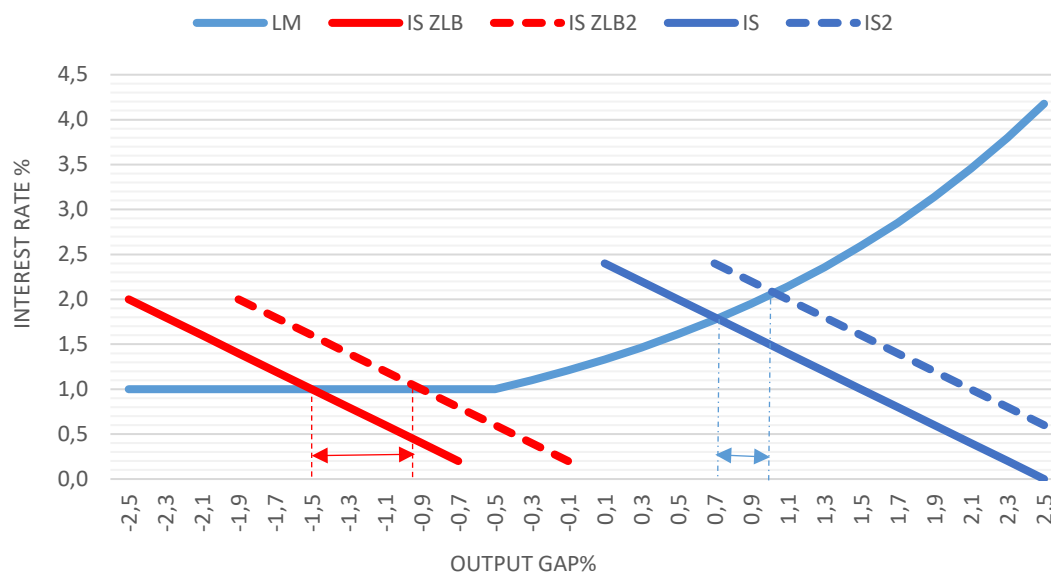
The remainder of this contribution is organised as follows: Section 2 shows why the transition away from a 'low-for-long' period should reduce the multipliers, i.e. reduce the potential output cost of a fiscal adjustment. Section 3 discusses the recent evidence that the Phillips curve has become steeper. Section 4 provides some illustrative calculations of the fiscal cost of the ECB's past bond buying in the new environment of normalised interest rates. Section 5 concludes.

## 2. FISCAL POLICY AWAY FROM THE LOWER BOUND

### 2.1. A simple framework

During the low-for-long period, when interest rates were stuck at the lower or zero bound, fiscal policy seemed to have become the main countercyclical instrument. The usual argument that a higher deficit leads to higher interest rates, which then crowd out other expenditure, no longer seemed to hold. In the standard, if dated, IS-LM framework that economists often use to describe the impacts of fiscal and monetary policy, this corresponds to the situation depicted below, a very flat (horizontal) LM curve. Figure 1 illustrates this using an LM curve that is horizontal for large negative values of the output gap.

**Figure 1.** IS LM illustration



Source: Authors' own elaboration.

Note: Output gap is the difference between actual GDP and potential GDP. The arrows illustrate the change in the output gap after IS curve shift, from IS ZLB to IS ZLB2, and from IS to IS2.

A fiscal expansion, i.e. a higher deficit, would shift the IS curve to the right. It is apparent that when the economy is at or close to the zero/lower bound, a fiscal expansion has a greater impact on output than when the economy is far away from the zero lower bound (ZLB). This is shown in Figure 1, which depicts a (horizontal) shift in the IS curve of the same amount for these two cases.

## 2.2. Empirical estimates of changing multipliers

There have been extensive efforts to estimate the size of fiscal multipliers in different circumstances (see de Rugy and Salmon (2022) for an exhaustive survey of multiplier estimates over the last two decades). Some contributions distinguish between the multiplier effect of different fiscal instruments such as government spending, taxes and transfers (Forni et al., 2009; Eggertsson, 2009; Coenen et al., 2012, Barrell et al., 2012). Several studies have investigated the cyclical variation of fiscal multipliers (Berge et al., 2021).

Following the prolonged period of low interest rates, a large body of literature has discussed the impact of fiscal policy during episodes of zero/lower bound nominal interest rates. Consistent with theories, many find a larger value of the government spending multiplier with interest rates at the zero/lower bound than in normal times (to name a few, see Christiano et al., 2010; Klein and Roland Winkler, 2019; Di Serio et al., 2020).

The use of asset purchases and other non-standard policy instruments led to a situation (mostly in advanced economies, including the euro area) that has been called a persistent 'liquidity trap', where the further monetary expansion no longer stimulated the economy and fiscal policy became the main countercyclical instrument (Gopinath, 2020).

More recent analyses based on state-of-the-art macroeconomic models confirm the higher effectiveness of fiscal spending in boosting economic activity in a liquidity trap (Michau, 2019; Lemoine and Lindé, 2023). During the COVID-19 pandemic, interest rates remained at the lower bound (and central banks intensified the use of expansionary non-standard policies, but the massive fiscal stimulus packages deployed by governments did not seem to have a major effect on output. This was to be expected given the sectoral nature of the COVID-19 recession and recovery (Capolongo and Gros, 2020)<sup>4</sup>.

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<sup>4</sup> See [https://www.europarl.europa.eu/cmsdata/211390/2\\_CEPS%20final.pdf](https://www.europarl.europa.eu/cmsdata/211390/2_CEPS%20final.pdf)

### 3. A STEEPER PHILLIPS CURVE?

The Phillips curve theory suggests a trade-off between the rate of change of wages (and prices) and the employment level. The theory was first introduced by William Phillips in 1958 based on empirical observations of wages and unemployment in the UK, where he identified an inverse relationship between the two variables. The underlying intuition is that when the economy is experiencing a period of strong growth and there is a high demand for labour (unemployment is very low), wages tend to be bid upward rather rapidly, pushing firms to increase prices, and vice versa (Phillips, 1958).

The occurrence of stagflation in the 1970s, with high levels of both inflation and unemployment, however challenged the validity of the original Phillips curve concept and motivated the refinement of the theory over time. Lucas (1972) proposed the new classical version of the Phillips curve incorporating the role of rational expectations into the analysis. Keynesian economists of the 1960s exploited the concept of the Phillips curve, reasoning that policymakers could reduce unemployment by accepting higher inflation or vice versa. Lucas argued that if policymakers attempt to exploit the Phillips curve trade-off by creating surprise inflation, individuals would adjust their behaviour and factor in the expected inflation. As a result, any short-term reduction in unemployment achieved through surprise inflation would be temporary, leading to higher inflation expectations and no long-term reduction in unemployment, resulting in a breakdown of the Phillips curve relationship.

The relationship between inflation and unemployment has become more complex over time in view of the strength of the labour market. Historically low unemployment, and core inflation remaining persistently below the target preceding the COVID-19 crisis led to a discussion about whether the link between output or unemployment and inflation had disappeared. Mishkin et al. (2019) thus asked whether the Phillips curve was dead<sup>5</sup>. In the euro area, the ECB examined over 500 specifications of the Phillips curve in 2019 using different measures of inflation (wages, core, headline, etc.) and different slack measures (output gap, unemployment, etc.) and arrived at the conclusion that the Phillips curve was alive<sup>6</sup>.

Using regional data from the US, Mishkin et al. (2019) reported that in tight labour markets the Phillips curve may be subject to important nonlinearities. Also, Hooper et al. (2020) suggested an emergence of nonlinear dynamics in the Phillips curve. This implies that the relationship between inflation and unemployment may not be a simple linear trade-off, as suggested by the original Phillips curve theory (Hooper et al., 2020).

#### 3.1. The renaissance of the Phillips curve

The pandemic entailing significant supply and demand shocks with the corresponding unprecedented monetary and fiscal policy responses – introduced new dynamics and challenges to the applicability and predictability of the traditional Phillips curve, as a consequence of higher inflation expectations, supply shocks and structural changes (Ari et al., 2023). So the linear Phillips curve with anchored expectations failed to predict the surge in inflation following the pandemic (Gopinath, 2022).

The key issue for the ECB at present is not so much whether a fiscal adjustment would have a large impact on output, but whether it would have a large impact on inflation. This in turn depends on the

<sup>5</sup> See <https://cepr.org/voxeu/columns/phillips-curve-dead-or-alive#:~:text=Figures%20and%20%20show,inflation%20to%20tight%20labour%20markets>

<sup>6</sup> See [https://www.ecb.europa.eu/pub/economic-bulletin/articles/2019/html/ecb.ebart201904\\_02~d438b3e4d4.en.html#toc5](https://www.ecb.europa.eu/pub/economic-bulletin/articles/2019/html/ecb.ebart201904_02~d438b3e4d4.en.html#toc5)

relationship between output or employment and wages (Schanbel, 2023). A key question is whether the slope of the Phillips curve has increased (again) over recent years.

The present combination of high inflation and low unemployment suggests that the Phillips curve is not dead (Baba et al., 2023). Moreover, unemployment has declined only marginally over the last year, while inflation has shot up and remained high despite now-falling energy prices. This suggests that the slope of the Phillips curve may have increased, implying that even a relatively small change in demand could have a significant impact on inflation. Even a small negative impact of fiscal adjustment on demand could provide considerable support for the ECB's fight against inflation.

More recently, Chai Dao et al. (2023) present further evidence of nonlinearities in the slope of the Phillips curve. They measure the Phillips curve as the unemployment-inflation trade-off, which is slightly different from the growth-inflation relationships used in the ECB's evaluations. They argue that the slope of the euro area curve has roughly doubled relative to the pre-pandemic years. The increase in the slope of the US curve is even greater. An important aspect of their findings is that one should use the pre-2019 estimates as a benchmark rather than the 2022 estimates.

Chai Dao et al. (2023) report the following results:

“the slope of the US relation is about  $-0.3$  at 8 percent unemployment but steepens to  $-2$  at 3.5 percent unemployment. ... The euro area might have a similarly steep part of the curve, but this remains uncertain as there has not yet been sufficient overheating to reveal it. A further implication is that policy tightening that cools demand can potentially achieve larger inflation reductions in a more overheated economy.”

One important use of the Phillips curve is in forecasting inflation – a key issue for the ECB. Its own analysis (Bańbura and Bobeica, 2020) concludes that some specifications of the Phillips curve could help forecast inflation, potentially also including nonlinear aspects<sup>7</sup>.

Taking into account today's probably much larger impact of a slowing economy could be important for the ECB in calibrating its own policy.

### 3.2. Can fiscal policy shift the curve?

Most modern economic models do not treat the Phillips curve as a simple relationship between some measure of inflation and some measure of economic slack. A key third ingredient is the expected inflation rate. Actual inflation is thus understood as the result of two elements, namely expected inflation and the degree of economic slack (e.g. the unemployment rate). Various models and approaches differ mainly in terms of what determines expectations of inflation. We do not want to enter into this debate of rational versus adaptive, versus static expectations<sup>8</sup>.

The evidence presented in the previous subsection on the slope of the Phillips curve referred to the magnitude of the impact of a change in unemployment on inflation, given inflation expectations.

There is also some evidence that fiscal policy may influence inflationary expectations and shift the curve. This could mean that contractionary fiscal measures may reduce the expectations of inflation by firms and households (at any given level of economic slack) and indirectly curb inflationary pressures to a significant extent. Łyziak and Mackiewicz-Łyziak (2020) find that economic agents reduce their inflation expectations in response to a more sustainable fiscal policy. Similarly, Grigoli and Sandri (2023) find that high public debt has stagflationary effects, with weaker economic activity and

<sup>7</sup> See <https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2471~fc87caada8.en.pdf>; for the US see [https://www.nber.org/system/files/working\\_papers/w31197/w31197.pdf](https://www.nber.org/system/files/working_papers/w31197/w31197.pdf)

<sup>8</sup> For a very recent discussion, see a long blog post by J. Cochrane <https://johnhcochrane.blogspot.com/> (28 August 2023).

higher inflation. Increasing government spending and higher interest rates on sovereign debt have a similar effect according to Coibion and Weber (2021). The inflation expectations channel and the pass-through from fiscal policy to inflation, have also been documented based on a natural experiment (D'Acunto et al., 2016).

The evidence that in some circumstances a fiscal policy that becomes more sustainable shifts the curve is still tentative. If confirmed, it would provide another argument to accelerate the reduction in deficits.

## 4. THE FISCAL COST OF CENTRAL BANK BOND BUYING

When inflation and interest rates increase, central banks ordinarily profit because they pay no interest on cash and have investments whose yields rise along with interest rates. This is known as seigniorage income, which ultimately accrues to national treasuries. In recent decades, the ratio of cash holdings to GDP has grown in most countries<sup>9</sup>, thereby increasing the base for seigniorage. For example, in the euro area, the amount of currency in circulation – almost EUR 1 600 billion<sup>10</sup> – is now worth about 12 % of GDP. At the present deposit rate, the ECB (the Eurosystem, to be precise) should be earning at least 3.75 % on the assets that are the counterpart of this EUR 1 600 billion. Its seigniorage revenue should therefore be EUR 60 billion, or 0.45 % of GDP. For the US, the theoretical seigniorage revenue is similar as a proportion of GDP because the policy rate is higher, although the cash-to-GDP ratio is somewhat lower at 9 %. On the over USD 2 200 billion outstanding, the Fed should now be earning 5.5 %, resulting in seigniorage revenues of USD 120 billion, or about 0.5 % of GDP<sup>11</sup>.

But this time is different. Central banks are now taking losses from the large amounts of bonds they have bought over the past nearly 10 years of low inflation. Central banks bought long-term bonds during their various quantitative easing (QE) operations because they wanted to alleviate private investors from the interest rate risks inherent in holding long-term bonds. The stock of bonds on the balance sheets of central banks is generally low yield and long term.

For this part of their balance sheet, the impact of rising rates on central bank accounts is the opposite of that of seigniorage: as policy rates rise, central banks must pay more on their liabilities to banks than they earn on the stock of bonds.<sup>12</sup>

When the stock of bonds held under QE is larger than the cash in circulation (which is the case for most large central banks that engaged in QE), these losses are larger than the seigniorage revenues, leading to unprecedented overall losses for the central banks concerned. If one wants to calculate the impact of higher interest rates due to past QE, one should look at the change in the net revenues of central banks.

The deterioration of the profit and loss accounts of the major central banks is impressive.

In the US, the quarterly net income of the Federal Reserve went from a profit of USD 32 billion in Q1 2022 to a loss of USD 28 billion in Q1 2023, a reduction of USD 60 billion per quarter or USD 240 billion annually, which is equivalent to about 1 % of US GDP.<sup>13</sup>

In the UK, the losses for the Bank of England will be particularly severe because the cash-to-GDP ratio in the UK is only 4 % and the accumulated bond purchases amounted to about 40 % of GDP by the end of 2023. Accordingly, the Bank of England will need transfers from HM Treasury of about GBP 40 billion, or around 2 % of GDP, as long as interest rates remain at their present levels.

The Bank of England also provides an estimate of the total cumulative fiscal cost of its QE operation, including past gains, which of course depends on future interest rates<sup>14</sup>. The estimates range from

<sup>9</sup> As an aside, one should note that this fact is difficult to reconcile with the widely-held proposition that cash is disappearing, which constitutes one of the key arguments for the digital euro project of the ECB.

<sup>10</sup> [https://www.ecb.europa.eu/stats/policy\\_and\\_exchange\\_rates/banknotes+coins/circulation/html/index.en.html](https://www.ecb.europa.eu/stats/policy_and_exchange_rates/banknotes+coins/circulation/html/index.en.html)

<sup>11</sup> Authors own calculations.

<sup>12</sup> Gros (2016) shows that one could consider QE operations as the investment arm of central banks, with all the attendant risks involved.

<sup>13</sup> Federal Reserve Banks Combined Quarterly Financial Report, <https://www.federalreserve.gov/aboutthefed/files/quarterly-report-20230818.pdf>

<sup>14</sup> For an independent source of the cost of QE, see <https://www.niesr.ac.uk/news/ongoing-costs-quantitative-easing>



over GBP 100 billion to GBP 200 billion, or between 5 % and 10 % of UK GDP. Over the next 3 years, the Bank expects transfers from HM Treasury of GBP 40 billion, or close to 2 % of UK GDP.<sup>15</sup>

For the euro area, the accounts of the ECB and those of the 20 national central banks that conduct the euro area's monetary policy are too opaque to provide a similarly simple indication of the fiscal cost of (past) bond buying, but the overall numbers lead to a similar result: holding bonds worth close to a third of GDP that yield nearly nothing will lead to a cost of about 1 % of GDP when the ECB has to pay banks 3.75 % to hold their excess reserves (Gros and Shamsfakhr, 2022).

The loss to the Eurosystem as a whole will be smaller than this amount, because 40 % of this loss will be offset by the increased seigniorage revenues mentioned above, but 0.6 % of GDP is still relevant, corresponding to the annual adjustment effort required under the (old) fiscal rules. Furthermore, the ECB has recently lowered the interest it pays on required reserves to zero.<sup>16</sup> This will have only a small impact on the losses of the Eurosystem, but shows what steps the ECB is taking to reduce losses.

What is more, the ECB and many national central banks have large reserves that can now be used to offset some of these losses and spread them over time. However, these accounting adjustments do not change the underlying fact that the national central banks in the euro area, which receive the bulk of the so-called monetary income, will have to reduce or even stop their transfers to national treasuries for some time.

Table 1 below shows in the first column the net income, or rather the expected loss, of the three major central banks in 2023. The second column then shows the change in the net income between 2022 and 2023. This difference reveals the loss incurred by the existing stock of low-yielding government debt on the balance sheets of these central banks. As argued above, an increase in inflation should normally lead to higher central bank profits. But massive QE has completely reversed this.

**Table 1:** Income/losses of QE- major central banks (% GDP)

	Absolute loss 2023	Change in income from 2022 level (p.p.)
US Federal Reserve	0.5	1.0
Bank of England	1.9	1.9
Eurosystem	0.7	0.6

Source: Own calculations based on ECB, BoE and Federal Reserve data.

Note: The forecast for euro area GDP in 2023 is taken from the European Commission.

The losses for the Eurosystem would be even larger had the ECB not made an unprecedented unilateral change to the terms of its long-term lending in late 2022. Back in 2020, the ECB wanted to entice banks to take up its 'targeted long-term operations' (TLTRO) by promising them a rate of minus 1 % if banks expanded their loan books. This seemed aggressive, but barely justifiable, when inflation hovered close to zero and no end seemed in sight for the negative interest rate policy. Yet, by late 2022, with inflation out of control and the ECB needing to raise its own rates quickly, the cost of this

<sup>15</sup> Asset Purchase Facility Quarterly Report - 2023 Q2, <https://www.bankofengland.co.uk/asset-purchase-facility/2023/2023-q2>

<sup>16</sup> <https://www.ecb.europa.eu/press/pr/date/2023/html/ecb.pr230727~7206e9aa48.en.html>

promise had become clear. The ECB then simply decided to unilaterally change the terms on the TLTROs, arguing that this "drastic change in circumstances could not have been foreseen".<sup>17</sup>

The cost estimates presented here can only be approximations of the order of magnitude, as the exact details of the holdings are not known. The key point is that, as the stock of PSPP and PEPP holdings will diminish only in homoeopathic doses, these costs are likely to continue for as long as the ECB keeps interest rates at current levels (Gros and Shamsfakhr, 2023).

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<sup>17</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32022D2128>

## 5. MONETARY POLICY AND THE (NEW?) ECONOMIC GOVERNANCE FRAMEWORK

Before entering into a discussion of the Commission proposals for a new economic governance framework, it is useful to consider the history of the euro area's fiscal rules.

The basis of the Maastricht consensus was that monetary policy would be unified only through EMU and that the ECB would aim solely at price stability as its overarching mandate. The purpose of the fiscal rules first enshrined in the Maastricht Treaty was mainly to prevent "gross errors" and to avoid pressure on the ECB from highly indebted countries. This was also the main reason why the deficit and debt "reference values" were included in the Treaty. These fiscal rules represent the only link between fiscal and monetary policy. Sound public finances facilitate a monetary policy that can pursue price stability without having to fear financial instability arising from the debt problems of individual Member States.

The SGP operationalised the meaning of "reference values" for fiscal policy oversight after the start of EMU in 1999. The Pact specified that Member States should aim for a balanced budget on average over the cycle. The purpose was to allow countercyclical policies in a recession, when the fiscal deficit could move from balance to a maximum of 3% of GDP. The 3% limit, which was lower than the actual value at the time of the negotiations in Maastricht, was chosen because it was thought that it would only be reached in the event of a very deep recession. With an elasticity of the deficit relative to growth of about 0.5, growth would have to fall by 6 percentage points below trend before countries would see the deficit increase above 3% of GDP – provided of course that they started from a balanced budget in cyclically normal times.

In addition, the SGP introduced an escape clause ("exceptional circumstances") that allowed larger deficits in the event of a severe downturn. To ensure compliance with these rules, the Pact created an elaborate "excessive deficit procedure" with a number of escalation stages, finally including fines for Member States that persistently run excessive deficits.

As is well known, the SGP did not survive contact with reality. (Most) Member States did not run balanced budgets in favourable times during the first years of EMU and thus ran into higher deficits when the first downturn came in 2001-2002. In late 2003, the proposal of the Commission to launch an excessive deficit procedure against France and Germany was met by opposition of the three largest EMU Member States. This episode showed the fundamental problem with the enforcement of fiscal rules in the euro area. Member States are always very reluctant to impose harsh measures on their peers because they might need their votes for something else in the future.

Subsequent rounds of reforms confirmed this Achilles heel. In 2005, the Pact was made more "intelligent" by referring more to cyclically adjusted deficits; but it also became more complicated. This was not the last reform. The 2011 reform even attempted to overcome the enforcement problem with the reverse majority voting system, under which a Commission proposal within the excessive deficit procedure could be overruled by Member States only with a two-thirds majority in Council. However, this only shifted the problem on the Commission, which then became more reluctant to propose fines.

During calmer times after the financial and public debt crises of 2007-2012, Member States made little progress in reducing debt levels. Some countries, in the first instance Italy but also Spain (Greece being a special case because it was under a macroeconomic adjustment programme) caused continual frictions with requests for more flexibility under the rules formally in force then. The limits on debts

and deficits were then suspended in 2020, as envisaged by the rules, when COVID-19 led to a severe downturn.

The Commission has since proposed new rules that concentrate squarely on the sustainability of debt levels. In principle, this is exactly the problem identified by Maastricht (and which materialised during the euro debt crisis). At the same time, the new rules would require much less adjustment than the old ones. Moreover, the basis for the new rules should be tailor-made paths for fiscal policy negotiated individually by Member States with the Commission. The Commission maintains that this will create more national ownership, solving the enforcement problem.

The new proposed rules, if adopted, would not require major immediate adjustments in fiscal policy. They would therefore not influence monetary policy, at least not in the short term. The medium- to long-term effect of the new rules all depends on their success in ensuring the sustainability of public finances. Whether this will be the case is impossible to say at present. The main argument put forward by proponents of the new rules is that Member States will be much more likely to follow less demanding adjustment plans negotiated with the Commission than to comply with the more demanding existing rules. There is no objective basis for or against this argument. It remains a hope and only experience will show.

## 6. CONCLUSION

Fiscal and monetary policy should now work in the same direction.

There is no need for formal coordination. The ECB remains fully responsible for combatting inflation and the overall stance of fiscal policy should mainly be geared towards maintaining sustainable debt ratios and be countercyclical. At present, these two requirements coincide.

The 2024 budgets presented by Member States envisage a reduction in deficits of about 0.5 % of GDP. This gradual path of adjustment should be accelerated, given that at the present juncture a stronger adjustment will also help to reduce inflation. Achieving this acceleration of adjustment will be made harder by the unintended fiscal costs of the PSPP and PEPP.

It is a different question whether the still large stock of government debt held in the Eurosystem influences the level of interest rates and keeps them lower than they otherwise would be.<sup>18</sup> The argument made is simply that the sharp increase in interest payments on reserves makes the necessary fiscal adjustment more difficult.

The European Commission has underpinned its reform proposals for economic governance, inter alia, with the assertion that imposing the existing rules in 2024 would require excessive adjustment. Irrespective of the validity of this assertion in normal times, the call for softer fiscal rules comes at a very inopportune time. The present situation of sticky (core) inflation and full employment provides the ideal backdrop for decisive action to put debt on a plausible and sustainable downwards path.

Moreover, the ongoing discussion on the reform of the SGP has created an incentive for (highly indebted) Member States to keep their deficits elevated this year, because this provides a higher watermark from which the adjustment plans that would have to be negotiated/agreed under the proposed governance framework would depart. The 4-7 year time horizon envisaged for the adjustment plans would presumably take as their starting point the debt level at the end of 2023, with little pressure to reduce debt even by 2027 under the 4-year horizon, or by 2030 if the country fulfils the conditions for this extension. It is thus likely that this optimal moment for fiscal adjustment will be missed.

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<sup>18</sup> <https://www.niesr.ac.uk/news/ongoing-costs-quantitative-easing>

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Fiscal policy becomes less potent in affecting output in an inflationary environment. As the economy nears full employment an increasing part of any fiscal stimulus either crowds out other expenditure or leads to higher prices. This reinforces the case for an accelerated reduction in deficits, especially through the termination of energy subsidies that are now longer appropriate as energy prices have returned to pre-war levels.

An unintended (but predictable) consequence of the past bond buying schemes of the ECB (PSPP and PEPP) is that the net income of the Eurosystem is likely to fall by about EUR 70–80 billion, or 0.5–0.6 % of GDP, making the fiscal adjustment harder.

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