



Reforming the Stability and Growth Pact

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Jacques de Larosière - Honorary Chairman, EUROFI

Tuomas Saarenheimo (Chair), President of the Eurogroup Working Group (EWG), Council of the European Union

Tuomas Saarenheimo (Chair) noted that during World War 2 the Commander-in-Chief of the Finnish armed forces, Field Marshall Mannerheim, who led the Finnish war efforts for four years, had lunch with the central command every day. There was one rule for that lunch which was to not speak about the war. In that spirit, the panel is not speaking about the war; instead, it is talking about the Stability and Growth Pact (SGP).

Political discussions for the SGP are at the halfway mark. In the coming months deliberations should be encapsulated by outputs. It is therefore a good moment to discuss this issue. The panel will discuss two broad issues. The first is whether there is a need to change the SGP. Here the questions concern how to reconcile the SGP with the present high and divergent public debt ratios and how to reduce them in a sustainable and growth-friendly manner. There is a question about the future of specific thresholds three and 60. There is also the question of heterogeneity and how to address that.

The other part of the discussion is about the quality of public finances. There the questions concern how to promote better quality and composition of public finances, what the role of the European Union is in promoting better quality national public expenditure in member states and what the role might be of national fiscal frameworks in doing the same. Tuomas Saarenheimo (Chair) asked Nadia Calviño to comment.

Nadia Calviño, Vice-President and Minister for Economy and Digitalization, Spain

Nadia Calviño highlighted the need to deal with these issues that are important for the future. The SGP must be reviewed. Nadia Calviño agreed with Paolo Gentiloni, who was emphasising the word 'and'. It is the Stability and Growth Pact. That summarises everything.

We need a growth friendly fiscal framework that reinforces financial stability, supports the recovery and job creation and is adjusted to the specific circumstances of different countries. We need to create fiscal space and we also need to undertake an unprecedented investment effort to drive the necessary green and digital transitions.

To succeed, we should draw lessons from the past. As Paolo was making his speech, Nadia Calviño thought about Spain as an example of the difficulty of reducing debt to gross domestic product (GDP) ratios without growth. There is also the risk of public investment being the first casualty of wrongly approached fiscal consolidation policies. In previous crises, public investment and other growth-enhancing expenditure were the first victims of fiscal consolidation policies. In the case of Spain, public investment and private investment also dropped significantly from 2008. They never recovered, dragging potential growth and prosperity for several generations. Indeed, this has been worsening and reducing the capital of the country, which means infrastructure and education, and it also means health, as the country had to discover when the pandemic hit. The lessons of the past have to be learned to avoid making the same mistakes.

The second lesson is the positive experience there was in the response to the pandemic. There was coordinated action, which explains the effectiveness of the actions taken since March 2020. It has been realised that everyone is in the same boat. This is a pertinent reflection for the current situation. Ownership by the countries of the reform programmes and the investment programmes are key to making them effective on the ground. These are good lessons going forward in terms of the review of the rules.

Nadia Calviño noted that this debate should have a forward-looking approach. There should not be a return to the old trenches and debates of the past that have wasted so much energy and led to a confrontation between north and south, rich and poor, new and old member states, east and west and any other division that can be imagined. The old rules cannot be applied as such in the new reality. This forward-looking approach is needed with a pragmatic and realistic starting point. Nadia Calviño agreed with Paolo's assessment and believed that around the table there is a good, positive spirit in all member states about the need to approach this with realism and pragmatism. That is more promising than some of the debates of the last 15 years which have led to very complicated rules with clear shortcomings that should be addressed before they become fully operational again.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) asked for Gintarė Skaistė's views.

Gintarė Skaistė, Minister of Finance, Lithuania

Gintarė Skaistė underlined that in previous SGP discussions some years ago, there had been a clear schism between Member States with more difficult fiscal situations and the others, like Lithuania. However, the situation is changing. The mindset of people is changing. How the situation is perceived is changing.

When thinking about stability and growth, both 'stability' and 'growth' have to be kept in mind. We must not forget the "G" in the "SGP". Stability and long-term fiscal sustainability is very important and there is a need for safeguards, but growth should not be forgotten. Also, there are very ambitious goals for the green and digital agendas at the European level, and, when talking about the goals and targets that have to be achieved, the financial resources needed to get there should be considered as well.

Lithuania is a good student, because it has had low debt levels and balanced budgets in the past years. Being a good student, we want the same for other countries, we want to have rules that everybody can feel domestic ownership towards. We have to be realistic –the current rules may not be implementable in some countries anymore. From the perspective of a minister in a country, where there is a debt level above 100%, the current debt reduction rule would never be implemented in practice (as it implies large scale fiscal consolidation), and it is not credible anymore because of that. There has to be consideration of how to change the rules that are not credible so everybody can follow them. Just pointing a finger and saying someone is not

following a rule when it is not implementable anymore makes Gintarė Skaistė somewhat uncomfortable.

There can be a discussion about additional flexibility for productive green and digital investment as well, but with the necessary safeguards that are both quantitative and qualitative. The evaluation of the quality of investments would be key in this regard. Experience with the Recovery and Resilience Facility (RRF) instrument could be helpful in this situation. We have to see how implementation is ongoing and whether the goals are being achieved, namely, the milestones and targets, and then we can determine to what extent we can rely on the RRF experience aiming for additional flexibility to promote investments.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) invited Klaus Regling to comment.

Klaus Regling, Managing Director, European Stability Mechanism (ESM)

Klaus Regling noted that he has been discussing the Stability and Growth Pact for 25 years, and it is always about stability and growth for the very simple reason that without stability there is no growth. The starting point remains correct. However, Klaus Regling raised five points to help structure the debate.

Firstly, fiscal coordination in the euro area is needed because there is centralised monetary policy and de-centralised fiscal policy.

Secondly, the rules that guide the SGP need to be made simpler and more credible so that they can be better understood by politicians, the public and financial markets. Reforms are needed and overdue. As Paolo Gentiloni highlighted, the SGP will have its 25th birthday this year. It is perhaps a good time to think about reform.

Thirdly, though Klaus Regling agreed in principle that the mood is good and there is pragmatism, without consensus on how to reform the current legal framework will remain in place, and that would require the European Commission to make full use of flexibility and continuously take ad hoc decisions. That is exactly what the Commission does not want to do. All efforts should be made to find consensus for reform. That is also much better for transparency, for the political debate and for financial markets.

Fourthly, the current debate is heating up, and the Commission will soon come out with recommendations based on the 800 proposals they received on how to reform. This current debate is trying to tackle too many problems, so there is a risk of losing the focus of the SGP, which remains debt sustainability correctly understood. The good news is that debt sustainability can now be maintained with a higher debt level than was possible 25 years ago, but the focus should remain.

There is a public debate about other objectives that should be achieved with the SGP. The SGP should achieve many objectives, like more counter-cyclical policies, more public investment to promote growth and more expenditure for green and digital transformation.

All of that is very laudable and positive, but they should be subordinated to the key objective of debt sustainability.

The European Central Bank (ECB) may be a good example here. It has one primary objective. When that is achieved the ECB is encouraged to also support other objectives. There is a hierarchy here. That also means that, to the extent that good expenditures promote growth or prevent ecological costs in the future, those good expenditures contribute to lowering the debt ratio and promote debt sustainability. That should obviously be taken into account in the debt sustainability analysis, so even when there is this hierarchy, good expenditure and more public investment show up in a positive way.

Klaus Regling concluded that, when looking at the other objectives, it should be remembered that there are other important frameworks and tools that may be more suitable for meeting them. There is the EU budget; the European Semester and country-specific recommendations. There may be a desire for consideration of a new facility for macroeconomic stabilisation that could be added to the toolbox. The SGP on its own cannot do everything and that should be accepted.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) asked Jacques de Larosière to comment.

Jacques de Larosière

Jacques de Larosière suggested a fiscal framework is needed, because monetary union implies fiscal cooperation at a minimum, barring the ideal of fiscal union. A monetary union cannot afford inconsistent negative externalities stemming from uncoordinated fiscal decisions in different states. That would not be a cooperative system; it would be a hazardous, selfish-directed system.

The SGP has been experienced for years, and it did not work well because it was not respected. That was not because the rules were necessarily wrong. It was not respected because the system was based on one-size-fits-all. There were a few figures or percentages. The figures were abstract and not necessarily related to local needs, situations and realities. Therefore, there was not a sense of ownership. It was considered something external to comply with, and it was not felt to be necessary. Countries like France and Germany gave the wrong example at the beginning, because they insisted that the Commission exempt them from the rules, which had a terrible contagious effect.

If that analysis is true, a more tailor-made system with specific, well-adapted norms is needed, which would be the result of a dialogue between each member state and the Commission. This does not mean giving up all of the present norms. For instance, the 3% limit for deficits in normal times should be kept because it is a relatively important and doable norm.

Jacques de Larosière proposed that every year the Commission examines, with each interested country, the progress made on fiscal sustainability and, more importantly, the definition of the right vital objectives.

For example, a country that has an excessively high ratio of public expenditures to GDP would be required to use this excess related to the eurozone average in a period of time, such as five years. Other countries which do not necessarily have this problem of too high expenditures but has a too high public debt compared to GDP would have to reach an agreed primary surplus.

The ownership problem is essential. The ownership problem can only be solved through common trust between the Commission on the one side and the state on the other. Having spent nine years on them, Jacques de Larosière vividly recalls what the International Monetary Fund (IMF) used to call Article 4 examinations. Each year, the IMF looked at the intricacies of the economic situation and the policies of the member states. The staff of the IMF was completely independent; there was no question about that. It was not possible to soften or water down their reports. It would have been impossible, and Jacques de Larosière would never have accepted it. The staff was free to say what it wanted, but it did so in a dialogue. It did not just expose the tools and say, 'That is what you have to do.' It was the result of a dialogue. At the end, the member state agreed on the gist or the thrust of the Article 4 examination, because it was very difficult to disagree given the rationality that presided over the exercise.

The country did not necessarily apply what was said in the Article 4, but if it turned a blind eye to the gist of the Article 4, which everybody agreed upon, for several years then it entered into the problem of lost credibility. If the European Union is a cooperative game where everybody tries to achieve what is the common interest, then turning a blind eye to this sort of Article 4 examination, as Jacques de Larosière was proposing, becomes a problem less so for the others but more for the one turning a blind eye to it, because it is not cooperating.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) noted that Nadia Calviño was the first to speak about ownership and has written about the need for the rules or the strategies to be homegrown. Tuomas Saarenheimo (Chair) asked how Nadia Calviño would ensure that this homegrown consolidation strategy does not become an eternal exercise in backloading adjustment.

Nadia Calviño

Nadia Calviño concurred with Jacques on the need to be more tailor-made when doing the assessment, and that there should be a more constructive dialogue that actually leads to the country owning these reforms, proposals or rules. The issue is how to make sure that that leads to actual consolidation, and that will depend a great deal on the situations of each of the countries.

Nadia Calviño thought, as Gintarė Skaistė was speaking, about the labour market reform that has just been passed, which was a very difficult exercise. It took many months of negotiation, but it was achieved and this was a long-lasting recommendation by all European institutions, the IMF and others. An agreement was reached with social partners. Having this broad social agreement about what needs to be done and having

a target are key elements that facilitate broad, social and political agreement. Nadia Calviño agreed with this kind of approach because it also leads to or facilitates consensus at a national level. Although it would take hours to explain how the labour market reform managed to pass, it was achieved.

Currently there is an 'alignment of the planets'. The talk of Article 4 reminded Nadia Calviño of the fact that 15 years ago it would never have been dreamt that the IMF would be talking about inclusive and sustainable growth. All institutions and all governments around the table in the G20 meetings were talking about inclusive and sustainable growth, and that is an important political change of mindset that provides a new opportunity for having better growth that ensures stability and growth.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) noted that Gintarė Skaistė spoke about the need to recognise the special role of productive investment, green and digital investment. At the same time, the desire is to make the framework simpler. Tuomas Saarenheimo (Chair) asked how Gintarė Skaistė would incorporate this special treatment without making things more complicated.

Gintarė Skaistė

Gintarė Skaistė suggested keeping in mind both qualitative and quantitative safeguards. Talking about qualitative safeguards is quite challenging. Whereas, talking about quantitative safeguards is rather straightforward. The numbers can be discussed quite easily. Regarding a qualitative assessment and whether an investment is good or not, the experience of the Recovery Resilience Facility (RRF) can be used. Of course, the RRF has not been fully implemented yet and its success remains to be seen. But the basis is good to work on. A virtuous circle can be achieved where improved enforcement will lead to better fiscal strategies and those will lead to easier enforcement in the future.

Within the framework of the IMF's Article 4, Lithuania has received, in essence, the same recommendations for 10 or more years. Nobody wanted to implement them because it was difficult politically. However, when all of the reforms are connected with appropriate funding, it is easier. Furthermore, all of the country specific recommendations that were set to Lithuania by the European Commission are covered in the RRF plan.

The RRF instrument is a challenge in itself, especially from the implementation perspective. If it works, more trust can be built among Member States. If it does not work, it may provide valuable insights in how to achieve better outcomes in similar future endeavours.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) noted that Klaus Regling spoke about how the complexity has hampered implementation and asked whether that was correct in Klaus Regling's experience, and whether the problem of implementation enforcement has been that governments do not know what they are expected to achieve, or have not been able to anticipate the numbers that come out of Brussels, or whether it is

just that meeting these numbers has been politically difficult.

Klaus Regling

Klaus Regling replied that it is mainly the latter. Quite often the political will was not there, and therefore it was easy to hide behind the complexities. That is one thing, but it is also important to have a Stability and Growth Pact that can be understood by the public, by the media, by parliamentarians and by financial markets. The number of exemptions and exceptions that have crept into the pact over the last 25 years have prevented that. Sometimes the Commission is blamed for that. That is not fair. It is the Council that decided on that and then the Commission had to implement it. That is a strong reason to return to simpler rules.

Ownership is really useful. That was also learned when the European Stability Mechanism (ESM) programmes were implemented. In countries where there was ownership, such as Ireland, the programme ended a year early. In countries like Greece where ownership was not as clear it took eight years. Ownership is important, but that requires political will. The Commission and Eurogroup need to explain to the country what they think should be done. The complexity of the rules does not help, because if it is not popular in the country and the public does not understand, ultimately the Pact requires parliamentarians to vote on it. There are trade-offs. Ownership is great, but without political will it is difficult to achieve. A case can be made for simpler rules that are easier to understand so that countries cannot hide behind complexities.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) noted that Jacques de Larosière's advice for creating ownership was to create country-specific strategies in dialogue with the member states by making use of the experience gathered in Article 4. However, Article 4 is not rule-based. It is customised. Tuomas Saarenheimo (Chair) asked the extent to which Jacques de Larosière wants to maintain a framework of rules instead of a framework of consultation.

Jacques de Larosière

Jacques de Larosière was not sure he could answer that. The cement of ownership was given by Nadia Calviño, and that is growth. If the gist of the examination by the Commission does not lead to more growth, then ownership can be forgotten about. It is very important to place the exercise under the notion of improving growth.

It must be sustainable growth because there cannot just be growth for the sake of growing. Creating microeconomic imbalances will eventually hurt growth, so it has to be done in the right way.

The ownership problem is very important. Many countries that did not respect the rules had no ownership at all. They just said there were external prescriptions that they did not believe in and which do not address the needs of that country. Therefore, they

just set them aside. That has to be changed. The best approach is having a thorough examination.

The 60% had no meaning because the borrowing capacities of a country like France are much bigger than that. People in the treasuries thought they could borrow much more than 60% and for it to be okay. This was an element in the ownership; the 60% should not be kept but should be tailor-made.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) summarised that there is a sense of pragmatism and realism in this discussion. That is something that was not present 10 years ago for the previous reform. There is much less division. The words that have appeared in this debate have been part of the political debate. There are a number of points of agreement and ownership is one of them. No one disputes this. There is an understanding that ownership is not something that can be spoon-fed. It grows from within and there has to be work with countries in order to create it. Growth is elementary. Sustainability is not just about austerity; it is about creating conditions for growth. How to get from this position to agreement on new rules is something that will be found out in the coming months.