



## Reforming the Stability and Growth Pact

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### Pierre Gramegna

Thank you to Eurofi for giving us the opportunity to address a topic that is of paramount importance, and that is the reform of the Stability and Growth Pact, key remaining issues and way forward. I would like to thank our Spanish hosts for organising this event together with Eurofi and I would like to thank the four panellists who are with me. Let me start by introducing Gintarė Skaistė, who is the Minister of Finance of Lithuania, Vincent Van Peteghem, the Vice Prime Minister and Minister of Finance of Belgium, Heiko Thoms is State Secretary in the Ministry of Finance in Germany, and Emmanuel Moulin, Director General of the Treasury in France.

The topic of the reform of the Stability and Growth Pact has been with us now for quite some time, and is reaching a final phase, which means compromises are going to be necessary and time is of the essence. We need a reform of the European fiscal rules that ensures that the principles of transparency, credibility, ownership and sustainability are in the limelight. In order to go more deeply into detail, we are going to have two rounds of discussion.

The first-round of question is what are the stumbling blocks, the possible solutions and key success factors in reaching a swift agreement on revising the Stability and Growth Pact? This question is obviously very wide. I would like to divide it into three sub-items which could be the following. The first sub-item is should the EU move towards a case-by-case framework approach, as was proposed by the EU Commission a couple of months ago or should the Stability and

Growth Pact stay closer to the current fiscal rules with quantitative benchmarks? What are the pros and cons, how could these approaches make the Pact more effective, and eventually can the two approaches be combined? The second sub-item would be how can we make sure that the new Stability and Growth Pact can ensure equal treatment of all countries? The third sub-item would be to what extent can the revision of the Stability and Growth Pact contribute to rationalise expenditures, improve the quality of spending, create space for supply-side reforms, and last but not least, boost public and private investment. This is a very vast question and three sub-questions in three minutes is a real challenge. I count on your cooperation and ask all the panellists to focus on those points that they find are the most important. With the rule that it is ladies first, I have the pleasure to invite Gintarė to start.

### Gintarė Skaistė

Thank you very much. It is a difficult topic. Previously we discussed with colleagues about the digital euro, but I said that the EU fiscal rules is, probably, even a geekier topic than the digital euro. It is an important topic, but it is difficult to explain to society what you are doing, why it is important and what will be the outcome of the discussions with colleagues in the European Union. I would like to start from the beginning: it is a Stability and Growth Pact. The name of our fiscal rules itself suggests that we seek for stability and growth. Now we have to answer the question, is everything stable enough? Is there enough growth in Europe? Can we change the rules in a way that helps us to achieve the stability and growth better than we do today?

Looking from the perspective of recent years, I would say that the current system is not working well enough, because the debt levels have been increasing across many countries. While it was not a big concern until recently, the situation has changed with increasing interest rates as debt servicing cost has started to raise sharply. We have to answer what other expenditure in the budget will we cut because of that. These are difficult trade-offs which can become easier if there are strong enough growth and debt levels that are on a downwards path.

The new rules must bring more stability and more growth. In my opinion, there is room to change the rules for the better, and the proposal from the European Commission is a step in the right direction, because it ensures more domestic ownership. Member states will be able to define their own fiscal paths and have their own political means to achieve the fiscal targets. Building individual fiscal trajectories should naturally result in more realistic and achievable fiscal objectives. Also, it is important to have space for political manoeuvre to react to changing situations, while keeping the initial fiscal targets unchanged.

The question then is how to have the certainty that countries will stick to the agreed fiscal path. We have seen previously when fiscal targets have been revised and pushed back for several years. The backloading is a serious problem and risk going forward. Thus, we must have very clear rules on how and when do we measure the progress – is it after seven years, after three years, after one year? We must have certainty how exactly the Commission will act, limiting room for discretion. We also need to have a very clear rules around the possibility of extending fiscal adjustment timeline to create space for certain investments and reforms. Who will measure what effect will particular reform have on economic growth? If the Commission will do the assessment, what will be the measurement of the success for the reform? We have many remaining questions and I think the answers are still not there, we need to agree on them at the political level.

### Pierre Gramegna

Thank you, Gintaré. On your last point, you will have the possibility of continuing to discuss it because it is in the second block of questions.

### Vincent Van Peteghem

Thank you, Pierre. My answer on your first question is 'yes', my answer on your second – 'no'. What we need to do, and that is the goal of the Stability and Growth Pact, is that we have a very clear goal, and that goal is, of course, the medium-term debt sustainability. That is important, and that is what we are working on. The only thing that we saw in the last decades was that it did not give enough growth or that the focus was not enough on investments and on reforms. If you look to the situation today, we must be honest and we have to come to realistic new rules. What do I mean by realistic rules? First, that we should look to the case-by-case situation. Every country, every member state, is different. They have different backgrounds, different

contexts, different social welfare systems, different labour markets and so on. I think that we need to take into account the diversity that we have, to recognise it and look at how we are going to deal with that.

I know, of course, that today there is also a demand for still some common quantitative benchmarks. I think that is necessary as well. I understand also that question because it is necessary that there are some minimum requirements. It is necessary that there are some clear targets, again, to focus on that medium-term debt sustainability, to look at how we can be sure that in certain situations we go to a medium-term debt level that is sustainable in the long term. The main concern that I have today about the discussion that is ongoing, and I am convinced it is necessary that we come up with a new framework in the coming months – it is important to give that predictability to the markets to also be sure that we can move forward – but I have a concern about the reforms and investments that we are going to deal with and that will be linked to that package.

Some reforms cannot be done, or the impact of a reform cannot be seen, in the short timeframe of four to seven years. If we do a pension reform in our country, the real budgetary impact is not seen within four or five or six years. It is a much longer timeframe and time window, and so I am a bit afraid that countries will be afraid or be de-incentivised to actually do these reforms because they are not or cannot be linked with that planning horizon that is now also in the proposal. I understand the concern about the backloading and the frontloading. My concern is also that some countries will avoid doing important reforms that are necessary, as we all know. There is the possibility to come to a situation where we have the case-by-case approach within that new framework. The question I have, which is important, is that if we introduce the quantitative benchmarks that there is still enough room to do the investments and the reforms that are necessary.

### Pierre Gramegna

Thank you, Vincent, and I give the floor to Heiko Thoms, State Secretary of Germany.

### Heiko Thoms

Thank you, Pierre. Let me say it is a pleasure to be here. You ask about the biggest stumbling blocks. I can say there are still many. There are a number of issues which we will need to do a great deal of work on, but my first message would be that we are fully committed to getting these stumbling blocks out of the way and to reach an agreement before the end of the year. Not at any price, I have to say. We see the need for reform, very much so, but what we need to do is to make the system work better. That is the final goal. If we do not reach that, then I have to mention here, of course, the fallback is always to go back to the existing rules. We have to acknowledge this – nobody wants that – but if it happens, it is also a test of credibility we will all be facing in case this scenario is going to materialise, which we all do not want. We are fully committed to working this out.

You asked also about fair and equal treatment or if we want to do more on a case-by-case basis. These are not contradictions, I believe, and it is not a contradiction also in the Commission proposal. One thing I want to highlight is that we fully subscribe to the general concept that the Commission has chosen and to the methodology in general, although we would still like to understand the methodology a little better. This is what we are doing in the working groups. This is what we will be doing in the coming weeks and months. Fair and equal treatment will be absolutely essential because even perceived unequal treatment can be as bad as actual unequal treatment politically. This is why we have made our proposals, which I believe have sometimes – deliberately or not – been misunderstood, maybe because we are German, and we look serious and fierce. We are not.

Our proposal is, I believe, quite moderate. The base of this is that we accept the methodology, the general concept by the Commission, but we need certain safeguards and benchmarks. This is the reason why we have proposed, and that is the core of our thinking, an expenditure rule. Our proposal is that expenditure growth should be lower than potential growth. That is the first and then in case this does not fully work – because it may not, if there is, for instance, a structural change in revenue – we have proposed a safeguard, which means basically a holding line in debt reduction. In our proposal that we transmitted to the Commission, we put X, but let us say X is 1 for highly indebted countries per year, just a debt reduction by 1 percentage point per year, in case the expenditure rule does not achieve that goal.

These are only minimum requirements. The debt sustainability analysis the Commission has proposed is the way to go and should, of course, in some cases be more ambitious than this. Only if the methodology proposed by the Commission does not achieve the debt reduction and deficit reduction that we all see is necessary, then these benchmarks and safeguards would kick in. This is where we see the basis for reaching a way forward that would indeed ensure fair and equal treatment. Only dealing with the debt situation in a given country on a case-by-case basis will not do the trick.

#### **Pierre Gramegna**

Thank you, Heiko. That was quite clear and, for many in the room, very useful that you could explain that. Emmanuel Moulin, please.

#### **Emmanuel Moulin**

Thank you, Pierre. Very happy to be here and thank you for the invitation. We are right to try to draw the lessons of the past experience of our current rules. In fact, when we look at what happened after the great financial crisis, we had quite a bad experience in terms of growth-friendly consolidation. Consolidation was imposed on countries, which reduced investment and therefore there was lack of growth and hence we were not able to reduce debt-to-GDP. GDP was also so low that, in fact, the ratio of debt-to-GDP was increasing while we were consolidating. I think that the

Commission has drawn the lessons and the spirit of the proposal of the Commission goes clearly in the right direction with a number of features.

First, ownership, because we want rules that are owned by member states and not imposed by the Commission. We need differentiation because nowadays we have levels of debt which are very different from member state to member state, from 30% of debt-to-GDP to 140% and even higher, so we cannot have the same pace of reduction of debt-to-GDP in all countries. We need to focus on the long-term also, and that is the reason why there is a focus on debt sustainability. I think that is one of the points that Vincent made. If we look at debt sustainability over the medium term, we can take into account the impact of, for example, pension reform, and we know in France that there is an impact on the long term, also you can have a political impact in the short term. We need to have an incentive for investments and reforms.

To me, these features were clearly going in the right direction. However, during the preparation of the legislative proposal, the Commission decided to include some safeguards and benchmarks. When we look at them quite deeply, they tend to defeat a little the purpose of the reform. I would like to focus maybe on one benchmark, the benchmark which was included with a bit of haste in the last discussions in the Commission, and without looking deeply into the impact. We have a provision that says that the debt-to-GDP ratio should be lower at the end of the plan period, so four years, compared to the initial position. You need to have debt which is lower after four years than in the first year.

This, in fact, creates a major change in the consolidation that you are expected to fulfill. There is a paper which will be coming out from Bruegel, which says that, for example, for France, while in the system without the safeguard, you need to consolidate either from 0.8 or 0.4, if you have the extension to seven years, this would jump to 1.1% of structural primary adjustment per year to fulfill this benchmark. We think this is the type of adjustment which is economically unsound, and which will have a procyclical bias, and so we need to revise this benchmark. We are not against benchmarks, but they should be aligned with the spirit of the reform.

#### **Pierre Gramegna**

The second round of questions is how to ensure the effective commitment of a member state to its fiscal path? Here are two sub-questions. If a country is noncompliant, what tool should the Commission use? Should it use the Excessive Deficit Procedure (EDP)? The second question is about the role of institutions – in the plural. I would like to phrase it this way, besides the key functions and competencies of the Commission and the Council of Ministers, what possible role is there for an ad hoc committee of academics, for the already existing European Fiscal Board, for the ESM, or for any other international financial institution? With this, I would like to come back to you, Gintaré. You had already touched upon the second part of the question and maybe if you could also have a view on the excessive deficit procedure, please.

### Gintaré Skaistė

The answer is trust and I think that currently we have a lack of trust because of poor track record. The enforcement of fiscal rules is an issue, because the history shows that sticks envisaged in the current framework were not used consistently when member states did not comply with the rules. If no one believes that there will be consequence when you are doing something wrong, so why follow the rules? I think with this new start we can create a more credible system. If we increase the transparency of the system and of the methodology regarding the evaluation of process, if we have a very clear system how to assess if you are doing right or wrong in terms of budgetary discipline, everybody will know who is following the rules and who is not. In this regard, it will be important to ensure that the EDP, either debt or deficit based, will start automatically or at least semi-automatically. I would say that it could be an answer to have more credibility and ensure equal treatment.

The review of the fiscal framework should also bring more balance between negative and positive incentives, that should work in favour of strengthening national ownership. The ability to prepare individual structural-fiscal plans to reflect country-specific circumstances means that fiscal adjustment path will not be imposed on a country, but will be a result of joint efforts that should lead to a higher buy-in from the beginning of the process and stronger ownership later on. It will be important for member states to have enough room for political manoeuvre in shaping their reforms and investment policies, while keeping the agreed fiscal targets. I would say that the role of institutions, for example the European Fiscal Board or national Independent Fiscal Institutions (IFIs), could have a more prominent role in assessing whether your data is credible, whether you are reaching the target and moving in the right direction.

### Pierre Gramegna

Thank you, Gintaré. I will give the floor now to Emmanuel, who is eager to give a few more insights.

### Emmanuel Moulin

I do not want to jump the line, but to me, on the enforcement and the implementation of the rules, clearly, ownership is key. If you are drawing your own national plan and your own national trajectory, then you are much more bound to stick to it, in particular, towards your public opinion than if it is a trajectory which is imposed by the Commission. To me, member states will be more inclined to apply rules that are economically more relevant, that they understand better and that have a clear objective. I think this is key, because in the previous rules we had a medium-term objective, which was to have a balanced budget over time, which would lead to a reduction in debt normally to zero or almost zero at the end of a long, long, long period. The only objective was really a reduction of the deficit. We are balancing more the objective in terms of growth, in terms of reforms and in terms of financing investments that are needed for the green and the digital transition. I think this will make the rules easier to implement and more enforceable.

In terms of the institutional set up, I was in the team negotiating for France for the 'two pack', 'six pack' in 2011-2012 and at the time we did not trust the Council because it had failed in implementing the rule in 2005 with two big countries which said these rules do not apply to us, with the support of a small country. We did not trust the Council. We said the Commission should be in the driver's seat and now we have the Commission applying the rules, I think more smartly, but then some people say, 'Well, the Commission is not doing its job', so now we have to go back to something else, the something else being independent counsel. I do not think we need to change the institutional set up. The Commission is doing its role. We should entrust it with the surveillance; that is their role. Independent counsel can give advice. They do not have the legitimacy to impose sanctions or monitoring.

### Pierre Gramegna

Thank you, Emmanuel. Heiko Thoms.

### Heiko Thoms

You cannot possibly overestimate the importance of this topic of enforcement. To say at the outset, if there were no enforcement, we would eventually all be sanctioned. We will be punished by the markets, and this is why we do this. That is what we want to avoid, so we need to get enforcement right this time. It is crucial. It is maybe the biggest flaw of the current system that enforcement did not work. We still believe that the existing rules – and they are still the existing rules – would have worked if they had been applied properly, but they have not been. Emmanuel pointed at who is to blame so we know. Nobody is innocent in this respect, so we need to do it differently this time, but what we have to start with always is the willingness to implement the actual rules. Of course, if there is a lack of implementation it is the enforcement and that is probably the area that we need to do the most work on until the end of the year. We need to do this in the preventive arm. There will be things like a control account, and we will need to figure out much better what the consequences will be if there is deviation and how we will deal with this. This still needs to be spelled out because it has not been spelled out properly.

Then there is the most important aspect; we need to properly apply the corrective arm. It is important for me to mention here once again everything I said in the first round on benchmarks and safeguards. That is, of course, only for the preventive arm. If we come to the corrective arm, so that is the EDP, that is what we need to do differently this time. I have to say once again, the excessive deficit procedure is part of primary law. This is not something we can get around. This is something that we will need to apply, that we need to do, and this is where we need a lot more clarity and a lot more transparency on when the corrective arm, the excessive deficit procedure, will be applied or will be started, because this will make all the difference.

### Pierre Gramegna

Thank you very much. Vincent.

### Vincent Van Peteghem

We were already talking about the fact that the rules and the Pact should be more realistic, and I think that one of the elements in it is the fact that the enforcement today should be stricter, but at the same time the way we deal with it is the case-by-case approach, so that there is more flexibility. I think that ex ante there should be more flexibility. Countries should have the possibility to decide what reforms they are going to do and so on. Ex post, it will be important that we will be a little stricter on the way we are controlling everything and how everything is organised. I sometimes refer to the NextGenerationEU and how a country like Belgium, which has high debt but at the same time needs reforms, dealt with that. We proposed some reforms, and we got our money. That is a little how it worked. It should be similar within the economic governance review.

We also need to first see what kind of reforms can be done. I think that they also should be linked with some expectations at the European level, with the European Commission saying and setting some priorities. There should be a kind of labelling approach that we also had in NextGenerationEU and afterwards, of course, there should be a strict control to see what the impact is. I do not think that EDP and the financial enforcement should be the key element of it, but I think that there needs to be a stricter follow-up. There, the European Fiscal Board – or ESM, if you want – Pierre or others can play an important role in determining ex ante what kind of flexibility, what kind of labelling, what kind of investments and reforms will be done, but at the same time afterwards, following up looking how the implementation needs to be done, how it can be improved and so on.

### Gintaré Skaistė

I disagree with Vincent on this topic because the example of the Recovery and Resilience Facility (RRF), in my opinion, is not the best one – because of being a rigid instrument. For example, when one government is preparing the plan, and then another government is coming in, and having to implement commitments that the previous government has made, you do not have ownership that we want to strengthen. From my perspective, the possibility to adapt the plans, while focusing on the final target, is the main issue.

Regarding the domestic ownership, Lithuania is suggesting one element of flexibility, which, in my opinion, is very important. I am not talking about the golden rule, but about smart and targeted flexibility for defence investments. For example, in Lithuania we are now increasing substantially the spending on defence, but we still have the benchmark of 3% deficit. That is our key criteria, but at the same time I cannot predict when the military equipment will be delivered, so in practice it makes it hard to follow the 3% rule strictly. For a small economy, military purchases may lead to large one-off expenditure increase causing budget deficit to go up to 3.5 or 3.7 percent, just because the military equipment came on a different fiscal year than initially planned. Thus, we argue that defence spending should be regarded as a "relevant

factor" when assessing breaches of the 3% deficit limit.

From my perspective, the flexibility, when looking at the situations like that, is crucial. We need a possibility to adapt to the changing situation and to fundamental challenges, especially under the geopolitical circumstances that we currently have.

### Pierre Gramegna

Thank you, Gintaré. I think the Panel showed that there is common ground. But there are still quite a few differences. The common ground I see, and that is very encouraging, is when you talk about ownership, equal treatment, transparency and the observable data and results. If we take it from there, considering the facts, what comes out at the end of the analysis is that we have a system where you can very easily say there are numbers out there. I do not dwell on what the numbers are. Not only the old ones that we know where there is a consensus that we should keep them. But also the additional data that we want that will indicate if you are complying. Then we will all help each other a lot. Then it is not only about the Commission doing a good job in judging what has been done. The numbers will speak for themselves. That is a big difference for the system that we want to have in the future compared to what we have now. That is what is interesting for the common ground.

The other thing I see for the common ground is that there is a willingness for flexibility on all sides. The different countries are a good sample, I would say, of the 27 countries and they want to use the flexibility in different ways. Let me take first what Heiko said. He explained the two safeguards that you see. You want to play on those criteria. Others would like to have flexibility in terms of which kind of investments should get maybe a different treatment or should be counted differently, which is not easy, but this is a very important topic. I like this example of defence spending, which is becoming much more important than it has been in our history for 20 or 30 years, so neglecting that factor would be a pity. At the same time, Gintaré, you are the first one to say, 'This should be quite strict. You have to go for gold', but then you are the last one to say 'Well, but by the way, for defence spending, maybe we should do it differently.'

I think that it will be important to understand all the different types of flexibilities that might be requested by member states. This might help the process reach an acceptable compromise. If we have observable data and have looked at all the possible ways of flexibility that we can agree on we might find that enforcement will be easier. Obviously, enforcement is key. Because if you cannot make sure that what has been observed and the flexibility that is built in is observed, then there is no enforcement. Obviously, then the reform of the SGP will not be a success. I thank you all. Enjoy your evening. Thank you.