Finance Watch

Making finance serve society

Fiscal Mythology Unmasked

Debunking eight tales about European public debt and fiscal rules

A Finance Watch report

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"The great enemy of the truth is very often not the lie, deliberate, contrived and dishonest, but the myth, persistent, persuasive and unrealistic. Too often we hold fast to the clichés of our forebears. We subject all facts to a prefabricated set of interpretations. We enjoy the comfort of opinion without the discomfort of thought"

- John F. Kennedy

"Myths which are believed in tend to become true."

- George Orwell

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Executive summary

Europe faces serious environmental, economic and social challenges that require a rethink on public intervention. Not free to do as they wish, European governments devise fiscal and socio-economic policies constrained by a self-imposed maze of economic governance rules. Those rules are built on a series of debatable conceptions about public debt and the role played by the state.

This paper focuses on debunking eight often-espoused conceptions:

DEBT OVERLOAD — MYTH 1

The public debate overly relies on arbitrary debt-to-GDP thresholds to gauge debt sustainability, overlooking true explanatory factors.

Those include evolution of government revenue, interest rate, debt composition (i.e. currency denomination, ownership, maturity structure), differential between interest and growth rates and the building up of fiscal risks. ***Interest payment-to-public revenue*** **(flow-to-flow) seems a more meaningful proxy indicator of debt sustainability** than *debt-to-GDP* (stock-to-flow).

INFLATION — MYTH 2

A growing concern centres on inflation possibly returning, driving up interest rates, which would render debt unsustainable.

Meanwhile, analysis shows a different story: a situation where this risk is not the most pressing one as **inflation and interest rates are driven by structural factors unlikely to change in the near future.** Temporary, measured inflation can be expected in the short-run, not a sustained rise of inflation and interest rates.

FUTURE BURDEN — MYTH 3

Public debt often gets framed as an unfair burden on future generations.

The "intergenerational equity" story overplays the liability trope around debt while overlooking three fundamental arguments.

First, **intergenerational equity commands investment that builds a resilient and sustainable world**. Without that investment, governments will fall short when trying to provide for the most basic needs of future generations. Investment costs will weigh less on future generations' shoulders than the cost of failing to do so.

Second, **debt provides a legitimate way of spreading costs across all benefiting generations** when it provides financing for investments in education, research, innovation, sustainable and resilient infrastructures and productive capacities.

Third, the current ultra-low interest rate environment provides the **opportunity to lock-in low, long funding costs**, which relieve the debt burden for future generations.

Intergenerational equity commands to discern debt sustainability as intertwined with the sustainability of the world. In a context where there can be no such thing as sustainable debt without a sustainable world, **Europe must shift from an excessive focus on public spending *quantity* to a pledge to ensure its *quality*.**

CROWDING OUT EFFECT — MYTH 4

Public investment often gets brushed off under the argument that it would crowd out more productive private investment.

In fact, this portrait overlooks three core arguments.

First, a crowding-out effect cannot exist in the current worldwide **environment of excess liquidity and savings**.

Second, **public goods provision, resilience building, and climate change mitigation requires public money**, as related investments cannot be expected to be solely privately financed.

Third, **quality public investments can boost and steer the economy towards socially desirable goals**. Captured by the fiscal multiplier, this crowding in effect proves particularly strong during recessions and low interest rate periods.

Far from being antagonistic, public and private investments must be seen for what they are: namely complementary.

SPENDTHRIFTS — MYTH 5

EU countries with comparatively high stocks of government debt to fellow Member States often get accused of living "*beyond their means*".

A closer look shows a more nuanced picture. While no evidence exists showing excessive social spending or lower working hours, **significant shares of public debt appear to be a legacy from unexpected events** such as the financial crisis of 2007-2009 or the current Covid-19 pandemic. In a number of cases, high levels of public indebtedness embody the **legacy from the high interest rates that prevailed in the 1980s and 1990s** and not from supposedly reckless fiscal policies conducted since then. Italy provides a case, for instance, as it suffered an average yield on 10-year government bonds of 14% between 1980 and 1993, with a peak surpassing 20% in 1982, and reached continuous primary surpluses during the recent decades.

BUDGET SURPLUS ANALOGY

MYTH 6

Building on the household analogy, public budget surplus is often presented as a necessity to repay debts and build "fiscal space".

This debate reveals two main flaws: First, a public budget surplus means the government takes from society more than it gives to society. Seeking budget surpluses proves counterproductive when **interest rates fall below growth rate** and when **economic depression hits**, and is always of secondary importance in comparison with **investing to build a sustainable and resilient society** – as evidenced by the importance of sustainability-related fiscal risks. Second, **intra-EU trade imbalances** continue to hamper the prospects for every Member State to run concomitant budget surpluses.

Rather than trimming back spending to comply with arbitrary numerical fiscal rules, the European Union and its Member States should **focus on investments that contribute to building a sustainable and resilient economy**, pouncing on the current rock-bottom interest rate environment to lower fiscal risks, extend debt maturities and bring down debt servicing costs. **Protecting public budgets better from swings in market sentiment** requires monetary policy that ensures permanent market access for sovereigns at favourable conditions as well as a stronger "lender of last resort". **Orderly sovereign debt restructuring should be facilitated** when debt becomes unsustainable. Lastly, **policy should address intra-EU trade imbalances**.

FENCED IN RULES

MYTH 7

EU fiscal rules are presented as a package of sound limits designed to eschew the deficit bias of politicians.

Meanwhile, the chosen fiscal limits **lack economic justification**: while the 60% debt-to-GDP limit was only a rough average of the then 12 EU countries, the 3% deficit limit is the economically unjustified heritage of its prior usage in France. Whilst the "debt-to-GDP" ratio suffers important **conceptual flaws** – such as non-commensurability and time-inconsistency – **debt sustainability requires more than reaching a specific threshold**.

AMPLE WRIGGLE ROOM

MYTH 8

European fiscal rules usually get depicted as flexible enough.

In fact, flexibility is sparse and the rules dampen growth and employment while holding back Europe from reaching its environmental and social goals. Reforms must aim to **improve quality of spending**, take context better into account and prioritise long-term social and environmental **sustainability over arbitrary fiscal constraints**.

Introduction

Europe faces serious economic, environmental and social challenges. Climate change, biodiversity loss and the economic crisis have rightly grabbed headlines during the past three years. At the same time, Europe must tackle additional long-term trends such as concern around economic and digital sovereignty, decaying infrastructure, rising unemployment and social inequality in an ageing Europe. Whilst the Covid-19 pandemic has only made these challenges more acute, it has also shed a crude light on how decades of cuts and underfunding in healthcare have led to insufficient preparedness and resilience.

These challenges call Europe to rethink how the public sector best interplays with the economy. Voters and policymakers increasingly recognise the need for more and better public spending in education, research, innovation, sustainable and resilient infrastructures and productive capacities. Less widespread understanding exists that the transition to a sustainable, resilient and more equal society will not happen without a rethink of public action. Relatedly, whilst tackling the challenges Europe faces will require an improved regulatory framework, evidence also points to the need for more and better public investment to catalyse significant amounts of private capital towards these socially desirable goals.

The stakes are higher than ever as Europe will wake up from the Covid crisis in a new environment of greater risks and opportunities. On the one hand, sustainability-related fiscal risks build around growing environmental concerns, weakened private companies and households, rising joblessness and social tensions. On the other hand, excess liquidity, bulging savings levels and ultra-low interest rates provide the opportunity to reduce these sustainability-related risks by bridging deep environmental and social funding gaps and reinforcing the European economy.

But actions remain constrained by the European economic governance, a *maze of rules* built on debatable conceptions around public debt and the role the state should or should not play. Whilst *the review of the European economic governance* provides the legislative momentum, escaping the Maastricht "curse" of ill-timed fiscal consolidation and fiscal short-termism starts by fixing how people think about fiscal policy and public debt, and on the need to bind them with arbitrary rules.

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Myth I

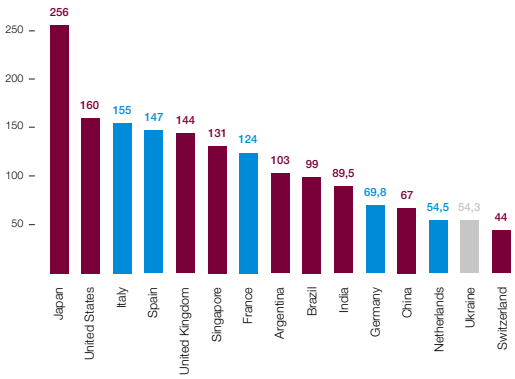
"When public debt exceeds 100% of GDP, it becomes unsustainable."

Public debt reaching 100% of gross domestic product sounds shocking and spurs public discussion about potential sovereign defaults. In the course of the ensuing debate, **comparing a country's public debt to its GDP has become commonplace**. It has made headlines following soaring levels of public debt across the globe as a consequence of Covid-19 pandemic-related economic fallout and large-scale recovery spending by governments.[1]

Despite the symbolic importance given to the issue in public debates, **the absolute size of debt-to-GDP proves a poor gauge of debt sustainability**. Numerous examples exist of countries not defaulting despite a high level of debt. Take Japan. It continues to borrow and service its debt with a debt-to-GDP ratio of more than 230%. Whilst Japan services its debt without a hitch, other countries default, despite seemingly low levels of debt. Case in point being Ukraine, which defaulted in 1998 with a stock of debt equivalent to 42% of its GDP.[2] Whilst debt sustainability describes the ability of a government to repay its debt and continue to finance public expenditure in the future, debt-to-GDP ratio provides just a point-in-time measure based on the stock of debt accumulated in the past. This indicator lacks economic relevance due to **comparing a stock (debt) with a flow (GDP)**, among others cf. Myth 7.

Figure 1: Government debt-to-GDP (%), 2020

Source: OECD, Eurostat, Statista, VoxUkraine



Assessing debt sustainability requires a look through **a wider and more forward-looking lens** by taking the evolution of other factors into consideration[3]:

1. **Future government revenues** compared to expenditures – so-called "primary balance" – which in turn depends on future GDP growth, political system stability, as well as the ability to collect taxes.
2. **Cost of debt**, namely the level of interest rate at which the government borrows money – currently at a historically low level cf. Myth 2.
3. **Maturity of debt issued** as a key determinant of sovereign issuers' outgoing cash flows in the future. Whilst the low interest rate environment has enabled many sovereign issuers to extend the average maturities of their debt stock over the last decade, some European countries still exhibit high proportions of short-term debt.[4]
4. **Investor belief** about government ability to service and repay its debt in the future, which determines the **risk premium** required by investors who purchase government debt securities. Risk premia in the European Union have tumbled since the set up of both the European Stability Mechanism and unconventional monetary policy conducted by the European Central Bank.

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1 Refer to the coverage by the *Financial Times* and *The Wall Street Journal*.

2 DEBRUN, X., et Al., "*The art of assessing public debt sustainability: Relevance, simplicity, transparency*", VoxEU, December 2019; More precisely, significant debt restructuring was required in 1998-2000 to avoid Ukraine default on a debt stock equivalent to 42% of its GDP, see: DAIZ-CASSOU, J., et Al., "*Recent Episodes of Sovereign Debt Restructurings. A case study approach*", Occasional Paper Series N.º 0804, Banco de España, 2008, p. 54.

3 For recent analysis of debt sustainability determinants refer to: e.g. BLANCHARD, O., LEANDRO, A. ZETTELMEYER, J., "*Redesigning the EU Fiscal Rules: From Rules to Standards*", October 2020; FURMAN, J, SUMMERS, L, "*A Reconsideration of Fiscal Policy in the Era of Low Interest Rates*", November 2020.

4 For average maturities, see: OECD, "*OECD Sovereign Borrowing Outlook 2019*", p.22.; For precision on the share of short-term debt (original maturity of less than 1 year) in EU debt, see: EUROPEAN COMMISSION, "*Debt Sustainability Monitor 2020*", DG ECFIN, Institutional Paper 143, February 2021, 256p., p.80 and 109.

5. **Type of investors holding the debt**, which in turn determines their market power and affects market sentiment and risk premia.[5] The bulk of EU sovereign debt is held by domestic or euro area holders.[6]

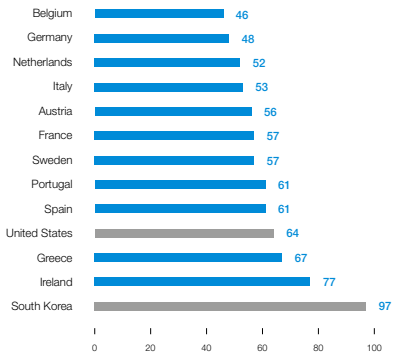
6. **Fiscal risks:** sources of potential large deviations from the fiscal forecast such as risks of banks bailout, guarantee to companies and natural disasters.[7] The notion of **sustainability-related fiscal risks** captures the impacts of climate change and other sustainability concerns on public budgets.

7. **Differential between interest rate and economic growth**. Whilst a positive differential contributes to debt accumulation through the so-called snowball effect, **a negative differential contributes to reducing the debt ratio**. Negative since 2014 in Europe, this differential is expected to remain negative until at least 2031[8] – which is historically more the norm than the exception (cf. Figure 2).[9]

Taking these aspects into account, **there clearly does not exist a one-size-fits-all optimal debt-to-GDP ratio to guarantee debt sustainability** over time. With debt limits ranging historically from 150% to 260% of GDP,[10] the much-fretted debt-to-GDP ratio of 100% remains hardly more than a scarecrow. Debt sustainability should be accepted as essentially being a probabilistic exercise conducted under uncertainty, as recently suggested by former IMF Chief Economist Olivier Blanchard.[11] Alternatively, the ***interest payment-to-GDP*** or ***interest payment-to-public revenue*** (flow-to-flow) appear to be more meaningful indicators of debt sustainability than debt-to-GDP (stock-to-flow), as they tell the percentage of economic output or public revenue needed to service debt.[12]

Figure 2: Share of years (in%) with negative interest-growth differentials

Source:IMF, Mauro, Zhou 2020



Still, given its simplicity to understand and apply, **the debt-to-GDP indicator has been used as an instrument to achieve political commitment to so-called sound fiscal practices** by European governments. The Maastricht Treaty made the 60% debt-to-GDP, together with its most famous companion – the 3% budget deficit cap – a binding constraint for Member States. Meanwhile, these thresholds have neither economic rationale nor empirical validity[13] **cf. Myth 7** and have earned heaps of criticism in recent years.[14]

Changes to the overall EU fiscal framework are expected as part of the upcoming economic governance reform. Accepting that **no debt-to-GDP ratio can guarantee debt sustainability and that debt sustainability analysis will always be a probabilistic exercise conducted under uncertainty** needs to be an important part of the discussions.

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5 In the case of Japan, domestic investors hold around 90% of its debt. This makes Japan less vulnerable to external pressure and dramatic swings in the price of the debt less likely. Greece is a different case: Before the debt crisis of 2010, most of the government debt was held by international financial institutions. In such circumstances, deteriorating state finances led to a change in the market sentiment, massive debt sell-off and increasing risk premium demanded by the investors.

6 "At the end of 2019, government debt was mainly held by resident financial corporations sector in fourteen EU Member States. Its share was the highest in Denmark (73.7%), followed by Sweden (73.1%), Croatia (66.8%) and Italy (62.7%)." EUROPEAN COMMISSION, "Debt Sustainability Monitor 2020", Institutional Paper 143, February 2021, p.82.

7 The most commonly used categories of fiscal risks are: (1) direct liabilities (contracted and predictable obligations), (2) indirect or contingent liabilities (obligations triggered by an independent but uncertain event), (3) explicit liabilities (defined by law or contract), (4) implicit liabilities (a practical effect different from the legally accepted or expected situation).

8 EUROPEAN COMMISSION, "*Debt Sustainability Monitor 2020*", Institutional Paper 143, February 2021, p.38.

9 MAURO, P., JING, Z., "*r – g < 0: Can We Sleep More Soundly?*", IMF Economic Review, 13 March 2020.

10 According to an IMF study of 23 advanced countries, the estimated debt limits where the debt dynamic can turn unsustainable range from about 150 to 260% of GDP, with a median of 192%. The authors meanwhile emphasize that it should neither be interpreted as an absolute and immutable barrier, nor as being the optimal level of public debt. Source: OSTRY, J.D., GHOSH, A.R., et al., "*Fiscal space*", IMF Staff Position Note, September 2010.

11 BLANCHARD, O., LEANDRO, A. ZETTELMEYER, J., "*Redesigning the EU Fiscal Rules: From Rules to Standards*", October 2020, Presented at the 72nd Economic Policy Panel Meeting, p.12.

12 Replacing debt-to-GDP ratio by debt service-to-GDP ratio has been suggested in: FURMAN, J, SUMMERS, L, "*A Reconsideration of Fiscal Policy in the Era of Low Interest Rates*", November 2020, p.37.

13 While alleged causality between some debt-to-GDP thresholds and lower growth rates were critical in legitimising post-financial crisis austerity, it has now been largely debunked. For a summary of the Reinhart and Rogoff controversy, see: POLLIN, R., "*Public debt, GDP growth, and austerity: why Reinhart and Rogoff are wrong*", LSE blog, 8 March 2014.

14 For details: SUTTOR-SOREL, L., "*One Framework to Rule them All*", Finance Watch, 2021.

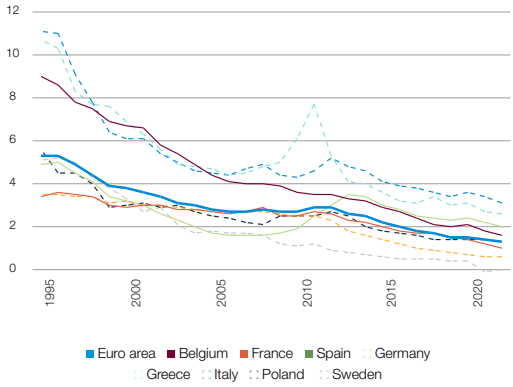
Myth II

"When inflation returns, interest rates will rise and debt will become unsustainable as a consequence."

European Member States' debt sustainability increased during the last decade due to several factors. Those include the fall of sovereign bond interest rates (Figure 5), debt maturities lengthening in most European countries, and the resulting **significant decline in interest payment-to-GDP** (Figure 3) – a good proxy of debt services cost as sovereign borrowers tend to rollover their debt. The trend will likely last in the coming years, with the European Central Bank pointing to an average annual interest rate for euro area 10-year government bonds ranging from -0.1 to 0.1% until at least 2023.[15] With a higher stock of debt meaning a higher sensitivity of debt sustainability to interest rate levels, the looming question is to figure out how long the current low interest rate environment will prevail.

Figure 3: Cost of interest on public debt (%GDP)

Source: AMECO



Arguments have been made that interest rates are kept artificially low by European Central Bank monetary policy, and that this situation might not last as inflation could rise after the Covid crisis ends. While it remains undisputed that inflation plays a central role in ECB determination of its short-term interest rates and other unconventional monetary policy decisions[16], four counterarguments can be made:

1. **Temporary, measured inflation can be expected in the short run, *not* sustained, accelerating inflation**. Recent small spikes in sovereign interest rates stem from inflation expectations by market participants that are unlikely to last. As stated by the European Central Bank, the **recent upswing in inflation in the euro area is due to idiosyncratic factors** such as the end of temporary VAT rate reduction in Germany or higher energy price inflation.[17] Temporary, measured inflation is a plausible scenario in the aftermath of the Covid-19 crisis due to base effects[18], supply chain disruptions[19], and pent-up demand for services.[20] Expected to fade over time as economies recover, **these temporary effects have a low risk of leading to sustained or accelerating inflation**.[21] They should not be expected to overcome the structural drivers behind the decades-long fall in inflation rates.[22]

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15 "*ECB staff macroeconomic projections for the euro area*", December 2020.

16 In fact, the ECB asset purchase programmes are expected to still have an impact 10 to 15 years after the end of the net purchases. In: "*The effects of APP reinvestments on euro area bond markets*", Benoît Cœuré, Member of the ECB Executive Board, at the ECB Bond Market Contact Group meeting, 12 June 2019.

17 "The upswing in headline inflation reflects a number of idiosyncratic factors, such as the end of the temporary VAT rate reduction in Germany, delayed sales periods in some euro area countries and the impact of the stronger than usual changes in HICP weights for 2021, as well as higher energy price inflation. [...] These factors can be expected to fade out of annual inflation rates early next year." in: "*Introductory statement to the press conference*", C. Lagarde and L. de Guindos, President and Vice-President of the European Central Bank, 11 March 2021.

18 The *base effect* refers to the fact that the measure rate of year-to-year inflation depends not just on what prices are doing now but what they were doing a year ago. In our current situation, a temporary higher inflation rate in 2021 could solely reflect the falling prices of 2020.

19 Temporary cost-push inflation could come as a consequence of *supply chain disruptions* due to lock-downs. In the near-term some businesses may temporarily pass on the added costs from these disruptions into higher consumer prices.

20 Temporary demand-pull inflation due to *pent-up demand*, especially for services, could happen. Prices of many services have decreased due to the lock-down, while high-touch services have been shut-down for months. As more people get vaccinated, demand for these services could surge and temporarily outstrip supply.

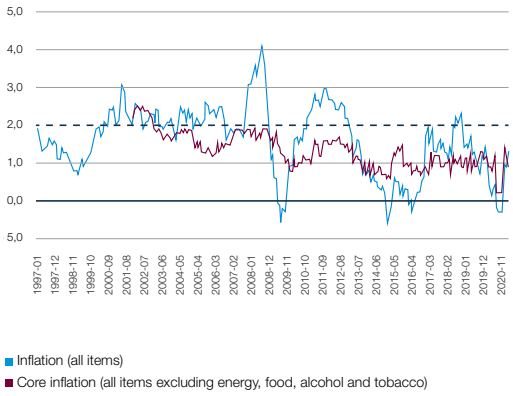
21 BERNSTEIN, J., TEDESCHI, E., "*Pandemic prices: assessing inflation in the months and years ahead*", The White House, Briefing Room, Blog, April 12, 2021.

22 Detailing these drivers would go behind the scope of this paper. Meantime, it is worth noting the growing understanding that inflation is increasingly driven by *global competition* from emerging economies that puts downward pressure on price and wage growth in advanced economies. See: AUER, R. A., et al.,"*Low-wage import competition, inflationary pressure, and industry dynamics in Europe*", European Economic Review, Elsevier, vol. 59(C), p. 141-166; FORBES, K., "*Has globalization changed the inflation process?*", BIS, June 2019, 63p.

2. **Central banks could allow measured inflation temporarily without raising their key interest rates**. Assuming inflation rate would surge as a hypothetical consequence of a post-Covid recovery, major central banks have given indications that they could allow for some years a situation where inflation would exceed their usual 2 percent target without raising their key short-term interest rates. The US Federal Reserve already stated this by adopting **an average inflation targeting framework** that allows for higher inflation offsetting prior underperformance.[23] The European Central Bank has made a similar move by recently adopting a symmetric 2% inflation target over medium term as part of its new monetary policy strategy.[24]

Figure 4: Inflation rate, Euro area (HICP)

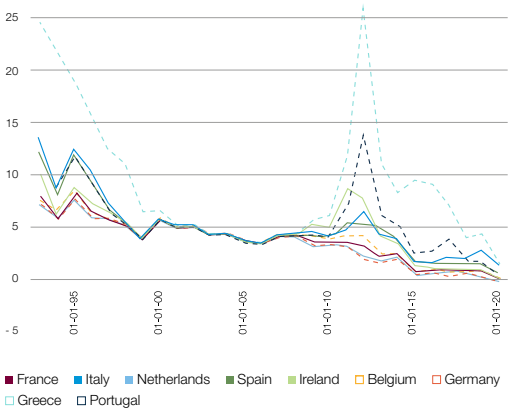
Source: Eurostat



3. **Other macroeconomic factors play a role in explaining historically low interest rates in advanced economies**. The lasting fall in sovereign interest rates in advanced economies is not only conjunctural or related to accomodative monetary policy, it also has structural roots, among which: (i) **economic growth lower** than during previous periods, (ii) **increased savings** due to an ageing population, (iii) **income growth** in emerging economies, and (iv) **an unmet uptick in demand for safe assets** such as sovereign bonds due to a surge in risk aversion in the wake of the global financial crisis.[25] All these structural and long-term factors play an important role in explaining why the multi-decade decline in sovereign interest rates should not be expected to be easily reversed.

Figure 5: Evolution of long-term sovereign interest rate (10Y)

Source: ECB



4. **Policy choices also play a role in explaining historically low sovereign interest rates in Europe**. Designing **sovereign bonds as risk-free assets** in prudential regulation and in ECB open market operations, along with the institutionalisation of the European Stability Mechanism as a (conditional and limited) **lender of last resort for sovereign issuers** both play a role in lowering market risk perception and therefore risk premia.

A lasting rise in sovereign interest rates seems the less likely scenario for the coming years. Structural factors cannot be quickly reversed and are therefore expected to continue to exercise downward pressure on inflation, on sovereign interest rates and on ECB interest rate decisions. The European Central Bank observed that they "do not see that development in any particular yields pose an issue"[26], but stated its commitment to prevent any tightening of euro-area-wide financing conditions. **This leaves plenty of time for expansionary fiscal policy to act** in order to make the EU economy more sustainable and resilient.

23 POWELL, J.H., "*New Economic Challenges and the Fed's Monetary Policy Review*", Chair, Board of Governors, Federal Reserve System, speech at the Jackson Hole annual conference, August 27, 2020.

24 "5. The Governing Council considers that price stability is best maintained by aiming for two per cent inflation over the medium term. […] This may also imply a transitory period in which inflation is moderately above target." In: "*The ECB's monetary policy strategy statement*", 8 July 2021.

25 CEA, "*Long-Term Interest Rates: A Survey*", Council of Economic Advisors, White House, 2015, 54p.; FIELDER, S, GERN, K-J., JANNSEN, N., WOLTERS, M., "*Growth prospects,the natural interest rate, and monetary policy*", European Parliament, In-depth analysis requested by the ECON committee, November 2018, 35p.

26 ECB *press conference, 21 January 2021*, C. Lagarde and L. de Guindos, President and Vice-President of the European Central Bank.

Myth III

"Public debt is an unfair burden on future generations."

Intergenerational equity is often invoked in the debate around public debt. The argument goes as follows: public spending in excess of available income, i.e. borrowing, will be an unfair burden for future generations who will have to reimburse the debt they inherited. But this story overplays the liability trope around debt whilst overlooking that running balanced budgets does not automatically guarantee intergenerational equity. As counterintuitive as it may appear at first sight, **higher debt-financed expenditures made today do not necessarily mean a higher burden for upcoming generations**. Considering large funding gaps (cf. fig 6)[27] in a structurally-low interest rate cf. Myth 2 and a high savings and liquidity context[28], intergenerational equity calls instead for a higher level of qualitative debt-financed expenditures. The three main reasons for this are:

1. **The cost of failing to invest now in societal resilience and sustainability will weigh more on future generations' shoulders than the cost of debt resulting from investments made today**. Failing to mitigate *climate change*, *environmental degradation*, and *biodiversity loss* will lead to droughts, floods, and soil depletion, not to mention mass migrations and conflicts for water and space. These disruptions of human societies will have without doubt profound and unprecedented social, economic, and financial consequences. **Mitigating these disruption risks and adapting to them calls for policymaking and precautionary public investment**. Whilst the former is essential to steer the economy towards sustainable processes, the latter is required to bridge the **EU environmental funding gap estimated at €470 billion per year until 2030** (cf. Figure. 6).[29] Avoiding the future disruption of societies will require investment in sustainable infrastructures, conservation, and restoration, investments that the private sector today looks unable to finance.[30] In comparison with the economic, social, and human cost of not investing, the cost of servicing the debt resulting from those investments will be, at worst, a problem of secondary importance.

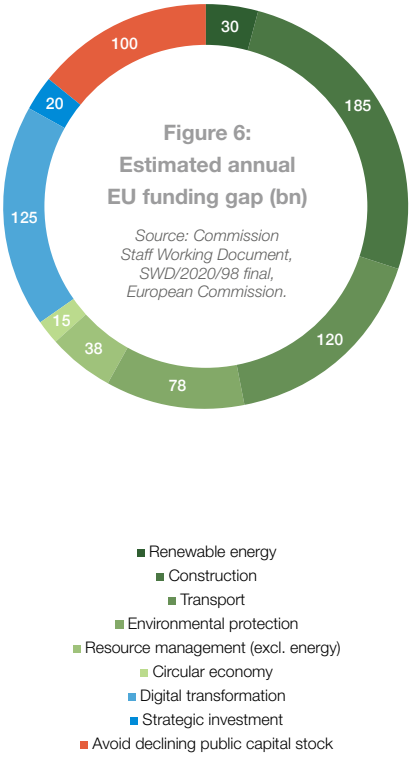


Figure 6: Estimated annual EU funding gap (bn)

Source: Commission Staff Working Document, SWD/2020/98 final, European Commission.

> ***I want to be clear. If we don't clear this development fast enough, our children and grandchildren will fight wars over water and food.***
>
> **Frans Timmermans**
> Executive Vice-President of the European Commission, 18 May 2021, ZDF Heute Journal

27 For an estimation of EU funding gaps, see: European Commission, "*SWD(2020) 98 final - Identifying Europe's recovery needs*", Communication accompanying the document 'Europe's moment: Repair and Prepare for the Next Generation', 27.5.2020.

28 As illustration, excess liquidity (i.e. holdings of central bank reserves in excess of minimum reserve requirements and holdings of equivalent central bank deposits) exceeded in 2018 €1,900 billion or 17% of euro-area GDP. Source: DARVAS, Z., PICHLER, D., "*Excess Liquidity and Bank Lending Risks in the Euro Area*", Bruegel, Septembre 2018, p.44.

29 For details on this estimation: European Commission, "*SWD(2020) 98 final - Identifying Europe's recovery needs*", Communication accompanying the document 'Europe's moment: Repair and Prepare for the Next Generation', 27.5.2020, p.14-16.

30 The EU environmental funding gap appears precisely in those activities that fail to attract private investors as they do not generate enough revenue streams, are perceived as too risky, or must be conducted by the public sector or households, for example in public and residential energy efficiency.

2. **As a large part of spending and investments made today do not solely benefit the present generation, intergenerational equity requires spreading the cost across all benefiting generations**. The most notable examples include: ***(i) investments in early education, training and research*** that yield significant benefits for future generations, offsetting in the long-run their original cost as they lead to higher future wages and reduced government transfers.[31] ***(ii) investments in resilience-oriented social and economic infrastructures*** that also create jobs, produce positive spillover effects in other sectors of the economy as well as reduce future maintenance costs.[32] ***(iii) sustainable industrial and innovation policies*** which benefit future generations, as they usually lead to higher economic development and lower unemployment.[33]

3. **Investment done by prolonging debt maturity relieves the debt burden for future generations**. Sovereign interest rates sit lower today than during past decades. Consequently, old stocks of debt exhibit higher debt servicing costs than those of the debt issued today. Considering ultra-low interest rates, flattened yield curves cf. Myth 2 and 6 and the existence of important funding gaps, **governments would be wise to "lock-in" as much low interest rate debt as possible by refunding maturing debt with long-term debt**. This would ensure both long-term, cheap funding and minimise future roll-over risk of public budgets. The longer the period of ultra-low rates lasts, the lower the total interest burden will be.

Based on the considerations expressed above, **intergenerational equity should not be about restraining the quantity of public spending but ensuring its *quality***, namely what the proceeds of the additional debt raised today are invested in. This point proves particularly relevant given the current economic slowdown, as poorly timed fiscal contraction has aggravated economic crises and carried long-term, negative knock-on effects for the economy.[34] Instead, provided quality public investments get made today, Europe can ensure intergenerational equity. This means quality spending made now to benefit future generations will lead to improved welfare, higher employment levels, a better natural environment and prevention of disruptive events that will in turn improve long-term fiscal sustainability.

31 A recent analysis of 133 different future-oriented policy changes (i.e. directed to children, job training, social insurance, etc.) shows that on average their benefits outweighed their original cost – among other things because these policies led to higher future wages and reduced government transfers. In particular investments in children's education and health were shown to pay off well in the future. In: HENDREN, N., SPRUNG-KEYSER, B., "A Unified Welfare Analysis of Government Policies", The Quarterly Journal of Economics 135(3), February 2020, p. 1209-1318.

32 Despite the growing calls for infrastructures to be privately financed, the financial characteristics of many infrastructure projects – such as high initial investment costs, unmonetized positive externalities, or natural monopolies – explain why a significant part of those projects have to be, and will remain, mostly publicly funded. For a discussion on the uniqueness of infrastructure, its economic and social benefits and the level of investment in Europe, see: ATHENOSY, L., "Investing in public infrastructure in Europe - A local economy perspective", ZBW, CEB, September 2017, p.8-10.

33 See for example: GULOGLU, B., TEKIN, B., "A Panel Causality Analysis of the Relationship among Research and Development, Innovation, and Economic Growth in High-Income OECD Countries", Eurasian Economic Review, volume 2, p. 32–47, August 2014; BLANCO, L., et Al., "The Impact of Research and Development on Economic Growth and Productivity in the U.S. States", Southern Economic Journal 82(3), December 2015; YIFU LIN, J., WANG, Y., "Seventy years of economic development: a review from the angle of New Structural Economics", China & World Economy, Vol.28, Issue 4, July 2020.

34 FATAS, A., SUMMERS, L. H., "The Permanent Effects of Fiscal Consolidations", Journal of International Economics 112, December 2017; GECHERT, S., HORN, G., PAETZ, C., "Long-term Effects of Fiscal Stimulus and Austerity in Europe", Oxford Bulletin of Economics and Statistics, 2017.

Myth IV

"Investing is not the responsibility of the state. Public investment crowds out more productive private investment!"

Developed by monetarist economists in the 1970s as a criticism of expansionary fiscal policy, the "crowding out effect" hypothesis goes as follows: By absorbing limited financial resources, public investment causes interest rates to rise, which leads to less private investment. Two hidden assumptions underlie this assertion: first, that the amount of financial resources available would be limited and, second, that the public sector would be less efficient than the private sector at creating value.

But the crowding out effect hypothesis overlooks three key arguments.

1. **Public investments are necessary for public goods provision, national interest protection, climate change mitigation, as well as for stimulating the economy**. Transport and electricity infrastructures, sanitation services, schools, hospitals or nature conservation areas all comprise important activities of public interest. **They require public investment, as they lack characteristics attractive to private investors**: some of these activities are public goods[35] that generate little or no returns; others are natural monopolies such that only one supplier could invest in them – for example water supply.

   Public investment today is more important than ever as **society faces significant disruption risks due to climate change and nature degradation**. While the EU environmental funding gap until 2030 has been estimated to be around €470 billion a year,[36] the gap appears precisely in those activities that fail to attract private investors as they do not generate enough revenue streams, are perceived as too risky[37], or must be conducted by the public sector or households, for example in public and residential energy efficiency.

   Furthermore, there is growing understanding that government action proves less efficient when limited to de-risking or financing projects that fail to attract private funders (market fixing), than when it **actively co-shapes economic development towards socially desirable goals** (market shaping).[38] Government can help shape new markets by co-investing in innovation, research and development[39], as it has been shown that absent public support, investments in research and development remain below their socially optimal level.[40]

2. **Public investment produces a positive knock-on effect of "crowding in" private investment under certain circumstances**. Fiscal multipliers in most European countries usually exceed 1.0[41], which means that increasing government expenditure has on average a positive impact on the level of economic activity and growth. The amplitude of this positive effect is a function of the type of fiscal policy considered and the economic context in which it takes place. Whilst an increase in public expenditure has on average a greater effect on the economy than tax cuts, **public investment is especially associated with permanent and positive impacts on the**

35 Public goods have two key characteristics – non-rivalry and non-excludability. Non-rivalry means that more than one person can use the good without diminishing others' ability to use it. There is also non-excludability, which refers to the inability to restrict other consumers from using the good.

36 Comprising €240 billion for climate and energy, €100 billion for transport infrastructure and €130 billion for the other environmental objectives. Source: European Commission, "SWD(2020) 98 final - Identifying Europe's recovery needs", Communication accompanying the document 'Europe's moment: Repair and Prepare for the Next Generation', 27.5.2020, p.14-16.

37 SUTTOR-SOREL, L., HERCELIN, N.,"Nature's Return - Embedding environmental goals at the heart of economic and financial decision-making", Finance Watch, May 2020.

38 MAZZUCATO, M., RYAN-COLLINS, J., "Putting value creation back into 'public value': from market fixing to market shaping", 2019, UCL Institute for Innovation and Public Purpose, Working Paper Series (IIPP WP 2019-05); YIFU LIN, J., WANG, Y., "Seventy years of economic development: a review from the angle of New Structural Economics", China & World Economy, Vol.28, Issue 4, July 2020.

39 LAPLANEA, A., MAZZUCATO., B. "Socializing the risks and rewards of public investments: Economic, policy, and legal issues", December 2020.

40 BLOOM, N., et Al., "Identifying Technology Spillovers and Product Market Rivalry.", Econometrica 81(4): 1347-1393, July 2013; Akcigit, UFUK, A., HANLEY, D., SERRANO-VELARDE, N., "Back to Basics: Basic Research Spillovers, Innovation Policy, and Growth.", The Review of Economic Studies, May 2020.

41 CHARLES, S, DALLERY, T., MARIE, J., "Why Are Keynesian Multipliers Larger in Hard Times? A Palley-Aftalion-Pasinetti Explanation", Review of Radical Political Economics, Vol. 50, issue 4, p. 736-756.

level of economic activity.[42] In particular, public investment in infrastructure provides a jolt to private sector productivity and a boost to community development.[43] **This multiplier effect becomes considerably higher during recessions**[44], when economic resources lay underutilised[45], as well as when interest rates are persistently low.[46] In other words, public investment holds the potential to *crowd in* private investment by expanding the productive capacity of the economy, especially during a recession. When applied to Europe, this effect is expected to be pronounced in countries of Southern Europe where economic resources remain underutilised.[47]

3. **Under current economic conditions, there can be no such thing as the crowding out of private investment by public investment**. Supported by accommodative monetary policies and ample levels of savings, **liquidity in the European**[48] **and global capital markets is abundant and interest rates remain at historic lows**, having reached negative levels. Whilst this situation seems likely to prevail for the foreseeable future **cf. Myth 2**, the large size of the European economy, capital markets and savings, as well as its wide access to international capital markets, adds further reason not to consider the crowding out effect as a meaningful phenomenon in the current context.

In a context of abundant capital, public and private investment must be seen for what they are: complementary.

42 GECHERT, S., "*What fiscal policy is most effective? A meta-regression analysis*", Oxford Economic Papers, 2015, 67(3), p. 553–580.

43 For the overview of empirical literature refer to ESPINOZA, R., GAMBOA-ARBELAEZ, J., SY, M., "*The Fiscal Multiplier of Public Investment: The Role of Corporate Balance Sheet*", IMF Working Paper WP/20/199, September 2020, p.6-7.

44 Multipliers increase by 0.6 to 0.8 units during an economic downturn. Source: GECHERT, S., RANNENBERG, A., "Which fiscal multipliers are regime-dependent? a meta-regression analysis", Journal of Economic Surveys, Vol.32, Issue 4, 2018.

45 DELONG, J.B., SUMMERS, L., "*Fiscal policy in a depressed economy*", 2012, Brookings Papers on Economic Activity, 44, p. 233–97.; QAZIZADA, W., STOCKHAMMER, E., "*Government spending multipliers in contraction and expansion*", International Review of Applied Economics, 2015, 29 (2), p. 238–258.

46 BONAM, D., DE HAAN, J., SOEDERHUIZEN, B., "*The effects of fiscal policy at the effective lower bounds*", Macroeconomic Dynamics, 2020, Cambridge University Press, p.1-37.; AMENDOLA, A., et al., "*The Euro-Area Government Spending Multiplier at the Effective Lower Bound*", IMF Working Paper, WP/19/133, July 2019, 32p.

47 DELEIDI, M., et Al. "*Public investment fiscal multipliers: An empirical assessment for European countries*", UCL Institute for Innovation and Public Purpose, Working Paper 2019-08.

48 Excess liquidity, defined as holdings of central bank reserves in excess of minimum reserve requirements and holdings of equivalent central bank deposits, exceeded, in 2018, €1,900 billion or 17 percent of euro-area GDP. Source: DARVAS, Z., PICHLER, D., "Excess Liquidity and Bank Lending Risks in the Euro Area", Bruegel, Septembre 2018, p. 44.

Myth V

"Some European Member States are over-indebted because they live beyond their means!"

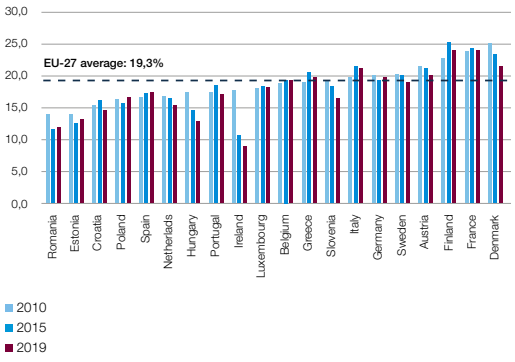
EU countries with comparatively high stocks of government debt are often accused of improperly managing public budgets.[49] Allegedly, these countries would be running budget deficits to enable their populations to enjoy a standard of living beyond their means. Criticism is often hurled towards Greece, Italy, Spain and Portugal – four of the five countries which received financial assistance in 2010 and subsequent years. Far from being limited to the realm of economics, the discussion has at times turned into a "cultural battle", whereby ordinary citizens point out the irreconcilable cultural differences in attitudes to the rules and working cultures of different countries. Politicians have often not shunned away from the "living beyond the means" argument either.[50]

Before resorting to cultural hostilities, **it is worth taking a closer look at EU countries' public spending structures and debt levels** and at their underlying factors.

1. **Statistics do not offer evidence that some populations benefit from particularly high social benefits or work less**. The highest levels of public expenditure on social protection (in percent of GDP) occur in Denmark, France and Finland, whereas ratios for Greece, Portugal and Spain fall below the EU average (cf. Figure 7).[51] In terms of working hours, **Greece clocked the highest number of working hours per employee per week** (41.8) during the period from 2008 to 2020, whereas **the lowest number was observed in the Netherlands** (30.4). This compares with other countries as follows: Poland (40.3), Spain (37.6), France (37.4), Italy (37.1), Sweden (36.4), Germany (34.9), and the EU-27 average (37.1).[52]

Figure 7: Public expenditure on social protection, 2019, % of GDP

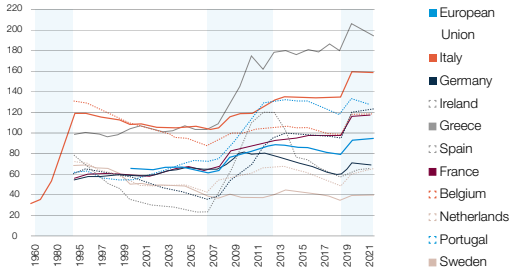
Source: Eurostat



2. **A large share of public debt stock is a legacy from unexpected events**. Common to all European countries, **the costly consequences of the 2007-2009 financial crisis** amounted to around an additional 20 percentage points added to the EU debt-to-GDP ratio.[53] The financial and economic crises morphed into a debt crisis as **investors started to price in the sovereign default risk** of Greece, Italy, Spain, Portugal and Ireland. Deficits and public debt rose particularly in these countries as they

Figure 8: Public debt in % of GDP

Source: AMECO



49 Refer to the myth n°1 on the discussion of appropriateness of using popular debt indicators.

50 HARRIS, M., "*Schäuble Strikes Again: Greece Not Living Within Its Means*", Greek Reporter, November 18, 2016.

51 It must be mentioned that these statistics say nothing on the appropriate level of public expenditure on social protection, as it depends on country-specific situations and democratic choices.

52 Source: "*Average number of usual weekly hours of work*", Eurostat.

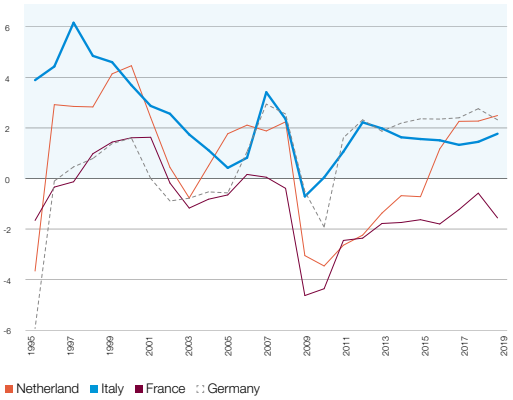
53 Additional deficit and debt were not the result of spendthrifts but of "sizeable fiscal costs through a combination of financial sector rescues, forfeit revenues owing to depressed activity, and, more secondarily, discretionary counter-cyclical fiscal impulse to lessen the downturn". In: BUTI, M., CARNOT, P., "*The EMU Debt Crisis: Early Lessons and Reforms*", Journal of Common Market Studies, 50 (6), p. 899–911.

faced soaring interest rates.[54] Fiscal contraction later imposed on them as a condition to access EU financial assistance[55], which led to further declines in economic output and rising debt-to-GDP, prevented the intended fiscal consolidation.[56]

In the case of Italy, a significant part of the stock of debt is a legacy left from the 1980s and 1990s when the government had to borrow at high rates. The Bank of Italy introduced back then high discount rates – peaking at *19%* in 1981 compared to *9%* in Germany – to combat inflation and manage exchange rate fluctuations prior to the introduction of the euro. Consequently, yields on 10-year government bonds peaked at over 20% in 1982 and averaged 14% between 1980 and 1993.[57] In this context, the public debt ratio could only be stabilised at around 130% of GDP[58] despite **continuous substantial primary surpluses** achieved in subsequent years (see Figure 9).

Figure 9: Primary balance in % of GDP (excluding interest payment)

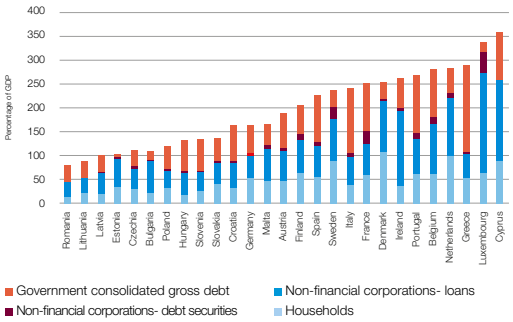
Source: ECB



3. **Considering private debt gives a different picture of the debt situation of each country**. Statistics show a more nuanced and complex picture, with **several countries with relatively low levels of public debt exhibiting much higher levels of private debt-to-GDP** (see Figure 10). Analysing mechanisms at stake and conditions under which private debt is sustainable looks beyond the scope of this paper. Meanwhile, it is worth mentioning that 11 Member States exceeded macroeconomic imbalance procedures (MIP) thresholds[59] for total private debt in 2019 – with some countries recording private debt-to-GDP ratios of over 200%.[60]

Figure 10: Public and private debt in EU-27, 2019

Source: Eurostat



These discussions do not provide a full explanation for the stock of debt and deficit level of any given country. **Other factors also impact public and private debt** among which budget revenue, structure of economic sectors, volumes of imports and exports and associated trade and current account balances **cf. Myth 6**. Their importance might differ over time depending on the economic cycles and other developments within each economy.

Drawing conclusions from the above, understanding the situation of any country requires a careful look at a wide number of variables, not a single ratio.

54 "*A very short history of the crisis*", The Economist, November 12th, 2011 edition.

55 Article 7 of the Regulation (EU) No 472/2013.

56 PANICO, C., PURIFICATO, F., "The role of institutional and political factors in the European debt crisis", Political Economy Research Institute, University of Massachusetts at Amherst, Working Paper Series, March 2012, p. 12-15.

57 "Italy's Debt Woes,30 Years in Making", Wall Street Journal, November 18, 2011.

58 HEIMBERGER, P., "Italy is of systemic importance – European solutions are needed", Vienna Institute for International Economic Studies.

59 The Macroeconomic Imbalances Procedures (MIP) is monitoring imbalance in Member States via a series of indicators, among which private debt levels. While the MIP was first built around an indicative threshold of private sector debt-to-GDP of 133%, European Commission' monitoring is now referring to "fundamental-based thresholds" and "prudential thresholds". These thresholds have been recently developed by researchers and supervisors in an attempt to establish private debt levels above which financial stability is at risk. According to the authors, "The median prudential benchmark for NFC debt is around 85% of GDP, while for household debt it is about 55%. For fundamental-based benchmarks, the median lies at about 75% for NFCs and is close to 50% for households." Source: BRICONGNE, J.-C., COUTINHO, L., et al., "*Is Private Debt Excessive?*", Open Economies Review, 3, p. 471-512, 2020.

60 European Commission, "*Alert Mechanism Report 2021*"

Myth VI

“Public budgets, like those of healthy households, must stay in surplus.”

Building on the household analogy, **public budget surplus is often presented as a necessity to repay debts and build “fiscal space”** that can be used in case of crises with public budget balance as the expected minimal norm.

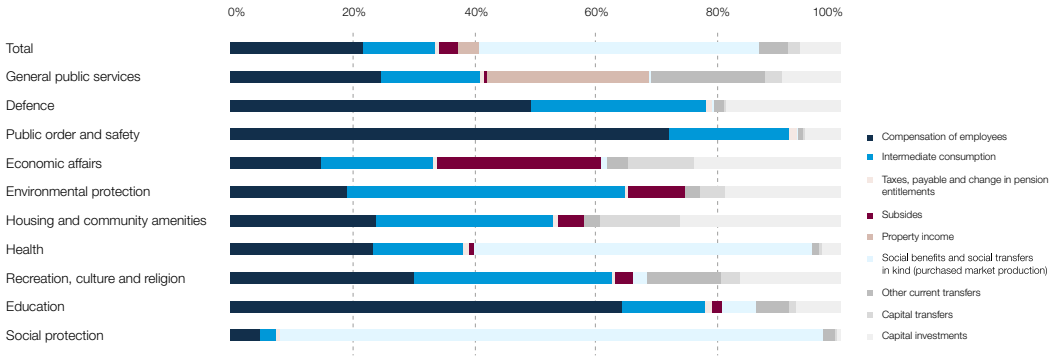
But states are not households and are therefore not expected to manage budget and debt like one. In fact, a closer look shows that **public budget surpluses are rarely desirable or achievable and are never the only option** to ensure long-term public debt sustainability.

First, budget surplus is often fiscally unwise and harmful

Surpluses accrue either by **reducing government expenditures**, such as social transfers, civil servant salaries, public consumption and/or investment[61], or by **raising public revenue** via corporate, consumption and/or income taxes. Choosing one option over another, one sector over another, is anything but neutral, as it can significantly affect the level of economic activity and employment, but also of social cohesion, education, public order or environmental protection (cf. Figure 11).

Figure 11: General government expenditure by function and transaction, EU-27, 2019, % of TE

Source: Eurostat



Meanwhile, two more fundamental questions surface: **when to seek surpluses and when to run deficits?**

Whilst a budget surplus can be the natural outcome of a booming economy – as social expenditures decrease and tax revenues increase – it can also be temporarily sought after with the aim of cooling-down an overheating economy and preventing runaway inflation. **Conversely, seeking budget surpluses proves fiscally unwise when:**

1. **Interest rates fall below the growth rate**. In these cases, ***debt-financed expenditures*** can become a economically sound choice as future revenues are likely to outweigh debt servicing costs. This has been the situation in Europe since 2014 and is expected to last until at least 2031.[62]
2. **The economy faces depression and economic resources lay underutilised**. In these situations, fiscal expansion is the only responsible course of action as fiscal multipliers are above 1.0, meaning that €1 of public

61 These expenditures correspond to (i) social benefits and transfers, such as pension payments, unemployment benefits and child allowances (46.1%), (ii) compensation of employees in the sectors of education, healthcare, defense and public services, (iii) consumption of goods and services (12%) and (iv) public investment in roads, schools or hospitals (6.5%). Source: “*General government expenditure by function*” (EU-27, 2019), Eurostat.

62 EUROPEAN COMMISSION, “*Debt Sustainability Monitor 2020*”, Institutional Paper 143, February 2021, p.38 and 49.; The International Monetary Fund recently undertakes an empirical analysis of interest-growth differentials for 55 countries over up to 200 years. IMF staff conclude that negative differentials have occurred more often than not, in both advanced and emerging economies. See: MAURO, P., JING, Z., “*r – g < 0: Can We Sleep More Soundly?*”, IMF Economic Review, 2020.

spending leads to more than €1 of economic activity **cf. Myth 4**. An approach with a longer view can be found with ***growth-enhancing expenditures*** that can boost the economy, therefore further expanding tax-related public revenue that ease public debt servicing whilst reducing social spending. Meanwhile, pursuing undifferentiated economic growth proves environmentally and socially harmful and will eventually lead to the materialisation of *disruption risks and debt unsustainability*.

3. **The economy is unsustainable and faces disruption risks**, as its sustainability and resilience form preconditions for debt sustainability.[63] *Climate change*, *biodiversity loss*, and the destruction of the social fabric will result in excessively high costs that will ultimately be borne by public budgets. Considering the importance of these 'sustainability-related fiscal risks', debt-financed expenditures prove definitely rational ***if they reduce risks and costs of future environmental and social disruptions***, even if they do not have a short-term, growth-enhancing impact **cf. Myth 3**.

Second, budget surplus cannot be achieved by all countries at the same time

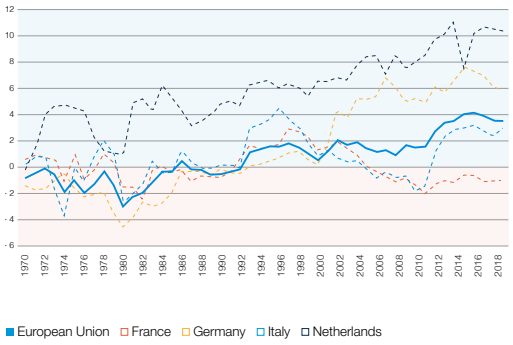
Absent a current account surplus, a sustained public budget surplus implies a shrinking economy. But running such surplus requires, by construction, exporting more than importing.

Meanwhile, all countries cannot run a current account surplus at the same time as surpluses and deficits, by construction, must balance each other out in the global economy.

A comfortable €349 billion EU-27 current account surplus reached in 2020[64] should not hide persistently large intra-EU current account imbalances. Whilst EU finance and economy ministers take an official stance that "symmetric rebalancing of current accounts can be beneficial for all Member States"[65], efforts to re-balance have proven asymmetric so far.

Figure 12: External balance on goods and services (% of GDP)

Source: woldbank, WDI



Export-oriented economies have not resorbed their permanent large intra-EU current account surplus. In particular, the large and persistent German current account surplus, and to a lesser extent the Dutch surplus, have been repeatedly pointed out by international and EU institutions, trade partners, and economists, as participating in EU imbalances.[66] Whilst around 70% of German trade flows in 2018 took place with European partners, €120 billion of its €230 billion surplus on the trade of goods[67] was achieved vis-à-vis EU Member States.[68] The EU-27 economic and finance ministers are officially calling for this surplus to be resorbed via wage growth, public and private investment and increased domestic demand.[69]

63 PHILIPPONNAT, T., "*Debt sustainability and a sustainable COVID recovery*", Finance Watch, July 2020, 9p.

64 This surplus is mostly due to a trade surplus for goods and services of €389 billion. More precisely, the EU-27 current account balance in 2020 is composed of goods (+ €329 billion), services (+ €60 billion), primary income (+ € 22 billion) and secondary income (- €62 billion). Source: "*European Union and euro area balance of payments - quarterly data (BPM6)*", Eurostat, 2021.

65 "*Alert Mechanisùm Report 2020 - ECOFIN Council Conclusions on 18 February 2020*", p.3.

66 Source: Germany, Denmark and Netherlands "continue recording current account surpluses that exceeded the MIP scoreboard upper threshold" in: EC, "*Alert Mechanism Report 2021*"; "stronger and more balanced growth in Germany is critical to a lasting recovery in the euro area and global rebalancing" in: IMF Country Report No. 13/255; "'Germany's anemic pace of domestic demand growth and dependence on exports have hampered rebalancing at a time when many other euro-area countries have been under severe pressure to curb demand and compress imports in order to promote adjustment." in: U.S. Department of the Treasury, "*Report to congress on international economic and exchange rate policies*", 2013; "PRIEWE, J., "*A Time Bomb for the Euro? Understanding Germany's Current Account Surplus*", IMK Study, Berlin, 2017.

67 Among its foreign trade partners, Germany has the largest trade surplus with the United States (€48.8 billion), the United Kingdom (€45.0 billion), France (€40.1 billion), Austria (€21.7 billion) and Spain (€11.8 billion). Its largest trade deficits are with China (€13.0 billion), Russian Federation (€10.0 billion) and Netherlands (€6.0 billion). Source: BMWI, "*Facts about German foreign trade*", 2019.

68 BMWI, "*Facts about German foreign trade*", Federal Ministry for Economic Affairs and Energy, Berlin, September, 2019, 18p.

69 The Economic and Financial Affairs Council (ECOFIN) recommended that "[...] Member States with large current account surpluses should further strengthen the conditions to promote wage growth [...] foster public and private investment, support domestic demand [...]. Acknowledges that symmetric rebalancing of current accounts can be beneficial for all Member States, generally supporting deleveraging in the euro area as a whole. [...]". Source: "*Alert Mechanism Report 2020 - ECOFIN Council Conclusions on 18 February 2020*", p.3.

Conversely, most Member States that encountered significant current account deficits in the 2000s have resorbed them,with France being the notable exception (cf. Figure 12). Achieved by a combination of internal devaluation[70] (lowering wages to boost exports) and reduced internal demand (imports reduction), the result contributed less to improving these countries' public finances than if it had been achieved through higher economic growth.

Considering the link between current account and budget surpluses, intra-EU trade imbalances make, and will continue to make, hardly possible for every country to run budget surpluses at the same time.

Third, debt management is also important and should be facilitated

Budget management is not the only tool to ensure long-term sovereign debt sustainability. Debt management is as important and **different options exist to give sovereign issuers the needed room for manoeuvre**.

1. **Debt management offices should lengthen debt maturity to mitigate roll-over risks**. Most of the time, long-term debt demands a higher interest rate than short-term debt but involves lower roll-over risks.[71] Consequently, favouring long maturity was historically a strategy mostly chosen by debt management offices of countries facing little differential between the cost of issuing short- and longer-term debt (captured by the yield curve slope). But the context is evolving.

   First, euro area yield curves have overall flattened over the last decade. The distance between short- and longer-term debt yields reflects market expectations about future interest and inflation rates as well as perceptions of long-term creditworthiness and default risks. These "differentials" have been positively impacted during the last decade by ECB unconventional monetary policies[72] and the institution of the European Stability Mechanism as a limited and conditional lender of last resort for sovereigns.[73]

   Second, ultra-low interest rates should be locked-in over a long period, whatever the yield curve. Calls have rightly been made to take advantage of the structurally ultra-low-yield environment by borrowing with long, extremely long[74] or even infinite maturity through the issuance of perpetual bonds.[75] Whilst this would participate to close vast funding gaps if its proceeds are well-used, this would also **mitigate potential long-term roll-over risks by locking in ultra-low interest rates**, therefore reducing long-term debt servicing costs.

2. **Monetary policy should continue to ensure market access for sovereigns at favourable conditions**. Acting hand in hand with other non-standard tools such as negative rates and forward guidance[76], the European Central Bank asset purchase programmes[77] have helped **secure market access for sovereign issuers** at

70 Internal devaluation was one of the main pillars of the conditionality to gain access to EU financial assistance (ESFS and then ESM). Analysis of the content of the Memorandum of Understanding of Greece, Portugal and Spain shows that major labour market reforms were requested from debtor countries, but also minimum wage cuts, cuts or freezes in civil servants' wages and public pensions. For a discussion, see: XIFRE, R., "*The political value of internal devaluation in the euro area crisis*", Global Policy, 2020, vol. 11, issue 4, 12p.

71 Historically, sovereign debt crises have been often based on an excessive reliance on short term debt and/or debt with floating interest rates, leaving governments exposed to sudden changes in financial markets conditions. The share of short-term government debt therefore matters as it partly captures rollover risks. The share of short-term debt exceeds 10% in Sweden, Hungary, Portugal, Italy and Denmark. Source: EUROPEAN COMMISSION, "Debt Sustainability Monitor 2020", Institutional Paper 143, February 2021, p.80.

72 Philip R. Lane, Member of the ECB Executive Board, states in 2019 that "ten-year sovereign bond yields would have been almost 1.4 percentage points higher in 2018" without the ECB asset purchase programmes, negative rates and forward guidance. In: "*The yield curve and monetary policy*", Speech, London, 25 November 2019.

73 The firepower of the European Stability Mechanism is limited to a maximum lending volume of €500 billion and is conditioned on the country accepting Macroeconomic Adjustment Plans.

74 The Austrian government issued a 100-year bond last year.

75 A perpetual sovereign bond allows an incredible amount of leverage to the sovereign. Only the interest must be serviced as the principal will never have to be repaid. This option has been proposed in: GIAVAZZI, F., TABELLINI, G., "*Covid Perpetual Eurobonds: Jointly guaranteed and supported by the ECB*", VoxEU, 24 March 2020; SOROS, G., "*EU should use perpetual bonds to finance Covid-19 recovery fund*", The Guardian, 21 April 2020.

76 "*The monetary policy toolbox: evidence from the euro area*", Keynote speech by Philip R. Lane, Member of the Executive Board of the European Central Bank, at the 2020 US Monetary Policy Forum.

77 Namely the 2010s-era Securities Market Programme (SMP), which was replaced in September 2012 by the Outright Monetary Transactions (OMT) and finally the diverse Asset Purchase Programmes (APP).

favourable conditions by lowering long-term interest rates, re-financing risks and market volatility[78] – whether stated as the official objective or not.[79]

In reaction to the Covid crisis, the European Central Bank has gone a step further and unambiguously framed **the preservation of "favourable financing conditions"** as its compass to reach its price stability objective[80] whilst bringing flexibility to its assets purchases.[81] Only different from yield curve control policy[82] by its absence of publicly stated numerical targets, this policy rightly participates to **shield public budgets from swings in market sentiment**. It opens the question of whether this aim should be further carved in stone.

3. **Public budget should be protected from swings in market sentiment**. In complement to the EU fiscal rules, policymakers originally engineered market discipline as a force for fiscal prudence in the euro area. This was achieved by barring the way to a lender of last resort for sovereign issuers in the European Treaties.[83] But crises showed the necessity to have a different approach. The first step in that direction was the institutionalisation of the European Stability Mechanism (ESM) as **a limited and conditional lender of last resort for sovereigns**: the euro debt crisis crudely illustrated that the absence of such a lender creates higher risks of sovereign default.[84] The second step was the progressive transformation of the ECB into **a guardian of sovereign "favourable financing conditions"** as sharp increases in yield spreads at the onset of the Covid crisis reinforced the case for more flexible and decisive actions.

   With crises repeatedly showing **the limits of relying on market discipline as a force of fiscal prudence**, policymakers should once and for all **reject this logic** and act accordingly in future reforms.

4. **Sovereign debt restructuring must be made easier**. Whilst default costs have been often said to be significant but short lived,[85] evidence suggests that the cost of sovereign defaults and debt restructuring are in fact determined by the amounts of debt, the size of the haircut (i.e. the loss imposed on creditors) and the type of creditors affected.[86] That being said, **positive effects of preemptive debt restructuring**[87] appear to generally outweigh reputational costs.[88]

   The European Stability Mechanism Treaty introduced **initial legal provisions** by conditioning European financial assistance to debt restructuring. To cope with this condition, euro area sovereign bonds since 2013 include a standardised model of **collective action clauses** (*CACs*) that enables a supermajority of creditors to trigger a

78 Central banks act as stabilising investors on bond markets as they are less likely to divest when faced with yield volatility.

79 Whilst European Treaties prohibition of direct monetary financing of public deficit (article 123 TFEU) has been mobilised to challenge these programmes, the Bank has justified the buying of euro area sovereign bonds on secondary markets as (temporarily) necessary to pursue its primary mandate of price stability. Refer to the *speech by Yves Mersch*, Member of the ECB Executive Board (2016) and a more recent *contribution by Isabel Schnabel*, Member of the ECB Executive Board (2020).

80 "The compass of monetary policy: favourable financing conditions", Speech by Philip R. Lane, Member of the Executive Board of the ECB, at Comissão do Mercado de Valores Mobiliários, 25 February 2021.

81 "We will flexibly adjust our purchases over time and across asset classes and jurisdictions in a way that ensures favourable financing conditions for the entire economy and paves the path to recovery." in: "*Paving the path to recovery by preserving favourable financing conditions*", Speech by Isabel Schnabel, Member of the Executive Board of the European Central Bank, at NYU Stern Fireside Chat, Frankfurt am Main, 25 March 2021.

82 Yield Curve Control (YCC) refers to central banks' policy of publicly committing to keep sovereign yields at a specific level. While the Reserve Bank of Australia has a three-year horizon, the Bank of Japan offers a fixed value for the 10-year yield.

83 The combination of the monetary financing prohibition (art 123 TFEU) and the 'no bailout clause' (art 125 TFEU) incented financial market participants to monitor euro area countries' fiscal policies and to punish or reward governments according to the perceived quality of their fiscal policies.

84 "Pessimistic expectations can quickly coordinate on a "bad" equilibrium where due to high interest costs a government default becomes an imminent threat." in: SPAHN, P., "Central bank design in a non-optimal currency union: A lender of last resort for government debt?", ROME Discussion Paper Series, No. 16-10.

85 BORENSZTEIN, E., PANIZZA, U., "*The Costs of Sovereign Default*", IMF Working Paper, 2008, 52p.

86 Default on private debt is highly visible and hence more likely to result in a rating downgrade, while an orderly default between sovereigns is generally much less visible and hence less likely to negatively impact interest rates. In: MARCHESI, S., MASI, T., "*Life after default. Private and official deals*", Journal of International Money and Finance, Vol. 113, 2021.

87 By contrast to post-default debt restructuring, preemptive debt restructuring aimed at preventing a default.

88 Evidence from episodes of sovereign debt restructuring between 1950 and 2010 shows that restructuring agreements are usually followed by an increase in economic growth rate, a reduction of inflation and an improvement in the country's credit rating. Source:.DAS, S.U., et al., "*Sovereign Debt Restructurings 1950–2010: Literature Survey, Data, and Stylized Facts*", 2012, IMF Working Paper, 128p.

debt restructuring that becomes binding for all creditors.[89] Meanwhile, a comprehensive **European *sovereign debt restructuring*** mechanism[90] remains to be created.[91]

Contrary to a household, running surplus budgets or reducing its outstanding debt are not objectives as such for a state. **Public budget and debt management should be seen as tools to pursue longer-term policy objectives** that are beyond the scope of private actors – such as full employment, sustainability and resilience.

Consequently, rather than striving to run budget surpluses by all time and all means, the European Union and its Member States should **focus on investments that contribute to build a sustainable and resilient economy**, pouncing on the current rock-bottom interest rate environment to lower sustainability-related fiscal risks, extend debt maturities and bring down debt servicing costs. **Better protecting public budgets from swings in market sentiment** requires monetary policies that ensure permanent market access for sovereigns at favourable conditions as well as a clarification and strengthening of the role of lender of last resort. **Orderly sovereign debt restructuring** should be facilitated when debt becomes unsustainable. Lastly, **intra-EU trade imbalances** should be addressed.

89 Among important features such as providing a backstop to the Single Resolution Fund, the revised ESM Treaty signed on 27 January and 8 February 2021 also envisages the introduction by 2022 of single-limb Collective Action Clauses (CACs) that aim to make sovereign debt restructuring more orderly and predictable, while neutralising the blocking action of vulture funds.

90 For more discussion on the features of a comprehensive sovereign debt restructuring mechanism (SDRM), see: EIDAM, F., HEINEMANN, F., ed., "*Towards more feasible sovereign debt restructurings in the euro area*", EconPol Policy Report, n°12, Vol.3, March 2019, 58p.; DESTAIS, C., EIDAM, F., HEINEMANN, F., "*The design of a sovereign debt restructuring mechanism for the euro area: Choices and trade-offs*", CEPII Policy Brief, No 25, March 2019, 16p.

91 One of the most common proposals is to transform the European Stability Mechanism (ESM) into an European Monetary Fund (EMF) by incorporating a mechanism for restructuring sovereign debt and an independent dispute resolution mechanism, among other features. Source: GROS, D., MAYER, T., "*How to Deal with Sovereign Default in Europe: Create the European Monetary Fund Now*", CEPS Policy Brief No. 202, 2010; MERSCH, Y., "*Reflections on the Feasibility of a Sovereign Debt Restructuring Mechanism in the Euro Area*", at the ESCB Legal Conference 2016 Proceedings, 2017, p. 6-13.

Myth VII

"Numerical fiscal rules set economically sound limits to counteract deficit bias of politicians."

In the run-up to the launch of the European Monetary Union (EMU), two intertwined fears were felt by some negotiators of the Maastricht Treaty. The first was that governments would use lower interest rates brought by their participation in the EMU to succumb to their deficit bias[92] and spend recklessly, leading to debt unsustainability, contagion to other EMU members[93] and eventually the need to bail them out. The second was that this situation could lead to monetary financing and unsustainable inflation rates.

To cope with these fears about debt unsustainability and inflation, negotiators designed **the EMU in a way that would ensure monetary dominance and constrain fiscal policy**, reducing the possibility of fiscal dominance. While the former was obtained by setting up an independent central bank and a price stability-oriented monetary policy,[94] the latter objective was deemed obtained by **prohibiting any lender of last resort for sovereign issuers**[95] **and instituting strict fiscal limits**, i.e. the famous 3% budget deficit and 60% debt-to-GDP limits. Set in stone by the Maastricht Treaty of 1992, these numerical fiscal rules now constitute Article 126 and protocol n°12 of the Treaty on the Functioning of the European Union (TFEU). Member States breaching these limits are subjected to the so-called Excessive Deficit Procedure, which creates an obligation to take measures to reduce the deficit and/or debt levels. The preventive arm of the 1997 Stability and Growth Pact (SGP) further specified that Member States must commit to achieve a close-to-balance or in-surplus budget (Art. 3, 2., (a) of Regulation (EC) No 1466/97).[96]

In other words, **fiscal limits and commitment to achieve balanced or surplus budgets have been introduced to ensure debt sustainability**. Whilst they may sound like appropriate tools to reach a legitimate objective, a closer look shows fundamental flaws in this approach:

1. **Using debt-to-GDP ratio makes little economic sense** for four reasons: First, it comes down to comparing a stock (debt) to a flow (GDP) whilst logic tells us that, being **non-commensurable**, these two quantities can not be meaningfully compared. Second, there is a **time-inconsistency issue** in comparing one year of GDP with stocks of debt that have an average maturity of roughly eight years. Third, it **creates illusions that hide causality**. More specifically, whilst a rise in debt-to-GDP ratio is generally interpreted as the consequence of excessive spending – causing a surge in the stock of debt (numerator) – it can also stem from a fall in GDP (denominator) due, for example, to ill-timed fiscal contraction. Lastly, there appears **no convincingly proven causality** between any debt-to-GDP threshold and debt unsustainability or lower growth rates.[97]
2. **No economic justification exists for the chosen thresholds**. During the negotiations of the Maastricht Treaty, the French government eventually suggested the 3% deficit-to-GDP rule, based on its **previous usage in France**.[98] The 60% debt-to-GDP limit had no further economic justification other than being an **approximate average** of the then 12 EU Member States. An "economic" link between these two limits later surfaced: with

92 Deficit bias is defined as the short-term incentives to cater to political constituencies and overspend today at the price of future fiscal consolidation, where policymakers might not be in power at a later period to deal with it. For the literature overview see, for example:, DEBRUN, X., "*Democratic Accountability, Deficit Bias and Independent Fiscal Agencies*", IMF Working Paper WP/11/173, July 2011, p. 4-5.

93 The fear was that a mismanagement of public debt in a particular country could lead not only to a rise in interest rates on its own debt (i.e. risk premia) but also in the interest rates of other members of the Union.

94 It was built around the European Central Bank independence, price stability primary mandate and the no-debt-monetization clause – respectively TFEU protocol No 4, article 127 and article 123.

95 Via the 'no-debt-monetisation' and 'no-bail-out' clauses included respectively in TFEU articles 123 and 125.

96 For a more complete discussion on the European fiscal framework, see: SUTTOR-SOREL, L., "*One Framework to Rule Them All*", Finance Watch, 2021; SUTTOR-SOREL, L., "*Navigating the Maze*", Finance Watch; 2021.

97 While alleged causality between some debt-to-GDP thresholds and lower growth rates were critical in legitimising post-financial crisis austerity, it has now been largely debunked. For a summary of the Reinhart and Rogoff controversy, see: POLLIN, R., "*Public debt, GDP growth, and austerity: why Reinhart and Rogoff are wrong*", LSE blog, 8 March 2014.

98 The threshold had been devised earlier by two officials in the French Ministry of Finance at the request of the newly elected president Francois Mitter- and who aimed to curb the growing government deficit. Given the actual deficit of 2.6% of GDP in France at that time and in order to avoid political pressure on the government, a 3% limit was considered reasonable. See: SCHUBERT, C., "*Wie das Maastricht-Kriterium im Louvre entstand*", Frankfurter Allgemeine Zeitung, September 26, 2013.

an expected average 5% nominal growth and the target inflation rate of 2%, an average deficit of 3% allowed to maintain the 60% debt level. As subsequent years have shown, growth rate projections at 5% proved unrealistic and none of the reasons used to come up with these thresholds had any rational economic justification.[99]

3. **Debt sustainability can never be captured by a unique ratio**. Whilst assessing debt sustainability will always be a probabilistic exercise conducted under uncertainty, it requires to look at least through the evolution of factors such as the overall **debt servicing costs** (that can be heavily impacted by the presence or absence of a lender of last resort), **debt composition** (i.e. currency denomination, ownership, maturity structure), the existence and building up of **fiscal risks** (e.g. contingent liabilities related to climate change, increased spending due to lack of resilience, loss of tax revenue due to lower employment), but also the **differential between interest and growth rates** cf. Myth 1.
4. **States are not households and public budget surpluses rarely end up desirable or reachable**. Whilst a budget surplus can be the natural outcome of a booming economy, seeking budget surpluses proves fiscally unwise when **interest rates fall below the growth rate** (a European reality expected to last until at least 2031[100]), when **the economy is depressed** and economic resources lay underutilised and when **the economy is unsustainable** and faces sustainability-related fiscal risks cf. Myth 6.

Using numerical fiscal rules appears to make little economic sense, while failing to account and positively impact factors that truly determined debt sustainability. Associated with a commitment to achieve "close-to-balance or in-surplus budget", they can on the contrary be often counterproductive cf. Myth 8.

The EU countries that entered the monetary union **gave up control over the currency in which their debt was issued**. As crudely illustrated by the EU debt crisis, in the absence of an institutionalised lender of last resort in the EMU, this means accepting vulnerability to swings in market sentiment, contagion risks and higher risks of default. If debt sustainability is the real concern, it appears more important to shield public budgets from harmful swings in market sentiment cf. Myth 6 and from the building up of significant fiscal risks cf. Myth 1.

99 PRIEWE, J., "*Why 60 and 3 percent? European debt and deficit rules – critique and alternatives*", paper presented for the 23rd Conference of the Forum for Macroeconomics and Macroeconomic Policies, October 2018.

100 EUROPEAN COMMISSION, "*Debt Sustainability Monitor 2020*", Institutional Paper 143, February 2021, p.38.

Myth VIII

"EU fiscal rules don't need reform. They are flexible enough to take in economic, environmental and social factors."

Since their introduction, several rounds of reforms have attempted to make EU fiscal rules less pro-cyclical, more flexible and better responsive to country-specific circumstances.[101] Among others, investment and structural reform clauses included budgetary rule exceptions for Member States to conduct structural reforms or undertake growth-enhancing investments.[102] By virtue of the 2011 general escape clause, the fiscal rules were temporarily suspended in March 2020 to support the economies hit by the pandemic. While the date to reactivate EU fiscal rules remains under debate, **their design appears ill-suited for current and the future challenges EU economies and societies now face**.

Why should Europe care now?

1. **Europe faces an emergency stage to reach environmental targets** to prevent irreversible damage to the planet. Despite the pressing need, significant amounts of funding are still required to conserve (e.g. set up protected areas), restore (e.g. renaturalise soils) and for businesses to transition towards sustainable practices (e.g. low-carbon and resource-efficient processes).[103] The EU environmental funding gap has been estimated at **€470 billion a year until 2030**.[104]
2. **Social disparities in Europe remain wide**[105] and additional challenges are being posed by ageing populations, long-term youth unemployment, the need for better access to quality healthcare, life-long education, among others. Whilst improving regulation is key for upward convergence, the European Union also suffers from a social infrastructure[106] investment gap of **at least €142 billion per year**.[107]
2. **The Covid-19 pandemic exacerbated existing socio-economic problems** by widening disparities in income distribution whilst causing job losses and deep drops in economic activity in certain sectors.[108] The crisis also led to soaring levels of public and private debt.
3. **Given all of the above, a strong need exists for public expenditure**. In particular, the environmental funding gap cannot be expected to be exclusively bridged by private finance due to inappropriate risk/return ratios associated with most *nature-related investments* **cf. Myth 3**.

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101 For a more complete discussion on the EU fiscal framework, see: SUTTOR-SOREL, L., "*One Framework to Rule Them All*", Finance Watch, 2021; SUTTOR-SOREL, L., "*Navigating the Maze*", Finance Watch, 2021.

102 "An investment can be considered economically equivalent to a major structural reform only if it can be shown that the investment has a major net positive impact on potential growth and on the sustainability of public finances.", in: *Code of Conduct of the Stability and Growth Pact*, 2017, p.10.

103 More discussion in: SUTTOR-SOREL, L., HERCELIN, N.,"*Nature's Return - Embedding environmental goals at the heart of economic and financial decision-making*", Finance Watch, May 2020.

104 Comprising €240 billion for climate and energy, €100 billion for transport infrastructure and €130 billion for the other environmental objectives. Source: European Commission Communication "*SWD(2020) 98 final - Identifying Europe's recovery needs*", accompanying the document "Europe's moment: Repair and Prepare for the Next Generation", 27 May 2020, p.14-16.

105 The EU average rate of people at risk of poverty or social exclusion is 20.9%, with only one country below 15%. The severe material deprivation rate (SMD) is at 5.4% in Europe (min. 1.8%; max. 19.9%). Source: *Social scoreboard*, 2019.

106 The term "Social infrastructure" includes physical facilities and spaces where the community can access social services. These include health-related services, education and training, social housing programs, police, courts and other justice and public safety provisions, as well as arts, culture and recreational facilities.

107 FRANSEN, L., Del BUFALO, G., REVIGLIO, E., "*Boosting Investment in Social Infrastructure in Europe - Report of the High-Level Task Force on Financing Social Infrastructure in Europe*", 2018, 116p.

108 TURGUT, M.B., "*The Adverse Impact of COVID-19 Pandemic on Inequality Levels in the EU and What Can Be Done to Mitigate It*", CASE, July 2020.

Why does Europe need a deep reform of fiscal rules?

1. **Sparse available flexibilities**. Strict safeguards weaved into investment and structural reform clauses significantly limit their potential.[109] A Member State can benefit from a cumulative temporary deviation from its budgetary objective (MTO) **limited to 0.75% of its GDP**, and one single time period of budgetary adjustment.[110] As a matter of comparison, the volume of potential spending from the EU Recovery and Resilience Facility alone represents about 5% of EU GDP.[111]
2. **EU rules focus on quantity and ignore quality of fiscal spending**. EU fiscal rules limit public spending regardless of the quality or goals to be reached, thereby making long-term environmental and social sustainability goals **subordinated** to arbitrary fiscal constraints.
3. **An economically unjustified 60% debt-to-GDP ratio limit remains** **cf. Myth 1 and 7**. Given that the levels of government debt have swelled due to the pandemic, with an average of 100%-to-GDP across the European Union at the end of 2020[112], a fateful return to the existing fiscal rules would promptly force EU governments to cut spending, which could break the recovery. Spending cuts would be needed due to the **debt-reduction benchmark** within the Stability and Growth Pact (SGP), whereas Member States with debt-to-GDP levels higher than 60% must lower their debt level annually by 1/20 of the debt stock in excess of 60%.[113] A clear need prevails to move to **country-specific debt-reduction pathways**.
4. **Fiscal rules fail to take economic cycles into account**. The country-specific structural deficit targets (medium-term objectives, or MTO) rely on **unobservable variables** with the overall methodology being highly contested.[114] Legitimate concerns over cyclical conditions should not end up in smoke and mirrors.
5. **Fiscal rules remain asymmetric**. Whilst the EU fiscal framework constrains deficits and can force spending cuts (i.e. fiscal contraction), it is not equipped to force upward bumps in spending (i.e. fiscal expansion) in countries with excessive current account surpluses and comfortable budgetary positions. This asymmetry can cause **a downward spiral** that shrinks aggregate demand and creates deflationary pressure.

Thus, **existing EU fiscal rules do not live up to the needs of Europeans** given current economic realities and challenges people face today. Moreover, the rules jeopardise the future economic stability and welfare of European society by applying and enforcing unnecessary fiscal contraction whilst remaining insufficiently responsive to country-specific goals and economic situations.

Many reform proposals were tabled in the last decade to (i) reduce reliance on arbitrary numerical fiscal rules, (ii) improve quality of spending, (iii) take context better into account and to (iii) prioritise long-term social and environmental sustainability over arbitrary fiscal constraints.[115]

EU fiscal rules need to be reformed along these lines to allow governments to better cope with challenges now faced by European economies and societies.

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109 "The condition that a Member State must be experiencing bad economic times to benefit from the investment clause limited its use significantly. The need to respect the safety margin vis-à-vis the 3% deficit ceiling for three years has also proven constraining for some Member States." in: COM(2018) 335 final, "Communication on the review of the flexibility under the Stability and Growth Pact", 2018, p. 3.

110 *Code of Conduct of the Stability and Growth Pact*, 2017, p.10.

111 The number is larger than 10% of GDP for the 15 EU (highest for Bulgaria, Greece, Croatia and Latvia). Source: PICEK, O., "*Spillover Effects From Next Generation EU*", Intereconomics, Volume 55, 2020, Number 5, p. 325–331.

112 Communication from the European Commission on the 2021 Draft Budgetary Plans: Overall Assessment, Brussels, 18.11.2020 *COM(2020) 750* final.

113 See *Regulation (EU) 1177/2011* amending the Stability and Growth Pact corrective arm (New Article 2(1a) of Regulation (EC) No 1467/97).

114 See for example: HEIMBERGER, P., KAPELLER, J., "*Output Gap Nonsense' and the EU's Fiscal Rules*", January 2020; BUTI, M., CARNOT, N. et al., "*Potential output and EU fiscal surveillance*", September 2019; or a *blogpost* from think tank Bruegel.

115 More discussion in: SUTTOR-SOREL, L., "*One Framework to Rule Them All*", Finance Watch, 2021.

About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

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