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Public debate on the review of the EU economic governance

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1. Improving the framework

In the light of experience, effective delivery on the objectives of ensuring sustainable public finance positions and avoiding macroeconomic imbalances is key. Effective economic coordination and surveillance is a cornerstone for ensuring resilience in the EU and the Economic and Monetary Union in view of potential negative spillovers resulting from the building up of unsustainable positions. While there has been progress overall in terms of debt sustainability and correction of macroeconomic imbalances, that progress has not always been sufficient, with large differences across Member States. Therefore, an effective framework needs to ensure the sustainability of public debt, including where it is most necessary, and the prevention and correction of macroeconomic imbalances.

Question: How can the framework be improved to ensure sustainable public finances in all Member States and to help eliminate existing macroeconomic imbalances and avoid new ones arising?

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Start with a clean sheet. The current SGP/MIP and the associated arrangements like the European Semester are unworkable.

First, do away with the numerical debt and deficit ceilings. The numbers are completely arbitrary. The 60% of annual GDP ceiling for general government gross debt was close to the EU average number at the time the Maastricht Treaty was signed (1992). In 2020Q4, the EU average public debt ratio was 75.9%. Even Germany was above the ceiling at 69.8%. Greece is off the scale at 205.6%. Italy at 155.8% and Portugal at 133.6% are also highly unlikely to be targeting 60% any time soon. The 3% of GDP ceiling for the general government budget deficit does not even have the merit of being consistent with the 60% debt ceiling in a steady state with inflation at the target rate of 2%. That would require an annual real GDP growth rate of 3%; the average EU growth rate from 1992 to 2019 was around 1.7%.

Recognize that focusing on gross public debt as a benchmark for fiscal sustainability is bad economics. Focusing on net debt (i.e. netting out government financial assets) is a step in the right direction, but still fails to recognize that in most countries the government (central, state/provincial and local) owns significant stocks of real assets. Many of these assets have significant commercial or market value as well as social value; government real estate is an obvious example. Proper fiscal sustainability analysis requires the inclusion of public sector real commercial assets, valued at the present discounted value of their contributions, direct or indirect, to future government cash flows. These cash returns may well differ from their social returns, but it is the cash flows that matter for fiscal sustainability.

Recognize that the debt sustainability analysis for each member state and the analysis of appropriate countercyclical policies must be performed simultaneously - they are be inextricably intertwined. In particular, a country that is required to engage in medium-term and longer-term fiscal tightening to restore sustainable public finances should not be prevented from engaging in appropriate countercyclical fiscal stimulus. If necessary (should market funding of a debt-financed fiscal stimulus be unavailable or too expensive), funding should be made available by the ECB (pace Article 123 TFEU, which should be scrapped or amended in any case to allow direct funding of national sovereigns by the central bank), by the ESM or by another designated entity (e.g. an enlarged central EU fiscal facility with a countercyclical mandate).

Recognize that the appropriate fiscal stance for each individual member state depends on the fiscal stances of the other member states. This is obviously the case for the 19 euro area member states but likely also applies to the EU as a whole - the textbook Mundell-Fleming complete crowding out of expansionary fiscal policies under a floating exchange rate and perfect capital mobility is several simplifications too far.

Recognize that the appropriate (joint) budgetary policies to address macroeconomic imbalances can only be determined together with the appropriate monetary policy. The ECB has to be a fully integrated participant in the European Semester process.

2. Safeguarding sustainability and stabilisation

Fiscal policy guidance supports Member States in ensuring the long-term sustainability of public finances and in pursuing counter-cyclical fiscal policies to contribute to a better macroeconomic stabilisation in both good and bad times. While an effective framework should aim to be counter-cyclical in good and bad times, it has often not been achieved in practice. An appropriate fiscal effort and debt reduction in good economic times helps to create the space to use fiscal policy in bad times. Appropriate medium-term policy planning, both regarding fiscal targets and structural reforms to promote productivity and investment, and an appropriate policy anchor help in that regard.

Question: How to ensure responsible and sustainable fiscal policies that safeguard long-term sustainability, while allowing for short-term stabilisation?

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There is no mystery about the analytics of sustainable fiscal policies that safeguard long-term sustainability, while allowing for short-term stabilization. It is the political economy of public debt and deficits that is complex and often frustrating. The main problem is the routinely pro-cyclical nature of fiscal policy during cyclical upswings. Most euro area member states most of the time do not seriously attempt to run general government budget surpluses (or even primary surpluses) when the economy is booming. Apparently, the European Commission (and the Council) do not have the effective authority to compel recalcitrant member states to engage in proper counter-cyclical fiscal restraint/tightening during cyclical upswings. The inevitable consequence is the repeated and painful necessity of procyclical fiscal tightening during cyclical downturns as financial markets restrict access to excessively indebted sovereigns.

I don't know whether this issue of "fair-weather fiscal procyclicality" can only be addressed at the national level, one member state at a time, or whether members states collectively will be able to grant the necessary authority to a supranational entity (some convex combination of the European Commission and the European Council).

A related problem is that governments tend to be severely myopic in their revenue and especially in their expenditure decisions. Public investment yielding future returns that might only materialize under a different administration or parliamentary majority tends to be under-provided in a systematic way. Examples include infrastructure investment and financial support for fundamental research, but even when it comes to public expenditure on health and education, spending programs yielding significantly deferred benefits tend to be underfunded. I do not favor exempting certain public spending categories (like public sector investment) from inclusion in the government deficit measures when public debt sustainability is evaluated . The reason is that the returns to public investment need not take the form of cash income for the government. The desirability of public sector investment depends on its social rate of return. Debt sustainability is about current and future cash flows. So the right approach is to include government investment in the deficit metrics, and to allow properly for any future pecuniary returns on this investment that accrue to the state.

To the extent that inadequate information or lack of understanding account for public sector underinvestment in projects like the prevention and mitigation of global warming, that yield the bulk of their returns in the (sometimes distant) future, there are grounds for optimism. Learning does occur, in society at large and even among our political masters. Thanks to the internet and social media, the dissemination of new facts and new insights can be very swift indeed. If political myopia is instead driven by the (often highly uncertain) expected duration of the incumbent's term of office, it is hard to be optimistic about the adequate provision of government investment-dependent public goods and services. Even if the majority of individual citizens take the long view, the political mechanisms and institutions for translating this into appropriate long-term public investment decisions are defective and deficient.

3. Incentivising reforms and investments

The framework should be consistent with today and tomorrow’s challenges. It needs to be discussed what the appropriate role of the EU surveillance framework is in helping to promote a growth-friendly composition of public finances and for Member States to sustain adequate levels of investment. In particular, significant investment will be required to meet the broader ambition of the European Green Deal. This raises the question of the extent to which the fiscal framework can support the investments needed for the transition to a climate-neutral, resource-efficient, and competitive economy, in a manner that leaves no one behind. This includes re-assessing the appropriateness of the current flexibility clauses in terms of their scope and eligibility, in order to facilitate the right type and level of investment while preserving debt sustainability. In addition, thought should be given to the role of the fiscal framework in greening national budgets.

Question: What is the appropriate role for the EU surveillance framework in incentivising Member States to undertake key reforms and investments needed to help tackle today and tomorrow's economic, social, and environmental challenges while preserving safeguards against risks to debt sustainability?

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There are two different issues here. The first issue concerns the best way to fund adequate levels of public sector investment, and in particular the public investments required to limit the extent of global warming and to adjust to whatever global warming materializes - mitigation and adaptation. This assumes the political will to spend the right amount of public money on climate change-related projects and programs is there. All we need is adequate government revenues. I don't think the funding issues associated with climate change-driven public expenditure are qualitatively different from those associated with traditional public expenditure on infrastructure investment, health and education, national defense, law and order and other public goods and services.

The social returns to public expenditure on climate change, biodiversity, fundamental research etc. are bound to greatly exceed the cash returns to the state. A higher tax burden is therefore inevitable. Existing taxes (direct and indirect) will have to have their bases broadened and/or their average rates boosted. Many countries would be well-advised to look seriously at a land tax as a material source of additional revenue. Some additional revenues will be obtained from the new Pigovian carbon taxes that will be introduced if nations get serious about greenhouse gas (GHG) emissions and/or from the enhanced sale of tradable emissions quotas under an emissions trading system (ETS) with comprehensive coverage. Carbon likely needs to cost at least $100/tonne now (or very soon indeed) to reach net zero by 2050. If this applied to all GHG emissions, it could be a handsome source of government revenue in addition to providing the right incentives for limiting carbon emissions.

The second issue is the more fundamental one of ensuring that the public investment implications (and the other fiscal implications, like carbon taxes and an expanded EU Emissions Trading System) of the climate change ambitions of the European Green Deal (and COP26), are realized. Here I fear that we are likely to see supposedly solid commitments and firm targets revealed as mostly empty rhetoric and idle promises. The reason is that three obstacles stand in the way of effective action to mitigate climate change. The first is myopia. The benefits from higher carbon emissions - low energy costs - are now. The benefits from lower carbon emissions are deferred. The time between a pulse of GHG and most of its warming impact is probably around a decade. The second obstacle concerns an externality and the associated free rider problem. The benefits from higher carbon emissions are local (lower energy costs are enjoyed by the GHG emitter). The costs from higher carbon emissions are global indeed - global warming. The third obstacle is the unwillingness of rich countries to make significant cross-border transfer payments to poor nations. The most effective approaches to lower GHG emissions impose disproportionate burdens on developing countries and low income emerging markets. There appears to be very little willingness on the part of the rich beneficiary nations (including the EU) to compensate poor countries for the unjust climate change mitigation burdens they are being asked to bear.

What this means is that we are likely to see far too little investment in the mitigation of climate change. Although this is bad news from a global welfare perspective, it means that the funding challenges and debt sustainability problems associated with ambitious green public spending plans are unlikely to materialize. Another environmental fiscal failure is, however, likely to worsen the budgetary outlook: we are unlikely to see a comprehensive carbon emissions tax of anywhere near $100/tonne (or its ETS equivalent) imposed globally in the near future.

4. Simplification and more transparent implementation

Whereas the current fiscal surveillance framework has included elements of flexibility and discretion through a complex set of provisions adopted against a background of lack of trust amongst key stakeholders, an effective application of economic judgement within a rules-based framework needs to be done in an objective and transparent manner. This includes, for example, considering whether a clear focus on gross policy errors as set out in the Treaty, based on clearly defined objectives and operational policy targets, could contribute to an effective implementation of the surveillance framework. A simpler framework and implementation could contribute to increased ownership, better communication, and lower political costs for enforcement and compliance.

Question: How can one simplify the EU framework and improve the transparency of its implementation?

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The Macroeconomic Imbalance Procedure a is supposed to be a "surveillance framework that aims to identify potential macroeconomic risks early on, prevent the emergence of harmful macroeconomic imbalances and correct the imbalances that are already in place". It is instead a confused and confusing distraction, as a perusal of the 14 Scoreboard (or headline) indicators with their associated arbitrary indicative thresholds and the 28 Auxiliary indicators makes clear. It is incomprehensible that a procedure meant to prevent and correct macroeconomic imbalances includes structural social Auxiliary indicators like "People at risk of poverty or social exclusion", "People at risk of poverty after social transfers", "Severely materially deprived people" and "People living in households with very low work intensity". Other Auxiliary indicators may be informative about the long-term growth potential of member states. "Gross fixed capital formation" (% of GDP) and "Gross domestic expenditure on R&D" (% of GDP) fall into that category, as does the "Export market share" (% of world exports), but again they have no bearing on macroeconomic imbalances. The informativeness of the "Current account balance" and the "Net international investment position" as regards macroeconomic imbalances is dubious. The absence of a price inflation indicator is surprising.

The European Semester (MIP and SGP) should focus on national sovereign debt sustainability issues and on macroeconomic imbalances, including the spillovers from national macroeconomic imbalances to other EU member states, and on the euro area-wide balance between the monetary and fiscal policy stances. Social issues, structural issues like the drivers of trend growth, and environmental issues, including climate change, should not be on the agenda.

Private sector financial stability issues (involving banks, non-bank financial institutions, non-financial corporations, and households) should be addressed by a significantly modified and enhanced European Systemic Risk Board - the EU's macroprudential supervisor/regulator. National fiscal authorities and the relevant fiscal representatives of the European Commission and the European Council) should be integral (voting) members of this new ESRB (more in the spirit of the Financial Stability Oversight Council in the U. S.). Sovereign financial stability (public debt sustainability) problems often spill over into wider financial stability crises and should be addressed both in the simplified European Semester and by the enhanced ESRB.

5. Focus on pressing policy challenges

Surveillance should be commensurate to the gravity of the situation, with a stronger focus on the most pressing cases and less-intrusive procedures where overall risks are low. Therefore, it is to be considered whether the surveillance framework, in order to be effective, should focus more on ‘identifying gross errors’ [i.e. on Member States whose policy Cf. Article 126(2) of the Treaty on the Functioning of the European Union.] strategy puts public debt on a potentially unsustainable trajectory or leads to other macroeconomic imbalances. Moreover, a strong policy dialogue with Member States and stakeholders is key, especially in a multilateral setting, but also bilaterally with the Commission.

Question: How can surveillance focus on the Member States with more pressing policy challenges and ensure quality dialogue and engagement?

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The surveillance framework focuses, not surprisingly, on countries in the Excessive Deficit Procedure (in the corrective arm). Too little attention has been paid up till now to preventing procyclical expansionary fiscal policies by countries that are not in the Excessive Deficit Procedure (in the preventive arm). I recognize that it is not at all straightforward to come up with positive or negative incentives (rewards or penalties) that would encourage appropriate countercyclical fiscal behavior during cyclical upturns. If the central EU fiscal capacity were more substantial than the current MFF with its measly spending program of no more than 1.1% of GDP, central EU public expenditure decisions could be made contingent on the implementation of an appropriate countercyclical national fiscal policy. Selective loss of member state voting rights in EU/Euro area deliberative bodies dealing with public debt sustainability and macroeconomic imbalances is another instrument worth considering.

For countries in the corrective arm, the focus should be on appropriate quantitative "stress tests" that assess the viability of its proposed fiscal program in a range of highly adverse scenarios. The quantitative models used in these simulations should be in the public domain - the numerical exercises should be replicable by independent third parties.

6. Lessons from the RRF

The RRF’s commitment-based approach to policy coordination, with strong national ownership of policy design and outcomes, is expected to support implementation of agreed reforms and investments. This approach takes into account the complexities that arise from the simultaneous pursuit of various national and EU objectives, in a context of differences in socioeconomic structures and national preferences. It underpins ownership and trust. Rapidly-evolving developments since the start of the pandemic (and even before it) have illustrated the difficulty of designing comprehensive rules that are able to cater for all possible circumstances. Taking into account the lessons from the RRF, the economic governance review should consider how national ownership, mutual trust, the effective delivery of the framework on its key objectives, and the interplay between economic and fiscal dimensions can be best ensured.

Question: In what respects can the design, governance and operation of the RRF provide useful insights in terms of economic governance through improved ownership, mutual trust, enforcement and interplay between the economic and fiscal dimensions?

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The Recovery and Resilience Facility has been a failure. The euro 723.8 billion funding at current prices (euro 385.8 billion in loans and euro 338 billion in grants) should have been available to help fund a countercyclical fiscal stimulus in fiscally and financially constrained member states when the Covid-19 pandemic struck, i.e. starting in March 2020. Instead, the first national recovery and resilience plans were only approved by the Commission in June 2021.

The RRF also tried to combine a belated funding of national countercyclical fiscal stimuli with the pursuit of all things bright and beautiful - the "Six Pillars of the Recovery and Resilience Facility": green transition; digital transformation; economic cohesion, productivity and competitiveness; social and territorial cohesion; health, economic, social and institutional resilience; policies for the next generation. Other things being equal - that is, provided the short-run impact on public debt sustainability and aggregate demand of programs funded by the RRF according to the priorities set by the Six Pillars is not less than that of any other programs - allocating the RRF funds according to these priorities makes sense. I doubt whether the authors of the Six Pillars made such a determination.

The RRF is both temporary and undersized: euro 723.8 billion looks impressive until you realize that these funds are spread out over three years and that a significant share of the loan allocation of the facility will likely remain unused.

One positive feature of the RRF is that the bonds issued by the EU to fund the program have been heavily oversubscribed despite the fact that the borrowing entity has no discretionary tax instruments at its disposal to service the debt, but is dependent on the goodwill and good faith of the EU member states.

7. National fiscal frameworks

It has to be considered whether a stronger role for national fiscal frameworks, in particular independent fiscal institutions, would contribute to better compliance with EU fiscal rules and improve ownership of the framework at the same time. Moreover, given that high quality statistics are key for a transparent fiscal framework, it has to be assessed what further improvements in data quality would be needed.

Question: Is there scope to strengthen national fiscal frameworks and improve their interaction with the EU fiscal framework?

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It makes sense to have one or more independent national fiscal institutions to perform two tasks. First, to provide the economic projections (GDP, employment, inflation, interest rates, exchange rates etc.) the government uses to make its budgetary plans. Second, to validate (or provide themselves) the budgetary projections (public non-interest expenditure, tax and non-tax revenues, government deficit etc.) incorporating the details of the government's fiscal-financial program.

Data are an underprovided public good. The EU's central inflation statistic, the harmonized index of consumer prices (HICP), excludes (imputed) owner-occupied housing. Minimum standards for all the data required for the European Semester to perform properly have to be determined and enforced centrally.

Additional data will have to be collected if serious carbon taxes become part of the EU's green arsenal. It is not easy to tax if you don't observe and measure the tax base. The objective should be to tax all GHG emissions. We should start with energy (electricity, heat and transport) but extend the net to include agriculture, forestry and land use, industry and waste and ultimately the direct and indirect GHG emissions associated with all economic activity, including household consumption.

There are special problems in federal states where the state/provincial fiscal authorities have significant spending and taxation powers. The fiscal sustainability analysis focuses, correctly, on the general government. Somehow the fiscal-financial actions of the state/provincial and local government authorities will have to be incorporated more explicitly into the European Semester's fiscal sustainability analysis. The logistics will not be easy.

8. Effective enforcement

The appropriate balance between pecuniary sanctions and tools incentivising macroeconomic stability and sustainable growth, such as a Budgetary Instrument for Convergence and Competitiveness or the Convergence and Reform Instrument, has to be carefully considered as an element to ensure an effective implementation of the framework.

Question: How can the framework ensure effective enforcement? What should be the role of pecuniary sanctions, reputational costs and positive incentives?

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Imposing pecuniary sanctions on countries - whether through fines/penalties or by withholding funds expected to be provided under the proposed BICC - does not really make a lot of sense. The sanctions would most likely be imposed on a member state when it is in financial dire straits and its government is unable to meet its outstanding financial obligations. If financial penalties have to be paid immediately (or expected incoming funds are withheld as soon as the sanctions are imposed) this could trigger or exacerbate a sovereign financial crisis.

Non-pecuniary sanctions, e.g. loss of voting rights on financial/economic matters (or more broadly) in the Council of the European Union or other relevant decision making bodies like the Eurogroup) might be more effective and certainly less damaging. Reputational costs are not an instrument, but something inflicted or imposed by financial markets and other counterparties of the troubled sovereign. Positive incentives - offering financial rewards for doing the right thing - could be effective but would likely upset the fiscally conservative EU member states.

9. Interplay between the SGP and MIP

Multiple surveillance streams partially overlap but the links have not always been fully exploited. While the integration of the MIP and the SGP within the framework of the European Semester has helped to strengthen the interaction between those surveillance strands, there is further scope to make them work better together while avoiding overlaps between them when addressing at the same time macroeconomic imbalances, potential growth challenges and risks to public fiscal sustainability. MIP surveillance may also have so far insufficiently taken account of interactions between new emerging economic challenges, notably related to climate change and other environmental pressures.

Question: In light of the wide-ranging impact of the COVID-19 crisis and the new temporary policy tools that have been launched in response to it, how can the framework – including the Stability and Growth Pact, the Macroeconomic Imbalances Procedure and, more broadly, the European Semester – best ensure an adequate and coordinated policy response at the EU and national levels?

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The fiscal rules of the SGP (the public debt and deficit ceilings) were suspended during the COVID-19 crisis, alongside the state aid rules. Although, under the MIP, in June 2021, Ireland, Portugal, Spain, France, the Netherlands, Germany, Romania, Croatia and Sweden continued to experience macroeconomic imbalances and Cyprus, Greece and Italy continued to experience excessive imbalances, no corrective actions were deemed necessary and no sanctions were imposed. The European Semester has been effectively suspended for the duration of the COVID-19 crisis. A framework that cannot provide guidance when it is most needed is not worth having. Instead, in addition to national fiscal stimulus measures, a number of ad-hoc EU-level fiscal and financial stimulus measures were proposed and implemented. All were late. The ECB responded promptly and effectively, as soon as the financial markets seized up in March 2021.

What did the central fiscal-financial authorities of the EU do by way of countercyclical fiscal stimulus? The answer is: very little indeed, and mostly too late. Consider the following.

SURE (temporary Support to mitigate Unemployment Risk in a Emergency) only became available on 22 September 2020. It provides up to euro 100 billion (0.75% of 2020 EU GDP) in loans, backed by euro 25 billion of voluntary guarantees by member states. By December 2021, euro 94.3 billion had been allocated. The instrument is of a temporary nature. "Its duration and scope are limited to tackling the consequences of the coronavirus pandemic."

The European Investment Bank (EIB) created a euro 24.4 billion (0.19% of 2020 EU GDP) Pan-European Guarantee Fund (first operation in December 2020). This was expected to mobilize loans for companies up to euro 200 billion (1.5% of 2020 EU GDP). The initial investment period is until 31 December 2021. By the end of June 2021, the EGF had approved financing of euro 16 billion (0.12% of 2020 EUGDP).

The European Stability Mechanism (ESM) introduced the Pandemic Crisis Support in April 2020 based on an existing precautionary credit line. It can make loans to member states up to euro 240 billion (1.8% of 2020 EU GDP). The credit line will be available till the end of 2022, although this period can be adjusted, depending on the evolution of the crisis. I have been unable to find out how much credit has been extended by this facility.

The Next Generation EU euro 750 billion (5.6% of 2020 EU GDP) recovery plan was finally adopted in December 2020. The Recovery and Resilience Facility, which accounts for most of the NGEU, was at last adopted by the Council in February 2021. It provides euro 672.5 billion of funding to member states over the 3-year period 2021-2023. This becomes 723.8 billion funding at current prices (euro 385.8 billion in loans and euro 338 billion in grants). On an annual basis this is about 1.8% of GDP. Again, this facility is time-limited to the duration of the Covid-19 crisis.

The regular EU budget for the seven-year period 2021-2017 is a mere euro 1,074.3 billion - about 1.1% of annual GDP for the budget period. It has not been materially increased as a result of the COVID-19 pandemic.

The only element in this package of measures that looks like a direct countercyclical fiscal stimulus is the grant element of the RRF - although even here we must make assumptions about how these grants influence the recipient national government's spending or tax decisions. That is about 2.5% of 2020 EU GDP - spread out over 3 years, i.e. just over 0.8% of annual GDP. The rest are loans and credit - no doubt on better than market terms for all except the triple A-rated sovereigns - but with a fiscal impact (on national public expenditure and taxation) that is likely to be less than the size of the loans/credit provided.

The EU has to get serious about creating a central countercyclical fiscal capacity capable of addressing the next significant EU-wide downturn - and indeed for funding the provision of the EU-wide public goods and services called for by Europe's Green and Blue transitions. The NGEU (and RRF) and SURE should be made permanent, grants only, and doubled in size. The EIB and ESM COVID-19 credit facilities should be made permanent. The regular central budget of the EU should be steadily increased to at least 5% of EU GDP, with appropriate discretionary tax instruments at the disposal of the EU central fiscal authority. An EU land tax and an EU carbon tax would be a good place to start. If necessary, another dedicated EU-wide VAT tranche and/or some other broad-based EU personal income tax component are likely to be part of the badly needed new, enhanced central fiscal arsenal. I am not holding my breath.

10. Euro area dimension

There are a number of concrete links between the economic governance framework and the broader agenda to complete the Economic and Monetary Union. First, both the SGP and the MIP focus exclusively on national policies, in particular on the prevention and correction of high public debt levels and current account deficits. In such a context and in the absence of a central fiscal capacity with stabilisation features, the ability to steer the fiscal stance for the euro area as a whole remains constrained. The introduction of a stabilisation capacity of appropriate size would allow fiscal policy to contribute more to macroeconomic stabilisation at the level of the euro area as a whole. Second, the completion of the financial union (Banking Union and Capital Markets Union), the introduction of a common safe asset and the review of the regulatory treatment of bank sovereign exposures, could – depending on the specific design – facilitate market discipline and allow further simplification of the design of an effective fiscal surveillance framework. Third, a vibrant and resilient Economic and Monetary Union, resting on solid foundations, is the best means to increase financial stability in Europe. It is a prerequisite to strengthening the international role of the euro, which in turn is a tool to enhance Europe’s clout in the world and on global markets, thereby helping protect European firms, consumers and governments from unfavourable external developments.

Question: How should the framework take into consideration the euro area dimension and the agenda towards deepening the Economic and Monetary Union?

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It is clear that, in the absence of a significant central fiscal authority with material freedom to set public expenditure levels, tax revenues and the implied debt issuance, getting the fiscal stance for the euro area as a whole right is going to be challenging. For each member state, the cross-border spillovers to the other 18 member states (and to the rest of the world) will have to be quantified. It is true that for the smallest member states the cross-border spillover effects are small or even insignificant. However, they will be impacted very materially by the fiscal policy stances of the larger member states. Because countries matter in the EU political welfare function, all member states should be treated with care and attention in the joint fiscal surveillance framework. Another way of putting this is that the appropriate fiscal stance for any member state can only be determined jointly with that of the other 18 member states. And the appropriate joint fiscal stance can be determined only together with the appropriate monetary policy stance of the ECB. So the ECB should be part of the new "Euro Area Semester".

It will be a long time until Capital Markets Union is complete. A necessary condition is the end of national level supervision and regulation of systemically important non-bank financial intermediaries. There is no early prospect of that.

Even when Banking Union and Capital Markets Union will be completed, there will remain material differences in the creditworthiness of euro area sovereigns. The drivers of this are different public debt burdens, different political capacities for generating primary budget surpluses and different growth prospects. Only the extremely low level of the neutral real risk free interest rate and the artificially low sovereign credit spreads (driven to a significant extent by the asset purchase programs of the ECB) stand between countries like Greece and Italy and a material sovereign debt crisis. Because of the underlying risk this poses to the viability of the monetary union, the euro is unlikely to become a serious rival for the U.S. dollar as a global reserve currency in the foreseeable future. The euro can make itself a somewhat more attractive global means of payment and store of value by speeding up the creation and rolling out of a central bank digital currency (CBDC) for the euro area. The Fed is well behind the curve as regards the introduction of a U.S. CBDC.

11. New challenges due to the COVID-19 crisis

Question: Considering how the COVID-19 crisis has reshaped our economies, are there any other challenges that the economic governance framework should factor in beyond those identified so far?

The COVID-19 crisis has brought, for the euro area, an effective monetary policy response across all member states and national fiscal policy responses whose effectiveness has varied according to the creditworthiness of the sovereign. What could have been a centralized EU/euro area-level countercyclical fiscal response unconstrained by national public debt sustainability differentials - the Recovery and Resilience Facility - turned out to be too late and too little.

The combined adverse aggregate demand and supply shocks triggered by the COVID-19 pandemic was aggravated for fossil fuel importing countries in 2021 by a sharp rise in energy prices. This was a global phenomenon, but it affected the EU disproportionately. The absence of an effective EU-wide energy policy (exemplified through inadequate gas inventories and excessive dependence on gas imports from Russia) has been painfully obvious. It has provided a reminder that Europe not only must target Net Zero Emissions by 2050 (and preferably earlier), but that it also has to carefully manage transitional vulnerabilities while fossil fuels remain part of the energy portfolio.

The precautionary principle calls for the active pursuit of resilience and the acceptance of a significant degree of redundancy in the precautionary buffers we build when faced with the near certainty of unpredictable and potentially devastating shocks. This means that climate change has to be the overriding political economy priority for the EU, but through mechanisms other than the European Semester, the SGP and the MIP. Focus and comparative advantage matter. The SGP and MIP should prioritize fiscal sustainability and macroeconomic stability, with other good causes pursued only if this can be done without prejudice to the achievement of these primary targets. Boosting resilience means that the persistent failure to build up appropriate fiscal buffers (to lower the public debt burden or rather to boost public sector net worth) during periods of above-trend growth must end.

Finally, the COVID-19 pandemic has provided yet another reminder that effective countercyclical policy requires the coordination of monetary and fiscal policies, which in turn requires cooperation between the monetary and fiscal authorities. A central bank can be operationally independent yet choose to cooperate with its fiscal counterpart(s). It is time to scrap the letter and spirit of Article 123 TFEU.

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