THE FISCAL ROOM FOR MANOEUVRE OF THE EURO AREA COUNTRIES

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Abstract

Economic and Monetary Union (EMU) in the EU envisages a centralised monetary policy and national fiscal policies under a certain degree of coordination and surveillance. Budget deficits should be kept under control in order to guarantee sufficient room for manoeuvre to cope with economic shocks thus safeguarding the stability of the euro area. The aim of this article is to describe the working of fiscal surveillance as far as the budget balances are concerned and to explain the concept of the fiscal room for manoeuvre with reference to the output gap. Sufficient room for manoeuvre of euro area countries, in fact, is needed especially after the Covid-19 crisis of 2020. The health emergency has made sovereign debts peak in many countries, at a time when the ECB found itself without a complete war-chest after having abundantly used its conventional and unconventional tools since the sovereign debt crisis.

1. Introduction

A nation's decision to renounce its currency and join a currency union, like every policy decision, is based on expectations of net positive effects. In the European Union (EU)[1] a single currency is consistent with the project of a common market and with the approximation of member states' economic policies[2]. Like a fixed exchange rate regime, a single currency eliminates the cost of the uncertainty stemming from the volatility of currency values[3] and increases cross-border price transparency thus favouring the free circulation of goods, services, capital and people (the so-called 'four fundamental freedoms'). Moreover, it wards off the threat of beggar-thy-neighbour policies, such as competitive devaluation[4], within the area. A single currency also eliminates the transaction costs of currency exchanges, may gain an international role[5], and it is less easily reversible than a fixed exchange rate regime.

Yet when a country gives up its national currency to adopt a common currency, it also surrenders substantial economic policy

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[1] This article uses 'European Union' to refer also to the predecessor organisations: the European Economic Community (EEC) and the European Community (EC).

[2] Art. 2 of the Treaty establishing the EEC (TEEC).

[3] Assuming risk-averse economic agents, exchange rate risk can be hedged by buying forward contracts.

[4] Competitive devaluations occur when a country intentionally intervenes to drive down the value of its currency to provide a competitive boost to its export.

[5] For an assessment of the costs and benefits of international currency status, see European Central Bank, "The International role of the euro", 13 June 2019, and Francesco Papadia and Konstantinos Efstathiou, "The euro as an international currency", *Bruegel Policy Contribution* 25 (2018).

sovereignty. On the way towards Economic and Monetary Union[6] (EMU), the EU eventually acknowledged the strict conditions set by the 'impossible trilemma'[7], which posits that in a context of free capital mobility, a common currency (the most robust of fixed exchange rate regimes) requires uniform monetary policies. The surrender of monetary policy autonomy, combined with the lack of a federal fiscal tool, or of a larger, redistributive EU budget, requires the EU to leave national governments with sufficient fiscal room for manoeuvre, albeit with some restrictions to safeguard the resilience of the euro area.

The aim of the article is to describe the working of fiscal surveillance as far as the budget balances are concerned and to explain, with a simplified model, the concept and the importance of the fiscal room for manoeuvre with reference to the output gap[8].

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[6] The decision to institute an Economic and Monetary Union was taken by the European Council in Maastricht in 1991 and later enshrined in the Treaty on European Union (the Maastricht Treaty), which went into force in 1993.

[7] The 'trilemma', also known as the Mundell-Fleming model (in recognition of the research of Robert Mundell and Marcus Fleming in the 1960s), posits that a country can choose only two among three key policies: capital mobility (vs. capital control), fixed exchange rate (vs. flexible exchange rate) and monetary policy autonomy (vs. monetary policy harmonisation). The model is based on the principle of interest rate parity, according to which if capital can move freely across borders and exchange rates are free to float, the difference between the interest rates of two countries should be equal to the expected variations in their currencies' exchange rates.

[8] Output gap is the difference between the actual Gross Domestic Product (GDP) of a country and its potential GDP as a percentage of potential GDP. The potential GDP is what a country can produce when unemployment is at its natural rate and there is no inflationary pressure. Unlike actual GDP, potential GDP is not observable but must be estimated.

The article is organised as follows. Section 1 traces the troubled path the EU walked from Bretton Woods to EMU. Section 2 explains why the EMU countries, in addition to abandoning monetary policy autonomy, need to coordinate fiscal policies as well, and in particular to keep national deficits under control. Section 3 shows how a balanced structural budget expands the scope for fiscal policy on the part of the members and thus enhances the resilience of the EMU. Section 4 assesses the room for manoeuvre available to euro area members. Section 5 explains the importance of achieving and/or preserving sufficient fiscal room for manoeuvre especially after the Covid-19 crisis.

1. The Path towards EMU

Since its inception, the EU proposed a certain degree of coordination for national economic policies to make "*fixed exchange rates implicitly the norm*"[9]; and indeed fixed exchange rates should have been the norm when the Treaty establishing the European Economic Community (TEEC) came into force in 1958. This thanks to the Bretton Woods agreement[10], which fixed the exchange rates of the participating currencies with the US dollar, itself in turn pegged to gold. However, since the Bretton Woods countries preferred to retain national monetary sovereignty, the exchange rates were not

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[9] See Leland B. Yeager, "Exchange rates within a common market", *Social Research* 25 (1958), p. 415-438.

[10] In 1944, delegates from 44 countries met at the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire. One of its aims was to craft a new monetary order for the post-war world so as to foster world trade and prevent 'beggar thy neighbour' competitive currency devaluations.

actually fixed but adjustable[11] and capital controls were in place. Those conditions, required by the impossible trilemma, made the Bretton Woods model inconsistent with that of the EU, since adjustable rates did not eliminate exchange rate risk, while capital controls violated one of the four 'fundamental freedoms'. This is why, even during the Bretton Woods regime, the EU opened the discussion[12] on fixing exchange rates in a context of free capital movement, which ultimately produced the proposal in 1970 for a 10-year plan for adopting a single currency[13].

Capital controls began to be lifted in the 1960s, and inflation differentials and divergent policy aims – reducing inflation vs. reducing unemployment – drove national interest rates apart. Eventually, in 1973, the Bretton Woods regime collapsed. In this context, the European 10-year plan for a single currency was shelved in favour of quicker solutions to avoid the return of variable exchange rates within the Community.

The various European monetary regimes that spanned the period between Bretton Woods and the single currency in 2002 were

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[11] See Art. IV, 'Par values of currencies', of the Agreement of the International Monetary Fund, 22 July 1944.

[12] In 1962 the Marjolin Memorandum, named after French Commissioner and Vice President Robert Marjolin, launched discussion on a common currency and prompted several measures in the field of monetary cooperation.

[13] In 1970 the Werner Report, named after the Prime Minister of Luxembourg Pierre Werner, stated: "*A monetary union […] may be accompanied by the maintenance of national monetary symbols, but considerations of a psychological and political order militate in favour of the adoption of a single currency which would guarantee the irreversibility of the undertaking.*".

designed to limit intra-EU exchange rate fluctuations, first with the 'snake in the tunnel'[14] and then with the European Monetary System (EMS)[15]. Both failed, because they violated the trilemma by fixing exchange rates but allowing free capital movement, with member states pretending to have abandoned monetary policy autonomy. In particular, with the EMS, member states began to follow the monetary policy of the German Bundesbank, which was recognised as the most effective in controlling inflation. Thus, thanks to decreasing inflation rate differentials, exchange rates had been successfully kept within their bands of fluctuation and there had not been any central parity realignment[16] since 1987. But, as soon as the EMS was crossed by divergent objectives[17], the pretence of exchange rates stability was targeted by speculative attacks obliging many members to abandon the commitment to keep exchange rates fixed in 1992 to restore competitiveness by devaluing their currencies.

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[14] Under this mechanism, European states' currencies could fluctuate against the dollar within a band of 2.25%. The oil crisis of 1973 and poor compliance by the member states brought the failure of the 'snake' mechanism.

[15] Unlike the 'snake in the tunnel', the EMS established the Exchange Rate Mechanism (ERM) to fix member states' currencies to one another at a designated 'central parity', but still with a margin of fluctuation. The EMS also included a tool of cooperation between central banks to avoid breaking the set exchange rates. Realignment of the parities was possible only in extreme cases, and with unanimity of countries.

[16] See footnote 15.

[17] After German reunification (3 October 1990) the Bundesbank was in favour of a restrictive monetary policy to keep inflationary pressures under control, while other countries - *e.g.* the UK, France and Italy – were against it to avoid any slowing of the domestic economy. In 1991 the reunited Germany's GDP grew by a solid 5% (in constant prices), but Italy's GDP grew by 1.4%, France's GDP by 1% and the UK's GDP shrank by 1.1%.

Therefore, based on both theory (the 'impossible trilemma') and on experience (Bretton Woods, the 'snake' and the EMS), it emerged that the surest way to retain free capital movement (a fundamental aim of common market) and fixed exchange rates (to boost cross-border trade and economic activity in general) was to give up national currencies and introduce a single currency.

The Maastricht Treaty created the EMU in 1993 and established the basic rules for both the monetary policy of the single currency – the euro – and the fiscal policies of the member states[18]. Under the Treaty, the prime objective of monetary policy is to ensure price stability[19] in the euro area; the European Central Bank (ECB)[20] has interpreted 'price stability' to mean an inflation rate "*below but close to 2% over the medium term*"[21]. To guarantee its effectiveness, the ECB was created as an independent institution[22]: other EU institutions, member states and governments cannot interfere with its activities or decisions[23], nor can the ECB provide any direct financial support to

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[18] Some of the rules apply to non-euro EU states as well, but for the purposes of this article we refer to euro-area states.

[19] Art. 3, par. 3 of the TEU and Art. 119 of the TFEU.

[20] We use 'ECB' as a simplified designation for the European System of Central Banks (ESCB) and Eurosystem that consists of the ECB and the national central banks of the 19 euro area countries.

[21] Decision of the Governing Council of the ECB, 8 May 2003.

[22] The governance model of the ECB was inspired by that of the Bundesbank, as observed in the study by Vittorio Grilli, Donato Masciandaro, Guido Tabellini, Edmond Malinvaud and Marco Pagano, "Political and Monetary Institutions and Public Financial Policies in the Industrial Countries" in *Economic Policy* Vol. 6, No. 13 (1991), pp. 341-392.

[23] Art. 130 of the TFEU.

them[24]. As far as fiscal policies are concerned, the Treaty sets restrictions on national governments' deficits and debt[25]. This translated into numerical rules[26] for countries to qualify for the euro area and for its members: public deficits should be kept below 3% and debt below 60% of Gross Domestic Product (GDP). Unlike the deficit criterion, the one on debt was to be understood as non-mandatory either for admission (countries whose debt was above 60% had to commit to reduce it at a "*satisfactory pace*"[27]) and for continued membership; the rules focused exclusively on the deficit, until the outbreak of the sovereign debt crisis[28].

2. The Rationale for Fiscal Surveillance in the EMU

National fiscal policy generally deploys the budget – expenditure and revenue – to smooth the economic (or business) cycle and to facilitate or generate economic growth. During downturns, for example, tax receipts shrink and public expenditure rises, thus fiscal policy becomes expansionary to reduce the negative effects. However, independently of the degree of involvement of the

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[24] The so-called no-bailout clause in Art. 123, para. 1, of the TFEU.

[25] Art. 126, par. 1 and par. 2, of the TFEU.

[26] TFEU, Protocol No. 12 on the excessive deficit procedure.

[27] This diverse treatment of those two variables could be explained by the fact that governments can hardly control their debt in the short term and by the political motivation to let Italy and Belgium, both with debts above 100% of GDP, join the euro area from its inception.

[28] Only then did the magnitude of the public debt become a mandatory standard. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (which went into force in 2013) instituted stricter deficit criteria for countries whose debt is more than 60% of GDP.

government in the economy, fiscal policy is subject to an inter-temporal budget constraint: deficits, which pile up into debt, should be counterbalanced by surpluses, so that the net present value of annual budget balances (the difference between revenue and expenditure) is zero. If deficits exceed surpluses over the long term, debt accumulates; this means larger interest payments owing to the larger stock of debt and the likely loss in presumed creditworthiness. The larger interest payments in turn will reduce a government's capacity to use fiscal policy effectively in downturns, further reducing the state's creditworthiness. This snowball effect can drive the debt towards unsustainable levels and eventually lead to default. Accordingly, a virtuous fiscal policy should be the aim of every government, whether or not it is part of a monetary union. However, the evidence is that most countries are prone to deficit even during economic booms thus accumulating public debt[29]. In a monetary union a 'vicious' fiscal policy can be more harmful for the country that undertakes it, as well as harmful for the other member states and for the union as a whole (the boundaries between these three categories being generally blurred in any case).

Deficits, due to an expansionary fiscal policy, can push national inflation rates up. The ECB, focusing on inflation in the euro area as a whole, cannot completely offset such local inflation surges[30], and

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[29] Marco Buti and André Sapir, *Economic Policy in EMU: A Study by the European Commission Services*, Oxford University Press, 1998, pp. 84-88.

[30] In the euro area, the inflation of each member state has relatively little impact on the overall inflation rate.

national governments cannot no longer devalue their national currencies to counter the rise in the real exchange rate and the consequent decline in competitiveness[31]. The only way to restore competitiveness is to reduce domestic prices and wages, the so-called 'internal devaluation'. As internal devaluation is inevitably slower than nominal exchange rate devaluation[32] (owing, say, to labour market regulations and resistance from trade unions), this prolongs the downturn, with severe economic, social and political consequences.

An expansionary fiscal policy may also drive national interest rates up, transmitting this effect to other countries in the area. Even without the other members' altering their fiscal policy stance, this interest rate rise can crowd out private investment and lead to an appreciation of the common currency, adversely affecting the area's competitiveness. Another reason to put a constraint on national fiscal policies is because the EMU has not instituted any form of debt mutualisation[33]. What is more, the member countries' public debt is now issued in euros, tantamount to a foreign currency for which states cannot use

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[31] The real exchange rate measures the purchasing power of one country's currency relative to others'. If the real exchange rate rises, the country's products become more expensive relative to its competitors'. Similarly, a fall in the real exchange rate should increase net exports as domestic goods become less expensive thus more competitive.

[32] See Jean Pisani-Ferry, *The Euro Crisis and its Aftermath*, Oxford University Press, 2014, p. 177.

[33] Along with the no-bailout clause for the ECB (see footnote 24), the Maastricht Treaty specified that a distressed state could not be bailed out by the other members (Art. 125 of the TFEU).

their fiat[34] power, and the ECB, with inflation its prime concern, will not erode its real value by expanding the money supply[35]. In this more constrictive framework, and notwithstanding the Treaty's express no-bailout clause, it was hard to believe that a euro area country excluded from the debt market could be left with nothing but the ordinary salvage package offered by the International Monetary Fund (IMF). The expectation, that is, was that the EU would devise its own form of support, not only as a matter of pride *vis*-à-*vis* the Bretton Woods institution, but as a matter of necessity, owing to the ever greater interdependence between member states. Thus a solvency problem in one country would, in fact, produce negative spill-overs (due to cross-border trade and investment), undermining the perceived stability of the entire euro area. The evidence of this expectation was the annulment of the differences in sovereign bond yields between the countries that adopted the single currency[36] (Figure 1 shows the spreads between 10-year maturity bond annual yields in some euro area countries and Germany[37]); the expectation was later confirmed

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[34] *Fiat money* is currency lacking *intrinsic* value, established as a legal tender by government fiat.

[35] Debt repayment is usually in fixed, nominal terms. In times of inflation, as the value of money declines it is easier for borrowers to repay their debts: borrowers pay less in real terms, as the nominal debt payments remain unchanged.

[36] The annulment of spreads in the first decade of the euro was encouraged by the ECB policy of accepting any sovereign bond posted by banks as collateral for ECB liquidity.

[37] In April 2020, for example, the average 10-year maturity bond annual yield in Italy was 1.80% and -0.45% in Germany resulting in a spread of 2.25%.

by the salvage tools that the EU created during the debt crisis[38].
Therefore, in order to reduce moral hazard in the 'spendthrift'
countries in this framework of perceived *de facto* solidarity, the EMU
imposed budget discipline for crisis prevention, owing to the original
lack of *de jure* tools for crisis management.

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[38] To contrast the worsening sovereign debt crisis, in May 2010 the EU instituted a
brand new fund, the European Financial Stability Facility (EFSF), supplanted in
March 2011 by a stronger, permanent European Stability Mechanism (ESM).

Figure 1 - Sovereign bond yields (spreads with Germany)
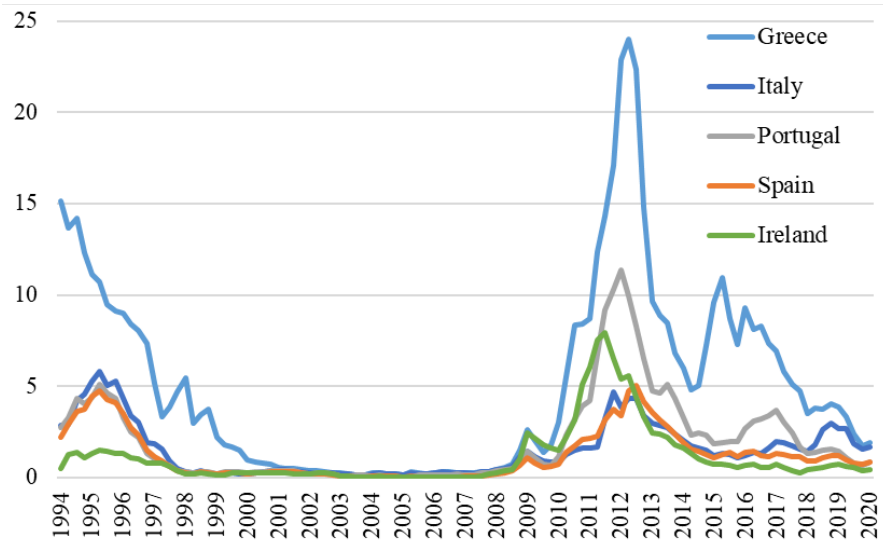
Source: Eurostat.

3.   The Numerical Rules for the Budget

The Maastricht Treaty mandates national budget deficits of less than 3% of GDP (or the budget balance higher than -3%), deeming this sufficient to enable countries to deploy countercyclical fiscal policies and to invest while guaranteeing the sustainability of public debt at 60% of GDP, assuming a real growth rate of 3%[39]. Fiscal discipline was considered so important that a fine[40] for breaching the limit was foreseen, as the outcome of the excessive deficit procedure (EDP). Four years after the entry into force of the Maastricht Treaty, the EU adopted the Stability and Growth Pact (SGP)[41] with the aim to detail the procedure of the 'corrective arm'[42], *i.e.* the EDP for countries violating the 3% deficit ceiling, and to introduce the 'preventive arm'[43], *i.e.* the *ex-ante* control on member states' commitment to reach and maintain a budgetary position "*close to balance or in surplus*", the so-called medium-term objective

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[39] This was in fact the average real growth rate over the nine years preceding the negotiations for the Maastricht Treaty (1991) in the 11 countries that joined the euro area at the outset.

[40] Art. 126, para. 11, of the TFEU.

[41] The SGP stems from a European Council resolution (adopted at Amsterdam on 17 June 1997) and two Council regulations of 7 July 1997. The SGP procedures were updated during the sovereign debt crisis, expanding its legal basis and increasing its complexity by the introduction of 'Six-pack' and 'Two-pack' legislation; for this reason, since 2013 the Commission publishes *Vade Mecum* to increase transparency and better explain the rules.

[42] Council Regulation (EC) 1467/97 on speeding up and clarifying the implementation of the Excessive Deficit Procedure.

[43] Council Regulation (EC) 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

(MTO)[44]. While the corrective arm is based on the actual budget balance, the preventive arm is based on the structural budget balance[45], *i.e.* a theoretical cyclically-adjusted balance (CAB) cleared of one-off and temporary measures that do not lead to a sustained change in the budgetary position[46].

Figure 2 describes the preventive and corrective arms of the SGP[47]. The horizontal axis plots the output gap, thus it tracks the cyclical fluctuation: on the left side the output gap is negative (downturn[48]), on the right side the output gap is positive (boom). The vertical axis gives the budget balance as a percentage of actual GDP (budget-to-GDP ratio): on the upper side the balance is positive (surplus), on the lower side the balance is negative (deficit).

The diagonal line exemplifies the behaviour of the fiscal policy of a country with respect to the economic cycle where:

[44] Along with the structural balance, the preventive arm analyses the growth rate of an expenditure aggregate net of discretionary revenue measures; however, for the aim of this article we focus only on the rules for the structural balance.

[45] European Commission, "Vade Mecum on Stability and Growth Pact", *European Economy Institutional Paper* 101 (2019), pp. 8-9.

[46] If a government sells non-financial assets over a period of time, this systematic liquidation cannot become a sustainable source of government financing, as the stock of assets is depleted further with every sale. See European Commission, "Report on Public Finances in EMU", *European Economy Institutional Paper* 014 (2015), Part II, Chapter 3.

[47] This model is based on the one proposed by Carlo Altomonte and Mario Nava in *Economics and Policies of an Enlarged Europe*, Edward *Elgar* Publishing, 2005, p. 139.

[48] In this article downturn is preferred to recession since the latter has a specific definition: two consecutive quarters of negative economic growth.

- The intercept is the CAB, *i.e.* the budget balance when the output gap is equal to zero, thus assuming the country is running at its potential in the absence of the economic cycle.

- The slope measures the absolute change of the budget-to-GDP ratio (along the vertical axis) as a result of the relative change of the GDP (along the horizontal axis) and is named budgetary semi-elasticity[49]. A positive slope means that the budget balance increases in good times and deteriorates in bad times, a countercyclical fiscal policy epitomized by the 'automatic stabilisers', *i.e.* fiscal measures triggered automatically with no discretionary intervention[50]. For example, in the case of a negative output gap, the budget balance falls due to the automatic increase in government expenditure (more unemployment benefits to pay) and the decrease in revenue (less income and consumption tax receipts).

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[49] The semi-elasticity differs from the elasticity by the type of the budget balance resulting from a relative variation of GDP. The semi-elasticity measures the variation of the budget balance as a percentage of GDP, while the elasticity measures the variation of the budget balance in absolute monetary terms (*e.g.* in euro). Thus the semi-elasticity captures both changes of GDP in numerator and denominator due to business cycle.

[50] Discretionary interventions are often characterized by long decisions and implementation lags that might reduce their effectiveness. See Jan in 't Veld, Martin Larch and Marieke Vandeweyer, "Automatic Fiscal Stabilisers: What they are and what they do", *European Commission, Economic Papers* 452 (2012); Martin Larch, Eloïse Orseau, and Wouter Van Der Wielen, "Do EU Fiscal Rules Support or Hinder Counter-Cyclical Fiscal Policy?", JRC Working Papers on Taxation and Structural Reforms No 01/2020.

The preventive arm of the SGP requires member states, such as Country X in our example, to adjust their CAB from a deficit (A in Figure 2) at least to the balance (0).

First of all, a CAB in balance is consistent with the inter-temporal budget constraint that should balance the deficits generated in times of negative output gaps with the surpluses generated in times of positive output gaps. Moreover, an improved CAB enables the national government to cope with a deeper downturn before running up against the 3% deficit ceiling. In our example, by improving the CAB from A to 0 along the vertical axis, *ceteris paribus*, Country X increases its room for manoeuvre from 0B to 0C, *i.e.* the automatic stabilisers can play their role to cope with a larger negative output gap[51], in the absence of a national monetary policy and exchange rate instrument, without violating the 3% rule of the corrective arm.

A CAB at least in balance provides national fiscal policy with greater room for manoeuvre to deal with the economic cycle, especially when this is not aligned with the prevailing cycle in the rest of the EMU. A common monetary policy, in fact, is effective when the cycles of members are synchronized and when the shocks are
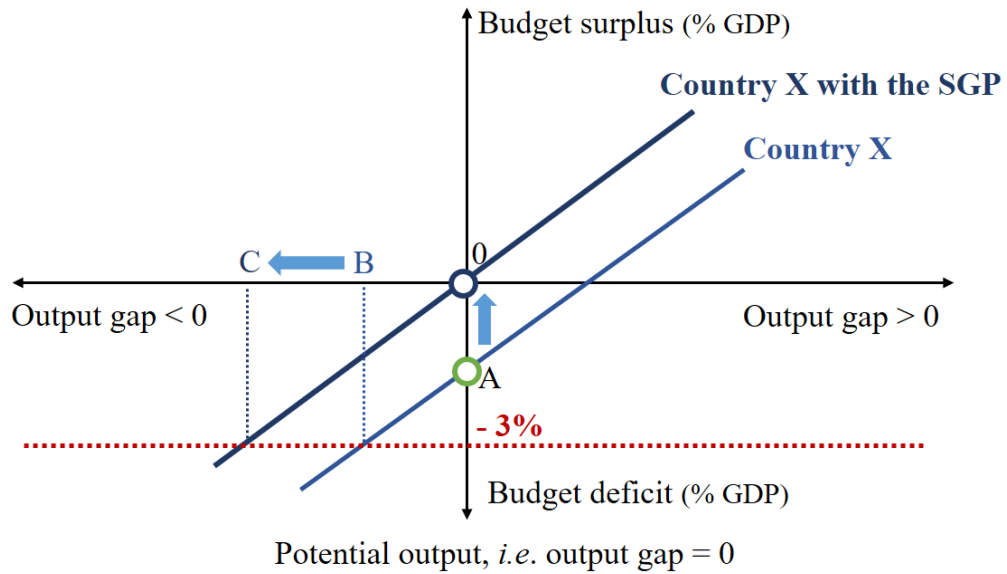
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[51] See Roel Beetsma, "Does EMU Need a Stability Pact?" in Anne Brunila, Marco Buti and Daniele Franco (Eds.), *The Stability and Growth Pact, The Architecture of Fiscal Policy in EMU,* Palgrave MacMillan, 2001, p. 49.

symmetric[52], *i.e.* when a negative or positive unexpected event affects all the members of the union in a similar way.

[52] See U. Michael Bergman ,"How similar are European business cycles?", article of the 4th Eurostat and European Commission DG Ecfin Colloquium on Modern Tools for Business Cycle Analysis "Growth and Cycle in The Euro-Zone", January 2004.

Figure 2 – Fiscal policy in the EMU: before and after the SGP

Budget surplus (% GDP)

Country X with the SGP

Country X

0

C ← B

Output gap < 0

Output gap > 0

A

- 3%

Budget deficit (% GDP)

Potential output, *i.e.* output gap = 0

In the case of asymmetric shocks, however, which may stem, say, from specialisation[53] among euro area countries[54], low cross-border labour mobility and the downward rigidity of wages and prices might make readjustment towards competitiveness, in the absence of exchange rate instruments, slower and more painful in the countries that are hit harder. Nor does the EU envisage any support mechanism for countries struck by asymmetric shocks: the EU budget is a mere 1% of the continent's GDP, it is very rigid in structure[55], and it is allocated, well in advance, for the most part to agriculture and regional cohesion. Consequently, greater room for manoeuvre at national level would guarantee the resilience of the EMU and improves its 'optimality'[56] as a currency union.

4. An Assessment of Fiscal Room for Manoeuvre

The EMU constrains States' budget balances with the preventive arm (a structural balance close to balance or in surplus) and the corrective arm (budget deficits of less than 3% of GDP) of the SGP;

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[53] According to Paul Krugman in *Geography and trade*, MIT Press (1991) the EMU would have increased specialization and inter-industry trade within the area.

[54] See Francesco Paolo Mongelli, Elisa Reinhold, Georgios Papadopoulos, "What's so special about specialization in the euro area? Early Evidence of Changing Economic Structures", *ECB Occasional Paper Series* 168 (2016).

[55] The EU budget should always be balanced (Art. 310, par. 1, of the TFEU), so unlike the member states the Union cannot run a deficit and is not allowed to borrow.

[56] Being 'optimal' an absolute adjective, it can only refer to a theoretical context; therefore, here we use it in relative terms as it is used in the theory of 'Optimum currency theory' proposed by Robert A. Mundell, "A Theory of Optimum Currency Areas", *American Economic Review*, Vol. 51, No. 4 (1961) p. 657, which lists the criteria according to which different countries should adopt a common currency.

but the 'slope' (the budgetary semi-elasticity) of national fiscal policies is a country-specific variable.

EMU countries have different fiscal policies in terms of size and composition of their budgets and the EU has not been given the task of harmonising them. For example, total government expenditure ranges from 24.8% of GDP (Ireland) to 55.6% (France)[57]; and education spending ranges from 8.2% of total expenditure (Italy) to 15.8% (Estonia), while defence spending ranges from 1.1% (Luxembourg) to 5.5% (Latvia)[58].
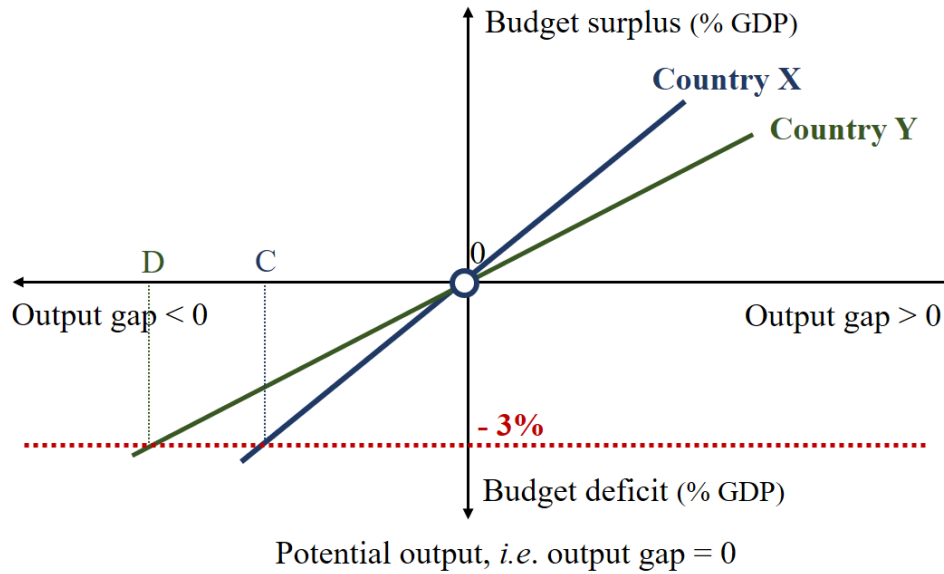
In our example, two countries – X and Y – have a balanced CAB and thus they fulfil the medium-term condition of the preventive arm of SGP (Figure 3). Their fiscal policies differ in their slopes, thus in their countercyclical effect, stronger in Country X than in Country Y (for example in Country X the taxation is more progressive and the unemployment benefit is more generous). However, Country Y enjoys greater room for manoeuvre (0D) than Country X (0C) before running up against the 3% deficit ceiling. That means that Country Y, with a 'cheaper' fiscal policy, can face more severe downturns without violating the corrective arm of the SGP.

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[57] Eurostat, Government revenue, expenditure and main aggregates (gov_10a_main), 2019 data.

[58] Eurostat, General government expenditure by function (COFOG) (gov_10a_exp), 2018 data.

Figure 3 – Fiscal policies and room for manoeuvre

Budget surplus (% GDP)

Country X

Country Y

D   C

0

Output gap < 0   Output gap > 0

- 3%

Budget deficit (% GDP)

Potential output, *i.e.* output gap = 0

The first column of Table 1 reports the budgetary semi-elasticities (the slopes of national fiscal policies) to be used for the fiscal surveillance in the period 2020-2025[59]; they are calculated by the Commission using:

- the elasticities of individual expenditure and revenue components[60], and

- the weight of individual expenditure and revenue components in the national budget[61].

With the semi-elasticities, the Commission calculates CAB, the basis for the structural balance used for the preventive arm of the SGP, for every country i according to the following formula:

$$CAB_i = Budget\ balance_i - Budgetary\ semielasticity_i \times Output\ gap_i$$

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[59] Gilles Mourre, Aurélien Poissonnier and Martin Lausegger, "The Semi-Elasticities Underlying the Cyclically-Adjusted Budget Balance: An Update & Further Analysis", *European Economy Discussion Paper* 98 (2019).

[60] Those elasticities are calculated by the OECD and approved by the EU Economic Policy Committee's Output Gap Working Group. For details, see Gilles Mourre, Caterina Astarita and Savina Princen, "Adjusting the budget balance for the business cycle: the EU methodology", *European Commission, Economic Papers* 536, (2014), and Robert W. Price, Thai-Thanh Dang and Yvan Guillemette, "New tax and expenditure elasticity estimates for EU budget surveillance", *OECD Economics Department Working Paper* 1174 (2014).

[61] The Commission has reviewed the national weights in 2019 (see footnote 59) with 2008-2017 data. The next update will be completed by the end of 2024 and will be used for fiscal surveillance period starting in 2026.

The room for manoeuvre, i.e. the size of negative output gap a country can absorb before hitting the 3% deficit ceiling, is calculated as follows:

$$Room\ for\ manoeuvre_i = -\frac{CAB_i + 3\%}{Budgetary\ semielasticity_i}$$

Table 1 reports the output gap and the room for manoeuvre for euro area countries in 2019, when the euro area as a whole experienced a positive output gap equal to +1.1% and all countries kept their budget balances above -3%, even the two in negative territory, namely Greece and in Italy.

Table 1 – Budgetary semi-elasticities and other variables (in % of GDP) of euro area countries in 2019

	Budgetary semi-elasticity	2019				
		Budget balance	Output gap	CAB	Room for manoeuvre	Specific Output gap
Austria	0.571	0.73	1.72	-0.25	-4.81	0.64
Belgium	0.615	-1.91	0.88	-2.45	-0.90	-0.20
Cyprus	0.504	1.73	5.91	-1.24	-3.49	4.82
Estonia	0.486	-0.32	4.28	-2.40	-1.23	3.19
Finland	0.582	-1.14	0.88	-1.65	-2.32	-0.21
France	0.630	-3.00	1.14	-3.72	1.14	0.06
Germany	0.504	1.45	1.04	0.92	-7.79	-0.04
Greece	0.524	1.46	-4.40	3.77	-12.92	-5.48
Ireland	0.522	0.39	2.13	-0.72	-4.36	1.04
Italy	0.544	-1.64	-0.25	-1.50	-2.75	-1.33
Latvia	0.378	-0.21	3.51	-1.53	-3.88	2.42
Lithuania	0.399	0.27	4.57	-1.56	-3.62	3.49
Luxembourg	0.462	2.18	2.21	1.16	-9.00	1.13
Malta	0.479	0.54	3.76	-1.27	-3.62	2.68
Netherlands	0.605	1.73	1.53	0.80	-6.29	0.45
Portugal	0.538	0.19	2.40	-1.10	-3.53	1.31
Slovakia	0.381	-1.30	2.66	-2.31	-1.82	1.58
Slovenia	0.468	0.54	3.03	-0.87	-4.54	1.94
Spain	0.597	-2.83	2.29	-4.19	2.00	1.21

Source: European Commission[62].

[62] See footnote 59.

Assuming that the common monetary policy is effective in dealing with the common output gap in the area, it is worth assessing whether the national room for manoeuvre is sufficient to absorb the country-specific negative output gap[63] calculated as follows:

$$Specific\ output\ gap_i = Output\ gap_i - Output\ gap_{euro\ area}$$

The last column of Table 1 reports the specific output gaps in 2019 and Table 2 shows if the room for manoeuvre was large enough to absorb the negative ones since 2010, where the output gap of the euro area is the GDP-weighted average of the 19 members. If the cell is green, the room for manoeuvre was large enough. If the cell is red, the specific output gap was larger than the room for manoeuvre. When a country has a sequence of 'red' cells, that means that its fiscal policy is not consistent with the EMU rules if its specific output gap is taken into account (i.e., its economic cycle relative to that of the euro area as a whole). A room for manoeuvre that is not sufficient to absorb negative specific output gaps can be a source of continuous violations of the 3% deficit ceiling. The ECB, in fact, may absorb the

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[63] According to the European Commission *"for the 19 Member States of the euro area, at most 60% of the fluctuations in output can be ascribed to a common factor. Therefore, more than 40% of the fluctuations in output either stem from asymmetric sources, or at least reflect asymmetric transmission across Member States of common shocks"*. Commission Staff Working Document Impact Assessment Accompanying the document "Proposal for a Regulation of the European Parliament and of the Council on the establishment of a European Investment Stabilisation Function", SWD (2018) 297 final of 31 May 2018.

negative output gap of the euro area as a whole[64], but not the one of a specific country.

Notwithstanding the clarity of the numerical rules of fiscal surveillance, not a single country has been sanctioned yet for non-compliance with both the preventive and corrective arms of the SGP. For example, with a reference to the latter, a country whose deficit exceeds the 3% ceiling does not automatically trigger the EDP.

The Commission, in fact, evaluates the budgetary position taking into account factors such as "*achieving the policy goals of the Union*", "*implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances*" and "*in the context of the common growth strategy of the Union*"[65]. Moreover, both the preventive and the corrective arms of the SGP can be 'suspended' in the case of: (i) an unusual event outside of the Member State's control and with a major impact on its public finances (*e.g.* natural disasters, exceptional refugee inflows), or (ii) a severe economic downturn in the euro area or in the Union as a whole[66]. The latter, also known as 'the escape clause'[67], was adopted for the first

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[64] Without prejudice to the objective of price stability as requested by Art. 127 par. 1 of the TFEU.

[65] Art. 2 par. 3 of the Council Regulation (EC) No 1467/97.

[66] For the preventive arm, Art 5 par. 1 and Art. 9 par. 1 of the Council Regulation (EC) 1466/97; for the corrective arm, Art. 3 par. 5 and Art. 5 par. 2 of the Council Regulation (EC) No 1467/97.

[67] European Commission, "Common principles on national fiscal correction mechanisms", COM (2012) 342 final of 20 June 2012.

time in 2020[68], when the output gap of the euro area was forecasted at -7.3%[69], due to the Covid-19 crisis.

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[68] On 23 March 2020, the Ecofin Council has agreed with the Commission, as set out in its Communication of 20 March 2020, that "*the conditions for the use of the general escape clause of the EU fiscal framework – a severe economic downturn in the euro area or the Union as a whole – are fulfilled*".

[69] European Commission, "Statistical annex to European Economy Spring 2020", 8 May 2020.

Table 2 – Difference between specific output gap and room for manoeuvre

Legend:
x = Specific output gap - Room for manoeuvre

	x = 0
	-2 = x < 0
	-4 = x < -2
	x < -4
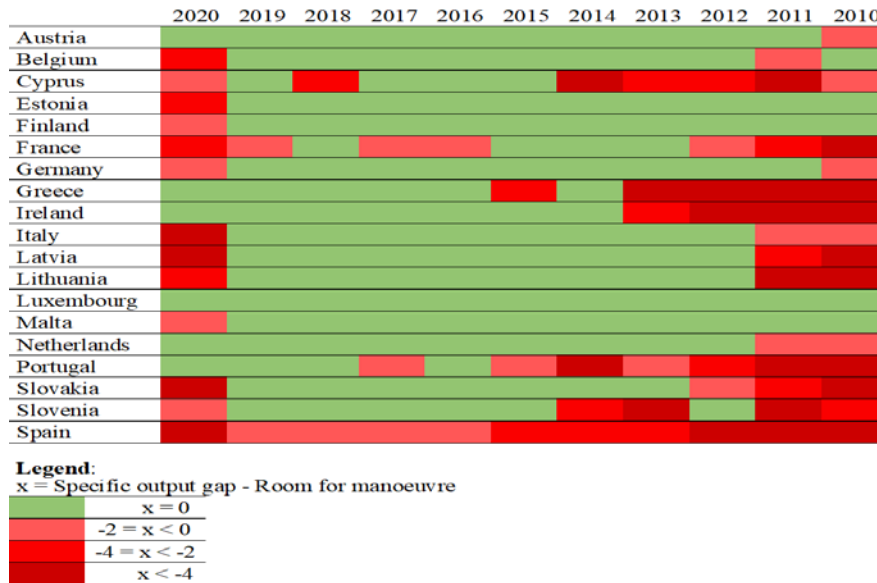
Source: Author's elaboration on European Commission's data.

5.   Fiscal Policies after the Covid-19 Pandemic

In 2020, both the preventive and the corrective arms were temporarily suspended to allow EU member states to undertake the necessary budgetary measures to deal adequately with the Covid-19 health emergency. However, euro area countries should not abandon their commitment to achieve and/or preserve sufficient room for manoeuvre due to the increasing level of sovereign debts and to a limited monetary firepower.

6.   Increasing Level of Sovereign Debts

In 2020 both the average and the standard deviation[70] of the sovereign debts in the 19 countries of the euro area reached their highest levels since the birth of the euro area (Figure 4). Although there is no threshold above which a debt is unsustainable *per se*, a rising debt can hardly be beneficial for a country since it enlarges the basis of the interest payment. As far as the interest rate is concerned, the confidence restored after the sovereign debt crisis, as is demonstrated by the shrinking spreads in Figure 1, has not led to the *status quo ante*; the days when every euro area member enjoyed German-level creditworthiness are over. Due to the SGP, higher interest payment subtracts resources to other expenditures, such as investment, thus negatively affecting countries' competitiveness. Investment in the euro area is already dropping: the average of

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[70] Standard deviation is a measure of dispersion of the 19 sovereign debts around their average.

investment[71] for the 19 euro area countries moved from a 24% of GDP in the 1999-2008 decade to a 20% in the 2010-2019 decade; and the Covid-19 is likely to negatively affect investment even further. Moreover, the increase in standard deviation signals a wider heterogeneity among the euro area countries that might fuel asymmetric effects weakening the optimality of the currency area.

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[71] We use the 'Gross fixed capital formation' defined as resident producers´ acquisitions, less disposals, of fixed tangible and intangible assets. This covers, in particular, machinery, equipment, vehicles, dwellings and other buildings.

Figure 4 – Sovereign debt in the 19 countries of the euro area (% GDP)
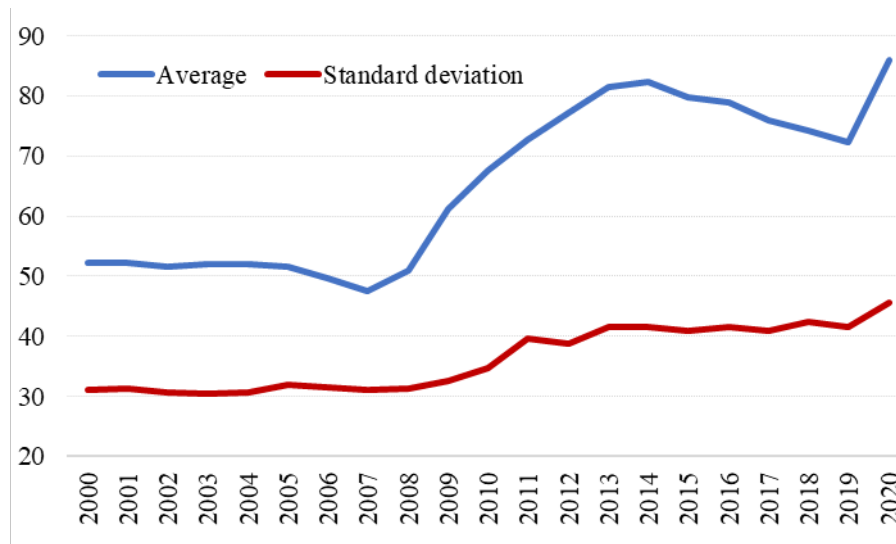
Source: European Commission, AMECO database.

6.1. Limited Monetary Firepower

National governments can no longer count on massive ECB support after the Bank's extensive use of its conventional tools: the reference interest rate[72] has been lowered to zero since 16 March 2016 and the deposit facility rate[73] has been pushed into negative territory since 11 June 2014. In particular, the ECB's decision to apply a negative deposit rate was intended to increase banks' desire to lend[74]; this was a priority when the euro area was still struggling to recover in the aftermath of the sovereign debt crisis and is still a priority after the Covid-19 crisis erupted in 2020. Being a novelty for the euro area, there is an ongoing debate[75] about the effectiveness of negative

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[72] The main refinancing operations (MRO) rate is the interest rate on the bulk of liquidity provided by the ECB to the banking system.

[73] The interest rate paid on the excess liquidity (reserve holdings in excess of minimum reserve requirements) that banks may deposit overnight with the ECB.

[74] A negative deposit facility rate means that the banks would be charged for holding their money with the ECB. That way, the ECB penalizes banks for holding on to cash in the hope of prompting them to boost lending to businesses and consumers.

[75] See for example: Miguel Ampudia and Skander Van den Heuvel, "Monetary Policy and Bank Equity Values in a Time of Low Interest Rates", *ECB Working Paper*, No. 2199, 2018; Florian Urbschat, "The Good, the Bad, and the Ugly: Impact of Negative Interest Rates and QE on the Profitability and Risk-Taking of 1600 German Banks", *CESifo Working Paper,* No. 7358, 2018; Jan Stráský and Hyunjeong Hwang, "Negative interest rates in the euro area: does it hurt banks?", *OECD Economics Department Working Papers*, No. 1574, 2019.

deposit rates[76]; however the ECB itself is aware that, with a -0.5% rate, it is close to a *de facto* lower boundary[77].

Even an unconventional monetary tool like the ECB's asset purchase program[78] (APP) (used heavily since 2015) might face declining effectiveness due to a combination of quantitative and qualitative factors. First, the ECB's balance sheet has ballooned since the APP's inception, also due to the Covid-19 crisis. With the Pandemic Emergency Purchase Programme (PEPP)[79], the ECB's asset portfolio is projected to grow up to €4 trillion by June 2021 - a third of the euro area's GDP and representing a tenfold rise in a six-year-period. Second, under the PEPP the ECB has started buying sovereign bonds, relaxing both the eligibility criteria[80] and the

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[76] A negative deposit rate might squeeze banks' profits thus reducing their capacity to lend and eventually damaging the economy. Banks, in fact, can hardly transfer negative rates to depositors since, in times of negligible inflation, they might prefer to keep cash under the mattress, since cash pays an interest rate of zero.

[77] After lowering the rate from -0.4% to -0.5%, on 18 September 2019, the ECB started a two-tier system for banks' liquidity parked in its coffer: *i.e.* a portion of liquidity deposited is remunerated at 0% instead of being remunerated (or better, charged) at the negative rate.

[78] This is the quantitative easing (QE) of the euro area that was launched in 2015. The ECB uses new money to buy assets – such as corporate and sovereign bonds - to hold down borrowing costs, to push their prices up thus setting the conditions to restore confidence of economic agents and to revamp the economy of the area.

[79] On 18 March 2020 the ECB announced a €750 billion temporary APP of private and public sector securities, the PEPP, expanded to €1,350 billion on 4 June 2020.

[80] Under the PEPP, the ECB has abandoned the rule of buying 'investment grade' bonds by granting a waiver of the eligibility requirements for purchases of Greek sovereign bonds classified as '*non-investment grade*' by some rating agencies.

geographical criterion of purchase allocation[81]. If, on the one hand, those changes have coped with the overall scarcity of eligible assets and the asymmetric geographic impact of Covid-19, on the other hand they have intensified the already sharp criticism[82] of a policy said to be indirectly helping specific countries thus actually violating the no-bailout clause[83]. The sovereign bond-buying by the ECB amid the Covid-19 crisis follows similar moves by the US Federal Reserve, the Bank of Japan and the Bank of England. However, unlike its peers, should the ECB incur a loss in its bond portfolio, it would have to request additional capital from the members according to the 'capital key'[84], thereby transferring resources in favour of the countries benefitting from the purchases[85]; a type of financial solidarity that is not listed among the objectives of the ECB.

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[81] Under the PEPP, the ECB has abandoned the rule of buying assets in proportion to each country's contribution to the ECB's capital (the capital key). At the end of May 2020, for example, Italian public sector securities weighted 22% of the ECB portfolio of national assets, while Italy had a 14% capital key; French securities weighted 14% with France's capital key of 17%.

[82] On 5 May 2020 the German constitutional court ruled that with the previous sovereign bond-buying scheme, the ECB transgressed its competences and violated German constitutional law.

[83] With the PEPP expansion announced on 4 June 2020, according the Financial Times (in "ECB boosts bond-buying stimulus package by €600bn" of 4 June 2020), "*some ECB governing council members, including Bundesbank boss Jens Weidmann, warned Ms Lagarde* [the ECB President] *that by extending the emergency programme into one that lasts for years, the ECB risked being accused of monetary financing of governments, which is illegal under EU law*."

[84] See footnote 81.

[85] Jean Pisani-Ferry, "The Euro Crisis and The New Impossible Trinity", Bruegel Policy Contribution, Issue 2012/01.

7.   Conclusions

Since its inception, the SGP has been leniently enforced. This has fostered criticism about its effectiveness and efficiency[86] and has driven a fine-tuning of its rules that accelerated during the sovereign debt crisis and it is still ongoing[87]. However, notwithstanding this long-lasting revision process, the numerical cornerstones of fiscal surveillance have been left untouched: a national budget deficit below 3% of GDP and a balanced structural balance in the medium term.

For the resilience of the euro area, in fact, this author would argue that it is not advisable to derogate from the principle of a virtuous fiscal policy due to the simple mathematics of the inter-temporal budget constraint. And, in the EMU, sovereign debt is a national issue with no automatic and unconditional burden-sharing at EU-level. If anything, euro area countries should strengthen their commitment to a virtuous fiscal policy in a context of higher sovereign debts and of a curtailed effectiveness of the monetary policy.

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[86] See, among others: Charles Wyplosz, "Europe's Quest for Fiscal Discipline", *European Commission, Economic Papers* 498 (2013); European Commission, "Completing Europe's Economic and Monetary Union", (the so-called 'Five Presidents' report'), 22 June 2015; Jean Pisani-Ferry, "The Eurozone's Zeno paradox – and how to solve it" in Richard Baldwin and Francesco Giavazzi (Eds.), *How to fix Europe's Monetary Union*, CEPR Press, 2016; Joseph R. Stiglitz, *The Euro: How a Common Currency Threatens the Future of Europe,* W. W. Norton & Company, 2016; European Fiscal Board, "Assessment of EU fiscal rules with a focus on the six and two-pack legislation", European Commission, August 2019; Jörg Bibow, "How to redesign the fiscal regime of the Eurozone: an alternative take on lessons from US and Eurozone experiences", European Trade Union Institute, Working Paper 2019.02.

[87] The most recent review has been launched by the Commission on 5 February 2020 to gauge the effectiveness of the economic surveillance framework.

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