21 November 2022

Euro macro notes

EU fiscal rules: An evolution rather than a revolution

- **The EU Commission proposes a more transparent risk-based EU fiscal surveillance framework that differentiates between countries by taking into account their public debt challenges. Under the Commission's new proposal, both the 3% deficit and 60% debt targets will remain in place, but greater flexibility is introduced to adapt fiscal adjustment paths.**
- **The uniform 1/20th rate of debt reduction rule would be scrapped and replaced by country-tailored pathways with a four-year time horizon. The rules would be simpler and the Commission would have wider powers if Member States fail to stick to their plans. EU financing could be suspended, if countries do not take effective action to correct their excessive debts and deficits.**
- **The proposal is a starting point for what can still be a very long process before a new set of fiscal rules are in place. At best, it could simplify the rules and make enforcement more efficient. At worst, it could include loopholes that would allow member states to escape adequate fiscal discipline as the current rulebook does.**
- **We think the proposal is a step to a right direction, but implementation is everything for the credibility of the new rules. We do not expect the new rules to reduce risks relating to public finances any time soon. Over time, the rules can give politicians at least a better chance to bring debt to a more sustainable level.**

Obvious reform needs

For years, the EU's fiscal framework has failed to contain the rise in sovereign debt ratios, which has led to increasing debt related risks and forced the ECB to adopt a wider role as guardian of financial stability. The framework has also failed to give proper guidelines for effective fiscal policies at the national or EU level during times of crisis, and the rules have remained suspended since the outbreak of the COVID-19 pandemic in March 2020. The rulebook is complex and yet leaves too much space for interpretation. At the same time, demands on the state have increased following the pandemic and Russia's war of aggression against Ukraine, with investments in defence or the green transition gaining prominence. In light of all this, the EU fiscal framework is in dire need of reform, and a *first proposal by the European Commission* was unveiled on 9 November.

The Maastricht Treaty (1992) required that EU members keep public debt below 60% and public deficits below 3% of GDP. These limits were not based on undisputed science. A higher debt ratio would not necessarily be unsustainable. The Stability and Growth Pact (1997) elaborated these rules and their enforcement mechanisms. The rules were considered necessary to avoid mutualisation of sovereign liabilities, limit the potential spill-overs from a sovereign debt crisis to the banking system, and to allow for fiscal policy flexibility during times of economic crisis. Without fiscal rules and limits, independence of the ECB would also be at risk. All these targets have been missed in one way or the other. Yet, rules are still needed for the EU to function effectively, as a union that brings together a variety of different economies and ideas of good economic policies.

EU fiscal rules

- EU fiscal rules date back to the Maastricht treaty (1992) and Stability and Growth Pact (1997).
- The rules are complex and they have not functioned well, allowing a rise in fiscal instability.
- Currently fiscal rules remain suspended until the end of 2023, to help countries cushion the economic fallout from the Ukraine war.
- The EU Commission proposes a reform to take place ahead of Member States' budgetary processes for 2024.

Chief Economist Danske Bank Finland
Pasi Kuoppamäki
+358 50 4240025
pasi.kuoppamaki@danskebank.com

Debt has continued to grow in several member states during normal times, and the COVID-19 pandemic caused a new jump in debt ratios. Furthermore, the EU decided to raise mutual debt in order to show solidarity and stimulate economies ('Next Generation EU' - NGEU). In 2021, 14 member states had debt-to-GDP ratios in excess of 60%, including Germany, and 15 member states had budget deficits exceeding 3% of GDP. Breaking the limits has rarely led to tough enforcement measures, but several countries feel that the rules are too inflexible. On the other hand, fiscally prudent countries mainly in Northern Europe have lamented the weak approach to enforcement, which diminished the rules' credibility. Combining flexibility with more credible enforcement is not an easy task.

Under the new Commission proposal, both the 3% deficit and 60% debt targets will remain in place, but greater flexibility is introduced to adapt the national debt reduction goals to specific country circumstances. The much criticised rule that imposed a uniform 1/20th rate of debt reduction will be scrapped and replaced by country-tailored pathways, a tweak that can help cushion the most painful decisions. Member states will be able to draft their own blueprints to control public deficits and gradually decrease debt ratios over a four-year period. Highly indebted countries might be granted an extra three years to adjust their finances, if it is justified by investment and structural reform needs. The national plans will be negotiated first with the European Commission and then approved by the Council. The approach is modelled on the performance-based model also used to unlock NGEU funds.

Combining flexibility with more credible enforcement

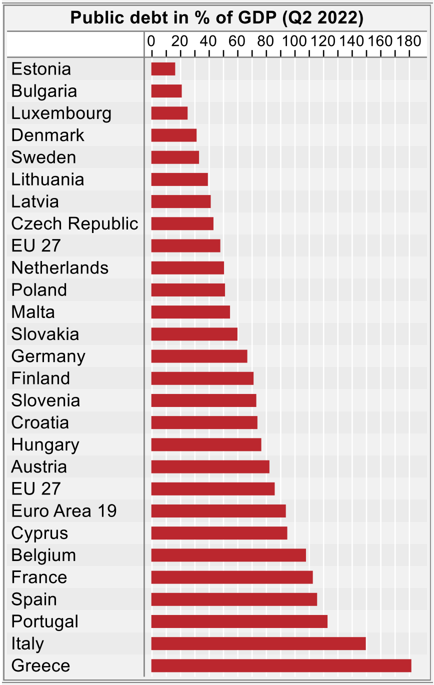
The Commission proposes a risk-based surveillance framework that differentiates between countries by taking into account their public debt challenges. National medium-term fiscal-structural plans would be the cornerstone of the proposed framework. The plans would integrate fiscal, reform and investment objectives into a holistic single medium-term plan. Member States would have greater say in setting their fiscal adjustment path. A single operational indicator – net primary expenditure, i.e. the expenditure which is in a government's control and excludes interest payments – would serve as a basis for setting the fiscal adjustment path. Using just one indicator makes things simpler, but revenues and the total fiscal stance would play a lesser role in the analysis. The approach could therefore make politicians too focused on the expenditure side alone.

The first step in the framework would be a reference fiscal adjustment path proposed by the Commission. The path would be based on the Commission's debt sustainability analysis (DSA) methodology and cover a period of four years. The reference adjustment path aims to put the debt ratio of the Member States with significant debt challenges on a clear downward path. DSA is not entirely objective. Like potential output, the methodology requires many assumptions, like interest rates and spreads, and DSA results can be sensitive to relatively small changes in those inputs.

Secondly, Member States would submit plans setting out their medium-term fiscal path, including reform priorities and public investment commitments. Member States could propose a longer adjustment period, extending the fiscal adjustment path by up to three years, if justified by a set of reform and investment commitments that support debt sustainability and respond to common EU priorities. The national plans could take special national circumstances better into account. The proposal left out a 'golden rule' to exclude investment from fiscal rules, which forces governments to look at total expenditure.

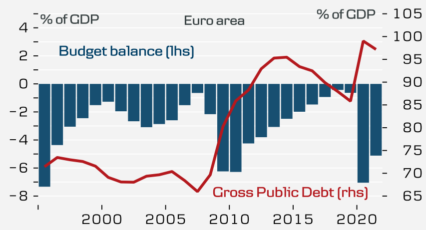
As a third step, the Commission would assess national plans, providing a positive assessment if debt is placed on a downward path or stays at prudent levels, and the budget deficit remains credibly below the 3% reference value over the medium term. The Council would endorse the plans following a positive assessment from the Commission.

Many countries exceeded 60% limit



Source: Eurostat, Macrobond Financial, Danske Bank

Fiscal sustainability challenges remain



Source: EU Commission, Macrobond Financial, Danske Bank

Finally, the Commission would continuously monitor the implementation of the plans. Member States should submit annual progress reports on the implementation of the plans to facilitate effective monitoring and ensure transparency.

As a critical piece of the new framework, enforcement mechanisms would be tightened. The use of financial sanctions would be made more realistic by lowering their amounts. The macroeconomic conditionality for structural funds and for NGEU would be applied in a similar spirit, i.e. EU financing could also be suspended when Member States do not take effective action to correct their excessive deficits. The debt-based excessive deficit procedure would be reinforced. It would be activated when a Member State with debt above 60% of GDP deviates from the agreed expenditure path. A failure to implement reform and investment commitments could result in a more restrictive adjustment path. Due to the significant risk of negative spill-overs within a monetary union, the Commission could also impose financial sanctions on euro area countries. In addition, some reputational sanctions would be introduced. A minister from the Member State failing in its fiscal consolidation efforts could be called before the European Parliament.

The Macroeconomic Imbalance Procedure (MIP) aims to identify potential macroeconomic risks early on, prevent the emergence of harmful imbalances and correct the imbalances that already exist. The reform proposals for the MIP centre on an enhanced dialogue between the Commission and Member States to create a better common understanding of the challenges and the policies needed to address them. This should lead to a commitment from Member States to include the reforms and investment plans needed to prevent imbalances in their national medium-term plan. The assessment of whether imbalances exist would be more forward-looking. More weight would be placed on trend developments and on the assessment of policies to address imbalances. The intensity of post-programme surveillance would evolve over time, along with the evolving risk assessment.

On the one hand, national tweaks in the adjustment and the flexibility in timing can give rise to loopholes, which might reduce the effectiveness of the new framework. The proposal includes an idea of escape clauses needed to address exceptional situations, where the endorsed adjustment path could not realistically be met. Increasing the reputational costs and streamlining the penalties is, on the other hand, an improved incentive for governments to be fiscally accountable. The reform would empower the Commission to become more like a 'European IMF', with better carrots and sticks. The political legitimacy of this can and will be questioned in our view. Financially stressed Member States would have to give more say to the Commission. On a positive note, focus on multi-annual targets could encourage forward-looking, structural policies instead of short-term budget items.

Uphill struggle still ahead

The reform is high on the Commission agenda. Current rules have been suspended and public debt is likely to rise in several Member States during the forecasted economic slowdown. The Commission hopes a consensus on the reform could be reached ahead of Member States' budgetary processes for 2024. In essence, the Commission presented a communication and not a proposal for new regulation. Therefore, the proposal is a starting point for what can still be a very long discussion before a new set of fiscal rules are in place. Overall, we think an agreement before mid-2023 is unlikely and there remains a possibility that the reform will not yet be in place when the old rules apply again in 2024. Especially Germany remains sceptic about the idea of countries striking individual deals on their public finances with the Commission. The idea of country-specific debt plans seems to have more support among other EU countries, but we expect lengthy discussions about the details regarding processes, oversight and enforcement mechanisms.

Disclosure

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Pasi Kuoppamäki, Chief Economist.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Authorised and regulated by the Danish Financial Services Authority (Finanstilsynet). Deemed authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorisation, are available on the Financial Conduct Authority's website.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Ad hoc

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank A/S's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank A/S is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank A/S who have prepared this research report are not registered or qualified as research analysts with the New York Stock Exchange or Financial Industry Regulatory Authority but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

Report completed: 18 November 2022, 13:00 CET

Report first disseminated: 21 November 2022, 06:00 CET