Will Europe recede into macroeconomic instability with its proposed new fiscal rule?

Given the disparate levels of debt and deficits across member states, the key question is whether it is fair to impose a universal austerity rule for all of EU

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Highlights

- *A German non-paper has proposed debt reduction targets for EU nations, similar to that of post 2008 financial crisis*
- *Countries have to reduce debt by cutting spending and raising taxes*
- *Austerity measures adopted in aftermath of 2008 financial crisis led to deep recessions in some nations*
- *In November 2022, the EC had proposed a flexible path to debt reduction*
- *Imposing a common fiscal rule on all EU nations could induce an unacceptable GDP contraction in countries that have low debt and high standards of living*

The austerity debate is set to reopen in Europe with a German non-paper (a paper unofficially setting out the opinion of the government) released earlier this month calling for a minimum debt reduction of 1 percent of GDP per year for highly indebted countries (like Greece and Italy), and 0.5 percent for medium-indebted countries (like Austria and Germany). A return to such a rule-based approach to debt reduction in January 2024 could once again trigger an economic and political crisis in Europe akin to the turmoil that erupted in the aftermath of the 2008 global financial crisis (GFC) that severely inflicted many countries, some derisively referred to by the acronym PIIGS (Portugal, Ireland, Italy, Greece and Spain).

The EU fiscal rules of a 3 percent deficit target and 60 percent debt-to-GDP ratio first introduced in 1997 (strangely, also adopted by many countries outside the EU including India) as the Stability and Growth Pact (SGP) was put to the test in the aftermath of the GFC.

However, in adherence to the rules, severe austerity measures were consequently imposed with the 1/20 rule: countries which had exceeded the debt limit would have to reduce it by at least 1/20th of the difference between their current debt-to-GDP ratio and the 60 percent target every year. At the same time, these reductions in debt had to come from cuts in expenditures and increases in taxes. This resulted in a bout of severe recessions in many EU states that threatened its very continuance. The COVID-19 pandemic that followed even before full recovery from the austerity measures, forced the EU to introduce the 'general escape clause', allowing for relaxation in fiscal rules during times of severe economic shocks. It was further decided to keep such measures in place until the end of 2023. The European Central Bank's (ECB), bond-buying support through the Pandemic Emergency Purchase Programme (PEPP) was a crucial tool that prevented a major economic catastrophe in Europe during the pandemic.

Given the positive acceleration of GDP growth rates in 2022 and downward trend in inflation in spite of the ongoing Ukraine-Russia war, it was considered time to reopen the discussion on fiscal rules. In November 2022, the European Commission (EC) proposed that countries breaking debt targets would have to present four-year plans on how they planned to reduce debt, whereas highly indebted countries would be granted an additional three years, while retaining the overall fiscal rules (3 percent deficit and 60 percent debt to GDP) of the EU. These plans would then have to be negotiated with the EC and approved by the European Council. However, and most interestingly, the proposal did not fix the pace of debt reduction in quantitative terms, instead recommending a flexible path, allowing each country to design its own national blueprints. This allowed countries the option of increasing public investments to raise growth rates, a preferred method to austerity in bringing the debt-to-GDP ratio down to the target.

The recent German non-paper, supported strongly by Netherlands, has now taken a U-turn from the November 2022 proposals. Apart from quantitative rules on debt reduction – with more stringent rules for the worst performers – the non-paper also calls an actual reduction in debt ratios on an annual basis to be achieved with 'simple and transparent' (sic) rules to manage public expenditure and furthermore a provision to automatically trigger a new reform process if high debt persists.

Is it prudent to impose a universal rule for all EU countries? This is the moot question given the disparate levels of debt and deficits across member states. While the PIGS (Ireland has now broken away from the group) countries as well as France and Belgium continue to have a debt-to-GDP ratio exceeding 100 percent (Greece and Italy with 200 percent and 150 percent respectively), there are others like Denmark and Estonia with less than 50 percent. With many still reeling from slow growth and even the general GDP growth rate for the EU forecasted at less than 1 percent for 2023 and around 1.5 percent for 2024, the plausible (re)imposition of austerity rules on cutting expenditures and raising taxes is reminiscent of the post-GFC austerity crisis that roiled Europe.

Austerity policies to reduce fiscal deficits and debt are essentially required to eliminate current account deficits (CAD) in the balance of payments (which implies net asset accumulation by foreigners) when private sector leveraging is shallow, the latter implying that the private sector also desires net financial asset accumulation or private savings exceeding private investment. This desire for net asset accumulation by foreigners and domestic private sector forces the government to accumulate financial liabilities or debt. With a fixed exchange rate mechanism in place, countries with an overvalued exchange rate, for instance Greece or Italy, must resort to 'internal devaluations' by running fiscal surpluses/reducing debt or in other words, forcing recessions to bring down costs of production, particularly, inducing unemployment to reduce wages and thereby increase competitiveness so that the CAD is eliminated or even worse, a current account surplus (CAS) results in net financial accumulation of liabilities by foreigners to accommodate the domestic private sector's desire to accumulate net financial assets.

Countries on the other side of the spectrum with low fiscal deficits and low debt-to-GDP ratios may either have large current account surpluses (for instance, Denmark), or like Estonia have a substantial CAD but the private sector actively leveraging, i.e., the private sector is desirous of accumulating net financial liabilities or debt. It is therefore not surprising that we find many Eastern European nations with low debt-to-GDP ratios given that their growth potential is higher (and consequently, the drive for leveraging) relative to some of the more advanced parts of Europe like Italy and Spain.

The imposition of a common fiscal rule is therefore bound to induce an unacceptable GDP contraction in many countries, which are presently at the wrong end of the debt spectrum but with high standards of living. The recent wave of violence in France sparked off by President Emmanuel Macron's proposal to lessen the burden on the exchequer by revising the retirement age to 65 for eligibility to receive pension is perhaps a warning of what is likely to erupt across Europe were the German non-paper to be accepted and implemented in 2024. **Olivier Blanchard** was prompt in his condemnation of such a move: 'The German "non paper" proposal ... would be catastrophic. It would lead to the worst form of pro-cyclical fiscal policy.'

With the EU's GDP of around $14 trillion or 15 percent of world GDP, it is imperative to monitor the uncertainties unleashed by its rigid fiscal policy that are bound to have repercussions around the world, including India given that the EU is our largest trading partner.

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