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Europe's debt hawks are flapping their wings

The question of public debt hangs over Europe's future — and debt hawks already push for post-pandemic fiscal consolidation. That would be a mistake

The question of public debt hangs over Europe's future. Brussels prefers to talk about other things — the Green Deal or social Europe. The European public is more urgently interested in vaccines, lockdowns and immigration. But nothing is closer to the heart of power in the European Union than public debt.

To even mention it brings back painful memories of the eurozone crisis. After the shock of 2020, the debts are even bigger. And, like it or not, the debate is beginning again. More than any other issue it will decide the future of Europe.

The Stability and Growth Pact has undergone many stages of evolution since the Maastricht treaty was signed in 1992, but two fixed points remain. The ratio of public debt to gross domestic product of EU member states should not exceed 60 per cent and annual budget deficits should not exceed 3 per cent. Those who do not meet these criteria are expected to take measures to ensure compliance.

Applying the rules has proved complex and contentious. But the existence of the pact — regardless of its practicality — is crucial to the legitimacy of monetary union as it stands.

Faced with Covid-19 and the need for urgent government action, in March 2020 the fiscal rules were suspended. Currently, that suspension extends for two years into 2022.

With the constraints lifted, Europe's governmental debts surged as never before in peacetime. By the end of 2020, the ratio of general government consolidated gross debt to GDP stood at 90 per cent for the EU and 98 per cent for the euro area. At this point just 14 of the 27 member states meet the 60 per cent criterion.

Saved from disaster

Rather than being viewed as a matter of regret, the generous fiscal response to the pandemic should be celebrated. It saved European society from disaster. But it poses the question of what comes next. If it is the exception, when does 'normality' return and on what terms? Haggling over the EU's own budget began in the summer of 2020. But that amounts, even with the addition of the recovery fund, to less than 2 per cent of EU GDP. The real issue is the ceiling on national budgets.

The Covid-19 crisis has not just increased public debts but further polarised their distribution. Seven member states, all in western and southern Europe, now have debts over 110 per cent of GDP and the ratios are rising. Deciding what framework will govern this uneven fiscal terrain has implications for every facet of public spending, economic policy and Europe's external economic position.

Debt hawks want more. They want a full-throated policy of long-term consolidation.

For now, the Eurogroup of eurozone finance ministers is happy to leave the fiscal taps open and bet on a strong recovery. If one believes the European Commission's statistics, the fiscal position of the EU in 2021 is broadly neutral: support is neither expanding nor contracting.

That may however under-rate the contractionary effect of winding up emergency programmes. According to analysis by Jérémie Cohen-Setton and Shahin Vallée, Europe in 2021 is already undergoing the beginnings of a consolidation.

Dramatic call

Debt hawks want more. They want a full-throated policy of long-term consolidation. The president of the *Bundesbank*, Jens Weidmann, has emphasised the need for Germany and Europe to prepare for fiscal consolidation. In the pages of Germany's most widely read broadsheet, the *Süddeutsche Zeitung,* a coalition of senior figures from Germany's once dominant parties — Christian-democrat, social-democrat and liberal — have issued a dramatic call for a return to debt rules, at the national and European levels. The group are mainly superannuated, but there is little doubt their opinion is shared by much of the centre-right.

Their views are predictable; more puzzling is the stridency. The grand-coalition government in Berlin does not deny the need for fiscal consolidation. On current plans it aims to return to compliance with Germany's *Schuldenbremse* (debt-brake) criteria in 2023-24. Given the

scale of Germany's deficits in 2020 and 2021, this implies a dramatic tightening.

As Vallée and Cohen-Setton warn in a paper co-authored with Dominik Buhl, such a sharp contraction would have implications well beyond Germany's borders. Germany accounts for 30 per cent of eurozone GDP. A 2 per cent fiscal contraction in 2022 would amount to about 0.7 per cent for the eurozone as a whole—a significant negative impulse. Nor is Germany alone in plotting consolidation: France and Italy are also planning to bring down their deficits sharply.

Stunting growth

The optimistic version is that deficits will automatically shrink as economies recover. The worry must be that a comprehensive squeeze on public budgets will stunt growth. If the decade after 2010 is anything to go by, the result will be to make Europe even more dependent on exports to sustain aggregate demand.

That will put pressure on Europe's trading partners. After 2017 it was easy to blame deteriorating relations between Europe and the United States on the former president, Donald Trump. Unlike Trump, his successor, Joe Biden, is an Atlanticist — but his administration will not take kindly to European free-riding on American stimulus.

For the sake of domestic and external balance, Europe would be well advised to defer budgetary consolidation until recovery is firmly established. If Germany is to reapply its debt brake, then why not in 2025 rather than 2023 or 2024? Regardless of the timeline, what consolidation will not do is to reverse the debt accumulation of 2020-21.

That would require large and sustained surpluses, which would risk inducing a vicious spiral, in which recession raised the debt/GDP ratio by contracting the denominator. As far as Greece, Italy, Portugal, Cyprus, France, Spain and Belgium are concerned — all their public debts exceed 110 per cent of GDP — the Maastricht limit of 60 per cent is self-evidently wholly unrealistic.

Unlike in 2010, there is however no risk of an immediate crisis. In 2020, even as debts surged, interest rates plunged. Asset purchases by the European Central Bank are calming the bond market.

Yet the Maastricht-derived criteria are wholly

Although the ECB intends ending its emergency purchases in 2022, its president,

out of date.

Christine Lagarde, is not likely to indulge in the cat-and-mouse games with which her predecessor Jean-Claude Trichet destabilised European bond markets in 2010 and 2011. Key voices at the ECB, notably Isabel Schnabel of its executive board, have called for complementarity between monetary and fiscal policy.

Peculiar construction

Fiscal rules came into fashion in the heyday of the 'bond vigilantes' in the 1990s, in a very different interest-rate environment. Given today's low rates, the burden of debt service is far less. It is tempting to dispense with rules altogether. But the peculiar construction of monetary union and the mutual suspicion prevailing between parts of the European public exact their price. Europe needs rules.

Yet the Maastricht-derived criteria are wholly out of date. To bring the old Stability and Growth Pact back into effect in 2022 would be a recipe for dysfunction and recrimination. It would unleash uncertainty and hamper recovery. If there has to be a restoration of rules, a prerequisite would be agreement on a new system which corresponded to European fiscal reality.

Since the ruling by the German Constitutional Court in May 2020 on the ECB's asset purchases, conservatives have taken to invoking the principle of proportionality in relation to monetary policy. One might well apply that, though, to fiscal policy — starting with an end to scaremongering. To pose the problems in terms of 'cliff edges', 'slippery slopes', 'mountains' of debt or 'floods' of money encourages alarmism, not balanced analysis.

Balanced approach

As two recent analyses — one by Olivier Blanchard, Álvaro Leandro, and Jeromin Zettelmeyer, the other by Philippe Martin, Jean Pisani-Ferry and Xavier Ragot — propose, a balanced approach does not fetishise absolute debt and deficit ratios. What matters first and foremost is avoidance of debt crises.

That depends on a credible commitment to debt sustainability. But establishing what debt level is sustainable depends on a nuanced judgement of national fiscal possibilities and long-term financial-market

conditions. It is a complex calculation hedged with great uncertainty.

Furthermore, when the interest rate is close to the zero lower bound, fiscal policy is the essential complement to central-bank monetary policy. The basic Keynesian insight that public budgets have macroeconomic implications cannot be ignored. All the more so, since a key factor in debt sustainability is the state of the economy, which in turn depends on healthy aggregate demand. And this too spills over from one country to another within the European bloc.

Excessive fiscal tightening in big economies is as much a problem as excess debt. And since debt is serviced over the long run, what matter is not just today's aggregate demand but growth in the long run. That depends on investment. A system of fiscal rules that stifles investment undercuts its own sustainability. And this is doubly so in the context of the climate crisis, which requires long-term investment in decarbonisation.

Individualised assessment

The analyses cited above both put debt sustainability, in this comprehensive sense, at the heart of their proposals. This requires an individualised assessment of national fiscal viability, which acknowledges uncertainty and contingency and the quality of spending decisions. Where they differ is in their proposed architecture for surveillance and enforcement.

Blanchard *et al* propose to make the assessment more flexible but the enforcement more rigid. They suggest involving the European Court of Justice to rule on violations of fiscal standards. Martin *et al* favour a more conventional mode of surveillance and enforcement via the Council of the EU.

Federal elections are due in Germany in September. Who controls the Chancellery and the finance ministry will be key.

What their political architectures have in common is a technocratic flavour. Both rely heavily on the analytical capacity of independent fiscal bodies. Budget proposals would, in effect, be subject to macroeconomic stress-testing, to assess their sustainability on the assumption of different growth rates and interest rates. Those tests would be a matter of expert judgement, delivered by fiscal oversight bodies at national and European levels.

The spirit of both proposals is to leave behind the rigidity of the Maastricht criteria. But in political terms the proposals are squarely in

keeping with the original spirit of fiscal rule-making, which sought to depoliticise budgetary decision-making and subject it to expert control. Were Europe to go down this route it would be akin, in the fiscal domain, to the evolution of central-banking practice, from the mechanical monetarist rules of the early 1980s to the expert discretion of central banking since the 1990s.

The difference is that whereas central bankers manipulate the private credit system by way of interest rates, fiscal policy is the classic domain of parliamentary politics and its decisions affect the entire structure of state expenditure and revenue. It is, thus, a far more dramatic act of technocratic usurpation. And as we know from earlier rounds of European fiscal battles, its preconditions can only be political — it will depend on agreement among national governments.

Position of strength

Federal elections are due in Germany in September. Who controls the Chancellery and the finance ministry will be key. The Greens favour a strong investment policy, exempt from debt-brake provisions, and a revision of Europe's fiscal and monetary architecture. They would be promising partners for a programme of European fiscal reform. A very different scenario would emerge if the right wing of the Christian Democratic Union ended up replacing the social democrat Olaf Scholz at the finance ministry.

Whatever happens, Germany will be negotiating from a position of strength. Its strategic partner, as demonstrated once again in 2020, is France. It is not by coincidence that French economists — whether located in Paris, Berlin or Washington — are making the early running in this conversation.

With a debt/GDP ratio of 115.7 per cent, the old Maastricht criteria are no longer within France's reach. For Paris, therefore, shaping the new rules is of strategic importance. It will decide whether it is able to pursue a strategy of investment-led growth or be forced into humbling and divisive cuts to its large public sector.

Next year is shaping up to be a moment of high drama. On current timetables, the ECB's pandemic purchase programme and the suspension of the Stability and Growth Pact come to an end in the spring. In the first half of 2022 France will hold the rotating presidency of the Council of the EU and, if that were not enough, the first round of its presidential elections is due in April.

All of Europe will watch anxiously as the centrist incumbent, Emmanuel Macron, jousts, once again, with Marine Le Pen of the far-right *Rassemblement National*. Macron will no doubt want to run on a platform of European reform. The rest of Europe should brace. One option that really isn't available is a continuation of the *status quo*. Neither, however, is a return to the rules of the pre-crisis era.

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