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# Challenges of EU economic governance for 2023

On 9 November, the European Commission opened an institutional debate about the new fiscal rules for the Economic and Monetary Union (EMU), with its new *Communication on orientations for a reform of the EU economic governance framework*. Almost three years earlier, at the beginning of the pandemic, the enforcement of the Stability and Growth Pact (SGP) set of fiscal rules was suspended. Now, the end of the suspension is warranted, but the old framework cannot come back into force without substantial reform.

The rationale behind the existence of this SGP framework is well-known. To ensure consistency between the European Central Bank's monetary policy and fiscal policies under the responsibility of national authorities, the EMU needs to coordinate the latter. Agreement was reached on the initial Stability and Growth Pact rules in 1997, before the single currency came into force.

The enforcement of the SGP has never been an easy task. Its rules were revised twice: in 2005, after the clash between the Commission and the Ecofin Council; and in 2011-2012, during the financial crisis. But in neither the period when the rules were designed more rigidly, nor in the period when their interpretation could be considered more flexible, were the results fully satisfactory. Criticism towards the EMU governance framework comes from different perspectives and it points to different aspects.

The SGP rules and the way their enforcement operates show a clear pro-cyclical bias, asking for fiscal adjustments in bad economic times and allowing expansionary policies when the economy grows above potential. Other groups of critical voices have pointed out that the degree of complexity of the rules has become totally excessive, even for those in charge of its interpretation and enforcement. Furthermore, some of the economic variables to be considered are not directly observable, thus increasing the difficulties. Many decisions of the Commission and the Council have consequently given way to serious disagreements among political authorities and experts, and the lack of credibility of the framework was evident when, at the outbreak of the pandemic, the Commission decided to suspend the enforcement of the rules.

The adoption of a revised framework was expected in 2022, but had to be postponed, given the new difficulties with the war in Ukraine and the rise of inflation. On 9 November 2022, the Commission finally tabled its proposal, in a difficult context of inflation, ECB decisions to increase interest rates and looming risks of a recession.

The Communication, to be discussed in the coming months by the Council and the Parliament before the Commission puts forward its legal proposals, tries to accommodate the ideas of the different groups of countries.

On the one hand, the so-called 'frugals' – Germany, Netherlands, Baltics and so on – are generally supportive of the basic elements of the framework that was suspended in 2020, but are also aware of the need for some corrections. On the other hand, the 'doves' – France, Italy, Spain, Portugal and so on – are in favour of more profound changes. Some of them have sent the Commission written documents describing their ideas in detail, and also presenting possible compromises between their original position, like a Spanish-Dutch non-paper for example, which has already influenced the Commission Communication.

What are the main suggestions of the Communication? Regarding the 'corrective part' of the SGP, the reference values for deficits (3% of GDP) and public debt (60%) are maintained. The relevant modifications compared to the present rules are two. First, the path to annually adjust the public debt ratio by 1/20 until reaching the reference value is eliminated. Second, the sanctions for non-compliance with GDP recommendations will be more realistic, given that until now this possibility has never been used.

As far as the 'preventive part' is concerned, the Medium Term Objective (MTO) as a reference also disappears. Debt adjustments, based on Debt Sustainability Assessments, will be attainable over four years, or over seven years if combined with structural reforms and investment programmes. These paths will be negotiated between the Commission and each member state and measured by an expenditure rule. National independent fiscal authorities (IFIs) can participate in these negotiations and assess the degree of implementation of the commitments. The involvement of member state authorities, including IFIs, represents a clear improvement in relation to the unilateral submission of Convergence Programmes prepared by the national capitals. Furthermore, the link of the adjustment paths with reforms and investments negotiated *ex ante*, inspired by the NexGenerationEU procedures, seems more efficient than the previous systems.

Overall, the Commission proposal looks better than the old SGP rules. Nevertheless, the new economic governance deserves further decisions, on top of a new revision of the SGP. The Banking Union still awaits completion through the creation of an insurance deposit mechanism at the euro area level. The Capital Markets Union remains a work in progress. A common fiscal capacity at the euro area level is badly needed to complement the aggregate impact of the different national fiscal policies. And the mutualisation of debt must not remain a one-off initiative.

My prediction for 2023 is that discussions around the economic governance framework will not end during the Swedish presidency of the Council of the EU. Should the agenda not be limited to fiscal rules, even the Spanish presidency will not be able to reach a compromise. These rules are needed, but we must be aware of the importance of having a sustainable EMU to cope in an efficient manner with present and future shocks. Attention at the highest political level, after or at the same time as the set-up of new fiscal rules, will be of primordial importance.