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The new economic governance framework

Implications for monetary policy

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MONETARY POLICY

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The new economic governance framework

Implications for monetary policy

Abstract

Credible ECB monetary policy requires that the revised EU economic governance framework be tightly enforced from its start. Net primary expenditures as key control variable allow predictable monetary policy focused on stabilisation. However, widespread debt reduction pushing spending growth below potential GDP growth may prompt more accommodative ECB policy. Moreover, potentially cumulating changes in public spending-to-GDP ratios need close monitoring. Finally, the criteria for TPI may increase pressure to be lenient on enforcement of the fiscal rules.

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LIST OF ABBREVIATIONS

DSA	Debt Sustainability Analysis
EC	European Commission
ECB	European Central Bank
EFB	European Fiscal Board
EPG	European Public Goods
EU	European Union
IFI	Independent Fiscal Institution
MTFSP	Medium-term fiscal structural plan
MTM	Monetary transmission mechanism
SGP	Stability and Growth Pact
US	United States

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EXECUTIVE SUMMARY

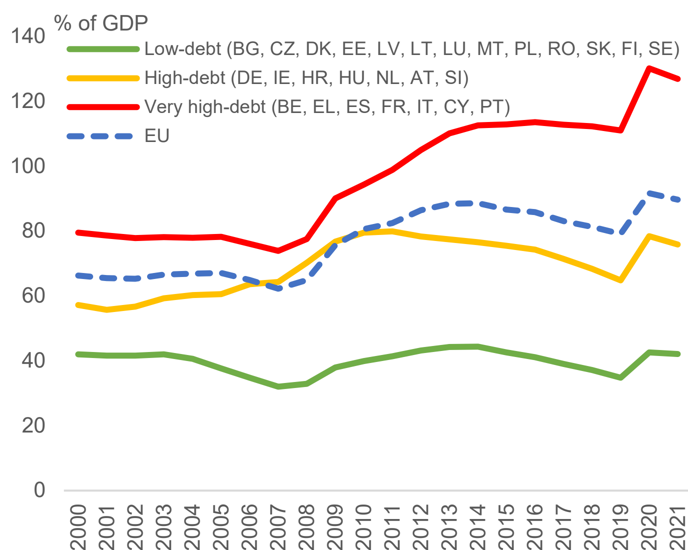
- In April 2024, the revised EU economic governance framework officially came into effect, carrying several implications for ECB monetary policy.
- First, **a strong start is crucial for the success of the new framework. Effective enforcement, when necessary, will be key to establishing its credibility**, signalling that the Commission and Council are committed to steering debt dynamics toward sustainability. This will help control interest rate spreads and ensure the smooth transmission of monetary policy.
- Second, **the Commission and Council must set ambitious standards for boosting potential growth** through the reforms and investments outlined in the medium-term fiscal structural plans (MTFSP), and for the reforms and investments underpinning extensions of the adjustment period. Enhancing potential growth is vital for ensuring debt sustainability, especially in light of future challenges.
- Third, net primary expenditures, a directly observable indicator that is largely unaffected by the business cycle, will become the main guiding variable. **Governments are encouraged to avoid discretionary fiscal adjustments, which will lead to greater fiscal predictability and, in turn, make monetary policy more predictable.**
- Fourth, in much of the euro area, **reducing debt will require net primary expenditures to grow more slowly than nominal GDP**, at least in the near future**. This could exert downward pressure on euro area inflation, potentially prompting the ECB to adopt a more accommodative monetary policy**, which may not be ideal for countries with stronger public finances. The latter group may see inflation rise, which might require them to tighten their fiscal stance.
- Fifth, since the MTFSP establishes the nominal path of net primary expenditures in advance, **changes in the ratio of public spending to GDP may accumulate over time**. This could lead to gradually rising or falling macroeconomic demand relative to supply, with potential implications for price stability. The Commission and Council are advised to closely monitor these public spending ratio dynamics.
- Sixth, **while the Transmission Protection Instrument (TPI) criteria serve as guidelines for discretionary decisions by the ECB Governing Council, deviations from these criteria seem possible**. It should be clearly communicated that countries failing to meet these criteria will not have their debt purchased under the TPI and will instead need to seek an adjustment program from the ESM. With the TPI criteria now tied to compliance with the Stability and Growth Pact, the stakes are even higher, increasing the risk of political pressure on the Commission or within the Council to avoid placing a country under an Excessive Deficit Procedure (EDP), even when justified, or to inadvertently conclude that corrective actions have been taken.

1. INTRODUCTION

In April 2024 the revision of the EU economic governance framework finally entered into force. The agreement followed a review by the Commission of the framework that had been in place since the so-called "six-pack" of 2011, the "two-pack" of 2013, and interpretative changes in 2015. The review was originally foreseen for 2020, but was postponed for some years, because of the Covid-19 crisis. An early input to this review by the European Fiscal Board (2019) found that, (i) although fiscal slippages had become smaller since the introduction of the six- and two-packs, the relevant numerical limits of the various EU fiscal rules had been routinely violated by some countries, (ii) the system had not prevented procyclical fiscal policies,[1] and (iii) it had not protected the quality of public finances (as measured by public investment or, more broadly, growth-enhancing spending). The system was complicated, not transparent in its application partly because it was based on unobservable indicators, and weak in its enforcement. In spite of repeated and persistent transgressions by some Member States, no financial sanction had ever been imposed. Importantly, many countries had failed to induce to build up buffers during good times, leading to a group of very high debt countries potentially vulnerable to the gyrations of the financial markets. Indeed, it was precisely this group that during the Covid-19 pandemic saw the largest jump in their public debt ratios. Overall, viewed over a long period in time, the debt ratios of this group seem to exhibit a ratcheting up pattern with debt increasing during each crisis, but not coming down by the same amount in the aftermath of the crisis (see Figures 1 and 2).

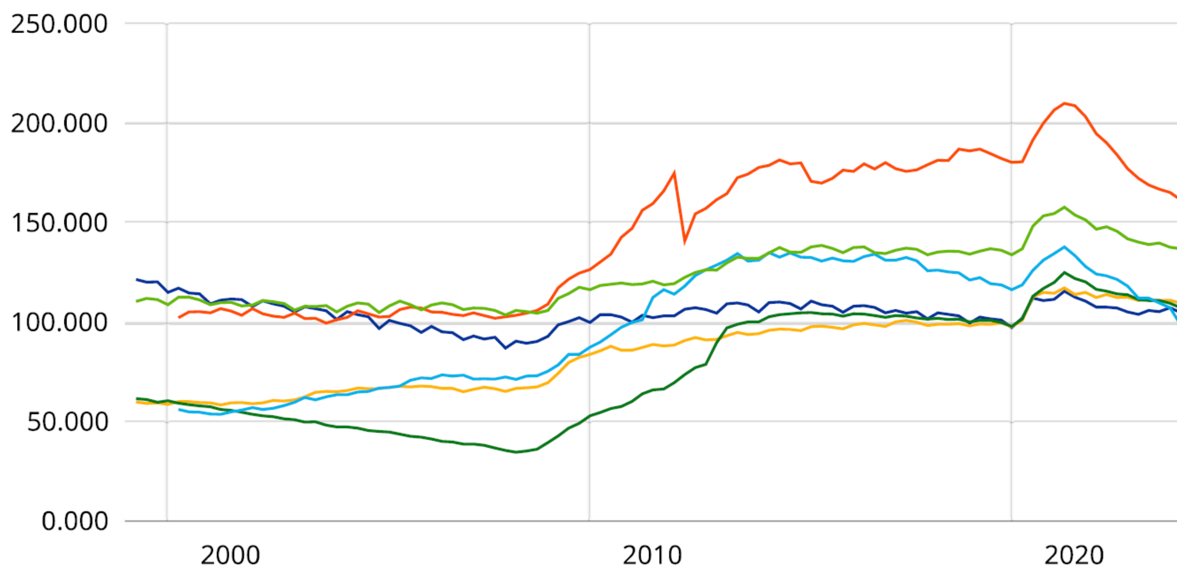
[1] See also Larch et al. (2021).

Figure 1: Government debt-to-GDP ratio by group of Member States, in %



Source: European Fiscal Board (2022).

Figure 2: Government debt-to-GDP ratio of Member States with very high debt, in %



Source: ECB (access date: 6 October 2024).
Notes: legend: dark blue = BE, red = EL, dark green = ES, orange = FR, light green = IT, light blue = PT.

While higher-than-expected inflation in the aftermath of the Covid-19 crisis has brought a temporary relief to public debt ratios, the medium- to long-run poses substantial challenges for the health of public finances: large investments are needed for the energy and digital transitions, costs associated with ageing (mainly pensions and healthcare) will increase, defense spending will have to go up and, directly as a result of the period of high inflation, borrowing costs have increased. The EU economic governance framework requires countries to work towards sustainable public debt trajectories. This should help to prevent harmful cross-border spill-overs through various possible channels, including through the common monetary policy and the banking systems. A sovereign debt crisis could force

the ECB into a position of lender-of-last-resort. Hence, the effectiveness of the revised framework in producing or maintaining the sustainability of public debts in the euro area is of crucial importance for the ECB to achieve its goal of price stability.

This briefing paper addresses implications of the new economic governance framework for monetary policy in the euro area. It focuses on a number of key elements:

- A review of previous actions by the ECB against the backdrop of the debate on fiscal versus monetary dominance.
- An assessment of the relationship between Quantitative Easing (QE) and fiscal discipline, and the implications for central bank's independence.
- A discussion of the role of the Transmission Protection Instrument (TPI) in ensuring the transmission of monetary policy vis-à-vis the normalisation of fiscal policy as well as the potential threats to price stability.
- An evaluation of the potential impacts of the new fiscal consolidation approach on the ECB's ability to maintain price stability. What are the main challenges and opportunities?
- An exploration of the potential tensions between the EU's new fiscal rules and the need for investment in strategic areas such as the green transition and defence. How might these be reconciled within the framework of the ECB's mandate?

The remainder of this briefing paper is structured as follows. Section 2 summarises the potential interactions between fiscal and monetary policy, and how these are affected by being in a monetary union. Section 3 reviews the main elements of the revision of the economic governance framework. Section 4 reviews previous ECB actions in light of the debate on fiscal versus monetary dominance. Here, we address also the relationship between QE and fiscal discipline. In Section 5 we turn to the TPI and the governance framework. Section 6 discusses the specific implications of the revised fiscal framework for ECB policies, while Section 7 turns to the potential tensions between the revised fiscal framework and the need for strategic investments, and the role the ECB can play to alleviate these tensions. Section 8 concludes this in-depth analysis.

2. INTERACTIONS BETWEEN FISCAL AND MONETARY POLICY

Fiscal and monetary policy interact in various ways. A fiscal expansion (a structural deficit) raises the demand for products, thereby putting upward pressure on prices, leading to higher inflation.[2] Similarly, a disruption of supply, as seen in the aftermath of the Covid-19 pandemic, will lead to higher inflation. Depending on the strength of the trade unions and the pricing power of firms, a wage-price spiral may set off. Hence, a central bank tasked with preserving price stability will be forced to contract the monetary policy stance by raising the interest rate. Depending on the length of existing borrowing contracts, and especially when borrowing has been done on variable rates, resources available for consumption and investment will fall. Also, new borrowing for consumption and investment will fall. These responses will undo some of the effect of the fiscal expansion on growth. If inflation reacts to the fiscal expansion with a lag, as it does in practice, then the monetary policy response will in the medium run lead to a slowdown in growth relative to the baseline path without fiscal expansion. The reason is that the positive growth effect of the expansion precedes the response of inflation. The broader takeaway is that governments should generally try to avoid using discretionary fiscal policy to fine-tune demand. Fiscal policy should aim at macroeconomic stabilisation, letting automatic stabilisers dampen normal cyclical fluctuations and only actively engaging when the effectiveness is fast and beyond doubt.[3]

In the euro area, the effect of an increase in inflation resulting from a national fiscal expansion on the union interest rate is diluted because the ECB sets interest rates with a view to the whole euro area's average inflation, which is only to a limited extent affected by higher inflation in an individual country. Since the ensuing tightening of monetary policy following an individual expansion is on average smaller, a fiscal expansion in one country is more effective in raising its output than under monetary autonomy. In effect, at the level of an individual government the output-inflation trade-off becomes more favourable than under monetary autonomy. Therefore, it can be expected that, in the absence of some force to keep a check on governments, fiscal policy in the euro area will be more expansive than with an autonomous monetary policies.[4] Even in the absence of an enhanced likelihood of debt default, expansionary fiscal policy may generate negative cross-border spill-overs by shifting the savings-investment balance, thereby driving up interest rates throughout the entire euro area.[5]

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[2] The European Commission (EC) defines a fiscal expansion as the increase in the structural deficit. The European Fiscal Board (EFB) refers to the latter as the "fiscal impulse". It defines an expansionary fiscal policy as one characterised by a negative structural balance.

[3] This was the case, for example, immediately after the outbreak of the Covid-19 crisis. The US government sent cheques to households leading to a fast-working spending impulse that helped to alleviate the effects of the Covid-19 crisis.

[4] Early contributions in which these mechanisms are described are Beetsma and Uhlig (1999), and Beetsma and Bovenberg (1998, 1999).

[5] Note that the spill-overs from fiscal expansion are not by definition negative. For example, in a lacklustre economic environment, a fiscal expansion by a country with healthy public finances will benefit economic activity in other countries through increased imports.

While there is empirical controversy in the literature about the effects of a fiscal expansion on the real exchange rate,[6] to the extent that the currency appreciates, as is likely to be the case at least in the short run, in a monetary union the effect will be muted when it comes from a unilateral expansion. The dilution of this downside of a fiscal expansion in a monetary union will *ceteris paribus* increase the attractiveness of fiscal expansion compared to a setting of national monetary autonomy, especially for very open economies.

High growth of public spending not backed by a commensurate rise in government revenues may lead to unsustainable public debt trajectories. With an autonomous monetary policy, unsustainable debt would either result into explicit default or a debt restructuring (e.g. lengthening the maturity and lowering coupon rates) or implicit default by loosening money policy, resulting in higher inflation, hence higher interest rates when the debt is rolled over. An independent central bank might attempt to resist relaxing monetary policy, but confronted with sufficient pressure it will be unlikely to hold ground, because explicit default leads to a prohibitively high output cost and/or a banking crisis when a substantial part of the debt is held in the banking sector, as is typically the case. A regime in which the central bank has lost control over inflation can be labelled a regime of "fiscal dominance".

In the euro area, direct recourse of governments to the monetary instruments is absent, as the Treaty prohibits bail-outs by the ECB. However, explicit default has union-wide negative effects through negative spillovers from a slowdown in economic growth and, more acutely, through negative spill-overs via the banking sector and financial market contagion. Faced with a threat of large-scale financial market disruption and potentially even to the continued existence of EMU, other Member States and EU institutions are likely to step in with support packages and the purchase of the country's debt. The experience with the Greek debt crisis makes clear that acute budgetary trouble of even a relative small economy has serious consequences for the rest of the euro area. In the end, during the euro area debt crisis the elimination of the financial market unrest and the preservation of the common currency prevailed over other potential outcomes – recall Draghi's (2012) "whatever it takes speech" and the associated Outright Monetary Transactions (OMT) Programme.

[6] For a review of the literature, see Ferrara et al. (2021).

3. MAIN ELEMENTS OF REVISION OF THE ECONOMIC GOVERNANCE FRAMEWORK

Following initial orientations by the European Commission (2022) and subsequent discussions with Member States and the European Parliament, the revised EU economic governance framework finally entered into force in April 2024. The "old" preventive arm of the Stability and Growth Pact (SGP) was replaced with a new set of rules,[7] corresponding changes to the SGP's corrective arm[8] and the revision of Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, which in particular also deals with the role of the so-called independent fiscal institutions (IFIs).[9]

There was widespread dissatisfaction with the old governance regime. As pointed out in the 2019 summary review conducted by EFB, the SGP's numerical targets had not been adhered to in a large fraction of cases, the rules had not prevented procyclicality of fiscal policies, and they had not prevented a weak or weakening quality of the public finances. This was evidenced by the fact that in particular very high-debt countries, i.e. those with debt-to-GDP ratios over 90%, cut public investment and growth-promoting spending during the global financial crisis and the eurozone debt crisis. The central role of the structural balance and its medium-term objective in the preventive arm was to encourage countries to build up fiscal buffers during relatively favourable times, such as in the years preceding the Covid-19 crisis. However, especially the very high-debt countries failed doing so.

The new governance framework tries to address a number of (interrelated) shortcomings of the old framework: high complexity, surveillance based on unobservable indicators, a lack of national ownership, failure to reduce public debts, insufficient incentives for reforms and investments, and weak enforcement. The key objectives of the reform of the economic governance framework were to promote debt sustainability, sustainable and inclusive growth, and the prevention of excessive deficits. To this end, the new framework deploys a number of key principles:

i. a medium-term approach through so-called medium-term fiscal-structural plans (MTFSP);
ii. incentives for reforms and investments, through the possibility to extend the fiscal adjustment period from a minimum of 4 to a maximum of 7 years;
iii. gradual and credible debt reduction, differentiating the debt reduction path to reflect differences in challenges, mainly as a result of initial debt positions;
iv. national ownership, with Member States designing their own plans based on their own economic priorities;
v. a multilateral approach, based on common methodologies underlying the plan design and assessment;

[7] Regulation (EU) 2024/1263 replaces Regulation (EU) 1997/1466.

[8] Regulation (EU) 1997/1467.

[9] For an overview, see Jankovics and Sherwood (2017).

vi. simplification, by having a single operational indicator (net primary expenditure) to monitor compliance; and
vii. better enforcement, with a more credible debt-based excessive deficit procedure (EDP).

Economic and multilateral surveillance under the revised governance system comprises the following stages. Countries with public debt above 60% of GDP or a budget deficit above 3% of GDP receive from the European Commission a multi-annual reference trajectory anchored on debt sustainability. Other countries may ask for "technical information" from the Commission, which provides them with information on the structural primary balance necessary to keep their headline deficit under 3% of GDP. Next, all countries submit an MTFSP, detailing reforms and investment commitments. The Commission assesses the plans, after which the Council may endorse it or request a revision. During the implementation stage, both the Commission and the Council monitor compliance with the endorsed expenditure ceilings.

The MTFSP covers at least 4 years and may be extended to a maximum of 7 years, based on proposed investment and reforms. By the end of the plan debt should be "on a plausibly downward trajectory or stays at prudent levels" and the deficit should be "brought and maintained below 3% of GDP". The key element of the preventive arm is net primary expenditure, the single operational indicator, which is defined such that it is not affected by the operation of automatic stabilisers and other expenditure fluctuations beyond the direct control of the government. In particular, the indicator consists of "government expenditure net of interest expenditure, discretionary revenue measures, expenditure on Union programmes fully matched by revenue from Union funds, national expenditure on co-financing of programmes funded by the Union, as well as cyclical elements of unemployment benefit expenditure."[10] Also excluded are one-offs and other temporary measures.

The MTFSP must show how to ensure delivery of reforms and investments in response to the main challenges in the context of the European Semester, in particular in the country-specific recommendations (CSRs), and how the Member States will address listed common EU priorities, i.e. the fair green and digital transition, social and economic resilience, energy security and, where necessary, build-up of defence capabilities. The reforms and investments underpinning an extension of the adjustment period should improve the growth and resilience potential of the economy, support fiscal sustainability with a structural medium-term improvement in the government's finances, address the listed common EU priorities, address relevant CSRs to the Member States, and ensure that nationally financed public investment over the fiscal adjustment period is not lower than the medium-term level in the period preceding the plan. The revised SGP also foresees general and country-specific escape clauses.

[10] Regulation (EU) 2024/1263, recital (13).

As to enforcement of the rules, the instrument set has been expanded and refined. While the Treaty reference values and the opening of a deficit-based EDP are unchanged, the opening of a debt-based EDP (so far never applied) has become easier. In particular, failure to comply with the MTFSP may lead to the opening of a debt-based EDP. In addition, the financial sanctions toolbox has been made "smarter" by lowering the threshold for the smallest sanction and reducing the size of the subsequent steps.

The reform has brought about some desirable improvements in the SGP's design, in particular the single operational indicator, the medium-term orientation and the increased country-specificity of adjustment paths. However, rigorous implementation will in the end determine its success. In particular, the governance structure has been adjusted only marginally. A weak launch of the new rules could undermine their credibility right from the start. This calls for a speedy resolution of the uncertainties relating to the transition to the new system, in particular those related to its implementation, such as how the adjustment requirements defined in the preventive and corrective arms relate to each other, the treatment of potential budgetary slippages in 2024 (to what extent will they be forgiven) and any unsettled computational and statistical details around the net expenditure path.

While the Commission orientations pointed the way towards substantial simplification of the SGP, part of the simplification potential was lost during the negotiations about the revision. As the analysis in Darvas et al. (2024) makes clear, the various additions relative to the orientations imply a variety of requirements that a country need to fulfil, which carries a danger of "arbitrage" between the requirements. The EDP requirements may be tighter or less tight than the adjustment requirements embedded in the preventive arm. The preventive arm effectively combines a number of different requirements, which for a comparison can all be translated into a requirement on the structural balance or the structural primary balance (SPB) at the end of the adjustment period. There is the objective for public debt at the end of the adjustment period as determined by the Debt Sustainability Analysis (DSA). The requirement of a deficit lower than 3% at the end of this period may tighten the adjustment path further, and the debt sustainability and deficit resilience safeguards may impose even further tightening.

Another factor relevant for the effectiveness of the new framework concerns the alignment of national institutions and procedures with the EU fiscal framework. A guiding principle of the reform was the reinforcement of national ownership. While national authorities welcomed the possibility to have a say in the eventual budgetary requirements, inter alia via the possibility to request an extension of the adjustment path based on proposed reforms and investments, they have failed to fully integrate the national stakeholders in the surveillance process. This is particularly glaring when it comes to the involvement of independent fiscal institutions (IFIs). IFIs could also fulfil a useful role where it comes to the shift in focus from the annual to the medium-term horizon, which may have implications for

budgetary planning procedures, in particular in those EU Member States where the national medium-term budgetary framework has so far only served indicative purposes.

Although both the original orientations of November 2022 and the subsequent draft legislative proposals of April 2023 by the European Commission envisaged a substantially enhanced role for the IFIs, the eventual agreement has resulted in only a marginal expansion of their original role. Hence, the Directive 2011/85/EU on the requirements for budgetary frameworks of the Member States has been modified only marginally, by requiring all Member States to have one or more IFIs, and by strengthening the comply-or-explain provisions.[11] They will produce, assess or endorse both the annual and multiannual macroeconomic forecasts, as well as assess the consistency, coherence and effectiveness of the national budgetary framework. They will also "upon invitation, participate in regular hearings and discussions at the national Parliament".[12] Further, under the new preventive arm Member States may (hence, are not obliged to) ask their IFIs for their opinion on the macroeconomic forecast and macroeconomic assumptions underlying the net expenditure path in the MTFSP or its revision.[13] For countries in the EDP, the corrective arm of the revised SGP mentions that "The Member State may invite the relevant independent fiscal institution to produce a non-binding, separate report on the sufficiency of the measures taken and envisaged with respect to the targets".[14] However, these provisions are non-binding and, hence, carry little force.

The missed opportunity to substantially strengthen the IFIs will weigh on the transparency of the public finances and the possibilities for the financial markets to assess the health of the public finances, which may inject uncertainty in market dynamics that are relevant for monetary policy.

[11] Chapter V, Article 8a, sub 6. Previously, EU law obliged only euro-area Member States to set up an IFI equipped with a set of minimum safeguards and mandatory tasks.

[12] Amended Directive 2011/85/EU, Chapter 5, Article 8a, sub 5.

[13] This becomes, under conditions, mandatory as of May 2032.

[14] Regulation (EU) 1997/1467, Article 3, sub 5.

4. PREVIOUS ECB ACTIONS IN LIGHT OF THE DEBATE ON FISCAL VERSUS MONETARY DOMINANCE

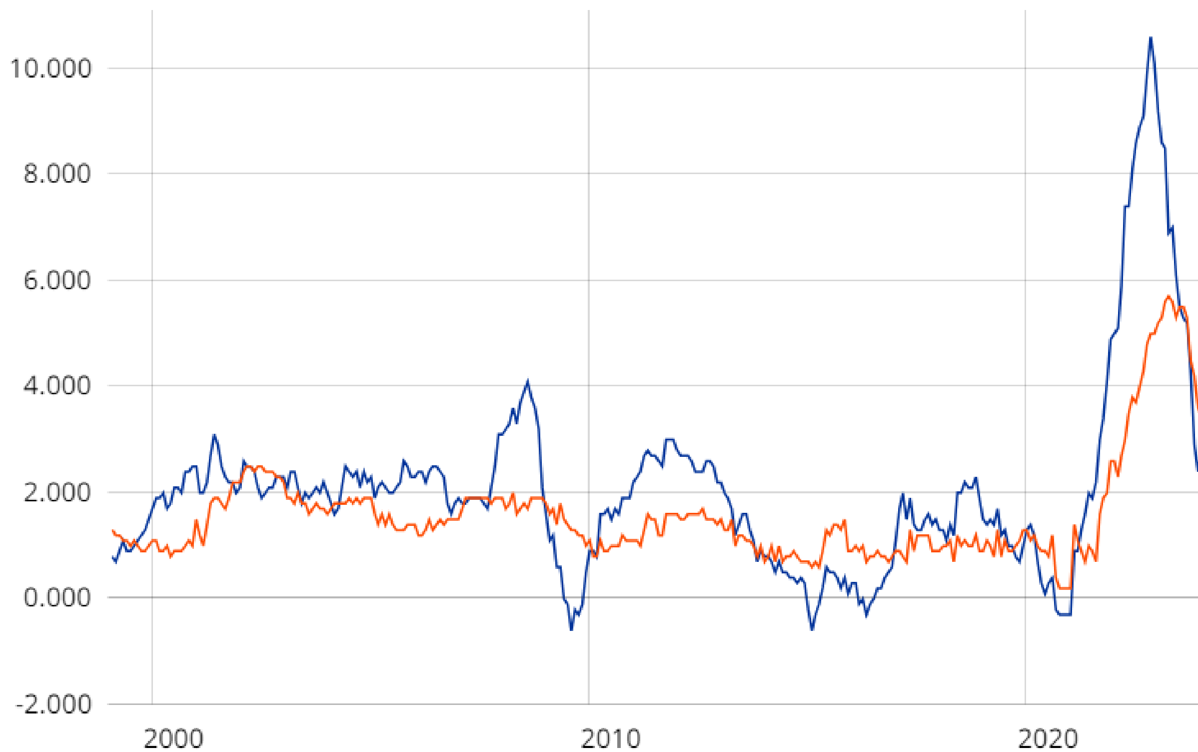
The ECB had deployed several asset purchasing programmes. In response to the erupting euro area sovereign debt crisis, it announced on 10 May 2010 the Securities Markets Programme (SMP) of discretionary purchases of sovereign bonds in secondary markets to "address severe tensions in financial markets." Potentially most momentous was the "Whatever it takes" speech by ECB president Draghi to preserve the euro and its stability on 26 July 2012, with the ensuing announcement of the Outright Monetary Transactions (OMT) programme on 6 September 2012. The OMT consists in bond purchases on secondary markets conditional on a country following an adjustment programme of the ESM. So far, OMT has never been activated, however, but it remains in the ECB's policy toolkit.

In theory "fiscal dominance" means that the central bank has lost over the inflation rate, which adjusts so as to ensure that the intertemporal government budget constraint is balanced (by deflating the real value of the outstanding government debt).[15] In practice, it is not easy to precisely establish the distinction between monetary and fiscal dominance. Between the global financial crisis and during much of the Covid-19 crisis core inflation stayed at levels below 2% (see Figure 3), while policy interest rates were falling and later stuck at their zero lower bound. The ECB had little or no control over inflation, not being able to raise it to its 2% target. However, it is unclear to what extent fiscal policies, rather than more fundamental factors determining the savings – investment balance, might have played a role in driving inflation so low.

In any case, the gradually declining inflation rate since the last global financial crisis pushed the ECB into unconventional monetary policy, which combined asset purchases, targeted long-term refinancing operations (TLTROs) and forward guidance. These policies usually operate through three channels: the interest rate channel, the credit easing channel and the implicit guarantee channel (Benigno et al., 2022). An asset purchasing programme operates in principle through all three abovementioned channels. Besides having a direct negative effect on long-term yields, asset purchases can strengthen the credibility of forward guidance policies of keeping interest rates low for a longer period, because deviating from this policy would lower the value of the assets acquired by the central bank. Various authors have estimated the effects of the ECB's Asset Purchase Program (APP), finding a non-negligible negative effect on long-term interest rates and significant positive effects on growth and inflation – see Benigno et al. (2022) for an overview of the findings.

[15] The intertemporal government budget constraint requires the outstanding value of government debt to be equal to the discounted sum of future primary surpluses. An early contribution on "fiscal dominance" was Leeper (1991). In his terminology, the described setting is one of passive monetary – active fiscal policy. To understand the determinants of inflation, Cochrane (2022a, b) explores the dynamics of the market value of the public debt and the distribution of the maturities of the outstanding debt.

Figure 3: HICP inflation all items and excluding food and energy, in %



Note: Blue line is HICP - Overall index, Euro area (changing composition), Monthly. Red line is HICP - All-items excluding energy and food, Euro area (changing composition), Monthly. Source: ECB (access date October 16, 2024).

The ECB announced the Covered Bond Purchasing Programme (CBPP3) and Asset-Backed Securities Programme (ABSPP) in September 2014 and a full-scale "quantitative easing" (QE) programme including sovereign bonds in January 2015. The ECB's decision of March 2015, which was subsequently revised several times, led to the start of the Public Sector Purchasing Programme (PSPP).[16] Purchases had to take place in the secondary market to avoid violating of Article 123 of the Treaty on the Functioning of the European Union (TFEU) that prohibits public debt purchases on the primary market. Issuers needed to fulfil minimum credit quality criteria or, if that was not the case, be under a financial assistance programme. Both the ECB and national central banks (NCBs) conducted purchases, where the latter bought debt of issuers of their own jurisdiction (and securities issued by eligible international organisations and multilateral development banks). Purchases were distributed across jurisdictions based on the key for subscription of the ECB's capital. Over 90% of the purchases were conducted by the NCBs and the rest by the ECB, with the latter purchasing securities issued by central governments and recognised agencies of all jurisdictions. Finally, maximum limits were imposed on the share held of an issue (initially 25%, raised later) and of an issuer. The former was done with a view to avoid obstructing orderly debt restructurings by the Eurosystem central banks.

[16] DECISION (EU) 2015/774 OF THE EUROPEAN CENTRAL BANK of 4 March 2015 on a secondary markets public sector asset purchase programme.

The ECB started Long-term Refinancing operations (LTROs) at the end of 2011, under which commercial banks could borrow at an interest of 1% for 3 years, a facility used mostly by banks from Greece, Ireland, Spain and Italy. The use of the LTROs by banks for carry-trades and the criticism on their effectiveness led the ECB to launch the targeted long-term refinancing operations (TLTROs) towards the end of 2014, with conditionality in terms of lending to firms and households.

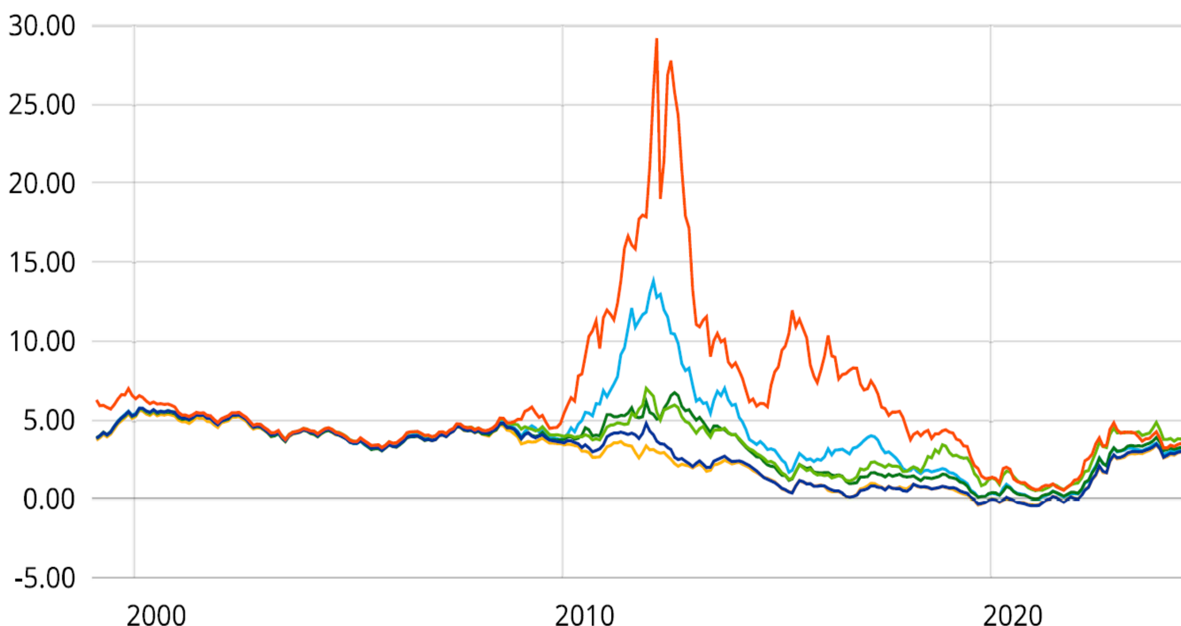
The Covid-19 pandemic caused investor flight-to-safety, risking fire sales in asset markets. As a result, the ECB announced its Pandemic Emergency Purchase Programme (PEPP) in March 2020, which was then further expanded in June 2020 and in December 2020, amounting to a total envelope of EUR 1850 billion. Net purchases ended March 2022. The specific role of the PEPP was to ensure the uninterrupted transmission of monetary policy and to restore investor confidence during the COVID-19 crisis through the purchase of public and private securities in a flexible manner, allowing for deviations from the capital key and not being bound by the limitations on holdings of a single security per issuer and the total volume of a Member State's outstanding securities, unlike the APP. PEPP expanded also the range of assets eligible for purchase, such as Greek sovereign bonds. In general, programmes to purchase assets are intended to reduce risk premia or term premia. The flexibility of the PEPP to deviate from the capital key allowed to compress yield spreads among sovereign bonds of different Member States caused by the flight-to-safety of investors. Net PEPP purchases have ended and maturing secutrities are no longer fully reinvested. By the end of this year, all reinvestment will be terminated. Effectively, the PEPP will have disappeared from the ECB's toolbox.[17]

At the end of April 2020, the ECB introduced the Pandemic Emergency Longer-Term Refinancing Operations (PELTROs), with an interest discount of 25 basis points on the average rate applied in LTROs. Figure 4 suggests that the various unconventional monetary policy measures have succeeded in containing interest spreads.

Finally, on July 21, 2022, the ECB introduced the Transmission Protection Instrument (TPI) to allow it to hike interest rates and unwind its balance, while avoiding market fragmentation. The TPI tries to ensure the smooth transmission of monetary policy decisions across all euro area countries through secondary market purchases and avoid expectations of crises to become self-fulfilling, thus enabling the ECB to control the interest spreads across the euro area.

[17] See https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html .

Figure 4: Yields on 10-year maturity debt of very high debt countries, in %



Source: ECB (access date: 6 October 2024).
Notes: legend: dark blue = BE, red = EL, dark green = ES, orange = FR, light green = IT, light blue = PT.

Not all of the above asset purchasing programmes feature(d) explicit conditionality. There was no conditionality underlying the SMP, the APP and the PEPP. However, the OMT requires the country to apply for an ESM adjustment programme. TPI has conditions discussed in detail below. The various purchase programmes have supported the ECB in its pursuit of price stability. In the words of the ECB "However, the Governing Council also recognised that, in the presence of an effective lower bound on policy rates, it will also employ other instruments, namely forward guidance, asset purchases and longer-term refinancing operations, as appropriate. This means that asset purchase programmes are now part of the ECB's set of instruments for steering its monetary policy to ensure inflation stabilises at its 2% target in the medium term".[18]

Each programme seems in addition to have alleviated the debt-financing burden of governments.[19] In this regard even though asset purchase programmes take place in the secondary market, the increased demand in the secondary market coming from the ECB *will spill over to the primary market, lowering the yields at which a government can place its debt*. Indeed, government bond yields on primary and secondary markets are very highly correlated. The spill over may have negative incentive effects on the

[18] https://www.ecb.europa.eu/mopo/implement/app/html/index.en.html

[19] Fiscal and monetary policies are highly intertwined, at least in the perception of the financial markets. A telling example is ECB President Lagarde at the ECB press conference on 12 March 2020 stating that "we are not here to close spreads". This caused Italian sovereign yield spreads to spike. The Italian prime minister at the time, Giuseppe Conte, reacted by saying that he would not accept "formal and abstract" interpretations of the situation and "In particular, the job of the central bank should not be to hinder but to help such measures by creating favourable financial conditions for them". Following the interest spike, Lagarde replied by stating that the ECB was "fully committed to avoid any fragmentation in a difficult moment for the euro area" – see https://www.reuters.com/article/business/italy-furious-at-ecbs-lagarde-not-here-to-close-spreads-comment-idUSKBN20Z3VM/.

fiscal discipline of governments that are under short-term electoral pressure. Further, by suppressing interest spreads purchasing a country's public debt *quells potential financial market signals about the country's financial fundamentals*. Ideally, these consequences would be investigated in a *fully-fledged evaluation of the ECB's purchase programs*, in particular those did not come with explicit conditions. Such an exercise would not be straightforward, however. It would require exploring the budgetary health of the euro area Member States when purchases were announced and conducted to assess whether the purchases were not inadvertently helping governments to alleviate the consequences of a lack of fiscal discipline. The complication is that such an investigation would need to explore how government finances would have fared under the counterfactual of no asset purchases.

5. TPI AND THE GOVERNANCE FRAMEWORK

The Russian invasion of Ukraine in 2021 caused extreme increases in energy prices that in turn led to a broader rise in inflation not seen since the oil crises of the 1970s. To contain inflation, the ECB was forced to hike interest rates. The transmission protection instrument (TPI) introduced in July 2022 allows the ECB to do so, while avoiding market fragmentation. In the words of the ECB Governing Council: "Subject to fulfilling established criteria, the Eurosystem will be able to make secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals, to counter risks to the transmission mechanism to the extent necessary." [20] Hence, the TPI can be activated to counteract self-fulfilling increases in interest spreads hampering the transmission of monetary policy across the euro area. The criteria for the TPI are the following:

- *i.* compliance with the EU fiscal framework: not being subject to an excessive deficit procedure (EDP), or not being assessed as having failed to take effective action in response to an EU Council recommendation under Article 126(7) of the TFEU;
- *ii.* absence of severe macroeconomic imbalances: not being subject to an excessive imbalance procedure (EIP) or not being assessed as having failed to take the recommended corrective action related to an EU Council recommendation under Article 121(4) TFEU;
- *iii.* fiscal sustainability: in ascertaining that the trajectory of public debt is sustainable, the Governing Council will take into account, where available, the debt sustainability analyses by the European Commission, the European Stability Mechanism, the International Monetary Fund and other institutions, together with the ECB's internal analysis;
- *iv.* sound and sustainable macroeconomic policies: complying with the commitments submitted in the recovery and resilience plans for the Recovery and Resilience Facility and with the European Commission's country-specific recommendations in the fiscal sphere under the European Semester.

Angeloni et al. (2022) argue that the ECB's Governing Council should only activate the TPI when high short-term spreads clearly signal imminent risks that the monetary transmission mechanism (MTM) may be impaired. High short-term spreads reduce the profitability of the maturity transformation, discouraging banks to provide credit. Indeed, the ECB monetary policy is transmitted through the short end of the yield curve, while the long end is more intimately linked to the economy's fundamentals. Hence, spreads on long-term rates should *not* be a reason for an activation of TPI. There is no *a priori* limit on the amount that can be purchased, neither on the type of securities. However, the ECB would

[20] See https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr220721~973e6e7273.en.html

primarily buy government bonds on the secondary market while avoiding a persistent effect on the overall Eurosystem balance sheet.

There are number of aspects of the TPI that come to the fore. First, the sharing of the potential losses (or gains) on purchased assets has been left unspecified, probably a result of the haste with which it was established (Angeloni et al., 2022). Second, the ECB treats the MTM as a separate end in itself. A general rise in the interest rate, i.e. an increase in the risk-free rate, tends to lead to larger interest spreads. This produces asymmetries in the MTM, which in principle would justify controlling those spreads. However, at the same time controlling spreads might implicitly provide favourable financing to some governments with weak budgetary fundamentals, which would be an unintended side effect of the policy to maintain the MTM (Angeloni, et al., 2022).[21] Third, the above criteria do not seem to be "hard" criteria as "These criteria will be an input into the Governing Council's decision-making and will be dynamically adjusted to the unfolding risks and conditions to be addressed." More clarification would be needed about what would happen when not all these criteria are fulfilled at the moment interest spreads rise to heights clearly impeding the MTM. The possibility of the ECB stepping in when borrowing costs rise and the above criteria acting as input rather than sine qua non to may invite moral hazard from governments counting on the ECB trying to avoid devastating financial market disruptions. *It should be made clear that when capital market access comes under pressure and the criteria are not fulfilled, countries would need to turn to the ESM for an adjustment program.*

Fourth, the fulfilment of the criteria depends on judgments by other EU institutions, where it comes to compliance with the EU fiscal framework, the absence of severe macroeconomic imbalances, and sound and sustainable macroeconomic policies. The Commission and the Council have found it difficult to enforce the fiscal framework as intended. *With the TPI criteria the stakes will be even higher than before, and there is an even greater risk of political pressure on the Commission or within the Council to not put a country in an EDP when this would be warranted or conclude that it has taken effective action.* As pointed out earlier, there are situations in which the requirements under the preventive arm of the SGP are tighter than under the corrective arm (Darvas et al., 2024). However, when in an EDP, it is the requirement of the corrective arm that applies and that of the preventive arm will only start to apply once the country has exited the EDP. In other words, *the conditionality on fiscal discipline asked by the ECB may be weaker than the adjustment required by the preventive arm*, which is calibrated to achieve debt sustainability. Indeed, a number of countries enter the new regime while they are under an EDP and they may be shielded from an adjustment assignment tougher than what it would have been otherwise. The ECB could potentially condition the activation of the TPI on this tougher requirement.

[21] Angeloni et al. (2022) question the impairment of the MTM when TPI was announced. The MTM works primarily through short interest rates (interest payments on long-dated securities are not affected in the short run by central bank asset purchases). However, spreads at the short end of the yield curve were and remained very low over the period June – August 2022 for Italy. In addition, the long-short spread was around 2.5 percentage points throughout, suggesting no imminent risk of default (in which case this spread would shrink, as the expected returns on short- and long assets would become similar).

However, that does not seem to be a realistic option, as the Commission will not issue some "shadow" trajectory for the preventive arm if the country is in an EDP. In addition, burdening the country with two numerically different conditions does not seem politically expedient.

Compliance with the EU fiscal framework is always an imperfect guarantee of debt sustainability. Hence, adding debt sustainability as an explicit separate criterion is warranted. The potentially tougher requirements of the preventive arm for a country had it not been in the EDP may indirectly come back in this way. Apart from its internal analysis, the ECB will use the results of the debt sustainability analyses of other policy institutions. This allows to assess the robustness of debt sustainability assessments, because underlying assumptions and methodologies differ across institutions. There is a tendency for policy institutions not to share the details of their methodologies. This is unfortunate, because it makes it difficult to scrutinise the validity of the analysis, it may inject unnecessary uncertainty and it may leave financial markets second-guessing that the institution is avoiding to come up with unwelcome conclusions.

Further, compliance of the commitments with the recovery and resilience plans of the Recovery and Resilience Facility (RRF) seems a slightly narrow interpretation of "sound and sustainable macroeconomic policies", as the plans do not always consist of coherent sets of investments to raise potential growth. Examples of the latter would be investments in physical infrastructure critical for the energy and digital transitions and in the educational system.[22] The SGP's preventive arm may provide additional incentives to make investments that raise potential growth, in line with the common EU priorities[23] and in line with what would be needed for an extension of the MTFSP beyond four years.[24] However, we need to see how strict the Commission will be on the requirements for investments in the non-extended MTFSP and as well as in the MTFSP extended beyond four years. Indeed, the Commission is advised to set high standards in this regard.

The above criteria not being hard gives the ECB freedom to take into account additional elements of a country's behaviour into its TPI decision. An example of differences in interpretation on what might trigger TPI relates to the potential market turbulence that could have followed a bad outcome of France's recent snapshot parliamentary election.[25] Some euro area central bankers thought the ECB should have not stepped in before a debt reduction deal would have been struck with the Commission, while others believed that the ECB might have been forced to come to the rescue. France being under the "excessive deficit procedure" was viewed as just "an alternative condition" by ECB President Lagarde, who referred to the ECB's price stability mandate, which in turn would rely on financial

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[22] For example, a scheme to isolate houses is a demand impulse to the construction sector, but it unlikely to raise potential growth.

[23] In particular, fair and green digital transition and ensuring energy security.

[24] In particular, these include investments that raise the growth potential and resilience.

[25] See https://www.reuters.com/markets/europe/can-france-count-an-ecb-rescue-if-vote-upsets-markets-2024-07-04/

stability. The flexibility that the ECB affords itself may invite strategic behaviour on the side of individual countries and political pressure for leniency when push comes to shove.

6. IMPACTS OF NEW ECONOMIC GOVERNANCE FRAMEWORK ON THE ECB'S ABILITY TO MAINTAIN PRICE STABILITY

How does the economic governance revision affect the ability of the ECB to achieve price stability? During the execution of the MTFSP the net primary expenditure indicator limits the degree of procyclicality of fiscal policy by excluding windfall revenues and the cyclical component of unemployment benefits from the indicator. In addition, it is not affected by swings in annual estimates of potential GDP which tend to be correlated with actual GDP movements. The reduction in pro-cyclicality should in principle alleviate the burden on the ECB in conducting counter-cyclical policies. This benefit is particularly large when countries' business cycles are highly correlated.

However, there are various factors that limit this benefit. First, countries that *enter* the MTFSP with a substantial debt and/or deficit reduction requirement, whether as part of an EDP or as part of the preventive arm, may be forced into a procyclical tightening as part of the program itself. To achieve their requirements, they would need to have net primary expenditures grow at a lower average speed than potential output. *To the extent that the overall tightening in the euro area fiscal stance is substantial, the ECB may have to moderate its own policy stance*. The reason is that a broad-based fiscal contraction suppresses demand, potentially reducing inflation to below the level consistent with price stability, which would require the ECB to relax monetary policy. Second, net expenditure paths are set ex ante in nominal terms, implying that if output growth deviates from what was projected, there will effectively be an unforeseen budgetary expansion or contraction, working against the ECB's policies to maintain price stability. For example, *if nominal GDP growth falls below planned nominal spending growth as part of the MTFSP (and the country adheres to its spending path), then the spending ratio of GDP increases, potentially adding to inflationary pressures*. Over a period of 4 to 7 years, cumulative deviations from ex-ante spending paths can become large. Third, the failure in substantially strengthening the role and capacity of the IFIs is directly relevant for the ECB in that an opportunity has been wasted *to enhance the transparency of public budgets,*[26] *which would have strengthened the role of spreads as indicators of the true state of the public finances.* After all, the IFIs have more detailed information on their own country's public finances than the European Commission does, and it can assess these in a more nuanced way.

[26] For a theoretical analysis of IFIs, see Beetsma et al. (2022). They shed light on the circumstances in which there is political support for setting up an IFI that increases the transparency of the public budget by increasing the precision of information about the state of the economy and the competency of the government.

7. THE REVISED ECONOMIC GOVERNANCE FRAMEWORK, EU STRATEGIC INVESTMENT NEEDS AND THE ROLE OF THE ECB

Climate change and the natural environment are in various ways relevant for ECB policy.[27] Climate change, through more extreme weather events and gradually rising temperatures, affects the availability of resources and impacts GDP. Climate change mitigation policies, in particular investments in the energy transition, will increase demand for specific resources and labour. These developments will affect inflation and, therefore, monetary policy. Climate change also creates financial risks for banks (and other investors), with implications for the ECB supervision. Finally, the ECB's asset holdings are also exposed to climate change.

The ECB deals in various ways with climate change, evaluating the impact of mitigating policies on future macroeconomic and fiscal developments and of the energy transition on inflation. It also promotes sustainable finances for an orderly energy transition. Further, the ECB wants to invest in assets that do not contribute to climate change or deterioration of nature. In fact, the selection of the assets for its investment portfolio may even help to promote green activities. The question is how the new governance framework can aid the ECB in these activities.

The investment needs for the energy and digital transitions in the EU are immense. Basing themselves on official estimates by the European Commission and NATO, Dorrucci et al. (2024) calculate an *additional* need, i.e. relative to historical averages, of EUR 5.4 trillion for the period 2025-2031. This is the sum of the extra costs of the green transformation, the digitalisation of the economy and the strengthening of military defence. They estimate that about EUR 1.3 trillion euro needs to come from public sources, of which almost EUR 400 billion can come from existing EU resources, which leaves a public funding gap of EUR 900 billion for the EU as a whole over the period 2025-2031. Taking into account the considerable uncertainty surrounding these numbers, the authors estimate a public funding gap of between 0.6% and 1% of EU annual GDP. We can compare these numbers with the figures in Draghi (2024), who estimates a required minimum additional investment of 750 to 800 billion euros per year, which is on the order of 4.5% of 2023 EU GDP. Staying in line with a historical division of one-fifth for public and four-fifths for private investment, this would come down to around 0.8% of GDP, well in line with the abovementioned figures.

The revised EU economic governance framework can help addressing these needs to some extent. First, the MTFSPs need to show how Member States will address a fair green and digital transition as one of the listed common EU priorities. This will also be the case for the reforms and investments underpinning an extension of the adjustment period. These various incentives should encourage

[27] See https://www.ecb.europa.eu/ecb/climate/html/index.en.html on the ECB's objectives in its work on climate change. A concise summary of the ECB's current and future work in this area is found in https://www.ecb.europa.eu/ecb/climate/our-climate-and-nature-plan/shared/pdf/ecb.climate_nature_plan_2024-2025.en.pdf. See also Beckmann et al. (2023).

Member States to take measures to adopt investments towards these objectives. Dorrucci et al. (2024) estimate that an extension of the adjustment path from 4 to 7 years would free up additional space for public investment in the EU of up to €700 billion over the period 2025-2031. Further, countries have to plan a margin of 1.5%-points of GDP vis-à-vis the 3% reference value for the deficit. Compared with the (now counterfactual) requirement to attain the medium-term objective for the structural balance under the previous version of the SGP, countries would at the end of the fiscal adjustment period have structurally about 1%-point of GDP additional space. However, to the extent that this additional space is not absorbed for the fulfilment of the investment commitments as part of the next round of MTFSPs, countries are free to use it as they like.

The net primary expenditure path does not contain specific “carve outs” for investments in the green and digital transitions.[28] [29] There are good reasons for this, because carve outs may enhance the scope for creative accounting as governments may try to label other types of spending as public investment (Mintz and Smart, 2006), while what matters for financial sustainability is the integral budget, i.e. all public expenditures and revenues.[30] If the additional investment encouraged by a carve out leads to only a very small increase in potential output, hence in revenues, then sustainability would be weakened and cuts would have to be made elsewhere.

As pointed out by among others the EFB (2024), and understandable from a political point of view, a gap in the revised governance framework is the absence of some central capacity for investments that have a public good character for the EU as a whole, because they benefit multiple countries and/or provide economies-of-scale. Examples are investments related to the energy transition, such as in hydrogen infrastructure and the capacity of electricity grids, and spending on defence. Proposals for such a capacity have been made by, for example, Bakker et al. (2024a, b). The EU could itself come up with proposals for such investments or it could be the Members States who come up with such proposals individually or jointly. Access to central funding would be under a number of conditions. The investments should have positive net present value and generate positive cross-border spillovers or benefit multiple countries at the same time. In addition, countries would have to adhere to the EU fiscal rules, not being in an EDP or not having failed to take effective action. A nuance is warranted. Project finance that benefits a limited set of countries would ideally require tighter fiscal conditionality than expenditures that benefit all countries, because the former is more redistributive.

[28] The idea of a carve out, possibly up to some maximum, is closely related to a so-called “golden rule” in which deficit-financing is confined to the financing of public investments. Proposals have been made in past in relation to the SGP, e.g. Blanchard and Giavazzi (2004) and Barbiero and Darvas (2014); also, golden rules have been discussed in the run-up to the current SGP revision, see Reuter (2020), Blesse et al. (2023) and van den Noord (2023).

[29] The corrective arm of the SGP mentions aggravating and mitigating factors in Article 2.4. These do not seem to provide direct leeway for this purpose.

[30] As elaborated above, the net primary expenditure path already excludes a number of items that make it more difficult to make an integral budget assessment.

European Public Goods (EPGs) are relevant for ECB policy for at least two reasons. First, assuming that EPGs substitute for national public good provision, the returns-to-scale associated with EPGs will reduce budgetary pressure and/or the cross-border spillovers of investment-type EPGs will raise potential growth. *The cost savings and supply increase would reduce inflationary pressures, holding everything else constant*. Second, EU debt earmarked to finance specific investments related to, for example, the energy transition could be included in the ECB's asset portfolio. This would lower the financing costs, thereby further limiting inflationary pressures.

8. CONCLUDING REMARKS

This briefing paper has highlighted a number of implications of the revision of the EU fiscal framework for the conduct of ECB policies. Most essential for the latter is to what extent the revision is able to induce countries to put their public debt on sustainability trajectories. If not corrected, unsustainable public debt trajectories will at some point in the future lead to prohibitively high interest rates, forcing explicit default, debt restructuring or other parties stepping in to the rescue. Confronted with the severe consequences of debt default or restructuring, the ECB may well have no other choice than to buy the debt that is under threat, thereby risking a monetisation of a country's debt-servicing burden. The prospect of the ECB stepping in may induce moral hazard, discouraging governments from restraining public spending or increasing revenues.

It seems that thus far each crisis affecting the euro area has led to new purchase programmes or, more generally, instruments to fend off the consequences of the crisis. Short-run crisis management has been successful during the first twenty-five years of the euro: the debt crisis was solved, with private parties taking a hit in the case of Greece, the currency has survived and there are nowadays very few politicians calling for a return to monetary autonomy. However, the danger lies in moral hazard in anticipation of a rescue when push comes to shove, at a time when the burden on public budgets is rising: defense spending will have to go up, investments in the energy and digital transitions will need to increase, and the costs associated with the demographic transition will rise.

How will the revised governance framework affect the ECB's policy and what does a strong conduct of the latter require from the side of the fiscal policymakers? First, the credibility of the framework has too often been undermined in the past by insufficiently rigorous follow-up in the SGP's corrective arm. The revision of the governance framework should not be perceived to be a further watering down of the weak enforcement in the past. Hence, a tough stance on countries failing to adhere to the MTFSPs will be necessary for the credibility of the revised framework. The Commission and the Council need to demonstrate that they are serious about their determination to bend the debt dynamics towards sustainability. This will in turn help to contain interest spreads and support the uninterrupted transmission of monetary policy. Second, in view of the challenges ahead raising potential growth is essential to promote debt sustainability and ensure that the ECB will be able to follow an independent monetary policy. To provide member states with the right incentives to this extent, the Commission and the Council need to set high standards in terms of raising potential growth for the reforms and investments that are part of the MTFSPs and their potential extension. Third, with the new main steering variable, the net primary expenditure indicator, unaffected by the business cycle, governments are encouraged to abstain from discretionary fiscal finetuning. Better fiscal predictability will in turn make monetary policy more predictable. Fourth, the debt reduction requirements in a large part of the euro area imply net primary expenditure to grow more slowly than nominal GDP at least in the coming period. If governments are serious in taking up this challenge, then demand for goods and

services by the public sector will be suppressed, leading to downward pressure on inflation. Hence, the ECB might have to follow a monetary policy that is more accommodating than desirable for countries with healthy public finances. The latter group may see inflation rise, which might require them to tighten their own fiscal stance. Fifth, with the MTFSP setting the nominal path of net primary expenditures only ex ante, increases or decreases in ratios of public spending to GDP may gradually accumulate, leading over time to substantial deviations of macroeconomic demand originating in the public sector from what was projected, with potential consequences for price stability. It is important that the Commission and the Council pay specific attention to the dynamics of the public spending ratios. Sixth, and finally, the criteria for TPI do not seem to be "hard criteria", but serve as an input for discretionary Governing Council decisions, potentially alongside other considerations. The ECB needs to make clear that it intends to apply the stated criteria strictly and that deviations from them will only be allowed in exceptional circumstances. Countries that come under financial market pressure and are unable fulfil the criteria should turn to the ESM for an adjustment program instead of counting on the TPI.

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Credible ECB monetary policy requires that the revised EU economic governance framework be tightly enforced from its start. Net primary expenditures as key control variable allow predictable monetary policy focused on stabilisation. However, widespread debt reduction pushing spending growth below potential GDP growth may prompt more accommodative ECB policy. Moreover, potentially cumulating changes in public spending-to-GDP ratios need close monitoring. Finally, the criteria for TPI may increase pressure to be lenient on enforcement of the fiscal rules.

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