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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

This paper studies the implications for the European Central Bank (ECB) of the new EU fiscal framework, focusing on five aspects where monetary and fiscal policies intersect: (1) fiscal dominance over monetary policy; (2) fiscal drag created by the new framework; (3) moral hazard created by very low interest rates; (4) the effectiveness of the ECB's Transmission Protection Instrument (TPI), and (5) the impact of the new framework on green public investment.

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CONTENTS

LIST OF ABBREVIATIONS

APP	Asset Purchase Programme
CMU	Capital Markets Union
DSA	Debt Sustainability Analysis
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EIP	Excessive Imbalance Procedure
ELB	Effective Lower Bound
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IBC	Intertemporal Budget Constraint
MS	Member States
MTO	Medium-term objective
MTP	Medium-term fiscal structural plan
NECPs	National Energy and Climate Plans
NGEU	Next Generation European Union
OMT	Outright Monetary Transactions
PEPP	Pandemic Emergency Purchase Programme
PSPP	Public Sector Purchase Programme
SPB	Structural primary balance
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union
TLTROs	Targeted Longer-Term Refinancing Operations
TPI	Transmission Protection Instrument

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EXECUTIVE SUMMARY

This paper analyses the implications for the European Central Bank (ECB) of the EU's new fiscal framework which entered into force in April 2024. We examine five areas relevant to monetary policy and financial stability on which the new framework might potentially have an impact: fiscal dominance, the euro-area fiscal stance, the possibility that easy monetary policy might undermine fiscal discipline (also known as "moral hazard" on the side of the fiscal authorities), the effectiveness of the ECB's Transmission Protection Instrument (TPI) and the chances that the EU will close its green investment gaps. We assess the *status quo* with respect to each of these areas and take a view on how the new fiscal framework might change the *status quo*.

- We find **no evidence of fiscal dominance over euro area monetary policy**. However, to the extent that the risk of fiscal dominance has risen because of higher debt and higher interest rates, the new fiscal framework's focus on debt sustainability helps to contain that risk.
- Based on the fiscal plans submitted so far under the new framework, **the euro area fiscal stance is expected to be contractionary in the short and medium terms, with a contractionary impulse of about 0.5% of euro area GDP in 2025 and a continued contraction of 0.2% to 0.3% per year until 2031** (about 1.9% of GDP over seven years). On present estimates of the neutral real interest rate (r*), the ECB can offset this impulse by lowering interest rates. However, if r* falls or comes close to the lower bound of current estimates, the ECB may need to return to asset purchases to meet its price stability objective.
- We find **no evidence that loose monetary policy stance of the ECB during 2014-19 contributed to inappropriately loose fiscal policy or reduced compliance with the fiscal rules that were in place at the time**. We expect compliance with the new fiscal rules to be no worse, and likely better, than compliance with the old rules, as the new rules are conceptually sounder and somewhat less demanding, and because the ECB's TPI strengthens market discipline.
- While the TPI remains untested, the ECB's TPI announcement appears to have had the desired effect of preventing euro area financial fragmentation while maintaining the disciplining effect of sovereign bond markets (spreads continue to differ across Member States and remain reactive to relevant fiscal news). The new framework **makes no difference to the application and credibility of the TPI**.
- **The EU faces a large public 'green' investment gap which is unlikely to be closed, including in light of constraints imposed by the new EU fiscal framework**. This mainly reflects the trade-off between ensuring debt sustainability and raising public investment when such investment does not pay for itself through higher growth. However, arbitrary minimum adjustment requirements maintained or introduced by the new framework exacerbate the problem. Insufficient public green investment would place additional pressure on the ECB to support the green transition, amplifying its financial stability challenge. Beyond measures directly within the ECB's remit, the institution should continue actively encouraging European and national policymakers to intensify their efforts in fostering the green transition.

1. INTRODUCTION

Monetary and fiscal policy influence the attainment of each other's objectives. They can help or hinder each other. The nature of these spillovers depends on the frameworks within which each set of policies is conducted.

This paper discusses the impact on monetary policy of a recent change in the European Union (EU)'s fiscal framework – also known as the 'economic governance framework'. We also assess the impact on some of the secondary objectives of European Central Bank (ECB) policy, including the preservation of financial stability. Drawing on experience of interactions between monetary and fiscal policy in the euro area since the global financial crisis (GFC), we focus on five aspects.

First, will the new framework reduce or increase the chances of 'fiscal dominance' over monetary policy – that is, pressures to monetise debt, or more generally, to run a looser policy than would be consistent with price stability to help governments cope with high debt levels?

Second, might the new framework complicate the attainment of the ECB's primary mandate by creating a fiscal drag that would contribute to a return to very low interest rates, making it harder to deal with adverse demand shocks by lowering interest rates?

Third, will the new framework alleviate or amplify concerns that loose monetary policy could lead to moral hazard on the side of the fiscal authority, undermining fiscal discipline? Such concerns could complicate the job of monetary policy either by contributing to fragmentation risk, or – to forestall this risk – by inducing current monetary policy that is too tight.

Fourth, what is the impact of the framework on the functioning of the Transmission Protection Instrument (TPI), a policy tool created in July 2022 to prevent fragmentation and ensure smooth monetary transmission?

Finally, does the new framework complicate the objective of reaching the EU's 2030 climate goals by constraining public investment spending excessively? If so, what can the ECB and other policymakers do about it?

Each of these questions is answered in two steps. First, we characterise the potential problem – fiscal dominance, fiscal drag, moral hazard, the effectiveness of the TPI and low investment spending – by looking for evidence on how, if at all, the problem has manifested itself in the past. Second, we seek to answer the question of how the new fiscal framework might modify the problem.

The remainder of the paper is structured as follows. Section 2 reviews the main features of the new framework and explains how it differs from the previous one. Section 3 answers the five questions. Section 4 concludes.

2. MAIN FEATURES OF THE NEW FISCAL FRAMEWORK

The EU's new fiscal framework is based on country-specific debt sustainability analyses (DSA) and uses a single indicator, net public expenditure, as the fiscal policy target[2]. In contrast, the previous system took into account debt sustainability indirectly through the so-called medium-term objective (MTO) for the structural balance, using an *ad-hoc* parameterisation, and had multiple operational targets, which sometimes resulted in inconsistencies[3]. As a result, the economic rationale for any required fiscal adjustment is stronger under the new system than under the old. All else being equal, this should enhance compliance with the fiscal rules.

Another useful feature of the new fiscal framework is the option to extend the baseline four-year adjustment period to seven years. This extension is available if a country proposes reforms and investments that are growth-enhancing, support fiscal sustainability, address common EU priorities, align with European Semester country-specific recommendations and increase nationally-financed investments. Since the seven-year adjustment period requires smaller average annual fiscal adjustments than the four-year one, this could incentivise countries to propose meaningful reforms and investments.

However, the new framework also includes numerical safeguards to ensure ex ante a minimum pace of debt and deficit reduction, reflecting a mistrust in the DSA approach by some member states[4]. These safeguards may override the DSA-based requirements, potentially undermining the rationale for the new rules and reducing the incentives for compliance. Moreover, these safeguards could introduce some pro-cyclicality. More critically, they may constrain the ability to increase public investment. Specifically, minimum adjustment requirements driven by safeguards and the excessive deficit procedure imply that in countries where these safeguards are binding, any increase in investment must be offset one-for-one by greater fiscal adjustment in the non-investment items of the budget in the same year. This constraint makes it harder to undertake a substantial, temporary investment push, even if it aligns with long-term fiscal sustainability goals (Darvas *et al*, 2024a, 2024b)[5].

Table 1 compares the fiscal-adjustment requirements under the new and previous sets of fiscal rules, focusing solely on the MTO-based requirement for the structural balance in the previous framework[6]. To facilitate comparison, we express the fiscal adjustment requirements under the new rules in terms of the structural balance. Column (3) of Table 1 presents the MTO from the previous fiscal framework, while columns (4) and (5) display our calculations of the structural-balance-equivalent targets under the new framework. These calculations assume adjustment periods of either four years (column 4) or seven years (column 5). Columns (7), (8), and (9) present the total adjustment requirements over the full adjustment period, while columns (10) and (11) show the differences between the adjustment

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2 Net expenditure is defined as government expenditures minus (1) interest expenditures, (2) changes in revenues attributable to discretionary revenue measures, (3) expenditures on EU programmes fully matched by EU funding, (4) national co-financing of EU programmes, (5) cyclical elements of unemployment benefit expenditures, and (6) temporary measures.

3 Namely, the structural balance, an expenditure indicator and the change in the debt-to-GDP ratio.

4 See, for example, the "German technical non-paper": https://www.bruegel.org/sites/default/files/private/2023-04/German%20technical%20non%20paper.pdf

5 The exclusion of national co-financing of EU programmes from net expenditures has no impact on the *ex-ante* fiscal adjustment requirements, because the co-financing remains included in the definitions of deficits and debts, and hence subject to the DSA requirements, the requirement to reduce the budget deficit below 3% of GDP, and the four safeguards. The provision can make a difference *ex post*, however (during the implementation of the MTFSP). An increase in the deficit on account of higher-than-planned co-financing of EU programmes would not constitute a violation of the agreed net expenditure ceilings, and hence would not trigger the debt-based excessive deficit procedure. See Darvas et al (2024a).

6 For the previous framework, we disregard the debt reduction rule (which mandated lowering the debt-to-GDP ratio by one-twentieth of the gap to the 60 percent reference value) and the expenditure benchmark.

requirements of the new and previous frameworks. A negative value indicates that the new framework requires less adjustment than the previous one.

As shown in Table 1 (columns 9 and 10), the new framework generally requires less fiscal adjustment compared to the previous one, with the difference averaging 0.7% of GDP with a four-year adjustment period, and 1% of GDP with a seven-year adjustment period. The main exception is Finland, where the debt sustainability safeguard imposes a significantly tougher adjustment than under the previous framework[7]. Portugal also faces a larger adjustment, by approximately 1% of GDP. In about five countries, the new (reformed) and old frameworks produce similar adjustment requirements, while for the remaining 20 countries, the new framework requires substantially less.

Even though the required adjustment is generally lower than under the previous framework, the new framework still demands sizeable adjustments from certain countries. Belgium, France, Finland, Hungary, Italy, Poland, Romania, Slovakia and Spain face significant fiscal adjustment needs in the coming years.

Table 1: Fiscal adjustment requirements under the new and the previous frameworks

Units: % of GDP

	European Commission forecasts for 2024		Medium term targets, in structural balance terms			Adjustment requirements, in structural balance terms			Difference in adjustment requirements, new versus old	
	Debt	Structural balance	Previous (MTO)	New 4-year	New 7-year	Previous	New 4-year	New 7-year	4-year	7-year
	(1)	(2)	(3)	(4)	(5)	(6)=(3)-(2)	(7)=(4)-(2)	(8)=(5)-(2)	(9)=(4)-(3)	(10)=(5)-(3)
Greece	154	-1.7	0.5	-1.3	-1.1	2.2	0.4	0.6	-1.8	-1.6
Italy	139	-5.0	0.3	-1.5	-2.2	5.3	3.5	2.8	-1.8	-2.5
France	112	-5.0	-0.4	-2.0	-2.4	4.6	3.0	2.6	-1.6	-2.0
Spain	106	-3.4	0.0	-0.1	-0.2	3.4	3.3	3.2	-0.1	-0.2
Belgium	105	-4.0	0.8	-1.4	-1.6	4.8	2.6	2.4	-2.2	-2.4
Portugal	96	0.0	-0.5	0.5	0.2	-0.5	0.4	0.2	1.0	0.7
Finland	80	-1.8	-0.5	2.7	1.6	1.3	4.4	3.3	3.2	2.1
Austria	78	-2.5	-0.5	-1.0	-1.2	2.0	1.5	1.3	-0.5	-0.7
Hungary	74	-4.9	-1.0	-1.2	-0.8	3.9	3.7	4.1	-0.2	0.2
Cyprus	71	2.1	0.0	-0.9	-1.6	-2.1	-3.0	-3.7	-0.9	-1.6
Slovenia	68	-2.7	0.8	-0.9	-1.0	3.4	1.7	1.6	-1.7	-1.8
Germany	63	-0.9	-0.5	-0.7	-1.1	0.4	0.2	-0.2	-0.2	-0.6
Croatia	60	-3.6	-1.0	-1.4	-1.3	2.6	2.2	2.3	-0.4	-0.3
Slovakia	58	-5.6	0.3	-1.0	-0.9	5.8	4.6	4.7	-1.2	-1.1
Poland	54	-4.8	-1.0	-2.3	-2.2	3.8	2.5	2.6	-1.3	-1.2
Malta	52	-4.2	0.0	-2.4	-2.5	4.2	1.7	1.7	-2.4	-2.5
Romania	51	-6.4	-1.0	-2.5	-2.1	5.4	4.0	4.3	-1.5	-1.1
Netherlands	47	-1.3	-0.8	-1.1	-1.3	0.6	0.2	0.0	-0.4	-0.6
Czechia	45	-1.5	-0.8	-1.2	-1.0	0.8	0.3	0.5	-0.5	-0.2
Latvia	45	-2.4	-1.0	-2.4	-2.3	1.4	0.0	0.1	-1.4	-1.3
Ireland	42	1.8	-0.5	-1.3	-1.3	-2.3	-3.1	-3.1	-0.8	-0.8
Lithuania	39	-0.8	-1.0	-1.0	-1.3	-0.2	-0.3	-0.5	0.0	-0.3
Sweden	32	0.0	-1.0	-3.2	-3.3	-1.0	-3.2	-3.2	-2.2	-2.3
Luxembourg	27	-0.3	0.5	-1.2	-1.2	0.8	-0.9	-1.0	-1.7	-1.7
Denmark	27	2.4	-0.5	-1.6	-1.9	-2.9	-4.0	-4.3	-1.1	-1.4
Bulgaria	25	-2.8	-1.0	-3.0	-2.9	1.8	-0.1	0.0	-2.0	-1.9
Estonia	21	-0.7	-0.5	-2.8	-2.8	0.2	-2.1	-2.0	-2.3	-2.3

Source: Bruegel. Note: May 2024 Commission forecasts for columns (1) and (2).

Some critics have expressed concern that the fiscal adjustment prescribed by the new framework may get watered down by negotiations between Member States and the European Commission, particularly regarding the assumptions underlying the DSA (Lindner and Redeker, 2023), after countries

[7] See Darvas *et al* (2024b) for a discussion of the Finnish case.

submit their 'medium-term fiscal-structural plans' (MTPs), in which they explain how they intend to comply with the requirements of the new framework and justify any request for an extension of the adjustment period. However, some factors help mitigate this concern. First, the Commission's initial calculations, referred to as reference trajectories, are made public along with the MTPs, so that any deviations are easily detectable[8]. Additionally, the transitional provisions of Regulation (EU) 2024/1263 (the law underpinning the new framework) state explicitly that growth assumptions must ensure that "*cumulated growth over the projection horizon remains broadly in line*" with the EU's commonly agreed methodology, which cannot be blatantly flouted. Furthermore, numerical safeguards ensure a minimum pace of debt and deficit reduction, potentially limiting fiscal policy even if growth or interest rate assumptions are overly optimistic.

The MTPs submitted by time of writing this paper suggest that most countries are not trying to get away with less fiscal adjustment than prescribed by the Commission. As of early November 2024, 21 EU countries – all except Austria, Belgium, Bulgaria, Croatia, Germany, and Lithuania – had submitted medium-term fiscal structural plans. Among these, 12 had previously received reference trajectories from the European Commission that required fiscal adjustment[9]. Panel A of Figure 1 shows the latter on the horizontal axis and the MTP-implied fiscal adjustment on the vertical axis. Most points are on or close to the (dashed) 45-degree line – that is, the adjustment envisaged in the reference trajectory and in the MTP are the same. Romania and France are proposing higher adjustment than envisaged by the Commission's reference paths, while Hungary and Finland are proposing substantially lower and Italy and Spain moderately lower adjustment than envisaged by the reference trajectory. However, some of these differences reflect differences in the starting position (expected 2024 deficits) compared to June European Commission projections. Panel B of Figure 1 adjusts for these differences – hence, it measures the extent to which the structural primary balance target at the end of the adjustment period proposed by the country differs from the target proposed by the Commission.

The bottom line is that with only two exceptions – Hungary and Finland – all EU countries that have seem to have submitted their MTPs so far appear to have accepted, and in some cases plan to exceed, the adjustment targets implied by the new fiscal rules.[10]

[8] The MTPs and the prior Commission guidance are available at: https://economy-finance.ec.europa.eu/economic-and-fiscal-governance/national-medium-term-fiscal-structural-plans_en.

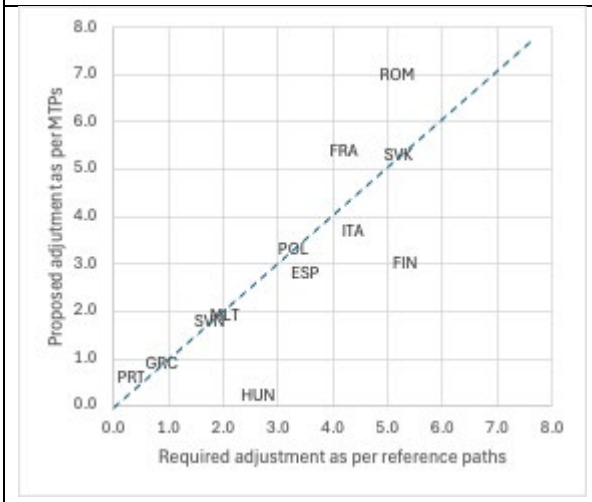
[9] Bulgaria, Czechia, Denmark, Ireland, Latvia, Lithuania, Luxembourg, Netherlands, and Sweden received technical information but no reference trajectory. Cyprus and Estonia received reference trajectories indicating that no adjustment was needed.

[10] Hungary's MTP aims at a significantly lower 2028 SPB than proposed by the Commission (1.6 rather than 2.7 percent of GDP), for reasons that are not explained in the MTP report. Furthermore, the adjustments proposed for 2025-2026 fall short of the 0.5 percent of GDP annual minimum required by the excessive deficit procedure. Finland's lower fiscal adjustment is based on the use of more stable potential growth path than the reference trajectory, the reversal of stock-flow adjustments that increased the debt between 2022 and 2024 without impacting the deficit, and the financing of public investment by the sale of government assets.

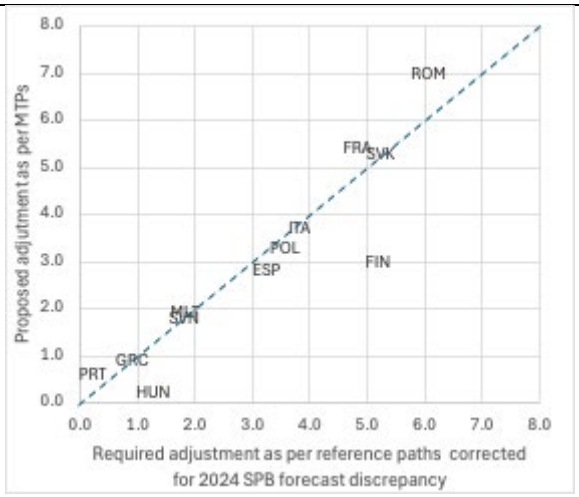
Figure 1: Required fiscal adjustment based on reference paths and fiscal adjustment proposed in MTPs

Units: % of GDP

A) Without correcting for differences between 2024 SPB projected by the reference path and the MTPs



B) After correcting for differences between 2024 SPB projected by the reference path and the MTPs



Source: European Commission and Member States' medium-term fiscal-structural plans.

Note: The figures compare the fiscal adjustment required according to the reference paths transmitted by the European Commissions with the fiscal adjustment proposed in medium-term fiscal-structural plans (MTPs) for of all EU countries that both received a reference path requiring non-zero fiscal adjustment and submitted an MTP by November 5, 2024. The length of the adjustment period is based on the MTP, namely: 4 years for Greece (GRC), Hungary (HUN), Slovenia (SVN), Slovakia (SVK), Poland (POL) and Malta (MTL) and 7 years for the remaining countries, Finland (FIN), France (FRA), Italy (ITA), Portugal (PRT), Romania (ROM), and Spain (ESP). The x-axis of Panel A reports the difference in the target structural primary balance (SPB) at the end of the adjustment period and the 2024 projected SPB as reported in the June 2024 reference paths provided by the European Commission. The x-axis of Panel B reports the difference in the target SPB at the end of the adjustment period and the 2024 SPB as projected in MTPs. The y axis is identical in the two panels.

3. IMPLICATIONS FOR MONETARY POLICY

3.1. Fiscal dominance

3.1.1. Characterisation and evidence

The concept of fiscal dominance derives from the consolidated public sector budget constraint. Government expenditure can be financed through taxes and by issuing public debt and currency. If future primary balances are perceived as insufficient to cover the current level of public debt, and monetary policy is compelled to ensure the intertemporal budget constraint (IBC)[11] is satisfied, the central bank would need to allow seigniorage revenues and hence inflation to increase (Sargent and Wallace, 1981). In this case, monetary policy can be said to be 'dominated', that is subservient to the preceding fiscal policy. The result is that the central bank fails to control inflation.

Monetary dominance, a regime in which monetary policy commits to an inflation objective while fiscal policy is chosen to satisfy the IBC for any given monetary policy trajectory, has hence been considered a necessary condition for the pursuit of a central bank's price stability mandate. The Treaty on European Union, signed in Maastricht in 1992, which established economic and monetary union (EMU), and the Treaty on the Functioning of the European Union (TFEU) seek to ensure monetary dominance by (1) prohibiting the monetary financing of government deficits (Article 123 TFEU), (2) making the ECB independent (Article 130 TFEU), and (3) requiring Member States to avoid excessive deficits (Article 126 TFEU).

Notwithstanding these legal safeguards, some critics have interpreted very loose ECB monetary policy between 2014 and 2022 as reflecting fiscal dominance in the wake of large deficits and debts arising from the 2010-2012 euro debt crisis and the 2020 COVID-19 pandemic shock. Two facts are often cited in support of this view. First, since 2015 monetary loosening has mostly taken the form of large-scale government bond purchases – the 2015 public sector purchase programme (PSPP) and the 2020 pandemic emergency purchase programme (PEPP). While consistent with Article 123 of the Treaty, which prohibits direct central bank purchases of government debt instruments but is silent on secondary market purchases, these purchases lowered government borrowing costs, making it easier to satisfy the IBC. Second, under the PEPP, the proportions in which bonds were purchased were allowed deviate from the ECB's capital key. This was interpreted by some as allowing monetary policy to be tailored in support of the most highly indebted euro area countries.

The available evidence, however, does not support the fiscal dominance hypothesis. Instead, it backs the view that is consistent with the intentions of the TFEU: monetary dominance prevails in the euro area.

First, there is evidence that EMU generated a change in regime towards monetary dominance in euro area countries. Bouabdallah *et al* (2024b) provided empirical evidence on recurrent policy regimes in France[12] from 1955 to 2019. The estimated model suggests that France operated under a regime of fiscal dominance up to the early 1990s and transitioned to a regime of monetary dominance thereafter.

[11] The government's intertemporal budget constraint requires that the present value of current and future taxes must be sufficient to cover the present value of current and future government spending plus the initial stock of government debt.

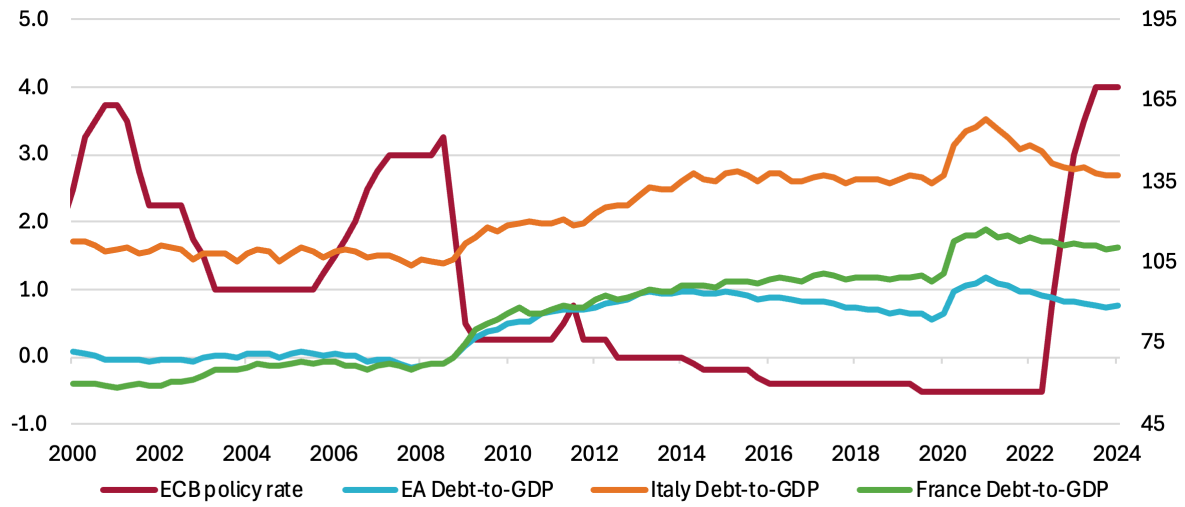
[12] These regimes are characterised by different policy rules and the aggressiveness with which policy instruments are adjusted to meet certain objectives. More specifically, monetary policy is described by a rule relating the nominal policy interest rate to inflation, while the fiscal policy rule relates taxes to public debt. Under monetary (fiscal) dominance, the interest rate moves by more (less) than one-to-one with inflation, while taxes rise by more (less) than net real interest rate expenses.

This shift coincided with adoption of the Maastricht Treaty in 1992 and beginning of ECB operations in 1999.

Second, the available empirical evidence does not point to a reaction of monetary policy to fiscal variables (public deficits or debt; see Figure 2). Jurksas *et al* (2024) and Afonso *et al* (2024) showed that fiscal deficits were not statistically significant in explaining the ECB's monetary policy stance. In the same vein, Schnabel (2020) showed that since the GFC, actual and shadow policy rates – an indicator used to capture non-standard policy measures – have reacted to output and prices similarly to the estimated pre-GFC ECB's reaction function[13]. Moreover, when adding government debt to the estimated ECB reaction function as an explanatory variable, its coefficient has not been statistically significant, including during the pandemic period. Thus, our calculations confirm that the ECB did not consider public debt as a factor in determining its monetary policy.

Figure 2: ECB policy rate and public debt ratios, selected countries

Units: left scale in % for interest rate and right scale in % of GDP for public debt



Source: ECB and Eurostat, latest observation: 2024-Q1.
Notes: The ECB policy rate reflects the deposit facility rate and is aggregated to a quarterly frequency as end-of-period.

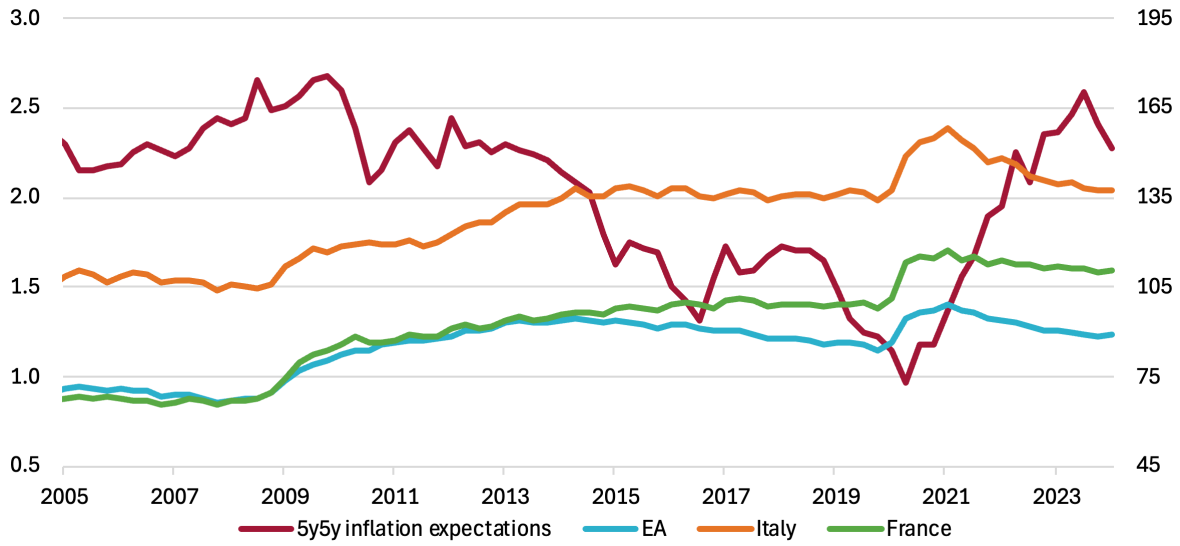
Third, under a fiscal dominance regime, inflation expectations would be expected to be affected by public debt. ECB (2021) showed that perceptions of a rising fiscal burden, using as a proxy various indicators of sovereign risk for Spain, Italy, France and Germany, are not associated with higher long-term inflation expectations, either during the sovereign debt crisis or during the pandemic crisis (see also Figure 3)[14].

[13] The monetary policy reaction function is a function that gives the value of a monetary policy tool that a central bank chooses in response to some indicator of economic conditions. One such reaction function is the Taylor rule. It specifies the nominal interest rate set by the central bank in reaction to the inflation rate, the assumed long-term real interest rate, the deviation of the inflation rate from its desired value, and the log of the ratio of real GDP (output) to potential output.

[14] Barro and Bianchi (2024) tested the so-called fiscal theory of the price level (FTPL) for 37 OECD countries for 2020-2023 by analysing the relationship between each country's inflation rate (relative to a baseline rate) and a composite government-spending variable (equal to the increases in ratios of government expenditure to GDP in 2020 and 2021, divided by the ratio of public debt to GDP in 2019 and the duration of the debt in 2019). They found that inflation responded positively to this government-spending variable in a sample of 20 non-euro-area countries and an aggregate of 17 euro-area countries. In contrast, across 17 euro-area countries, differences in the government-spending variable did not generate significant differences in inflation rates. Moreover, as the authors recognised, an important limitation of this analysis is the fact that is based on a model that neglects effects on inflation from changes in real variables, such as real GDP, real interest rates and real exchange rates.

Figure 3: Euro area long-term inflation expectations and public debt ratios, selected countries

Units: left scale in % for inflation expectations and right scale in % of GDP for public debt



Source: Bloomberg and Eurostat, latest observation: 2024-Q1.

Notes: 5y5y inflation expectations are aggregated as quarterly averages.

These factors leave one possible argument in favour of the fiscal dominance hypothesis: the fact that ECB tightening in 2022 came too late, allowing inflation to rise to unprecedented levels. However, this is explained by ECB forecast errors rather than fiscal dominance. As late as March 2022, projections for headline inflation in the euro area averaged 5.1% in 2022, 2.1% in 2023 and 1.9% in 2024. These forecasts turned out to be significantly wrong (with average inflation in the euro area at 8.4% in 2022 and 5.4% in 2023). Conditional on expectations at the time, however, ECB policy was consistent with its mandate: price stability in the medium term[15].

Starting in July 2022, the ECB reacted to the inflation spike with the largest and fastest hiking cycle in the history of EMU[16], combined with a swift reduction in its balance sheet, mainly through the phasing out of the so-called targeted longer-term refinancing operations (TLTROs), and also by ending the reinvestments under its asset purchase programmes. The ECB's forceful action has not triggered a significant widening of sovereign spreads in the higher-debt euro area members. Two factors linked to ECB policy actions have contributed significantly to this outcome. The reduction in the balance sheet, as in many other central banks, has been done in a predictable, gradual and cautious way[17]. Furthermore, the ECB announced the simultaneous adoption of the TPI in July 2022, aiming to support the effective transmission of monetary policy by countering unwarranted and disorderly market dynamics by fundamentals (see section 3.4 and Reichlin *et al*, 2024).

[15] Darvas and Martins (2022) argued that inappropriate forward guidance by the ECB contributed to the delayed start of monetary tightening in 2022. In December 2021, the ECB Governing Council announced monthly net asset purchase amounts extending until October 2022, and committed to raising interest rates only after net asset purchases had concluded. Ultimately, the ECB ended net asset purchases in June 2022 and began raising interest rates the following month.

[16] Within 14 months the ECB raised interest rates by a total of 4.5 percentage points.

[17] Alberola *et al* (2022) pointed to sizeable favourable effects of the PEPP on debt sustainability, which were only partly reversed as the programme was unwound. They also showed that a more persistent inflation spike that requires an acceleration of the unwinding of PEPP worsens debt dynamics as compared to the passive quantitative tightening scenario. However, under the accelerated PEPP unwinding scenario, debt dynamics remain much more favourable than without PEPP (Alberola *et al*, 2022, Figure 9).

3.1.2. What might change under the new framework?

While the debt-to-GDP ratio for the euro area has declined from its 2020 record level, it remains historically high in several large euro area countries, including France, Italy and Spain. At the same time, interest rates are significantly higher than before the COVID-19 pandemic, adding to the fiscal burden. In the absence of fiscal consolidation, this could put fiscal sustainability at risk. This might lead to pressures on the ECB to keep interest rates lower than warranted by the price stability objective, and hence run the risk of replacing monetary dominance by fiscal dominance.

The fiscal framework introduced in April 2024 helps contain this risk. As described in section 2, the new framework focuses explicitly on public debt sustainability. Fiscal dominance would imply lower interest rates than what the macroeconomic situation would require, which would support public debt sustainability. While the success of the new framework will depend on its effective implementation, it is well positioned to address any fiscal dominance concerns. In any case, the baseline risk that such concerns might resurface appears low: if fiscal dominance was not an issue under either the old framework or during 2020-2023 – when the old framework was temporarily disapplied – it is unlikely to become an issue under the new one. To the extent that the new framework has a greater chance of success in containing debt levels than the old one, the possibility of fiscal dominance would be further reduced.

3.2. Fiscal stance

3.2.1. Characterisation and evidence

The decade before the COVID-19 pandemic was characterised by a prolonged period of below-target inflation and very low real interest rates. The reasons for this macroeconomic environment included low productivity growth, demographic changes and the consequences of the global financial crisis. As recognised in the ECB's 2021 monetary policy strategy review, a major monetary policy concern during this period was the ineffectiveness of interest policy, with interest rates constrained by the effective lower bound (ELB), and the consequent need for the central bank to rely on unconventional policy tools such as large-scale bond purchases. This may not be fully effective in returning inflation to its medium-term target and/or could have undesirable side-effects, such as fuelling financial bubbles.

In such a context, expansionary fiscal policy is particularly useful to increase demand and inflation. Under the ELB, if fiscal policy expansion generates an increase in output and inflation, it can generate also a fall in real interest rates that amplifies the rise in aggregate demand. Conversely, if the economy is close to the ELB, a long period of tight fiscal policy might put pressure on inflation, leading it to decline below the ECB's target. The ECB might find it difficult to offset this without again resorting to quantitative easing.

3.2.2. What might change under the new framework?

The new fiscal framework requires more than half of EU countries to undertake fiscal adjustment over the medium term (see Table 1 and Darvas *et al*, 2024b). In nine cases, which include three of the EU's largest economies (France, Italy and Spain) the required adjustment is expected to exceed 3% of GDP. In four cases, including France and Italy, it is expected to exceed 4% of GDP. The adjustment must happen over four years, but can be extended to seven years under certain conditions (section 2). As early November 2024, most high-debt countries had indicated their intention to request an extension (Table 2).

Table 2: Fiscal adjustment requirements based on medium-term fiscal structural plans submitted by 8 November 2024, or European Commission reference paths

Units: year-on-year change in the structural primary balance, % of GDP

Country	Length of period	2025	2026	2027	2028	2029	2030	2031
Greece	4	0.40	0.20	0.10	0.20	...	...	...
Italy	7	0.50	0.60	0.50	0.50	0.60	0.50	0.50
France	7	1.30	0.60	0.70	0.70	0.60	0.80	0.70
Spain	7	0.40	0.40	0.50	0.40	0.40	0.40	0.40
Belgium	7	0.50	0.50	0.50	0.59	0.42	0.42	0.42
Portugal	4	-0.20	-0.40	1.10	0.10	...	...	...
Finland	7	0.80	0.70	0.30	0.40	0.30	0.20	0.30
Austria	7	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Hungary	4	-0.30	0.20	0.20	0.10	...	...	...
Cyprus	4	-0.82	-0.28	-0.53	-0.09	...	...	...
Slovenia	4	0.40	0.50	0.40	0.50	...	...	...
Germany	7	0.75	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
Slovakia	4	0.80	1.80	1.40	1.30	...	...	...
Poland	4	0.30	1.10	1.00	0.90	...	...	...
Malta	4	0.50	0.50	0.50	0.40	...	...	...
Romania	7	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Netherlands	4	-0.70	-0.10	0.60	-0.40	...	...	...
Czechia	4	-0.20	0.50	0.50	0.30	...	...	...
Latvia	4	-0.50	0.00	0.00	0.00	...	...	...
Ireland	6	-0.40	-0.80	-0.70	0.50	-0.10	-0.10	...
Sweden	4	-0.50	-0.50	-0.50	-0.50	...	...	...
Luxembourg	4	-0.50	0.10	0.00	-0.30	...	...	...
Denmark	6	-0.40	-0.40	0.00	0.00	-0.10	0.00	...
Estonia	4	-1.00	-0.30	0.00	0.00	...	...	...
Euro Area		0.49	0.26	0.34	0.28	0.23	0.25	0.24

Source: European Commission and Member State MTPs submitted by 8 November 2024.

Note: Countries are ordered according to their 2024 debt ratios. For countries without shading, the fiscal adjustment path of the MTP is included. Gray shading denotes countries which received a Commission reference path but did not submit a MTP by end-October 2024. For those countries, the table shows the adjustment envisaged by the reference path (for the seven-year adjustment horizon). Germany (blue shading) had not submitted and MTP by 8 November, but had published a 2025 draft budget. In this case, the 2025 value is taken from the 2025 draft budget, while remaining values are computed by interpolating between the structural primary balance projected for 2025 in the budget documents and the 2031 structural primary balance target stated in the Commission seven-year reference path. Croatia, Lithuania and Bulgaria did not receive reference paths and did not submit MTPs by 8 November.

While the new framework focuses on the net expenditure growth trajectory, this is derived using an interim variable, the structural primary balance (SPB) trajectory during the four or seven year adjustment period. The Commission's prior guidance includes reference trajectories both for net expenditure growth and the SPB. Table 2 shows the fiscal adjustment in terms of SPB change from 2025 to 2029 proposed by all countries that have submitted medium-term fiscal-structural plans to the European Commission. For three countries – Austria, Belgium, and Germany – that had not yet submitted proposals by 8 November 2024 (for Austria and Belgium, Table 2 reports the SPB reference paths provided by the European Commission in June; while for Germany, we use the budget announcement for 2025 and the SPB target for 2031 provided by the European Commission and interpolate the intervening values). The last row shows the GDP-weighted average of the fiscal adjustment of the countries shown. The main result is that under current fiscal plans, the euro area will be subject to a contractionary fiscal impulse of about 0.5% of GDP in 2025, followed by further fiscal contraction until 2031, in the order of 0.2% to 0.3% per year. The total fiscal contraction between 2025

and 2031 is approximately 1.9% of euro area GDP. Using a fiscal multiplier of around 0.8 to 1, this translates into a cumulative output impact of 1.5% to 1.9% of GDP[18,19].

The question is whether the ECB will be able to offset this drag through interest rate policy alone. The answer depends on what is assumed about r* (the real interest rate that is cyclically 'neutral', that is neither expansionary nor contractionary), the conduct of national fiscal policy, future EU-level investment (if any), the evolution of private investment, and whether the euro area enters a recession or not.

R*. Recent ECB research puts r* somewhere between -0.5% and slightly above +1% (Brand et al, 2024). With expected inflation at 2%, this means that the present level of ECB interest rates, with the deposit facility rate at 3.25% and the main refinancing operations rate at 3.4%, is still contractionary. To offset the fiscal drag, ECB rates first need to turn expansionary. If r* is 1%, this could happen after nominal ECB interest rates drop below 3%. Once this has happened, the ECB rate still has 3 percentage points to "travel" until it hits zero, imparting stimulus on the way. Taking the average of several models, Lane (2024) argued that a 1% interest-rate hike leads to a peak impact on growth of -0.9 percentage points and a -0.3 percentage point impact on inflation. On the assumption that the effect is symmetric, this implies that a reduction in interest rates by 3 points would translate into a stimulus of at least 2.7% of GDP – more than enough to offset the fiscal drag of 1.5% to 1.9%. In contrast, if r* is -0.5%, nominal interest rates will need to decline to 1.5% before imparting stimulus, with an associated output impact of just 1.3% of GDP. In that case, interest policy alone would not be able to offset the fiscal drag triggered by the application of the new framework.

National-level fiscal policy. A major source of uncertainty relates to the conduct of national-level fiscal policy within the constraints of the new framework. This could either increase or reduce fiscal drag, through several channels.

- *Sovereign risk premia*. Kalan *et al* (2018) found that countries under excessive deficit procedures (EDPs) show spreads between 50 and 150 basis points higher than countries in compliance with the fiscal rule. Afonso *et al* (2019) found that a country being placed in EDP increases its spread by 0.6-0.9 points. By analogy, one should expect that moving out of an EDP will lead to an improvement of the spread of similar magnitude. Hence, even if the overall magnitude of adjustment is in line with what the new framework prescribes, its impact might vary depending on whether countries move out of the EDP on schedule, or whether the EDP drags on.
- *The composition of fiscal adjustment*. Alesina and Ardagna (2010) found that spending cuts have a smaller detrimental effect on growth than tax increases. For the euro area, Cugnasca and Rother (2015) found that fiscal consolidation via cuts to non-transfer spending (public investment, for example) is more costly than consolidation via cuts to transfers and subsidies or via increases in taxes. In their previously cited simulation, Bouabdallah *et al* (2024a) assumed that 70% of the consolidation will be implemented on the expenditure side and 30% on the revenue side, and that government investment is preserved. If this is not the case – that is if

[18] This is consistent with results from Bouabdallah *et al* (2024a), who estimated the impact of the new framework on GDP growth and inflation – without yet taking into account the large upfront adjustments recently announced by France and Germany – to be between 0.2% and 0.3% of GDP per year, and 0.05 percentage points of inflation per year. By comparison, Cugnasca and Rother (2015) found that a 1% of GDP fiscal consolidation applied in the context of the EDP in EU countries between 2004-2013 resulted in a decline of 0.5% of GDP that year, leading to a smaller overall impact.

[19] The items excluded from net expenditures (interest expenditure, discretionary revenue measures, expenditure on programmes of the Union fully matched by revenue from Union funds, national expenditure on co-financing of programmes funded by the Union, cyclical elements of unemployment benefit expenditure, and one-offs and other temporary measures) have no impact on the fiscal stance calculated in Table 2, because these are not excluded from the debt and deficit indicators which determine the fiscal adjustment requirements according to the DSA, the 3% deficit criterion, and the safeguards.

investment suffers and if a higher share of adjustment happens through taxes – fiscal drag might be worse than the estimated 0.2% to 0.3% per year.

- *Whether consolidation is accompanied by structural reforms and how these impact demand*. For a given debt sustainability objective, reforms that lead to higher potential output growth should reduce fiscal consolidation needs (although the extent to which the new framework will give countries credit for such reforms is unclear; see Darvas *et al*, 2024a). Reforms that increase potential output should also contribute to a higher euro area r*, giving monetary policy more room for stimulus.
- *Use of remaining Next Generation EU (NGEU) funds*. Significant funds remain available in some countries in the next two years. More (or less) deployment of NGEU funds than currently incorporated in macroeconomic projections would help to counteract (or exacerbate) the impact of the fiscal consolidation requirements derived from the implementation of the new framework.

Upside risks relating to higher private and EU-level public investment. According to the Draghi's report (Draghi, 2024), meeting the EU's green transition and competitiveness goals requires higher total investment of 4.2% to 4.8% of GDP per year. If EU policymakers find a way to make this happen – through some combination of structural reform and capital market deepening that drives up private investment, and additional public investment at EU level – this would swamp the fiscal drag associated with national-level fiscal adjustment under the new framework.

Downside risks relating to a new EU recession. In the context of the high uncertainty still prevailing in the world economy and the structural challenges faced by the euro area economy, one cannot exclude the possibility of the euro area entering a recession in the coming years. The combination of a recession with a fiscal drag in the order estimated above (0.5% in 2025 and about 0.25% in the following years) may well be too much for the ECB to handle without resorting to unconventional stimulus. Importantly, however, conditional on a recession, the fiscal drag of the new framework would likely be much lower. Under the new fiscal framework, the commitments made by national governments are based on a net expenditure path, which excludes cyclical revenue and expenditure categories. This means that, in the event of a negative shock, deficits will be allowed to adjust (increase). The framework also includes two escape clauses that would allow Member States to deviate from their net expenditure paths in the event of a severe economic downturn.

To conclude, based on present estimates of r*, the ECB likely has enough room for manoeuvre to offset the fiscal drag imparted by the new framework simply by lowering interest rates. If, however, the ECB is currently overestimating r*, or if r* declines for structural reasons, then interest rate cuts may not suffice to counteract the fiscal drag of the new system. Unless the latter is offset either by higher private investment or by higher public investment supported by EU-level borrowing, the ECB maybe forced back into quantitative easing policies.

3.3. Moral hazard

3.3.1. Characterisation and evidence

Expansionary monetary policy lowers interest rates, allowing governments to increase non-interest spending or lower taxes (that is lower the primary fiscal balance) without increasing the deficit and debt. This spillover of expansionary monetary policy is welcome, and the resulting fiscal policy reaction could be socially optimal.

At the same time, one can also imagine a situation in which a lower interest environment facilitates a fiscal expansion beyond what can be justified as socially optimal. This might arise, for example, if the

fiscal authorities assume that the reduction in interest rates is permanent, whereas it is in fact temporary. When low-interest debt matures and must be rolled over during a period of higher interest rates, the government's interest payments could rise sharply. Low interest rates might also backfire by weakening market discipline – that is it might disrupt the feedback from higher debt risks to higher borrowing costs. As a result, fiscal authorities might be tempted to borrow too much. In cases like these, loose monetary policy would create (or exacerbate) a moral hazard problem on the side of fiscal authorities. The question is whether loose ECB policy has created such a problem in the past, and how this problem would be modified by the proposed fiscal framework.

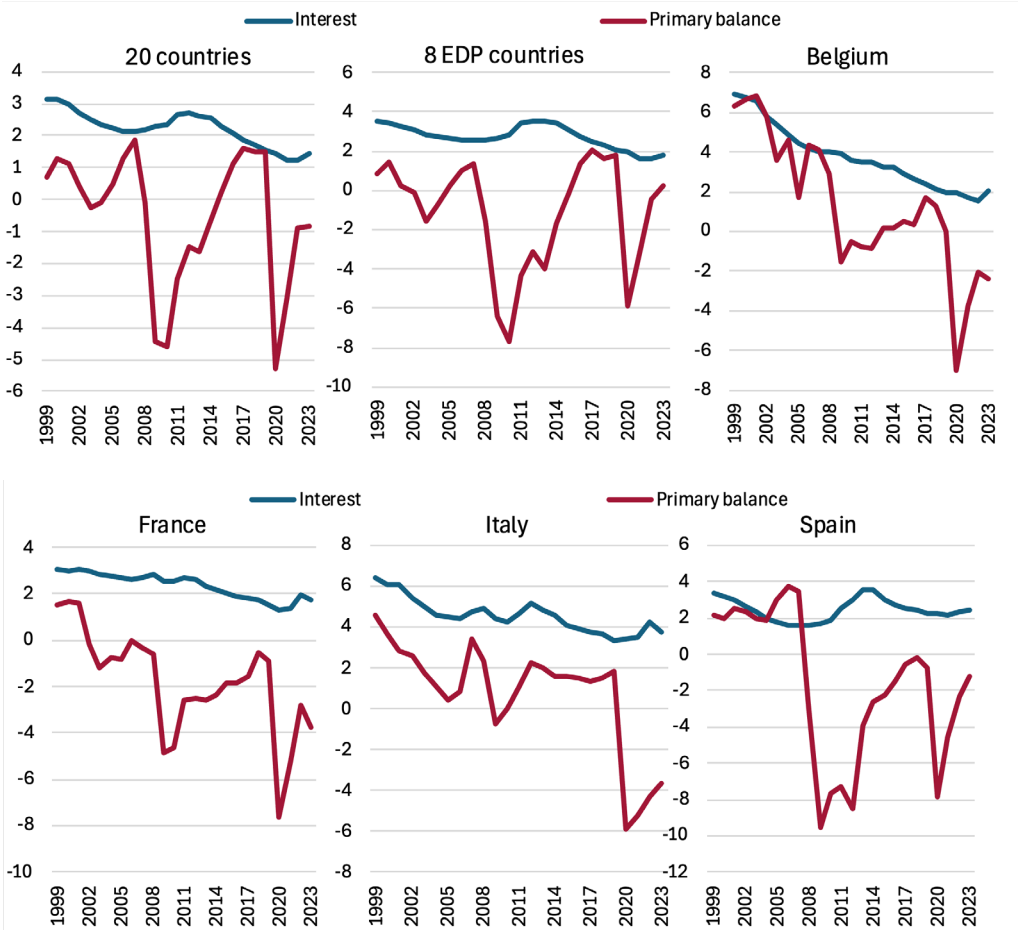
There is little direct evidence on whether the 2014–2019 period of pre-pandemic monetary expansion weakened fiscal discipline in the euro area. One exception is a study by Hülsewig and Steinbach (2021). By estimating local projection models for a panel of ten euro area countries using quarterly data from either 2003–2018 or 2010–2018, they found that while long-term interest rates fell after monetary expansion, the primary balance improved. This contradicts the hypothesis that easy monetary policy was a source of fiscal moral hazard.

Our reading of the evidence supports the findings of Hülsewig and Steinbach (2021). Three stylised facts appear to be inconsistent with the moral hazard hypothesis.

First, *the reduction of government interest expenditures during 2014-19 was not accompanied by a reduction in the primary fiscal balance*. This is clear from Figure 4, which shows government interest payments and the primary balance as a share of GDP since the inception of the euro, for the group of 20 euro area countries on average (top left panel), the group of eight countries under an EDP in this period (top middle panel), and the four largest high-debt countries (Belgium, France, Italy and Spain). Interest payments show a downward trend, with a steady pronounced drop from 2014 to 2021. Movements in the primary fiscal balance were dominated by the impact of the 2009-2010 GFC and the 2020 COVID-19 crisis. In 2011, the primary fiscal balance started to recover, and this recovery continued during 2014-2019 despite the coincident decline in government interest payments as a share of GDP. Among the four relatively high-debt euro area countries shown in Figure 4, only Italy experienced a slight decline during that period, but from a much higher level than other countries: Italy's primary surplus was 2.2% of GDP in 2012, falling to 1.6% in 2014 and 1.4% in 2016, before rising again to 1.9% in 2019[20].

[20] The European Commission (2021) suggested that a lower r-g (the implicit interest rate on public debt minus annual nominal GDP growth) might lead to reduced fiscal effort, particularly in highly indebted Member States. However, this conclusion was based on a panel regression covering the 27 current EU members and the UK from 2000 to 2019, a period that included both the GFC and the euro crisis. The regression found a statistically insignificant parameter for r-g in explaining the SPB, but a significant positive parameter for the interaction of r-g with the squared difference of the debt ratio from the 60% benchmark. This implies a positive correlation between r-g and the SPB when the debt ratio exceeds 105% of GDP. Greece, Ireland, Italy and Portugal (the countries with debt levels above 105% during the early 2010s) undertook significant fiscal consolidation when interest rates surged and GDP growth collapsed. If the positive correlation is driven by these crisis-related outliers, it might not indicate how high-debt countries would behave if r-g were to fall due to monetary easing. Moreover, the estimated fiscal reaction functions do not account for the adjustment requirements imposed by EU and national fiscal rules, or by financial assistance programs. A better approach might be to examine whether deviations from fiscal adjustment requirements are larger when interest rates decrease, compared to when they increase.

Figure 4: Government interest payments and primary balances Unit: % of GDP



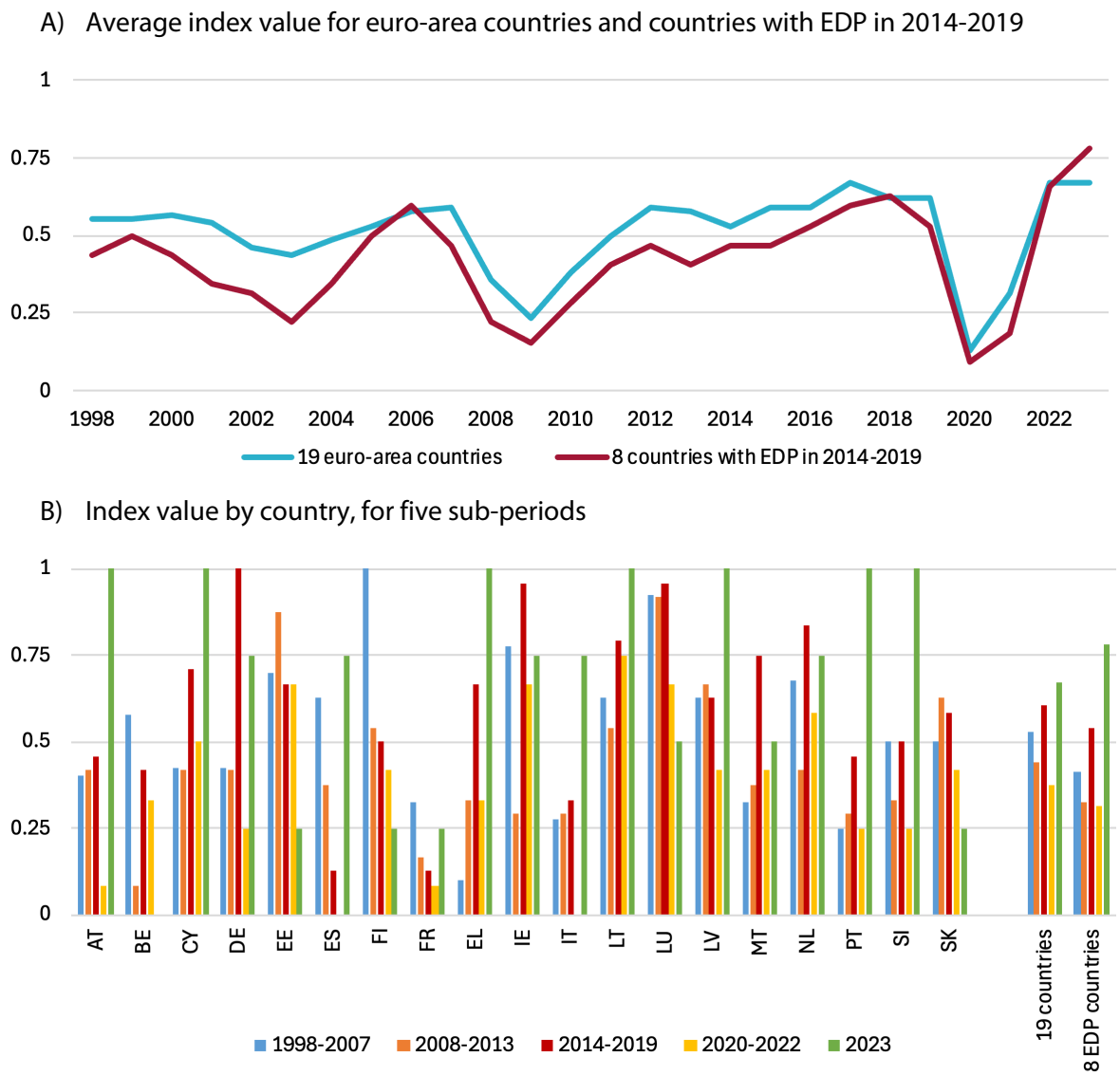
Source: European Commission, AMECO dataset, May 2024 version.

Note: Unweighted average for country groups. The eight countries subject to an EDP in 2014-2019 are Cyprus, France, Greece, Ireland, Malta, Portugal, Slovenia and Spain.

Second, *compliance with the EU fiscal rules improved during 2014-2019*. This is clear from Figure 5, which plots the Larch *et al* (2023) index of compliance with the fiscal rules on average as well as for individual countries (see the Annex for an explanation of the index and some caveats). During the pre-pandemic ECB asset purchase period of 2015–2019, compliance with EU fiscal rules improved on average both for the euro area as a whole and for the EDP countries (Panel A). Notably, compliance scores in 2015–2019 were better than during the pre-global financial crisis period of 1998–2007[21]. Panel B of Figure 5 shows that there were significant variations in compliance across countries. Germany was the only euro area country to meet all four rules every year from 2014 to 2019, nearly matched by Ireland and Luxembourg. In some higher-debt countries – such as Cyprus, Greece, Italy and Portugal – compliance improved in 2015–2019 compared to 1998–2007. In other higher-debt countries, such as Belgium, France and Spain, compliance in 2015–2019 was worse than in 1998–2007. However, on average and in most countries, compliance with the fiscal rules improved during the ECB's pre-pandemic monetary expansion.

[21] During the GFC and the COVID-19 pandemic, compliance with the EU fiscal rule numerical requirements deteriorated significantly. This was partly due to the sharp reduction in GDP and the resulting decline in tax revenues, and partly because of the fiscal stimulus measures countries implemented to mitigate the adverse effects of the crises.

Figure 5: EU fiscal rule numerical compliance index, 1998-2023

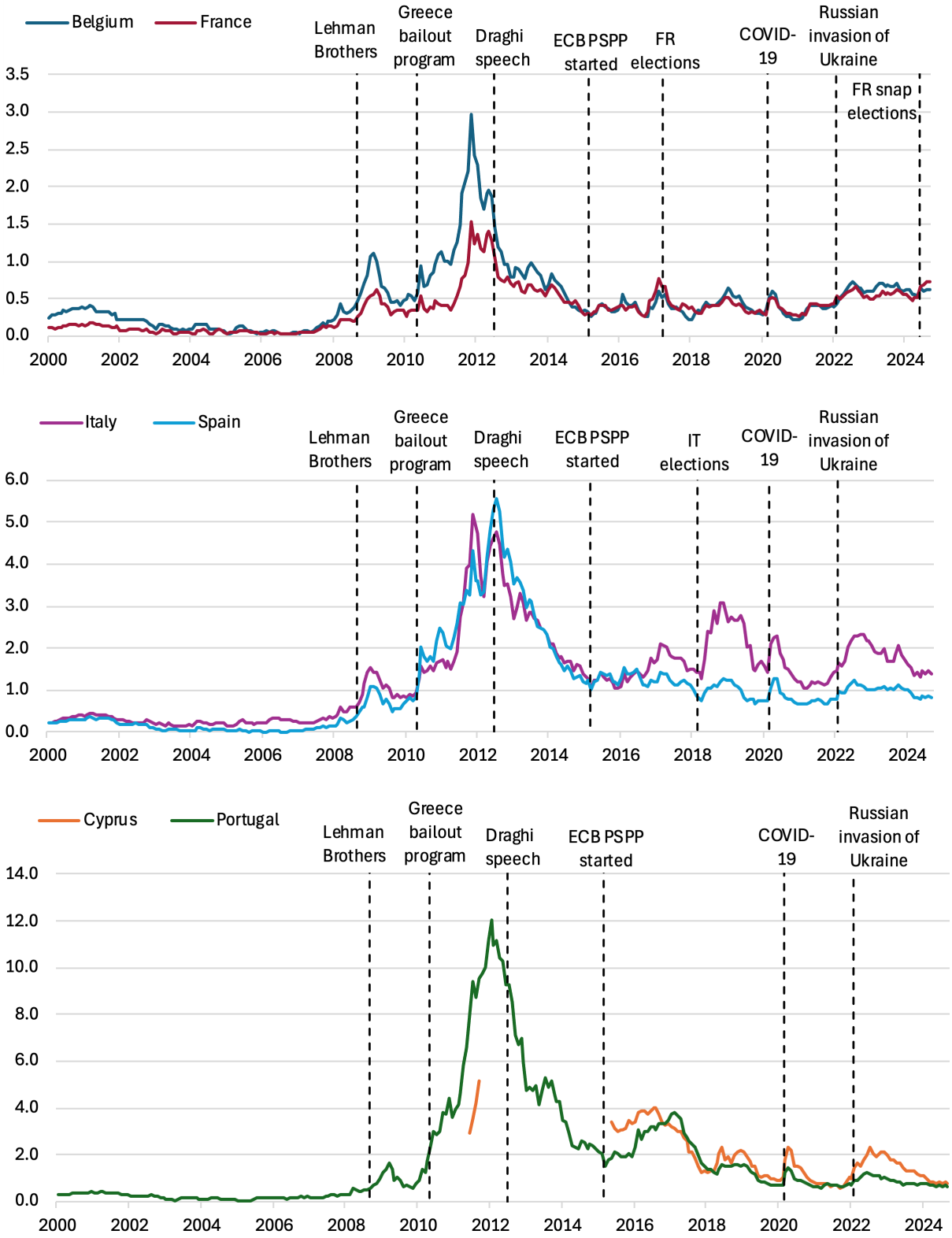


Source: European Fiscal Board.

Note: See Annex for the definition of the compliance indicator. The group of 19 countries comprise of the first 19 members of the euro area; Croatia is omitted because of missing values in 1998-2001. The eight countries subject to an EDP in 2014-2019 are Cyprus, France, Greece, Ireland, Malta, Portugal, Slovenia and Spain. Unweighted average for country groups.

Third, *the 2015-19 bond purchase programme did not prevent sovereign spreads and bond yields from reacting to events with clear implications for sovereign risk* (Figure 6). As the euro crisis was gradually resolved– partly due to ECB President Mario Draghi's *"whatever it takes"* speech in July 2012 – euro area government bond yield spreads narrowed. However, after the ECB launched its public sector purchase programme (PSPP) in March 2015, the reduction in spreads halted, and in many countries, spreads actually increased. Furthermore, the spreads of countries with relatively high debt remained volatile and sensitive to political events and economic uncertainty.

Figure 6: 10-year government bond yield spreads to Germany, in %



Source: Bruegel based on Eurostat's EMU convergence criterion series - monthly data [irt_lt_mcby_m] dataset for government bond yields; various sources for the dates of the events indicated.

For example, ahead of the April-May 2017 French presidential elections, Marine Le Pen, a far right candidate who was then sceptical of France's euro area membership, gained popularity. As a result, France's 10-year government bond yield spread relative to Germany rose from less than 0.3 percentage

points in September 2016 to 0.77 percentage points in February 2017. The uncertainty surrounding the French political situation spread to other euro area countries, as the bond spreads of Belgium, Italy and Spain increased alongside the French spread. After Emmanuel Macron won the presidential election with a large majority, and his party secured an outright majority in the June 2017 legislative elections, the French spread fell below 0.4 percentage points. The Belgian, Italian and Spanish spreads also declined as the risk of political turmoil in the euro area's second-largest economy receded.

Similarly, following the March 2018 Italian elections, Italy's government bond yield spread increased significantly, from 1.4 percentage points in March 2018 to 3.1 percentage points in November 2018. Because of political stalemate, it took three months to form a coalition government between the right-wing Lega and the anti-establishment Movimento 5Stelle. Political uncertainties, along with the associated fiscal and economic concerns, kept the Italian bond spread high and volatile for several months after the government was formed.

These episodes, along with similar events in other countries, indicate that yield spreads reacted strongly to political and economic uncertainties even after the ECB launched its PSPP. This suggests that the PSPP had limited impact on market discipline, if any.

3.3.2. What might change under the new framework?

The evidence presented suggests that moral hazard – i.e. irresponsible fiscal policy responses to ECB monetary easing – was not a significant issue during the pre-pandemic monetary-easing period. Under the new EU fiscal framework, the risk should be even lower, for two reasons.

First, as discussed in section 2, the new fiscal framework is conceptually sounder than the previous one. For about two-thirds of EU countries, including those with the largest adjustment needs, it also requires less fiscal adjustment (for the remaining one-third of countries, the adjustment requirements under the old and new frameworks are similar, with the main exception of Finland). These factors should improve compliance with the fiscal rules.

Second, the ECB has made it clear that governments openly violating fiscal rules will not benefit from the TPI. This could strengthen market discipline, as markets may react more sharply to fiscal slippages when fiscal rules are breached. The fear of exclusion from the TPI and the possibility of stronger market reactions will likely incentivise governments to comply with the new EU fiscal framework[22]. The impact of fiscal uncertainty on the French spread after the European elections in June 2024 demonstrated that market discipline remains strong under the new framework, while the fiscal adjustment plans announced by the new French Prime Minister Michel Barnier suggest that efforts will be made to comply with fiscal rules, even in France's challenging political environment.

3.4. The effectiveness of the TPI

3.4.1. Characterisation and evidence

In July 2022, the ECB announced its TPI aiming to ensure the smooth transmission of monetary policy by countering disorderly market dynamics, unwarranted by fundamentals. Under the TPI, 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.

[22] Pench (2024) argued that, given that it could result in the loss of eligibility for government security purchases by the ECB under the TPI, the European Commission might be more cautious about escalating the EDP. However, even if this proves to be true in practice, the net effect of the TPI is still to make the rules easier to enforce: the ECB gets a stick, even if it may choose not to use it.

To ensure that market discipline for sound fiscal policies is preserved, the TPI can only be used in countries that pursue sound and sustainable fiscal and macroeconomic policies, defined by a cumulative list of criteria:

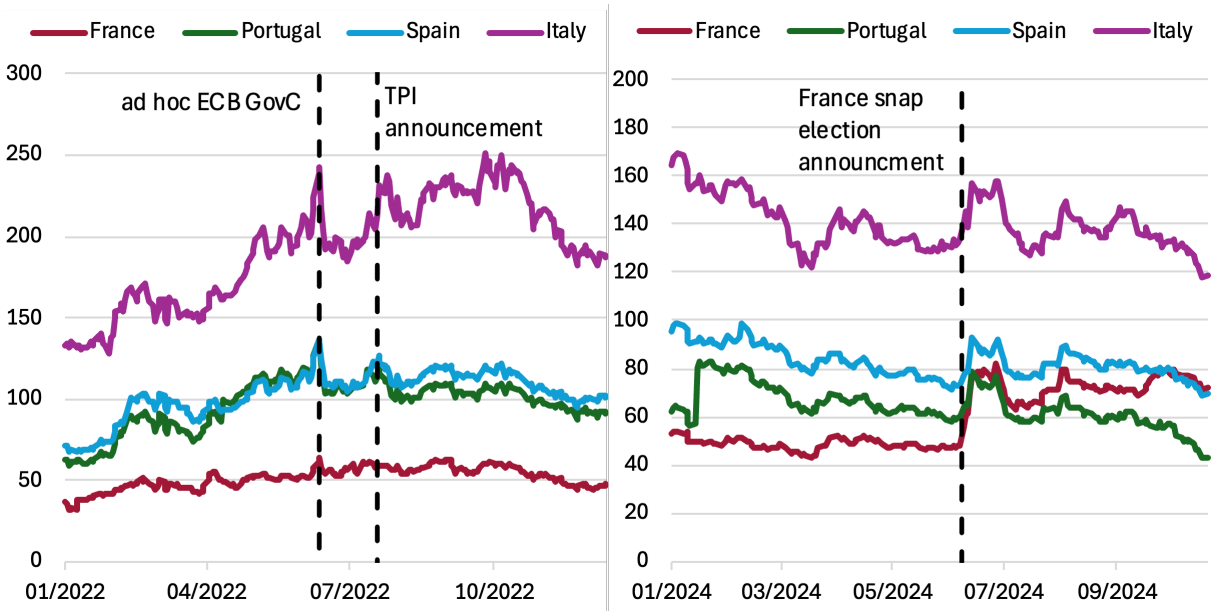
> *"(1) compliance with the EU fiscal framework: not being subject to an EDP, or not being assessed as having failed to take effective action in response to an EU Council recommendation under Article 126(7) of the Treaty on the Functioning of the European Union (TFEU); (2) absence of severe macroeconomic 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; (3) 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; (4) 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."*

These eligibility criteria provide an input into the Governing Council's decision-making. When the ECB assesses that the criteria are fulfilled, it will decide independently whether to conduct TPI operations by assessing a further condition, thus whether *"unwarranted, disorderly market dynamics"* arose, following a *"comprehensive assessment of market and transmission indicators, an evaluation of the eligibility criteria and a judgement that the activation of purchases under the TPI is proportionate to the achievement of the ECB's primary objective"*.

Thus, under the TPI, the ECB cannot be used to counter persistent tensions that are due to country fundamentals. If such circumstances emerge, the ECB can only play a role under the outright monetary transactions (OMT) programme, which require a European Stability Mechanism (ESM) macroeconomic adjustment programme or precautionary programme, and the fulfilment of the conditionality attached to such a programme.

The evolution of spreads since the announcement of the TPI by the Governing Council of the ECB supports the view that the instrument works in two ways: (1) it helps to avoid negative destabilising interest rates spread spirals within EMU at a time of tightening financial conditions (Figure 7); (2) it helps maintain the disciplining role of sovereign bond markets, as shown by the fact that risk premia in euro area sovereign bond markets have not disappeared. Indeed, as argued in the previous section, the TPI is likely helping with the enforcement of the new fiscal rules, as evidenced by the recent episode of increase in the French sovereign yield spreads.

Figure 7: 10-year government bond yield spreads to Germany around announcements in basis points



Source: Bloomberg. Latest observation: 20 October 2024.

3.4.2. What might change under the new framework?

The TPI was introduced with the previous set of EU fiscal rules in mind, at a time when the new EU fiscal framework was not yet on the horizon. The question is whether the new rules complicate the application of the TPI. As argued by Darvas and Zettelmeyer (2023), this is not the case. Condition (1) will be determined by the Council as before, while condition (3) could be evaluated by the ECB as before. Debt sustainability analyses from the institutions named will continue to be available (indeed, the European Commission's DSA may be available more frequently, as it is now a required input into the preparation and assessment of MTPs). Thus, the activation of the TPI will remain under the discretion of the ECB, while this decision could use the more frequently available Commission DSA as an input.

3.5. Low (green) investment spending

3.5.1. Characterisation and evidence

European Commission (2023) and Calipel *et al* (2024) highlighted a significant investment gap in the EU's efforts to meet its climate and energy goals. As highlighted by Andersson *et al* (2024), the EU invested an average of EUR 764 billion per year from 2011 to 2020 (equivalent to 4.8% of EU GDP in 2022) to reduce greenhouse gas emissions. To reach the 55% reduction target by 2030, relative to 1990, the European Commission (2023) estimated *additional* annual investment needs of EUR 477 billion (3% of EU GDP in 2022), mostly in the transport sector and in boosting the energy efficiency of residential housing. Estimates reported by Calipel *et al* (2024) are of a similar magnitude, with a required increase in investment of about EUR 406 billion per year on average from 2024 to 2030 relative to 2022 investment levels.

Estimates of the public-private split of these investment needs vary. Based on an analysis of National Energy and Climate Plans (NECPs) of EU countries for climate-related investments (including tax incentives and subsidies) over 2021–2030, Darvas and Wolff (2023) estimated the public share to be about 30%. For France, Pisani-Ferry and Mahfouz (2023) suggested a public sector share of about 50%.

At the global level, the International Renewable Energy Agency (2021) estimated a somewhat lower public share in the scenario that global warming is kept to 1.5°C above pre-industrial levels, with the public share declining from 22% in 2019 to 17% beyond 2030.

The presence of a large green investment gap complicates the role of the ECB. What this means concretely will depend on whether the gap is filled or not.

- If the massive public and private investments required to fill the gap materialise, the ECB's main problem will be to contain the resulting inflationary pressure. This might be an issue particularly if these investments drive up demand in sectors with supply bottlenecks (e.g. renewable energy and green infrastructure). Additionally, rapid increases in green investments could potentially lead to a 'green bubble' in asset prices or misallocation of resources;
- If the gap is not closed, the EU's 2030 emissions reduction goal may well be missed. This will increase both the physical risk and the transition risk associated with climate change, as a slower pace of emissions reductions in the near term may require more disruptive, accelerated reductions in the future. Both translate into risks to financial stability, which is one of the ECB objectives (Schoenmaker and McKechnie, 2024). The ECB has already begun integrating climate considerations into its monetary policy framework, including adjustments to its corporate bond purchases and collateral frameworks (ECB, 2022). These steps are designed to reduce the financial risks of climate change and align monetary policy with the EU's green transition objectives. The ECB's efforts to support the climate transition might need to be stepped up, creating additional complexity for the ECB's operations.

While both underinvestment and very large investment would create complications for the role of the ECB, the ECB has the instruments to deal with the inflationary pressures resulting from overinvestment. In contrast, the financial stability consequences of a failure to meet the 2030 EU climate goals are more ominous and will be harder to address. It is hence in the interest of the ECB for the investment gap to be closed as much as possible.

3.5.2. What might change under the new EU fiscal framework?

The activation of the general escape clause during the COVID-19 pandemic and the subsequent energy crisis allowed EU countries to provide fiscal support to the economy, which would otherwise have been prevented. The reactivation of EU fiscal rules from 2024 implies that several EU counties will have to adjust their budgets starting in 2025. For about two-thirds of EU countries (including those facing the largest adjustment needs), the new fiscal framework requires less fiscal adjustment than the previous fiscal framework. In addition, it provides incentives that did not exist under the previous framework to protect public investment, including green investment. Hence *compared to the previous fiscal framework*, the new one might better support green public investments. However, *considering the large public investment needs*, the new framework is likely to fall short of providing the necessary fiscal tools to sufficiently advance the green transition.

Insufficient public green investment would place additional pressure on the ECB to support the green transition, amplifying several challenges outlined in the previous section.

Several options have been suggested for the ECB to enhance its efforts to incentivise green investments. The ECB could further tighten the requirements of its collateral framework and corporate bond purchase programme beyond the measures already implemented. As suggested by van Tilburg (2023), potential actions include: (1) more aggressive tilting in corporate bond purchases, such as a shift to stock-based tilting, and stricter criteria for the collateral framework; (2) exclusion of the most climate-damaging assets, such as coal and new fossil fuel projects, and (3) limiting eligibility to companies with Paris-Agreement-aligned transition plans, which include science-based absolute targets covering all

emissions. Another potential tool could be a green long-term refinancing operation (GLTRO), which would offer banks more favourable conditions, such as lower interest rates and longer maturities, to enable them to pass similar benefits to borrowers investing in energy efficiency and clean-energy generation (Darvas and Martins, 2022; van Tilburg, 2023; Schoenmaker and van Tilburg, 2024).

As stated in the 2021 ECB monetary policy strategy review, while the primary responsibility for fostering the green transition lies with governments and parliaments, the ECB's mandate requires the ECB to assess the impact of climate change and incorporate climate-related considerations into its policy framework, since risks related to climate change have implications for price and financial stability and affect the value and the risk profile of the assets held on the Eurosystem's balance sheet. Opinions differ on the scope and effectiveness of the green measures the ECB can undertake within its mandate.

Beyond the measures directly within the ECB's remit, the institution should actively encourage European and national policymakers to intensify their efforts in fostering the green transition. This includes increasing climate financing through national and EU budgets, supporting EU-level green public investments funded by common borrowing, phasing out fossil-fuel subsidies, implementing reforms to enhance investment returns and completing the EU's capital markets union (CMU). A more robust policy framework would not only facilitate green investments but also strengthen the ECB's ability to manage the economic and financial stability challenges posed by climate change.

4. CONCLUSION

Our analysis presented in this paper leads to three main conclusions on the implications for the ECB of the new economic governance framework.

First, with respect to fiscal dominance, moral hazard triggered by low interest rates and an effective TPI, the new framework either makes no difference or helps. For the most part, fiscal dominance and moral hazard have been non-issues even under the previous fiscal framework. To the extent that they were to become more of an issue, the new framework would help to contain them. As far as the TPI goes, the announced policy, while never applied, succeeded in preventing a sharp rise in spreads during the period of monetary tightening. Although it was designed with the old framework in mind, it can be just as readily applied under the new framework. And by making compliance with the fiscal rules one of the cumulatively necessary conditions for deploying the TPI, it arguably helps enforce the new rules.

Second, the new framework will create a fiscal drag on euro area demand. With inflation back on target, this will need to be offset by the ECB. Conditional on prevailing estimates of the neutral real interest rate (r*), the ECB has is likely to have sufficient firepower to do so solely through interest rate cuts. But if r* turns out to be overestimated or falls, the application of the framework alone could contribute to a new 'lowflation' regime in the euro area, which the ECB will need to fight by returning to asset purchases.

Finally, with respect to creating fiscal space for and incentivising green investment, the framework is an improvement over its predecessor. Unfortunately, this is not nearly enough. The nine or so EU Member States for which the framework prescribes fiscal adjustment of more than 3% of GDP over the next four to seven years are very unlikely to both meet these adjustment requirements and raise public investment to levels consistent with achieving 2030 climate objectives. This will increase pressure on other policies, including structural reform, capital market deepening and ECB prudential measures to raise private green investment, along with EU-level public investment that makes up for the shortage of public investment at the national level.

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ANNEX

The Larch *et al* (2023) index of compliance with the fiscal rules

While the Maastricht Treaty's requirement for governments to avoid excessive deficits has been the cornerstone of European fiscal rules, the requirements used to operationalise the rules have evolved, making comparisons over time difficult. To address this, Larch *et al* (2023) developed a dataset measuring numerical compliance with the 2011 version of EU fiscal rules, applying from 1998. The dataset was later updated through 2023, including 2020-2023, when EU fiscal rules were suspended[23].

The Larch *et al* index considers the four main sub-components of the 2011 rules:

Deficit rule: A country is considered compliant if (i) the general government budget balance is equal to or greater than -3% of GDP, or (ii) if the -3% GDP threshold is breached, the deviation remains small (a maximum of 0.5% of GDP) and is limited to one year.

Debt rule: A country is considered compliant if its debt-to-GDP ratio is below 60%, or if the excess above 60% has been declining by one-twentieth on average over the past three years.

Structural balance rule: A country is considered compliant if the structural budget balance of the general government is at or above the medium-term objective (MTO). If the MTO has not yet been reached, compliance is determined if the annual improvement in the structural budget balance is at least 0.5% of GDP, or if the remaining distance to the MTO is less than 0.5%.

Expenditure rule: A country is considered compliant if the annual growth rate of primary government expenditure (net of discretionary revenue measures and one-off items) is at or below the ten-year average of the nominal rate of potential output growth, adjusted by a convergence margin necessary to ensure that the structural budget deficit of the general government aligns with the structural balance rule.

The index assigns a value of either one (if the rule is met) or zero (if not) but does not quantify whether deviations from the rule were large or small. Nor does it account for flexibility allowed by the legislation, or consider the European Commission's judgments regarding whether deviations from the numerical requirements relate to factors that do not warrant concluding the existence of an excessive deficit. Nonetheless, it remains instructive to examine numerical compliance regardless of the Commission's actual judgments.

The application of the 2011 version of the rules to pre-2011 data is debatable. For instance, the one-twentieth debt reduction rule had no prior equivalent. However, the Treaty-based requirement that the debt ratio be "*sufficiently diminishing and approaching the reference value at a satisfactory pace*" when it exceeds 60% of GDP has been in place since the Maastricht Treaty, even though a specific numerical target was not specified originally. One could argue that the one-twentieth rule provides an approximation of this Treaty-based requirement.

[23] The dataset is available at: https://commission.europa.eu/business-economy-euro/economic-and-fiscal-governance/european-fiscal-board-efb/compliance-tracker_en

This paper studies the implications for the European Central Bank (ECB) of the new EU fiscal framework, focusing on five aspects where monetary and fiscal policies intersect: (1) fiscal dominance over monetary policy; (2) fiscal drag created by the new framework; (3) moral hazard created by very low interest rates; (4) the effectiveness of the ECB's Transmission Protection Instrument, and (5) the impact of the new framework on green public investment.

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