European Fiscal Board

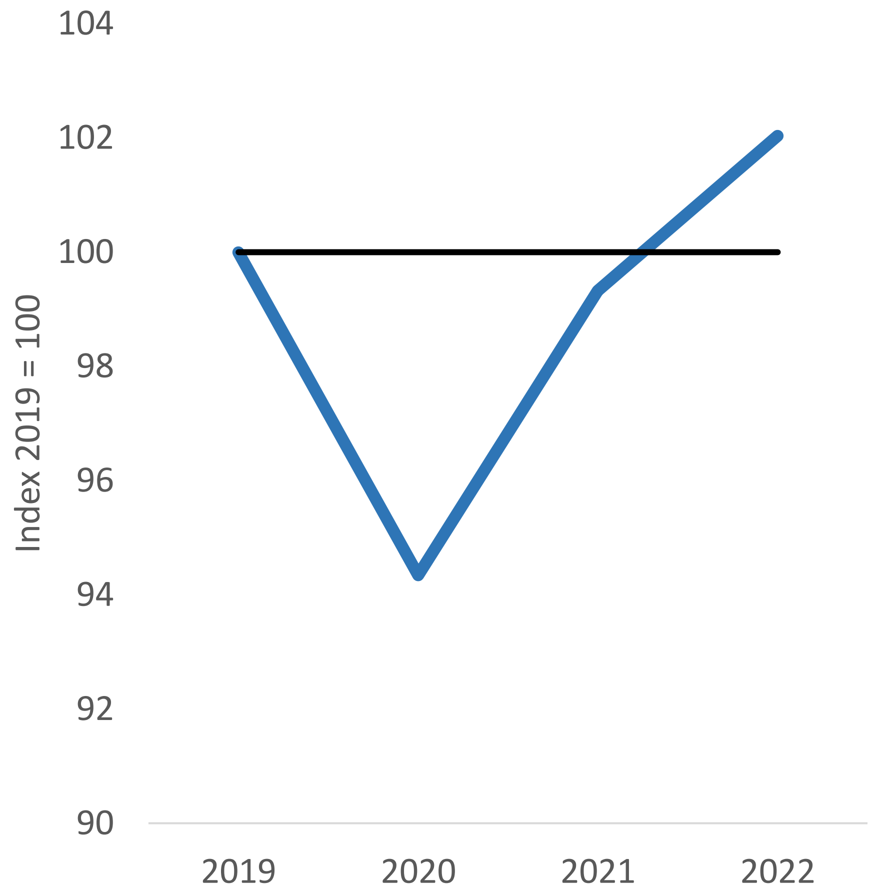
Annual Report 2022

Prof. Niels Thygesen, Chair of the Board

Press briefing – Brussels, 26 October 2022

Macroeconomic developments in 2021

- After a sharp recession, 2021 recorded an **exceptionally strong rebound**
- Economic **growth** in the EU **surprised** on the upside
- Annual real GDP in the EU and the euro area **approached pre-pandemic levels** by the end of 2021
- **Sizable cross-country differences** emerged
- **Unemployment** rates dropped to **record-low** levels and **inflation** started to **pick up**



Idiosyncrasies in the European semester 2021

- The Commission repeatedly stressed that the **severe economic downturn does not suspend the SGP**. However, the extensive interpretation of the clause *de facto* **shelved the normal implementation of the rules**

- **EU fiscal guidance** to Member States was **purely qualitative** with **no country differentiation**

- The need to **safeguard sustainability** in medium term was duly stressed, but **no indications were provided** on how to achieve it

- The **debt sustainability analyses** in the 2021 surveillance cycle were used in an **unusual** manner

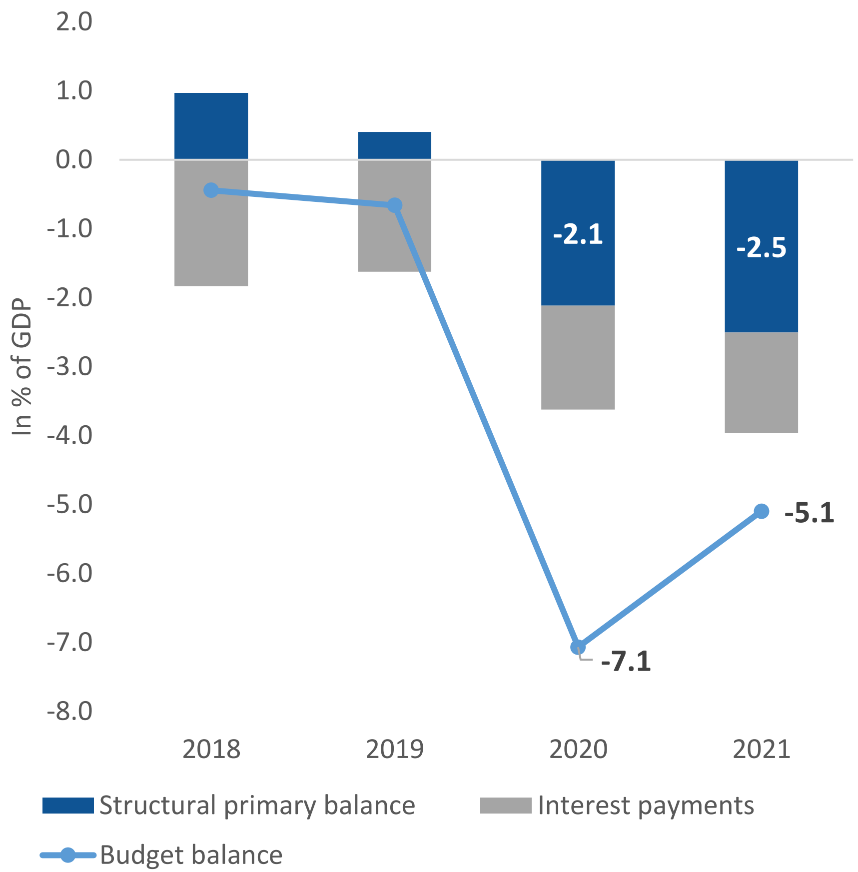
- **Reporting under the SGP fell short of requirements and practice**, hampering transparency and medium-term orientation

- In autumn 2020 and 2021, the **Commission did not produce the usual reports under Art. 126(3) of the Treaty** as excessive deficits persisted, but continued to implement the EDP for Romania.

Fiscal developments in 2021

- In **2020** Member States launched **massive fiscal support** in response to the Covid-19 pandemic
- In 2021, **headline deficits** of EU/EA **improved** by nearly one-third to around 5%, but the reduction was **entirely cyclical**
- **Higher than expected revenues** were used to **extend emergency measures** and to further increase expenditure
- As a result, discretionary **fiscal support in the EA** increased from already very high levels, despite the rapid economic recovery

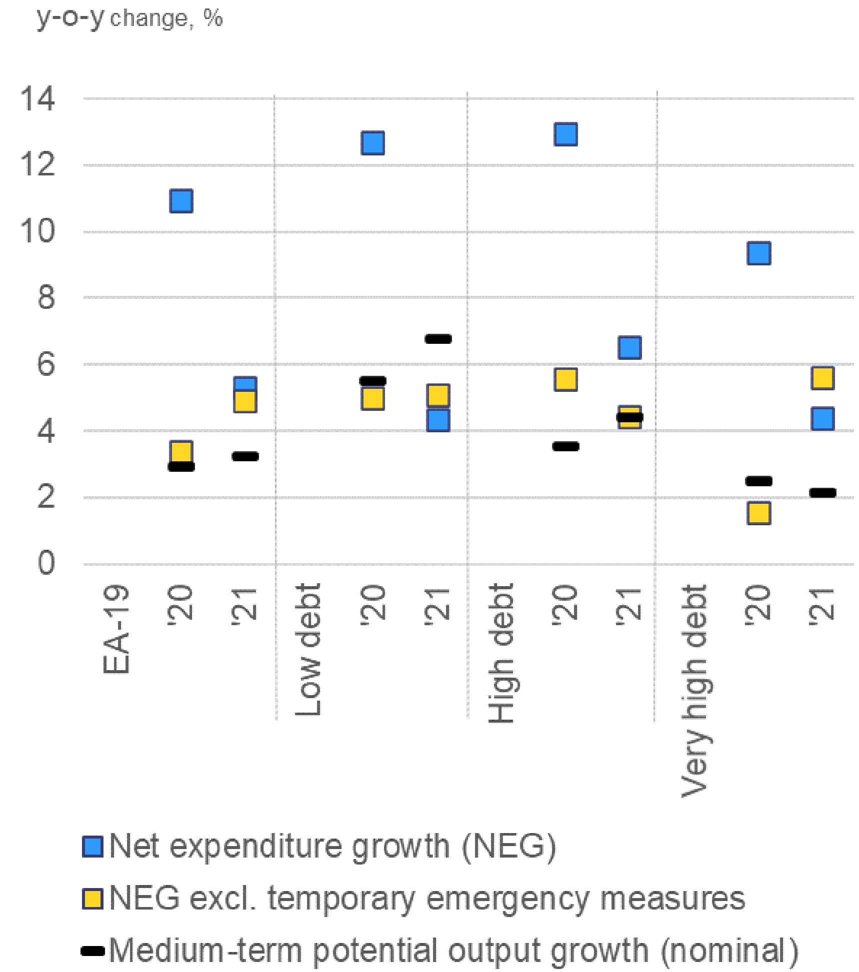
Euro area budget balance breakdown



Return of old patterns

- Better headline figures **hide problematic trends**
- **Important differences across country** groups emerged
- Growth of net permanent expenditure **accelerated** in **very high debt countries** exceeding medium-term potential output growth
- If all countries had stuck to **original budget plans** for 2021, EU/EA deficit would not have been 5%, but **closer to 3% of GDP**
- **Additional space would have been useful** in face of energy price hikes

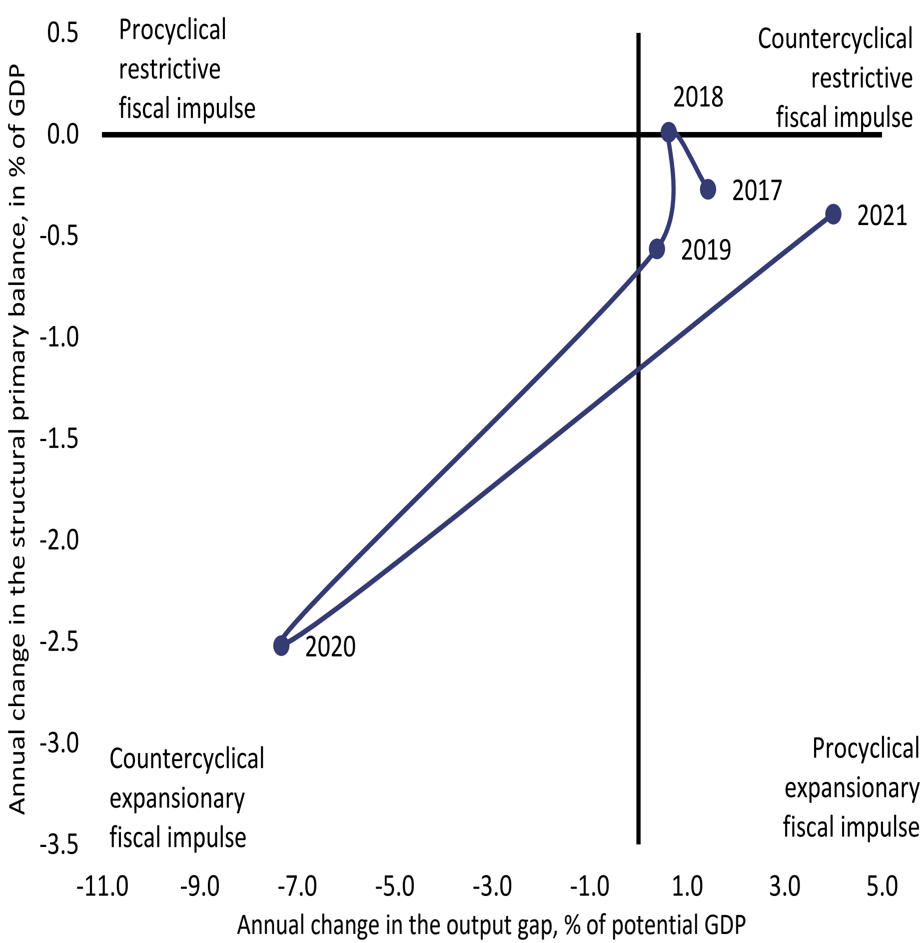
Net expenditure growth well above medium-term economic growth potential



Euro area fiscal stance in 2021

- The additional discretionary **fiscal expansion** of 1/3% of GDP in 2021 stands in **contrast** to
    - ➢ **rapid recovery** and
    - ➢ swift **decline in economic slack**
- Policies led to a **pro-cyclical expansion** and **fed inflation**
- **Very high debt countries** contributed most to the pro-cyclical impulse

Change in discretionary fiscal support and cyclical position, euro area



DIFFICULT YEAR ALSO FOR INDEPENDENT FISCAL INSTITUTIONS (IFIS)

- Simultaneous activation of **SGP's severe economic downturn clause and national escape clauses** in some countries gave rise to **inconsistency** between the two (e.g. exit)
- **Lack of numerical targets** to assess fiscal policy
- Difficulty of producing or endorsing **macroeconomic forecasts** in volatile times
- **Limited involvement of IFIs** in Recovery and Resilience Plans (**RRPs**)

Context of the economic governance review

- Continued recourse to the **SGP's severe economic downturn clause** is **creating a harmful vacuum** of quantitative fiscal guidance
- Due to rising debt levels, **sustainability** of public finance is back in **spotlight**
- Urgent need to **return to rules-based fiscal framework** and some normality
- **Economic governance review** should be concluded as **swiftly** as possible in order to return to guidance, ideally consistent with revised framework from 2024
- But governance is about more than updating the SGP - **a more comprehensive reform is needed**

Proposals for SGP reform

- **A guiding principle**: focus on preventing, identifying, and correcting **gross policy errors**
- The legitimacy in the Treaty for fiscal rules hinges primarily on **reducing risks of harmful spill-overs**; **surveillance** has to become more **differentiated**
- Member States with a debt ratio well above 60% - six are currently well into tripple figures – **should agree a reduction path over a 3-5 year horizon with the Commission**, to be endorsed by the Council
- The **expenditure benchmark** to be **operational target**

Proposals for SGP reform (ctd.)

- For other Member States – the large majority – **monitoring fiscal outcomes** through national frameworks and efforts would be **relied upon**, but

- such **decentralisation** would be contingent on: (1) **a transparent medium-term national budgetary framework**, (2) **fiscal rules well aligned with those of the EU**, (3) **an IFI meeting minimum standards**

- The **Commission** would **validate these conditions on a continuing basis** and stand ready to **open EDP** with any country committing gross errors

BEYOND SGP: JOINT EU ACTION

- **Two major governance gaps still to be filled**: better protection of the provision of EU public goods, and more scope for stabilisation against major temporary shocks

- **Budget allocation remains a national prerogative**, but economies of scale and spending externalities justify an important EU role to face new priorities

- **Neither national golden rule allowances**, nor an **extension of the one-off RRF** seems to offer the best way of reconciling these considerations

- The EFB would prefer **a larger EU budget**, extended by **national envelopes**, to address priority challenges

BEYOND SGP: JOINT EU ACTION

- A **central fiscal capacity (CFC)** to stabilise against major transitory shocks is missing

- **SURE of 2020** provided an example of **temporary strengthening of national automatic stabilisers**

- Countries draw on cumulated contributions to a rainy-day fund, enlarged by EU-financed loans with conditionality - and eligibility **to be assessed by independent body prior to political decision**

- **Moral hazard risks:** no grants and limited redistribution involved in the design

Thank you for your attention

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