PROPOSALS FOR THE REFORM OF EU FISCAL RULES

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ABSTRACT

The aim of this paper is to contribute to the ongoing debate regarding the reform of the EU fiscal framework, with a special focus on fiscal sustainability for Greece. Our key policy proposals for the EU fiscal rules draw on lessons from past experience, the conclusions of relevant studies and the fiscal sustainability risks faced by Greece and other high-debt countries in the euro area. To this end, we use the European Fiscal Board's Compliance Tracker Dataset to assess compliance with the existing SGP framework. Moreover, we employ the Bank of Greece's Debt Sustainability Analysis (DSA) model to identify possible fiscal sustainability risks for Greece over the medium- to long-term horizon, taking into account alternative economic policy scenarios (including a debt rule scenario). Our main findings indicate that the revised fiscal framework should focus on the need to enhance sustainability of public debt as a key priority, by setting a debt anchor as a medium-term fiscal objective, with a single operational expenditure rule that promotes countercyclicality of fiscal policy. The current benchmark levels could be maintained and complemented with the appropriate flexibility in the rate of debt reduction to address cross-country heterogeneity and avoid self-defeating effects of fiscal policy. In the case of Greece, despite the favourable characteristics of public debt, fiscal policy in the short and medium term should focus on accelerating debt reduction. The exposure of Greece's public debt dynamics to market and interest rate risks will gradually increase, as official sector debt is replaced by market financing, thereby changing the structure of public debt and highlighting the need to create fiscal buffers in order to increase its resilience to future adverse macroeconomic shocks.

Keywords: Economic and Monetary Union (EMU); fiscal rules; debt sustainability; Stability and Growth Pact (SGP); fiscal policy

JEL classification: E62; E63; H11; H50; H6

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ΠΡΟΤΑΣΕΙΣ ΓΙΑ ΤΗΝ ΑΝΑΘΕΩΡΗΣΗ ΤΩΝ ΔΗΜΟΣΙΟΝΟΜΙΚΩΝ ΚΑΝΟΝΩΝ ΤΗΣ ΕΕ

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ΠΕΡΙΛΗΨΗ

Σκοπός της παρούσας μελέτης είναι να συμβάλει στη συνεχιζόμενη συζήτηση σχετικά με τη μεταρρύθμιση του δημοσιονομικού πλαισίου της ΕΕ, με ιδιαίτερη έμφαση στη δημοσιονομική βιωσιμότητα της Ελλάδος. Οι βασικές μας προτάσεις πολιτικής για τους δημοσιονομικούς κανόνες της ΕΕ βασίζονται σε διδάγματα από την εμπειρία του παρελθόντος, στα συμπεράσματα σχετικών μελετών και στους κινδύνους δημοσιονομικής βιωσιμότητας που αντιμετωπίζουν η Ελλάδα και άλλες χώρες με υψηλό χρέος στην ευρωζώνη. Για την ανάλυσή μας, χρησιμοποιούμε τη βάση δεδομένων παρακολούθησης της συμμόρφωσης με τους ευρωπαϊκούς δημοσιονομικούς κανόνες (Compliance Tracker Dataset) του Ευρωπαϊκού Δημοσιονομικού Συμβουλίου, προκειμένου να αξιολογήσουμε τη συμμόρφωση με το υφιστάμενο πλαίσιο του Συμφώνου Σταθερότητας και Ανάπτυξης. Επιπλέον, χρησιμοποιούμε το μοντέλο βιωσιμότητας δημόσιου χρέους της Τράπεζας της Ελλάδος για τον εντοπισμό πιθανών δημοσιονομικών κινδύνων για την Ελλάδα σε μεσομακροπρόθεσμο ορίζοντα, λαμβάνοντας υπόψη εναλλακτικά σενάρια οικονομικής πολιτικής (συμπεριλαμβανομένου ενός σεναρίου εφαρμογής του κανόνα χρέους). Τα κύρια ευρήματά μας δείχνουν ότι το αναθεωρημένο δημοσιονομικό πλαίσιο θα πρέπει να επικεντρωθεί στην ανάγκη ενίσχυσης της βιωσιμότητας του δημόσιου χρέους ως βασική προτεραιότητα, θέτοντας τη μείωση του χρέους ως μεσοπρόθεσμο δημοσιονομικό στόχο, με ένα λειτουργικό κανόνα δαπανών που προωθεί την αντικυκλικότητα της δημοσιονομικής πολιτικής. Τα υφιστάμενα επίπεδα αναφοράς θα μπορούσαν να διατηρηθούν και να συμπληρωθούν με την κατάλληλη ευελιξία στο ρυθμό μείωσης του χρέους, για την αντιμετώπιση της ετερογένειας μεταξύ των χωρών και την αποφυγή αυτοαναιρούμενων επιδράσεων της δημοσιονομικής πολιτικής. Στην περίπτωση της Ελλάδος, παρά τα ευνοϊκά χαρακτηριστικά του δημόσιου χρέους, η δημοσιονομική πολιτική βραχυπρόθεσμα και μεσοπρόθεσμα θα πρέπει να επικεντρωθεί στην επιτάχυνση της μείωσής του. Η έκθεση της δυναμικής του δημόσιου χρέους της Ελλάδος σε κινδύνους αγοράς και επιτοκίου θα αυξηθεί σταδιακά, καθώς το χρέος του επίσημου τομέα αντικαθίσταται από χρέος που χρηματοδοτείται με όρους αγοράς, με αποτέλεσμα να αλλάζει η δομή του δημόσιου χρέους και να εντείνεται η ανάγκη δημιουργίας δημοσιονομικών αποθεμάτων, προκειμένου να αυξηθεί η ανθεκτικότητά του σε μελλοντικές δυσμενείς μακροοικονομικές διαταραχές.

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INTRODUCTION

The objective of fiscal rules is to introduce incentives and restrictions on discretionary fiscal policy, in order to promote policies that ensure the sustainability of public finances. The main reasons for using fiscal rules are: (1) the increase in budget deficits and public debt recorded in most advanced economies in recent decades; and (2) the tendency of economic policymakers to implement procyclical fiscal policies leading to instability and significant macroeconomic imbalances. Ideally, fiscal rules should be designed to promote in tandem fiscal discipline and macroeconomic stabilisation. Their design should also include key elements such as monitoring and compliance mechanisms, a framework of sanctions and appropriate procedures for correcting potential deviations, in order to ensure their credibility and effectiveness.

The consultation on the reform of EU fiscal rules is a process initiated before the outbreak of the pandemic. The pandemic crisis prompted a temporary suspension of the Stability and Growth Pact (SGP) rules and the activation of the General Escape Clause, leading to a sharp increase in public debt due to the expansionary fiscal policy and the increased borrowing required to finance emergency measures, coupled with a decline in economic activity. A prompt return to the strict implementation of the current European fiscal framework would require excessive fiscal consolidation, especially in countries with high debt levels, in order to avoid entering the Excessive Deficit Procedure. Therefore, following the lifting of the SGP General Escape Clause, it is necessary to adapt the current fiscal rules to the new economic conditions.

The purpose of this paper is to contribute to the ongoing debate regarding the reform of the EU fiscal framework, drawing on lessons learnt from past experience, the conclusions of relevant studies and the analysis of future economic challenges.[1] To this end, the key principles of the current SGP are presented (Section 1) and then assessed (Section 2), with particular focus on compliance with the existing fiscal rules (Section 3). The main public proposals for the reform of the SGP are summarised next (Section 4). In the longer term, there is an urgent need to strengthen public debt sustainability, and the outlook for Greece vis-à-vis other high-debt euro area countries is analysed in this respect (Section 5). In addition, a similar comparison is made as regards the implications of applying the current debt rule in these countries (Section 6). The combined results of this analysis lead to proposed guidelines for the reform of the European fiscal rules (Section 7).

1 KEY PRINCIPLES OF THE CURRENT STABILITY AND GROWTH PACT (SGP)

The SGP was introduced at the same time as the single currency, with a view to ensuring sound public finances in the euro area. However, before the financial crisis it had limited success in preventing the emergence of severe fiscal imbalances in some Member States. During the euro area debt crisis, the SGP was reformed by introducing a stricter framework of common rules through the Six Pack (2011)

* The views expressed in this article are of the authors and do not necessarily reflect those of the Bank of Greece. The authors are responsible for any errors or omissions.

1 For a similar analysis, see the special feature entitled "European fiscal rules: achievements, weaknesses and proposal for their improvement", in Bank of Greece, *Annual Report 2019*, March 2020.

and the Two Pack (2013), which brought significant changes to the fiscal framework and the way these rules were enforced.[2] These rules were further enhanced by the Fiscal Compact,[3] introduced in 2013. The current SGP includes five main restrictions and rules and a monitoring framework:

1) Two medium-term targets: budget deficit of less than 3% of GDP and debt of less than 60% of GDP.

2) Two fiscal rules relating to the "Preventive Arm" of the SGP: (i) The first is the Structural Budget Balance Rule.[4] It concerns the convergence of the structural balance towards the Medium-Term Budgetary Objective (MTO), i.e. a relatively balanced budget in structural terms, giving Member States sufficient flexibility to use the available fiscal space without exceeding the deficit threshold of 3% of GDP. For convergence towards the MTO, the structural budget balance should improve by 0.5% of GDP per year, or by the remaining distance from the MTO if this is less than 0.5% of GDP. If a country's fiscal position is above its MTO, then the structural balance cannot fall short of the MTO. (ii) The second is the Debt Rule, which was introduced to ensure convergence of debt-to-GDP ratios towards the medium-term benchmark. According to the debt rule, the debt-to-GDP ratio should decrease by 1/20 of the distance between the current debt/GDP level and the benchmark value per year, on average over a 3-year period.[5]

3) A ceiling on the increase in primary expenditure. The European expenditure rule provides that the annual growth rate of primary government expenditure must not exceed the medium-term growth rate of potential GDP in nominal terms (10-year average) minus the margin necessary for the adjustment of the structural budget balance (in line with the corresponding rule), unless the excess is combined with revenue measures. The current "expenditure limit" is not a "rule" in the sense of other budgetary constraints, but is primarily designed to indicate to government authorities what is needed in order to meet the requirements based on the MTO.[6]

4) Fiscal policies are monitored using multiple indicators, which inevitably often lead to conflicting conclusions. Compliance is therefore assessed using a critical approach, weighing the strengths and weaknesses of the various indicators.

5) A complex regulatory framework allows for Member State flexibility (depending on the cyclical fluctuations of the economy), enabling them to negotiate the size of the required fiscal adjustment.

6) An escalating system of warnings and sanctions for non-compliance. This is the "Corrective Arm" of the SGP, which sets out two procedures: (i) the Significant Deviation Procedure (SDP); and (ii) the Excessive Deficit Procedure (EDP). These procedures are triggered when a country breaches the preventive arm or the fiscal targets of the SGP, respectively, and indicate concrete actions that

2 For more details, see European Commission, EU Economic governance: monitoring, prevention, correction, and Legal basis of the Stability and Growth Pact.

3 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, TSCG. According to this Treaty, the medium-term budgetary objectives (MTOs) should be transposed into national law with a clear structural deficit limit of 0.5% of GDP (or 1% of GDP in exceptional circumstances). The MTOs are different for each country, depending on the level of debt and the estimated cost of population ageing. The Treaty also provides for automatic correction mechanisms in case the structural deficit threshold is breached. The MTOs may be revised when a major structural reform is undertaken or every 3 years, on the occasion of the publication of projections allowing for an update of the estimated population ageing costs. For Greece, the MTO is set at 0.25% of GDP.

4 In 2005, a cyclically adjusted operational indicator, the structural budget balance, was introduced into the SGP, which removes from the fiscal balance the effects of both the economic cycle and one-off measures. It is therefore a measure of the intensity of the fiscal adjustment effort. Its level is a target in the SGP's preventive arm and indicates whether there is need for fiscal adjustment.

5 In practice, the activation of the Excessive Deficit Procedure was based more on the structural budget balance rule and convergence towards the MTO, rather than on the debt rule.

6 Although the European Commission is carrying out a comprehensive assessment based on both the structural budget balance rule and the expenditure rule to determine whether or not a country complies with the SGP preventive arm, significantly less attention has so far been paid to the expenditure rule than to the structural budget balance rule. The Vade Mecum on the SGP describes the expenditure rule as a "complement to structural fiscal adjustment", suggesting a kind of implicit hierarchy between the rules within the preventive arm.

countries need to take, in order to correct their fiscal imbalances and avoid sanctions.

2 ASSESSMENT OF THE CURRENT SGP

Before the pandemic crisis, fiscal performance in the euro area as a whole showed that the reformed fiscal framework contributed to the sustainability of public finances, leading to lower deficits and improved debt dynamics. The achievement of the MTOs created fiscal buffers in most Member States. At the same time, it has been possible to identify fiscal risks early on and coordinate fiscal policies through the European Semester process, in the context of which Member States' Stability Programmes and National Reform Programmes are submitted and assessed, and the resulting recommendations are taken into account in the preparation of the Draft Budgetary Plans.

The consultation on the reform of fiscal rules in the EU is a process initiated before the pandemic, since some weaknesses of the current fiscal framework were already evident, despite the progress in strengthening economic governance.[7] These weaknesses included:

(i) The procyclicality of fiscal policy, especially in countries with high public debt.[8] Procyclicality led to limited accumulation of fiscal buffers in good times on the one hand and, on the other hand, to self-defeating effects on public debt dynamics, as the size of the recession caused by the required sharp fiscal adjustment cancelled part of the positive contribution of the budget balance, weighing on its dynamics.[9] At the same time, procyclical national fiscal policies have resulted in a number of countries marginally complying with the 3% deficit criterion, but not converging in structural terms towards the MTOs.[10]

(ii) The fact that the SGP has become a complex and confusing set of rules. Through the various revisions of the SGP, the number of monitoring rules and indicators, together with the implementation procedures and exceptions, increased significantly, making the fiscal framework complex and onerous. In addition, the national fiscal rules linked to the Fiscal Compact were found to be inconsistent.[11] Lastly, the use of non-observable variables, such as the output gap, has been accompanied by frequent revisions, complicating the comprehension and, thus, the political ownership of fiscal rules.[12]

(iii) The difficulty of practical implementation and compliance by Member States, undermining the credibility of the fiscal framework. Compliance with the fiscal framework has been largely heterogeneous across countries, periods and rules, including compliance with the MTOs, even in good times. According to the European Network of EU Independent Fiscal Institutions, the revision of some SGP rules was seen as optimistic, the main example being the debt rule. While the SGP's debt rule was initially designed as a counterbalance to the observed fiscal policy procyclicality in the euro area, ultimately it led to limited compliance by Member States with high debt, which resorted to the available flexibility as a way to avoid an EDP.[13]

7 European Commission (2020), "European governance review", Staff Working Document; Pisani-Ferry, J. (2018), "Euro area reform: An Anatomy of the debate", *VoxEU.org*; Feld, L., C. Schmidt, I. Schnabel and V. Wieland (2018), "Refocusing the European fiscal framework", *VoxEU.org*; and Blanchard, O., A. Leandro and J. Zettelmeyer (2021), "Redesigning EU fiscal rules: from rules to standards", Peterson Institute for International Economics, Working Paper 21-1.

8 European Fiscal Board (2019), *Assessment of EU fiscal rules with a focus on the six and two-pack legislation*.

9 Attinasi, M.G. and L. Metelli (2016), "Is fiscal consolidation self-defeating? A panel-VAR analysis for the euro area countries", ECB Working Paper No. 1883.

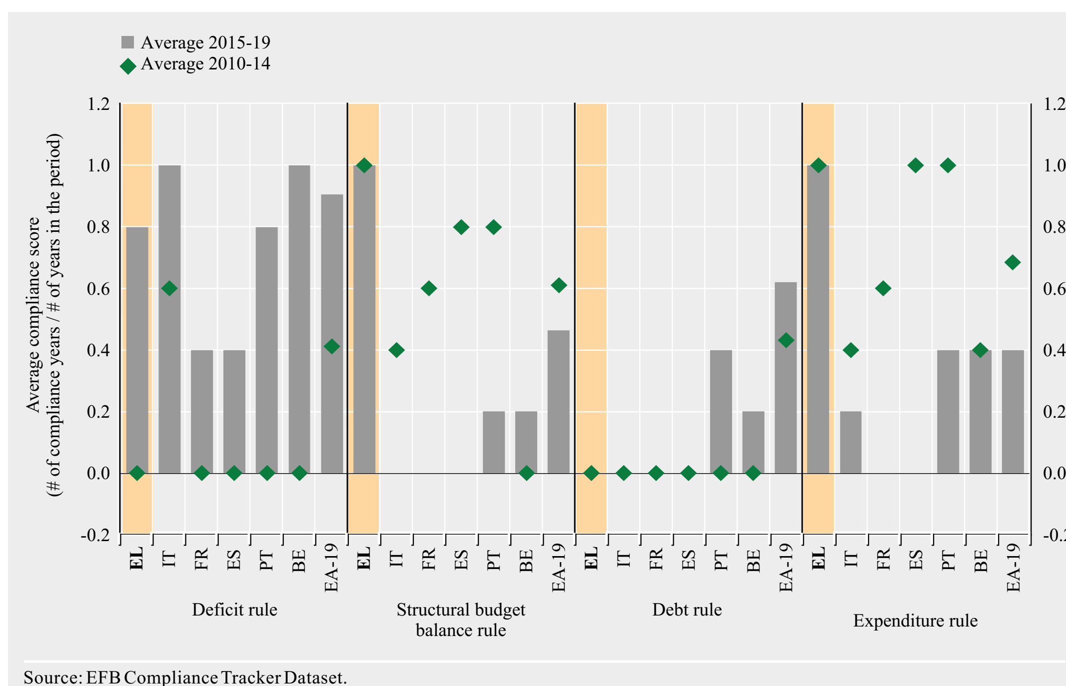
10 Mainly countries with high public debt or countries subject to an Excessive Deficit Procedure (EDP). See European Commission (2020), op. cit., footnote 7; and Caselli, F. and P. Wingender (2018), "Bunching at 3 Percent: The Maastricht Fiscal Criterion and Government Deficits", IMF Working Paper No. 18/182.

11 Deroose, S., N. Carnot, L.R. Pench and G. Mourre (2018), "EU fiscal rules: Root causes of its complexity", *VoxEU.org*.

12 European Commission (2020), op. cit., footnote 7.

13 Larch, M. and S. Santacroce (2020), "Numerical compliance with EU fiscal rules: The compliance database of the Secretariat of the European Fiscal Board"; Darvas, Z., P. Martin and X. Ragot (2018), "European fiscal rules require a major overhaul", *Policy Contribution*, No. 18; and De Jong, J. and N.D. Gilbert (2018), "Fiscal Discipline in EMU? Testing the Effectiveness of the Excessive Deficit Procedure", De Nederlandsche Bank Working Paper No. 607.

Chart 1 Compliance scores – Fiscal rules (EA-19, selected countries)



Source: EFB Compliance Tracker Dataset.

3 COMPLIANCE WITH THE CURRENT FISCAL RULES[14]

- **Deficit rule:** The assessment of the fiscal performance of EU Member States in recent years has mainly focused on the deficit rule,[15] in order to avoid sanctions and country surveillance. According to the European Commission's indicators, compliance with this fiscal rule increased significantly in 2015-19 compared with the previous period 2010-14 on average in the euro area (EA-19), with all high-debt countries improving their performance due to fiscal adjustment (see Chart 1). Among the high-debt countries, Greece recorded on average the largest annual target overperformance during the 2015-19 period (by around 2 p.p. of GDP), the second largest improvement at the EU level compared with 2010-14.

- **Structural budget balance rule:** Fiscal adjustment in most countries mainly relied on one-off measures, as compliance with the structural budget balance rule in 2015-19 remained moderate and marginally deteriorated compared with 2010-14 on average in the EA-19. Among high-debt countries with increased debt sustainability risks, Greece is an exception due to the large structural fiscal adjustment in 2010-19, fully complying with this fiscal rule (see Chart 1) and even recording the largest target overperformance (by 4 p.p. of GDP) among all EA-19 countries on average per year.

- **Debt rule:** Compliance with the deficit rule resulted in greater compliance with the debt rule at the EA-19 level, but not in most countries with high debt/GDP levels and high sustainability risks. On average, most high-debt countries (except Portugal and

14 The compliance scores for fiscal ruless (see Chart 1) are compiled by the European Fiscal Board. These are dummy variables that take the value of 1 for each year if a country is compliant with each EU fiscal rule and 0 otherwise.

15 A country is deemed to comply with the deficit rule if: (i) the general government deficit is equal to or below 3% of GDP; or (ii) the 3% of GDP threshold has been exceeded, but the deviation remains small (up to 0.5% of GDP) and is limited to a single year.

Belgium) have breached this fiscal rule, showing significant underperformance, which means that they have not managed to reduce the debt-to-GDP ratio at the required pace (see Chart 1).[16] Over time, Greece has the largest negative deviations from this rule on average per year, despite some improvement in 2015-19.

- **Expenditure rule:** The compliance score for the expenditure rule shows that, on average, compliance deteriorated in 2015-19 (compared with fiscal performance in 2010-14) for most EA-19 countries. From 2011 onwards, the balance between the EA-19 compliant and non-compliant countries with regard to this fiscal rule started to deteriorate in favour of the latter, while in 2016-19 non-compliant countries outnumbered compliant countries. Greece is one of only two EU countries that fully complied with this rule throughout the period 2010-19, while the other high-debt euro area countries saw a sharp deterioration in their compliance indicators. It is worth noting that Greece had the highest target overperfromance among EA-19 countries as a result of the strong fiscal adjustment during this period.[17]

4 MAIN PROPOSALS FOR THE REFORM OF THE SGP

In order to be more effective and resilient, the fiscal governance framework in the post-pandemic period must not only correct pre-existing failings, but also adapt to the new macroeconomic and fiscal reality. It should therefore address a number of crucial issues for the euro area, such as high public debt levels, the need to finance investment for the green and digital transformation of the economy, and the prevention of economic divergence among Member States. With the publication of the European Commission's views in the first half of 2022, many authors and researchers propose concrete changes to the SGP, aiming to reduce the number of rules and revise the debt rule, with stronger emphasis on the growth rate of primary expenditure as the main operational tool to achieve the fiscal targets.

The European Fiscal Board (EFB) (2018, 2019, 2020)[18] recommends setting country-specific debt adjustment rates towards a long-term target (debt rule). The rate of convergence towards the long-term target[19] will depend on a set of fundamental variables,[20] promoting debt reduction in good times. The EFB's proposals are also based on a ceiling on government expenditure growth (expenditure rule) to strengthen fiscal policy countercyclicality, which is equal to the 3-year average growth rate of potential output.

The European Stability Mechanism (ESM),[21] with a view to simplifying fiscal rules, proposes a two-pillar approach, the first one relating to the 3% of GDP deficit threshold and the second one setting a new debt benchmark of 100% of GDP. The proposal includes a debt rule, whereby countries with public debt over 100% of GDP would have to converge towards this benchmark ratio by 1/20 of their deviation annually, and an operational expenditure rule to replace the MTO (in structural terms), setting the 3-year trend in nominal GDP growth as their growth limit. Exceptions to the debt rule are allowed in cases of major crises, recessions and significant investment gaps. The 3% of GDP budget deficit threshold remains binding and the EDP is maintained, while stressing

16 This is because (i) some countries did not carry out the required fiscal adjustment; (ii) the implementation of fiscal rules and, in some cases, large target overperformance set in the SGP have led to procyclical policies. As a result, debt dynamics deteriorated, as the recessionary impact of excessively tight fiscal policy in downturns effectively cancelled part of the positive contribution of primary deficit reduction; and (iii) support to the financial sector in 2010-19 weighed heavily on public debt dynamics in some countries.

17 Specifically, in Greece the average annual rate of reduction in primary expenditure over the period 2010-14 was around 6% (6.2 p.p. higher than the "expenditure limit" set by the fiscal rule), whereas in 2015-19 this rate remained unchanged (3.9 p.p. higher than the "expenditure limit" set by the fiscal rule).

18 European Fiscal Board, *Annual Reports* 2018, 2019, 2020.

19 Although the EFB proposal is 60% of GDP as a benchmark for debt convergence, it is explicitly stated that, after the end of the pandemic, this threshold has become impracticable.

20 For instance, the level of government debt as a percentage of GDP or the difference between the servicing costs of public debt and the growth rate (r-g).

21 See Francová, O., E. Hitaj, J. Goossen, R. Kraemer, A. Lenarčič and G. Palaiodimos (2021), "EU fiscal rules: reform considerations", ESM Discussion Paper No. 17.

the need for a stronger focus on public investment in the light of the green transition needs. This proposal differs from that of the EFB in that it sets a common rate of government debt reduction for all countries but suggests a new debt benchmark value.

An alternative proposal is that of Blanchard et al. (2021)[22] supporting the abolition of existing numerical fiscal rules in favour of fiscal standards on the basis of stochastic debt sustainability analysis. A country's performance and fiscal risks will be based on the use of stochastic debt sustainability analysis to assess the likelihood that the primary balance exceeds the debt-stabilising primary balance during a reference period. These assessments could be conducted by independent national fiscal councils and/or the European Commission.[23]

5 THE NEED TO STRENGTHEN THE SUSTAINABILITY OF PUBLIC DEBT

In the post-pandemic period, the adoption of credible and effective fiscal policies aimed at public debt sustainability is more urgent than ever. One of the fundamental weaknesses of the European economy is the high level of public debt, which: (i) limits the room for flexibility to address future challenges; (ii) makes public finances vulnerable to interest rate increases; and (iii) undermines the ECB's ability to respond to rising inflationary pressures. Lower public debt also contributes to reducing divergences between Member States, as debt ratio differentials lead to variations in the fiscal space available to each country to stabilise the economy after a shock and to finance growth-enhancing expenditure. Therefore, in such an uncertain economic environment, it is imperative to strengthen fiscal sustainability and increase the resilience of public finances to adverse shocks.

According to the Bank of Greece's Debt Sustainability Analysis (BoG's DSA), risks from adverse macroeconomic and fiscal shocks to Greek public debt dynamics remain contained in the medium term, assuming sustained commitment to fiscal targets and effective use of NGEU funds (see Charts 2 and 3). The Baseline Scenario assumes broad compliance with SGP's structural balance rule, with primary surpluses averaging 2.2% of GDP during the long-term horizon 2023-60. Moreover, steady-state deflator growth is set at 2.0% and steady-state real GDP growth is set at 1.7%, assuming effective utilisation of NGEU funds. Regarding the assumptions on debt refinancing, the average maturity of new debt is set at around 6.5 years at a refinancing rate that evolves in line with the assumed gradual increase of policy rates, an endogenously determined risk premium that penalises debt-to-GDP ratios above 60% and an exogenous country risk premium. Against the baseline scenario, BoG's DSA considers three alternative risk scenarios: Scenario 1 assumes lower potential growth by 0.5 p.p.; Scenario 2 assumes higher interest premium by 100 bps as of 2022; and Scenario 3 assumes lower primary balance by 1 p.p. of GDP over the long-term forecasting horizon. The analysis indicates that the downward trajectory of Greek public debt is maintained under all scenarios. However, gross financing needs are expected to hover marginally close to the agreed 15% of GDP threshold by the mid-2030s (or even breaching it under an adverse fiscal scenario), thus leaving little room for fiscal loosening.

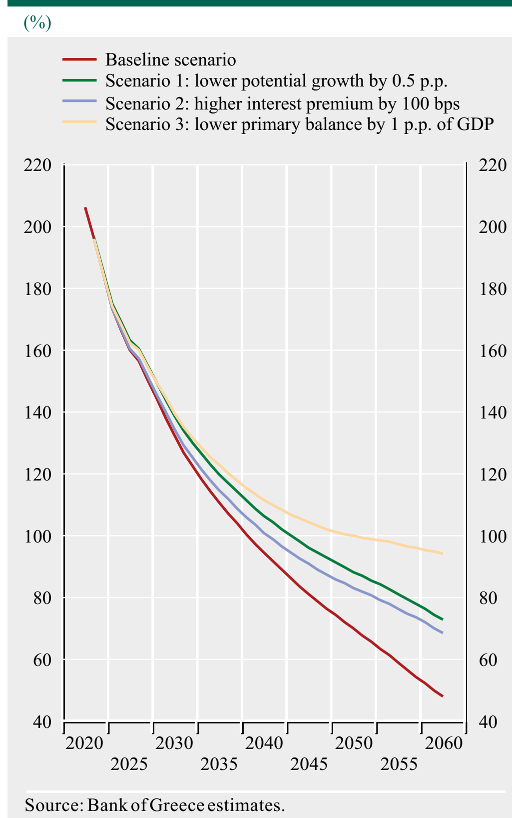
Greece's public debt, despite its high level, displays increased resilience over the medium term (until around 2030) under several adverse macroeconomic and fiscal scenarios, much higher than in other high-debt euro area countries. According to a European Commission cross-country analysis,[24] public debt in Greece is stabilising and is expected to reach pre-crisis levels earlier than in other high-debt countries, recording the largest drop in the debt-to-

22 Blanchard, O., A. Leandro and J. Zettelmeyer (2020), "Revisiting the EU fiscal framework in an era of low interest rates", PIIE manuscript.

23 Disputes between Member States and the European Commission on the application of the fiscal standards could be resolved by an independent institution, such as the Court of Justice of the EU.

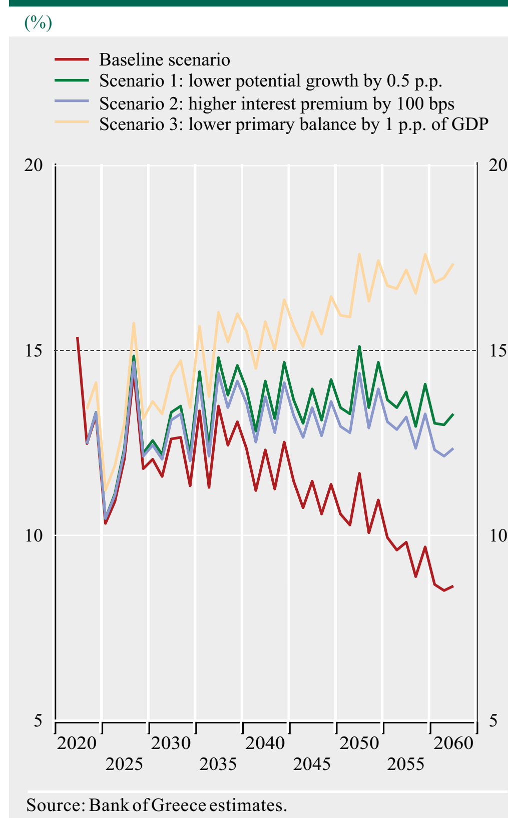
24 European Commission (2022), *Fiscal Sustainability Report 2021.*

Chart 2 Debt/GDP – Baseline and alternative scenarios



Source: Bank of Greece estimates.

Chart 3 Gross financing needs/GDP – Baseline and alternative scenarios



Source: Bank of Greece estimates.

GDP ratio by 2030, both in the baseline scenario and in various alternative scenarios. The strong resilience of Greek public debt dynamics vis-à-vis other countries is attributed to the following factors:

(i) The specific characteristics of Greek public debt,[25] which ensure relatively low interest rate and refinancing risks over the next ten years.

(ii) Greece's fiscal position, as a result of structural fiscal surpluses. This means that, after the pandemic-related emergency support measures are lifted and in the absence of new permanent expansionary fiscal measures, Greece will return to structural primary surpluses, which will reinforce downward public debt dynamics without a need for further fiscal adjustment measures. This is the outcome of the structural fiscal adjustment that has taken place in previous years, as a result of which Greece has outperformed other high-debt countries.

(iii) The positive contribution of the snowball effect, i.e. the difference between the implicit borrowing rate and the nominal GDP growth rate. The snowball effect is a key driver of the rate of change in the debt-to-GDP ratio and reflects, *inter alia*, the impact of the macroeconomic envi-

25 Specifically, according to the latest available data by the Public Debt Management Agency (PDMA, February 2022), in December 2021: (a) 77% of public debt consisted of liabilities to the official sector (including ESM/EFSF loans and GLF loans under the first economic adjustment programme); (b) the share of fixed-rate liabilities amounted to 98.9% of central government debt; (c) the weighted average remaining maturity of general government debt is 20.58 years; (d) the effect of the two previous indicators is that the weighted average time to the next re-fixing of general government debt is 19.76 years; (e) the estimated implicit interest rate of 1.4%, one of the lowest among euro area countries, will therefore remain essentially unchanged over the next 20 years.

ronment on debt dynamics. Compared with other countries, the contribution of this effect to debt reduction is expected to be more than double in the case of Greece, because of the disproportionately high debt level[26] and due to the anticipated large GDP gains from the utilisation of the Recovery and Resilience Facility (RRF) resources.[27]

However, improving the sustainability of public debt and reinforcing its downward trend should be a priority of fiscal policy in the coming years, in order to prevent another debt crisis. Besides, the long maturity of EFSF and ESM loans (over 30 years) calls for a long-term perspective on Greek public debt sustainability, well beyond the medium-term 10-year horizon. It should also be taken into account that the stock of public debt is projected to slightly increase after 2032, once the interest deferral period on the EFSF loan has expired. The main reason for fiscal policy focusing on accelerating debt reduction is that debt's resilience to future adverse shocks will be comparatively weaker, despite its projected lower level. More specifically:

(i) The current favourable characteristics of Greek debt are not of a permanent nature. In the coming years, official sector debt (which is not marketable and thus not exposed to market volatility, has long maturity and carries low interest rates) will be gradually replaced by marketable debt to the private sector, with relatively shorter maturities and higher interest rates. Thus, despite its expected significant de-escalation as a share of GDP, the factors that make Greek debt resilient to negative shocks will gradually weaken in 10 years, as an increasing part of the debt will be subject to market risk.

(ii) The focus should be on annual gross financing needs. In the case of Greece, where the bulk of the debt has not been accumulated on market terms, but rather through official sector low-interest loans with a very long repayment period, a grace period and deferral of interest payments for many years, focusing exclusively on the debt-to-GDP ratio would be misleading. As a result, the sustainability of public finances is also assessed on the basis of the annual gross financing needs criterion for the period up to 2060. In particular, a cap of 15% of GDP in the medium term and a cap of 20% of GDP in the long term were introduced.[28] Despite the expected steady de-escalation of the debt-to-GDP ratio in the coming years, gross financing needs are estimated to remain significantly higher in the medium term vis-à-vis pre-pandemic levels, due to the additional borrowing that was required to finance the fiscal deficits during the health crisis.

(iii) The significant debt-reducing contribution of the snowball effect is expected to decrease over time. The key factors underlying this development will be both the changing macroeconomic environment, with more moderate growth and higher borrowing rates expected in the long term, and the mechanical effect of gradually decreasing debt levels. Accordingly, in the long run, fiscal policy will face growing pressures to contribute more to debt reduction by achieving primary surpluses.

Therefore, in the context of the upcoming reform of the fiscal rules, regardless of the direction it may take, Greece should put particular emphasis on reducing public debt through sustainable budget surpluses in order to make it less vulnerable to future crises. The favourable economic environment in the post-pandemic period makes fiscal adjustment easier, while preserving its countercyclicality and strengthening fiscal credibility.

26 The size of government debt algebraically amplifies the impact of the difference between the implicit nominal interest rate and the nominal GDP growth rate.
27 The output gap in the economy, i.e. the difference between actual and potential output, is estimated to be positive over the 10-year projection period.
28 The criteria for annual gross financing needs were also confirmed in the Eurogroup statement on Greece of 22 June 2018.

6 THE APPLICATION OF THE CURRENT DEBT RULE IN GREECE AND COMPARISON WITH OTHER HIGH-DEBT EURO AREA COUNTRIES[29]

According to the baseline scenario of the Bank of Greece's Debt Sustainability Analysis, which assumes a primary surplus of 2.2% of GDP on average over the period 2023-60 according to the Eurogroup decisions of June 2018,[30] the average annual rate of public debt reduction (Δdebt) is around 6.6 p.p. of GDP in 2023-30 (see Chart 4). When comparing the respective variables for other high-debt euro area countries,[31] we observe that for 2023-30 the average annual rate of public debt reduction in Greece is much higher than that in the other countries, with a much larger positive contribution from both the broader macroeconomic environment and budgetary surpluses. According to Bank of Greece long-term projections, the rate of reduction in the Greek debt ratio gradually decelerates over the coming decades. However, the share of the fiscal balance in downward debt dynamics gradually increases, as the contribution of the snowball effect is fading. This means that, from 2030 onwards, although debt will decrease as a percentage of GDP, its downward dynamics will increasingly rely on the build-up of fiscal surpluses.

The implementation of the current debt rule (60, 1/20 hereinafter)[32] in high-debt euro area countries implies a strengthening of downward debt dynamics, increasing the requirements for fiscal primary surpluses for all countries except Greece. According to the baseline assumptions, Greece will comply with the current debt rule until 2060. However, under all alternative scenarios (most notably, under Scenario 3), Greece fails to comply with the current SGP debt rule after 2030, therefore implying the need to create fiscal buffers in order to account for such risks (see Chart 5). The required primary surpluses come to around 2.2% of GDP on average annually,[33] exceeding the required fiscal target implied by the debt rule (60, 1/20) by almost 0.8 p.p. of GDP, in order to address possible adverse fiscal shock scenarios (see Chart 6). Gross financing needs remain manageable, below the 15% of GDP benchmark, under the baseline scenario. Nevertheless, possible adverse economic shocks could risk breaching the agreed threshold after 2030 (see Chart 7).

On the other hand, the application of the current debt rule is likely to lead to significant fiscal adjustment needs for countries such as Spain, Italy, France and Belgium, as the primary balance requirement relative to the baseline scenario is significantly higher. This additional fiscal effort for most high-debt countries is attributable to the fact that broad compliance with the structural budget balance rule (which is the baseline assumption in our simulations) assumes the realisation of primary deficits[34], while the contribution of the snowball effect in the annual debt reduction is smaller compared with that for Greece. As a result, the declining trend in their debt trajectories is relatively mild, while many of them do not reach pre-pandemic levels by 2030. It should also be noted that over a long-term horizon, contrary to other high-debt countries, Greece has the most favourable contribution of both structural fiscal position and fiscal savings from past pension and social security reforms, whereas other countries will need structural fiscal efforts in order to account for the long-term ageing costs.

29 The following analysis relies on sovereign debt sustainability analysis models, which are partial equilibrium models and tend to underestimate the interaction between macroeconomic and fiscal variables. However, these models are a key tool for designing fiscal strategies and are widely used by public, private and credit rating agencies to identify and assess macroeconomic and fiscal risks.

30 The analysis takes into account the updated macroeconomic and fiscal assumptions of the Bank of Greece. In particular, the baseline scenario incorporates the impact of the pandemic on fiscal aggregates and economic activity. The general government primary balance is assumed to turn into a surplus in 2023 and come to 2.2% of GDP on average in 2024-60 (assuming broad compliance with the SGP's structural budget balance rule). The real GDP growth rate converges to 1.7% over the long term, incorporating the positive impact of the utilisation of NGEU funds on the potential growth rate of the Greek economy. The refinancing rate is 2.8% on average in 2023-60 and the weighted average maturity of new issues is around 7 years.

31 Comparison is made with Belgium, Spain, Italy, France and Portugal.

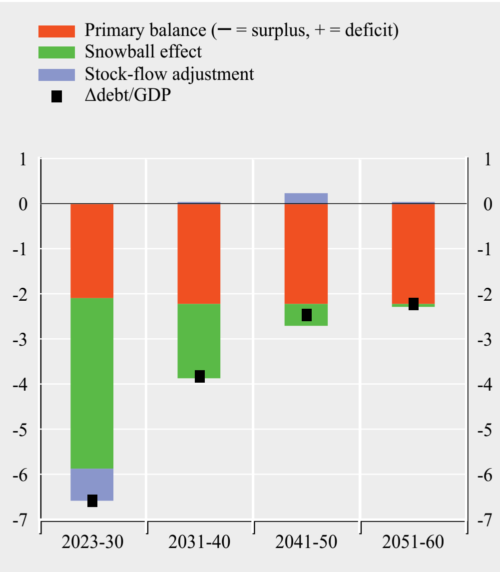
32 For the implementation of the debt rule, the following assumptions are made: The annual rate of reduction in the debt-to-GDP ratio is 1/20 of the distance between the ratio of the previous period and the 60% benchmark level and is revised every three years. By maintaining the baseline assumptions on the snowball effect, we use the debt accumulation accounting equation to calculate the primary surplus requirements to comply with this rule.

33 At the level foreseen in the Eurogroup decisions of June 2018.

34 Or a small balanced primary budget in the case of Italy.

Chart 4 Components of Δdebt/GDP (annual average 2023-60) - Baseline scenario

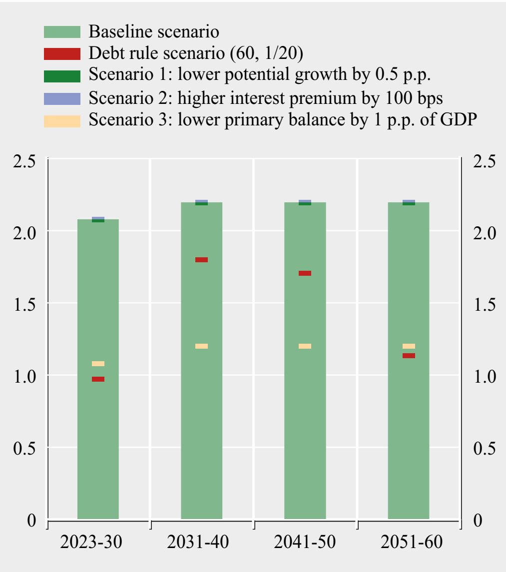
(percentage points of GDP)



Source: Bank of Greece estimates.

Chart 6 Primary surplus (annual average 2023-60) - Baseline and alternative scenarios vs. Debt rule

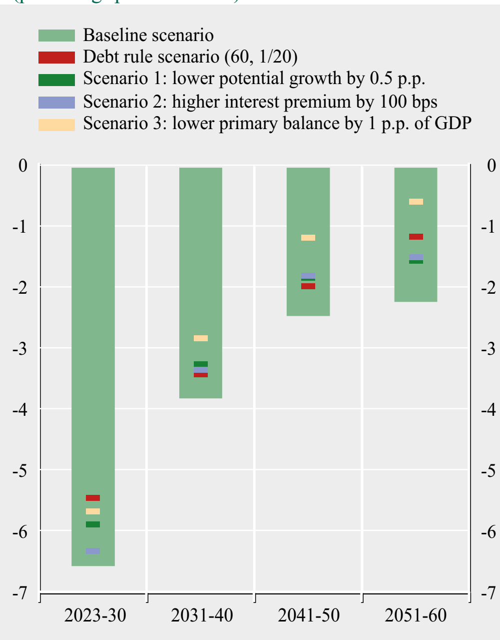
(% of GDP)



Source: Bank of Greece estimates.

Chart 5 Δdebt/GDP (annual average 2023-60) - Baseline and alternative scenarios vs. Debt rule

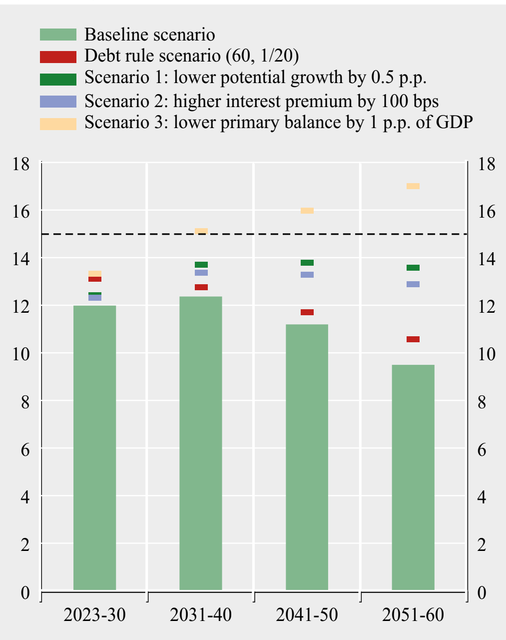
(percentage points of GDP)



Source: Bank of Greece estimates.

Chart 7 Gross financing needs (annual average 2023-60) - Baseline and alternative scenarios vs. Debt rule

(% of GDP)



Source: Bank of Greece estimates.

In conclusion, according to the above analysis, Greece appears to comply with the current debt rule foreseen in the SGP over the medium term. In the long term, however, the country could benefit from any flexibility, following under all circumstances the principle of countercyclicality. Any easing of fiscal targets over the medium term will worsen its debt dynamics, increasing future sustainability risks, gross financing needs and market refinancing risk. By contrast, in the medium term, efforts should be made to strengthen Greece's fiscal credibility by reducing the distance from other euro area countries as quickly as possible. The favourable macroeconomic environment of the next decade would accommodate a further strengthening of fiscal consolidation, provided that the principle of countercyclicality is not breached. On the contrary, over a long-term horizon, when fiscal performance will play a more prominent role in debt-reducing dynamics, Greece could benefit from a possible flexibility of the debt rule to avoid a procyclical fiscal policy.

7 PROPOSED GUIDELINES FOR THE REFORM OF THE EUROPEAN FISCAL RULES

The fiscal footprint of the pandemic crisis and the threat of increased divergence among euro area economies warrant a reform of the European fiscal rules, with debt sustainability as a top priority. The new fiscal framework should aim at increasing the capacity of fiscal policies to stabilise the economic cycle, thereby contributing to monetary policy normalisation. Therefore, the new rules should take into account the new macroeconomic environment and the uncertainties that accompany it, in order to achieve a more effective coordination of national fiscal policies.

The fiscal framework could be revised towards:

(i) Strengthening the countercyclicality of fiscal policy.[35] Retrenchment in good times and expansion in downturns are particularly important for both macroeconomic stabilisation and fiscal sustainability.

(ii) Setting a debt anchor as a medium-term fiscal objective, combined with a single operational expenditure rule: At the current juncture, as shown by the above analysis, ensuring public debt sustainability becomes a key medium- to long-term fiscal policy objective. The operational rule to achieve this objective should be to control the rate of change in government primary expenditure, since it has been regarded as a rule of fiscal discipline that enhances the countercyclicality of fiscal policy and promotes an effective mix of adjustment measures when necessary.[36] However, an expenditure rule alone is not capable of preventing deficits and increases in public debt originating on the revenue side. This is why it should apply alongside other rules (e.g. minimum revenue thresholds) to ensure fiscal discipline.

(iii) Maintaining current benchmark levels,[37] with flexibility in the rate of adjustment where appropriate: Although they seem

35 Larch, M., E. Orseau and W. van der Wielen (2021), "Do EU fiscal rules support or hinder counter-cyclical fiscal policy?", *Journal of International Money and Finance*, 112; Debrun, X., L. Moulin, A. Turrini, J. Ayuso-i-Casals and M. Kumar (2008), "Tied to the mast? The role of national fiscal rules in the European Union", *Economic Policy*, 23, 298-362; and Thygesen, N., R. Beetsma, M. Bordignon, X. Debrun, M. Szczurek, M. Larch, M. Busse, M. Gabrijelcic, L. Jankovics and J. Malzubris (2021), "The EU fiscal framework: A flanking reform is more preferable than quick fixes", *VoxEU.org*.

36 European Fiscal Board (2018), *Annual Report*, and European Fiscal Board (2019), *Assessment of European fiscal rules with a focus on the six and two-pack legislation*. The expenditure rule has also been favoured by other economists in the public debate on the reform of the SGP: Barnes, S. and E. Casey (2019), "Euro area budget rules on spending must avoid the pro-cyclicality trap", *VoxEU.org*; Bénassy-Quéré, A., M. Brunnermeier, H. Enderlein, E. Farhi, M. Fratzscher, C. Fuest, P. Gourinchas, P. Martin, J. Pisani-Ferry, H. Rey, I. Schnabel, N. Véron, B. Weder di Mauro and J. Zettelmeyer (2018), "How to reconcile risk sharing and market discipline in the euro area", *VoxEU.org*; and Darvas, Z., P. Martin and X. Ragot (2018), "The economic case for an expenditure rule in Europe", *VoxEU.org*.

37 Deficit: 3% of GDP, debt: 60% of GDP. Although there are many studies suggesting that there is no single "public debt limit" for all countries beyond which economic growth is slowing, most agree that high debt levels are associated with low growth and increased volatility. For more details, see Caner, M., T. Grennes and F. Koehler-Geib (2010), "Finding the Tipping Point – When Sovereign Debt Turns Bad", World Bank, Policy Research Working Paper No. 5391; and Pescatori, A., D. Sandri and J. Simon (2014), "Debt and Growth: Is There a Magic Threshold?", IMF Working Paper No. 14/34.

outdated in the present economic context, current benchmark levels are enshrined in EU treaties, which are difficult to amend and require broader consensus among Member States and lengthy procedures. The pace of debt reduction is easier to modify, so as to ensure a sustainable downward path through a realistic and credible fiscal adjustment, which would take into account the broader macroeconomic environment and fiscal position of each country, while maintaining the principle of countercyclicality. Changing the reduction rate of public debt would require unanimity on amendments to secondary EU legislation, through a set of agreements among countries.

Changes in the pace of adjustment to the current debt rule could be limited, as its application already assumes a differentiated fiscal path for each country, depending on the different economic conditions and fiscal position of each Member State (heterogeneity across countries).[38] Furthermore, differentiated rules and various exceptions do not help simplify and enhance the credibility of the fiscal framework. Therefore, flexibility should depend on whether the fiscal adjustment required to comply with the debt rule is procyclical.

(iv) Simplification: The structure of the new framework should be simple and transparent. To this end, the new rules should be less dependent on non-observable variables that complicate their comprehension and effective monitoring. The proposed operational expenditure rule relies on the rate of change in potential output, which is less subject to measurement problems.

(v) An effective and reliable mechanism for surveilling the implementation of the new framework: Governments' compliance with the new rules is essential for their sustainable implementation and credibility. Improving the institutional set-up for surveilling compliance with fiscal rules is all the more necessary if more flexibility is granted to take into account country-specific circumstances. It is therefore proposed to strengthen national independent fiscal institutions (e.g. fiscal councils). Alongside the European institutions, national fiscal councils could contribute to better compliance with the rules and to more effective policy surveillance and evaluation, thereby strengthening fiscal credibility and ownership of the new fiscal framework.

(vi) Safeguarding public investment: Given the pressing needs for green and digital transformation of the economies in the coming years, the practice of cutting investment spending as a means of achieving fiscal targets should come to an end.[39] The priority given to public debt reduction as a fiscal policy objective does not allow for investment expenditure financed by new borrowing to be excluded from the new fiscal rules and, in particular, from the debt rule. Targeted investment expenditure could be financed through a system of transfers, which would be financed through the issuance of common European debt by a permanent European mechanism (see below). In any case, excluding various expenditure categories —the classification of which is complex in any event— from the fiscal rules would

38 The smaller the snowball effect, the larger the primary surplus needed to achieve the same debt reduction and thus the need for fiscal adjustment (depending on the fiscal position of each country). Therefore, the primary surplus requirement needed to comply with the current rule in high-debt countries may be lower than in countries with relatively lower debt levels, if the contribution of the snowball effect in the former is significantly higher than in the latter. Therefore, countries with a high debt level do not necessarily require a high primary surplus to comply with this rule. Also, the fiscal adjustment needs of countries with a structural fiscal position in surplus are smaller than those of countries with structural primary deficits. Lastly, when the current debt rule was introduced, it did not aim at the convergence of Member States' debt-to-GDP ratios to 60% of GDP in 20 years (since the adjustment rate is revised every 3 years, depending on the debt level and its distance from the benchmark), but mainly at promoting fiscal adjustment in high-debt countries, ensuring a permanent debt-reducing path and asymptotic convergence to the benchmark.

39 The practice of cutting public investment in the past, with negative effects on economic growth, is not a weakness of the current fiscal rules, but a common policy option for governments that refused to promote structural fiscal measures to achieve the targets.

hamper the simplification and credibility of the fiscal framework.

(vii) The new NGEU instrument should become permanent, so as to function as a central fiscal capacity to increase public investment. By issuing common European debt, the NGEU is instrumental in creating fiscal space and enhancing convergence among European economies, as the high-debt countries benefit more from the available funds. NGEU financial support will help reduce the investment gap and support the growth of European economies in the coming years. Combined with a low interest rate environment in the medium term, NGEU resources will help countries improve their debt dynamics by making the required fiscal adjustment easier.

Therefore, the objective of boosting (green, digital) public investment could be achieved by making the NGEU a permanent central mechanism for fiscal transfers beyond 2026. Although it is still under development, its operational design provides a model for the future of economic governance in the euro area by combining fiscal transfers with fiscal responsibility at a transnational level.[40]

40 As the NGEU is centrally organised, there are fewer incentives to classify all investments as "green" or "digital" in order to be exempt from fiscal rules.