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Towards a new fiscal governance in the eurozone

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It has long been thought that a monetary union can only function well if its governance imposes extra fiscal discipline on the member countries of the union. I argue that the arguments for extra fiscal discipline in a monetary union are weak. The current Stability and Growth Pact (SGP) is broken. It has incredible complexity that has been built in over the years when it became clear that fiscal discipline based on the use of numerical targets does not work. As a result, it has lost credibility as a way to organize fiscal discipline. There is an urgent need of reform of the fiscal rules embedded in the SGP.

In this paper I contribute to the debate by developing the principles that should guide this reform of the fiscal rules in the Eurozone. These principles are that the numerical targets should be replaced by sustainability analyses of each member countries' budget and debt prospects. In addition, I argue that the reforms should prioritize public investments by making it possible for the latter to be financed by issuing debt. Finally, I argue that any fiscal sustainability governance should be integrated with the ECB's policies regarding its holdings of government bonds. Decisions by the ECB to sell or not to sell these bonds affect the sustainability of public debts of the member countries of the union.

1. Introduction

When the Eurozone was created it was thought that a monetary union can only function well if it is embedded in a regulatory system that imposes fiscal discipline on the member countries of the union that goes further than the discipline standalone countries face. In this paper we first review the arguments that were used to justify such fiscal discipline. We will argue that these arguments are weak and that there is no need for extra discipline on member countries of a monetary union. We will then argue that there is a need for reform of this regulatory system of fiscal discipline as embodied in the Stability and Growth Pact (SGP). This analysis is important today as we face the prospect of a restauration of the SGP after the pandemic induced freezing of the SGP. Finally, we discuss the principles that should guide this reform of the fiscal rules in the Eurozone. This will lead us to argue that the excessive reliance on numerical targets (3 %, 60 % balanced budget) is counterproductive, even dangerous. We will propose a system of discipline based on sustainability analysis and on bottom-up approach of governance.

2. Monetary union and fiscal discipline

When the Eurozone was created the general view was that such a monetary union had to include rules disciplining national fiscal authorities. This view gave rise to the Stability and Growth Pact (SGP). Countries joining the Eurozone were required to follow the fiscal rules as set out in the SGP. In a nutshell these rules required the member-states governments to avoid budget deficits exceeding 3 % of GDP, to ensure that the government debt to GDP ratio would not exceed 60 % of GDP and if it did to follow policies aiming at bringing back the debt ratio to the 60 % target (For more detail see De Grauwe (2022)). In addition, the SGP introduced the requirement that the structural government budget be balanced. With structural budget balance is meant that over the business cycle the government budget should be in equilibrium.

These fiscal rules were generally seen as necessary for a well-functioning monetary union, for two reasons. First, it was commonly assumed that a monetary union would

create a bias towards running too high budget deficits. This bias could then lead to a dynamics of unsustainable government debt levels leading to defaults and great financial disturbances. Second, excessive budget deficits and debt levels in some countries would raise the long-term interest rates in the union, thereby creating negative spillover effects on other countries.

Let us turn to these two arguments.

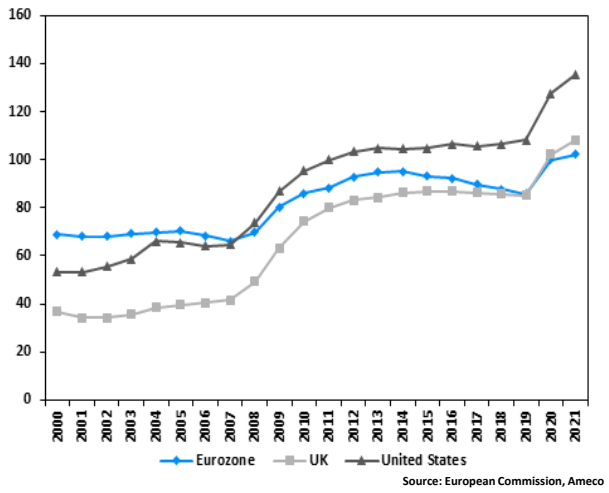
2.1. Does a monetary union lead to less fiscal discipline?

There are two mechanisms in a monetary union that have opposing effects on fiscal discipline in a monetary union. The first one arises from the "common pool problem". The latter refers to the problem of a lake in which property rights are not well defined. This will lead to overfishing as each fisherman has a strong incentive to fish as much fish as possible before the fishing population is depleted. In the end the whole fishing population of the lake disappears. Similarly, the capital market in a monetary union can be seen as a lake to which, thanks to the monetary union, each member country has unlimited access. As a result, these governments have an incentive to borrow as much as possible so that the common interest rate will have to increase as the available pool of savings dries out.

There is a second mechanism, however, which tends to reduce the incentive of member states of a monetary union to run excessive deficits. Countries that join the union issue debt in a currency they have no control over. This eliminates their ability to finance budget deficits by money creation. As a result, the governments of member states of a monetary union face a "harder" budget constraint than sovereign nations that maintain their own currency. The latter are confronted with "softer" budget constraints because they have access to the local national bank, which can be pressurized to alleviate the burden of financing budget deficits. And even if in normal times the government of such a country may not use such pressure, it is more likely to do so in difficult times. The sheer fact that there is a national bank that can be pressurized to finance budget deficits creates incentives for having larger budget deficits.

Which one of the two effects—the common-pool or the no-monetization one—prevails is essentially an empirical question in that it depends on institutional features and on the incentives governments face. Here I provide some preliminary empirical evidence suggesting that the no-monetization constraint has been important in the Eurozone to keep the Eurozone's government debt in check. I do this by comparing the evolution of the debt-to-GDP ratios in the Eurozone, the UK and the USA since 1999. This is shown in Fig. 1.

Figure 1. Government debt in the Eurozone, the USA, and the UK (% of GDP)



Source: European Commission, Ameco

One observes that there is no evidence of a faster increase in the Eurozone government debt ratio as compared with the USA and the UK. On the contrary, since 2000 these ratios have increased significantly faster in the USA and the UK than in the Eurozone. This can be seen from Table 1. We observe that while the debt to GDP ratio of the USA more than doubled and the UK almost tripled, the Eurozone's governments debt-to-GDP ratio increased by only 50 per cent during the existence of the monetary union (2000 to 2021). Thus, the second (no-monetization) effect seems to play a stronger role than common pool effect. The fact that the members of the Eurozone have to issue debt in a "foreign" currency severely restrains their possibilities of financing government debts. Because these member countries of the monetary union are cut off from the possibilities of monetary financing, they face a harder budget constraint than "stand-alone" countries such as the USA and the UK. This effect seems to be stronger than the moral hazard effect that has so much influenced the drafters of the SGP.

Table 1. Increase in debt-to-GDP ratio (2000–21) (in percent)

	Increase (en %)
United States	150%
United Kingdom	192%
Eurozone	50%

Source: European Commission, *Ameco*.

2.2. Spillover effects in a monetary union

As argued earlier the proponents of fiscal rules have based their view on the spillover effects of unsustainable government deficits and debts. The basic insight of this view is that a country that finds itself on an unsustainable path of increasing government debt creates negative spillover effects for the rest of the monetary union. A country that allows its debt–GDP ratio to increase continuously will have increasing recourse to the capital markets of the union, thereby driving the union interest rate upwards. This increase in the union interest rate in turn increases the burden of the government debts of the other countries. If the governments of these countries choose to stabilize their debt–GDP ratios, they will be forced to follow more restrictive fiscal policies. It will therefore be in the interest of these other countries that a control mechanism should exist restricting the size of budget deficits in the member countries.

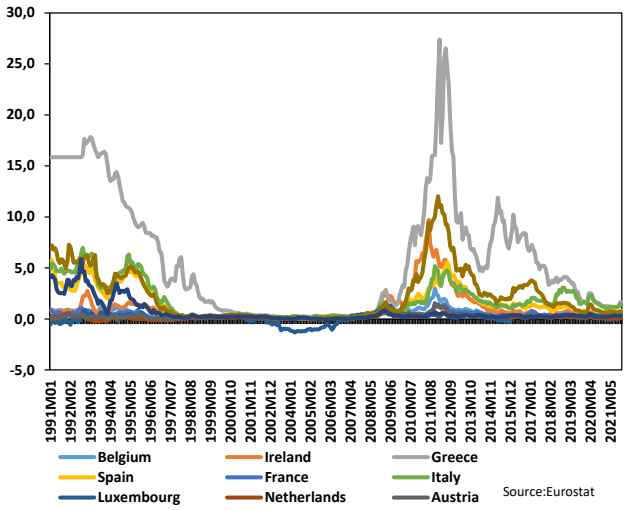
There is a second spillover that may appear here. The upward movement of the union interest rate, following the unsustainable fiscal policies of one member country, is likely to put pressure on the European Central Bank (ECB). Countries that are hurt by the higher union interest rate may pressure the ECB to relax its monetary policy stance. Thus, unsustainable fiscal policies will interfere with the conduct of European monetary policy. Again, it may be in the interest of the members of the union to prevent such a negative spillover from occurring by imposing limits on the size of government budget deficits.

These arguments based on the spillover effects of fiscal policies appear reasonable. They rely, however, on the lack of efficiency of capital markets in the union.

Implicit in the spillover argument, there is an assumption that capital markets do not work properly. In order to see this, let us suppose that capital markets work efficiently, and ask what happens when one country, say Italy, is on an unsustainable debt path. Does it mean that the union interest rate must increase, i.e. that the interest rate to be paid by German, Dutch, or French borrowers equally increases? The answer is negative. If capital markets in the monetary union work efficiently, investors recognize that the debt problem is an Italian problem. The market then attaches a risk premium to Italian government debt, reflecting a higher risk of default. The German government is not affected by this. It is able to borrow at a lower interest rate, because the lenders recognize that the risk inherent in German government bonds is lower than the risk involved in buying Italian government debt instruments. Thus, if the capital markets work efficiently, there are no spillovers. Other governments in the union do not suffer from the existence of a high Italian government debt. In addition, it does not make sense to talk about the union interest rate. If capital markets are efficient there are different interest rates in the union, reflecting different risk premia on the government debt of the union members.

To what extent have financial markets been able to correctly price the different risks of the government bonds in the Eurozone? Fig. 2 allows us to obtain some insights into this question. It presents the spreads of ten-year government bonds of a number of Eurozone countries vis-à-vis Germany from 1991 to 2021 (May). These spreads can be interpreted as additional risk premia for investing in these government bonds rather than in German government bonds. We observe that during the 1990s (the period prior to the Eurozone) these spreads were significant but declining. The most convincing explanation is that during this pre-Eurozone period the devaluation risk (vis-à-vis the German mark) was the most important source of the risk premium. As the start of the Eurozone came nearer, the risk of devaluation declined and so did the risk premium.

Figure 2. Spreads of ten-year government bond rates vis-à-vis Germany (1991-2021)



At the start of the Eurozone in 1999 the devaluation risk disappeared; the spreads dropped to close to zero and remained in that position until 2008. Thus, during this period the financial markets considered that investing in, say, a Greek government bond carried the same risk as investing in a German government bond. This means

that the markets perceived the default risk on Greek government bonds to be the same as on German government bonds. In 2008, perceptions dramatically changed, and spreads increased and reached levels that were higher than during the 1990s. Thus, suddenly, the markets perceived huge default risks on the government bonds of countries such as Ireland, Portugal, Greece and Italy. Suddenly, these spreads declined dramatically again in 2012.

The evidence of Fig. 2 casts doubts on market efficiency. During almost ten years (1999–2008), financial markets did not perceive default risks on the government bonds of "peripheral countries". Then, suddenly, financial markets discovered that the Eurozone is fragile and in a matter of a few weeks started to attach huge risk premia to government bonds of peripheral countries. Put differently, in 1999–2008 financial markets failed to see any differential risks in the Eurozone, and there was basically one long-term bond rate, despite the fact that government deficits and debt levels differed substantially between these countries. In 2008, the markets suddenly saw that the sovereign debt risks were dramatically different within the Eurozone. When the ECB announced its "Outright Monetary Transactions" (OMT) programme in 2012, it took out the fear factor from the market, and, as a result, the spreads declined precipitously, despite the fact that in most of the countries of the periphery the debt-to-GDP ratios continued to increase dramatically.

It remains true, though, that when the interest rates on Greek, Italian, Spanish government bonds increased, this did not affect the risk of German or Dutch government bonds. In fact, the interest rates on the government bonds of Germany and the Netherland declined. The reason was that as investors dumped the Greek, Italian and Spanish bonds they fled to Germany and the Netherlands, considered to be "safe havens" and massively bought the bonds issued by the German and Dutch governments, thereby bidding up their prices and lowering the yields.

Thus, the evidence on spillover effects is mixed. On the one hand, the fact that financial markets appear not to have been efficient could lead to the conclusion that spillover effects are a serious problem. However, the empirical evidence seems to suggest that in times of crises, large differences in yields erupt thereby shielding countries with low solvency risk from the high interest rates produced by countries with high solvency risks.

3. The need for reform of the fiscal rules

National fiscal policies in the EMU must find a balance between two conflicting concerns. The first one has to do with flexibility and is stressed in the theory of optimum currency areas: in the absence of the exchange rate instrument and a centralized European budget, national government budgets are the only available instruments for nation-states to confront asymmetric shocks (see De Grauwe (2022)). Thus, in the EMU, national budgets must continue to play some role as automatic stabilizers when the country is hit by a recession. This has been very clear with the recession that hit the Eurozone countries in 2008. Luckily, the European Commission invoked an escape clause in 2020 during the pandemic thereby setting the fiscal rules aside and allowing the automatic stabilizers in the budget to fulfil their roles of stabilizing the economy.

A second concern relates to the spillover effects of unsustainable national debts and deficits, which were described earlier. Unsustainable debts and deficits in particular countries may harm other member countries and may exert undue pressure on the ECB.

How does the SGP strike a balance between these two concerns? It is clear that the SGP has been guided more by the fear of unsustainable government debts and deficits than by the need for flexibility. As a result, it is fair to say that the SGP is quite unbalanced in stressing the need for strict rules at the expense of flexibility. This creates a risk that the capacity of national budgets to function as automatic stabilizers during recessions will be hampered, thereby intensifying recessions.

The lack of budgetary flexibility to face recessions creates a potential for tensions between national governments and European institutions. When countries are hit by economic hardship, EU institutions are perceived as preventing the alleviation of the hardship of those hit by the recession. Worse, they are seen to be threatening to hand out fines and penalties when countries are struggling with economic problems. This certainly does not promote enthusiasm for European integration. On the contrary, it is likely to intensify Euro-scepticism.

We conclude that the SGP has gone too far in imposing rules on national government budgets. The lack of flexibility of national budgetary policies in the EMU creates risks that may be larger than the risks of default stressed by the proponents of rules. As we argued in the previous section, there is very little evidence that a

monetary union increases fiscal indiscipline compared to a situation without a monetary union (see Eyraud et al. 2017).

The flaws of the SGP we have just described led to serious problems in 2002–04, when major Eurozone countries were hit by an economic downturn. This led to an increase of the budget deficits of France, Germany, Italy, and Portugal. In the name of the SGP, the European Commission insisted that these countries should return to budget balance even in the midst of a declining business cycle. A number of countries, in particular France and Germany, refused to submit their economies to such deflationary policies. The result was an inevitable clash with the European Commission, which, as the guardian of the SGP, felt obliged to start procedures against these countries. The result was very predictable. The Commission had to yield to the unwillingness of these countries to subject their policies and their commitments to the increasing number of unemployed to the rule of the mythical number three. In November 2003, the Council of Ministers abrogated the procedure that the European Commission had started. For all practical purposes, the SGP had become a dead letter.

The recession that started in 2008 and the ensuing increase in government budget deficits and debts started a new phase in the application of the SGP. The provisions of the SGP were tightened up again (see De Grauwe (2022)). Sanctions were made more automatic again, and the European Commission obtained a stronger monitoring power. Whether this tightened-up SGP will be more successful in constraining government budget deficits and debts remains to be seen.

The Covid-19 pandemic in turn led to a suspension of the fiscal rules of the SGP. Happily, the European Commission understood that the severity of the recession brought about by the pandemic risked and implosion of the market systems in many countries without massive spending by the fiscal authorities. When these rules will be reinstated and under what conditions remains unclear, but the European Commission has made it clear that these rules, in whatever form, will have to be re-instituted in the future.

4. How to reform the fiscal rules?[1]

The future restauration of the fiscal rules of the SGP has led to a discussion on whether the same rules will have to apply, or whether these rules should be reformed. It is clear that the reform of the fiscal rules has become inevitable. I will formulate two principles that should guide this reform process:

- No numerical targets any longer
- Priority should be given to public investment both at the EU and national levels

4.1. Numerical targets are a thing of the past

The budgetary governance in the euro area has been based on an enforcement program of numerical targets, like the 3% budget target, the 60% government debt target and the balanced structural budget rule. It is now clear that this approach has not worked well. The reason is very simple. Top-down rules that have no scientific basis will not be followed by elected politicians that are under pressure because the economy experiences a major downturn. Which politician can afford to abide by a holy number 3, or a balanced budget rule, when millions of domestic citizens suffer because of a recession that can be made less severe by trespassing these unintelligent rules? Few will subject their citizens to extra suffering to abide by those non-scientific rules.

In its 20-year existence, the euro area has been hit three times by this painful dilemma. And predictably, three times the rules were set aside. In the periods 2002-04, in 2008-09, and more recently during the pandemic years of 2020-21. Surely, this will happen again, and these rules will be set aside again. As a result, these rules have a very low credibility.

Another constant in this approach to enforce numerical targets is that after each recession when the rules were suspended, they were also changed. It happened in 2003, when they were relaxed, and after the Great Recession of 2008-09 when inexplicably they were tightened up, leading to a second-dip recession in 2011-12. This time, after the pandemic, they are likely to be changed again[2]. Hopefully by ditching the numerical rules. And each time the fiscal rules change they are made more complex. So much that only few persons outside Brussels understand them. This increasing

[1] This section is based on De Grauwe (2021).

[2] In February 2020 the European Commission launched a review of the economic governance framework (see European Commission (2020)).

complexity is built-in into a governance based on numerical targets, as with each negative shock hitting the economy, new exceptions and new rules have to be introduced. In the end, such a governance, like the Soviet system of governance, will collapse under its own weight. It is better not to wait for this to happen and to develop a governance model that ditches the numerical rules.

Our criticism of numerical rules also applies to the expenditure rule made popular by the European Fiscal Board (European Fiscal Board (2018)). This rule would prevent the growth of government spending from exceeding the growth rate of potential output. Such a rule dictates that the ratio of government spending to GDP has to remain constant over the business cycle. There is no good economic argument for fixing this ratio. Some countries have low ratios, others have high ratios. Why would these ratios have to be frozen? There might be good reasons why in some countries this ratio should increase, while in others it should decline. Again, this is an example of imposing a rule that has no scientific basis. As the other rules, also this one will be set aside by rational governments when they come under pressure because of unfavourable economic conditions.

There is now a broad consensus among economists that a new governance of sustainable fiscal policies should be developed without such numerical targets. It is not the intention of this paper to develop a fully worked out proposal of an alternative governance. Many such reform proposals have been made recently (see Beetsma, et al. (2018), Benassy-Quéré, et al. (2018), Blanchard, et al. (2021), Darvas, et al. (2018), Debrun, et al. (2019), Wyplosz (2019)). Instead, I wish to highlight the main principles that should guide this new governance.

The principles that should guide a future reform of the fiscal rules are the following:

- Instead of numerical rules, debt sustainability analysis.
- Instead of top-down, bottom-up governance.

Instead of numerical rules we need debt sustainability analyses

There is a growing consensus that the new governance should be based on long-term sustainability analysis of public debt (see Barnhill and Kopits (2004), European Commission (2014), Debrun *et al.* (2019), Wyplosz (2019)). This is a scientific tool of analysis that projects the future expected (net) debt levels given the current forecasts about interest rates, inflation, GDP growth rates and tax capacity. The net debt levels refer to the fact that in such extrapolation one should also include public assets that contribute to future debt repayment capacity. I will come back to this point.

Such a sustainability analysis will allow policymakers to focus on the things that really matter, instead of focusing on numerical targets for budget deficits and debt levels. The numerical targets are often not necessary to guarantee sustainability. To give an example: when the nominal interest rate is expected to be lower than the growth rate of the economy, the debt to GDP ratio obeys a stable dynamics, i.e. it tends to decline automatically. It is then not necessary to push countries into austerity to achieve a particular numerical target of the debt ratio. Conversely, when the interest rate exceeds the nominal growth of GDP, a government debt ratio of less than 60% will not guarantee debt sustainability. In this sense, the 60% government debt target is not sufficient to guarantee sustainability.

Obviously, since the analysis is based on forecasts of a number of macroeconomic variables, there is a lot of uncertainty involved in this exercise. That is why such a debt sustainability analysis should be seen as a benchmark to which future debt levels should broadly converge. It also implies that debt sustainability should be performed in a stochastic framework (see Barnhill and Kopits (2004), Di Bella (2008) and European Commission (2021a)). In addition, a procedure of "name and shame" should be used to explain, when a divergence occurs, which of the underlying assumptions of the sustainability path is responsible for the deviation.

Such an exercise should and is already performed by the European and by some National Fiscal Boards. It is therefore important to strengthen the mandate and the independence of these institutions.

Instead of a top-down, a bottom-up approach is necessary

The budgetary governance based on numerical rules has been a top-down affair where national governments are monitored by the Council upon proposal by the Commission. This model has an obvious weakness, which can be described as follows. In a democracy, the power to spend and to tax is vested in parliaments ("no taxation without representation"). And these parliaments are accountable to national electorates, which can punish the parliament in the next election. In the euro area, the power to spend and to tax is vested mostly in national parliaments. When, then, a supranational institution tries to override decisions made in these parliaments,

problems are bound to arise. The major one is that this supranational institution (European Commission cum Council and European Council) does not face the political costs of the budgetary rules it tries to enforce. It is the national government and parliament that face these political costs. This disconnect between those who take decisions and those who suffer the political costs of these decisions is the major weakness of the governance of budgetary rules in the euro area.

Put differently, the political legitimacy of spending and taxation today mainly rests with national parliaments. The interference in this decision-making process by an authority that does not have the political legitimacy necessarily leads to conflicts and makes this governance model unsustainable. Note that I am talking of political legitimacy. This is the legitimacy that arises from the fact that those who take decisions are accountable to the electorate and face sanctions by this electorate. This is the case today for national governments and parliaments. It is not the case for the European Commission nor for the Council when they take decisions concerning one particular country.

One may object to this reasoning by pointing out that the Stability and Growth Pact came about because of an international treaty that gave responsibilities to the European Commission, the Council and the European Council. Thus, in a legal sense, these institutions are legitimate. However, they lack the political legitimacy as defined earlier. It is this lack of political legitimacy that makes the EU governance of national government debts and deficits unworkable, and therefore in need of reform.

There are two ways to solve this problem. The first one consists in transferring a significant part of the power to spend and to tax to European institutions, prominent among which must be the European Parliament and a European government that is accountable to the European Parliament. The NextGeneration-EU programme is a first timid step in this direction. Many more steps, however, will have to be taken to achieve a situation where European institutions have obtained a fiscal space that is large enough to matter.

In the meantime, this problem of a lack of political legitimacy can only be overcome by moving to a bottom-up approach. This has also been called a "renationalisation" of the budgetary governance (Wyplosz (2019)). Such a "renationalisation" should go together with giving a greater degree of independence and authority to national fiscal boards. This also implies that these national fiscal boards should have sufficient resources to perform this task. One way to ensure this is for the National Central Banks to transfer part of their profits to the national fiscal board. In this approach, a peer pressure exerted by other institutions such as the European Fiscal Board can be useful (Kopits (2013)).

4.2. Absolute priority to public investment

The necessity to boost public investment is not contested any longer. There was a time when economists were teaching the crowding-out theory of public investment. This postulated that more investment by the government would raise the interest rate and in so doing would reduce private investment. And since private investment was considered to be more productive than public investment, society would lose when governments engaged in public investment.

It is now realised that public investment is key to overcome the environmental problems we face today and to make economic growth sustainable. It is also realised by more and more economists that the crowding out theory is wrong and that instead public and private investment are complementary. Without public investments in collective goods such as infrastructure, power grids, education, fundamental research, etc., the private sector will also lack the incentives to make the necessary investments that will promote sustainable growth (see Mazzucato (2014)). A massive boost in public investment has acquired an existential dimension.

Unfortunately, the fiscal rules in the euro area are obstacles for such a boost in public investment. As is well-known, the SGP requires member countries of the euro area to have balanced budgets (or "close to balance") in structural terms, i.e. balanced (or "close to balanced") government budgets over the business cycle. This implies that public investments cannot be financed by the issue of debt. The same problem applies to the recently proposed expenditure rule that would dictate government spending to remain constant as a percent of GDP over the business cycle. This rule also implies that if governments wish to increase public investment they have to reduce other spending items. Such a constraint makes no economic sense for at least two reasons.

First, for several years, the cost of borrowing for most euro area member countries has been close to zero and for some even negative. It has increased recently, but remains quite low in historical perspective. Surely, one

can find public investments with a rate of return exceeding the low rates of interest paid on the public debt today. As these public investments are key in making economic growth environmentally friendly and thus sustainable, they have an expected return by far exceeding the cost of borrowing. As long as this is the case, no restrictions on borrowing should be imposed. In fact, the only constraint to public investment should be that its expected return exceeds the cost of borrowing.

Another way to put this is the following. When the government makes public investments, it increases both assets and liabilities in its balance sheet. When the expected return to public investment exceeds the cost of borrowing, the value of the public assets (measured by their capacity to generate additional production) increases faster than the value of its liabilities. This implies that these public investments will reduce net-debt of the government in the future. No constraints on such debt-financed public investments should be imposed. A good model for this approach is the Recovery and Resilience Facility embedded in the NextGeneration-EU programme.

This conclusion fits well with our earlier discussion of the necessary reforms of the fiscal rules. We argued that we should move to an analysis of future sustainability of the net debt position of the government. Our discussion now makes clear that lifting the fiscal compact and its requirement of structural balance would actually make it possible to improve the sustainability of public debt. By making debt-financed public investments possible, economic growth could be made more sustainable, thereby generating future tax revenues capable of (more than) servicing the added debt. Thus, the best way to make government debts more sustainable in the euro area would be to abolish the balanced budget rule in the SGP. This rule is the result of poor economic thinking. By constraining public investments, it ensures lower sustainable growth in the future, and therefore lower tax revenues for future governments. In doing so, it actually ensures future debt problems of countries struck in low growth.

There is a second, political economy reason why the (structural) balanced budget rule should be abolished. By forcing politicians to finance public investment through taxation or through spending cuts, it puts all the costs of the public investment on the present generation of voters. These public investments, however, will also generate benefits for future generations. Thus, while the benefits of the public investments are shared by present and future generations, the costs fall squarely on the present generation. This gives the wrong incentives to politicians needing the electoral support of the present generation of voters. They will not be inclined to boost public investment.

Debt-financed public investment is the solution of this political economy problem. It allows the costs of the investment (the interest payments) to be aligned inter-generationally with the benefits of these investments. In doing so, it also gives more incentives to politicians to boost public investments. This requires reliable estimates of the returns of these "public goods" investments and their likely financing costs over time.

To what extent is the obstacle to public investment produced by the fiscal compact resolved by the existence of the NextGeneration-EU programme? The Recovery and Resilience Facility (RRF) in this programme has the capacity to borrow €672 billion and to fund public investments supporting green and digital transitions. Would that not be sufficient to substitute for national debt-financed public investment programmes? The answer is definitely negative. Clearly, the RRF is a significant step forward and it could be a model for the governance of public investment programmes at the national level. Its macroeconomic impact will remain limited, however. On average, the public investments made possible by the RRF will amount to at most 1.1 % of euro area GDP during the period 2021-26. This is significant but hardly sufficient to deal with the challenges we face with climate change and environmental crises.

To trigger a boost in public investment, it will therefore also be necessary to use the national governments' capacities to borrow. In fact, since most of the power to tax is still vested in these national governments, the capacity to borrow of these governments is a multiple of the European Commission's capacity to find "own resources" in the context of the RRF.

Thus, the approach should be two-pronged. The European Commission's capacity to borrow should be used to the maximum. Since this capacity is limited, the national governments' capacity to borrow should be used to the fullest extent possible. It makes no economic sense to allow debt-financed public investments in member countries only through the channel of the European Commission and to leave the much higher capacity to borrow of national governments untapped. The need for public investment has acquired an existential dimension and should override the current dogmas that exist in the European Union.

Therefore, the way forward would be to apply the "golden rule" that has been proposed many times in the past by well-known economists (example: Mario Monti (2014)). The approach consists in dividing the government budget in two parts, a current budget and a capital budget. The structural balanced budget rule could then apply to the current budget; the capital budget would record public investments and could be financed by issuing debt. The overall budget would then be subject to the sustainability analysis described earlier.

It is therefore also clear that this sustainability analysis must also involve an analysis of the selection of public investment projects. These should be productive, i.e. they should increase the future sustainability of economic growth. I am aware that this is not an easy task. But it is not impossible. The proof is that up to now the European Commission has had some success in selecting productive investments presented by national governments in the framework of the NextGeneration-EU. Thus one could envisage that national governments make a selection of public investment projects that they present to the European Commission for approval. The Commission would then analyse the expected future returns of these projects. Once approved, national governments can fund these investments by the issue of government bonds. Or put differently, with the fiat of the European Commission, spending associated with the approved public investment projects can be recorded in the capital budget.

4.3. The governance of the government debt levels cannot be dissociated from the ECB's bond purchasing policies

When the central bank buys government bonds, say in the context of the PEPP, it substitutes interest bearing government bonds for monetary liabilities (money base typically taking the form of bank reserves). At that very moment, the central bank creates "seigniorage". This is the monopoly profit arising from the creation of money. This "seigniorage" is transferred to the national government budget in the following way: the government pays interest to the central bank, which now holds the bonds, but the central bank returns this interest revenue to the government. Thus, when the central bank buys the government bonds, de facto, the government does not have to pay interests any longer on its outstanding bonds held by the central bank. The central bank's purchase of government bonds is therefore equivalent to debt relief granted to the government.

This is also the case within the euro area. As long as the government bonds are on the balance sheet of the ECB, these bonds do not exist anymore from an economic point of view[3]. This is so because, as I just argued, when a government bond is on the central bank's balance sheet, a circular flow of interest payments is organised from the national treasury to the central bank and back to the treasury. So, the burden of the debt for the national government has become zero. The central bank could cancel that debt (i.e. set the value equal to zero), thereby stopping the circular flow of interest payment. This would not make a difference for the burden of the government debt. Put differently, as long as the government bonds are on the balance sheet of the central bank, they do not exist from an economic point of view. They only exist in the world of the accountants.

This has important implications for our discussion of the sustainability of the government debt. The latter cannot be dissociated from the bond purchases effectuated by the ECB. To be more concrete: according to Eurostat, gross government debt in the euro area increased from €10.2 trillion (85.8 % of GDP) in 2019 to €11.3 trillion (100 % of GDP) in 2021; an increase of €1.1 trillion of government debt which occurred mainly during 2020.

It appears that the total purchases of government bonds (APP + PEPP) during 2020 amounted to €0.9 trillion. Thus, while the official statistics record an increase of the euro area gross government debt of €1.1 trillion during 2020, from an economic point of view, the government debt in the euro area has increased only by €0.2 trillion (or 2 % of euro area GDP). €0.9 trillion is now on the balance sheet of the ECB and has ceased to exist. Instead, the ECB has issued €0.9 trillion of monetary liabilities (money base) that has displaced government bonds in the portfolios of private investors, and that can be considered as a "super-safe" asset. This is important because, as a result of the bond buying programme of the ECB, the total stock of government bonds in the portfolios of private investors has barely increased. And, therefore, the sustainability of the government debt has barely been affected by the pandemic.

The "only" issue that remains concerns the future of the bond buying programmes of the ECB. Will the ECB keep

[3] Note that in the euro area each national central bank (NCB) purchases the bonds issued by its national government and puts these on its balance sheet. Thus, technically the government bonds bought in the context of PEPP are on the balance sheets of the NCBs of the euro area.

the government bonds on its balance sheet forever? In that case, it will have to buy new bonds in the markets when the old bonds mature. Or will it want to wind these down, e.g. by not replacing the maturing bonds by new purchases? This is a crucial question. For, if the ECB chooses the latter strategy, the national governments will have to issue new bonds to rollover the old ones. In other words, the government bonds that were on the balance sheet of the ECB reappear as liabilities of the national governments and the government debt increases again. If, however, the ECB keeps the amount of government bonds on its balance sheet unchanged, then the debt relief that the ECB initiated when it bought government bonds will be permanent.

It is not entirely clear what the intentions of the ECB are. When the ECB started its QE-programme, it announced that it would keep the stock of the government bonds on its balance sheet unchanged by buying new bonds when the old ones come to maturity. It is unclear how long it will keep this commitment.

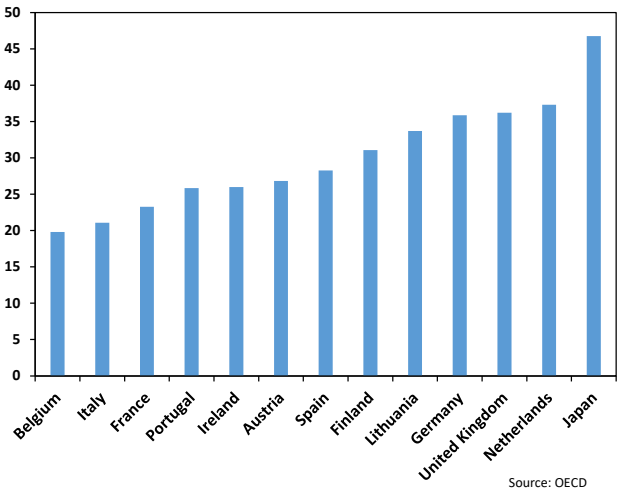
The ECB certainly could keep these bonds on its balance sheet indefinitely. When as today, it is compelled to fight inflation, it could do this by raising the interest rate without selling government bonds. It could also raise the minimum reserve requirement that banks are subjected to. The ECB made it clear that if inflation increases permanently it will reduce the amount of government bonds on its balance sheet. In fact there is no need to do so. The ECB can combat inflation by raising the interest rate (and possibly minimum reserve requirements) without having to dispose of government bonds on its balance sheet.

It is sometimes argued that since the central bank remunerates bank reserves, the increase in the interest rate to fight inflation would force the central bank to pay a higher interest rate on these bank reserves. As a result, the central bank would make less profit (seigniorage) to be returned to the government. Thus, government would lose revenue. What it gains by the fact that the bonds are on the central bank's balance sheet, it loses by the fact that it gets less revenue from the central bank.

In this reasoning, there is no fundamental difference between government bonds and the money issued by the central bank (the liabilities of the central bank). Both are remunerated and thus if one substitutes the other (e.g less bonds and more money base) it does not make a difference for the government budget.

This reasoning takes it for granted that the central bank has to remunerate bank reserves. Nothing could be further from the truth. In the old days, these liabilities of the central bank were not remunerated. For about 10 years, however, central banks have fallen victim to the lobbying by the banks and have started to remunerate these banks reserves. Nothing in the statutes of the central banks forces them to do so, and they could quickly reverse this policy. In fact, for a couple of years major central banks, including the ECB, apply negative interest rates on these bank reserves, indicating how easy it is to reverse the remuneration policies.

Figure 3. Percent outstanding government debt held by central bank



Source: OECD

The point here is that any analysis of the sustainability of the government debt should be done together with an analysis of the bond purchase programme of the ECB, present and future. It makes a big difference to know how much of these government bonds will be kept on the ECB's balance sheet to decide how sustainable government debts are. This is also illustrated by the Japanese experience. The official Japanese government debt has been extremely high in the last 20 years, exceeding 200 % today. A large part of this debt, however, has been held by the Bank of Japan for a long time. It looks like the Bank of Japan does not have intentions to reduce its government bond holdings significantly. As a result, the high official Japanese government debt looks unsustainable, but in fact is very much sustainable because almost half of this debt is held by the Bank of Japan and therefore has ceased to exist from an economic point of view (see Figure 3). This figure also shows that the amount of government bonds held by other central banks, although less important than in Japan, is also significant. My forecast is that the ECB, like the Bank of Japan, will want to hold significant amounts of government bonds on its balance sheet for a long time. And this will not endanger price stability.

5. Conclusion

It has long been thought that a monetary union can only function well if its governance imposes sufficient fiscal discipline on the member countries of the union, i.e. a degree of discipline that goes further than the discipline standalone countries face. In this paper I challenged this view. I argued that the arguments for extra fiscal discipline in a monetary union is weak. This does not mean of course that there is no need for fiscal discipline. It means that there is no need for more intense fiscal discipline on countries of a monetary union compared to countries not in a monetary union.

The current SGP is broken. It has incredible complexity that has been built in over the years when it became clear that fiscal discipline based on the use of numerical targets does not work. As a result, it has lost credibility as a way to organize fiscal discipline. There is an urgent need for reform of the fiscal rules embedded in the SGP. This reform is important today as we face the prospect of a restauration of the SGP after the pandemic induced freezing of the SGP. It would be a tragedy if the Eurozone policymakers were to just re-install a broken system.

The major contribution of this paper lies in developing the principles that should guide this reform of the fiscal rules in the Eurozone. These principles are that the numerical targets (3 %, 60 % balanced budget) should be ditched and should be replaced by sustainability analyses of each member countries' budget and debt prospects. This is a difficult exercise that does not lead to the same clear-cut recommendations that are present in a numerical targets approach. But it is the only approach that is workable. In addition, I argued that the reforms should prioritize public investments by making it possible for the latter to be financed by issuing debt. Finally, I argued that any fiscal sustainability governance should be integrated with the ECB's policies regarding its holdings of government bond, for the simple reason that these bonds held by the ECB do not exist in an economic sense. Decisions by the ECB to sell or not to sell these bonds affect the sustainability of public debts of the member countries of the union.

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