PIIE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM TO

THE EUROPEAN COMMISSION ON REFORMING EUROPE'S ECONOMIC POLICY TO HANDLE PANDEMIC SHOCK

To: The European Commissioner for Economic and Financial Affairs
From: Ángel Ubide
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Background: The overriding objective of the European Commissioner for Economic and Financial Affairs must be to avoid permanent economic consequences from the pandemic shock. This goal entails unambiguously supporting the efforts of EU member states to maintain an expansionary fiscal policy at least until the 2019 level of GDP is restored, while ensuring that the economic policies adopted to cushion the shock do not widen intra–euro area economic divergences. As the shock fades, it is paramount that the commissioner lead the reform to strengthen the economic policy framework in order to better meet the needs of the European economy in the current context of low growth, inflation, and interest rates.

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KEY PRIORITIES

a. Reform the Stability and Growth Pact (SGP) to adapt to the reality of persistent low r and low inflation*

The secular decline in neutral interest rates and very low levels of inflation have left fiscal policy as the main macroeconomic policy tool to respond to recessions. Therefore, "sound fiscal policy" is no longer equivalent to deficit reduction: Deficits and debt ratios now have to be instruments, not objectives, of policy. Furthermore, deficits and debt ratios have increased as a result of the necessary fiscal expansion required to successfully manage the COVID-19 shock. The combination of these two factors make the Stability and Growth Pact targets set before 1999 obsolete in two senses: The SGP targets of 3 percent deficit and 60 percent debt-to-GDP ratio have become unrealistic, and the focus on debt and deficit levels, rather than on the uses of fiscal policy, is counterproductive. Therefore, the Stability and Growth Pact must refocus the assessment and design of fiscal policies on three new objectives: (1) avoiding past errors of premature tightening and instead supporting the European Central Bank's efforts to reduce unemployment and increase inflation to its target; (2) improving *the quality* of fiscal policies, instead of prioritizing the reduction of deficits at all costs; and (3) protecting public investment by developing fiscal golden rules.

b. Successfully deploy the Recovery and Resilience Facility

The Recovery and Resilience Facility, and the associated Recovery and Resilience Plans, provide unique opportunities to improve the growth potential of European economies, in addition to fostering the EU objectives of enhancing economic fairness and mitigating the impact of climate change. These tools allow the Commission to demonstrate the power of common fiscal efforts in Europe. These plans involve a large deployment of resources, which must achieve the right combination of near-term demand support and long-term productivity growth increases. The Commission must carefully manage these plans to avoid a deployment that is misguided by an excessive focus on spending too fast on projects that might be suboptimal or face capacity constraints. Countries should also be able to keep the option to request the loans at a later stage as needed, and the European Central Bank should stay away from pushing for a full take-up of loans at the outset.

c. Develop the European Union's own resources

The European Council decision to launch the Next Generation EU (NGEU) program included a request to the European Commission to present proposals for new EU own resources that could be used to repay NGEU borrowing. These new resources—for example, creating an EU tranche of the value-added tax—will stabilize the European Union's borrowing ability and allow it to create revenues better suited to tax bases that are mobile or pan-European. A better revenue base should also correct the current political distortion whereby countries try to minimize their contributions to the European Union's resources without internalizing the spillback benefits of the spending programs that they finance.

d. Build a euro area safe asset

The debt issuance associated with the Recovery Fund, combined with new EU own resources, set the stage for the creation of a true euro area safe asset. Making this new asset succeed at scale will reduce the cost of capital for European households and businesses and boost potential growth. This safe asset is also a necessary condition for completing the European banking and capital markets union and for boosting the international role of the euro. The next step should be making the Recovery Fund a permanent facility and catalyzing the creation of an EU debt management office.

KEY PAST PRIORITIES THAT SHOULD BE ABANDONED

The European Union should abandon the excessive focus on "risk reduction" that has been so detrimental to growth in the past decade. The endless debates on reducing sovereign exposures and debt restructuring mechanisms have kept financial conditions excessively tight over the last decade and diverted attention from the key priority of creating a euro area safe asset.

KEY PRIORITIES THAT HAVE BEEN IGNORED AND SHOULD NOW BE PURSUED

a. Develop a euro area countercyclical fiscal capacity

The economic architecture of the euro area is incomplete, as it lacks an instrument to achieve the optimal fiscal stance for the euro area as a whole. The Stability and Growth Pact is asymmetric, with detailed mechanisms to force countries to tighten fiscal policies but a complete lack of mechanisms to force them to loosen fiscal policies. Developing a euro area fiscal capacity should become a priority, especially in an environment where fiscal policy must be the leading economic policy for aggregate demand management. For example, some of the new EU own resources could become tools for countercyclical stabilization.

b. Boost the international role of the euro

The euro area accounts for about a third of global GDP, and yet the euro is a much smaller share of global foreign exchange reserves and international transactions. Developing the international role of the euro, for which the creation of a euro area safe asset is a necessary condition, is a priority that would have large positive economic and geopolitical benefits for the European Union, including sharing the low financing costs generated by the US dollar's so-called exorbitant privilege and boosting the effectiveness and reach of the euro's global payment system.