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When and how to deactivate the SGP general escape clause?

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Abstract

This paper provides a framework for considering when and how to deactivate the general escape clause of the Stability and Growth Pact (SGP). That framework takes into account the goals of the SGP, the desire to avoid pro-cyclical policy influences that might stifle Europe's economic recovery, and the necessity not to endanger fiscal sustainability in the medium term. The framework also considers the variation in performance across countries and the indicators that might be used to map transitional arrangements.

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CONTENTS

LIST OF ABBREVIATIONS

ECB	European Central Bank
GDP	Gross domestic product
Ecofin	Council of Economic and Finance Ministers
SGP	Stability and Growth Pact

LIST OF TABLES

EXECUTIVE SUMMARY

Background

On 23 March 2020, the Council of Economic and Finance Ministers activated the 'general escape clause' in the Stability and Growth Pact. In doing so, they afforded the European Commission greater flexibility in interpreting the procedures for fiscal surveillance, particularly as these apply to fiscal consolidation and the achievement of medium-term objectives by the governments of the Member States.[1] This provision made it possible for Member State governments to respond more effectively to the economic consequences of the COVID-19 pandemic. At the same time, however, this greater flexibility in interpretation of the procedures raised questions about how the European Commission could ensure the '*medium term financial sustainability*' that the general escape clause requires.

The European Fiscal Board deliberated over the summer as to when and how the general escape clause should be deactivated so that the current fiscal stimulus could be progressively withdrawn and governments could again turn their attention to medium-term sustainability considerations. What the Board realized is that the general escape clause lacks a sunset provision; indeed, while there are indicators for the onset of a severe economic downturn, there are no set indicators for when a severe economic downturn ceases to exist.

The purpose of this briefing note is to suggest ways to fill that gap in the macroeconomic policy framework. In general terms, the briefing note considers when and how the general escape clause can be deactivated. In more specific terms, the briefing has four objectives:

Aim

- The first is to establish a general principle for considering when a severe economic downturn would cease to exist;
- The second is to suggest how the active use of monetary and fiscal policy instruments might influence the debate about deactivating the general escape clause given the progressive distortions they create;
- The third is to examine the variation in performance across Member States as a possible justification for replacing the general escape clause with the unusual circumstances clause as the justification for more targeted flexibility in fiscal surveillance; and,
- The fourth is to outline potential transitionary arrangements that could be used to move from the activation of the general escape clause back to the normal application of the preventive and corrective arms of the Stability and Growth Pact.

[1] The European Commission already has 'flexibility' to interpret the SGP without changing the rules and with respect to the categorization of state expenditures, the pattern of structural reforms, and the state of the business cycle. See, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0012&from=EN. The general escape clause enhances that flexibility.

1. INTRODUCTION

KEY FINDINGS

The activation of the general escape clause rested on the identification of a severe economic downturn affecting the euro area or Union as a whole. The deactivation relies on a deeper understanding of the causal mechanism at work behind the crisis. A pandemic-induced downturn will only end once the contagion is eliminated or society adapts to the new circumstances. This implies a period of flexibility that is longer than may be optimal to ensure fiscal sustainability. Therefore, it may be necessary to deactivate the general escape clause and rely on the flexibility available under the unusual circumstances clause to create transitionary arrangements for individual countries. Such arrangements would mitigate the distortions created by fiscal and monetary policy while at the same time responding effectively to the variation in experiences across Member States in response to the pandemic.

The purpose of this briefing is to provide a framework to discuss when and how to deactivate the general escape clause of the Stability and Growth Pact (SGP) with the goal of ensuring that the Member States maintain 'the medium-term budgetary objective of positions close to balance or in surplus … and take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes' (European Council 1997).[2]

The general escape clause provides for additional flexibility in the application of both the '*preventive*' (Council Regulation 1466/97 as amended)[3] and the '*corrective*' (Council Regulation 1467/97 as amended)[4] arms of the SGP in '*periods of severe economic downturn for the euro area or the Union as a whole*'. This additional flexibility with respect to deviations in Member State fiscal policy is permissible '*provided that this does not endanger fiscal sustainability in the medium term*.'

The challenge, as noted by the European Fiscal Board (2020a: 3, 6),[5] is that this general escape '*clause does not contain a sunset provision*' and there is no '*common understanding on when and how the clause should be reviewed*'. Any discussion of deactivating the clause should ensure that policies undertaken are consistent with the goals of the SGP in terms of both stability and growth, and that they avoid having a pro-cyclical impact on macroeconomic performance. Such policies should rest on indicators used by the European Commission in its application of the SGP, including those identified under its flexibility provisions, and they should be reactive to officially notified and forecast data. These assumptions are built into the analysis presented here.

The question is whether a discussion of deactivating the general escape clause should take into consideration possible transitionary arrangements. Such arrangements would rest on the divergence in macroeconomic performance across Member States noted by the European Fiscal Board (2020a: 5, Graph 1.9); they would necessarily also take into account both the increase and the divergence in debt and deficit levels that have emerged as a result of the crisis. This is possible under existing legislation. Both the preventive and the corrective arms of the SGP make provision for additional flexibility in the

[2] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31997Y0802(01)&from=EN

[3] https://eur-lex.europa.eu/legal-content/GA/TXT/?uri=CELEX:31997R1466, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32011R1175

[4] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A31997R1467, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32011R1177

[5] https://ec.europa.eu/info/sites/info/files/2020_06_25_efb_assessment_of_euro_area_fiscal_stance_en.pdf

situation where '*an unusual event outside of the control of the Member State concerned … has a major impact on the financial position of the general government*'.

If the Commission and the Council were to provide for transitionary arrangements, it would be relevant to discuss what measures they would recommend that the Member States adopt to correct excessive deficits or to update medium-term objectives. It would also be important to identify which factors are most relevant to consider in framing those recommendations. To reiterate, the goal is to ensure that corrective policy action following the deactivation of the general escape clause does not have a pro-cyclical influence that could slow down or undermine efforts to recover from the current crisis and so worsen rather than improving the prospects for fiscal sustainability over the medium term.

This briefing has five elements, numbered 2 to 6. Part 2 is an overview of the '*severe economic downturn*' that justified the activation of the general escape clause. This overview is important to interpret when the downturn is coming to an end, taking with it the justification for general flexibility in the application of the preventive and corrective arms of the SGP. Part 3 looks at the policy response to the crisis to consider how much it is possible to mitigate the economic downturn through the use of available fiscal and monetary instruments. Part 4 focuses on the divergence in macroeconomic performance across Member States and the implications of that divergence for the financial position of the general governments. Part 5 outlines those factors that should be taken into account in considering transitionary arrangements, including possible country-specific recommendations. Part 6 concludes with implications for a more general understanding of the terms under which the deactivation of the general escape clause might take place in the context of future severe economic downturns for the euro area or the Union as a whole.

2. SEVERE ECONOMIC DOWNTURN

The wording of the general escape clause positions the '*severe economic downturn*' that justifies additional flexibility in the pattern of macroeconomic policy coordination as an exogenous shock. That positioning is different from the '*unusual event provision*' that makes it possible for the European Commission to deal more flexibly with individual Member States. The Commission made this distinction explicitly in the communication recommending that the Council activates the general escape clause.[6] For its part, the Council of Economic and Finance Ministers (Ecofin Council) acknowledged that '*the COVID-19 pandemic has led to a major economic shock*' but then goes on to explain that it is the existence of '*a severe economic downturn*' that constitutes '*the conditions for the use of the general escape clause of the EU fiscal framework*'.[7]

This characterization of the severe economic downturn as an exogenous shock explains why there is no common understanding of how and when the Commission should review the activation of the general escape clause. Severe economic downturns have different dynamics depending upon the causal mechanisms that underpin them. Economic crises driven by demand shocks follow different patterns from those that originate in shocks to the supply side of the economy; financial crises follow different patterns as well. These patterns involve different movements in macroeconomic indicators: demand shocks tend to express a trade-off between inflation and unemployment; supply shocks can see inflation and unemployment increase at the same time; financial shocks have unemployment rise and prices fall but without a trade-off between the two variables. The patterns also have different durations: demand shocks tend to be short-lived; both supply shocks and financial shocks tend to have a more lasting impact.

The implication is that not all severe economic downturns are the same. Therefore, the first step in assessing when to review the activation of the general escape clause is to identify the causal mechanism behind the severe economic downturn in order to anticipate both how that downturn will be reflected in macroeconomic indicators and how long that severe economic downturn is likely to endure. This is why the Ecofin Council's acknowledgement that the severe economic downturn in Europe originates in the COVID-19 pandemic is important – not for the activation of the general escape clause, but for its deactivation.

The pattern for pandemic-induced economic downturns is unlike that for economic downturns that originate in demand shocks, supply shocks, or financial crises. As we are learning through the experience of the current crisis, a pandemic-induced severe economic downturn has four features that differentiate it from downturns with demand, supply, or financial origins:

- to begin with, policies introduced to mitigate and manage the public health crisis – social distancing, contact tracing, quarantine, travel restrictions, sanitary requirements, etc. – are the source of the negative economic shock;
- on the demand side, uncertainty about the progress of the pandemic and the pattern of the public health responses exacerbate the impact of the shock on both consumption and investment;
- on the supply side, variations in the spread of the virus and in the measures adopted by governments (or their institutions) for public health reasons across jurisdictions disrupt patterns of trade and manufacturing; and,

[6] https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1591119459569&uri=CELEX:52020DC0123

[7] https://www.consilium.europa.eu/en/press/press-releases/2020/03/23/statement-of-eu-ministers-of-finance-on-the-stability-and-growth-pact-in-light-of-the-covid-19-crisis/

- on the financial side, banks face the prospect that non-performing assets will accumulate over time and as the demand and supply consequences intensify, with implications for capital requirements and credit standards that add to the severity of the economic downturn.

These characteristics of a pandemic-induced severe economic downturn have three important implications. First, they explain both the suddenness and the depth of the economic contraction, as political authorities apply measures to respond to the public health concerns raised by the pandemic. In the second quarter of 2020, gross domestic product contracted by almost 12 percent and employment fell by almost 3 percentage points across the euro area.[8] Second, they explain the halting and uneven nature of the recovery in those jurisdictions that fail to contain the rate of infection or that are subject to multiple waves of contagion. The European Central Bank (ECB) highlighted this unevenness in its forecast for third-quarter performance.[9] Third, they explain how the economic scarring of the crisis tends to worsen with any prolongation of the pandemic as the consequences of public health measures, loss of consumer and business confidence, and trade or manufacturing disruption, undermine the balance sheets of otherwise productive firms. For this point, it is worth exploring the ECB projections in greater detail.[10]

The characteristics of a pandemic-induced severe economic downturn also explain a fifth distinguishing feature. Demand shocks end when demand recovers, or relative prices adjust. Supply shocks end when firms and governments undertake necessary structural reforms. Financial shocks end when governments restore confidence in banks and other financial institutions. Pandemic-induced severe economic downturns end when governments successfully contain the spread of disease or when business and society adapt to widespread contagion. In this sense, the time to review the activation of the general escape clause should be tied to the causal mechanism underlying the economic shock; the first question for consideration is whether whatever caused the shock is eliminated, contained, or mitigated.

[8] https://ec.europa.eu/eurostat/documents/2995521/10545471/2-08092020-AP-EN.pdf/43764613-3547-2e40-7a24-d20c30a20f64
[9] https://www.ecb.europa.eu/press/blog/date/2020/html/ecb.blog200911~9864e7ae6d.en.html
[10] https://www.ecb.europa.eu/pub/projections/html/ecb.projections202009_ecbstaff~0940bca288.en.html#toc3

3. POLICY REMEDIES

Macroeconomic responses to the crisis play an important role in mitigating the effects of public health measures on economic performance. At the same time, however, these monetary and fiscal policy responses create distortions both in terms of relative prices, particularly in asset markets, and on public and private sector balance sheets. Monetary and fiscal policies also create a form of dependence that makes them easier to introduce than to unwind without damaging economic performance. This dependence raises the prospect that appropriate consideration of the end of any severe economic downturn may rest on whether the recovery can hold its momentum without continuous policy support. Such consideration is not unprecedented. For example, the ECB defines price stability as being free from monetary accommodation (Jones 2019: 78).[11] Prices are not stable until market expectations for future price inflation can stand on their own. Nevertheless, consideration of the interaction between the macroeconomic policy stance and the pace of the recovery from the severe economic downturn threatens to complicate any debate about deactivating the general escape clause.

The impact of fiscal supports is easiest to evaluate. Member State governments have introduced a range of measures to subsidize employment or unemployment, incentivize investment, forgive or defer tax payments and social security contributions, and underwrite access to credit.[12] Such measures have either immediate (subsidies, tax forgiveness and deferrals) or delayed (incentives, deferrals, underwriting) consequences for government finances. Their primary function is to blunt the initial impact of public health measures on household or firm income and therefore economic performance. Moreover, some of these measures have implications that can be precisely estimated while others are only contingent. Governments can plan to finance income support measures, for example. They can only estimate how much they will eventually have to cover in terms of credit guarantees.

The dependencies created by these fiscal measures emerge only over time. For the economy, these distortions arise when the crisis extends beyond the period of subsidy, forgiveness, or deferral. As these programs run out, their withdrawal constitutes a negative income shock for actors in the private sector. The best illustration comes from the United States and not Europe; the expiry of weekly federal unemployment benefits in July 2020 pulled down household incomes dramatically and put downward pressure on household consumption, slowing the recovery of the economy (Casselman 2020, Davidson 2020).[13] Avoiding this kind of situation has been a major concern in Europe for policy makers at all levels of government.

For the financial system, the dependency arises from credit guarantees. Such arrangements not only make it easier for banks to extend credit to the private sector, but they also make it easier for banks to roll over credit relationships that already exist with firms that were profitable prior to the pandemic. Of course, not all the risk associated with these loans is transferred to the government; banks usually keep a percentage of the exposure on their own balance sheets. But enough risk is transferred to hold down credit requirements and thus to ensure that viable firms retain access to liquidity. Again, the problem arises as the crisis drags on and otherwise profitable firms find themselves facing increasing indebtedness to cover fixed costs. Such indebtedness only increases as subsidies and tax forgiveness run off, or as deferred taxes come due. At some point, the firms are no longer viable – and neither are the loans they took out to stay in business. As for the lending side, exposure to non-performing assets becomes a drag on bank capital and a liability for government accounts.

[11] http://www.sefofuncas.com/pdf/jones_8.1.pdf

[12] https://ec.europa.eu/info/sites/info/files/coronovirus_policy_measures_12_october.pdf

[13] https://www.nytimes.com/2020/07/21/business/economy/coronavirus-unemployment-benefits.html, https://www.wsj.com/articles/lapse-in-extra-unemployment-benefits-to-hurt-u-s-recovery-economists-say-11596636000.

Monetary policy and banking supervision can mitigate much of this tension. The ECB Governing Council recognized this potential at the start of the crisis. In early March, the ECB introduced a new pricing structure for targeted long-term refinancing operations to make it profitable for banks to extend credit to non-financial corporations at low rates of interest. ECB prudential and macro-prudential supervisors also made it easier for banks to manage at-risk or non-performing assets by releasing additional capital buffers and by exercising a loose form of regulatory forbearance. Such measures played an important role in expanding access to credit during the initial wave of the pandemic and public health response (Jones 2020).[14] As a result of the mix of policy measures and economic imperatives, the ratio of debt to value added in the private sector grew by 15 percentage points in the first two quarters of 2020.[15]

Monetary policy has blunted the impact of the crisis for sovereigns as well. The expansion of the ECB's public sector purchase program in March 2020, together with the creation and enlargement of a pandemic emergency purchase program in March and June, has helped to hold down sovereign borrowing costs in the face of a rapid increase in public indebtedness (Jones 2020). Moreover, the ECB Governing Council's determination to maintain the public sector purchase program well into the future and to continue making net purchases in the pandemic program at least through June 2021 means that governments are able to borrow at favourable rates across the whole of the maturity structure. This means they can refinance existing obligations alongside new net debt issuance. The savings in debt servicing costs not only make the debt outstanding easier to maintain, but also create more fiscal space for additional subsidies, tax deferrals, and credit guarantees.

A positive description of this arrangement points to the strong synergies between fiscal and monetary policy. A more negative interpretation points to their tight interdependence. Fiscal policy can remain expansionary provided that monetary policy is suitably accommodating; monetary policy remains effective so long as fiscal authorities continue to avoid the 'cliff edge' that will result from an end to fiscal support measures at bay. This explains why the ECB Governing Council talks about running down the stock of assets it has purchased under the pandemic emergency purchase program only long after it ceases to make net purchases; even then, the Governing Council is careful to insist than any run down in the stock of its debt holdings under the program will only take place at a pace and in a manner that can minimize any market distortions.[16]

The longer the severe economic downturn continues, the more difficult it becomes to unwind the fiscal stance, the monetary stance, or the interaction between the two. As a result, there is increasing pressure to start drawing down on the fiscal and monetary policy responses as early as possible. Such concern is evident in the 1 September 2020 speech by Dutch central bank governor Klaas Knot or the 8 October 2020 interview with Bundesbank President Jens Weidmann.[17] In turn, that pressure creates an incentive to anticipate any lifting of the general escape clause in light of the evolution of fiscal and monetary policy over time. Such an incentive is consistent with the requirement that any deviation in fiscal performance from European norms exercised under the general escape clause '*not endanger fiscal sustainability in the medium term*'.

The challenge is to ensure that policy support is not withdrawn before the recovery is able to hold momentum on its own. This challenge is related to the requirement to understand the causal mechanism underlying the severe economic downturn. The balance between the impact of the crisis and the distortions created through fiscal and monetary policy intervention are offsetting.

[14] https://doi.org/10.1080/00396338.2020.1792124

[15] https://www.ecb.europa.eu/pub/economic-bulletin/html/eb202006.en.html#toc7

[16] https://www.ecb.europa.eu/press/pressconf/2020/html/ecb.is200910~5c43e3a591.en.html

[17] https://www.dnb.nl/nieuws/nieuwsoverzicht-en-archief/speeches-2020/dnb389989.jsp, https://www.bundesbank.de/en/press/interviews/weidmann-constitutional-court-hasn-t-given-us-a-free-pass-847110

4. VARIATION IN PERFORMANCE

It may not be necessary to find the right balance across the euro area or the Union as a whole. Indeed, it may be more fruitful to examine the impact of the pandemic on a country-by-country basis. While it is true that the euro area has experienced a severe economic downturn, it is also true that individual Member States have experienced and continue to experience the pandemic as '*an unusual event outside of [their] control*' and which '*has a major impact on the financial position of the general government*'.[18] Such conditions warrant the application of the unusual circumstances clause.

Table 1 provides data for the variation in performance across euro area Member States with reference to four variables: the ratio of public debt to gross domestic product (GDP),[19] the real rate of GDP growth,[20] the unemployment rate,[21] and the rate of inflation in the harmonized index of consumer prices.[22] This data is the most recent available from Eurostat as of mid-October 2020, but is subject to constant revision. What it shows is the dramatic differences across euro area Member States. This illustration is restricted to the euro area for reasons of space, but the same point applies across the Union as a whole.

The data for public debt is best understood as a starting point for analysis. That data reflects the ratio of government debt to GDP in the first quarter of 2020, as the pandemic struck. The data for real growth is for the second quarter, when the effects of the lock down were most pronounced. Looking across these two lines of data, it is possible to suggest that the countries with the weakest fiscal positions in terms of debt-to-GDP ratios – meaning Greece, Italy, Portugal, Belgium, France, and Spain, in order from highest to lowest outstanding public debt – were also the countries that suffered the greatest loss of output in the initial phase of the pandemic – this time running from Spain to France, Italy, Portugal, Greece, and Belgium. Malta was also hard hit in terms of real output.

The argument here is not causal. There is no mechanism linking high levels of public indebtedness to a dramatic loss of output, and some of these Member States made great efforts to blunt the economic impact of the measures introduced to protect the public through the aggressive use of fiscal instruments. The point is only that these countries started out in a weaker fiscal position and then suffered from a greater economic shock. In this sense, the pandemic has been symmetrical, but the initial conditions and the consequences have not.

Labour market conditions reinforce the variation. The data here show only the rate of unemployment in August, five months into the crisis – the data for Greece are from June. What they reveal is the variation in national conditions, with Spain and Greece being at one end of the spectrum while Germany and the Netherlands at the other.

[18] This language can be found in both the preventive and the corrective arms of the SGP. See notes 3 and 4 above.

[19] https://ec.europa.eu/eurostat/documents/2995521/11129607/2-22072020-AP-EN.pdf/ab6cd4ff-ec57-d984-e85a-41a351df1ffd

[20] https://ec.europa.eu/eurostat/documents/2995521/10545471/2-08092020-AP-EN.pdf/43764613-3547-2e40-7a24-d20c30a20f64

[21] https://ec.europa.eu/eurostat/documents/2995521/10663603/3-01102020-AP-EN.pdf/f45c24be-3304-e6b7-80c8-04eae7529519

[22] https://ec.europa.eu/eurostat/documents/2995521/10663702/2-16102020-AP-EN.pdf/24c495e2-62ac-8f65-9e87-47db57cf62f7

Table 1: **Variation in Performance among Euro Area Countries**

	Public Debt / GDP	Real GDP Growth	Unemployment	HICP Inflation
Belgium	104.4	-14.4	5.1	0.5
Germany	61.3	-11.3	4.4	-0.4
Estonia	8.9	-6.5	7.8*	-1.3
Ireland	59.1	-3.7	5.2	-1.2
Greece	176.7	-15.2	18.3**	-2.3
Spain	98.8	-22.1	16.2	-0.6
France	101.2	-18.9	7.5	0.0
Italy	137.6	-17.7	9.7	-1.0
Cyprus	97.7	-11.9	7.4	-1.9
Latvia	37.1	-8.6	8.8	-0.4
Lithuania	33.2	-4.0	9.6	0.6
Luxembourg	22.3		6.8	-0.3
Malta	44.4	-15.2	4.1	0.5
Netherlands	49.5	-9.0	4.6	1.0
Austria	72.8	-12.9	5.0	1.3
Portugal	120.0	-16.3	8.1	-0.8
Slovenia	69.6	-12.9	4.7	-0.7
Slovakia	49.3	-12.2	6.8	1.4
Finland	64.2	-6.3	8.1	0.3

Source: Eurostat. Links in notes to text references for data lines.

Note : Debt to GDP ratio is for 2020:Q1 in percent, GDP growth is change over the previous year for 2020:Q2 in percent, unemployment is percent of active labor force in August 2020, HICP inflation is annualized percentage change in September 2020. * is July 2020; ** is June 2020.

These data also show the success of policy efforts to help firms hold onto workers. Given the impact on output, the consequences for unemployment could be much worse. Here again, the United States provides a good illustration. This is another reason to focus attention on efforts to run down fiscal support mechanisms; without fiscal assistance to firms in exchange for holding onto workers through temporary furlough programs, for example, the impact on unemployment would have been greater.

The data for consumer price inflation shows variation of a different sort. Some of this movement reflects policy decisions that have the effect of lowering prices, like the reduction of value-added taxes in Germany; some also reflects the dramatic changes underway in the price of energy inputs. The point to note here is that negative price movements tend to put upward pressure on the ratio of public debt to gross domestic product; when coupled with negative movements in real growth, that upward pressure is even greater (since nominal GDP is in the denominator of the ratio). Hence negative price movements in countries like Greece, Cyprus, Italy, Portugal, and Spain are worth noting.

The divergences across Member States are likely to widen as the pandemic continues, particularly as Member State governments are forced to engage in a second round of public health interventions to enforce social distancing and restrict freedom of movement. Should the second wave of the pandemic follow a pattern similar to the first one, all Member States will suffer, even those Member States that already have weak conditions in government finances and in terms of employment are likely to be weakened further. The more severe macroeconomic projections provided by the ECB build in extensive scarring in labour and product markets.[23]

Such scarring will not be evenly distributed across Member States. Hence while the impact is likely to weaken the recovery and they may even deepen the economic downturn for the euro area as a whole, the country-by-country effects will warrant particular consideration. By implication, any effort to launch a discussion of deactivating the general escape clause in spring 2021 in anticipation of budgetary planning for 2022 under the European Semester will need to consider transitionary arrangements for one or more Member States under the unusual circumstances clause.

The open questions are about signalling and timing. The signalling question relates to what indicators are appropriate to use in deciding to deactivate the general escape clause and in devising country-specific transitionary arrangements. The timing question concerns whether the movement from the general escape clause to some transitional arrangement would result in a premature withdrawal of fiscal stimulus that could slow down or stall any country-specific recovery.

The main indicator for deactivating the general escape clause is government reliance on temporary fiscal measures as income or credit support for households and firms. Such measures are inconsistent with the normal pattern of fiscal surveillance practiced by the European Commission and derive from the exceptional circumstances created by public response to the novel coronavirus pandemic. So long as Member States continue to rely on these fiscal instruments, they will need the general escape clause to deviate temporarily from the numerical targets for fiscal policy coordination under the SGP.

The challenge arises when one or more Member States approaches the boundaries of medium-term fiscal sustainability. That sustainability is a function of general public debt, public deficits, nominal GDP growth, and nominal interest rates. Relatively large debts and deficits are sustainable provided that nominal GDP growth is high and nominal interest rates are low. When nominal GDP growth is low or nominal interest rates are high, even relatively smaller debts and deficits can give rise to sustainability problems in the medium term.

[23] https://www.ecb.europa.eu/pub/projections/html/ecb.projections202009_ecbstaff~0940bca288.en.html#toc3

Table 2 provides data for debt outstanding at the end of the second quarter of 2020 as a ratio of domestic output and the change in that ratio from the first to the second quarter.[24] The table also provides the (non-seasonally adjusted) deficit to output ratio in the second quarter[25] and the secondary market yield on ten-year bonds as a measure of the long-term nominal interest rate.[26] What the table shows is that the debt ratios are generally high and increasing quickly, particularly in the larger Member States. It also shows that long-term nominal interest rates are exceptionally low. Hence, for example, Greece has a historically high debt-to-GDP ratio and yet faces historically low nominal interest rates.

This combination of factors is a result of the expansive fiscal and monetary policies being deployed during the crisis. So long as those fiscal and monetary policy instruments are deployed in tandem, the results are sustainable. Indeed, the yield on Greek government bonds has declined even as its debt-to-GDP ratio has increased. The same is true for other Member States.

Nevertheless, the combination of high debts and low nominal interest rates is not *prima facie* evidence of medium-term fiscal sustainability. On the contrary, the high (and increasing) debt-to-GDP ratio suggests that the Greek government will have to make great efforts and fiscal adjustment once the shock of the pandemic is past. It also suggests that Greek public finances remain vulnerable to a negative interest rate shock that would result from a withdrawal of monetary stimulus or a loss of credibility in the commitment of the ECB Governing Council to maintain an accommodative monetary policy stance. The same is true in varying degrees for the governments of Italy, Portugal, Spain, Cyprus, Belgium and France. Hence, while the deactivation of the general escape clause should coincide with the end of temporary fiscal measures, the structure of that deactivation and the transitionary arrangements to follow will depend upon the evolution of debt-to-GDP ratios and the requirements for sustained nominal output growth.

Those Member States with high debt-to-GDP ratios need special treatment under the SGP during the crisis. As the data in Table 2 suggest, so do the other Member States. What sets the more highly indebted countries apart is that they are likely to need special treatment once the crisis has passed as well. In its 2020 Annual Report, the European Fiscal Board (2020b: 2) notes that it will be important '*to set realistic targets for debt reduction in Member States far above the 60% reference value*'.[27] Such targets are likely to be substantially lower than the annual reduction of outstanding debt by 1/20th of the difference between the actual debt-to-GDP ratio and the reference value that is required in the current procedures (60% of GDP). This is not an argument for abandoning numerical targets in European fiscal policy coordination; it is an argument for striking a balance between the need for fiscal consolidation and the need to maintain macroeconomic growth both within individual Member States and across the euro area as a whole.

Even the '*realistic targets for debt reduction*' alluded to by the European Fiscal Board will imply a withdrawal of fiscal stimulus for those Member States most at risk of losing medium-term fiscal sustainability. Meanwhile, the Member States with the greatest capacity to use fiscal spending to stimulate European macroeconomic performance are also likely to turn toward fiscal consolidation once the general escape clause is deactivated. Hence the challenge is to find some alternative source of fiscal stimulus in order to maintain an adequately fast pace of nominal output growth to prevent debt-to-GDP ratios from deteriorating even further during the period of post-crisis adjustment. The European Recovery Fund – or Next Generation EU – could fill that gap provided that the deactivation of the general escape clause and the initiation of spending under the European Recovery Fund are well coordinated as part of any transitionary arrangements.

[24] https://ec.europa.eu/eurostat/documents/2995521/11442886/2-22102020-BP-EN.pdf/a21ffbf8-09c9-b520-8fa9-6e804146bf0f
[25] https://ec.europa.eu/eurostat/documents/2995521/11442902/2-22102020-CP-EN.pdf/b7af0afd-d898-c815-9e16-ffc332d66350
[26] https://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/long_term_interest_rates/html/index.en.html
[27] https://ec.europa.eu/info/sites/info/files/efb_annual_report_2020_en_0.pdf

Table 2: **Selected indicators with relevance for Debt Sustainability considerations**

	Public Debt / GDP in Q2 2020	Debt Change since Q1	Deficit / GDP in Q2	10 Year Bond Yield
Belgium	115.3	11.0	10.3	-0.34
Germany	67.4	6.4	7.6	-0.61
Estonia	18.5	9.6	7.3	-0.08
Ireland	63.7	3.8	8.0	-0.22
Greece	187.4	10.5	12.1	0.90
Spain	110.1	11.1	24.6	0.17
France	114.1	12.8	12.3	-0.30
Italy	149.4	11.8	10.3	0.77
Cyprus	113.2	17.1	16.5	0.44
Latvia	42.9	5.9	1.3	-0.23
Lithuania	41.4	8.4	5.7	0.16
Luxembourg	23.8	1.6	6.5	-0.54
Malta	51.1	7.1	13.9	0.38
Netherlands	55.2	5.7	12.5	-0.53
Austria	82.6	9.5	16.8	-0.40
Portugal	126.1	6.6	10.5	0.18
Slovenia	78.2	9.3	16.1	-0.13
Slovakia	60.2	10.6	7.3	-0.35
Finland	68.7	4.4	6.3	-0.38

Source: Eurostat for debts and deficits ; ECB for bond yields. Links in notes to text references for data lines.

Note : Debt to GDP ratio, change in the ratio, and deficit ratio are all percent of GDP. Deficit data is not seasonally adjusted. Bond yields are secondary market yields on government bonds with maturities close to ten years.

5. TRANSITIONARY ARRANGEMENTS

The timing for activating any transitionary arrangement would depend upon four factors: the progression of the pandemic (or societal adaptation to the continuing presence of the contagion); the distortions caused by fiscal and monetary efforts to provide mitigation for the economic consequences of policy measures to manage the spread of the virus; the divergence among Member State economies as a result of the economic downturn and despite the macroeconomic policy response; and the introduction of new spending under the European Recovery Program.

The European Commission documents outlining how Next Generation EU would be implemented provide the framework through which such transitionary arrangements could be made.[28] These documents show clear connections between the national recovery and resilience plans and the pattern for macroeconomic policy coordination through the European Semester. The conditionality attached to the Recovery and Resilience Facility also provides a more credible set of incentives for the Member State governments to adhere to their medium-term objectives and to implement country-specific recommendations – including those agreed in 2019, before the onset of the pandemic (Moschella 2020).[29] In this way the application of any transitional arrangement would tie more tightly to the requirement for medium-term financial sustainability than would have been the case under the 'unusual circumstances' clause prior to the adoption of Next Generation EU.

Nevertheless, there are three hurdles to be overcome before it is easier to shift from the broad application of the general escape clause to the narrower application of the unusual circumstances clause for those countries most severely affected by the pandemic. The first of these is the final adoption of the Recovery and Resilience Facility coupled with the submission and acceptance of the national recovery and resilience plans. This hurdle is largely political and involves action at both the European and Member State levels. Such action is necessary to ensure that the funds committed to invest in a European recovery actually result in continuing economic growth; the funds agreed on 23 April 2020 provide a cautionary illustration.[30] Although the European Commission has succeeded in distributing the funds to backstop national unemployment and job protection schemes through SURE, no Member State has drawn on the funds available from the European Stability Mechanism to finance spending related to the public health crisis.

A second hurdle is to avoid having the economic consequences of the pandemic spread from the real economy into the banking system. The possibility that an accumulation of non-performing assets could put pressure on bank capital and lending requirements is only the leading edge of such a development. Behind that lies the risk that systemically important financial institutions will lose access to equity finance or other funding instruments that can be bailed in during resolution. If that were to happen, the pressure on national fiscal resources would increase suddenly. The European Banking Union has instruments to prevent this from devolving into crisis, but they are untested in the face of systemic financial fragility and they remain incomplete. National governments still play the main role in any banking recapitalization and the European Commission recently extended its temporary framework for the application state aid rules related to such measures until September 2021.[31] National governments

[28] https://ec.europa.eu/info/sites/info/files/3_en_document_travail_service_part1_v3_en.pdf, https://ec.europa.eu/info/sites/info/files/3_en_document_travail_service_part2_v3_en_0.pdf

[29] https://www.europarl.europa.eu/RegData/etudes/IDAN/2020/651377/IPOL_IDA(2020)651377_EN.pdf

[30] https://www.consilium.europa.eu/en/press/press-releases/2020/04/23/conclusions-by-president-charles-michel-following-the-video-conference-with-members-of-the-european-council-on-23-april-2020/

[31] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020XC1013(03)&from=EN

also have responsibility for backstopping national deposit guarantee schemes. As the recent experience of Commerzialbank in Austria illustrates, the failure of even a relatively small institution can impose significant costs on national deposit insurance schemes (Graber 2020).[32]

A third hurdle is the continued support from the Governing Council of the ECB for monetary accommodation in general and for the pandemic emergency purchase program in particular. The argument here is not that the ECB should allow monetary policy to be dominated by fiscal policy. Rather it is that the current low level of the spread between sovereign debt instruments issued by different Member States rests in large measure on the credibility of the ECB's monetary accommodation.[33] Support for continued accommodation within the Governing Council cannot be taken for granted; neither should market reactions to ECB communications. This is unlikely to create problems under normal circumstances but could become important if systemically important banks go into resolution and require significant government support.

So long as the European Recovery Program and national recovery and resilience plans find quick approval, systemically important financial institutions retain access to funding, and the ECB's Governing Council commands credibility in the markets, the prospects for shifting from the general escape clause to transitionary arrangements organized through the unusual circumstances clause are good. The European Commission will have the instruments to enforce Member States' commitment to medium-term objectives and country specific recommendations, and the withdrawal of national fiscal stimulus can be matched with an increase in fiscal spending through European funds. This is a best-case scenario that could play out as early as spring 2021, and so allow for a resumption of the normal pattern of macroeconomic policy coordination within the European Semester as early as 2022.

[32] https://www.derstandard.at/story/2000121352884/schiefer-haussegen-weil-raiffeisen-fuer-commerzialbank-bluten-muss

[33] https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp201006~e1d38a1ccc.en.html

6. CONCLUSION

The greatest source of uncertainty in the timing and manner for deactivating the general escape clause is the evolution of the COVID-19 pandemic. This is not a trivial assertion. The policy response to the pandemic is the reason why the European Union experienced a severe economic downturn and so it is also the reason why the European Commission and the Council required greater flexibility in coordinating macroeconomic policies across Member States. So long as the pandemic continues to threaten national populations, Member State governments will need to enforce policies that have powerful negative economic consequences. Even without such policies, however, economic performance would be muted by the lack of consumer confidence and the weakness of corporate investment. By implication, the deactivation of the general escape clause is contingent in many ways on a solution for the global pandemic.

The deactivation of the general escape clause cannot be put off indefinitely. The application of the clause is only possible so long as medium-term fiscal sustainability is ensured. The assessment of that sustainability involves a complex evaluation of the interaction between fiscal and monetary policy. The longer both macroeconomic instruments remain accommodative, however, the more they tend to distort private and public balance sheets. It is necessary, therefore, that both monetary and fiscal policies be allowed to unwind their accommodative positions. This is a delicate process given how the two sets of policy instruments reinforce one-another. The longer they remain active, the more challenging this unwinding becomes. Therefore, it is important to begin steps to reset these instruments sooner rather than later.

Such consolidation should not come at the expense of the economic recovery. The European Commission recognized as much in its overall assessment of the 2021 draft budgetary plans:

> *[F]iscal policy should continue to support the recovery in 2021. In light of this need and the still high uncertainty about the economic consequences of the pandemic, the general escape clause will remain active in 2021. In spring 2021, … the Commission will reassess the situation and take stock of the application of the general escape clause.*[34]

As part of that reassessment, any effort to unwind monetary and fiscal policies should also take the sharp divergences across Member States into consideration. The Commission was careful to note that point as well:

> *When economic conditions allow, government should resume fiscal policies aimed at achieving prudent medium-term fiscal positions while enhancing investment. Credible medium-term fiscal strategies are important to support fiscal sustainability, not least in the case of highly-indebted Member States.*[35]

Finding a balance between a durable recovery and fiscal sustainability explains why it is necessary to have transitional arrangements in place when deactivating the general escape clause. The Stability and Growth Pact makes provision for this through the unusual circumstances clause.

More important, the European Recovery Program provides an opportunity to enhance the credibility of the European Union's pattern for fiscal policy surveillance and macroeconomic policy coordination while at the same time replacing national fiscal stimulus that might be removed through consolidation efforts. The major challenge for European policy makers will be to coordinate across these various instruments. A related challenge will be to avoid some of the political pitfalls that might stand in the way of a successful transition. The general escape clause was created without an explicit sunset provision. Through their decisive action in response to the COVID-19 pandemic, however, European policymakers may have found a workable solution.

[34] https://ec.europa.eu/info/sites/info/files/economy-finance/dbps_overall_assessment.pdf

[35] *Ibid.* The first citation comes from p. 4, the second from p. 10.

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This paper provides a framework for considering when and how to deactivate the general escape clause of the Stability and Growth Pact (SGP). That framework takes into account the goals of the SGP, the desire to avoid pro-cyclical policy influences that might stifle Europe's economic recovery, and the necessity not to endanger fiscal sustainability in the medium term. The framework also considers the variation in performance across countries and the indicators that might be used to map transitional arrangements.

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