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The debate on how to improve the EMU's economic governance framework

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Introduction

On 5 February 2020, the European Commission published a "Communication"[1] on Economic Governance Review, opening a public debate on the complex body of norms regulating the governance of the European economy. Before the health and economic crises caused by the pandemic, the EU Institution observed that a new political cycle in the Union offered an opportunity to assess the effectiveness of the current framework for economic and fiscal surveillance, especially the six-pack and two-pack reforms, for which the Commission was required to report on their application.

The first objective of the review launched by the Commission was to assess the extent to which the different surveillance elements, as introduced or amended by the six-pack and two-pack reforms, have been effective in achieving their key objectives:

(i) ensuring sustainable government finances and growth, as well as avoiding macroeconomic imbalances;

(ii) providing an integrated surveillance framework that enables closer coordination of economic policies, in particular in the euro area; and

(iii) promoting the convergence of economic performances among Member States.

Since the early 1990s, the framework for economic and fiscal surveillance has been laid down in a range of secondary legislation, as well as in other documents that provide more details and transparency on how surveillance is carried out in practice. The latter include the Code of Conduct of the Stability and Growth Pact and the Code of Conduct of the Two-Pack.[2] As noted in the "Communication", the framework "has evolved in waves over time", with changes introduced in response to the emergence of new economic challenges, as well as based on the lessons gained in the implementation of the surveillance framework.

[1] https://ec.europa.eu/info/sites/default/files/economy-finance/com_2020_55_en.pdf

[2] Further details on the implementation of the surveillance framework are provided in the Vade Mecum on the Stability and Growth Pact and the Compendium on the Macroeconomic Imbalance Procedure.

The economic context has evolved over time. The Great Recession coincided with a whole set of new norms whose appropriateness has been questioned. After 10 years, Member States (MSs) face a combination of challenges that are different compared to when the six-pack and two-pack reforms were adopted. The decline in potential growth and interest rates, in a context of an ageing population, has gone hand in hand with persistently low inflation. The Communication notes that "while implementation of structural reforms to strengthen potential growth and support economic adjustment was strong in the aftermath of the crisis, reform momentum has faded and progress has become uneven across Member States and policy areas."

However, it was the pandemic crisis that upheld the existing framework for economic governance. In March 2020, the Commission and Council activated the so-called 'general escape clause' of the Stability and Growth Pact (SGP). While the clause does not suspend the procedures of the Pact, it allows MSs to temporarily depart from the normal budgetary requirements, provided that this does not endanger fiscal sustainability in the medium term. There are currently no numerical fiscal adjustment requirements stemming from the Pact that can guide MSs' fiscal policies.

The decision to adopt the general escape clause offers an opportunity to set out the considerations on future decisions about the appropriate use of fiscal rules and on the assessment of exceptional conditions versus 'normal times'. The Recovery and Resilience Facility (RRF) Regulation, which entered into force in February 2021, represents another major change in the fiscal framework, linking fiscal indications with the funds for NextGeneration-EU (NGEU). The impact of the innovations adopted after the pandemic crisis will also need to be assessed for future developments.

The purpose of this paper is to collect and discuss relevant academic contributions and reform proposals, both preceding and following the Communication on Economic Governance Review of 5 February 2020, that are intended to respond to the critical issues for public debate identified by the Commission in order to enhance the current set of fiscal rules. A general observation can be summarized as follows: the euro-area aggregate fiscal stance has mostly remained procyclical or neutral (see **European Commission** 2020, p. 8). This suggests that fiscal policy in the Eurozone has barely complemented and supported the European Central Bank's (ECB) monetary policy in the attainment of both debt sustainability and macroeconomic stabilization, as many MSs did not properly take advantage of benign economic times to build up countercyclical buffers and gather enough fiscal space for automatic stabilizers and discretionary policy measures in bad times (see also Thygesen et al. 2021; Bini Smaghi 2021).

This issue is particularly relevant if nominal short-term policy rates hit the zero lower bound (ZLB), as the ECB is increasingly constrained and is likely to face a liquidity trap with its expansionary monetary policies, even unconventional ones, failing to substantially stimulate economic activity (see European Commission 2020, p. 6; Eggertsson; Krugman 2012; Masera 2016; Schupp 2020). In this regard, the deposit facility rate has been negative since 2014, when the ECB cut the interest rate on its main refinancing operations (MROs), also known as the repo rate, to approximately zero. For this reason, the ECB does not have a margin to further cut short-term rates to offset deflationary dynamics and a couple hundred billion of supplementary money base is unlikely to substantially stimulate economic activity (see De Grauwe; Ji 2019). Therefore, it may be necessary to redesign existing fiscal rules to make them more transparent and enforceable in order to safeguard budgetary discipline and debt sustainability in the long-run and, at the same time, flexible and contingent

enough to allow for short-term stabilization. They should also be able to incentivize MSs to increase growth-enhancing net public investment.

While the consensus around the existence of various areas for improvement in the current SGP rule-based system, hence around the need to redesign it, appears almost unanimous, some disagreement about the design of the EMU's economic governance framework persists (see Ilzetzki 2021). In this respect, the Commission, in its Economic Governance Review of 5 February 2020, launched a debate on how to effectively reform the EMU's fiscal rules, identifying several issues for public debate raised to enhance the effectiveness of the EMU's economic governance framework. Here below we describe, also in analytical terms, the debate and the experts' contributions elicited by, or connected with, the questions raised by the European Commission in its Communication.

1. How can the framework be improved to ensure sustainable public finances in all Member States and to help eliminate existing macroeconomic imbalances and prevent new ones from arising?

a) A framework for the coordination of sound macroeconomic policies

The **European Commission** (2020, p. 2) emphasizes how the main purpose of the 3% government deficit and 60% public debt thresholds established by the Maastricht Treaty and enforced under the SGP is to ensure that MSs implement sound fiscal policies in a coordinated manner in order to prevent potential negative spillovers from arising in the euro area as a result of divergent national economic policies associated with free-riding behavior, moral hazard or distorted incentives. In this regard, the 2011 six-pack reform operationalized the debt criterion, requiring MSs to reduce the difference between current debt and the 60% benchmark by 1/20th on an annual basis and not to let public expenditure, net of discretionary revenue measures, grow faster than potential output. Furthermore, the six-pack introduced the Macroeconomic Imbalance Procedure (MIP), namely an instrument in the hands of the Commission and the Council aimed to detect, prevent and correct harmful external or internal imbalances on the basis of a scoreboard of indicators, including current account balance, public and private indebtedness, housing bubbles, productivity and price and wage competitiveness. The reforms of fiscal surveillance implemented during the 2010-2013 Eurozone crisis should thus be instrumental for making sure that MSs build-up countercyclical fiscal buffers in good economic times and do not accumulate imbalances as occurred in the first decade of the single currency, when core countries ran current account surpluses over the deficits of their trade partners in the periphery, where cheap credit was 'misallocated' in non-traded sectors or in the construction sector, fueling property bubbles in Ireland and Spain, among others. However, the **Commission** itself (2020, p. 8) points out that, although the MSs' structural effort to reach their MTOs is corrected by the effect of the business cycle, hence governments shall be incentivized to increase fiscal adjustment efforts in benign economic times so as to gather enough fiscal space for automatic stabilizers and discretionary policy measures in bad times, the euro-area fiscal stance has frequently been procyclical and, since 2014, when fiscal adjustment efforts were interrupted, it has become neutral. This, as also maintained by **Beetsma and Larch** (2018), **Thygesen et al.** (2021) and **Deroose et al.** (2018), could be an indication of an insufficiently differentiated fiscal effort between MSs having significantly divergent fiscal positions, with several highly-indebted countries remaining far from their MTOs and showing no satisfactory

evidence of progress towards them. In this regard, the deviation of structural balances and government expenditure from country-specific MTOs and the number of countries that are far from their numerical fiscal targets under the Stability and Convergence Programmes increased over time during the 2014-2019 period (see Thygesen et al. 2020). At the same time, the follow-up to MIP-related recommendations, which was initially effective, as observed by **Bricongne and Turrini** (2017), in encouraging national implementation, declined similarly to the increasingly lower level of compliance with other recommendations under the European Semester (**European Commission** 2020, p. 13). If measured according to the implementation rates of country-specific recommendations (CSRs), as indicated by **Bénassy-Quéré and Wolff** (2020), the average implementation of MIP-related recommendations amounts to less than 50%, with CSRs that are fully addressed or show substantial progress accounting for only 10% on aggregate. Furthermore, and most importantly, the implementation of MIP-related recommendations displays an evident declining trend over the 2013-2018 period as financial market pressure for reform receded.

b) An enhanced institutional interplay between the SGP and the MIP to deal with pressing policy challenges

Considering that, with the six and two-pack legislative reforms, fiscal and economic policy coordination among MSs started to be promoted under the European Semester, which arranges a common timeline for a multilateral assessment of national budgetary plans and fiscal positions, **Hagelstam et al.** (2019) called for a 'renewed' European Semester, whereby the potential for a better interaction between the SGP and the MIP is fully exploited. This enhanced institutional interplay, according to the proponents, could constitute a viable solution to make fiscal surveillance more effective in identifying gross policy errors and the most pressing policy challenges, and simultaneously addressing unsustainable fiscal policies and harmful macroeconomic imbalances. More specifically, the proposal envisages a clearer separation between more binding CSRs under the SGP and the MIP, whose corrective arms entail that the Council can approve an Excessive Deficit Procedure (EDP) and an Excessive Imbalance Procedure (EIP) on a recommendation from the Commission, possibly leading to financial sanctions, and other more general recommendations relative to the euro-area as a whole under the Broad Economic Policy Guidelines (BEPGs) and the Guidelines for Employment Policies (EGs), the so-called 'integrated guidelines', for which the tool at the Commission's disposal consists of the Open Method of Coordination and peer pressure to promote best practices (see Hagelstam et al. 2019). In other words, the authors propose to jointly treat and approve CSRs under the SGP, MIP and integrated guidelines, but indicating that the recommendations encompassed in the new EU instrument with a joint legal basis shall specify as extensively and precisely as possible the different objectives of the three economic governance tools and be adopted only after extensive country-specific analyses focused especially on certain unsustainable fiscal and economic policies that constitute gross policy errors and, therefore, could potentially endanger the euro-area's systemic financial stability. Another proposal for a better interaction between economic tools under the European Semester aimed at averting policy mistakes in national policies that might provoke negative spillovers towards other MSs (see also Buti; Gaspar 2021) is provided by **Bénassy-Quéré and Wolff** (2020). The latter, also considering that financial imbalances are included in the MIP scoreboard but the recommendations of the European Systemic Risk Board (ESRB) are not always aligned with the common budgetary timeline of the European Semester, invoke the need for a better integration between the SGP, the MIP and the ESRB under the European Semester, simultaneously recognizing the independence of the respective objectives of fiscal discipline, economic and financial sustainability and macroprudential supervision, but also their frequent overlap. Indeed, for example, the ESRB issued warnings to 11 countries in

2016 and, more recently, to Belgium in 2019 in relation to risky developments in the national real estate markets, but, in both circumstances, the corresponding CSRs were mostly not in line with the ESRB's appraisals, so that many of these countries were classified as without imbalances (see Bénassy-Quéré; Wolff 2020). The authors also suggest making the in-depth reviews and the CSRs under the MIP more focused on the euro area as a whole and less country-specific. A broader perspective could let the Commission not only attempt to correct current account deficits in the periphery through price and wage adjustments and reduction in unit labor costs, with the risk of creating a deflationary bias in the EMU. It would allow the Commission to also reduce current account surpluses in the core through expansionary fiscal policies able to boost import demand from the periphery, hence moderating current account imbalances and real exchange rate misalignments in the euro area and boosting export competitiveness, productivity and GDP growth in the periphery, with possible beneficial effects for the public finances of MSs with deteriorated economic fundamentals (see also Bénassy- Quéré et al**.** 2019). This issue is highly relevant, and the **Commission** itself (2020, p. 13) claims that the MIP has been much more successful in reducing current account deficits than in moderating persistent and large current account surpluses that can jeopardize the smooth functioning of the euro area. Other contributions (see e.g. Feld et al. 2018; Kopits 2018) perhaps are, in this view, less ambitious, since they attempt to improve the SGP set of rules separately from the MIP framework in order to promote market discipline.

c) Stricter enforcement of budgetary discipline and sinking funds

Proponents of a stricter enforcement of budgetary discipline seek to counter distorted incentives, moral hazard and procyclical fiscal policy in the most direct way possible. For example, **Feld et al.** (2018) give relevance to a stricter enforcement of the structural balanced budget rule that the Fiscal Compact introduced into national legislation with the objective to limit the primary deficit below 0.5%, or 1% in MSs whose debt/GDP ratios are significantly lower than 60%, over the business cycle. More specifically, only the cyclically-adjusted primary balance (CAPB) is required to remain close to balance, while cyclical unemployment payments are allowed to fluctuate freely, as automatic stabilizers are assumed to be more suitable than discretionary policy measures, which are said not to change remarkably over the cycle, and sufficient to offset business cycle fluctuations. In this regard, **Blanchard, Leandro and Zettelmeyer** (2020) hold the view that a single operational rule on medium-term expenditure ceilings or on the structural balanced budget would be excessively constraining in the event of deep and prolonged downturns that require larger countercyclical discretionary stimulus in addition to fiscal automatic stabilizers. **Kopits** (2018) offers a few options for future reforms of the SGP framework, with the attempt to make the rules more suitable for promoting fiscal discipline and positive incentives. The first option, while maintaining the expenditure benchmark, which entails that public expenditure adjusted for discretionary revenue measures does not exceed the potential growth rate of the economy, as well as the existing budget deficit and public debt thresholds in force, entails a debt-reducing primary surplus target that is computed by establishing a target for the public debt/GDP ratio to be reached in a given subsequent year. The higher are the interest rates on sovereign bonds, the actual public debt stock, the annual debt reduction and the lower is GDP growth, the higher would be the debt-reducing primary surplus needed to reach the future target debt ratio. The second option is an operational debt rule that introduces an annual ceiling on discretionary budget deficit that is estimated when the government, every year, sets a target debt reduction to be realized three years later and is obtained by subtracting the target primary surplus required to reach the target debt reduction from a forecast on the mandatory expenditure items in the budget, for example interest payments, automatic stabilizers or public investment. Among the

advantages of the operational debt rule option, the author identifies transparency and accountability for policymakers, as national executives are responsible for compliance, considering that they have direct control of discretionary expenditures and are expected to produce reliable forecasts on future mandatory components of government budgets. Aligned with a reform package prone to impose budgetary discipline more forcefully on EMU MSs is former German Finance Minister Wolfgang **Schaüble** (2021), who claims that an effective way to prevent the COVID-19 pandemic from turning into a 'debt pandemic' is, besides tightening the euro-area fiscal and monetary policy stance, to promote sinking funds for the Eurozone, namely reserves into which governments set aside money that is saved over time to pay-off their outstanding debt in the future. **Hagelstam et al.** (2019) discuss the launch of rainy day funds at the EMU level based on the model of the Irish rainy day fund introduced into national legislation in June 2019 in order to offset the potentially counterproductive effects of procyclical discretionary fiscal policies both in good and bad economic times. In this way, the government shall increase public savings in benign times, automatically transferring resources to rainy day funds in order to reduce outstanding public debt and, at the same time, build up additional margin for expenditure to implement countercyclical fiscal policies for stimulating economic activity during downturns.

2) How to ensure responsible fiscal policies that safeguard long-term sustainability while allowing for short-term stabilization

a) The introduction of expenditure ceilings as the intermediate target for debt reduction in the long run

The **European Commission** (2020, p. 9) emphasizes how the absence of a central fiscal capacity prevents fiscal policy from contributing to macroeconomic stabilization at the euro-area level, thereby the EMU can mainly rely on the ECB's expansionary monetary policy for short-term stabilization purposes. However, it is necessary to take into account that the ECB may eventually be stuck at the ZLB for nominal interest rates at certain critical junctures. In those circumstances, a liquidity trap can severely limit the ECB's capacity to counter deflationary dynamics and stimulate economic activity. Furthermore, it is also useful to point out that euro-area MSs, contrary to standalone countries, can be forced to default as a result of negative market expectations, because the ECB shall not monetize national debt, as the strict no-monetary financing obligation under Article 123 TFEU establishes. In light of this, as argued by the **European Commission** (2020, p. 6 and p. 17), **Masera** (2016), **Blanchard, Leandro and Zettelmeyer** (2020), **Bartsch et al.** (2020) and **Buti and Gaspar** (2021), the need for an appropriate and more active role of fiscal policy in the policy mix with expansionary monetary policy for macroeconomic stabilization and potential output growth should be assessed. At the same time, the **Commission** (2020, p. 11) makes it clear that the medium-term orientation of government budgets has progressively weakened, with many MSs postponing the achievement of their MTOs, also because of the Stability and Convergence Programmes losing their significance in the surveillance framework over time. Hence, more stringent intermediate fiscal targets aimed to ensure appropriate medium-term budgetary planning and, thus, achieve a long-term target, namely the debt anchor, would be required to guarantee long-term public debt sustainability (see also **European Commission** 2020, p. 18). **Beetsma and Larch** (2018) and **Bénassy-Quéré et al.** (2018), indeed, evaluate risk-sharing mechanisms and more stringent and credible fiscal rules as complementarily functional for an efficient framework of fiscal rules able to assure an appropriate balance between long-term debt sustainability and short-term economic stabilization. In this concern, as

argued by **Carnot** (2014) and **Cottarelli** (2018), the introduction of intermediate expenditure ceilings implying medium-term country-specific debt reduction targets aimed to reach the long-term 60% debt target is reminiscent of the Taylor rule for monetary policy. In fact, just like a central bank has tools, namely interest rates and intermediate targets, such as a fixed reference value for the yearly growth rate of the money stock, explicit inflation forecasts and forward guidance through policy statements, to achieve a long-run inflation target, a euro-area government, with this approach, can employ intermediate primary expenditure ceilings as an instrument to achieve a long-term public debt objective, in this case the 60% debt anchor. From the perspective of the long-run trade-off between inflation and output volatility identified by Taylor (1994), a central bank that gives prominence to price stability in a tight inflation targeting regime faces a larger output variability and, instead, another one that gives priority to output and employment stabilization does so at the expense of higher price fluctuations, suggesting that the optimal choice for policy is for the central bank to attach sufficient weight to both output and price stability. Similarly, as suggested by **Carnot** (2014) and **Cottarelli** (2018), governments in the euro area could employ medium-term expenditure ceilings as the intermediate target to reach the long-term objective, namely the 60% public debt anchor, and set this tool on the basis of both the distance of public debt from the 60% benchmark and the difference between actual output and its full employment level, namely the output gap. Such an approach would be instrumental to reduce the risks of a trade-off between debt sustainability and output stabilization.

b) An intermediate approach to promote debt sustainability and enough capacity for output stabilization

In this sense, also in light of the Commission's appraisal in its Communication on Economic Governance Review of the need to complement more stringent medium-term fiscal targets with a higher capacity for macroeconomic stabilization at Community level, as discussed before, it is possible to assume that this take on the issue of the EMU's fiscal rules reform is the mainstream one. This is so because it constitutes an acceptable compromise between the proponents of higher fiscal discipline and risk prevention and, on the other hand, the advocates of risk-sharing mechanisms in the euro area. Indeed, an influential paper by 14 German and French economists (see **Bénassy-Quéré et al.** 2018) is the emblem of this compromise, as the authors recommend to replace the plethora of existing rules with a single operational rule based on a constant ceiling on the growth rate of government expenditure and, on the other hand, to establish a common fiscal capacity allowing MSs to absorb disruptive negative shocks. Several authors, including members of the European Fiscal Board (EFB) (see **Thygesen et al.** 2020), have adopted the same intermediate approach to SGP reforms, suggesting the implementation of a medium-term nominal expenditure rule aimed to reduce government debt down to a debt anchor corresponding to the 60% debt benchmark as the long-term reference value, at the same time endorsing the launch of a common budget for fiscal stabilization. **Carnot** (2014) elaborated a 'rule of thumb' that should satisfy both the need to effectively tie the governments' hands with the attempt to eradicate deficit biases in national fiscal policy and the need to concede the budget sufficient margin to react to business cycle fluctuations in order to provide macroeconomic stabilization in the short run. A rule of this kind, on the one hand, sets an annual fiscal adjustment effort, determined in relation to CAPB movements, to move actual government debt close to the long-term anchor and, on the other hand, adjusts the medium-term operational target with reference to short-term stabilization needs, possibly making the economic governance framework efficient in the face of a trade-off between debt sustainability and output stabilization. **Dolls and co-authors** (2016), on their part, support the introduction of a common unemployment insurance mechanism to provide fiscal stabilization and absorb transitory asymmetric disturbances, accompanied by an insolvency procedure for irresponsible sovereigns being stringent enough to enforce market discipline. Notwithstanding,

this theoretical approach, overall, attaches higher priority to preventing moral hazard and ensuring budget discipline and debt sustainability, considering that its main attempt is to prevent MSs from building up distorted incentives by subordinating participation in the insurance scheme to compliance with fiscal rules and by making sure that the largest national contributions to the centralized fiscal backstop are disbursed by the main net beneficiaries of the euro-area fund. In this regard, the primary objective of a set of rules relying on a single operational rule and debt anchor is to strengthen the medium-term orientation of budgetary policy. For this purpose, as foreseen in the proposals by **Beetsma et al** (2018), **Darvas, Martin and Ragot** (2018) and **Thygesen et al.** (2020), government expenditure, net of interest payments and cyclical unemployment benefits, hence under direct control of the government, is restricted, since it will not grow faster than long-term nominal output and is capped at a level that guarantees the attainment of medium-term country-specific debt reduction targets that are recalculated after 3-5 years based on changing economic conditions and the gap between the actual debt/GDP ratio and the long-term 60% debt anchor in a given country. On the other hand, an original revision proposal that is in the spirit of an effective economic governance framework suited to harmonizing the double objective of sustainable public finances and output stabilization is that envisioned by **Blanchard, Leandro and Zettelmeyer** (2020), whose main idea is to replace existing rigid quantitative fiscal rules with enforceable fiscal standards designed to achieve debt sustainability with high probability. This new framework relies upon the legal standard enshrined in Article 126(1) TFEU, according to which MSs shall avoid excessive government deficits, while the 60% debt benchmark is retained as a symbolic long-term reference value. Budget deficits are considered excessive when the Commission, subsequently to a stochastic debt sustainability analysis based on all relevant information, such as primary balances, interest rates and the maturity structure of public debt, ascertains that the estimated debt-stabilizing primary balance significantly exceeds the actual primary balance. In this case, the country is called to adjust at a speed that depends on specific risks to sustainability and on the capacity of expansionary monetary policies to offset the contractionary effects of fiscal consolidation. Overall, enforceable fiscal standards would leave MSs free to resort to discretionary fiscal policy to stabilize output to the extent that public debt dynamics are deemed sustainable with high probability, especially considering that, in an incomplete monetary union such as the EMU, the extreme and volatile animal spirits of investors, namely endogenous, collective and self-fulfilling waves of optimism and pessimism, can force MSs to default. Actually, the contention that debt sustainability is a probabilistic statement, as is, more generally, the framework of enforceable and country-specific fiscal standards proposed by Blanchard and his co-authors, has a very solid theoretical foundation. In fact, as mentioned before, EMU MSs, contrary to standalone countries, cannot implicitly guarantee that the central bank, operating as a lender-of-last-resort (LOLR), is always ready to provide governments with enough liquidity to repay holders of government bonds at maturity, with the result that there is scope for so-called multiple equilibria. Indeed, even small changes in collective, endogenous and self-fulfilling market sentiments of optimism and pessimism can lead to large movements from a good equilibrium where government solvency is not in jeopardy to a negative equilibrium in which market operators are doubtful about a country's debt-servicing capacity, leading to a high default probability. In this respect, given that all euro-area MSs saw their debt/GDP ratios increase substantially with respect to 2019, reaching historic highs, and, consequently, the distance between the stock of several Eurozone countries' outstanding debt in 2021 and the 60% Maastricht reference value has increased if compared to the period preceding the COVID-19 crisis (see Bofinger 2020), the SGP framework needs to adapt to a new economic juncture characterized by highly-differentiated budgetary positions across the EMU. For this reason, **Messori** (2021) contends that the medium-term nominal expenditure rule that anchors public spending, net of discretionary changes in taxation, to potential output growth and to the reduction in the outstanding public debt stock, is counterproductive both for debt and

output stabilization, especially in the case of highly-indebted countries with low GDP growth rates, including Italy. The author, thus, proposes to replace the old SGP framework with a fiscal rule entailing that the Commission conducts annual sustainability tests under which every MS's government debt is subject to a long-run sustainability assessment based on future alternative monetary policy scenarios. If the test results signal that MS fiscal positions are sustainable, governments would not need to correct their current fiscal policy stance. If, on the contrary, the sustainability tests detect that the dynamics of debt accumulation are unsustainable and public debt sustainability is in jeopardy, the Commission would have to agree with the MS under assessment on a series of cyclically-adjusted primary surpluses, to be run annually, that will be compatible with the double objective of debt reduction and GDP growth, while, in case no agreement between the Commission and the country was reached, the old SGP rules, as established in the 2011-2013 legislative packages, would apply. The author also emphasizes that the money base expansion triggered by the ECB's current accommodative monetary policy stance is likely to reduce the government debt burden only temporarily. This can be seen from the government budget constraint equation, $\dot{b}=(g-t)+(r-x)b-\dot{m}$, where b is the public debt stock, (g-t) is the cyclically-adjusted primary balance (CAPB), r is the interest rate on government debt, x is the GDP growth and $\dot{m}$ is the money base. Correspondingly, debt stabilizes if $(r-x)b=(t-g)+\dot{m}$. In light of this, the dynamics of debt accumulation for MSs with deteriorated fundamentals could possibly become unsustainable as long as the ECB remains strongly committed to its inflation target. In this scenario, the ECB would suspend liquidity injections into the financial system as soon as the inflation rate exceeds 2%, hence reducing the money base. Returning to the author's proposal (see Messori 2020), the author argues that a solution to the trade-off between debt and output stabilization could be to promote contractual arrangements, which were proposed by the Commission already in 2012, between MSs being net beneficiaries and, on the other hand, the Commission and the ESM as the 'financial donor', with the latter transferring resources to the former to finance junctural expansionary public expenditures through the issuance of EU debt securities. According to the proponent, the beneficiary countries, in exchange for those EU funds, could cede part of their fiscal sovereignty by regularly sharing the composition and implementation of their budgetary plans with European institutions. Moreover, a proposal of this kind is notably coherent with the 2021-2027 Multiannual Financial Framework, which was reinforced by the €750 billion NGEU, under which the European Commission is enabled to issue bonds to borrow funds on the capital markets and finance the recovery from the pandemic crisis on behalf of the EU. In this regard, the NGEU constitutes the main instrument to facilitate the recovery from the severe supply and demand shocks provoked by the COVID-19 crisis and the digital transformation and ecological transition of the European economy, and also represents an initial but significant step towards fiscal unification in the EMU.

3. How can one simplify the EU framework and improve the transparency of its implementation?

a) Incremental reforms for an overly complex set of rules

The original Maastricht Treaty framework was quite simple, since, of the two rules established, only the 3% government deficit threshold was actually applied, because, before the 2011 six-pack, the requirement to reduce the gap between the actual public debt/GDP ratio and the 60% reference value lacked a precise

numerical definition of the 'satisfactory pace' of the annual debt reduction towards the target. The first reform of the Pact dates back to 2005, when the country-specific MTOs were introduced, attaching greater emphasis to the MSs' fiscal effort in relation to the CAPB. In other words, the SGP was made less stringent at a time when, precisely in 2003, both Germany and France saw their budget deficits exceed the 3% limit, and an EDP was opened for both countries in the same year. Then, the six-pack reform increased the scope of the public debt rule, requiring MSs to run primary surpluses in order to reduce the difference between current debt and the 60% benchmark by 1/20th per year, and established an expenditure benchmark for public spending net of discretionary revenue changes. At the same time, the imposition of financial sanctions under the EDP became semi-automatic, in the sense that they are approved unless a reverse qualified majority in the Ecofin Council opposes them, even if no pecuniary sanction has ever been imposed on MSs in breach of rules under the corrective arm up to date. Furthermore, the Commission's Communication on flexibility of January 2015 made the assessment of most fiscal rules under the preventive arm more contingent and country-specific, as the required fiscal adjustment speed is lower the higher is the output gap. Simultaneously, a structural reform clause and an investment clause under the SGP's preventive arm were operationalized in 2015, allowing the Commission to adapt its compliance assessments not only based on the state of the economy, but also on whether a MS is implementing structural reforms or increasing net public investment. Finally, as emphasized by **Cottarelli** (2018), further flexibility is ensured by a method for assessing compliance reliant upon consideration of a breach of the debt rule both from a backward-looking and a forward-looking perspective, considering that the forward-looking criterion contemplates the possibility that budgetary plans can be opportunely revised later on and also that, if the magnitude of deviations from fiscal rules is deemed sufficient to launch an EDP, a MS can later prove to the Commission that it is on the right path. Moreover, many exceptions and escape clauses have been introduced over time, not only to create room for structural reforms and net public investment, but also to allow for fiscal slippages to cover public spending related to pensions, refugees, natural disasters and exceptionally severe economic downturns. Overall, it is clear that fiscal authorities in the Eurozone have attempted to make the SGP framework at the same time more enforceable and credible in guaranteeing market discipline, especially with the six and two-pack legislative reforms, but also more flexible and adaptable to different country-specific circumstances. In this regard, **Feld et al.** (2018) claim that this proliferation of exceptions and flexibility clauses increases complexity and, therefore, considerably limits the transparency in the implementation of the SGP framework, especially as concerns the wide discretion of the Commission in its compliance assessments, and the enforceability of fiscal rules. **Deroose et al.** (2018) maintain that, in view of a trade-off between simplicity and adaptability, the current state of the rules is well below the efficiency frontier, with subsequent reforms of the Pact actually improving the adaptability, but to the detriment of much lower simplicity of the framework. More generally, the authors argue that the EMU's fiscal authorities face a trilemma between adaptability, enforceability and simplicity. In view of the precedent discussion, it is licit to state that the SGP rules have over time become more stringent and enforceable with the 2011-2013 fiscal surveillance reforms and, simultaneously, extremely more adaptable to country-specific cyclical positions and needs, but with the side effect of turning into an overly complex construct. The **Commission** (2020, p. 10 and p. 17) is aligned with this statement, claiming that the SGP framework has become more sophisticated and adaptable to changing economic conditions, but also excessively complex and less transparent as concerns the application of fiscal surveillance under the preventive arm, with the result of weakening national ownership, communication, political buy-in and predictability of EU fiscal rules. All in all, the SGP framework is evaluated as the most complex rules-based system in the world (see Kopits 2018).

b) A roadmap to simplify the rules and improve the transparency of their implementation

In light of the precedent discussion, several observers have developed proposals to effectively simplify the SGP framework. Among others, **Hagelstam et al.** (2019) invoke the need to get rid of the rule on structural balance MTOs. On the one hand, the rationale for a coexistence between a rule requiring a convergence towards country-specific MTOs and the expenditure benchmark is doubtful. This is so because the two are almost identical indicators, with the only difference lying in the focus of the expenditure rule on the general government deficit rather than the CAPB. On the other hand, the expenditure rule, which anchors government expenditure, adjusted for discretionary changes in taxation, to potential output growth, only needs a computation of potential GDP. The expenditure benchmark is thus associated with fewer measurement problems compared to the structural balance rule, since the latter involves an estimate of the output gap, which is more affected by ex-post revisions of the actual and potential GDP level, exactly because potential growth estimates are mostly computed on the basis of past GDP growth records, which are subject to much fewer revisions with respect to current GDP (see Heinemann 2018; Darvas 2019). The **European Commission** (2020, p. 10) is perfectly aligned with this scrutiny of the disadvantageous coexistence between a structural balance and an expenditure rule, maintaining that the structural balance and the indicator to compute it, i.e. the output gap, are not directly observable variables that are often revised. On the other hand, it emphasizes that the ever growing relevance attached by the Commission to the expenditure benchmark both in the preventive and in the corrective arm has made its policy guidance more stable and operational over time. Furthermore, public expenditure is said to focus on budgetary items that are largely under the direct control of the government, while, as **Darvas** (2019) contends, spending components of exogenous origin outside government capacity, especially interest payments and cyclical unemployment benefits, can easily be excluded from the computation of the reference value. With the attempt of making the framework more effective and transparent in its enforcement, **Cottarelli** (2018) and **Darvas** (2019) discuss the case for a radical legal simplification of the SGP framework, replacing the current four-rule system, consisting of the 3% government deficit rule, the 60% reference value for the public debt rule, the attainment of country-specific MTOs with reference to the CAPB and the public expenditure benchmark, with a single rule in which an 'operational target', namely net expenditure growth, responds to deviations of public debt from its long-term objective. Moreover, **Cottarelli** (2018) proposes the abrogation of several flexibility clauses, including those for structural reforms, investment and the amplitude of the output gap, only maintaining the backward-looking criterion for assessing compliance with the debt rule, in that a compliance assessment with a backward-looking orientation does not envisage instrumental future reversals in budgetary plans. In line with this approach, **Feld et al.** (2018) propose to abolish all the existing exceptions and almost the entirety of the escape clauses currently in force, except for the one related to natural disasters and the one linked to exceptionally severe recessions, deemed to be the only two necessary escape clauses for an effective and credible set of rules. The authors also argue that these two residual escape clauses shall be activated only after technical scrutiny on the part of national and EU fiscal institutions operating as independent watchdogs. A more radical reform is that conceived by **Heinemann** (2018). On the one hand, the author supports the need for the transfer of surveillance responsibilities from the Commission to an independent fiscal institution. On the other hand, he puts into question the continuing separation between the preventive and corrective arms of the SGP, arguing that subsequent reform packages have led to a procedural convergence between the two arms. Therefore, the author establishes the integration of the preventive and corrective arms into a single procedure based on a single operational rule, net public expenditure, while the headline deficit and the structural balance rules would be downgraded to simple reference values.

c) The role of sanctions for an effective enforcement

An essential component of a credible set of fiscal rules is for sure the enforceability of financial sanctions in case of non-compliance with the agreed requirements. In this respect, CSRs under the SGP and the MIP are formally and procedurally very different from the policy recommendations issued by external institutions such as the IMF and the OECD, as in the EU they are enshrined into primary and secondary law and, if MSs are found in breach of the rules, financial penalties in the form of a lump sum or penalty payment might ultimately be imposed. In this respect, the EMU's economic governance framework can be identified as a rule-based system (see Bénassy-Quéré; Wolff 2020). Notwithstanding, no financial sanction targeted on non-compliant MSs has ever been levied under the corrective arm, and the Commission has also never proposed the opening of an EIP so far. **Deroose et al.** (2018) and **Hagelstam et al.** (2019) indicate that the implementation records and compliance with the rules appear uneven across fiscal reference indicators and countries. In recent years, overall, more than half of the CSRs related to the MIP and SGP were implemented, with a significant convergence in headline deficits and a sizeable reduction in public expenditure growth. On the other hand, however, the annual implementation rates of CSRs experienced a downward trend, and the fiscal positions of MSs with reference to the structural balance continue to diverge substantially, especially because of highly-indebted MSs' inertia in getting close to their country-specific MTOs. Hence, a correlation between low costs for non-compliance and a mixed evidence of abidance by the rules may be established, suggesting the need to make penalties more credibly enforceable to avert moral hazard, free-rider behavior and distorted incentives. **Feld et al.** (2018) examine solutions to make the imposition of sanctions more automatic and fit for increasing the reputational and political costs for non-compliance by MSs. More specifically, they assume that the assessment of compliance and non-compliance with the rules should not be performed by the Commission because its judgments are said to be influenced by national political interests and to determine time inconsistency in the enforcement of financial payments. The authors, thus, advocate for a new EU regulation that makes the imposition of fines more automatic by determining the size and design of sanctions ex-ante, instead of letting the Commission decide on the matter on a case-by-case basis, and by making sure that the Commission binds its compliance assessments to the opinion of an independent fiscal council, which could also be the EFB, while the Council would retain the competence to approve the levy of sanctions unless a reverse qualified majority votes against it. As a supplementary ex-ante requirement, the compliance with fiscal rules and the historical records of conformity with country-specific MTOs would become preconditions for benefiting from a precautionary credit line or requesting loans from the European Stability Mechanism (ESM). Other contributions tend to lean towards moving away from fines and adopting a market-based approach that entails huge reputational costs for non-compliance, mirrored in high risk premiums on government bonds issued by 'irresponsible' MSs. **Kopits** (2018) discusses a rather extreme option for a radical reform of the governance framework, foreseeing a scenario where penalty payments are withdrawn and non-compliant MSs are forced to issue junior bonds, namely subordinated debt securities that enjoy a lower payment priority compared to senior bonds and are backed by no collateral, to finance excessive deficits under the EDP. Then, in order to avoid fiscal policy procyclicality, MSs would deposit excess budget surpluses in order to have the chance to draw liquidity from rainy day funds in bad times. Also, the reform proposal elaborated by **Bénassy-Quéré et al.** (2018) consists in forcing MSs in violation of the rule on country-specific primary expenditure ceilings to issue junior bonds, since the real-time market pressure expressed in the high-yields on sovereign debt securities with low mark-to-market value is deemed to be much more threatening than the possible imposition of fines. This is so because junior bonds rank lowest in the pecking order of repayment. Therefore, junior bonds are highly-risky both for investors and the issuers, as market operators will accept to hold them

in their portfolios only to the extent that the rate of return on subordinated bonds is high enough to compensate for their risky investment. Besides this, in the event of a solvency crisis, the government is forced to repay senior debt in the first place and may find itself devoid of sufficient liquidity to ultimately pay-out junior bondholders at maturity. On these grounds, **Tabellini** (2018) and **Micossi and Messori** (2018) are critical of the recommendation to employ the issuance of junior sovereign bonds as a punitive sanction for the breaching of fiscal rules, contending that the creation of a seniority structure through tranches may propagate a default risk on more senior debt and, thus, destabilize the government bond market in its entirety.

4) What is the appropriate role for the EU surveillance framework in incentivizing Member States to undertake key reforms and investments needed to help tackle today and tomorrow's economic, social, and environmental challenges while preserving safeguards against risks to debt sustainability?

a) Net public investment and budgetary discipline at national level

The **European Commission** (2020, p. 9-10) underlines that the SGP, as manifest in its denomination and content, attaches great significance to the growth-friendliness inherent in the composition of public revenues and expenditures and to the fundamental importance of public investment for sustainable economic growth. Indeed, Article 126(3) TFEU provides that the Commission shall take into account the level of public investment before establishing that a MS has an excessive government deficit, and an investment clause was operationalized in 2015-2016 to strengthen the SGP's growth orientation by protecting investment during downturns. However, the Commission recognizes that the possibility to activate the investment clause in case of a negative growth forecast has rarely made MSs invoke the clause, with the latter thus being unable to impede a decline in public investment during periods of fiscal consolidation. In this regard, public investment as a ratio to GDP in the euro area has sharply declined since the 2008-2009 Great Recession, standing at a level well below 3% and the levels of net public investment witnessed in the non-EMU EU MSs and the US (see Buti; Gaspar 2021; Bofinger 2020; Arak; Czernicki; Sawulski 2021). Moreover, **Thygesen et al.** (2020) show that most of the slippages of government expenditures in relation to the levels foreseen in their country-specific MTOs in the 2016-2019 period falls in the category of current expenditure, while a minimal part was devoted to financing government investment. As regards the issue of debt sustainability, while the Fiscal Compact introduced a structural balanced budget rule into national legislation with the objective to limit primary deficit below 0.5% over the business cycle, Directive 2011/85 and Regulation No 473/2013 set minimum requirements for budgetary fiscal frameworks. As claimed by the **European Commission** (2020, p. 11), while the transparency of fiscal policy and the national ownership of fiscal rules have been consequently enhanced as a result of national fiscal institutions performing independent monitoring of rules compliance and forecasting of budgetary plans based on solid fiscal statistics, the design of national fiscal rules and frameworks and compliance with national provisions diverge substantially across MSs. The precedent analysis suggests that there are several areas of improvement for the EMU's economic governance system to become more investment-friendly and a more credible promoter of budgetary discipline at the level of national fiscal frameworks. This is particularly relevant at a time when the EU's main recovery instrument, the €750 billion NGEU, has opened a new cycle of the European Semester focused upon the European Green Deal and on

competitive sustainability, whose dimensions, namely environmental sustainability, productivity, social equity and macroeconomic stability, are coherent with the EU's objectives, notably the ecological and digital transition.

b) The interoperability between national and EMU fiscal frameworks

As mentioned before, the minimal part of public expenditure growth targeted to increase net investment over the last decade demonstrates that the SGP framework is ill-equipped to treat net public investment separately from current expenditure and gross investment, thus failing to incentivize fiscal authorities to perform growth-enhancing spending reviews so as to replace several items of current expenditure with an equivalent amount of government investment with high fiscal multipliers. In this regard, the **IMF** (2015) and **De Grauwe and Ji** (2019) find that investment in human and physical capital and in technological innovation, together with national institutional features such as administrative efficiency and the rule of law, are the main drivers of the economic growth process. Accordingly, **Hagelstam et al.** (2019) introduced the idea of a 'renewed' European Semester in which multiannual policy recommendations on a comprehensive set of economic policy coordination objectives, including public investment, private investment to meet the digital innovation and environmental challenges, productivity, social inclusion and efficiency of public administration, are addressed to MSs with an Open Method of Coordination strategy based on positive peer pressure. In order to ensure higher degrees of implementation following-up CSRs, the authors elaborate on the need for a multilevel consultation to pursue consensus for reforms at national level. Such a broad consultation would involve independent opinions both at Community and MS level from the EFB and national fiscal councils for issues concerning public finances, and from the ESRB and national productivity boards for issues related to macroprudential risks and imbalances. Moreover, national fiscal institutions and productivity boards, coordinated by the EFB and ESRB, would be expected to produce annual reports on the implementation progresses of CSRs in their jurisdictions and submit them to national parliaments, with the Commission taking them into account when it conducts in-depth reviews and proposes the launch of a CSR to the Council. National productivity boards are deemed essential, if national fiscal frameworks are opportunely strengthened and let interact with EU fiscal authorities, to contribute to correcting current account imbalances because of their specific focus on productivity and competitiveness, especially considering that the Council invited all EMU MSs to set up national productivity boards in 2016. In this regard, in light of persisting large current account surpluses in core countries not justified by economic fundamentals and reflecting an excess of savings over investment and depreciated real exchange rates vis-à-vis low-competitive trade partners in the periphery (see Bénassy-Quéré et al. 2019 on this issue), national productivity boards are likely to be helpful for an economically resilient euro area. More specifically, **Sapir and Wolff** (2015) hypothesized that national councils could regularly publish reports on the evolution of price and wage competitiveness and employment policies relative to their own country's trade partners in the euro area so that trade unions would be allowed to adjust their wage demands for the subsequent collective bargaining round compatibly with EMU membership. According to the authors, a Eurosystem Competitiveness Council could thus be established to assure coordination between national competitiveness councils with the aim of promoting a symmetric adjustment strategy against internal and external imbalances in the euro area. Similarly, **Koll** (2020) proposed the establishment of a Macroeconomic Dialogue at national level, with the involvement of the national central bank, the head of government, the finance minister and social partners representatives in each MS, that exchanges information with the existing analogous EU Macroeconomic Dialogue on a regular basis in order to prevent and correct macroeconomic imbalances and efficiently allocate the RRF funds to enhance the

competitive sustainability of the euro-area economy. Other contributions invoke the necessity to make some supplementary progress in the process of internalizing fiscal rules within national law initiated with the Fiscal Compact, which has already improved national ownership of SGP rules. On the one hand, **Heinemann** (2018) believes that national fiscal rules must be more coherent with the SGP requirements in form and substance, but with a continuing coexistence between national and supranational fiscal frameworks and the enhancement of national fiscal councils as independent watchdogs. Also **Feld et al.** (2018) give prominence to the rationale for a stricter implementation of the rule on close to balance CAPB over the cycle at national level. On the other hand, **Kopits** (2018) is more oriented towards a decentralized system of exclusively national sets of rules established by national executives, whereby MSs are induced to implement sound budgetary policies because of the threat of punitive risk premiums set by market operators on their sovereign bonds, whose value, according to this market-based approach, will be calculated by banks and the ECB when it determines the criteria for eligible assets as collateral in open market operations by adjusting them for risk. In discussing their proposal for a single operational rule based on a 5-year reduction target in the debt-to-GDP ratio towards the 60% long-term debt anchor, **Darvas, Martin and Ragot** (2018) recommend a regular consultation with national fiscal councils and the Commission before governments present their annual Stability and Convergence Programmes in the context of the European Semester. More specifically, both the independent national fiscal boards and the euro-area fiscal watchdog are allowed to assess the adequacy of national medium-term public expenditure targets and the relative annual expenditure ceilings on an early stage based on in-depth economic analysis, whose main parameters are the distance between actual public debt/GDP ratio and the 60% benchmark and the cyclical position of the economy.

c) A golden rule for a sustainable and resource-efficient economy

The previous discussion has made it clear that there is significant scope for potentiating ownership and transparency in the implementation of SGP rules at national level both by making national frameworks more coherent with supranational standards and requirements and by facilitating a more formal and systematic institutional interaction of national fiscal councils and productivity boards with EU institutions. With reference to the issue of the depressed levels of net public investment as a share of GDP registered in the Eurozone since the 2008-2009 Great Recession, many observers (see e.g. **Buiter** 2003; **Blanchard; Giavazzi** 2004; **Arak, Czernicki; Sawulski** 2021) have invoked the need to redesign the existing set of rules by including a golden rule that allows for capital account deficits while forbidding current account deficits, with independent national fiscal institutions eventually deciding on growth and environment-friendly budget items, such as investment in human capital and skills and technological progress, to be excluded from the budget deficit estimation. Such a golden rule could also ultimately facilitate a relaxation of the eligibility criteria for the structural reform and investment clauses, which include adherence to the 3% government deficit benchmark and country-specific MTOs and, only in the case of the investment clause, negative GDP growth or output gap inferior to -1.5% of GDP. This, as the **European Commission** (2020, p. 10 and p. 18) emphasizes, is particularly relevant in the context of the transition to a climate-neutral and resource-efficient economy suited for the ecological and digital transition. In this respect, classic contributions (see **Blanchard; Giavazzi** 2004; **Bassetto; Sargent** 2006) have identified the inability to account for public investment and capital government budget separately from gross investment and current expenditure as the major shortcoming of the SGP framework. They maintain that the SGP should include a golden rule that excludes net investment from the definition of government budget and allows for the accumulation of capital account deficits with sufficiently high returns on investment, especially to finance investment in human and physical capital and technological innovation and to promote

reforms enhancing the administrative capacity of the bureaucratic apparatus. In fact, such investments and structural reforms will guarantee future surpluses instrumental to repaying newly issued debt. In other words, over the economic cycle, the government should be authorized to borrow only to invest, while the current budget should remain in balance, hence MSs should be incentivized to promote net public investment on new capital with high fiscal multipliers rather than increasing current expenditure to offset the capital depreciation of obsolete assets. Also **Buiter** (2003) declared to be in favor of a substantial rethinking of the SGP rules. In fact, the author carried out an in-depth analysis of the strengths and weaknesses of three sets of rules, the first notably being the EMU's fiscal rules under the SGP framework, followed by the UK's golden and sustainable investment rules and, finally, a permanent balance rule conceived by Buiter himself. More specifically, the UK's budgetary rules rely upon a golden rule similar to that described above, thereby forbidding government borrowing for current expenditure purposes, and a sustainable-investment rule implying that the public debt/GDP ratio shall be kept at a stable and prudent level, ideally below 40% in normal times. On the other hand, the permanent balance rule is a tax-smoothing guideline foreseeing that taxes are anchored to a constant share of GDP that is not lower than the lowest share of GDP, which, absent severe temporary disturbances or exogenous shocks, permanently ensures government solvency. The main finding is that both the UK's golden rule and Buiter's tax-smoothing rule are more efficient than the SGP rules. Indeed, both sets of rules are evaluated as instrumental for avoiding procyclical behavior of fiscal policies, very likely to ensure sustainable public finances and government solvency and flexible enough to give the right weight to country-specific economic and structural conditions through detailed analyses on prospective trends of GDP and government bond yields and on future public spending plans and needs. Entirely aligned with this kind of proposal is **Bofinger** (2020), who supports the implementation of medium-term debt targets set out by the Commission and the Council that take into account estimated future trends in GDP and nominal interest rates on government bonds, which are thus country-specific, and leave room for primary deficits for business cycle stabilization. Similarly to proposals by other academics, the author calls for the introduction of a golden rule aimed to encourage public investment at the expense of current expenditure. Also **Arak, Czernicki and Sawulski** (2021) call for abandoning the existing set of rules in favor of explicit expenditure rules that distinguish between productive and unproductive government spending. In other words, rules should be redesigned to exploit the crowding-in effect of public spending, namely the stimulating effect of capital government expenditure on economic activity and, therefore, on private investment, as firms are therefore incentivized to invest because more profitable investment opportunities emerge.

5) How should the framework take into consideration the euro-area dimension and the agenda of deepening the Economic and Monetary Union?

a) Small steps towards a more resilient and complete EMU

The **European Commission** (2020, p. 9) underlines that the lack of a common fiscal capacity hampers the ability to control the euro-area aggregate fiscal stance and limits the scope for fiscal policy to contribute to macroeconomic stabilization when large negative shocks hit the Eurozone. Ideally, the most straightforward solution to complete the EMU, and therefore reduce its structural fragility, would be to consolidate national budgets and debts into a common EU budget insuring the euro area against idiosyncratic disturbances. However, the reluctance of creditor MSs to contribute to fully-fledged centralized fiscal backstops entailing a

system of permanent transfers both for the EMU and the Banking Union (BU) is well-established today. In view of this, many observers have adopted a more realistic strategy of small steps to equip the EMU with risk-sharing mechanisms and a fiscal capacity at euro-area level. In October 2015, former Italian Minister of the Economy Pier Carlo **Padoan** presented a proposal for the launch of a European unemployment insurance scheme to the Ecofin Council (see MEF 2015). This proposal envisaged the establishment of a European unemployment insurance system with the purpose of absorbing asymmetric disturbances and moderating the amplitudes of cyclical fluctuations in the euro area. According to the proponent, a common fiscal capacity in the form of a European unemployment scheme would contribute to the Eurozone's macroeconomic stability and anchor positive expectations about the smooth functioning of the single currency. More specifically, the European unemployment insurance scheme should be financed through national contributions of euro-area MSs, which would pool part of the resources spent on various national unemployment benefits into a common Unemployment Insurance Fund to be mobilized only in cases of large negative shocks causing a sizeable increase in the unemployment rate. Padoan's proposal also includes an appropriate incentive structure for the scheme in order to limit moral hazard and prevent the setup of a system of permanent transfers, in that eligibility criteria to receive resources from the unemployment fund shall include the implementation of structural reforms to enhance labor mobility and harmonize employment policies in the Eurozone (see MEF 2015). According to the proponent, the establishment of a common unemployment insurance system of the kind would provide MSs with sufficient incentives to promote a gradual convergence between national institutions. The latter, because of persistent discrepancies in national labor market institutions, legal systems and different degrees of wage flexibility and labor mobility, tend to segment product and labor markets across national lines, hence hindering full trade integration and economic symmetry, which refers to the frequency with which asymmetric shocks occur or to the symmetry in the macroeconomic impact of shocks. In this regard, such an unemployment insurance system, not only envisaging the provision of cyclical unemployment support, but also aiming at incentivizing beneficiary countries to implement reforms in order to promote harmonization of employment policies across euro-area MSs, certainly could, if properly designed, contribute to making the EMU an Optimal Currency Area (OCA) whose criteria identified by Mundell would be labor market flexibility, economic symmetry and full trade integration (see Mundell 1961). **Beblavi, Marconi and Maselli** (2015) proposed to create a fiscal space in the Eurozone in the form of a common unemployment insurance scheme able to absorb output shocks and idiosyncratic disturbances at EU level. A well-designed unemployment insurance system is evaluated as an ideal solution because unemployment expenditure is inherently cyclical and brings high fiscal multipliers linked to aggregate demand support, and, at the same time, it does not constitute a system of permanent transfers because, while it can be automatically activated in cases of severe recessions or to counter strong surges in unemployment rates, its redistributive function is limited to a short-term horizon. **De Grauwe** (2018, p. 140) points out that this kind of common unemployment insurance mechanism is suitable for a monetary union where asymmetric shocks prevail, in that MSs experiencing a boom transfer resources to MSs experiencing a recession and increasing unemployment. However, business cycles in the Eurozone are usually well-synchronized, while the asymmetry is detectable in the divergent amplitudes in business cycle fluctuations, with periphery countries tending to be influenced by boom-bust dynamics and core countries characterized by business cycles with much more moderate amplitudes. In light of this, MSs are likely to experience a recession at about the same time, hence an ordinary unemployment insurance mechanism is unable to provide orderly inter-country smoothing because, by promoting a transfer of resources from a country experiencing a mild recession to another MS hit by a deep downturn, this would end up reducing the intensity of the recession in the beneficiary country and aggravating the recession in the contributor country. Therefore, only a common unemployment insurance system that has the capacity to issue

bonds to finance deficits during recessions, when the payments made by the scheme exceed national contributions, is fit to provide the Eurozone with the most needed kind of stabilization support, namely cyclical fluctuations volatility smoothing. As a valid alternative to a common unemployment insurance mechanism with the capacity to accumulate deficits and surpluses over time, **De Grauwe and Ji** (2016) discuss the eventuality of making the ESM contribute to common stabilization efforts by letting the ESM purchase government bonds and issue an equivalent amount of ESM-bonds during recessions. This proposal seems coherent with the ESM's mandate, since the purpose of the ESM, as enshrined in Article 3 and 12(1) of the ESM Treaty, is to safeguard the systemic stability of the Eurozone through the provision of financial assistance, whereas Articles 17 and 18 of the Treaty allow the Board of Governors to decide on the provision of financial assistance to an ESM MS through the purchase of sovereign debt securities on the secondary and even primary market. An innovative proposal of the EMU's economic governance framework is the one elaborated by **Drèze and Durré** (2012). The authors suggest to incentivize MSs to issue sovereign bonds indexed to the GDP growth rate so that countries with a GDP growth rate exceeding the EMU average become net contributors to the centralized fiscal backstop, while countries growing below the euro-area average become net recipients from the common fund. In this way, a common fiscal capacity in the form of a mutual insurance system is set up and is able both to stimulate aggregate demand and finance net public investment through government bonds linked to the growth rate of GDP. As part of the ESM Treaty reform, whose agreement was signed by the ESM member countries in early 2021 and will have to be ratified by the national parliaments of all 19 ESM MSs before coming into force, a common backstop for the second pillar of the BU, namely the Single Resolution Mechanism (SRM), is being endorsed, with the possibility for the ESM to allocate loans up to €68 billion in order to let the Single Resolution Fund (SRF), in case it is depleted, continue to perform its role in recapitalizing credit institutions. In this regard, **Buti et al.** (2017) had concluded that agreement on the backstop to the SRF is essential for making the SRM framework effective. However, the authors also invoked the need to set up the European Deposit Insurance Scheme (EDIS), namely the third pillar for a complete BU, which would substantially reduce the vulnerability of national deposit guarantee schemes, prevent runs on deposits and significantly contribute to eliminating the bank-sovereign doom-loop. Indeed, while the European Council adopted the proposal to establish the BU in 2012, with the SRM becoming operational in January 2014 and the SSM in September 2014, the BU remains an incomplete construct. This is because it is equipped with a limited SRF, currently amounting to €33 billion (although it will gradually be increased in the 2016-2023 period until it reaches the target of at least 1% of the amount of covered deposits of all banks), which corresponds to approximately €55 billion. Hence, as argued by **De Grauwe** (2018, p. 142), it should be able to absorb circumscribed liquidity crises, but not to deal with systemic banking crises in the Eurozone. Moreover, the BU remains completely devoid of a pan-EU deposit guarantee mechanism, hence it is unable to remedy the bank-sovereign deadly embrace (see Howarth and Quaglia 2013), which is one component of what Pisani-Ferry (2012) referred to as the 'impossible trinity' at the basis of the EMU's structural fragility, together with the strict no-monetary financing obligation and the absence of co-responsibility for public debt. In this regard, **Dias and Grigaitė** (2020) specified that the Commission published a legislative proposal on EDIS in November 2015 and a Communication on the BU in October 2017, in which it made progress in the gradual introduction of the EDIS conditional on the reduction of non-performing loans (NPLs) in banks' balance sheets. Actually, the Commission itself, in its 2018 progress report on the Action Plan on NPLs, detected evidence of progress in reducing NPLs across the euro area. In spite of this, the proposal for the establishment of the BU's third pillar is still pending, and EDIS negotiations in the Council have been experiencing continuing stalemate (see Dias; Grigaitė 2020).

b) Euro-area safe assets and financial stability

A wide stream of literature supports the introduction of a euro-area safe asset and the review of the current zero-risk weight regime for sovereign exposures to EU MSs, envisaged in Article 114(4) of the Capital Requirement Regulation (CRR), with the attempt to break the bank-sovereign doom-loop and promote larger cross-border holdings of sovereign debt securities. **Buti et al.** (2017) maintain that the creation of a Eurozone safe asset would help keep MSs' debt financing conditions sustainable and facilitate the transmission of the ECB's monetary policy. In view of reconciling the essential objectives of risk-sharing and risk-prevention, EMU MSs, according to **Delpla and von Weizsäcker** (2010), should pool up to 60% of their government debt at Community level for the creation of a blue bond, while the residual share of outstanding debt above the blue bond allocation would have to be issued in national bond markets in the form of red bonds. The main advantage of this proposal is that the senior blue tranche would constitute a highly-liquid asset characterized by very low yields that would make the average debt servicing cost decline and the euro-area government bond market more liquid, hence attracting foreign investors and possibly upgrading the euro to the status of reserve currency. On the other hand, the risk premiums on sovereign bonds in excess under the junior red tranche would probably be higher than the interest rates MSs would normally pay on their total outstanding debt because the probability of a default on junior bonds increases when a senior tranche is created. Consequently, the marginal cost of the debt issued in national bond markets actually increases. Ultimately, the decline in the average debt cost due to the optimal rating enjoyed by blue bonds would result in minor scope for solvency crises and multiple equilibria related to market pessimistic expectations and, at the same time, the higher interest rates on red bonds would increase the marginal borrowing cost, thus providing strong incentives for MSs to enhance fiscal discipline so as to reduce their public debt level. Moreover, returning to the issue of solvency risk spread to more senior debt instruments when junior bonds are issued, with possible related turmoil in large parts of the Eurozone's government bond market, an eventual default on the junior red tranche, according to the proponents, would be less disruptive because the senior blue tranches pooled together at euro-area level generate a Eurobond with the best possible credit rating attached to a truly safe European asset. In this regard, **De Grauwe and Moesen** (2009) also propose to apply different fees to countries participating in the blue bond issuance, with low-indebted countries paying lower fees and, consequently, lower interest rates on senior blue bonds than MSs with deteriorated fundamentals. This would, on the one hand, induce more virtuous MSs to take part in the blue bond allocation, while, on the other hand, provide highly-indebted countries with even fewer incentives to commit moral hazard in case they relied on the implicit guarantee that, through Eurobonds, MSs become jointly liable for the debt issued and pooled together. **Philippon and Hellwig** (2011), on their part, put forward the case for the creation of common debt instruments with maturity of less than one year called Eurobills. These are issued by a joint debt management office to satisfy the needs of all Eurozone countries, provided that MSs do not receive more than 10% of their national GDP in Eurobills and comply with the EMU's fiscal rules. The rationale is that Eurobills would replace short-term national sovereign bonds, hence not expanding the overall amount of short-term debt, which is riskier than debt with a longer maturity structure (see Blanchard; Leandro; Zettelmeyer 2020), as it is more vulnerable to sudden interest rate upsurges. Furthermore, given that Eurobills replace national sovereign bonds with short-term maturity and receive seniority over all the remaining debt securities issued at national level, they should achieve the double objective of preventing solvency crises caused by self-fulfilling prophecies and convince MSs to implement prudent fiscal policies, without, anyway, guaranteeing an elevated degree of risk mutualization and foreign investment attractiveness as the senior tranche under the blue bond proposal, as

also claimed by Buti et al. (2017). **van Riet** (2017) contends that the best solution to resolve the 'safety trilemma' between national safe assets, capital market integration and financial stability is for the ESM to pool national sovereign bonds for the creation of a 'synthetic Eurobond' that includes a safe senior tranche and a risky junior tranche built on a diversified portfolio of government bonds. Participation in the 'synthetic Eurobond' would be conditional on compliance with the EMU's economic governance framework. This kind of safe euro-area asset, according to the proponent, would avert capital market fragmentation and guarantee financial stability, especially if MSs decided to also issue GDP growth-indexed bonds. The latter, indeed, avoid interest payment procyclicality that could magnify the amplitude of business cycle fluctuations because GDP-linked bond contracts contain a clause allowing governments to lower or even suspend interest payments when output growth falls below a given threshold while increasing them when GDP grows in a sustained way. In relation to the issue of the Capital Markets Union (CMU), whose launch was proposed by the Commission in 2015, it is well established that a fully integrated stock/equity market and bond market in the EMU would provide a private risk-sharing and insurance mechanism against asymmetric shocks. In fact, cross-border holdings of stocks and bonds across MSs would imply that the losses arising from a decline in stock prices and in the value of bonds in a country experiencing a negative shock are also borne by investors from another country holding part of these securities. However, the aggregate size of the equity market in the Eurozone is hugely undersized compared to the stock markets of the UK and the US, where the largest share of lending to households and firms passes through capital market channels. This is so because the traditional specializations that prevail across MSs, namely the production of commodities and real estate services, mainly rely upon bank intermediation, and also because certain national business environments in the euro area, characterized by nominal rigidities and scarce incentives to promote technological innovation, are hardly attractive for equity investors (see Gambacorta; Yang; Tsatsaronis 2014; Raposo; Lehman 2019). In this sense, according to **Beck and Levine** (2004), **Demirgüç-Kunt, Feyen and Levine** (2011) and **Merler and Wolff** (2017), the EMU does not have an optimal financial structure in terms of a uniform and functional combination of sufficiently developed interbank and equity/stock markets, especially considering that both bank and market-based intermediation are positively correlated to GDP growth. That said, it would be overly pretentious to contend that capital markets could replace Eurozone monetary and fiscal authorities in absorbing output shocks on a permanent basis, as financial flows tend to be procyclical and private risk insurance mechanisms often dissipate during deep downturns, provoking credit crunches that, more often than not, make the public intervention of governments necessary (see D'Imperio; Shelkle 2017).

c) The case for concentration charges and a euro-area safe asset to remedy the bank-sovereign doom-loop

With the aim of enhancing market discipline and breaking the bank-sovereign nexus, other observers (see notably **Brunnermeier et al.** 2016) have proposed to create European Safe Bonds (ESBies), also known as Sovereign Bond-Backed Securities (SBBS), from the senior tranche of a diversified portfolio of sovereign bonds purchased by a common institution issuing ESBies and European Junior Bonds (EJBies) to finance such a purchase. This reform would have to be accompanied by a revision of the regulatory treatment of banks' sovereign exposures by exempting banks from the requirement to raise capital for ESBies holdings, while making EJBies and other sovereign debt instruments subject to concentration charges and exposure limits that apply to risky assets. Furthermore, no form of joint liability or risk-sharing is contemplated, since each MS remains fully responsible for the debt issued and for bearing the costs of a default, which would initially result in lower payments to junior bondholders absorbing the losses. The Commission has adopted a similar proposal on SBBS in May 2018. However, **Deslandes, Dias and Magnus** (2018) underline that, differently from

Brunnermeier and his co-authors, the Commission's proposal adopts a lighter approach not entailing a revision of the regulatory treatment of sovereign bonds in order to incentivize credit institutions to invest in senior SBBS and reduce the home bias in banks' sovereign debt holdings. On the contrary, the Commission proposed to treat not only the senior tranches, but also the junior tranches as high-quality liquid assets that could enjoy a zero-risk weight treatment, contrary to the overly radical proposal discussed before, which aims to significantly reduce banks' exposure to EJBies and national government bonds. Related to this issue is also the contribution by **Bénassy- Quéré and co-authors** (2018), who propose to break the bank-sovereign doom loop and promote higher cross-border capital market integration through the introduction of sovereign concentration charges. More specifically, banks would be required to raise more capital in case the bonds issued by a single sovereign, typically the home country, on their balance sheets exceed a certain proportion of their CET1 capital. This proposal has been disputed by **Messori and Micossi** (2018) and **Micossi** (2018) on the grounds that, although it is reasonable to support the introduction of concentration charges to restrict the home bias in the sovereign exposure of banks, a structural impediment to making home debt holdings eligible assets as collateral in exchange for liquidity injections from the ECB in the context of its open market operations in times of financial distress could be detrimental for systemic stability. Furthermore, as emphasized by **Lanotte and Tommasino** (2018) and **Tabellini** (2018), periphery banks did increase the purchase of domestic sovereign bonds during the 2011-2012 sovereign debt crisis when their home countries were experiencing sudden stops and capital outflows, whereas domestic credit institutions acquired large amounts of highly risky debt instruments with low mark-to-market value previously held by Northern investors. Therefore, banks provided some countercyclical liquidity support in periphery sovereign bond markets, while self-fulfilling and collective waves of fear and panic had become endemic and were causing high degrees of fragmentation in the Eurozone's securities market. Consequently, the authors declared themselves against the introduction of more stringent rules on sovereign exposures for banks, especially considering that, while banks increase their holdings of sovereign bonds during downturns contributing to macroeconomic stabilization, they tend to reduce their sovereign exposures in normal times, switching to other more profitable assets. This countercyclical behavior has entailed that credit institutions in the euro-area decreased their portfolio of domestic sovereign bonds during the 1999-2008 period, then let their balance sheets massively fill up with government debt securities during the double-dip recession in the 2009-2013 period and, subsequently, saw their levels of domestic sovereign exposures diminish since 2015 when the ECB started its net purchases of government bonds under the Public Sector Purchase Programme (PSPP).

In this regard, the ECB has been providing quantitative easing (QE) support in the interbank and bond markets since the launch of the Asset Purchase Programme (APP) in 2015, consisting of the aforementioned PSPP and of the Corporate Sector Purchase Programme (CSPP). Then, in response to the COVID-19 crisis, it injected supplementary money base to encompass the €1,350 billion temporary asset purchase programme of sovereign and corporate bonds, the Pandemic Emergency Purchase Programme (PEPP), and liquidity support to ensure smooth money market conditions and stimulate bank lending to the real economy through Pandemic Emergency Longer-Term Refinancing Operations (PELTROs) and Targeted Longer-Term Refinancing Operations (TLTROs) (see Belz et al. 2020). With the aim of further easing the government budget constraint of the EMU's risky borrowers by keeping sovereign bonds out of the market for an indefinite period of time and lengthening the maturity of public debt, **Micossi** (2020) envisages the gradual transfer of substantial amounts of sovereign debt securities from the ECB to the ESM. The latter should finance such purchases of government bonds ending up in the ECB's balance sheet as a result of its QE operations through the issuance and sale of ESM-bonds on capital markets. By issuing its own securities with very long maturities,

the sovereign bonds purchased by the ECB and acquired by the ESM would become equivalent to irredeemable obligations, that is, consolidated debt whose capital reimbursement does not take place at a given date established in the contract but is at the discretion of the issuers, which have the only obligation to pay interest rates on a regular basis. In this way, the government debt dynamics in the EMU, according to the proponent, should benefit in terms of sustainability and risk reduction, even though the responsibility for the debt issued would continue to be borne at national level, without the sovereign default risks being permanently transferred to the ESM. Furthermore, the author contends that, in light of the triple insurance assured by the ESM's sizeable capital stock, MSs' guarantee for ESM liabilities and the continuing responsibility for solvency crisis absorption at national level, ESM-bonds issued to fund purchases of government debt securities from the ECB would presumably enjoy a very favorable credit rating. Therefore, ESM securities would constitute a Eurozone safe asset that is attractive both for euro-area credit institutions whose portfolio of sovereign bonds would consequently become more diversified, with lower levels of banks' sovereign exposures to their home countries as the redenomination risk in the euro area declines, and for market operators inclined to invest in the highly liquid market for a European safe asset, hence likely enhancing the international role of the euro as a reserve currency. Moreover, such a strategy is said to be helpful for preventing the ECB from becoming overburdened with the responsibility for macroeconomic stabilization, instead employing the cash received from the ESM for its asset purchase operations to smoothly decide whether to continue to implement expansionary monetary policies by purchasing other sovereign debt instruments or to suspend its QE interventions and, therefore, make its balance sheet decline, with the presumably less disruptive impact of a tightening monetary policy stance on government debt sustainability dynamics (see Micossi 2020). A proposal by **Codogno and van den Noord** (2021) conceives the issuance of a euro-area safe asset at Community level that is swapped for national sovereign bonds on banks' balance sheets and replaces government bonds in their role as collateral in repos. Ultimately, this should lead to higher profits for banks, as the safe asset would obtain seniority over government bonds, and to lower risks of liquidity and solvency crises both for domestic governments and intermediaries, hence reducing the bank-sovereign deadly embrace. Considering that the CRR allows banks to accumulate large amounts of sovereign exposures, many other regulatory reform proposals have been put forward. In this regard, there are proposals that recommend attaching appropriate risk weights to national sovereign bonds based on external credit ratings or assume that no sovereign debt is entirely risk-free (see **ESRB** 2015; **Schneider; Steffen** 2017), and others that rely upon the imposition of concentration charges for large sovereign exposures (see **Bénassy-Quéré et al.** 2018; **Véron** 2017). In this regard, **Véron** (2017) contends that the main determinants of the bank-sovereign doom-loop are the continuing allocation of deposit insurance at national level, which can undermine trust in deposits and in national sovereign creditworthiness, and the very high euro-area banks' sovereign exposures to their home country, expressing a deeply rooted home bias and the highly concentrated domestic sovereign exposures of Eurozone credit institutions. Therefore, the author advocated the joint implementation of EDIS and of a new regulatory treatment established by a Sovereign Concentration Charges Regulation (SCCR), with the aim of tackling the risks related to large concentrations of sovereign exposures in banks' balance sheets and promoting a higher diversification of government bonds in bank portfolios. More specifically, the proponent pictures a scenario in which sovereign concentration charges are applied on the basis of the sovereign exposure ratio, that is, the ratio of a bank's sovereign exposure to a given country, namely the sum of its exposures to the central government, local/regional agencies and state-owned enterprises, over its Tier 1 capital. Any exposure above the exemption threshold, which is set at 33% of Tier 1 capital, is multiplied by a marginal multiplier coefficient, the sovereign concentration charge, which is directly proportional to the exposure ratio. Subsequently, the sum of exposures above the 33% threshold multiplied by the relevant concentration charges, encompassing

euro-area aggregate sovereign concentration charges, is added to the bank's risk-weighted assets, implying that any sovereign exposure above the exemption threshold would result in lower capital ratios. Finally, the author emphasizes that the introduction of risk weights on sovereign exposures would imply an excessive reliance upon the volatile and fallible assessments provided by credit rating agencies, which would intensify the procyclicality of the prudential framework, e.g. by making the sovereign risk weights surge in case of a debt crisis, further worsening the MSs' government balance. Furthermore, sovereign risk weights are said not to solve the home bias problem, in that they would not promote a diversification of banks' sovereign portfolios being sufficient to reduce the bank-sovereign linkages. On the contrary, the expected impact of sovereign concentration charges entails that most banks would bring their sovereign exposure to each country, including their home jurisdiction, below 150% of their Tier 1 capital, diversifying their portfolios of government bonds to include several euro-area sovereigns. Such a cross-border bank holding of government bonds would be beneficial, since it could attenuate the bank-sovereign doom-loop at national level and pave the way for higher risk-sharing through the channels of a more integrated euro-area securities market, which would make the impact of sovereign debt restructuring and asymmetric disturbances more widespread and, hence, less disruptive for the Eurozone (see Véron 2017).

However, while reasonable in the logic of a wider diversification of banks' asset portfolios that could trigger a higher cross-border integration of stock, bond and interbank markets to provide a sort of private risk insurance mechanism against asymmetric shocks, the economic rationale for a substantial revision of the regulatory treatment of euro-area banks' sovereign exposures, especially one focused on sovereign credit risk rather than on sovereign concentration risk, is not indisputable. As **Lanotte and Tommasino** (2018) contend, both the stress tests regularly conducted in the euro area since 2011 and the bail-in regime introduced by the Bank Recovery and Resolution Directive (BRRD) have already managed to significantly scale down the bank-sovereign doom-loop. On the one hand, the bail-in resolution tool foresees the mandatory involvement of shareholders and creditors holding bonds and deposits superior to €100,000 for the recapitalization of banks. In other words, the private sector has the obligation to cover a minimum of 8% of the total liabilities of failing banks before credit institutions can resort to a precautionary recapitalization from the SRF, which is allowed to cover 5% of total liabilities, and only ultimately to public refinancing from domestic governments. On the other hand, the stress tests and comprehensive assessments performed by the European Banking Authority (EBA) and the Single Supervisory Mechanism (SSM) tend to include the assessment of the large amounts of government bonds held by credit institutions on their balance sheets, eventually leading to poor performances in terms of CET1 capital shortfall. For example, this was the case for Italian banks, which were among the worst performers in the stress test carried out by the EBA in September 2011, which included the assessment of the large amounts of government bonds held by credit institutions, differently from the previous stress test of June 2011, and also in the comprehensive assessments performed by the SSM in January and September 2014, which resulted in the bankruptcy of Veneto Banca and Banca Popolare di Vicenza and in the precautionary recapitalization of Monte dei Paschi di Siena (MPS) in 2017. Secondly, there is no totally convincing economic reason for promoting the issuance of a euro-area safe asset to reduce risks for financial stability in the Eurozone. First of all, the ECB, under its QE operations, including the PEPP, returns the interest payments it receives from governments for the sovereign bonds it purchases to the governments themselves. This circular flow of interest payments implies that governments do not have to pay interest rates on their bonds purchased by the ECB any longer, so that sovereign debt purchases on the part of the central bank are equivalent to debt relief that reduces the debt burden for governments (see De Grauwe 2021 on this issue). Moreover, when the ECB decides to operate as an LOLR in the interbank and government bond markets, letting its balance sheet

increase as happened in 2008, in 2010-2012 in the context of the Securities Market Programme, in 2015 and in 2020, it tends to relax the eligibility requirements for eligible assets to be used as collateral in open market operations and for overnight borrowing. In this regard, besides continuously reducing the interest rate that applies to its MROs, the repo rate, to zero level in order to stimulate bank lending, the ECB, since the 2008 global crisis, has abandoned the variable-rate tender system that applied to MROs until 2008 and that required banks to bid for the desired amount of liquidity in exchange for adequate collateral at successive interest rates that could not be lower than the repo rate established by the ECB's Governing Council. Instead, from 2008 onward, the ECB has resorted to fixed-rate tenders, which entail that banks bid for the amount of liquidity they need at a fixed interest rate decided ex-ante by the ECB's Governing Council in exchange for eligible collateral. Moreover, as said before, the ECB has also significantly loosened the criteria for eligible assets as collateral that credit institutions have to provide if they want to borrow overnight from the marginal lending facility or if they want to benefit from the ECB's liquidity injections under MROs, longer-term refinancing operations (LTROs) and TLTROs. Consequently, the need for a Eurozone safe asset that is swapped for national sovereign bonds on the banks' balance sheets and is used as collateral in repos and interbank loans is not particularly pressing as long as the ECB remains resolute enough to provide LOLR support, and this seems to be the case today. As a matter of fact, in its Monetary Policy Strategy review announced on 8 July 2021, the ECB seems to have extended its interpretation of the 2% inflation rate objective in the medium term to encompass a longer time horizon. This might imply that the ECB would not immediately raise interest rates or severely tighten its expansionary monetary policy stance to counteract increasing inflationary pressures if it evaluates that this decision could lead to higher unemployment or financial instability (see Bini Smaghi 2021). Indeed, the ECB actually announced, on 22 July 2021, that it would keep short-term policy rates low until the inflation rate reaches the target and stabilizes at 2% over the medium-term horizon, suggesting that the ECB itself will, from now on, probably tolerate temporary deviations from the 2% target for longer compared to the past.

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