Designing EU economic policy

Recommendations of Finnish business and industry

Contents

Forword

ACTING CONSTRUCTIVELY WITH FINLAND'S LONG-TERM INTEREST AT THE FORE – FINLAND MUST FIND A PLACE IN THE CORE

Debates on economic policy structures are intensifying, and significant policy choices will be made at the EU level in the near future. We must remain vigilant.

The COVID-19 crisis triggered, at least partly, the need to create a special stimulus package for the EU economies ravaged by the crisis. Getting the package approved was politically challenging and not least in Finland. Criticism focused on the fact that most of the funding is going to the countries of Southern Europe and for a good reason, the EU is anticipated to be taking steps towards increasing joint liability.

However, EK supported approving the package in Finland. The collapse of the package would have put the financial markets in a state of great uncertainty and created a crisis in the EU during the COVID-19 pandemic. Finland approved the recovery package, but emphasised that it was approving a one-off package.

The EU is a vital reference framework for Finland and Finnish companies, and we have benefited from the Single Market and economic integration. It is therefore important for us to strengthen the EU's capacity to function. This also requires that the Member States assume greater responsibility for the resilience of their own economies and that the EU will focus on issues that should be handled at the EU level.

This EK report Designing EU economic policy. Recommendations of Finnish business and industry highlights the principal decisions that will have to be made by Finland. In the report, we want to present what businesses consider important in the development of the Union. We emphasise that Finland must take an active role in defending its interests and the success of its businesses and to find a place in the core of the EU where policies are drawn up.

We will not say no to anything automatically; instead, we will act constructively with Finland's long-term interest in mind.

The Board of Directors of EK decided to draft its policies well in advance to allow it to influence domestic and European decision-making. For the drafting work, the Board of Directors appointed a background group chaired by Timo Ritakallio, a member of the EK Board of Directors, with Kimmo Alkio, Harri Broman, Henrik Ehrnrooth, Tuuli Koivu and Risto Murto as the members. We also asked Johnny Åkerholm and Nicolas Véron, two well-known and recognised experts, for their views as economists. I would like to warmly thank the background group led by Timo, and Johnny and Nicolas for their excellent work.

Helsinki, 9 December 2021

Jyri Häkämies
Director General
Confederation of Finnish Industries (EK)

Recommendations of Finnish business and industry

EU membership has had significant positive impacts on Finnish business. Confederation of Finnish Industries (EK) is deeply committed to developing the Union. The EU is a natural reference group for Finnish companies, and it is their domestic market.

Since joining the EU, Finland has benefited immensely from the economic integration. The benefits of the Single Market are estimated at around 5 per cent of GDP per year (source: DG ECFIN, Ifo, Bertelsmann Stiftung 2019), in addition to which trade agreements signed by the EU provide substantial benefits for Finland and Finnish businesses.

The EU must be an expanding, dynamic and business-friendly environment. This is the only way to increase investment and close the technological gap between the EU and others. The EU's role in business policy must be strictly limited to, for example, regulation that benefits businesses, promoting research and technological development, and the search for market-driven solutions in climate and trade policy.

In recent years poor economic growth and lagging behind US and China in digitalisation, technological development and the growth of platform economy companies have been a major problem for the EU.

The EU has a strong role for Finnish industry in matters such as climate and trade policy. This strength must be further developed.

In Finland, there is regrettably little discussion about the most important issues for the future of the EU – the Union's role in climate and trade policy and as an advocate for the business environment, and an enabler of sustainable economic growth. The debate has been too unilaterally focused on issues such as reforming the rules of fiscal policy.

Too often in debates in the Member States concerning the EU people think that national policies have to be restricted or redirected due to rules agreed in the EU. What people forget, however, is that solutions that boost climate action and debt sustainability, for example, need to be made in any case purely because they are also in the interests of the individual countries.

EK believes that Finland must seek entry into the inner circle of EU decision-making and remain there to actively influence the development of common rules for the economy and other policy areas.

EU integration must always be assessed as a whole in which Finland can derive not only purely economic benefits but other benefits as well. For example, the benefits from cooperation in immigration and defence issues could be significant for Finland, and it is possible that these policy areas will only be developed between the countries involved in closer economic integration.

There is pressure to increase the size of the EU budget in future financial framework negotiations, as the aim is to intensify integration in new policy areas. EK believes that the financing needed for possible closer cooperation and, for example, for more extensive climate measures should be obtained by changing the internal priorities of the EU budget, by a considered increasing of the contributions of EU Member States, or by strictly defined own resources used to achieve behavioural changes.

"EK believes that Finland must seek entry into the inner circle of EU decision-making and remain there to actively influence the development of common rules for the economy and other policy areas."

REFORM OF THE STABILITY AND GROWTH PACT

The Stability and Growth Pact lays down criteria and rules for the management of public finances in the Member States. Already before the COVID-19 crisis, many countries violated the agreement's limit values. The application of the Pact has been put on hold because of the COVID-19 crisis. There is active debate in the EU on how the Pact should be reinstated (tentatively in 2023) and whether it should be revised at the same time.

Views of EK

- *The Stability and Growth Pact should be revised because in its current form, the Pact has lost its credibility and its full reinstatement is not realistic after the COVID-19 crisis.*
- *EK supports the development of strong and independent economic policy analysis and monitoring functions at the EU level. Consideration should be given to setting up an independent supervisory body, in conjunction with the Commission, for example. The EU-level analysis function must work in close cooperation with national supervisory organisations (in Finland, the National Audit Office of Finland (NAOF) and the Economic Policy Council, for example).*
- *It is possible to gradually move from the current rules towards country-specific criteria, as the countries' debt management capacity varies.*
- *EK has reservations about excluding investments from the fiscal framework (the 'golden rule') because interpretation of the rules would be difficult, and it would easily distort incentives. Rules relating to the management of public finances must be as clear as possible.*

STRENGTHENING MARKET DISCIPLINE

When the EU's rules of economic policy were created, it was thought that a strong market mechanism would guide the Member States' management of public finances. However, following the financial crisis, the economic policy environment has been unusual. At present, yield spreads between countries, for example, are markedly narrow and do not fully reflect the countries' fiscal situation and differences.

Views of EK

- *EK supports the strengthening of market mechanisms as a general principle guiding the economic policies of the EU Member States.*

- *EK also supports the finalisation of the Banking Union. However, the existing mechanisms in place in the Member States must be taken into account in creating a common deposit guarantee system, and the transition must be carried out in competition-neutral manner.*
- *A number of changes have already been made in the EU, which have significantly reduced the linkages between banks and governments and increased resilience to crises. This work must continue with the finalising of the Banking Union and the development of the Capital Markets Union, for example. The objective must be to provide credible opportunities for managed debt restructuring through the European Stability Mechanism (ESM).*

THE EU AND ECONOMIC CYCLES

From time to time, a broader role has been proposed for the EU in absorbing cyclical fluctuations across the EU or between Member States. Proposals have included various tools based on political discretion and so-called automatic stabilisers, such as the financing of social security.

Views of EK

- *There is no reason to give the EU a principal role in levelling out economic cycles. Decision-making at the EU level is subject to significant delays and rigidities, which have been noticed in the construction of the recovery package, for example.*
- *Member States' social policies (including unemployment security, pensions) must remain the responsibility of the Member States. There are also considerable problems associated with using an unemployment reinsurance scheme for national unemployment insurance systems as an automatic stabiliser.*

THE EU'S OWN RESOURCES (POWER TO TAX)

At present, EU funding consists mostly of the Member States' contributions. In the context of the recovery package, it has been agreed that the Commission will prepare proposals on possible sources of income for the EU, i.e. 'EU taxes' (e.g. taxes on digital business and major corporations, carbon border adjustment mechanism, emissions trading revenues).

Views of EK

- *EK has reservations about the planned taxation powers for the EU, as taxes at EU level will restrict the room to manoeuvre of national tax policies and/or lead to an increase in the tax rate.*
- *Potential taxes at EU level should relate to areas where behavioural effects are sought across the Union and where changes can best be achieved through EU-level solutions. Carbon border adjustment mechanism is an example of such a proposal, but many questions related to competitiveness would have to be solved if it was to be introduced, for example.*

SOCIAL CLIMATE FUND

The Commission has proposed that a fund be established in the context of the EU climate package (Fit for 55) to mitigate the negative impact of climate action on citizens and micro-enterprises, particularly in low-income and high-emission Member States.

Views of EK

- *Establishing a fund would be very problematic and difficult to justify from the perspective of Finland and the Finns.*

CONTINUATION OF THE RECOVERY PACKAGE

The recovery package created in the COVID-19 crisis in 2020 was originally intended as a one-off emergency measure. However, a debate has already begun in the EU on whether similar arrangements would be needed in future crises or whether the recovery package should be converted into a permanent mechanism.

Views of EK

- *EK has supported the recovery package as a one-off action to meet the needs of the exceptional conditions of the COVID-19 crisis. However, the stimulating effect of the package was achieved with a delay, and it is in fact more about funding of reconstruction and investment.*

- *The efficient use of recovery measures in all Member States and attaining the desired economic result in creating growth in the aftermath of the COVID-19 crisis must be ensured.*
- *A completely new crisis, which gives rise to a new debate on the need for coordinated EU-level stimulus, cannot be ruled out. This is why careful analysis of the effects of the recovery package is important.*
- *The proposals for making the recovery package permanent have been unstructured. A permanent structure similar to the recovery package would require major changes to the Union's structures and also to the Treaties. That is why the idea is not even realistic in the medium-to-long term.*

JOINT DEBT

Agreement has been reached on joint borrowing in conjunction with the establishment of the recovery fund. The joint debt already withdrawn would be repaid by 2058 with the EU's new own resources or through increased contributions from Member States.
A possible continuation of joint debt is being debated in the EU in order to rollover the debts of the recovery package, for example.

Views of EK

- *Continuing the joint debt, let alone expanding it, would require the Member States' financial situation to become substantially more harmonised and the capacity to avoid the risk of moral hazard associated with joint financing.*

Nicolas Véron:

Challenges and Next Steps for the European Union

Nicolas Véron is a senior fellow at Bruegel and at the Peterson Institute for International Economics.

Finland became a member of the European Union a generation ago, on 1 January 1995. During this time, the fundamental premises of EU integration have arguably not changed; but much else has. Finland, like other member states, cannot afford to consider EU debates through outdated lenses.

At EK's invitation, this text represents a personal perspective on some key aspects of the new EU policy landscape, with the main focus on economic and financial matters, and the relevant choices ahead. Its main themes revolve around the following four contentions:

- *Financial discipline and risk sharing should not be viewed as substitutes but as complements. To improve its future resilience and economic performance, the EU needs progress on both.*
- *Future substantial changes are likely to centre on the banking union and on the follow-up to the Next Generation EU (NGEU) programme, rather than on the revision of the EU fiscal rulebook.*
- *Completing the banking union offers tangible prospects of a better combination of risk sharing and market discipline, and should be prioritized despite the political difficulties.*
- *Further EU-level fiscal build-up beyond NGEU, going beyond one-off initiatives, should be based on progress towards greater EU own resources under appropriate democratic scrutiny.*

A DIFFERENT EU GEOGRAPHY

Beyond the 1995 enlargement, the very geography of the European Union has been profoundly modified in the past two decades. The further eastern enlargement with 13 new member states joining between 2004 and 2013, and the loss of the United Kingdom in 2020, represent an unmistakable shift of the EU's centre of gravity – literally, from somewhere south of Brussels to near Würzburg in Bavaria, but more importantly from a political and historic standpoint, with new borders, new neighbours, and new legacies. Even though the former Communist countries that have joined the EU remain poorer on average than the other member states, their development has been a spectacular and unmatched case of regional economic convergence.

Within the EU, membership of the euro area has proved to be immensely consequential. Put succinctly, the past decade has demonstrated that a non-euro-area member state can leave the EU (albeit not necessarily to its advantage), but that no euro-area member state will do the same. The confirmation of the euro area's resilience has made it attractive again after a pause of several years: Croatia is now near-certain to join on 1 January 2023, and Bulgaria probably a year later; some other countries may follow suit before the end of the decade, subject of course to political developments. From a Europe-wide perspective, albeit not from that of Finland's Scandinavian vicinity, the euro area is becoming more dominant within the EU than it ever was[1].

In the same way as the EU's internal geography has changed, so has its external environment. The immediate neighbourhood has become more challenging, raising acute security questions that could not have been foreseen in the 1990s – as the 2015 refugee crisis has illustrated. The wider world has witnessed the erosion of US unipolar dominance, the emergence of once-unthinkable political risks inside the United States, and the potentially disruptive rise of China's power. 'Strategic autonomy' or not, the EU needs to think about its security in profoundly renewed terms, and also about its external impact and responsibility. The sacrifice of Ukraine's Euromaidan protesters under EU flags, in early 2014, represented a change in what EU integration represents, even if Ukraine's accession prospects are remote.

NEW POLITICS AND POLICIES

EU institutions and politics have changed too, though in perhaps less obvious ways. They have been tested by a decade of existential turmoil throughout the 2010s: the euro area crisis, the 2015 refugee crisis, Brexit, and the COVID-19 shock in the spring of 2020. Against many predictions from inside and outside the EU, the centre has held. The euro

1 Between 1999 and 2020 the ratio of euro area GDP to EU GDP had fluctuated between 70 and 75 per cent. Following Brexit, the same ratio jumped to its current level slightly above 85 per cent. It is likely to increase further in the near future, with gradual euro area expansion and in the absence of significant EU enlargement.

area has survived the crises intact, and the EU's skilful management of its negotiation with the United Kingdom has mitigated the detrimental impact of Brexit. Such resilience generates legitimacy.

But the way the EU has overcome these threats also entails subtle institutional shifts. Its paragon has been the European Central Bank's (ECB) role in the euro area crisis, encapsulated by its president's words in July 2012, "whatever it takes". In the wake of the ECB's leadership under duress, other EU bodies have been created or given more authority, including the symbolically important capability granted to Frontex (the EU border protection agency) to use force as of this year. The ongoing empowerment of such bodies that are at least partly autonomous from the European Commission, sometimes referred to as the 'agencification' of the EU's executive functions, calls for more scrutiny and implies enhanced oversight by the European Parliament and the EU judiciary. Citizens appear to respond. EU-wide turnout in the 2019 European Parliamentary election was the highest-ever since Finland's accession, reversing decades of what had previously looked like an inexorable decline in voter engagement.

Change has been equally impossible to ignore in the economic and financial policy framework. While the euro area has been ultimately resilient, its economic and monetary union has not worked as initially intended. The apparatus of fiscal rules and disciplines created by the Maastricht and Amsterdam treaties has failed to withstand its first confrontation with reality, when both France and Germany were let off the hook for non-compliance in the early 2000s. Successive refinements of the rulebook have made it more complex, but not more effective or authoritative. Meanwhile, risk sharing has become a reality. This includes explicit instruments: the European Stability Mechanism (ESM), created in 2012 to provide conditional financial assistance to struggling member states; the Single Resolution Fund, whose creation was decided in 2014 to help the management of banking crises; and the unprecedented issuance of EU debt to finance the NGEU, as decided in 2020. Risk sharing is also embedded in implicit commitments that are

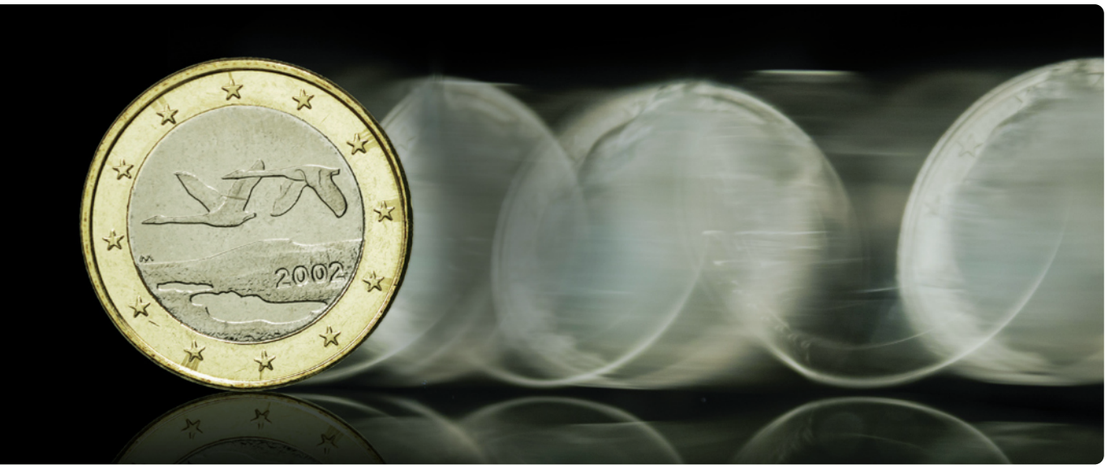
occasionally revealed by events, namely the collective preference for preserving the integrity of the euro area that was apparent throughout the euro area crisis, and the EU-wide solidarity embodied by the NGEU in 2020. Viewed from that perspective, the past decade has made it clear that the EU and particularly the euro area, because of the value they provide to their members, entail more risk sharing than is acknowledged in formal agreements: when their continued existence is threatened, member states are willing to pay a price. This experience, to which Brexit has been the proverbial exception that confirms the rule, needs to be properly analysed and understood for the right policy decisions to be made in the future.

THE HALF-FINISHED BANKING UNION

Banking issues tend to be less salient than fiscal challenges in public debates, primarily because they are less intuitive than matters of taxing and spending, but the euro area crisis has shown they are no less central to the European financial architecture and its possible reform. This became evident as the interplay between the deterioration of national government creditworthiness and national banking sector fragility, also known as the bank-sovereign vicious circle, was identified in 2011-2012 as the main driver of what came to be referred to as 'redenomination risk', namely the possibility of cross-border financial fragmentation that would force the disorderly exit of one or several member states from the euro area – and quite possibly from the EU as well. The response was the creation of a banking union, initiated in 2012 with the stated aim 'to break the vicious circle between banks and sovereigns' and aiming at pooling banking sector policy from the national to the European level. The first step of the banking union was the establishment of an integrated framework of bank supervision centred on the ECB, known as the Single Supervisory Mechanism. This European banking supervision has been implemented rather successfully, with a smooth transition from national to European-level licensing of all banks in the euro area in November 2014, and no glaring supervisory failures of the ECB since then, despite the temporary appearance of forbearance towards several German and Italian banks in the first few years of its operation.

But the banking union project remains evidently unfinished, with little cross-border bank consolidation in the past decade and powerful lingering linkages between national banking systems and governments. In particular, the new euro-area wide resolution mechanism, created to manage future banking crises under the authority of a new EU agency, the Single Resolution Board, has not developed as its designers intended. In the actual occurrences of bank failures since its entry into force in 2016, particularly in Germany and in Italy, the collective preference has almost always been for national bank bailouts over European crisis resolution that includes a 'bail-in', namely the imposition of losses upon the failed bank's creditors. Such national bailouts are enabled by multiple escape hatches that enable the avoidance of the European resolution procedure and its strict bail-in conditions. In economic terms, this revealed preference represents an implicit national guarantee that keeps feeding the bank-sovereign vicious circle, in

complement to the legal guarantee of insured deposits. On the other side of the bank-sovereign nexus, many banks have kept disproportionally concentrated credit exposures to their home sovereign (i.e. they own a lot of bonds issued by their home country on their balance sheet, against the sound principles of risk diversification), ostensibly the consequence of political influences on bank decisions and of the lingering possibility of euro-area breakup and redenomination.



Attempts to move towards a more complete banking union through the negotiation of incremental steps have failed repeatedly since 2015. Instead, acknowledging the interdependence between the different issues involved – bank crisis management and bail-in, deposit insurance, and concentrated sovereign exposures – appears to be a prerequisite for progress. But the corresponding reform agenda runs against powerful obstacles, which interact in complex ways even though none of them is intrinsically insuperable. These obstacles include member states' reliance on domestic banks as captive buyers of their sovereign bonds; banks' preference for the lower funding costs that they associate with implicit bailout guarantees; and the wide heterogeneity of existing banking structures across euro-area member states, as a consequence of which risk sharing appears to have cross-border distributional impact and is thus made politically more difficult.

Meanwhile, the project of a 'capital markets union', which the European Commission announced with fanfare in 2014, has become a textbook case of the EU overpromising and underdelivering. Some key policies that impede capital markets development – on investment taxation, insolvency law, pensions and housing finance – will remain of national responsibility for the foreseeable future. Even in the area where the EU has clear competence, namely financial services regulation and oversight, it has been reluctant to take an integrated EU approach to longstanding challenges such as financial consumer

protection, accounting enforcement, or the supervision of audit firms and of market infrastructures. The governance and funding of ESMA, the European Securities and Markets Authority, which in principle should play a pivotal role in the implementation of the EU capital markets agenda, would require in-depth reform to make it an effective and authoritative financial supervisor. Above all, since European finance is and will remain heavily reliant on banks, it is unrealistic to envisage integrated capital markets as long as banking systems remain fragmented along national lines: in a nutshell, the road to a capital markets union must go via the completion of a banking union first.

THE NGEU GAME CHANGER

The NGEU decision of July 2020 and its subsequent implementation have profoundly altered the terms of EU economic and financial policy debates:

- *The NGEU represents the first time that debt is directly issued by the EU on a large scale, establishing EU bonds as a prominent asset category in public debt markets with issuance volumes over the next few years comparable to those of the largest member states. This experiment has been very successful so far in terms of investor demand and pricing. The EU bonds' interest rate is near-identical to that of German federal sovereign debt, a sign of high investor confidence. In other words, through the NGEU, EU bonds are materializing the vision of a 'European safe asset', a financial instrument that anchors confidence in the European financial system as a whole and allows the financing on favourable terms of policies of common European interest.*
- *The NGEU represents the first case of direct transfers between member states being an explicit aim of EU policy, breaking a prior interdict. This vision has been endorsed by all member states, often by a significant parliamentary majority even in countries such as Germany that had previously rejected the concept of a 'transfer union'.*
- *The NGEU places the focus of European-level financing at the level of the European Union rather than of the euro area. Even though the ESM remains in place and could be used again, depending on inherently unpredictable events to come, EU bond issuance has become the default option for future large-volume European financing, now that a proof of concept exists.*

In terms of policy discipline, particularly of incentivizing structural reforms and long-term investment, the NGEU represents a concrete alternative to the framework envisaged at the time of the creation of the EMU, which was ultimately reliant on the imposition of fines on non-compliant member states as set out in Article 126(11) of the Treaty on the Functioning of the European Union (TFEU). Starting with the French and German breaches of the early 2000s, the fines-based rulebook has turned out to be unenforceable in practice despite its strong legal basis. Regarding a number of cases that cover a broad range of situations, there has never been one occasion in which a fine would not have been viewed as counterproductive, compounding the difficulties in which the

noncompliant member state is already in. Irrespective of how many further refinements are introduced into the procedure, it is hard to see how this fundamental limitation of fines as a disciplining instrument can be overcome. Instead of 'sticks' in the form of fines, the NGEU delivers 'carrots' in the form of grants (and loans on favourable terms). This has better prospects for success in leading to useful public investment and structural reform, but also carries risks of new forms of moral hazard and calls for careful scrutiny.

While deciding to initiate the NGEU in 2020 and to start the issuance of EU bonds accordingly, member states did not conclude their discussion on how the reimbursement of those bonds would be financed. They called for the identification of new own resources for the EU, a euphemism for European-level taxation, but because they knew this would be hard to achieve, they added a backup guarantee provided by member states. It is hoped that this guarantee will not have to be exercised. Because the reimbursement of NGEU debt is planned over three decades only starting in 2027, there is ample time to discuss whether the burden of NGEU debt reimbursement will ultimately fall on individual entities liable for their own resources (and if so, which ones), or on member states. The uncertainty about the reimbursement mechanism, and its very long horizon, imply that any computations of net contributions to the NGEU at the member-state level are essentially meaningless, even though attempts at such quantifications have predictably featured high in public debates about the initiative. Fortunately, even under reasonably conservative assumptions, the economic stimulation from the plan is enough to ensure that every member state would be a net beneficiary[2].

In terms of risk sharing, the NGEU has impact through the volume of the corresponding spending and transfers, but much more so through its powerful signal that the more fragile member states are not left on their own in the event of a massive unexpected economic shock, such as that generated by the COVID-19 pandemic. The corresponding compression of the weaker member states' sovereign spreads has brought them massive economic benefit without any cost to the stronger ones, an unambiguously positive-sum impact.

STRUCTURAL AND TRADE POLICY

The EU has powerful internal structural levers thanks to its single market and competition policy authority. The toolkit it has successfully used to integrate the internal market for goods, however, has been less effective when it comes to services. The cross-border fragmentation that exists in financial services can be observed in other areas as well including, critically, digital services and electricity and gas markets. In such industries where public regulation and supervision plays a major role in shaping market structures,

2 For this point I have relied on the analysis by Zsolt Darvas, available at https://www.bruegel.org/2021/01/the-nonsense-of-next-generation-eu-net-balance-calculations.

further EU-level integration of relevant authorities may be needed to achieve the promise of the single market, similarly as has happened with European banking supervision.

In trade policy, the EU has been active with recent bilateral initiatives that include the EU-Japan Economic Partnership Agreement (entered into force on 1 February 2019), the Canada-EU Comprehensive Economic and Trade Agreement (approved by the European Parliament on 15 February 2017, national ratification process underway), and the China-EU Comprehensive Agreement on Investment (for which the European Parliament approval process was suspended in 2021 following Chinese sanctions). As the latter example illustrates, however, the changing geopolitical environment, combined with the EU commitment to fighting climate change, is leading to rapid changes in the perception of the value of trade initiatives and or the priorities of trade policy. The EU has adopted some new instruments, such as the foreign investment screening regulation of March 2019, and is considering some more, such as the international procurement instrument initially proposed in 2012 and on which a Council negotiating mandate was reached in June 2021.

The EU's commitment to a global rules-based economic order is unique, because EU integration is itself a rules-based supranational order. The EU thus plays a constructive role in international agencies such as, for example, the World Trade Organization and various global financial regulatory bodies. Given the evolving positions of China and the United States, however, the EU will need to do more to sustain global bodies and enhance their legitimacy. In some cases, this will require the recalibration of the EU's own presence, where at least some of the individual member states' representation could be pooled, and by making itself fully compliant with the corresponding global standards[3]. Protectionist and mercantilist impulses run counter to the promise of EU integration. What the EU needs, instead, is more ambition and global leadership for its trade and international investment policy.

PROSPECTS FOR THE NEXT STEPS

The NGEU is only established on an exceptional temporary basis, politically as well as legally under Article 122(2) TFEU. A number of voices have called for making it permanent. But the reality is that for the NGEU's stabilizing impact and other advantages to become part of a steady-state framework, any NGEU-like permanent mechanism would need to be founded on a new legal and political basis, not just an extension of the decision made in 2020. A new one-off programme could, however, conceivably be envisaged on the same legal basis as the NGEU.

3 The Basel Committee on Banking Supervision is a relevant case on both these counts, and is far from the only one. The euro area is currently represented there not only by the ECB but also by individual authorities from seven different member states. Given that bank supervisory policy is now set at the European level, phasing out those redundant national seats would address the rest of the world's feeling that Europe is unduly overrepresented in the committee, which undermines its global legitimacy and authority.

Further steps towards a permanent European fiscal capacity should combine risk sharing with effective disciplining mechanisms, and it is doubtful that agreement can be found on such steps without such a sound combination. Critically, the treaty's 'no-bailout rule' in Article 125 TFEU, which prohibits making the EU or its member states liable for the obligation of individual governments, has to be made credible. Because the revealed preference of euro area member states, for good reasons, is to preserve the integrity of the euro area, this in turns implies that any difficulty of a given member state, no matter how serious the difficulty and how large the member state, can plausibly be addressed in compliance with the no-bailout rule, including through sovereign debt restructuring if necessary, without necessarily triggering a forced exit from the euro area. In other words, redenomination risk must be taken out of adverse scenarios to a much greater extent than is currently the case.

The completion of the banking union is an indispensable component of that effort, because the euro area crisis has exposed the bank-sovereign vicious circle as the main driver of redenomination risk and thus the main threat to the euro area's integrity. In order to complete the banking union, all relevant issues must be included, including regulations to penalize excessively concentrated sovereign exposures, the acceptance of creditor bail-in as the default treatment of future banking crises, and a genuine euro-area-level deposit guarantee that supersedes the existing national deposit insurance schemes.

This agenda is challenging. The NGEU decision of 2020, however, makes it less intractable than it used to appear, if only because the NGEU represents a much larger example of risk sharing, albeit on a time-limited basis, than a single European deposit insurance would entail. It is also helpful that the legacy of the euro area crisis in terms of banking sector fragility has now been nearly entirely addressed, with very few 'problem banks' left even after the 2020 pandemic-related scare. Even so, the deadlock observed once again in June 2021 in the banking union discussion has shown that the obstacles to completion remain powerful, and cannot be reduced to some member states' resistance against risk sharing. Ultimately, all member states must genuinely renounce what, in some cases, are longstanding practices of bank bailouts and financial repression, if they are to reap the benefits of a complete banking union, which in turn would unlock future progress towards a capital markets union.

Even assuming no bank-sovereign vicious circle, however, it is doubtful that scenarios of sovereign debt restructuring within the euro area can be made credible enough without any instrument of macroeconomic stabilization. Sovereign debt restructuring, whenever and wherever it happens, is always disruptive, and euro-area countries do not have the option of national currency devaluation and inflation to soften the shock, as is the case of all countries that have their own currency. It is highly doubtful that a European macro stabilization capacity can be created on a permanent basis while relying entirely on the kind of guarantee provided by member states that has been used as fallback option for the reimbursement of NGEU debt.

It thus appears indispensable to specifically identify own resources that would be available to finance the reimbursement of future issuance. This will obviously be difficult because no one likes to pay taxes, but a permanent system of European own resources, if well designed with credible checks and balances, would be sustainable in a way that the institutionalization of permanent transfers between member states would not. Since the need for new own resources has already been identified in the context of NGEU, it is plausible that a permanent framework such as this would adopt an EU-wide geographical scope as well, even though the alternative option of restricting it to the euro area cannot be ruled out. As for what form the own resources would take and which entities would be liable for them, that question remains for now widely open; from the perspective of most economists, the taxation of CO2 emissions appears to be a natural candidate, but that has not gained enough consensus to happen yet.

Furthermore, the discussion on the EU's own resources is the key to the next developments of EU fiscal policy reform, rather than any reform of the stability and growth pact and related rules for which it is likely that flexibility will be found anyway. Own resources that entail significant financial firepower, in turn, would require appropriate mechanisms of democratic scrutiny that make them acceptable to the entities that will be made liable for them and to the broader European public. The pace of any decision-making sequence along such lines is unpredictable. A mere repeat of the NGEU on a similarly one-off basis could conceivably happen in the relatively near term, depending on events. Anything more structural is likely to take some time.

NICOLAS VÉRON

CONCLUDING THOUGHTS

As noted at the start of this introduction, the European Union has gone through a painful and educational decade of existential challenges in the 2010s. Right now, it appears less immediately at risk. Moderate mainstream political forces are in charge of government in the EU's five largest economies by GDP. Unlike the situation at several times in recent years, that appears unlikely to change in the near future. Friction over the continued commitment of some other member states to the EU rule of law is escalating, but the EU is approaching this from a position of greater strength than was possible at any point during the 2010s. The NGEU decision of 2020 has considerably contributed to that strength, as it has demonstrated the EU commitment to solidarity and togetherness in an unprecedented and very concrete way.

Moving away from the status quo must not involve much additional risk sharing. The NGEU episode has demonstrated, as the euro area crisis did before, that a considerable degree of de facto risk sharing already exists in the euro area. What is needed is to organize it better, and to set the right mechanisms and incentives to enshrine risk sharing in a framework of democratic accountability and market discipline.

None of this ostensibly requires any major changes in the EU treaties. What is surely needed, though, is institutional innovation and experimentation, for which a defensive posture cannot be enough. Given its history, dynamism, quality of government and social institutions, Finland is among the member states best placed to contribute new ideas and solutions to EU policy thinking and negotiations. The temporary isolation that has come with the COVID-19 pandemic must not come at the expense of awareness of the big picture. Just as in 1995, EU integration presently promises a wealth of future opportunities. They should not be missed.

"The decisions to create a banking union in 2012, and to initiate the NextGenerationEU programme in 2020, both based on the painful lessons of the euro area crisis, have fundamentally reshaped the terms of debate about European economic and financial policy reform. But the currently unfinished banking union and the temporary NGEU, for all the improvements they have brought, do not add up to a sustainable framework. Further steps will eventually be needed to make the euro area and EU sufficiently resilient and to provide a sound basis for growth and investment. They must be informed with an appropriate balance of market discipline, risk sharing, and democratic accountability."

Johnny Åkerholm: EU development and development needs

Johnny Åkerholm is a recognised economist who has worked e.g. at the Bank of Finland and the Ministry of Finance, Finland and chaired the EU's Economic and Financial Committee.

THE EK'S STATEMENT PUBLISHED IN 2017 REMAINS RELEVANT

In October 2017, EK published an extensive statement on the issues being debated in the EU at the time[1]. Although major changes have taken place in the global economy and politics since then, the statement has not become dated to any significant degree. Following the publication of the statement

- *The integration of the global economy has backtracked as both increasing political tensions and the COVID-19 pandemic have revealed the vulnerability of the highly integrated global economy. This will increase the significance of the EU's Common Trade Policy as a tool to foster the interest of EU Member States.*
- *The pandemic has caused fluctuation in economic growth; it brought the economy to an abrupt stop in 2020, but economic activity has largely recovered in 2021. In response to the pandemic, the deficit and debt targets of the Stability and Growth Pact have been set aside, and the EU now has a temporary recovery fund that issues loans and grants. It is financed by EU borrowing and will later be paid for by the Member States.*
- *In addition, the European Central Bank has further increased its monetary stimulus. Both the public and private debt of the EU countries have increased by about 15 percentage points of GDP in just under four years. Inflationary pressure has increased and threatens to become an obstacle to the continuation of growth.*
- *The UK has left the EU and its contribution has been redistributed among the Member States.*

1 Future of EU – views by Finnish business, Confederation of Finnish Industries (EK), 6 October 2017

The efforts to reform the Monetary Union have not made any material progress in recent years. The application of the Stability and Growth Pact has become more complicated since the changes introduced in the wake of the financial crisis, and if anything, transparency has weakened. The development of the Banking Union has stopped, although there seems to be a broad consensus of the need to complete the project. The same applies to the Capital Markets Union. It, too, seems to enjoy broad support, but it is making virtually no progress at all.

The temporary shelving of the Stability and Growth Pact has led to a debate on its future. Many consider the limits it sets to be unrealistic at the current levels of debt.

Although the recovery fund is based on crisis legislation, its creation has raised hopes among many that it will become a perpetual arrangement. Its title – NextGenerationEU – refers explicitly to the fact that those who named it also had a permanent arrangement in mind. These efforts are underpinned by a wide range of political and economic objectives, and the climate objectives set by the EU have added to the justification of increasing shared resources. This also raises the question of the EU's funding sources. Both new forms of taxation and perpetual debt have been proposed.

Although many of the issues involve strong political undertones, these issues are addressed in the following exclusively from the economic policy point of view. Time after time, economic reality has trampled over the Stability and Growth Pact and it has been unable to prevent rising debt in the euro countries. The reasons for the failure are discussed below and the development potential of the EU's fiscal policy coordination system is considered. The need for a common EU fiscal policy will also be examined, as will the development potential of unfinished projects such as the Banking Union and the development potential of the capital markets.

At its best, the EU offers a broad and stable market area for a small economy and its businesses. Increasing productivity almost always requires specialisation, which is difficult or impossible if the market is very fragmented and access to new markets is uncertain. Cooperation within the EU also offers a strong common voice in international discussions. This is becoming more important as political tensions increase and international cooperation starts to stutter. It is therefore important to identify key areas of cooperation and to consider how cooperation in the framework of the EU will help Member States, especially the small ones, to face the challenges ahead.

THE RULES ON THE MEMBER STATES' FISCAL POLICIES DO NOT WORK

In connection with the establishment of the single currency, it was decided that fiscal policy (so-called budget policy) would remain the national instrument of economic policy. It was evident, however, that the room for manoeuvre available to national economic policy, particularly public sector indebtedness, would be able to increase with the single currency. Before the introduction of the single currency, the financiers' behaviour set limits, which on occasion were quite strict, on the public sector's indebtedness. A wide financing gap tended to make financiers uneasy, raise borrowing costs and, in the worst case, turn off the money taps. Budget planners often also had to resort to foreign financing, which resulted not only in interest expenses but also in an exchange rate risk.

It was feared that the single currency would dilute or even eliminate these market effects, as borrowing would take place on a large market without exchange rate risk. Easier access to financing would make increasing public sector spending by borrowing more attractive. Indebtedness could pose a threat to the stability of the euro area, as a high debt ratio would increase the region's vulnerability to disruptions.

The answer to these risks was scare tactics and strict regulation. In order to prevent undesirable developments, it was stipulated that if a Member State ended up in fiscal difficulties, neither the Community nor other Member States should come to its assistance and that the central bank should not finance the public sector ('no bailout clause'). A three per cent limit was set for budget deficits and a 60 per cent limit for debt. Under the agreement, a Member State violating the rules would ultimately have to pay a fine if it did not take corrective action. In other words, borrower and lenders were told that no assistance would be forthcoming should it become difficult to manage debt. It was believed that this would maintain market discipline and hence restrict indebtedness.

In practice, the threat did not work. After the introduction of the euro, yield spreads between countries were narrow, and market discipline did not restrict indebtedness. The ratio of public sector debt to GDP was around 70 per cent at the time of the introduction of the euro and is currently slightly above 100 per cent. In practice, the threat of not helping a Member State in trouble was untenable, as it was feared that one country's fiscal difficulties would spread and threaten the stability of the whole region. When suspicions regarding the solvency of Greece rose in the spring of 2008, the EU assumed the role of guarantor of Greece's debt management. This initiated a wave of reforms, and the basis for cooperation was radically changed; everything that is prohibited in the Treaty will now be done. There is a permanent mechanism (European Stability Mechanism, ESM) in place for countries in difficulty, and a substantial part of the bonds issued by the public sector can be found in the central banks' balance sheets. Current reality is a far cry from the framework established when the euro was created.

But even the reformed system was not enough to survive the disruption of the pandemic; after the financial crisis, the modified rules were forsaken and a new instrument, the recovery fund, was created. Why has this happened, and what does this mean?

One key reason for this failure is that the approach was too restrictive from the outset. Economic and economic policy realities are complex and cannot be summed up in one or two figures. The goal is to prevent debt from becoming a problem, but all the Member States do not have the same debt sustainability. It varies due to factors such as population structure (age and skills) and productivity growth. It also fluctuates over time; Finland's debt sustainability was clearly better in the late 1980s than it is at present. Back then, the proportion of the economically active population was high, which supported economic growth, and productivity was improving relatively well. Since then, productivity growth has slowed substantially, and the proportion of the economically inactive population has grown. Both reduce economic growth opportunities and the latter increases pressure on public sector expenditure. Debt sustainability has weakened and it has become more difficult to increase non-aging expenses.

In fact, the debt and deficit targets contained in the Stability and Growth Pact are not based on a particularly deep analysis of debt sustainability. At the time the figures were decided, the average debt of EU countries was 60 per cent, and with predicted growth and interest rates, the 3-per-cent deficit would have prevented an increase in the debt-to-GDP ratio. The significance of the figures has changed since then, and many seem to think that the debt is manageable provided it remains at 60 per cent, and will become a problem if it rises above it. If either of these assumptions is true, it would be pure chance.

Balancing the budget is not an economic policy instrument but a constraint. On the other hand, fiscal policy (i.e. the central government budget) is used to affect economic development by adjusting overall demand. Also, the development of the budget's balance

depends on the development of the economy as a whole; public expenditure is to a great extent (but not entirely) a matter of policy, but the revenue base of the budget fluctuates with the economy. The budget will not gain a billion euros even if public spending is cut by a billion euros.

And furthermore, economic policy cannot be evaluated solely on the basis of the size of the deficit. A large deficit may be justified if this significantly improves economic growth potential. In fact, the former German Chancellor Gerhard Schröder has retrospectively justified Germany's excessive deficits in terms of the Stability and Growth Pact in the early 2000s by saying that it was economically and politically impossible to balance public finances and implement structural reforms in the labour market at the same time. Following these reforms, Germany's economic growth accelerated in relation to other EU countries, and the public sector's financial position has remained strong. If the Schröder Government had a choice between structural reforms promoting growth and the short-term balancing of the public sector budget, it made the right choice, even if this was in contradiction with the Stability and Growth Pact that Germany advocated.

Correspondingly, a balanced or surplus budget is not necessarily a sign of successful economic policy. If the budget is balanced by neglecting important public investment (which Germany also seems to have done) or investments in education and research, problems will only be postponed. Short-term balancing is achieved at the expense of future growth, and balancing becomes more difficult later when growth slows down.

The balance of public expenditure should be reviewed together with the balance of the private sector. For example, Japanese public sector debt is among the highest in the world (currently just under 240 per cent of GDP), but since the private sector has a large financial surplus, the national economy as a whole is in surplus, i.e. the country has a positive current account.

The way the EU has directed its attention to the development of public sector balance and debt is clear and transparent, but they cannot be explained by economic policy. It focuses debate on technical details and does not properly address broader economic policy issues.

THE PROPOSALS AIM AT FINE-TUNING THE SYSTEM

The focus on technical issues is reflected in both the reforms that have been carried out and in the proposals under discussion. Following the financial crisis, indicators were developed to avoid inappropriate economic policies. Adjustment periods were extended when indebtedness had diverged from the targets and decision-making was streamlined to facilitate the implementation of possible sanctions. As a result, a large number of new implementing rules were created, and guidance related to fiscal policy was expanded. Currently, it includes over a hundred pages.

The economic disruption caused by the pandemic has given rise to a new debate on economic policy rules. There is a broad consensus among policy makers, international institutions and academic researchers that the system is in need of improvement[2]. At least three lines of thought have emerged:

- *Analysis should focus on public spending, as this is the easiest thing for policy makers to manage.*
- *The debt targets should be defined by country.*
- *Public investments should be treated outside the deficit criterion (the 'golden rule').*

Focusing attention on public expenditure instead of deficit has received broad support[3]. This would undoubtedly add structure to the analysis, even though public spending also contains elements that vary due to economic development, such as unemployment-related expenditure. The proposals set out models in which the trend in public expenditure (excluding interest payments and in some proposals without unemployment expenditure) is linked to the production potential of the economy and need to change the debt ratio. When the debt ratio is at an acceptable level, public expenditure would be able to grow in line with the GDP's production potential. If the debt ratio has to be reduced, the ratio between expenditure and economic growth is determined by the desired adjustment path. This could be deviated from only when changes in taxation have a permanent effect on public sector revenue. The model thus includes a certain type of automatic adjustment. When the economy operates below its potential, public expenditure's proportion of GDP will grow, which will support demand in the economy. When the economy operates above its potential, the system will restrain economic growth.

The economic growth potential is a key concept in this analysis. This is clear in principle, but there is rarely any consensus on numerical estimates. This has become even more apparent with the efforts made in the EU to focus on the evolution of the public sector's structural deficit[4].

Most of the proposals start off with the numerical targets of the Stability and Growth Pact, and the adjustment paths are calculated on the basis of a debt ratio of 60 per cent. As the euro area's average ratio is currently over 100 per cent (over 200 per cent in Greece) and increasing, the adjustment paths are very long, even in the average. The very long adjustment paths do not offer a viable anchor for economic policy, nor do

2 Also included are supporters of the so-called new monetary policy. In their opinion, there is no need to worry about the indebtedness of the public sector. This is essentially based on the belief that interest rates will remain low for a long time, which limits the costs of managing debt. The idea feels politically attractive and has received support from many users of revenue. However, the Nobel laureate Paul Krugman has said that "everything that is right in this theory is old, and everything that is new is wrong".
3 See Jean Pisani-Ferry – Jeromin Zettelmeyer (ed.) 'Risk Sharing Plus Market Discipline: A New Paradigm for Euro Area Reform? A Debate' A VoxEU.org Book, 2019. The book includes comments on the reform proposals put forward by seven French and seven German economists. See Bénassy-Quéré and others, 'Reconciling Risk Sharing with Market Discipline: A Constructive Approach to Euro Reform', CEPR, Policy Insight No.91, 2018. In their report, the Group of economists proposed shifting the focus to costs, and the proposal has received broad support. There is some variation in views on how to implement this, particularly as regards the gross domestic product that is used as the reference.
4 The definition of structural deficit requires an estimate of economic production potential. In most cases, different calculation methods arrive at very different results.

unrealistically steep adjustment paths. Adjustment periods that extend over several decades affect many generations and are susceptible to disruptions. If Finland had determined in 2000, when the Nokia boom was at its strongest, how its public debt ratio would decline in the following 20 years, the calculations would have proven to be totally unrealistic in the light of what actually happened. Adjustment paths extending over very long periods are not credible.

The European Fiscal Board (EFB) has drawn attention to this and proposed in its 2020 annual report that debt targets should be defined by country. This would make the targets more realistic and also more useful. It should be noted, however, that in the model outlined by the EFB the targets are set related to the existing debt situation and not based on any in-depth analysis of debt sustainability. It is not necessarily the case that countries with high indebtedness have higher debt sustainability than others. In practice, the opposite may be the case.

As the gap between the prevailing indebtedness and the set targets has widened, and while there are increasing public sector investment needs to strengthen infrastructure and combat climate problems, for example, the so-called 'golden rule' has received support

from many quarters[5]. The golden rule would distinguish between public investment — or other 'welcome' spending — and other expenditure. Such a distinction could be useful in terms of the quality of public expenditure because expenditure important for economic growth would receive special treatment. The European Fiscal Board (EFB) has shown that, in a tight spot, public investments have not been made in Member States when politically sensitive current expenditure has been left alone. Over time, this has reduced public investment in EU countries, and the EFB's calculations show that gross public investment has often been lower than depreciation. The public sector capital base – including infrastructure – has declined from time to time, contributing to weakening economic performance.

However, the exclusion of certain public expenditure from the balance review is problematic for at least two reasons. The approach encourages innovation in statistics. Distinguishing investments from other expenses is much easier in theory than in practice. For example, education and research support the renewal of the economy and enhancing growth potential, but how can the investment component be separated from current expenditure? More importantly, we must also manage the debt taken to make the investment. A household cannot move expenses it has incurred from buying a home (or any housing expense for that matter) outside their own budget review, even though housing is essential. One-off investments will almost always result in permanent running costs for households as well as for the public sector. The commitments involved with this approach are easily disregarded.

Blanchard, et al. (2020)[6] offer an alternative approach. They do not recommend the golden rule as such but replace it with a model that reduces the surprises associated with future expenditure. Investment costs are excluded from spending limits[7] in this approach, as well, but the associated depreciation and net interest expenses[8] are included in the limits. This is a clear improvement from the golden rule, but the classification issues remain unresolved. The authors suggest that there should be clear rules for classification and that compliance with these rules should be monitored by an international body.

The above proposals seek in different ways to address the problems of applying the Stability and Growth Pact and would – at least in principle – be improvements to economic policy in relation to the present situation. Although their aim is to clarify and simplify, their application is based on a number of contentious assumptions. Bénassy-Quéré and others outline a practical application of their model. If the fiscal policy were managed only by experts, the described multi-stage process could be a useful tool. But when fiscal policy is a central element of politics, the framework remains mechanistic, especially in the context of international negotiations. Cooperation would still be guided by various numerical

5 See also Vesa Vihriälä, 'Julkiset investoinnit, finanssipolitiikan säännöt ja velka' (Public investment, fiscal policy rules, and debt), Blog 17 October 2021.
6 Olivier Blanchard, Álvaro Leandro, Jeromin Zettelmeyer, 'Revisiting the EU Fiscal Framework in an ERA of lending rates'. PDF, March 2020.
7 They are transferred to the capital account.
8 Net interest expenses are incurred when the returns from an investment are not sufficient to cover the interest expenses incurred.

targets. There is a danger that the first serious disruption could lead either to deviation from the targets (as is currently the case) or to measures that are inappropriate in terms of economic policy.

WHERE TO ANCHOR THE EU DEBATE ON ECONOMIC POLICY?

The system is clearly in need of adjustment that goes further than what has been described above and so it is therefore worth revisiting the fundamental issues. External restrictions on public sector debt can be created in two ways: by increasing the EU's powers to impose changes to Member States' budgets or by applying market discipline. Increasing the EU's authority will require the amendment of the Treaty and a partial transfer of budgetary authority from the national level to the EU. This is not foreseeable, and strengthening market forces remains the only option.

Relying on market forces means in practice that interest payable on debt will vary from country to country if the Member States engage in mutually divergent economic policies. This has been difficult to accept in some (especially high-debt) EU countries. However, US experience shows that interest rates – or fear of a change in interest rates – are effective against indebtedness[9]. There is no legislation prohibiting providing aid in the United States, but despite the federal structure, no state has received aid in more than 170 years. The federal government does not impose restrictions on the indebtedness of states, but most states themselves impose different restrictions to keep expenditure under control. Since the discontinuation of giving aid, indebtedness has remained well under control. The average debt ratio is currently 16 per cent, with a variation of 10 per cent in both directions. There are clear differences in interest rates between the states.

A key challenge to relying on market discipline concerns the volatility of the markets. As long as financiers remain confident, financing costs may remain as quite reasonable. When confidence falters, changes can often be radical. This cannot be completely eliminated, but continuous provision of transparent information decreases the risk of surprises. The question is, how to offer information that shows the accumulation of problems as a gradual increase in financing costs rather than as a sharp jump?

As stated, an assessment of sustainability will require a broad review of economic performance. This includes the growth outlook for productivity, the development of population structure (both age and skills), existing promises (e.g. regarding pensions and public services), preparing for them (e.g. reserving funds), the maturity structure of

9 See Martti Hetemäki, 'Eurokriisin syyt ja euroalueen tulevaisuus' (Reasons for the euro crisis and the future of the euro area), Kansantalouden aikakirja, 2015

prevailing debt, and so on. Moreover, interest rates are also an essential sustainability factor. Debt sustainability will change as a result of the economic policies implemented; raising the economic growth potential will increase the debt sustainability of the public sector and vice versa.

There is no precise, time-constant limit after which debt will become unmanageable. On the other hand, an increase in debt will reduce the leeway available to economic policy and increase risks to financiers and risk from economic disruptions. Internal and external factors can trigger an acute crisis, the probability of which increases with a rising debt ratio. Debt that is well under control today may become uncontrollable tomorrow if, for example, energy availability is disrupted and prices increase, or interest rates rise due to rising inflationary pressures. Generally speaking, unexpected factors outside economists' analysis box trigger acute crises. Because of this, decision-makers and investors/financiers need up-to-date analyses of the changes in resilience. This facilitates risk assessment, but does not replace investors' own risk assessment.

There is an abundance of analyses as it is, and their conclusions often differ greatly. This will continue to be the case. An analysis accepted by all parties should have transparent criteria and it should be regular and sufficiently broad and must not be limited to deficit and debt figures but also review underlying factors. This requires an independent operator. Although the quality of work is good, the credibility of the results can be weakened by the other roles of the operator or its client. The idea of an independent analysis is not very original and is included in the proposals of the French-German Group and the European Fiscal Board, for example[10].

Organisational impartiality and credibility can only be established within the EU Commission if it is independent and credibly isolated behind 'walls'. The Commission's dilemma is its many roles. It is both a prosecutor and a judge, and if the decision were made to apply sanctions, it would also be responsible for the practical measures involved. The activities could also be located elsewhere, with the expanded European Fiscal Board, for example. Whatever its location, this type of activity should cooperate with the national institutions that carry out independent reviews. In Finland, these are the National Audit Office and the Economic Policy Council.

The way the results are used is at least as important as the organisational location of the activity. Could the analysis form the basis for a review of Member States' economic policies within the EU? Could the analysis replace detailed rules?

Expansion of the angle of view is included the model proposed by Blanchard et al. (2020). They have drawn attention to the mechanical nature of cooperation and criticised the current practise for being excessively rule-based. Instead, they propose a standard-based

10 European Fiscal Board, Annual Report, 2018, and Bénassy-Quéré et al., 'Reconciling Risk Sharing with Market Discipline: A Constructive Approach to Euro Reform', CEPR, Policy Insight No.91, 2018.

system where the focus is not on individual numerical quantities but on the content and quality of economic policies[11 12].

The economic policy review that takes place under the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) is in undeniable need of a fundamental change. This can be described by way of a practical example.

The debt ratio of many Member States has risen to a very high level as a result of the developments in recent years. For example, Greece's public debt currently exceeds 200 per cent of GDP. This means that many countries' economies will be vulnerable to disruptions for decades, and even minor changes in economic growth or the interest rates paid by the public sector may cause a deepening spiral of debt, in which case interest payments have to be financed with more borrowing.

In the case of Greece in particular, the path to success is painful, but the situation is not impossible, as Greece's debt profile is good. How should this situation be addressed in the context of EU economic policy monitoring? If the recently presented proposals for change were to be implemented, the EU would set annual targets for public spending (excluding interest payments and investments classified as 'necessary') with the aim of achieving a gradual reduction in the debt ratio. It remains unclear how the debt that has been taken to fund investments would eventually be handled, but it is perfectly clear that the review would in practice focus on statistical questions of a technical nature and various justifications for deviating from targets. Even in the best-case scenario this could continue for decades, as no economic policy will reduce Greece's (or any other countries') debt ratios very quickly.

Instead, it would be much more fruitful to focus on the content of the economic policy pursued by Greece. An independent body could analyse the Greek economy and assess the effects of the economic policies applied on economic growth and adjusting. Lowering the debt ratio and reducing the risk of disruption may require considerable changes to how the public sector functions and in public sector spending and its

11 Blanchard et al. put forward a list of possible standards:
I I. General fiscal standards—embedded in EU primary legislation (e.g., Article 126 TFEU)
II 1. "Member states shall avoid excessive government deficits" (unchanged)
III 2. "When a member state's deficit is excessive, the member shall reduce it at a speed that avoids harm to its prosperity and that of other member states."
IV II. Criteria explaining how to meet standards-EU primary or secondary legislation
V 1. "A member state's deficit is not excessive when a rigorous debt sustainability analysis indicates that its debt is sustainable with high probability."
VI 2. "In determining the speed of adjustments, member states shall take into account the probability with which debt is unsustainable, the state of their economic cycle, market conditions, and whether the ECB is constrained by the effective lower bound on interest rates."
VII III. Secondary legislation or commonly agreed positions of the EFC explaining how to determine whether criteria are satisfied.
VIII • Methods, metrics, and examples, e.g., for debt sustainability analysis, assessing market conditions, deciding on the state of the economic cycle, and deciding whether the ECB is constrained by the effective lower bound.
12 Blanchard et al. also emphasise that low interest rates have increased Member States' debt sustainability, which has reduced the external impacts of fiscal policy, or the chance of a Member State's fiscal policies posing problems for others. In their view, this would reduce the overall need for the EU to monitor Member States' fiscal policies. Although interest rates have remained low for a long time – real interest rates have been noticeably lower than real economic growth – future economic policy cannot rely on this as a permanent phenomenon. Rising inflation and increasing inflation expectations can also cut off this trend that in itself is positive.

structures, but ultimately only solid growth will be able to bring a permanent solution to the debt problem. The same goes for all other countries.

Attention should therefore be focused on identifying the measures that are needed. It should be obvious that success lies ultimately in the hands of the countries themselves and that the Member States have ownership of policy. Changing the focus would allow for a fundamental change in the tone of the discussion. Antagonism would disappear and the EU would become a partner that would contribute an outside expert's perspective and best practices from other countries to national economic policy discussions without becoming involved in national decision-making processes. Experience shows that as long as responsibility for fiscal policy remains on the national level, orders issued from outside will not be effective as long as funding remains available. Without the antagonism, the effectiveness of the economic policy debate within the EU would increase.

Focusing on the content of economic policy would also make it possible to examine the policies of Member States that have challenging debt ratios on the basis of current criteria and a very low production growth potential and substantial public expenditure pressures. This combination increases the risks associated with rising indebtedness, but in the current system these countries remain under the radar.

It is true that such an approach is less easily communicated than a numerical system. However, numbers lose their meaning when reality departs from targets. The EU would use its influence through publicity and the market, not through rigid rules[13].

13 According to Blanchard et al., market discipline does not in itself provide sufficiently strong guidance. In addition to market discipline, they advocate for an external referee and propose that the EU Court of Justice, the European Fiscal Board or some other independent body carry out the assessment. It is a wonderful idea, but it is difficult to assess whether or not vague standards are being observed with a view of possibly imposing punitive measures. At its worst, this would shift the focus to conflicts and interfere with investors' risk analyses.

Although the idea of abandoning numerical rules seems radical, it would simply confirm the existing situation. Now, however, with no common analytical basis, the system is completely lacking an anchor.

MARKET DISCIPLINE IS ONLY EFFECTIVE IF DEBT RESTRUCTURING IS A REALISTIC ALTERNATIVE

The risk of sovereign debt restructuring is currently considered to be low, although differences in interest rates indicate that creditworthiness varies between countries. During the autumn, yield spreads in the euro area have been slightly over 100 basis points (over 1 percentage point) in 10-year bonds.

Restructuring is possible and credible only if it can be implemented without triggering widespread unrest in the financial markets[14]. Financial crises always include a serious risk of contagion, and the financial problems experienced by one country can easily spread restlessness to other countries as well. This was the case in the recent financial crisis.

The purpose of the European Stability Mechanism (ESM) is to provide the tools to prevent contagion and its establishment in 2012 was an important step towards the restructuring of debt. The ESM is an intergovernmental body[15] that helps countries facing financial difficulties. The aid is conditional on an economic policy programme. In addition, the beneficiary country's debt situation must be manageable after the aid. The ESM cooperates with the International Monetary Fund (IMF), and countries in need of support are also expected to seek financing from the IMF.

Some changes to the ESM rules have been agreed this year, which will increase the possibility of restructuring[16]. A key change is the strengthening of the Collective Action Clauses (CAC). Since 2022, the CACs included in bond documentation have been 'single-limb' clauses in that they apply to all the bonds issued by the same issuer. The latter will facilitate the decision-making by financiers in connection with debt restructuring[17].

The success of debt restructuring requires that debt write-downs will not cause a crisis in the financial system, especially in the banking sector. Efforts have been made to reduce these risks through the Banking Union. The objective is to reduce the risk of disruption by

14 The group of French and German economists mentioned above has considered extensively how to combine risk-sharing with market discipline.
15 Discussions have taken place on the legal status of the ESM. The Parliament and the Commission would like to make the ESM part of the Community, for example. These efforts have not made progress.
16 This is why they have been resisted by Italy, and the implementation of the change has been delayed. Ratification is still ongoing.
17 Some companies are specialised in acquiring debt securities subject to restructuring. Once their prices have fallen, the acquisition of a qualified majority may prove to be relatively inexpensive. A qualified majority can prevent restructuring in the hope that the creditors will eventually have to repay the entire amount of the debt. A write-down could be made in the restructuring of Greece's debts only for every other bond. For others, the qualified majority decision that was required could not be reached.

promoting integration and by establishing a crisis management system that allows crisis management in accordance with pre-agreed principles.

Financial links between banks and central governments are critical in connection with debt restructuring. In many countries, banks are a key provider of financing for the public sector. At the end of the second quarter of this year, the balance sheets of Italian banks contained government bonds worth over EUR 330 billion. These bonds may constitute a problem simply if the interest paid by the government increases; if the bonds are in the banks' so-called trading portfolio, they will have to include the impairment resulting from higher interests in their result. If sovereign debt is written down due to debt restructuring, banks will suffer losses irrespective of the type of write-down. In that scenario, governments are no longer able to stabilise the banking system.

The central banks' large purchases of government debt securities have added to this challenge. Although decisions have been made centrally, the purchases have been carried out by national central banks. Thus the debt securities issued by the Finnish government totalled EUR 31 billion on the balance sheet of the Bank of Finland at the end of the second quarter of 2021. Similarly, Italian government debt securities amounted to EUR 660 billion on the balance sheet of the Bank of Italy. In all euro countries, the amount of debt is large in relation to the central banks' own capital. A substantial write-down in a country would weaken the balance sheet of its central bank[18]. A central bank's own capital is mostly a matter of credibility, and if it has strong credibility, capital plays a small role. In the 1970s the German central bank suffered several substantial exchange rate losses in as the value of its foreign currency reserves decreased as a result of the revaluation of the Deutsche mark. However, the losses were caused by the strong trust in the monetary policy exercised by the bank, and this trust was not undermined by the weakening of its balance sheet. With the euro, the significance of the balance sheet of individual central banks has decreased. Even if the negative capital were embarrassing, it would be of little importance to the credibility of the euro system as a whole.

Proposals to break the doom loop between the government and the banking system include the:

- *creation of 'a safe asset'; and*
- *restricting banks' investments to government bonds.*

The fundamental problem is that the Basel rules define sovereign debt as risk-free, which means that banks will not have to reserve their equity to cover the investments made by in government debt securities, which will increase their attractiveness. Banks need a certain amount of low-risk investment for their risk management. For this reason, various models have been proposed to create alternative investments, with the idea that they would

18 Barbados cut government debt in 2018. This caused the central bank a loss equivalent to 16 per cent of GDP. As a result, the bank's equity was negative. Capitalisation will take place within the framework of a long-term programme. (IMF Working Paper WP/20/34).

replace government debt securities in banks' balance sheets[19]. One suggestion is that debt securities issued by the EU Commission could offer such a risk-free investment. As stated below, they are not risk-free. Another idea would be to create a safe asset by pooling[20] (by securitising) EU Member States' government debt securities with new synthetic debt instruments[21]. Synthetic bonds would be classified as separate risk items. The lowest risk item would be 'safe.' If one of the pooled debt securities were to be restructured, the resulting losses would concern riskier items. Securitisation would be carried out by market participants and the prices of different items would be formed on the market based on the risks included in the debt items.

The plan has not progressed, however. Under the present rules, the synthetic debt instrument thus created is not, like the government debt instrument, risk-free. Therefore, banks' investment in synthetic debt securities would require the provision of equity to cover the risks. It has been proposed that these debt instruments be brought into line with government bonds. It would be more practical to make the risk rating of government bonds more realistic, however. This would also increase market discipline in relation to government borrowing[22]. The problem also concerns countries outside the EU.

New synthetic bonds could form a new reference for the bond markets and a market that would be liquid enough to increase the usability of the euro. The European bond market is currently based on national bonds and has thus become fragmented. Although the markets have grown as a result of rising indebtedness, they remain thin compared with the US bond market. A deepening of the markets would support the international position of the euro and reduce the dollar dependence of the global economy.

19 There are many reasons why banks' investments in the bonds of their national governments have remained high. In Italy, for example, the private sector has a surplus of savings, and as the financial system is still bank-centred, it is natural that some of the funding needed by the state goes through the banks.
20 For example, in relation to the ECB's capital key.
21 Sovereign Bond-Backed Securities: A Feasibility Study, European Systemic Risk Board (ESRB), January 2018
22 As mentioned above, banks are a key provider of central government finance in many countries. Taking real risk into account would lead to weaker demand from banks and could lead to higher financing costs for indebted countries.

However, it is unclear how a synthetic bond would affect the pricing of the underlying debt instruments. The demand for the debt of all Member States would increase with the volume of synthetic bonds. Could this blur the risks associated with the debt securities of individual countries?

Various other ways have been proposed to restrict banks' investments in the government bonds of their own country. One way is to set a price/fee for the concentration of investments. This would increase banks' willingness to diversify their debt security portfolios to several countries. The fee would actually increase the costs associated with banks' investments in government debt instruments if the concentration limit were set at a sufficiently low level. However, this would have a different incidence than if the risks were assessed on the basis of debt sustainability. In this model, the costs would be determined on the basis of the amount of debt issued rather than on the basis of debt ratio.

A common deposit guarantee would promote the integration of the banking markets but it has proven problematic, however. The differences between the systems in use in different countries are significant, and the non-performing loans of certain banks increase the risks involved. However, the latter have clearly declined in recent years. They accounted for more than 2 per cent of all bank loans in the euro zone at mid-2021. The situation of Italian banks has also improved: the proportion has halved in 30 months and is currently around 5 per cent. The corresponding figure for Finland is 1.5 per cent.

Factors other than non-performing loans also influence the risks of the banking sector. There are differences in legislation, for example. Because of this, Bénassy-Quéré et al., who thoroughly examine the obstacles to the completion of the Banking Union, propose that the contributions from different countries into the common deposit guarantee scheme would vary depending on the risk profile. The idea is good, but risk pricing may prove challenging.

The settlement mechanism set up for bank crises is in principle clear and is being strengthened by allowing ESM funding for the Single Resolution Fund. However, there have been issues with the practical application of the settlement mechanism which diminish its credibility. According to the agreed principles, both owners and lenders will have to participate in the resolution of the crisis ('bail-in'). This has proved to be difficult in practice, however, and in Italy (Monde dei Paschi di Siena) and Spain (Banco Popular), the governments recapitalised banks when confidence in them was faltering. There are local and national emotions associated with the banking system, and problems are exacerbated when write-downs cause losses to voters. What is needed in practice is a stronger grip on the part of both the Crisis Resolution Board (CRF) and the EU Commission, which is responsible for overseeing compliance with state aid rules.

The conditions for successful debt restructuring have in many respects become better after the financial crisis. Strengthening the resilience of the financial system is a permanent process without an endpoint, however.

WELL-FUNCTIONING CAPITAL MARKETS INCREASE FINANCING OPPORTUNITIES AND RISK SHARING

The integration of the capital markets contributes to maintaining stability. The European capital markets are fragmented for historical reasons. The advent of the single currency did not eliminate this, even though there are no foreign exchange risks anymore.
The European market is highly bank-centric compared with the US and UK financial markets. In Europe, the financing of investments is also based on debt finance to a larger degree and on risk financing to a lesser degree than in the above-mentioned countries.

There seems to be broad consensus on the usefulness of the integration and development of the capital markets. Integration would increase their depth and reduce their susceptibility to disruption. The first factor would enable the capital markets to play a stronger role in the portfolios of investors. The diversification of financing options would facilitate risk management and create more funding opportunities for investments in the EU. The integration of the markets would distribute the risks across the region more widely than at present, which would reduce the likelihood of serious disruptions in the event of problems[23].

The EU high level group set up by the Commission has studied the barriers in the way of market deepening and integration[24]. Factors associated with governance, information, taxation and supervision hinder the integration of markets. The list of measures that are needed is long and the measures themselves are varied. They also involve politically sensitive matters. Arguably, changes in attitudes are needed before a well-functioning Capital Markets Union can emerge; investing abroad is questioned in many countries (incl. in Finland) because it is feared that it will weaken tax supervision, for example.

WILL THE EU NEED GREATER BUDGET CAPACITY?

From the beginning of the Euro project, it has been proposed that the EU needs capacity to engage in budget policy to support the single currency. This debate has received a new impetus since the COVID-19 pandemic and the creation of the Recovery Fund. The need for a common budget is justified by various economic policy needs, although political objectives also often seem to play an important role. Before considering how to use common funds, the constraints on common budgetary capacity should be reviewed.

23 This applies as a general claim. However, experience with the financial crisis indicates that in the event of a very serious crisis, risk diversification may create uncertainty. At the beginning of this millennium, many US banks had securitised high-risk bonds (sub-prime bonds) and sold them to other financiers and the public. The idea was that when the risks were spread sufficiently widely, the materialisation of the risks would not cause any one unsurmountable difficulties. In practice, however, when the risks materialised, market participants were not aware of the risk of potential counterparties and trading collapsed, moving it to central banks.
24 "A New Vision for Europe's Capital Markets", Final Report of the High Level Forum on the Capital Markets Union, June 2020.

Many seem to believe that more space for public spending can be created through the EU. That is not the case. If growing EU activity is funded based on the current financing model,

Member contributions will increase as will the Member States' public expenditure. Irrespective of how the liabilities arising from the Member States' recovery fund are recorded, the Member States' liabilities have actually grown, albeit over a rather long period. If common spending is financed by giving the EU the power to tax, EU taxes will either increase the tax burden for EU citizens or, if this is to be avoided, reduce the Member States' own power to tax. There is no such thing as a free lunch.

There is also a tendency to believe that a good credit rating will enable the EU to obtain financing at a lower cost than the Member States. This is true in the case of the Member States in the poorest positions, but it is not universal. The EU does not have a general power to tax and is therefore in a different position from the federal government in the US, for example[25]. The EU's solvency ultimately rests on the Member States' solvency.
With the implicit support of the EU strengthening the position of many highly indebted Member States on the credit market, what emerges is a kind of a vicious cycle. Many seem to think that the mutual liabilities will increase everyone's creditworthiness. The risk associated with common EU debt resembles that of a Finnish housing company whose creditworthiness depends on the solvency of its shareholders. A housing company is in a better position than the EU, however, as it can ultimately sell insolvent shareholders' homes.

Traditionally, the justification for the need for a common budget capacity has been associated with asymmetric shocks. When a change in exchange rates has put individual countries in an impossible situation, a disruption affecting a single country can cause

25 US treasury bills may also become risky. There is a legal maximum for federal indebtedness, and this limit is often the subject of a political game.

massive losses in production and employment. A common budget, such as the federal budget, balances the impact of asymmetric shocks, at least in principle; the taxes collected by the federal government and the transfers of income it pays will change automatically when the state of the economy changes. When a state's growth accelerates, its taxpayers will pay more taxes to the federal coffers and when its economy slows down, income transfers from the federal budget will increase. This stabilising effect has been considered particularly important in the EU, where labour mobility, another possible stabilizing factor, plays a very small role.

The USA has often been used as an example to justify the need for common capacity. In his article referred to above, however, Martti Hetemäki (2015) mentions studies which show that many of the assumptions about the situation in the United States are false. If anything, fiscal policy is more procyclical in the different states of the USA than in euro area Member States. In net terms, labour mobility between the states is not high nor is it driven by economic cycles. In fact, migration between states is structural by nature[26].

It should also be noted that some asymmetric shocks have become less common thanks to the single currency. The effect of the forest industry on the cyclical variation of the Finnish economy is a good example of this. Its share of exports is substantially higher than its share of GDP and employment. When the Finnish mark was in use, an increase in forest industry exports strengthened the balance of payments, and when the exchange rate was kept fixed, foreign exchange reserves grew, increasing the liquidity of the national economy. The financial markets became more active and many activities that were not even closely connected to the forest industry experienced rapid growth. On the other hand, when forest industry exports declined, the financial markets tightened and economic growth slowed down. After the introduction of the euro, the forest industry has not caused financial market fluctuation anymore. The economic impact of the sector is today based on its GDP contribution and the indirect impact on production and employment.

Nevertheless, shocks may still emerge, and the global pandemic in 2020 is a good example of this. The impact of the pandemic on different countries varied depending on the structure of their economy (on the significance of tourism, for example). The purpose of the EU Recovery Fund is to remedy this asymmetry. However, the fund's investments in the various Member States are only partially based on the economic impact of the pandemic even though it was the formal reason for resorting to the exception clause[27].

Will the EU need a permanent capacity to support Member States experiencing serious (external or internal) disruptions? Although the best protection against surprising disruptions is a strong public economy, a shock experienced by one country can be so massive that external support is needed. To this end, various models and forms of

26 Wages also affect how an economy reacts to asymmetric shocks. The more rigid they area, the greater their impact on employment.
27 See Lars Anell, 'The Hidden Agenda behind the EU Recovery Fund', Forum för EU-debatt, 2020.

financing and opportunities for avoiding the resulting long-term income transfers have been outlined.

The European Fiscal Board considers this capacity to be necessary and has linked providing assistance to supporting public investment. The idea is that offering an affected Member State conditional support can contribute to growth both in the short and the long term. The growth potential of the economy is augmented by public investments.

This objective can be interpreted to be included in the Recovery Fund's terms, although the conditionality is limited, and the aid extends to all Member States. The Member States must use the funds they receive to combat climate change and promote digitalisation, for example. If successful, the Recovery Fund will thus support the Member States' long-term growth opportunities[28].

There are also further arguments for extending the EU's budget capacity. For example, the EU needs a permanent fiscal capacity to coordinate Fiscal and Monetary Policy. There is no guarantee that the Member States' combined budgetary policies will produce a fiscal policy stance that is aligned with the performance of the euro economy and monetary policy.

According to the European Fiscal Board (2020), the pandemic showed that the ability to respond with fiscal policy measures is needed when it caused a substantial gap in demand in the spring of 2020 that threatened to cause a deepening recession in the EU's economies and a wave of bankruptcies. This example is not a good one, however. In reality, measures taken at the national level were more important. The common aspirations of the EU will only start to have an impact on economic development in 2022, in a situation where economies have already been growing for a while, and inflationary pressures are becoming the principal threat to growth. It is true that the knowledge that the Recovery Fund would be established is likely to have increased the economic policy leeway of some highly indebted countries in 2020. The creation of the Recovery Fund also took its time, which delayed implementation. Taking this into account, the experience gained in 2020 shows that common efforts by the EU are subject to significant delays in implementation. The Recovery Fund must be seen primarily as a structural policy tool and not as a means of stabilization policy.

With such delays in economic policy, it is difficult to see that the EU could ever use stabilisation policies to an effective impact. The measures would be late and the risks from procyclical effects would increase. The correct timing of stabilisation policy measures is also difficult at a national level, and often it is thought that it is better to rely on so-called automatic stabilisers. An EU-level unemployment benefit scheme or the 'reinsurance' of national systems at the EU level have been proposed as such stabilisers. An increase in unemployment would automatically increase cash flows to the affected

28 For some countries, the level of support is so high in relation to the economy that absorption problems inevitably arise. For instance, the aid to Croatia is 22 per cent and to Bulgaria 19 per cent of GDP.

country, and a decrease would stem the flows. Joint liability with regard to unemployment benefits would require total harmonisation of national unemployment benefit systems. Nevertheless, there is a risk that there would be permanent transfers of income between countries, due to the large differences in economic structures and the functioning of labour markets (incl. wage formation).

Blanchard et al. examine a situation where there is no more room to manoeuvre in monetary policy, but the euro economy is nevertheless in need of stimulus. To this end, they outline a model that could be used to support the euro economy through common budget capacity. Although the analysis is carried out at a general level, it is linked to the criticism of Germany's fiscal policy. There are many who say that Germany's fiscal policy has been too tight in recent years, which has limited the growth of the region as a whole and has increased deficit pressure in other Member States. Although the new government being formed in Germany has announced that it will stick to the 'debt-brake'[29], it is more appropriate to target this criticism correctly than create new mechanisms whose practical application is uncertain.

In general, the debate on the need for the EU to participate in regulating demand is focused on the need to increase it when the Member States' own resources are insufficient or the fiscal stance is too restrictive for other reasons. This is somewhat surprising, given that the debt ratio of the public sector has risen by over 30 percentage points since the introduction of the euro. If public sector indebtedness is any indicator of fiscal stance, stimulus has been rather extensive during the first two decades of the euro! Over the long term, it is not possible to envisage borrowing to start taking place through the Community once the Member States' own borrowing capacity has been exhausted.

The need to tighten fiscal policy does not arise in the discussions, and it remains to be seen whether the fiscal policy debate within the EU will change as a result of the emerging inflation issues. If the EU’s role regulating demand would be confined to stimulus, it would threaten to bring an expansive tendency to the region's fiscal policy as long as creditworthiness allows this. The need for tight monetary policy would increase, which would have a long-term adverse effect on investment activities in the region.

THE SINGLE MARKET IS IMPORTANT – ESPECIALLY FOR SMALLER COUNTRIES

With globalisation and deepening integration, there is a growing number of challenges that can be tackled more effectively and better together than individually. The single market is a key example of this. It is particularly important for small countries. Specialisation often requires focusing on narrow product or service segments, which may constitute such a small national market that specialisation is not economically viable. The single market is becoming even more important as protectionism threatens international trade.

Although the creation of a single market has been one of the EU's key achievements, there is room for improvement in its effectiveness. According to a recent study[30], there are still many national barriers to the functioning of the single market. This applies to trade in goods but especially in services. According to the report, online trading has made cross-border transactions easier, but there are still many obstacles. Common rules are especially important for the development of new products and services.

Climate problems do not recognise national borders, but national measures set the pace for combating problems. They also affect business competitiveness and citizens' incentives and opportunities to adapt to new demands. Cooperation within the EU is therefore important for the achievement of jointly agreed objectives. In addition, a common voice in global forums will increase Europe's influence.

The energy crisis that is now taking place is a testimony to mutual dependence. Although the markets are not fully integrated, the effects of the various countries' measures are reflected outside their own borders. The development of the digital economy is another challenge and an opportunity in which cooperation will be helpful.

The same forms of cooperation are not appropriate for all sectors. Cooperation creates an equal framework at its best, but solutions can vary within this framework. In climate policy, harmonisation of objectives is essential – where necessary on a legislative basis – but actual solutions may vary depending on local circumstances and innovations. At its

29 The German Constitution restricts the federal state's annual borrowing to 0.35 per cent of GDP.

30 Erik Dahlberg ym. ”Legal Obstacles in Member States to Single Market Rules”, European Parliament, 2020.

worst, the EU countries' competitiveness will be weakened if the countries are forced to use common solutions, and the Union and its companies will not be able to compete with the best.

Over the past decade, a large number of giant international companies have emerged that dominate the digital market and its new businesses. Most of them are American or Chinese. Why are there no European competitors? Is this a sign of a malfunctioning of the single market, is the market too fragmented for competitive companies to develop?

There is probably a wide range of explanations, but current efforts to develop the digital economy may reveal one of the problems[31]. It is hard to guide development processes at a national level, but at an international level it becomes an extreme challenge. There is a clear risk that aiming for strict control will lead to resolving problems of the past, not those of tomorrow.

The EU's investments in research are important and promote useful cross-border cooperation. It is well known that cooperation between people from different backgrounds provides a good platform for new ideas and insights. It is vital that this cooperation will not be hampered by excessive control. At its best, the EU's contribution can create conditions and provide sufficient long-term funding for innovative research.

FINANCING THE EU BUDGET

The financing of the EU budget is based on a multi-component system. The contributions of the Member States are partly determined on the basis of national income, partly on the basis of VAT revenue, and customs duties that are paid to the EU. In addition, Member States have negotiated a whole range of rebates for themselves, which became increasingly important when the funding gap left by the United Kingdom was filled.

The Recover Fund makes increasing the EU's own resources necessary because the aid component in the fund is financed from own resources. The sources of funding for this additional cost are still unidentified. Although the need resulting from the Recovery Fund is reasonable in relation to the EU GDP, the decision on how to fund it may prove important from a fundamental point of view[32]. Many people see that this opens new doors for funding and increasing it in the future.

31 See. State of the Union: Commission proposes a Path to the Digital Decade to deliver the EU's digital transformation by 2030, September 2021
32 Bilbiie et al. point out that since the maturity of the debt taken for this purpose is long, the annual costs are less than 0.1 per cent of the gross domestic product of the EU. The authors examine proposals that have been put forth and are critical of many of them. See F. Bilbiie, T. Monacelli, R. Perotti, 'Fiscal Policy in Europe: Controversies over Rules, Mutual Insurance, and Centralization', Journal of Economic Perspectives, Volume 35, 2021.

The sources of EU funding affect not only the cost burden between Member States but also economic incentives. A wide range of new sources of funding have been proposed to increase the EU's own resources. These include the financial transaction tax, the digital tax, and taxes and levies related to the fight against climate change. We often want forms of tax that are new or are imagined to have a limited impact on the tax burden of EU citizens, but there are no taxes that generate revenue but have no impact on our tax burden or incentives[33].

As stated above, euro-level taxes either raise the area's tax rate or reduce the Member States' own opportunity to tax. More public resources cannot be created for the EU and its Member States by imposing EU-level taxes or levies. As a rule, a system based on contributions from Member States is therefore the most transparent if the aim is to increase own resources; the sharing of costs remains transparent[34].

In some cases, however, it is justified to introduce EU-level taxes and levies, especially when it comes to influencing behaviour. For example, the use of taxes or charges in climate policy is often more effective at EU level than at national level: they are based on jointly defined objectives and do not distort competitiveness between countries.

CONCLUSIONS

Many of today's problems are global, and solving home-grown problems also requires a favourable economic environment. This is why the EU plays a key role in finding solutions. However, success is based on clear roles, and it is now becoming unclear when the Community will provide a framework and when it will be responsible for implementation. There must be ownership in politics, and the obscuring of roles will, at worst, weaken joint efforts' chances of success.

This challenge is clearly reflected in fiscal policy. Since the creation of the euro, attention has focused on balancing the public sector, and a broad and complicated process has been developed as a basis for debate in the EU framework. However, we are now further away from the targets, and there is a wide range of conflicts in the Community. It should be clear that economic policy which promotes balanced and sustainable growth, is essentially in the interests of the Member States and is not practised primarily because of requirements established by the Community.

33 The financial transaction tax is a typical example of this. The proposed tax rates are typically low, but the impact on the functioning of the financial markets is potentially substantial, and the parties who eventually have to pay the tax may not realise they are bearing an additional cost.
34 It should be noted that Finland's position in the present system will change as Finland's relative income levels fall. If growth spreads remain at the same level as after the financial crisis, Finnish incomes will fall below the EU average after the middle of the next decade. This will automatically reduce Finland's contribution in the current financing model.

Many recently proposed reforms would be improvements to the current state of things, but even after they have been put in place, the big picture of economic policy will remain unclear and the focus will be on rules that risk failing with the first major disruption. Achieving a debt-to-GDP ratio of 60 per cent no longer provides a viable anchor for economic policy; it is too far away from the current situation of most countries. For this reason:

- *debate should be anchored on an analysis carried out by an independent body on Member States' debt sustainability[35]. This would allow us to expand the focus and extend the time perspective. Ultimately, it is a question of creating conditions for balanced and sustainable growth.*
- *The EU should act as a consultant and partner, not as a prosecutor. Political ownership lies with the Member States[36].*

An anchor based on analysis is more vague than numerical targets. Application therefore requires that both the analytical framework and the debate be transparent. This will increase and harmonise information and facilitate the financiers' own risk assessment.

The possibility of restructuring debts is a prerequisite for the interest paid on the loan to reflect the associated risk. This is a plausible alternative when the system enables restructuring without threatening to cause extensive multiplier effects.

35 The creation of an independent analysis body is justified irrespective of the chosen anchor. Moreover, debt sustainability varies from country to country and the more mechanistic the rule, the greater the likelihood that it will lose its significance in the event of disruptions.
36 This is also emphasised in the analysis by B. Eichengreen and C. Wyplosz. See B. Eichengreen – C. Wyplosz, 'Minimal Conditions for the Survival of the Euro,' Intereconomics, 2016.

JOHNNY ÅKERHOLM

The ESM reinforces this possibility, especially after the reforms currently under ratification. Other measures are also needed to reduce the risk from disruption:

- *financial links between banks and sovereigns need to be further weakened at national level;*
- *the crisis management mechanism included in the Banking Union, especially its credible application, must be strengthened;*
- *the harmonisation of deposit guarantee coverage should be advanced in order to advance the integration of the banking market; and*
- *obstacles to the formation of a Capital Market Union must be removed. This would reduce the risk of disruption and multiply available funding channels.*

Focusing the review on technical details has created a need to allow deviations. The most recent idea is that since public spending cuts are focused on public investment, they should be moved outside of spending limits[37]. This involves substantial economic policy risks, but the idea is politically very attractive. If this is done, it should be ensured that:

- *the expenditure can be excluded from spending limits is strictly defined; and*
- *depreciation and net interest expenses from investments are included in running expenses.*

The establishment of the Recovery Fund has raised the question of the need for EU-level demand regulation policy.

- *Stabilization policy measures under fiscal policy should be left to Member States.*

A country's economic situation and its needs can best be taken into account at national level, where implementation is more likely to be timely – although experience has shown timeliness is not very good at this level, either. Stabilization policy presupposes that the Member States are able to create sufficient fiscal space.

The most effective way to reduce the cyclical differences between Member States is by so-called automatic stabilisers. Potential stabilisers include the Community-level unemployment benefit system and the reinsurance of national systems at Community level. This requires extensive harmonisation. Nevertheless, there is a high risk that stabilisers will induce permanent cross-border income transfers due to structural differences and large variation in labour market performance.

- *Automatic stabilisers at EU level – e.g. in the form of a common unemployment benefit scheme – are in principle a good idea, but in practice they cannot be recommended.*

37 This problem does not exist when the analysis focuses on the content of economic policy and measures promoting economic growth opportunities.

JOHNNY ÅKERHOLM

Although responsibility for fiscal policy rests with the Member States within the meaning of the Treaty, situations may arise in which a country which has conducted a good policy may suffer a crisis such that external assistance is necessary. A clear distinction must therefore be made between normal cyclical regulation and supporting demand during crises, the latter of which may be needed at Community level in the event of a serious disruption. For that purpose:

- *it is important not to create new institutions, but to expand the ESM's ability to provide financial support on easy terms in the case of such eventualities*[38].

The potential contribution of the Recovery Fund to economic development is structural. It remains to be seen whether a scheme with easy terms will improve the potential for economic growth of the Member States. This will not be known until after several years; the programme will be in force until 2026 and its impacts will only be realised gradually. Those who are already demanding a continuation to the programme either have doubts about the effectiveness of its measures or see the Recovery Fund purely as a means of transferring income.

- *We must gain experience of the fund's impact on the Member States' structural development before increasing investment.*

The EU's most effective means of supporting the growth potential of the community and the Member States are associated with creating conditions for growth. The EU is able to create an increasing number of so-called public goods, which cannot be achieved at national level. They include:

- *the improvement of the functioning of the single market, the setting of common objectives for climate and energy policies, the creation of EU-wide transport networks and, in general, the setting of common standards. These are prerequisites for the emergence of markets that are sufficiently large and conditions that are sufficiently stable. EU countries and companies operating within the EU need a stable, competitive environment to move to the top of the global economy.*
- *Fulfilment of the common goals is best achieved through national solutions. This is because on the one hand, conditions and structures vary from one country to another and on the other, it enables learning from one another.*
- *National application requires monitoring and control at Community level. Even though sanctions have proven inappropriate in the area of fiscal policy, their use is justified in this context.*
- *However, responsibility for the consequences of measures decided at national level must stay at national level. The Social Climate Fund and setting up other similar structures would cause a risk of moral hazard and of resulting perpetual income transfers.*

When Member States' resources are limited due to a high tax rate or public sector indebtedness, the pressure to create additional resources through EU taxation and/or borrowing will increase. Ultimately, however, Community expenditure will be paid through taxing EU citizens in one way or another. Similarly, increasing borrowing in the name of the Community, once the indebtedness of the Member States has become a problem, is not a sustainable solution.

Nevertheless, in certain circumstances it may be more efficient to address common challenges by increasing resources at a common level rather than by increasing national efforts. In such cases,

- *the EU's financial resources should be increased through higher contributions from Member States. This is a transparent way of monitoring costs and their distribution among the Member States; and*
- *EU-level taxes and levies can be enacted in order to guide behaviour, and the consensus is that this can be achieved more effectively together than nationally.*

38 This may require an extension of the ESM's funding base. Vesa Vihriälä has proposed that the ESM invoke the ECB's liquidity support in such situations. See Vesa Vihriälä, 'EMU: Liquidity of Solvent Members States More Important than Fiscal Stabilisation,' in Jean Pisani-Ferry – Jeromin Zettelmeyer (eds.) 2019.

Confederation of Finnish Industries

Confederation of Finnish Industries (EK)
PL 30 (Eteläranta 10)
00131 Helsinki, Finland
+358 9 420 20
www.ek.fi/en
@Elinkeinoelama

ONLINE REPORT

www.ek.fi/EUeconomy

MORE INFORMATION

Director Penna Urrila
+358 40 570 7860
penna.urrila@ek.fi

Chief Policy Adviser Janica Ylikarjula
+358 40 560 1275
janica.ylikarjula@ek.fi

LAYOUT DESIGN

Riesen Design

DECEMBER 2021