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Policy Brief

After the German Election

What's next in EU economic governance?

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The new German government will face a number of unresolved issues of varying urgency when it comes to EU economic governance. In the case of the fiscal rules, there is an urgent need for a decision on how to proceed after 2022. In the medium term, the future of EU finances and economic policy coordination is open; both have undergone drastic changes as a result of the Recovery Instrument. Last but not least, the new German government must decide whether and how to break the deadlock in negotiations on completing the banking union and breathe new life into the capital markets union.

The pandemic has changed EU economic governance forever: For the first time in its history, the EU is now issuing debt to mitigate the economic consequences of the crisis in the most affected member states through joint spending. This experience will last. For the first time, the plans for the use of the funds are leading to real pressure to reconcile national and European policy goals. Previous economic policy coordination had never been able to do that. Finally, nearly all member states are emerging from the pandemic with substantially higher debt levels, making it illusory to apply the fiscal rules as they currently stand.

While the pandemic has shaken up economic and fiscal policies, unresolved tasks remain in the area of financial market policy: Without a common deposit insurance scheme, the banking union remains unstable, member states are reluctant to apply the common resolution regime, and no single market for banks is emerging. The fronts between member states are completely hardened in this respect. Finally, although everyone is talking about the capital markets union, substantial progress over the last four years was rare.

A new German government will therefore inherit both a completely new setup on the fiscal and economic policy side and a completely deadlocked situation

in financial market policy. At the same time, there will be a shift in political priorities: The clear commitment to ambitious European climate targets has not yet fully reached the economic policy discussion; yet it is clear that all member states as well as the EU as a whole will have to invest significantly in climate policy measures in the coming years. The rules and instruments in place to date are inadequate for this challenge.

This situation presents the new German government with three sets of questions of varying urgency:

- Very acutely, the new government will have to find a position on the future of the fiscal rules;
- In the medium term, it will have to take a stance on the question of new own resources for the EU budget, on the structure of the next EU financial framework and on possible compensation mechanisms under the Fit-for-55 climate package;
- More fundamentally, there is the question of ambition in the banking and capital markets union.

We address these points individually below:

1. The future of the fiscal rules

The application of EU fiscal rules is suspended until the end of 2022 due to the pandemic. As early as spring 2022, the EU will have to make a decision on whether and under what premises the rules will apply again from 2023, as the member states will begin drawing up their budgets for 2023 in the spring and need guidance as to which rules they will have to follow.. Formally, this decision is in the hands of the Commission; politically, a further general deviation from the rules would require a consensus decision by member states.

If there is no agreement, the rules will apply in full again from 2023. Due to the increased debt levels in many member states, the application of the debt rule in particular would become a substantial problem. The rule states that countries with debt levels exceeding 60% of GDP must reduce their gap to this target mark by 1/20 every year. For a country like Italy, reaching 160%, this would mean an annual reduction of five percentage points; for France, Belgium, Spain or Portugal, it would still mean a reduction of three percentage points. This would be poison for the post-pandemic recovery that is just taking shape; it would also be a repeat of the mistakes at the end of the financial crisis that plunged Europe into a double-dip recession at the time. Moreover, such a course would leave little room for additional spending on climate protection. Finally, a mechanical resumption of the rules would force governments on a fiscal tightening path, in particular those that have just embarked on an ambitious reform course on the back of the Recovery Instrument. This would not only be economically absurd, but also politically dangerous.

Hence it is clear: The rules can no longer be applied to the letter without causing massive macroeconomic damage. This is not surprising: The reference values of the rules are based on macroeconomic assumptions of the 1990s. The design of the rules reflects a fiscal policy consensus that, under the sway of the euro crisis, placed an excessive focus on fiscal consolidation and led to a strong tightening of the rules in the early 2010s. The world has changed since then. In particular, the biggest macroeconomic risk today is not fading debt sustainability, but a premature fiscal tightening and insufficient investment in climate neutrality.

Policy must always be adapted to reality. In this case, there are two ways to do so:

- ***Muddling through:*** If there is no political agreement on a new fiscal consensus among member states, the pre-pandemic game continues: then the Commission is forced to prevent the grossest macroeconomic accidents by finding loopholes in the rules over and over again, while having to maintain the appearance that the rules are somehow still being applied. This massively damages the credibility of the Commission and of the rules as a whole. At the same time, such a modus operandi means continuous uncertainty for member states and markets about future fiscal policy; agreements with the Commission would have to be negotiated on an ad hoc basis again and again. In the medium term, this would lead to a situation in which the rules erode completely and there are no guardrails left for the fiscal policy of the member states. In particular those member states such as Germany and the Netherlands that have repeatedly expressed a strong preference for coherent and transparent enforcement of the rules should have a strong interest in avoiding this outcome.

- ***A new fiscal consensus:*** Alternatively, a new fiscal consensus could be built that would allow the Commission to handle the rules in a coherent manner from 2023 onward. Such a consensus could consist of three pillars: long-term sustainability of public finances, continued support for the recovery, and allowing for more investment towards climate neutrality. This could be achieved politically as early as the first quarter of 2022 under the French Council Presidency and would give member states as well as markets guidance on the future direction of fiscal policy. In the medium term, such a consensus should then also be reflected in the letter of the rules; in the short term, the Commission would have backing for their uniform, flexible application. The technical ideas on how to carry out such a reform are all already on the table (e.g., here and here); what is now crucial is a clear political mandate for the direction of reform.

The decisive question for the next German government is therefore not between softening or maintaining the rules. **The alternatives are instead either a continuation of the non-transparent muddling through or an adjustment of the rules to reality, making enforcement of the rules possible again in the first place.** In any case, the new government should quickly decide on a position here. The window of opportunity to reach an agreement for 2023 is likely to be short after the new government takes office.

2. The future of EU finances and economic policy coordination

Last year, the EU took far-reaching decisions on the structure and volume of EU finances over the entire upcoming legislative period of the Bundestag with the Recovery Instrument (RI) and the Multiannual Financial Framework (MFF). The disbursements of the RI run until 2026; the MFF runs until 2027. The next overall package on the EU's finances will therefore not be negotiated and concluded by the next German government, but rather by the one after the next. **The coming four years in this area should therefore be seen more as a phase of implementation than of far-reaching new decisions.**

Nevertheless, the new German government will have to take a stand on five issues:

- The Commission will present a proposal in the fall to **introduce new own resources** based on the European Emissions Trading Scheme (ETS) and the proposed new Carbon Border Adjustment Mechanism (CBAM). The Council, Parliament and Commission have agreed on a roadmap for the introduction of these own resources in an inter-institutional agreement as part of the overall compromise on the MFF; they are to take effect on January 1, 2023. Further proposals for new own resources, e.g. a financial transaction tax, are to be agreed by 2026.

The stated aim is to provide the EU with sufficient funds to be able to repay the RI debt from 2028. Introducing new own resources before the decision on the next MFF package seems ambitious because it requires a unanimous decision by the member states and ratification by national parliaments. Nevertheless, the new German government must position itself here and, in particular, state whether it considers itself bound by the interinstitutional agreement.

- As part of the Fit-for-55 package, the Commission has proposed a **Social Climate Fund** to mitigate hardships from the planned extension of the ETS to buildings and transport („ETS2"). This fund is to be fed by revenues from ETS2. However, the fund would start as early as 2025, but ETS2 would not start until 2026, meaning that regular budgetary resources would have to be made available for it at least on a transitional basis. The Commission proposes a volume of 23.7 billion euros for 2025-27, with a further 48.5 billion for 2028-32. The Own Resources Decision and the MFF itself would have to be amended accordingly. The fund will presumably be negotiated as part of the climate package; however, once the MFF is opened for renegotiation, this of course also opens the possibility of raising further points. Accordingly, the German government also needs a clear position on this issue.

- The **next MFF** will not be decided until 2027. However, the Commission will present its proposal for it in the first half of 2025 at the latest. This proposal will already have to contain all the main structural elements of the new MFF and, in particular, make a statement on how the approx. 15 billion euros in annual costs to redeem and service the RI debt will ultimately be financed - via an increase in the spending cap as provided for in the interinstitutional agreement, via a reduction in other spending or via a rollover of the debt. The Commission proposal must also find an answer to the question of **whether and how the Recovery Instrument should be made permanent.** The new German government‘s stance on these issues will have a considerable influence on the decision-making process within the Commission. There will be no formal votes on this issue in the Bundestag in the next four years. However, it is absolutely clear that the EU needs a stable and sustainable financial architecture in the long term. This requires a coherent position of the next German government in the coming years. The new government should be honest rather than reverting to old ideas such as windy guarantee schemes or relying on the financial magic of the European Investment Bank: The EU needs permanent, powerful budgetary instruments to be able to jointly tackle the huge investment needs of the future.

- The RI has completely upended **economic policy coordination** in the EU as it existed so far. The European Semester, which was essentially based on non-binding recommendations that were not followed through on, is history. Instead, in the coming years, the review of compliance with the national recovery and resilience plans will become the decisive steering instrument. The future development of economic policy coordination is currently completely open. It is already apparent that, for the first time outside the adjustment programs in the euro crisis, the RI is bringing about a genuine internalization of European priorities into national economic policies. It will not be possible to immediately repeat this in the same way after the RI expires, as the effect hinges on the sheer size of the available funds. But the question is how to reorganize economic policy coordination on the basis of the positive experience of the RI. This will be decided in the coming years, and the new German government should play an active role.

- Finally, there is a big gap in the European toolbox when it comes to **crisis management:** It cannot be ruled out that, in the wake of a normalization of ECB monetary policy and diverging economic developments, eurozone member states could again come under market pressure in the coming years. The pandemic has shown that the ESM has become politically toxic in

much of Europe; no country applied for ESM liquidity assistance, but many did use EU credit assistance from the RI and SURE, although the conditions for access were almost identical. The ESM reform will further complicate access to precautionary credit lines. Against this background, alternatives should be considered. One possibility would be to keep access to the credit compartment of the Recovery and Resilience Facility open beyond the end of 2023 and/ or to extending and, if necessary, topping up the SURE program. Here, too, the new German government needs a plan.

3. The future of the banking union and of the capital markets union

Seven years after the establishment of the banking union, it is clear that it has not yet achieved most of its objectives. Thanks to the reforms of recent years, Europe's financial institutions are much sounder than they were at the beginning of the last financial crisis. The supervision of the largest banks by the European Central Bank is working. But the unholy nexus between states and banks, which the banking union sought to sever, persists. The increase in public debt due to the pandemic has actually exacerbated the interdependence. Moreover, the banking union has so far failed to create a truly single market for banking. When banks in Europe merge, they do so at the national level. Finally, member states - led by Germany and Italy - have broken their promise to never again bail out banks with taxpayer money. Lacking confidence in the European bank resolution regime, the relevant actors preferred to utilize the exemptions and stabilise distressed banks with national funds.

The main reason why the banking union has so far failed to achieve its goals is the lack of a European deposit insurance scheme. The absence of the third pillar of the banking union not only diminishes the credibility of the European crisis mechanism for banks. Without common deposit insurance, bank supervisors in the countries hosting bank subsidiaries feel compelled to impose excessive requirements on them; („ring-fencing") in order to protect domestic financial stability. A true single market for banks, in which capital and liquidity flow freely even within cross-border banking groups, cannot emerge in this way.

In the past, progress on the banking union has regularly been stalled also by Germany, which always formulated new preconditions for European deposit insurance. But the attitude that risk sharing at the European level could only take place after further reduction of risks in bank balance sheets led to a dead end. The next federal government must therefore be honest: In the current environment, rapid risk reduction is impossible. **If the banking union project is to be prevented from getting stuck halfway, steps toward risk sharing are unavoidable.** The fact that risk sharing can also have risk-reducing effects is demonstrated by the European bonds financing the recovery fund: every EU bond that a bank takes into its bond portfolio reduces the nexus between banks and individual member states.

EU bonds also make an important contribution to strengthening the **capital markets union.** However, to become an anchor of stability, they would have to remain permanently present in the market and reach a higher volume. Beyond EU bonds, which do not feature in any of the EU Commission's action plans, the capital markets union has made little significant progress in recent years. Because the member states are shying away from far-reaching reforms, the Commission has also become increasingly unambitious in its proposals. **Whether a deepening of the capital markets union succeeds therefore depends crucially on whether the member states find new courage to tackle a major project.** In addition to the urgent harmonization of national tax and insolvency laws, the overhaul of the ten-year-old European financial supervisory system is currently on the agenda.

Specifically, the next German government will have to develop a position on the following three issues:

- What form can a European deposit insurance system take that prevents false incentives to increase individual bank risks („moral hazard“) and at the same time effectively caters for the risk of customer runs on failing banks („bank runs“) and the overstretching of national deposit insurance systems?

- Can a European crisis mechanism strengthened by joint deposit insurance be trusted to guarantee financial stability even in a systemic banking crisis, or will member states take refuge again in one of the exceptions to the ban on state aid when the next big banking crisis occurs?

- What major project will be put on the agenda to give new impetus to the capital markets union? After the failure of German financial supervision in the Wirecard scandal, one possibility would be to regulate the independence of national supervisory authorities on a European scale and, along the lines of joint banking supervision, also to make supervision of securities and insurance more European.

Similar to the issues surrounding the future of EU fiscal rules, there is also a relatively short window of opportunity in the area of banking and capital markets union in which the next German government must take a position. The big end of Corona-related loan defaults is yet to come for European banks once government support aid expires, and fittingly, the European Commission is currently working on overhauling the crisis management and deposit insurance framework. If the new German government wants to actively shape rather than be driven by events, it should make important decisions quickly - not least so that it can press ahead with these projects in conjunction with the next French government.

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