# The European cris response framework: the fiscal dimension

*Is Europe Prepared for Extreme Events? Risk-resilience – policy responses*

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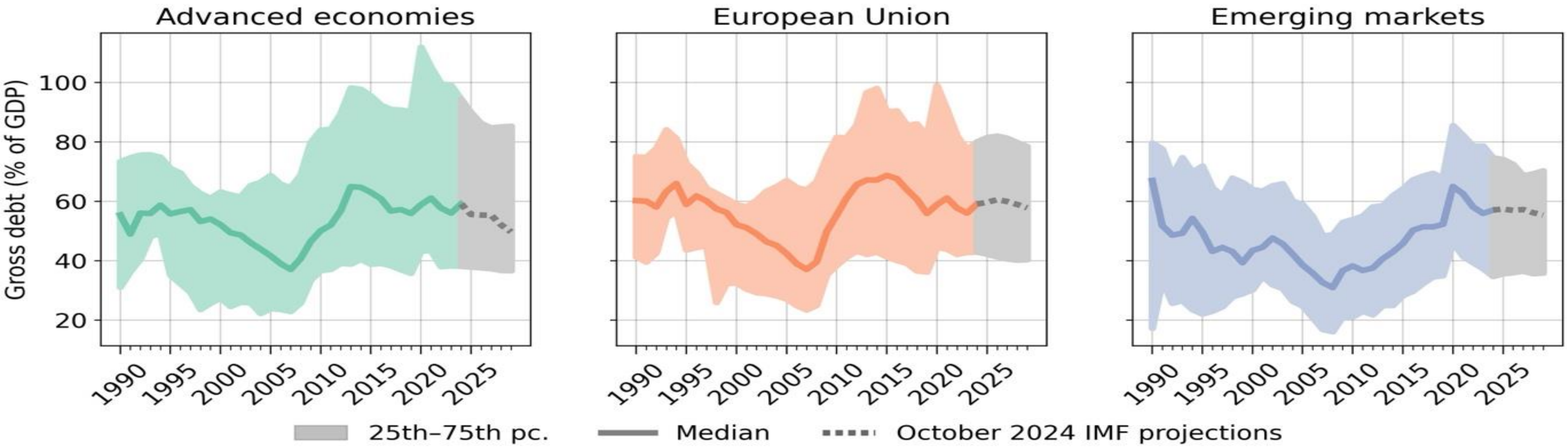
# Evolution of public debt in the EU and the world (1990-2024) (2025-2029 forecast)

**Government debt ratios at historically high levels**




**Drivers of debt dynamics drivers (productivity, population, interest rates, social entitlements) generally not moving in the right direction**

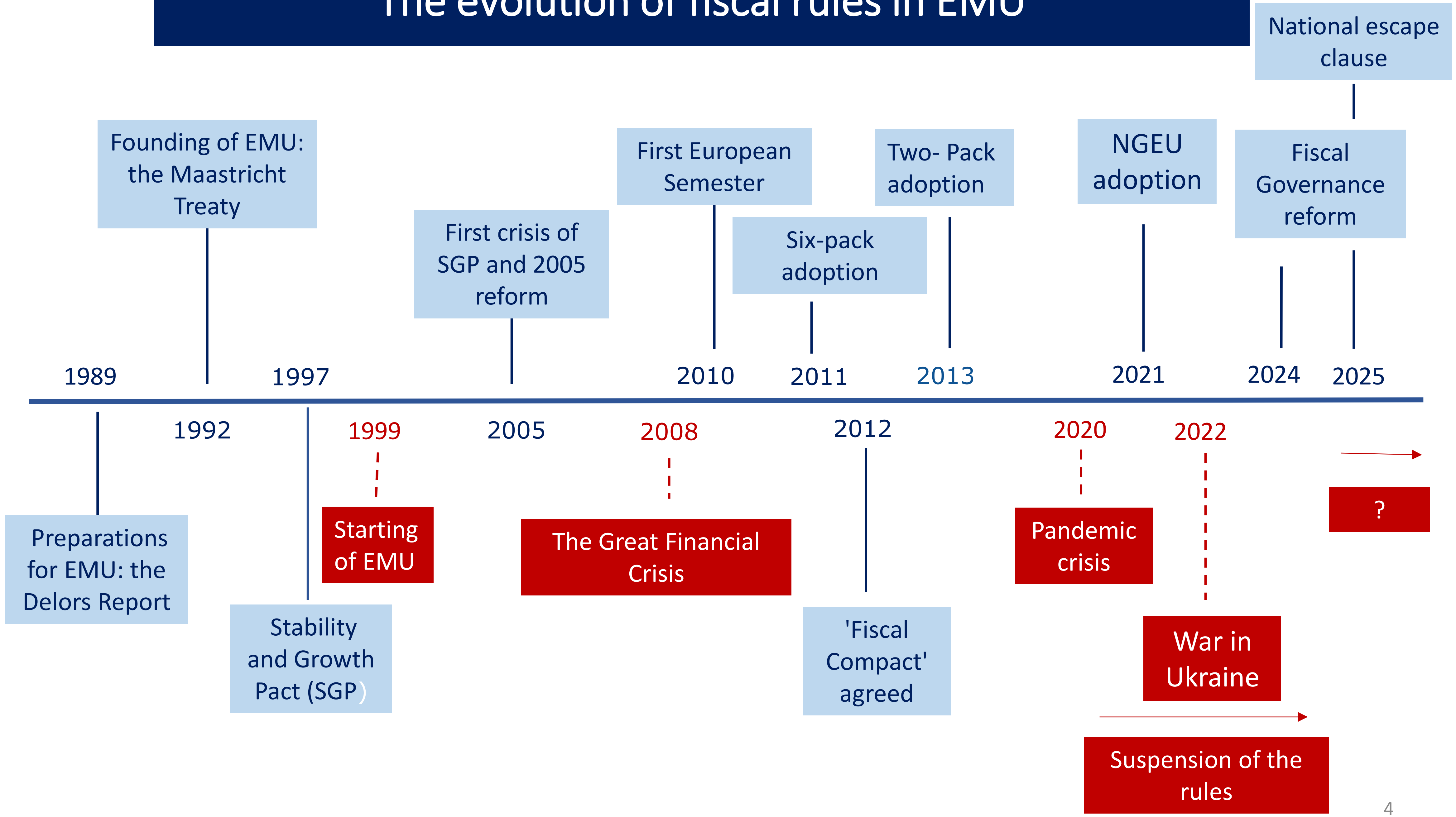
# How is likely that euro area countries will stabilise their debts in the medium term?

| | Debt (2024) | SPB (2024) | SPB (2029) | SPB*(2029, 50%, 2044) | SPB**(2029, 70%, 2044) | Prob SPB (2029)>SPB* | Prob SPB (2029)>SPB** |
|---|---|---|---|---|---|---|---|
| **Greece** | 153 | 2.2 | 2.1 | 1.0 | 3.6 | 61 | 47 |
| **Italy** | 137 | -0.4 | 0.9 | 1.4 | 2.4 | 3 | 0 |
| **France** | 113 | -4.0 | -2.8 | -1.4 | -0.6 | 5 | 2 |
| **Spain** | 102 | -1.1 | -0.3 | 0.5 | 1.2 | 17 | 10 |
| **Belgium** | 103 | -2.0 | -3.9 | -1.7 | -0.5 | 30 | 15 |
| **Portugal** | 96 | 2.5 | 2.1 | -1.3 | 1.0 | 70 | 60 |
| **Finland** | 83 | -0.6 | -1.2 | -1.1 | -0.3 | 44 | 31 |
| **Austria** | 80 | -1.3 | -1.2 | -0.8 | -0.4 | 26 | 21 |
| **Cyprus** | 66 | 3.4 | 2.5 | -1.1 | -0.1 | 73 | 67 |
| **Slovenia** | 67 | -1.0 | -0.6 | -2.4 | -0.8 | 59 | 34 |
| **Germany** | 63 | -0.3 | 0.8 | -0.3 | -0.1 | 37 | 33 |

**SPB* (SPB**)**: structural primary balance required by 2029 (5y) to stabilise debt over the 2044 (20y) horizon with 50% (70%) probability

Source: Darvas, Huertas, Welslau and Zettelmeyer (2025 forthcoming)

# The evolution of fiscal rules in EMU



# Who needs the national escape clause for what?

- Recourse to escape clause – presupposing deviation limited in time and size - meant to allow **maximum fiscal flexibility consistent with debt sustainability as defined by the rules**;
- Need to distinguish between **'legal'** and **'economic'** fiscal space:
  - **Low-debt Member States don't really need extra legal fiscal space from the escape clause** (if debt below 60% of GDP excess of 3% of GDP deficit threshold from defence expenditure not resulting in EDP and no consequences from deviation from medium-term adjustment path)
  - **High-debt Member States may not have extra economic fiscal space, even with the escape clause because of negative market reactions**. Financing of defence expenditure by EU borrowing would be their preferred solution.
- But **escape clause** could make a difference for high-debt Member States as **signal** that they will be protected by the **'TPI umbrella' of the ECB** in case of materialisation of rollover risk.

# A limited recourse to EU borrowing

- reArm EU as ‘EU label’ for goods financed and delivered at national level.
- Overall **secondary role of of EU financing**:
  - Exclusion of a ‘defence-RRF’, in particular, spending by Member States offset by EU grants financed by EU borrowing – legally difficult, politically impossible.
  - SAFE instrument is a ‘defence-SURE’, ie, back-to-back EU loans to Member States.
  - Size relatively limited (EUR 150 bn in 4 years for ‘defence SURE’ vs EUR 100 bn for SURE in 2 years + 750 bn in 6 years for RRF)
- Effective end of Treaty ban on financing of “operation having defenceimplications’ (Art. 41(2)).
- **More EU pooling of resources to follow?**

# The reform of the German debt brake: breaking with the past and with EU rules

- EU policy announcements overshadowed by reform of German debt brake, in both size (> EUR 1000 bn) and structural significance (end of German fixation on ‘numerical safeguards’).
- What does debt brake reform mean in terms of framework design? Two perspective: single-country and EU-wide.
- Single-country perspective: new debt brake as ‘defence golden rule’ without differentiation between current and capital expenditure and only limited effects on productive potential. Political economy providing the only rationale.
- EU-wide perspective: EU fiscal framework not meant to prescribe optimal fiscal policies but avoid potentially unsustainable debt trajectories:
  - **Debt brake reform not endangering debt sustainability in Germany** (Zettelmeyer 2025);
  - BUT **Non-temporary implementation of debt brake reform inconsistent with SGP**: prospect of devolution of SGP accompanied by risk of fiscal dominance: how can ECB resist call to intervene in financial markets to protect countries with less fiscal space if Germany in open defiance of EU fiscal rules?
- Can SGP be reformed to accommodate events while maintaining core sustainability focus?

# Annex

# The national escape clause of the SGP

<table>
<tr><th></th><th>Condition</th><th>Activation</th><th>Effect</th><th>Length and extension</th><th>Aftermath</th></tr>
<tr><td>Not EDP (default)</td><td rowspan="2">“Exceptional circumstances outside the control of the Member State hav[ing] a major impact on the public finances of the Member State concerned provided that ... deviation does not endanger sustainability in the medium term” (Reg.(EU) 2024/1264 Art. 26(1))</td><td>“Council recommendation [Art. 121(4) TFEU)] on recommendation by Commission based on its analysis… following request from Member State ” (Reg. 2024/1264 Art. 26(1))</td><td>Deviations from adjustment path in medium-term fiscal structural plan (MTFSP) not taken into account (Reg. 2024/1264 Art. 22(7))<br>Possibility of not opening EDP even for breach of 3% deficit threshold (Reg; (EC) 1467/97 Art. 2(5)</td><td>“Time limit specified by the Council”<br>Extensions possible (more than once) for one year each ” (Reg. 2024/1264 (EU)Art. 26(1))</td><td>New adjustment path according to revised or new MTFSP (?)</td></tr>
<tr><td>EDP</td><td>Revised Council recommendation (Art. 126(7))/Council notice (Art. 126(9 TFEU) on recommendation by the Commission (Reg. (EC) 1467/97 Art. 3(6) and Art. 5(2))</td><td>Revised adjustment path under EDP [excluding effects of response to exceptional circumstances] (Reg. (EC) 1467/97 Art. 3(6) and Art. 5(2))</td><td>Deadline for correction of excessive deficit extended by one year “as a rule” (Reg. (EC) 1467/97 Art. 3(6) and Art. 5(2)) [Repeated revised recommendations possible]</td><td>Adjustment path according to latest applicable EDP recommendation/ notice</td></tr>
</table>

# How  is likely that countries will stabilise  their debts in the medium term?

- To assess the plausibility of high-debt countries putting their debts on a robust downward path one computes the probability of reaching $SPB^*(5, 50, 20y)$ and $SPB^*(7, 70, 20y)$ *conditional* on IMF projections for medium-term fiscal adjustment (WEO (October 2024 World Economic Outlook)).
- The computation proceeds in two steps:

  1) a probability distribution for the structural primary balance in 5 years, centred on the IMF's 5-year projections for the structural primary balance, is calculated (using bootstrapped errors from a vector autoregression.

  2) For each percentile level of the structural primary balance in this probability distribution, we calculate the probability of asymptotic debt stabilisation, applying the same methodology (projections for growth, interest rates, and the exchange rates, and bootstrapped errors) used in our stochastic DSA analysis.

One can then select the percentile levels of the probability distribution for the 5-year-out structural primary balance that leads to debt stabilisation with 50 or 70 percent probability. We refer to these as $Prob\{SPB(5, WEO) > SPB^*(5, 50, 20y)\}$ and $Prob\{SPB(5, WEO) > SPB^*(5, 70, 20y)\}$, respectively).