HSBC Global Research

2 January 2024

New EU fiscal rules

How they work and do they matter?

Free to View
Economics - Eurozone

- EU Finance Ministers have finally agreed on new fiscal rules
- We answer the top 10 questions we have received from clients
- Overall, we don't see much of an impact on the fiscal stance in 2024, but some countries could face challenges in 2025

Fabio Balboni
Senior Economist, Eurozone
HSBC Bank plc

A deal, at last

On 20 December, EU finance ministers agreed a new set of EU fiscal rules. The main aim of the reforms was to simplify the rules, improve their enforceability and – as a result – credibility, while promoting greater compliance by countries. In this note, we answer the 10 questions we have received most frequently from our clients:

1. **How do the new rules work?**
2. **What are the main changes from the old rules?**
3. **How do the new rules compare to the initial Commission proposal?**
4. **What are the next steps to ratify the rules?**
5. **When will the new rules be implemented?**
6. **What do they mean for the eurozone fiscal stances in 2024 and 2025?**
7. **Which countries could be affected most?**
8. **What could be other implications of a country being in an EDP?**
9. **Could we see more fiscal tightening in Germany in 2024?**
10. **What could be the consequences of Italy not ratifying the ESM Treaty?**

A positive development, but not a game changer

In a nutshell, the new rules move towards a greater focus on the more observable net primary spending (ie, stripping out interest payments, cyclical components of spending and structural revenue changes) and away from targets based on a top-down cyclical adjustment of the deficit. We see this as positive given how hard it is to measure the output gap in real time, albeit the new metrics still leave some margin for interpretation.

The deal is based on the proposal made by the European Commission (EC) in spring 2023, but also reflects several requests and red lines from EU member states. These have increased the complexity of the rules and introduced, in our view, the potential for conflicting targets and metrics, which could create some confusion.

We don't think the new rules will have a bearing on eurozone fiscal policy in 2024, particularly given the European Parliament elections scheduled for early June. In 2025, high-debt and high-deficit countries could face tough consolidation challenges. But in practice, a number of exceptions already carved out should limit the extent of the fiscal consolidation required. As former EC director and author of the initial EC proposal Lucio Pench put it, "the impression is that countries such as France and Italy have accepted some commitment that would not be binding in the short term, in the conviction that it will never be applied." (FT, 20 Dec 2023). Time, as always, will tell.

This is a Free to View version of a report with the same title published on 2-January-2024. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

Issuer of report: HSBC Bank plc

View HSBC Global Research at:
https://www.research.hsbc.com

New EU fiscal rules – how they work and do they matter?

1. How do the new rules work?

The new rules have a greater focus on net spending

Countries with deficits higher than 3% of GDP will enter into an Excessive Deficit Procedure (EDP) – the so-called "corrective arm", in line with the old rules. They will be given a four-year trajectory for net spending (spending stripping out interest payments and cyclical components of spending, such as unemployment benefits and structural changes to revenues, such as tax rises) by the European Commission (EC). This is extendable to seven years if a country commits to undertaking reforms to enhance debt sustainability.

Countries in an EDP will have to achieve a minimum structural adjustment of 0.5% of GDP per year. In the period 2025-27, however, the adjustment will be measured on the primary balance, rather than the overall balance, to account for higher interest payments. Defence spending will also be taken into account to assess compliance with the spending rule. There are no specific exceptions for public investments, other than only a limited exclusion for projects funded by the NGEU fund and national co-financing of EU funds in 2025 and 2026.

For high-debt countries there is also a "debt safeguard" to ensure debt falls…

For countries with deficits lower than 3% of GDP, what happens next depends on the debt ratio. If countries have a debt-to-GDP ratio higher than 60%, the EC will provide a four (or seven) year trajectory based on debt sustainability analysis (DSA). Countries with debt-to-GDP ratios between 60% and 90% will have to achieve a debt reduction of 0.5% of GDP per year on average over the adjustment period (the so-called "debt safeguard"). For countries with debt-to-GDP ratios higher than 90%, the adjustment is 1%. To assess compliance, the EC will establish a "control account" – if a country deviates from the net expenditure pathway by more than 0.3% of GDP in a year (or by more than 0.6% of GDP cumulatively), it will go into an EDP.

…and a "deficit safeguard" to create a buffer below the 3% of GDP deficit threshold

Further, there will be a "deficit safeguard", whereby countries should achieve a buffer (1.5% of GDP) below the 3% of GDP deficit threshold, to ensure there is fiscal space when needed without crossing 3%. Effectively, this means that the primary deficit should be 1.5% of GDP by the end of the adjustment period. To achieve that, the annual adjustment required is 0.25-0.40% each year (again, excluding interest in the period 2025-27).

If these different rules lead to slightly different adjustment requirements for countries, the EC will likely determine the rule that will apply at the start of each adjustment period.

Countries not complying with the EDP can be fined up to 0.05% of GDP every six months (to a maximum of 0.5% of GDP cumulatively). This is lower than previous fines (up to 0.5% of GDP every six months), but possibly more credible, as previous fines were never implemented.

2. What are the main changes from the old rules?

The main aim of the reforms is to simplify EU rules, improve their enforceability, and to promote greater domestic ownership of the rules by introducing country-specific requirements. The new rules also aim to move away from targets based on cyclical adjustment of the budget balance and focus more on net primary spending (ie, spending stripping out interest payments, cyclical components, such as unemployment benefits, and structural revenue changes).

For countries in an EDP, the requirement of a 0.5% of GDP minimum adjustment remains

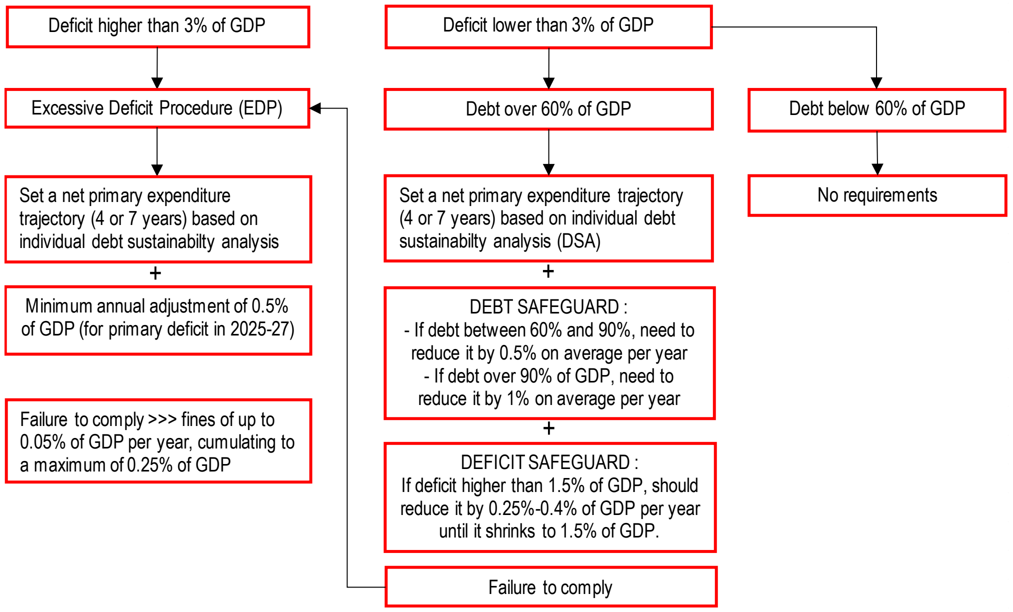
In practice, little changes for countries with deficits higher than the Maastricht limit of 3% of GDP, with the minimum structural adjustment remaining at 0.5% of GDP per year (albeit with the exception of the period 2025-27, when it will be measured on the primary balance).

The main changes are to the debt-reduction rule. Under the old rules, countries with debt-to-GDP ratios higher than the Maastricht limit of 60% had to reduce them by 1/20th of the difference between their debt levels and 60% each year. As this would require an unrealistic level of debt reduction – nearly 4% of GDP for Italy, for instance – and therefore annual fiscal adjustments for some countries, it was rarely enforced, undermining its credibility.

The new more realistic debt-reduction rule should improve enforceability and compliance

The new rules set out country-specific paths for net spending-embedded in the country's overall reform plans, aiming for more realistic debt reduction over the adjustment period, which should improve enforceability and also compliance by the countries.

1. The new EU fiscal rules in a nutshell



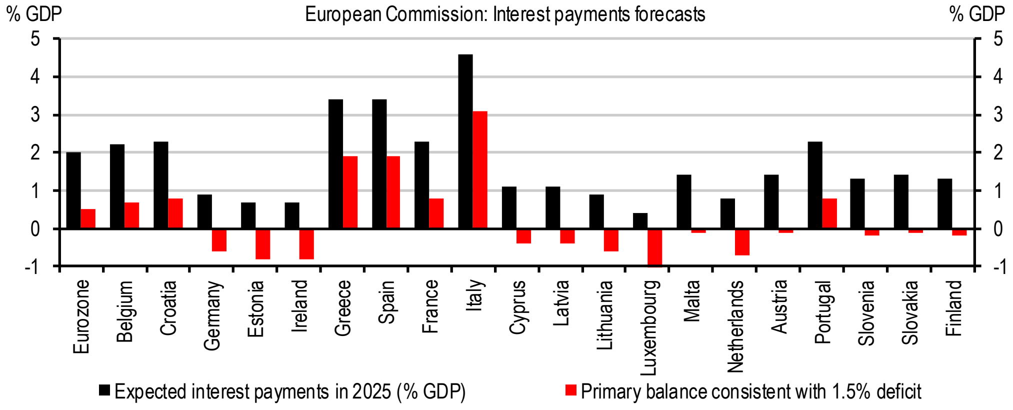
Source: European Commission, Bruegel, HSBC

3. How do the new rules compare to the initial Commission proposal?

Countries facing high interest payments could struggle to achieve a 1.5% of GDP deficit

The new rules are based on the EC proposal from April 2023[1], but two main changes where introduced to the deficit and debt safeguards to satisfy individual countries' demands and red lines. First, the deficit safeguard effectively introduces a deficit target of 1.5% of GDP, which could be challenging for high-debt countries with high interest spending. For instance, a country such as Italy, which the EC expects to spend 4.5% of GDP in interest payments by 2025 (chart 2), might have to run a primary surplus target of over 3% of GDP, which it has never achieved historically.

2. A deficit of 1.5% of GDP could require hefty primary surpluses in some countries



Source: European Commission, HSBC calculations

[1] See https://economy-finance.ec.europa.eu/publications/new-economic-governance-rules-fit-future_en

Reducing debt during the adjustment period is tougher than having to reduce only it by the end of the period

Second, relates to annual debt reduction during the adjustment period (0.5% or 1%, depending on whether the debt is lower or higher than 90% of GDP). In the initial EC proposal, countries would have had to put debt on a downward trajectory only by the end of the adjustment period. In the final compromise, debt has to fall during the adjustment period, which will be considerably more challenging for some countries, forcing them to front-load fiscal adjustment (even if this is partially offset by focusing on primary deficits in the period 2025-27). A growth downturn during the adjustment period could make this even more challenging.

4. What are the next steps to ratify the rules?

Ratification of the rules should be straightforward

The EC will now amend the initial regulation proposal from April, which will then have to be formally approved by the European Council and the European Parliament (EP). On fiscal matters, however, the role of the EP is limited as it does not have the power to introduce amendments to the proposal, for instance, so its ratification should be relatively straightforward.

5. When will the new rules be implemented?

In autumn 2023, the EC had already identified some risk of non-compliance for some countries…

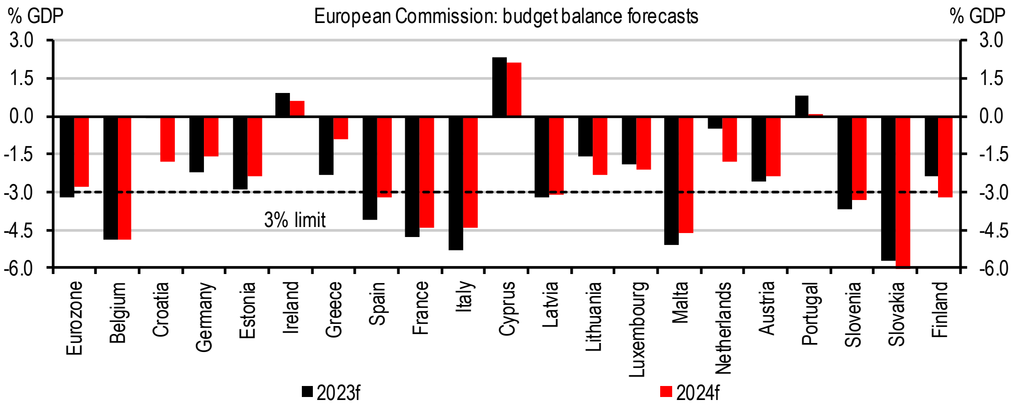
The new rules should not have a bearing on 2024. In November 2023 when assessing the 2024 draft budgets submitted by eurozone countries, the EC found that four countries (Belgium, Finland, France and Croatia) "risk not being in line with the Council Recommendations" of July 2023 in terms of fiscal policy stance, while another nine (Austria, Germany, Italy, Luxembourg, Latvia, Malta, Netherlands, Portugal and Slovakia) were not "fully in line" with the recommendations.

The former is considered worse than the latter; therefore, the EC invited Belgium, Finland, France and Croatia "to take the necessary measures within the national budgetary process to ensure that fiscal policy in 2024 will be in line" with the recommendation, while for instance Italy, Latvia and the Netherlands were "invited to stand ready to take the necessary measures". However, there was no immediate requirement for these countries to act, as there was no outright rejection of the draft budgets, which would have necessitated countries to submit amended budgets.

…but with no immediate requirement for countries to act, kicking the can down the road to the spring

So in practice, the can is kicked down the road to the next EC fiscal assessment, in spring 2024, following the submission of each country's multi-annual budgetary plan in April, when the EC will see how the situation has evolved relative to its current forecasts. At that stage, the EC is likely to put forward a proposal for several countries to enter into an EDP, which would then have to be approved by the European Council. As things stand, at least nine eurozone countries, which the EC expect to have a deficit higher than 3% of GDP (chart 3), should enter into an EDP. But with the EP election scheduled for 6-9 June, it seems unlikely that this would happen before July, possibly even later, depending on how long it takes to form a new EC. So it might be too late for the EC to request an in-year fiscal adjustment for 2024.

3. The EC expects nine eurozone countries to have deficits higher than 3% in 2024



Source: European Commission, HSBC

It seems more likely that the axe will fall on 2025 rather than 2024 in terms of possible adjustment requirements

Therefore, it seems more likely that the axe will fall on 2025, when the EC might request fiscal adjustments in line with the requirements of the new rules, which would be assessed at the time of the submission of the draft budgetary plans in autumn (15 October deadline).

6. What do they mean for the eurozone fiscal stances in 2024 and 2025?

In its latest forecasts, the EC expected a contractionary fiscal stance for the eurozone in 2024, with an improvement in the structural primary balance (ie, after stripping out interests and the impact of the economic cycle) of 0.6% of GDP. The ECB made a similar assessment in December 2023.

However, in Italy, that consolidation would be about only half without the change in 'Superbonus' accounting (a housing tax credit worth 1.8% of Italy's GDP in 2023 and expiring next year). More fundamentally, the bulk of consolidation is set to be made up of savings on energy support measures owing to lower energy prices with little negative impact on growth. Some countries have been recycling part of the energy savings into other forms of support.

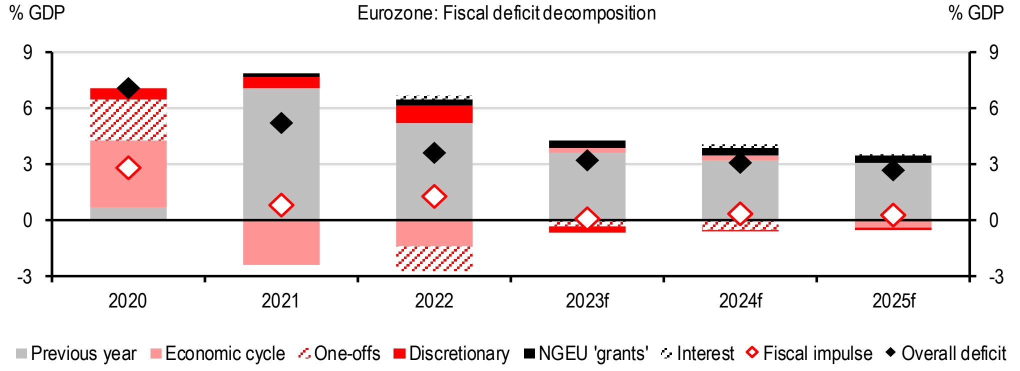
We see only a very small net tightening of domestic fiscal policy in 2024, largely offset by NGEU spending…

As a result, we expect only a very small net tightening of domestic fiscal policy in 2024 (chart 4) with a risk of fiscal slippage if economic growth disappoints. Further, based on their 2024 budgetary plans, we estimate that countries across the eurozone are expecting to spend over 0.4% of GDP of grants under the Recovery and Resilience Facility (RRF) in 2024, further supporting public investment. So we see a mildly expansionary fiscal stance in 2024, which should not be affected by the new EU fiscal rules.

…while in 2025, we see more of a risk of greater tightening as a result of the new rules

For 2025, we also see only modest domestic fiscal tightening, again largely offset by RRF grant spending. However, we see a risk of further tightening because countries under and EDP could be requested to make greater fiscal adjustments (despite the exception already granted under the new rules for the 2025-27 period, which reduces the extent of the adjustment needed to account for higher interest payments, which should limit the risk to some extent).

4. We expect only modest tightening of domestic fiscal policy in 2024 and 2025



Source: HSBC forecasts, HSBC calculations based on Eurostat, European Commission.

7. Which countries could be affected most by the new rules?

Overall, the countries with higher deficits – and well above the 1.5% medium-term target – could face a tough consolidation challenge. The inflation-related boost to revenues is now over, while spending – particularly on inflation-indexed items, such as pensions and public-sector salaries – is catching up. In addition, rising borrowing costs are eating away at fiscal space (despite being accounted for under the rules, at least for the period 2025-27).

Countries such as Italy, France and Spain could face large fiscal adjustments

A considerable amount of fiscal tightening might still be needed to reduce debt-to-GDP by 1pp on average each year, as required by the new rules (although once again the exceptions for 2025-27 will likely reduce that amount in practice). Based on current sovereign borrowing costs, we estimate that Italy, France and Spain could face a cumulative primary adjustment need of between 1.7% and 3.5% of GDP to reduce their debt by 1pp, depending on growth (Table 5).

5. Fiscal adjustment required to reduce debt-GDP ratios by 1ppt per year at current rates

	Current (2023e)	Growth (real) →	0.5%	1.0%	1.5%
Italy	-1.4%		3.5%	2.7%	2.0%
France	-3.1%		3.5%	3.0%	2.5%
Spain	-1.6%		2.7%	2.2%	1.7%

Source: HSBC calculations, European Commission. Notes: Shows the cumulative change in primary balance needed (from current level) as a percentage of GDP under each growth assumption and assuming GDP deflators rise by 2% y-o-y.

Large issuance needs and the ECB Quantitative Tightening could contribute to pressure on borrowing costs

A recent study by Brussels-based think tank Bruegel, after the deal on fiscal rules reforms and based on EC data, calculates that the annual fiscal adjustment required on average by some high-deficit and high-debt countries (and even under the extended seven-year adjustment period) could be 0.61% of GDP in Italy, 0.56% in Spain and 0.47% in France. Other countries with large adjustment requirements could be Slovakia (1% of GDP) and Belgium (0.71%).[2]

Further, having large deficits – and large amounts of issuance that markets have to absorb, accounting also for the ECB Quantitative Tightening – could weigh on sovereign yields, adding further to borrowing costs.

8. What could be other implications of a country being in an EDP?

An EDP could create some political backlash, and affect eligibility for the ECB TPI

In addition to having to undertake the fiscal adjustments mentioned previously, being in an EDP could increase the risk of negative sentiment around some countries, although having almost half of the eurozone countries under an EDP would limit this. There could also be domestic political backlash in some countries, particularly where euro-sceptic parties are gaining support ahead of the EP elections in June. Lastly, it would increase the risk of a country losing eligibility for the ECB Transmission Protection Instrument (TPI), which could become the only tool available to contain wider spread when PEPP reinvestments are ended in 2025. Based on ECB regulation on TPI, failure to comply with EDP requirements could mean losing access to it.

9. Could we see more tightening in Germany in 2024?

Germany could see more fiscal tightening in 2024

Although many countries risk insufficient fiscal consolidation in 2024, there is a notable exception. Following the German Constitutional Court ruling that the transfer of EUR60bn (2% of GDP) of unused pandemic debt to the “Climate and Transformation Fund” (KTF) is illegal, Germany had to redraft its 2024 budget, including cutting EUR5.5bn of support to relieve consumers from higher electricity grid fees. To generate more revenue, the government raised carbon prices on heating and transport fuels more than initially agreed and introduced a new levy on plastics. So overall, this could add to an already difficult economic backdrop in the eurozone’s largest economy.

10. What could be the consequences of Italy not ratifying the ESM Treaty?

In the immediate aftermath of the deal on EU fiscal rules, on 21 December 2023, the Italian parliament rejected the ratification of the new European Stability Mechanism (ESM) Treaty. Italy is the only country not having ratified it yet. This took many by surprise as the government had initially tied the ratification to a deal on EU fiscal rules so it seemed assured.

Failure to ratify the ESM Treaty increases risks for banks and could isolate Italy

This means that it is impossible for the ESM Treaty to be in place by 1 January 2024, which was the intention of EU policymakers, and crucially with the new backstop facility for eurozone banks (Single Resolution Fund). Although it has been mooted in the press that the other 19 eurozone countries could go ahead, leaving Italy isolated (Il Sole 24 Ore, 21 Dec 2023), this seems unlikely to us. This situation could increase risks for the banking sector, and leave Italy isolated. It seems likely the issue will take centre stage at the next EU finance minister gathering on 16 January, but by law, the Italian parliament won’t be able to approve the same reform text in the next six months.

[2] https://www.bruegel.org/first-glance/assessing-ecofin-compromise-fiscal-rules-reform .

Disclosure appendix

The following analyst(s), who is(are) primarily responsible for this document, certifies(y) that the opinion(s), views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Fabio Balboni

This document has been issued by the Research Department of HSBC.

HSBC and its affiliates will from time to time sell to and buy from customers the securities/instruments, both equity and debt (including derivatives) of companies covered in HSBC Research on a principal or agency basis or act as a market maker or liquidity provider in the securities/instruments mentioned in this report.

Analysts, economists, and strategists are paid in part by reference to the profitability of HSBC which includes investment banking, sales & trading, and principal trading revenues.

Whether, or in what time frame, an update of this analysis will be published is not determined in advance.

For disclosures in respect of any company mentioned in this report, please see the most recently published report on that company available at *www.hsbcnet.com/research*.

Additional disclosures

1. This report is dated as at 02 January 2024.
2. All market data included in this report are dated as at close 28 December 2023, unless a different date and/or a specific time of day is indicated in the report.
3. HSBC has procedures in place to identify and manage any potential conflicts of interest that arise in connection with its Research business. HSBC's analysts and its other staff who are involved in the preparation and dissemination of Research operate and have a management reporting line independent of HSBC's Investment Banking business. Information Barrier procedures are in place between the Investment Banking, Principal Trading, and Research businesses to ensure that any confidential and/or price sensitive information is handled in an appropriate manner.
4. You are not permitted to use, for reference, any data in this document for the purpose of (i) determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments, (ii) determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument, and/or (iii) measuring the performance of a financial instrument or of an investment fund.

Disclaimer

Issuer of report
HSBC Bank plc

This document has been issued by HSBC Bank plc, which has based this document on information obtained from sources it believes to be reliable but which it has not independently verified. Neither HSBC Bank plc nor any member of its group companies ("HSBC") make any guarantee, representation or warranty nor accept any responsibility or liability as to the accuracy or completeness of this document and is not responsible for errors of transmission of factual or analytical data, nor is HSBC liable for damages arising out of any person's reliance on this information. The information and opinions contained within the report are based upon publicly available information at the time of publication, represent the present judgment of HSBC and are subject to change without notice.

This document is not and should not be construed as an offer to sell or solicitation of an offer to purchase or subscribe for any investment or other investment products mentioned in it and/or to participate in any trading strategy. It does not constitute a prospectus or other offering document. Information in this document is general and should not be construed as personal advice, given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on it, consider the appropriateness of the information, having regard to their objectives, financial situation and needs. If necessary, seek professional investment and tax advice.

The decision and responsibility on whether or not to purchase, subscribe or sell (as applicable) must be taken by the investor. In no event will any member of the HSBC group be liable to the recipient for any direct or indirect or any other damages of any kind arising from or in connection with reliance on any information and materials herein.

Past performance is not necessarily a guide to future performance. The value of any investment or income may go down as well as up and you may not get back the full amount invested. Where an investment is denominated in a currency other than the local currency of the recipient of the research report, changes in the exchange rates may have an adverse effect on the value, price or income of that investment. In case of investments for which there is no recognised market it may be difficult for investors to sell their investments or to obtain reliable information about its value or the extent of the risk to which it is exposed. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors.

This document is for information purposes only and may not be redistributed or passed on, directly or indirectly, to any other person, in whole or in part, for any purpose. The distribution of this document in other jurisdictions may be restricted by law, and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions. By accepting this report, you agree to be bound by the foregoing instructions. If this report is received by a customer of an affiliate of HSBC, its provision to the recipient is subject to the terms of business in place between the recipient and such affiliate. The document is intended to be distributed in its entirety. Unless governing law permits otherwise, you must contact a HSBC Group member in your home jurisdiction if you wish to use HSBC Group services in effecting a transaction in any investment mentioned in this document.

Certain investment products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. Investors should consult with their HSBC representative regarding the suitability of the investment products mentioned in this document.

HSBC and/or its officers, directors and employees may have positions in any securities in companies mentioned in this document. HSBC may act as market maker or may have assumed an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell or buy securities and may also perform or seek to perform investment banking or underwriting services for or relating to those companies and may also be represented on the supervisory board or any other committee of those companies.

From time to time research analysts conduct site visits of covered issuers. HSBC policies prohibit research analysts from accepting payment or reimbursement for travel expenses from the issuer for such visits.

HSBC Bank plc is registered in England No 14259, is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority and is a member of the London Stock Exchange. (070905)

[1226428]