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The (potential) contribution of the European Union's fiscal architecture to financial stability

Fabian Amtenbrink

Erasmus School of Law, Erasmus University Rotterdam, Rotterdam, Netherlands

ABSTRACT
Based on a discussion of main channels through which fiscal stability can contribute to financial stability, the current legal governance framework of the euro area and the experience gained in its application are assessed with the aim to offer an answer to the question alluded to in the title, namely whether the EU's fiscal architecture, namely the current EMU legal framework on economic policy coordination, provides a meaningful contribution to financial stability. Moreover, the potential of this framework to accommodate future measures to enhance fiscal stability is briefly assessed.

KEYWORDS
Economic and monetary union; fiscal stability; financial stability; shock-absorption capacity; NextGenerationEU

1. Introduction

European policy makers consider EBU as a key component of EMU (European Council/Council 2022) and thus as a building block of, rather than a policy field separate from economic and monetary policy. This is hardly controversial, as it has become apparent from the events leading up to and during the global financial crisis (GFC) and the European sovereign debt crisis (hereafter: euro area crisis) that these policy fields are intrinsically linked and indeed communicating vessels. Problems arising in the sphere of fiscal policy, namely with regard to the budgetary positions of countries, can have spill over effects on financial stability, whereas financial market instability can impact public finances (European Central Bank 2010). It has been held – though not uncontested – that EBU and the strong fiscal capacity of the European Union (EU) 'complement and reinforce each other', especially in times of crisis (Buti and Carnot 2018). Arguments have been put forward in support of additional crisis prevention and mitigation tools mainly to ensure both the fiscal and financial stability of the euro area. Such tools are thus not only sought regarding the EU's financial market regulatory and supervisory framework but also concerning the 'fiscal architecture' of the euro area (Bénassy-Quéré et al. 2018).

Based on a discussion of main channels through which fiscal stability can contribute to financial stability, the current EMU legal framework and the experience with its application are assessed with the aim to offer an answer to the question alluded to in the title whether the EU's fiscal architecture can provide a meaningful contribution to financial stability and – to the extent that this is not the case – what the potential of the current legal framework is to accommodate fiscal stability in the future.

CONTACT Fabian Amtenbrink amtenbrink@law.eur.nl

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To this end, first, the theoretical case for the link between fiscal and financial stability is discussed, thereby *inter alia* offering working definitions of both concepts and identifying main determinants for fiscal stability with relevance for financial stability (section 2).[1] Based on these findings, the contribution then assesses to what extent the current legal framework can ensure that these factors are sufficiently observed in the euro area (section 3).[2] Finally, section 4 briefly explores the potential of the EU's constitutional framework to accommodate such adjustments, considering the cumbersome and politically uncertain process of a revision of the current EU Treaties.

2. Financial and fiscal stability: two sides of the same coin

Contrary to what could be assumed from the numerous references in policy documents and legislation,[3] certainly in the EU context, the terms financial stability and fiscal stability elude a clear, universal, and legally binding definition. In fact, neither of these notions can be considered to constitute legal concepts.

2.1. Conceptualizing financial and fiscal stability

As Issing (2003, 16) observes, a generally accepted definition of 'financial stability' is missing. This author differentiates two types of definitions based on whether they take 'a system approach' by referring to the overall state of the financial system and its vulnerability to the disruption of financial markets (i.e. its vulnerability to financial crisis), or whether they focus more concretely on 'the volatility of directly observable financial variables', such as the development of asset prices. Ferguson (2003) approaches the terminology by defining its opposite, that is financial *in*stability, which in the author's view ' … involves some notion of market failure or externalities that can potentially impinge on real economic activity'. In this view, financial stability does not only entail the 'prevention of instability' but also the 'management of the consequences once markets become unstable.'[4] These two main elements can also be found in the definition offered by Schinasi (2004, 8), who refers to the ability of a financial system 'of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events.' What becomes clear from these and other contributions to the subject matter is that the roots of the notion of financial stability are non-legal (Lo Schiavo 2017, 31).

Considering the importance that financial stability is given by national and EU policy-makers, as well as in EU secondary law (Lo Schiavo 2017), it is rather astonishing that an unequivocal legal definition of this notion is missing. The pursuit of financial stability has been considered as 'a clear public interest' (Ferguson 2003;) and certainly since the GFC has been assigned the status of public or collective good' (De Larosière Report: The High-Level Group on Financial Supervision in the EU 2009; Dyson and Marcussen 2010; Lo Schiavo 2017). Financial stability features prominently in the first and second pillars of EBU, that is the Single Supervisory Mechanism (SSM), based on Article 127(6) TFEU,[5] and the Single Resolution Mechanism (SRM), based on the central internal market legal basis of Article 114 TFEU,[6] by referring to the 'restoring, 'safeguarding', or 'maintaining' of financial stability. Providing a glimpse at what the European legislator had in mind when drafting these major financial market regulatory instruments, Article 10(5) of the SRM

Regulation[7] defines a threat to financial stability as 'a situation where the financial system is actually or potentially exposed to a disruption that may give rise to financial distress liable to jeopardize the orderly functioning, efficiency and integrity of the internal market or the economy or the financial system of one or more Member States.' The creation of a regulatory framework ensuring a consistent set of rules and the creation of institutional structures that ensures adequate macro- and micro-prudential oversight, and a framework for crisis management has been the major goal of the EBU (De Larosière Report: The High-Level Group on Financial Supervision in the EU 2009; European Council 2012, 4–5; European Commission 2015, 11 et seq.).

The European Central Bank (ECB) not only has 'to contribute to the smooth conduct of policies pursued by competent [national] authorities' (Article 127(5) TFEU) but since November 2014 is also in charge of banking supervision in the context of the SSM aimed at safeguarding financial stability in the EU. The ECB takes a systematic approach to the definition of financial stability, referring to 'a condition in which the financial system – which comprises financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances' (European Central Bank 2022A). The self-declared goal is 'mitigating the likelihood of disruptions in the financial intermediation process that are severe enough to significantly impair the allocation of savings to profitable investment opportunities' (European Central Bank 2010, 7; European Central Bank 2016).

Turning to 'fiscal stability', Lo Schiavo (2017, 43) takes a broad approach to defining this notion, pointing out that 'Fiscal stability presupposes the power to control economic choices over budgets, tax, welfare, labour, external financing, and other macro-economic policies in order to exercise public functions and respect fiscal discipline'. He considers 'the preparation and management of budgets as well as the formulation and imposition of taxes, labour and other economic policies' as important instruments in this regard. In the EMU context, 'fiscal stability', but also terms such as 'fiscal capacity' and 'fiscal union', is predominantly used to describe institutional and procedural arrangements pertaining to sound or sustainable public finances and budgetary policies and to the adherence to the basic budgetary rules laid down in primary Union law (fiscal discipline) (see e.g. Eichengreen 2004; Scott 2012).[8] This becomes already apparent from the names and objectives assigned to some major economic policy coordination instruments in EMU. The 1997 *Stability* and Growth Pact (SGP) refers in its Resolution (European Council 1997) to 'the importance of safeguarding sound government finances as a means to strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation'. The global financial and euro area crisis has reinforced this approach, as the build-up of unsustainable public debt has been considered as one of the main drivers of the crisis (e.g. Weder Di Mauro 2015; Bassanini and Reviglio 2011, 11). Correspondingly, the 2012 Treaty on *Stability*, Coordination and Governance in EMU (Fiscal Compact) refers to 'the need for governments to maintain sound and sustainable public finances and to prevent a general government deficit becoming excessive is of essential importance to safeguard the stability of the euro area as a whole', a focus that is mirrored in EU policy documents (e.g. European Commission 2015; European Parliament 2021). More importantly, fiscal stability is also more broadly linked to macroeconomic stability,[9] whereby a stability oriented fiscal policy is considered to assist 'public expenditure to smooth

cyclical swings of economic activity and supports crisis mitigation when needed' (European Commission 2022).

Two main elements featuring in this understanding of the notion of fiscal stability are a sustainable budgetary policy that puts policy makers in the position of being able to address cyclical fluctuations and the existence of shock-absorption or crisis mitigation instruments. In fact, these two elements can be considered as the preventive and the corrective arm of a system that is geared toward crisis prevention (sound budgetary policies) and crisis mitigation (shock absorption), in an approach that shares some similarities with what has been noted for financial stability with the two main elements there being prudential supervision and resolution in the case of failing credit institutions.

2.2. The contribution of fiscal stability to financial stability

Both financial and fiscal stability have been identified as key components of 'a healthy and well-functioning economic system' and considered a 'pre-condition for durable and healthy growth' (Bassanini and Reviglio 2011, 11). This does not, however, answer the question how financial and fiscal stability are related to one another and mainly how the latter can contribute to the former.

The ECB (2010, 69) has identified several channels through which fiscal policy can contribute to or impede financial stability, including the '(i) contributing to a high level of public and market confidence through a responsible and sustainable conduct of fiscal policy; (ii) creating fiscal room for maneuver in order to have a strong capacity for intervention in crisis times; (iii) providing sound incentives to financial institutions' owners and managers, as well as to the economy at large, in connection with tax and expenditure structures; and (iv) creating restrictive rules for providing financial assistance to financial institutions in order to limit 'moral hazard' behaviour.' The first and second channels are directly linked to the preventive and the corrective arm of a stability oriented fiscal policy framework referred to in the previous section (sound budgetary policy and the ability to deal with crises) and – as will become clear hereafter – are also mutually connected, whereas the third and fourth channels relate to the broader regulatory and supervisory environment that falls outside the scope of this contribution.

While a definition of what constitutes a 'responsible and sustainable conduct of fiscal policy' in the EMU context is not provided in the above-cited publication, this can be linked to the above-observed approach to the notion of fiscal stability. The focus lies on 'the level and composition of government expenditure and revenue, budget deficits and government debt' (European Central Bank 2022B). Fiscal stability is associated with debt sustainability (European Commission 2020A, 20), that is the ability of government 'to meet all its current and future payment obligations without exceptional financial assistance or going into default.' (International Monetary Fund 2020, 60). The euro area crisis has highlighted how unsustainable debt levels, in part resulting from costly financial rescue operations, can shake market confidence in the solvency of countries, endangering financial stability. The latter can be explained with reference to the doom loop between banks and the sovereign that has been abundantly discussed in the economic literature (see e.g. Caruana and Avdjiev 2012), whereby 'sovereigns are exposed to bank risk, but banks are also exposed to sovereign risk' with 'devilish implications for systemic stability' (Alogoskoufis and Langfield 2019, 3).

The second main contribution of fiscal stability to financial stability that has been observed is that sustainable sovereign debt levels are a prerequisite to deal with risks to financial stability (Komárková, Dingová, and Komárek 2012/2013, 105–106), as liquidity and capital requirements in financial market regulations are considered insufficient in this regard. Sound public finances have to provide the budgetary headroom to smoothen and absorb economic shocks and to mitigate crises. Two main instruments that have been identified with regard to the latter are automatic stabilizers, that is 'elements, built into government revenues and expenditures, that reduce fluctuations in economic activity without the need for discretionary government actions' (Bouabdallah et al. 2020), and discretionary fiscal policy, namely in the shape of 'countercyclical discretionary spending to stabilize domestic income' (Alcidi and Thirion 2017, 7).[10] The ability of a country to deal with crisis situations is linked to the sustainability of its budgetary policy, as balanced or surplus budgetary positions provide a safe margin for cyclical developments and unanticipated budgetary risks (Amtenbrink and De Haan 2003, 1092). The economic impact of the GFC has highlighted the importance of the existence of such budgetary safety margins. In the absence thereof, EU Member States felt compelled to counter risks to financial stability through ad hoc arrangements, namely, the temporary Financial Stabilisation Mechanism (EFSM) and, subsequently, the permanent European Stability Mechanism (ESM).[11] More recently, the COVID-19 pandemic has triggered an unprecedented increase in the government deficit and debt levels in the euro area, which has been attributed to the working of automatic stabilizers and discretionary fiscal (spending) policies in the Member States (European Fiscal Board 2021), which in turn has triggered ad hoc measures, as will be observed in sections 3 and 4.

Opinions differ as to whether financial stability is sufficiently secured if sustainable national budgetary policies and national automatic stabilizers are in place to deal with asymmetric shocks, next to the establishment of the EBU and a European Capital Markets Union. In essence, this debate among economists is not so much about whether a stabilization and crisis mitigation function is needed, but at what level in the multilevel governance system of the EU it should be situated and what shape it should take. Van Dijk et al. 2018) reject the idea of a need for a central role of the EU, arguing that the focus should be on 'completing Banking Union, developing a capital markets union, and ensuring that its members have the fiscal space to use automatic stabilisers in a downturn.' Feld (2018) stresses that next to the completion of EBU also reforms in the Member States and budgetary consolidation are required. Both Van Dijk et al. (2018) and Feld (2018) emphasize the importance of budgetary policies that provide countries with the fiscal space to deal with economic downturns. These authors thus consider fiscal stabilization odd to be provided through national automatic fiscal stabilizers. This approach heavily relies on the ability of the EMU legal framework to ensure budgetary discipline and the build-up of fiscal buffers (to ensure that automatic stabilizers can operate freely) without severely breaching the European fiscal rules that are meant to ensure the fiscal stability of the euro area. Whether the experience in the application of the current framework allows for a positive evaluation in this regard is doubtful, as will become clear from the next section. Moreover, in the case of the euro area it needs to be considered that Member States no longer have monetary policy instruments at their disposal to deal with crises autonomously..[12] It is questionable whether national fiscal buffers alone can in all instances provide for a sufficient shock-absorption capacity in the

case of large asymmetric shocks (Alcidi and Thirion 2017, 39; European Commission 2015, 4 and 14).[13] It is in this context that it has been argued that the EU has to play a more prominent role in providing fiscal stabilisation, as such by Bénassy-Quéré et al. (2018, 14 et al.), referring to the need for 'a European fiscal capacity for large economic shocks', and Buti and Carnot (2018), who argue that EBU and a strong fiscal capacity of the EU are complementary, in particular in times of crisis, as private risk sharing in EBU, and national fiscal stabilizers are considered insufficient to fully deal with such shocks.

3. The fiscal architecture of the euro area: providing fiscal stability?

Assessing the current EMU governance framework and the experience gained with its application in relation to the main channels through which fiscal stability can positively or negatively impact financial stability reveals a rather mixed picture for the euro area. In part, this is due to the nature and scope of this framework and in other parts, it results from the lack of compliance of euro area Member States and the inconsequential execution of the existing rules by the EU institutional actors. While the reform of the legal framework introduced by the 1992 Treaty on European Union (Maastricht Treaty) in response to the euro area crisis has been explicitly aimed at addressing some of the shortcomings, these measures have certainly not fundamentally altered the fiscal architecture of EMU laid down in primary Union law, and they have even less so resulted in (many) more favourable outcomes in terms of the budgetary positions of at least parts of the euro area. The fact that the ECB, in its role as monetary policy authority, had to intervene repeatedly not only to ensure financial stability but also the stability of the euro area in the face of fiscal instability in the Member States highlights this point.[14]

3.1. In search of sustainable budgetary policies in the euro area

At the outset, it is important to recognise that at the time of the establishment of the EMU legal framework, a political consensus among the Member States to transfer powers for the conduct of economic policy comparable to those for monetary policy to the supranational level was missing.[15] This has resulted in the well-known asymmetric integration of EMU and the somewhat artificial legal distinction (Amtenbrink and Repasi 2020, 758) for the euro area between monetary policy and economic policy, whereby the latter remains a national competence with the EU involvement in principle being limited to the coordination of national policies based on common objectives and principles. To be sure, EU law does engage with national economic policies, whereby the focus rests on sustainable public finances and budgetary policies. This is already reflected in Articles 123 and 125 TFEU, respectively, prohibiting monetary (government) financing and the assumption of national government debts by the EU or other Member States (the so-called no bailout clause).

Set by Articles 121 and 126 TFEU as the two principal Treaty provisions introducing the preventive and corrective arm of the supranational economic surveillance system and flanked by the two Council Regulations at the core of the SGP, the EU legal framework has been drafted as a rules- and procedure-based bureaucratic process, based on somewhat arbitrary (Buti 2003, 101) (numeric) government deficit and debt targets, and the semblance of a hierarchical relationship, that hardly reflects legal and political reality. It is a system which from the outset has been designed to rely on the force of persuasion, self-

commitment by Member States, and intergovernmental bargaining in the Council as part of the system of peer-review (Amtenbrink and De Haan 2003, 1076), lacking decision-making procedures that would allow for the impartial enforcement of the existing rules. The latter shortcoming is rooted both in the non-legally binding nature of the acts adopted[16] and the exclusion of judicial review by the European Court of Justice (ECJ) of the breach of the excessive deficit rule by Member States in the context of a Treaty infringement procedure.[17]

While certainly not being entirely unsuccessful in achieving improvements in the fiscal situation of at least some Member States (Amtenbrink and De Haan 2003, 1104), over time the track record of the governance framework in ensuring the adherence of euro area Member States to the basic European fiscal rule has deteriorated. This applies not only to the well-known 3% to GDP deficit and the 60% to GDP debt ratio limits stated in the Protocol on the Excessive Deficit Procedure,[18] but mainly also the differentiated medium-term objective (MTO) for the budgetary positions of Member States introduced under the SGP Council Regulation 1466/97, whereby Member States are required to achieve a cyclically adjusted improvement of their budget balance with 0.5% of GDP.[19] Even if the excessive deficit procedure has been attested with the ability to 'affect both planned and actual fiscal policy' (De Jong and Gilbert 2020, 2) in the Member States, the corrective arm of the system has proven ineffective in persuading Member States to conduct counter-cyclical fiscal policies.[20] Member States have regularly taken a pro-cyclical fiscal stance (Commission (2020B, 16–17)), which has inter alia been explained with the current fiscal rules, high levels of debt and a lack of market discipline (Alcidi and Thirion 2017, 39). This conclusion is not only based on the observation of recent events. Already in the leadup to the 2005 reform of the SGP, the Council (2003, 16) identified pro-cyclical budget policies in good times as one of the major flaws of the SGP and noted that 'Member States shall avoid pro-cyclical policies, especially when growth conditions are favourable.' The lack of political commitment to consistently apply the excessive deficit procedure in all its available steps was highlighted by its inconsequential application to Germany and France in 2003 that led to an open standoff between the Commission and the Council before the ECJ, which in its ruling[21] essentially verified the political nature of the decision-making process (Maher 2004). Not much seems to have changed since, even though the SGP Council Regulation 1466/97 explicitly states that when examining the Stability Programs of the Member States and deciding on whether to demand adjustments, the Council and the Commission must consider whether Member States are making higher adjustment effort in economic good times.[22]

Based on our own calculations for the period 1999–2015, inter alia considering the above numeric rules, but, for example, also to what extent Member States have been subjected to excessive deficit procedures, Eyraud, Gaspar, and Poghosyan (2017, 18) testify the system with 'a poor record of compliance with key rules' by the euro area countries. While it is hardly surprising that these authors observe a particular bad track record during the euro area crisis, their conclusion that the crisis-reform measures have not changed this picture (Eyraud, Gaspar, and Poghosyan 2017, 18) is weighty. After all, namely, the Six Pack and Two Pack were geared towards improving economic governance to ' . . . built on stronger national ownership of commonly agreed rules and policies and on a more robust framework at the level of the Union for the surveillance of national economic policies',[23] introducing for the euro area Member States (the threat of)

a sanction mechanism in the multilateral surveillance phase (interest-bearing deposits) and at the outset of the excessive deficit procedure (non-interest bearing deposits that can turn into penalty payments), as well as the reversed qualified majority voting in the Council aimed at strengthening the role of the Commission (Keppenne 2020, 845 et seq.). Moreover, the Fiscal Compact has been aimed at reiterating the commitment of the Member States and the EU to the basic fiscal rules *inter alia* by introducing a mandatory balanced budget rule and automatic correction mechanisms both to be implemented in the domestic laws of Member States. Member States have had to commit to a rapid convergence towards the country-specific respective medium-term objectives.[24] Finally, the scope of the surveillance of the economic policies of the Member States has been broadened beyond budgetary policy developments through the inclusion of the macroeconomic imbalances procedure into the EU economic policy surveillance cycle, including corresponding enforcement measures.[25] In fact, the economic, financial and structural indicators included in the so-called Scoreboard to detect imbalances are geared towards detecting threats to macroeconomic stability. Furthermore, euro area countries experiencing or threatened with serious difficulties with respect to their financial stability, which are likely to have adverse spill-over effects on other Member States, can and, in the case of receiving financial assistance, must be subjected to an enhanced economic surveillance regime by the European Commission.[26]

Yet, the reinforced sanctioning regime as part of the preventive and corrective arm of the surveillance system for the euro area Member States has never been applied. In fact, it has actually been avoided, as becomes clear from the European Commission proposal in August 2016, backed by the Council, to zero the procedurally foreseen fines for Portugal and Spain in favour of the extension of the deadlines for the correction of the respective excessive deficits (Council 2016). Also, in the context of the macroeconomic imbalances procedure sanctions have yet to be applied. While 14 Member States (euro area and non-euro area) did not meet the 60% debt to GDP ratio in 2021, whereby all seven Member States with values of above 100% of debt to GDP ratios are part of the euro area, by November 2022 no euro area Member State has been subject to an excessive deficit procedure. In the context of the COVID-19 pandemic, the Commission and Council (European Commission 2020C) decided to effectively suspend the working of the preventive and corrective arm of the SGP referring to the legal possibility provided for in SGP Council Regulations 1466/97 and 1467/97 to effectively take into account unexpected adverse economic events with major unfavourable consequences for government finances in the context of the multilateral surveillance and excessive deficit procedure.[27] Yet, except for Romania for which an excessive deficit procedure was decided upon in April 2020, the reference by the Commission and the Council to the escape clause in the context of the application of the excessive deficit procedure is somewhat misleading. Legally speaking, the corresponding provisions in Council Regulation 1467/97 can only be utilized once an excessive deficit procedure has actually been triggered by a Council decision.[28] To be sure, while it can be defended that it makes perfect sense not to apply the excessive deficit procedure in the given economic circumstances, the above legal observations highlight the shortcoming on parts of the legal framework to accommodate for such crisis situations, requiring somewhat creative political solutions, such as the Commission refraining from setting into motion the initial steps of the excessive deficit procedure.

3.2. The absent shock-absorption and crisis mitigation capacity of the euro area

What has become clear from the previous section is that the current governance framework falls short of delivering on its declared objective to ensure the (close to) balanced or surplus budgetary position of Member States, at the very least hindering the working of national automatic stabilisers within the confinements of the basic EU fiscal rules and restricting the room for discretionary fiscal policy in times of crisis. At the same time, it can be observed that the supranational legal framework does not foresee a general shock-absorption capacity for the EU or at least for the euro area (European Commission 2020B, 16–17) in addition to what can be found in euro area Member States (regarding the latter, see Bouabdallah et al. 2020). Moreover, the EU institutions are not in a position to unilaterally generate additional resources necessary to engage in a meaningful counter-cyclical spending policy to stabilize the euro area economies in times of crisis.

Regarding automatic stabilizers, the primary Union law arguably does not provide a forthright and undisputed legal basis for the establishment of such a mechanism, which can be explained by the fact that based on the before-noted basic distribution of competences in the EU Treaties, budgetary policy, and thus government revenues and expenditures in principle remains a national domain. Still, the establishment of a European shock-absorption capacity has been on the European policy agenda for some time (European Commission 2015, 14 et seq., 2017; European Fiscal Board 2021, 71 et seq.). This has resulted in various proposals (Spath 2016), such as the establishment of a rainy-day fund e.g. in the shape of a cyclical shock insurance scheme financed by the Member States in economic good times (Enderlein, Spiess, and Guttenberg 2013, Lenarčič and Korhonen 2018;), a European unemployment benefits scheme (Alcidi and Thirion 2017; Beblavy ; Repasi 2017; and Lenaerts 2017; European Commission 2020D, 3), and the establishment of a euro area budget (European Commission 2017, 26; Lenarčič and Korhonen 2018; Claeys 2020).

To be sure, the above conclusion does not mean that the current EU governance framework does not provide for any crisis mitigation mechanism. Yet, the scope of measures than can be said to fulfil such a function is limited and at times of an ad hoc nature. Moreover, they generally do not amount to *automatic* stabilizers but rather require the (discretionary) intervention of policy makers. Past and present multiannual financial frameworks (MMF), which determine the long-term budget of the EU, have included sections ('thematic special instruments') to mitigate the effects of economic shocks. Instruments include the Youth Employment Initiative, the EU Solidarity Fund, and the European Globalisation Adjustment Fund (Commission 2017, fn. 7; Amtenbrink and Markakis 2023). A more recent example from the current MMF 2021–2027[29] is the Brexit Adjustment Reserve, aimed at addressing the economic consequences of the withdrawal of the United Kingdom from the EU. Other examples of EU instruments that can be said to contribute to the economic policy of the Member States include the European Fund for Strategic Investments[30], as well as the five European Structural Funds. The latter *inter alia* foresee in additional allocation of resources to specific regions in certain euro area countries to address the effects of the economic crisis on their level of prosperity as part of the Fund's goal to invest in growth and jobs in less developed regions.[31] Yet, the actual amounts assigned to these instruments are relatively small, and – as is observed by Amtenbrink and Markakis (2023), – the Own Resources Decision of the Council that sets

the applicable ceilings for commitments and own resources of the EU in the past had 'not foreseen a category of own resources available to structurally or temporarily allocate substantive resources to address (asymmetric) economic shocks'.

The euro area crisis has highlighted the legal limits of the current EU Treaties to provide (euro area) Member States with support in case of financial distress triggered by a major economic shock. The legal viability of the utilization of financial assistance tools, such as the temporary ESFM and the subsequent permanent ESM has not remained undisputed, namely with regard to the compatibility of such instruments with main principles of EMU laid down in Title VIII TFEU, including the conditions set by Article 122(2) TFEU under which financial assistance may be granted by the EU (Borger 2020), as well as Article 125 TFEU and the overarching principle reiterated by the ECJ in its judgment in *Pringle* that Member States remain 'subject to the logic of the market when they enter into debt.'[32] Financial assistance may not lead to moral hazard by diminishing the incentive of the recipient country to conduct a sound budgetary policy. There has also been uncertainty regarding the financing of such instruments in light of the limited EU budget. The result of all this has been a somewhat messy application of a mix of bilateral assistance (initial loans to Greece), EU financial assistance (the EFSM), a special purpose (financial) vehicle under private law (the European Financial Stability Facility), and the application of an intergovernmental (the ESM Treaty) instrument (Amtenbrink 2018). The history of the coming into existence of these instruments highlights how the EMU legal framework was unprepared for the euro area crisis, triggering heated legal and political debates and uncertainty in the financial markets. Moreover, the focus of the temporary and subsequent permanent financial assistance based on strict economic conditionality has impacted Europe's social dimension (Costamagna 2020, 342 et seq.). History repeated itself to some extent during the COVID-19 pandemic, as once again ad hoc solutions had to be resorted to in the shape of the European instrument for temporary support to mitigate unemployment risks in an emergency (SURE),[33] the temporary Recovery Instrument[34] and the Recovery and Resilience Facility (RRF) at the core of NextGenerationEU to deal with the major economic shock.[35] Once more these developments have raised serious concerns with regard to the legality of the measures, namely the validity of the legal bases utilised and the compatibility of the measures with the EU's principles of budgetary balance and discipline.[36]

Concerning the capability of the EU itself to engage in a meaningful countercyclical spending policy in times of crisis, it must be observed that its means to generate its own sources of income and the actual volume of these (annual) resources are limited (Amtenbrink and Markakis 2023). Consequently, also the capability of the EU budget to provide macroeconomic stabilisation is limited (European Commission 2017, 25). The EU finances itself through its own resources, such as main customs duties, contributions from the Member States based on value-added tax levied and contributions based on the gross domestic income (GNI) of Member States. The total amount of own resources is laid down in the Own Resources Decision (ORD) that the Council has to adopt unanimously in accordance with a special legislative procedure, and which thereafter has to be ratified by all Member States.[37] In the current ORD, the upper limit for total amount of annual resources to cover annual appropriations for payments has been set at a mere 1,40% of the sum of all the Member States' GNIs.[38] In 2019 roughly 98% of public spending in the EU took place at the level of the Member States and thus, formed part of the national

budgets (European Commission 2019, 16), seriously limiting the EU's financial ability or fiscal space to mitigate economic crises in the euro area. The EU's revenue and payments[39] must be in balance and the current ORD in principle also excludes the borrowing on capital markets as a source for the financing of operational expenditure of the EU.[40] In fact, for the financing of the EU Recovery Instrument extraordinary and temporary additional means had to be foreseen in the ORD that allow the Commission to borrow funds on the capital markets on behalf of the EU.[41] Moreover, the own-resources ceiling had to be temporarily raised by 0.6% to cover the liabilities arising from the EU borrowing.

4. The unused potential of the EMU constitutional framework

The capacity of the current EMU economic governance framework to contribute to financial stability by ensuring sustainable budgetary policies in the Member States and by guaranteeing the necessary fiscal room for manoeuvre at the national and European level to act in the face of large economic shocks is limited. Namely, those rules geared towards ensuring adherence of Member States to the fiscal rules laid down in primary Union law and the SGP fall short of ensuring sustainable budgetary policies that allow automatic stabilizers to fully operate over the economy cycle in all countries and that provide them with the fiscal space to take discretionary public spending to stabilize the economy in times of crisis without resulting in unsustainable budget deficit and debt levels. Moreover, even if this framework has the potential to achieve these aims, for the reasons stated above it is doubtful whether such national fiscal buffers are sufficient on their own in all instances in the case of large (a-)symmetric shocks. Yet, at the supranational EU level, it does not provide for a permanent stabilization capacity or robust crisis mitigation mechanism.

At the fundamental level, these shortcomings can be explained with the basic design of EMU and, namely, its approach to asymmetric integration. The legal significance of this observation can hardly be overstated, as this asymmetry is entrenched in what is arguably the most fundamental EU constitutional principle, that is the distribution of competences between the EU and its Member States.[42] This is moreover also reflected in the more detailed rules on economic policy coordination in Title VIII of the TFEU. EMU law is thus a by-and-large constitutional law (De Witte 2020, 278), whereby a reshaping of these arrangements requires an amendment of primary Union law. While legally certainly feasible, the outcome of the application of the ordinary Treaty revision procedure[43] is anything but certain given the very high hurdles it sets as a result of the need for consensus among all euro area and non-euro area Member States and the involvement of national parliaments in the mandatory national ratification processes.[44] The difficulties this creates in the context of a reform of the EU's fiscal architecture could be witnessed during the euro area crisis when do to legal uncertainty about the scope of the EU's competences and political division among Member States it was decided to move main reform measures, such as the Fiscal Compact and the ESM Treaty, outside the EU Treaty framework altogether and to conclude them as intergovernmental treaties that have yet to be fully integrated into EU law.

What this implies is that some of the more fundamental proposals to reinforce fiscal stability in the euro area that would require Treaty revision will be difficult to realise. This

does not only apply to proposals to outrightly provide the EU with an exclusive or shared competence pertaining to economic policy but also to more refined proposals to strengthen fiscal stability through the creation in some shape or form of a shared European safe asset (e.g. De Grauwe and Moesen 2009; Delpla and Von Weizsäcker 2010; European Commission 2011; Philippon 2015, European Commission 2017) aimed at reducing the vulnerability of banks to sovereign risk,), as well as ideas for a permanent system of common debt issuing in the euro area with the aim not only to provide for necesssary fiscal headroom to deal with crises but also as 'a structural instrument to strengthen economic policy coordination and sound budgetary policies in the euro area in a more sustainable way' (Amtenbrink, Repasi and de Haan 2016, 27). The same also applies to the fundamental rethinking of the budgetary capacity of the EU as far as the establishment of an autonomous taxation power is concerned, thereby giving the EU a greater fiscal capacity in the broader sense of the notion.

Despite what may seem like a rather sombre assessment, the response to the euro area crisis and arguably even more so to the COVID-19 pandemic also highlight the resilience of the existing legal framework to deal with crises situations and adapt and innovate within the margins of the given EU constitutional framework, effectively testing the outer limits of what is legally feasible. In this regard, EMU law is indeed a 'living constitution' (2021De Witte 2020, 290) that is moreover embedded in the equally living overarching constitution of the EU. This framework has proven to have more potential to adjust and innovate than what some observers would have (liked to) imagined at the time of its introduction or thereafter. Namely, the TFEU offers various legal starting points, i.e. legal bases, that have been partially tested during the aforementioned crises, including Article 122 TFEU (EFSM, European Union Recovery Instrument), Article 121(6) TFEU (preventive arm of the SGP, part of the Six Pack regulations, the Two Pack regulations), Art. 126(14) TFEU (corrective arm of the SGP, part of the Six Pack regulations), Article 175(3) TFEU (Recovery and Resilience Facility), and Article 311 TFEU (ORD that has empowered the Commission to temporarily borrow funds on capital markets for the EU Recovery Instrument). Especially worth mentioning in this context is Article 136(1) TFEU that provides a legal basis for the adoption of measures specific to euro area Member States and which has become the co-legislative basis for the above-mentioned reinforcement of the economic policy coordination framework, including the newly established macroeconomic imbalances procedure, for the euro area Member States.

Each of these legal bases comes with its own scope of application and decision-making procedure, which determines and limits its usability as legal basis for future measures strengthening the fiscal architecture of the euro area, not least in terms of their democratic legitimation.[45] Moreover, EU budgetary principles have to be observed, taken intnamely the principle of budgetary balanceand the principle of unity (Art. 310(1) TFEU), as well as the principle of universality (Art. 20 EU Financial Regluation). This also applies to Article 352(1) TFEU – also referred to as the 'flexibility clause' of the EU Treaties – which does not only require a unanimous decision in the Council and the consent of the EP for any legal act to pass but also rules out the adoption of harmonization measures in cases where the EU Treaties exclude such harmonization. Proposal for a further strengthening of the fiscal stability of the euro area must navigate this legal labyrinth in the face of the EU legal principle of conferral and the monitoring review of compliance of EU institutions with this principle by the national highest (constitutional) courts.[46] The

discussion on the existence of a proper legal basis in EU law for a European unemployment benefits scheme is a prime example of the complexity of this exercise (Beblavý, Lenaerts, and Maselli 2017; Repasi 2017).

Still, when it comes to the EU's own ability to address the consequences of economic shocks in Member States that form risks to financial stability, its dealing with the economic consequences of the COVID-19 pandemic can be seen as an evolution to the euro area crisis when it comes to the political willingness to consider a more robust fiscal capacity of the EU. The EU's response has been more attuned, resolute and less risk-adverse, being even prepared – in the face of the unpredictability of the length and severity of the crises – to at least temporarily break with some political taboos and deadlocks that have stood in the way of advancing proposals for a greater supranational fiscal capacity for the benefit of financial stability. SURE, which is mainly geared towards assisting countries that experience a sudden and severe increase in public expenditure on short-time work schemes for employees, is a good example. While after years of legal and political debates, the European Commission has yet to follow up on its announcement to put forward a legislative proposal for a general European scheme, under pressure a supranational crisis instrument has been created, financed through EU social bonds that are backed by voluntary guarantees by the Member States.[47] Another remarkable development is the empowerment of the Commission in the ORD to borrow on behalf of the EU on the financial markets on a hitherto unprecedented scale to finance the RRF. While both of these arrangements are limited in (financial) scope and of a temporary nature, they can very well function as a testing ground for a broader and permanent stabilization function at the supranational level, such as with regard to the future shape of a supranational fiscal stabilisation function and the issuing of joint debt at the supranational level. This is in particular the case for the ability of such legal arrangements to prevent moral hazard behaviour in the euro area, which is at the centre of many discussions about the legal, economic, and political feasibility of an increased fiscal capacity of the EU.

5. Concluding remarks

In the designing of EMU, financial stability has been coined as 'Maastricht's Stepchild' (Brunnermeier, James, and Landau 2016). Despite its huge policy relevance to this day, financial stability is nowhere to be referred to, let alone, defined in the EU Treaties. Still, the establishment of the first two pillars of the EBU, but also previously of the European System of Financial Supervision and the works on the establishment of a Single European Rulebook have gone a long way in addressing the financial trilemma observed by Schoenmaker (2011), at least putting more institutional safeguards in place to ensure financial stability in the EU and, namely, the euro area than has previously been the case. Yet, as has been argued in this contribution, financial stability does not exist in splendid isolation and fiscal stability has role to play in supporting financial stability.

The capability of the current EMU legal framework and its application in practice to provide fiscal stability, is inadequate. To be sure, even if Member States were (incentivized) to engage more effectively in fiscal policies that provide sufficient fiscal space for automatic stabilizers to function and, moreover, to engage in discretionary spending measures, they can arguably still experience economic shocks of a magnitude that cannot be effectively addressed at the national level alone, requiring also a concerted

supranational response. Yet, currently no permanent large-scale European shock-absorption or stabilization function is provided for, despite numerous calls by scholars and policy makers. This can not only be explained by the lack of political consensus among the Member States and EU political institutions on the characteristics of such a function but also by the rather tide constitutional corset within which such major reforms of the current arrangements must take place if Treaty revision is to be avoided.

In this regard, the recent measures taken to address the economic consequences of the Covid-19 pandemic highlight the actual potential that the existing legal framework of the EU Treaty provides in assigning a more robust fiscal capacity to the EU. One can only hope that the recent developments signal a political window of opportunity to make use of this potential more readily, while not shying away from the issue of a more fundamental revision of the Maastricht system of economic policy coordination in EMU through Treaty amendment. It may in any event be questionable whether the genie can be put back into the bottle as far as the EU borrowing is concerned.

Notes

1. The discourse on the interaction between financial and monetary stability (namely the role of monetary policy) falls outside the scope of this contribution.
2. The present article thus does not focus on the contribution of the European Banking Union and the financial market regulatory framework to financial stability.
3. A search in the official database for EU documents *EUR-Lex* for the term “financial stability” results in more than 6600 references and for “fiscal stability” in more than 100 references.
4. See also Ohler (2022), 9.
5. According to which the EU can confer on the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions On the scope and limits of this competence see e.g. Ohler (2022), 6–7.
6. On the implications of this legal basis, see Binder (2022), 457–459.
7. Regulation 806/2014, (2014) OJ L 225/1.
8. Correspondingly, the term is presently not used to refer to the broader notion of fiscal policy that mainly also refers to taxation.
9. The latter has been defined by Ames et al. (2001) as a state 'when key economic relationships are in balance – for example, between domestic demand and output, the balance of payments, fiscal revenues and expenditure, and savings and investment.'
10. Alcidi and Thorion (2017) also refer to other factors, such as wage correction and labour mobility.
11. See also section 3.
12. Namely, through interest rate reductions, currency devaluations, and unrestricted purchase of sovereign bonds by the national central bank, see (D'Alfonso and Stuchlik 2016), 609.
13. As was arguably demonstrated during the GFC, such as in the case of Ireland (Keane 2015).
14. On the relationship between monetary policy and financial stability, see European Central Bank 2021.
15. See Arts. 3(1)(c), 5, 120–121 TFEU. On the legal distinction see also case C-370/12 *Pringle* ECLI: EU:C:2012:756.
16. Namely, in the shape of non-legally binding “recommendations”. See Art. 288 TFEU.
17. Art. 258 TFEU. Explicitly excluded by Art. 126(10) TFEU.
18. Protocol No. 12 annexed to the EU Treaties.
19. Arts. 2a and 5 Council Regulation 1466/97 (as amended). In the original version of the Regulation a single medium-term objective of a budgetary position close to balance or in surplus was foreseen. This was amended with the 2005 reform of the SGP.
20. To be sure, these authors also note the pro-cyclical effects of the excessive deficit procedure.

21. Case C-27/04 *Commission v. Council*, ECLI:EU:C:2004:436.
22. Art. 5(1) Council Regulation 1466/97 (as amended).
23. As stated in Preamble No. 3 of Regulation 1173/2011 on the effective enforcement of budgetary surveillance in the euro area, (2011) OJ L 306/1.
24. Art. 3 Fiscal Compact.
25. Regulation 1176/2011 on the prevention and correction of macroeconomic imbalances, (2011) OJ L 306/25; Regulation 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, (2011) OJ L 306/8.
26. Art. 2 Regulation 472/2013, (2013) OJ L 140/1.
27. Arts. 5(1) and 6(3) Council Regulation 1466/97. Arts. 5(1) and 6(3) Council Regulation 1466/97. Referred to as the “escape clauses”.
28. Pursuant to Art. 126(6) TFEU.
29. Council Regulation 2020/2093 laying down the multiannual financial framework for the years 2021 to 2027, (2020) OJ L 433I/11.
30. Regulation 2015/1017 on the European Fund for Strategic Investments, the European Investment Advisory Hub and the European Investment Project Portal, (2015) OJ L 169/1, preamble No. 2.
31. See Art. 90(2) and Annex VII of Regulation No 1303/2013, (2013) OJ L 347/320.
32. Case C-370/12 *Pringle*, ECLI:EU:C:2012:756, para. 135.
33. Council Regulation 2020/672, (2020) OJ L 159/1.
34. Council Regulation 2020/2094, (2020) OJ L 4431/23.
35. Regulation 2021/241, (2020) OJ L 57/17.
36. E.g. (Leino-Sandberg and Ruffert 2022).
37. Art. 311 TFEU.
38. Art 3(1) Council Decision 2020/2053, (2020) OJ L 424/1.
39. See Art. 310(1) TFEU.
40. Art. 4 Council Decision 2020/2053, (2020) OJ L 424/1..
41. Ibid, Art. 5.
42. See, namely, Art. 3(1)(c) and 5 TFEU. On the principle of conferral, e.g. (Amtenbrink and Vedder 2021, 32 et seq.).
43. Art. 48 TEU.
44. On Treaty revisions, e.g. (Amtenbrink and Vedder 2021, 248 et seq.).
45. E.g. Article 122(2) TFEU, does not foresee in a formal role for the EP in the decision-making procedure and makes the granting of financial assistance subject to conditionality.
46. Such as by the German Federal Constitutional Court in the case of NextGenerationEU, see BVerfG, Urteil des Zweiten Senats vom 06. Dezember 2022 - 2 BvR 547/21 -, Rn. 1-43.
47. Council Regulation 2020/672 on the establishment of a European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) following the COVID-19 outbreak, (2020) OJ L 159/1.

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ORCID

Fabian Amtenbrink http://orcid.org/0000-0002-8624-8925

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