

Fiscal Rules, Capital Flows, and the Integration of Macroeconomic Imbalance Monitoring in Small Open Economies¹

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1. Introduction

Small open economies (SOEs) are highly integrated into global trade and capital markets. While openness fosters growth and integration, it also magnifies risks. On the trade side, export volatility can create sudden swings in growth and fiscal revenues. On the financial side, reliance on foreign capital exposes SOEs to volatile credit cycles and sudden stops. These dynamics can amplify both booms and busts, leaving governments with little time to react.

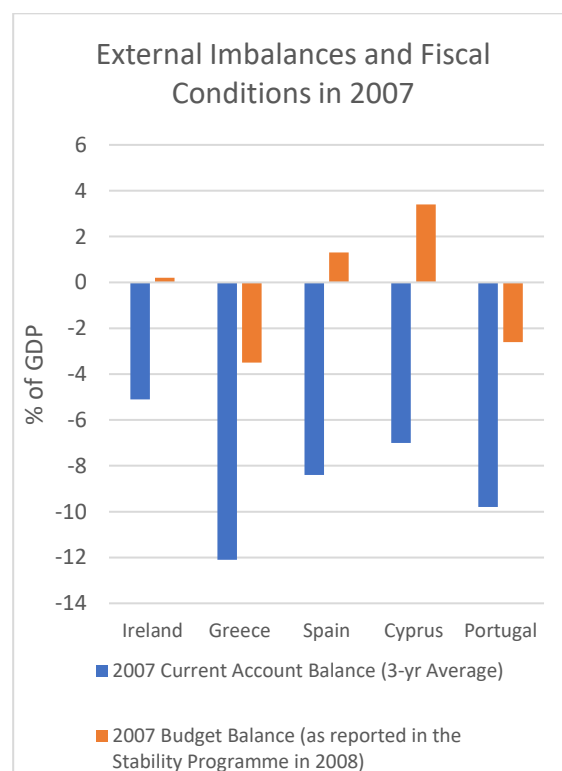
Fiscal rules intersect with this openness in two critical ways: they provide credibility by promoting the build-up of fiscal buffers in good times and reducing the deficit bias, helping to attract stable financing by signalling discipline. But they must also allow flexibility, giving governments room to respond when external shocks inevitably occur. The balance between discipline and flexibility is delicate: Overly rigid rules can force pro-cyclical tightening during recessions, worsening downturns — a key lesson of the euro area crisis. Overly lax rules can allow unsustainable fiscal behaviour, undermining confidence and sparking crises.

2. Lessons from the Euro Area Crisis: Hidden Vulnerabilities

The euro area crisis (2010–2013) is commonly described as a sovereign debt crisis, but this narrative obscures its true origins. Many affected countries, such as Ireland, Spain,

Cyprus and Portugal, entered the crisis with strong or relatively benign headline fiscal positions. In Greece, compressed sovereign bond yields created a false sense of security, encouraging borrowing. However, beneath these healthy fiscal indicators, macroeconomic imbalances were accumulating.

Fig. 1



Source: Eurostat, Stability Programmes

Fig. 2**Private Sector Credit Flows (% of GDP)**

	2005	2006	2007	2008	Average 2004-2024
Ireland	33.6	40.9	24.9	22.3	4.6
Greece	14.7	16.8	16.3	15.8	3.2
Spain	27.1	35.6	26.5	12.0	4.5
Cyprus	40.7	16.7	37.7	43.0	11.2
Portugal	12.0	13.3	19.0	16.2	4.0

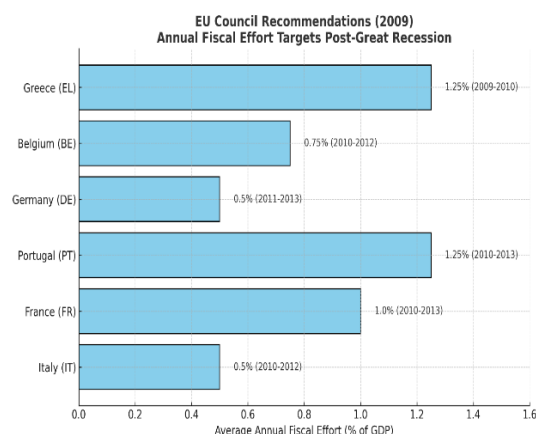
Source: Eurostat

Rapid credit growth and capital inflows fuelled housing booms in Ireland, Spain, and Portugal, while in Greece, compressed sovereign yields created a false sense of security. Rising tax revenues from these booms gave the illusion of permanent fiscal strength.

When the bubbles burst, the illusion shattered. Economies collapsed, revenues evaporated, borrowing costs spiked. Governments had to intervene to stabilize banks and the wider economy. Private-sector imbalances quickly morphed into public-sector crises. Countries that were considered ‘good performers’ overnight became crisis economies.

3. Misdiagnosis and the Austerity Trap

In response, European policymakers diagnosed the crisis primarily as a first-generation fiscal problem, presuming that excessive deficits had caused the loss of market confidence. Consequent to this diagnosis, fiscal austerity was deemed the inevitable cure to restore market confidence. Economies were asked to cut spending, raise taxes, sell assets, and implement painful structural reforms.

Fig. 3

Paul Krugman famously criticized this approach as a misplaced faith in the “confidence fairy”, arguing that cutting public spending during a deep recession would not restore confidence but deepen the downturn.

This approach had two damaging effects: It imposed pro-cyclical tightening during bad times, worsening recessions and increasing social and political instability. It ignored the underlying private-sector imbalances, leaving their root causes unaddressed.

In reality the crisis should have been regarded as a third-generation crisis, essentially a balance of payments crisis brought about by excessive capital movements between the core and periphery of Europe, which flows fuelled excessive credit to the private and public sector, promoted excessive risk taking and inflated asset prices.

There were, however, two promising ideas at the time which indicate that policymakers were considering a more appropriate diagnosis of the economic problem at the time. The first relates to the constitution of the expenditure benchmark in the 2011/13 reform of the Stability and Growth Pact. The benchmark essentially tied public spending growth to potential GDP. Unlike the structural balance which was the basis of the Pact at the time of

the crisis, the expenditure benchmark was tied to potential growth rather than to the output gap. The former is much more stable than the latter. More importantly, whereas the structural balance measure does not guarantee that revenue windfalls from asset price bubbles would be corrected in the cyclical component of the budget balance, the expenditure benchmark has the advantage of treating such revenue windfalls as cyclical and should in theory be used for fiscal consolidation. This would have forced governments to save tax windfalls generated by bubbles, creating fiscal buffers for future crises. Unfortunately, the benchmark remained a 'soft rule,' hard to enforce and easy to sideline.

A second relevant milestone was the constitution of the Macroeconomic Imbalance Procedure. The procedure monitors various indicators such as credit growth, house price inflation, current account imbalances and external debt positions (NIIP) which could potentially signal the build-up of dangerous macroeconomic imbalances, which imbalances could sow the seeds of the next crisis. In theory, the MIP can be regarded as an early warning system for vulnerabilities that can spill over into public finances. Unfortunately, the MIP procedure remains up to this day, to a large extent distinct from fiscal procedures contemplated in the Stability and Growth Pact.

4. The 2024 Reform: A Risk-Based Framework

The new EU fiscal framework introduced in 2024 has taken a major step forward. Its focus on net primary expenditure growth makes this principle the central operational rule for fiscal policy. By linking expenditure to potential GDP, the new framework automatically filters out revenue windfalls caused by bubbles. Governments can no longer convert boom-driven revenues into permanent spending increases. In this way, the new rules act like a macroprudential tool, leaning against the wind

in good times and preserving space to act when crises hit.

Secondly, the Debt Sustainability Analysis framework anchors net expenditure growth not only to potential GDP growth but also takes into account country specific macroeconomic vulnerabilities. Through stochastic and deterministic simulations inbuilt into the DSA framework, country specific net expenditure growth targets should ensure that debt dynamics remain stable and where appropriate continue to converge to the 60 per cent treaty reference value with a given probability. Presently that probability is set arbitrarily at 70 per cent. In adopting such a framework, the new rules promote resilience to potential shocks over the medium term. In essence, the reformed framework turns fiscal rules into a form of macroprudential tool — restraining excessive public spending in good times to prevent private imbalances from morphing into public crises.

However it does not, in itself, prevent the build-up of private sector imbalances. The reform brings fiscal policy into closer alignment with the Macroeconomic Imbalance Procedure. Yet despite this progress, the link between the fiscal framework and the MIP remains weak. MIP warnings rarely translate into concrete fiscal action. This is the challenge we must now address.

5. Integrating the Excessive Deficit Procedure with the Macroeconomic Imbalance Procedure

One possibility is to directly connect fiscal rules to MIP indicators. For example, when indicators exceed the established thresholds and signal dangerous imbalances — such as rapid credit growth or persistent current account deficits — spending growth ceilings could be tightened. Conversely, when indicators are benign, governments could be given slightly more room to act. This would create a direct bridge between external imbalance monitoring and fiscal action, making fiscal policy a first line of defence rather than a

last resort. It creates a direct bridge between external imbalance monitoring and fiscal action and creates a greater incentive to address the build-up of macroeconomic imbalances.

This could be implemented in various ways; two options are here being considered. The most straightforward way of doing this, without necessitating any changes to the legislative framework just reformed, is to require in the DSA framework a differentiated probability that debt will decline, depending on the presence of the build-up of macroeconomic imbalances. In essence member states exhibiting dangerous macroeconomic imbalances are at greater risk of a crisis and therefore should act more cautiously in allowing net public expenditure to grow irrespective of the level of public debt. Conversely, member states which do not display such risks could be allowed to raise net expenditure growth, even in cases where their public debt is relatively high.

Another option to consider is the automatic suspension of the resilience safeguard requirements when MIP indicators exclude the presence of macroeconomic imbalances. This would be more difficult to implement as it would require legislative changes to the framework which has just recently been overhauled. Whilst conscious of these difficulties, this option should not be excluded as there may be cases where such safeguards may become more binding, despite the flexibility introduced in the first option proposed.

Considering past experience with the implementation of such rule-based frameworks, and in recognition of the difficulty in predicting the advent of a potential crisis, it is suggested that the link with MIP Triggers should be subjected to an “overall qualitative assessment”.

6. The Perspective of Small Open Economies

Small open economies face disproportionate exposure to external shocks due to their size and openness. In 2023, among EU states with GDP below €100 billion, gross external debt ranged from half to a multiple of 8 of GDP, while net international investment positions varied between -100% and +140% of GDP. External liabilities can range up to a multiple of 30 to GDP. GNI is always less than GDP and the difference can be as much as 32% of GDP. This makes SOEs more exposed and vulnerable to global financial markets and global capital flows and the potential risk of a build up of macroeconomic imbalances as a consequence of these flows. In this context the integration of the MIP procedure in the formulation of net expenditure growth ceilings is of significant relevance to SOEs.

However this integration is also relevant for larger economies in the EU. After all even large EU economies are small globally when compared to global capital markets. More relevant, Mario Draghi (2024) estimates that Europe will need to mobilize €800 billion annually — approximately 5% of EU GDP — to finance the green transition, digital transformation, and increased defence spending. Since then the investment needs have increased further with the new drive to raise defence spending to 5% of GDP. In essence, just like small economies trying to attract foreign capital, bigger European economies need it to attract back European savings which have so far flowed abroad. Those European savings are today financing the innovation and competitiveness edge of our major competitors. That repatriation of European capital is urgently needed to finance Europe’s competitiveness and innovation agenda, the green transformation, energy resilience and security.

This is both an opportunity which requires a credible fiscal framework but also presents a potential risk of the build-up of future

imbalances. What Mario Draghi is advocating necessitates a greater predisposition for risk taking; hence monitoring that risk and the potential build-up of macroeconomic imbalances is going to matter even more for fiscal policy in the EU. Such vast capital flows will increase the potential for new imbalances emerging, making effective early warning systems and counter-cyclical fiscal policy essential.

8. Conclusion: Towards an Integrated Framework

The last crisis taught us that fiscal crises often begin in the private sector. The new EU Economic Governance framework is a major improvement, but it must be fully connected to the mechanism that detect the build-up of dangerous macroeconomic imbalances. Europe today must balance two imperatives: taking on more risk to finance its transformation and security, while remaining vigilant against the build-up of dangerous imbalances. The 2024 reform has strengthened the EU's fiscal governance architecture, but integration with the MIP is the missing piece. The integration of MIP and fiscal rules offers a pathway to achieve stability, growth, and resilience for the decades ahead. If we get this right, Europe can achieve what once seemed impossible:

sustainable growth, fiscal stability, and resilience for the benefit of future generations.

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ⁱ The views expressed in this research article are those of the author and do not necessarily reflect those of the Economic Policy Department, Ministry for Finance. Any errors and omissions are the author's own.