



Which Fiscal Union for EMU?

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Outline

- 1. Fiscal policy in EMU: changes since the crisis***
- 2. Which Fiscal Union for a sustainable EMU***
- 3. Concluding remarks***

Fiscal policy in EMU: an evolving view

**Conventional view
on fiscal policies in
EMU – pre crisis**



**"Put your house
in order"**

- Rules to tame deficit bias in absence of national exchange rate policy
- Automatic stabilisers: let them play
- Risk of debt monetisation dominates monetary-fiscal relations
- Low spillovers because of offsetting monetary policy reaction

**Revising the role of
fiscal policy in EMU
– post crisis**



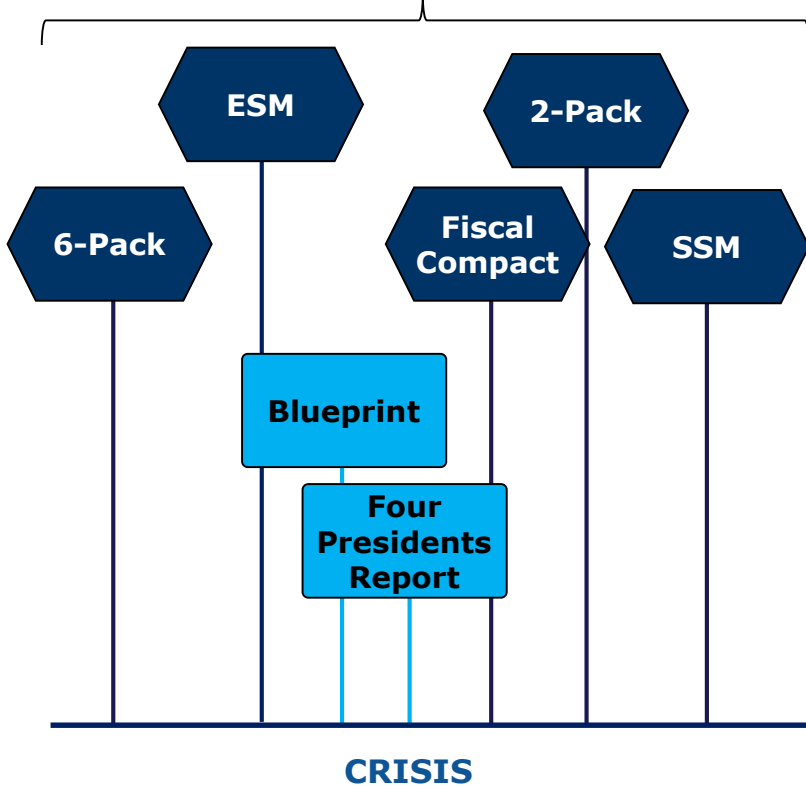
**"Augustinian
view"**

- Discretionary fiscal policy needed in case of large shocks
- High multipliers and spillovers when monetary policy is constrained
- Aggregate fiscal stance and differentiated fiscal space matter
- Sovereign-banks nexus
- Institutions vs. rules
- Links fiscal policies/ structural reforms

What has been done since the crisis?

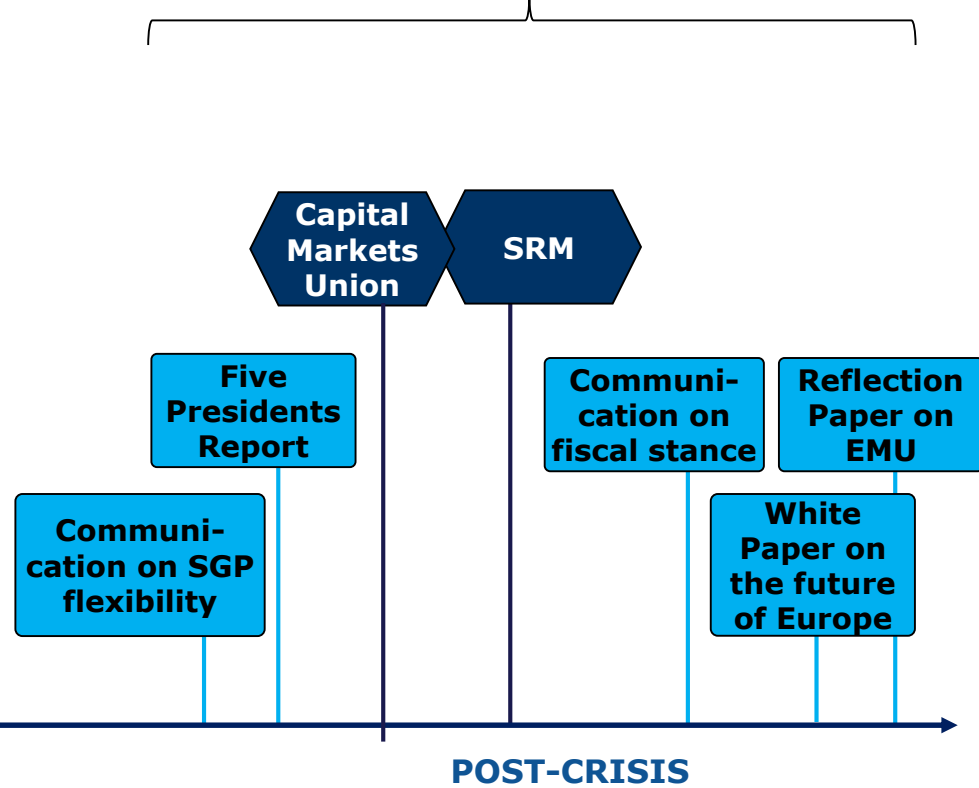
Political economy:

More fiscal discipline allows crisis response



Political economy:

Better articulation of national/EA fiscal policies



CRISIS

POST-CRISIS

Dec

Sep

Nov

Dec

Jan

May

Nov

Feb

Jun

Sep

Jan

Nov

Mar

May

2011 2012

2013

2014

2015

2016

2017

Far-reaching institutional changes since 2011

Challenge	Measure taken to address the challenge	Measure in greater detail	Application
Conventional view on fiscal policies in EMU – pre crisis	Stronger SGP	<ul style="list-style-type: none"> • Introduction of expenditure rule, debt benchmark (6-P) and balanced budget rule (TSCG) • Possibility of imposing earlier/more gradual sanctions (6-P) • Surveillance of DBPs (2-P) 	✓
	National fiscal frameworks	<ul style="list-style-type: none"> • Mandatory min. requirements at the national level) (6-P) 	✓
	Macro surveillance	<ul style="list-style-type: none"> • Prevention/correction of macroeconomic imbalances via the introduction of the new Macroeconomic Imbalance Procedure (MIP) (6-P) 	being implemented
Revising the role of fiscal policy in EMU – post crisis	Crisis resolution mechanism	<ul style="list-style-type: none"> • European Stability Mechanism (ESM) 	✓
	Breaking sovereign/banks nexus	<ul style="list-style-type: none"> • Banking Union • Capital Markets Union 	to be completed

Remaining vulnerabilities

- ***Have the financial sovereign doom loops been sufficiently severed?***
 - Banking union not completed yet
 - Exposure of national financial sectors to sovereigns remains high
 - ***Will the revised governance framework be effectively implemented?***
 - Limits to the application of rules/peer pressure on democratically elected governments
 - ***Has EMU the capacity to withstand the next large shock?***
 - ESM remains entirely dependent on national Treasuries and slow decision-making
 - No tool for smoothing asymmetric shocks and managing the euro area fiscal stance when needed
 - ***Is the appropriate fiscal stance at the EA level being achieved?***
 - Bottom-up coordination does not work
- ***Task of sustaining euro falls too much on the shoulders of the ECB***
- ***Missing piece: minimum fiscal capacity to secure macroeconomic and financial stability***

Which framing conditions for a Fiscal Union?

- ***Three classic functions of public finance (Musgrave, ...):***
 - Allocation function
 - Distribution function
 - Stabilisation function
 - ***Interaction of Fiscal Union with national public finances***
 - All three functions to remain primarily at national level
 - Pre-existence of significant national budgets tends to exclude allocative or distributive functions at euro area level
 - Euro area stabilisation function as complement to national stabilisation
- > *Fiscal Union sui generis***

Politically-feasible Fiscal Union

- ***Primary rationale***
 - Improve counter-cyclical stabilisers
 - Address remaining sovereign bank loops
 - Improve market discipline
 - ***What a Fiscal Union cannot be:***
 - Redistributive mechanism with permanent transfers
 - Issuance of (large-scale) Eurobonds
 - Fully fledged allocative function or controlling MS expenditure and revenues
- => *Fiscal Union would be a one of its kind construction: the minimum fiscal arm of the monetary union***

Fiscal Union - quasi-minimum requirements -

***Risk
reduction***

- Enforce fiscal rules
- Improve market discipline

- Backstop for Banking Union
- Crisis management
- Provision of safe asset

***Risk
sharing***

***Growth
support***

- Set overall fiscal stance
- Stabilisation capacity
- Investment capacity

- External representation

***Global
governance***

Process: next steps

- ***Commission White Paper on the future of Europe.***
Reflections and scenarios for the EU27 by 2025 (*published 1 March 2017*)
- ***Commission reflection paper on the deepening of the Economic and Monetary union*** (*expected end-May 2017*)
- ***Conditions for an acceptable package***
(implementing current framework, tackling asymmetries, rebuild trust, agreeing on a balanced and well-sequenced package)

In sum

- Crisis revealed fault lines in original EMU design and steps have been taken to breach those
- The present set-up remains vulnerable to shocks and leaves too heavy responsibilities on the ECB
- There has been an evolution on the view of fiscal policy in EMU
- A large EU budget is not in the cards
- Fiscal Union should be based on minimum conditions

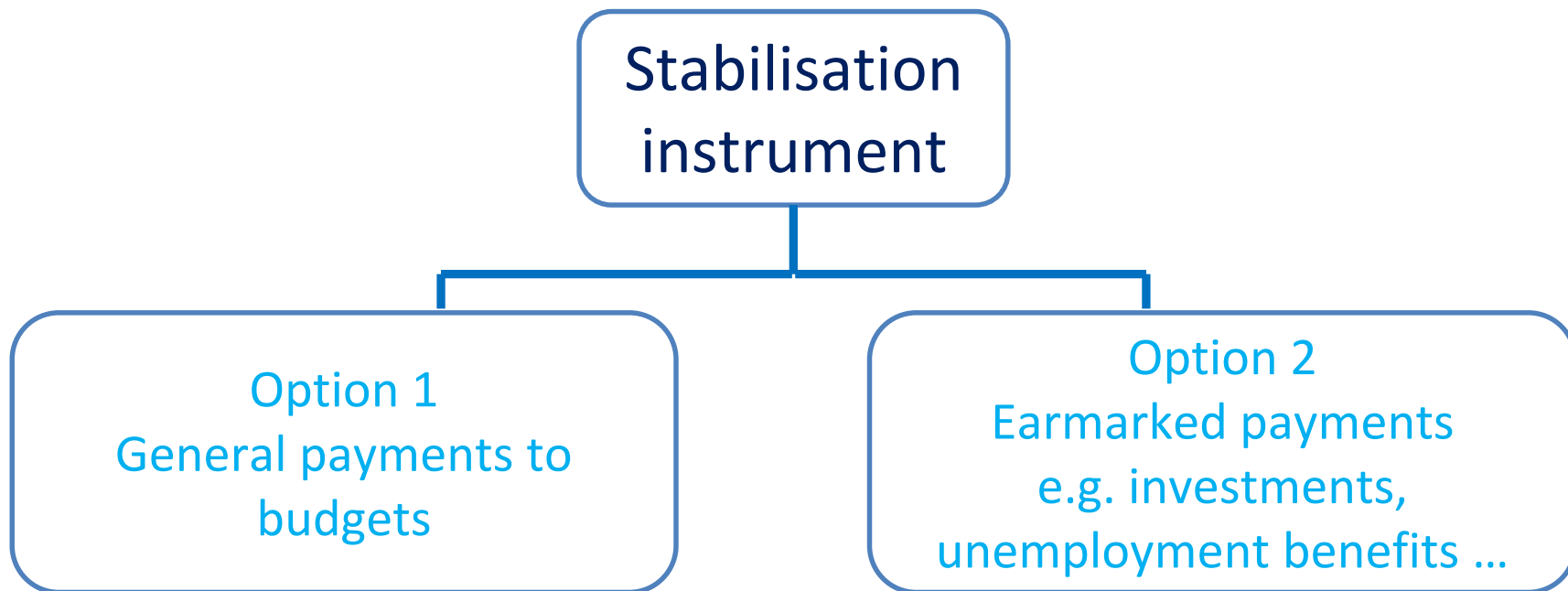
Thank you very much for your attention

Background slides

Setting up a stabilisation function

- **Why?** Stabilise large country-specific shocks and/or common shocks? Limited to unusual circumstances?
- **How?** Different concepts floating in public and among pundits (not mutually exclusive)
 - Stabilisation function based on unemployment
 - Investment capacity
 - Provision of public goods (e.g. security-related)
- **Key challenges?**
 - No permanent transfers
 - Beware moral hazard – ensure fiscal discipline
 - Respect subsidiarity principle
 - What degree of automaticity and conditionality?

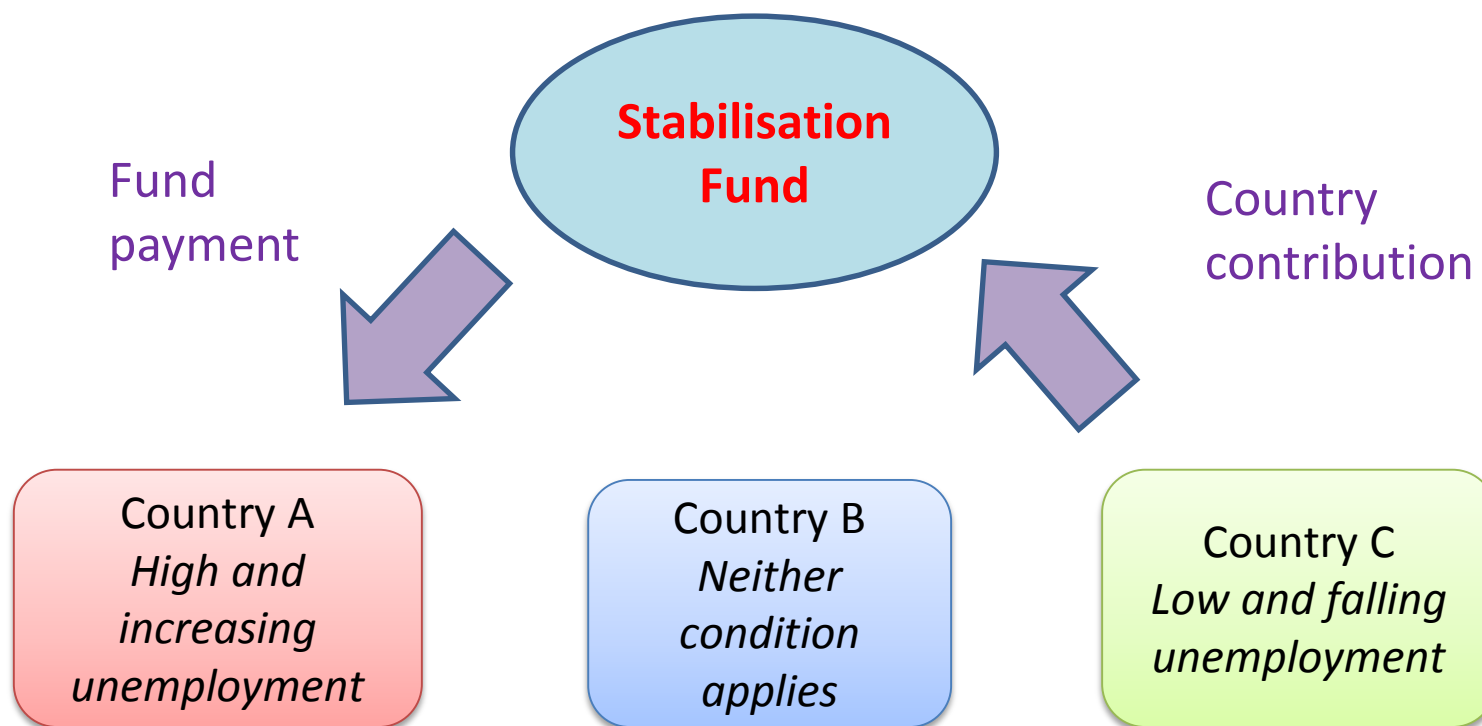
Options for a stabilisation instrument



Whatever option, need for 'active stabilisation' against large shocks

- A 10% cyclical variation of a 2% of GDP budget brings only 0.2% of GDP stabilisation
- But contributing 0.2% every year allows active stabilisation of 2% of GDP every 10 years

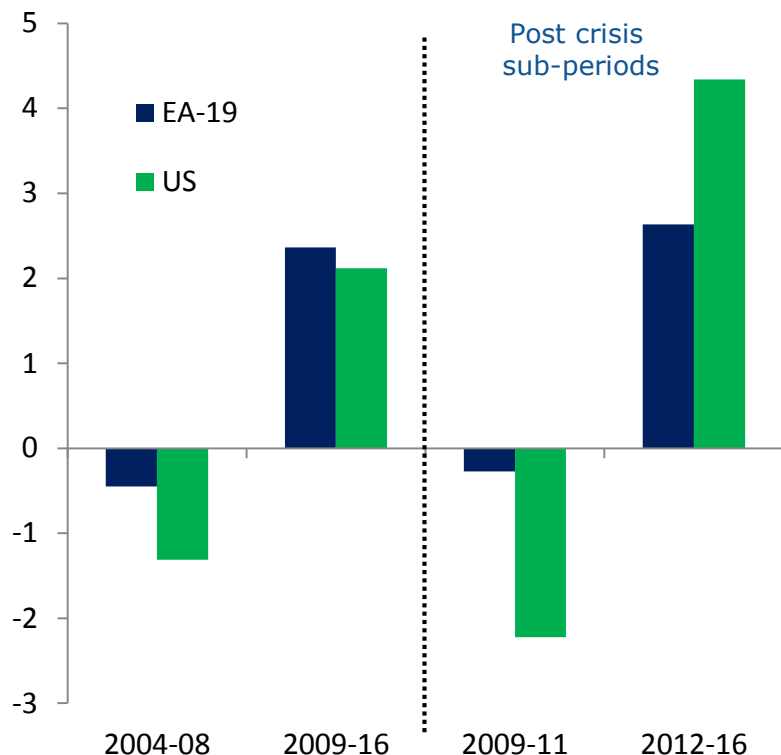
Example trigger for active stabilisation: Double condition



- **High U** = higher than past 15 years average. **Low U** = the opposite
- **Increasing U** = higher than previous year. **Falling U** = the opposite

Similar fiscal adjustment in the US and EA, but timing was different

Change in structural balances EA vs. US
(in % of GDP)



Source: Own calculations based on IMF World Economic Outlook, October 2016.

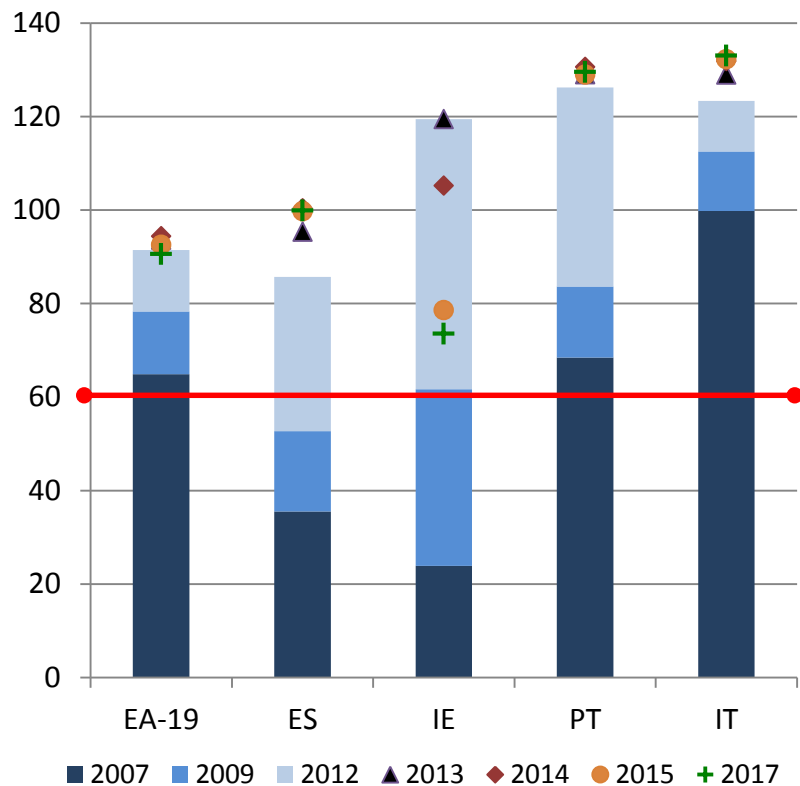
Functioning of automatic stabilisers
EU vs. US (in %)

Region	Type of shock	Stabilisation of ...	
		Income	Demand
EU	Income	37.8	22.1
	Unemployment	46.9	29.7
US	Income	32.2	17.4
	Unemployment	33.7	19.7

Source: Dolls et al. 2012: Automatic stabilizers and economic crisis: US vs. Europe, Journal of Public Economics, 96, 279-294.

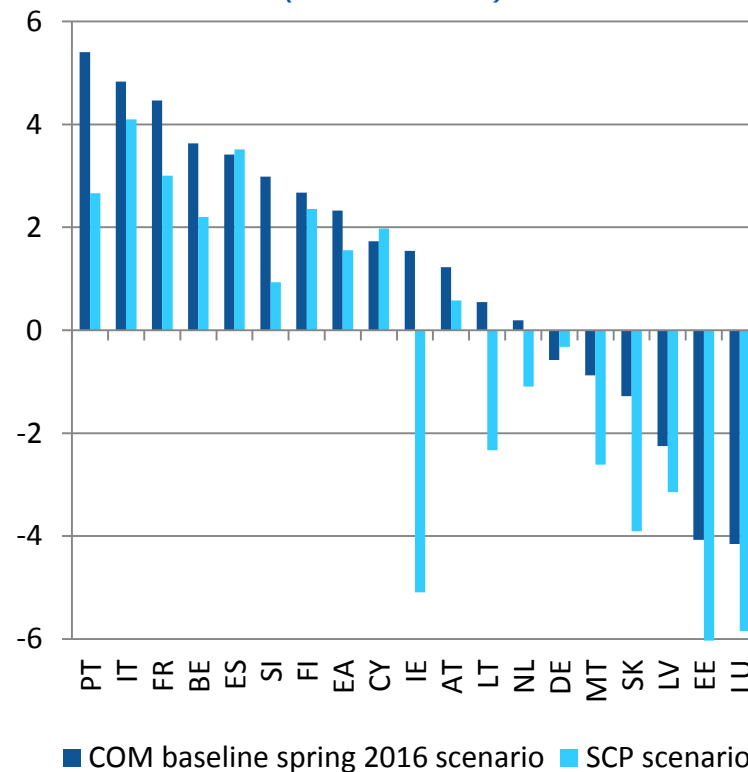
Limited fiscal buffers to cope with shocks

Gross debt general government
(in % of GDP)



Note: Red line shows the Maastricht reference value.
Source: European Commission winter forecast 2017.

Fiscal adjustment required to reach a 60% public debt-to-GDP ratio by 2030
(in % of GDP)



Source: Commission services. 2016 Stability and Convergence Programmes (SCP).

Procyclical fiscal policies

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Dependent variable:	Δ SB	DFE	DFE	Δ SB	Δ SB	Δ SB	Δ SB
Dummy:				EDP	IMF programme	EDP if Δ OG > 0	Publ. exp. < potential gr
Data:	real time	ex post	ex post	real time	real time	real time	real time
Measure for econ. cycle:	Δ OG	Δ OG	level OG	Δ OG	Δ OG	Δ OG	Δ OG
Econ. cycle (t-1)	-0.27*** (-3.64)	-0.39*** (-3.39)	0.09 (0.73)	-0.18** (-2.33)	-0.28*** (-2.99)	-0.23* (-1.86)	-0.31*** (-3.84)
Debt (t-1)	0.04*** (4.92)	0.01*** (2.94)	0.050*** (3.57)	0.04*** (5.10)	0.04*** (4.41)	0.02** (2.03)	0.04*** (5.03)
Econ. cycle x dummy (t-1)				-0.36*** (-3.35)	-0.25** (2.13)	-0.12 (-0.66)	0.09 (0.85)
Dummy (t-1)				0.16 (0.80)	-0.33 (-0.68)	0.13 (0.44)	-0.11 (-0.53)
Obs.	367	168	168	367	367	191	367
# countries	28	28	28	28	28	28	28
R-squared	0.39	0.39	0.52	0.41	0.39	0.25	0.39
Econ. cycle dummy = 1				-0.54***	-0.53***	-0.34**	-0.22***

← amplifies pro-cyclicality (pointing to column 7)
← reduces pro-cyclicality (pointing to column 7)
← pro-cyclical if < 0 (pointing to column 7)
← additional impact if dummy is 1 (pointing to column 7)
← marginal impact if dummy is 1 (pointing to column 7)

Source: Own calculations.

Note: The table shows panel regression results using the following specification: $\Delta SB_{i,t} = \beta_1 \Delta \text{output gap}_{i,t} + \beta_2 \text{debt}_{i,t-1} + \beta_3 \text{dummy}_{i,t-1} \cdot \Delta \text{output gap}_{i,t} + \beta_4 \text{dummy}_{i,t-1} + \theta_t + \vartheta_i + u_{i,t}$. The sample includes 28 EU countries covering the period 2000-16. Data for regressions using "ex post" data come from the Commission autumn forecast 2016. "Real time" indicates outturns in period t reported in period $t+1$. All estimations include time and country dummies and a constant, which are not shown due to space constraints. Estimation approach: least square dummy variable estimator (LSDV) using heteroskedasticity-robust Huber-White standard errors. Regressions using the System GMM estimator yield similar results. t -statistics in parentheses. ***, ** and * denote respectively statistical significance at 1, 5 and 10%.

Procyclical fiscal policies (not only in the EU)

Average change in cyclically-adjusted balance

(in % of potential GDP)

		1992-98	1999-07	2008-16	1992-98	1999-07	2008-16
		Good times			Bad times		
		$\Delta OG \geq 0$			$\Delta OG < 0$		
EA-19	Mean	0.5	0.1	0.2	0.9	-0.4	0.2
	(Obs)	(102)	(132)	(107)	(31)	(39)	(64)
US	Mean	0.4	0.0	0.3	0.8	-1.5	-0.2
	(Obs)	(5)	(6)	(5)	(2)	(3)	(4)
		level OG ≥ 0			level OG < 0		
EA-19	Mean	0.6	0.0	0.0	0.5	0.0	0.3
	(Obs)	(72)	(128)	(69)	(61)	(43)	(102)
US	Mean	0.7	0.0	NA	0.5	-2.2	0.1
	(Obs)	(1)	(7)	(0)	(6)	(2)	(9)

Legend: ■ Countercyclical ■ Acyclical ■ Procyclical

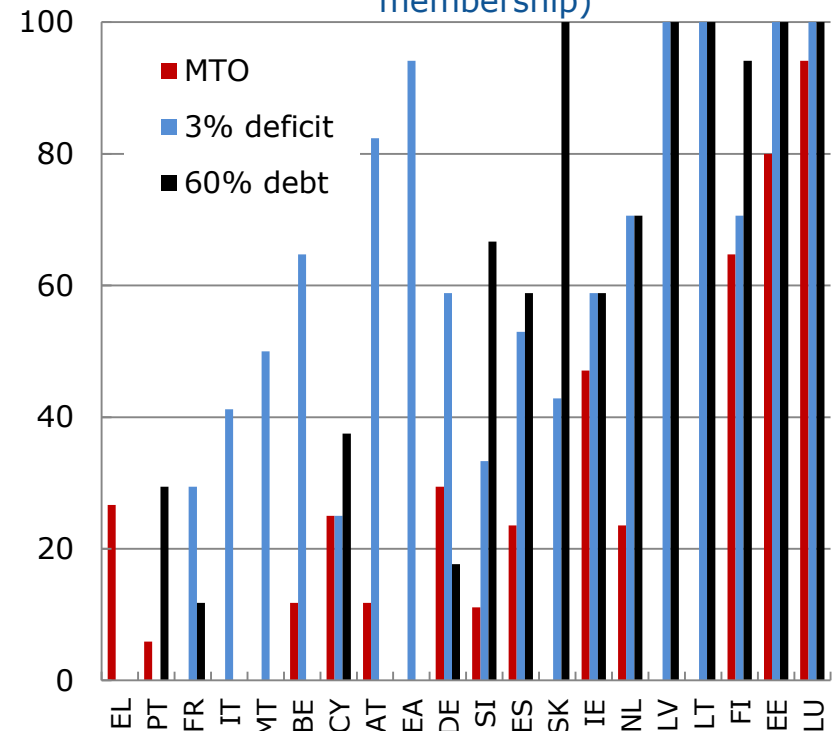
Source: Commission calculations based on (ex post) data from the OECD Economic Outlook 2006 (ex post).

Note: Data for the EA-19 are averages of the changes in cyclically-adjusted balances weighted by potential GDP. EA-19 shown (instead of EU-28) for data availability reasons. Good (bad) times correspond to periods with positive (negative) changes in/levels of output gaps.

Complex fiscal rules and weak compliance

Complex rules
(XXX how to visualise it? XXX)

Meeting fiscal reference values
(in percent of years since EMU membership)



Note: XXX

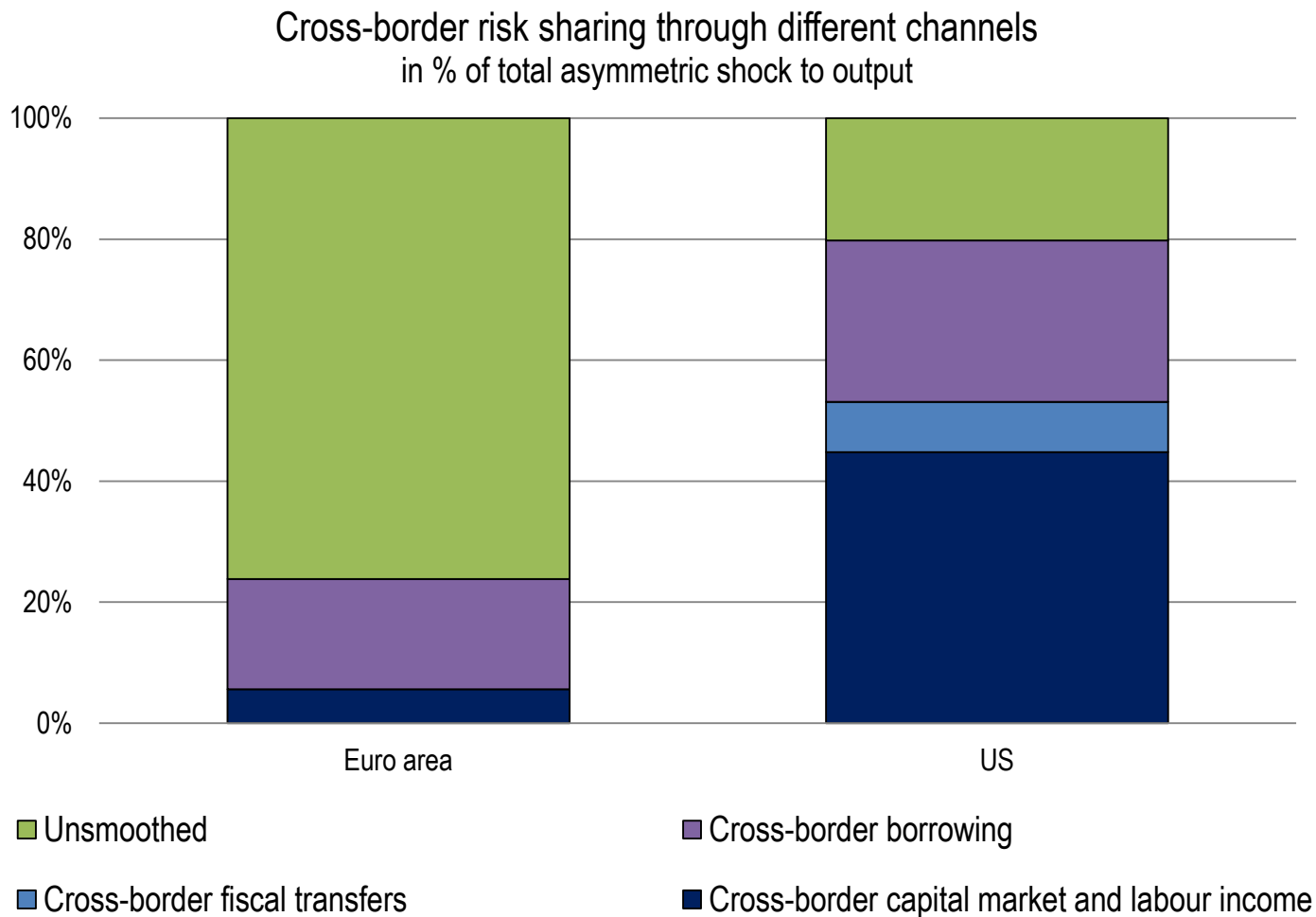
Reading example: LU reached the fiscal reference values of the preventive arm of the Stability and Growth Pact (SGP) (the so-called medium-term objective (MTO)) in around 95% of the years and the corrective arm of the SGP (consisting of the 3% deficit and 60% debt values) in all years since EMU membership. Source: Ameco spring 2016.

Minimum criteria strongly depend on the future vision for euro area

	Discipline	Solidarity	Governance	Legitimacy
Fully decentralised model	Strict no bail out, maximum exposure ceilings for banks	No Euro area-specific solidarity	Insolvency procedures for sovereigns	No specific accountability
Federal model	Rules and procedures for fiscal and macroeconomic surveillance	Countercyclical transfers and conditional assistance financed by common budget	Federal institution (presumably COM) as Euro area executive	Accountability to European Parliament
Hybrid model	National rules consistent with common principles, network of national institutions	Graduated mutual support system	Euro area coordination executive	Parliamentary body built from national parliaments and the EP

Source: Pisani-Ferry (2015): Rebalancing the governance of the euro area, p. 20.

Low insurance against income shocks in EMU

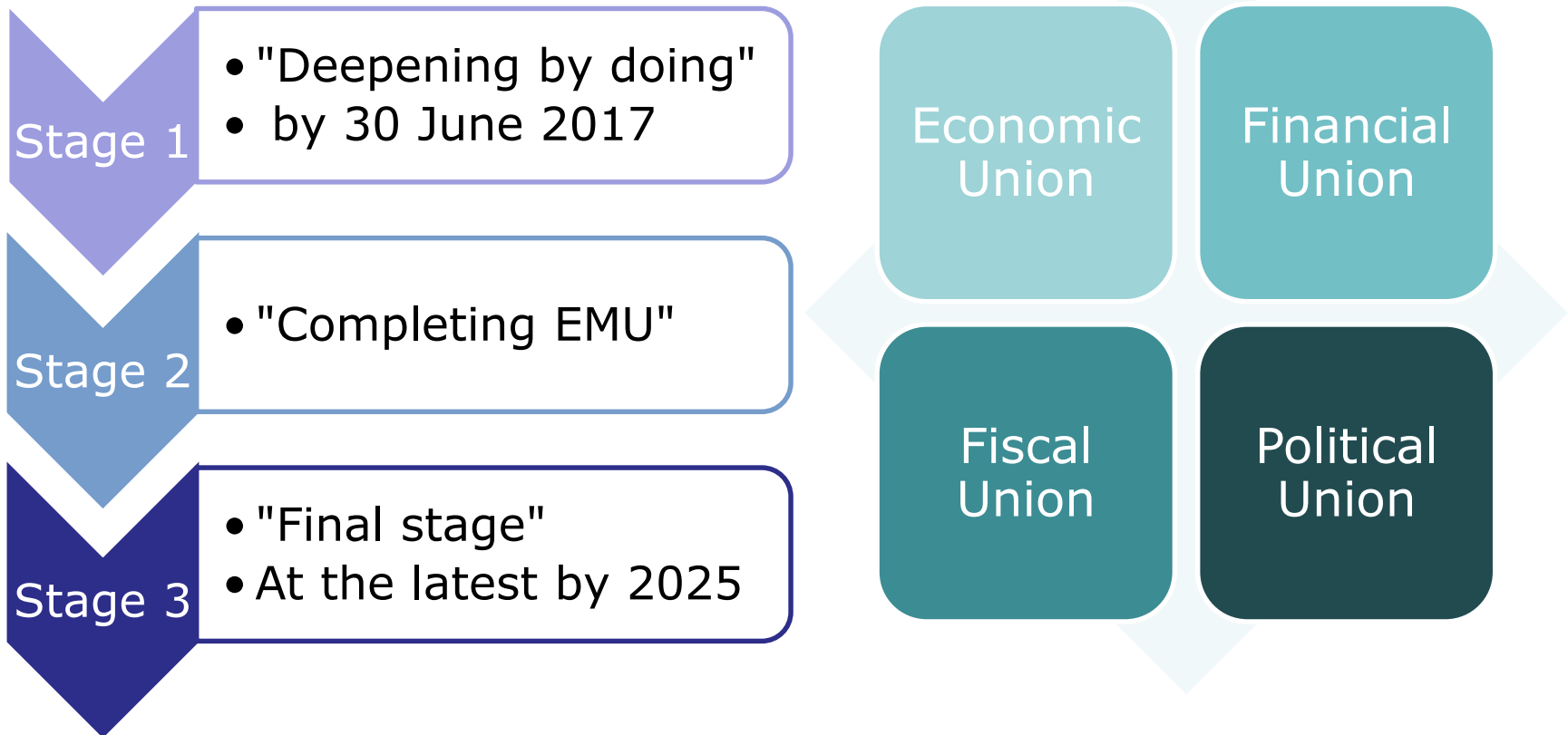


Source: Buti et al. (2016): Smoothing economic shocks in the Eurozone: The untapped potential of the financial union, vox.eu.org, August 2016.

Minimum functions of a Fiscal Union

	POSSIBLE FUNCTIONS
Implementation of fiscal discipline	<i>Ensure fiscal sustainability of Member States to preserve the stability of the zone and of the currency.</i>
Crisis management	<i>Provide conditional liquidity assistance to preserve financial stability of euro area and Member States. Very last resort backstop to the banking union.</i>
Macroeconomic stabilisation	<i>Conduct aggregate counter-cyclical policies, at least in unusual circumstances, and foster sound national fiscal policies. Can be designed as macro-based capacity or (partial) unemployment benefits system. No permanent transfer.</i>
Central investment capacity	<i>Fill a persistent investment and demand insufficiency in the euro area, in the context of a prolonged situation at the zero lower bound. Help preserve investment and implement the SGP.</i>
Provision of a safe asset	<i>Provide a safe and liquid pan-European asset serving as the instrument of choice for ECB operations and the financial system.</i>

The Five Presidents' Report



Much stronger risk reduction and risk sharing in the US than in the EA

		Elements in the US	Reached in EMU?
Risk Reduction		<ul style="list-style-type: none"> Effective no bail-out clause (e.g. Puerto Rico, California, 1840s) 	Red
		<ul style="list-style-type: none"> Strict enforcement of fiscal rules (sharp fiscal adjustment can be required) 	Red
Risk Sharing	Private	<ul style="list-style-type: none"> Significant private risk-sharing (via foreign financial markets, including through foreign capital markets) 	Red
	Public	<ul style="list-style-type: none"> Full Banking Union: little contagion of sovereign debt stress to bank balance sheets 	Orange
		<ul style="list-style-type: none"> Significant fiscal stabilisation/redistribution 	Red

→ EMU is a monetary union "sui generis"

Note: Green / orange / red stand for 'fulfilled' / 'partly fulfilled' / 'not fulfilled'.

The White Paper on the future of Europe – EMU implications

