Which Fiscal Union for EMU?

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European Commission, DG Economic and Financial Affairs

ADEMU conference: "How much of a Fiscal Union for the EMU?"
Madrid, 19 May 2017
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

- ESM
- 2-Pack
- Fiscal Compact
- SSM
- Blueprint
- Four Presidents Report

**Political economy:**
Better articulation of national/EA fiscal policies

- Capital Markets Union
- SRM
- Five Presidents Report
- Communication on SGP flexibility
- Communication on fiscal stance
- Reflection Paper on EMU
- White Paper on the future of Europe

**CRISIS**
-Dec 2011
-Sep 2012
-Nov 2012
-Dec 2012
-Jan 2013
-May 2013
-Nov 2013

**POST-CRISIS**
-Feb 2015
-Jun 2015
-Sep 2015
-Jan 2016
-Nov 2016
-Mar 2017
-May 2017
## Far-reaching institutional changes since 2011

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Measure taken to address the challenge</th>
<th>Measure in greater detail</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conventional view on fiscal policies in EMU – pre crisis</td>
<td><strong>Stronger SGP</strong></td>
<td>• Introduction of expenditure rule, debt benchmark (6-P) and balanced budget rule (<em>TSCG</em>) • Possibility of imposing earlier/more gradual sanctions (6-P) • Surveillance of DBPs (2-P)</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td><strong>National fiscal frameworks</strong></td>
<td>• Mandatory min. requirements at the national level) (6-P)</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td><strong>Macro surveillance</strong></td>
<td>• Prevention/correction of macroeconomic imbalances via the introduction of the new Macroeconomic Imbalance Procedure (MIP) (6-P)</td>
<td>being implemented</td>
</tr>
<tr>
<td>Revising the role of fiscal policy in EMU – post crisis</td>
<td><strong>Crisis resolution mechanism</strong></td>
<td>• European Stability Mechanism (ESM)</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td><strong>Breaking sovereign/banks nexus</strong></td>
<td>• Banking Union • Capital Markets Union</td>
<td>to be completed</td>
</tr>
</tbody>
</table>
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**
  o Improve counter-cyclical stabilisers
  o Address remaining sovereign bank loops
  o Improve market discipline

• **What a Fiscal Union cannot be:**
  o Redistributive mechanism with permanent transfers
  o Issuance of (large-scale) Eurobonds
  o 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 -

<table>
<thead>
<tr>
<th>Risk reduction</th>
<th>Growth support</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Enforce fiscal rules</td>
<td>• Set overall fiscal stance</td>
</tr>
<tr>
<td>• Improve market discipline</td>
<td>• Stabilisation capacity</td>
</tr>
<tr>
<td></td>
<td>• Investment capacity</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Risk sharing</th>
<th>Global governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Backstop for Banking Union</td>
<td>• External representation</td>
</tr>
<tr>
<td>• Crisis management</td>
<td></td>
</tr>
<tr>
<td>• Provision of safe asset</td>
<td></td>
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</tbody>
</table>
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, rebuilding 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)
  o Stabilisation function based on unemployment
  o Investment capacity
  o Provision of public goods (e.g. security-related)

• **Key challenges?**
  o No permanent transfers
  o Beware moral hazard – ensure fiscal discipline
  o Respect subsidiarity principle
  o What degree of automaticity and conditionality?
Options for a stabilisation instrument

- **Option 1**
  General payments to budgets

- **Option 2**
  Earmarked payments e.g. investments, unemployment benefits ...

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

Country A
High and increasing unemployment

Country B
Neither condition applies

Country C
Low and falling unemployment

Fund payment
Stabilisation Fund
Country contribution

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

*Note: Carnot, Kizior, Mourre, forthcoming*
Similar fiscal adjustment in the US and EA, but timing was different

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

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

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

Limited fiscal buffers to cope with shocks

**Gross debt general government**

*(in % of GDP)*

- EA-19
- ES
- IE
- PT
- IT

- 2007
- 2009
- 2012
- 2013
- 2014
- 2015
- 2017

**Fiscal adjustment required to reach a 60% public debt-to-GDP ratio by 2030**

*(in % of GDP)*

- PT
- IT
- FR
- BE
- ES
- SI
- FI
- IE
- CY
- AT
- LT
- NL
- DE
- MT
- SK
- LV
- EE
- LU

- COM baseline spring 2016 scenario
- SCP scenario

*Note: Red line shows the Maastricht reference value.*

*Source: European Commission winter forecast 2017.*

*Source: Commission services. 2016 Stability and Convergence Programmes (SCP).*
## Procyclical fiscal policies

<table>
<thead>
<tr>
<th>Dependent variable:</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
<th>(7)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Δ SB</td>
<td>DFE</td>
<td>DFE</td>
<td>Δ SB</td>
<td>Δ SB</td>
<td>Δ SB</td>
<td>Δ SB</td>
<td>Δ SB</td>
</tr>
</tbody>
</table>

**Dummy:**
- EDP
- IMF
- EDP if Δ OG > 0
- Publ. exp. < potential gr

**Data:**
- real time
- ex post

**Measure for econ. cycle:**
- Δ OG
- level OG

<table>
<thead>
<tr>
<th>Econ. cycle (t-1)</th>
<th>Δ OG</th>
<th>Δ OG</th>
<th>Δ OG</th>
<th>Δ OG</th>
<th>Δ OG</th>
<th>Δ OG</th>
<th>Δ OG</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-0.27***</td>
<td>-0.39***</td>
<td>0.09</td>
<td>-0.18**</td>
<td>-0.28***</td>
<td>-0.23*</td>
<td>-0.31***</td>
</tr>
<tr>
<td></td>
<td>(-3.64)</td>
<td>(-3.39)</td>
<td>(0.73)</td>
<td>(-2.33)</td>
<td>(-2.99)</td>
<td>(-1.86)</td>
<td>(-3.84)</td>
</tr>
</tbody>
</table>

| Debt (t-1)        | 0.04*** | 0.01*** | 0.030*** | 0.04*** | 0.04*** | 0.02** | 0.04*** |
|                   | (4.92)  | (2.94)  | (3.57)  | (5.10)  | (4.41)  | (2.03)  | (5.03)  |

| Econ. cycle x dummy (t-1) | -0.36*** | -0.25** | -0.12 | 0.09 |
|                          | (-3.35)  | (2.13)  | (-0.66) | (0.85) |

| Dummy (t-1)         | 0.16 | -0.33 | 0.13 | -0.11 |
|                     | (0.80)  | (-0.68)  | (0.44)  | (-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*** |

### Source:
Own calculations.

### Note:
The table shows panel regression results using the following specification:

\[
\Delta SB_{it} = \beta_1 \Delta output gap_{it} + \beta_2 debt_{it-1} + \beta_3 dummy_{it-1} \cdot \Delta output gap_{it} + \beta_4 dummy_{it-1} + \theta_t + \theta_i + u_{it}. \]

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)*

<table>
<thead>
<tr>
<th></th>
<th>Good times</th>
<th>Bad times</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$\Delta \text{OG} \geq 0$</td>
<td>$\Delta \text{OG} &lt; 0$</td>
</tr>
<tr>
<td>1992-98</td>
<td>0.5</td>
<td>0.9</td>
</tr>
<tr>
<td>1999-07</td>
<td>0.1</td>
<td>-0.4</td>
</tr>
<tr>
<td>2008-16</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>1992-98</td>
<td>0.4</td>
<td>0.8</td>
</tr>
<tr>
<td>1999-07</td>
<td>0.0</td>
<td>-1.5</td>
</tr>
<tr>
<td>2008-16</td>
<td>0.3</td>
<td>-0.2</td>
</tr>
</tbody>
</table>

### Level of output gap

<table>
<thead>
<tr>
<th></th>
<th>Level OG $\geq 0$</th>
<th>Level OG $&lt; 0$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992-98</td>
<td>0.6</td>
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<td>0.0</td>
<td>0.0</td>
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<tr>
<td>2008-16</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>1992-98</td>
<td>0.7</td>
<td>0.5</td>
</tr>
<tr>
<td>1999-07</td>
<td>0.0</td>
<td>-2.2</td>
</tr>
<tr>
<td>2008-16</td>
<td>NA</td>
<td>0.1</td>
</tr>
</tbody>
</table>

### 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

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

*Source: Pisani-Ferry (2015): Rebalancing the governance of the euro area, p. 20.*
Low insurance against income shocks in EMU

Cross-border risk sharing through different channels
in % of total asymmetric shock to output

## Minimum functions of a Fiscal Union

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

The Five Presidents' Report

Stage 1
- "Deepening by doing"
- by 30 June 2017

Stage 2
- "Completing EMU"

Stage 3
- "Final stage"
- At the latest by 2025
Much stronger risk reduction and risk sharing in the US than in the EA

Elements in the US

- Effective no bail-out clause (e.g. Puerto Rico, California, 1840s)
- Strict enforcement of fiscal rules (sharp fiscal adjustment can be required)
- Significant private risk-sharing (via foreign financial markets, including through foreign capital markets)
- Full Banking Union: little contagion of sovereign debt stress to bank balance sheets
- Significant fiscal stabilisation/redistribution

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

Carrying on
Steps to drive growth and prevent shocks
- financial supervision
- sustainability of public finances
- capital markets development

Nothing but the single market
The integrity of the euro and the capacity to respond to a new financial crisis is at risk

Those who want more do more
Deepened cooperation on
- taxation
- social standards

Doing less more efficiently
Several steps taken to consolidate the Euro area and ensure its stability

Doing much more together
Economic, financial and fiscal union achieved as envisioned in the Five Presidents Report