The future of the EU fiscal governance

Marco BUTI

Director-General
European Commission, DG Economic and Financial Affairs

FIRSTRUN Final Conference
Brussels, 29 January 2018
Outline

1. Key changes of EMU's fiscal architecture since the crisis

2. Assessment of the current EU fiscal framework

3. The future of EU fiscal governance (including the 6 December package)
Part 1: Key changes in EMU's fiscal architecture

Fiscal policy in EMU: an evolving view

Conventional view on fiscal policies in EMU – pre crisis

"Put own 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
- Threat of financial sanctions helps discipline governments
- Negative coordination suffices

Revising the role of fiscal policy in EMU – post crisis

"...and strengthen the joint foundation"

- 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 / rules / markets
- Links fiscal policies/ structural reforms
- Difficult to sanction sovereign states
### Institutional changes in EMU 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>Stronger SGP</td>
<td>• 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)</td>
<td>✔</td>
</tr>
<tr>
<td></td>
<td>National fiscal frameworks</td>
<td>• Mandatory min. requirements at the national level) (6-P)</td>
<td>✔</td>
</tr>
<tr>
<td></td>
<td>Macro surveillance</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>Crisis resolution mechanism</td>
<td>• European Stability Mechanism (ESM)</td>
<td>✔</td>
</tr>
<tr>
<td></td>
<td>Better articulation of fiscal rules</td>
<td>• More flexibility in applying the rules</td>
<td>✔</td>
</tr>
<tr>
<td></td>
<td>Breaking sovereign/banks nexus</td>
<td>• Banking Union • Capital Markets Union</td>
<td>to be completed</td>
</tr>
</tbody>
</table>

**Note:** Key reforms steps taken in the area of fiscal and macroeconomic policies are shown in italics in brackets, namely 6-Pack (6-P), Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), 2-Pack (2-P).
Part 1: Key changes in EMU's fiscal architecture

Remaining vulnerabilities

• **Have the financial sovereign doom loops been sufficiently severed?**
  - Banking union not completed yet

• **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 large 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

→ **Sustaining euro area falls too much on the shoulders of the ECB**
→ **Missing piece: minimum fiscal capacity to secure macroeconomic and financial stability**
Part 2: Assessment of the current EU fiscal framework

The rules have evolved to respond to economic developments... but at the cost of increased complexity.

Inherent trade-offs in design of a fiscal framework.

The diagram illustrates the trade-offs between Simplicity, Predictability, and Adaptability ("smartness") in the evolution of the EU fiscal framework:

- **Simplicity**: SGP.0 (1997)
- **Predictability**: Current rules
- **Adaptability**: SGP.1 (2005), SGP 2.1?

The rules have evolved to respond to economic developments, but at the cost of increased complexity.
Part 2: Assessment of the current EU fiscal framework

Have the rules ensured sound fiscal positions?

*Aggregate budget deficit in the euro area fell from over 6% of GDP in 2010 to below 1% in 2018, much lower than US/Japan*

**Note:** Figures between brackets above the columns represent real GDP growth rates.
Part 2: Assessment of the current EU fiscal framework

Have the rules ensured sound fiscal positions?

*Pro-cyclical stance in bad times*

Aggregate euro area fiscal effort versus requirements and output gaps (% of potential GDP)

Source: European Commission autumn forecast 2017
Part 2: Assessment of the current EU fiscal framework

Have the rules ensured sound fiscal positions?

Large divergences in fiscal positions between Member States

Public debt levels (% GDP) and structural budget balance (% GDP)

Source: European Commission autumn forecast 2017
### Part 3: The future of EU fiscal governance

**Which future? Searching for the right balance**

<table>
<thead>
<tr>
<th>Elements of centralisation</th>
<th>Elements of decentralisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simplified fiscal rules</td>
<td>Operational national rules with links to the EU framework</td>
</tr>
<tr>
<td>A common fiscal capacity</td>
<td>More binding nature of medium-term fiscal planning at MS level</td>
</tr>
<tr>
<td>Last resort backstop to the banking union</td>
<td>Empowered independent national fiscal institutions</td>
</tr>
<tr>
<td>Reinforced ability to intervene in case of gross errors</td>
<td>Reinforced market discipline</td>
</tr>
</tbody>
</table>

**Fiscal federalism by exception vs No bail out/market discipline**
Which future? Searching for the right balance

Elements of centralisation

- Simplified fiscal rules

Elements of decentralisation

- Operational national rules with links to the EU framework
- More binding nature of medium-term fiscal planning at MS level
- Empowered independent national fiscal institutions
- Reinforced market discipline

A common fiscal capacity

- Last resort backstop to the banking union
- Reinforced ability to intervene in case of gross errors

Fiscal federalism by exception vs No bail out/market discipline
A European stabilisation function in support of investment

**EU BUDGET**
- Back-to-back loans without conditionality

**EUROPEAN MONETARY FUND**
- Grants
- Loans and/or precautionary credit line

**INSURANCE MECHANISM**
- Member states’ contributions and/or dedicated resources

**STABILISATION FUNCTION**
- Dedicated vehicle managed by the Commission
  - Mixed support of loans and grants
  - Loans reimbursement

**NATIONAL PLATFORM FOR INVESTMENT**
### Which future? Searching for the right balance

#### Elements of centralisation
- Simplified fiscal rules
- A common fiscal capacity
- Last resort backstop to the banking union
- Reinforced ability to intervene in case of gross errors

#### Elements of decentralisation
- Operational national rules with links to the EU framework
- **More binding nature of medium-term fiscal planning at MS level**
- **Empowered independent national fiscal institutions**
- Reinforced market discipline

---

**Fiscal federalism by exception vs No bail out/market discipline**
### Part 3: The future of EU fiscal governance

#### Which future? Searching for the right balance

<table>
<thead>
<tr>
<th>Elements of centralisation</th>
<th>Elements of decentralisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simplified fiscal rules</td>
<td>Operational national rules with links to the EU framework</td>
</tr>
<tr>
<td>A common fiscal capacity</td>
<td>More binding nature of medium-term fiscal planning at MS level</td>
</tr>
<tr>
<td>Last resort backstop to the banking union</td>
<td>Empowered independent national fiscal institutions</td>
</tr>
<tr>
<td>Reinforced ability to intervene in case of gross errors</td>
<td>Reinforced market discipline</td>
</tr>
</tbody>
</table>

Fiscal federalism by exception vs No bail out/market discipline
Part 3: The future of EU fiscal governance

Which future? Searching for the right balance

<table>
<thead>
<tr>
<th>Elements of centralisation</th>
<th>Elements of decentralisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simplified fiscal rules</td>
<td>Operational national rules with links to the EU framework</td>
</tr>
<tr>
<td>A common fiscal capacity</td>
<td>More binding nature of medium-term fiscal planning at MS level</td>
</tr>
<tr>
<td>Last resort backstop to the banking union</td>
<td>Empowered independent national fiscal institutions</td>
</tr>
<tr>
<td>Reinforced ability to intervene in case of gross errors</td>
<td>Reinforced market discipline</td>
</tr>
</tbody>
</table>

Fiscal federalism by exception vs No bail out/market discipline
Conclusions

• The 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.

• Find right balance between EU and national levels, and between rules, institutions and market discipline.

• Reforms have to pass the political, economic and market stability test: sequencing is key but challenging.

• 6 December 2017 package: Roadmap for deepening EMU: "fix the roof when the sun is shining"
Thank you very much for your attention