Euro@20

Marco Buti
Director General - DG ECFIN
European Commission

Harvard University, Centre for European studies – 30 October 2018
Content

1. Introduction
2. Did EMU change policy behaviours?
3. Euro area throughout the crisis
4. Reforms during the crisis but job still not done
MUSGRAVE + and the MAASTRICHT ASSIGNMENT

- **Efficiency** ++
  (but certain aspects, like productivity/reforms fully decentralised)

- **Stabilisation** +
  (only based on monetary policy and automatic stabilisers)

- **Equity** 0
  (interpersonal fully in the hands of Member States; cohesion between countries in EU budget)

- **Sustainability/Stability** +++
  (necessity of supranational fiscal rules to secure sustainability and protect monetary policy from deficit bias and debt spillovers/ ECB as the most independent CB in the world)
MAASTRICHT ASSIGNMENT

Institutional setting in EMU (strong version of the “consensus” on policy making of the 80s' – see Buti Sapir 1998)

i) Monetary Policy (centralised) by independent central bank instrumental to credibly bring down inflation <= conservative, independent central bank to bring down inflation, Barro-Gordon (1983), Rogoff (1985)

ii) Fiscal Policy (decentralised) action limited to automatic stabilization (normal cycles) <= Barro (1979)

iii) Ban on excessive government deficits & on monetary financing of government deficits <= avoid fiscal dominance and no government bailout, Sargent & Wallace (1981)


Our early beliefs…

…and what happened

<table>
<thead>
<tr>
<th>What was expected</th>
<th>What happened</th>
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<tbody>
<tr>
<td><strong>Efficiency</strong></td>
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<tr>
<td>- Financial markets as shock absorbers</td>
<td>- Shock propagated in the crisis</td>
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<tr>
<td>- Improve resource allocation</td>
<td>- Capital allocation not always efficient</td>
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<tr>
<td>- Uptake of structural reforms</td>
<td>- Limited, anaesthetic effect</td>
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<tr>
<td><strong>Stabilization</strong></td>
<td><strong>Stabilization</strong></td>
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<td>- House in order allows &quot;negative coordination&quot; and facing country-specific shocks</td>
<td>- Adequate EA fiscal stance not necessarily resulting from bottom-up national fiscal stances</td>
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<td><strong>Equity</strong></td>
<td><strong>Equity</strong></td>
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<tr>
<td>- Real convergence</td>
<td>- Limited</td>
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<tr>
<td>- Equity/redistribution</td>
<td>- Limited, no redistribution</td>
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<tr>
<td><strong>Sustainability/Stability</strong></td>
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<tr>
<td>- Credibility of the central bank</td>
<td>- Established</td>
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<tr>
<td>- Expectations that MS would maintain sustainable public finances</td>
<td>- Fiscal benefits of euro accession largely spent</td>
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</tbody>
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Improvement in prosperity broadly at par with the US, but convergence with the US stalled

GDP per capita growth (%)

GDP per capita (in pps, US=100)

Source: Ameco
Credibility of the Central Bank

Dispersion of HICP inflation

Notes:
Dispersion measured as an unweighted standard deviation.
2018/19 projected values according to Autumn 2018 forecast.
EA changing composition: according to entry date in EA
Source: Ameco
Not all MS improved sufficiently public finance sustainability

Government debt/GDP

10-year government bond yields (%)

Data source: AMECO
Real convergence mostly driven by 'new' euro area Member States

GDP per capita (in PPS) **before** and **after** the start of the financial crisis

Note: Countries which were in 1999 (left chart) and in 2008 (right chart) not members of the euro area are highlighted in red. The black regression line is based on the full sample of countries, the blue one excludes the 'new' euro area Member States, which are highlighted in red.

Source: Eurostat.
**Imbalances and resource allocation**

**Increasing imbalances**

**Cumulative growth rate of non-tradable/tradable value added**

Source: Commission calculations based on AMECO
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Origin of the EA crisis: my preferred reading

• A "sudden stop" crisis following capital misallocation in pre-crisis years

• A banking crisis triggered a feedback loop: bank solvency concerns → higher bond yields and debt service → default worries → deeper recession

• The euro-area crisis was not a fiscal crisis (apart from Greece), but lack of fiscal space hindered the policy response during the crisis

• Heterogeneity in the euro area much larger than assumed before the crisis: different growth models and agglomeration effects

• Structural divergences during the first 10 years of EMU led to divergent social and political preferences → "ultima ratio" mode
Upon sudden stops, short-term flows were replaced by central bank lending

* start in 2002 , ** start in 2004
Source: Eurostat
ECB intervention: rates and balance sheet

ECB policy and euro overnight rates, Eurosystem BS size

Lehman Brothers default
Start of EA Sovereign Debt Crisis
ECB negative policy rate
OMT
QE announcement
index

ECB deposit facility rate
EONIA
BS total (Jan-07 = 100), rhs

Source: Macrobond, ECB
Fiscal policy tended to be pro-cyclical

Fiscal stance over the economic cycle, EA 2011-2018e

Pro-cyclical loosening

Contra-cyclical restriction

Contra-cyclical loosening

Pro-cyclical restriction

Change in Structural Balance (pps. of GDP)

Output Gap (% of GDP)

Source: Commission calculations based on spring 2018 Commission forecast
Structural reform uptake

Source: OECD (PMR)
Programs: the euro-area crisis was not a fiscal crisis (apart from Greece)

Five financial assistance programmes

Ireland: €85bn, exit in 2013

Portugal: €78bn, exit in 2014

Spain: financial sector support; €40bn, exit in 2014

Greece: 1st €110bn in 2010, 2nd €172.6bn in 2012 and €86bn in 2015, exit in 2018

Cyprus: €10bn, exit in 2016
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EMU reform during the crisis: an overview

Sound fiscal policy
- More effective prevention of gross policy errors
  - Focus on structural balances
  - Expenditure benchmark
- Better enforcement of SGP rules
  - Sanctions
  - Two Pack: ex ante submission of draft budgets, closer monitoring
  - National layer: Directive on fiscal frameworks, Fiscal Compact

Focus on debt developments
- Debt reduction benchmark

Crisis resolution instruments
- EFSM/EFSF: temporary
- ESM: permanent
- ECB: OMT

Balanced growth
- More effective supervision and regulation of the financial system
  - ESAs - ESRB - CRD IV
  - Banking Union: SSM; direct recaps by ESM

Structural reform strategy (Europe 2020)

Growth Compact (EIB, Structural funds, Projects bonds)

European Semester for economic policy coordination
- Prevention and correction of macro imbalances
  - Procedure and sanctions
- Balanced growth
- Better enforcement of SGP rules
- Sound fiscal policy
- Focus on debt developments
- Crisis resolution instruments
## Two competing models for EMU

<table>
<thead>
<tr>
<th>&quot;Back-to-Maastricht&quot;</th>
<th>Fast forward to federalist EMU</th>
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<tbody>
<tr>
<td>Stronger enforcement of EU fiscal rules to rein debt and deficits</td>
<td>Distribution of fiscal efforts to achieve an appropriate aggregate fiscal stance</td>
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<td>Mechanism of imbalances procedures (MIP) focused on competitiveness of lagging countries</td>
<td>Symmetric adjustment to help weak countries and reduce Euro area current account surplus</td>
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<td>Banking Union does not need common deposit insurance</td>
<td>Full Banking Union to ensure financial stability and private risk sharing</td>
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<td>End to the risk-free status for sovereign debt and establish sovereign debt restructuring mechanism</td>
<td>Fiscal capacity for public risk sharing and eventually sovereign debt mutualisation</td>
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<td>More market discipline</td>
<td>Euro area Treasury</td>
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*In their « pure » form, both are economically and/or politically unfeasible*
To enter into the adult age of the Euro, the institutional framework is to be profoundly reinforced

1. Financial Union
   - Diversified banks' sovereign exposures
   - Economic and social convergence
2. Economic and Fiscal Union
   - Accountable institutions and effective governance
3. Institutions and Governance
   - Complete Banking Union and Capital Markets Union
   - European safe asset, Not €bonds
   - Common fiscal stabilisation function
Banking & Capital Market Union

OUTSTANDING COMPONENTS:
- European Deposit Insurance Scheme
- Common backstop for the Single Resolution Fund

A SINGLE RULEBOOK APPLIES TO BANKS IN ALL EU MEMBER STATES

CAPITAL MARKET UNION

33 action in 6 areas
Possible forms for a European safe asset

Source: Buti, Deroose, Leandro and Giudice (2017)
The evolving EA fiscal framework

*Increased adaptability at the expense of simplicity...*

**CLARITY**
(simplicity)

**ADEQUACY**
(adaptability)

**PREDICTABILITY**

- SGP.0 (1997)
- SGP.1 (2005)
- SGP.2 (2011-)

Current rules
Impact of a central stabilisation capacity in bad times

Fiscal stance over the economic cycle, EA 2011-2018

Source: Commission calculations based on spring 2018 Commission forecast
Conclusion, quasi

• Crisis is over, but the job is not yet done
• EMU deepening is an unfinished business
• Key ingredient: trust to be rebuilt (Habermas helps).
• Overcome creditors/debtors divide
• Additional difficulties in a multi-layer governance. Discount rate of COM < than that of Member States
• ...and Italy
LEONON FROM THE US: completing monetary unions take a long time

Total Federal Government Expenditure 1792-2020p

Total Federal Government Expenditure, Excl. War Department, Naval Department and Interest on the National Debt 1792-1945

EU Budget in 2014 = ~1.17% of EU GDP

Thank you for your attention