



The reform of EU's fiscal rules: between centralisation and decentralisation

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Outline

- 1. The evolution of EMU's fiscal architecture**
- 2. An assessment of the current EU fiscal framework**
- 3. The future of EU fiscal governance**
- 4. Conclusions**

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

Challenge	Measure taken	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 (<i>6-P</i>) and balanced budget rule (<i>TSCG</i>) • Possibility of imposing earlier/more gradual sanctions (<i>6-P</i>) • Surveillance of DBPs (<i>2-P</i>) 	✓
	National fiscal frameworks	<ul style="list-style-type: none"> • Mandatory min. requirements at the national level) (<i>6-P</i>) 	✓
	Macro surveillance	<ul style="list-style-type: none"> • Prevention/correction of macroeconomic imbalances via the introduction of the new Macroeconomic Imbalance Procedure (<i>MIP</i>) (<i>6-P</i>) 	being implemented
Revising the role of fiscal policy in EMU (post-crisis)	Crisis resolution mechanism	<ul style="list-style-type: none"> • European Stability Mechanism (<i>ESM</i>) 	✓
	Better articulation of fiscal rules	<ul style="list-style-type: none"> • More flexibility in applying the rules • Euro area fiscal stance 	✓
	Breaking sovereign/banks nexus	<ul style="list-style-type: none"> • Banking Union • Capital Markets Union 	to be completed

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).

Remaining vulnerabilities

Have the financial sovereign doom loops been sufficiently severed?

- Banking union not completed yet

Are large public debts being reduced sufficiently?

- Difficult to enforce rules in good times

Does EMU have the capacity to withstand the next large shock?

- ESM remains entirely dependent on national Treasuries and slow decision-making
- No tool for smoothing large shocks

Is the appropriate fiscal stance at the EA level being achieved?

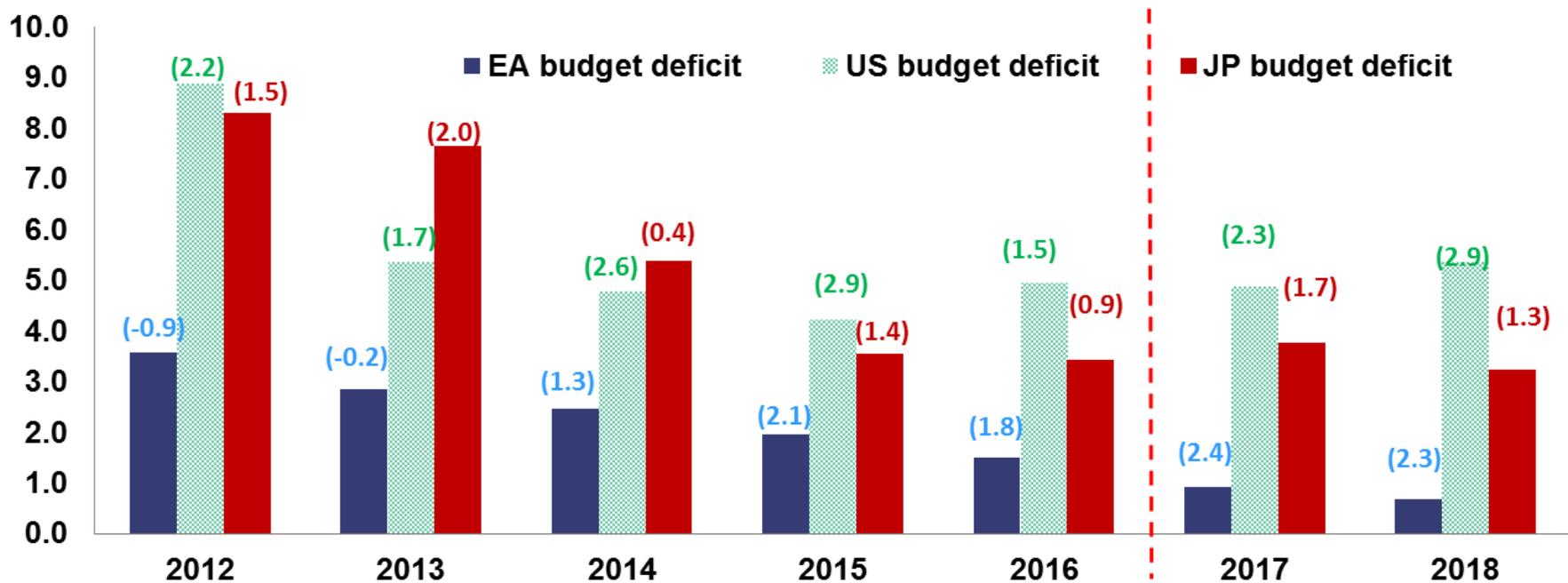
- Bottom-up coordination to achieve appropriate EA fiscal stance does not work

→ Sustaining euro area falls too much on the ECB shoulders

→ Missing piece: minimum fiscal capacity to secure macroeconomic and financial stability

Have the rules ensured sound fiscal positions?

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

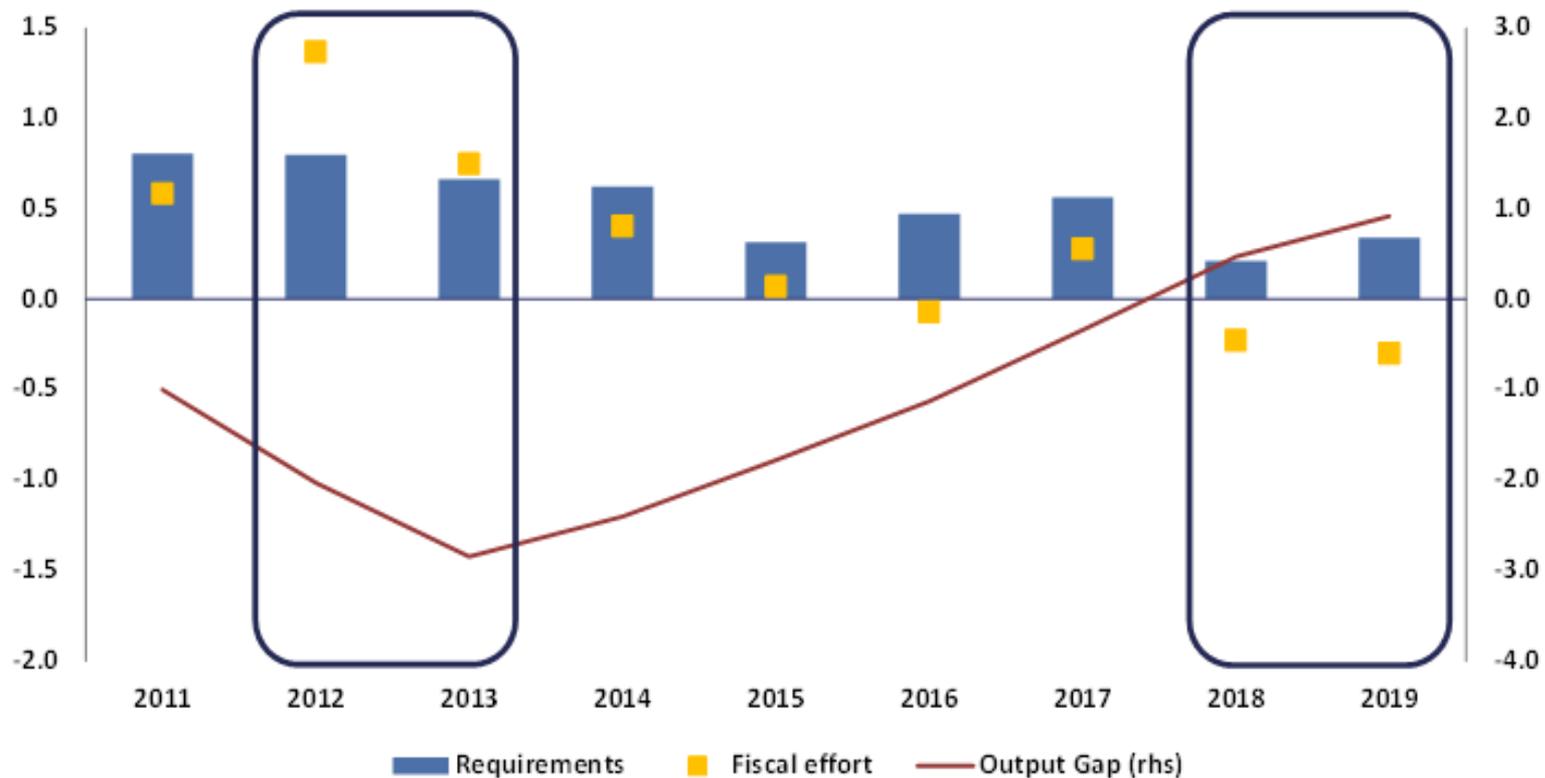


Note: Figures between brackets above the columns represent real GDP growth rates

Have the rules ensured sound fiscal positions?

A pro-cyclical bias

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

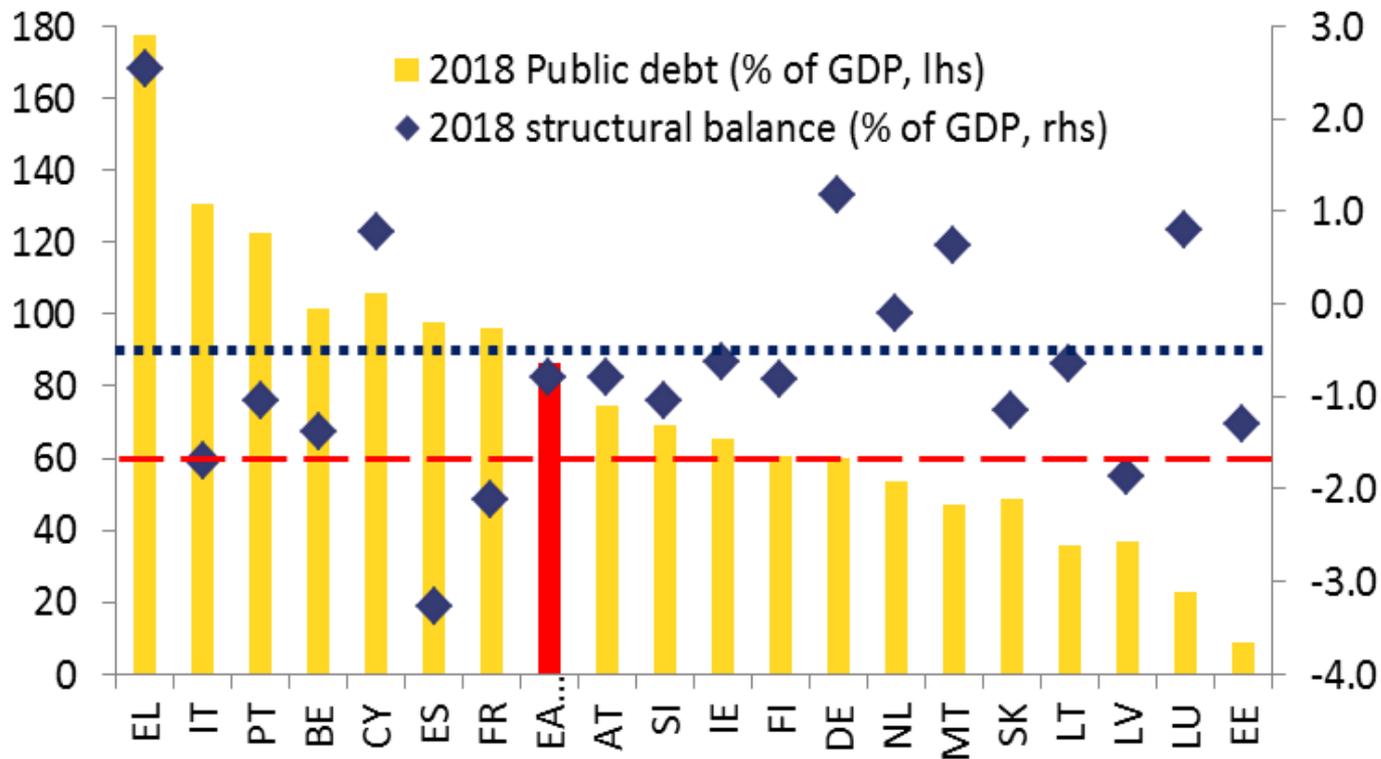


Source: European Commission spring forecast 2018

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 spring forecast 2018

What next?

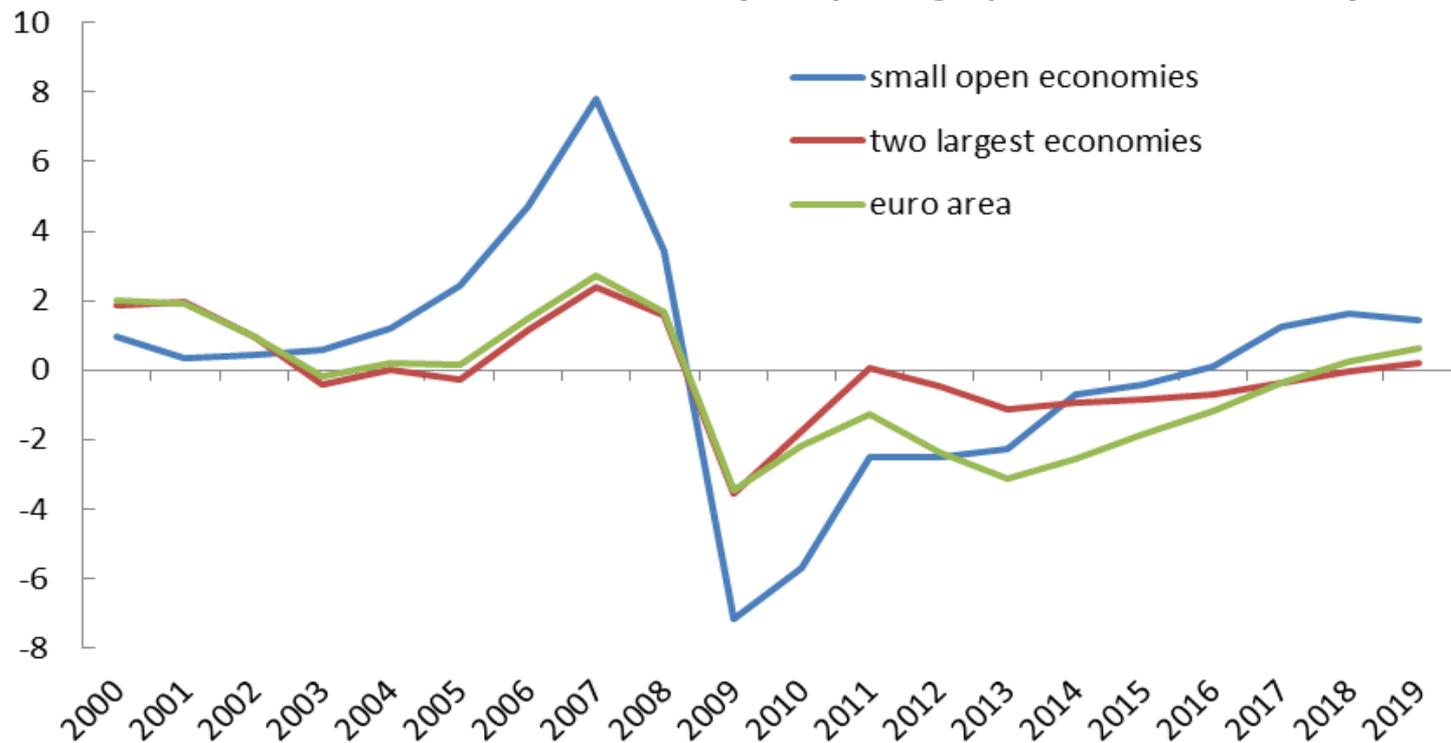
- (1) A central fiscal stabilisation function?
- (2) Simplified fiscal rules?
- (3) What role for market discipline?

Does the EMU need a stabilisation function?

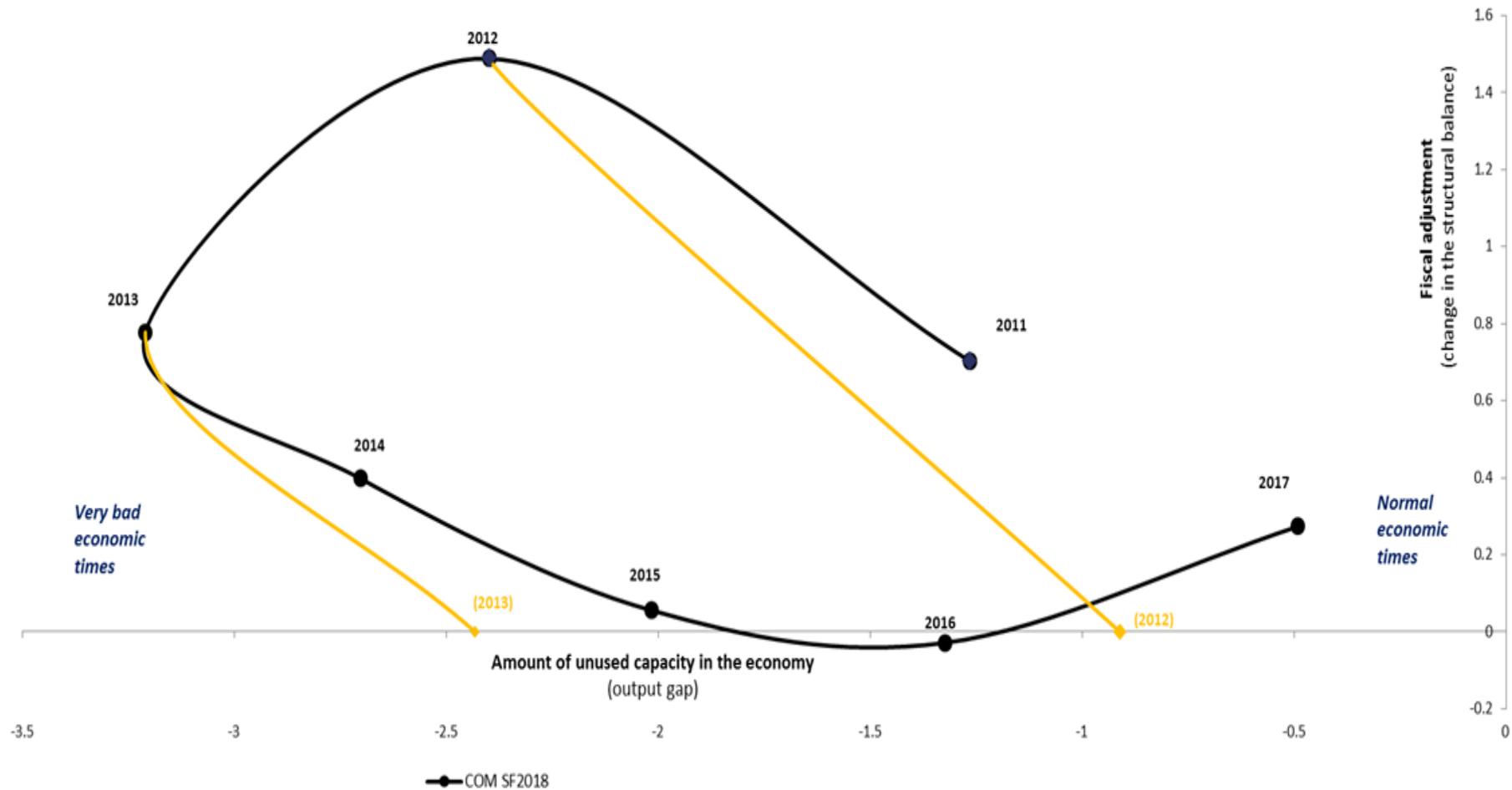
Lack of instruments in case of large shocks:

- Automatic stabilisers insufficient to ensure proper stabilisation in the presence of large shocks (especially in small open economies)

Disparities in amplitude of cyclical variations across Member States (output gap, in % of GDP)



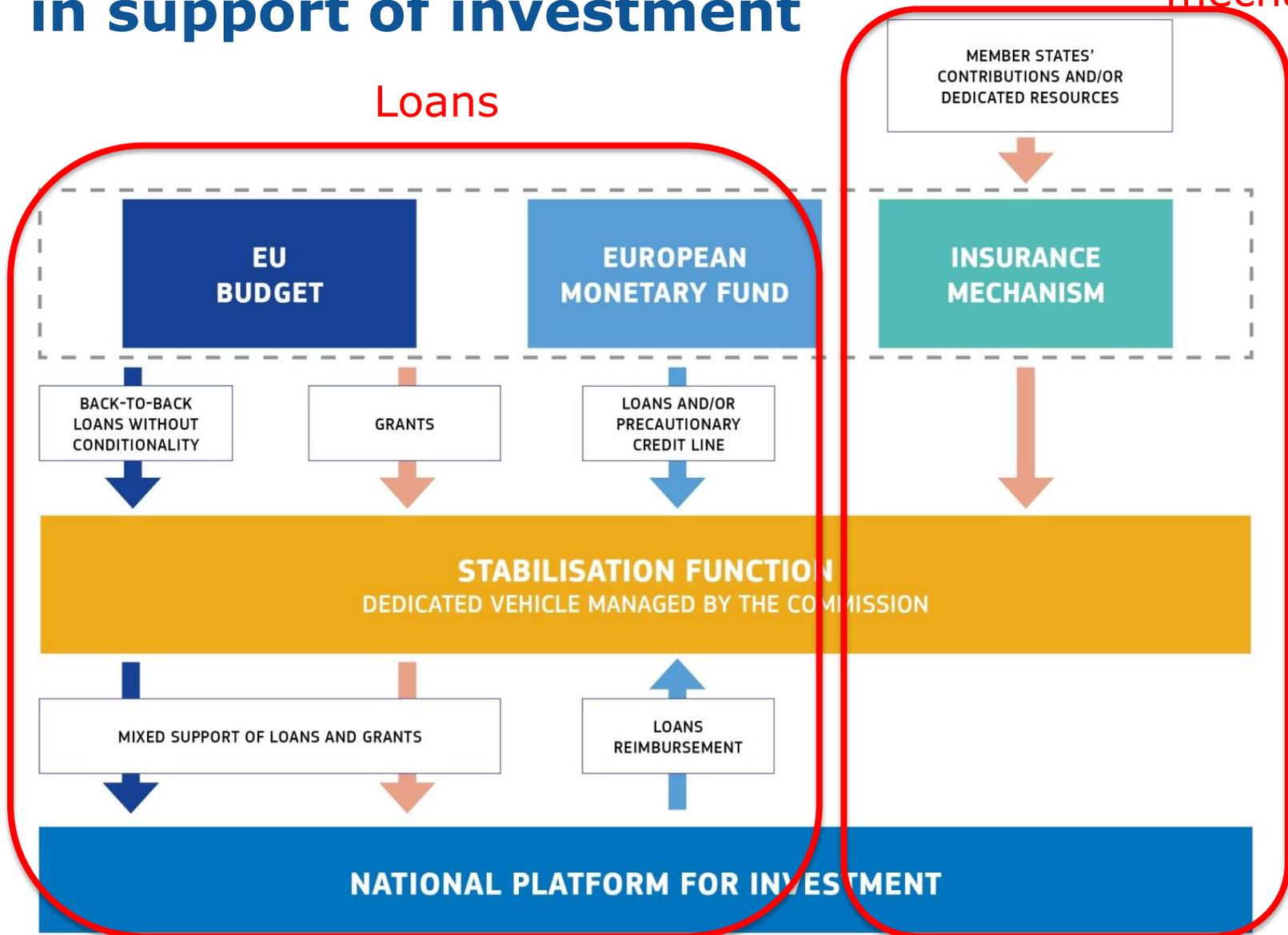
Benefits of a central stabilisation capacity



A European stabilisation function in support of investment

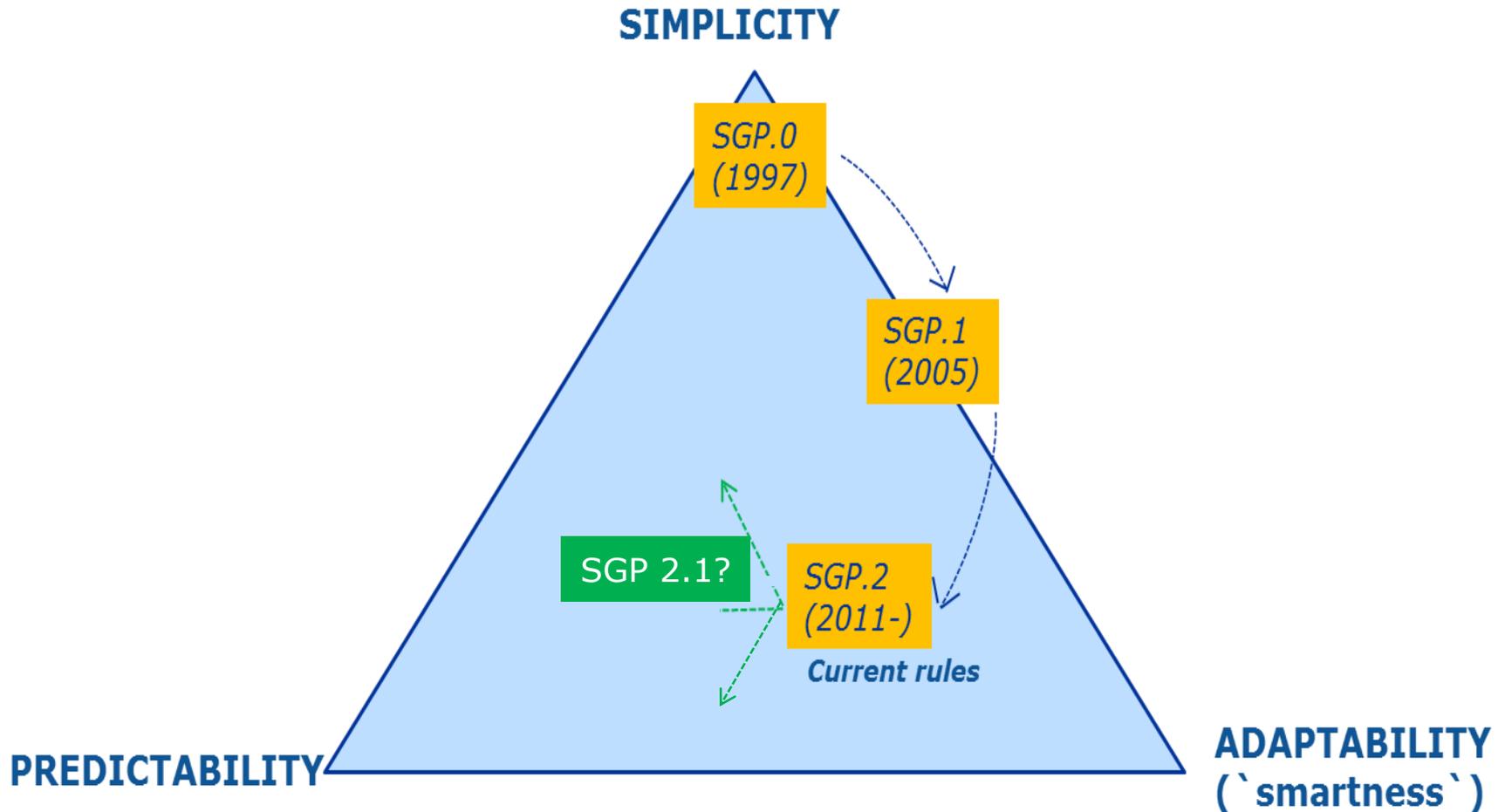
Insurance mechanism

Loans



*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



Simplified EU rules

- Simplification is ... complicated
- Search for the 'complete contract' rooted in lack of trust
- Stark choice:



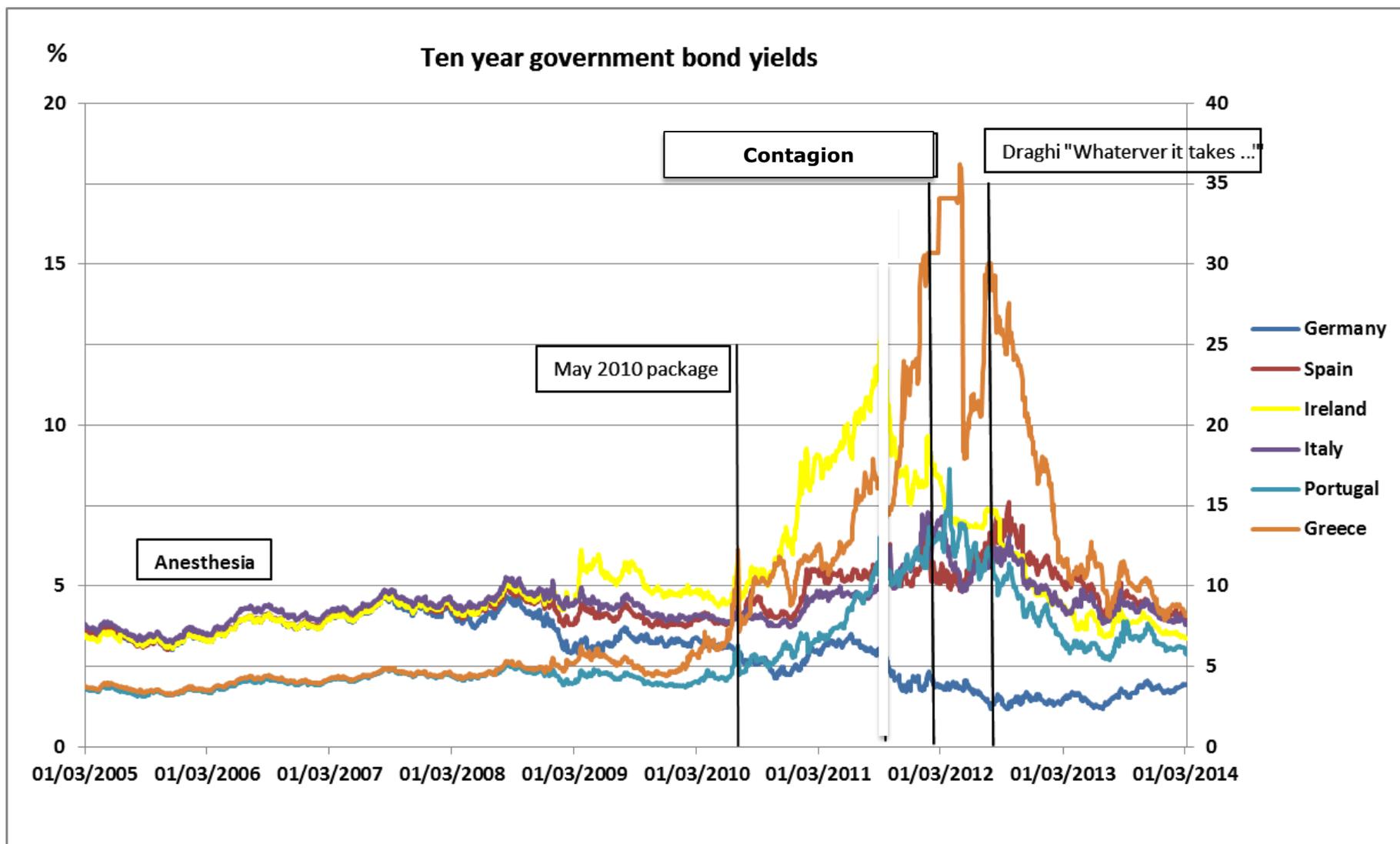
Possible avenues for simplification

Move towards a debt-based anchor underpinned by operational expenditure rule

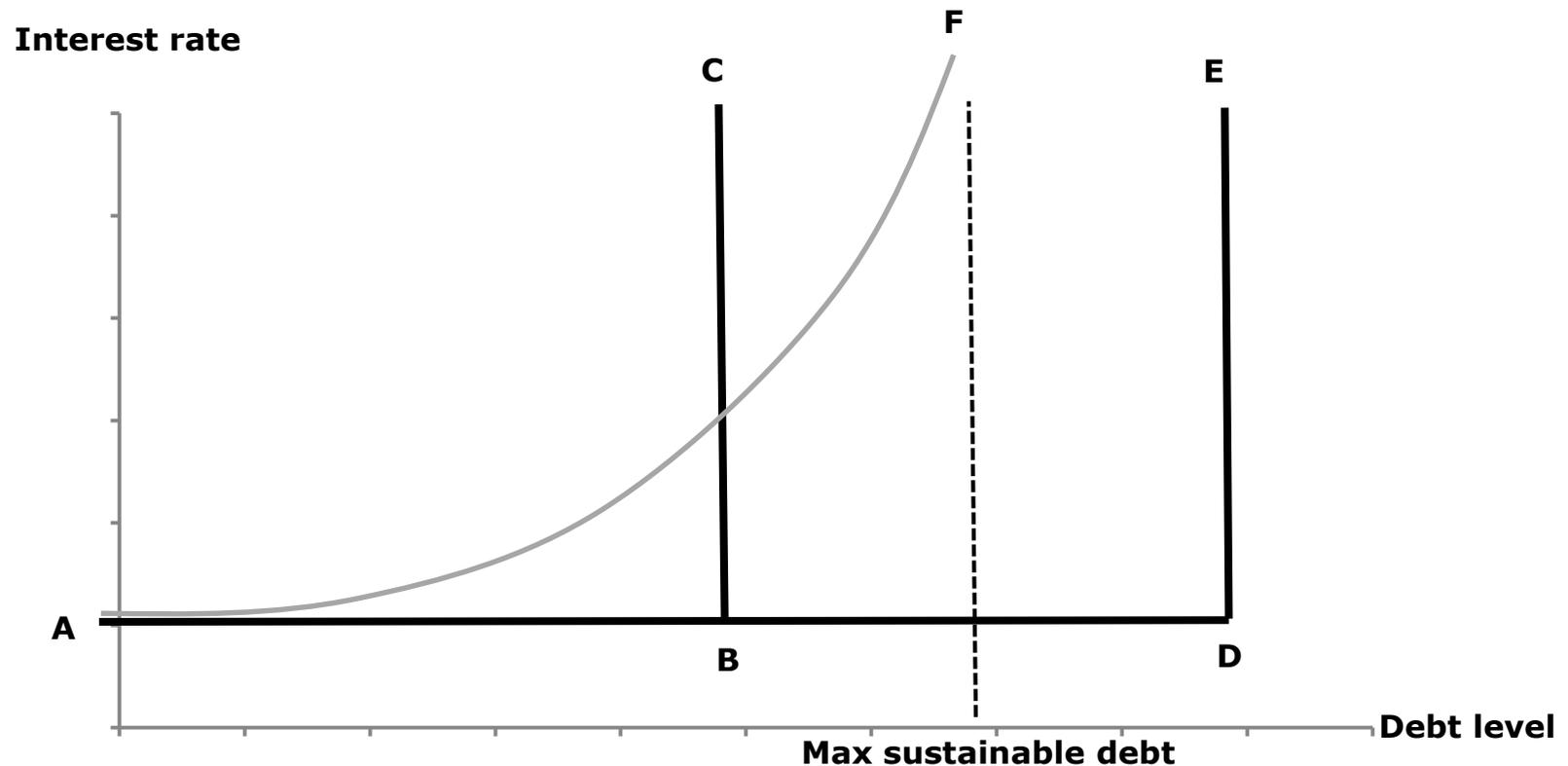
Some decentralisation of the preventive arm towards Member States/markets

Remove overlaps between EU and national level of surveillance

Can market discipline help?



Can markets be made more gradual?



ADE: "Greece"

ABC: Market reaction to a misguided communication on SDRM

AF : Desirable market behaviour

Fiscal federalism by exception

Jean-Claude Trichet (May 2012):

<< Instead of imposing fines on countries that transgress rules and ignore recommendations, as the SGP was supposed to do, the European commission, the European council and – this is essential – the European parliament should decide directly on measures to be immediately implemented in the country concerned. Fiscal and certain other economic policies should be subject to activation of a eurozone "federation by exception">>

Jens Weidmann (June 2012):

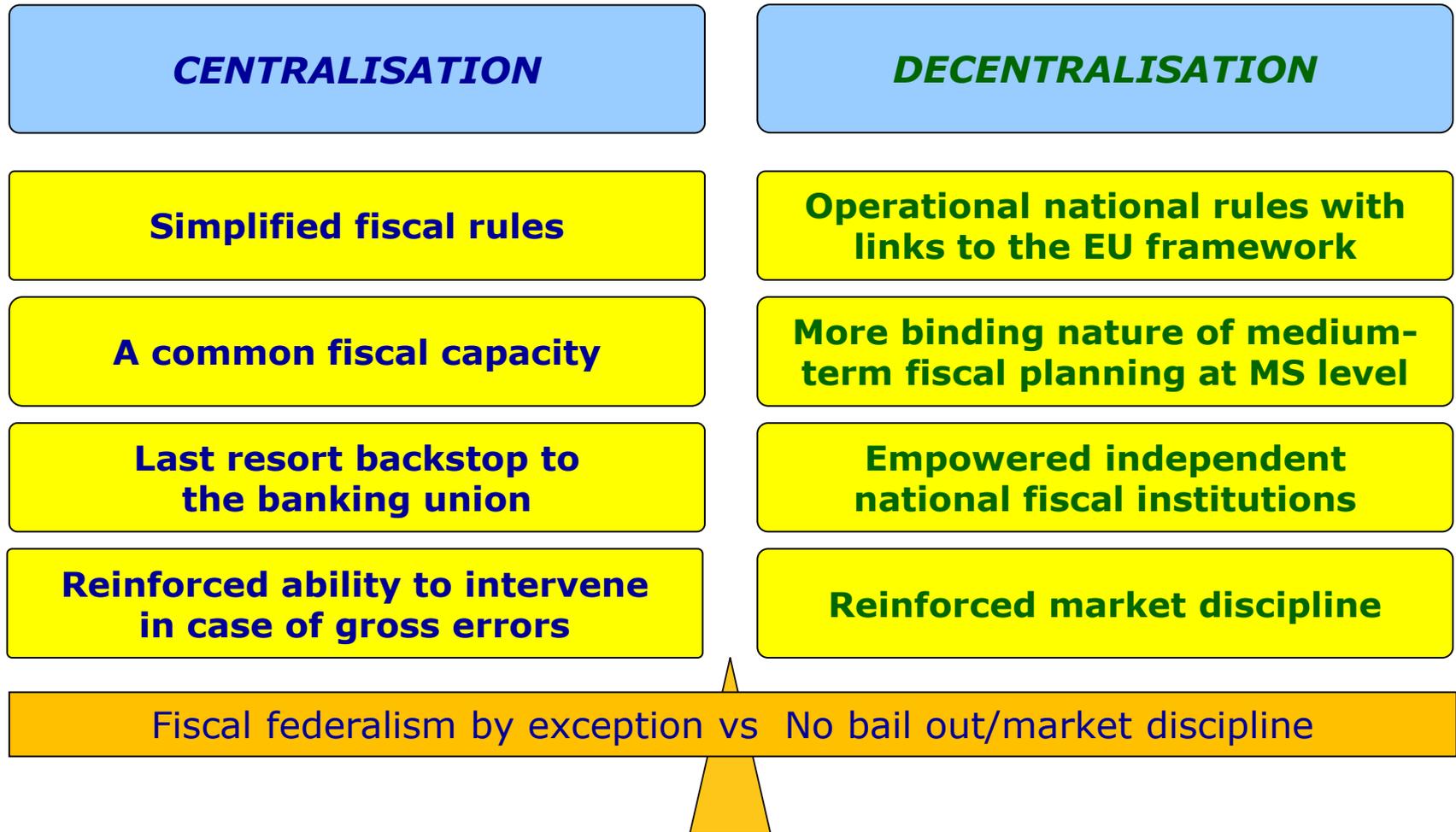
<< In the event of a country not abiding by the budgetary rules, national sovereignty would be automatically transferred to the European level on a scale that can ensure compliance with the objectives >>



EU level empowered to take over some national budgetary prerogatives in case of 'gross errors'



Seeking the right balance



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
- 29 May 2018 package: Proposal for a European Investment Stabilisation Function