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
Part 1: Evolution of 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..."

Revising the role of fiscal policy in EMU – post crisis
"...and strengthen the joint foundation"

- 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

- 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
<table>
<thead>
<tr>
<th>Challenge</th>
<th>Measure taken</th>
<th>Measure in greater detail</th>
<th>Application</th>
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<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)</td>
<td>✓</td>
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<td>• Possibility of imposing earlier/more gradual sanctions (6-P)</td>
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<td>• Surveillance of DBPs (2-P)</td>
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<td>National fiscal frameworks</td>
<td>• Mandatory min. requirements at the national level) (6-P)</td>
<td>✔</td>
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<td>Macro surveillance</td>
<td>• Prevention/correction of macroeconomic imbalances via the introduction of the new</td>
<td>being implemented</td>
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<td>Macroeconomic Imbalance Procedure (MIP) (6-P)</td>
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<td>Revising the role of fiscal policy in EMU (post-crisis)</td>
<td>Crisis resolution mechanism</td>
<td>• European Stability Mechanism (ESM)</td>
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<td>Better articulation of fiscal rules</td>
<td>• More flexibility in applying the rules</td>
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<td>• Euro area fiscal stance</td>
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<td>Breaking sovereign/banks nexus</td>
<td>• Banking Union</td>
<td>to be completed</td>
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<td>• Capital Markets Union</td>
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*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: Evolution of EMU's fiscal architecture

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
Part 2: Assessment of the current EU fiscal framework

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
Part 3: Future of EU fiscal governance

What next?

(1) A central fiscal stabilisation function?
(2) Simplified fiscal rules?
(3) What role for market discipline?
Part 3: Future of EU fiscal governance

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)
A European stabilisation function in support of investment

**Insurance mechanism**

**Loans**

**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**
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
Part 3: Future of EU fiscal governance

Simplified EU rules

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

Possible avenues for simplification

Very articulated rules with little discretion

Simple rules with ample discretion
Part 3: Future of EU fiscal governance

Can market discipline help?

Ten year government bond yields

Contagion
Draghi "Whatever it takes ..."

May 2010 package

Anesthesia
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'
Part 3: Future of EU fiscal governance

Seeking the right balance

**CENTRALISATION**

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

**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
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