European Fiscal Board

The future of EMU: the fiscal side

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Conversations for the Future of Europe
European University Institute, Florence, 5 March 2019

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Introduction

- **Context/disclaimer:** analysis largely based on EFB 2018 Annual report
  - Backward-looking assessment of implementation of EU fiscal rules
  - Forward-looking suggestions for possible reform

- **Focus on (partial) role and constraints of fiscal policies in EMU:**
  - Stabilising role envisaged? Possible? Effective?
  - Sustainability ensured?

- **Outline:**
  - Planned Maastricht setting
  - Reality check: what has worked, what not?
  - EFB proposal: central stabilisation function + reformed fiscal rules including clarified governance
  - Obstacles

Main messages

- **Current set-up for economic stabilisation in the euro area:**
  - Monetary policy (for symmetric shocks in the euro area)
  - National fiscal policies (for asymmetric shocks)
- **Limits to this set-up:**
  - Monetary policy alone not always sufficient
  - High debt → no room for fiscal stabilisation
  - Rules ineffective to prevent pro-cyclical discretionary fiscal policies
  - Governance issues:
    - Commission both guardian of the treaties and political body
    - EU fiscal framework provides weak incentives to comply
- **Double proposal:**
  - A central stabilisation function to help with stabilisation, conditional on compliance with fiscal rules
  - Reformed SGP with simpler, more practical rules, and clearer technical/political breakdown

Policy mix in the ideal Maastricht setting

One centralised monetary policy
to deal with shocks in the euro area as a whole

National fiscal policies
- **To deal with country-specific shocks**
- **To allow national economies to adjust to central monetary policy decisions**

Assumes sound underlying fiscal positions
- Public debt at a sustainable level
- Budget close to balance over the medium term
- Limit to allowed deficit

Assumes mainly automatic fiscal stabilisation

Automatic fiscal stabilisers ensure counter-cyclical fiscal stabilisation, while keeping the deficit below 3% of GDP

Assumes fiscal discipline
- Monitoring
- Peer pressure
- Fear of sanctions

To ensure compliance with EU fiscal rules

Policy mix in EMU: reality check

One centralised monetary policy
to deal with shocks in the euro area as a whole

- **Ability of monetary policy to stabilise the economy reaching its limits in crisis times (ZLB)**
- **Still significant differences across countries: not only symmetric shocks**

→ Importance of stabilising role of fiscal policy may have been underestimated

Policy mix in EMU: reality check

Assumes sound underlying fiscal positions

- Debt at a sustainable level
- Budget close to balance over the medium term
- Limit to allowed deficit

- **60% was an average, not all countries had that level of debt**
- **Few countries at MTO, some far from it and not approaching it**
- **Consolidation in the run-up to EMU as stakes were high, but not so much afterwards**
- **Impact of the crisis**

→ INSUFFICIENT FISCAL BUFFERS

Policy mix in EMU: reality check

- **Stabilisation vs sustainability trade-off**
- **Pro-cyclical discretionary fiscal policies largely offset automatic stabilisers**
- **National perspective: spillover effects not taken into account (including in case of simultaneous consolidation)**

Assumes mainly automatic fiscal stabilisation

Automatic stabilisers ensure counter-cyclical fiscal stabilisation, while keeping the deficit below 3% of GDP

Policy mix in the ideal Maastricht setting

- **Financial market pressure has proven more binding than SGP (see 2012) but not ideal**
- **Increasing complexity of fiscal rules meant to address distrust but counterproductive: more opaque, political implementation**
- **National independent fiscal institutions potentially useful but often weak**

Assumes fiscal discipline

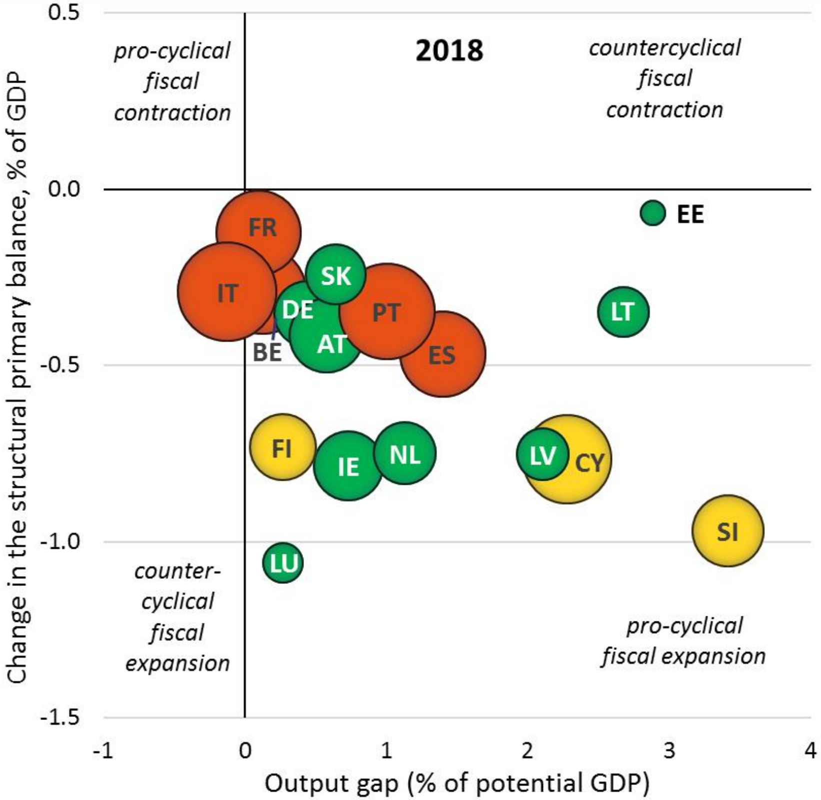
- Monitoring
- Peer pressure
- Fear of sanctions

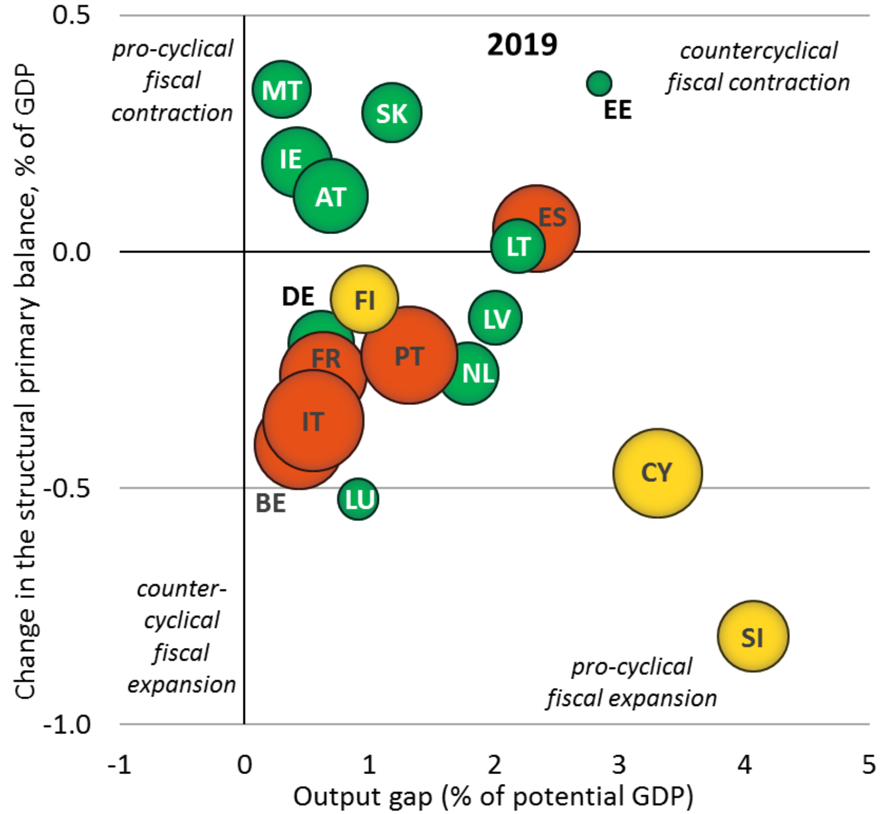
To ensure compliance with EU fiscal rules

Illustration: lopsided differentiation across countries

Fiscal expansion originates in high-debt countries

(fiscal stance, cyclical conditions and sustainability in euro area Member States; **Commission spring 2018 forecast**)





Worryingly, the fiscal expansion in 2018-2019 emerging from budgetary trends expected in spring 2018 largely originated in countries with higher sustainability risks

Has the fiscal framework delivered?

Principle/expectations:
Ensure sustainability, allow (automatic) stabilisation; stabilisation not a big issue, everything will be fine as long as public finances are sustainable

- **But not equipped for a severe crisis**, nor its legacy, nor subsequent downturns
- **Not preventing pro-cyclical fiscal policies in bad and good times**

Some Member States have done their homework: fine (although not sure if this is thanks to the EU fiscal framework)
But not all Member States have, so overall the framework is not delivering – irrespective of who is to blame for it.

What is missing?
Do we need more pressure? Higher stakes/incentives? Both sticks AND carrots? Better informed public opinions? Alternative/additional stabilisation tools?

The European Fiscal Board's suggestion

Two components of a major overhaul (**Annual Report 2018**)

- **Create a central stabilisation function to help with stabilisation**
  - Add a missing tool in EMU's toolbox
  - Ease the stabilisation/sustainability trade-off
  - Provide a new carrot by making access conditional on compliance with EU fiscal rules

- **Reform the SGP**
  - Simpler rules
  - Focus on ultimate aim (sustainability) with more practical guidance (expenditure)
  - Rethink governance to clarify distinction between technical assessment and political decision
  - Reinforce role of independent watchdog(s) to increase transparency and therefore pressure

Governance framework needs to be upgraded

Two complementary elements

Central stabilisation function
- Addressing large symmetric and asymmetric shocks
- Sufficiently funded
- Based on independent economic judgement
- Access conditional on compliance with fiscal rules

Reform of Stability and Growth Pact
- Simpler and stronger rules
- Enhanced transparency
- Greater role for independent analysis and advice
- Needed to ensure even-handed assessment of compliance

European Investment Stabilisation Function:
step in the right direction,
but narrow focus on country-specific shocks,
very limited size,
and automatic trigger

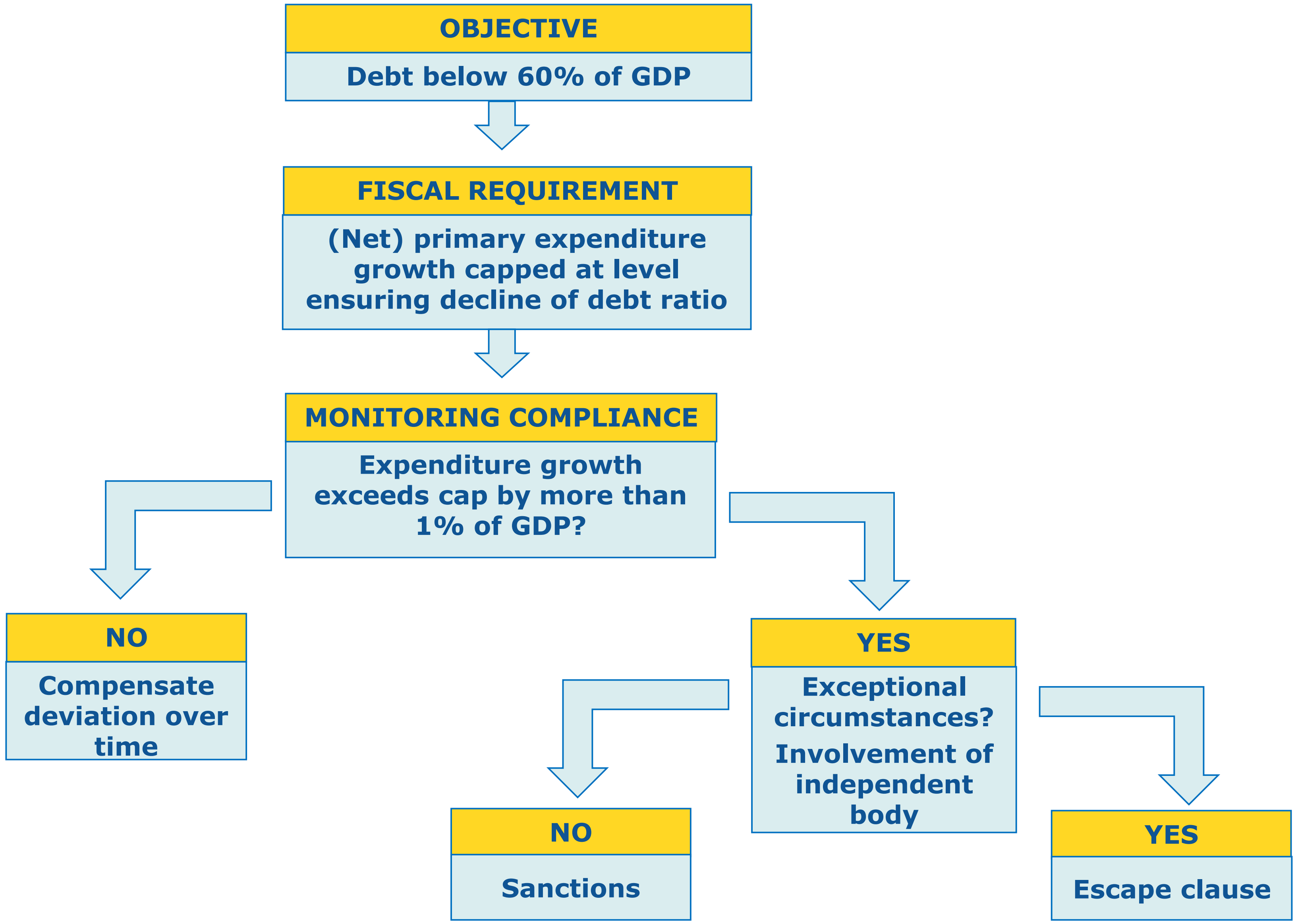
Review of fiscal framework
currently envisaged
only after 2020

- ➢ Politically difficult to achieve both at the same time
- ➢ Still, a central stabilisation function will work neither politically nor economically without conditionality; this requires better EU fiscal rules and a more reliable assessment

Proposal for a new fiscal framework

CURRENT SGP	NEW FISCAL RULES
TWO FISCAL ANCHORS: → Maintain balanced budget over the cycle, with deficit ceiling at 3% → Reduce debt to 60%	**ONE FISCAL ANCHOR:** → Reduce debt to 60%
FOUR FISCAL REQUIREMENTS: → Structural budget balance → Nominal budget balance → Net expenditure growth → Short-term debt dynamics	**ONE FISCAL REQUIREMENT:** → Net expenditure growth
MANY FLEXIBILITY PROVISIONS: → Fiscal adjustment modulated over the cycle → Flexibility clauses: investment, structural reforms → Several escape clauses covering different contingencies: economic downturn, unusual events	**ONE ESCAPE CLAUSE :** → Covering different contingencies (economic downturn, unusual events)
SURVEILLANCE: → Annual surveillance cycle	**LESS INVASIVE SURVEILLANCE:** → 3-year surveillance cycle
GOVERNANCE: → Commission and Council	**UPGRADED GOVERNANCE:** → Commission and Council → Independent bodies to produce economic assessment including for escape clause

Proposal for a new fiscal framework (fits on one page!)



Obstacles

- Fiscal rules: no easy solution between “stupid rules” and complete contract
- Political economy considerations for the central fiscal capacity:
  - Fear of moral hazard and permanent transfers
  - Acceptability of reversed transfers?
- IFIs: more direct role and power may imply less independence
- No framework can work without political buy-in, including from voters

Thank you for your attention

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