

MONETARY AND FISCAL INTEGRATION IN EMU

Background for presentation by
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AGENDA

- MOTIVATIONS AND DESIGN OF EMU 1988-91
- A "PURIST" CENTRAL BANK UNDERPINNED BY RULES FOR NATIONAL FISCAL POLICY
- CRITICISM/REVISIONS OF THE STABILITY AND GROWTH PACT 1999-2008
- THE EUROPEAN ECONOMIC RECOVERY PROGRAMME (EERP) AND THE EFFORTS TO EXIT FROM 2010 ONWARDS

- THE FILLING IN OF MISSING PIECES: A SAFETY NET (EUROPEAN STABILITY MECHANISM (ESM)), JOINT BANK SUPERVISION (SSM) AND THE REMOVAL OF REDENOMINATION AND DEFLATION RISKS BY THE ECB FROM 2012
- HOW TO REFORM THE FISCAL RULES AND GOVERNANCE - PROPOSALS BY THE EUROPEAN FISCAL BOARD (EFB) AND OTHERS
- THE FUTURE MACROECONOMIC POLICY MIX

MOTIVATIONS FOR AND DESIGN OF EMU

WITHIN EMU TO REDUCE SPILL-OVERS FROM DIFFERENCES IN MONETARY POLICY – ACTUAL OR PERCIVED – WHICH COULD UPSET THE DEVELOPMENT OF THE SINGLE INTERNAL MARKET WITH THE ADOPTION OF DETAILED RULES AND PROCEDURES

THE PRECEDING REGIME – THE EUROPEAN MONETARY SYSTEM (EMS) – HAD DELIVERED PROGRESS, BUT WOULD BE VERY HARD TO MANAGE WITH FULL CAPITAL MOBILITY

EXTERNALLY A SINGLE CURRENCY WOULD MAKE EUROPE MORE ROBUST AND COHESIVE IN THE FACE OF DISTURBANCES FROM THE USD AND ENERGY/COMMODITY PRICES – AND IT WOULD RELIEVE GERMANY OF REPRESENTING EUROPE IN THE G7 OR IN MORE GLOBAL FORA; AND GERMANY WAS BECOMING READY TO BE RELIEVED IN THE COURSE OF THE 80s

MOTIVATIONS (ctd.)

WITH THESE MOTIVATIONS IN MIND IT BECOMES MORE UNDERSTANABLE WHY FISCAL POLICY WAS TREATED SO DIFFERENTLY FROM MONETARY POLICY, BUT STILL

WOULD RULES FOR NATIONAL FISCAL POLICIES PROVE AN ADEQUATE COMPLEMENT TO A CENTRALISED MONETARY POLICY?

IN "NORMAL" TIMES YES - SPILL-OVERS OF NATIONAL TAX AND EXPENDITURE POLICIES WOULD NOT JUSTIFY EU-IMPOSED CONSTRAINTS AND INTRUSIVE "COORDINATION"

THE IMPACT OF FISCAL POLICY CHANGES WOULD BE LARGELY CONTAINED WITHIN NATIONAL BORDERS, ALSO FOR LARGE MEMBER STATES, BY OFFSETTING MOVEMENTS IN INTEREST RATES

MOTIVATIONS (ctd.)

HOWEVER, VERY HIGH PUBLIC DEBT WOULD HAVE THE POTENTIAL TO TRIGGER FINANCIAL SPILL-OVERS WITHIN EMU – AND FISCAL RULES TO CONSTRAIN DIVERGENT BEHAVIOUR WOULD THEN BECOME APPROPRIATE

PROTECTION AGAINST THE RISK OF “FISCAL DOMINANCE” – OR ENCOURAGEMENT OF “MONETARY DOMINANCE” (DRAGHI, 2019) – WAS SEEN AS ESSENTIAL FOR THE ABILITY OF THE FUTURE ECB TO CONDUCT A POLICY OF MEDIUM-TERM PRICE STABILITY - AND NOT ONLY BY CENTRAL BANKERS WHO HAD OBTAINED MORE DE FACTO INDEPENDENCE FROM THEIR RESPECTIVE GOVERNMENTS OVER THE 1980's

NO BAIL-OUTS OF GOVERNMENTS, PROHIBITION OF LENDING TO PUBLIC INSTITUTIONS – IN COMBINATION WITH FISCAL RULES – WERE SEEN AS PROVIDING DESIRABLE, BUT ALSO ECONOMICALLY ADEQUATE, PROTECTION

A "PURIST" ECB AND THE FISCAL RULES

HENCE, THE FOCUS ON GETTING THE ECB OFF TO THE BEST POSSIBLE START IMPLIED A STRONG PROTECTION FOR A STABLE MONETARY POLICY

NOT ONLY BY REMOVING THE ECB FROM THE ROLE OF LENDER-OF-LAST-RESORT TO GOVERNMENTS, BUT ALSO BY RESTRICTING ITS ROLE IN FINANCIAL RESCUES AND IN FOREIGN EXCHANGE INTERVENTIONS

MORE REMARKABLY, NO EU – COMMUNITARIAN OR INTER-GOVERNMENTAL – FRAMEWORK WAS DEFINED IN THESE AREAS UNTIL THE POST-2012 INITIATIVES; WHAT THE ECB WAS NOT TO DO, SHOULD NOT BE DONE AT THE EU LEVEL AT ALL

THE FISCAL RULES WERE INSPIRED FROM TWO SOURCES: RULES-BASED MONETARY POLICY (INFLATION TARGETS) AND FISCAL FEDERALISM IN LARGE, DIVERSE COUNTRIES

A “PURIST” ECB AND THE FISCAL RULES (ctd.)

HOWEVER, BOTH ANALOGIES WERE (AND REMAIN) OF LIMITED APPLICABILITY:

- FISCAL POLICY HAS SEVERAL OBJECTIVES, OCCASIONALLY IN CONFLICT, WHILE MONETARY OBJECTIVES ARE CLOSER TO BEING UNI-DIMENSIONAL, AND
- THE RESPONSIBILITY FOR MACROECONOMIC STABILISATION IS OVERWHELMINGLY AT THE FEDERAL LEVEL IN LARGE FEDERATED NATION STATES – IN CONTRAST TO IN EMU WHERE NATIONAL GOVERNMENTS REMAIN IN CHARGE OF STABILISATION WITH 40-50% OF GDP PASSING THROUGH THE GOVERNMENT ACCOUNTS

A “PURIST” ECB AND THE FISCAL RULES (ctd.)

LEAVING ROOM FOR AUTOMATIC STABILISERS – STRONGER IN EUROPE THAN ELSEWHERE
– TO OPERATE OVER MOST CYCLES WOULD GO MUCH OF THE WAY TOWARDS MAKING
SUSTAINABILITY OF PUBLIC FINANCES ACCEPTABLE AS THE PRIMARY FISCAL OBJECTIVE

BUT THE MODEL WAS BOUND TO BE CHALLENGED, EVEN IN RELATIVELY “NORMAL” TIMES

THE MAIN REASON IT TOOK SO LONG FOR FISCAL POLICY IN MACROECONOMIC
STABILISATION TO GAIN STATUS AS A MAJOR TOOL FOR STABILISATION WERE THE MANY
EXAMPLES OF PRO-CYCLICAL NATIONAL FISCAL POLICIES OVER TWO DECADES PRIOR TO
THE MAASTRICHT TREATY – CREDIBILITY HAD BEEN SEVERELY UNDERMINED

FRANCE AND ITALY TRIED TO DEFEND A STABILISING ROLE FOR AGGREGATE FISCAL
POLICY THROUGH THE NOTION OF “A EURO AREA FISCAL STANCE” – BUT IN VAIN

CRITICISM AND REVISIONS OF THE SGP 1999-2008

THE FIRST DECADE OF EMU APPEARS, IN RETROSPECT, RELATIVELY HARMONIOUS DESPITE THE JOINT GERMAN-FRENCH ATTACK ON THE SGP IN 2003

ONE EXPLANATION FOR "HARMONY" WAS THE OVERSTRETCH AND WEAK PUBLIC FINANCES IN GERMANY, WHERE PUBLIC DEBT GREW IN STEP WITH THAT OF FRANCE – THERE WAS LESS OF A CREDITOR-DEBTOR DIVIDE IN THIS FIRST DECADE THAN LATER

THE 2005 SGP REFORM REPAIRED THE POTENTIALLY PRO-CYCLICAL NATURE OF THE HEADLINE DEFICIT AS THE MAIN POLICY INDICATOR (FOR COUNTRIES WHO REGARDED IT AS A TARGET RATHER THAN A CEILING)

BUT THE STRUCTURAL DEFICIT WHICH REPLACED IT FOR THE PREVENTIVE ARM WAS/IS UNOBSERVABLE AND SUBJECT TO MAJOR REVISIONS

CRITICISM AND REVISIONS (ctd.)

THE SECOND HALF OF THE DECADE WAS INCREASINGLY MARKED BY THREE OMISSIONS IN FISCAL SURVEILLANCE:

- UNDERESTIMATION OF THE STRENGTH OF THE UPSWING RELATIVE TO POTENTIAL GROWTH, NOTABLY BY NATIONAL GOVERNMENTS;
- DISREGARD OF GROWING CURRENT ACCOUNT IMBALANCES INSIDE EMU, DESPITE THE GOOD HABIT TO MONITOR THEM CLOSELY IN THE PREVIOUS EMS-REGIME – AND THE EFFORTS OF ECB PRESIDENT TRICHET TO KEEP THAT HABIT ALIVE; AND,
- THE RISK THAT A REVERSAL OF THE CAPITAL FLOWS WHICH HAD FINANCED THE CURRENT DEFICITS COULD UNDERMINE EVEN VIRTUOUS-LOOKING PUBLIC FINANCES

THE EERP AND THE SIX- AND TWO-PACKS

AN EARLY PHASE OF LIQUIDITY TENSIONS IN 2007 WAS SO SMOOTHLY HANDLED BY THE ECB THAT FISCAL POLICY-MAKERS REMAINED RATHER RELAXED DURING MOST OF 2008

THE MAJOR DOWNTURN IN PROSPECT FROM SEPTEMBER 2008 WAS HANDLED THROUGH THE ONLY EXAMPLE OF A MAJOR COUNTER-CYCLICAL EFFORT IN EMU HISTORY – THE EERP WITH A 1,5% OF GDP BOOST FOLLOWING A SUSPENSION OF THE SGP RULES

THE AGGREGATE SIZE OF THE EERP WAS NOT INAPPROPRIATE, BUT THE EFFORT WAS INSUFFICIENTLY DIFFERENTIATED BETWEEN EMU-PARTICIPANTS; TOO MUCH OF THE STIMULUS CAME IN VULNERABLE COUNTRIES

THE EERP AND THE 6-2 PACKS (ctd.)

THE COMBINED IMPACT OF THE DOWNTURN AND THE EERP WAS A JUMP IN THE DEBT RATIO IN EMU FROM THE STEADY LEVEL OF 60% PRE-CRISIS TO 90% OF GDP IN 2010

TOGETHER WITH THE DRAMATIC WORSENING OF GREEK PUBLIC FINANCES, THE TENSIONS IN FINANCIAL MARKETS, AGGRAVATED BY THE PROSPECTS OF DEBT RESTRUCTURING, DETERMINED THAT THE MAIN THRUST OF THE SGP REVIEW FROM 2010 ON HAD TO REEMPHASISE SUSTAINABILITY AS THE PRIMARY ELEMENT IN THE FISCAL RULES

THE SURVEILLANCE PROCESS WAS INTENSIFIED AND STREAM-LINED THROUGH THE EUROPEAN SEMESTER, THE GUIDELINES FOR DEBT REDUCTION WERE MADE MORE OPERATIONAL, AND VOTING IN THE EUROGROUP WAS REDSIGNED TO REINFORCE THE COMMISSION'S ROLE AS A "GUARDIAN OF THE TREATY" APPLYING ITS RULES

THE FILLING IN OF MISSING PIECES

THE TIGHTENING OF THE SGP, FULLY OPERATIONAL AT THE START OF 2013, CONTRIBUTED TO THE DOUBLE-DIP RECESSION OF 2011-13, MAKING THIS PERIOD A MAJOR EXAMPLE OF PRO-CYCLICALITY

- SIMULTANEOUS CONSOLIDATION IN MOST EMU-COUNTRIES AGGRAVATED THE CONTRACTION AS DID THE APPROACH TO THE EFFECTIVE LOWER BOUND (ELB)
- THE LEGACY OF VULNERABILITIES FROM PRE-CRISIS YEARS AND FROM THE EERP FURTHER DELAYED RECOVERY

THE 6-2Ps WERE ACCOMPANIED – AND MADE ACCEPTABLE - BY THE FILLING-IN (FROM 2012 ON) OF THREE MISSING PIECES :

MISSING PIECES (ctd.)

- A LOWERING OF FINANCIAL RISKS TO PUBLIC FINANCES BY EARLY STEPS TOWARDS BANKING UNION (WITH SSM, THE JOINT SUPERVISION PLACED AT THE ECB)
- THE SET-UP OF A SAFETY NET THROUGH AN INTER-GOVERNMENTAL INSTITUTION (ESM) TO PROVIDE CONDITIONAL LOANS TO GOVERNMENTS THAT WERE LOSING ACCESS TO FINANCIAL MARKETS
- THE OFFICIAL MONETARY TRANSACTIONS (OMT) DECISION BY THE ECB TO INDICATE WILLINGNESS TO BUY SOVEREIGN BONDS, CONTINGENT ON THE ISSUER UNDERGOING AN ESM ADJUSTMENT PROGRAMME

WITHOUT THESE FINANCIAL/MONETARY STEPS IT IS HARD TO BELIEVE THE SGP COULD HAVE SURVIVED – IN A CLIMATE OF REDENOMINATION AND DEFLATION RISKS

HOW HAVE THE FISCAL RULES WORKED IN RECENT YEARS – AND CAN THEY BE REFORMED?

THE EUROPEAN COMMISSION IS LEGALLY MANDATED TO PRODUCE AN ASSESSMENT OF THE FISCAL RULES BY THE END OF 2019 (NOW SLIGHTLY DELAYED BY TRANSITION)

PRESIDENT JUNKER ASKED THE EFB TO PROVIDE INPUT INTO THAT EXERCISE AND WE PUBLISHED OUR “ASSESSMENT REPORT” IN SEPTEMBER, PRESENTING IT TO THE COLLEGE OF COMMISSIONERS, TO THE ECOFIN COUNCIL AND TO THE EP ECON COMMITTEE

WE WERE CHALLENGED BY THE THREE-DIMENSIONAL CRITERIA OUTLINED BY PRESIDENT JUNKER AS THE BASIS FOR OUR EVALUATION – HE ASKED :

REFORMING THE FISCAL RULES (ctd.)

- HAVE THE RULES ENSURED SUSTAINABILITY OF PUBLIC FINANCES?
- HAVE THE RULES PROMOTED COUNTER-CYCLICAL STABILISATION – OR AT LEAST MINIMISED PRO-CYCLICAL EXPERIENCES?
- HAVE THE RULES IMPROVED THE QUALITY OF PUBLIC FINANCES?

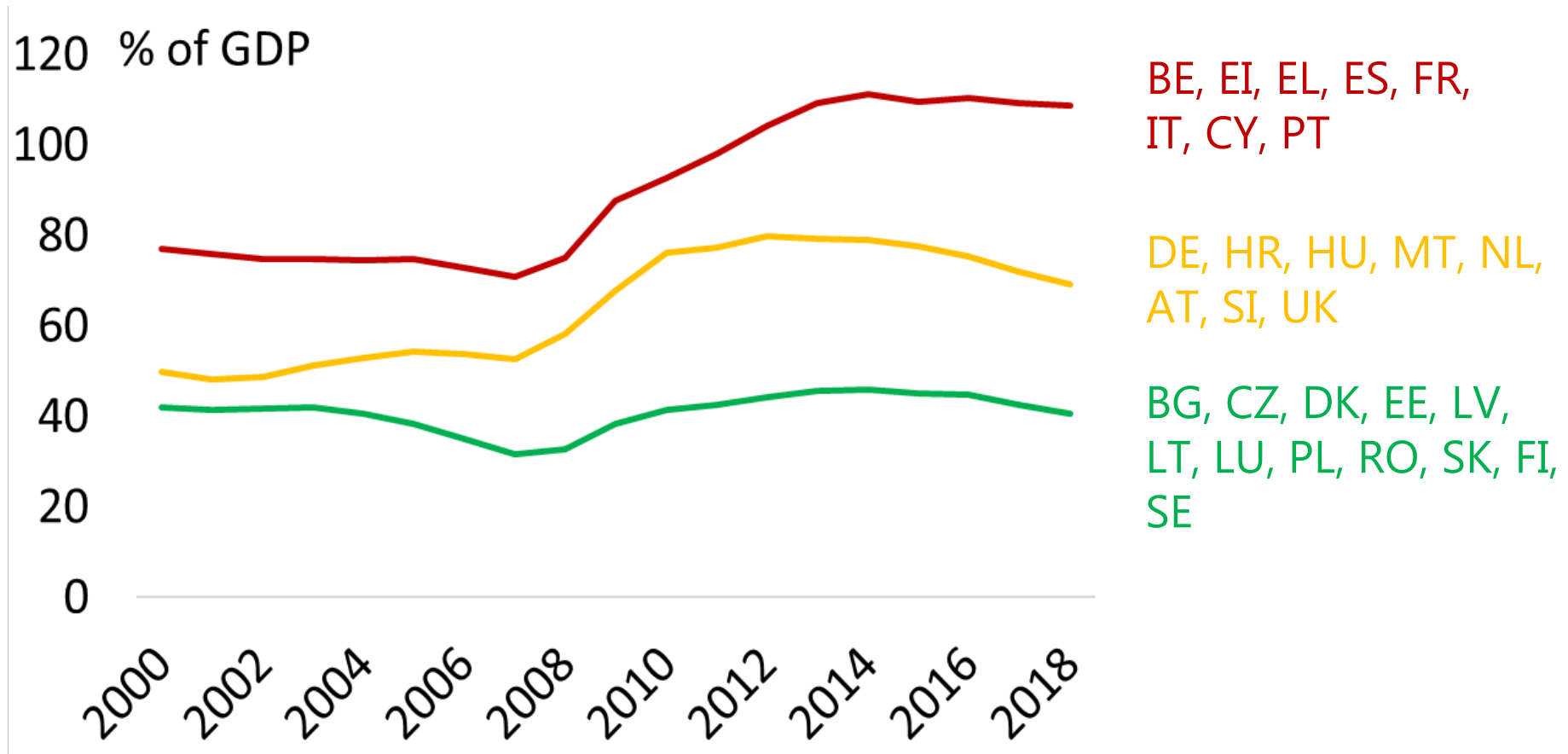
THESE THREE CRITERIA GO BEYOND THE EMPHASIS ON THE FIRST ELEMENT BY THE ARCHITECTS OF THE REFORMS A DECADE AGO – AS SEVERAL OF THESE OFFICIALS CONFIRMED TO US IN INTERVIEWS, BUT THEY DO REFLECT THE FLEXIBILITY WHICH THE COMMISSION WAS LEFT WITH - AND IMPLEMENTED FROM 2015 ONWARDS

REFORMING THE FISCAL RULES (ctd.)

THE EFB'S ANSWERS TO THE THREE QUESTIONS WERE, AS A VERY ROUGH SUMMARY :

- *SUSTAINABILITY* HAS BEEN GREATLY IMPROVED SINCE 2010; HEADLINE DEFICITS REDUCED FROM 6.5 TO BELOW 1%, COMPLIANCE WITH THE RULES HAS IMPROVED, EXCEPT WITH RESPECT TO DEBT REDUCTION – BUT PROGRESS REMAINS UNEVEN WITH 6-7 EMU COUNTRIES ABOVE A 90% DEBT RATIO, SEE GRAPH 1
- THE RECOVERY WHICH STARTED IN LATE 2013 WAS STIMULATED BY MONETARY ACCOMODATION HAS MADE A MAJOR CONTRIBUTION TO IMPROVE PUBLIC FINANCES
- FOUR COUNTRIES NEVER SUBMITTED A FULLY-COMPLAINT DRAFT BUDGET 2014-2019

GRAPH 1: Average debt-to-GDP ratio

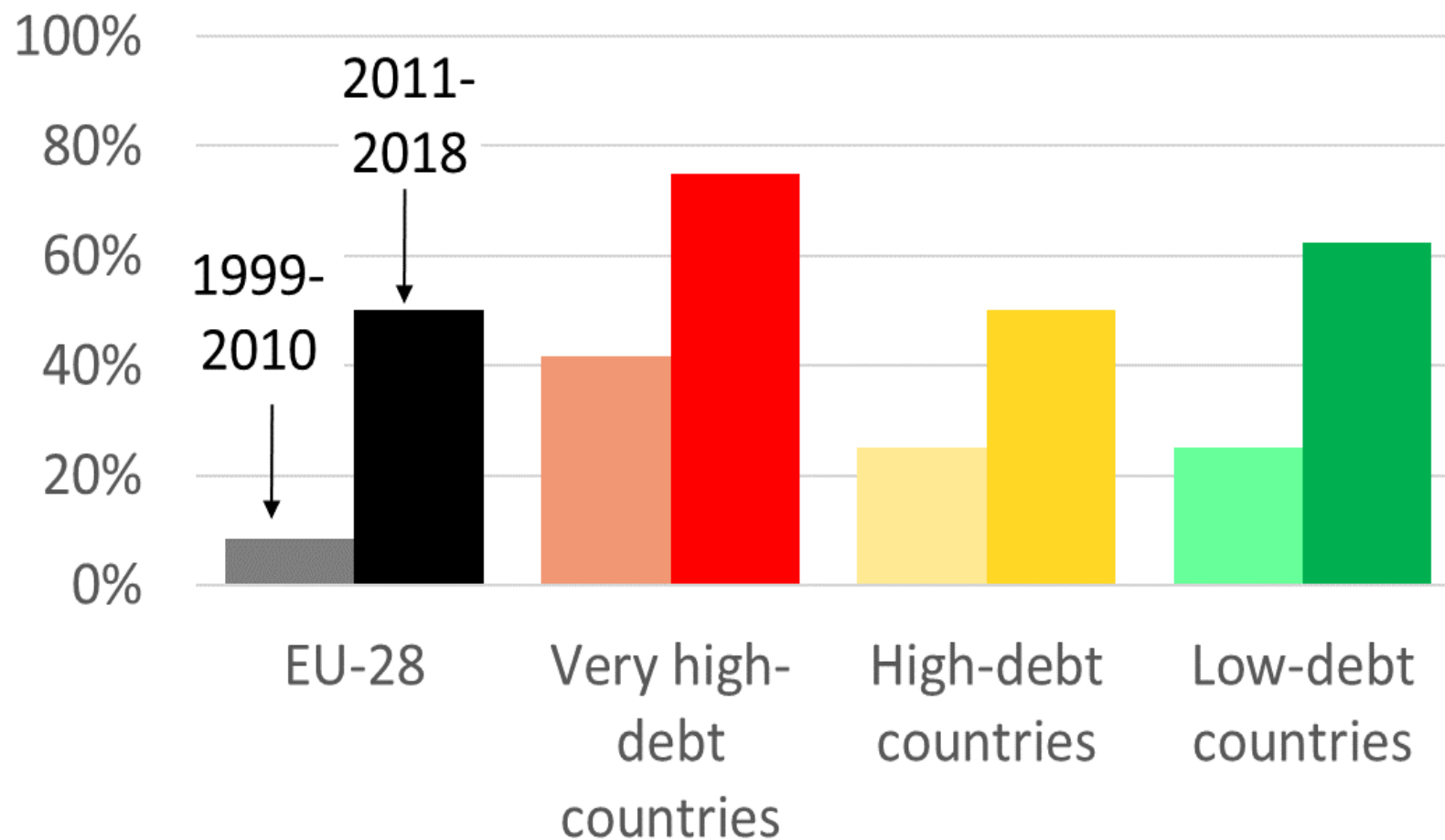


Note: Countries are grouped based on their average debt levels in 2011-2018.

REFORMING THE FISCAL RULES (ctd.)

- *COUNTER-CYCLICAL STABILISATION* HAS NOT BEEN OBSERVED SINCE THE 6-2Ps, AND THERE WAS A MAJOR PRO-CYCLICAL PHASE 2011-13; THE FREQUENCY OF PRO-CYCLICALITY HAS RISEN SINCE 1999-2010, SEE GRAPH 2
- SINCE THEN AGGREGATE FISCAL POLICY HAS BEEN “BROADLY NEUTRAL”, i.e. WITHIN A BAND OF $\pm 0.25\%$ CHANGE IN THE STRUCTURAL BUDGET BALANCE, MISSING A MAJOR OPPORTUNITY TO CONSOLIDATE, AS THE RECOVERY STRENGTHENED IN 2017-18
- IN THE REGIME OF VERY LOW AND STABLE INTEREST RATES THE SPILL-OVER EFFECTS OF NATIONAL FISCAL POLICIES HAVE BECOME CLEARLY MORE POWERFUL THAN ASSUMED WHEN THE RULES WERE DESIGNED, ENHANCING THEIR POTENTIAL ROLE IN STABILISATION

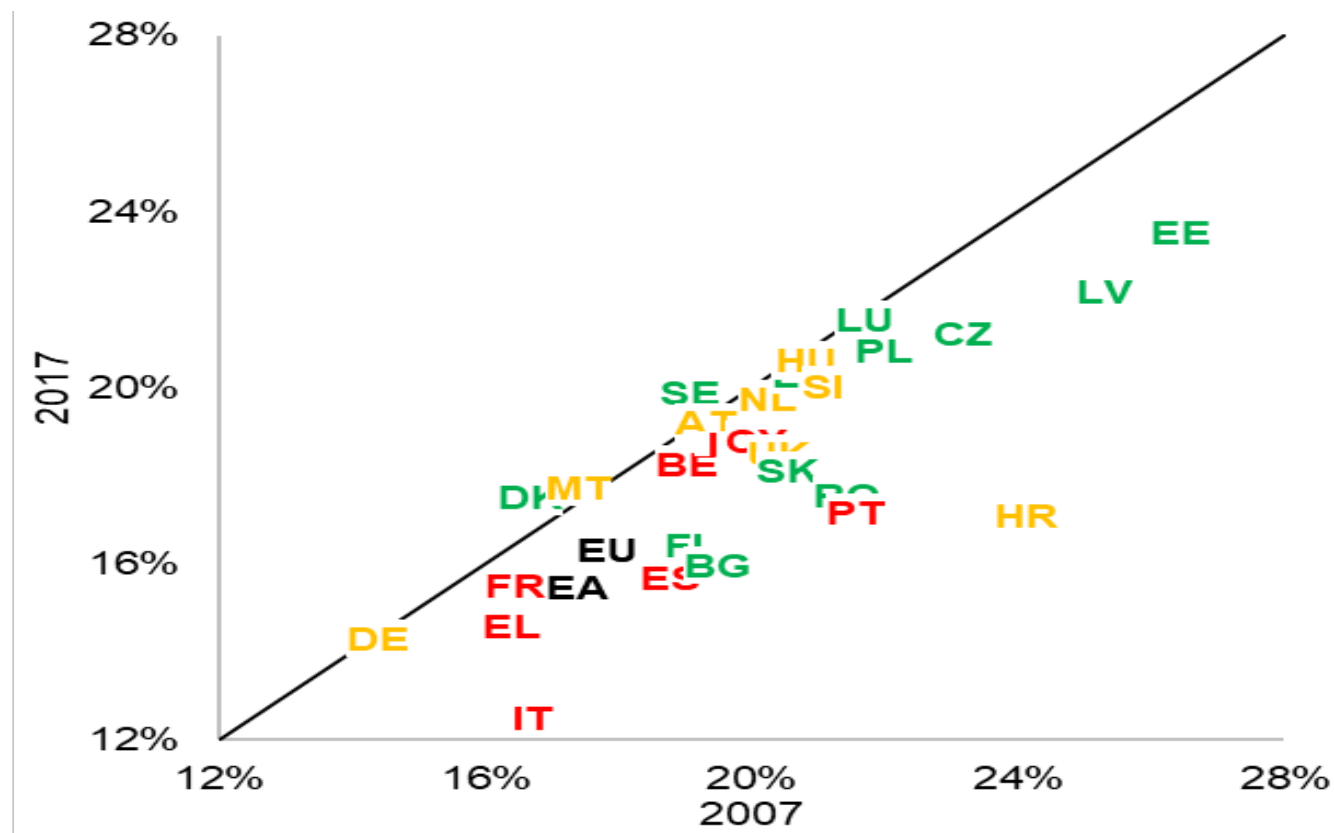
GRAPH 2: Frequency of fiscal policies in a pro-cyclical direction



REFORMING THE FISCAL RULES (ctd.)

- *THE QUALITY OF PUBLIC FINANCES* HAS NOT IMPROVED – IN THE SENSE THAT GROWTH-ENHANCING EXPENDITURES WERE REDUCED IN THE CRISIS YEARS RELATIVE TO CURRENT EXPENDITURES – AND THEY HAVE NOT RECOVERED AS A SHARE OF GDP (OR OF TOTAL PUBLIC EXPENDITURES), SEE GRAPH 3
- THE FLEXIBILITY PROVISIONS LINKED TO INVESTMENT SINCE 2015 HAVE PROVED INAPPLICABLE AT A TIME OF RECOVERY AND DIMINISHING OUTPUT GAPS – NO COUNTRY WAS ESTIMATED TO HAVE A NEGATIVE GAP WORSE THAN 1.5% OF GDP IN THE MOST RECENT YEARS

GRAPH 3: Productive public expenditure as share of total public expenditure, 2017 versus 2007



Note: Productive public expenditure includes expenditure on R&D, education and transport (COFOG classification).

REFORMING THE FISCAL RULES (ctd.)

TRYING TO ACHIEVE THREE BROAD AND FREQUENTLY CONFLICTING OBJECTIVES SEEMS OVERAMBITIOUS, PARTICULARLY IN THE ABSENCE OF ANY CENTRAL FISCAL CAPACITY AND AUTHORITY TO "COORDINATE", i.e. DIFFERENTIATE NATIONAL RECOMMENDATIONS AND MAKE THEM MORE SYMMETRIC

THE COMMISSION'S EFFORTS TO IMPLEMENT – SO FAR WITHOUT DISAPPROVAL FROM THE COUNCIL/EUROGROUP – THE RULES FLEXIBLY HAVE BEEN WELL-INTENTIONED, BUT SOMEWHAT LACKING IN ECONOMIC PRINCIPLES AND EFFECTIVENESS

RATHER THAN ADDRESSING MORE EXPLICITLY THE TRADE-OFFS BETWEEN OBJECTIVES, FLEXIBILITY HAS BEEN APPLIED IN AN OPAQUE, PIECE-MEAL WAY : BY REINTERPRETING POLICY INDICATORS, BY ACCEPTING A PRIORI "BROAD COMPLIANCE", AND BY ALLOWING FUTURE COMMITMENTS TO REPLACE CURRENT ACTION, e.g. IN THE CASE OF ITALY

REFORMING THE FISCAL RULES (ctd.)

MAIN WEAKNESSES OF THE CURRENT RULES IDENTIFIED:

- PUTTING EXCESSIVE RELIANCE ON UNOBSERVABLE POLICY INDICATORS – IN REAL TIME, OFTEN EVEN EX POST DUE TO MAJOR REVISIONS – AND ALLOWING CHERRY-PICKING BETWEEN INDICATORS (STRUCTURAL BALANCE AND EXPENDITURE BENCHMARK)
- FOSTERING AN ANNUAL, RATHER THAN A LONGER-TERM PERSPECTIVE, HENCE ENCOURAGING BACK-LOADING OF FISCAL ADJUSTMENTS OVER 3-4 YEAR PLANS
- DEVELOPING FACING INCREASINGLY BILATERAL SURVEILLANCE PROCEDURES RATHER THAN RELIANCE ON MULTILATERAL PEER PRESSURE IN THE COUNCIL/EUROGROUP
- ACCEPTING A LACK OF SUPPORT FOR APPLYING SANCTIONS (AND THE INADEQUACY OF EXISTING FINANCIAL SANCTIONS)

REFORMING THE FISCAL RULES (ctd.)

THE MAIN EFB PROPOSALS ARE:

- TO ACHIEVE SIMPLIFICATION IN REACHING THE ORIGINAL SUSTAINABILITY OBJECTIVE, DEFINE FOR THE VERY-HIGH-DEBT COUNTRIES A NET-EXPENDITURE GROWTH BENCHMARK LOWER THAN THE LONG-TERM POTENTIAL GROWTH RATE TO TARGET A DECLINING PATH FOR THE DEBT RATIO PATH OVER A LONG HORIZON
- TO PROTECT AGAINST MAJOR PRO-CYCLICAL POLICIES, DEFINE A GENERAL ESCAPE CLAUSE TO BE APPLIED PARSIMONIOUSLY STARTING FROM ECONOMIC CRITERIA
- TO DESIGN A LIMITED/TARGETED GOLDEN RULE TO PROTECT CATEGORIES OF NEW/NET PUBLIC INVESTMENT OF EU PRIORITY; e.g. DIGITAL INFRASTRUCTURE, MITIGATION OF CLIMATE CHANGE

THE FUTURE MACROECONOMIC POLICY MIX

THE INITIAL CONCERN IN PLANNING FOR EMU WAS TO PROTECT THE FUTURE ECB AGAINST THE POTENTIAL FISCAL DOMINANCE OF HIGHLY-INDEBTED GOVERNMENTS

NO COORDINATION OF THE JOINT MONETARY POLICY WITH THE AGGREGATE OF FISCAL POLICIES – THE AGENDAS OF THE ECB AND OF THE EUROGROUP WERE WITHOUT OVERLAP

FOR A DECADE AND A HALF BOTH THE MONETARY AND THE POLITICAL AUTHORITIES BROADLY ACCEPTED THIS DIVISION OF LABOUR: THE ECB MADE THE OMT CONTINGENT ON AN ESM ADJUSTMENT PROGRAMME, AND UNDERTOOK ASSET PURCHASES ACCORDING TO THE ECB CAPITAL KEY, WHILE

THE EUROGROUP PAID ONLY LIP SERVICE TO THE AGGREGATE EURO AREA STANCE

THE POLICY MIX (ctd.)

HOWEVER, SINCE 2014 – THE JACKSON HOLE SPEECH OF PRESIDENT DRAGHI – THE ECB HAS ARGUED FOR A MORE EXPANSIONARY STANCE, PROPERLY DIFFERENTIATED, OF FISCAL POLICY TO ADJUST THE POLICY MIX AT A TIME OF EXTREME MONETARY EASE (ELB)

SOME EASING IS UNDERWAY IN 2019-20, NOT LEAST IN GERMANY AND THE NETHERLANDS WITH HAD SOME FISCAL SPACE

BUT UNLESS THE SLOWDOWN WORSENS SIGNIFICANTLY RELATIVE TO THE MODEST BUT STABLE OUTLOOK FOR 2020-21, NO MAJOR DISCRETIONARY STEPS SEEM LIKELY

HAVE THE OBJECTIVES OF THE ECB AND OF THE GOVERNMENTS BECOME BETTER ALIGNED? THE ECB TRIES HARD TO GET CLOSER TO 2% INFLATION, GOVERNMENTS WATCH MAINLY REAL INDICATORS, NOTABLY EMPLOYMENT – AND THEY STILL GIVE LITTLE REASON TO ACT

COULD THE GOLDEN RULE OFFER A WAY OUT TOWARDS A BETTER POLICY MIX?