Fiscal Union:
What could it mean?

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(revised version)

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Outline

1. The return of the ghosts
2. The Maastricht assignment revisited
3. Alternative stabilisation schemes
4. Conclusions

The return of the ghosts

A stabilisation mechanism…

- "A conjunctural convergence facility to extend grant finance to economically weak member states in particularly difficult economic situations" (MacDougall report, 1977)

- « A common instrument dedicated to macroeconomic stabilisation could provide an insurance system whereby risks of economic shocks are pooled across member states » (Commission communication,11/2012)
- « An insurance-type mechanism between euro-area countries to buffer large country-specific economic shocks » (Van Rompuy report, 12/2012)

..a budget..

- “A high-powered budget model for the Community which would aim at the specific needs of economic, monetary and political union”
(MacDougall report, 1977)

- « An autonomous euro-area budget providing for a fiscal capacity for the EMU to support member states in the absorption of shocks »
(Commission communication,11/2012)

… unemployment insurance

- “A Community Unemployment Fund under which part of the contributions of individuals in work would be shown as being paid to the Community and part of the receipts of individuals out of work as coming from the Community.” (MacDougall report, 1977)

- « Une capacité budgétaire propre à la zone euro, distincte du budget des 27 et financée sur des ressources autonomes, et qui aurait une véritable fonction contra-cyclique.. un socle d’indemnisation chômage en zone euro, par exemple » (Moscovici Speech, 11/2012)

“Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back”

John Maynard Keynes, 1936

Question is why?

The Maastricht assignment revisited

Maastricht assignment:

- Stabilisation role of national budgets (within limits)
- Private agents' unconstrained access to financial market

- "Loss of the monetary policy and exchange rate instrument at the national level will place new demands on budgetary policy at the national level for stabilization and adjustment purposes in the case of country-specific disturbances [..] National budgets will [..] retain their capacity to respond to national and regional shocks..."
(One Market, One Money report, 1990)
- "A major effect of EMU is that balance of payments constraints will disappear in the way they are experienced in international relations. Private markets will finance all viable borrowers, and savings and investment balances will no longer be constraints at the national level."
(One Market, One Money report 1990)

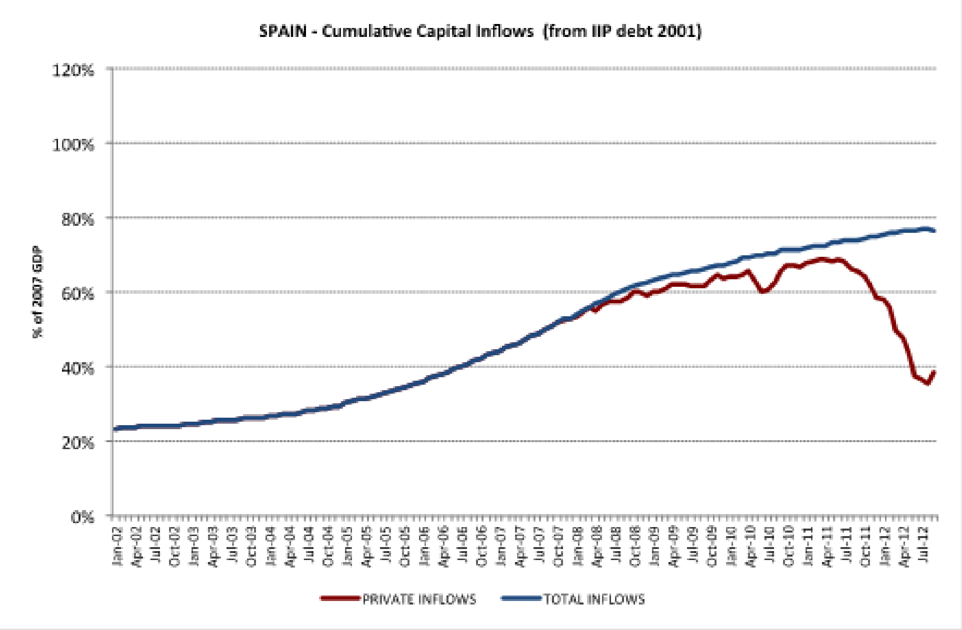
What went wrong with the Maastricht assignment?

Unforeseen developments

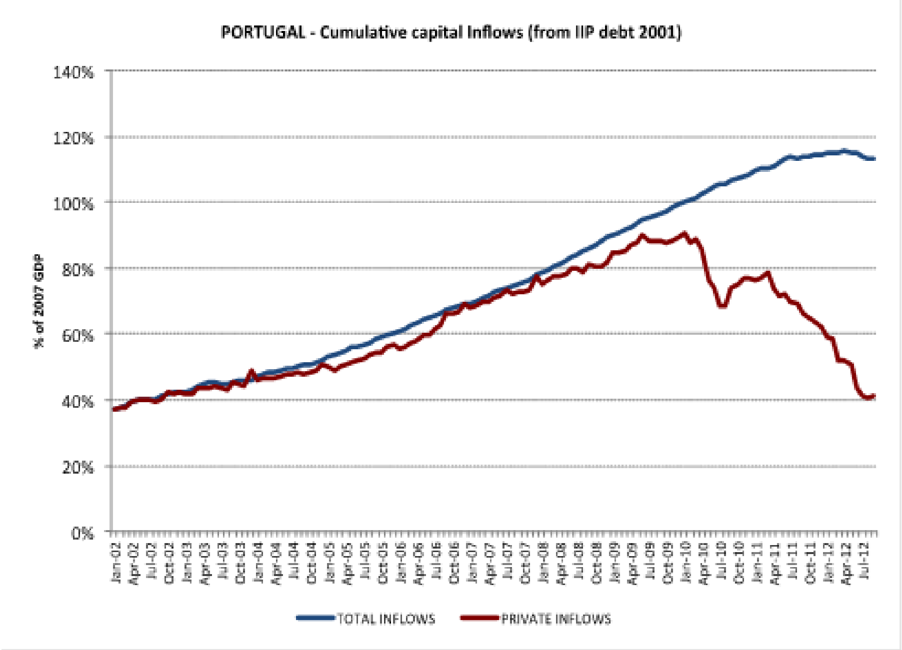
- Shocks an order of magnitude bigger than expected
- States may be cut off from access to credit market faster than expected
- Bank-sovereign loop
- Impairement of credit channel for private agents too (sudden stops)

Sudden stops (over and above sovereign crises)

Spain: private outflows = 30% of GDP



Portugal: private outflows = 45% of GDP



Capital outflows exceeded by far sell-off of sovereign bonds

The response so far: Maastricht+

- ECB liquidity to banks
  - Indispensable, major stabilisation effect
  - But short-term fix, and strengthens bank-sovereign loop
- Conditional assistance through the ESM
  - Indispensable, but intervened after state had lost market access
  - Uncertainty about treatment of insolvency
- Strengthening of fiscal framework (euro-area and national levels)
  - Indispensable, but will deliver only in the medium term
  - Experience suggests stabilisation can be impaired even if initial debt level is low
- Banking union
  - Indispensable, but will only help restore credit channel
  - Banks still vulnerable through asset side

The case for doing more

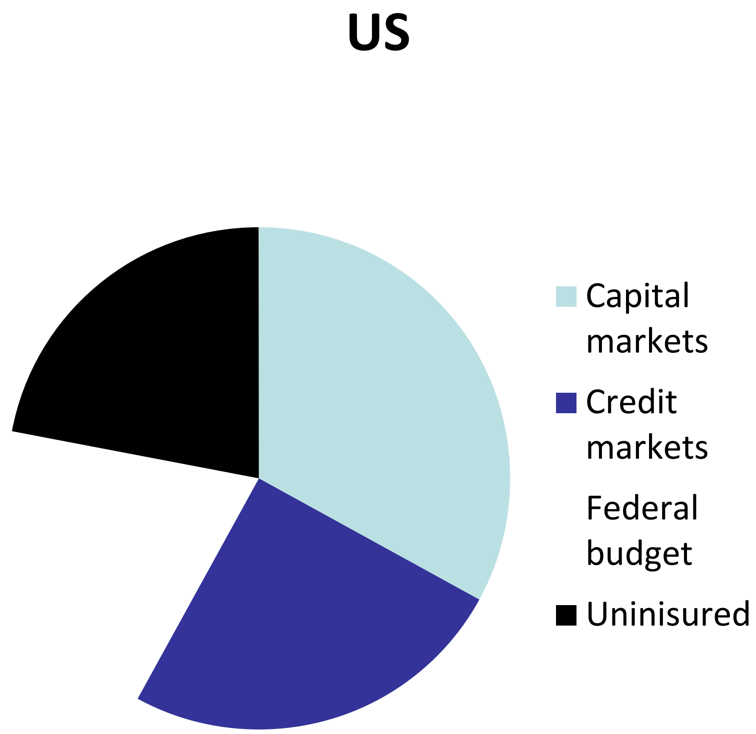
Maastricht+:

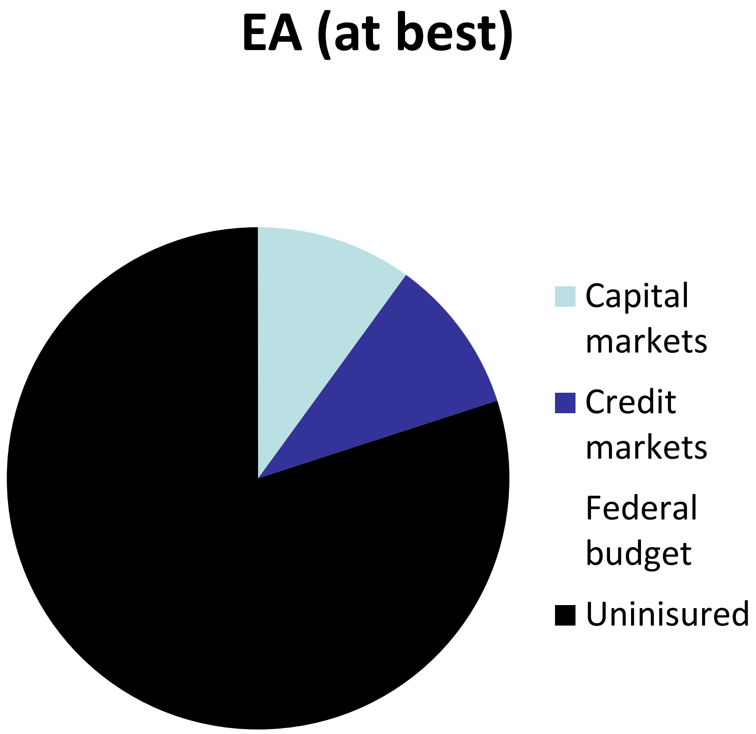
- Better prevention of risky behaviour
- Better systemic resilience
- Crisis management regime

Desirable additions

- Completion of banking union (resolution and fiscal backstop)
- Exposure limits for banks (avoid high exposure to domestic sovereign)
- Insolvency regime for sovereign (not excluding liquidity provision)
- Improve stabilisation capability

How much stabilisation of regional shocks (rough evaluation) ?





Counterarguments

Once-in-a-century events?

- 2009 shock of exceptional magnitude but subsequent developments were home-made

Maastricht+ will alleviate risk of sudden stops

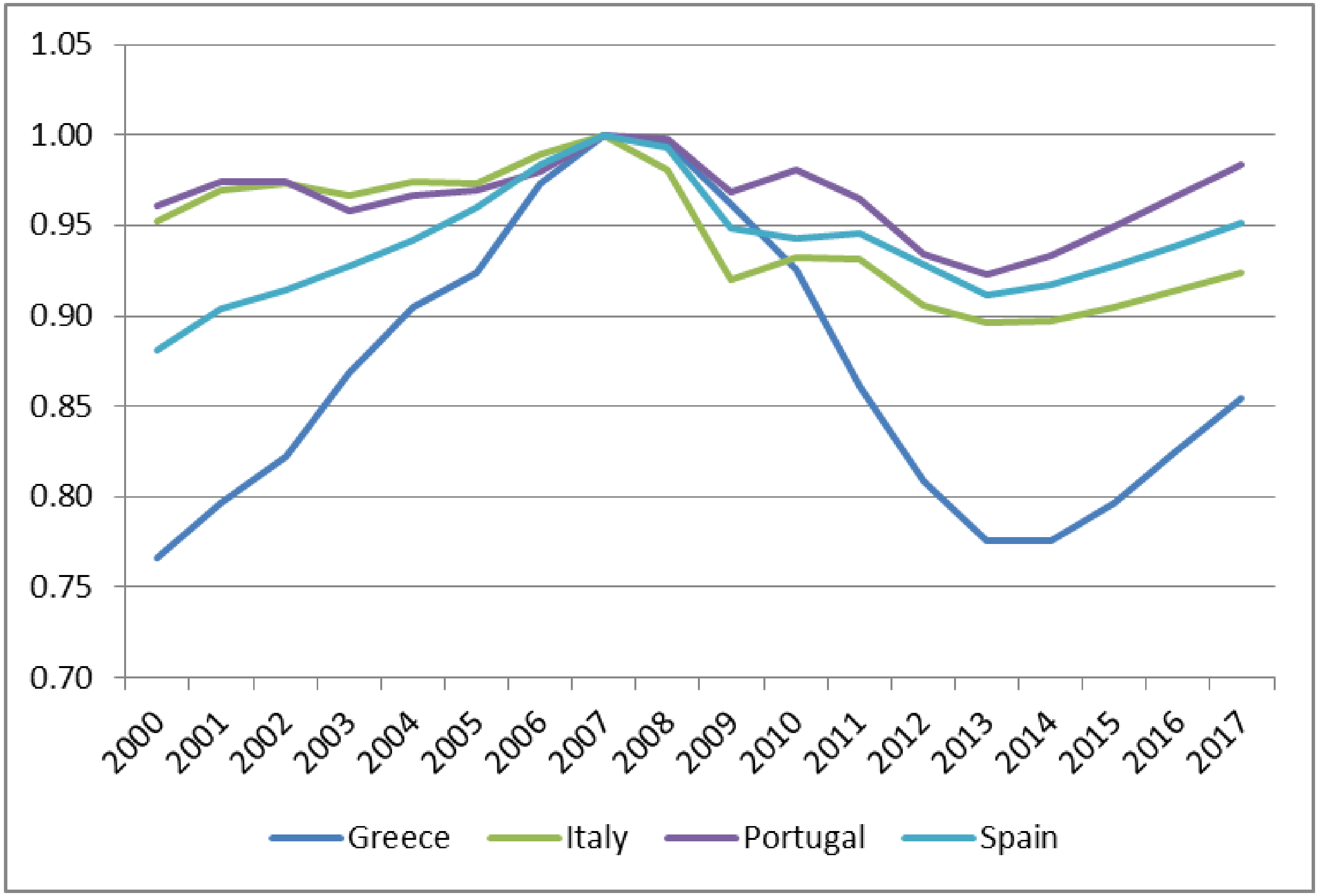
- Yes, to the extent they arose from redenomination risk (no clear evidence)
- Yes, to the extent banking union addresses sovereign-bank loop

But long shadow of crisis

- High public debt levels
  - 6 EA members with debt above 100% of GDP in 2014
  - 2 others with debt above 90%)
- Widespread debt renationalisation and strengthening of bank-sovereign interdependence

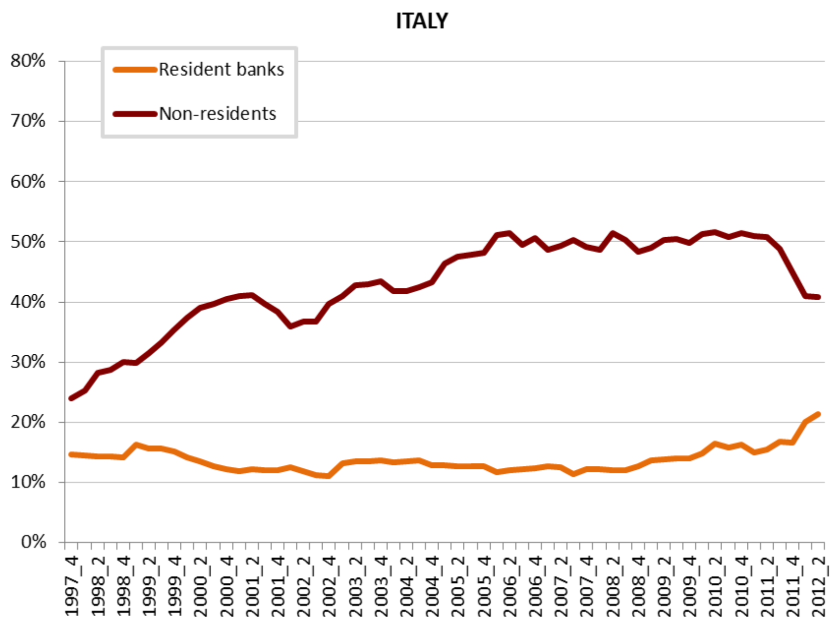
2009 was just the beginning..

Real GDP per capita, 2007-2017 (IMF WEO database, Oct. 2012)



Shares of public debt held by non-residents and by domestic banks

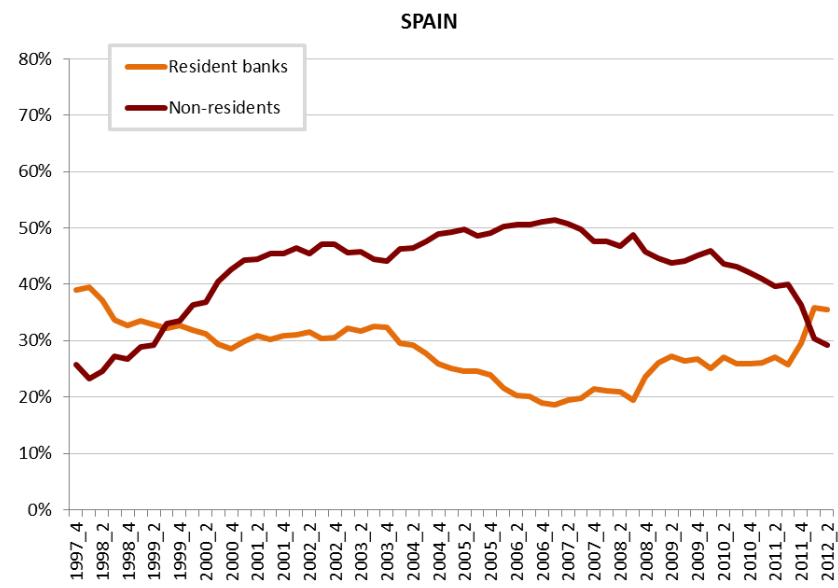
Italy



Bonds held by domestic banks:

- €168bn in June 2007
- **€364bn** in June 2012

Spain



Bonds held by domestic banks:

- €71bn in June 2007
- **€235bn** in June 2012

Alternative stabilisation schemes

(i) A small, high-power euro-area budget

- Ex: support for unemployment expenditures financed with a federal corporate tax

(ii) A support scheme based on deviations from potential output

- Triggers federal contributions or transfers
- Example: scheme to stabilise 25% of output gap above 2% of GDP

(iii) GDP-indexing of government bonds (debt as equity)

- Amount of the principal to be repaid depends on output growth
- If growth disappoints, value of debt reduced

(iv) Quotas for the issuance of mutually guaranteed debt

- Recourse to limited federal borrowing during financial market volatility

A small, high-power euro-area budget

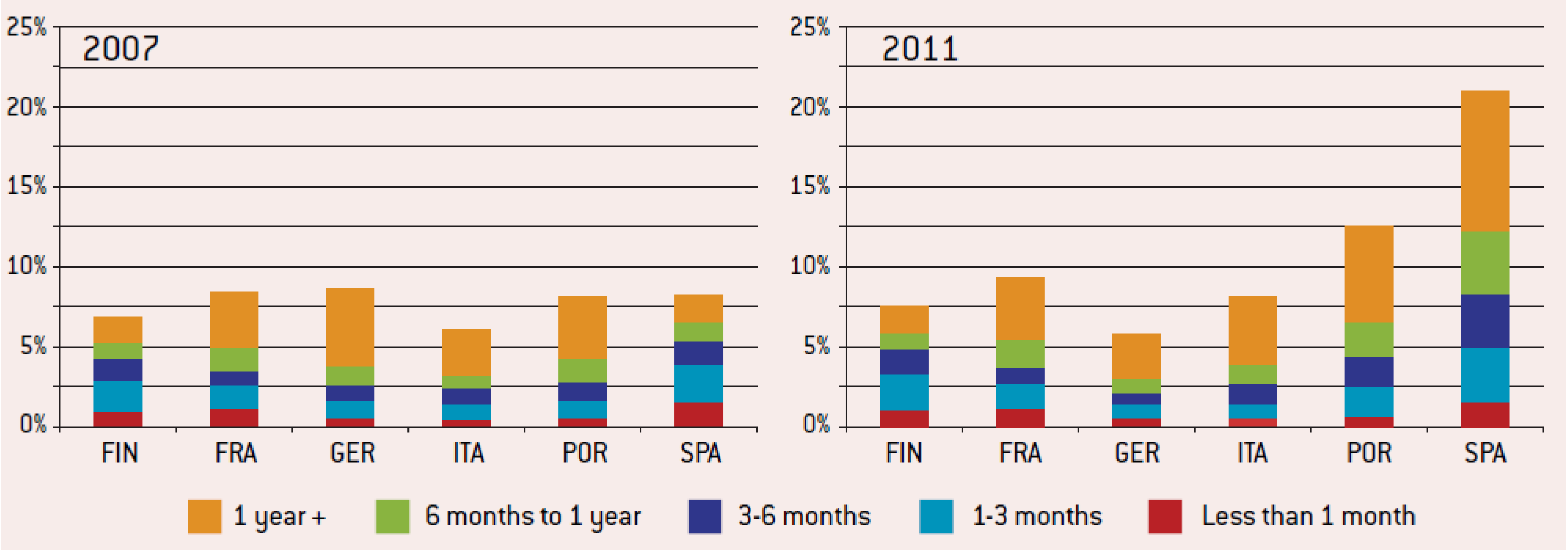
Advantages

- Tested solution: macro support as side-effect of public finances

Drawbacks

- Which are the euro-area public goods? (politically controversial)
- High power = high elasticity = prone to volatility of aggregate balance
- Undesirable distributional biases + undesirable incentive properties
- Still limited stabilisation

Unemployment by duration in selected euro-area countries



Source: Bruegel based on OECD unemployment data.

A pure stabilisation mechanism

Design

- Net transfers = 25% of output gap above 2% of GDP

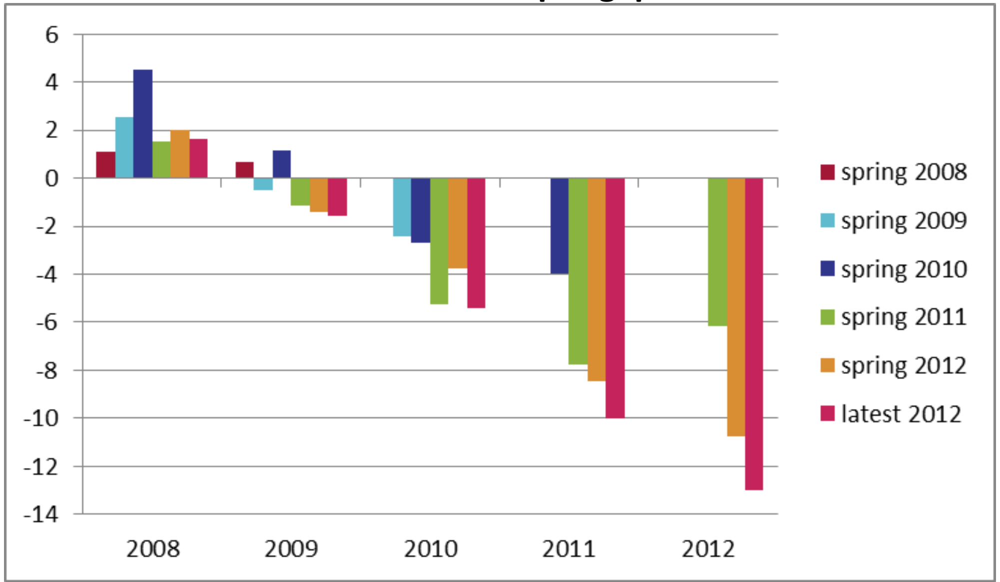
Advantages

- Designed to stabilise
- Symmetric effects (tax on booms)
- Maximises bang for the buck

Drawbacks

- Based on unobservable estimates
- Real-time uncertainty
- Distributional effects?

Real-time and ex-post Commission estimates of Greek output gap



GDP-indexed bonds (debt as equity)

Design

- Up to 30% of GDP of GDP-indexed bonds (issued in good times)

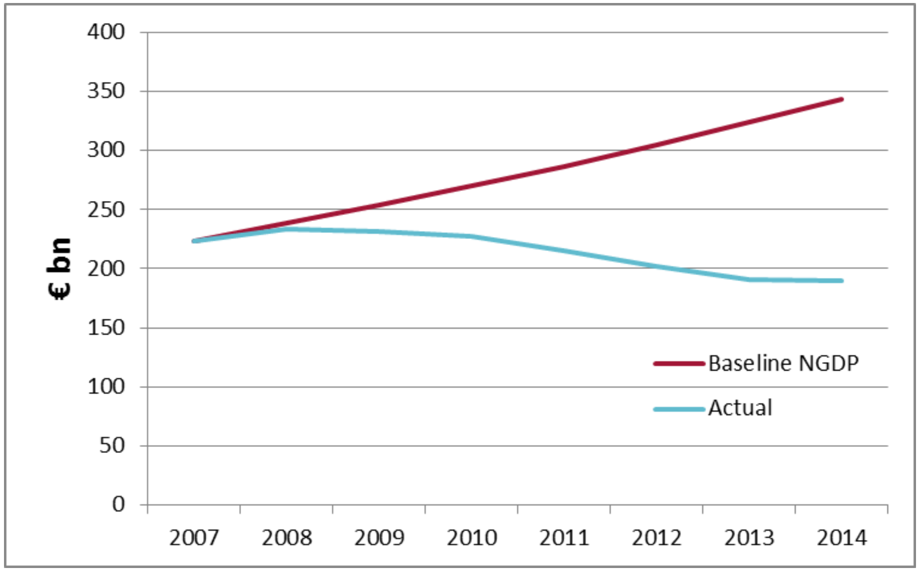
Advantages

- Recognises risky character of debt in a monetary union
- Automatic restructuring

Drawbacks

- Higher cost of borrowing
- Aggregate stabilisation only from non-resident holdings
- Financial stability?

Greece: projected (WEO) and actual GDP



Quotas for issuance of mutually guaranteed debt

Design (adapted from Enderlein et al. 2012)

- Unconditional issuance for all (10% of GDP) for liquidity
- Unconditional additional tranche (20% of GDP) subject to interest-rate premium
- Low-conditionality third tranche
- Then ESM

Advantages

- Rescues Maastricht assignment (no transfers)
- Continuum from independence to programme (à la IMF facilities)

Drawbacks

- High initial debt
- Segments bond market
- Eurobonds (controversial)

Simulations (VERY rough)

Reduction in 2014 debt ratio for alternative stabilisation schemes

Country	Euro-area budget	Automatic transfer scheme	Debt as equity	Guaranteed bonds quota
Greece	-1.2	14.4	12.0	4.4
Ireland	11.1	2.6	5.3	3.1
Portugal	-0.5	4.4	4.3	3.2
Spain	10.6	6.2	5.3	2.4
"Southern country"	5.7	6.7	7.8	3.4

Especially rough for unemployment insurance
Bond quota impact: interest-rate effect only

Summing up

	Euro-area budget	Automatic transfer scheme	Debt as equity	Guaranteed bonds quota
Principle	Automatic stabilization role of federal budget	Transfers based on deviation of output gap from EA average	Transfers based on deviation of output gap from EA average	Right to issue jointly guaranteed bonds (several tranches with increased withdrawal of sovereignty
Origin of stabilisation	Income transfer from partners	Income transfer from partners	Wealth transfer from (non-resident) bondholders	Borrowing capacity, mutualisation of default risk
Advantages	-True budget	-Maximises stabilization power for any given level of contributions - Symmetric	-Recognises risky character of government debt	-Builds on Maastricht logic that stabilization is done nationally -Continuum with assistance
Drawbacks	-Difficulty to agree on euro-area public goods. -High elasticity implies that budget balance prone to volatility -Large variations across countries -Incentive effects	-Relies on technical potential output assumptions. -Real-time estimates uncertainty -Distributional effects?	-Untested instrument -Increases cost of borrowing for sovereigns -Macro stabilisation comes from non-resident holdings only	-Requires controversial Eurobonds -High initial debt level may impair stabilisation -Limited stabilisation impact

Issues for discussion

Permanent regime vs. transition

Permanent regime: lesser need for stabilisation mechanisms

- Low national public debt
- Full banking union
- Stronger market integration (products, capital, labour)

Transition: more need but more difficulties

- Interference with discipline requirements
- Interference with reform requirements (contractual or automatic transfers?)
- Bond market segmentation/subordination issues

Conclusions

Issue remains of major importance (even if put aside by European Council)

Maastricht assignment not effective enough

But no solution dominates the other ones

- Budget desirable in its own right, but will be slow and of limited effect
- Automatic transfer scheme: feasible?
- Debt as equity: hard to introduce
- Guaranteed bonds a logical development, but controversial and limited

References

- Enderlein, Henrik, et al. (2012), « Completing the euro: A roadmap towards fiscal union in Europe », report of the Padoa Schioppa group, Notre Europe, June 2012.
- Pisani-Ferry, Jean, Erkki Vihriälä and Guntram Wolff (2012), « Options and rationale for an integrated budgetary framework », Note for the European Parliament's ECON Committee, December 2012
- Wolff, Guntram (2012), « A budget for Europe's monetary union », *Bruegel Policy Contribution* 2012/22, December