Speech at York Fiscal Policy Symposium - The future of the EU fiscal framework – rules, markets and what else?

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The future of the EU fiscal framework – rules, markets and what else?[1]

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It is a great pleasure to participate in this conference and talk about the future of the EU fiscal framework. Although this is of course timely, it is also a long-standing issue. Several of the distinguished speakers and participants in this symposium have worked on this topic for decades. Thinking back to my own modest contribution to the academic world, I finished my PhD 18 years ago studying budget rules and budget processes in US states. The objective was to understand what could be learned for the future of the euro area fiscal framework. Over the last six years – which could be considered a personal “irony of history” – I have had the honour of helping build up the European crisis resolution framework: the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). These institutions have preserved the integrity of the euro area throughout the sovereign debt crisis – a crisis that should never have happened had the euro area fiscal framework worked as its founders envisaged. Against this background, the title of today's panel "The future of the EU fiscal framework" inevitably requires us to look at the past and assess where we have succeeded as well as where we have failed, and examine the lessons learned.

The objective of the European fiscal framework has always been to enhance the stability and resilience of countries' public finances, in particular of the euro area and its Member States. We need a combination of measures to enhance institutional robustness. As the fable says: *You can break a stick, but you cannot brake a bundle*. More importantly, however, in the post-UK referendum world, we need a package of measures that can gain legitimacy and support across a wide range of European constituencies. The package has to strike the right balance between control and support as well as between risk sharing and risk reduction. To move towards a better framework we should be confident that it incentivises proper economic behaviour in all member countries and reduces moral hazard. In short, we cannot achieve further fiscal integration unless everybody is (made) accountable. How do we do that?

Broadly speaking we could take a three-pronged approach. First, we can improve the existing rules-based framework, make it more watertight and backed by better institutional ownership. Second, we can in a cautious manner reinvigorate market forces. And third, we can consider developing a necessary element of risk sharing. Let me explain to you how I think the three elements add up to a robust, and hopefully compelling, bundle of measures that moves Europe forward.

1/ Fiscal rules and institutions

First, let me briefly reflect on past developments, as an analysis of the measures already taken represents a necessary starting point for any discussion on what should be done to improve our institutional framework in the future.

Over the last few years, Europe has invested considerable work into improving fiscal policy governance at the euro area level. The initiatives have focused mainly on increasing the flexibility and effectiveness of the already existing framework. The changes to the framework centre on four aspects. First, the rules were modified to focus more strongly on the debt trajectory and to inject more flexibility into the deficit rule. The possibility of taking exceptional circumstances into account was evidently vital during the crisis years. Second, a regime of ex-ante coordination was created with the European semester, shifting the focus from pure ex-post assessment. Now, EU Member States must submit their budgetary plans to the European Commission before they are adopted. Third, the fiscal regime was tightened. Some decisions can now only be overturned when a majority of Member States opposes the views and recommendations of the European Commission in the Council. Finally, the system of ex-post monitoring and sanctioning was strengthened. Countries can be put under enhanced surveillance when they have left an adjustment programme and in other circumstances, which allows the European Commission to closely scrutinise economic and budgetary developments. Sanctions can be imposed faster.

In addition, there was a deliberate attempt to increase national ownership. The so-called Fiscal Compact, which 25 Member States signed, required countries to put European fiscal rules into national law and install councils of fiscal experts as monitoring and policy advisory entities. It also strengthened the enforceability of the framework through the European Court of Justice. The beneficial effects of the legislation adopted so far lie mainly in raising fiscal awareness and helping voters better understand fiscal policies and budgets, thereby supporting public scrutiny and political accountability.

Despite all these efforts, the complexity of the rules and a politicised decision-making process hamper the effectiveness of the whole framework. We should try to improve both dimensions.

Good rules have a better chance of being implemented. Complex and counterintuitive rules are less likely to be implemented because they cause communication problems and create resistance. The amendments made in response to the crisis have made the fiscal rules too complicated. Under the preventive and corrective arm of the Stability and Growth Pact, there are debt vs deficit, structural vs nominal, level vs change-related benchmarks and ex-ante vs ex-post or bottom-up vs top-down assessments. Given this complexity, the European Commission felt the need to issue a matrix clarifying the sustainability related needs and how to assess them under different economic conditions. The Five Presidents' report includes some measures to streamline procedures and provide more explanation, but they do not yet address the fundamental problem.

Policymakers have started debating whether to use the debt rule as the fiscal framework's long-term anchor and apply an operational expenditure rule. Such rules could be introduced within the corrective arm as new assessment methods. 'Outside' stakeholders and the general public are likely to better understand the expenditure base rule for two reasons. First, it could make the assessments and requested policy action more predictable. Second, expenditure rules represent an operational and easy-to-measure target in setting an upper limit for (the growth rate of) government expenditure.

- Such a rule could usefully guide Member States in preparing their budgets and monitoring their execution.
- It could further increase consistency between the preventive and corrective arms of the Pact since both arms would use the same types of indicators.
- At the same time, it is economically necessary to keep a focus on debt to ensure sustainability in the long-run.

The European fiscal framework needs to be backed by strong institutions ensuring a depoliticised implementation. European decisions on budgets at the national level will always be political by nature. However, the rules in place should be applied clearly and equitably. Possibly, as one scholar put it, "[t]he belief that a group of sovereign states which fundamentally differ with regard to political and economic characteristics could be governed through a mesh of statistics and numerical rules remains an illusion".[2] Indeed, any government would try to exploit all possible room to manouevre when it comes to fiscal constraints. It is very challenging to write a transparent and economically sensible rule for a single country – even more so for a set of countries. Therefore, as many experts including Wolfgang Schäuble[3] and Mario Draghi[4] have argued, Europe needs to move towards stronger institutions in the fiscal area to ensure the proper conduct of fiscal policy.

A European Fiscal Board (EFB) could fill this gap in the future. The fiscal board recently created within the European Commission, as envisaged in the Five Presidents report, does not, however, provide a solution. Even the standards anchored in EU secondary legislation and the documents linked to the Fiscal Compact go beyond the current setting of the EFB by underlining the importance of the independence of monitoring institutions. They especially emphasise "unhindered" communication with the public. A sensible EFB would have the following features:

a. It would be able **to access and scrutinise the Commission's data and information.**
b. It would be **politically independent**, both from the Commission and national governments. This independence would bolster the credibility of the euro area fiscal framework. An EFB created at euro area level would have a clear mandate and the sole task of monitoring the **sustainability of public finances**.
c. It would **make recommendations** to the Council on an excessive deficit in a Member State and the country's budgetary policies, and issue early warnings if a country deviates from its Stability and Convergence Programme and the medium-term objective.
d. It would **conduct studies** on relevant topics and make its reports and recommendations available to the public.[5]

The role of the European institutions will evolve and the European Commission might assume a more political role in the future. This would make it less suitable to be the „guardian of the Treaty". If the European Commission becomes more political, one could create a European Monetary Fund (EMF) to serve not only as a crisis resolution mechanism but, like the International Monetary Fund (IMF), also as a "watchdog" with expertise in fiscal policy matters. Fiscal policy assessment could be an essential part of the EMF's surveillance if this independent institution were to be established.

2/ Market mechanisms

Let me turn to the second element of the bundle. The crisis experience led to a renewed call for market mechanisms to discipline governments. Lack of market discipline was certainly one of the root causes of the crisis. Before 2008, government bond spreads were extremely compressed and credit risk was not priced in. The underlying driver was the misguided belief that either the fiscal rules would prevent any sustainability problem, or that countries that ran into trouble would be bailed out under all circumstances. The mispricing of risk was one of the deficiencies that allowed policymakers to pursue relatively lax fiscal policy stances when backed by high growth rather than build up buffers to weather future crises.

To ensure effective market monitoring, the market framework should encourage proper risk pricing. For markets to play their monitoring role effectively, the proper conditions must be in place. First, a no bail-out policy should be in place. Otherwise investors will not factor in the possibility of losses if their investments go wrong. Second, financial market conditions must be set to encourage proper pricing. Regulation, central bank action, and other factors such as herd behaviour can all distort asset pricing.

The European crisis resolution framework establishes effective mechanisms to address debt overhang including debt restructuring. Sustainability issues can be addressed through fiscal discipline, concessional lending, and debt restructuring. The operational framework of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (EMS) combines all three elements. It requires countries to undertake tough policy and fiscal adjustment programmes. EFSF and ESM terms of lending are also very soft given their low interest rates and long maturities. Finally, following the IMF role model, both institutions can only provide assistance to countries if their debt sustainability is confirmed, which can imply a need for debt restructuring. On that basis, Greece had to conduct the world’s largest modern debt bail-in before it could enter an EFSF programme. Later on, to avoid overburdening another sovereign, the Cypriot banks were bailed in. The ESM Treaty also requires countries to adopt the European model of collective action clauses in their bond documentation, facilitating debt restructurings, before they can benefit from ESM financial assistance.

Several proposals have been made to strengthen market forces, including some debt restructuring mechanisms as part of a European fiscal framework. Others focus on specific financial market instruments or bank regulation. The thrust of advocates of a European debt restructuring mechanism is that past restructuring done for Greece follows the “too little too late” pattern visible on an international scale more generally. The design details vary considerably. Some conceive of a forced restructuring based on a rule or benchmark value rather than the assessment of each individual case. Others assume such a debt restructuring mechanism would be statutory, thereby applying to the entire stock of debt instantaneously. Other arrangements are contractual and affect debt only when newly issued. This includes so-called sovereign CoCos, which contractually require a restructuring or rescheduling under certain conditions.

In addition, bank regulation can contribute to the pricing of sovereign risk by tightening existing regulatory standards which give a zero-risk weight to sovereign debt and do not impose any exposure limit. The current arrangement implies a more generous treatment of sovereigns compared to private borrowers.

Mechanisms to ensure more reliable pricing of sovereign risk face two hurdles. First, market pricing of sovereign risk has to be "well behaved". The crisis experience both in the US and Europe showed us that market discipline is not a continuous "variable". It tends to be a "binary" phenomenon. Markets either "barely care about you or your fundamentals" or "get obsessed with them". Unfettered market pricing can entail an element of excess volatility which, though not driven by fundamentals, may still have negative effects on a sovereign and reinforce rather than resolve or prevent a crisis. Market capriciousness provided a crucial rationale to put in place a rule-based fiscal framework at the start of EMU. Therefore, careful thought would have to be given to how to improve market functioning. Just to give one example, we recently made a proposal on how to improve the transparency of ratings to better identify procyclical judgement.[6]

Second, interest rate differentials must be compatible with a functioning monetary union. The interest rate on domestic sovereign debt has a sizable influence on the cost of capital for the private sector and on credit flows from banks and, therefore, on investment and growth. This is especially the case in the euro area where banks, which play a much larger role in the financing of the economy than those in the US or the UK, largely remain "national" rather than "European" institutions and exhibit a worrying home bias in their portfolio allocations. This incomplete integration of the European banking sector meant that monetary policy became ineffective during the crisis because the ECB could no longer steer the very different Member countries' private sector borrowing conditions. Against this background, it is key to understand that, while eliciting a higher degree of market discipline is always conceptually positive, it may end up being more damaging than helpful in a flawed environment. Therefore, some argue that the euro area needs to create a common safe asset by pooling debt across countries and leveling the playing field. But currently, no political basis for such a proposal exists and other ways have to be found to address the legacies of the crisis.

Further measures in this direction should be carefully calibrated to not unsettle financial markets. Drastic changes could spark immediate and undesired market reactions. Closely related, and in line with the "regulatory overkill" concerns, a close link exists between sovereign debt restructuring mechanism proposals and other initiatives, such as the introduction of non-zero risk weights for banks' holdings of sovereign bonds, which could mount up and reinforce dynamics. We should avoid a constellation where different mechanisms lead to pro-cyclical price spirals and market closure in crisis times. This should not exclude, however, that further measures are taken to enhance or strengthen existing arrangements. There are two main lines along which current arrangements could be reinforced and would not require cumbersome legal changes. One is to further reinforce contractual arrangements, such as tighter collective action clauses alleviating the problem of holdouts in debt restructuring. The other is to develop an informal dispute resolution procedure. These proposals suggest creating bodies for facilitating creditor-debtor dialogue and dispute resolution via arbitration.[7]

Market discipline can play a useful role as US states' experiences show. They combine fiscal rules with a no-bail out arrangement. Plenty of studies have documented that state fiscal institutions and macro conditions have a meaningful impact on the yields of state bonds. In other words, market discipline works. More importantly, this market discipline has worked so far in a much less disruptive way for broad economic activity than in the euro area. But the states benefit in certain areas (such as service delivery) from budgetary transfers by the US federal government, and they also have buffers that shield them from regional income shocks.

3/ Fiscal capacity

Implementation of initiatives which would remedy the current situation will no doubt take time. It is hard to see that much progress can be made in relying on "sticks" only. Surrendering political freedom in return for stronger control will not gain broad-based support and does not in any case address all problems. Therefore, we should explore other ways of risk sharing. Despite their political sensitivity, public risk sharing and fiscal capacity certainly deserve consideration as potential solutions.

According to the Five Presidents' report, EMU should follow the example of all mature monetary unions and introduce a common macroeconomic stabilisation function.[8] Its main aim would be to underpin the resilience of EMU by cushioning shocks that could overwhelm national budgets. This step, though considered a natural long-term development, is however constrained by political and economic realities. The report also points out elements to avoid when thinking about a stabilisation function. A stabilisation function should, for example:

- not lead to **permanent transfers** between countries or to transfers in one direction only, which is why converging towards an Economic Union is a precondition for participation. It should also not be conceived of as a way to equalise incomes between Member States.
- neither undermine the incentives for sound fiscal policymaking at the national level, nor the incentives to address national structural weaknesses. Accordingly, and to prevent moral hazard, **it should be tightly linked to compliance with the broad EU governance framework** and to progress in converging towards the common standards described.
- be **developed within the framework of the European Union**. This would guarantee that it is consistent with the existing EU fiscal framework and with procedures for the coordination of economic policies. It should be open and transparent vis-à-vis all EU Member States.
- aim to improve the **overall economic resilience of EMU and individual euro area countries**. It would thus help to prevent crises and make future interventions by the ESM less likely.[9]

So far, several proposals on precise forms and different features have been put forward. In the context of EMU, four main aspects are important: a) purpose, b) disbursements, c) funding, d) discretionary vs. rules-based decision-making.

The **main purpose** of the fiscal capacity is to absorb asymmetric shocks, and to facilitate financially cyclical policies or structural reforms. Currently, there seems to be no scope for a fully discretionary fiscal capacity in the form of a euro area budget until further steps can be taken in political integration. However, more targeted and specific arrangements could receive support, e.g. in the form of a rules-based fund, insurance scheme or a broader cyclical stabilisation arrangement with specific eligibility requirements and governance arrangements. Any discretionary feature should be commensurate with conditionality.
In particular, drawing on different elements of various existing proposals, a **fund** structured like the Single Resolution Fund (SRF) seems to be an interesting option:

- Member States could have automatic access to the funds they have paid-in to their national compartments. This would constitute the first layer of the fiscal capacity, in case of a large enough shock.

- Then there could be a more discretionary layer with a risk-sharing elements, for example, through limited medium-term inter-compartmental borrowing. Such a top-up could be proportional to the individual pre-withdrawal contributions over a fixed number of years – say two or three years - depending on how much leverage would be initially targeted.
- In addition, if Member States want to go one step further, the fund's capacity to support members beyond outstanding balances could be increased by retaining part of the annual contributions as capital that guarantees short-term borrowings during exceptionally harsh recessions, but before the member state loses market access. The Member State could borrow these funds to support further long-term growth-enhancing reforms or investment.

Fiscal capacity **could also be designed as an insurance scheme against a negative shock**. Such a scheme would operate in accordance with ex ante rules. [10] In an insurance model, national contributions could be revised based on the history of usage (received disbursements) as done for private insurance schemes. And the pay-outs could be subject to a co-financing contribution of the country, which should help the appropriate scaling of assistance, and alleviate moral hazard issues. Although insurance schemes are most likely to be set up for a specific policy area, a general stabilisation insurance could also be designed.

A basic advantage of an insurance scheme is that it does not react to all shocks and it indemnifies only part of the damage caused by an eligible shock, **which preserves financial capacity**. But at the same time, it reassures sovereign bond investors and other market players, because it provides a floor.

Several types of euro area unemployment insurance arrangements have been proposed: a common unemployment insurance[11], a common basic benefit scheme[12], complementary European unemployment insurance scheme[13], reinsurance of national unemployment benefit schemes[14]. Such a scheme would require that labour policies play a more important role in the European Semester. [15] In most cases, this would mean considering the further harmonisation of basic assistance. Another option would be to rely on an agreed notional benefit as a basis for indemnity (from which Member States may divert disbursements to citizens), execution of active labour market policies, or even harmonisation of labour taxation. Currently, there is no clear requirement or guidance on translating such social policies into concrete national measures.[16]

Even when equipped with technical independence and general conditionality it is unlikely that Member States would unanimously support joint debt that allows discretionary expenditure. The step by step implementation of these elements could significantly increase the resilience of Economic and Monetary Union. Thus, trust in economic policy making could be progressively strengthened.

Conclusions

In my talk, I have focused on the three main elements which should be combined in the re-design of the Economic and Monetary Union's architecture. First, I highlighted the importance of an enhanced rules-based framework that could be further underpinned by better institutional structures. Second, I underlined the need to find instruments that induce not only "more", but also "more reliable", market discipline. Finally, I outlined the basis for potential risk sharing mechanisms.

To conclude, I would like to reiterate the importance of a pragmatic approach towards the implementation of such proposals. They should be based on realistic expectations and knowledge of both the economic reality as well as the idiosyncrasies of the EU integration process. The skilful combination of measures in a bundle will play a crucial role, especially if we want to create a consistent system with a proper balance between power, responsibility, and benefits.

[1] I would like to thank Olga Francova, Angel Gavilan and Kari Korhonen for helping me prepare this speech.

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[4] Draghi, M., 2015, Speech at SZ Finance Day 2015, 16 March.

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[9] Ibid. p.15.
[10] Dullien, S., (2013, “), A euro-area wide unemployment insurance as an automatic stabilizer: Who benefits and who pays?”,?; paper prepared for the European Commission.
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[12] France Trésor, June 2014, “: An unemployment insurance scheme for the euro area”, *Directorate General of the Treasury* (DG Trésor), no., TRÉSOR-ECONOMICS No. 132. – June 2014
[13] New Pact for Europe, October (2014, “): Second report, Towards a new pact for Europe”. King Baudouin Foundation, the Bertelsmann Stiftung, European Policy Centre.
[14] Beblavý, M., Gros, D., Maselli, I., January (2015, “): Reinsurance of National Unemployment Benefit Schemes”,, CEPS *Working Documents*, no. 401.
[15] Dhéret, C. et al., (2013, “) Making progress towards the Completion of the Single European Labour Market”,, European Policy Centre, Issue Paper, no. 75.
[16] According to Allard, C., & al (2013, “) Toward a fiscal union for the euro area”,—background papers, IMF *Staff Discussion Note* SDN/13/09, unemployment insurances in existing federations have been mainly structured as fully centralised and harmonised (e.g., Australia, Belgium, Brazil) or state-level and unharmonised with ad hoc federal backstops (USA).

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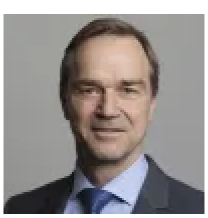

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