The fiscal measures leading to the completion of EMU - speech by Andreja Lenarčič

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Speeches

Andreja Lenarčič, Senior Economist and Policy Strategist
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I would like to thank the organisers for inviting me to this panel. It is a pleasure to be here in Komotini to discuss how to make the EMU more resilient and better prepared for future economic challenges. I will focus on the elements we need in the fiscal area, and in particular, on the need for more fiscal risk-sharing to deal with

economic shocks that the common monetary policy cannot address.

Before I start, I would like to briefly touch upon what has been achieved so far. We can recognize that the euro area countries have taken major steps forward in improving the EMU architecture and its resilience since the crisis. The main steps were developing new institutions and frameworks.

The development of the banking union strengthened financial stability in the euro area by transferring the supervisory and resolution competences for the largest banks to common bodies and, importantly, by shifting the costs of bank failures from taxpayers to investors.

The establishment of the two rescue funds, first the EFSF and then the permanent ESM provide a safety net for sovereigns, which did not exist before.

Moreover, euro area member states recently reached an agreement on enhancing the ESM, which will provide further elements that support resilience of the euro area. In the future, the ESM will not only provide financial assistance but will be also more involved in the design of future programmes and country monitoring, and it will act as a backstop to the Single Resolution Fund.

The list of reforms already implemented is long, yet, **further effort is needed in some areas.**

First, we need to complete banking union, which is still lacking a common deposit insurance, and a credible solution for ensuring sufficient liquidity for the banks emerging from a resolution.

Second, we should make progress on the capital markets union, which would help with sharing risks across countries via cross-border capital holdings and would lead to less fragmented financial markets.

Third, additional measures in the fiscal area, the topic on which I will focus today. We need to improve the countries' capacity to deal with large shocks when these affect some economies in the monetary union more than others and they cannot be addressed by a common monetary policy.

The past crisis revealed the fragility of a monetary union when countries need to rely on national fiscal policy and run out of fiscal space. During the crisis, many countries found themselves with insufficient fiscal space to implement fiscal stimulus for various reasons and many had to introduce saving measures to improve market perceptions and reduce financing costs at the time when the economy would need stimulus. Some had to ask for international financial assistance.

What the countries were missing was more fiscal space in the downturn. To provide that we need to rethink the adequacy of current fiscal rules and improve them to better balance the goals of stabilisation and sustainability and, since that might not be enough, we need to enhance cross border fiscal risk sharing**. I will focus on the latter.**

Fiscal stabilisation function

We now have a permanent institution, the ESM, which provides financial assistance to countries that have lost market access – that is one layer of fiscal risk sharing.

However, there is a missing piece: a fiscal stabilisation facility that would provide more fiscal space before the country loses market access. This would allow good stabilisation through automatic response of fiscal revenues and expenditures to fluctuations in economic activity and would allow countries to use fiscal policy measures to stimulate the economy in bad times.

Design of the fiscal stabilisation function

There are numerous proposals for a common fiscal stabilisation facility provided by academia and policymakers, yielding a rich set of options. Proposals range from reinsurance of national unemployment schemes to stabilisation funds to support investments, short-term ESM loans, and even a fully-fledged euro area budget. The question is what would be the right model?

Recently two concrete proposals were discussed. In 2018, the Commission proposed to develop a European Investment Stabilisation Function within the EU budget. The purpose of this instrument was to support investment in downturns; however, it has so far not gained sufficient political support.

Another proposal is the Budgetary Instrument for Convergence and Competitiveness (BICC), on which member states are slowly converging towards an agreement. The instrument will provide funds to support structural reforms and public investment in the euro area. It includes some cyclical aspects on the financing side, but the stabilisation properties seem to be relatively weak given the size currently foreseen. In this respect, it does not provide a proper fiscal stabilisation facility.

At the ESM we have developed our proposal for a fiscal stabilisation facility in the format of a revolving rainy day fund, that tries to take into account four elements that we consider crucial for getting the right economic outcome and for making the proposal politically palatable. These elements are effectiveness, meaning good stabilisation properties; predictability, providing confidence and transparency; avoiding moral hazard; and no permanent transfers, meaning the scheme would need to be loan-based.

There are several design features that would deliver these elements and bring the right incentives and results.

First, the stabilisation facility should address large shocks. Recent literature suggests that a stabilisation facility addressing exclusively large shocks can bring about good stabilising properties with relatively limited resources. An effective size of the facility in the range of 1% to 2% of euro area gross domestic product (GDP) could be sufficient.[1]

Such a capacity would not overburden member states' public finances. Focusing on large shocks would also provide the right incentives. If only large shocks are covered, then domestic automatic stabilisers and buffers would have to be used as a first line of defence, therefore reducing moral hazard.

Second, rules determining payments to and from the stabilisation fund should be based on changes rather than on levels of a relevant macroeconomic variable. This way the payments would be more likely linked to cyclical developments rather than structural situation in the economy. This would reduce the likelihood of one country permanently benefitting from aid and would also reduce moral hazard in economic policies of participating countries.

Third, the scheme should be based on saving and lending rather than transfers. This

is a key element preventing permanent transfers. The loan should be repaid over the business cycle. Finally, the participation in the fiscal stabilisation facility should be conditional on some ex-ante eligibility criteria to access the funds to create incentives for the implementation of sound policies and to enhance market confidence. Moreover, the contribution payments to the scheme could be linked to the country's policy performance (experience rating).

This is the basis for our rainy day fund proposal.[2] The fund would be comprised of national compartments. The countries would save up in their national compartment in good times and could consume their savings in bad times. **This would represent the self-insurance layer.** The size of the country's compartment in the fund would be a function of country's GDP and the volatility of the economy. **The second layer is insurance:** The countries could also borrow up to a limit from other compartments of the fund in bad times, if so prescribed by the economic rule.

The borrowing limit would depend to the size of the country's compartment. The rules determining payments from and to the fund would be based on changes in unemployment rate and would include a threshold for activation. Any borrowing would need to be repaid over the course of the business cycle. Ex-ante eligibility criteria to access the funds would apply.

To conclude, our proposal shows that it is possible to develop a fiscal stabilisation facility without permanent transfers, while containing moral hazard and maintaining effectiveness. The key elements are that the saving-loan structure helps to reduce moral hazard and creates an obligation to save in good times, and limits payouts to episodes of large shocks, subject to ex-ante conditionality.

The stabilisation properties of such a fund are comparable to models based on transfers, except in extreme situations where the country in any case would have needed financial help from the ESM.

Other lending based mechanisms are possible; but, a facility like a rainy day fund has a specific feature, since it requires building up savings in good times. Doing so, it supports the counter-cyclicality of fiscal policy, which has proven difficult to achieve so far.

The good news is that good technical solutions for the fiscal stabilisation facility are available and this is a good foundation for future discussions. A stronger, more stable EMU is in the interest of everyone, so it is very important that the debate on instruments with sizeable fiscal stabilisation properties continues and that we find a workable solution.

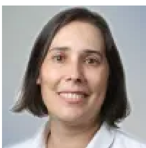
[1] See Allard et al. (2013), Furceri and Zdzienicka (2013) and Carnot et al. (2017).
[2] See Lenarčič and Korhonen (2018), "A case for a European Rainy Day Fund," ESM Discussion Paper no. 5.

Author

Andreja Lenarčič
Senior Economist, Policy Strategy and Institutional Relations

Contacts

Cédric Crelo
Head of Communications and Chief Spokesperson
+352 260 962 205
c.crelo@esm.europa.eu



Anabela Reis

Deputy Head of Communications and Deputy Chief Spokesperson
+352 260 962 551
a.reis@esm.europa.eu

Juliana Dahl
Principal Speechwriter and Principal Spokesperson
+352 260 962 654
j.dahl@esm.europa.eu