

Fiscal Institutions for a Monetary Union

Alan Auerbach

Discussion by
Jürgen von Hagen

Summary

- Why are there fiscal rules in EMU?
 - Fiscal spillovers? Probably not.
 - Because bailouts cannot be avoided? Probably!
 - Samaritan's dilemma
 - Cross-border financial exposure
 - Other issues
 - Large fiscal gaps due to implicit liabilities? Unlikely, because the SGP does not address these.
 - Tax coordination? Unlikely, because the SGP is ineffective to deal with tax rates.

Summary

- So, why are there the fiscal rules we observe?
 - Auerbach doesn't know
 - Nor do I

Fiscal Policy Framework in the Euro Area

- Principles of fiscal policy in European integration:
 - Sound fiscal policies (**necessary** to ensure the functioning of the euro)
 - Coordination (**possible** to improve on national policies)

Fiscal Policy Framework in the Euro Area

- EU Coordination (spillovers):
 - Broad Economic Policy Guidelines (confidential and public assessments and recommendation)
 - Mutual Surveillance (checking the consistency of national fiscal policies)
 - Euro-Group for coordination among euro-member states
 - Enforcement by persuasion

Fiscal Policy Framework in the Euro Area

- Ensuring sound public finances
 - No-bailout clause (Art. 125)
 - No financing of public deficits by the ECB (Art. 123)
 - Excessive Deficit Procedure (Art. 126)
 - Monitoring and enforcement through fines
 - 3% and 60% triggers
 - Stability and Growth Pact
 - (Council Regulations 1466/97, 1476/97, Council Resolution 97/C236/01-02; Declaration on Art. 126 of the Treaty on the Functioning of the EU)

SGP

- „Preventive arm“:
 - Fiscal rules (Mutual surveillance, not enforceable)
- „Corrective arm“
 - speeding up SGP procedures, financial fines
 - Governed by finance ministers instead of Commission

The Incredible No Bailout Clause

- Constitutional conflict: Samaritan's dilemma
 - EU as a group of sovereign nations: Limits on debt and deficits are not enforceable
 - EU as a community owing solidarity to its members: Leaving defaulting states with no support is not acceptable
 - Result: Fiscal laxity & bailouts
 - „It is unacceptable that those who work hard pay for those who take it easy.“ (Bild Zeitung May 19, 2011, commenting on the bailout of Greece and Portugal)
 - „The government of the Union is neither in a legal nor in a moral sense bound for the debts of the states, and it would be a violation of our compact of union to assume them...“ (US President James K. Polk, Inaugural Address March 4, 1845)

The Incredible No Bailout Clause

- Constitutional conflict
- Cross border financial exposure through the banking system

Cross-Border Exposures

	Greece	Ireland	Portugal	Spain
Domestic banks' claims on sovereign	56	5	14	201
EU banks' claims on sovereign	62	17	40	94
ECB claims on sovereign	40	20	20	
Official EU claims on sovereign	20			
EU banks' claims on domestic banks	9	112	51	217

Billions of Euros; End 2010; Source: BREUGEL

The Incredible No Bailout Clause

- Constitutional conflict
- Cross border financial exposure through the banking system
- ECB reliance on government debt in monetary policy operation
 - Eurosystem bond purchasing program
 - Eurosystem EUR BN 76.2
 - Covered Bond Purchase Program EUR BN 60.4
 - ECB holdings EUR BN 17.9, ECB Capital BN 5.3

The Incredible No Bailout Clause

- Constitutional conflict
- Cross border financial exposure through the banking system
- ECB reliance on government debt in monetary policy operation
- Lack of operational framework for sovereign default

Why unsustainable debt is not sustainable

Primary balance adjustment needed to stabilize Debt/GDP ratio at projected level

	ES	PT	IE	GR
Debt ratio	75%	95%	115%	155%
Interest – growth rate = 2%	1.5	1.9	2.3	3.0
Interest – growth rate = 6%	4.4	5.6	6.8	9.1
2012 primary balance proj.	-2.7	-1.1	-4.8	-0.3
Required adjustment (6%)	7.1	6.7	11.6	9.4
Interest – growth rate forecast				
2011	4.7	7.0	8.1	14.5
2012	3.7	5.2	7.1	10.2

Source: Bruegel

Proposed Solutions I: More rules

- **Tougher SGP**

- van Rumpuy Commission (Oct 2010)
- Deeper and broader budgetary surveillance (European semester)
- More ambitious fiscal targets
- Tougher and more automatic sanctions

Will not work because of adverse incentives and lack of enforcement.

Proposed Solutions II: The ESM

- **The European Stability Mechanism**
 - Adopted by the European Council March 27
 - To follow the ESFS in 2013
 - Lending capacity (effective) EUR BN 500
 - A lender of last resort for sovereigns „experiencing or threatened by severe financing problems.“
 - **Governed by the ministers of finance .**
 - Bailouts through loans and primary market purchases
 - Strict conditionalities??? **Samaritan's dilemma**
 - Private sector involvement possible but unlikely
- An invitation for excessive borrowing!

What Europe needs:

- A framework for sovereign default run by a court to solve the Samaritan's dilemma
- More reliance on market discipline