The European fiscal policy framework: too complicated

a) The European semester

Autumn package

- **Commission's Annual Growth Survey (AGS)**
- **Alert Mechanism Report (AMR)**
  Screening device, based on a scoreboard of indicators.
  The inclusion of macroeconomic imbalances in general was a nod to the countries other than Germany, that accused Germany of focusing exclusively on the government balance government and ignoring other sources of imbalances, like excessive current account surpluses.
- **Joint Employment Report (draft)**
- **Recommendation for the euro area**
- **Communication on fiscal stance**
- **Commission's opinion on draft budget plans for eurozone countries**
  Opinion on draft budgets submitted by 15 October.

<u>The analysis phase</u>

- **Country reports (February)**
- **In-depth reviews** (Only for countries selected in Alert Mechanism)

<u>National plans</u>

- **National Reform Programmes (April)**.
- **Stability Programmes (April**)

<u>EU country-specific recommendations</u>

- Country Specific recommendations (May)

<u>Putting recommendations into practice</u>

- **Draft Budget Plans**
- **Formal Commission opinion.**

Why is this **not only unwieldy, but actually dangerous**?
Because this allows governments to play around with **dreams** and **propaganda** instead of facts. The National Reform Program is a pie in the sky with dozens of **unrealistic reform plans** and **unsubstantiated claims** on the effects of reforms allegedly implemented.

It also generates confusion. With the National Reform Program in Spring governments submit a sort of pre-budget. In Italy, it consistently shows a budget deficit that is 1 percent of GDP lower than what everybody knows it will be in October. But very few in the media understand the difference.

b) The SGP developed by accretion

2005 – more flexibility
2011 (Six Pack) – more rigidity
2016 “Commonly agreed position on flexibility within the SGP” - more flexibility

Matrix of requirements.

- Counter-reaction to what was perceived by some countries as the excessive stringency of the Six Pack.
- But also attempt to clarify and quantify the notion of “unusual event outside the control of the Member State”

	Condition	**Required annual fiscal adjustment** (pp of GDP)	
		Debt ≤ 60% and low/medium sustainability risks	Debt > 60% or high sustainability risks
Exceptionally bad times	Real growth <0 or output gap < -4	No adjustment needed	
Very bad times	-4 ≤ output gap <-3	0	0.25
Bad times	-3 ≤ output gap <-1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5≤output gap <1.5	0.5	> 0.5
Good times	Output gap ≥1.5	>0.5 if growth below potential, ≥0.75 if growth above potential	≥0.75 if growth below potential, ≥1 if growth above potential

Risk-sharing vs. Risk-reducing approach

Usually: Commission’s “Position paper” vs. German “Non paper”. But there is a third, widespread position that is mostly unrecognized in Northern Europe….

Germany: risk-reducing tools. France: risk-sharing tools.

Risk-sharing is politically feasible only if it does not generate permanent transfers

What does “permanent” mean? In economics, when the expected value of the net transfer, given a random component with zero mean, is zero.

Very difficult to characterize its stochastic process. In practice, very easy to end up with a very long sequence of realized errors of the same sign.

In politics, “permanent” means “ a few years”, possibly “before the next election”.

But…. it is nearly impossible to imagine a realistic risk-sharing mechanism that does not generate long lasting net transfers to the weaker countries with a high probability.

<u>a) Automatic stabilizers</u>

Take the two most prominent examples:

- Unemployment insurance
- Deposit insurance

Unemployment insurance could be based on some measure of deviation from an “equilibrium” or “long-term” level of unemployment. But we have no idea how to measure it. The output gap measures used now are enormously controversial, and almost certainly conceptually flawed. But they are used only to allocate a small part of the EU budget (which is about 1 percent of European GDP), and for the surveillance process. Imagine if they were used to allocate a sizable stabilization tool.

b) Centralized stabilization tool

Commission's position paper talks of "fiscally neutral" centralized financing (whatever it means).

- Commission: stabilization tool, through
  - European Structural and Investment funds: but minimal
  - Protection of public investment. What is public investment? Does Europe need more public investment? Juncker plan
  - More ambitious plans

- Southern European countries: typically in favor of more centralization of resources. "Without a common fiscal policy, common monetary policy cannot work". But:
  - Sometimes meant explicitly as an ex-ante redistributive tool among countries.
  - Sometimes meant to be a stabilization tool.
  - However, in either case, I have never, ever seen a precise proposal for allocation of revenues and expenditures.

But if there were a new government debt crisis in Italy, and no more "whatever it takes", the net transfers to Italy would be enormous, and would be repaid in decades, if ever (think of Greece). Politically unsustainable in all other countries. And probability of government debt crisis in Italy is much higher than in Germany or Austria.

Centralized fiscal policy

Lots of talk about a European Treasury / European Monetary Fund

- Germany: only surveillance tool, to take away power from politicized Commission

- Commission: coordination and stabilization tool

- Southern European countries. Progressive assumption by the center of more and more fiscal policy tasks. But which tasks? How?

Very vague motivation. "A unified monetary policy requires a unified fiscal policy". "There cannot be progress towards a political union without a common fiscal policy".

But the underlying notion is always some permanent transfers: ("Europe cannot survive with some sharing of sacrifices"; "we have suffered already enough because of austerity, it is time to get something back".

<u>Bail-in vs. Bail-out</u>

Perhaps the most controversial (and unpopular, in southern European countries) proposal of the German non-paper is the resolution mechanism for government debt, a form of automatic bail-in.

People always raise the specter of Deauville. But the world survived Lehman Brothers and Europe survived Deauville, and arguably it is better off because of this. The moral hazard problem is a real, tangible problem in politics, that should not be underestimated (Italy, summer 2011: the start of the government debt crisis).

The alternative to a bail-in is a bail-out!!!

How can anybody realistically believe that Northern countries will ever accept the prospect of a bailout of a country richer and bigger than Greece?

Eurobonds

Enormous misunderstanding on Eurobonds.

Most serious proposal: European safe bonds.

To enhance the supply of safe bonds to the European financial system, and break the “doom loop” of southern.

Does not imply ex-ante nor ex-post redistribution between countries

Tranching of a basket of government bonds. The senior tranche is extremely safe.

- Do southern European countries really need a safe bond? Before OMT, ample supply of German bonds, and never used them

- Why **did** Italian banks and insurance companies invest mostly in Italian government bonds before the crisis?
    - Moral suasion
    - Funding costs of Italian banks are linked to riskiness of Italian government bonds, independently of the share of government bonds in Italian assets. Same for insurance companies.

- Why **do** Italian banks hold mostly Italian bonds now? Need the higher returns. If forced to buy ESB's right now, would go bankrupt => enormous problem of transition

- Need to think more about general equilibrium effects: who would also the residual (more concentrated) risk on junior tranches? Not foreigners. If they did, incentives for Italian government to default on securitized and tranched bonds. But then….

More generally, when Southern European countries talk of Eurobonds, they talk of a mutualization tool. The Italian political discourse and specialized publications are full of proposals of plain vanilla Eurobonds.

The Italian Treasury, all political parties and virtually all the media are not interested in any notion of Eurobonds that did not imply some mutualization.