Revisiting the Economic Case for Fiscal Union in the Euro Area

Maurice Obstfeld

(*with Helge Berger and Giovanni Dell'Ariccia*)

June 2018

https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2018/02/20/Revisiting-the-Economic-Case-for-Fiscal-Union-in-the-Euro-Area-45611

The euro’s fundamental quadrilemma

The following four circumstances are mutually incompatible; at most 3 out of 4 can hold simultaneously:

- No national money printing
- Nominally risk-free sovereign debt
- Fiscally vulnerable public sectors
- Credible rules against fiscal support from other countries

In a currency union, the first is normally a given.

So at least one of the three others must give.

Optimally, all three should be in play – because they interact.

(Relatively) safe sovereign restructuring

Post-Deauville and Greece, EA debt is un-safe

- Pre-crisis, little differentiation of sovereign credit risks, which contributed to the buildup of vulnerabilities
- More differentiation post crisis, despite ECB operations
- Since 2013, CACs mandatory for bonds > 1 year; Meseberg Declaration called for single-limb disaggregation
- ESM support requires a DSA
- But in practice, Greece aside, other crisis countries have avoided restructuring
- Also, there is no systematic sovereign bankruptcy framework

What role for market discipline?

- It would be redundant, if rules were effective enough to eliminate default risk – but in practice they are not
- In principle, defaultable debt could → more market discipline
  - On sovereign borrowers
  - On their private-sector creditors
- **The paradox of market discipline**: it limits fiscal vulnerability by ensuring that vulnerability can be costly—a risky business
- One could, therefore, ask: *is the prospect of sovereign restructuring credible?*
- Depends on extent of costs and, especially, who bears them

The sovereign/bank nexus limits credibility

- Sovereign and bank distress interact at the national level (Dell'Ariccia et al., forthcoming)
- Mutual amplification hurts at home and across borders
- Foundations of banking union elements (SSM, SRM) have helped
- Domestic, not area, fiscal resources remain the prime backstop for resolution and deposit insurance
- Banks still heavily hold domestic sovereign bonds, with zero regulatory risk weights and serving as high-quality collateral
- Domestic GDP shocks weaken both banks and the sovereign
- Default costs thus are now too big and widely felt for routine use

To summarize thus far ….

- Sovereign restructuring threat not credible enough to yield strong market discipline
- A major reason is that sovereign collapse would likely also drag down a country’s banking system, with repercussions throughout the EA – might even imperil euro membership
- In EA, no “Puerto Rican” scenario of minimal/no banking fallout from sovereign’s debt problems
- It might even endanger its membership in the euro
- In these circumstances, some form of *ex post* transfer from other EA members becomes likely

Reducing public sector vulnerabilities

Limiting fiscal vulnerability is vital

There are three main avenues:

- Strengthening the financial sector, where implicit liabilities reside
    - Stronger supervision/regulation
    - Reducing NPLs
    - When possible, shifting bank risks from taxpayers to big creditors
    - Elements that help to complete banking union
- Directly reducing sovereign vulnerabilities
    - Debt reduction/tax reform in many countries
    - More effective fiscal governance/rules
    - Market discipline
- Structural growth-enhancing reforms

The case for fiscal rules is strong

- Not all federations have them, or sometimes they are self-imposed—but other currency areas are political unions
- Countries with high degree of sub-national risk sharing also tend to impose relatively tighter rules
- Euro area framework does not lack rules (which were already envisioned in the 1989 Delors Report)…
- …but compliance remains a concern (e.g., Andrle and others 2015; Eyraud and others 2016)
- Rules can be improved (see the recent Staff Discussion Note by Eyraud et al. 2018)

Rules usefully complement market discipline

- Markets can be myopic. To quote Rudiger Dornbusch:

"The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought."

- At the same time, externally-imposed rules are unlikely to bind sovereigns fully, and if they do, may limit responses to country-specific shocks; so one more guard-rail is helpful

Making risk sharing work

Modes of risk sharing

- Through private financial markets
- Through fiscal federalism or other inter-governmental transfers
- In principle, default means risk sharing with creditors (public or private), not partner sovereigns or domestic wage earners

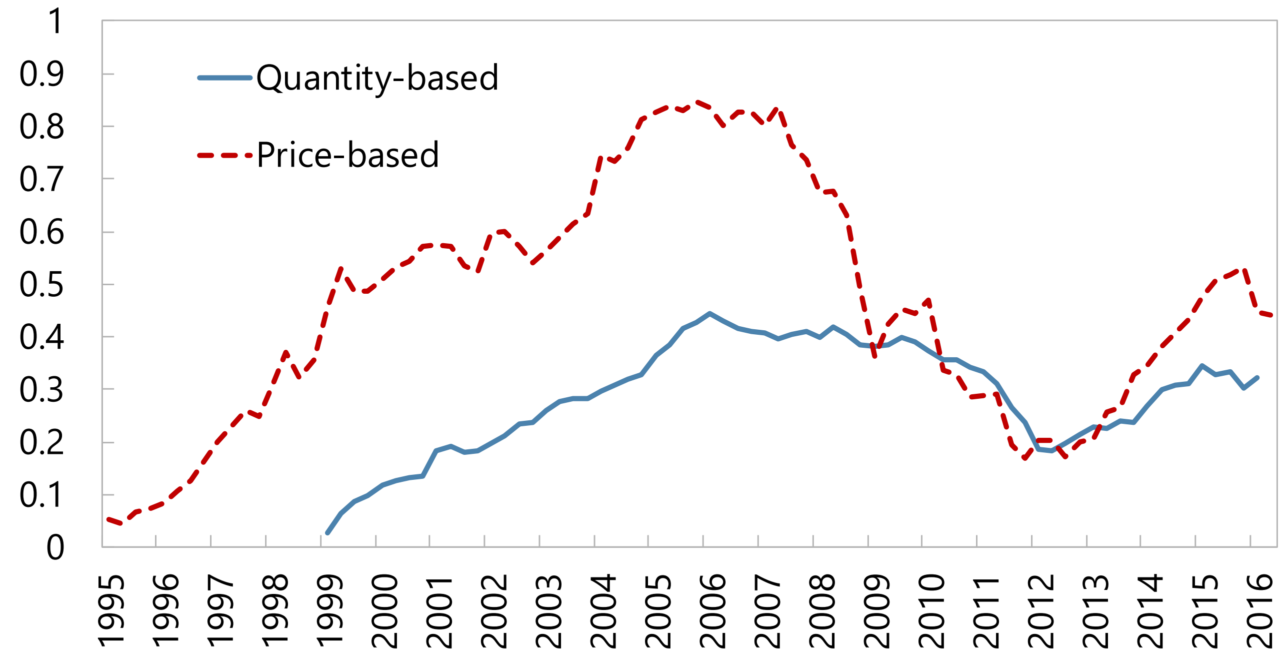
Theoretical efficiency → full ex ante risk sharing

- Even with complete markets, households ignore macro externality and under-insure (Farhi and Werning 2012), suggesting a basic need for government intervention
- While incomplete, capital and credit markets contribute significant inter-regional risk sharing in most currency areas
- Given their incomplete financial integration, euro area financial markets provide relatively little risk sharing
- Moreover, euro area cross-border financing recedes under stress (e.g., Furceri and Zdziencka 2013; ECB 2016)

Asset-market fragmentation under stress

Indicators of Financial Integration in Euro Area

(Index; 1=full integration, 0=full fragmentation)



Source: ECB Report on "Financial Integration in Europe, 2016"

Note: The composite indicators measure the average degree of financial integration across the Euro area, and are constructed by aggregating various sub-indicators across money, bond, equity, and banking markets.

Capital-market unification clearly critical

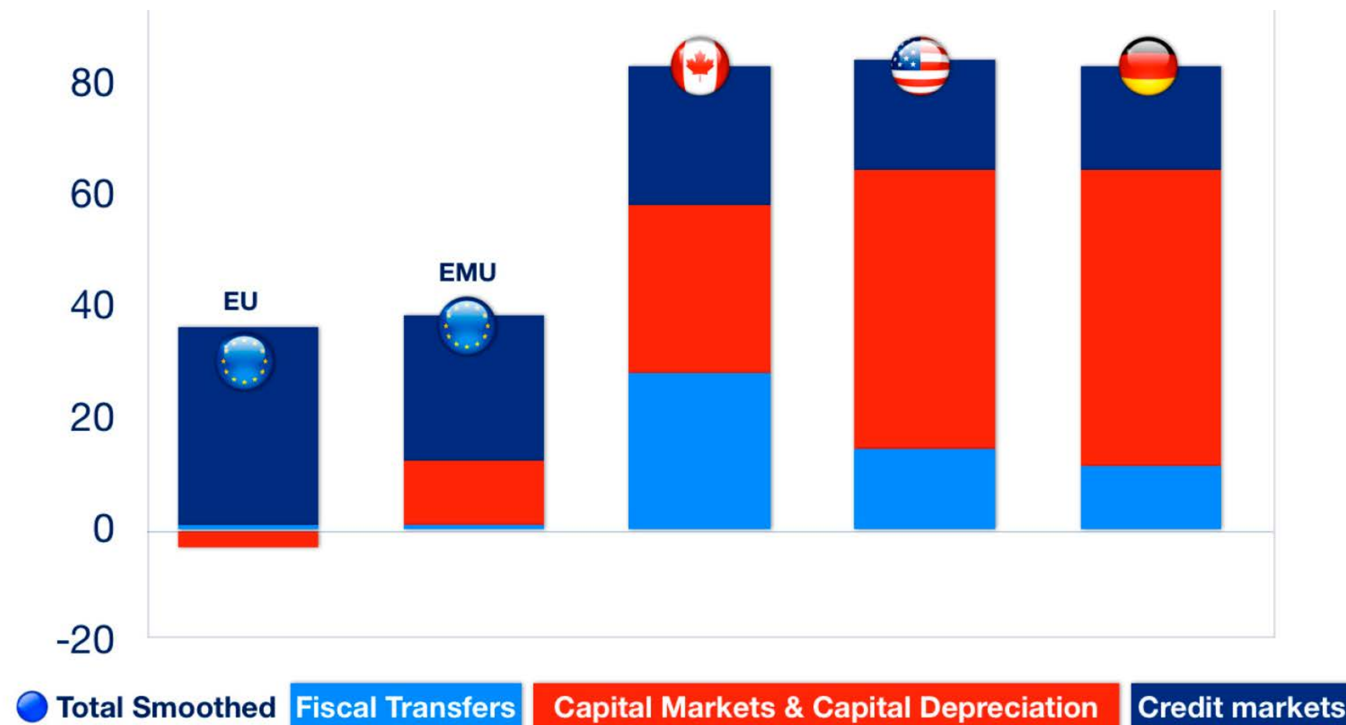
- This important avenue for market-based risk sharing is underdeveloped in Europe
- Unlike in some other national currency unions
- Requires overcoming remaining national obstacles (e.g., capital markets union initiative) and better common frameworks – e.g., for securitization (ECB 2016)
- Would also reduce reliance on bank funding, weakening the sovereign/bank nexus

Fiscal risk sharing complements markets

- Kenen (1969) and MacDougall Report (1977) are the classics
- Present in various combinations in other currency areas
- Ex ante (automatic) & ex post (conditional on a crisis)
    - Crisis emergency funds/help
    - Sharing/redistribution of tax revenue
    - Common budget with joint provision of public goods
    - Area-wide social insurance in addition to common budget
- Financial market backstops
    - E.g., common deposit insurance, bank resolution funds

Historically, EA risk sharing has fallen short

The smoothing of regional income shocks
(*Percent of shock overall*)



Source: Allard and others (2013)

EA governmental risk sharing mechanisms already exist, but are limited

- EU budget (≈1 percent of GDP)
- EIB Group
- SRF (still incomplete)
- TARGET2 (regional BOP adjustment)
- ECB discretionary purchases
- ESM

Ex ante versus ex post risk sharing (“bailout”)

- The Meseberg Declaration aimed to enhance the ESM and make it more like an EMF – below-market liquidity under strict conditionality, triggered by crisis
- ESM provides *ex post* support – expanded surveillance?
- Single-limb aggregation in new EuroCACs would support efficient restructuring
- Precautionary credit lines reside between ex post and ex ante
- More conventional elements of fiscal union imply *ex ante* or automatic risk sharing
- This has advantages but going beyond current capacities requires more of a *central fiscal capacity*

Advantages of ex ante fiscal risk sharing

- Many modes of ex post risk sharing pre-suppose a crisis
- But the aim is to avoid them
- Ex ante systems help prevent crises by buffering idiosyncratic shocks
- Bond markets with default may be subject to multiple equilibria; ex ante risk sharing reduces the likelihood of multiplicity, *given the sovereign’s fiscal position*
- Ex ante risk sharing softens domestic repercussions of default, and hence the spillovers
- Reduces incentive to avoid default via third-party side-payments (bailouts) to sovereign debtors and creditors (Bulow-Rogoff 1988)

Area-wide shocks

- The optimum-currency literature focuses on adjustment to country-specific shocks
- Of course, a central fiscal capacity can help offset system-wide shocks, notably when monetary policy is more constrained at the effective lower bound
- A danger that will not go away soon ….

The important problem of moral hazard

- Making the EA safe for restructuring (including through more risk sharing) helps mitigate moral hazard – by *making rules more credible* as well as more effective *market discipline*
- In other ways, allowing more fiscal risk sharing and a centralized fiscal capacity (CFC) could *encourage* moral hazard
- Mechanisms to contain moral hazard (such as more effective rules) overlap with those to reduce fiscal vulnerabilities
- Defaultable debt also creates other needs – e.g., for safe EA assets, which, in turn, might pre-suppose a bigger CFC
- Better rules – but eventually, perhaps, more migration of control to the center; needs careful design to avoid widening democratic deficit

What next?

Even post-crisis reforms left EMU vulnerable

- Political difficulty does not absolve from economic necessity
- Envisaged **fiscal backstop to the banking union** is a key element of risk sharing, key to weaken bank/sovereign loop
- Requires common deposit insurance, joint resolution fund
- Meseberg Declaration made ESM the backstop to the SRF, with “fiscal neutrality” – after “sufficient” risk reduction
- Fully addressing EMU vulnerabilities will eventually require additional efforts to extend fiscal risk sharing (Meseberg’s “Eurozone budget”?) and fiscal discipline

Reform deficits and legacy issues

- Significant unaddressed structural reform needs across EMU
- Similarly, resolving legacy debt and balance sheet issues will help the functioning of banking union, while smoothing the politics – additional national efforts are needed
- Linking these reforms to fiscal risk sharing is sensible, both from an economic point of view (it will add to resilience) and politically.

Go raibh maith agaibh/Thank you