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Improving the fiscal framework of the euro area

NOTE

Abstract

The recent global financial and debt crisis has exposed, for the first time in its ten years of existence, the underlying problems, weaknesses and vulnerabilities existing in the governance and coordination of the Euro Area (EA) fiscal framework, which have ended producing a major blow to its previous reputation and well gained trust.

What can be done? It is rather clear that the EA needs a new fiscal framework independently of the success of the recent European Stability Fund. There are several ways to improve the present fiscal framework, all of them second best and less efficient than aiming ideally for an EA joint Treasury and Budget, which is still too far reaching.

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DISCLAIMER

The recent global financial and debt crisis has exposed, for the first time in its ten years of existence, the underlying problems, weaknesses and vulnerabilities existing in the governance and coordination of the Euro Area (EA) fiscal framework, which have ended producing a major blow to its previous reputation and well gained trust.

1) The Stability and Growth Pact (SPG) has not been able to impede the very large increase in the EA Member States public deficits. The EA average general government deficit increased from -0.6% of GDP in 2007 to around 7.0% in 2010 and the EA average level of public debt, increased from 66% of GDP in 2007 to close 88% in 2010, (excluding contingent liabilities related to population ageing).

2) The "one fits all" single monetary policy of the ECB has helped to induce growing macroeconomic imbalances within the EA by applying the same nominal interest rates to Member States with large growth and inflation differentials, which affect very seriously its proper and effective functioning. From an almost balanced position in 1999, current account surpluses have reached 7% in 2007 and aggregated current account deficits have gone up from 3.5% in 1999, to 9.7% of GDP in 2007.

3) The slow, hesitant and often uncoordinated reaction by Member States to the Greek fiscal crisis has induced a very large sovereign debt crisis when financial markets have finally decided to discipline the EA Member States for not being able to solve it quickly and decisively, producing large contagion effects to other Member States and eventually to the EA as a whole and the euro. Markets have realised the absence of any proper mechanism in the EA able to deal with and resolve these crisis situations, putting at risk their general confidence on the construction of EMU and on its three basic pillars, i.e., the ECB independence, the non-bail out clause and the excessive deficit procedure (EDP) of the SGP.

4) The large rescue package to save Greece and the new European Stabilization Fund (ESF) approved "in extremis" over the weekend May 8-9 2010 in collaboration with the IMF and in close coordination with the ECB, to avoid a "Black Monday" the next day, (six months after Prime Minister Papandreou send his sign of alarm about Greece's huge fiscal problems) shows all the weaknesses of the present EA fiscal governance. The Commission, Eurostat and the SGP did not know about the Greek situation in advance and thus did not act accordingly. Moreover, this package seems to violate the Treaty "non bail clause" in the sense that EA taxpayers are assuming indirectly the risks of the sovereign debt purchased by the Fund in case of default by Greece. Furthermore, the ECB decision to start purchasing government debt from countries facing funding difficulties could be a violation the spirit (but not the letter, because the ECB does not buy it directly and is sterilizing it) of the "non monetization rule"

What can be done? It is rather clear that the EA needs a new fiscal framework independently of the success of the recent European Stability Fund. There are several ways to improve the present fiscal framework, all of them second best and less efficient than aiming ideally for an EA joint Treasury and Budget, which is still too far reaching.

1) Forging a new SGP by making it truly enforceable through changing the way its decisions are taken on the EDP. The Member States which are "sinners" cannot be their own judges. The rule breakers should have EU funds withheld and voting rights suspended. More credible rules should be introduced: General Government over the cycle deficits are a complex rule difficult to compute. Deficits are more sustainable when debt is lower and/or growth is faster and/or when Member States have less contingent liabilities. Growth is a precondition for fiscal stability, not something to be traded against it. Putting Member States in a situation of debt-deflation will not stabilise their economies and will destabilise their politics.

a) There is a need for a more independent system of evaluating and enforcing fiscal responsibility on Member States. This can be achieved by fixed rules that will be automatically applied to any Member State when found to be breaching them or, alternatively, by allowing the European Commission to initiate the ED procedures and to apply them as well, independently of the Member States. This second alternative is more difficult to apply, given that Member States are still fiscally sovereign, while the first is easier, given that the same Member States could agree previously on the rules and sanctions that should be automatically applied to them.

What is not possible is to continue with a system by which the same Member States decide, by qualified majority, if the ED procedures apply and how. What happened when Germany and France EDP's were not applied because it was not possible to achieve a qualified majority, ruined the EDP and gave a strong incentive to other Member States to get into excessive deficits.

b) There is also a clear need to change the present EDP rules. The rules should be centred on debt levels (stocks) and not on deficits (flows), while at the same time, as it happened, debt levels of Member States have been left to go up well above their sustainability limits. This change is based on three reasons: First, it gives more room for manoeuvre to Member States that have been more fiscally prudent in the past and which have shown to follow a more credible and sustainable long term fiscal policy. Second, it would be a far more simple rule than the present "over the cycle" rule for guessing general government deficits, which is extremely complex to compute given that it needs to be based on output gaps, which are themselves highly complex and difficult to guess and finally the deficit composition in the Member States, is different introducing more difficulties. Third, in the case of a huge financial crisis, like the present one, the premium for the less profligate Member States would be even larger giving an incentive to the others to behave better in the future.

c) This change needs to be introduced at the same time as a temporary transition rule to put pressure on Member States with high debts levels to reduce them up to a level that it is considered sustainable in the medium to long run. Member States experiencing higher growth rates and more room to catch up should have higher levels of sustainable debt than countries more developed and mature and with lower growth rates. Member States with higher contingent long-term liabilities derived from population ageing in terms of future higher pensions and health costs should have lower levels of debt than member countries with lower future contingent liabilities. Larger Member States which can produce larger negative spillovers on the rest of the Member States should be subject to more stringent debt levels than small Member States.

d) Imposing fines to rule breaker Member States is not the most efficient way to sanction them because it increases their debts. It should be more efficient to impose on them fiscal contractions or to withhold European funds or to suspend voting rights in the Eurogroup decisions.

2) Encouraging structural reforms to avoid large EA macroeconomic and competitiveness imbalances. These imbalances should be dealt much more through increases in productivity than by reducing wages. That is, by encouraging or even imposing strong structural reforms in the product and labour markets of the large current account deficit Member States, instead of using fiscal and monetary macro-policies, which are not efficient to fixing microeconomic problems. Nevertheless, surplus Member States should also help, at the same time, to reduce these imbalances through fostering their own consumption and internal demand, otherwise, deficit Member States will end being pushed into inflationary policies to avoid deflation and/or stagnation, which may undermine the ECB independence.

a) Even if it is true that the EA is not a real closed economy where the current account surpluses in some Member States are by definition mirrored by current account deficits in other Member States, the truth is that when the EA current account transactions with the rest of the world was zero per cent of total GDP, it was behaving as a closed economy and internal surpluses would be matched by internal deficits. Some Member States are in deficit because they are less competitive than other Member States and they are less so either because their margins and wages levels are higher than those Member States which are in surplus or because their productivity levels are lower than in the others or because of both.

Conversely, other Member States are in surplus because they are more competitive within the EA either because their wages and margins levels are relatively lower or because their productivity levels are higher or both, than those in deficit. But it can also happen that Member States in current account surplus tend to be mature and highly developed, having a lower rate of consumption and investment and a higher rate of savings than the deficit Member States and therefore, by definition, they have a current account surplus while those Member States in deficit tend to have a higher internal consumption and investment demand growth than their own savings and need to finance this higher internal demand with the savings of the surplus Member States.

For instance, Germany which is the largest world exporter of goods exports to the rest of the EU Member States 26.6% of its GDP but only imports from the rest of the EU 21.3% of its GDP, while Greece exports to the rest of the EU only 5% of its GDP while imports 14.3% of its GDP. In terms of goods and services, Germany total exports are 49% of its GDP and total imports are 41% of its GDP while Greece exports 23% and imports 34% of its GDP. Therefore, Germany has a total current account surplus of 8% of its GDP and a trade surplus within the EU (only in goods) of 5.3% of its GDP. Given that Germany's GDP is 28 per cent of the EA, only its trade account surplus within the EA is 1.5 per cent of the EA GDP, while Greece that is only 2.5% of the EA GDP, its trade deficit is only 0.2% of the total EA GDP. In the end, Germany's trade surplus within the EA is double than the sum of the trade deficits of Spain, Greece and Portugal.

Therefore, encouraging or imposing structural reforms on Member States with current account deficits, to increase their productivity and to reduce their costs, should be done at the same time as asking or imposing surplus Member States to foster their internal demand, otherwise it will be extremely difficult to avoid large imbalances. It is true that current account surplus Member States have invested a relevant part of their surplus in sovereign debt of the deficit Member States through their banking systems and that this is one of the main reasons why they have not let down Greece. Nevertheless, their banks did not do a very good job analysing their risks that they were taking.

3) Introducing a new and transparent crisis resolution mechanism. The EA has paid great attention to introduce prevention rules and institutions to avoid "fires", but it has forgotten that it also needs a "fire brigade" to act swiftly in case the prevention mechanisms fail. Sometimes, crisis prevention is not enough and a clear resolution mechanism should be in place and intervene when the crisis of a Member State finally arrives. The 750 billion euros "bazooka" approved in the last 9th of May is only the hard way to stop a self-fulfilling crisis, to avoid contagion to other Member States and to help contain the crisis within a given Member State, which is also necessary. Nevertheless, it is also important to have a system that not only allows any EA Member State to receive extra funds under strong conditionality both from the IMF, the EU Commission and the Member States, in order to get out of it, but also that the Member State under this situation is able to, eventually, organize an orderly restructuring of its debts with its creditors.

The EA cannot stabilize totally and avoid sovereign future debt runs from financial markets without a solid framework for crisis resolution and the ability to deal with a sovereign default by a Member State. The EA cannot say that its Member States cannot be allowed to default unless it becomes a fiscal union or even a political union which is definitely not yet one and, unfortunately, it may take decades to be.

Therefore, the EA needs to do the following: On the one side, to reiterate and reassure financial markets that the "non bail out" and the "non debt monetization" clauses of the Treaty are going to be always respected. On the other side, to state very clearly that its Member States under funding difficulties should be encouraged to request financial support by the IMF.

If Greece would have been allowed to receive financial support, under strong conditionality, from the IMF since the beginning, most probably, markets would not have reacted with the same lack of trust on the EA and Greece would have restructured its debt later, after having demonstrated that it was fulfilling the IMF conditionality, as any other country in the world under the same situation. Markets would have not called into question the survival of the euro, (even if this thought in itself is so absurd and far from reality, which shows how little financial markets as a whole know about the euro and the euro area).

Finally, it is clear that Member States are not ready to relinquish fiscal power to the centre, in order to avoid defaults and to reinforce (or even to replace) the SGP (given that it conflicts every time with fiscal sovereignty of Member States). For this reason, an alternative solution could be that Member States impose upon themselves a budgetary constitutional rule, as Germany has done and it looks like if France may follow. These rules should not or need not to be the same in all Member States, given that the economic and political situation of every Member State is different, but they will help to avoid defaults and to induce debt crisis.

This alternative could be similar to the one applied in the US, where it is not individual but federal. Its federal Member States are allowed to default and to restructure their debts, but previously they are able to have recourse to the federal budget to try to avoid it because the US federal budget is 25% of the US GDP, versus the EU where it is only 1.1% of the EU GDP. At the same time, to avoid an excessive use of this recourse, they are not allowed to have fiscal deficits since they are subjected to a balanced budget constitutional amendment that concerns a part of their total spending and that it is not applied on a yearly basis, given that they can carry the deficit or surplus from previous years into the following year.

Therefore, when a US state has a large fall in revenue due to a large recession (what is the case this year in 48 US states) the US federal budget still pays all their social security and unemployment subsidies, plus their health expenditure and some of its public services, which help to get them out of the budget deficit earlier and avoid default. In the case of Greece, as it is a fiscally sovereign Member State, it cannot be much helped by a very small centralized budget or by any other Member State due to the "non bail out clause" included in the Treaty. If Greece had introduced a constitutional budget rule in its constitution it would be in a much better situation than it is today.

4) Introducing a joint Euro Area Bond. Given that Member States are not ready to relinquish more fiscal sovereignty by enlarging the EU budget or having a European Monetary Fund, they should, at least, introduce the option of issuing a single euro bond, which may help to avoid future crises, to increase the attraction of investors to EA sovereign debt and to strengthen the international role of the euro.

The very recent 440 billion euros European Stability Fund (ESF), designed to purchase government debt from Member States facing funding difficulties at an interest rate below market rates, is going to finance its purchases issuing debt jointly guaranteed by the EA Member States. This precedent solves the main problem of issuing an EA Eurobond, which also needs to have the guarantee of all its Member States. The issuer could be the European Investment Bank (EIB), where the Member States percentages of its capital could be used as a benchmark for the Member States guaranties, or a new EU financing agency that could be eventually the germ of a future European Treasury, so much needed today after the debt crisis.

The Eurobond has many advantages for all Member States. First, it is a clear signal to the markets that the EA can do something together on the fiscal front and on the funding front. Second, it would increase the capability of issuing as it did after 1999, where total issuance by governments multiply by 75% in a few years. Third, it would lower significantly the average cost of funding of the EA given that higher liquidity is, by definition a "free lunch", in the sense that it would bring a liquidity premium to the present bond issuance and thus, it would lower average yields regardless whether the Euro Area Bond is guarantied jointly by all Member States or a tranche by every Member State. In the first case the fall in yields will of course be much larger. Fourth, it would eliminate the present liquidity-induced spread widening that has affected to all EA Member States, including Germany. Fifth, it would attract far more investors looking for diversification among the 16 EA members, which would also lower average yields. Finally, its size and depth will be almost a large as the US Treasury Bond attracting a much larger number and variety of international investors.

This Euro Area Bond could be structured in two basic ways: as a jointly guaranteed bond or as a bond split into a senior and a junior tranche or as a blue and red tranche. In the first case, unless the new EA fiscal framework is strong and transparent enough and well received and perceived by the markets, its yields will be, at least at the beginning, higher than expected because markets will expect issues of moral hazard where some Member States benefit at the expense of others. In the second case, the senior and junior tranche will benefit both types of Member States because they will be represented in both tranches, so as to reduce the moral hazard peril and to increase the rating of the senior debt further.