European Macroeconomics
VI. The institutional framework for fiscal policy in the euro area

Lecture 10
The Euro area is a hybrid entity:
- **Supranational** monetary policy (European Monetary Union)
- 19 independent **national** fiscal policies

Is a single monetary policy possible without political integration?
- **German view before Maastricht**: Monetary union is the last step of integration after political union (“Krönungstheorie”: monetary union is the coronation of political integration)
- **Traditional French view**: Monetary union leads to political union (“Grundsteintheorie”: monetary union is a foundation of political integration). Jacques Rueff (French economist, 1896-1978): “L'Europe se fera par la monnaie ou ne se fera pas »
Fiscal policy externalities due to the lack of political integration

Positive externalities:
In case of negative demand shocks, especially smaller countries try to free-ride in anti-cyclical fiscal policies

→ Solution in the Maastricht Treaty: Weak coordination of national fiscal policies

Negative externalities:
A country follows unstable fiscal policies with negative effects on EMU and other member states as the discipline by foreign exchange markets is absent in a monetary union:

→ Solution in the Maastricht Treaty: Political discipline plus market discipline:
  - Rules with limits for budget deficits and debt to GDP ratios. Procedures for sanctioning member countries.
  - No-bail-out clause which should foster market discipline by capital markets
The insolvency problem for governments due to EMU membership

- Key insight of Modern Monetary Theory:
  - Large countries have no financing constraint as they can issue debt denominated in their own currency.
  - The national central bank supports the government by purchasing government bonds (“Quantitative Easing”)
- EMU member states issue debt in euro and their national central bank is unable to support them
- They are de facto in the situation of an emerging market economy which can only issue debt in a foreign currency („original sin“)
- Euro crises (2010/12) show that in a crisis of confidence, EMU member states are faced with severe liquidity and solvency risks
VI. I) The difficult task of fiscal policy coordination in a monetary union
Insights of the Delors-Report (1989)\(^1\)

- The Delors Report was the **blueprint European Monetary Union**. It was written in 1988/89 by Jacques Delors (President of the Commission), the EU central bank governors and academics.

- **Insights** on the need for cooperation:
  - "(...) uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community.
  - Moreover, the fact that the centrally managed Community budget is likely to remain a very small part of total public-sector spending (...) will mean that the task of setting a Community-wide fiscal policy stance will have to be performed through the coordination of national budgetary policies.
  - Without such coordination it would be impossible for the Community as a whole to establish a fiscal/monetary policy mix appropriate for the preservation of internal balance (...). **Monetary policy alone cannot be expected to perform these functions.**"

## Macroeconomic shocks and policy assignments in EMU

<table>
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<tr>
<th>Shock affects all member states</th>
<th>Shock affects only a single country (idiosyncratic shock)</th>
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<tbody>
<tr>
<td><strong>Monetary Policy</strong></td>
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<td>ECB can react in optimal way: Fast response and no need for cooperation at the national level</td>
<td>ECB reacts only to the degree of the share of the country in the EMU-GDP. For smaller countries very weak interest rate effect</td>
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<td><strong>Fiscal Policy</strong></td>
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<td>In a strong crisis and when zero-lower-bound of interest rates is reached, additional fiscal policy response is necessary, but strong coordination problems</td>
<td>A response of national fiscal policy is required which has to be stronger than without EMU as monetary policy response is insufficient</td>
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Institutional mechanism for the coordination of fiscal policies in EMU

Article 121 TFEU

1. Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council, in accordance with the provisions of Article 120.

2. The Council shall, on a recommendation from the Commission, formulate a draft for the broad guidelines of the economic policies of the Member States and of the Union, and shall report its findings to the European Council. The European Council shall, acting on the basis of the report from the Council, discuss a conclusion on the broad guidelines of the economic policies of the Member States and of the Union. On the basis of this conclusion, the Council shall adopt a recommendation setting out these broad guidelines. The Council shall inform the European Parliament of its recommendation.

In practice: Very general recommendations

“Coordination of national fiscal policies remains crucial to underpin the recovery. The overall fiscal stance, taking into account national budgets and the Recovery and Resilience Facility, should remain supportive in 2021 and 2022. Fiscal policy should remain agile and adjust to the evolving situation as warranted, and a premature withdrawal of fiscal support should be avoided. (…) Finally, given the expectation of economic activity gradually normalising in the second half of 2021, Member States’ fiscal policies should become more differentiated in 2022, taking into account the state of the recovery, fiscal sustainability and the need to reduce economic, social and territorial divergences. “

The **European Semester**: A complex and very broadly-based mechanism for policy coordination focusing on

- structural reforms, focusing on promoting growth and employment,
- social and labour policies, in line with the principles of the European Pillar of Social Rights
- structural reforms set out in the national recovery and resilience plans
- fiscal policies, in order to ensure the sustainability of public finances in line with the Stability and Growth Pact
- prevention of excessive macroeconomic imbalances

This year the assessment was made in the context of the Recovery and Resilience Facility.

US versus Euro area: US fiscal policy with stronger impulses and more stable US GDP growth

Source: IMF, World Economic Outlook
In the 2010s, Germany could not be persuaded to stimulate the euro area.

Source: IMF, World Economic Outlook
VI. II) How to set limitations for national fiscal policies?
Fiscal discipline provided by two pillars:

- **Market discipline** enforced by the no-bail-out clause

Art. 125 TFEU: “The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.”

- Additional safeguards by a **rule-based approach** (Stability and Growth Pact)
Justification for fiscal rules in the Delors-report: Market reactions too late or too abrupt

- “To some extent market forces can exert a disciplinary influence. Financial markets, consumers and investors would respond to differences in macroeconomic developments in individual countries and regions, assess their budgetary and financial positions, penalize deviations from commonly agreed budgetary guidelines or wage settlements, and thus exert pressure for sounder policies.
- However, experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances.
- Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing.
- The constraints imposed by market forces might be either too slow and weak or too sudden and disruptive. Hence countries would have to accept that sharing a common market and a single currency area imposed policy constraints.“ (S. 20)
Ratings improved and risk premiums for Greece were very low

Greece: Creditworthiness using the example of government bonds before the outbreak of the financial crisis

Ratings of long-term government bonds

Risk premiums on German government bonds ¹)

Sources:
Fitch, Moody's, S&P, Thomson Financial Datastream

¹) Yield differentials of 10-year government bonds to German government bonds; monthly averages

Source: Annual report 2010/11 of the German Council of Economic Experts. Figure 19.
Already in 2007, one could see that Greek fiscal data are very unreliable

Source: Recommendation for a COUNCIL DECISION abrogating Decision 2004/917/EC on the existence of an excessive deficit in Greece
In 2010, the financial markets abruptly woke up and panicked.
Legal framework for fiscal rules in the EMU

- Stability and Growth Pact (1996), which restrains Article 126 TFEU
- Reform of the Stability and Growth Pact in 2005 and in 2011 (Sixpack)
- Fiscal compact (2012)
1. Member States shall avoid **excessive government deficits**.

2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt (...) on the basis of the following **two criteria**:

(a) whether the ratio of the planned or actual **government deficit** to gross domestic product exceeds a **reference value**, unless:

- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,
- or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

(b) whether the ratio of **government debt** to gross domestic product exceeds a **reference value**, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The reference values are specified in the Protocol on the excessive deficit procedure annexed to this Treaty.
How the reference values were derived

- **Debt/GDP ratio of 60%**: derived as average of EU member states in 1990
- **Deficit/GDP of 3%**: derived under the assumption of 5% nominal GDP growth. The 60% debt/GDP ratio can be held constant with a deficit relative to GDP of 3%
- **Arithmetics**: the deficit/GDP ratio \( b \) which holds the debt/GDP ratio \( d \) constant for a given nominal GDP growth rate \( g \) is:
  \[
  b = g \times d
  \]
Stability and growth pact (1997): The preventive arm aims at balanced budgets in normal times

- Each Member State shall have a differentiated medium-term objective (MTO) for its budgetary position.

- These country-specific medium-term budgetary objectives may diverge from the requirement of a close to balance or in surplus position, while providing a safety margin with respect to the 3% of GDP government deficit ratio.

- The medium-term budgetary objectives shall ensure the sustainability of public finances or a rapid progress towards such sustainability while allowing room for budgetary manoeuvre, considering in particular the need for public investment.

- Countries who do not meet the medium-term objective must present a convergence programme with the adjustment path towards the MTO.

- The pact has become extremely complex over time.
Corrective arm of the excessive deficit procedure

„Six pack“ (2011)

- If the **60% reference for the debt-to-GDP ratio** is not respected, the Member State concerned will be put in excessive deficit procedure (even if its deficit is below 3%!), after taking into account all relevant factors and the impact of the economic cycle, **if the gap between its debt level and the 60% reference is not reduced by 1/20th annually** (on average over 3 years).

- In case a euro area Member States does not respect its obligations, a financial sanction can be imposed by the Council on the basis of a Commission recommendation, unless a qualified majority of Member States vote against it. This is the so-called **“reverse qualified majority”** voting procedure.
How realistic is the 60% debt threshold today?

Gross government debt ratio in 2021
(percent of GDP)

Source: OECD, Economic Outlook Annex Tables
“Functional Finance”: Science opposed to scholasticism

Abba P. Lerner (1903 – 1982)

“(…) government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall be undertaken with an eye only to the results of these actions on the economy and not to any established doctrine of what is sound and unsound.

The principle of judging only by the effects has been applied in many other fields of human activity, where it is known as the method of science as opposed to scholasticism.”
Is 90 % a reasonable limit?

Source: Growth in a Time of Debt, Carmen M. Reinhart and Kenneth S. Rogoff
“Our results **do not identify any clear debt threshold** above which medium-term growth prospects are dramatically compromised. On the contrary, the association between debt and medium-term growth becomes rather weak at high levels of debt, especially when controlling for the average growth performance of country peers.”

Source: WP/14/34 Debt and Growth: Is There a Magic Threshold? Andrea Pescatori, Damiano Sandri, and John Simon
Deriving from this the demand for a **general ban on debt** would be as economically **nonsensical** as prohibiting private individuals or companies from borrowing.

Such a ban would be accompanied by **welfare losses**(...)

[A] **permanent public debt** (...) may be justified to some extent from an intergenerational distributional point of view, namely in the context of **public investments** that increase the wealth of future generations or, mediated by their productivity effects, leave future returns and thus make them 'richer'.

The intergenerational redistributive effect of public debt is a desired outcome here, so that **future beneficiaries** of today's spending also **share in the burden of financing**. This is the intention behind the ‘**Golden Rule of Fiscal Policy**’, which allows credit financing of investment.”

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The members of the Council handing over the 2007 report to Chancellor Angela Merkel

*Image copyright: Sachverständigenrat*
The model of the European Fiscal Board

Source: https://voxeu.org/article/reforming-eu-fiscal-framework-now-time
Can the euro area compete with China and the United States?

Budget balances (percent of GDP)

- Euro area
- USA
- China (incl. province governments)

VI. III) Rescue mechanisms
In the years 2010-2012 countries were losing "market access", i.e., the ability to finance itself on the capital market at reasonable rates.

The European Financial Stability (EFSF) and, since 2012, the European Stability Mechanism (ESM), which are backed by capital from all member states, provide long-term loans with low rates. ESM refinances itself at low rates on the capital market.

EFSF/ESM loans are conditional. Countries receiving loans must implement a structural adjustment programme which was monitored by IMF, EU and ECB (the so-called 'Troika')
Official loans to problem countries

Source: International Monetary Fund, European Commission, European Stability Mechanism, various countries Central Banks and Bloomberg. Debt is measured as percentage of GDP. Market rates, measured on the right hand side axis, refer to the spread on benchmark 10-year sovereign bonds. ESM debt collects all euro area official loans (GLF, bilateral loans, EFSF, EFSM and ESM).
Borrowing costs

Figure 2. Dynamics of borrowing Costs by Creditor Type

Rates by instrument: Greece

Rates by instrument: Ireland

Rates by instrument: Portugal

Rates by instrument: Cyprus

Source: International Monetary Fund, European Commission, European Stability Mechanism and Bloomberg.
## Detailed borrowing costs

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<th>Table 2. Evolution of the terms of official support in the euro area</th>
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<td><strong>Vehicle</strong></td>
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<td>June-2011</td>
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<td>Greece</td>
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Sources: International Monetary Fund, European Commission, European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM). EFSF stands for European Financial Stability Mechanism. * The SBA program was replaced by the subsequent EFF. ** For EFSM loans the reference rate is the EU funding cost, for the EFSF the EFSF’s funding cost and for the GLF the 6 month Euribor. *** Only 41.3 Billion were actually disbursed. **** On December 2021, the EFSF waived Greece the payment of the guarantee commitment fee and deferred interest payments for 10 years.
Redemption profiles

Figure 3. Official Debt: Redemption Profiles

Greek debt redemption profile: EFSF/ESM vs IMF
Portuguese debt redemption profile: EFSF vs IMF
Cypriot debt redemption profile: ESM vs IMF
Irish debt redemption profile: EFSF vs IMF

Source: International Monetary Fund and European Stability Mechanism.
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