How far can Eurozone reform go?

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Calmfors, L., *Eurokrisen, eurosamarbets regelsystem och den framtida integrationen* (The euro crisis, the economic governance of the eurozone and future integration), Sieps 2017:1.

The Euro crisis

Sovereign debt crises

- Greece
- To a large extent Portugal
- (France)
- (Italy)

Banking crises

- Ireland
- Spain
- Cyprus
- (Italy)

Doom loop – interplay between soverign debt crises and banking crises

Measures and Reforms

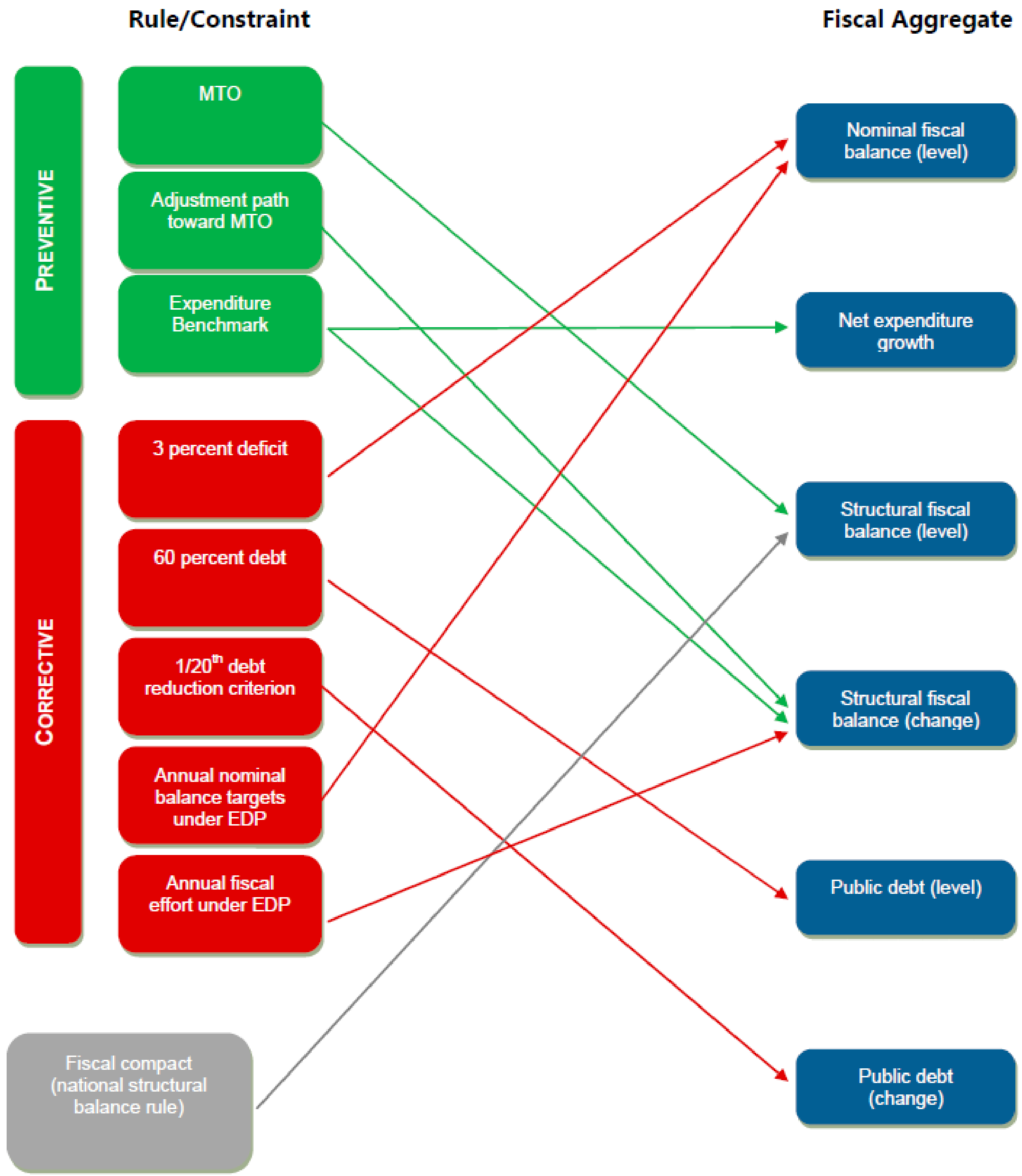
- Bail-outs of governments (in de facto violation of the no-bailout clause)
- ECB: Outright Monetarty Transactions (OMT) and Asset Purchase Programmes (QE)
- Establishment of permanent rescue fund (ESM)
- The European Semester
- Reforms of the Stability Pact
- The Macroeconomic Imbalance Procedure (MIP)
- Strengthening of national fiscal frameworks
- Banking union

A hodge-podge of fiscal rules

- Nominal fiscal deficit ceiling: 3 per cent of GDP
- Government debt ceiling: 60 per cent of GDP
- Stipulations on speed of convergence to government debt ceiling
- Medium-term objectives (MTOs) for structural fiscal balance
- Stipulations on speed of convergence to MTOs
- Net government expenditure rule
- Nominal and structural fiscal balance targets for members states in Excessive Deficit Procedure (EDP)
- National fiscal targets

Figure 3. The EU Fiscal Framework

Multiple Rules and Various Aggregates (as of mid-2014)



Source: IMF.

Factors determining speed of fiscal adjustment when deviations from MTO

- GDP gap
- Government debt ratio
- Fiscal sustainability
- Actual growth relative to potential growth
- Structural reforms
- Some types of government investment
- Escape clauses

  - serious downturn in euro area

  - unusual events outside the control of the individual member state

Table II.2.1: **Matrix for determining the annual fiscal adjustment towards the MTO required under the preventive arm**

	Condition	Required annual fiscal adjustment*	
		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

Source: European Commission.

The fiscal rules are too complex

- Violations of fiscal rules should cause reputation costs with voters
- This requires the rules to be simple, at least not overly complex
- Need for clear benchmark against which to evaluate policy
- A Byzantine system
- First priority: Simplify the rules!

Fundamental credibility problem for the fiscal rules

- Fundamental **time inconsistency problem**
  - fiscal rules are not fully applied
  - no fines for Portugal and Spain
  - silk gloves for France and Italy
- Financial sanctions seem impossible to use
  - repeated game: tomorrow´s sinners will not punish today´s sinners
  - hard to explain that the medicine against too large budget deficits is fines that increase the deficits further
  - fears of political backlash against the EU

Surprisingly large steps towards more integration with the Banking Union

- Single Supervisory Mechanism (SSM)
- Single Resolution Mechanism (SRM)
- Single Resolution Fund (SRF)
- Bail-in rules

But the Banking Union is incomplete

- European Deposit Insurance System (EDIS)
- Curbs on sovereign exposure of banks
- Mandate for ESM to provide a backstop to the SRF and EDIS (and to recapitalise banks directly)

  - bail-in rules not likely to work in systemic crisis

The way forward?

- Bailouts of governments create moral hazard problems

  - incentives of lenders rather than governments
- Fiscal union could handle these problems
- Also other arguments for fiscal union

  - cyclically dependent fiscal transfers between member states as a(n imperfect) substitute for own monetary policy

  - common fiscal stance
- But fiscal union is not politically feasible in the short run and perhaps not even in the long run

  - fiscal decisions are often seem to form the core of national policy-making

Lessons from recent reforms

- It is easier to pusue integration in the area of financial policy than in the area of fiscal policy
  - financial regulation and crisis management are seen as more *technocratic* areas
- Complete the Banking Union!
- This reduces the need for government bailouts
- Restore the no-bailout clause and establish an orderly process for restructuring of government debt
- Change the mandate of the ESM
- Acknowledge that financial sanctions will never be used
- Rely instead on market discipline and stronger national fiscal institutions
- Simpler common fiscal rules as a helpful ”fiscal norm” in the national fiscal policy debate

What is the role of the euro for European integration?

- My earlier view: the euro crisis was a threat against the EU and future European integration
- But the popularity of the euro held up well despite the crisis
- My current view (after Brexit): the euro is one of the most important pillars of the EU and European integration
- But the main reason is fear of what would happen without the euro
- This is also the main problem for European integration
- ”Integration by fear” should be replaced by ”Integration by hope”

  - easy to say, hard to do