Public hearing of the European Parliament on a budgetary capacity in the euro area (Brussels, 2 March 2016)

Introductory remarks by Klaas Knot

Mr Chair,

Mme Rapporteur, Mr Rapporteur,

Honorable Members of the European Parliament,

Ladies and Gentlemen,

Thank you for your invitation to participate in this public hearing on a budgetary capacity for the euro area. I am honored to share my views here in the European Parliament, and I hope my contribution is useful for the report you are preparing on this topic.

You seem to approach a possible fiscal capacity from a relatively wide angle. The working document for this meeting sums up an impressive number of potential functions for such a capacity, including supporting convergence, incentivizing reforms and providing a lender of last resort. I want to focus my remarks on the function that could in my view provide the greatest added value: the stabilization of asymmetric shocks. To this end, I want to discuss four aspects that are relevant when thinking about a European budgetary stabilization fund. These are: 1) the impact of business cycles and financial cycles; 2) the interaction of Eurozone and national Member States' fiscal spaces; 3) the difference between ex-ante risk-sharing and ex-post redistribution through (one-directional) transfers and 4) the relative importance of private versus public risk-sharing.

But before I get to these aspects, let me give you a short recap of how budgetary policy evolved during the crisis. In the original setup of EMU a federal budget was not seen as necessary. The view was that countries could stabilize asymmetric shocks via their national budgets, if they would stick to the rules of the Stability and Growth Pact. Unfortunately, the situation played out differently. In several countries, budgetary policy could not perform its stabilizing function well. This was partly due to insufficient budgetary discipline prior to the crisis. Many countries reached the medium term objective of a budget close to balance

or in surplus only in their projections, never in reality. Moreover, the fiscal shock during the crisis was amplified significantly by the macroeconomic imbalances that had built in the years before. In the countries with the most severe imbalances, Greece, Portugal, Ireland and Spain, the budget deficit for 2009 turned out to be on average almost 11% of GDP higher than foreseen just one year earlier.[1]

As a result, a longer period of fiscal consolidation was unavoidable in several Member States. Over 2011-2014, the overall fiscal stance in the euro area was contractionary, exactly in a period when monetary policy reached the *zero lower bound*. In these exceptional circumstances, a budgetary stabilization fund could at least in theory have helped to stabilize asymmetric shocks in Member States, and could have contributed to a more balanced policy mix for the euro area as a whole.

At the same time, it was already clear before the start of EMU that designing a stabilization fund is much more difficult in practice than in theory. It is hard to meet the conditions that would make such a fund politically acceptable, some of which are repeated in the Five Presidents' Report. As there is very little support for a large federal budget, the fund would have to remain limited in size. Moreover, it also seems especially challenging to avoid permanent transfers and negative effects on budgetary discipline. In that context, I want to highlight three main practical challenges and one potential alternative.

First, a challenge is that the type of asymmetric fluctuations we had in the euro area is difficult to stabilize effectively with a limited fiscal capacity. Stabilization funds are typically directed at the *business* cycle, which has a duration of around 8 years. This would keep contributions to the fund and payments from the fund fairly temporary. However, business cycles have been surprisingly synchronized since 1999 in the euro area. Instead, the asymmetric fluctuations in fiscal positions were much larger and longer lasting. They were related to the *financial* cycle, which has a duration of 16 to 20 years, and coincided with persistent

[1] In the Spring 2008 European Commission Economic Forecast.

divergences in price competitiveness, current accounts and in the growth of credit and house prices. These longer lasting fluctuations pose significant feasibility challenges, which have not yet received much attention, neither in the Five Presidents' Report, nor elsewhere.[2] A fund directed at business cycles will only stabilize a small part of the financial cycle. But a fund directed at the financial cycle leads to much longer-lasting transfers than countries seem currently willing to accept.

The second practical challenge is that the budgetary capacity will inevitably interact with national fiscal policies. For one, the fund might increase taxes levied at the European level. But eventually all taxes need to be paid by the same pool of European taxpayers. A federal fund may (depending on its design) thus reduce the scope for national taxation, and therefore the fiscal space available to Member States. This problem could become more severe if the fund is allowed to borrow, as it carries the risk of *deficit bias* at the federal level. Given the current level of taxation in euro area Member States, a stabilization fund should preferably not lead to higher overall taxation or borrowing. But that means that the fund could interfere with the enforcement of the Stability and Growth Pact. Thus, the conclusion appears inescapable that any move towards a fiscal capacity at the Eurozone level should go hand in hand with much stronger enforcement of fiscal rules at the Member State level, with an even stronger focus on debt levels and implicit future tax liabilities.

The third practical challenge is that a stabilization fund would further increase public risk sharing. Public risk sharing in EMU has increased markedly in recent years, through mechanisms such as the ESM. While this is not a bad thing, the fundamental problem is that EMU is still not functioning sufficiently well in some important policy areas. Member States still differ substantially, not only in terms of government debt or current account balances, but also in terms of adaptability, overall competitiveness and institutional quality. If starting positions differ so much, a stabilization fund might well result in permanent one-

[2] Gilbert en Hessel (2014), Hoe nuttig is een budgettair stabilisatiefonds in de EMU?, *Tijdschrift voor Openbare Financiën*, vol 46(4), p. 96-105.

directional transfers rather than a form of risk-sharing that is fair ex-ante, in the sense that one has no clue beforehand in which direction the payments will go. Any further increase in public risk sharing should therefore be accompanied by stronger efforts for risk reduction. EMU would need a much stricter compliance with both the SGP and the Macroeconomic Imbalances Procedure, in order to effectively prevent future imbalances. And EMU would also need much stronger convergence of economic structures, such as a more coordinated approach towards product and labour market reform.

Due to these challenges, policymakers will have to think very carefully about the design of any fund and about the requirements it brings for other areas of the monetary union. Meanwhile, and this is my fourth and final observation, other ways to improve the stabilization of shocks are available. A well-known study shows that in the U.S., *private* risk-sharing via integrated financial markets is smoothing a larger percentage of asymmetric shocks (around 62%) than *public* risk sharing via the federal budget (around 13%).[3] More recent studies for Canada and Germany find similar results.[4] Private risk sharing is much less developed in EMU. In fact, private capital flows even exacerbated asymmetries during the crisis, when vulnerable countries experienced pro-cyclical capital flight. There is much to gain from stimulating more robust forms of financial integration, and from better preventing capital flight. The European Capital Markets Union is a good starting point for this. This implies that even before we turn to a federal budget, the smoothing of shocks can still be improved upon markedly.

Thank you for your attention.

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[3] Asdrubali, Sorensen and Yosha (1998), Channels of interstate risk-sharing. The United States 1963-1990, *Quarterly Journal of Economics*, 111(4), p. 1081-1110.
[4] Hepp and Von Hagen (2012), 'Interstate risk sharing in Germany: 1970–2006', *Oxford Economic Papers*, 65(1), p 1–24. Balli, Basher and Rosmy (2011), 'Channels of risk-sharing among Canadian provinces: 1961–2006', *MPRA Paper No. 30876*.