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Fiscal policies and public finance challenges



EUROPEAN CENTRAL BANK

EUROSYSTEM

Overview

- 1 Fiscal Policy in a monetary union
- 2 Fiscal governance framework: main elements and implementation
- 3 EMU deepening



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1 Fiscal Policy in a monetary union

The division of monetary & fiscal policy tasks in EMU

Monetary Policy

- Single monetary policy
- The primary objective is maintaining price stability
- Without prejudice to this, support the policies in the Community
- Central bank independence
- No monetary financing of governments

Fiscal Policies

- Competence of Member States
- But: fiscal policies are subject to common rules of budgetary discipline, and surveillance
- No bailout clause (no debt mutualisation)



The need for fiscal discipline in EMU

- Counteract **deficit bias** in form of **expansionary fiscal policies/accumulation of high debt** in a monetary union (no free-riding)
- Limit risk of **spillover effects and contagion** (limiting risk of sovereign-bank nexus)
- **EMU stability** is based on sound policies – debt limit (**no bail-out clause**)
- Sound fiscal positions allow for **automatic stabilisers** to work
 - dampen cyclical fluctuations
 - provide a buffer against shocks
- **Avoid pro-cyclical fiscal policies** under normal circumstances (i.e. no expansionary policies in boom period as this would require even higher consolidation needs during bad times)
- Building buffers in good times helps to reduce economic and social costs in recessions or **crisis times**

Why are fiscal policies important for the ECB?

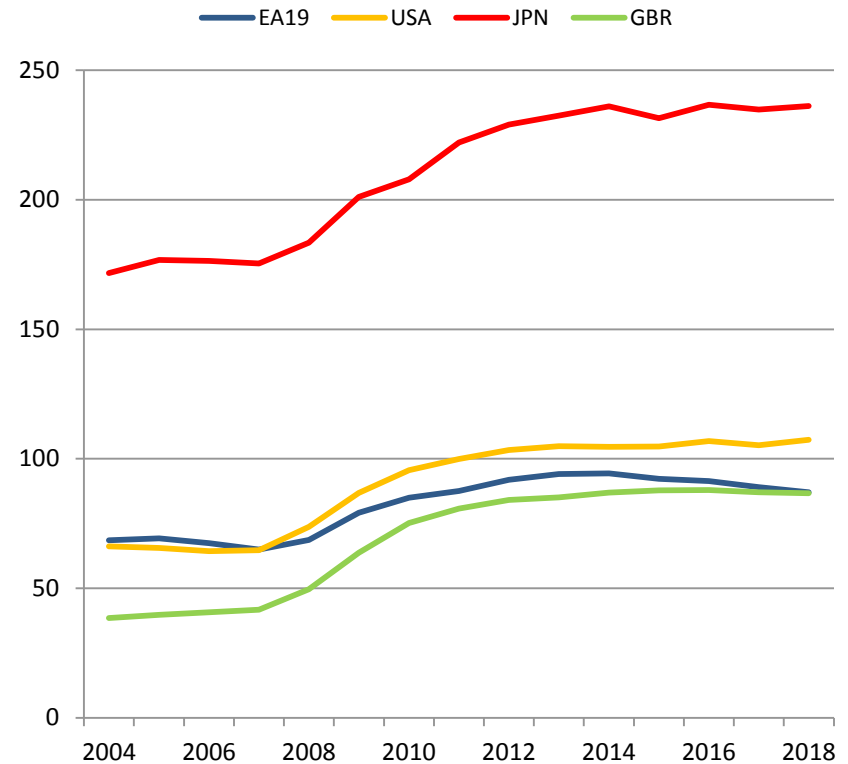
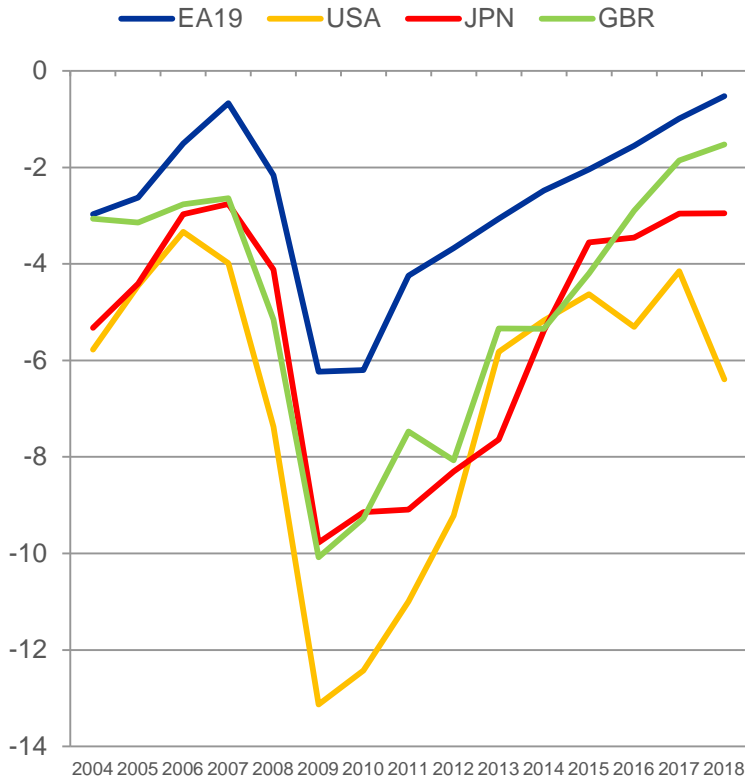
- Possible risks from fiscal policy stance for price stability:
 - direct (e.g. increases of the VAT)
 - indirect (e.g. public wages/aggregate demand)
- Possible risks from unsustainable fiscal policies on monetary policy:
 - increase pressure on ECB to tolerate higher inflation to erode the real value of debt: risk of fiscal dominance
 - fiscal stress may lead to dysfunctional government bond markets, which hamper the transmission of monetary policy
 - risks to the balance sheet

Currently lower deficits & debt compared to other regions ...



Evolution of government deficit in major economies
(% of GDP)

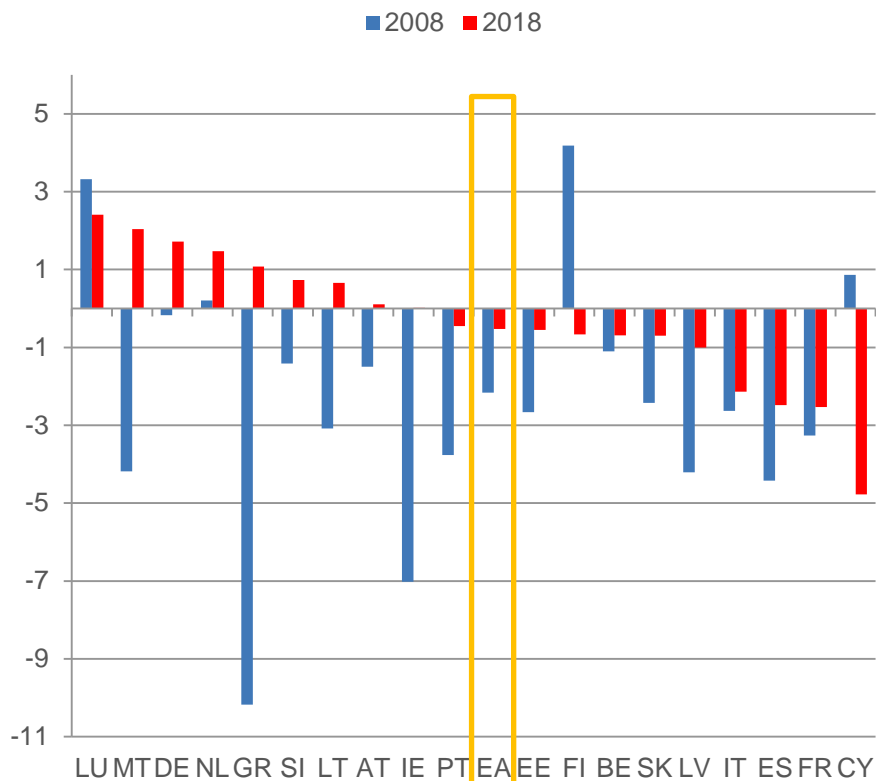
Evolution of government debt in major economies
(% of GDP)



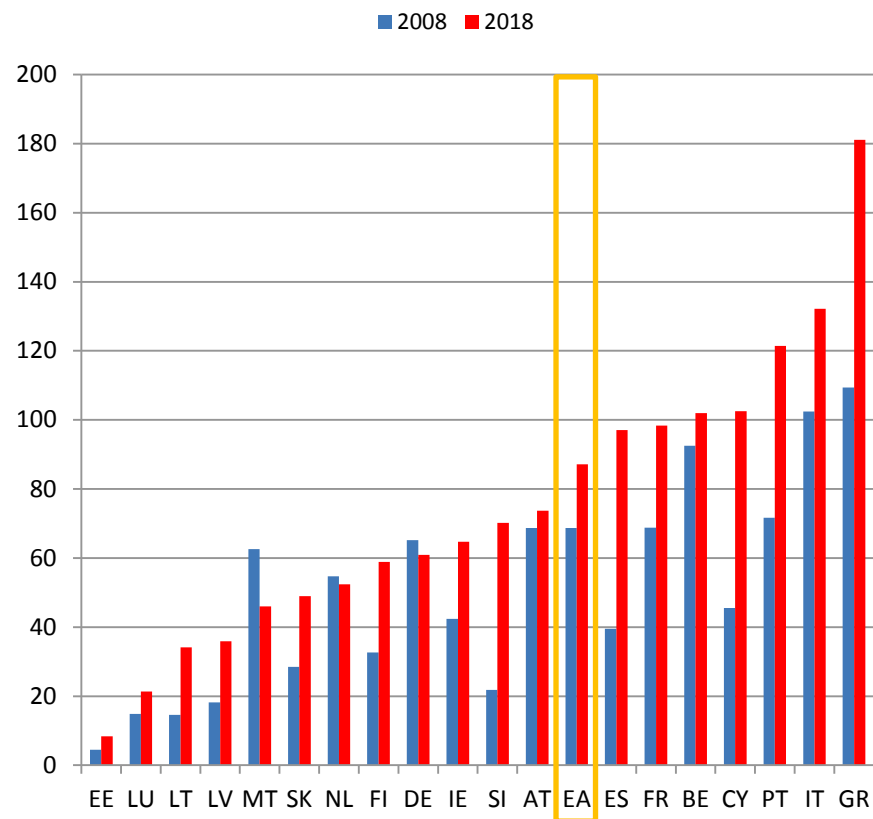
Source: European Commission

... but sizeable differences across EA countries

Government deficit in the euro area countries
(% of GDP)



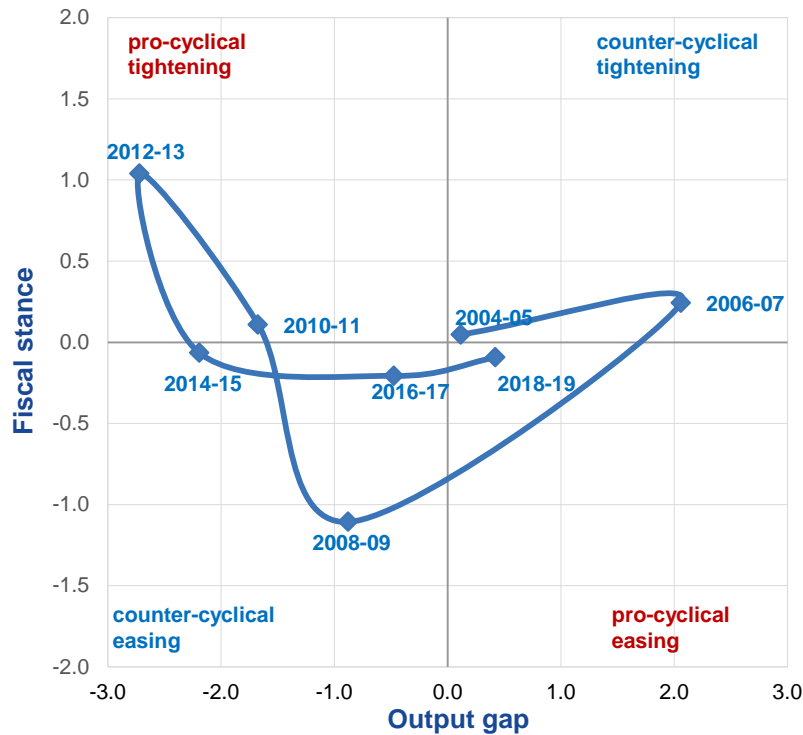
Government debt in the euro area countries
(% of GDP)



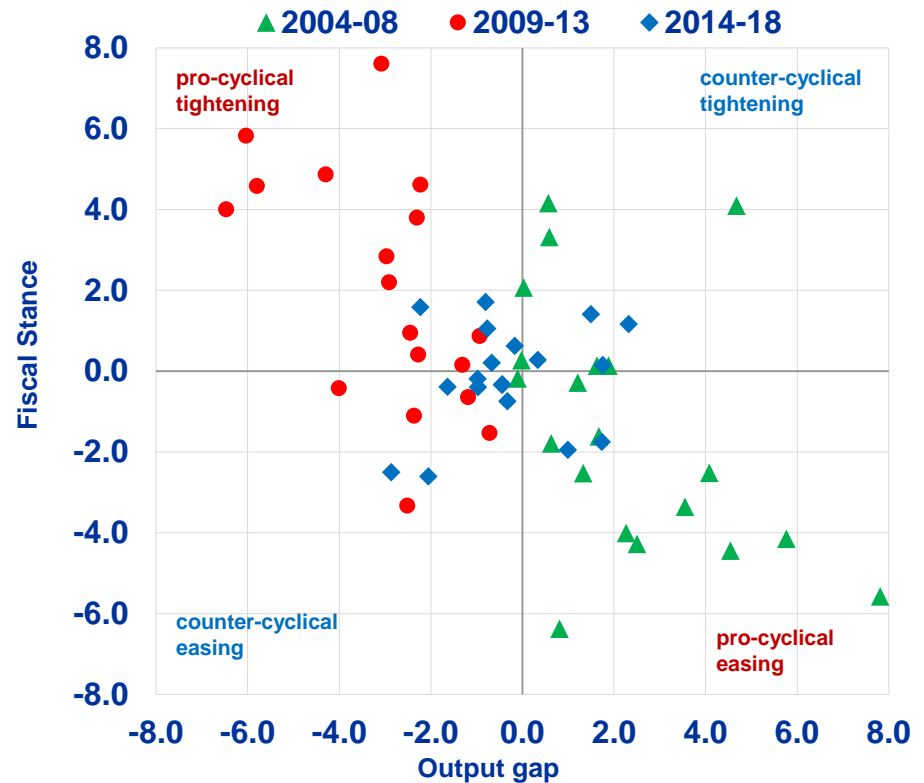
Source: European Commission

Fiscal stance and business cycle: some evidence of past pro-cyclical fiscal policies

Evolution of the fiscal stance and output gap:
euro area
(in % of potential GDP)



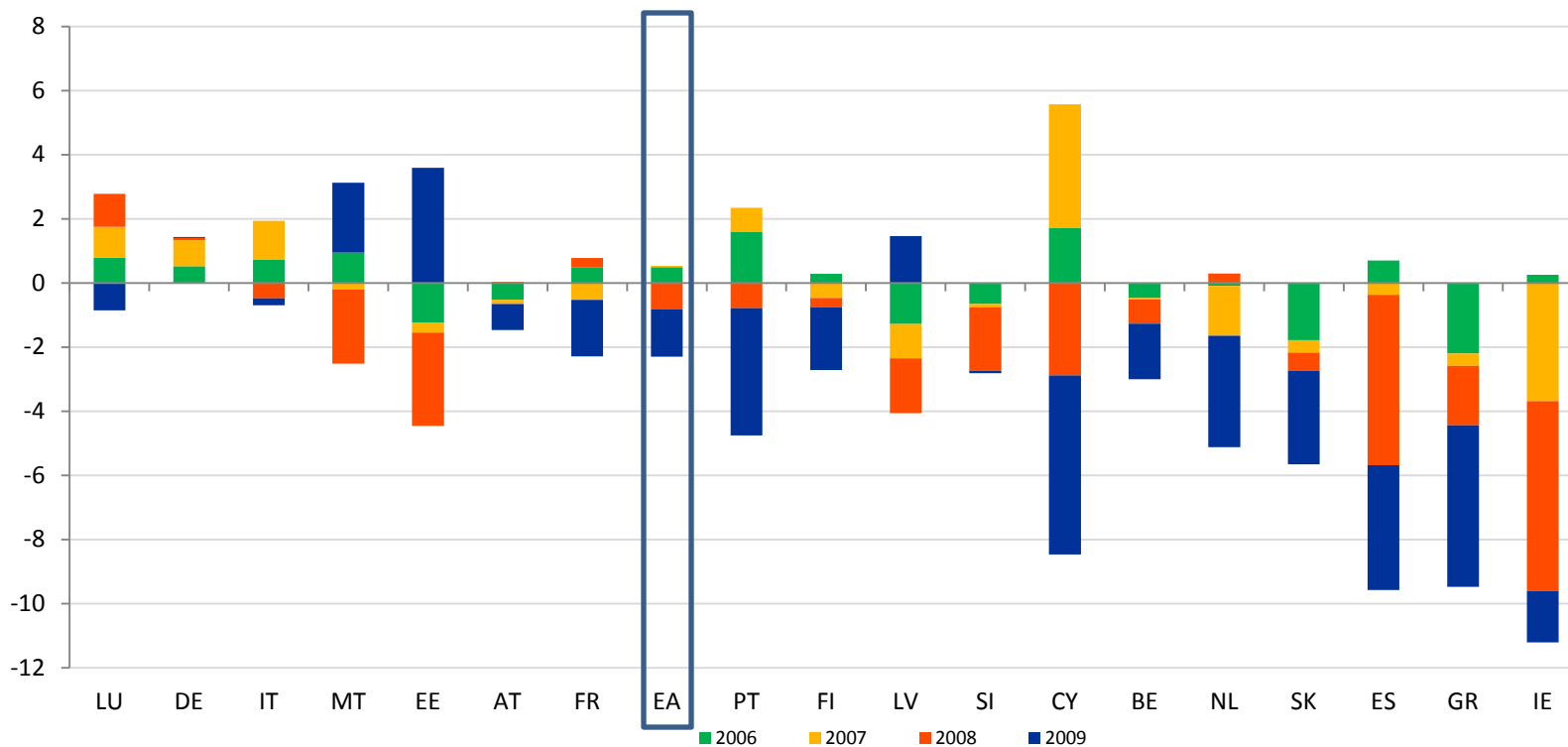
Evolution of the fiscal stance and output gaps
across euro area countries
(in % of potential GDP)



Source: ECB staff computation on European Commission data. 2019 is Commission's forecast (Spring 2019).

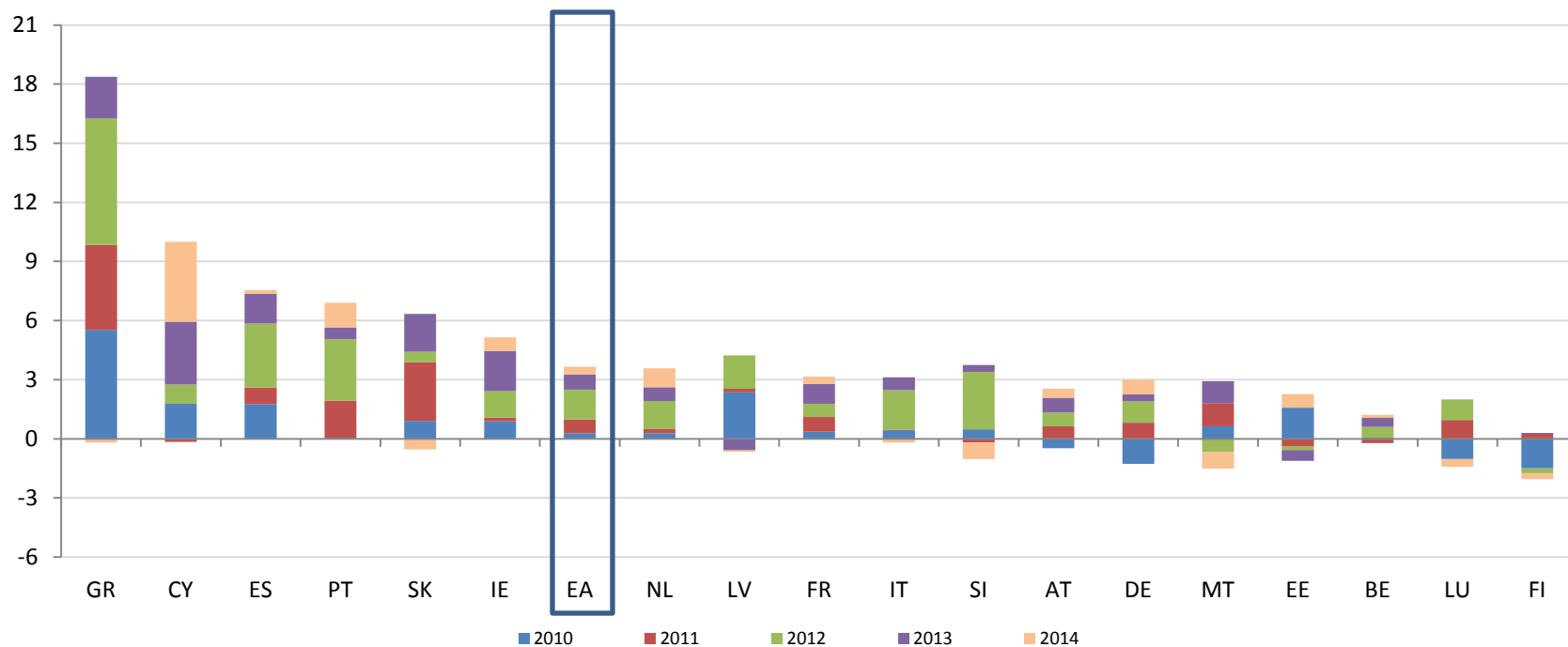
In run up and in response to financial crisis

Fiscal expansion in EA countries (change in structural balance)



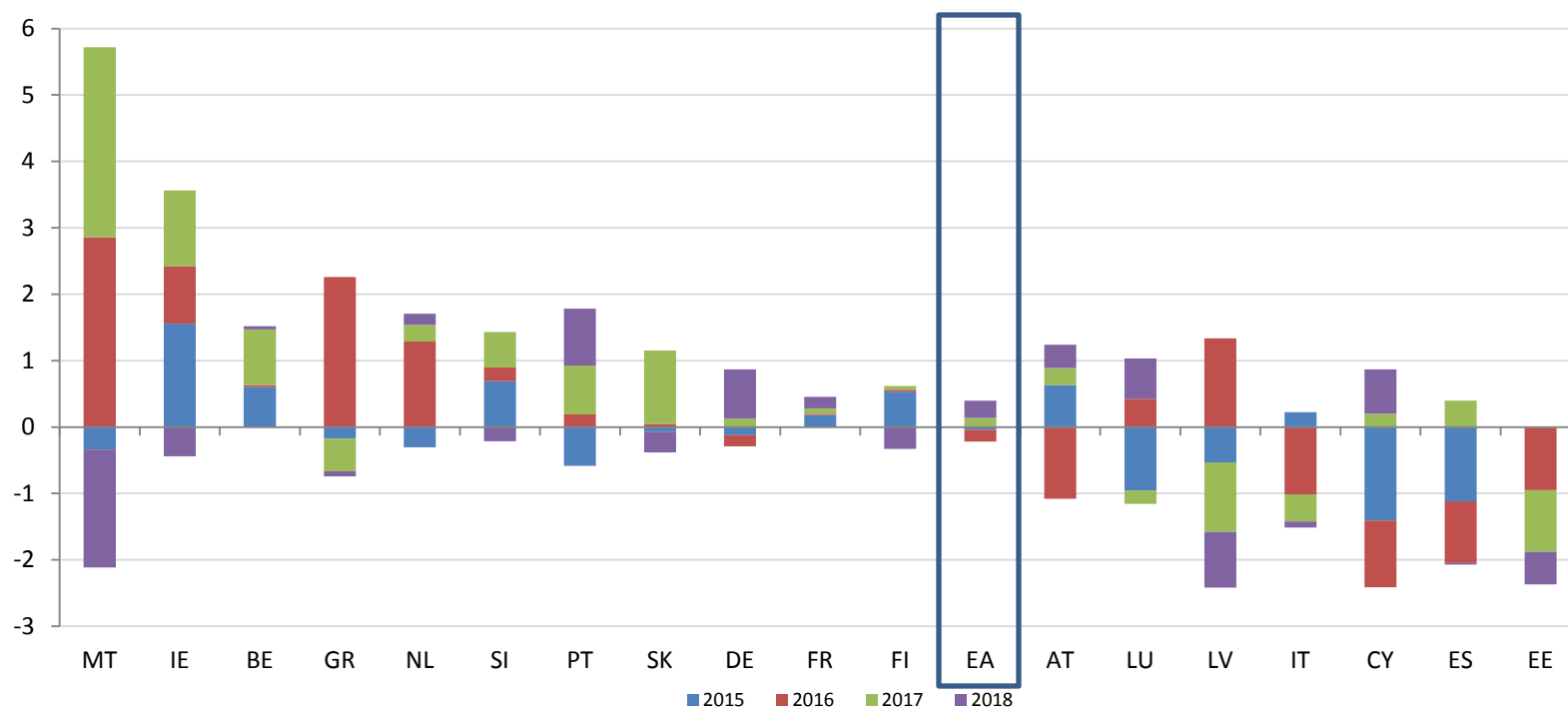
Sizeable consolidation has been achieved

Consolidation in EA countries (change in structural balance)



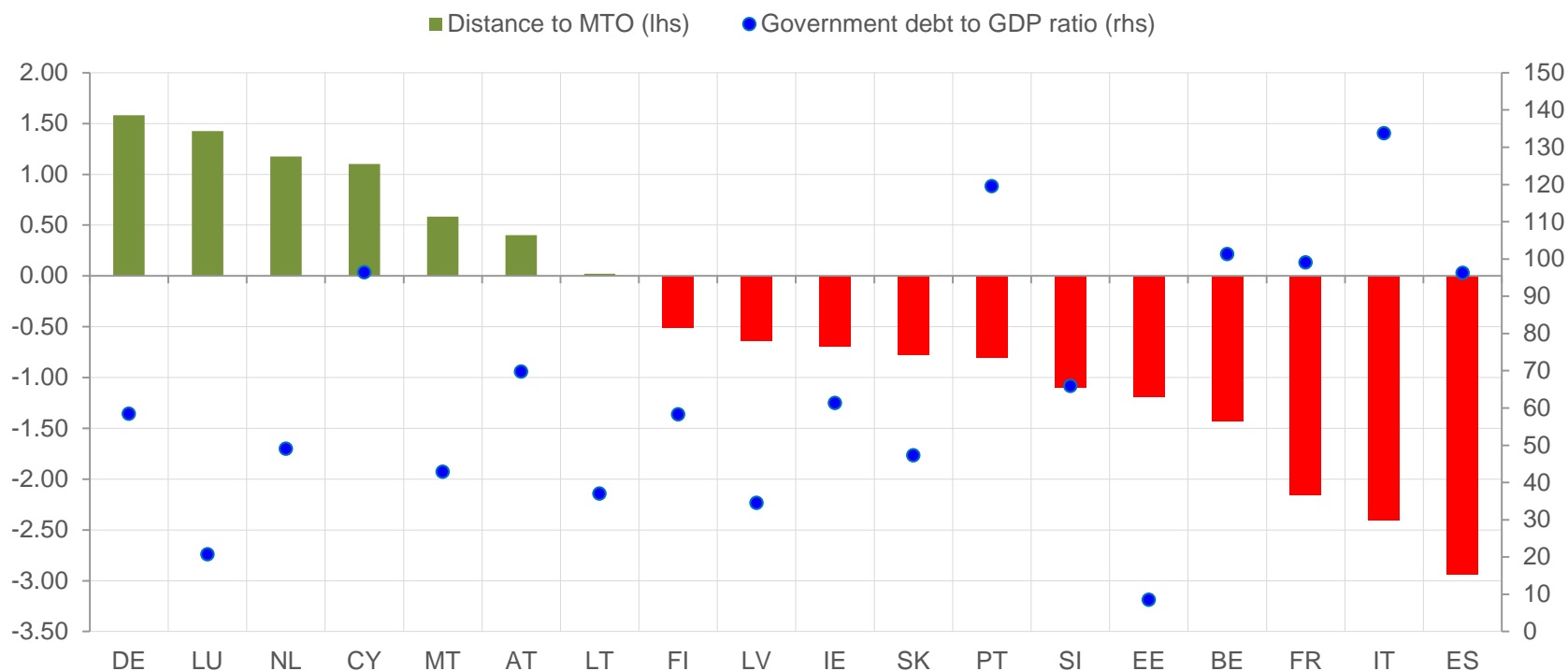
... but efforts are slowing down and turning expansionary

Consolidation in EA countries
(change in structural balance)



Fiscal space and risks of future pro-cyclical fiscal policies

Public debt and distance to medium term objectives for 2019
(in % of GDP)



Sources: European Commission data (2019 Spring forecast) and ECB staff calculations.



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2 Fiscal governance framework: main elements and implementation

Fiscal rules in EMU: the EU Treaty



Building blocks of EMU fiscal policy framework in the Treaty

- Article 126: Excessive Deficit Procedure (EDP)
- Protocol on the EDP: 3% and 60% reference values
- Further relevant provisions
 - Article 121: Co-ordination of economic policies
 - Article 122: Union financial assistance in exceptional circumstances
 - Article 123: no monetary ECB financing of governments
 - Article 124: no privileged government access to financial institutions
 - Article 125: no bail out clause

Treaty needs to be made operational: **Stability and Growth Pact**

The two arms of the Stability and Growth Pact



Stability and Growth Pact

Preventive arm

Definition of country-specific budgetary objectives (MTO)

Surveillance of compliance with MTO/adjustment path

Decision on significant deviation from adjustment path

Recommendation for correction

Decision on effective action

Decision on sanctions (interest bearing deposit)

Corrective arm

Deficit and debt reporting by MS, checked by Eurostat

Surveillance of compliance with deficit/debt criteria

Decision on excessive deficit and/or debt

Recommendation for deficit reduction

Decision on effective action

Decisions on financial sanctions (fines)

The preventive arm of the SGP



- Member States commit to reach a country-specific “medium-term objective” (MTO), of a structural balance “close to balance or in surplus”:
 - a safety margin with respect to 3% of GDP reference value
 - to ensure rapid progress towards sustainable public finances
 - accounting for implicit liabilities (ageing)
- **Assessment** of progress towards sound fiscal positions :
 - benchmark: annual structural adjustment of 0.5% of GDP
 - SGP flexibility clauses (accounting for cyclical position/debt level, public investment, structural reforms)
 - expenditure growth needs to be in line with medium-term potential GDP growth (“expenditure benchmark”)
- The ECOFIN Council can issue **early warnings**; ultimately possibility of **financial sanction** (interest bearing deposit)

The corrective arm of the SGP



- Identification of **excessive deficits** or **excessive debt**
 - 3% of GDP deficit and 60% of GDP debt threshold
 - 1/20 debt rule for debt reduction
 - based on data submitted by national governments & checked by EUROSTAT
 - consideration of escape clauses
- Recommendations for the **correction** of excessive deficits
 - speed of adjustment at least 0.5% of GDP in structural terms per year
 - annual nominal deficit targets
 - deadline for correction one year after excessive deficit is diagnosed (as a rule); but multi-annual EDP deadlines possible
 - EDP deadline extension possible in case of unexpected adverse developments and provided that effective action has been taken
- If no effective action: **escalation of procedure** and **possibility to impose sanctions** (non interest-bearing deposit, fines)

Strengthened fiscal governance framework



- **Six-pack:** (since Dec 2011)
 - inclusion of expenditure benchmark and debt rule, better enforcement mechanism, minimum requirements for national fiscal frameworks, macroeconomic imbalances procedure
- **Fiscal compact:** (since January 2013)
 - balanced-budget rule with automatic correction mechanism at national level
- **Two-pack:** (since May 2013)
 - ex-ante coordination of budgetary policies; stronger fiscal surveillance during the year
 - fiscal councils to monitor compliance with fiscal rules
 - independent macroeconomic projections

Poor compliance with the preventive arm...



Structural budget balance (% of GDP)

		Structural net lending (+) / net borrowing (-) (in % of GDP)														
	<i>MTO</i>	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
Belgium	0.0	-0.9	-1.4	-1.4	-2.2	-3.9	-3.9	-4.1	-3.5	-3.1	-2.9	-2.3	-2.3	-1.4	-1.4	
Germany	-0.5	-2.2	-1.7	-0.8	-0.8	-0.7	-2.0	-1.2	-0.1	0.2	1.0	0.9	0.7	0.8	1.6	
Estonia	-0.5	-0.1	-1.3	-1.6	-4.5	-1.0	0.6	0.2	0.1	-0.5	0.2	0.2	-0.8	-1.7	-2.2	
Ireland	-0.5	1.3	1.6	-2.1	-8.0	-9.6	-8.7	-8.6	-7.2	-5.2	-4.5	-2.9	-2.1	-0.9	-1.4	
Greece	n.a.	-5.2	-7.4	-7.8	-9.7	-14.7	-9.2	-4.9	1.6	3.7	3.5	3.3	5.6	5.1	5.0	
Spain	0.0	0.3	1.0	0.6	-4.7	-8.6	-6.8	-6.0	-2.7	-1.2	-1.0	-2.2	-3.1	-2.7	-2.7	
France	-0.4	-4.7	-4.2	-4.7	-4.4	-6.2	-5.8	-5.1	-4.4	-3.4	-3.0	-2.8	-2.8	-2.7	-2.6	
Italy	0.0	-5.1	-4.3	-3.1	-3.6	-3.8	-3.4	-3.4	-1.3	-0.7	-0.9	-0.7	-1.7	-2.1	-2.2	
Cyprus	0.0	-3.4	-1.7	2.2	-0.7	-6.3	-4.5	-4.7	-3.7	-0.5	3.5	2.1	1.1	1.3	2.0	
Latvia	-1.0	-2.0	-3.3	-4.3	-6.0	-4.6	-2.2	-2.0	-0.3	-0.9	-1.0	-1.5	-0.2	-1.2	-2.1	
Lithuania	-1.0	-1.9	-2.3	-3.2	-5.3	-6.9	-3.1	-3.3	-2.2	-1.8	-1.2	-0.6	-0.4	-0.8	-0.8	
Luxembourg	-0.5	-0.2	0.6	1.5	2.6	1.7	0.7	1.6	2.7	2.7	2.3	1.3	1.7	1.5	2.1	
Malta	0.0	-4.2	-3.3	-3.5	-5.8	-3.6	-3.0	-1.8	-2.5	-1.4	-2.2	-2.6	0.3	3.1	1.4	
Netherlands	-0.5	0.6	0.5	-1.0	-0.7	-4.2	-3.9	-3.7	-2.3	-1.6	-0.6	-0.9	0.4	0.6	0.8	
Austria	-0.5	-1.3	-1.8	-1.9	-1.9	-2.7	-3.2	-2.5	-1.8	-1.1	-0.6	0.0	-1.1	-0.8	-0.5	
Portugal	0.25	-6.1	-4.5	-3.8	-4.6	-8.5	-8.5	-6.6	-3.5	-2.9	-1.6	-2.2	-2.0	-1.3	-0.4	
Slovenia	0.25	-1.9	-2.5	-2.6	-4.6	-4.7	-4.2	-4.4	-1.5	-1.1	-2.0	-1.3	-1.1	-0.5	-0.7	
Slovakia	-0.5	-2.2	-4.0	-4.3	-4.9	-7.8	-6.9	-3.9	-3.4	-1.5	-2.0	-2.1	-2.0	-0.9	-1.3	
Finland	-0.5	2.9	3.2	2.7	2.4	0.5	-1.0	-0.8	-1.0	-1.0	-1.3	-0.7	-0.7	-0.7	-1.0	
Euro area *	-0.3	-2.8	-2.3	-2.2	-3.0	-4.5	-4.2	-3.5	-2.0	-1.3	-0.9	-0.9	-1.1	-0.9	-0.7	

Sources: European Commission's spring 2019 economic forecast, figures prior to 2010 are from Spring 2014 vintage of forecasts

(*) Euro area implied MTO

Corrective arm compliance



Budget balance (% of GDP)

	Net lending (+) / net borrowing (-) (in % of GDP)															
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
Belgium	-0.2	-2.8	0.2	0.1	-1.1	-5.4	-4.0	-4.2	-4.2	-3.1	-3.1	-2.4	-2.4	-0.8	-0.7	
Germany	-3.7	-3.4	-1.7	0.2	-0.2	-3.2	-4.2	-1.0	0.0	-0.1	0.6	0.8	0.9	1.0	1.7	
Estonia	2.4	1.1	2.9	2.7	-2.7	-2.2	0.2	1.2	-0.3	-0.2	0.7	0.1	-0.3	-0.4	-0.6	
Ireland	1.3	1.6	2.8	0.3	-7.0	-13.8	-32.1	-12.8	-8.1	-6.2	-3.6	-1.9	-0.7	-0.3	0.0	
Greece	-8.8	-6.2	-5.9	-6.7	-10.2	-15.1	-11.2	-10.3	-8.9	-13.2	-3.6	-5.6	0.5	0.7	1.1	
Spain	0.0	1.2	2.2	1.9	-4.4	-11.0	-9.4	-9.6	-10.5	-7.0	-6.0	-5.3	-4.5	-3.1	-2.5	
France	-3.6	-3.4	-2.4	-2.6	-3.3	-7.2	-6.9	-5.2	-5.0	-4.1	-3.9	-3.6	-3.5	-2.8	-2.5	
Italy	-3.5	-4.1	-3.5	-1.5	-2.6	-5.2	-4.2	-3.7	-2.9	-2.9	-3.0	-2.6	-2.5	-2.4	-2.1	
Cyprus	-3.7	-2.2	-1.0	3.2	0.9	-5.4	-4.7	-5.7	-5.6	-5.1	-9.0	-1.3	0.3	1.8	-4.8	
Latvia	-0.9	-0.4	-0.5	-0.5	-4.2	-9.5	-8.6	-4.3	-1.2	-1.2	-1.4	-1.4	0.1	-0.6	-1.0	
Lithuania	-1.4	-0.3	-0.3	-0.8	-3.1	-9.1	-6.9	-8.9	-3.1	-2.6	-0.6	-0.3	0.2	0.5	0.7	
Luxembourg	-1.3	0.1	1.9	4.2	3.3	-0.7	-0.7	0.5	0.3	1.0	1.3	1.4	1.9	1.4	2.4	
Malta	-4.3	-2.6	-2.5	-2.1	-4.2	-3.2	-2.4	-2.4	-3.5	-2.4	-1.7	-1.0	0.9	3.4	2.0	
Netherlands	-1.8	-0.4	0.1	-0.1	0.2	-5.1	-5.2	-4.4	-3.9	-2.9	-2.2	-2.0	0.0	1.2	1.5	
Austria	-4.8	-2.5	-2.5	-1.4	-1.5	-5.3	-4.4	-2.6	-2.2	-2.0	-2.7	-1.0	-1.6	-0.8	0.1	
Portugal	-6.2	-6.2	-4.3	-3.0	-3.8	-9.8	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.0	-3.0	-0.5	
Slovenia	-2.0	-1.3	-1.2	-0.1	-1.4	-5.8	-5.6	-6.7	-4.0	-14.7	-5.5	-2.8	-1.9	0.0	0.7	
Slovakia	-2.3	-2.9	-3.6	-1.9	-2.4	-7.8	-7.5	-4.3	-4.3	-2.7	-2.7	-2.6	-2.2	-0.8	-0.7	
Finland	2.2	2.6	3.9	5.1	4.2	-2.5	-2.6	-1.0	-2.2	-2.6	-3.2	-2.8	-1.7	-0.8	-0.7	
Euro area	-3.0	-2.6	-1.5	-0.7	-2.2	-6.2	-6.2	-4.2	-3.7	-3.1	-2.5	-2.0	-1.6	-1.0	-0.5	

Source: European Commission Spring 2019 forecast

Poor debt rule compliance in a few cases

- The Commission has issued Article 126(3) reports for Italy and Belgium in which compliance with the debt rule is assessed.
- No-debt based EDP launched for BE and IT despite gaps to debt reduction benchmark once relevant factors have been taken into account.

Italy: Gap to debt reduction benchmark (p.p. of GDP)	2016	2017	2018	2019
Article 126(3) report for Italy 18.5.2016	5.6	4.7		
Article 126(3) report for Italy 22.2.2017	7.4	7.1		
Article 126(3) report for Italy 23.5.2018	5.9	5.1	5.1	5.1
Article 126(3) report for Italy 5.6.2019	5.8	6.7	7.6	9.0
Belgium: Gap to debt reduction benchmark (p.p. of GDP)	2016	2017	2018	2019
Article 126(3) report for Belgium 18.5.2016		2.3		
Article 126(3) report for Belgium 22.5.2017		2.7	2.1	
Article 126(3) report for Belgium 23.5.2018		0.9	0.9	0.9
Article 126(3) report for Belgium 5.6.2019		1.3	1.1	1.7



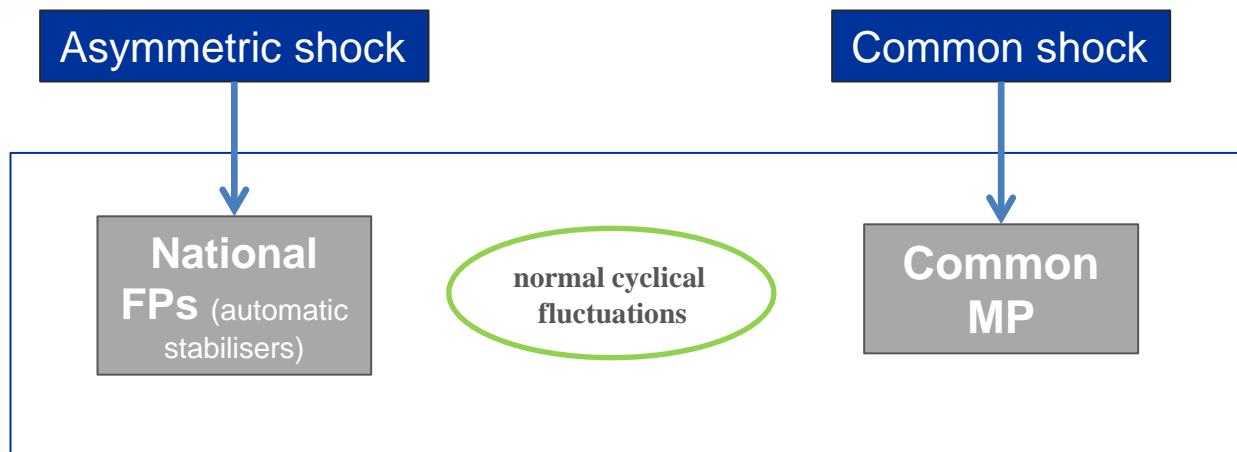
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Overview

3 | EMU deepening

Requirements for a well-functioning EMU



- **The pre-crisis consensus - a clear separation of tasks:**
 - National fiscal policies to smooth idiosyncratic shocks through the operation of automatic stabilisers
 - Monetary policy to stabilise euro-area wide shocks
- **Experience with the Great Recession:**
 - Large and persistent shocks (and pro-cyclical policy in good times) may exhaust fiscal buffers at the national level, hindering automatic stabilisers.
 - Monetary policy may be constrained or more difficult when reaching the effective lower bound, creating rationale for fiscal stabilisation of major area wide recessions.

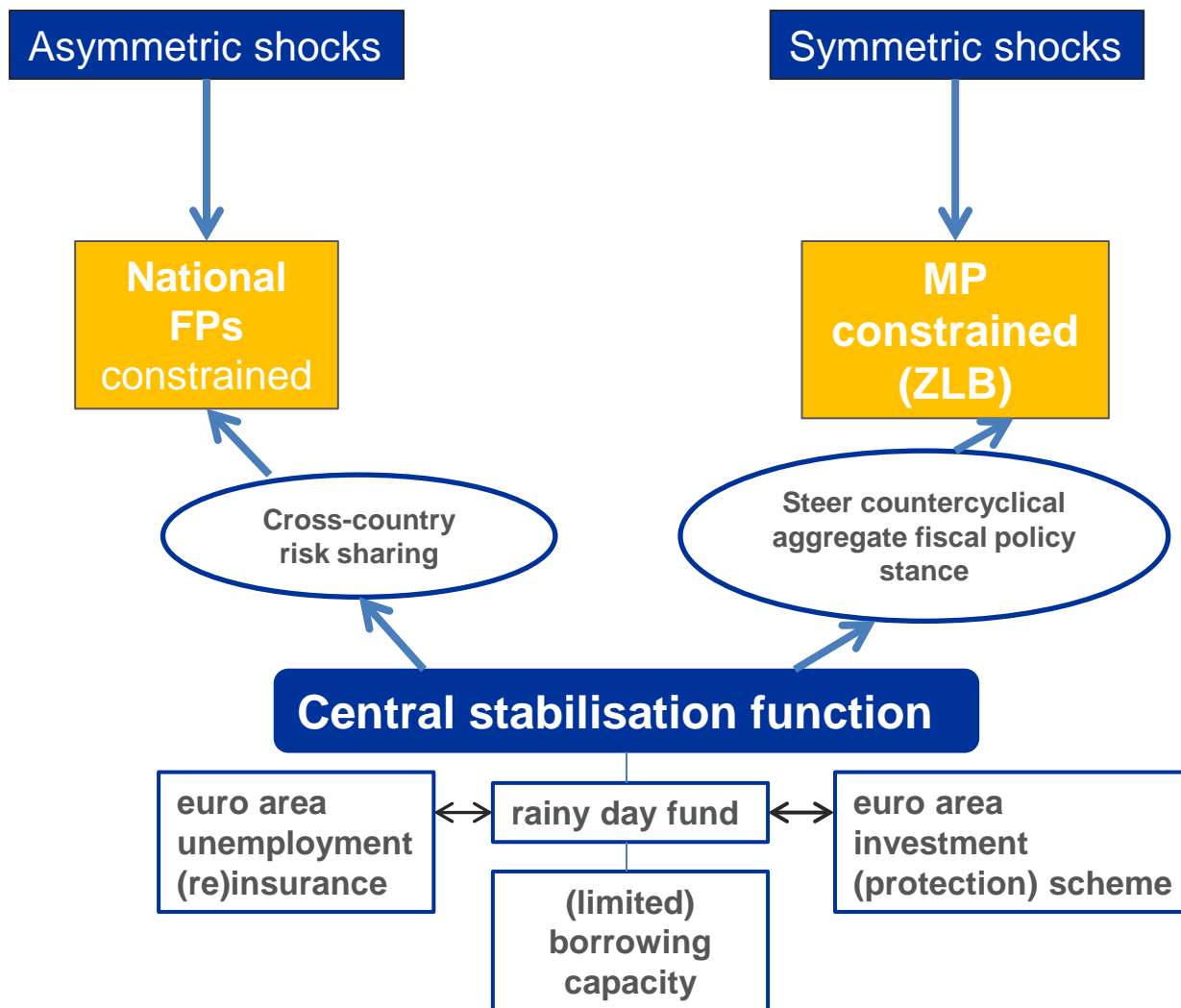
How much private or public risk-sharing in the EMU?

- The architecture of the EMU has been severely challenged during the recent period. Common view: lack of appropriate **risk-sharing mechanisms** at the euro area level.
- **Five President Report**: euro area countries have to take steps, both individually and collectively, to compensate for the national adjustment tools they gave up on entry in the EMU.
- When a country-specific **economic shock occurs**:
 - Each country should be able to respond effectively at the **domestic level**.
 - Member states may also smooth the impact of shocks through private or public **risk sharing within the EMU**.

Options for a euro area fiscal capacity

- **Central fiscal stabilisation instrument standard feature of monetary unions**
 - EA fiscal capacity core proposal on EMU deepening agenda (5PR, COM EMU reflection paper) to:
 - complement national fiscal stabilisers / allow smoother aggregate fiscal policies for the euro area in unusual circumstances ...
 - ... while avoiding permanent transfers and minimising moral hazard
- **Existing governance framework cannot substitute for euro area stabilisation tool**
 - SGP is asymmetric: designed to ensure fiscal discipline, no obligation to use fiscal space
 - Fiscal expansion in Member States with fiscal space may not be equivalent to centrally operated expansion (uncertainties regarding spillovers)

Options for a euro area fiscal capacity



Conclusions and the way ahead



- **Fiscal rules are key in a monetary union, but effective implementation is crucial.**
- **Need to build fiscal buffers in good times.**
- To the extent that **central fiscal capacity** implies risk sharing, features that minimise moral hazard are important.
- **Importance of cross-border private sector financial risk sharing.**



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Thank you for your attention!