


Reviewing SGP and filling gaps in the EMU architecture

Jacques de Larosière - Honorary President, EUROFI

Klaus Regling - Managing Director, European Stability Mechanism

Alessandro Rivera - Director General of the Treasury, Ministry of Economy and Finance, Italy

Harald Waiglein - Director General for Economic Policy, Financial Markets and Customs, Federal Ministry of Finance, Austria

Klaus Regling (Chair)

Klaus Regling outlined that the task for the panel is to talk about how to fill the gaps in the monetary union, which is a broad subject. It is basically agreed that we want to make our monetary union work better, become more resilient and less vulnerable, but the difficult question is how to get there. We need appropriate economic policies, but that was not the subject of this panel.

The other question is how public decision makers can strengthen economic convergence among Member States and avoid fragmentation in the euro area. One key aspect for me is risk sharing, which is under-developed in the euro area. Risk sharing is an essential shock absorbing capacity of any monetary union. In the United States there are several quasi-automatic mechanisms for risk sharing that prevent the regional, cyclical and structural developments to lead to permanent fragmentation. First, a common tax and social security system; second, an integrated banking union and capital markets union; third, fiscal mechanisms that help in a crisis. In Europe, the common tax and social security system will not happen anytime soon. Therefore, it is all the more important to make progress on the Capital Markets Union, Banking Union and fiscal instruments. If there is no progress on risk sharing than the risk of fragmentation will remain present in the monetary union. Any progress on risk sharing would be good for growth and convergence, European sovereignty, and financial autonomy and for the international role of the euro.

Klaus Regling stated that in this context a credible reform of the Stability and Growth Pact is important to make risk sharing politically possible in the economic monetary union (EMU). The panel will address risk sharing more broadly, fiscal mechanisms for risk sharing and the Stability and Growth Pact (SGP). In terms of risk sharing more generally, why is there such a big gap in Europe versus the US. Is it a question of trust or a question of instruments and mechanisms?

Jacques de Larosière

Jacques de Larosière stated that it is not a question of instruments or mechanisms, but that the US is a country and the EU is 27 mostly diverging countries, each one trying to preserve its national regulations. That is the reason for the difference.

Klaus Regling

Klaus Regling stated that Jacques de Larosière's comment seemed pessimistic. Harald Waiglein was asked whether anything can be learned from the US example which is a successful example of risk sharing?

Harald Waiglein

Harald Waiglein agreed that something can be learned from the US. Risk sharing can have a stabilising effect but it is important to get the incentive structure in a risk sharing mechanism right. The Hamilton moment has been much quoted in connection with the Recovery and Resilience Facility (RRF) and NextGenerationEU. We have learned that the US was a failure over many decades, because when Hamilton first took on the debts of the individual states and made them federal debts the incentive that was set was that they could take on new debts and they would be bailed out again. This happened consecutive times over the next 50 years until the strict no-bail-out clause for states and municipalities was added. We do not have the strict no-bail-out clause for states and municipalities in the EU. The disciplinary effect is very necessary, because from that moment onwards the current union in the US started to work.

It is not possible to have mutualisation of everything. You can postpone the solution to a problem by throwing money at it, but the problem will likely become bigger. Money and mutualisation are only part of the answer, they are not the full answer, because it is important to get the incentives right.

Klaus Regling

Klaus Regling agreed with Harald Waiglein's comments. Alessandro Rivera was asked whether he could see a trade-off between the public risk sharing that Harald talked about and private risk sharing and what the trade-off should be if we agree in Europe we want more risk sharing.

Alessandro Rivera

Alessandro Rivera stated that there is not any trade-off. There is a full complementarity between the public risk sharing and private sector risk sharing. When the monetary union was established, there was the assumption that the private sector and markets would be enough to perform the risk sharing function. The markets would send signals through prices while covering the funding needs. Market discipline did not work. The price signal was not there, both in good times and in bad times.

Alessandro Rivera suggested there has been a mistaken, brave assumption that short-term, volatile price signals can guide political decisions for making good choices for long-term policies. Short-term market signals call on politics to react with short-term responses that are often mistaken. It works the other way round that the policy framework has to provide to markets the signal that there is a stable institutional environment through risk sharing.

The framework the market called for that they can safely put money at work in risk sharing is that there is skin in the game from the public sector, the capacity for the institutions to react to shocks in the first place and provide resources, stabilisation and support where needed.

Klaus Regling

Klaus Regling agreed that markets do overshoot in both directions and so to rely only on those signals is not sufficient. He recalled that there has been some fiscal risk sharing via the EU budget since the beginning of the EU. The European Investment Bank (EIB) provides subsidised loans. The ESM has been doing public risk sharing since the euro crisis.

Harald Waiglein

Harald Waiglein returned to the comment made by Jacques de Larosière that a lot of this relates to harmonising rules as a basis for risk sharing, with social security being one prime example. To have a European social security system there would need to be agreement on standards for unemployment, when someone would need to take a job or benefits would be cut. These would need to be equal across Europe and it is a very heterogeneous system. Risk sharing would benefit some countries at the cost of others. Risk sharing cannot be to the benefit of just some and at the cost of others.

Harald Waiglein agreed that there has always been a fair amount of risk sharing, but it is debateable whether it is enough. Before the financial crisis hit, we inadvertently sent signals to the markets that it was safe to invest in European public debt, because there no difference in spreads before the financial crisis. The assumption was that this is safe. If that signal is given and the underlying structure is not safe at all it is actually more dangerous than not giving the signal and letting markets have the disciplining effect.

Klaus Regling

Klaus Regling agreed that there were problems before the euro crisis, but it was a market failure or a misunderstanding between public sector and private sector. Jacques de Larosière had been pessimistic about the possibility of the euro area becoming like the US. The panel was asked whether it would help to have a fiscal capacity for macroeconomic stabilisation in the euro area. That is one of the gaps. The other gaps are the banking union and capital markets union but let us leave that aside and focus on risk sharing here.

Jacques de Larosière

Jacques de Larosière stated that he did not feel his comments about the US and EU comparison were pessimistic. It is just a fact.

Jacques de Larosière did not believe that the EU can institute a stabilisation fund that will help the bad performers eternally without any condition, because this would be the end of the purpose and the work of the EU. To help those who have derailed, there is a fiscal capacity which is conditionality driven. The question should be whether a fiscal non-conditionality driven capacity is the missing element. One should be very sceptical about that for the reasons indicated by Harald Waiglein.

It is childish to think that everything will be alright if there is an EU fiscal capacity. If there are fiscal or public debt problems the market is going to tell us about problems. Alessandro was perfectly right in insisting on the importance of what the markets tell us in terms of trust and assessment. The basic thing is to let the market work. If that is not enough and we need some element of conditionality driven money, the European Stability Mechanism (ESM) is there for that.

Klaus Regling

Klaus Regling stated that in terms of what kind of fiscal capacity is needed, the ESM did a good job during the euro crisis with very tough conditionality. The EU budget has been very helpful over the last 60 years with very little conditionality, just transfers to promote convergence. The panel was asked what other type of instruments might be useful, and, looking to the US, whether there are recommendations for where Europe should move.

Harald Waiglein

Harald Waiglein stated that he was most tempted to look at the financial sector and the Banking Union. In terms of fiscal relations, the crucial element is the strict no bailout clause that has credibility in the markets. Everyone knows that when Detroit or Puerto Rico goes bust there will be no help from the federal government which means there is an element of market discipline we do not have in Europe. The Stability and Growth Pact rules do not provide for the full effect that one would have if engaged in the fiscal policy and markets were to react to your own currency. That gap has never been closed. We need to think about reforms, but it is not clear that we can come up with something better than the SGP. The activation of the General Escape Clause at the beginning of the pandemic was justified. But now we cannot wait for crisis-free times to reactivate fiscal rules. When a storm arises, you have to sail your ship with a working navigation system. No captain would turn it off permanently. We need to follow the rules again as soon as possible in order to get safely through these times. Whatever rules we agree on, they must safeguard the long-term sustainability of public finances and be implemented forcefully, particularly in periods when markets are calm. This is the only way for euro area Member States to regain and protect their capacity to respond to shocks.

Klaus Regling

Klaus Regling noted that Alessandro Rivera wrote in the Eurofi Magazine about a broad definition of fiscal capacity, which is macroeconomic stabilisation on the one hand, but it also talks about financing public goods. Alessandro Rivera was asked if it is necessary to put it all into a central fiscal capacity and whether the EU budget is not the place to finance European public goods.

Alessandro Rivera

Alessandro Rivera advised that theoretically the two functions of stabilisation and funding of public goods could be separated. The two forms of public spending and intervention are closely intertwined. The lack of a stabilisation capacity relates to the largely pro-cyclical framework that we have as well as the underinvestment in terms of what is needed for funding public goods. This is one way where the two forms of support are connected. The EU budget has always had redistribution features. At the same time, the EU budget can be used for addressing divergence dynamics and risks of fragmentation through investment to public goods. The NextGenerationEU and Support to Mitigate Risks in an Emergency (SURE) tools have proved that the EU budget can be used effectively for a stabilisation function. These have introduced further redistribution capacity in the EU budget, providing financial stability and channelling the funds where they are more needed.

Alessandro Rivera had stated initially that there is no trade-off between private sector risk sharing and public sector risk sharing, but they are closely related and complementary. Conditionality has to be present in public sector risk sharing, but the kind of conditionality and how the governance works has to be discussed. The incentives have to preserve ownership and not to create unintended effects in terms of perception of choices imposed elsewhere that create political issues.

The creation of a central fiscal capacity should be part of a wider reform of the EU economic governance. Of course, a thorough review of existing fiscal rules is needed to make them suitable for current challenges. First of all, rules need to allow counter-cyclical fiscal policies, both in good and in bad times. Second, they should provide the right incentives for investment, in order to achieve a robust and sustainable economic growth and to complete the twin transition. Last but not least, they should require a gradual, credible and sustainable reduction of public debt over time.

Klaus Regling

Klaus Regling could see some convergence between Alessandro Rivera and Jacques de Larosière, who always wants conditionality. It can depend on the problem that is being addressed. During the Euro crisis it was impossible to avoid conditionality because the macroeconomic imbalances had to be fixed. The SURE programme was very different because the conditionality was very low as there were no imbalances to be fixed. That could be an approach there will be some consensus on here. Risk sharing cannot be discussed without mentioning the SGP, because a framework is needed to fit it all together otherwise political consensus cannot be reached.

Debt levels have grown over the last 10 years in all European countries, for reasons that are easy to understand. The panel was asked how countries can be convinced to add new mechanisms to risk sharing and how to get a credible stability pact as a framework to tie countries together.

Alessandro Rivera

Alessandro Rivera stated he will continue to argue for conditionality. Countries that are members of a monetary union are linked through so many different channels that focusing the policy recommendations needed by all those countries only on a debt, is a mistaken perspective. Debt may be seen as simply the sum of deficits of a year. If the deficit is reduced then there will be a lower debt at the end, but this is not the case. The more the countries' economies are interconnected, the more debt is part of an extremely complex set of relationships and causalities.

Public decision makers have to enlarge the perspective and look at how the rules are able to address all the relevant aspects of staying together in the monetary union. The conditionality applied so far has put a lot of emphasis on external competitiveness, but external competitiveness for each single member does not make much sense looking at the overall position of the euro area. The balance has to be found with correction all around.

Further steps should be taken towards monetary union because it is not a zero-sum game; it is a positive-sum game. The contribution is not simply mirrored by the net contributors. It is something that creates positive effects, not only in the beneficiary countries, but also benefiting the other ones in terms of macroeconomic dynamics, confidence of consumers and companies, and financial stability. The amount put in by the net contributors will be largely offset by the benefits that would return to them.

Klaus Regling

Klaus Regling stated that if EU public decision makers get this right everybody benefits and there will be convergence, more growth and a stronger financial sector. There is a macroeconomic imbalance procedure and it should be more symmetrical. The panel was asked how it saw the SGP and where progress can be made.

Harald Waiglein

Harald Waiglein stated that there are several layers of perception of the SGP. At the technical level EU Member

States probably agree on many things, if not on all. There is the symbolic element, in that it is a perception of either relaxation or toughening the pact that will influence the political debate and will determine how ministers will be seen in their own countries. It is also a symbolic debate and that is probably the most difficult element to overcome.

At the technical level, the SGP is very much an instrument to address moral hazard in fiscal policy, as the banking regulation is to address moral hazard in banking. The reform proposals that have been discussed so far fall short of credibility. There is the logic behind creating new exceptions for expenditure, but when addressing fragmentation, the single biggest risk is the reappearance of credit risk in the sovereign sector. The ECB is withdrawing support and now we see that debts still matter.

It is not clear whether the answer to that is creating new exceptions for expenditure and having longer adjustment paths, whether that is the message we want to send to markets. If there is a conviction that the NextGenerationEU will counteract those forces why there is widening of spreads just now.

Klaus Regling

Klaus Regling highlighted that a proposal from the European Commission may give the NextGenerationEU credibility. The primary objective in the end is debt sustainability. Jacques de Larosière was asked if using fiscal councils more is the answer.

Jacques de Larosière

Jacques de Larosière stated that it might be part of the answer, but not the whole answer. In order to have a system that will work for a long time it needs to be ingrained in the minds of those who are the actors of the system that there will not be a permanent flow of money to those who are in need because the way they have handled their public and general economic affairs. Without that in mind one could do whatever one wanted but will not be credible on the markets and the duration of the European system will be threatened.

Harald Waiglein had called it very rightly 'a problem of moral hazard'. Fiscal councils are not going to help with credibility on the moral hazard problem. It does not seem the fundamental answer to the question. A very independent fiscal board might be good for strengthening the credibility of the system, but it is not the answer.

For the Stability and Growth Pact to work there needs to be two things. First, a case-by-case framework where specific national problems are considered. This is better than a single number, because that is considered by the member in question as an arbitrary rule and arbitrary rules are eventually never abided by. Secondly, there needs to be a thoughtful analysis and explanation of the situation where both the Commission and the interested country would interact. Both a country in surplus and a country in deficit are to be considered. An Article 4 discussion is better than a percentage to apply.

In order for it to work, the actors have to have a sense of ownership. The Article 4 is going to introduce an element of rationality in the system in a more forceful and institutionalised manner. There would be a system that would be more tailor-made, more acceptable by each country. It may be naïve, and it may not work, but it would be better to be rational in this matter. We are going to give ourselves another year of suspension of the rules and relaxation, but that may not be wise because it is urgent to do this.

Klaus Regling

Klaus Regling noted that Commissioner Gentiloni today said that reaching an agreement is urgent.

Jacques de Larosière

Jacques de Larosière agreed it is urgent because the house is burning.

Klaus Regling

Klaus Regling thought it would be likely that the Commission followed Jacques de Larosière's advice of proposing a case-by-case approach although he would advocate a different approach.

Participant

An audience member highlighted that it has been a very striking discussion. The US system has been mentioned, but not the automatic stabiliser system. There has been one experience with the SURE system during the Covid crisis. The panel was asked if it took any lessons from how this was used well by member states or whether it is just a one-off related to Covid.

Harald Waiglein

Harald Waiglein stated that the Austrian view is that these are one-time measures, which has also been made clear by the legal Council service. Anything else would be against the treaty. The instruments were possible legally in special circumstances, but Europe cannot just continue using them. That is a legalistic answer.

The SURE instrument was important although it did not work perfectly, because there was one country that struggled to use the funds or make them available. When talking about the right incentives this is not the kind of mechanism. It is understandable why in an event like that there could be trouble establishing the right criteria and then implementing in a very short time span.

Alessandro Rivera

Alessandro Rivera stated that the treaty certainly had clear constraints of what can be done in terms of transfer to Member States. The EU has already introduced a strict no bail out clause for us. We have a starting point that is better than the one Hamilton had in the US. It is right that there are constraints, but it is also a matter of how those constraints are read and interpreted.

The constraint is that this kind of intervention can only be implemented to address temporary needs and shocks. It is necessary to understand and discuss what is meant by temporary. There was an interesting debate on how the whole green transition may be seen as something temporary in nature, but this may be stretching it too much. Certainly, with the EU budget there are limits and to make the right decisions one should not go through the lines and let them say something that is not there. The ESM is an important tool and provides more flexibility even with the other constraints. The ESM can only intervene with loans and not grants.

It is interesting that SURE is one of the things that worked, regardless of legal issues and constraints. It has worked properly because it is a form of risk sharing. It can be said ex ante which country is going to receive, which may overcome the issue of moral hazard that was raised. This is not sending money to countries that had excessive deficits or other behaviours that are not fully compliant with the rules.

Klaus Regling

Klaus Regling thanked the panel for their contributions. While the word 'automatic stabilisers' was not used explicitly it is acknowledged they are an important part of the policy tools and so had been taken as a given.