EU fiscal governance and cyclical stabilisation Searching for a lasting arrangement

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Views are those of the speaker only.

Two views on EU fiscal policies

- Fiscal policies should focus on sustainability
  - MS need to maintain prudent medium-term positions
  - Discretionary fiscal policy fraught with problems
  - Own house in order first

- The macroeconomic role of fiscal policies is essential
  - Crucial to give weight to the stabilisation objective
  - At country level: individual MS have 'lost' monetary policy
  - At euro area level: complements monetary policy

    (at least in some circumstances, poss. more generally)

Conciliating the two views

- How does current framework fare?
- Could one do better?

Assessing the current framework

- Coming from 1st view but increasingly including 2nd
- Mixed past record
  - SGP disciplined policies, but only partly
  - Pro-cyclical tendencies. In downturns but also upswings. At MS level and overall
- Recent evolution
  - Latest SGP rendition giving more weight to growth
  - But consensus eroding: criticisms from all sides : too austere, too lax, too complex…
  - Limited ability to influence aggregate stance if needed

Question of stabilisation remains Achilles' heel of (revised) framework ?

A better framework?
Not under-estimate the challenge …

- Entrenched differences of views (and interests?) over proper conduct of fiscal policies
- National politics the (main) game in town, limited ownership of requirements of belonging to EMU
- Objective situation difficult: legacy of high debts, low growth prospects, lack of policy space

Good framework can help address the challenges, but no substitute for difficult policies

Three conceivable avenues for medium-term evolution

(1) Insist current framework strikes (broadly) correct balance. Make best use of it (European Commission, 2015; 2016)

(2) Use more 'economic' rules

- Single rule based on "net" expenditure and debt anchor (Carnot, 2014; Andrle et al, IMF, 2015; Claeys et al, 2016)
- Rule of thumb squarely confronting sustainability/stabilisation trade offs (Carnot, 2014)

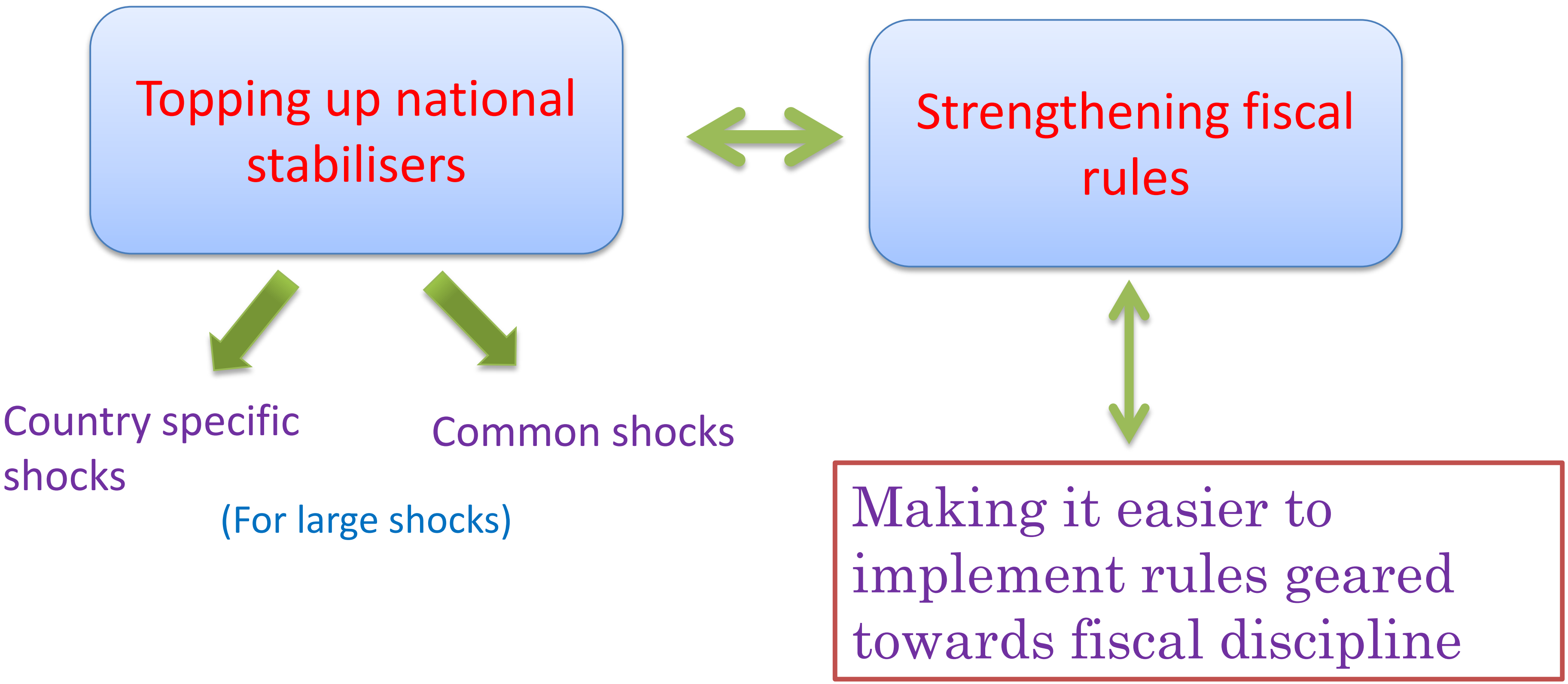
(3) In a revamped architecture, combine

- Simplified fiscal rules focused primarily on sustainability
- A common stabilisation capacity for smoothing large shocks

Inspecting a bit route (3) …

Few quick remarks
on a common stabilisation capacity …

Value-added of a stabilisation capacity



Thinking together fiscal rules and stabilisation capacity

- <u>Joint working</u> is what matters
  - In downturns:

    Transfer from stabilisation capacity <u>increases space under constraining fiscal rules</u>, allowing more spending, or less pro-cyclical cuts

  - Conversely in upturns:

    Transfer from MS to stabilisation capacity subject to constraining fiscal rules <u>forces constitution of buffers</u>

Thinking together fiscal rules and stabilisation capacity (cont'ed…)

- <u>Joint working</u> is what matters
- <u>Example of consequence</u>: how does a common unemployment benefit system really work?
  - Main effect is <u>NOT</u> to increase spending on UB
  - Direct effect is <u>substituting</u> EU financing to national financing on UB
  - Indirect effect is <u>increasing room</u> under constraining fiscal rules … allowing extra spending … but <u>elsewhere</u> !
  - From <u>demand stabilisation</u> perspective, indirect effect is most important one

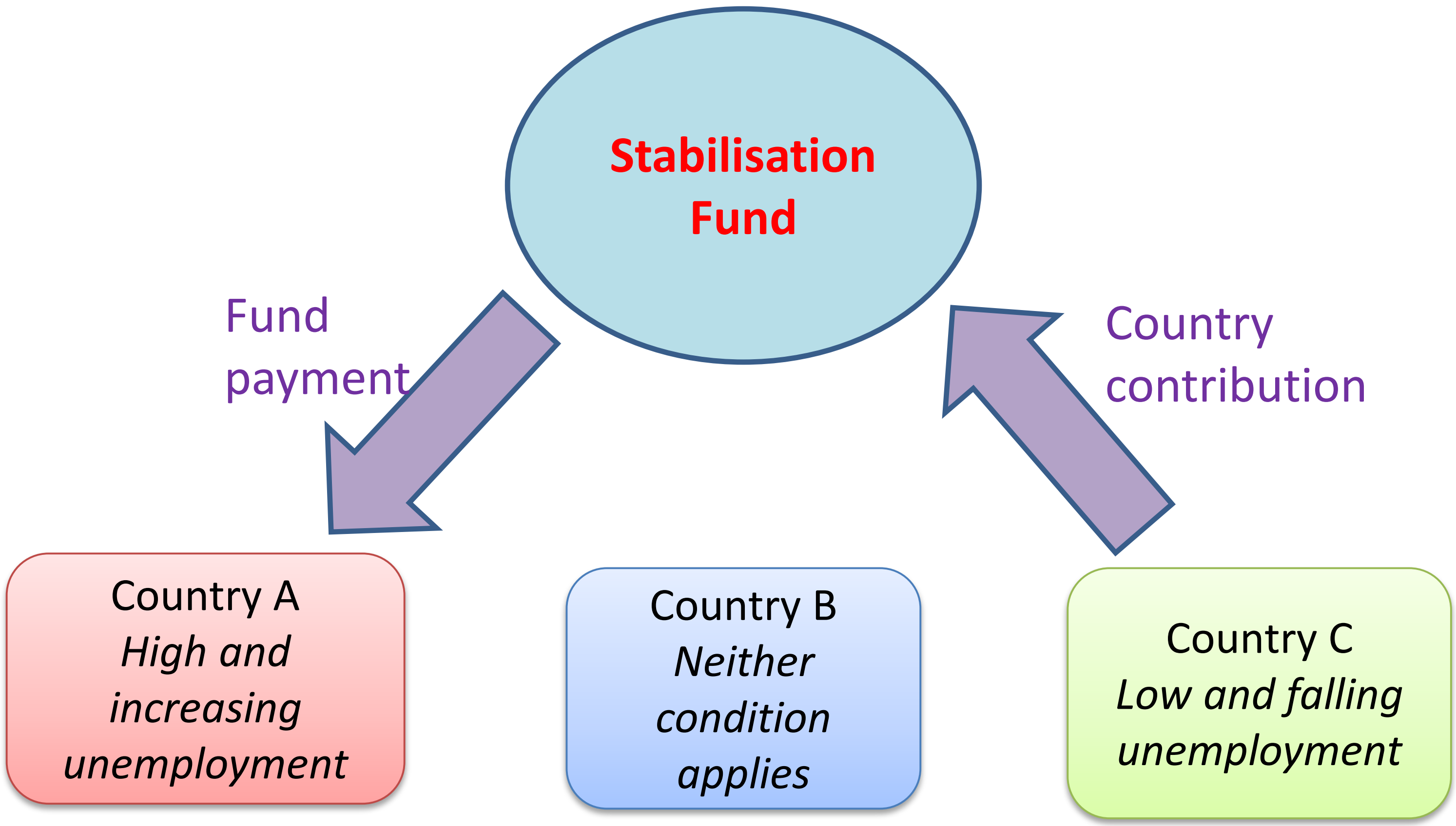
Cyclically-sensitive aggregates or active stabilisation?

- Even with cyclically sensitive spending and revenues, a small common budget brings limited "spontaneous" stabilisation
  - A 10% cyclical variation of a permanent budget of 2% of GDP brings only 0.2% of GDP stabilisation
- "Active stabilisation" against large shocks provides much more significant bang for the buck
  - Contributing every year 0.2% of GDP to a common pot allows active stabilisation payments of 2% of GDP every 10 years

→ Finding 'cyclical base' not so important. Allowing "active stabilisation" under some circumstances is game changer.

→ Next question: what trigger for active stabilisation?

EXAMPLE TRIGGER FOR ACTIVE STABILISATION : DOUBLE CONDITION (Carnot, Kizior, Mourre, forthcoming)



- **High U** = higher than past 15 years average. **Low U** = the opposite
- **Increasing U** = higher than previous year. **Falling U** = the opposite

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Good design features of a stabilisation capacity … and uneasy choices

- Restricting stabilisation capacity to large shocks
- Symmetric functioning good times / bad times
- Automaticity versus discretion in functioning
  - Very difficult choice
- Allowing limited borrowing and saving
  - Otherwise unworkable … but can this be accepted?
- Ensuring cross-country neutrality over long term
  - Need to be 'patient' given 'long cycles' …but again, can this be accepted?

Some "conclusions" ...

- Latest incarnation of SGP has given considerably more weight to stabilisation (more generally growth) concerns
- In short term: sensible and credible implementation of current fiscal framework critical under any scenario
- For long-term: combining rules (re)focused on sustainability with common stabilisation capacity against large shocks could prove a more effective arrangement
- Essential to conceive together the stabilisation capacity and the rules-based fiscal framework. Too often forgotten point.
- Some good design features help raising the effectiveness and the credible functioning of a stabilisation capacity
- Even assuming good features, there are some trade-offs and hard choices when designing a common stabilisation capacity

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