In-Depth Analysis

Euro-area fiscal stance: definition, implementation and democratic legitimacy

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Provided at the request of the Economic and Monetary Affairs Committee

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IN-DEPTH ANALYSIS

Euro-area fiscal stance: definition, implementation and democratic legitimacy

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Provided in advance of the Economic Dialogue with the President of the Eurogroup in ECON in autumn 2016

Abstract

This paper discusses the concept of Euro Area Fiscal Stance (EAFS), the current state of the EAFS and the instruments available to manage it. It closes with a proposal on how the management of the EAFS could be improved. The proposal comes in two parts. First, I discuss how the management of the EAFS could be improved within the boundaries of the Treaties. Next, I discuss a more ambitious plan, which might require a Treaty change.
This paper was requested by the European Parliament's Economic and Monetary Affairs Committee.

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LIST OF ABBREVIATIONS

EA FS   Euro Area Fiscal Stance
ECB    European Central Bank
EFI    European Fiscal Institute
ESM    European Stability Mechanism
EU     European Union
QE     Quantitative Easing
DG ECFIN European Commission, Directorate-General for Economic and Financial Affairs
MEF    Ministero dell’Economia e delle Finanze, Italy
OGWG  European Commission, Output Gap Working Group
OMT   Outright Monetary transactions

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EXECUTIVE SUMMARY

This paper starts asking why the concept of EAFS has recently come to the forefront of the policy debate and argues that this happened when the ECB reached the zero lower bound on interest rates, and its ability to use monetary policy to affect aggregate demand was thus significantly curtailed. Once it reached the zero lower bound, the euro area lost the ability to control aggregate demand using monetary policy. This explains why the focus shifted to fiscal policy and to the EAFS: an economy cannot function properly if has no tools to offset cyclical fluctuations in output.

Before addressing how the EAFS could be controlled, the paper discusses the current stance of aggregate demand in the euro area. The analysis suggests that about one half of the savings that the euro area currently exports to the rest of the world (measured, at the end of 2015, by a current account surplus equivalent to 4 per cent of euro area GDP) could be spent (for consumption and/or investment) inside the euro area, in an attempt to move output and employment close to potential.

Having established why the EAFS has become relevant, the paper discusses technical issues concerning its measurement, but argues that this is not the main problem. The real difficulties arise from the fact that the euro area lacks instruments to control the EAFS directly. The stance of fiscal policy can currently only be controlled through actions at the level of individual Member States – and such actions run into the difficulties of fiscal policy coordination in the euro area.

Two proposals are presented on how the management of the EAFS could be improved. The first one takes the existing Treaties as given and discusses how the management of the EAFS could be improved within the boundaries of the Treaties. Next, a more ambitious plan is presented, which might require a Treaty change.

The implementation of the first proposal requires a procedure whereby the Commission first decides the desired change in the EAFS and then the allocation of such a change among individual Member States, based upon their relative output gaps. Such a sequence could be implemented within the constraints of the Treaties. This is quite different from the way the Commission today monitors fiscal policy in the euro area.

The second proposal envisages the creation of a fiscal capacity at the euro area level, through the transformation of the European Stability Mechanism in a new institution designed to play a central role in managing euro area domestic demand. The paper calls such an institution a “European Fiscal Institute”. It then discusses its governance, its resources (which would come from the issuance of “Stability Bonds”), the moral hazard concerns it may raise and its relationship with the European Commission and the European Fiscal Board.
1. INTRODUCTION

This paper discusses the concept of Euro Area Fiscal Stance (EAFS), the current state of the EAFS and the instruments available to manage it. It closes with a proposal on how the management of the EAFS could be improved. The proposal comes in two parts. First, I discuss how the management of the EAFS could be improved within the boundaries of the Treaties. Next, I discuss a more ambitious plan that might require a Treaty change.
2. WHY THE CONCEPT OF EAFS HAS BECOME RELEVANT

There is a reason why the EAFS has only recently become central to policy discussions: it happened when the ECB reached the zero lower bound on interest rates, and its ability to use monetary policy to affect aggregate demand was thus significantly curtailed.

The president of the ECB made this point as early as August 2014 in his speech at the Federal Reserve Jackson Hole Economic Policy Symposium, where he said: “... it would be helpful for the overall stance of policy if fiscal policy could play a greater role alongside monetary policy ...” [Mario Draghi, “Unemployment in the euro area”, Annual Central Bank Symposium in Jackson Hole, 22 August 2014.]

For some time Quantitative Easing (QE) was a substitute for the ability, which had been lost, to set interest rates, and had some traction. There are two main channels through which QE works.

One is fiscal: when the ECB buys bonds issued by Member States, the interests governments pay on such bonds are returned to Member States via the distribution of ECB seigniorage. Since such bond purchases are proportional to Member States’ capital contribution to the ECB (the so called “capital key”), QE effectively erases the burden of a fraction of the public debt, thus widening fiscal space at the individual country level. The size of this channel depends on the volume of governments bonds the ECB buys. Thus, the channel will be effective as long as QE lasts.1

The second channel, instead, is likely to be only temporary, and operates as follows. An important effect of QE works via the exchange rate: by weakening the euro, QE raises net exports (other things equal) and thus aggregate demand. The nominal effective exchange rate of the euro2 fell from 104.5 on the 1st of May, 2014 (when market participants, interpreting ECB communication, started anticipating the duration and the likely size of QE, which was officially announced on the 22 January, 2015) to 90 on 1st March 2015, corresponding to a 14.2 per cent depreciation. (The effective exchange rate subsequently - between March 2015 and August 2016 -- gave back about 5% of the initial depreciation). The euro-dollar exchange rate fell much more, about 30 per cent. What is important, however, is that the impact of a given QE decision on the effective exchange rate depends on the overall amount of purchases announced: to induce a further depreciation of the currency, the ECB should increase the overall size of the program, either extending the monthly purchases to a longer period, or increasing their monthly size. Absent these changes, QE too eventually reaches its “lower bound”, at least as far as its effect on aggregate demand via net exports is concerned.

The bottom line is that the euro area has largely lost the ability to control aggregate demand using monetary policy. This explains why the focus shifted to fiscal policy and to the EAFS: an economy cannot function properly if it has no tools to offset cyclical fluctuations in output.3

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1 At the time of writing, monthly purchases of public and private sector securities amount to €80 billion on average, of which about three fourth are purchases of government bonds. From March 2015 until March 2016, this figure was €60 billion. These purchases are intended to be carried out until the end of March 2017, although the ECB has reserved the right to extend the program. At the time of writing the ECB has bought about Euro 1 trillion of bonds.

2 The nominal effective exchange rate of the euro – which is a trade-weighted index of bilateral nominal exchange rates -- is presented in the ECB Statistical Data Warehouse: http://sdw.ecb.europa.eu/browse.do?node=9691510. The data are available on the ECB website at: https://www.ecb.europa.eu/stats/exchange/effective/html/index.en.html

3 The point has also been made by the IMF: first in the context of the 2016 Article IV Consultation on the Euro Area, where is stated (IMF, 2016a, point 32, p. 20): «A central fiscal capacity would improve the policy mix», and, along the same lines, in IMF 2016b. The EU Commission has made a similar observation: «For the euro area as a whole, monetary policy can stabilise common shocks as a consequence of its action to maintain price stability. However, in unusual circumstances such as large downturns and/or at the zero lower bound, monetary policy may be overburdened and be usefully complemented by fiscal support. » (European Commission 2016c, p. 46)
3. DEFINITIONS AND FUNCTIONS OF A EURO AREA FISCAL STANCE

The concept of EAFS has become standard in the analyses of the economic situation in the euro area carried out by the European Commission. For example, in its European Economic Forecast - Spring 2016, it stated that: “The fiscal stance in the euro area should be slightly expansionary in 2016.” (European Commission 2016a, p. 45). The indicator the Commission uses to reach this conclusion is the change in the Structural Budget Balance, defined as the “cyclically-adjusted budget balance net of one-off and other temporary measures” as estimated by the Commission itself. The most recent data for the euro area as a whole and for individual Member States are presented in the document quoted above, and data for the euro area are reproduced in Figure 1 and Table 1.

**Figure 1:** Changes in the euro area Structural Budget Balance

![Graph showing changes in euro area Structural Budget Balance](image_url)

Table 1: Euro Area Budgetary positions of the general government, including the “cyclically adjusted budget balance”

<table>
<thead>
<tr>
<th>(% of GDP)</th>
<th>EURO AREA SPRING 2016 FORECAST</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
</tr>
<tr>
<td>Total receipts (1)</td>
<td>46.8</td>
</tr>
<tr>
<td>Total expenditure (2)</td>
<td>49.3</td>
</tr>
<tr>
<td>Actual balance (3) = (1)-(2)</td>
<td>-2.6</td>
</tr>
<tr>
<td>Interest expenditure (4)</td>
<td>2.7</td>
</tr>
<tr>
<td>Primary balance (5) = (3)+(4)</td>
<td>0.1</td>
</tr>
<tr>
<td>Cyclically-adjusted budget balance</td>
<td>-1.2</td>
</tr>
<tr>
<td>Cyclically-adjusted primary balance</td>
<td>1.4</td>
</tr>
<tr>
<td>Structural budget balance</td>
<td>-1.0</td>
</tr>
<tr>
<td>Change in structural budget balance</td>
<td>0.4</td>
</tr>
<tr>
<td>Gross Debt</td>
<td>94.4</td>
</tr>
</tbody>
</table>

The structural budget balance is the cyclically-adjusted budget balance net of one-off and other temporary measures estimated by the European Commission.


Measuring the EAFS and suggesting its desirable evolution has been an important progress in the euro area policy analysis, although the technical issues that arise in constructing such an indicator remain the subject of discussions between the Commission and Member States (see below the box on Measuring “Cyclical Adjustment of Budget Balances: an ongoing debate”).

Box - Measuring “Cyclical Adjustment of Budget Balances”: an ongoing debate

There is an ongoing discussion concerning the way the Commission staff estimates cyclically-adjusted budget balances. Given its relevance in determining structural budget balances under the framework of the Stability and Growth Pact, the agreed production function methodology shared at the EU level to gauge potential output and output gaps has come increasingly under scrutiny in recent years. Both the European Commission and the Output Gap Working Group (OGWG), in charge of monitoring the agreed methodology, have recognized the existence of theoretical and econometrical drawbacks and have discussed possible adjustments to the model. However, in the case of some Member States, such as Italy, problems still remain. According to the mandate of the OWG, the commonly agreed methodology should respect the following principles: a) It has to be relatively simple, fully transparent and stable. The trend extraction methods should be based on economic as well as statistical principles, with the key inputs and outputs clearly defined; b) It should strive for equal treatment for all EU Member States, whilst in exceptional circumstances recognizing country-specific characteristics; c) It should provide an unbiased assessment of the past and future potential growth in the EU Member States, while aiming to include the effects of all adopted structural reforms; d) It should aim at limiting the pro-cyclicality of potential growth estimates. (see MEF, 2016).

Beyond these measurement problems, the Commission highlights a more fundamental problem with the EAFS, namely the lack of instruments to control it – a theme to which I shall return in sections 6 and 7 below. The following passage in the “Forewords” to the Spring 2016 Forecast is revealing, clearly pointing out the burden currently falling on monetary policy and spelling out the desirable policy stance at the euro area level:

“In this context of modest growth amid high risks, economic policy has two functions to fulfil. First, it needs to support the ongoing, but still fragile economic expansion and reinvigorate potential
growth through the three-pronged strategy of monetary policy, fiscal policy and structural reforms endorsed by the G20. At present, this task is mainly being carried out by monetary policy. Fiscal policy levers, by contrast, are not being used to the necessary extent. [... ] Some countries could take better advantage of their fiscal space to increase investment, and all countries should still do more to make their tax and spending policies fair and more growth friendly.” (p. ix, my bold)

The difficulties arise from the fact that the euro area lacks instruments to control the EAFS directly. The stance of fiscal policy can only be controlled through actions at the level of individual Member States – and such actions run into the difficulties of fiscal policy coordination in the euro area.

Thus, if we agree that a proper functioning of the euro area requires the ability to control aggregate demand at the area level, it is urgent – at least so long as monetary policy will recover its effectiveness -- to think which instruments could be designed that could affect the EAFS directly. In other words to think how a fiscal capacity at the euro area level could be created. President Juncker’s “Investment plan for Europe” goes in this direction, though its size looks small. The project, announced in November 2014, aims at unlocking additional public and private investments of at least €315 billion over three years (2015-17), about 2.7 per cent of the euro area GDP. As of August 2016, the European Fund for Strategic Investments had financed €20.4 billion, expected to trigger a total investment volume of €115.7 billion, about a third of the overall size of the plan¹. By comparison the size of the 2009 Stimulus Program launched by President Obama, the American Recovery and Reinvestment Act, was almost double: close to 6 per cent of US GDP, albeit to be spent over a longer horizon, ten years.

¹ EU, «The investment plan for Europe; State of play », July 2016.
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4. THE EAFS TODAY

As we have seen, the Commission considers the fiscal stance in the euro area to be “slightly expansionary in 2016.”\(^5\). This statement is correct, because the indicator the Commission uses considers the change in the cyclically-adjusted budget balance. Nevertheless, the change not necessarily provides the most relevant information. The question “Is public sector demand contributing as much as it should (or could) to total domestic demand in the area?” requires considering the level of the EAFS, not its change.

Domestic demand including stocks at 2010 prices in the 19 euro area countries, was, at the end of 2015, lower by 7.9 percent than it was in 2008, at start of the financial crisis. By contrast, domestic demand in the United States at the end of 2015 was 9.8 percent higher than it was at the start of the financial crisis\(^6\). The overall fall in domestic demand is the result of divergent experiences across Member States: sharp contractions in the periphery (for example, over this period, 2008-2015, domestic demand in Italy and Spain contracted by 10.7 and 12 percent respectively) have been accompanied by a demand expansion in the core: + 5.4 percent in Germany and + 3.3 percent in France.

The mirror image of the fall in euro area domestic demand has been a rising current account surplus. This is because a country’s current account corresponds to the difference between what it produces and what it spends: a fall in spending, for a given level of production, means that the country as a whole is saving, and the way it saves is by running a current account surplus, that is by accumulating assets in the rest of the world. The euro area current account moved from almost balanced at the end of 2007 to a 4 percent of GDP surplus at the end of 2015. At that point in time, 12 out of 19 euro area countries (the exceptions being France, Slovakia, Finland, Cyprus, Greece, Latvia and Lithuania) were running current account surpluses. The German surplus at the end of 2015 was 8.5 percent of GDP.

Could the euro area eliminate its current account surplus by raising domestic demand, for instance by increasing budget deficits? Certainly yes, but the point is whether this would overheat the economy, putting pressure on its resources, raising prices and eventually inflation. This risk depends on the economy’s “output gap”, the difference between an economy’s level of output and its potential level, defined as the level beyond which the economy may start overheating. Therefore, so long as the output gap is positive – that is so long as potential output is above current output – domestic demand can be increased, and the current account surplus correspondingly reduced, without risking overheating.

The IMF estimates\(^7\) that at the end of 2015 the euro area output gap amounted to 2 per cent of the area GDP. This suggests that the euro area has room for increasing domestic demand by about 2 per cent of GDP before it could run into a capacity constraint. This situation contrasts sharply with that one in the United States, where the Council of Economic Advisers projected (in February 2016)\(^8\) real output to grow 2.7 percent during 2016, a rate which exceeds the Administration’s estimated rate of potential real GDP growth over the long run of 2.3 percent a year.

Increasing euro area domestic demand by 2 percent would mean cutting the area current account surplus (which, as we have seen, at the end of 2015 amounted to 4 per cent of GDP) by half. In other words, about one half of the savings that the euro area exports to the rest of the world (measured by a current account surplus equivalent to 4 per cent of euro area GDP) could be spent (for consumption and/or investment) inside the euro area, and in an attempt to move output and employment close to

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\(^5\) European Economic Forecast\(^7\) (Spring 2016), page 45.
\(^7\) IMF Country Report No. 16/219, Euro area policies: 2016 Article IV Consultation, July 2016, p.36.
potential, without risking overheating the economy. To summarize the facts: aggregate demand management in the euro area has gone out of control. Repair is urgent.
5. IS THE EAFS A SUFFICIENT INDICATOR?

The Commission, while relieved by the estimated change in the EAFS, appears to be concerned by the apparent pro-cyclicality of the fiscal stance of a few Member States (see Figure 2): in 3 out of 19 euro area countries (Belgium, Slovakia and Lithuania), the fiscal stance in 2016 appears to be pro-cyclical, that is in these countries fiscal policy tends to reduce domestic demand even if the economy is slowing down. Beyond the fact that this pro-cyclicality only appears in a small minority of countries, should we be concerned about the distribution across Member States of a given EAFS? The answer is a qualified yes.

**Figure 2:** Change in the structural budget balances vs. output gap in euro area Member States and in the euro area

![Graph 1.55: Fiscal stance in 2016 – structural balance vs. output gap, euro area and Member States](source)

In the presence of instruments that could move fiscal policy at the euro area level, the fiscal stance of individual countries should not matter. In the US, fiscal policy is set having the whole country in mind: no Treasury Secretary worries about the fiscal stance of South Carolina or North Dakota. This is possible for two reasons

9. See also Kirkegaard (2015).

10. A number of studies found that during the Great Recession and subsequent slow recovery, state and local budgets have acted procyclically (Aizenman and Pasricha 201, Kasparek 2011), while some find neutrality (Hines 2010).

None of these two reasons can be applied in the euro area, because (i) the aggregate fiscal stance today can only be controlled by moving the stance of individual Member States, and (ii) because local conditions matter -- as we have seen in the aftermath of the Greek debt crisis -- both because budget rules are difficult to impose and because no bail-out commitments are not fully credible. In this sense, the EAFS is not a sufficient indicator and must be accompanied by a monitoring of the fiscal position of individual states – which is what the Commission effectively does.

However, there is a more important dimension that explains why the EAFS is not a sufficient indicator, and could actually be misleading. Recent research on the effects of shifts in fiscal policy has shown that the composition of such shifts can make a huge difference. Analyses of major fiscal adjustments (changes in fiscal balances motivated by the objective of reducing a budget deficit or the level of the debt-to-GDP ratio) show\(^\text{12}\) that those adjustments that are mostly based upon cuts in government consumption (excluding transfers) are much less costly than tax based fiscal adjustments\(^\text{13}\). In fact, cuts in government consumption seem to have virtually no costs in terms of output losses on average – a result which probably balances some recessionary and some expansionary cases. Tax based fiscal adjustments are instead very costly in terms of output losses. Cuts in government transfers seem to lie somewhere in between the two extreme of government consumption cuts and tax increases, though they appear to be more similar to tax hikes.

Regarding which tax increases seem more costly, direct and indirect taxes appear to have overall similar effects. This research also shows that the differences between tax-based and expenditure-based fiscal adjustments cannot be explained by a different response of monetary policy, although the evidence points to a slightly more expansionary response of monetary policy in the case of expenditure-based adjustments. This might be because tax-based adjustments tend to raise prices, while expenditure-based adjustments tend to lower them, or because central banks believe that expenditure-based adjustments are more long lasting and credible. However, the different response of monetary policy cannot explain most of the differences we observe between the two types of adjustment.

Similarly, this research finds that the asymmetry between tax-based and expenditure-based adjustments is not explained by the fact that the choice between the two types of adjustment is related to the cycle. In other words, it is not the case that tax-based adjustments are chosen during recessions, while expenditure-based ones are chosen during periods of economic expansions. Furthermore, the asymmetry between tax-based and expenditure-based adjustments appears not to be explained by the fact that expenditure-based adjustments (differently from tax-based ones) are often adopted as part of a wider set of market-oriented reforms, such as labour and product market liberalizations, so that such reforms, rather than the character of the fiscal adjustment, are the reason for the milder effects on output growth\(^\text{14}\).

\(^{12}\) See Alesina and Giavazzi, 2015.

\(^{13}\) For instance the large fiscal adjustment implemented in Italy in 2011-13, worth (altogether measures implemented and announced for the coming three years) about 5 percentage points of 2011 GDP, was mostly based on tax hikes and resulted in a prolonged and deep recession. This fiscal impulse is sufficient by itself to explain the recession experienced by the country over the period 2011-2012 (with negative GDP growth of around 2 per cent in each year). Instead, the fiscal adjustments implemented in countries like the UK and Ireland, and mostly consisting of cuts in spending, were associated with much milder recession, with GDP growth fluctuating around zero.

\(^{14}\) Two qualifications are in order. First, this research, which uses data for EU and other major OECD economies over the past thirty years, has so far studied the effects of fiscal contractions. One cannot assume that these results are symmetric and thus we know little concerning the effects of tax-based as opposed to expenditure based fiscal expansions. More research is required to answer this important question. Second, as this research (for reasons explained in Alesina and Giavazzi 2015) studies the effects of “fiscal plans” rather than isolated shifts in individual fiscal variables, it has so far been impossible to separate government investment from government consumption, the reason being that there are not enough fiscal plans that are mostly based on changes in government investment. In other words, while there are numerous changes in government infrastructure spending, there are very few fiscal plans which are mostly based on changes in infrastructure spending. Again, for the reasons why one should analyse plans, rather shifts in individual fiscal variables, see Alesina and Giavazzi (2015).

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Why is this relevant in the context of our discussion? It is because this research shows that a given change in the EAFS – the indicator the Commission uses – will have very different effects depending on how it is implemented, whether by changing taxes or changing public spending. It follows that a given shift in the EAFS does not provide enough information: in order to gauge its impact on the economy, the size of such a shift should be accompanied by an explanation of how it is implemented, taxes versus spending measures.

Figures 3 helps gauge the asymmetry between tax-based and expenditure based fiscal adjustments. It documents the response of the level of output, over four years, to a fiscal contraction worth 1 percent of GDP, disaggregated by four components: direct taxes, indirect taxes, government transfers and government spending net of transfers.

Summing up. The EAFS is not a sufficient indicator for two reasons: (i) in the absence of a fiscal capacity at the euro area level, the aggregate fiscal stance can only be controlled by moving the stance of individual Member States. Local conditions matter also for the contagion that could arise from the fiscal stance of individual countries. In this sense, the EAFS is not a sufficient indicator and must be accompanied by a monitoring of the fiscal position of individual states; (ii) once a desirable change in the fiscal stance is decided, beyond the problem of how it should be allocated across countries, one needs to address the problem of how it should be implemented: either by changing tax revenue or changing spending. As we have seen, the two are very different and failing to recognize the difference can result in very unpleasant surprises.

**Figure 3:** Response of the level of output, over four years, to a fiscal contraction worth 1 percent of GDP, disaggregated by four components

![Graph showing the response of the level of output to fiscal adjustments](source: Alesina and Giavazzi (2015))
6. CONTROLLING THE EAFS WITHIN THE BOUNDARIES OF THE TREATIES

As I have discussed, the absence of a fiscal capacity at the euro area level means that the EAFS can only be controlled via coordination among the fiscal policies of Member States. However, current procedures, as I shall describe, make this difficult, in practice if not in theory.\(^{15}\)

What would be required is a procedure whereby the Commission decides first the desired change in the EAFS and then the allocation of such a change among individual Member States based upon their relative output gaps. For example, if the instrument to reduce the euro area-wide output gap was fiscal policy at the country level, the following rule could be used:

\[
\Delta f(i) = \Delta f \left[ \frac{\text{Gap}(i)}{\sum_{n=1}^{19} \text{Gap}(i)} \right]
\]

Where \(\Delta f\) denotes the euro area fiscal policy stance (that is the change in the euro area structural budget balance) deemed appropriate to close the euro area output gap, denoted Gap. \(\Delta f(i)\) is the change that country \(i\) should implement, which would depend on its contribution, denoted Gap(i), to the overall Gap. This rule could be further refined by weighing each country’s contribution not only by the term in square brackets but also by the country-specific estimated effect of a given change in fiscal stance on its output gap. The difficulties in estimating output gaps, presented in Box in Section 3, could raise doubts on this allocation rule. It is important however to keep separate the general point of the need to allocate a given change in overall fiscal stance across countries, from the technical way this could be implemented.

Current EU procedures, however, have country-level conditions in mind and are not derived from the need to achieve a given overall macro adjustment. In other words, the need to balance country-level sustainability constraints and euro area macroeconomic objectives is abandoned in favor of country-level constraints.

To give one example, the 2016 country specific recommendations to Member States (except Greece), adopted by the Council on Commission recommendations in July 2016, start from reminding Member States of the link between their own fiscal stance and the stance desirable at the area level

“... The onus is on the Member States to pursue the measures recommended by the Council, in order to improve the situation of their own economies and also of the European Union as a whole.” (my bold),

but when recommendations for individual Member States are presented, the reference to improving the situation of the Euro area as a whole is lost. For instance in the case of Spain and Portugal the Recommendations state

\(^{15}\) The point is also recognized and highlighted by the ECB (ECB 2016), where it is stated: “The EU’s current fiscal governance framework contains no rules or instruments to directly manage the aggregate euro area fiscal stance, which is a key difference when compared to fiscal federations such as the United States. In fact, in the absence of fiscal policy instruments at the central level, the euro area-wide fiscal stance is merely the sum of individual euro area countries’ fiscal stances. However, in some situations, a more active management of the euro area-wide fiscal policy stance may appear warranted from an aggregate perspective.” (ECB 2016)

\(^{16}\) COM(2016) 321
“As regards Portugal and Spain, the Commission recommends to the Council to recommend a durable correction of the excessive deficit in 2016 and 2017 respectively, by taking the necessary structural measures and by using all windfall gains for deficit and debt reduction.”

No reference is made to the contribution the two countries should give to the overall EAFS. In other words, the Commission, when issuing recommendations to individual Member States appears to be constrained by the Excessive Deficit Procedure and seems to give little or no weight to the impact of individual states’ fiscal actions on the EAFS. This is fully understandable, in the absence of rules prescribing a sequential ordering between euro area and local fiscal stances. In fact, the Commission had proposed (and the Council revised and then adopted in November 2015) a Recommendation on the fiscal policy of the euro area which opens the way for Member States to take into account aggregate Euro area macroeconomic imbalances when drafting their fiscal and reforms programs. The text of this Recommendation, however, is rather vague and, so far, it does not seem to have yet translated into specific action by Member States or by the Commission.

It appears to me that such a sequential ordering could be implemented within the constraints of the Treaties. Recommendations to individual Member States should be preceded by a decision of the desirable change in the EAFS and on its allocation across countries, using something like the formula introduced at the beginning of this section.

It is encouraging, in closing this section, that the Commission seems to appreciate the asymmetries in the effects of tax based and expenditure based fiscal actions described in the previous section:

“Revenue and expenditure sides of public finances can be made more conducive to growth and fairness. In the current context, striking an appropriate balance between the different components of public finances is crucial to preserving their growth-friendliness.”

This section has discussed how the Euro area could control aggregate demand within the constraints of the existing Treaty. The alternative is to think “outside the box”, that is outside the boundaries set by the Treaty, and ask how a euro area fiscal capacity should be designed and managed so as to be effective in controlling aggregate demand in the euro area and also robust to moral hazard concerns.

However, before starting such a discussion, it is important to note that there is an additional, relevant role that a fiscal capacity at the euro area level could play, beyond managing aggregate demand: guaranteeing that the euro area can withstand shocks that might give rise to a new crisis – a particularly important shock being a “sudden stop”, that is an abrupt end of private cross-border lending that typically leads to, or amplifies, banking and sovereign debt crises. A fiscal capacity at the euro area level is critical to withstand such a shock, as it could replace market access for a country that has lost it.

17 « The Commission recommends that euro area Member States take action, individually and collectively, within the Eurogroup in the period 2016-2017, to pursue policies that support the recovery, foster convergence, facilitate the correction of macroeconomic imbalances and improve adjustment capacity. To this end, Member States, particularly those with large stocks of private and foreign debt, should implement reforms that enhance productivity, foster job creation, raise competitiveness and improve the business environment. Member States with large current account surpluses should implement as a priority measures that help channelling excess savings toward the domestic economy and thereby boost domestic investment.” (COM2015 692 final).
7. A PROPOSAL FOR THE CREATION OF A FISCAL CAPACITY AT THE EURO AREA LEVEL

One of the positive responses to the crisis was, in 2012, the launch of the European Stability Mechanism (ESM). The Five Presidents Report (European Commission 2015) addresses the need for a fiscal capacity at the euro area level, starting from the second of the roles mentioned at the end of the previous paragraph - the risks posed by a sudden stop - and identifies the ESM as the instrument to respond to such shock. To play such a role, however, the ESM would require some, by no means uncontroversial, adjustments: absent such adjustments, the ESM is unlikely to be an adequate instrument to address a sudden stop. I shall first discuss such adjustments in the light of the objective of addressing sudden stops. I shall then explain how a “new” ESM could also play a central role in managing euro area domestic demand.

7.1 A “New ESM”

The current ESM resources (a maximum lending capacity of €500 billion, about 5% of Eurozone GDP) are far from sufficient to address a large systemic crisis. Many euro area nations have banks with assets that are several multiples of their GDP. Furthermore, the decision to provide stability support to an ESM member is taken by unanimity and requires prior approval by some national Parliaments. This makes its usage highly uncertain when it is needed most, namely when only prompt action can provide the assurance and certainty needed to calm a brewing crisis.

Even though the design of the ESM is far from ideal, a lesson of EU history is that it is typically safer, surer and quicker to build upon existing institutions. A reform of the ESM should take the existing institution as given and address its weaknesses: governance and resources.

7.1.1 Governance and Democratic Legitimacy

The key innovation here would be to abandon unanimity, thus avoiding national vetoes. The current ESM Treaty already foresees (qualified) majority voting if systemic stability of the euro area is at stake, but only under an emergency procedure. Qualified majority should become the normal procedure. ESM governance would then become similar to governance in a similar inter-governmental institution, the IMF.

Abandoning unanimity would raise the issue of democratic legitimacy. There are two possible solutions. One is to address democratic legitimacy as is done with ECB: the ESM Treaty should be incorporated into the EU Treaties framework (as was done with Schengen). The management of the ESM would be given a clear mandate within which it could exercise some discretion, and would then report regularly to a committee of the European Parliament devoted to euro area issues. An alternative would be to subject all major ESM policy decisions to oversight by such a committee, provided that this could be done with a timing that is not inconsistent with the need for swift action.

7.1.2 Resources

To increase its lending capacity, the ESM borrowing limits should be significantly extended. One possibility is that all euro area members would agree in advance to transfer to the ESM (upon request by the ESM and in addition to the guarantees already existing) a given fraction of their yearly tax revenue for the purposes of serving ESM debt. This authority would be given for a pre-established

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ceiling and would have a pre-determined end date. The transfer should correspond to the same percentage of GDP for all countries, to avoid redistribution issues. This would provide the backbone of a euro area fiscal capacity, which would allow the ESM to issue bonds (call them ‘Stability Bonds’ for short). The fiscal capacity would provide the ESM with the resources to service such bonds. For Stability Bonds to obtain a high rating, Member States would also give the ESM authority to request, at any time, an extraordinary transfer of revenues to meet unexpected debt servicing needs. The status of Stability bonds should be senior to that of ordinary sovereign bonds issued by euro area members. At the time of issue, the overall amount of Stability Bonds should be determined so as not to exceed a predetermined percentage of aggregate euro area GDP.

The debt ceiling and the ceiling on the pre-committed national funds would have to be mutually consistent. These ceilings could only be changed by unanimity. Various numerical limits have been put forth in the proposals mentioned in footnote 18. Likewise, different answers have been suggested for the source of government revenue, whether a fraction of VAT or other revenues. For the Stability Bonds to achieve sufficient liquidity – a condition for keeping a high rating -- the ESM should issue a minimum amount of bonds until it has reached up to, say, 10% of aggregate Euro area GDP. Absent a crisis, the sums raised through the issue of Stability Bonds would be returned to Member States, who could only use them to retire their own national debt – thus de facto exchange sovereign bonds with ESM debt. To mark the ‘graduation’ of the ESM to the fuller role here envisioned, Tabellini (2016) suggests renaming it as the European Fiscal Institute (EFI) echoing the successful predecessor of the ECB, the European Monetary Institute.

7.2 “European Fiscal Institute”

7.2.1 The EFI: Functions

As mentioned above, the new European Fiscal Institute (EFI) would have two main roles: address major systemic financial crisis, or sudden stops, and manage domestic demand in the EA. Let us start from the first.

The Institute could use the sums obtained from the issue of Stability Bonds (or part of the yearly transfer from Member States) to restore financial stability, by lending to Member States who have lost market access, under strict conditionality, or by supplementing national deposit insurance schemes, or by directly recapitalizing insolvent financial institutions. It could also develop precautionary credit lines (automatic, with ex ante conditionality).

Identifying such operations as liquidity or solvency interventions is a fine line. In principle, a sudden stop creates a liquidity, not a solvency problem. It is akin to the situation faced by a bank with a maturity mismatch between its assets and its liabilities and confronting a sudden withdraw of sight deposits. As we have learned during the recent crisis, however, sudden stops, particularly if not addressed swiftly enough, can induce a recession with the accompanying fall in tax revenues and increase in non-performing bank loans – i.e. they can turn into a solvency problem.

In addressing a systemic crisis, the EFI would undertake the roles currently attributed to the ESM and to the Commission. In performing these tasks, the EFI would be the euro area equivalent of what the IMF is to the global economy. I note that the ESM has already moved in this direction by creating an in-house analytical and surveillance capacity to monitor euro area economies.

In addressing a crisis, the EFI would also undertake some of the functions the ECB would take in such situations through its Outright Monetary Operations (OMT) – though an OMT operation so far has never been implemented. Importantly, EFI operations would help guaranteeing that OMT’s are liquidity provisions and never become solvency interventions.
The second role of the EFI would be to manage euro area domestic demand. Stability bonds would give the euro area a new instrument for inter-temporal aggregate demand management, without the need to rely on fiscal policy coordination. During deep euro area recessions, the EFI could issue additional amounts of Stability bonds and exchange the proceeds for the debt of Member States (in proportion to national GDP). Moreover, the revenues from the Stability bonds could be used to activate counter-cyclical fiscal policy in the euro area, if necessary in coordination with monetary policy (for instance the financing of public investment programs, investment in human capital etc.). This function of the Stability bonds could accompany some form of re-insurance for large shocks, which could operate via a re-insurance scheme for national unemployment schemes or other aspects of the social security systems.

Once the outstanding stock of Stability bonds is sufficiently large to be liquid, the EFI would manage it to avoid excessive debt accumulation. Thus, in normal times, the transfers from Member States would be used to retire the Stability bonds that were issued during previous large recessions (or no new transfers would be collected, if the stock of outstanding debt is deemed appropriate). Importantly, as mentioned above, care must be taken to avoid the danger that Stability bonds would pile up on unsustainable national debts, rather than leading to an overall debt reduction.

This arrangement would have several additional benefits. The Euro area would acquire a fiscal policy tool to stabilize aggregate demand or to grant emergency lending. Over time, the public debt composition in the Euro area would also become more efficient. Stability bonds would be relatively safe, because they could be issued with clauses that would make them senior to national bonds, thus implying zero capital usage by the banks that decide to hold them; they would circulate in relatively small quantities; be backed by a pool of revenues from several Member States, and be managed by a technical body less easily captured by domestic political uncertainties. They could be used by the ECB for QE and by domestic banks to diversify their portfolio, reducing the risk of the bank-sovereign ‘doom loop’ that was at work during the latest crisis. At the same time, national debts would become smaller (although riskier if junior to Stability bonds). Finally, the stronger enforcement capacity of the EFI compared to current arrangements would give more credibility to the goal of debt reduction in the highly indebted countries, and would more easily prevent new accumulation of national public debts. Once again, care must be taken to avoid the danger that stability bonds would pile up on unsustainable national debts, rather than leading to an overall debt reduction. This is why unanimity should be preserved in some EFI decisions such as the maximum amount of stability bonds that could be issued.

7.2.2 The EFI and Fiscal Discipline

Besides managing the common fiscal policy, the EFI could also assume the role of enforcer of fiscal discipline in Member States – a role currently performed by the Council of the European Union on recommendation by the European Commission and, in perspective, by the newly established European Fiscal Board. The latter institution could be integrated into the EFI.

In exchange for the enhanced risk sharing capabilities, Member States could be asked to accept a more intrusive external interference in national fiscal policy. Specifically, the EFI could also have authority to veto national budgets and impose specific targets for deficits or surpluses. While the procedures of the Growth and Stability Pact already envisage this, there is an important difference. The Pact can only issue recommendations and in extreme cases impose fines, which however have proven politically difficult to implement. The EFI would instead have the authority of an institution that has the resources to intervene in case of a crisis, a clout it wouldn’t have if its only instruments are recommendations and fines.
The main goal here is to insure adequate fiscal discipline in all Member States, but it is also conceivable that the EFI could impose a laxer fiscal policy than the one approved at the national level, if a fiscal expansion is justified by a major euro-wide recession. Over time, the EFI could evolve, if the political will materialized, into a more accomplished fiscal union for the euro area, funding, for example, some European level public goods.

7.3 Stability Bonds and Moral Hazard

With the stronger risk sharing capabilities discussed above, moral hazard would be an even bigger concern than under current arrangements. Some lessons could be learned from the United States, although direct application of the US solution is difficult, mostly because the US has a centuries-long tradition of no bailouts: at the states’ level, the balanced budget rules written in most states’ constitutions have very rarely been violated, thus creating a very strong precedent. And cities have been allowed to default: President Ford’s 1975 response to New York City’s call for financial aid, well summarized in this Daily News headline, “Ford to City: Drop Dead”, did more to limit moral hazard than volumes of no bail-out rules.

The situation in the euro area is rather different, first because balanced budget rules – now written in the constitutions of most Member States - do not have the clout of US states’ balanced budget rules. Second, because -- notwithstanding the views recently expressed by a member of the German Council of Economic Experts (Andritzky et al 2016) --, the commitment never to bail out Member States would not be credible, given the size of the debt of some Members. Thus, although the US experience is an important one, it will take years for the Euro area to reach similar conditions. In the meantime, moral hazard will remain a serious source of concern.

7.4 The EFI, the Commission and the European Fiscal Board

The functions we have outlined for the EFI would partially overlap with those assigned to the Commission. These institutions however have very different status: the EFI (evolving from the ESM) is an intergovernmental institution; the Commission is an institution of the European Union. This tension eventually will need to be addressed. In the short run, however, governments should build upon the ESM transforming into an EFI. As mentioned above, EU history reminds us that it is typically safer, surer and quicker to build upon existing institutions.

Many of the solutions to these problems will entail heightened political integration -- both to implement the solutions and to maintain democratic accountability. This is nothing to shy away from, because absent a fiscal capacity at the Euro area level, the monetary union, for the reasons discussed above, is unlikely to survive.
8. CONCLUSIONS

An economic region cannot work properly without an instrument to control aggregate demand. The euro area today, at the zero lower bound, lacks such an instrument. This is why the concept of an EAFS has become central to policy discussions in the euro area. However, while having introduced such a concept has been an important step ahead, the inability to control the EAFS is one of the most serious problems the euro area faces. I have illustrated two solutions. The first one is feasible within the boundaries of the Treaties and would require a procedure whereby the Commission decides first the desired change in the EAFS, and then the allocation of such a change among individual Member States, based upon their relative output gaps. The second proposal is more ambitious and envisages the creation of a fiscal capacity at the euro area level through the transformation of the European Stability Mechanism in a new institution, designed to play a central role in managing euro area domestic demand. The choice between the two options – but they could be implemented in sequence -- is a political decision, the most important political decision we face in the economic domain. The euro area is unlikely to exit the zero lower bond region any time soon. Designing alternative instruments to control aggregate demand should thus be on top of the policy agenda.
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