

Den statsfinansielle krisen i EU

CME Oslo 10 november 2010

*Lars Jonung, Lunds universitet och Finanspolitiska
Rådet, tidigare DG ECFIN, Bryssel*

Min tolkning av utviklingen

Stabilitets- och tillväxtpakten
("Pakten") står i fokus för mitt
anförande.

Pakten är grunden för finanspolitiken
inom EU och euroområdet

Stabilitets- och tillväxtpakten

Mitt anförande är en variant av
”policy-learning”.

Jag ser på sex lärdomar
rörande Pakten

Lärdomar för att undvika eller
minska risken för framtida
statsfinansiella kriser

The unique feature of the euro area

Centralized monetary policy making

ECB - with the goal of price stability

Decentralized fiscal policy making

No previous case in the history of monetary unions is similar to the euro area.

The unique feature of the euro area

SMU – den skandinaviska myntunionen:

Tre länder: Danmark, Norge och Sverige

Ingen finanspolitisk samordning överhuvudtaget

Ingen penningpolitisk samordning – guldmyntfoten.

Lösningen enligt Knut Wicksell:

Ett nordiskt Federal Reserve System med Feds
centralkontor i Göteborg

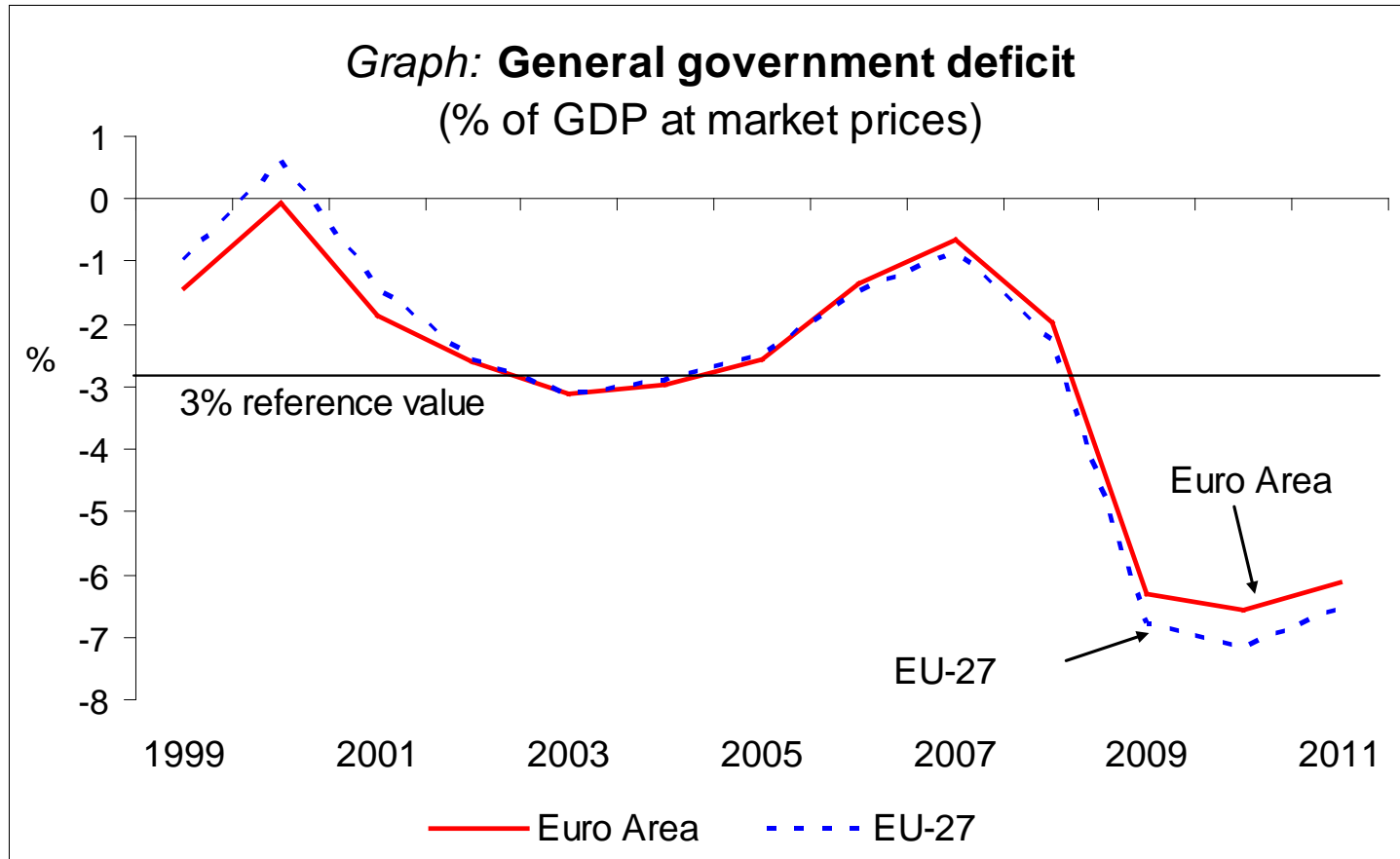
The unique feature of the euro area

The Stability and Growth Pact was designed to discipline the fiscal policy of the member states. (Övervakning, samordning och sanktioner)

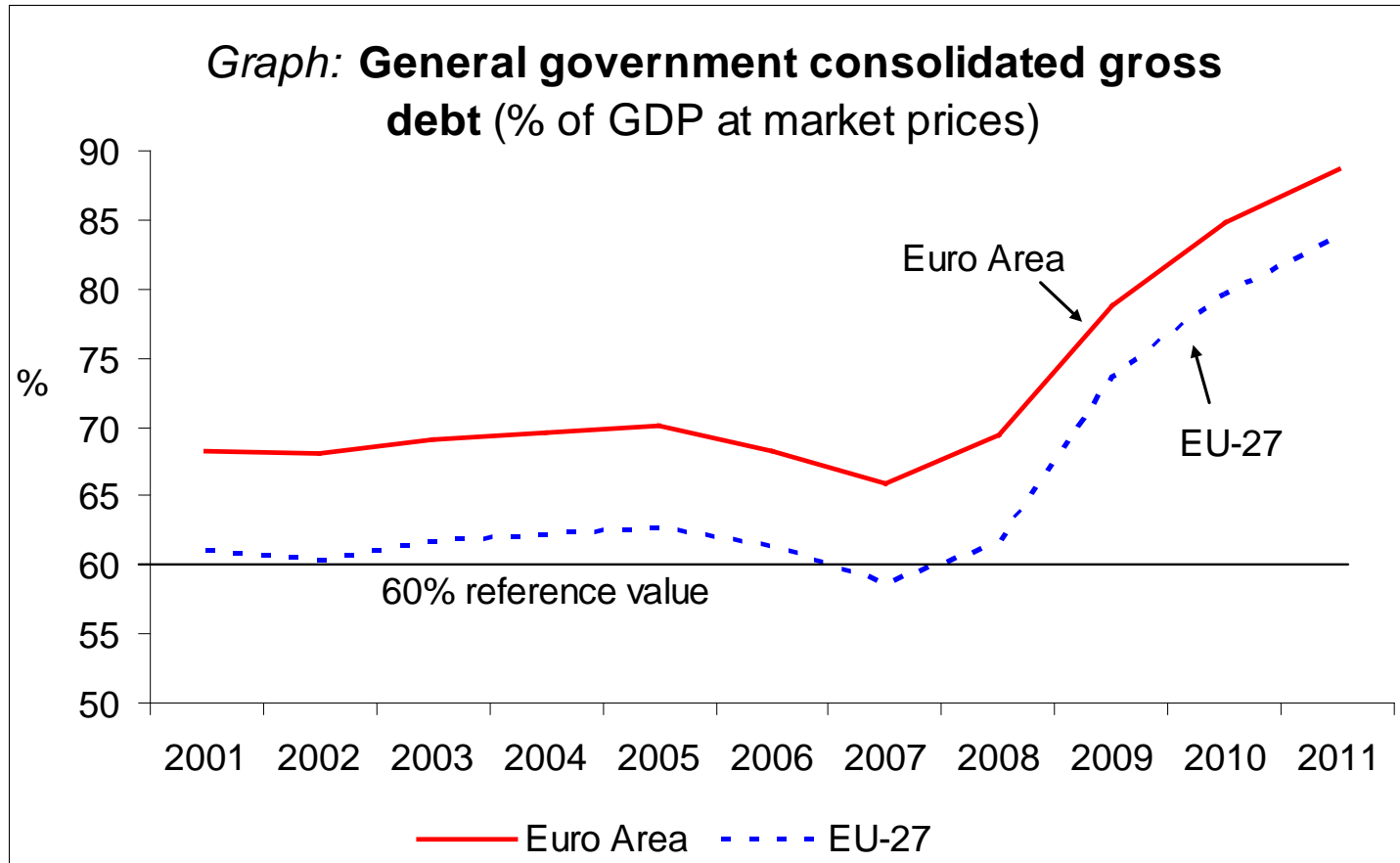
How did it work?

It looked OK before the crisis

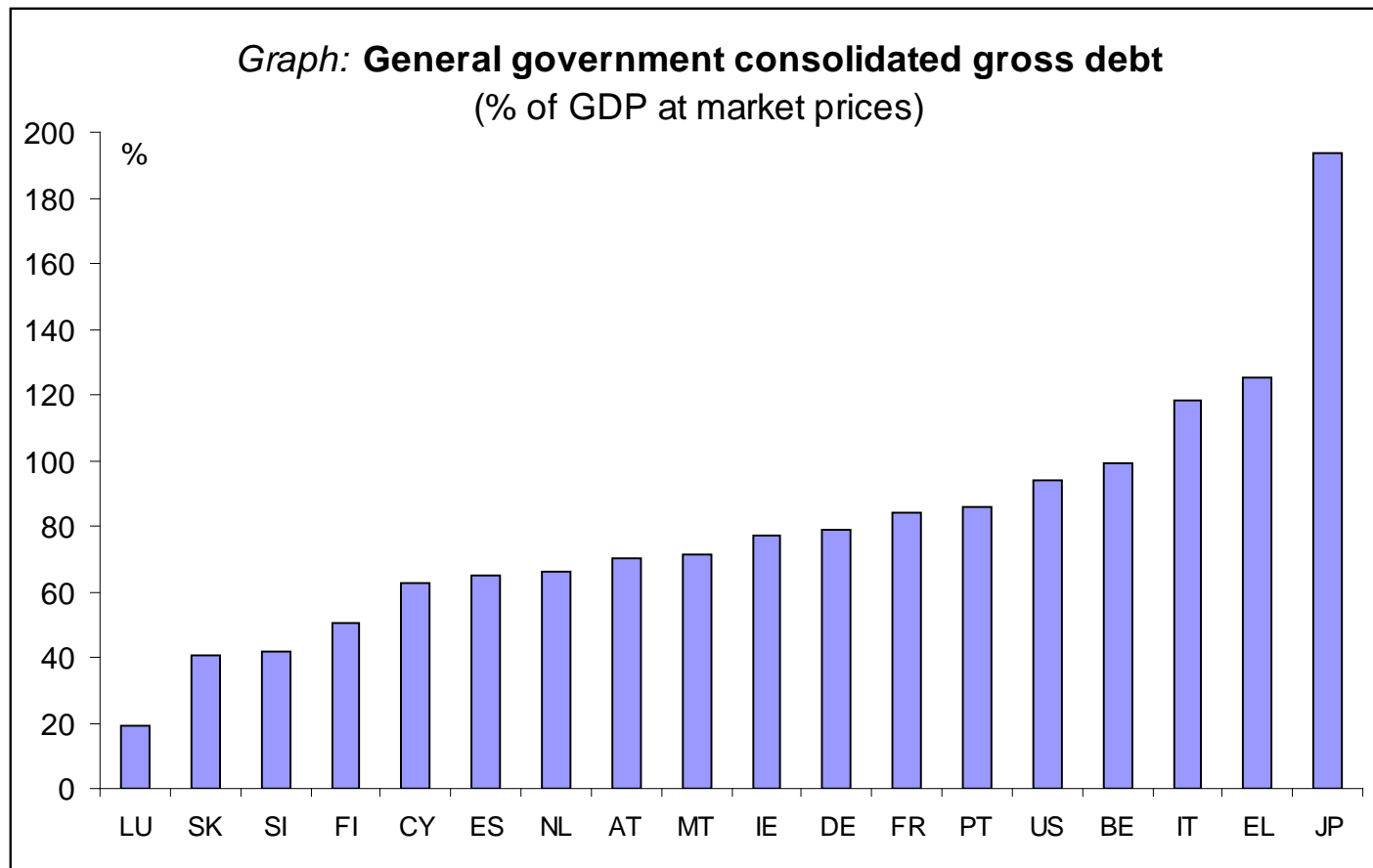
Euro-area budget deficits



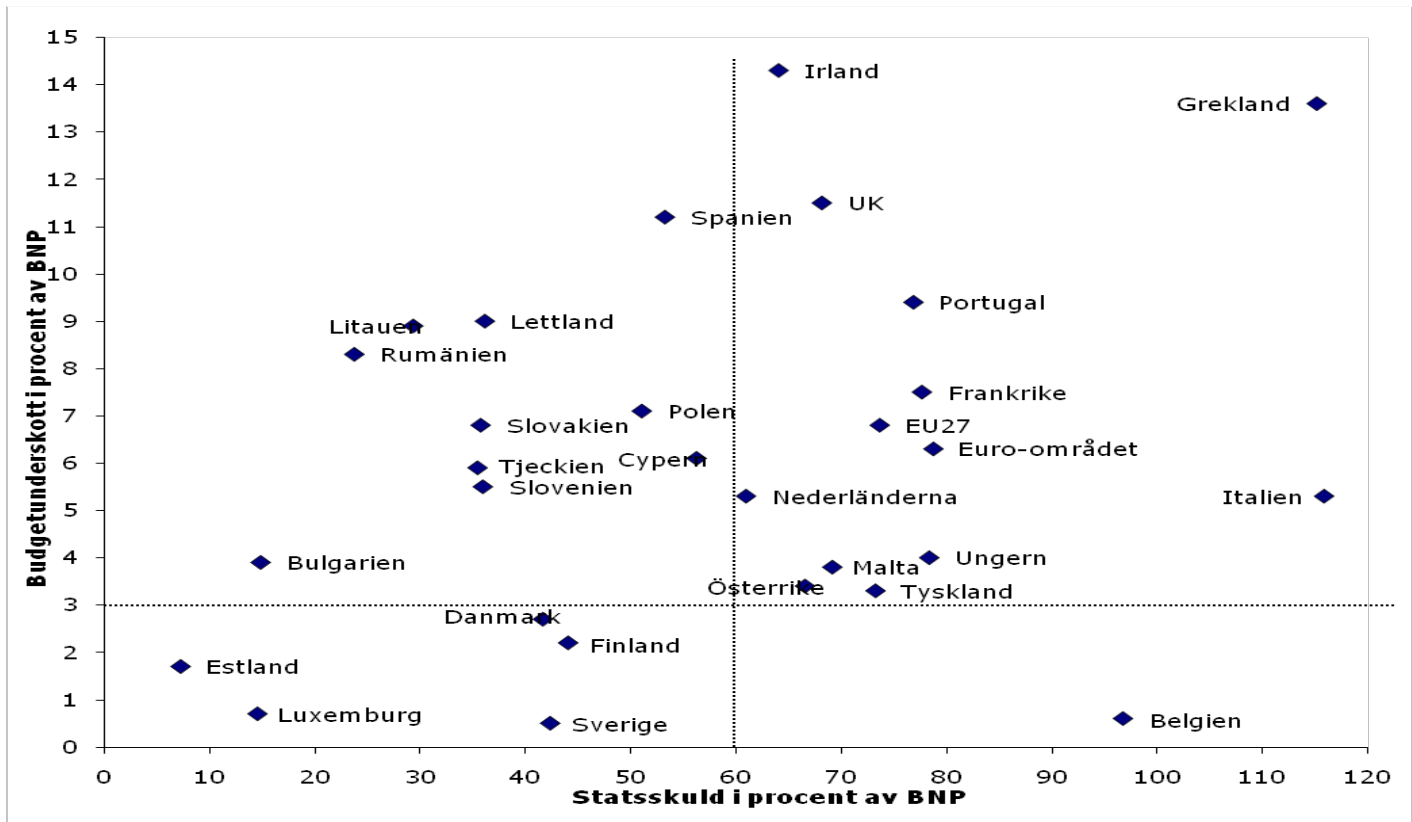
It looked OK before the crisis Euro-area debt/GDP-ratio



The global debt problem

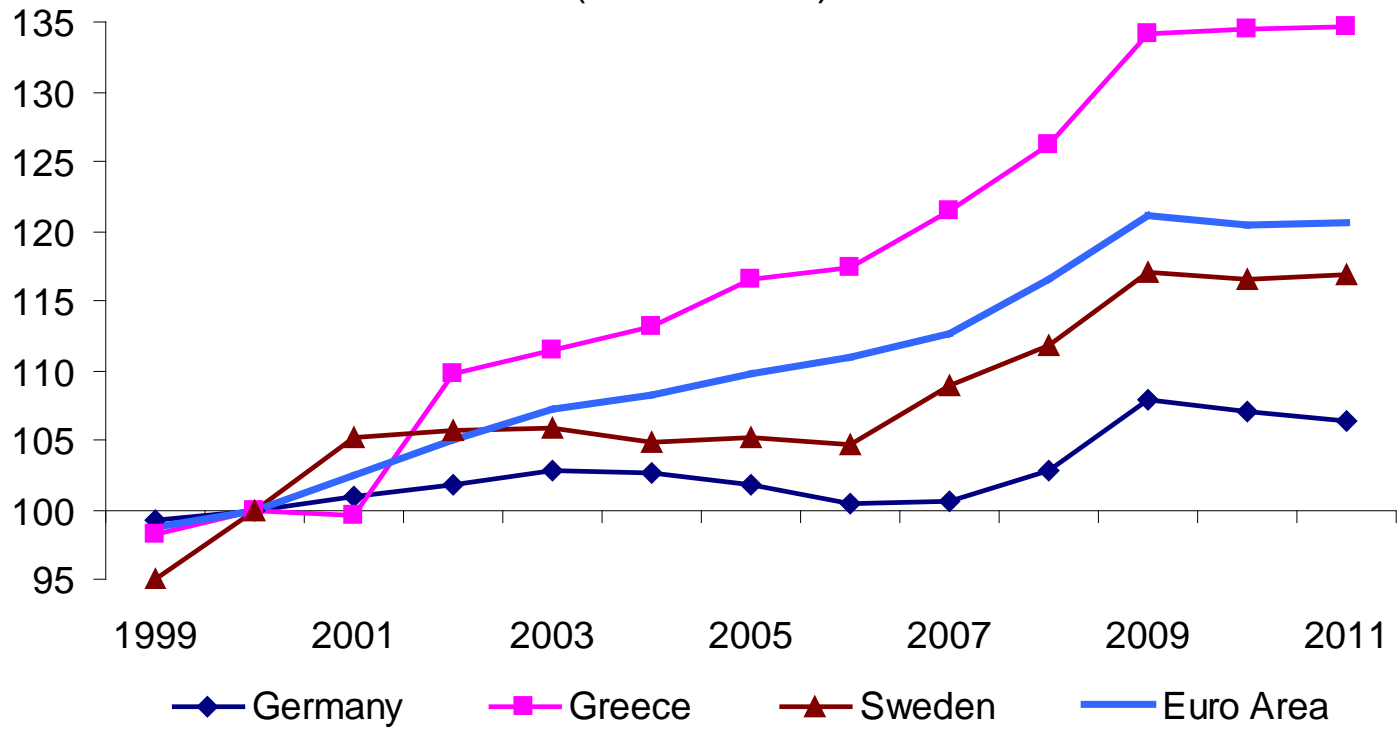


Figur 1: Statsskuld och budgetunderskott som andel av BNP 2009 inom EU-27

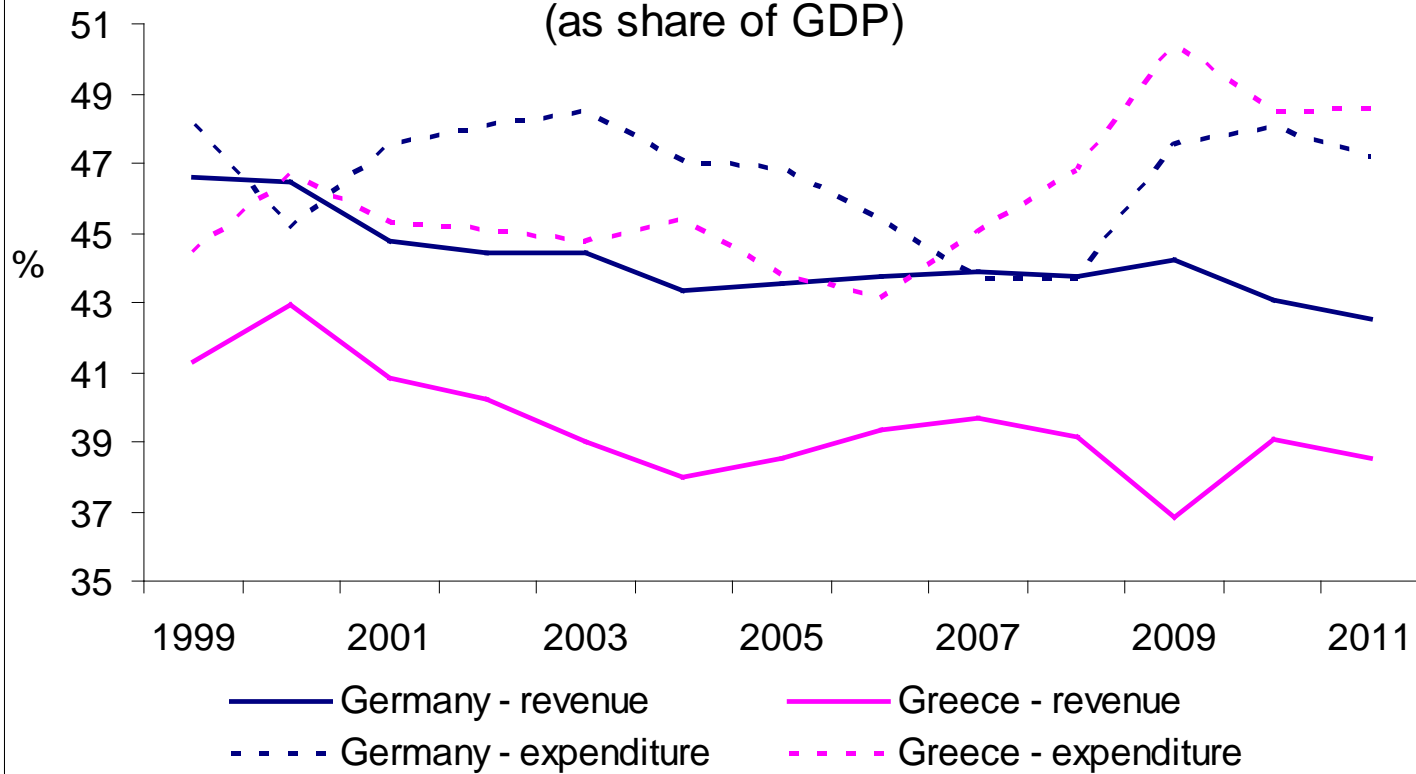


Källa: Ameco

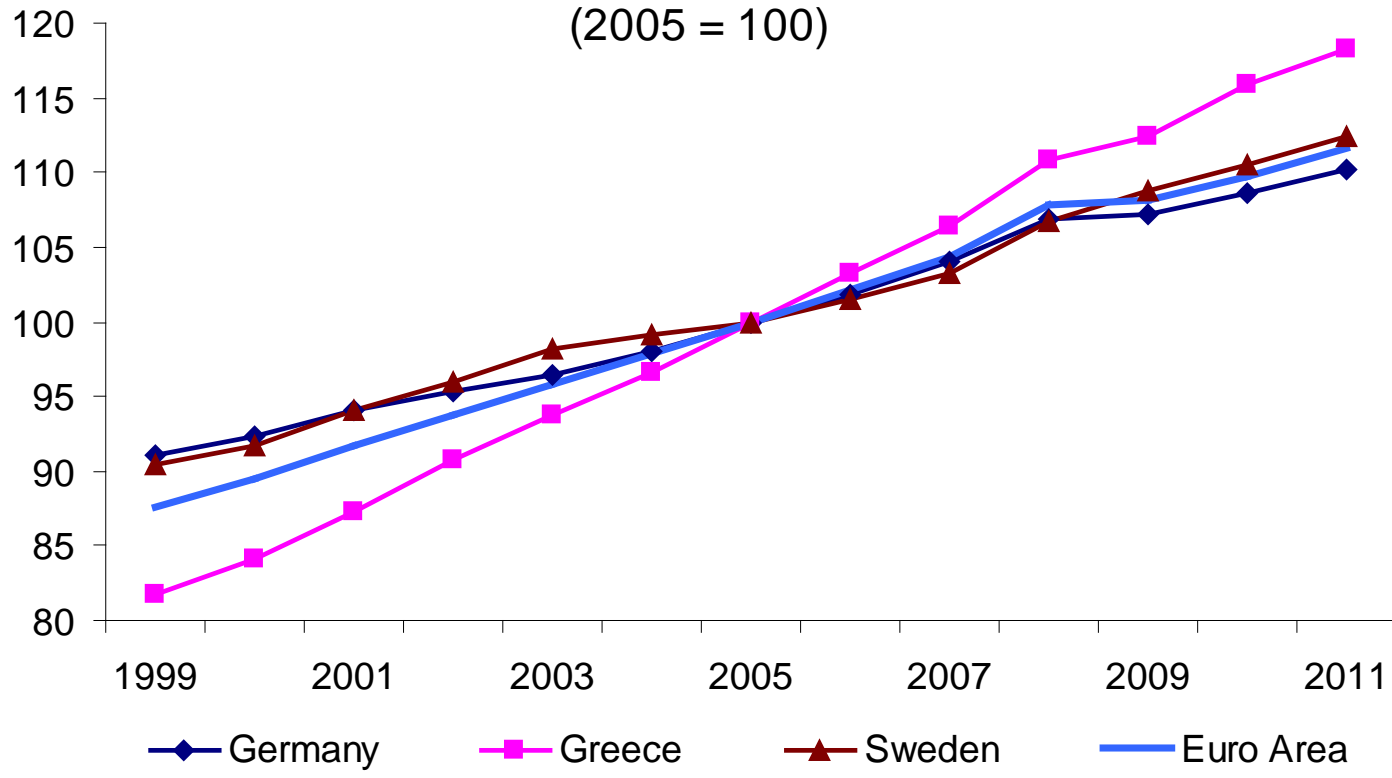
Graph 4: Nominal unit labour costs
(2000 = 100)



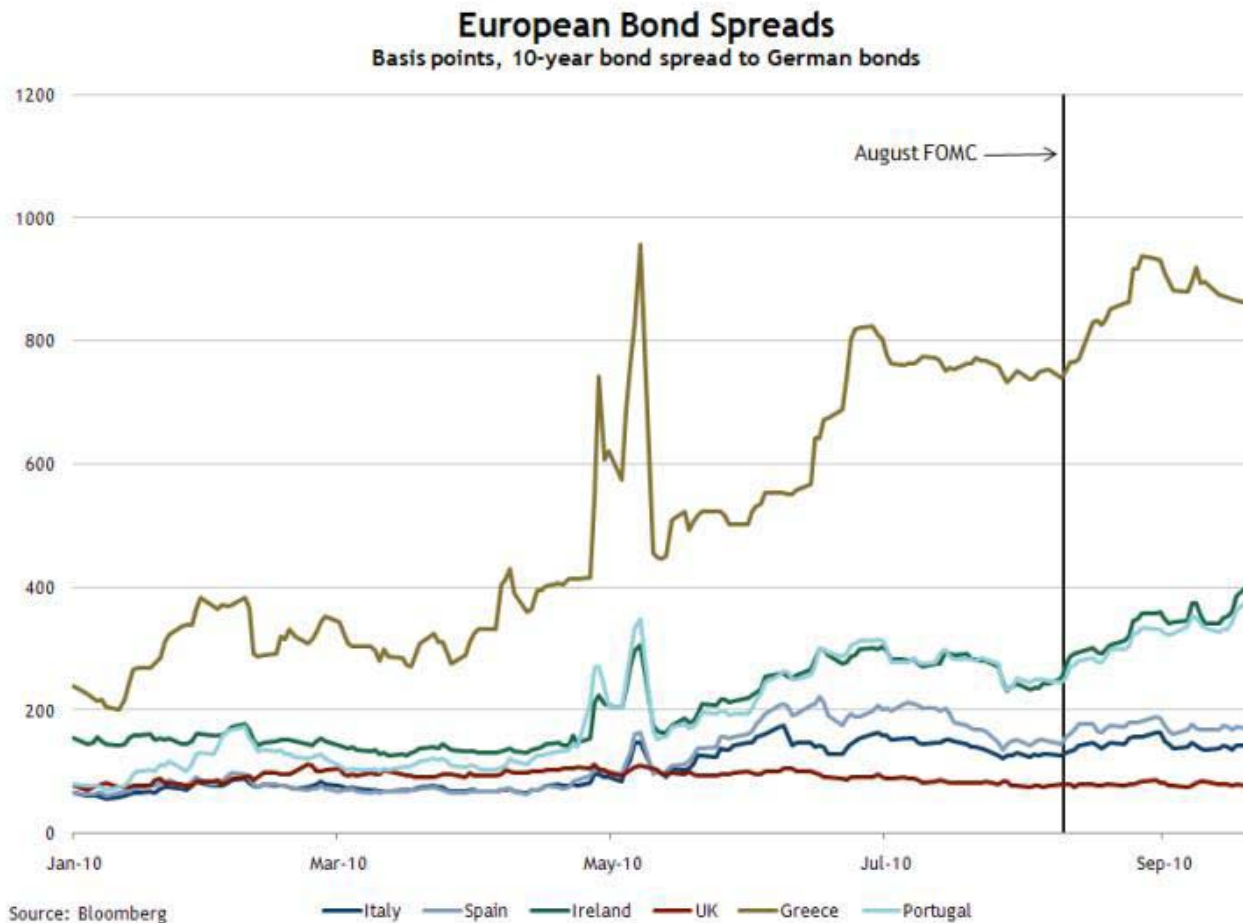
Graph 3: Government revenue and expenditures
(as share of GDP)



Graph 5: Harmonised consumer price index
(2005 = 100)



Räntegap inom euroområdet



The lessons from the crisis in the EU

Two questions:

A. Why did the SGP (EU fiscal policy governance) fail?

B. How should it be repaired? (Lesson drawing)

Overview: The main flaw of the SGP

The current system of fiscal policy coordination/surveillance is unbalanced:

It has been **too weak in good times**, building up the imbalances manifested in today's crisis, and **too tight in bad times**, lacking an explicit resolution mechanism.

The flaws of the SGP

Problem 1: Weak statistical surveillance

Reliable, complete and timely public finance data are essential for the success of any rule-based system of fiscal surveillance

The case of Greece ...

The remedies of the SGP

Solution (Lesson 1): More reliable government finance statistics

The quality of government finance statistics can be improved by enhancing Eurostat's access to information required to effectively verify compliance with existing rules.

The remedies of the SGP

Solution (Lesson 1): More reliable government finance statistics

- 1. Independent statistics offices**
- 2. Independent fiscal councils**
- 3. Independent fiscal authorities – ex ante and ex post institutions**
- 4. Eurostat offices in every member state?**

The flaws of the SGP

Problem 2. Lax fiscal policy in good times: the (non)preventive arm of the Pact

The consistent failure of the Pact to encourage fiscal adjustment in economic good times originated in a combination of two factors.

1. Uncertainty surrounding the crucial yardstick of EU fiscal surveillance, the cyclically-adjusted budget balance (**CAB**). Non-observable concept
.
2. Even when risks to fiscal virtue were visible, the **peer pressure** offered by the preventive arm of the Pact did not produce the desired results.

The remedies of the SGP

Solution (Lesson 2) . Making the preventive arm more effective

The CAB did not work.

A promising candidate for prudent fiscal policy making is **a simple expenditure rule** that builds on the main intuition underlying the notion of fiscal sustainability, namely that over the long term government expenditure can not grow faster than available government revenues.

Anchoring expenditure growth to GDP does not rule out discretionary fiscal policy or changes in the size of government. It simply means that to preserve sustainability discretionary expenditure increases, that exceed GDP growth, will have to be matched by discretionary tax increases.

The remedies of the SGP

Solution (Lesson 2). Making the preventive arm more effective

The main benefits of a surveillance approach centred on expenditure growth vis-à-vis the one based on the CAB are straightforward.

A simple expenditure rule **does not rely on unobservable variables**: both expenditure and GDP are observable; they do not involve speculative elements about future growth as is the case with the output gap

The flaws of the SGP

Problem 3. Fiscal blinders: other macro imbalances ignored

The radar screen did not pick up relevant threats to macroeconomic stability. Why?

The architecture of EU economic governance incorporates a key tenet of the macroeconomic paradigm that prevailed in the decades preceding the Great Recession.

It was built on the premise that **low and stable inflation combined with sound fiscal policy would be sufficient to safeguard overall macro-financial stability.**

Imbalances other than fiscal were taken to be the result of loose monetary and/or fiscal policy, rather than constituting independent risks for policy making.

The flaws of the SGP

Problem 3. Fiscal blinders: other macro imbalances ignored

The SGP rules did not provide for the possibility to ring the alarm bells and to deploy the formal instruments of peer pressure on the basis of developments outside public finances.

Still DG ECFIN was warning

The remedies of the SGP

Solution (Lesson) 3. Going beyond the fiscal area: broader economic surveillance

Fiscal discipline is a necessary yet not a sufficient condition for overall macroeconomic stability.

A truly and effective preventive economic surveillance needs to go *beyond* the fiscal dimension. It needs to keep an eye on other imbalances such as asset and housing bubbles or current account deficits.

In order to safeguard overall macro-financial stability, monetary and fiscal policy making, the two classical tools of macro policy, need to be combined with other policy instruments, in particular, **macro-prudential tools.**

The remedies of the SGP

Solution (Lesson) 3. Going beyond the fiscal area: broader economic surveillance

- We need a set of indicators gauging non-fiscal external and internal macroeconomic developments which, under certain circumstances, can have a bearing on public finances. Such a set of indicators could include the current account balance, net foreign asset positions, productivity and unit labour costs, the real effective exchange rate, private sector credit and asset prices.
- Because of the multitude of macroeconomic dimensions involved, trigger points for issuing a notice or warning to a Member State are likely to require a considerable degree of discretion. We cannot be rule-bound here. We lack a firm macro-theory

The remedies of the SGP

Solution (Lesson) 3. Going beyond the fiscal area: broader economic surveillance

As a result, the governance of a broadened economic surveillance is likely to be more complex than current fiscal surveillance.

Compared to fiscal policy making, which is controlled by national authorities, the responsibilities for important macro-prudential policy instruments (i.e. the regulation of banking operations) are shared among different players (i.e. central banks, national regulatory agencies, European regulatory entities).

This fragmentation is a challenge for both the formulation and, in particular, the implementation of policy responses. In addition, the involvement of the ECB in a European macro-prudential surveillance mechanism may create conflicts with independent monetary policy making.

The flaws of the SGP

Problem 4. Issues of governance: EU rules versus national sovereignty

As the EMU is a monetary union without political union the scope for effectively influencing fiscal policy making at the supranational level clashes with national sovereignty.

The circle is formally squared by submitting the national prerogative of fiscal policy making to the commonly agreed rules of the SGP.

The ultimate decision making authority in charge of implementing the rules are the Member States within the Council. Based on the initiatives and proposals of the European Commission, the Council approves or rejects the legislative instruments which are meant to ensure the functioning of the Pact. Decisions are generally taken with a qualified majority and Member States are expected to follow up on the decisions taken.

The flaws of the SGP

Problem 4. Issues of governance: EU rules versus national sovereignty

The two main instruments available to the Council to encourage compliance are ***peer pressure*** (under the preventive arm of the Pact) and the deliberation of ***financial sanctions*** (under the corrective arm of the Pact) if an excessive deficit persists and the Member States concerned fail to comply with the recommendations and decisions of the Council.

The flaws of the SGP

Problem 4. Issues of governance: EU rules versus national sovereignty

In terms of a principle-agent framework, the SGP could be characterised as a '**gentlemen's agreement**' among **multiple principles** to follow a pre-defined set of rules including the threat of sanctions for serious departures from these rules.

An agent, the Commission, is entrusted with monitoring compliance but apart from moral suasion it has no enforcement power, neither has **the group of principles** which at the end of the day has to trust the willingness of its individual members to abide by the rules.

Formally, the group of principles can, with a majority decision, agree to proceed against a non-compliant member. However, blocking coalitions can be formed. Thus, national fiscal sovereignty remains strong.

The remedies of the SGP

Solution (Lesson 4). Sovereignty versus responsibility

The experience of the SGP has exposed the fundamental dilemma of the EMU, namely monetary union without (strong) political union.

The fiscal sovereignty of Member States should be limited.

1. Strengthen domestic fiscal frameworks through Fiscal Policy Councils
2. The crisis may have demonstrated the cost to everyone of not complying, thus leading to better compliance?

The flaws of the SGP

5. Lacking provisions for severe economic stress or crises

The rule-based system of fiscal surveillance codified in the SGP essentially builds on the orthodox scepticism vis-à-vis fiscal discretion.

Under the provisions of the pact the stabilisation function is entrusted to automatic stabilisers and fiscal discretion is to be used for the purpose of fiscal consolidation only.

Discretionary fiscal expansions are not foreseen, and are in formal conflict with the requirements of the Pact.

The flaws of the SGP

5. Lacking provisions for severe economic stress or crises

However, the formal ban of discretionary fiscal stabilisation progressively weakened in the face of the alarming contraction of economic activity during the Great Recession.

The working of automatic stabilisers was soon considered to be insufficient to mitigate the impact of the crisis.

In its European Economic Recovery Programme (EERP), adopted at the end of 2008 and subsequently endorsed by the Council, the Commission encouraged Member States to ease fiscal policy in a timely, targeted and temporary fashion.

The crisis forced a change towards discretionary fiscal policies.

The flaws of the SGP

5. Lacking provisions for severe economic stress or crises

The crisis brings to the fore an important, although not new, insight concerning the design of rule-based policy frameworks:

Due to the inherent uncertainty of economic development, there will always be major unforeseen adverse events. From a practical point of view this means that it will be impossible to conceive a rules-based framework that *ex ante* accounts for all possible states of the world; **contingent flexibility is required.**

The credibility and sustainability of a rules-based framework depends on whether it includes robust **escape clauses** that allow policy makers to cope with particularly adverse circumstances when sticking to the rules is no longer viable.

The remedies of the SGP

Solution (Lesson) 5. Escape clauses: combining commitment with flexibility

Ideally, a rule-based policy framework should be as comprehensive as possible, covering all possible states of the world.

In a stochastic world, however, it is practically impossible to design a rule that encompasses provisions for all types of contingencies. Unforeseen and unforecastable events occur will always occur and when they do rules are likely to become too tight and untenable.

The tensions within the EU fiscal surveillance framework arising from the economic and budgetary impact of the Great Recession are a perfect case in point.

We need an escape clause ...

The remedies of the SGP

Solution (Lesson) 5. Escape clauses: combining commitment with flexibility

Actually, current events within the euro area have forced policy-makers to act in a manner consistent with an escape clause. There is a de facto escape clause although it does not exist de jure. The question arises: how should an explicit escape clause be designed?

The key element of such a mechanism or contingent rule is the trigger of the escape clauses. To avoid an indiscriminate use, which would undermine the essence of a rule-based system, recourse to escape clauses must be credibly constrained.

One effective way of achieving this would be to entrust an independent body with issuing a recommendation for switching off and back on the rules on the basis of a thorough assessment of economic circumstances.

Who should be this independent body?

The flaws of the SGP

Problem 6. Lacking provisions for severe economic stress or crises

On top of the tensions emerging from the absence of robust escape clauses, the Great Recession also revealed the lack of **crisis resolution mechanisms**.

As the sovereign debt crisis escalated in Greece the conclusion was drawn that an uncontrolled default should be avoided in the interest of financial stability of the euro area as a whole; but no instrument was at hand.

In an emergency meeting held on 9 May 2010 the Ecofin Council adopted the blueprint of a temporary but more general rescue mechanism – the European Financial Stabilisation mechanism and the European Financial Stability Facility- aimed at providing help to euro area countries that run into financial trouble.

The remedies of the SGP

Solution (Lesson) 6. When worse comes to worse: crisis containment and crisis resolution

The SGP is an *ex ante* construction in the sense that it was believed to prevent the worst outcome – a debt default – by combining crisis prevention and a promise not to come to the rescue of insolvent governments.

There is a need for an *ex post* corrective arm – an arm that contains a resolution mechanism for financial support and, possibly, orderly restructuring of public and private debt for euro area countries in emergencies – a mechanism of last resort when all other preventive and corrective measures have failed.

The remedies of the SGP

Solution (Lesson) 6. When worse comes to worse: crisis containment and crisis resolution

The long-run risks for the ECB of purchasing bonds with a rising default risk in order to maintain orderly financial markets are great. Such a policy runs the risk of eventually undermining the monetary and financial credibility of the ECB as it is forced to support the fiscal and budgetary policies of the euro area country carrying out the most irresponsible policies.

The present crisis in the EU is a solvency crisis but it is currently treated by EU policy-makers – and thus by the ECB - in the short run as a liquidity crisis. The risk is that short-run measures to guarantee liquidity to the system will build up and enforce long run problems of solvency.

The remedies of the SGP

Solution (Lesson) 6.

When worse comes to worse: crisis containment and crisis resolution

The credibility of the euro area as a well-functioning monetary union is dependent on the existence of a mechanism that can deal with solvency crisis – to prevent them from spreading from one country to all countries, to prevent ECB from turning into a fiscal agent, and to resolve them if and when worse comes to worse.

The remedies of the SGP

Solution (Lesson) 6. When worse comes to worse: crisis containment and crisis resolution

Ad hoc approach:

The European Financial Stabilization Mechanism (EFSM)

The European Financial Stability Facility (EFSF)

The remedies of the SGP

Crises are catalysts of reform and change – they initiate a process of policy learning and subsequent changes in institutions and instruments for economic policy-making.

This is also true for the Great Recession. In its wake an intensive debate started in both the political and the academic arena on how to redress the shortcomings of the SGP that may have caused the crisis and contributed to its fast and extensive propagation.

This debate also encompasses the role of fiscal policy and, in the European context, the role of EU fiscal surveillance in a monetary union.

Learning process

- Kommissionens förslag i september 2010
- Herman von Rompuys arbetsgrupp i oktober 2010
- Dessa förslag bygger på erfarenheterna av den misslyckade Pakten

Learning process

- Den nya Pakten:
- Mer automatik, hårdare övervakning, mer makt åt Eurostat, europeisk semester, bredare makroekonomisk övervakning, snabbare sanktioner, hårdare krav rörande statsskulden mm.

Framtiden

Vilka scenarier finns i debatten:

1. Allt går väl. PIIGS klarar åtstramning, strukturreformer. Krisen blir en hävstång till förnyelse. Euron går starkt ut ur krisen...
2. Skuldnedskrivning för vissa medlemmar....
3. Grekland blir ett Argentina ...
4. Tyskland tröttnar på alla som inte följer reglerna....
5. Den svarta svanen ...

Framtiden

- "We turned off the screens 10 years ago. Now we have turned them on again"
- Ett skäl för optimism: de finansiella marknaderna signalerar varje minut tillståndet i unionen.

Framtiden

Två metoder för att skapa finanspolitisk disciplin

- Via det politiska systemet
- Via marknaden

Vilken metod är den bästa?

Framtiden

Vilken metod är den bästa?

Vanlig reaktion: De finansiella marknaderna fungerar dåligt – de sov under lång tid. Nu har det vaknat. Men då överreagerar de ...

Det politiska systemet fungerar också dåligt

...

Framtiden

Kombinera de bägge metoderna.

Dagens reformer ökar transparensen, det ökar marknadens förmåga att bedöma utvecklingen.

Min prognos: de närmaste 10 åren med euron blir en tid då de finansiella marknaderna får en ny och starkare roll

Ödets ironi ...

*You never let a serious crisis go to waste.
And what I mean by that it's an opportunity to do
things you think you could not do before.*

Emanuel Rahm, White House Chief of Staff, 19
November 2008.

Don't waste the Greek crisis!