

EMU without fiscal and political union – could it work?

Vesa Vihriälä

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The mainstream argument

1. Monetary union => fiscal union

- Conjunctural differences => cross-country fiscal stabilisation needed in the absence of national monetary policy
- Efficient macro policy mix => joint fiscal policy stance
- Threats to financial stability => risk-sharing, tight constraints on MS fiscal policy
 - Bank failures: fiscal backstops for deposit insurance, resolution
 - Sovereign debt crises: mutualisation of sovereign risk, more powerful constraints on MS fiscal policy

2. Fiscal union => political union (federal decision making structures)

- Efficiency and legitimacy of joint fiscal decisions
- Control of moral hazard

Yes, but...

- Agree that
 - Fiscal union would improve the functioning of the EMU, if well managed
 - Fiscal union => political union
- However,
 - Little appetite for risk sharing among the likely providers of insurance,
 - Even less appetite for surrendering national fiscal sovereignty, lack of will not limited to the financially strongest countries
- Fortunately, a full-blown fiscal union probably not necessary

The unlikelyhood of political union

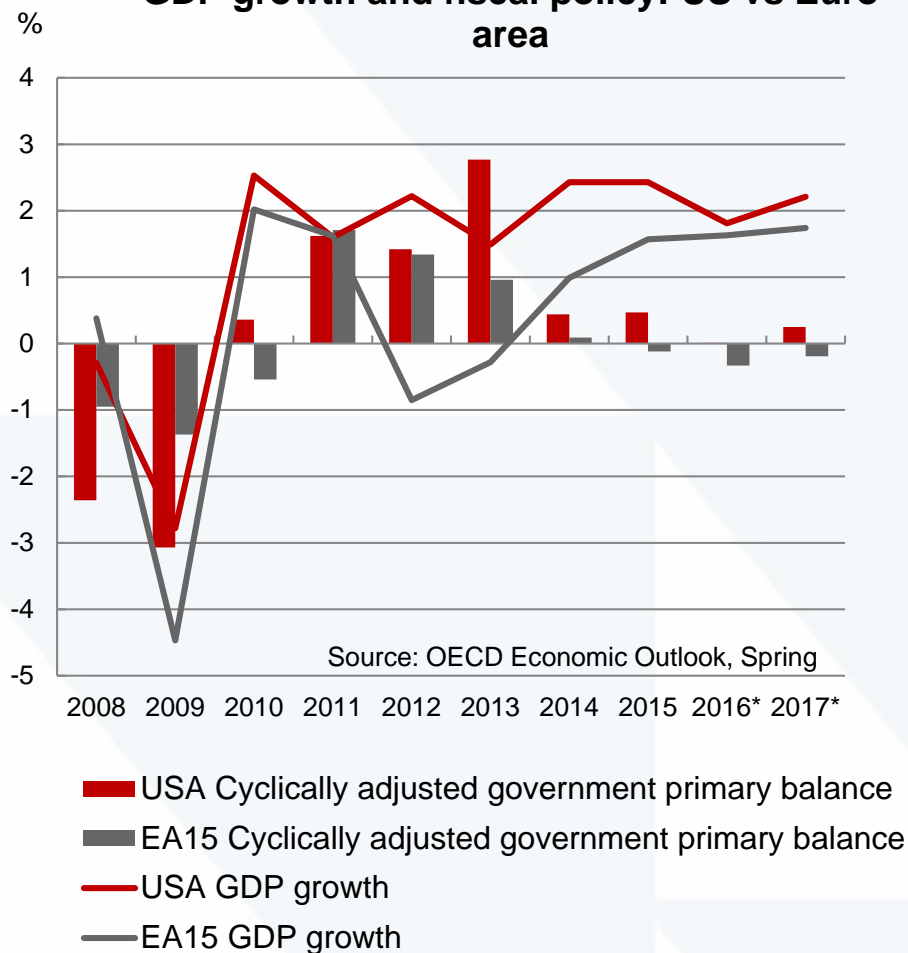
- Theory
 - political costs of providing public goods increase as a function the population heterogeneity (e.g. Spolaore 2015)
 - fiscal policy inherently distributive and subject to large differences of preferences
- Practice
 - Functioning federal structures have taken long time to develop (USA!)
 - In the EU, risk sharing has been accepted only under extreme duress
 - MS (especially the big ones) have protected their fiscal sovereignty fiercely
 - SGP 2003
 - Valls 2014: “We decide the budget... France should be respected. It is a big country”
 - Renzi 2014: “We don’t take orders from Brussels”
 - The de-facto watering down of the new strengthened governance rules (Spain, Portugal, Italy 2016)
 - Constraints only accepted when no feasible alternative (financial assistance programmes)
 - The crisis has led to populist reactions and driven countries further apart

The non-necessity of full-blown fiscal union

- Cyclical stabilisation across MS unlikely to be very important, according to the US experience
 - Most consumption smoothing through capital and credit markets (Astrubali & co)
 - State-level pro-cyclical policies have largely undone the stabilising effects of the federal budget (Darvas; Aizenman & Parischa; Rodden & Wibbels)
- The role of fiscal policy in the current crisis may be overstated
 - The US-EA difference less due to fiscal stance than monetary and financial conditions
- Credible and efficient bail-in rules limit the need for fiscal backstops in the handling of banking and sovereign crises

Differences in financial market conditions rather than in fiscal policy stance explain the US-EA growth difference

GDP growth and fiscal policy: US vs Euro area



GDP growth and interest rates: US vs Euro area



What is needed in an EMU without fiscal union?

- Unlimited supply of liquidity to solvent banks and sovereigns (elimination of self-fulfilling crisis expectations)
- An efficient resolution of solvency problems of banks and sovereigns
- Effective market discipline on sovereign indebtedness in the absence of effective fiscal rules
- Separation of bank and sovereign risks (elimination of the doom-loop)

What is also helpful for a functioning EMU

- Greater stabilisation of shocks via capital and credit markets
- Greater labour market flexibility in MS
- Greater labour mobility across MS
- Better regulation and supervision of banks and other financial institutions

What could to the trick?

- Completion of the banking union, including clarification of the rules on fiscal risk-sharing; steps towards a capital market union
- Clarification of the ECB financial stability mandate, including the option of financing ESM
- Creation of a mechanism for an orderly sovereign debt restructuring, combined with a one-off “stock operation” to reduce debt burdens (Corsetti et al.)
- Further tightening of financial regulation
 - Restrictions for banks’ sovereign exposures
 - More capital / less leverage (maybe steps towards less money creation as proposed by Lord King)
 - Stronger macro-prudential regulations

Why these might be doable reforms

- Acceptance of financial stability as a EA public good, and the associated “ultima ratio” risk sharing greater than of risk sharing in general
- Banking and financial regulation relatively more technical than political in comparison with taxes and expenditure
- Bail-in principle already accepted for banks, thus why not for sovereigns; legacy debt a major challenge, though

Similar argumentation

- Corsetti G. et al. (2016), Reinforcing the Eurozone and protecting an Open Society.
- Eichengreen B. and Wyplosz C. (2016), Minimal Conditions for the Survival of the Euro.
- Sandbu M. (2016), Europe's Orphan. The Future of the Euro and the Politics of Debt.

Thank you!

References

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