Monetary and fiscal integration in Europe
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Chapter 6

Conclusion

6.1 Summary

This thesis has focused on the consequences of European monetary integration and the associated minimal form of fiscal integration. Chapters 2, 3 and 4 concentrated on what went wrong, or is often perceived to have gone wrong, in the run-up to the euro crisis. Chapter 5 focused on the crisis itself, and on the effectiveness of one of the main measures that has been taken to contain it, the ECB’s OMT program.

In chapter 2, we highlighted how many of the imbalances that build up during EMU’s first decade can be traced back to the steep fall of interest rates in Southern European during the run-up to the introduction of the euro. Falling interest rates sparked a domestic demand boom, which in turn drove up wages, fueled growth of the nontradable sector, and contributed to diverging competitiveness positions between the Northern and the Southern half of the euro area as well as persistent current account imbalances. As foreign borrowing was not matched by an increasing capacity to repay, solvency problems were bound to emerge. In the model, a debt-elastic interest rate made sure that the debt eventually stabilized. In reality, interest rates for a long time did not react at all to the accumulating debt. A leaning-against-the-wind type of fiscal policy, or possibly macroprudential measures, could have helped to moderate the build-up of imbalances. In the absence of such
measures, investors ‘waking up’ during the crisis induced a sharp rebalancing process during which Southern GDP fell. Our analysis suggests that a deepening of the European internal market – i.e. fostering competition in the market for tradables – could offer a growth-friendly way of speeding up the necessary shift of resources towards the tradable sector in the South.

Chapters 3 and 4 focus on the coordination of fiscal policies within EMU. To date, this has mainly taken place via rules aimed at limiting the freedom of national governments to conduct deficit spending. In chapter 3, we highlighted that the way these rules are designed – specifically their forward-looking nature and the focus on the 3%-threshold – can lead to side effects. More specifically, for euro area member states, we showed that the official forecasts used to judge compliance with the SGP suffer from a bias when the 3%-threshold threatens to bind. We also provided suggestive evidence that this bias is smaller in EMU member states where an independent fiscal council produces the national forecasts. This suggests that reducing governments’ influence on (national) forecasts also helps supranational institutions to prepare unbiased forecasts. Chapter 4 offered a more optimistic message regarding compliance with the fiscal framework. Our results in this chapter suggest that the corrective part of Europe’s fiscal rules has largely done what it intended to do. The Excessive Deficit Procedure (EDP) – aimed at reducing budget deficits to less than 3% of GDP – has succeeded in getting euro area member states to tighten fiscal policy, even though this chapter too showed that planned fiscal effort has been somewhat larger than actual effort.

Finally, in chapter 5 we concentrated on the euro crisis and its aftermath. We showed that during 2009-2012 shocks to the Italian and Spanish sovereign spreads induced sizable spillovers to other euro area member states. Not only did Italian spreads react strongly to Spanish spreads, and vice versa, but also non-crisis, non-safe haven countries such as Belgium, France and Austria suffered from substantial sovereign risk spillovers. These often only reached their peak 2-3 days after the initial shock. The systemic nature of the euro crisis was illustrated by the fact that, during
2009-2012, the euro-dollar exchange rate and US government bond yields proved sensitive to events in both Italy and Spain. Our results confirm the announcement of the OMT as a watershed moment: since then, spillovers to non-crisis, non-safe haven countries have disappeared almost completely. While some spillovers among more vulnerable countries persist, these are smaller and shorter-lived than before. Overall, this chapter highlighted that, since the announcement of the OMT, problems in individual member states remain much more contained, greatly enhancing the stability of the eurozone as a whole.

### 6.2 Way forward

The first twenty years of the euro have been eventful. Perhaps this should not have come as a surprise: the introduction of the euro represented a gigantic economic experiment.\(^1\) From this perspective, the mere fact that it is still around – surviving the deepest global recession since the 1930s – is impressive. Yet, the euro has not delivered all that was hoped for. As is evident from this thesis as well as from the wider crisis, the original architecture of EMU contained several shortcomings that contributed to the build-up of imbalances and the depth of the eventual crisis. Most of these have been fixed or at least mitigated, although vulnerabilities remain.

Firstly, while the founders of EMU clearly worried about excessive deficit spending by governments, they chose to ignore countries’ overall external positions. This has proven unhelpful. As highlighted in chapter 2, the availability of cheap foreign credit tends to boost domestic demand but not exports. This can result in a mismatch between external debt and export capacity that puts pressure on a country’s solvency regardless of whether the borrowing is done on account of the private or the public sector. If markets do not impose limits on how much external debt EMU member states can rack up before it is too late, European policy makers

\(^1\) This is nicely illustrated by the discussion in Buiter and Sibert (1997) on whether the introduction of the euro would be a leap in the dark or ‘merely’ a step into the unknown.
must do so. Steps in this direction have been taken. A new set of rules, the Macroeconomic Imbalance Procedure (MIP) has been introduced. Central to the MIP is a score-board containing 11 indicators, covering multiple sources of macroeconomic imbalances as well as various ‘social indicators’.\(^2\) If a country scores poorly on any of the indicators this can trigger an in-depth review by the EC, which can eventually result in country-specific policy recommendations and, in case of non-compliance, a penalty. So far, however, first indications are that the MIP is not (yet) very effective (see Darvas and Leandro, 2015). To facilitate monitoring and enforcement, simplification and increased focus is desirable.

Secondly, Europe’s fiscal rules themselves require a rethink. The SGP has received significant criticism for perceived non-compliance. This thesis has shown the actual picture to be more nuanced, with EDP recommendations being lived up to quite well. Less clear is whether the SGP has always focused on the right targets. Up to the crisis-inspired 2011 reforms, only the 3% of GDP threshold for the budget deficit had any bite. The debt criterion had not been operationalized, while the preventive arm of the SGP – aimed at creating a safety margin to the 3%-threshold – relied on peer pressure only and was largely ignored (DNB, 2016). As a consequence, countries with a high debt but a deficit below 3% of GDP were left off the hook completely. This has contributed to the fact that some countries entered the crisis with little fiscal space. Following the crisis, the focus on the 3%-threshold also implied that even countries with modest debt levels were required to engage in pro-cyclical fiscal tightening. The 2011 and 2013 revisions of the SGP have, on paper at least, addressed most of these ills. Among other changes, the debt criterion has been operationalized, while the preventive arm now also foresees in the possibility of sanctions for non-compliance. The cost of all this is that the SGP, much like the MIP, has become very complicated. Especially in the preventive arm, an abundance of exceptions and discretionary margins undermines enforceability (European Court of Auditors, 2018). This highlights the difficult trade-off between completeness and en-

\(^2\) Such as youth unemployment. See Hessel et al. (2017) for a more elaborate discussion.
forceability. Given that, by itself, the level of public debt already is a summary indicator of the health of public finances, a simplification of the rules that puts the debt level at its core might offer a viable way forward (see also Eijffinger, 2010).

Thirdly, the crisis has put into spotlight the interconnectedness of banks and governments, and the absence of mechanisms to prevent or otherwise deal with a failure of either. This has contributed to a crisis response that, in the words of Lane (2012), was ‘makeshift and chaotic’ at least until mid-2012, while Corsetti et al. (2019) blame the absence of credible and timely policies to backstop banks and sovereigns for a recovery ‘delayed for a decade’. It is in this area that most progress has been made, from the creation of the banking union and the Single Resolution Mechanism for banks to the introduction of the European Stability Mechanism (ESM) and the announcement of the OMT program. At the time of writing, efforts to strengthen the ESM are ongoing, while the banking union still needs to be completed with a common, European, deposit insurance scheme to further reduce financial fragmentation and the risk of capital flight.

The combined effect of the measures that have been taken in the areas outlined above has been to reduce the chance of a new euro crisis. Moreover, in case something would go wrong, the toolkit to deal with it is substantially more developed than before 2011. However, progress has not been evenly distributed across all areas. Especially the revised and expanded governance framework still needs to prove its effectiveness, while the arguably biggest reform – the introduction of the banking union – remains in need of completion. Incremental progress across the lines suggested remains important to further boost the euro area’s economic resilience.

Going forward, important choices that will shape EMU’s ultimate form remain to be made. An important ongoing discussion, academically as well as politically, is to what extent it is necessary and/or welcome to expand fiscal risk sharing (see e.g. De Haan and Kosterink, 2018). From one end of

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3 Neither view is undisputed, with former ECB-president Jean-Claude Trichet referring to the crisis response as ‘quick and imaginative’ (Trichet, 2019).
the spectrum, calls have been made to reduce or eliminate risk sharing and to restore the credibility of the no bail-out clause. These proposals are often rooted in the belief that, firstly, a lack of fiscal discipline was a major cause of the crisis and, secondly, European fiscal rules are ineffective. This thesis has argued reality to be much more nuanced. Moreover, as highlighted in chapter 5, when going in this direction a way will need to be found to guard fundamentally healthy member states from the risk of contagion and self-fulfilling debt crises. As also argued by De Haan et al. (2014), not doing so would unnecessarily increase risk premia and borrowing costs. This would likely be most relevant during economic downturns, limiting the ability of fiscal policy to act counter-cyclically, and reduce welfare. Yet, it is not clear that proponents of this vision are much concerned with such scenarios. As former ECB chief economist Jürgen Stark puts it: “Why [...] should a “sound” eurozone member state need to obtain a “contingent credit line” [needed to be eligible for the OMT – NG] unless it is harboring hidden weaknesses?” (Stark, 2018).

More promising from a theoretical perspective, though not without political economy risks, are calls for increased fiscal risk sharing. The introduction of eurobonds – centrally-issued, jointly-guaranteed bonds for financing at least part of the euro area countries’ public debt – could, for instance, further reduce financial fragmentation in the euro area, increase the availability of safe assets, and make it easier to implement (unconventional) monetary policy measures (Claessens et al., 2012, Gilbert et al., 2013). A common euro area budget, on the other hand, could serve to more effectively counterbalance asymmetric shocks and/or provide EMU-wide fiscal stimulus when monetary policy is stuck at the effective lower bound. Yet, increased risk sharing might also lead to more risk taking by individual member states (‘moral hazard’), while any resulting permanent redistribution between member states could be politically poisonous. Therefore, to align incentives, it has frequently been stressed that increased risk sharing needs to be balanced with enhanced European control over economic policies (Weidmann, 2015, Hessel et al., 2017).
A recent research agenda seeks to (partially) sidestep this thorny issue by seeking ways to deliver some of the main benefits offered by eurobonds and a euro area budget without a commensurate increase in risk sharing. It focuses on ways to bundle and tranche euro area government bonds (see e.g. Brunnermeier et al., 2011, ESRB HLTF, 2018), as well as on designing fiscal stabilization schemes that avoid permanent redistribution and moral hazard (e.g. Beetsma et al., 2018). The proposals developed in this literature could offer a path towards less intrusive forms of fiscal integration. Yet, implementation of even these more limited proposals would benefit greatly from a reduction of structural differences between euro area member states and adherence to at least the existing European fiscal and macroeconomic rules. With convergence a gradual process at best and with reforms to the European governance framework still needing to prove their effectiveness, this suggests a gradualist approach towards fiscal integration. More generally, following a turbulent, crisis-driven, leap forward, incremental but unambiguous progress towards a better functioning monetary union would arguably suit EMU just fine.