Benoît Cœuré: A budgetary capacity for the euro area

Introductory remarks by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at a public hearing at the European Parliament, Brussels, 2 March 2016.

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Madam Chair, Mr Chair,

Honourable Members of the European Parliament,

Ladies and gentlemen,

I am grateful to the two rapporteurs and to the two committee chairs for holding this hearing today to advance the public debate on a fiscal capacity for the euro area. We are all well aware that political attention is largely focused elsewhere, but we should not lose sight of the objective of completing Economic and Monetary Union (EMU), securing its capacity to absorb economic shocks and creating confidence today in its future economic performance. As I have said elsewhere, if downside risks to the recovery were to materialise, this would not make it easier to respond to the refugee crisis or to counter terrorism.[1]

A quick glance at fiscal policies today should further convince us of the importance of this discussion:

- The recovery in the euro area is proceeding at a sedate pace; it is mainly supported by our monetary policy measures and by the low price of energy. At the same time, the global economy is overshadowed by renewed uncertainty and broader geopolitical risks.
- Public finances in many euro area countries are still in a fragile condition. After the past significant progress in fiscal consolidation, fiscal policy is at present mildly expansionary on average in the euro area. In many Member States, even though quality improvements by changing the composition of fiscal spending are still possible, high debt levels leave no room for fiscal manoeuvre. Only very few countries currently have fiscal space available. Rigidities in the economic structure of several Member States, although being addressed, are still significant.

This situation casts doubt on the euro area's capacity to face future economic shocks. A key policy challenge is therefore how to dispel these doubts *today* and to make sure that the euro area is well-prepared for downturns.

As one of two central bankers on this podium, it is not my role to explain to you which specific design of a fiscal capacity would be the right choice for the euro area. This is a political choice and should be the outcome of a political discussion.[2]

What I can offer you today is my assessment, as an economist, as to *why* we need a fiscal capacity for the euro area, why it cannot be the silver bullet that will make EMU work better, and *under what conditions* it could function well.

Fiscal policies in EMU

The role of fiscal policies in EMU has been at the core of the policy debate for some time now. Fiscal policies span a broad range of issues, ranging from public investment and collective

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1 See Cœuré, B., "Time for a new Lamfalussy moment", speech at the Professor Lamfalussy Commemorative Conference, Budapest, 1 February 2016.

2 See Cœuré, B., "Towards a political convergence process in the euro area", speech at the Interparliamentary Conference "Towards a Progressive Europe", Berlin, 16 October 2015.

goods – allocative functions that would also include the EU budget – to tools for macroeconomic stabilisation. Today, rather than discussing what, broadly speaking, fiscal policy could do to support growth at the current juncture, I will focus on how well-designed fiscal policies in an economic and monetary union – where monetary policy is exercised at the European level – could act as an instrument for stabilisation.

Let me start by clarifying that the euro area today is not at a crossroads between two starkly different routes, namely, responsible national fiscal policies on the one hand and a common fiscal capacity or a euro area budget on the other, with the choice between the routes being based on political or philosophical priors. From an economic standpoint, these are complementary. And in fact, we already have elements of both.

First, a precondition for fiscal policies to be able to contribute effectively to macroeconomic stabilisation is to ensure that markets have faith in the sustainability of public finances. And that is why adherence to, and the full and consistent implementation of, the Stability and Growth Pact and Fiscal Compact is so important. As I have said before, this is not a matter of theology; it is a political and economic imperative. Markets need to trust the capability of our governance framework to effectively coordinate fiscal policies in EMU, and citizens need to be confident that common rules are being respected. Let me add that any common fiscal capacity will be financed by current or future taxes on the same taxpayers and companies which already fund their national budgets. We cannot add to this edifice if its foundations are shaky, that is, if national budgets are not clearly sustainable.

In concrete terms, this means that Member States should rebuild fiscal buffers into their national budgets to be able to weather future economic shocks, while at the same time adjusting the composition of their fiscal policies to optimally support the recovery. Once these buffers are available, the Stability and Growth Pact provides ample flexibility to adjust fiscal requirements to enable the functioning of automatic stabilisers on a national level and to react to a severe downturn in the euro area as a whole if need be. Whether the Stability and Growth Pact should be further reviewed or complemented with new features, such as sovereign debt restructuring mechanisms, to improve ownership and set the right incentives is an open question, with ramifications which go far beyond our discussion today. But in any case, trust will not be rebuilt if we start by unravelling the existing rules.

Second, we have seen during the crisis that, without monetary policy instruments at the national level, fiscal policies can become overwhelmed if country-specific shocks are very large and not well catered for by the shock-absorbing capacity of the economy and the financial sector. Action can and should be taken to reduce the probability and size of such large shocks. The banking union, with its Single Supervisory Mechanism, Single Resolution Mechanism and the new bail-in rules, goes a long way in this direction, provided that all these elements are implemented in a resolute and consistent way. But we cannot responsibly assume that the euro area will from now on be immune to crises. The Five Presidents' Report therefore calls for the creation of a shock-absorption capacity at the euro area level to complement the automatic stabilisers of Member States.

And last but not least, there is ample scope for euro area countries to better absorb shocks internally, by having suitably resilient economies. Additionally, we need to improve and strengthen labour mobility and risk-sharing via financial markets. This is another reason why completing the banking union, and why complementing it with a capital markets union with substantial cross-border equity links, is so important. And this also reminds us of the importance of preserving labour mobility from the temptation of raising new fences.

A fiscal capacity for the euro area

There are many ways a euro area fiscal capacity could be implemented, ranging from simple macro insurance or an unemployment benefit scheme to a fully-fledged euro area budget that could include the provision of public goods. Each of these options entails its own technical and political challenges and opportunities. In the end, the choice as to which option or combination of options should be adopted will need to be a political one. This is in fact an opportunity to have a debate about Europe's collective goals; such a debate is more necessary than ever and goes beyond the economic sphere alone.[3]

From the perspective of the economist and of the central banker who has a keen interest in making EMU as a whole work better, the crucial question behind the discussion about a fiscal capacity for the euro area is how to maximise its positive effects on the functioning of EMU, while at the same time preserving incentives for sound fiscal policy-making and addressing structural weaknesses at the national level.

To start with, we should all be able to agree that the objective of the fiscal capacity should be to make EMU more resilient by increasing the capacity for automatic stabilisation in the euro area. The aim should not be to actively fine-tune national economic cycles or to equalise revenues. This is in line with the design principles described in the Five Presidents' Report, which notably insists that a fiscal capacity should not entail permanent transfers in one direction. A fiscal capacity in this sense would also be distinct in nature from more allocative tools such as those provided for by the EU budget.

To be able to reach this objective, and based on my introductory remarks, I believe we need to see significant further progress along the following three dimensions:

First, a pooling of fiscal resources, whatever their nature and size might be, only works if solidarity goes hand in hand with shared responsibility. A move towards more fiscal risk-sharing in EMU would therefore require a commensurate shift towards increased joint decision-making within strong common institutions. In any case, access to a joint euro area fiscal capacity should be made conditional on compliance with the fiscal rules of the Stability and Growth Pact.

Second, we should aim at containing the burden that falls on fiscal policies by strengthening market-based adjustment. As Ludwig Erhard famously said, we need "as much market as possible, as much state as needed". This means structural reform at the national level. But it also means completing banking union and supplementing it with a comprehensive capital markets union at the European level. In addition, this calls again for completing the Single Market more broadly, including in the services sector.

Third, it lies at the very heart of all insurance that risks are distributed equally ex ante. When it comes to mutual insurance against asymmetric shocks, it is clear that fiscal risks do not always stem from fiscal action, but from unsustainable economic and financial policies elsewhere. Therefore, any move in this direction should be accompanied by a new convergence process towards more resilient economic structures. Such a process would allow us to advance together towards a better-equipped EMU, outlining a clear path of reform and a commitment to a fiscal capacity. Political convergence is needed to kick off such a process, as any new convergence process can only be as effective as the legitimacy underpinning it.

Conclusion

Let me conclude by saying that protection against moral hazard is of course very important. At the same time, it should not be used as a strategy to relegate the move towards a fiscal capacity for the euro area to never-never land. The move towards a fiscal capacity could take the form of a *gradual* and *conditional* process that allows us to move in parallel towards restored fiscal buffers at the national level, convergence in the capacity to absorb shocks at the national level and a strengthening of institutions at the euro area level, while moving, equally gradually, towards more central fiscal stabilisation.

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3 See Cœuré, B.: "Drawing lessons from the crisis for the future of the euro area" speech at "Ambassadors Week", Paris, 27 August 2015.

I think we should be more ambitious in that respect. In fact, I would even argue that there is an urgent need to accelerate our efforts to complete the EMU architecture with a fiscal capacity. Although we should acknowledge that this will take time, and that getting it right will require effort and precision, we should act without delay and speed up our work.

Thank you for your attention