EUROPEAN CENTRAL BANK

EUROSYSTEM

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Market-Preserving Fiscal Federalism in the European Monetary Union

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A continuum of views on political integration after the euro crisis:

- Abolish the euro, return to national currencies and make a new start?
- Put in place the minimum requirements for a more perfect eurozone?
- Make a quantum leap to a single currency with a unitary state?

Governments seem to prefer the status quo of half-way political integration in order to preserve their sovereignty

But: is this sufficient to secure the integrity of the eurozone?

- Governments may adopt protectionist solutions to escape market discipline and suppress the free functioning of the single market
- This economic nationalism would entrench market fragmentation inside the eurozone which harms the smooth functioning of EMU

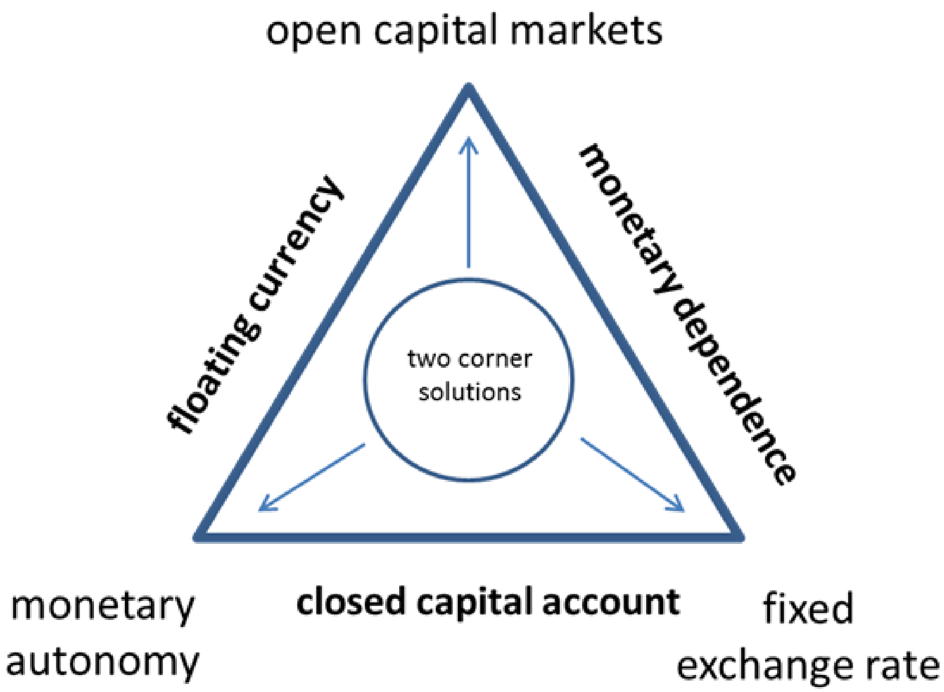
Key message:

- EMU needs more “market-preserving fiscal federalism”

Any country with an open economy faces a monetary policy trilemma:

1. given open capital markets: choice between
2. fixed exchange rate or
3. autonomous monetary policy

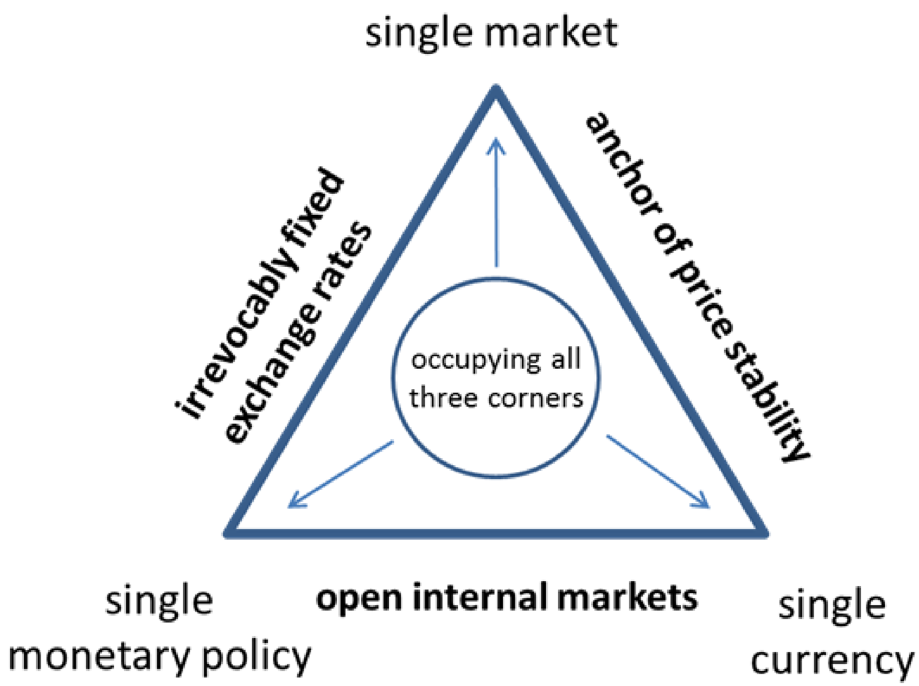
➢ One of the three corners of this 'holy trinity' (Rose, 1996) has to go



Monetary policy trilemma: only two-corner solutions are feasible and the line in between them

By adopting the euro, **EMU countries occupied all three corners of the monetary triangle** and got the benefits of a ‘holy trinity’ inside the eurozone

1. single market with open internal borders and free capital mobility
2. single currency with irrevocably fixed bilateral exchange rates
3. single monetary policy offering a common anchor of price stability



Presumption: market forces and peer pressure will prompt member countries to pursue sound policies and turn EMU into an optimal currency area

Lack of market discipline before the euro crisis

EMU implied national policy discipline from strong market competition and a hard budget constraint (McKinnon, 1997):

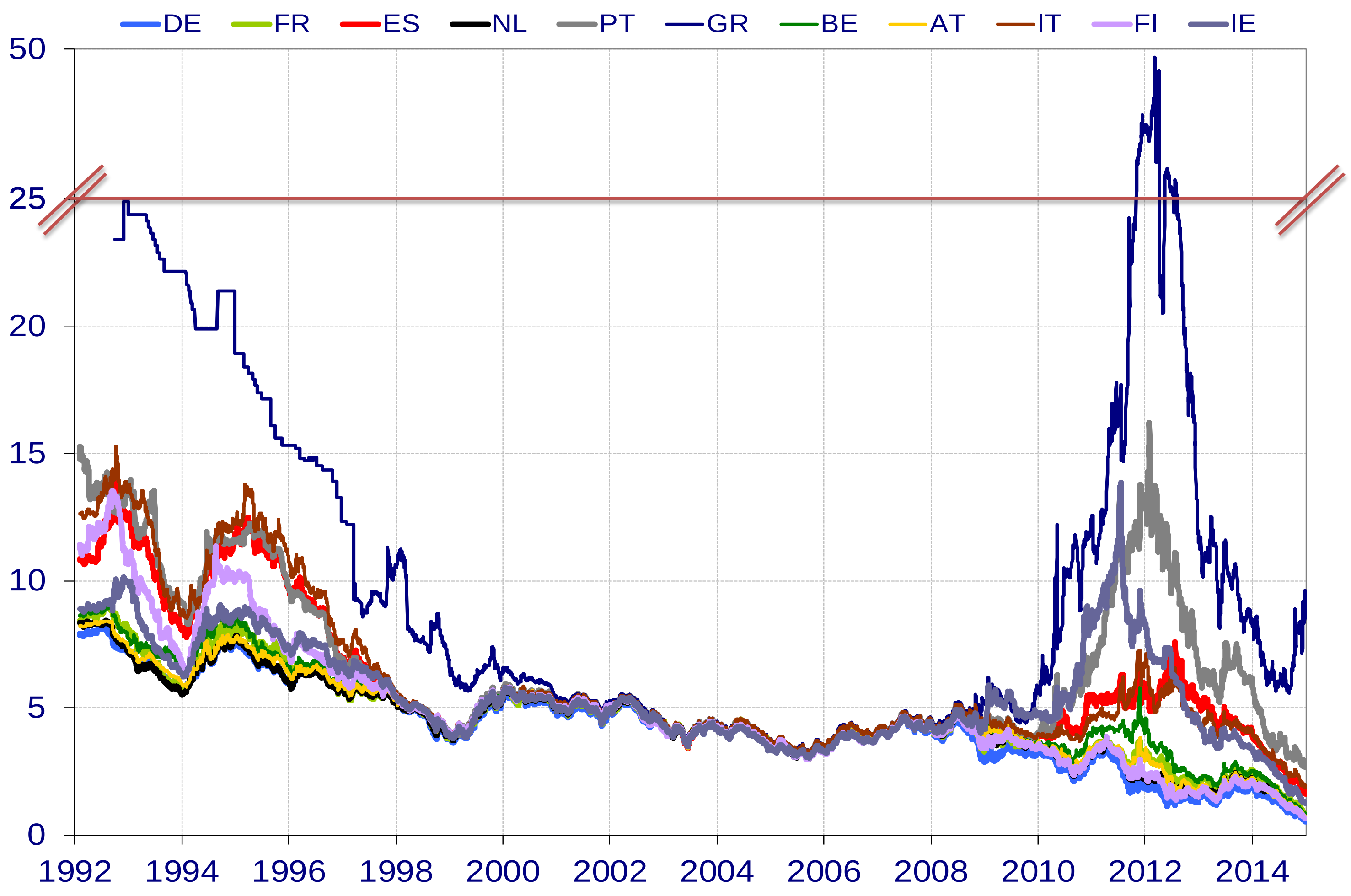
- Government financing in open, competitive capital markets
- No scope for a devaluation to support the economy and the budget
- No access to ‘printing press’ to reduce real value of debt by inflation
- No privileged access to financial institutions to ease funding constraints
- No bail-out by others in times of stress, as EMU was no transfer union

But: in reality markets largely ignored diverging country fundamentals

- EU banking legislation deemed all sovereign debt issued by Member States as risk-free, EU prudential laws allowed large sovereign exposures
- EU fiscal rules and ECB price stability inspired confidence, and markets probably expected a bail-out of troubled countries to preserve the euro
- The pre-crisis ‘hunt for yield’ showed that investors were keen to diversify euro country risk without having to accept exchange rate risk

Government bond yields of euro area countries

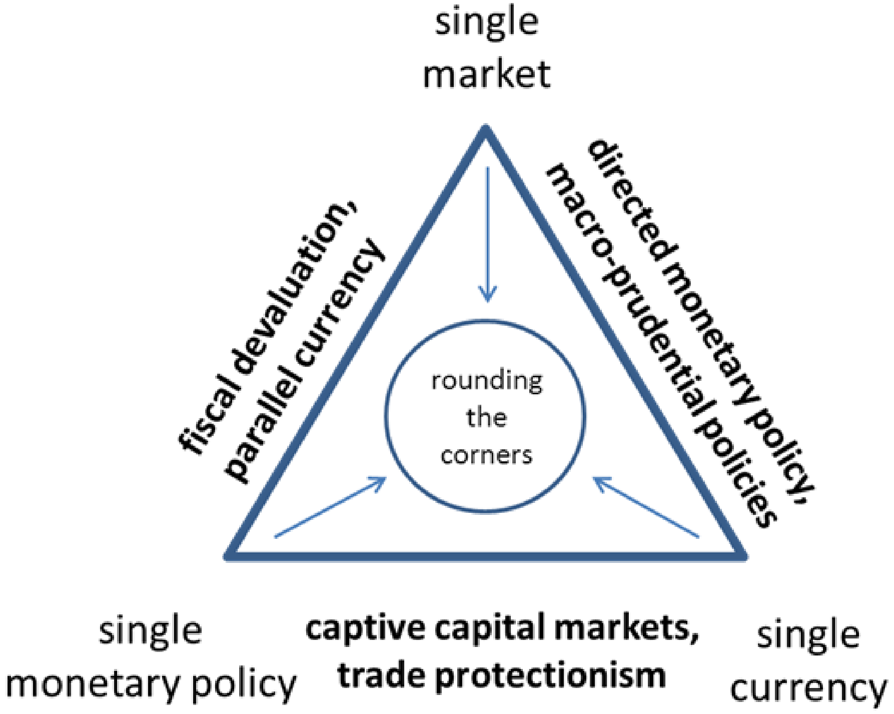
Compression of long-term sovereign bond yields (in %) in the run-up to EMU and during 1999-2008 was followed by sharply higher interest rates in 2009-2012.



Sources: Thomson Reuters and ECB. Chart excludes Cyprus, Luxembourg, Malta, Slovenia, Slovakia and the Baltic countries.

EMU countries look for tools to restore space for national policies and may try to relax market pressure by 'rounding the corners' of the trilemma (similar to emerging market economies, see Klein and Shambaugh, 2013):

1. positive: fiscal devaluation, national macroprudential policies
2. negative: trade protectionism, state aid to favoured firms, barriers to labour mobility, ring-fencing national banking systems, captive national sovereign debt markets, capital controls, parallel currency, pressure on ECB



Risk from 'rounding the corners': renationalisation, fragmentation of policies and markets frustrates the single monetary policy and the proper functioning of EMU

The integrity of a monetary union requires supranational public bodies with sufficient sovereign powers to preserve market discipline

- A welfare-enhancing monetary union between sovereign nations needs market-preserving fiscal federalism (Weingast, 1995; McKinnon, 1997):
  - a durable, self-enforcing multi-level governance structure
  - that secures free and open markets and promotes efficient competition between member countries,
  - that restricts discretionary national and supranational policies,
  - and places all political decisions under democratic control

Note: a powerful central government tends to face a soft budget constraint

- Federal bonds will be perceived as ‘risk free’ in the home capital market, especially when it may count on the common central bank in stressful times
- Local governments get indirect benefits via transfer payments from the center

To avoid the public debt bias from centralising sovereign powers a full fiscal union must have a governance structure that separates monetary and fiscal policies

Market-preserving elements of a multi-level structure to govern EMU:

- A durably institutionalised hierarchy between area-wide public authorities and subsidiary governments, each autonomous and subject to democratic control
- Area-wide public institutions provide common public goods and services that are essential for the efficacy and stability of the monetary union (securing open internal market, price stability, financial stability, a healthy financial sector, etc.)
- The area-wide fiscal authority has a structural balanced budget in normal times for modest spending backed by own taxes; it ensures aligned national policies; it manages a stabilisation mechanism to issue ‘safe’ common bonds (backed by a portfolio of subsidiary government debt), provide a fiscal backstop for banks and sovereigns in trouble, and implement a sovereign bankruptcy procedure
- Subsidiary governments keep a structural balanced budget for current spending; they can only borrow for cost-effective capital expenditure and to capitalise the stabilisation mechanism, no preferential regulatory treatment of sovereign debt
- Each subsidiary government is responsible for its own economy; it can draw on the fiscal backstop only for temporary loans under strict conditions that constrain their sovereignty, no bail-outs to restore solvency but a public debt restructuring

EMU needs more market-preserving fiscal federalism

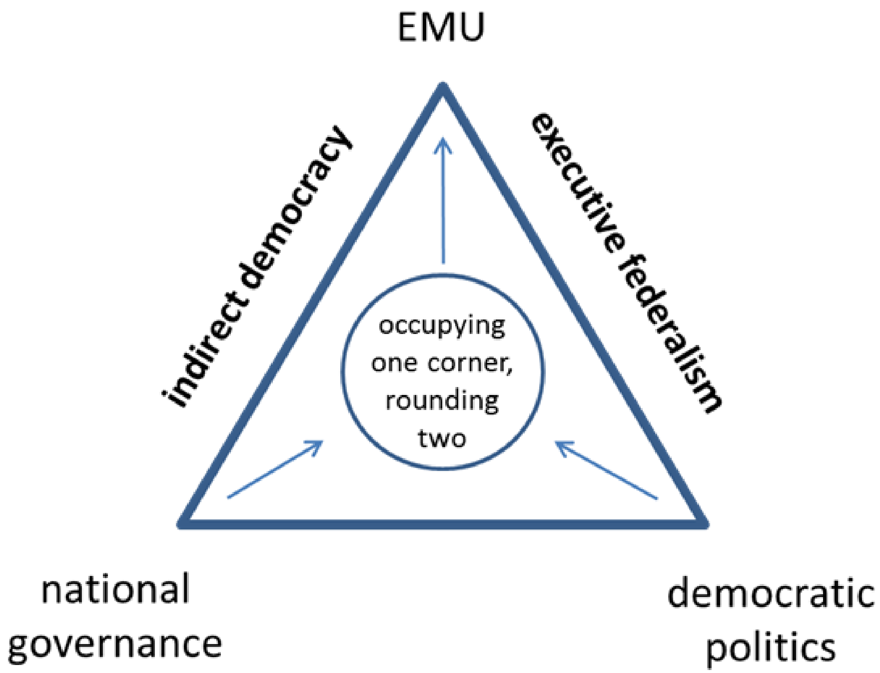
Euro area has many market-preserving supranational arrangements but lacks a few that are necessary for a smooth functioning of EMU:

- Hierarchy between autonomous EU institutions and national governments, anchored in Treaties but some key laws are on intergovernmental basis
- Many common public goods and services but EU internal market is still to be completed, only half a banking union and no single supervisor for non-banks, coordinated macro-prudential policies but without track record
- Small EU budget but no EMU treasury with own tax capacity, there is an ESM fiscal backstop under strict conditions but no 'safe' common bonds
- National budgets to be in structural balance but there is a growing preferential regulatory treatment of sovereign debt, some scope for more intrusive policy surveillance but no full alignment, collective action clauses for orderly public debt restructuring but no sovereign bankruptcy procedure to make no bail-out rule credible

➢ EMU needs a higher level of market-preserving fiscal federalism to more effectively counter risks of market repression and protectionism

For EMU to succeed, **Europe also has to complete its ‘half-way house’ for political decisions under democratic control** (Rodrik, 2011):

1. EU executive bodies only provide common public goods and services and promote national policies compatible with EMU: ‘executive federalism’
2. European Parliament received more powers, but democratic legitimacy of eurozone decisions is still vested at national level: ‘indirect democracy’



Risk from rounding these two corners: euro scepticism, could fuel protectionist tendencies

Conclusion

- Responding to the euro crisis, European leaders have put in place a reinforced governance framework for a more perfect monetary union.
- But: is the status quo of half-way political integration sufficient to secure the integrity of the eurozone?
- Countries have largely kept their macroeconomic and fiscal sovereignty and therefore still have leeway to circumvent the strong competition and the hard budget constraint that subject them to market discipline.
- The euro crisis indeed triggered a renationalisation of markets, which frustrated the single monetary policy and the proper functioning of EMU.
- A higher level of market-preserving fiscal federalism is warranted, i.e. a transfer of national sovereignty to the eurozone level as necessary to remove the ability of countries to encroach on markets.
- This requires a social consensus about the limits of the nation state and the economic and political reforms to underpin the viability of the euro.

Thanks for your attention!

Selected literature

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