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# **Monetary Union and Fiscal and Macroeconomic Governance (selected issues)**

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# Disclaimer:

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# My paper discusses three issues:

1. Interrelation between monetary and fiscal integration
2. Interrelation between monetary integration and macroeconomic policy coordination
3. Fiscal discipline vs. fiscal solidarity

Presentation contains elements of 1 and 3



# Interrelations between monetary and fiscal union

## – theoretical background

- Functioning of monetary union analyzed by an optimum currency area (OCA) theory:
  - Exposure to asymmetric shocks
  - Free factor mobility as the ‘first line of defense’
  - Fiscal response coming next (i) as federal transfers or (ii) from accumulated fiscal buffers on a sub-federal level  $\Rightarrow$  only (i) requires fiscal union
- Functioning of fiscal union analyzed by a theory of fiscal federalism  $\Rightarrow$  centralization can be justified by increasing returns to scale and addressing cross-border externalities



# Interrelations between monetary and fiscal union – empirical facts

- Two kinds of monetary unions:
  - within federal states (involve fiscal unions of various degrees)
  - of largely sovereign states with no or little fiscal centralization
- Historical and contemporary examples of monetary unions/ quasi-monetary unions of largely sovereign states without fiscal and political union: gold standard, WAEMU, CAEMC, unilateral dollarization/ euroization, currency boards
- In federal states both monetary and fiscal union result from political unification as an exogenous factor
- Political considerations: reluctance to transfer sovereignty and provide cross-border transfers



# The case of Eurozone

- Monetary union of largely sovereign states
- Are asymmetric shocks a real problem?
- Limited fiscal union (also non-Eurozone MS)
  - EU budget (mainly transfers) – max. 1% of EU GNI
  - Sovereign bail-out facilities
  - Limited harmonization of indirect taxation
  - Fiscal discipline rules
- Further fiscal centralization requires unanimity
- Principle of subsidiarity



# EU/EMU: benefits of fiscal centralization

- Several areas where common EU policies based on pooled resources would be beneficial – examples:
  - deposit insurance, banking resolution mechanisms,
  - foreign, defense and security policy,
  - joint border management, asylum, migration
- Only the first area relates to the monetary union
- Consequences for political integration and potential MS sovereignty concerns



# Other Eurozone-specific proposals

- Union-level counter-cyclical fiscal policy (CCFP)
- Union-level fiscal capacity to address asymmetric shocks
- Frequently considered jointly but these are separate issues
- The problem of size and content (which policies) of such a fiscal capacity; in most historical cases the fiscal potential (and CCFP) on federal level was the result of prior centralization of various policies
- Risks: redistribution conflict between MS, moral hazard, more microeconomic rigidities



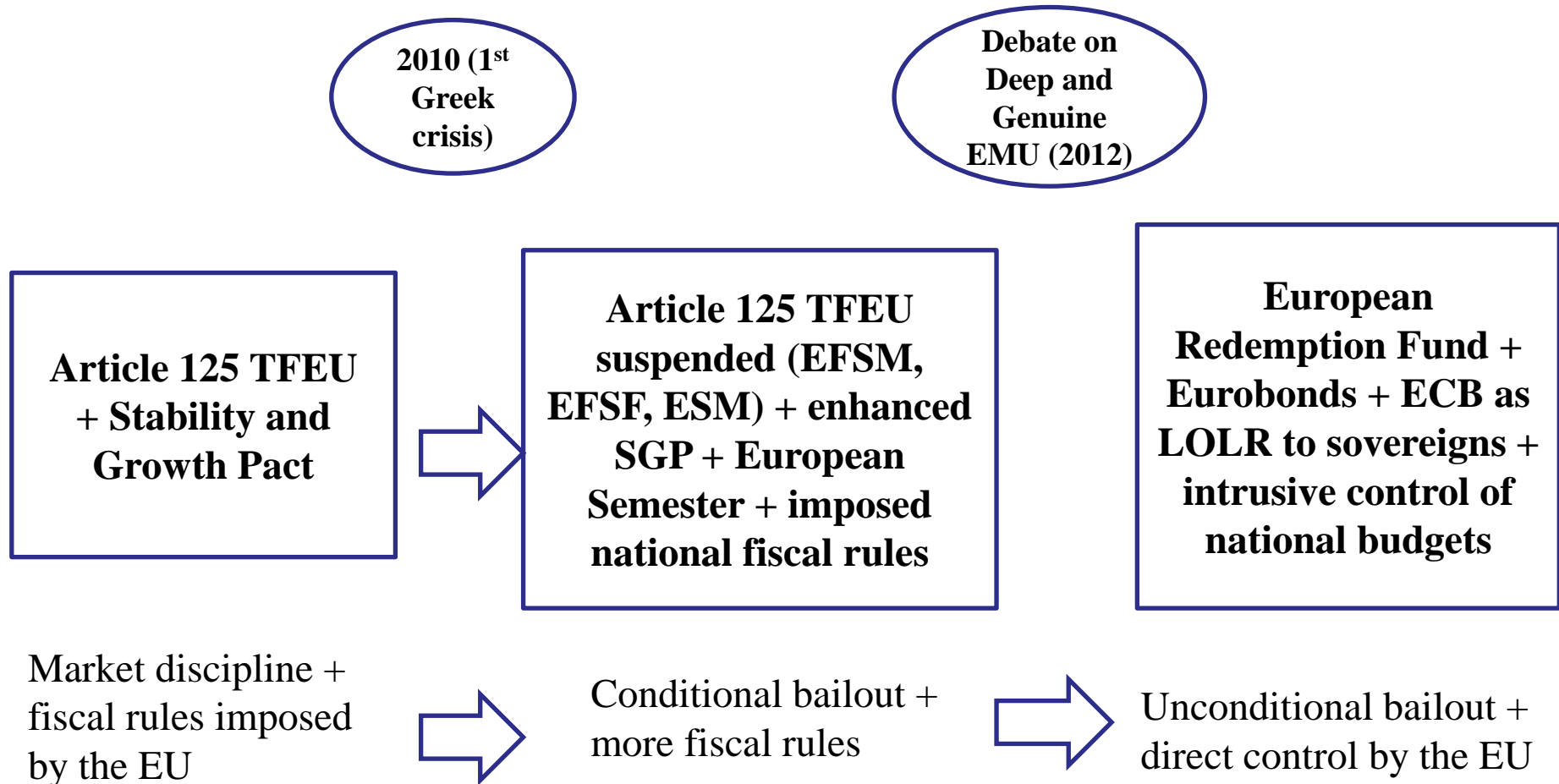


# Fiscal federalism and fiscal discipline

- Lack of fiscal discipline  $\Rightarrow$  danger of cross-border contagion, free riding, moral hazard problem, monetary instability
- Market discipline vs. fiscal rules
- Positive lessons: the US, Canada and Switzerland (no bail outs, largely market discipline and self-imposed fiscal rules on sub-federal level)
- Negative experience: Argentina, Brazil, Russia (repeated bail outs of subnational entities  $\Rightarrow$  dysfunctional fiscal federalism)



# Evolution of fiscal arrangements within the EU/EMU



# EU/EMU fiscal discipline at work

- Giving up market discipline (fear of contagion caused by sovereign over-indebtedness and excessive banks exposure to sovereign debt)
- Poor enforcement of fiscal rules (SGP) caused by their frequent breaching by most EU MS
- Both indicate a collective action problem
- Numerous intellectual confusions (sovereign default vs. exiting Eurozone, negating fiscal nature of the crisis, anti-austerity hysteria, etc.)
- Importance of the outcome of Greece's rescue program



## GG gross public debt, % of GDP, 2007-2013

Country	2007	2008	2009	2010	2011	2012	2013
EU	58.9	63.2	73.7	79.4	82.0	86.1	88.0
Eurozone	66.5	70.3	80.2	85.9	88.3	92.9	95.2
Belgium	84.0	89.2	96.6	96.6	99.2	101.1	101.2
Bulgaria	18.6	15.5	15.6	14.9	15.4	17.5	16.4
Croatia	32.9	29.3	35.8	42.6	47.4	54.2	60.2
Cyprus	58.8	48.9	58.5	61.3	71.5	86.6	111.5
Czech Rep.	27.9	28.7	34.6	38.4	41.4	46.2	46.0
Denmark	27.1	33.4	40.7	42.8	46.4	45.4	44.5
Estonia	3.6	4.5	7.0	6.5	6.1	9.7	9.8
Finland	33.9	32.5	41.5	46.6	47.3	51.8	54.7
France	63.2	67.0	78.0	80.8	84.4	88.7	91.8
Germany	65.2	66.8	74.6	82.5	80.0	81.0	78.4
Greece	107.2	112.9	129.7	148.3	170.3	157.2	175.1
Hungary	67.0	73.0	79.8	82.1	82.1	79.8	79.3
Ireland	24.0	42.6	62.2	87.4	98.9	111.4	116.1
Italy	103.3	106.1	116.4	119.3	120.7	127.0	132.5
Latvia	7.8	17.2	32.9	39.7	37.5	36.4	35.0
Lithuania	16.8	15.5	29.5	38.3	39.2	41.0	39.3
Luxembourg	6.7	14.4	15.5	19.5	18.7	21.7	23.1
Malta	60.7	60.9	66.5	65.9	68.8	70.5	72.2
Netherlands	42.5	54.7	56.4	59.0	61.3	66.5	68.6
Poland	45.0	47.1	50.9	54.9	56.2	55.6	57.1
Portugal	68.4	71.7	83.7	94.0	108.2	124.1	128.9
Romania	12.7	13.6	23.8	31.1	34.3	38.2	39.4
Slovakia	29.4	27.9	35.6	41.0	43.6	52.7	55.4
Slovenia	22.7	21.6	34.4	37.9	46.2	53.3	70.0
Spain	36.3	40.2	54.0	61.7	70.5	85.9	93.9
Sweden	40.2	38.8	42.6	39.4	38.7	38.3	40.5
UK	43.7	51.9	67.1	78.5	84.3	89.1	90.6

Source: IMF WEO database, October 2014



## GG net lending/borrowing, in % of GDP, 2007-2013

Country	2007	2008	2009	2010	2011	2012	2013	No of years with deficit >3%
Austria	-1.0	-1.0	-4.1	-4.5	-2.4	-2.6	-1.5	2
Belgium	-0.1	-1.1	-5.6	-4.0	-4.0	-4.1	-2.7	4
Bulgaria	3.3	2.9	-0.9	-4.0	-2.0	-0.5	-1.9	1
Croatia	-1.0	-0.9	-3.3	-4.5	-4.6	-3.3	-5.5	5
Cyprus	3.5	0.9	-6.1	-5.3	-6.3	-6.4	-4.9	5
Czech Rep.	-0.7	-2.2	-5.8	-4.8	-3.3	-4.2	-1.5	4
Denmark	4.8	3.3	-2.8	-2.7	-2.0	-3.9	-0.9	1
Estonia	2.4	-2.9	-1.9	0.2	1.2	-0.2	-0.2	0
Finland	5.1	4.2	-2.6	-2.7	-1.0	-2.2	-2.3	0
France	-2.5	-3.2	-7.2	-6.8	-5.1	-4.9	-4.2	6
Germany	0.2	-0.1	-3.1	-4.2	-0.8	0.1	0.2	2
Greece	-6.8	-9.9	-15.6	-11.0	-9.6	-6.4	-3.2	7
Hungary	-5.1	-3.7	-4.6	-4.4	4.2	-2.0	-2.4	4
Ireland	0.2	-7.1	-13.2	-29.3	-12.5	-7.8	-6.7	6
Italy	-1.6	-2.7	-5.4	-4.4	-3.6	-2.9	-3.0	3
Latvia	0.6	-7.5	-7.8	-7.3	-3.2	0.1	-1.1	4
Lithuania	-1.0	-3.3	-9.4	-7.2	-5.5	-3.3	-2.2	5
Luxembourg	3.7	3.2	-0.7	-0.8	0.2	0.0	0.1	0
Malta	-2.3	-4.6	-3.7	-3.5	-2.7	-3.3	-2.8	4
Netherlands	0.2	0.5	-5.2	-4.7	-4.0	-3.7	-2.3	4
Poland	-1.9	-3.7	-7.5	-7.9	-5.0	-3.9	-4.3	6
Portugal	-3.2	-3.7	-10.2	-9.9	-4.3	-6.5	-5.0	7
Romania	-3.1	-4.8	-7.3	-6.4	-4.3	-2.5	-2.5	5
Slovakia	-1.8	-2.1	-8.0	-7.5	-4.8	-4.5	-2.8	4
Slovenia	0.3	-0.3	-5.4	-5.2	-5.5	-3.1	-13.8	5
Spain	2.0	-4.5	-11.1	-9.6	-9.6	-10.6	-7.1	6
Sweden	3.6	2.2	-1.0	0.0	0.0	-0.7	-1.3	0
UK	-2.9	-5.0	-11.3	-10.0	-7.8	-8.0	-5.8	6
<b>No. of countries with deficit &gt;3%</b>	<b>4</b>	<b>12</b>	<b>22</b>	<b>23</b>	<b>18</b>	<b>17</b>	<b>10</b>	

Source: IMF World Economic Outlook database, October 2014

# Conclusions

- Monetary union can exist with no or limited fiscal union
- Given political constraints, progress in building the EU/ EMU fiscal union will be slow if any and follow consideration other than monetary union
- Fiscal discipline is important for Euro stability and functionality of fiscal federalism
- The focus should be given to restoring market discipline and fiscal rules on national level

