Will the reform of the institutional framework restore fiscal stability in the eurozone?

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Outline

1. The key elements of the reform
2. Does the reform improve things?
3. Conclusions
Main ‘message‘ of this talk

The key challenge for the fiscal reform of the eurozone is not better fiscal policy coordination or supervision. It is this:

• Make sure that the financial sector can absorb a sovereign bankruptcy without a financial meltdown. This requires much tighter regulation, more effective supervision, continued access of banks to ECB refinancing in the event of a sovereign restructuring. For a transitional period, this also requires an ESM type ‘rescue’ institution.
• The current fiscal reform package fails to deliver this.
1. Key elements of the reform
Elements of the Reform:

- European Stability Mechanism (ESM)
- Euro Plus Pact (EPP)
- New Stability and Growth Pact
Euro Plus Pact

Objectives:
- “…achieve a new quality of economic policy coordination, with the objective of improving competitiveness.”.
- “…concentrate on actions where the competence lies with the Member States”.

Policy areas covered
- Labour Markets, Public Sector Pay, Research and development, Education, Infrastructure, Tax Policy, Health and Pension System...

Practical Policy Coordination
- Each country makes yearly commitments
- Report of the Commission, Political Monitoring by Heads of State, no explicit enforcement or sanctions
New Stability and Growth Pact

Fiscal Rules
• more emphasis on balanced budgets (not just 3% deficit ceiling)
• more emphasis on debt levels: excess over 60% of GDP must be reduced by 1/20 per year

Example for the new debt level rule
• Debt level Italy 2011: 120% of GDP; in 2012 the debt level has to be reduced to 117%;
• With a nominal GDP growth rate of 4% this would allow for a budget deficit of appr. 1.6% of GDP
• The forecasted debt to GDP ratio for 2012 is also appr.120%, the forecasted deficit is 3.5% of GDP(down from 4.3% in 2011)
New Stability and Growth Pact (cont.)

Enforcement

- Sanctions proposed by the EC Commission can only be stopped with qualified majority
- but there will be no automatic sanctions
European Stability Mechanism (ESM)

- Replaces EFSF and EFSM in 2013
- May grant financial assistance, conditional on a macroeconomic adjustment programme
- May buy government bonds in the primary market
- ESM loans enjoy preferred creditor status relative to all other loans (except IMF)
ESM (cont.)

- Key novelty: ESM includes provisions for sovereign bankruptcies with involvement of private sector
- Obligation for eurozone countries to include collective action clauses in newly issued bonds with maturity above 12 months from July 2013
- Financial assistance is granted only after an assessment of the sustainability of the country’s debt after an adjustment programme; private creditors may face a restructuring if the debt level is seen to be unsustainable
2. Does the reform improve things?
The logic of fiscal institutions in the eurozone before the crisis:

- Commitment to fiscal rules
- If rules are violated: Early warning procedures and sanctions, Market reactions
  - If that does not help and a country faces bankruptcy
    - Let's hope it never happens; if it does, we'll figure out something
The expectations of a rational private investor:

Commitment to fiscal rules

If rules are violated:
- Bailout warning procedures and versus

If that does not help:
- Bailout or bankruptcy

European governments have a plan in case of bankruptcy?

Is the financial sector solvent enough to absorb a severe debt crisis?

- No
- Yes

- Taxpayers or other countries finance bailout
- Private investors pay
The logic of fiscal institutions in the eurozone after the reform:

- Commitment to fiscal rules and objectives in other areas (EPP)

  - If rules are violated:
    - Early warning procedures and sanctions
    - Market reactions

  - If that does not help

    - ESM Procedures
Implication: As long as the issue of financial sector stability in the event of a sovereign bankruptcy is not dealt with, the ESM procedures are not more credible than the institutional arrangement before the crisis.
Key Question for fiscal reform in the eurozone:

What has to be done to make sure that the financial sector will ever be robust enough to absorb a sovereign bankruptcy?

- Financial regulation and supervision has to be changed dramatically; BASEL III does not deliver this!
- It has to be made sure that no contagion effects arise: here the ESM may help
- It has to be made sure that banks do not lose access to ECB refinancing in the event of a sovereign bankruptcy
3. Conclusions
The most important aspect of the reform of the fiscal framework is that to make sure that the eurozone can let a sovereign bankruptcy happen without facing a financial meltdown.

This requires fundamentally different financial regulation.

In the short to medium term public financial assistance through an ESM-type institution is required.

In the long term it is desirable to reduce and ideally to abolish public financial assistance (otherwise incentive for private investors and government are distorted, debt bias remains).

The role of fiscal rules and supervision through Stability and Growth Pact and EPP is overestimated. It may help, but don’t expect too much from it!
Thank you very much.