



EUROPEAN CENTRAL BANK

EUROSYSTEM

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Ensuring sound fiscal policies and debt levels: lessons from European reforms

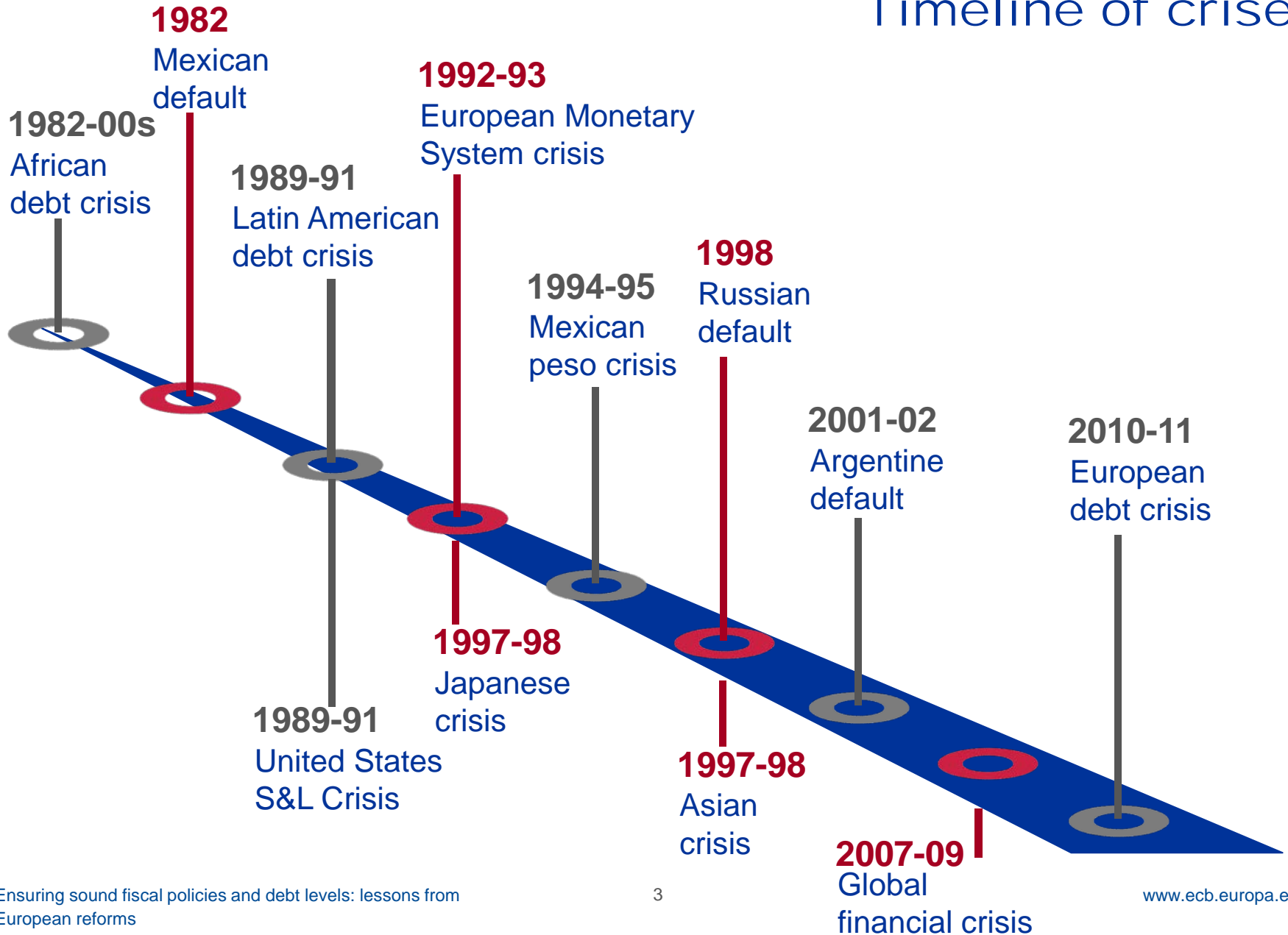
Symposium of the Association of
African Central Banks

Kigali, Rwanda, 31 July 2019

Overview

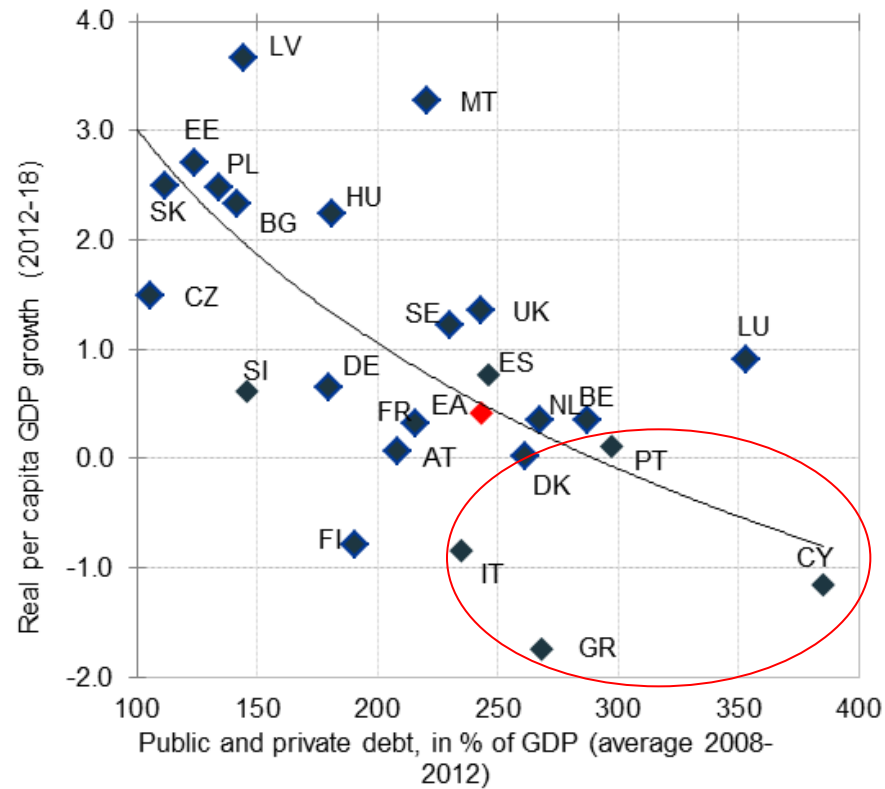
- 1 Introduction**
- 2 Lessons from the European debt crisis
- 3 Reforms to strengthen the fiscal governance framework

Timeline of crises



Lower debt associated with higher economic growth

Real per capita GDP growth vs. debt levels



Overview

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EMU's division of monetary and fiscal policies

Monetary Policy

- Single monetary policy
- Primary objective of maintaining price stability
- Without prejudice to this, can support the policies in the Community
- Central bank independence
- No monetary financing of governments

Fiscal Policies

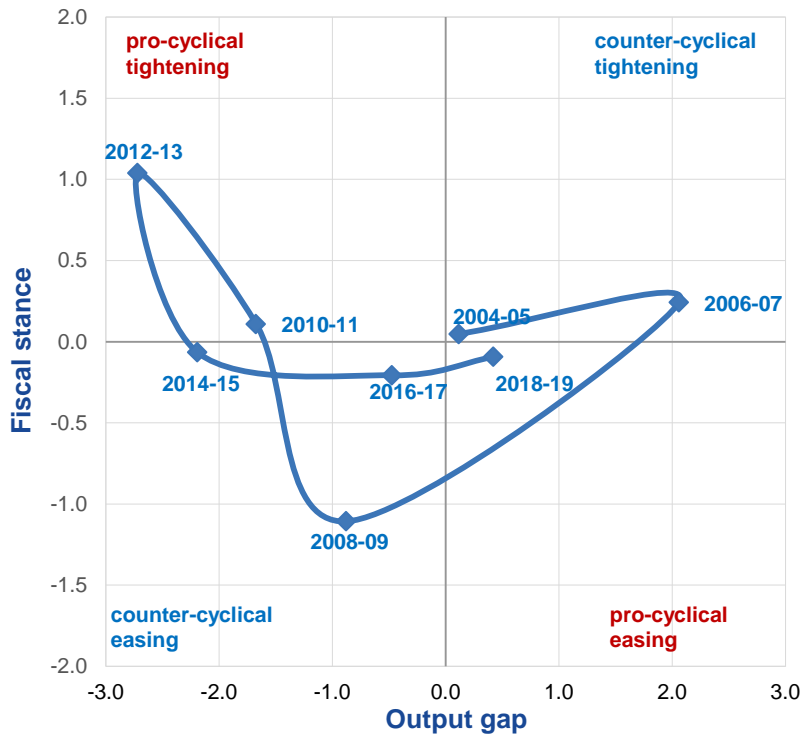
- Competence of Member States
- But subject to common rules of budgetary discipline, and surveillance
- No bailout clause (no debt mutualisation)

Fiscal policy leg

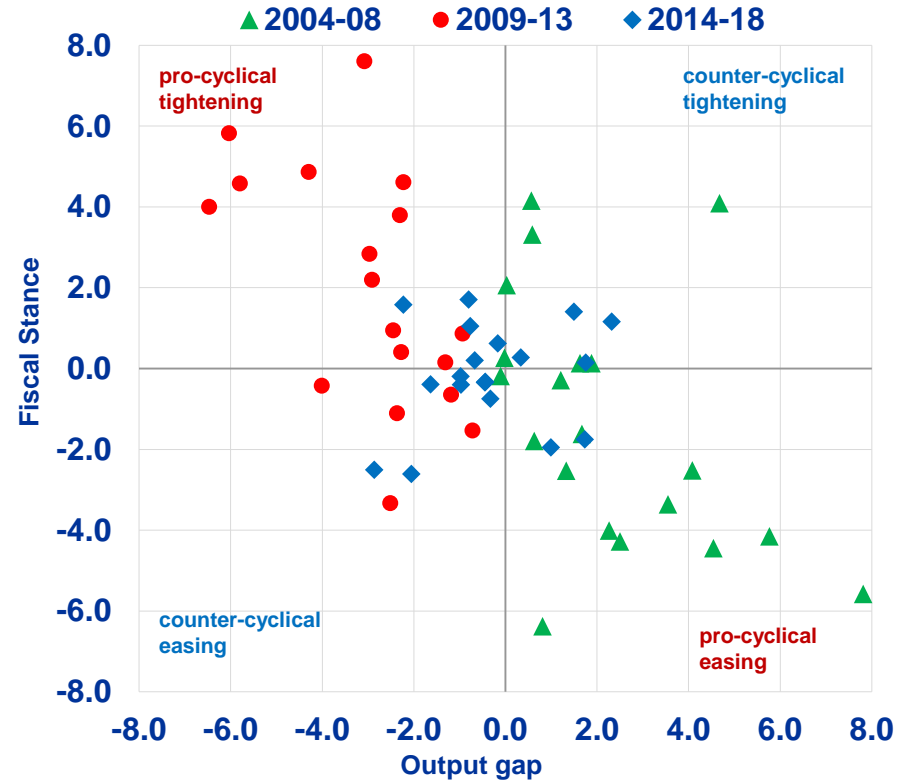
- **Stability and Growth Pact (SGP):** rule-based framework for national fiscal policies, but initial shortcomings:
 - **Too much political discretion, too little automaticity**
 - **Weaknesses in decision-making procedures and its enforcement**
 - **Too little national ownership**

Fiscal stance and business cycle: some evidence of past pro-cyclical fiscal policies

Evolution of the euro area's fiscal stance and output gap (in % of potential GDP)

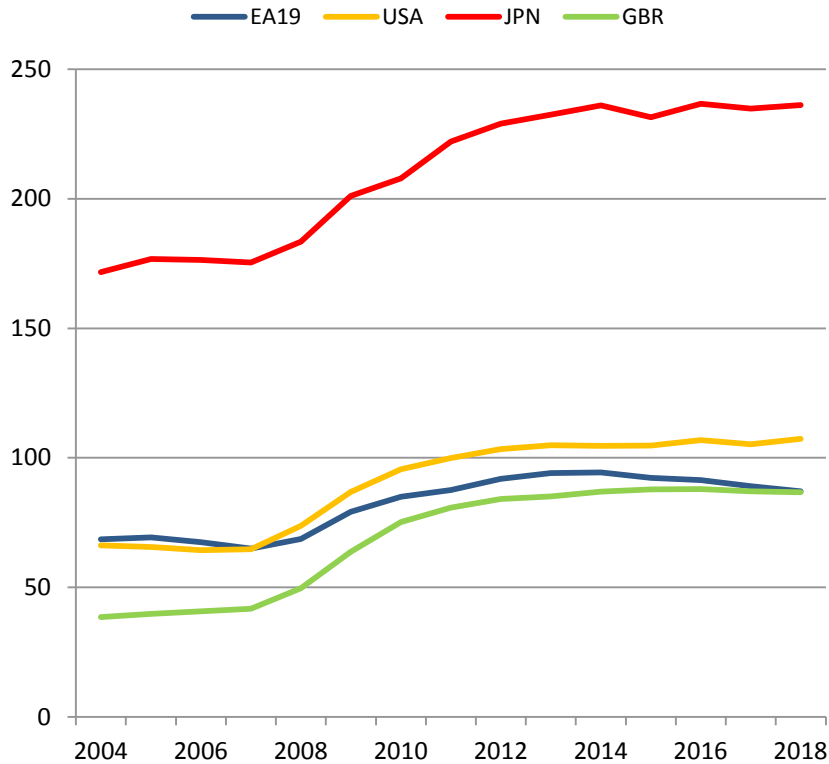


Evolution of the fiscal stance and output gaps across euro area countries (in % of potential GDP)

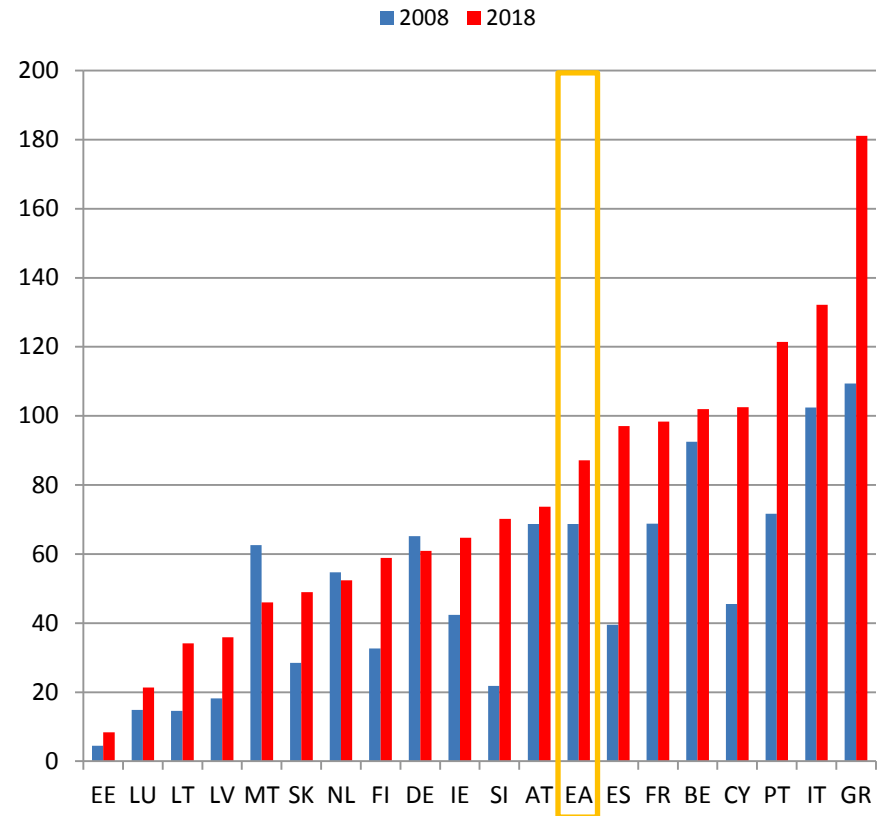


Currently lower debt compared to other regions but sizeable differences across EA countries

Evolution of government debt in major economies
(% of GDP)

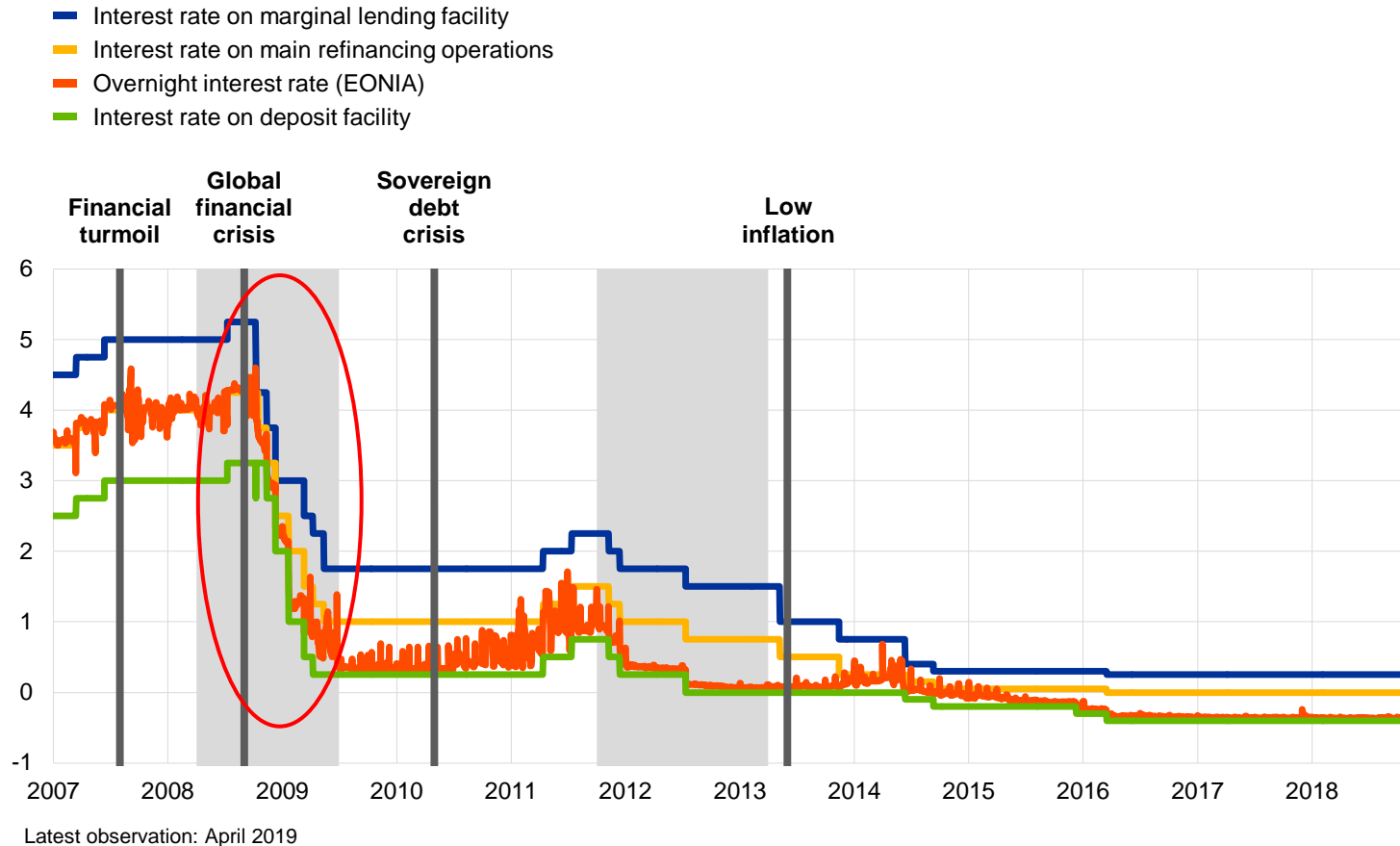


Government debt in the euro area countries
(% of GDP)



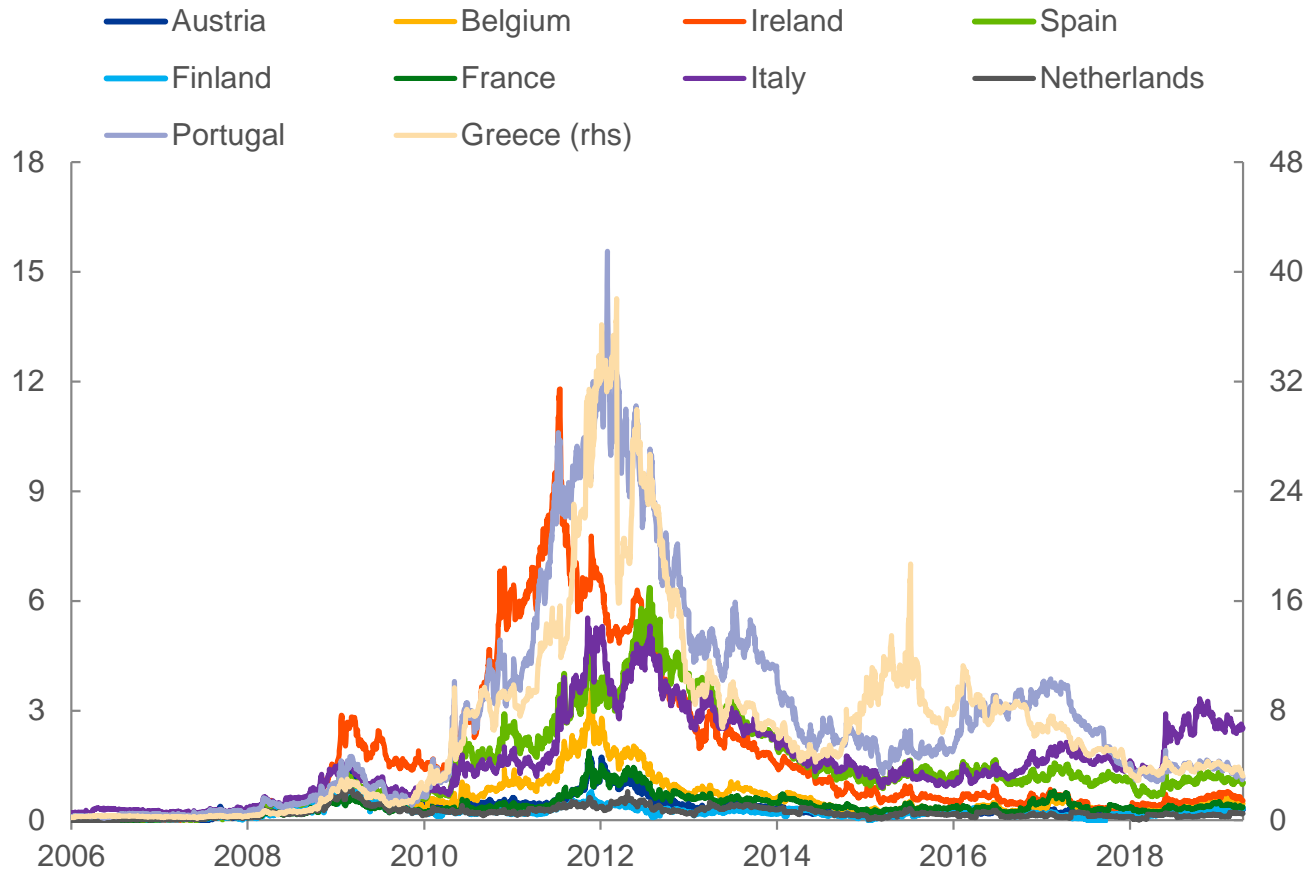
Despite looser monetary policy in response to the global financial crisis...

Key interest rates and the interbank overnight rate
(in percent)



...markets began differentiating those countries with fiscal sustainability concerns...

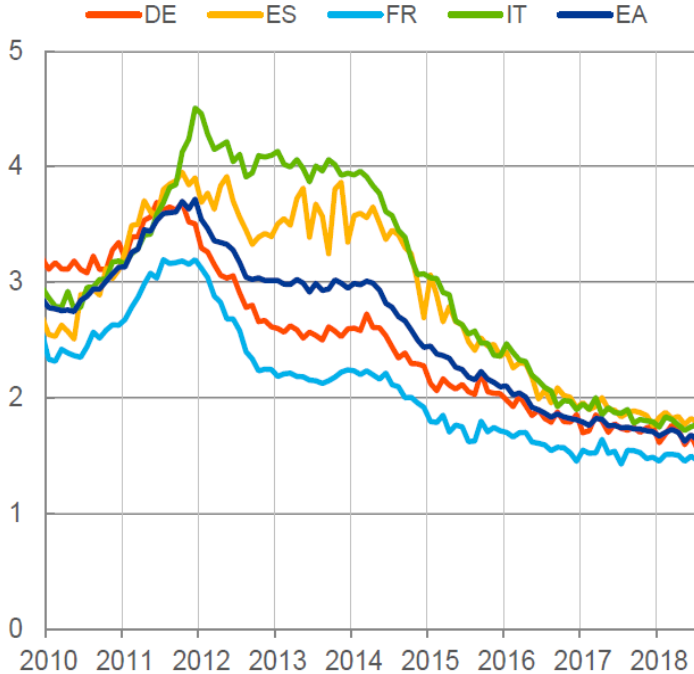
Spreads over German 10-year government bond yield



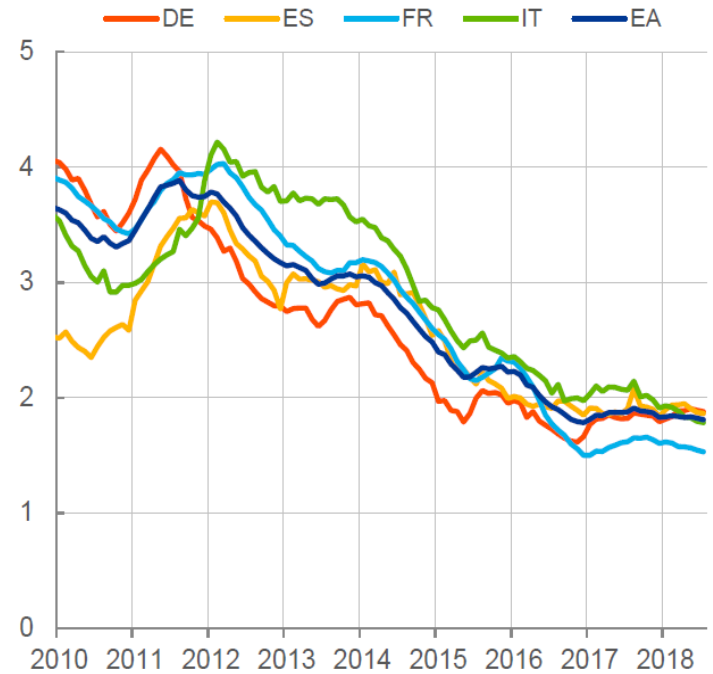
Latest observation: April 2019

...resulting in financial fragmentation...

Cost of borrowing for companies
(percentage per annum)

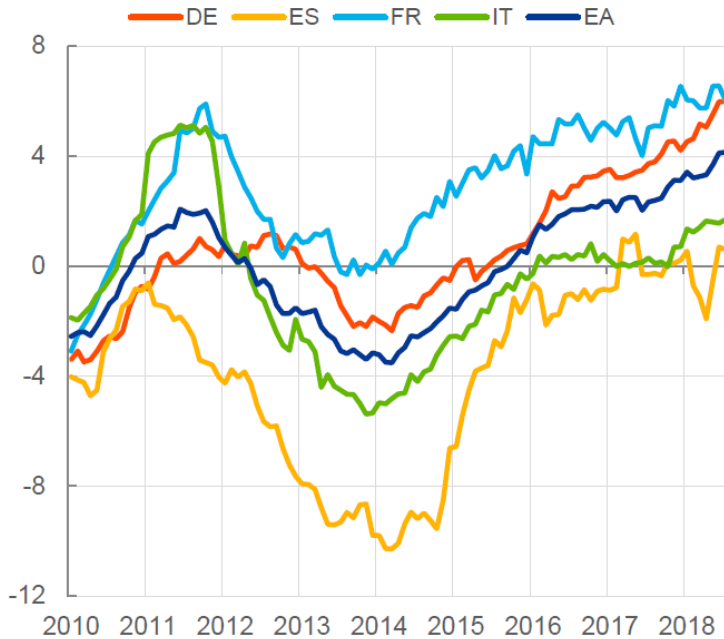


Cost of borrowing for households for house purchases
(percentage per annum)

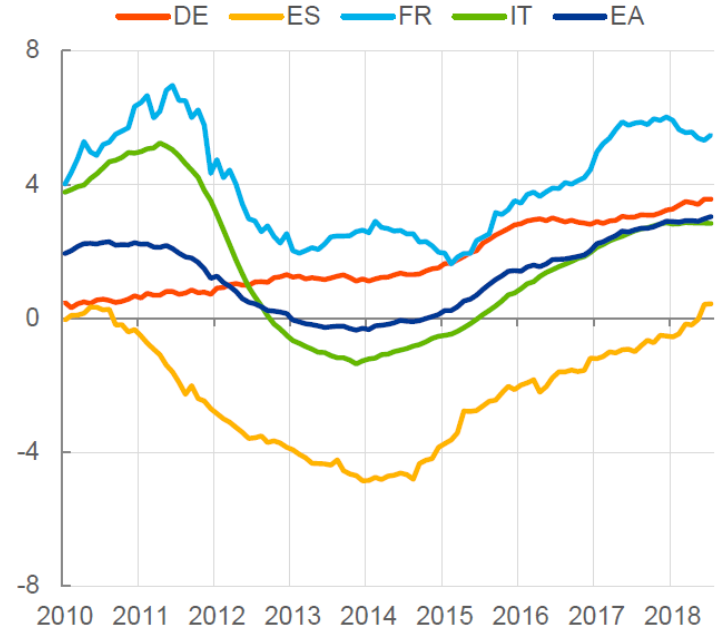


...and negative credit growth...

Loans to companies
(annual percentage changes)

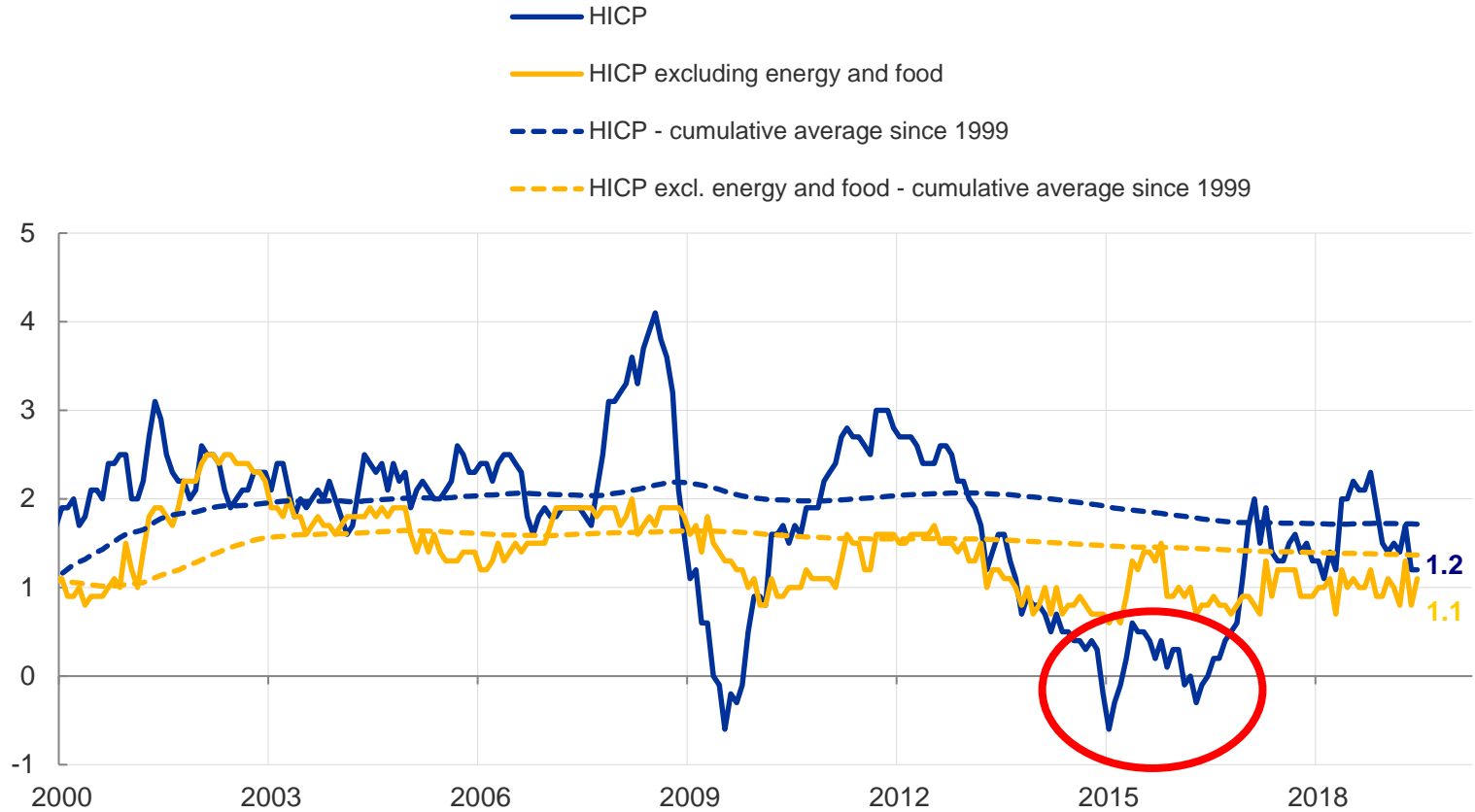


Loans to households
(annual percentage changes)



...and inflation became too low.

HICP and HICP excluding energy and food
(annual percentage changes)



Latest observation: June 2019 (flash estimates)

ECB non-standard monetary policy measures

**Fixed-rate full
allotment in main
refinancing
operations**

**Targeted longer-
term refinancing
operations**

**Asset purchase
programmes**

**Outright
Monetary
Transactions**

**Forward
Guidance**

**Expansion of
eligible collateral**

Main lesson: need for fiscal soundness in EMU

- EMU stability requires **sound fiscal policies**
- **Building buffers in good times** helps reduce economic and social costs in recessions or crisis times
- **Avoid pro-cyclical fiscal policies** (i.e., no expansionary policies in boom period as this would require even larger consolidation during bad times)
- **Counteract deficit bias** in form of expansionary fiscal policies / accumulation of high debt in a monetary union (no free-riding)
- **Limit risk of spillover** effects and contagion (limit risk of sovereign-bank nexus)
- **Allow for automatic stabilizers to work**, as they dampen cyclical fluctuations and provide a buffer against shocks

Fiscal policies are important for monetary policy

- Possible risks from **fiscal policy stance** to price stability:
 - direct (e.g., increases of the VAT)
 - indirect (e.g., public wages/aggregate demand)
- Possible risks from **unsustainable fiscal policies**:
 - increase pressure on the central bank to tolerate higher inflation to erode the real value of debt: risk of fiscal dominance
 - fiscal stress may lead to dysfunctional government bond markets, which hamper the transmission of monetary policy
 - risks to the balance sheet

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Fiscal policy framework in EMU

- Building blocks of EMU fiscal policy framework in the **Treaty on the Functioning of the European Union**
 - **Article 126: Excessive Deficit Procedure (EDP)**
 - Protocol on the EDP
 - Reference values: **3%** deficit/GDP and **60%** public debt/GDP
- Treaty needs to be made operational: **Stability and Growth Pact**

Further relevant provisions

- Article 121: Co-ordination of economic policies
- Article 122: Union financial assistance in exceptional circumstances
- Article 123: no monetary ECB financing of governments
- Article 124: no privileged government access to financial institutions
- Article 125: no bail out clause

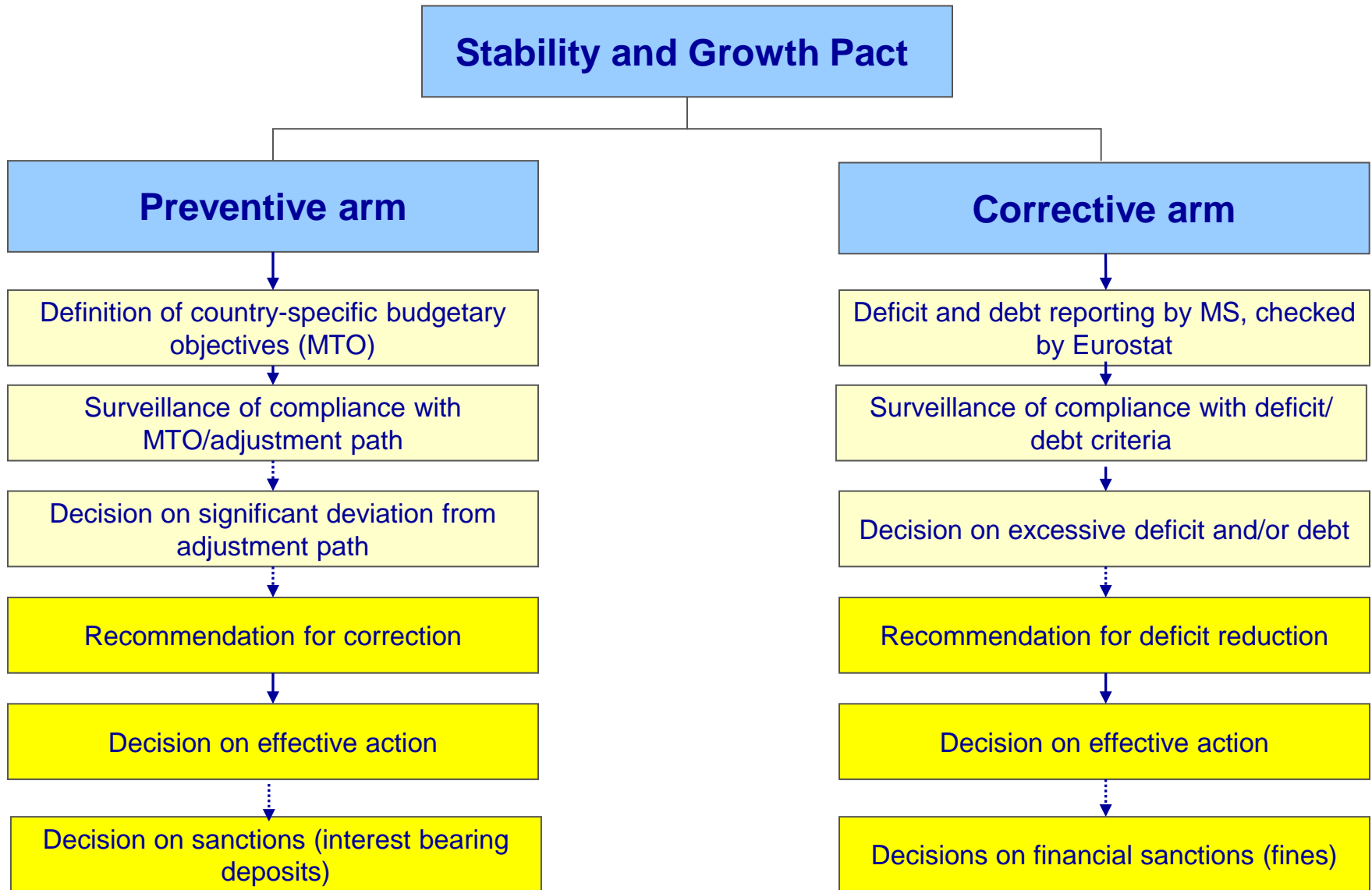
Continuous reforms to the SGP ⁽¹⁾

- **Six-pack reform (2011):** inclusion of **expenditure benchmark** and **debt rule**, better enforcement mechanism, minimum requirements for national fiscal frameworks, macroeconomic imbalances procedure
- **Fiscal Compact (2013):** **balanced-budget rule** with automatic correction mechanism at **national level**
- **Two-pack reform (2013):** ex-ante coordination of budgetary policies, stronger fiscal surveillance during the year, fiscal councils to monitor compliance with fiscal rules, independent macroeconomic projections

Continuous reforms to the SGP ⁽²⁾

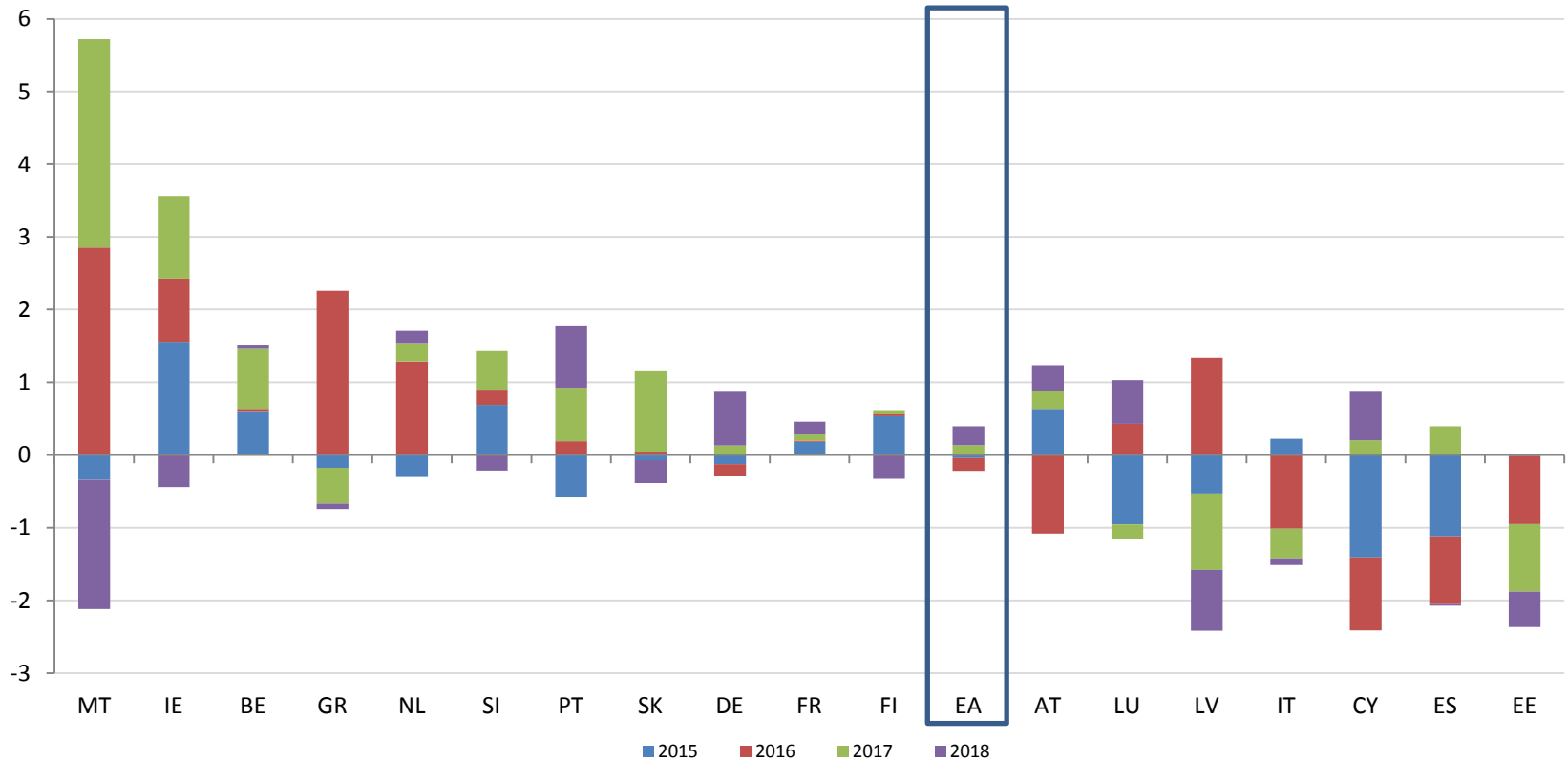
- **New effective action methodology in corrective arm (2014)** with two new compliance indicators: **adjusted structural balance, bottom-up approach**
- **New flexibility clauses in preventive arm (2015): modulation of required effort** according to cyclical conditions, structural reforms, investment-, refugee- and security-related spending

The two arms of the SGP



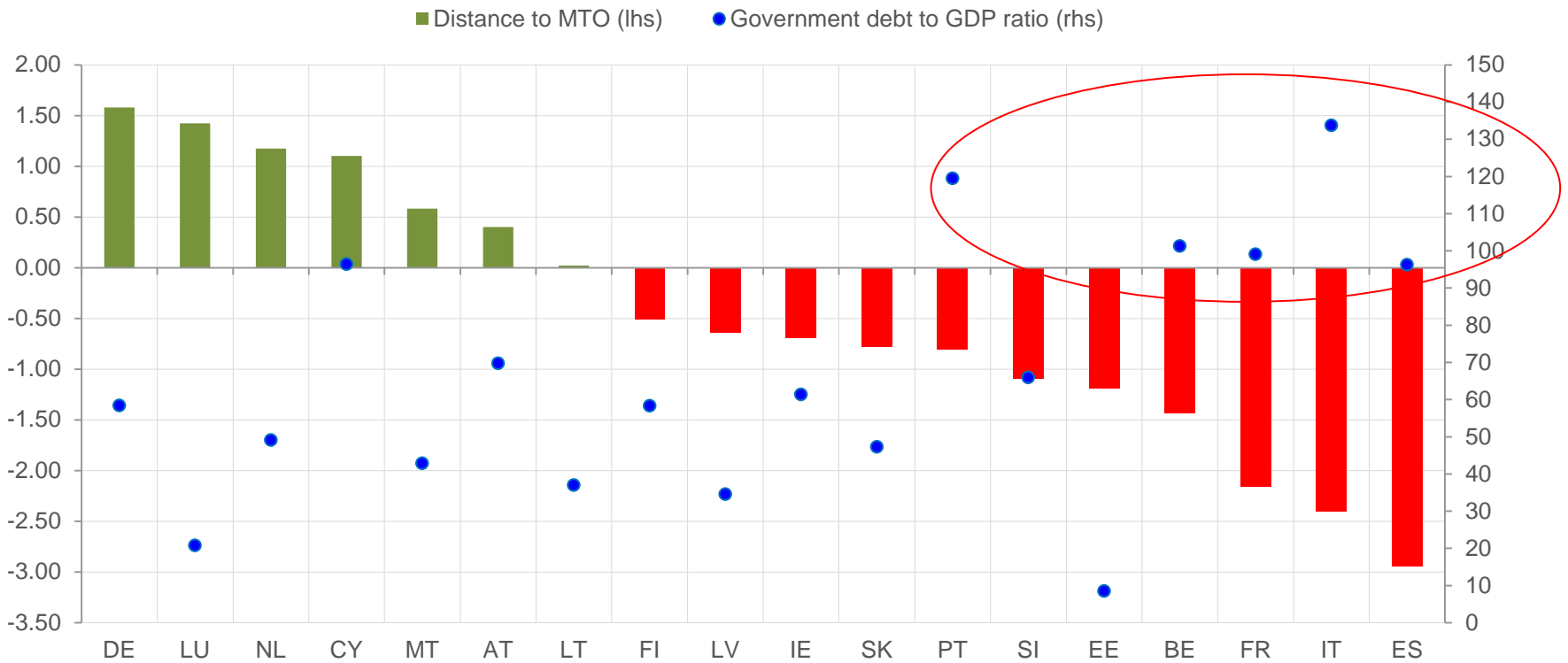
Sizeable consolidation has been achieved while the economy was recovering

Consolidation in EA countries
(change in structural balance)



But countries highly indebted need to build additional fiscal buffers

Public debt and distance to medium-term objectives (MTO) for 2019
(in % of GDP)



Poor compliance with the preventive arm

Structural budget balance (% of GDP)

	<i>MTO</i>	Structural net lending (+) / net borrowing (-) (in % of GDP)													
		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Belgium	0.0	-0.9	-1.4	-1.4	-2.2	-3.9	-3.9	-4.1	-3.5	-3.1	-2.9	-2.3	-2.3	-1.4	-1.4
Germany	-0.5	-2.2	-1.7	-0.8	-0.8	-0.7	-2.0	-1.2	-0.1	0.2	1.0	0.9	0.7	0.8	1.6
Estonia	-0.5	-0.1	-1.3	-1.6	-4.5	-1.0	0.6	0.2	0.1	-0.5	0.2	0.2	-0.8	-1.7	-2.2
Ireland	-0.5	1.3	1.6	-2.1	-8.0	-9.6	-8.7	-8.6	-7.2	-5.2	-4.5	-2.9	-2.1	-0.9	-1.4
Greece	n.a.	-5.2	-7.4	-7.8	-9.7	-14.7	-9.2	-4.9	1.6	3.7	3.5	3.3	5.6	5.1	5.0
Spain	0.0	0.3	1.0	0.6	-4.7	-8.6	-6.8	-6.0	-2.7	-1.2	-1.0	-2.2	-3.1	-2.7	-2.7
France	-0.4	-4.7	-4.2	-4.7	-4.4	-6.2	-5.8	-5.1	-4.4	-3.4	-3.0	-2.8	-2.8	-2.7	-2.6
Italy	0.0	-5.1	-4.3	-3.1	-3.6	-3.8	-3.4	-3.4	-1.3	-0.7	-0.9	-0.7	-1.7	-2.1	-2.2
Cyprus	0.0	-3.4	-1.7	2.2	-0.7	-6.3	-4.5	-4.7	-3.7	-0.5	3.5	2.1	1.1	1.3	2.0
Latvia	-1.0	-2.0	-3.3	-4.3	-6.0	-4.6	-2.2	-2.0	-0.3	-0.9	-1.0	-1.5	-0.2	-1.2	-2.1
Lithuania	-1.0	-1.9	-2.3	-3.2	-5.3	-6.9	-3.1	-3.3	-2.2	-1.8	-1.2	-0.6	-0.4	-0.8	-0.8
Luxembourg	-0.5	-0.2	0.6	1.5	2.6	1.7	0.7	1.6	2.7	2.7	2.3	1.3	1.7	1.5	2.1
Malta	0.0	-4.2	-3.3	-3.5	-5.8	-3.6	-3.0	-1.8	-2.5	-1.4	-2.2	-2.6	0.3	3.1	1.4
Netherlands	-0.5	0.6	0.5	-1.0	-0.7	-4.2	-3.9	-3.7	-2.3	-1.6	-0.6	-0.9	0.4	0.6	0.8
Austria	-0.5	-1.3	-1.8	-1.9	-1.9	-2.7	-3.2	-2.5	-1.8	-1.1	-0.6	0.0	-1.1	-0.8	-0.5
Portugal	0.25	-6.1	-4.5	-3.8	-4.6	-8.5	-8.5	-6.6	-3.5	-2.9	-1.6	-2.2	-2.0	-1.3	-0.4
Slovenia	0.25	-1.9	-2.5	-2.6	-4.6	-4.7	-4.2	-4.4	-1.5	-1.1	-2.0	-1.3	-1.1	-0.5	-0.7
Slovakia	-0.5	-2.2	-4.0	-4.3	-4.9	-7.8	-6.9	-3.9	-3.4	-1.5	-2.0	-2.1	-2.0	-0.9	-1.3
Finland	-0.5	2.9	3.2	2.7	2.4	0.5	-1.0	-0.8	-1.0	-1.0	-1.3	-0.7	-0.7	-0.7	-1.0
Euro area *	-0.3	-2.8	-2.3	-2.2	-3.0	-4.5	-4.2	-3.5	-2.0	-1.3	-0.9	-0.9	-1.1	-0.9	-0.7

Sources: European Commission's spring 2019 economic forecast, figures prior to 2010 are from Spring 2014 vintage of forecasts

(*) Euro area implied MTO

Better compliance with the corrective arm

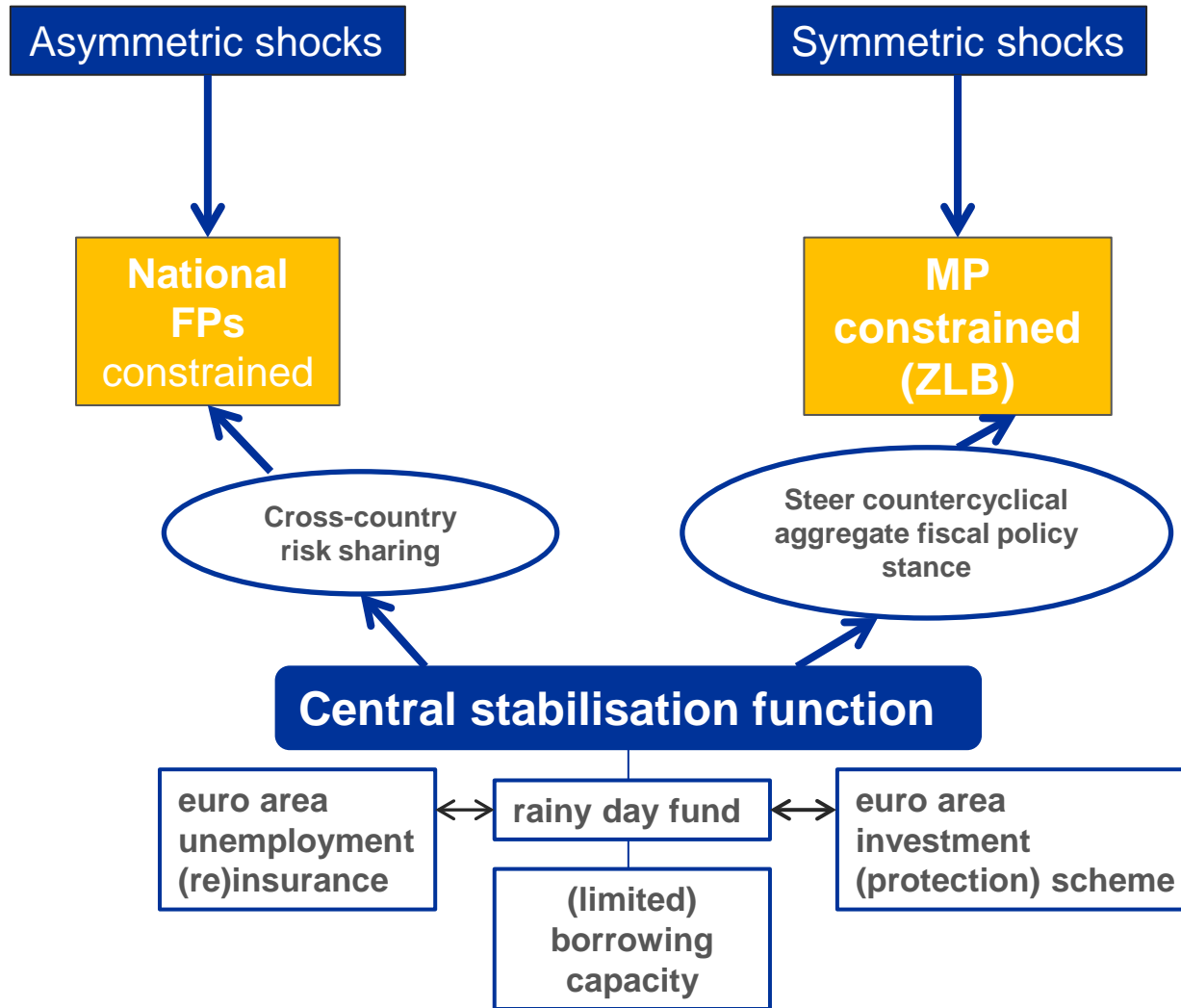
Budget balance (% of GDP)

	Net lending (+) / net borrowing (-) (in % of GDP)															
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
Belgium	-0.2	-2.8	0.2	0.1	-1.1	-5.4	-4.0	-4.2	-4.2	-3.1	-3.1	-2.4	-2.4	-0.8	-0.7	
Germany	-3.7	-3.4	-1.7	0.2	-0.2	-3.2	-4.2	-1.0	0.0	-0.1	0.6	0.8	0.9	1.0	1.7	
Estonia	2.4	1.1	2.9	2.7	-2.7	-2.2	0.2	1.2	-0.3	-0.2	0.7	0.1	-0.3	-0.4	-0.6	
Ireland	1.3	1.6	2.8	0.3	-7.0	-13.8	-32.1	-12.8	-8.1	-6.2	-3.6	-1.9	-0.7	-0.3	0.0	
Greece	-8.8	-6.2	-5.9	-6.7	-10.2	-15.1	-11.2	-10.3	-8.9	-13.2	-3.6	-5.6	0.5	0.7	1.1	
Spain	0.0	1.2	2.2	1.9	-4.4	-11.0	-9.4	-9.6	-10.5	-7.0	-6.0	-5.3	-4.5	-3.1	-2.5	
France	-3.6	-3.4	-2.4	-2.6	-3.3	-7.2	-6.9	-5.2	-5.0	-4.1	-3.9	-3.6	-3.5	-2.8	-2.5	
Italy	-3.5	-4.1	-3.5	-1.5	-2.6	-5.2	-4.2	-3.7	-2.9	-2.9	-3.0	-2.6	-2.5	-2.4	-2.1	
Cyprus	-3.7	-2.2	-1.0	3.2	0.9	-5.4	-4.7	-5.7	-5.6	-5.1	-9.0	-1.3	0.3	1.8	-4.8	
Latvia	-0.9	-0.4	-0.5	-0.5	-4.2	-9.5	-8.6	-4.3	-1.2	-1.2	-1.4	-1.4	0.1	-0.6	-1.0	
Lithuania	-1.4	-0.3	-0.3	-0.8	-3.1	-9.1	-6.9	-8.9	-3.1	-2.6	-0.6	-0.3	0.2	0.5	0.7	
Luxembourg	-1.3	0.1	1.9	4.2	3.3	-0.7	-0.7	0.5	0.3	1.0	1.3	1.4	1.9	1.4	2.4	
Malta	-4.3	-2.6	-2.5	-2.1	-4.2	-3.2	-2.4	-2.4	-3.5	-2.4	-1.7	-1.0	0.9	3.4	2.0	
Netherlands	-1.8	-0.4	0.1	-0.1	0.2	-5.1	-5.2	-4.4	-3.9	-2.9	-2.2	-2.0	0.0	1.2	1.5	
Austria	-4.8	-2.5	-2.5	-1.4	-1.5	-5.3	-4.4	-2.6	-2.2	-2.0	-2.7	-1.0	-1.6	-0.8	0.1	
Portugal	-6.2	-6.2	-4.3	-3.0	-3.8	-9.8	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.0	-3.0	-0.5	
Slovenia	-2.0	-1.3	-1.2	-0.1	-1.4	-5.8	-5.6	-6.7	-4.0	-14.7	-5.5	-2.8	-1.9	0.0	0.7	
Slovakia	-2.3	-2.9	-3.6	-1.9	-2.4	-7.8	-7.5	-4.3	-4.3	-2.7	-2.7	-2.6	-2.2	-0.8	-0.7	
Finland	2.2	2.6	3.9	5.1	4.2	-2.5	-2.6	-1.0	-2.2	-2.6	-3.2	-2.8	-1.7	-0.8	-0.7	
Euro area	-3.0	-2.6	-1.5	-0.7	-2.2	-6.2	-6.2	-4.2	-3.7	-3.1	-2.5	-2.0	-1.6	-1.0	-0.5	

Looking ahead – EMU Deepening (1)



Looking ahead – EMU Deepening (2)



Conclusions

- Fiscal policy matters for monetary policy and financial stability (risk of fiscal dominance, risk of dysfunctional government bond markets, risks to financial institutions' balance sheets)
- Well-designed fiscal rules are key (particularly in a monetary union) and effective implementation is crucial
- Need to build fiscal buffers in good times
- Need to avoid pro-cyclicality, particularly in boom periods, to minimize consolidation needs during bad times
- Limit risk of spillover effects and contagion, especially the risk of fueling a sovereign-bank nexus (which is costly!)

Thank you for your attention