



Fiscal Implications of Euro Adoption

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Milton Friedman: ...I think the euro is in its honeymoon phase. I hope it succeeds, but I have very low expectations for it. I think that differences are going to accumulate among the various countries and that non-synchronous shocks are going to affect them. Right now, Ireland is a very different state; it needs a very different monetary policy from that of Spain or Italy. On purely theoretical grounds, it's hard to believe that it's going to be a stable system for a long time. ... (2000)

Why Euro?

- No exchange rate risk/transaction costs
- Deepening the Single Market
- Higher trade/investments
- Importing German monetary policy
- Reserve currency
- „Insurance“ against extreme domestic policies

Consensus in 2005

- Common pool² – deficit bias at home, free riding in Europe; 3 pillars: SGP, no bail-out clause, independent monetary policy
- C/A developments are not very important in a currency union
- National sovereignty is key

Four Euro Area Crises (Buiter)

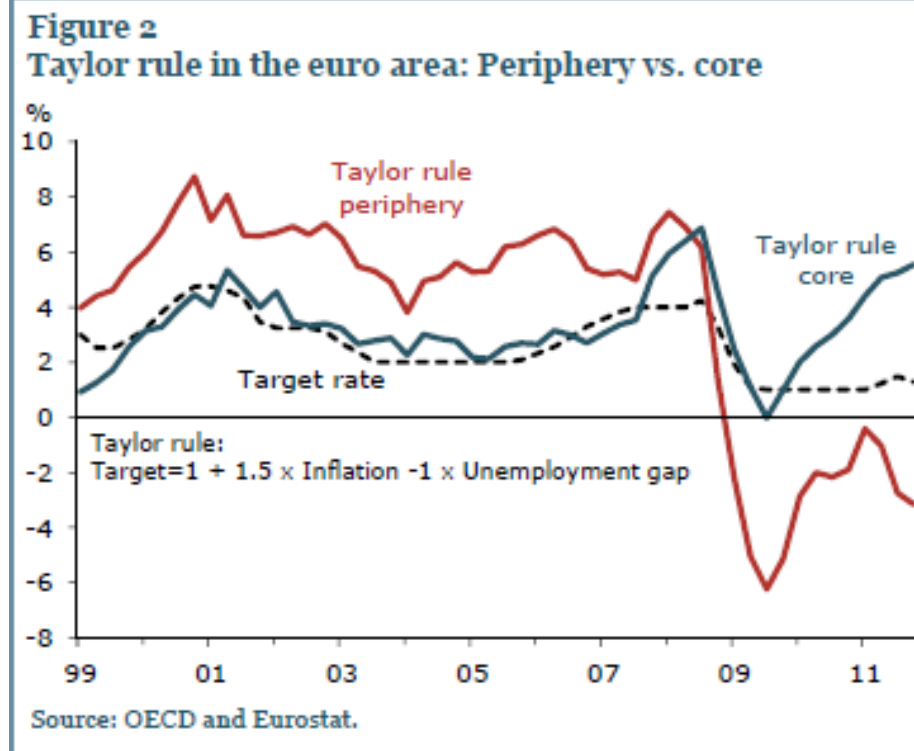
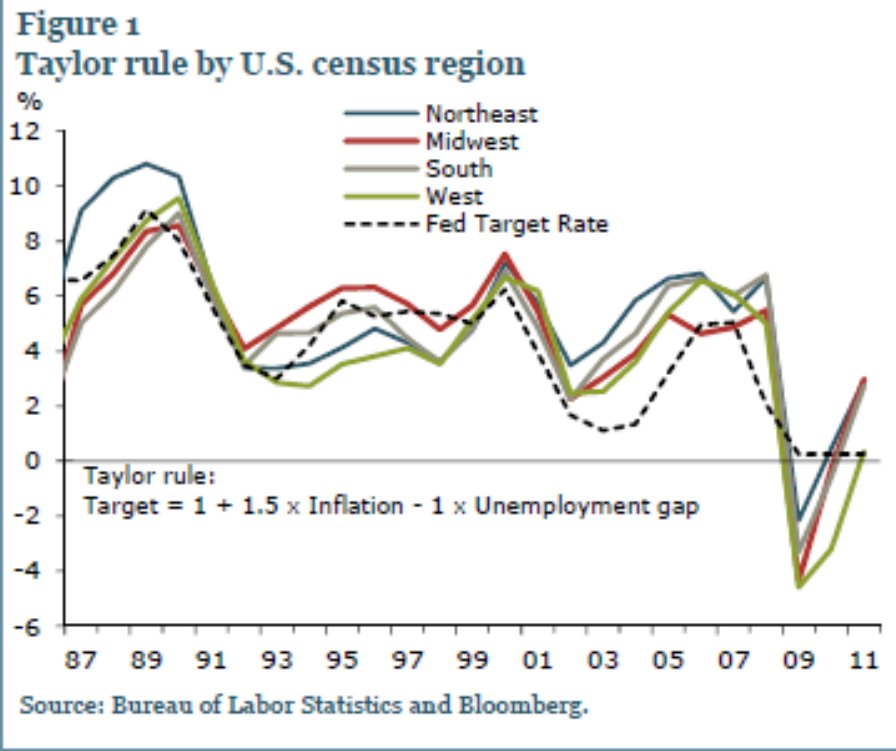
- **Sovereign debt/fiscal crisis:** member countries debt is real debt (monetization is not likely)
- **Banking crisis:** problems with liquidity and solvency
- **Currency regime crisis:** is the process reversible?
- **Political legitimacy crisis:** democratic deficit

What Have We Learnt?

- Markets were right – no credibility of the no bail-out clause
- Ex-ante crisis resolution mechanisms are important
- Democratic deficit limits the room for manouvre
- Links between sovereign and banking risks were underestimated
- C/A figures are very infomative

Large Differences

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Source: FRSF, Economic Letter 2012-06

Crisis Management

- Bail-outs, EFSF, ESM
- ECB policies (SMP, OMT, etc.)
- 6Pack, 2Pack, Fiscal Compact
- agreement on banking union

There Are No Easy Solutions (1)

- Sovereign debt reduction options:
 - fiscal consolidation
 - higher GDP growth (difficult if private sector is deleveraging)
 - higher inflation
 - default/restructuring
 - bailout
- Banking crisis – banking union (single supervision, burden sharing, common deposit guarantees, financial backstop)

There Are No Easy Solutions (2)

- Currency regime crisis: credible no bail-out clause or some form of fiscal union
- Democratic deficit – gradual changes to the Treaty, long-term solutions

Short-term Options

Minimum requirements

- Selective austerity strategy
- Growth-enhancing structural measures
- Quick move toward the banking union
- ECB support
- Political stability

Long-term: What Can We Learn from Federations?

IMF looked at 13 federations

- What is the role of centralized fiscal policies?
- What are the institutional arrangements between federal and sub-national governments?
- How have subnational crises been handled?
- When do crises occur in federations?

Minimal Elements of a Fiscal Union (IMF)

**1. Better
governance/Oversight**

**2. Temporary transfers or
joint provision of public
services**



**3. Common backstop for
Banking Union**

**4. Borrowing at the
center to finance (2) or
(3)**

Better Governance/Oversight

- Smarter fiscal rules
- Robust corrective mechanism
- Independent forecasts
- Credible no-bail-out rule or greater central oversight
- Banking union

Institutional Arrangements in Federations

Debt to GDP ratios		
	Germany (17 Laender)	USA (50 states)
Minimum	6.7%	2.3%
Maximum	66.9%	19.6%
Average	31.7%	8.3%
Total	24.2%	7.7%
Standard deviation	17.0%	3.9%

Source: Wyplosz (2013)

Transfers/Public Goods

Temporary transfer options:

- Rainy-day fund
- Unemployment benefits
- Euro area budget

Public goods:

- Defence
- Public infrastructure

Common Backstop

- Sufficient funds for the single resolution authority
- Ex-ante burden sharing (haircut on unsecured liabilities, bail in, deposit insurance)
- Funding from the industry/ESM
- ECB credit line?

Borrowing at the Center

- No debt mutualisation
- Rather borrowing against central revenues
- New safe asset
- Counter-cyclical policy

Conclusions

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- Fiscal stabilization in the medium-term is key, new enforcement mechanisms should start in a credible manner
- Banking union is necessary to fight against vicious circles between banking and sovereign risks
- Financial market oversight should be improved (as elsewhere)
- Gradual move towards some form of centralization – but hand in hand with further political integration (to eliminate the fundamental contradiction between national sovereignty and central enforcement)
- Credible no bail-out? Clear rules in ESM, bail-in, possible debt restructuring.

Otherwise the risk of a „Japanese“ scenario is high with possible break-up



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Thank you for Your attention!