European Commission

Financial stability: The (side-)role of fiscal Policy?

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The (indirect) link with fiscal policy

The adverse feedback-loop between 3 components:

- Risk on sovereign due to spiralling public debt dynamic
- Vulnerability of banking systems
- Slow growth (aggravated by strong fiscal adjustment in bad times)

- Ex 1: Slow growth in turn increases the risk of adverse debt dynamics and risks on sovereign.
- Ex 2: Large implicit liability from impaired banking systems worsen the debt dynamic
- Ex 3: Risks on sovereign debts increase risks on bank balance sheet
- Ex 4: Systemic risk not favorable to growth (low business confidence and investment)
- Ex 5: Strong fiscal adjustment in bad times not favorable for growth outlook

Outline

- Fiscal policy to reduce the macroeconomic and sustainability risks ex ante?
- A trade-off not to be ignored : LT sustainability vs. ST stabilisation
- Fiscal policy to share the risks ex post?
- Focus on fiscal sustainability indicators as part of financial stability analysis

Risk reduction & risk sharing

Ex ante **risk reduction**

- Strong economic coordination and strong governance
- Rules-based fiscal policy
- Preventive approach: prudent fiscal policy ex ante, as per the preventive arms of SGP
- Avoiding procyclical policy in bad but also good times

Ex post **risk sharing**

- More emphasis on stabilisation
- Risk sharing via transfers?
- Fiscal backstop: financial assistance instruments, e.g. ESM
- Rather corrective approach: corrective arm of SGP

Risk reduction instruments

Stringent fiscal governance

- Compliance with fiscal rules
- Monitoring national budgets: the two-pack

Economic coordination

- Macroeconomic Imbalances Procedure
- European Semester

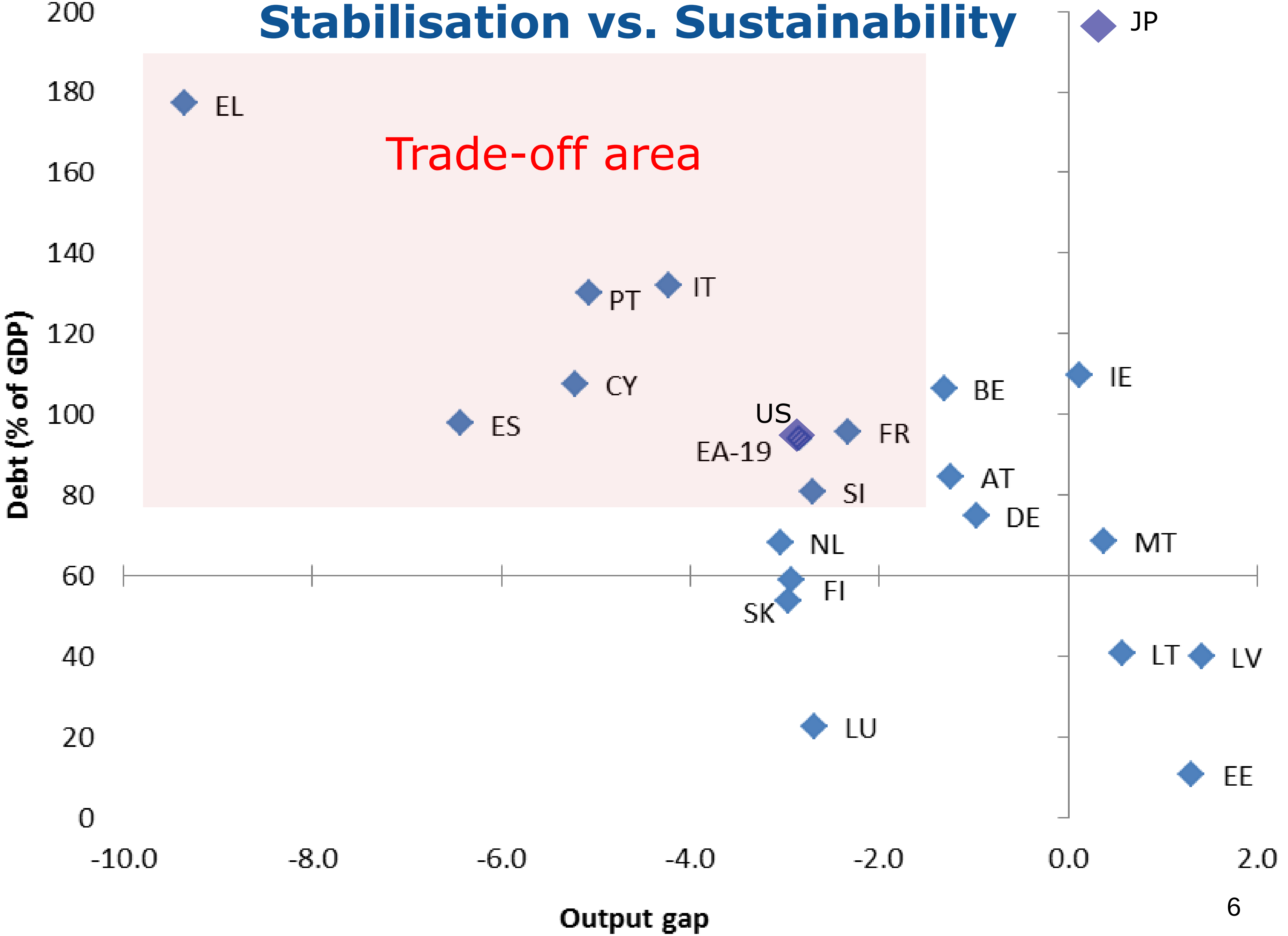
Banking union

- Common supervision
- Regulatory innovation to break bank-sovereign link?

Effective no bail out clause

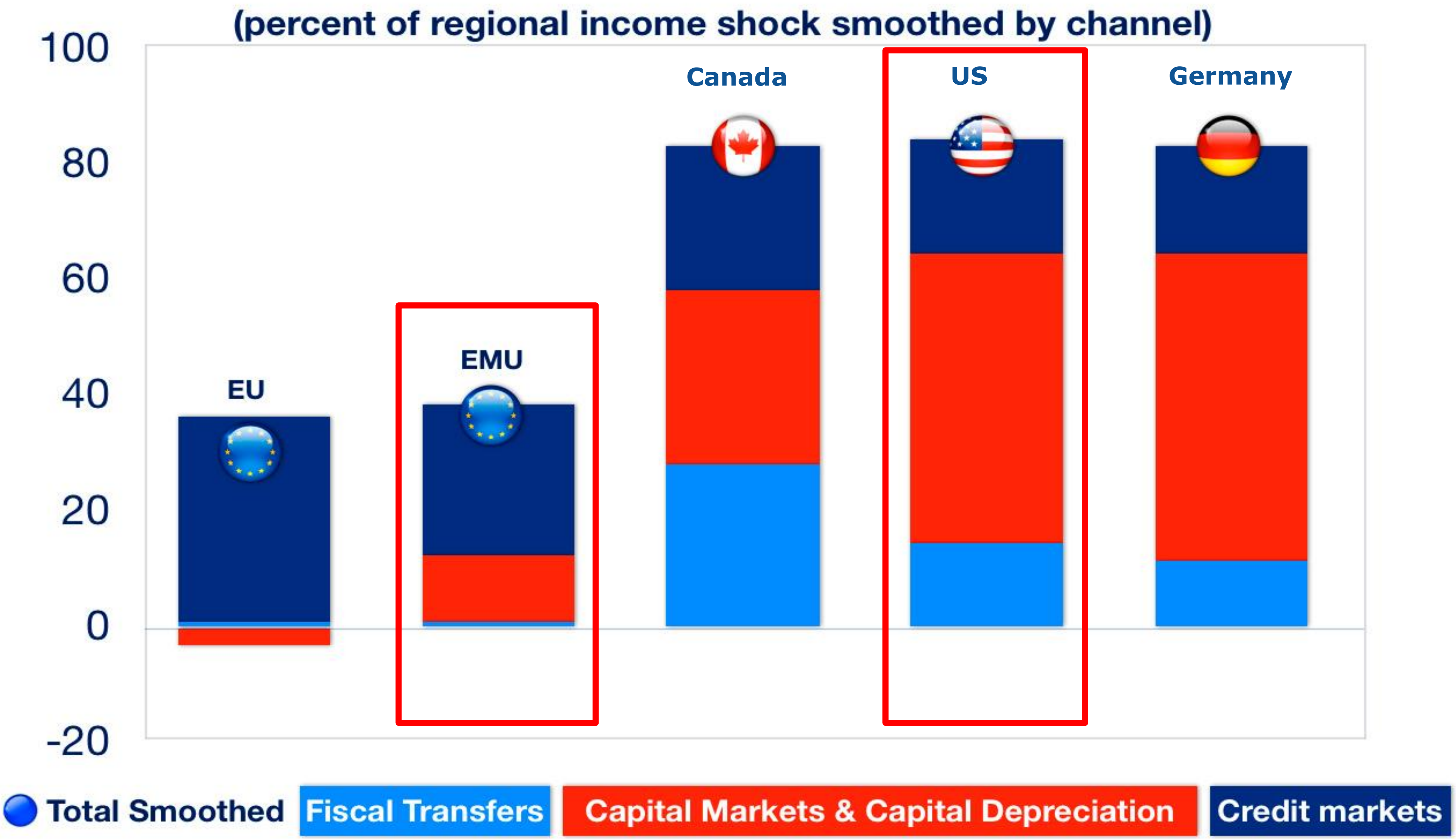
- Insolvency framework

Stabilisation vs. Sustainability



Sources: European Commission AMECO database and OECD Economic outlook

Insurance against income shocks in EMU remains low.



Source: IMF. Allard et al. (2013) Toward a Fiscal Union for the Euro Area

Risk sharing instruments

Macroeconomic stabilisation instruments?

- Unemployment insurance at EMU level
- Stabilisation funds (transfers triggered by output gap developments)
- Investment capacity

Fiscal backstops

- Financial assistance instruments, e.g. ESM
- Backstop for banking union: the resolution mechanism (partial "bail-in") to break sovereign-bank feedback loop

Private sector risk sharing

- Banking union and capital markets union to facilitate private sector risk sharing

Risk reduction <u>AND</u> risk sharing: fiscal

Case for **simultaneous** implementation: effective risk sharing and risk reduction reinforce each other

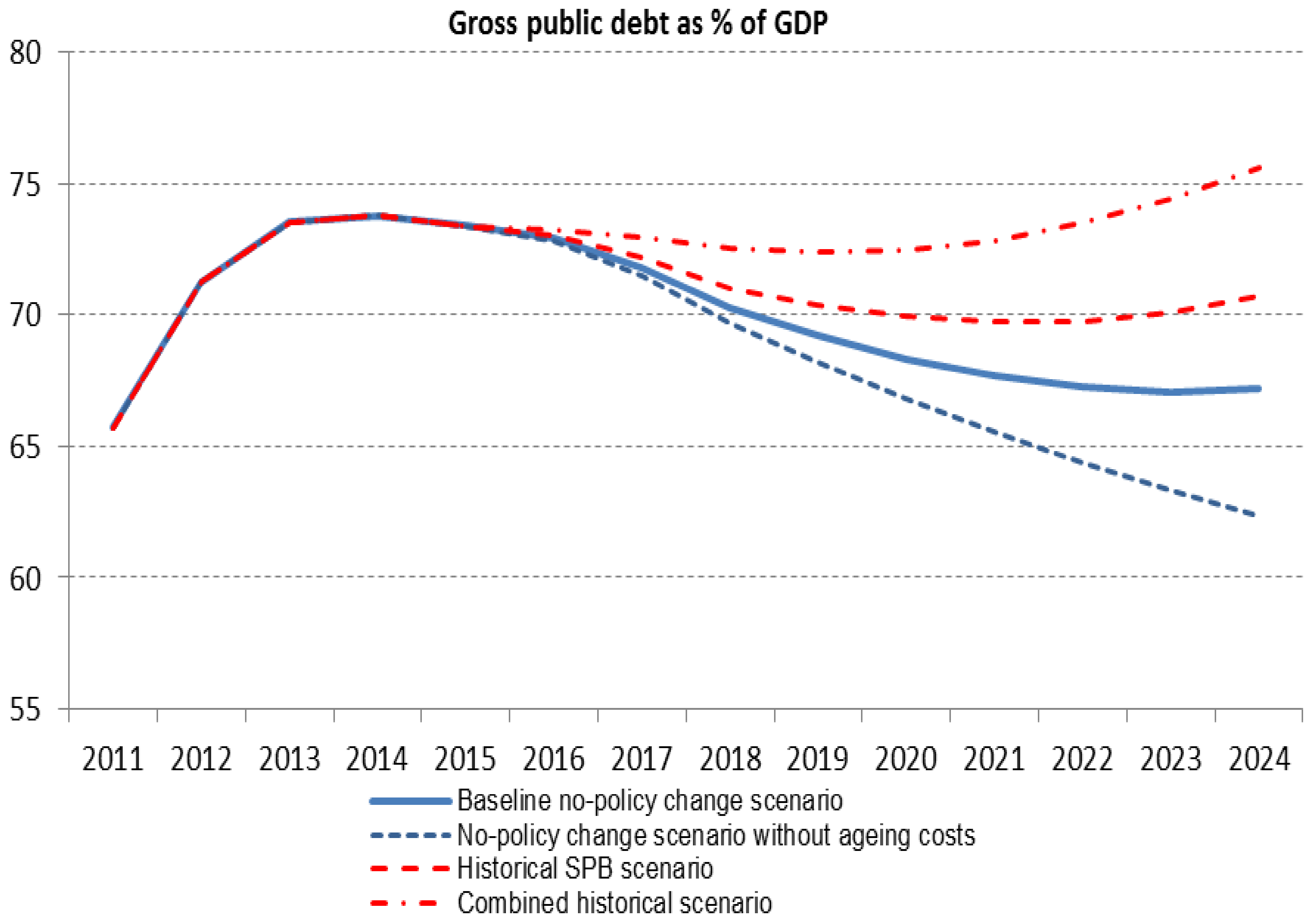
An example: Fiscal governance and fiscal capacity:

- Stringent fiscal rules to allow for the full play of economic stabilisers in bad times + discretionary policy margins

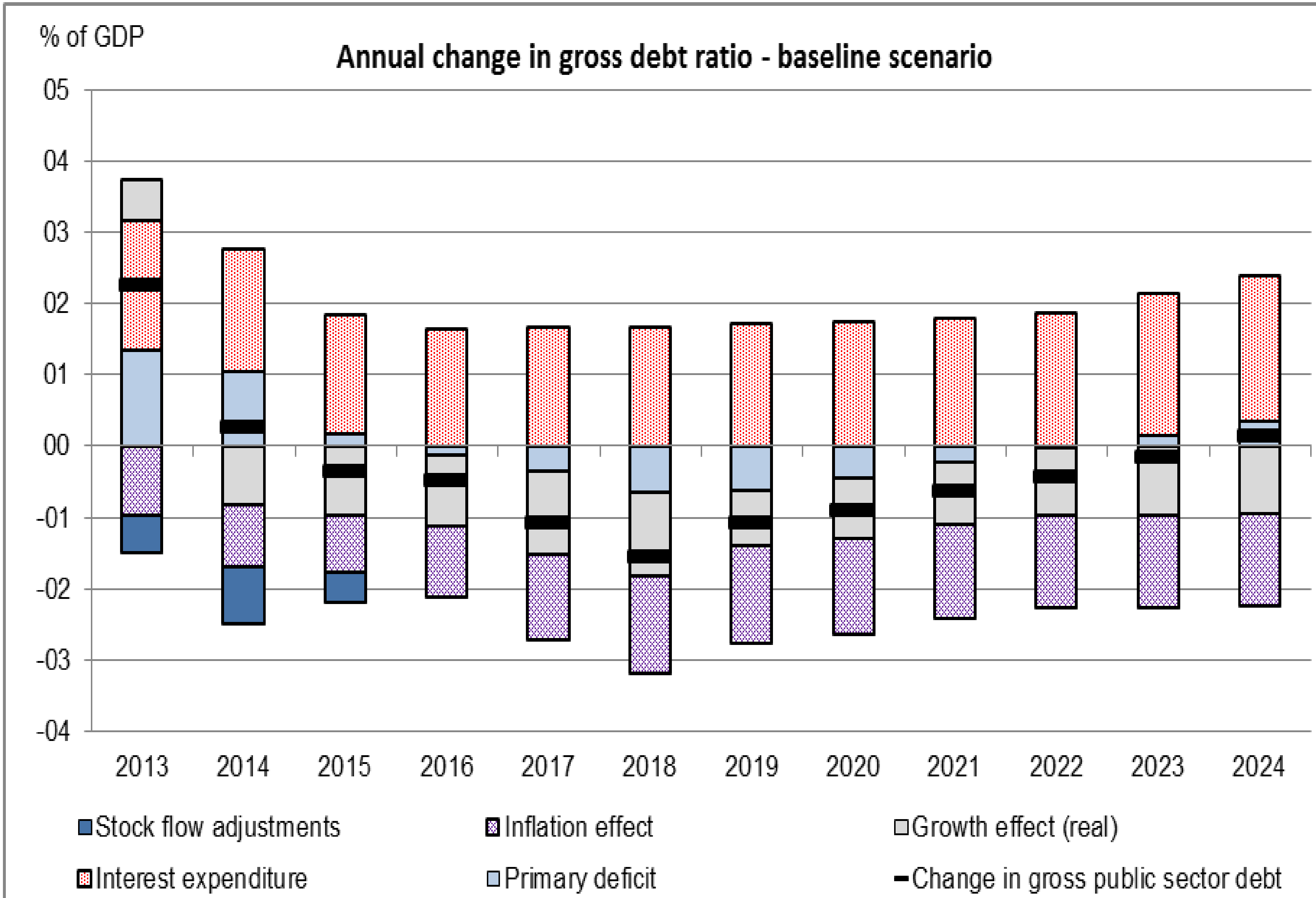
- Stabilisation capacity to provide ex post insurance for large shocks and to smoothen business cycle as risk sharing

- Credible prudent fiscal policy could reduce the sovereign rate spread in case of shocks ("confidence sharing")

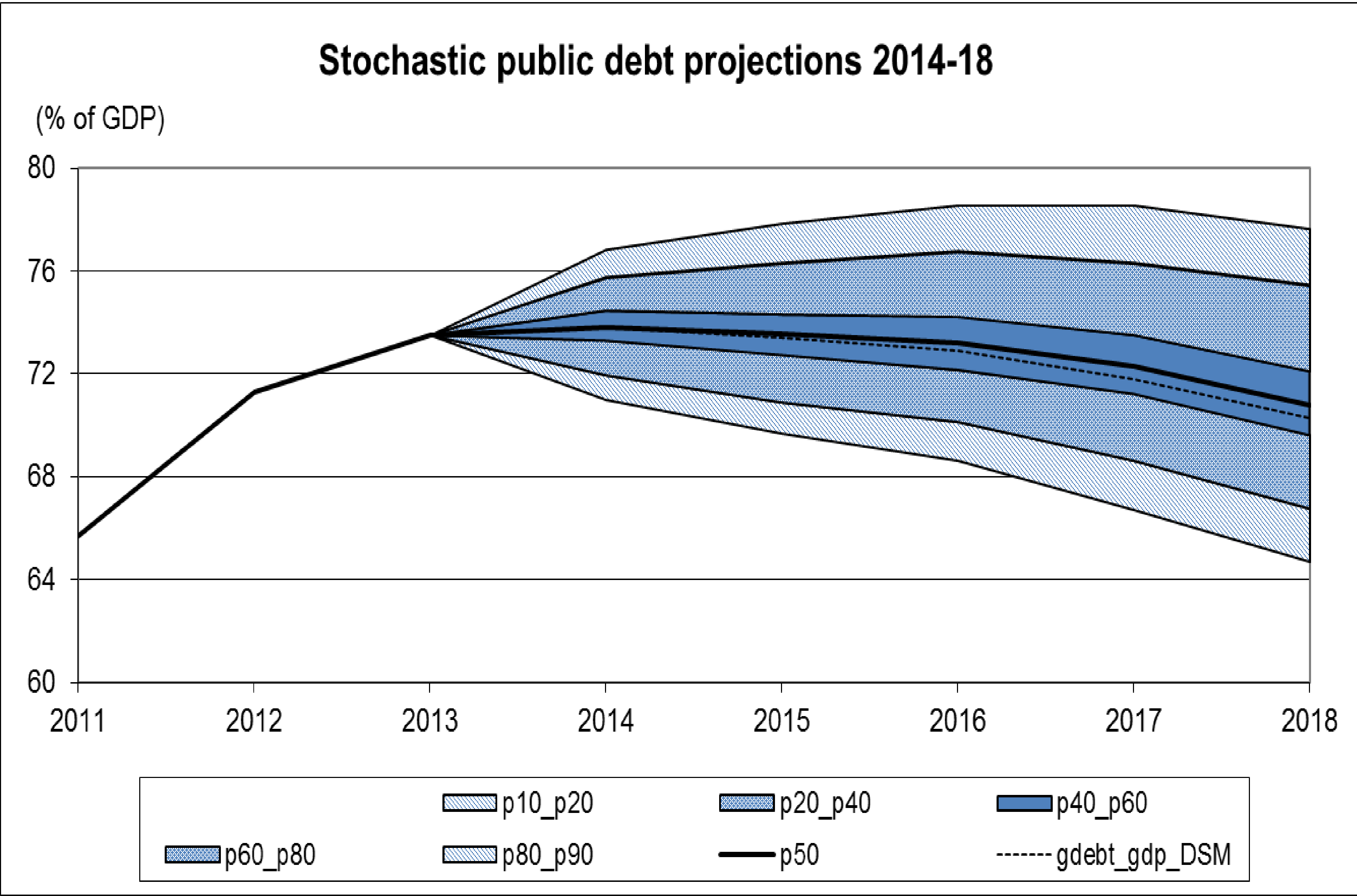
Deterministic projections of debts



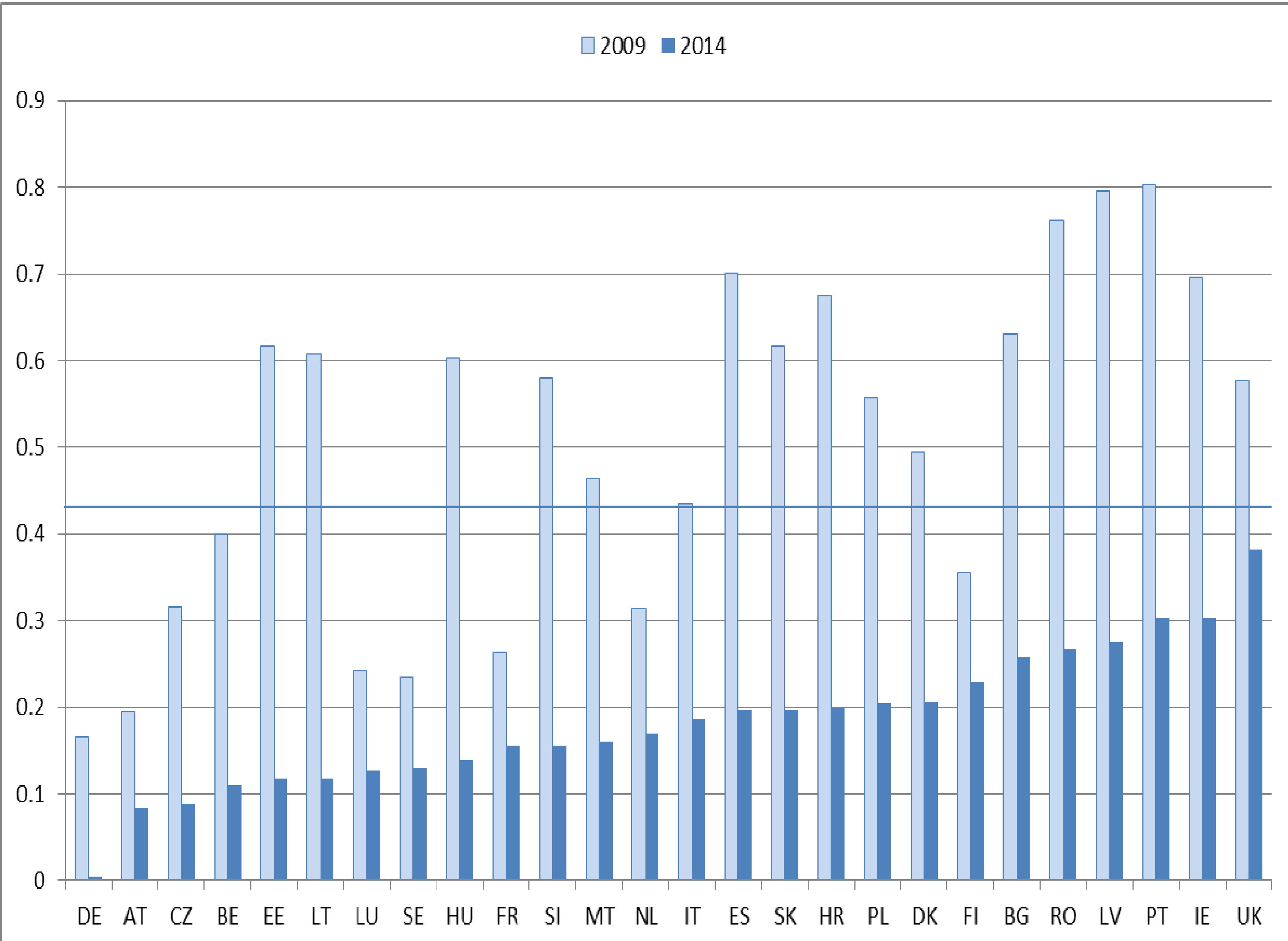
Determinants of changes in debt ratio



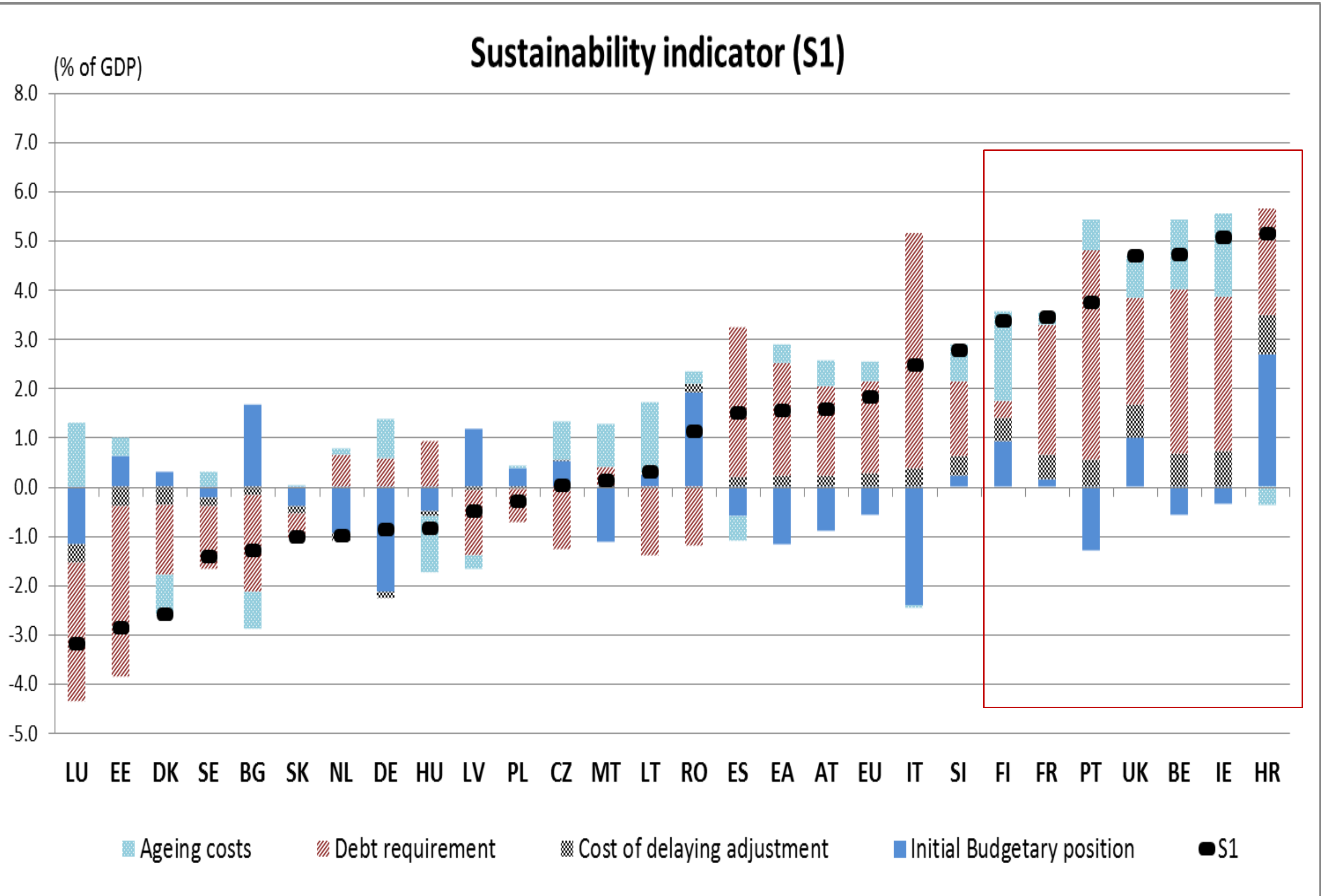
Stochastic projections of debts



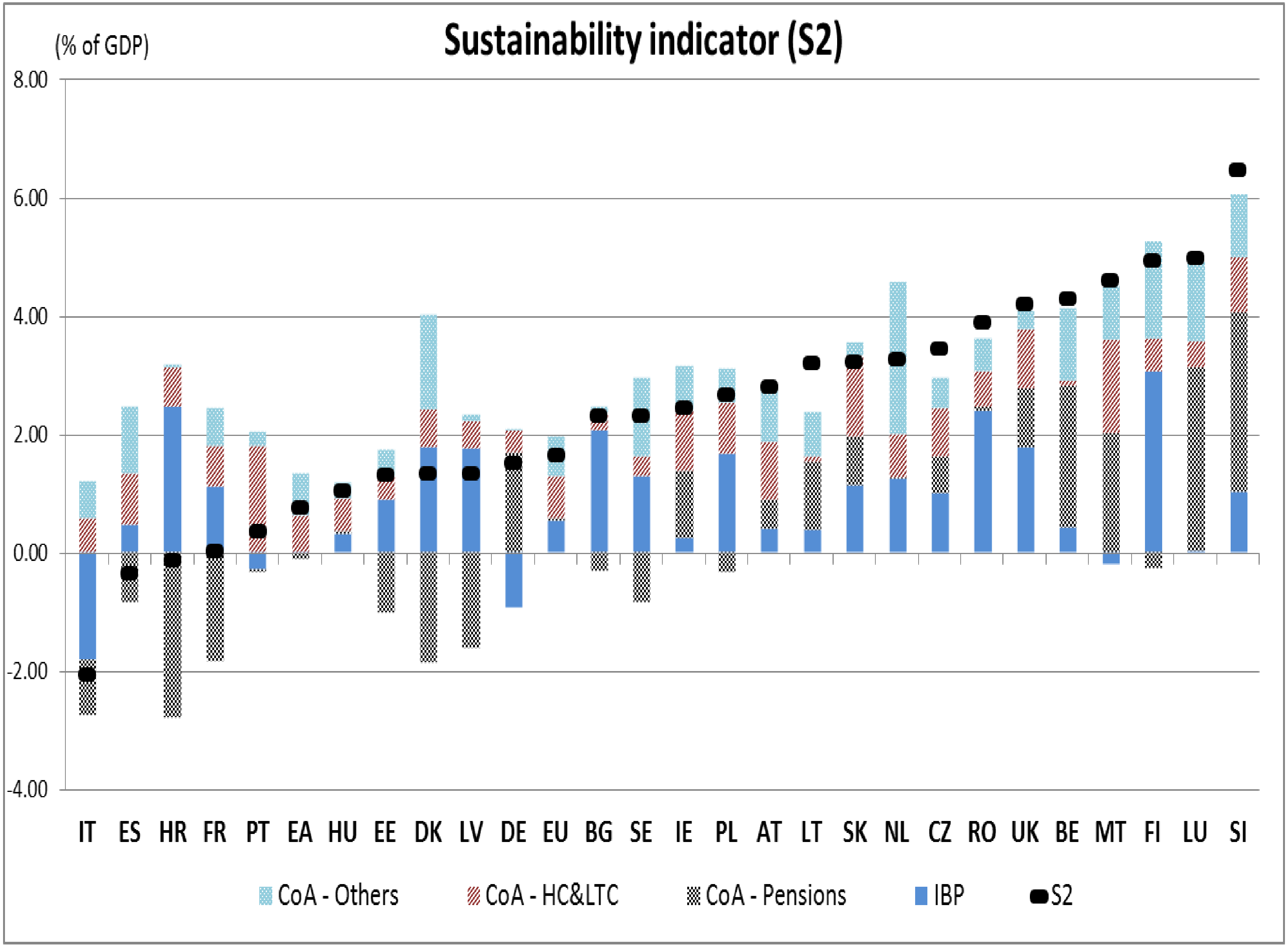
Short-term fiscal risks based on S0



Medium-term challenges based on S1



Long-term challenges based on S2



Thank you

14 fiscal variables in S0: thresholds and signalling power

Variables	safety	threshold	signaling power	type I error	type II error
Balance, % GDP	>	-10,17	0,07	0,04	0,89
Primary balance, % GDP	>	0,00	0,17	0,40	0,43
Cyclically adjusted balance, % GDP	>	-3,12	0,25	0,45	0,30
Stabilizing primary balance, % GDP	<	2,55	0,02	0,12	0,86
Gross debt, % GDP	<	103,28	0,03	0,06	0,91
Change in gross debt, % GDP	<	6,50	0,11	0,08	0,81
Short-term debt, government, % GDP	<	16,00	0,10	0,11	0,79
Net debt, % GDP	<	58,11	0,13	0,19	0,68
Gross financing need, % GDP	<	16,83	0,16	0,21	0,63
Interest rate-growth rate differential	<	5,92	0,08	0,07	0,85
Change in expenditure of gen. government, % GDP	<	2,25	0,14	0,13	0,74
Change in final consumption expend. of gen. governm	<	0,64	0,17	0,19	0,64
Old-age dependency ratio 20 years ahead	<	33,93	0,10	0,11	0,79
Avg yearly change in projected age-related public expend. as % of GDP over next 5 years	<	0,26	0,09	0,14	0,77
Fiscal index	<	0,35	0,23	0,21	0,56
Overall index	<	0,43	0,55	0,21	0,25

The S0 indicator

- Composite indicator of short-term risk of "fiscal stress"
- Constructed using 28 fiscal and financial-competitiveness variables (incl. from MIP scoreboard)
- Methodology: **non-parametric "signals' approach"** pioneered by Kaminsky, Lizondo and Reinhart (IMF, 1998) and Kaminsky and Reinhart (*AER*, 1999)

  (see Berti, Salto and Lequien, 2012)
- Values of S0 beyond critical threshold (endogenously determined) signal fiscal risks one year ahead (early-warning model)

Definition of S1 and S2 indicators

- **S1** (medium term) = additional adjustment effort required, in terms of *cumulated* gradual improvement in the structural primary balance over 5 years, to reach a 60% debt-to-GDP ratio in 2030

  (finite version of gov't intertemporal budget constraint)

- **S2** (long term) = permanent adjustment to the current structural primary balance required to stabilise debt-to-GDP ratio over infinite horizon

  (infinite version of gov't intertemporal budget constraint)

The Five Presidents' report

Reinforce the foundations of EMU, including by moving "*towards a Fiscal Union that delivers both fiscal **sustainability** and fiscal **stabilisation***"

The approach distinguishes two stages:

- **Stage 1 (until mid-2017): 'Deepening by doing'**
  - Build on existing instruments and make the best possible use of the existing Treaties

- **Stage 2 (2017-2025): 'Completing EMU'**
  - Measures of a more far-reaching nature to complete EMU's economic and institutional architecture
  - Creation of a EA Treasury which could be the place for 'joint decision-making on fiscal policy' while ensuring democratic accountability and legitimacy
  - President Juncker's State of the Union speech: The EA Treasury would build on the ESM and would assume a broader macroeconomic stabilisation function