“The Future of the Euro” (February 13, 2023)

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Questions:

I. What shortcomings do you see in the current functioning of the euro/EMU?
II. What costs and risks do these entail for the Netherlands?
III. Are reforms possible (if so, which ones) to reduce or eliminate those risks/shortcomings?

Major shortcomings in the current functioning of the euro/EMU:

1. Insufficient capacity to constrain fiscal profligacy
2. ECB is under frequent pressure to alleviate the burden on public budgets
3. Insufficient structural reforms and public investments
4. A central fiscal capacity to absorb major economic shocks
5. Insufficient provision of EU public goods

It is important to notice that the shortcomings are not standalone, but are highly interrelated. This is in particular the case for 1. – 3. Most directly relevant for the functioning of the euro are 1. and 2.

Let me take each one of them in turn with potential remedies:

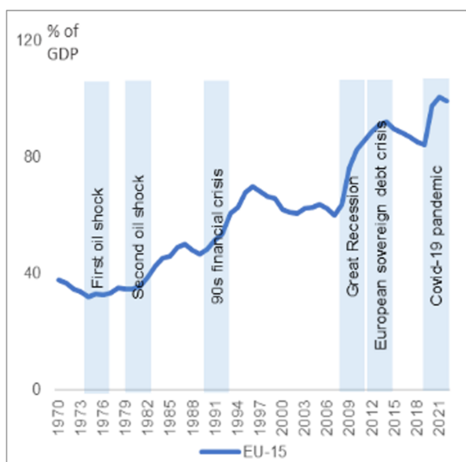
1. <u>Insufficient capacity to constrain fiscal profligacy</u>

   a. The Stability and Growth Pact has had a moderating influence on governments’ profligacy, but not to the same extent on each country, and too little on average. In addition, the SGP has given rise to pro-cyclical fiscal policies, because government build up too few buffers in good times, which forces them to consolidate in bad times.

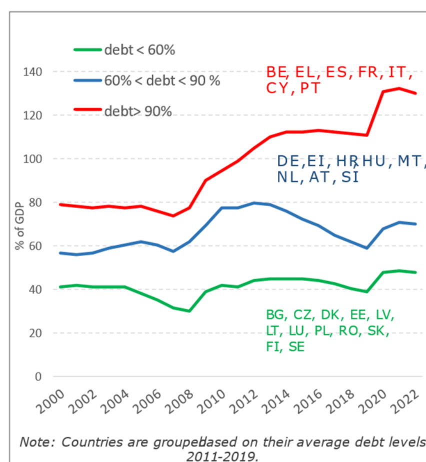
   There seems to almost be a ratchet pattern in the debt trajectories of the most indebted countries (see first figure below, from EFB, 2021): debt ratios shot up during the global financial crisis, came down by a smaller amount after the eurozone debt crisis, shot up to unprecedentedly high levels (in peacetime) in the first corona years, and are now correcting somewhat, mainly as a result of nominal growth (high inflation) exceeding nominal interest rates (also referred to as the “snowball effect”). The correction is not the result of active consolidation policies – spending growth continues to exceed potential growth (see second figure below, from EFB, 2022).

Government debt- a rising trend, ratcheted up in crisis

The aggregate view since 1970



A bit more detail since 2000



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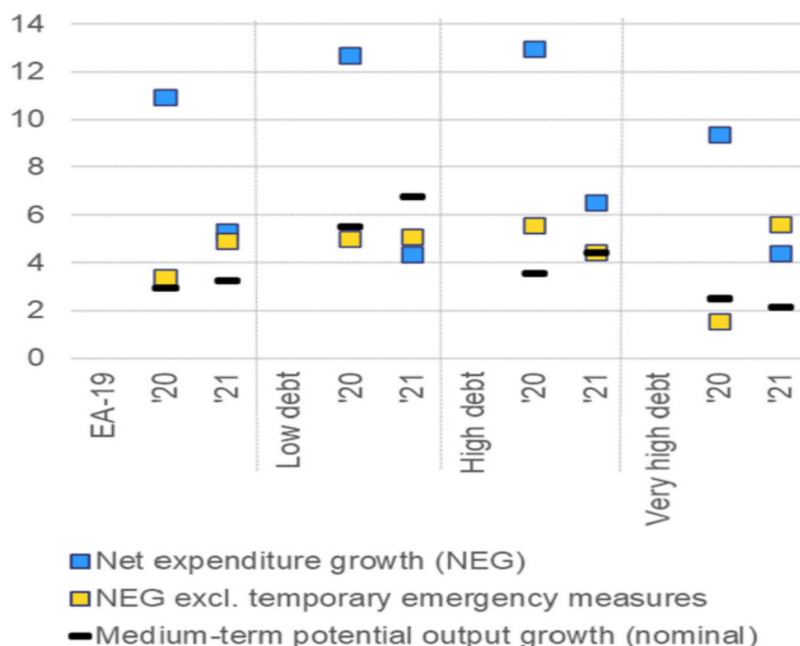
Net expenditure growth well above medium-term economic growth potential

y-o-y change, %



Until recently, there was an illusion that low interest rates would persist indefinitely and that public debt could essentially be issued for free, since

economies would automatically outgrow the extra debt. This illusion has collapsed: interest rates and spreads have risen, reflecting differences in risk

b. Risks: (self-fulfilling) debt crisis in very high debt countries, potentially starting in one country and then spilling over to other countries. Costs: a systematic bank crisis, followed by costly rescue of banks and sovereigns. It will be (politically) difficult for the Netherlands not to contribute to a rescue package. Also when debt of a sovereign is written off to a substantial extent, financial help will be needed from other countries in order keep the country's public sector functioning.

c. There are no silver bullets, but some measures will be of particular help:

A proper reform of the SGP should help; the Commission proposals go into the right direction with more emphasis on the medium term, differentiation of reduction requirements (embedded in expenditure paths). A flaw is that the proposals require only sustainably falling debt ratios (of the high-debt countries) at the end of the 4-year period, or the 7-year period, in case a country has received an extension on the basis of reform and investment plans. A requirement for countries to show early progress in terms of debt reduction would appease financial markets. Inducing countries to reduce debt and build up buffers early on also reduces risk of procyclical fiscal policy and boosts the capacity to weather new crises.

Break the doom-loop between banks and sovereigns: make it less attractive for banks to hold disproportionate amounts of their own government's debt, by imposing limits on concentration ratios on bank portfolios and imposing (different) risk weights on holding euro-area sovereign debt from non-AAA rated countries.

2. Pressure on the ECB

a. Problem is that if a country is in difficulty placing its public debt on capital market, the ECB will face a dilemma between letting interest rates go up and the country effectively be excluded from the market and acting as a backstop for buying the debt or promising to do so. The ECB has the Outright Monetary Transactions (OMT) instrument, which comes into action on conditional on an EFSF/ESM macroeconomic adjustment or precautionary programme (https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html) and the Transmission Protection Instrument, which comes with lighter conditions, such as the observance of the SGP.

b. Risk and cost is an effective debt mutualisation through higher inflation, something that we now actually see, which erodes the relatively high

savings of the Netherlands and erodes the real debt burden of in particular the very high debt countries.

c. Solutions: precise definition of price stability (refine mandate of ECB – see European Economy Expert Group, 2021); any measures that constrain fiscal profligacy (of very high debt countries) and that boost potential growth.

3. <u>Insufficient structural reforms and public investments</u>

a. The result is too low potential growth and therefore fiscal space.

   Implementation of the recommended reforms is systematically slow and incomplete.

   The specific reform needs (and their intensity) differs substantially across the Member States. For example, low retirement ages, weak tax collection systems, badly functioning product markets, badly functioning labour markets.

   Why does reform not come off the ground? (i) public and political support is often weak: benefits may not be easily visible and materialise only slowly; (ii) each reform need has its own obstacles to be overcome.

   Public investment: when budgetary pressure increases, it is politically easiest to cut public investment, as we have seen comparing post- and pre- global financial and eurozone crisis. This problem will be reinforced by demographic trends (public investment benefits younger people relatively than the elderly).

b. Costs and risks for Netherlands: subdued growth in other EU countries implies lower exports by the Netherlands. It also implies higher risk of debt crises, with the accompanying costs.

c. Potential solutions: tighter monitoring of progress; providing external expertise (similar as under a macroeconomic program); under the Commission proposals, the time window for debt to be put on a sustainable downward path is extended; financial incentives (via EU funds?).

4. <u>Missing central fiscal capacity (CFC) to absorb major economic shocks</u>

a. Such a capacity would alleviate the impact of large shocks, symmetric or asymmetric. It would not be used to alleviate the effects of smaller shocks.

b. Risks and costs: severe crises put an undue burden on populations and put the public finances under pressure. Countries may be on the hook for the CFC's losses; realising that there is a CFC to step in may lead to moral hazard in fiscal policy and undertaking structural reforms.

c. Potential solutions: the design is crucial. Ideally, the CFC would be a rainy day fund compartmentalised by country (EFB, 2022). Countries make their contribution to their own compartment and draw on it under highly adverse circumstances. If the country's compartment contains insufficient resources, a loan can be made to the country (the CFC might need to borrow on the capital market). The advantage of this setup is that the country is forced to save via the contributions it makes to the capacity in relatively favourable times.

   If a crisis occurs early during the building up phase of the capacity (or crises succeed each other after a short period of time) the capacity runs into debt that needs to be guaranteed by countries that do not make use of the capacity's support. There is a risk that the debt will be mutualised. Participation in the capacity requires at least strict adherence to the EU fiscal rules.

5. Insufficient provision of EU public goods

   a. Meant here are goods that produce beneficial spill-overs across countries, such as electricity grids, hydrogen infrastructure investments, high-speed railways, common medicine procurement, etcetera.

   b. Risks and costs: subdued potential growth. Insufficient progress on green transition.

   c. Potential solutions: expanding the provision of EU public goods can, for obvious political reasons, only take place gradually. It would require a reallocation of the current EU budget and an expansion of it.

      The NextGenEU is not the way to go in this respect, as it is focused on national plans, which have been constructed without internalising the potentially beneficial external effects. Moreover, the NextGenEU plan tend to be collections large numbers of small measures.

      A possibility is to give countries their own envelopes that they could spend on EU public goods (potentially jointly with other countries on common projects, which may earn them an additional co-payment from the EU budget) (EFB, 2022). Unspent money will go to the common part of the EU budget.

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