Evaluate future prospects of the Euro. Can monetary union exist without fiscal union?

http://www.macgillsummerschool.com/the-survival-of-the-euro-requires-fiscal-union-and-more/

• Fiscal union would be a major step towards a true political union. It would have to be administered by real federal bodies. Central tax resources and mutualized debt would become powerful symbols of a united Europe. The need for strong democratic oversight will spur the creation of a revitalised European Parliament and directly elected Commision. That could evolve into the government of a United States of Europe.

• A European fiscal union, with proper institutions would be able to provide joined-up management of the EU economy as a whole. Ex -ante control would mean that wayward Irish, Spaniards or Greek would not be able to recklessly inflate property bubbles or cook their budget books. The trust that responsible EU-wide economic management would engender will assure markets, draw investment and boost growth, creating a Europe that's more fair, stable and prosperous.

Paul De Grauwe: (2013)
In the Eurozone money and monetary policy are fully centralized. However, the rest of macroeconomic policies have remained firmly in the hands of national governments, producing idiosyncratic movements unconstrained by the existence of a common currency. As a result, there is very little in the monetary union that can make the booms and busts converge at the Eurozone level. The effect of all this is that booms and busts originate at the national level and have a life of their own at the national level without becoming a common boom-and-bust dynamics at the Eurozone level.

In fact it is even worse. The existence of the monetary union can exacerbate booms and busts at the national level. The reason is that the single interest rate that the ECB imposes on all the member countries is too low for the booming countries and too high for the countries in recession. Thus, when in Spain, Ireland, Greece the economy started to boom, inflation also picked up in these countries. As a result, the single nominal interest rate led to a low real interest rate in the booming countries, thereby aggravating the boom. The opposite occurred in the countries experiencing low growth or a recession. Thus, the fact that only one interest rate exists for the union exacerbates these differences, i.e. it leads to a stronger boom in the booming countries and a stronger recession in the recession countries than if there had been no monetary union.

As we can see a controlled break-up of the euro would be hugely risky and expensive. So, what would be the **solution?** Many economists argue in favour of a two-stage process, which involves both burden-sharing and the concession of sovereignty.

The first is financial: the euro zone needs a region-wide system of bank supervision, recapitalisation, deposit insurance and regulation.
Begin with the banks. Banks sprawl across national borders. German banks fuelled Spain's property boom, while their French peers funded Greece's borrowing. The answer is to move the supervision and support of banks away from national regulators to European ones. At a minimum there must be a euro-zone-wide system of deposit insurance and oversight, with collective resources for the recapitalisation of endangered institutions and regional rules for the resolution of truly failed banks. A first step would be to use Europe's rescue funds to recapitalise weak banks, particularly in Spain. But a common system of deposit insurance needs to be rapidly set up. Politicians will no longer be able to force their banks to support national firms or buy their government bonds. Banks will no longer be Spanish or German, but increasingly European.

The second is fiscal: euro-zone governments will be able to manage—and reduce—their fiscal burdens only with a limited mutualisation of debt. But in both cases the answer is not to transfer everything to the EU level.
With regards to the fiscal side: At the political level there is now a gradual recognition that the financial crisis can only be solved through stronger European (as opposed to national) political representation and control. This is the recognition that the economic and monetary union with the formal introduction of the euro back in 2002, cannot survive without a certain level of political integration. The financial crises experiences led to the realization of the fact that close mutual control of each other's fiscal policies, of the functioning of Member States' internal labor markets and more broadly the sustainability of Member States' social welfare systems, is in each country's national interest. What was once politically unthinkable now appears economically the only way forward: further European integration, not out of love but out of necessity.

Fiscal consolidation can support economic growth in the short term by fostering financial market confidence. It should go hand in hand with structural and financial sector reforms.

According to Francesco Nicoli from the European Policy Centre "Any form of fiscal union must accomplish, regardless of its institutional shape, two basic functions: preventing the emergence of endogenous asymmetric crises, and correcting acute economic and fiscal crises".

Solutions for the Eurozone

Eurobonds: a possible solution
Creation of Eurobonds: lower risk (higher credibility due to common debt guarantee)
• By issuing Eurobonds, the participating countries become jointly liable for the debt they've issued together
• This should convince the markets that member countries are serious about the future of the Euro.
• Debt will now be issued in currency over which the ECB has control, thereby protecting countries from the destabilising effects of liquidity crises.
• By allowing countries to issue senior debt up to 60% of GDP as relatively secure Eurobonds and any excess as higher-risk credit in the domestic market, the average cost of debt would be low, while the marginal cost of debt would be high for countries which have reached the 60% threshold. This encourages more prudential fiscal policies for these countries.

Suggested European bonds issued in euros by the 18 EZ nations by EC on 21 November 2011 - Way to tackle the European sovereign debt crisis: The indebted states can borrow new funds at better conditions, as they are supported by the credibility of the non-crisis states . Setting a euro-area wide integrated bond market would offer a safe and liquid investment opportunity for savers and financial institutions that matches its US$ counterpart in terms of size and liquidity, which would also strengthen the position of the euro as an international reserve currency and foster a more balanced global financial system
- Immediate effect even if introduction takes some time, since changed market expectations adapt instantly, resulting in lower average and marginal funding costs, particularly to those EU member states most hit by the financial crisis
- Eurozone financial system more resilient to future adverse shocks and reinforce financial stability
- Reduce vulnerability of banks in the eurozone to deteriorating credit ratings of individual member states by providing them with a source of more robust collateral
Potential Problem: Illegal -
- Legal and political reasons: Article 125 of the Lisbon Treaty states explicitly that the European Union and its member states are not liable for the commitments of other members.

Better regulation of the private sector: a possible solution
De Grauwe argues that the sovereign debt crisis has little to do with the poor performance of the SGP. The root cause of the debt problems in the EZ can be found in the unsustainable debt accumulation of the private sectors. The only sector that did not experience a rise in its debt level (%GDP) was the public sector. There were two reasons to explain the boom in govt debt.
1) Governments took over private debt (mostly bank debt).
2) Automatic stabilizers set in motion by the recession-induced decline in government revenues.

Further fiscal integration – European Fiscal Compact in 2012

What is a fiscal Union?
Involves the integration of fiscal policy between nations i.e. the members of the eurozone
The decisions regarding government expenditure and taxation are taken collectively by the participating institutions
The proceeds of government expenditure and taxation revenues are then shared between the governments of the participating states

Fiscal Union is the integration of the fiscal policy of nations or states; collection and expenditure of taxes are taken by the common institutions, and shared by the participating governments.
An intergovernmental covenant on the Stability and Growth Pact was considered to be sufficient, until the recent crisis have highlighted the structural and the deficiencies of the euro achitecture.
It is often proposed that the EU should adopt a form of fiscal union, but most decisions about taxes and spending remain at the national level.

A fiscal union merges the national financial authorities and fiscal policies into one: it amalgamates the government spending and revenues (taxes)

According to the latest paper published by the IMF survey the following elements are essential for functioning of a fiscal union:
• Better oversight of national policies and enforcement of rules: With more emphasis on structural fiscal targets and ongoing reforms to the governance framework, the design of fiscal policy has improved.
• Increasing risk sharing: Ex ante risk sharing reduces the need for costly support afterwards. So, provided there is better disciplining of national fiscal policies, all euro area countries would benefit from cross-country fiscal insurance mechanisms. There are a number of options available, including setting up a euro area-wide rainy day fund, a common unemployment insurance scheme, or a budget for the euro area.

Arguments For Fiscal Union:

+ *Incompatibility between supranational monetary policies and national fiscal policies.*
NO European Monetary Union WITHOUT European Fiscal Union
For three years, the debt crisis has provided daily evidence that monetary union cannot work without fiscal union. The euro-zone is clearly unable to manage its macro-economic imbalances without some sort of federal structure to oversee revenue collection and expenditure. Without it, the euro will always be vulnerable to *asymmetric shocks*. Combining supranational monetary policies with national fiscal policies is unsustainable. A fiscal union run by a fully empowered EU Finance Ministry under proper democratic oversight will give the Union strength and stability, *mutualizing credit risk* while imposing tough fiscal discipline.

+ *Raise Europe's market credibility and eurobonds would rival US treasuries*
Unity raises credibility
Unless a strong fiscal element is adopted, predatory markets will be able to pick off the weakest members of the euro herd. Fiscal union would *raise Europe's market credibility* and *eurobonds would rival US treasuries.*
US vs EU : The US federal budget is an important instrument of regional distribution: when the income of a US state declines, the federal budget redistributed back 25%. No similar inter-country risk sharing mechanism in the Eurozone.

+ *A major step towards a true political union due to the need for stronger democratic oversight*
Step towards political union?
Fiscal union would be a major step towards a true *political union*. It would have to be administered by real federal bodies. Central tax resources and mutualized debt would become powerful symbols of a united Europe. The need for strong democratic oversight will spur the creation of a revitalized European Parliament and directly elected Commission.

+ *Contribute to an orderly, stable and satisfactory arrangement of the union's finance, and prevent reckless inflate property bubbles done by the Spaniards or Greeks*
Efficiency through joined up management
A European fiscal union, with proper institutions would be able to provide joined-up management of the EU economy as a whole. Ex-ante control would mean that wayward Irish, Spaniards or Greeks would not be able to recklessly inflate property bubbles or cook their budget books. The trust that responsible EU-wide economic management would engender will *assure markets, draw investment and boost growth*, creating a Europe thats more fair, stable and prosperous.

+ *Euro will be less vulnerable to asymmetric shocks*
Only in the case of temporary asymmetries are fiscal transfers optimal.
• Argument that the current asymmetries reflect underlying, permanent economic differences
• In this case, it is more important that wage markets and prices adjust to bring back stability If this flexibility is not established, fiscal transfers can actually prevent the adjustment mechanism
• Countries facing negative shocks would receive transfers which slowly become permanent, keeping real wages in the depressed area too high and preventing required labour movements
• This can create political tensions leading to the collapse of the EZ

http://www.voxeu.org/article/spillovers-why-macro-fiscal-policy-should-be-coordinated-economic-unions
Carlino and Inman (2013, Vox)
Overcome coordination problems (prisoner's dilemma) of fiscal stabilisation policy
Which level of government manages macroeconomic stabilisation?
EU evidence finding on the significant positive spillovers from expansionary fiscal policies by economic neighbours raises the important institutional question of which level of government should manage fiscal policy for macroeconomic stabilisation. When there are important spillovers, the incentive for each lower-tier government in an economic union is to let its important trading partners adopt, and pay for, expansionary deficits. Though larger economies may find it beneficial to run their own fiscal stabilisation policies, they will ignore the job and income benefits those programmes create for their economic neighbours. *Thus too little stimulus will be provided relative to a best union-wide policy*. Germany rightly asks: why should we pay for fiscal deficits beyond what is best for Germany? If all states, provinces, or Eurozone countries think this way, there will be too little use of beneficial stabilisation policies.

What is needed, then, are *coordinated fiscal stabilisation policies decided by an overarching central government*. In the case of a full fiscal and political union such as the US this would be central government deficit financing of temporary tax cuts, increased transfer payments, expanded unemployment insurance, and perhaps added infrastructure spending. In the case of Europe, the best strategy may be to move more slowly, one well-defined program at a time, towards fiscal union. One possibility might be a Eurozone-wide unemployment-insurance trust fund specified by the European Parliament and the Council of Finance Ministers and supervised by the European Commission.

Fiscal Backstop
A fiscal backstop for euro area banks: Current steps to establish a Single Supervisory Mechanism and a Single Resolution Mechanism should be complemented by a firm and early commitment to establish an adequate backstop to anchor confidence in the banking system. While some of the insurance against banking accidents should be funded by the industry, a common backstop for the recapitalization, resolution, and deposit insurance would contribute to reducing the risk of

Borrowing at the centre
In the long term, when the appropriate governance structures are in place, borrowing by the center—backed by its own revenues—could help finance risk-sharing vehicles, and reduce the potential for large portfolio shifts between sovereigns by providing a safe asset.

Fiscal Policy:
If the centralised budget was more responsible than the collective of National governments, the centralised government would have more flexibility in its use of fiscal policy.

Benefits of Fiscal Union is greater than the cost - The benefits (political union, buffer to asymmetric shocks, a credible market would revive confidence and attract investment) are long term

High debt to GDP ratios in individual nations force national governments to run large budget surpluses to stabilise their debt.
• When a recession hits, national governments are restricted in their ability to use fiscal policy as a kickstarter
• A fiscal union, assuming it is more responsible, may not suffer from this issue
Having a centralised budget deficit also avoids the negative spillover effects associated with individual countries running excessive debt:GDP ratios.These spillovers include:
1) higher interest rates for the union interest rate as a whole (assuming one exists)
2) a higher union interest rate may cause countries to put pressure on the ECB to relax its monetary policy stance, thereby interfering with the conduct of monetary policy.
• If capital markets are integrated there is less need for capital market integration

-Arguments in favour of closer fiscal integration within the EU and EMU: pooling resources to carry out common policies and provide supranational public goods as suggested by the theory of fiscal federalism. (http://www.worldcommercereview.com/publications/article_pdf/746)

- The cost problem could be solved: Bad performing countries could take advice from other countries; let the public understand the benefit of fiscal union and what they have to sacrifice for that; introduce credible punishment terms in the agreement for loose spenders

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Arguments Against Fiscal Union:

Locality of national issues - *Local Problems need local solutions*
As long as the European Union is made up of independent nations with their own elected governments, their problems are going to be essentially local and they will need local solutions. Squeezing them into the same monetary straightjacket has clearly failed and adding a fiscal union would just exacerbate an already unsustainable situation. Governments need flexibility to deal with their own problems. Fiscal union would entail a ballooning of the EU budget – provoking endless bickering among the 27 (or more) member states on how to share it out, not to mention the expanded scope for graft and bureaucratic inefficiency. It's a recipe for gridlock.
- Independent nations need local solutions

DEMOCRATIC DEFICIT
Fiscal union is another nail in the coffin of national independence. Setting budgets is a core responsibility of sovereign parliaments. Transferring that power to some distance, opaque Brussels institution would be deeply undemocratic. History tells us citizens will not accept taxation without representation. An unpopular fiscal union would hand piles of ammunition to anti-European political demagogues, undermining the foundations of the Union.
2) Budget control is a central role of national parliaments so having policy set by a centralized institution will be *undemocratic*.
• In the past, individuals have found it hard to accept taxation without a representative body. The discontent of citizens over the fiscal union may *undermine its stability.*
- Transferring power of budget setting to a central institution would be deeply undemocratic

WE'LL ALL PAY MORE
The tax harmonization that will follow fiscal union will only move in one direction: up. We'll all end up paying more. Countries like Ireland or Slovakia that boosted their economies with innovative revenue policies will be forced to apply job-destroying high taxes as part of a French-led crusade against "fiscal dumping." Another blow to Europe's competitiveness.

Conflict and coordination between EU members could be drastically undermined owing to arguments over the sharing of taxation revenues.
• The result may be an increase in bureaucratic inefficiency
• Greece or France or Spain wouldn't accept the shift of economic, political and military power to Germany that this would entail
A fiscal union would require a homogenization of tax systems and government spending rules . Given each country's separate rules, a standardization of tax and budgetary rules would entail complex processes and might be ineffecFve • This may lead to over-complicated systems and red tape

Increased likelihood of *moral hazard* because countries who spend heavily will be provided with a safety net by respectable nations such as Germany.
Encourages moral hazard; loose spenders will be given an everlasting bailout by virtuous nations, led by Germany
Loose spenders will be given an everlasting bailout fed by virtuous nations, led by Germany. By necessity the fiscal union will become a transfer union that punishes budgetary righteousness. The safety net for sinners will lessen their incentive to tighten belts and push through reforms their economies need. Keeping high-debt countries afloat artificially will eventually drag everybody down.

This reduces the incentives for these heavy spenders to tighten budgets and implement the reforms their economies actually need .
Fiscal union implies better performing countries transferring funds to the worse-performing ones . Bailouts, overspending and free-riding would become serious issues, if the rules are not set up properly. Reckless behaviour of some countries would have stronger impact on others, due to transfer of losses into the common budget.

Forgone flexibility of national governments in setting tailored fiscal policies to rectify nation-specific problems.
• As a result, certain nations will be left to deal with policies that completely defy their requirements

-Fiscal discipline is critically important within federations and closely integrated economic blocks, due to intensive cross- border spillovers, more opportunity to free ride at the cost of neighbours, and moral hazard problem (expectation of bailout).

The EU has limited fiscal powers at the current state:
- A role in deciding the level of VAT and tariffs on external trade
- Stability and Growth Pact intended to coordinate the fiscal policies of member states (member states report their economic plans to the European Commission and explain how they are to achieve medium-term budgetary objectives.) But under the SGP, no countries have ever been fined for not meeting the objectives. So, it brings to the discussion of a powerful fiscal influence among member states.

Is this a prelude to political integration?
Fiscal union is seen as a requirement of a full economic and monetary union and as a result, countries have to accept political integration.
A political union requires acting together in the decision making process, creating common legal rules and regulations and also transferring part of the sovereignties to the supranational authorities and finally implementing coordinating fiscal policies.
A political union is necessary to embed the monetary union and make it sustainable in the long run, this is because:
1. possible to organise fiscal transfers that provide some insurance against asymmetric shocks. This increases the sense of belonging to the union and enhances its social and political base.
2. reduces the risk of asymmetric shocks that have a political origin; spending and taxation policies, wage and social policies (seen with Germany's wage policies at the moment).
3. makes it possible to have a fiscal policy at the level of the union that can complement and back up monetary policy.
At the moment, the transfer of sovereignty between national governments and the EU government is highly unequal across sectors: authority regarding agriculture, trade and competition has been largely given over to the European government, while in spending, social policies and wage policies there has been very little.

Political union would support the monetary (and fiscal) union in several ways:
1. Provision of insurance against asymmetric shocks:
• Makes it possible to centralise a large part of national budgets at the level of the union and then organise systems of automatic fiscal transfers in response to shocks.
2. Increased stability:
• The consolidation of national government debts into a jointly issued union debt would reduce fragility of the union, allowing it to better withstand movements of distrust afflicting national governments that cannot issue their own money.
3. Reduces the risk of asymmetric shock that have a political origin.

Dani Rodrick's trilemma of the world economy shows that democracy, national sovereignty and deeper economic integration are mutually incompatible because deeper economic integration eventually requires the removal of barriers created and preserved by nation states. Eurozone citizens therefore will eventually need to choose two of these three objectives. If they want to preserve the nation state and democratic politics they will have to accept less integration. But, if they want deeper economic, financial, and monetary integration they will have to surrender some national sovereignty.

ECB as a lender of last resort?

Arguments for the ECB stepping in as lender of last resort:
Once a country is illiquid, it loses its market credibility and it takes time for it to restore this (usually a year or so). Therefore, the ECB must act as a lender of last resort to buy sovereign debt while credibility is not yet restored in order to prevent a liquidity crisis from turning into a solvency crisis.
Having the ECB as a lender of last resort could drive down bond yields by providing credibility to the market.
Wren-Lewis argues that market reaction was always more to do with the ECB than the fiscal position of the countries involved. Moral hazard can be overcome by stricter regulation at the debt issuance stage, just as is seen at in the banking sector.
EFSM and ESM have been poor surrogate lenders of last resort → they will never have the necessary credibility to fully stop contagion as they cannot guarantee cash: even doubling the institutions' present resources 400bn Euros would not have this effect.
Wren-Lewis argues that market reaction was always more to do with the ECB than the fiscal position of the countries involved.

Arguments against the ECB stepping in as lender of last resort:
Could encourage moral hazard issues: but just like the banking sector, this should be overcome by effective supervision at the on the risks taken by governments.
Really the role of lender of last resort should be used when governments are illiquid, not when they are insolvent → in reality, it is difficult to distinguish between the given the causality.
If it was easy to differentiate between solvency and liquidity crises, the market would easily do so and there would be no role for the ECB: means ECB will end up supporting insolvent governments → moral hazard risks.

Can a monetary union exist without a fiscal union?
MAYBE:
http://eprints.lse.ac.uk/50178/1/blogs.lse.ac.uk-The_Eurozone_crisis_does_not_necessarily_prove_that_a_monetary_union_also_requires_fiscalpolitical_un.pdf
Wren Lewis argues that we should not draw conclusions on this question based solely on the example of the Eurozone. It has not been a fair test of a monetary union without a fiscal union because...
• There was the mistaken belief that default risk in all countries was the same as Germany
• only in Greece was there really any underlying fiscal excess
• The union should have allowed Greece to default early on, rather than avoid the situation through replacing private debt with intergovernmental lending
• ECB refusal to act as a lender of last resort

http://whynationsfail.com/blog/2012/9/20/is-europe-saved.html
MAYBE NOT:
We think not. The problems underlying the European crisis were institutional. What we are seeing now are mostly short-term fixes, not true solutions to these institutional problems.

The roots of the crisis lie in the difficulty of operating a currency union without centralized fiscal authority.
Europe's underlying problems cannot be tackled by short-term fixes. For the euro to survive and contribute to European economic prosperity in the medium term, Europe needs to follow the example of the United States as it transitioned from the Articles of Confederation of 1781 to the U.S. Constitution, which entailed strengthening the currency union with debt renegotiation (with the federal government assuming state liabilities) and more importantly, meaningful fiscal centralization.

And yet, there is no realistic plan for true fiscal centralization in Europe. Fiscal centralization doesn't just mean better monitoring Greece's austerity plans. It means a European organization with the power to set taxes and harmonize labor, product and credit market institutions. But this is not possible without some centralization of political and military power. It was crucial that with the U.S. Constitution, political and military power shifted to the federal government.

http://www.wsj.com/articles/bank-of-england-chief-urges-eurozone-fiscal-union-1422471240

Monetary union without fiscal union is unsustainable in the long run.
Theory of optimal currency areas:

A monetary union in Europe should be accompanied by some centralisation of national budgets. This would allow for automatic transfers to regions and countries hit by negative shocks.It makes it possible to consolidate part of national government debts and reduces the fragility of monetary union.

Without a fiscal union, monetary union will remain ineffective. Monetary union alone restricts fiscal possibilities, creating uncertainty and asymmetry =>national policies affect the EU through monetary effects, but there are no fiscal means to counter them.

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http://ec.europa.eu/economy_finance/publications/publication12121_en.pdf
The most obvious cost of federalism is the loss of autonomy by the central government. In fact, the advantages of decentralization require that the central government's authority be limited. As a result, in highly decentralized fiscal federations, central governments might find it difficult to implement coordinated policies and provide federation wide collective goods.

The interplay between several fiscal and one monetary authority can lead to free riding. Each individual fiscal authority sees itself as a small player who has little impact on monetary policy. In equilibrium each country free rides and the outcome is worse than in a cooperative equilibrium. An extensive literature has analyzed the existence of independent fiscal authorities with a single central bank (Dixit and Lambertini 2001, Chari and Kehoe 2004, Uhlig 2002). In line with the proposition by Rodden (2004 and 2006), these studies point out that a setup of a single monetary authority and numerous fiscal authorities requires effective fiscal policy constraints to avoid excessive deficits at the sub-central level.

Shocks/ OCA:
The original OCA approach weighed the benefits of adopting a single currency against the costs of abandoning independent monetary policy. The benefits of adopting a single currency and a single monetary policy are the reduction of transactions costs of using multiple currencies. These benefits would be greater the more open and the more extensive the trade connections are for the economies involved. *The costs occur in the face of shocks which hit the members asymmetrically. Adjustment to such shocks can be facilitated by flexible wages and prices and by labor mobility.*

Moral Hazard;
A formalized system of fiscal federalism would however not necessarily deal with the problems of fiscal indiscipline on the part of member states. Indeed, the expectation of institutionalized transfers or bailouts following fiscal problems might well be expected to increase the incentives for bad behavior. Stricter observance of the existing system and its rules, on the other hand, might lead to pressure to reform. Fiscal reforms would in the longer run be expected to raise the rate of growth.

At the core of euro-area vulnerability is an impossible trinity of strict no-monetary financing, bank-sovereign interdependence and no co-responsibility for publicdebt. – a broader European Central Bank (ECB) mandate – the building of a banking federation – fiscal union with common bonds .