

**Monetary and fiscal union**  
**- Lessons from the euro area -**  
**Guntram B. Wolff**  
**Bruegel**

- Good fiscal surveillance is necessary for a monetary union
- However, while necessary, it is not sufficient

This presentation:

- Big picture
- Focus on failures of the set-up in the euro area
- Highlight that financial fragility is a major concern
- Highlight that monetary policy is strongly linked with fiscal policy
- Highlight challenges on the way forward for the euro area

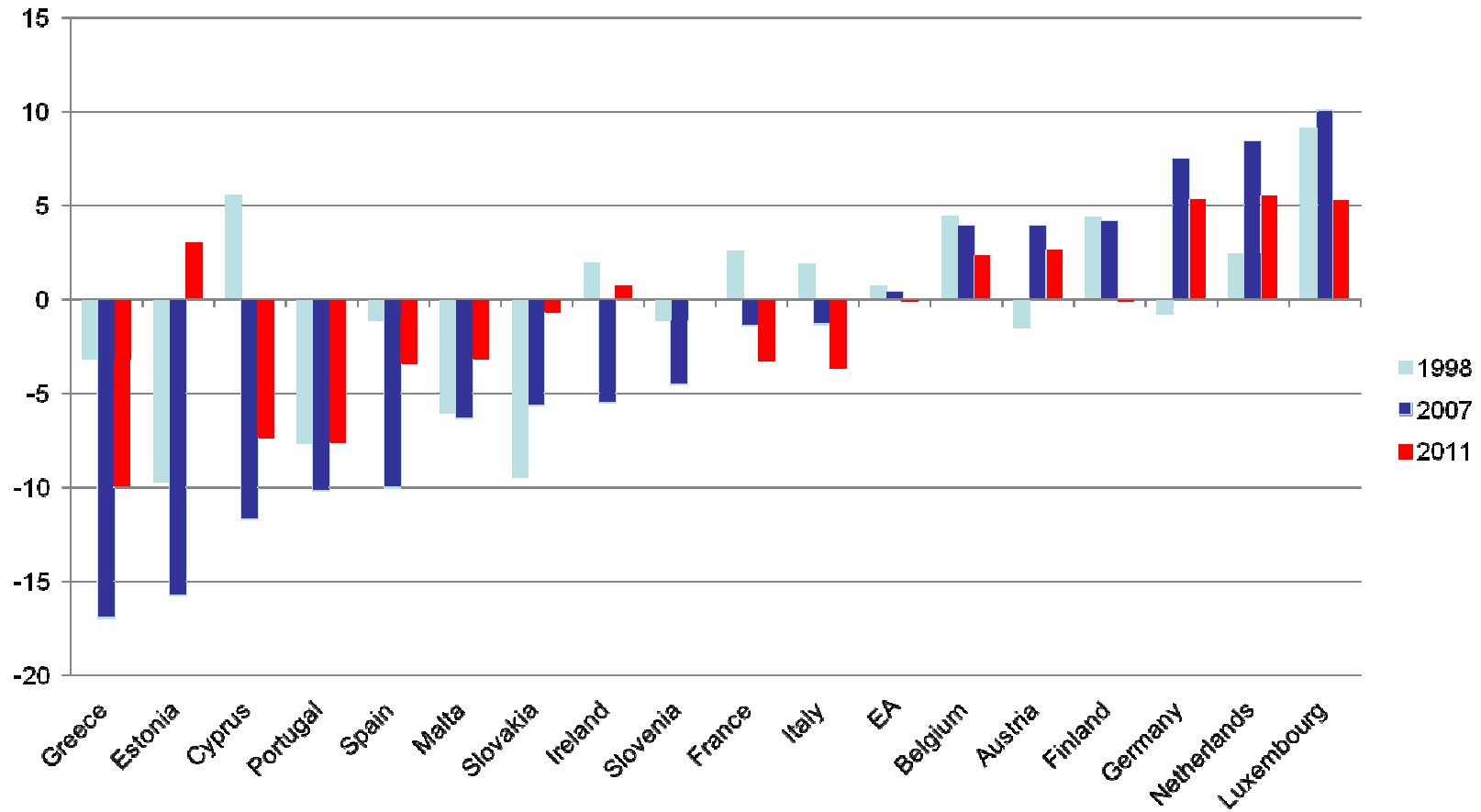
Next presentations

- Focus on SGP and national fiscal frameworks
- Focus on fiscal reporting underpinning the surveillance framework

## Introduction

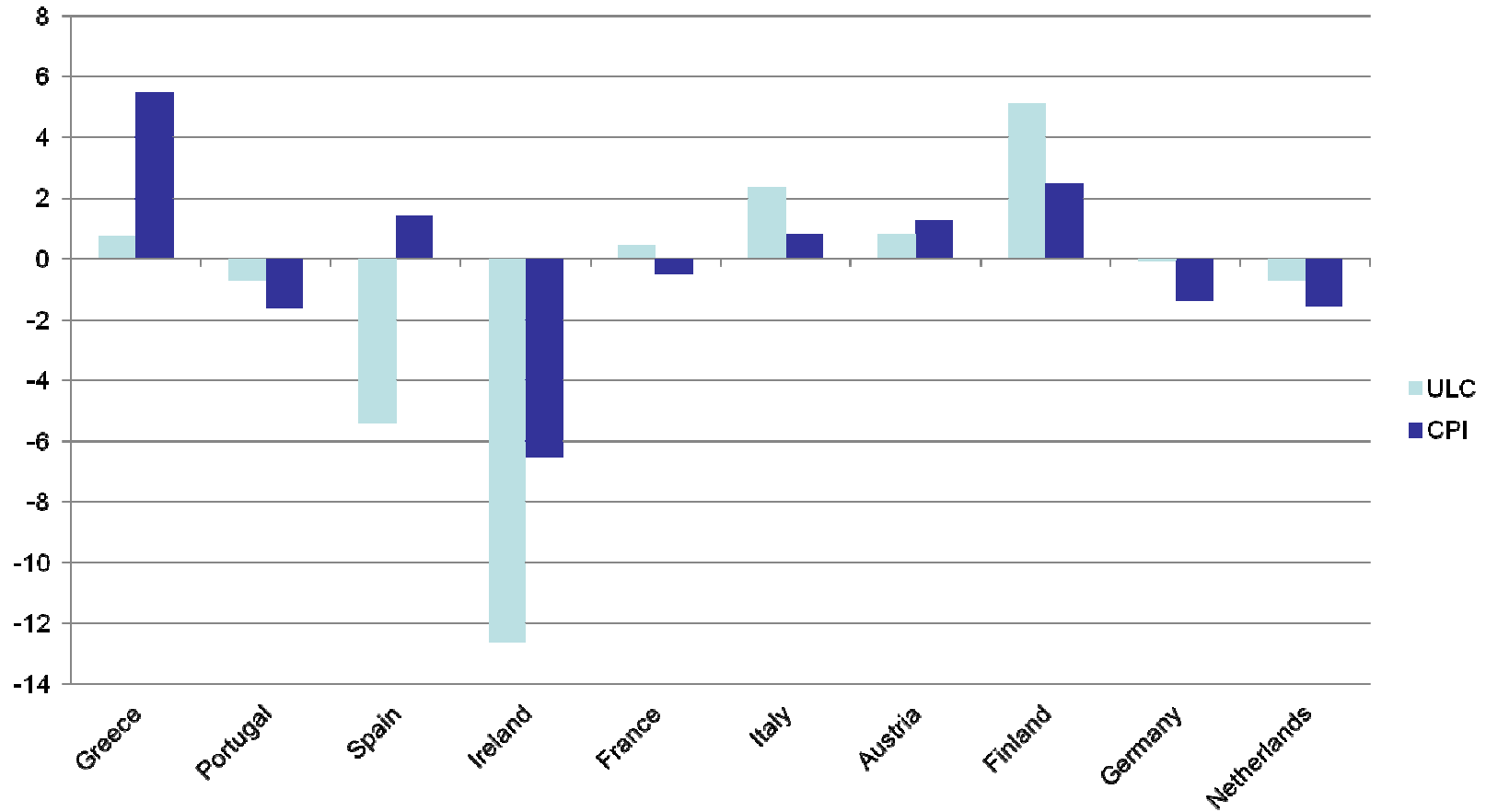
- Euro break-up is now openly discussed
- Maastricht set-up
  - SGP
  - Inflation targeting ECB
  - No bail-out clause
- Crisis has revealed the shortcomings of this approach
  - Insufficient surveillance and control of fiscal behavior (next presentations)
  - Private sector imbalances were largely ignored
  - Absence of crisis management and resolution mechanism
  - Insufficient banking supervision and resolution mechanism
- Self fulfilling crisis
  - Higher interest rate renders insolvency more likely
- Combination of banking fragility and self-fulfilling sovereign crisis is a deadly combination

# Real economic divergence

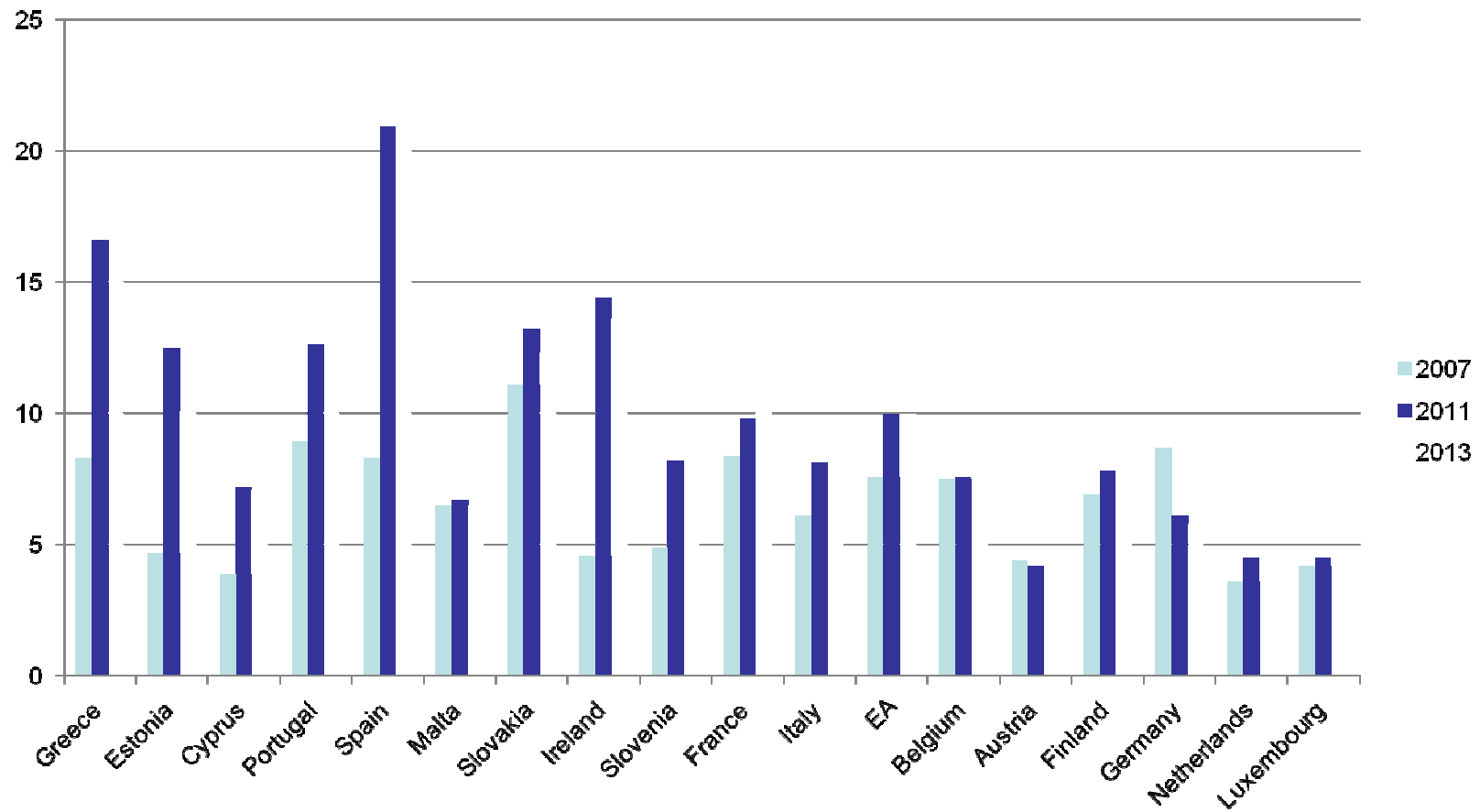


Current account in % of GDP

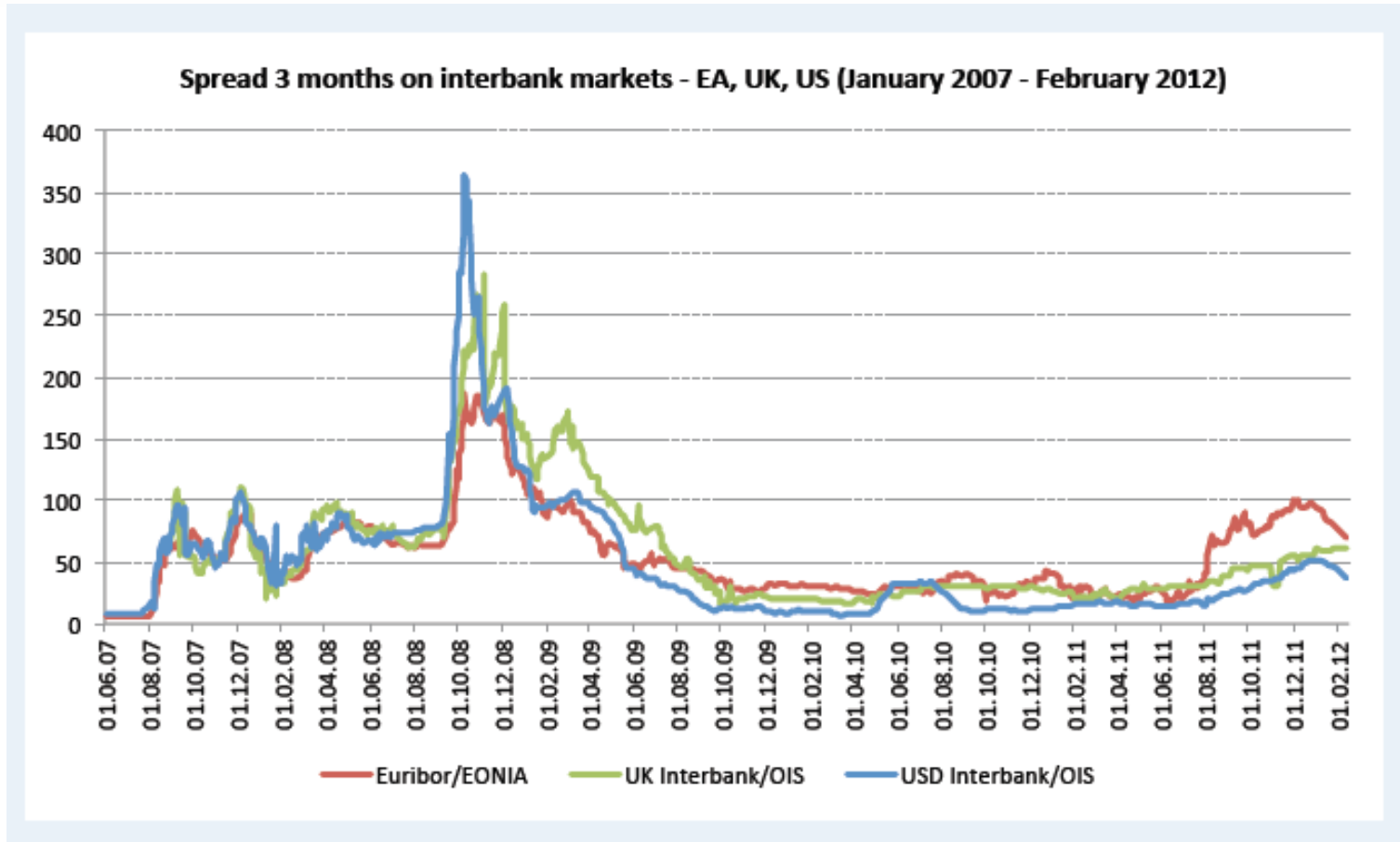
# The growth and adjustment agenda: price adjustment weak...



## ... and unemployment on the rise

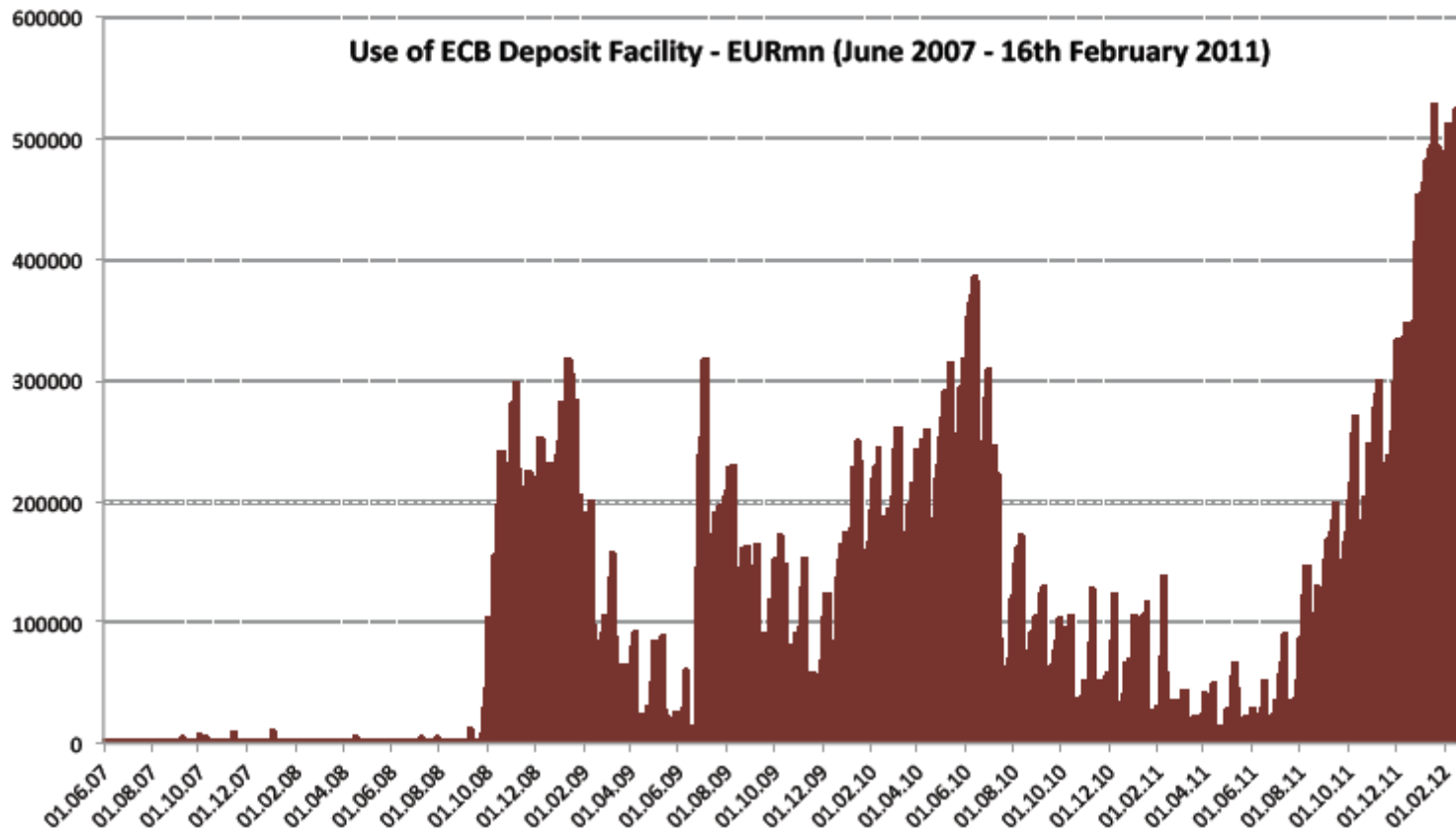


# Stress in interbank market reduced....



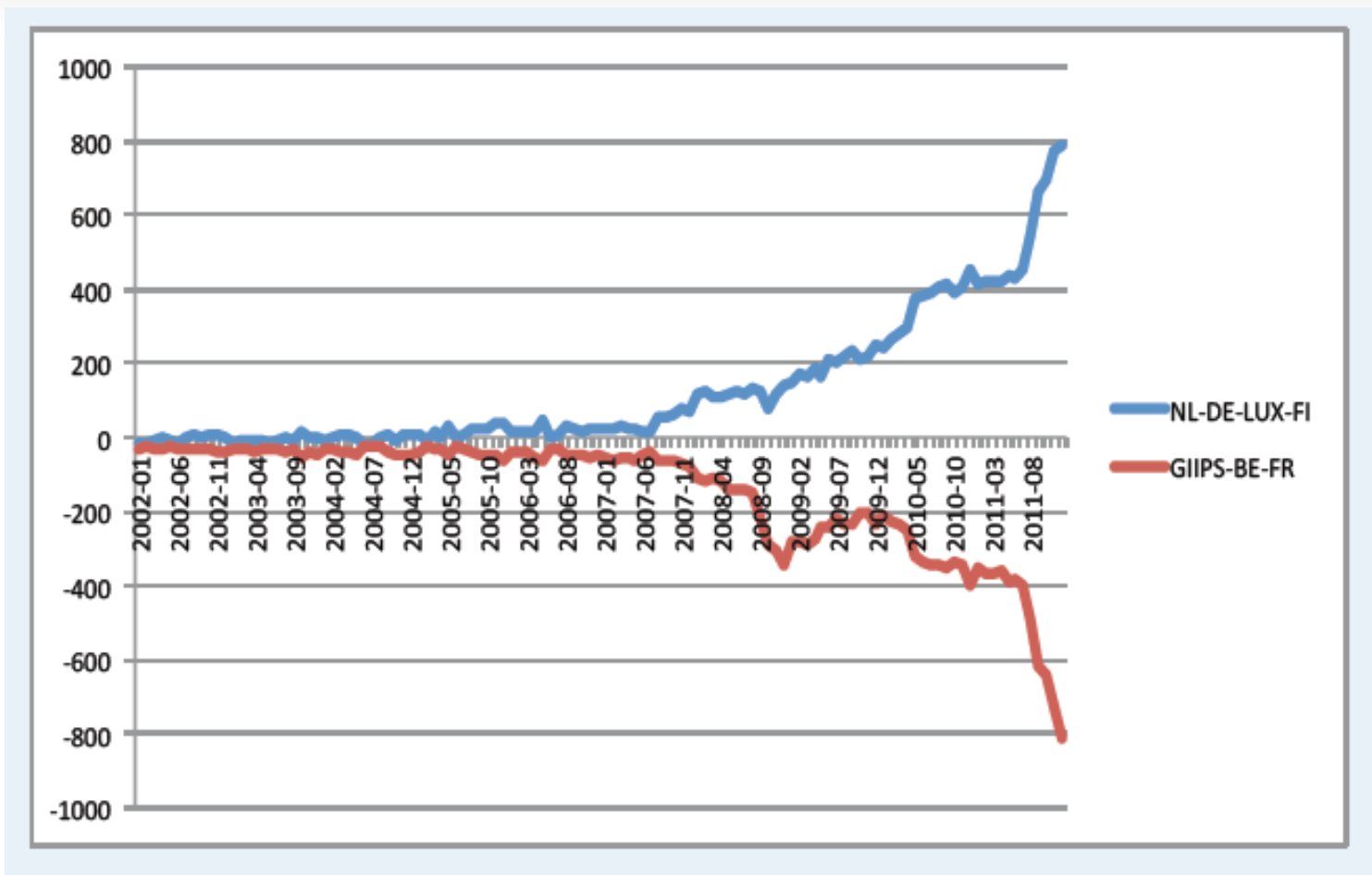
...but ECB has become intermediary

ECB use of Deposit Facility as of 16<sup>th</sup> February 2012 – all-time high





## Target 2 balances diverge --€bn



## Monetary and fiscal policy

- In response to confidence crisis following real economic divergence and weak policy response, monetary policy stepped into the void and prevented a financial catastrophe.
- This has led to very high risk exposure within the eurosystem, i.e. between national central banks
- Losses/gains for national central banks mean losses/gains for national treasuries.
- Risk in monetary policy thus translates into fiscal risk
- Burden sharing arrangements are key

## Current crisis response insufficient

- **Six-pack**
  - Right extension of supervision to non-fiscal part
  - National fiscal rules directive important
  - No true veto rights to effectively prevent moral hazard
- **EFSF/ESM**
  - Difficulty to access finance
  - Trajectory of instability as it depends on AAA rating countries
  - Overall size too small to credibly quell speculation
- **EBA**
  - Not a true European supervisor
  - Dexia test
- No credible way to break the vicious circle between banking and sovereign instability
- Fundamental reason: lack of fiscal capacity at EA level

## The Greek deal

- Chaotic default and/or exit scenario has been prevented
- Once deal is finalized, Greece should stop being a source of financial instability
- Debt sustainability still not given in the case of minor shocks
- I expect that further debt write-downs will become necessary, this will involve the official sector (OSI)

## What is needed?

- A growth and adjustment agenda
  - A framework for dealing sustainably with banking fragility
  - A stronger framework to provide assistance to countries if needed in combination with possibility to intervene in policy making
- A strong euro area finance ministry with democratic legitimacy

## What kind of fiscal union?

- Functions to be exercised at federal level
  - Insolvency vs illiquidity
  - Lender of last resort function: ECB vs Finance ministry
  - What kind of assistance: flow vs stocks
  - Budget veto right
  - EDIC
  - EU vs EA
- Financing
- Legitimacy
- Transition

## Conclusions

- Not all problems are fiscal
- Real economic divergence driven by the private actors in economy equally worrisome
- Banking sector instability and financial fragility highly dangerous
- Monetary policy is a part of fiscal policy and has strong fiscal implications.
- Best way to address these issues is with a strong federal fiscal institution
- Ideally, create political/fiscal union alongside monetary union