EUROPEAN CENTRAL BANK

EUROSYSTEM

Discussion of "*Central Fiscal Capacity in the EU Policy Mix*"

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Astrid Seminar

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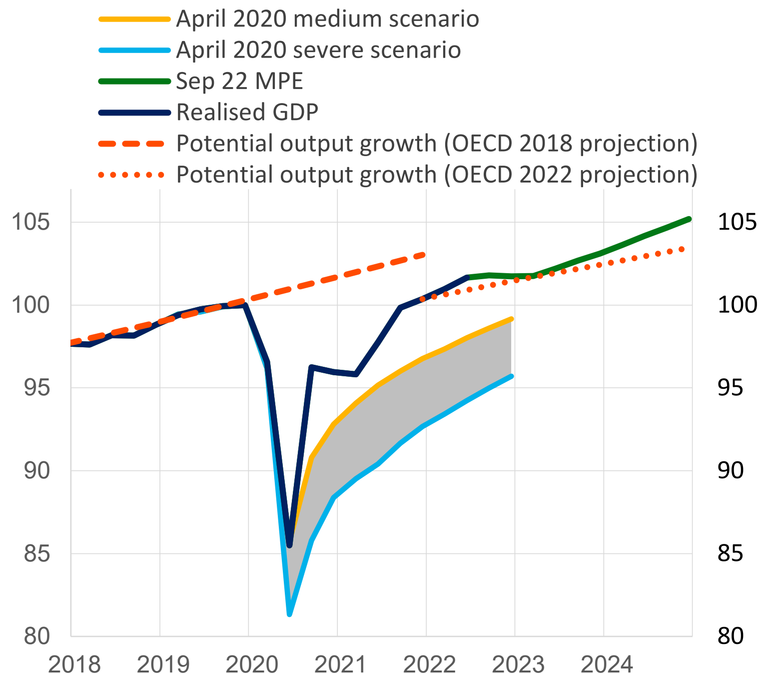
The views expressed are those of the speaker, and do not necessarily represent the views of the ECB's Executive Board or Governing Council

A central fiscal capacity?

GDP over the pandemic: Projections and actual evolution

(index, 2019 Q4 = 100)



Sources: Bloomberg, OECD, ECB calculations and ECB Economic Bulletin, Issue 3/2020.
Notes: "Potential output growth" applies annual potential growth rates to observed previous year-end real GDP values, using the OECD's May 2018 and June 2022 Economic Outlook, respectively; values beyond the OECD EO projection horizon are extrapolated using the last projection value.

Central fiscal capacity improves policy efficiency

- **Macroeconomic stabilization** in the face of demand shocks
- Promotion of **national reforms**
- **Provision of common public goods**

Provision of EU public goods wins the contest

- Demand stabilization is subject to **moral hazard**
- **'Contractual arrangements'** – financial transfers in exchange for commitment to national structural reform – risk being disavowed by the citizenry as undue external interference
- **Joint investment** in health (vaccines), energy transition (hydrogen, integration of power, heat and gas national networks), telecommunication, digital transition, security and defence and infrastructure to protect strategic autonomy have **economies of scale / positive externalities, and are areas where European preferences converge**

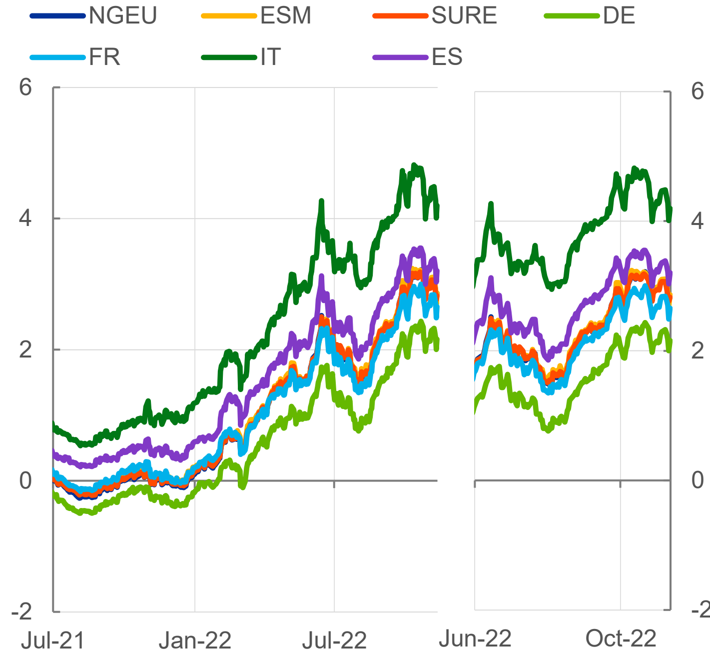
Fiscal boost to economic potential lightens the central bank's burden of inflation control

- Difficult to be too cheerful about the **speed limits of the euro area economy** even post NG-EU

Analysis is rigorous and convincing

What about the funding side?

10 year sovereign and supranational yields
(percent per annum)



Sources: Bloomberg, Refinitiv and ECB calculations.
Notes: NGEU, SURE, and ESM bond yields refer to fitted yields from a Nelson-Siegel-Svensson model, while country yields refer to outstanding benchmark bonds.
Latest observation: 11 November 2022.

One noteworthy aspect of the picture

- **Markets do not discriminate between ESM bonds** – which enjoy extensive cash credit enhancement – **and EU bonds** – not protected by either mutual guarantees or a cash buffer
- **The EU enforcement capacity** – to extract servicing payments from each country in all states of the world – **is entirely fiduciary**

Paradox

- **The same stream of tax revenue generated, say, in Italy is valued BBB** when it's funnelled to service the Italian debt, **but is considered AAA** when is preferentially diverted from Italy to the EU and used to service EU debt instead

There seems to be an untapped potential for the EU to intermediate issuance, *e.g.* for funding common public goods

A EU scheme for funding public goods in exchange for a stream of country revenues

Standard debt accumulation equation

$$t^{EU} = (d^{Tot} - d^{Nat})\left(\frac{r^{EU} - g^*}{1 + g^*}\right)$$

- **Imagine the EU (or a new EU Agency) assumes** liabilities to fund national public goods worth a share $d^{Tot} - d^{Nat}$ of a country's GDP
- **… In exchange for a stream of revenues t^{EU} to be collected indefinitely in the country** to service the new EU debt
- r^{EU} is the real rate at which EU can issue debt
- g^* is the internal real capitalisation rate adopted in the scheme

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Participation-incentive constraint

$$t^{EU} + t^{Nat} \leq t$$

$$t^{EU} + (d^{Nat})\left(\frac{r^{Nat} - g^{Pot}}{1 + g^{Pot}}\right) \leq (d^{Tot})\left(\frac{r^{Nat} - g^{Pot}}{1 + g^{Pot}}\right)$$

- **For a country to have an incentive to participate**, the revenue transfer to the EU – to support the EU's $d^{Tot} - d^{Nat}$ debt assumption – plus the primary surplus to fund its residual debt d^{Nat} have to be no larger than the primary surplus necessary to fund its total debt d^{Tot} in the absence of the scheme

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Or, equivalently

$$r^{EU} - r^{Nat} \leq g^* - g^{Pot}$$

- Countries that borrow at a positive spread vis-à-vis EU (say, Italy) will likely participate even if $g^* < g^{Pot}$
- Countries that borrow at lower rates (say, Germany) need to be offered an internal rate of capitalization $g^* > g^{Pot}$

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My conclusions

Read the paper! It will be influential

- **Supply of common public goods is the right mission for an (embryo of) a EU joint "fiscal capacity"**
- **It can align preferences across EU Members, North and South**
- **If well-designed, it can complement and facilitate the task of the ECB**
- ***One can conceive of funding schemes that divide payoffs among countries to ensure participation:***
  - ***High-rate countries have to forgo part of the benefit*** *of borrowing at the EU rate – by increasing their initial contributions into the scheme …*
  - *… So that* ***low-rate countries can join the scheme at a high internal capitalization rate*** *– and pay low initial contributions*

Thank you

EU vs ESM issuance

Next-Generation EU

"*[T]o back the borrowing, retain its high credit rating and raise funds under favourable market conditions, the EU will use the EU budget and its headroom. Headroom is the difference between the Own Resources ceiling of the long-term budget and the actual spending. To ensure sufficient headroom, the EU is increasing the Own Resources ceiling of its budget by 0.6 percentage points of the EU's Gross National Income (GNI). The Own Resources ceiling determines the maximum amount of own resources the Commission can call from Member States in any give year to finance expenditure. … The permanent Own Resources ceiling of the budget is currently being increased to 1.4% of the EU's GNI. The additional ceiling of 0.6 percentage points will come on top. … The headroom will serve as a guarantee that the EU will be able to make repayments under any circumstances. This will enable the EU to continue benefitting from its high credit rating and borrow funds under advantageous market conditions*." (**Next-Generation-EU prospectus**)

ESM

"The Managing Director shall implement a prudent investment policy for the ESM, so as to ensure its highest creditworthiness, in accordance with guidelines to be adopted and reviewed regularly by the Board of Directors." **(ESM Treaty Art. 22(1))**

"Losses arising in the ESM operations shall be charged: (a) firstly, against the reserve fund; (b) secondly, against the paid-in capital; (c) and lastly, against an appropriate amount of the authorised unpaid capital […]." **(ESM Treaty Art. 25(1))**

"*All Members, including all the programme countries, paid us capital, so we have it in hand. It doesn't matter whether the countries that gave it to us are downgraded or not […]. We have the paid-in capital, and there's also €620 billion in callable capital. Of course, for the callable capital, rating agencies take into account that some of those who would be called upon might not be able to provide the money in a crisis, but €80 billion [paid-in capital] is still a big buffer before one gets to that stage.*" **(Klaus Regling)**