ATHENS UNIVERSITY OF ECONOMICS AND BUSINESS

WORKING PAPER SERIES 20-2013

Strengthening the Economic Governance of the Euro Area

Nicholas C. Baltas

76 Patission Str., Athens 104 34, Greece

Tel. (++30) 210-8203911 - Fax: (++30) 210-8203301

www.econ.aueb.gr

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Nikolaos Baltas

Jean Monnet Chair

Athens University of Economics and Business

1. Introduction

The sovereign debt crisis in the euro area during the spring of 2010 has revealed that the monetary and fiscal policy framework of the European Monetary Union (EMU) is still incomplete. Obviously, the rules-based framework for fiscal policy created by the Excessive Deficit Procedure (EDP) and the Stability and Growth Pact (SGP) was insufficient to prevent a debt crisis despite its emphasis on keeping public sector deficits low and strengthening forward-looking budgetary planning. Moreover, once the crisis occurred and financial markets were agitated by it, it became obvious that EMU did not have policy tools to manage and resolve the crisis. In the end, the European Union responded to the crisis first by agreeing on stabilisation for Greece and then by creating the European Financial Stability Facility (EFSF) that relatively succeeded in calming the markets. However, these responses were developed in an ad-hoc manner and on a temporary basis only and do not provide a sufficient basis for dealing with any possible future debt crises in the euro area.

Several proposals have been put forward for how to improve the euro area's capacity to deal with problems of excessive public debts. In order to prevent sovereign crises, the European Commission (2010) has proposed a number of measures to strengthen the EDP and the SGP. These proposals focus mainly on making the rules of the current framework more effective and on strengthening their enforcement by introducing stiffer and more automatic penalties for violating these rules. The European Central Bank (ECB) has made proposals (2010) going in the same direction and, at the same time, has called for the creation of a crisis management fund for the euro area, which might cover some lender of last resort characteristics (Gianviti, et al., 2010).

The European Council of 28-29 October 2010 stated that 'Heads of State or Government agree on the need for Member States to establish a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole and invite the President of the European Council to undertake consultations with the members of the European Council on a limited treaty change required to that effect' (European Council, 2010). There are also reports that the German finance ministry has been preparing a proposal for coordinating the demands of bond holders in a sovereign debt crisis and imposing 'haircuts' on the face value of the debt of a government in financial distress. There have been several plans along similar lines, most notably by Gros and Mayer (2010) who proposed the creation of a European Monetary Fund (EMF) aimed at both improving crisis prevention and financing a mechanism for sovereign debt resolution.

The euro area needs a mechanism for dealing with sovereign debt crises in an effective and predictable way. Even the most sophisticated and most effectively enforced set of fiscal rules will not eliminate the possibility of future debt crises in the euro area.

2. A New European Economic Convergence

Policymakers in Europe must now concentrate their action on at least three areas (Draghi, 2011):

First, they need to deliver the growth-friendly fiscal adjustments they have committed to implement.

Second, they need to focus on the structural reforms that Europe needs in order to boost potential growth; current problems in many countries stem as much from excessive debt as from the weak economic growth expected in the years ahead.

Third, they need to agree on a thorough reform of European economic governance. The crisis highlighted some major shortcomings. Fiscal rules and procedures have proved unable to deliver prudent policies: many member states entered the crisis with an already high public debt and insufficient margins of manoeuvre. Moreover, macroeconomic imbalances were not given an adequate role in the design of EMU governance: tensions hit not only countries with problems of public finances, but also those with a high external deficit, unbalanced growth and/or a highly indebted private sector. Finally, an appropriate framework to safeguard the financial stability of the euro area in crisis situations was missing altogether.

Reform proposals have been set out in all the three areas by the European Commission and the Task Force chaired by President Van Rompuy.

Concerning fiscal surveillance, the Report of the Task Force states that "the debt criterion ... should be made operational to be effectively applied". It is well known that, while the Maastricht Treaty requires countries with high public debt to reduce it *"at a satisfactory pace",* this provision has never been effectively implemented. The Report also envisages a wider range of sanctions, both financial and political, to be applied progressively, starting at an early stage in the budgetary surveillance process, in order to strengthen the incentives to comply with the rules in good times to avoid procyclicality effects. However, the procedures remain too lengthy and largely determined by discretionary decisions of the European Council.

With regard to the surveillance of macroeconomic imbalances, the Task Force proposes an alert mechanism, based on the analysis of macroeconomic and competitiveness developments, and an enforcement mechanism that includes sanctions if a country in "excessive imbalance position" does not comply with the Council's recommendations. As the crisis showed, macroeconomic imbalances may lead to unsustainable development and dangerous spillovers to other countries.[1]

A crisis management framework has to be designed so as to ensure appropriate incentives for countries applying for financial support and for private credit markets, in order to limit moral hazard. At the end of November 2010, the Eurogroup agreed on the main features of a crisis management framework aimed at safeguarding the financial stability of the euro area as a whole. In particular, it has (i) stressed that assistance will be based on a stringent programme of economic and fiscal adjustment and on a rigorous debt sustainability analysis; (ii) clarified that the mechanism does not represent an unconditional bailing out and that there is always a possibility that private creditors may incur losses if the country concerned does not succeed in implementing the necessary adjustment.

The reformed Stability and Growth Pact, the new excessive imbalances procedure and the Euro Plus Pact will reinforce the economic and fiscal coordination and surveillance in the euro area and ensure that any deviation from the objectives set by these instruments are recognized and adressed at an early stage. This policy of prevention will be key to the medium- and long-term stability of the euro area.

[1] See, for example, Giavazzi and Spaventa (2010).

At the same time, by establishing the EFSF and, from mid-2013, the European Stability Mechanism (ESM), will enable targeted intervention if indispensable to safeguard the stability of the euro area as a whole - always subject to adequate conditionality. Member States which benefit from the EFSF undertake considerable efforts to takle the causes of the crisis - principally excessive public debt and a lack of competitiveness - effectively.

All the Member States of the euro area have committed themselves to swiftly reducing their deficits, achieving balanced budgets in the medium term and implementing the structural reforms required to enhance the competitiveness of their economies on a sustainable basis. Namely:

1. Strengthening the governance of the Euro area

All the decisions taken in the last year are aimed at enhancing stability and fostering growth in all Members States. In order to support this process, the euro area needs to strengthen and streamline its institutional framework to reinforce the efficiency of its decision-making process and to promote the coherence of its institutions and procedures.

2. Enhanced surveillance and integration of budgetary and economic policy

The economic and monetary union needs to be based on an even closer coordination of national budgetary and economic policies.

It should be further enhanced through the following proposals:

- All Member States of the euro area will incorporate a balanced budget fiscal rule into their national or constitutional legislation. The fiscal rule should implement the objectives of the SGP and ensure that every Member State of the euro area achieves a balanced budget as soon as possible. Therefore, it would ensure a sustained reduction of the debt ratios in the case they exceed the reference value (60% of GDP). In line with the revised SGP, all Member States of the euro area whose debt level exceeds the reference value must present an adjustment path for reducing their debt below the reference value.

- All Member States of the euro area should confirm without delay their resolve to swiftly implement the European recommendations for fiscal consolidation and structural reforms, especially as regards labour-market, competition in services and pensions policy, and adapt appropriately their draft budget.

- In line with the Euro Plus Pact, euro area Member's States should take all the necessary measures to improve competitiveness, foster employment, ensure stability of the euro area as a whole and deepen economic integration. In particular, further progress should be made on tax policy coordination to support fiscal consolidation and economic growth.

- Structural and cohesion funds should be used to support essential reforms to enhance economic growth and competitiveness in the euro area. The European Commission should automatically check to ensure that structural and cohesion funds provide the optimum support for the macroeconomic adjustment programme and be involved in the selection and implementation of projects. In the future, payments from structural and cohesion funds should be suspended in euro area countries not complying with recommendations under the excessive deficit procedure.

3. Concluding Remarks[2]

In summary, it has shown that the euro area requires:

First, a stronger commitment on the part of countries to effectively prevent the pursuit of unsustainable fiscal policies and the emergence of other harmful macroeconomic developments.

Second, if imbalances in public finances, significant losses in competitiveness or excessive macroeconomic imbalances nonetheless emerge, robust corrective mechanisms must come into force. There must be an appropriate degree of automaticity to ensure that these mechanisms are not open to wide interpretation or to undue political discretion.

Third, in the unlikely event that the reinforced preventive and corrective arms of the proposed enhanced framework are unable to prevent a crisis in the future, the euro area would benefit from a well-designed permanent crisis management framework.

Fourth, with regard to the debt reduction, the Commission proposal must be seen as the absolute minimum, as it may not constitute a sufficient incentive for fast debt reduction for countries with high debt and relatively robust nominal GDP growth. With regard to the assessment of compliance with the debt criterion, relevant factors should only be considered when the government debt ratio will decline over a three-year horizon according to the Commission's forecasts. Irrespective of whether the

[2] See European Central Bank (2011).

debt ratio is above or below the 60% of GDP reference value, when assessing whether the deficit is excessive, the relevant factors should only be taken into consideration if the deficit ratio, before taking into account such factors, is close to the 3% of GDP reference value and the excess over the reference value is temporary, in line with the current rules.

Fifth, general exemption clauses, which are proposed under the preventive and corrective arms of the SGP, should not be implemented. The application of the SGP in past years lacked the discipline needed to achieve sustainable fiscal positions before the crisis.

Sixth, greater automaticity is required in all surveillance procedures, including the new macroeconomic surveillance framework. When Member States fail to comply with recommendations to adjust their policies, this should lead to the consequences provided for in the preventive and corrective procedures, and the Council should have less room for halting or suspending procedures against the Member States.

Seventh, the macroeconomic surveillance framework should have a clear focus. In particular, it should focus on euro area countries with large current account deficits, significant competitiveness losses or high levels of public and private debt, as well as any other vulnerability threatening EMU.

Eighth, financial sanctions should be applied at an early stage and gradually within the macroeconomic surveillance framework to provide clear and credible incentives for countries to adopt appropriate macroeconomic policies.

Nineth, a new economic governance framework should include a crisis management framework that safeguards the financial stability of the euro area as a whole if one or more countries experience a sovereign debt crisis.

Tenth, the creation of a euro-area finance ministry, with a minister with veto rights over national budgets that could threaten euro-area sustainability. The ministry would also assess the liquidity and solvency of governments facing difficulties.[3]

[3] See, Marzionotto Sapiz and Wolff (2011).

In creating a crisis resolution mechanism, Europe is taking the lead where the international community failed to find agreement a decade ago. There are good reasons to think it has a fair chance to succeed, and we do not share the view of those who claim that no European solution can be found in the absence of a global solution. By the same token, however, we certainly consider that there would be significant benefits in the definition of a global response to the sovereign crisis-resolution issue, and we hope that Europe's decision to create a regional mechanism will help advance the global discussion.

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