ECONOMIC CRISIS AND INSTITUTIONAL REFORMS

The new economic governance of Europe after the crisis

Stefano Micossi

LUISS SCHOOL OF GOVERNMENT

Rome, 23 May 2011

Outline

- ✓ Economic polices in the EU at a turning point
- ✓ The new economic governance of the EU: an unprecedented agreement, substantially and procedurally
- a stronger stability and growth pact and a new binding procedures for the prevention of macroeconomic ‘excessive’ imbalances
- the euro plus pact
- commitments with immediate effects
- ✓ The new mechanism for crisis management: structure and criticism

Economic polices in the EU at a turning point

On March 24-25th the European Council reached an agreement on a comprehensive economic policy package that effectively completes the economic arm of economic and monetary union

If consistently applied, this reform holds out the premise of ending stagnation and dismal employment performance throughout the European Union

In sum

The treaty provisions whereby the member states:

"*shall conduct their economic policies with a view to the achievement of the objectives of the Union" (Art. 120 TFEU), and*

"shall regard their economic policies as a matter of common concern and shall coordinate within the Council" (Art. 121 TFEU)

so far with no effect, have now become **reality**

It is worth recalling that these areas do not fall under Union's exclusive or shared competence. For these, a legally binding procedure is now established to ensure that commitments under the broad economic policies guidelines are fully respected

Policy guidelines and surveillance in the TFEU

✓Art. 121.2: "*The Council [on the basis of the European Council conclusion] shall adopt a recommendation setting out the broad guidelines of the economic policies of the member states and of the Union.*"

✓Art.121.3: *"The Council shall, on the basis of reports submitted by the Commission, monitor economic developments in … the member states and in the Union"*

✓Art.121.4: "*Where it is established…that the economic policies of a member state are not consistent with the broad guidelines…or…risk jeopardising the proper functioning of economic and monetary union, the Commission may address a warning to the member state... The Council … may address the necessary recommendations to the member state… [and] may, on a proposal from the Commission, decide to make them public.*"

New strength to the surveillance of economic policies

Treaty provisions on the surveillance of economic policies will become binding through six legislative decisions – legislative procedure to be completed in June (4 in co-decision)

The European semester requires member states to align decisions on economic polices according to the Autumn decisions of the European Council on common guidelines, with legally binding rules to be detailed in the national stability and convergence and structural reform programmes

Emphasis on the prevention of imbalances: national programmes will be assessed **ex-ante and during their implementation** on the ground of their effectiveness to foster common goals

The substance of the new economic governance

Common principles for a new integrated economic policy cycle covering:

✓fiscal stability – the revamped stability and growth pact, with new operational criteria for debt reduction

✓prevention of ‘excessive’ economic imbalances: structural reforms – flexible labour markets, alignment of wages to productivity, investment in human capital and new technologies

✓market integration – application of the services directive to professional qualifications, commercial distribution, public procurement

Stability and growth pact

Preventive arm: precocious

- ✓Public expenditure benchmark: expenditure growth not exceed a ‘prudent’ medium-term rate of GDP growth; revenue windfalls allocated to debt reduction
- ✓introduction of sanctions (interest-bearing deposit) in case of a significant deviation from the medium-term structural budgetary objective

Corrective arm:

- ✓New operational criterion for the evaluation of the public debt reduction toward the 60% of GDP threshold
- ✓The excessive deficit procedure will take account of ‘all’ relevant factors, such as private sector debt, (pension) implicit liabilities, ageing;

National budgetary framework

✓EU budgetary coordination of public accounting systems – **Council directive**

✓Eurostat auditing powers and *professional independence* strengthened

✓For member states, recommendations:

- minimum requirement for statistics, forecasting practices, medium-term budgetary frameworks and adoption multi-annual fiscal planning to ensure that medium-term objectives are met
- additional provisions on budgetary procedure (‘top-down’) and independent authorities for the evaluation of public finance and national policies

Prevention of macroeconomic imbalances

- ✓ Each year the Commission will assess member states' economies and the risks of 'excessive' imbalances using a scoreboard of economic indicators – to be defined; Commission report to the Council who will discuss it; greater 'symmetry'?
- ✓ The Commission may decide in-depth reviews for member states considered at risk of imbalances
- ✓ If the imbalance is considered 'excessive', the Council could open a formal **excessive imbalance procedure**
- ✓ The member state concerned will be required to adopt detailed **corrective action** within a specified timeframe
- ✓ Sanction for **euro area** member states repeatedly failing to comply with Council recommendations

The powers of European Commission

- ✓ The Commission will be able to **act autonomously** to signal emerging deviations from budgetary objectives (**early warning**) and macroeconomic imbalances (‘**in-depth’ review**), without Council authorization
- ✓ Autonomous power of **formal proposal** for Council decisions declaring the existence of an excessive deficit (Art. 126.6 TFEU)
- ✓ All other Council decisions will be taken on the basis of Commission **recommendations**
- ✓ Commission recommendations on sanctions can be rejected by the Council with **reversed** qualified majority – only exception: late stage of sanctions in the stability and growth pact (Art. 126.11 TFEU)

The Euro Plus Pact

The new **'pact'** – which may be joined also by non-eurozone countries – requires enhanced policy commitments that amount to the requirements for an efficiently functioning monetary union, long-recognized as necessary but nonetheless ignored

Inclusion of new policy commitments in the annual national reform and stability programmes (Art. 121.2 TFEU), that the Commission, the Council and the Eurogroup will assess under the framework of the European semester and will be subject to the regular multilateral surveillance framework (Art. 121 TFEU, commas 3 and 4)

Four 'guiding rules' ...

i. Consistency with existing instruments (European semester, Europe 2020, integrated guidelines, SGP, the new macroeconomic surveillance framework); with agreed timetable for implementation

ii. Each year, based on priority policy areas, choice of tools and common objectives will be agreed upon that will be pursued by participating member states with their **own policy-mix** – German *diktat* on terms and modalities has been rejected

iii. The implementation and progress of national commitments will be monitored politically by the Heads of State or Government of the participating countries (*collective surveillance?*)

iv. Full commitment to the completion of the Single Market

… and four focus areas

i. Wage developments in line with productivity;

ii. Labour market reforms (flexicurity, decrease of undeclared work, increase in labour participation, lowering taxes on labour);

iii. Sustainability of public finances:

- granting the sustainability of pensions, health care and social benefits;
- commitment to translate EU fiscal rules as set out in the SGP into national legislation by the introduction of legally binding budgetary rules e.g. constitution or framework law;

iv. Reform of financial stability: financial sector supervision and regulation.

Immediate effects

- ✓Member states are committed to start **immediately** with their fiscal consolidation plans – with annual adjustments well above 0.5% of GDP for countries with high structural deficits or public debt levels – and well identified **structural reforms**: labour market, pensions, education systems and energy markets
- ✓The **Single Market** comes back to the **top of the policy priority list** – strongly requested by UK – imposing measure to open the services and professional qualification sectors to competition and to reduce the burden of business regulation
- ✓Even those governments, like Italy's, that have long refused to confront the structural roots of their dismal economic performance now must act or be shamed in front of their peers and the public

European Stability Mechanism

- ✓ The European Council has agreed to establish – from 2013 – a permanent stability mechanism (ESM) for euro area member states to be activated 'if indispensable' for financial stability of the euro area
- ✓ The ESM will have effective lending capacity of €500 bln (paid-in and callable capital up to €700 bln)
- ✓ Decisions on financial assistance will be taken by the Board of Governors autonomously under an intergovernmental framework – major drawback
- ✓ However, the policy conditions will be decided and implementation monitored under the rules and with the tools and procedures of the EU surveillance framework (art. 121 TFEU)

The simplified treaty revision

For the establishment of the ESM, a new paragraph will be added to Art. 136 TFEU: "*the member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area* …"

The treaty will be amended in accordance with the simplified revision procedure of Art. 48 TEU – revisions that do not increase the competences of the Union

The ESM will be established by a treaty among euro area members "*as an intergovernmental organization under public international law*"

The treaty revision: a cumbersome procedure

The simplified revision procedure has been adopted in order to circumvent possible objections by the German Constitutional Court to an increase in the competencies of the Union and to avoid, in other member states, the need to call a referendum on the treaty amendment

The European Parliament has objected to a procedure out of the treaty for achieving goals that clearly belong to the treaty – although it was able to contain the damage by bringing the decision of the adjustment programmes supported by the ESM under ordinary treaty procedures (Art. 121 TFEU)

Procedures for financial assistance

Upon receipt of a request for assistance, the Commission will assess the existence of a **risk** to the financial stability of the euro area and undertake an analysis of the **sustainability** of **public debt**

The Commission, together with the IMF and the ECB, will assess the actual financing needs of the country; on this basis, the Board of Governors will mandate the Commission to negotiate an adjustment **programme**, to be detailed in a memorandum of understanding

The Council will take a decision endorsing the adjustment programme and the Board of Governors will decide – by *mutual agreement* – on the granting and terms of financial assistance. The Commission, together with the IMF and the ECB, will monitor implementation

Debt restructuring

In principle possible within a credible adjustment programme and an adequate **private-sector** involvement – on a **case-by-case** basis and in line with IMF practice

If on the basis of a Commission analysis:

✓public debt is considered **sustainable**, the beneficiary member state will take initiatives to encourage private investors to maintain their exposures

✓the public debt is considered **unsustainable**, the beneficiary member state will be required to engage in active negotiations in *good faith* with its creditors to secure their direct involvement in restoring debt sustainability

De facto so far not a functioning procedure, everything up for political negotiations – destabilizing markets

What the ESM can and cannot do

- ✓The ESM can provide short or medium-term loans and intervene, as an exception, in debt *primary markets;* the Board of Governors may review the instruments at its disposal and may decide to change them – by *mutual agreement* (abstentions don't count)
- ✓The ESM *cannot* purchase distressed sovereign paper on the secondary market or from other holders
- ✓A better alternative would be enable the ESM to purchase sovereign paper in the ECB portfolio, at the prices paid by ECB in market interventions, or by banks at market price – banks would thus have to book losses in their portfolios
- ✓Sovereign debt securities could be then sold by the ESM to member states at the purchase price

Crisis resolution, the system remains incomplete

The Council could not agree on a system for bank crisis resolution

European leaders still hesitate, in the transparent hope that time, and generous hidden help by national governments, will help their cosseted national banks mend their books with no further need for public intervention

It is plainly absurd to boast about making private creditors take their share of sovereign debt losses that may soon emerge, while at the same time pretending that this will have no consequences for banks holding massive amounts of that sovereign paper