

DIRECTORATE GENERAL FOR INTERNAL POLICIES
ECONOMIC GOVERNANCE SUPPORT UNIT (EGOV)



IN-DEPTH ANALYSIS

Fiscal and macro-structural challenges and policy recommendations for the Euro Area and its Member States under the 2014 Semester Cycle

Author: **Dr. Jacob Funk Kirkegaard**

Provided at the request of the
Economic and Monetary Affairs Committee

August 2014

ECON

EN

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Provided in advance of the Economic Dialogue
with the President of the Eurogroup in ECON on 4 September 2014

Abstract

This paper focuses on the need for euro area policy makers to sustain their recent crisis-induced reform eagerness to pull the region away from the threat of economic stagnation. Important policy challenges in ensuring that fiscal consolidation protects public investment spending, and in overhauling national bankruptcy procedures to facilitate private debt deleveraging and complementing the Banking Union is presented.

The President of the Euro Group should be made a full-time position, and the post could have its democratic legitimacy enhanced through an expansion of the recent innovative Spitzenkandidat-framework to also include it. This would require that the European Parliament created a new euro area-only institutional setting. Proposals to enhance the working of the Euro Group and its President are also presented.

This paper was requested by the European Parliament's Economic and Monetary Affairs Committee.

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LANGUAGE VERSION

Original: EN

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Economic Governance Support Unit provides in-house and external expertise to support EP committees and other parliamentary bodies in playing an effective role within the European Union framework for coordination and surveillance of economic and fiscal policies.

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This document is also available on Economic and Monetary Affairs Committee homepage, under section European Semester and Economic Dialogue at:
www.europarl.europa.eu/ECON

Manuscript completed in August 2014.

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LIST OF ABBREVIATIONS

CSRs Country Specific Recommendations

ECB European Central Bank

GFCF Gross Fixed Capital Formation

MIP Macro-economic Imbalance Procedure

OMTs Outright Monetary Transactions

PEG President of the Euro Group

SGP Stability and Growth Pact

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EXECUTIVE SUMMARY

This paper focuses on the need for euro area policy makers to sustain their recent crisis-induced reform eagerness to pull the region away from the threat of economic stagnation. The important policy challenge in ensuring that fiscal consolidation protects public investment spending is identified, and the to date erratic achievement hereof by member states is highlighted. It is suggested to amend the Macroeconomic Imbalances Framework with data series to highlight the importance of public investments to achieve this goal. Secondly, the need to overhaul national bankruptcy procedures to facilitate private debt deleveraging and ensure the reduction of financial fragmentation in the euro area is discussed. While the Banking Union puts in place several important new institutions to integrate the euro area banking system, it will need to be complemented with national bankruptcy reforms to achieve its goal of comparable lending rates throughout the euro area and help the euro area private sector reduce its debt load to restore economic growth.

The President of the Euro Group should be made a full-time position, and the post could have its democratic legitimacy enhanced through an expansion of the Spitzenkandidat-framework to also include it. This could see the President of the Euro Group selected by voters solely in the euro area members, based on the identification of Spitzenkandidaten by the political groupings in the European Parliament. This proposal would require that the variable institutional geometry of the EU be extended to also the European Parliament. It would have to create a new euro area-only institutional setting, including a new euro area-only committee in the European Parliament in front of which the President of the Euro Group could regularly appear. The President of the Euro Group should if member state achievement of SGP fiscal consolidation goals and implementation of CSRs is in doubt publicly present a list of required CSRs to be implemented if any fiscal target flexibility under the SGP is to be possible.

INTRODUCTION

The euro area has recently entered a new economic and political phase, during which many of the economic and institutional reform remedies politically agreed during the height of the crisis are being implemented and must pass the feasibility test of working as intended and improving the operation the euro area economy. To date the restoration of economic growth in the euro area in the second quarter of 2013 and the return of financial market calm are grounds for a cautious optimism.

Yet at the same time, persistently high unemployment and dramatically lower price pressures in the euro area indicate how the central challenge for euro area policy makers remains to avoid that the region slides into a chronic state of economic stagnation. Success will first and foremost demand that reform complacency is eschewed and that much of the political will to “do whatever it takes” so evident and important at the height of the crisis is maintained also in the absence of imminent financial emergencies.

Only if the sustained political will exists to use the euro area’s new institutions – not least the new fiscal policy and economic reform surveillance mechanisms included in the European Semester and Country Specific Recommendations (CSRs) – to their full potential capacity to reform and integrate the common currency’s individual economies will the region expeditiously be able to return to the pre-crisis higher growth rates and employment levels. Ensuring therefore that Member States implement their fiscal and reform commitments to the euro area is today more important than ever.

1. MAIN FISCAL AND MACRO-STRUCTURAL CHALLENGES FOR THE EURO AREA AND ITS MEMBER STATES

1.1 Ensuring a Growth and Investment-friendly Fiscal Consolidation

Euro area long-term sovereign bond yields have in recent months fallen to historic lows in both the euro area core and among former crisis economies¹. This likely reflects a combination of the restoration of overall investor faith in the solidity of the euro, subdued regional growth prospects, accommodating ECB monetary policy, recent increased geo-political tension, and the determined fiscal consolidation efforts witnessed in the euro area since 2009. The latter has meant that the euro area as a whole in 2013 is for the first time since the crisis began projected to see a general government headline deficit at its 3 percent limit, a cyclically adjusted deficit of just 1.4 percent and a near primary balance².

The financial market pressure, which during the height of the crisis was instrumental in compelling euro area governments to take decisive action on fiscal consolidation and other important regional institutional reforms, has in other words not only now abated, but completely disappeared. This raises the spectre of the euro area again falling into pre-crisis policy complacency and financial markets again failing in a timely manner to monitor and punish unsustainable fiscal actions by member state governments. Consequently, the current situation offers an acid test for whether the EU and euro area’s new fiscal surveillance framework³ will be able to independently discipline Member States’ fiscal behaviour through political and bureaucratic scrutiny and without the earlier “coercive support” from financial markets.

¹ Benchmark German 10-year bonds have approached a 1 percent nominal yield, with other core countries like Finland, Netherlands, Austria, Belgium and France around 1.5 percent, Ireland and Spain at about 2.2-2.5 percent, and Italy close to 2.7 percent. Data from Eurostat Convergence Criterion Bonds at http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database.

² EC (2014: Tables 36, 38, 39).

³ This includes the updated Stability and Growth Pact (SGP), with its strengthened preventive and corrective elements, the new required national budget frameworks and fiscal rules, and the macro-economic imbalance procedure (MIP).

Here some concern surrounds the fact that while the headline euro area fiscal consolidation is projected to continue in 2014-15 at an appropriately slower pace than in recent years⁴, the ongoing euro area cyclically adjusted structural deficit improvement is expected to reverse again this year in 2014⁵. This highlights the danger that recent years' fiscal consolidation has come disproportionately in the form of short-term budget measures, which will fail to improve the longer-term structural balances in Member States' fiscal outlook.

The first risk to the quality of recent fiscal consolidation is that it in the euro area – a region characterized by high total levels of taxation – has come excessively in the form of tax increases, rather than in often politically more contentious cuts in government expenditure levels. Figure 1 breaks out the origins of post-crisis euro area fiscal consolidation from 2009-2015(p).

Figure 1: Euro Area 18 Fiscal Consolidation 2009-2015(p)

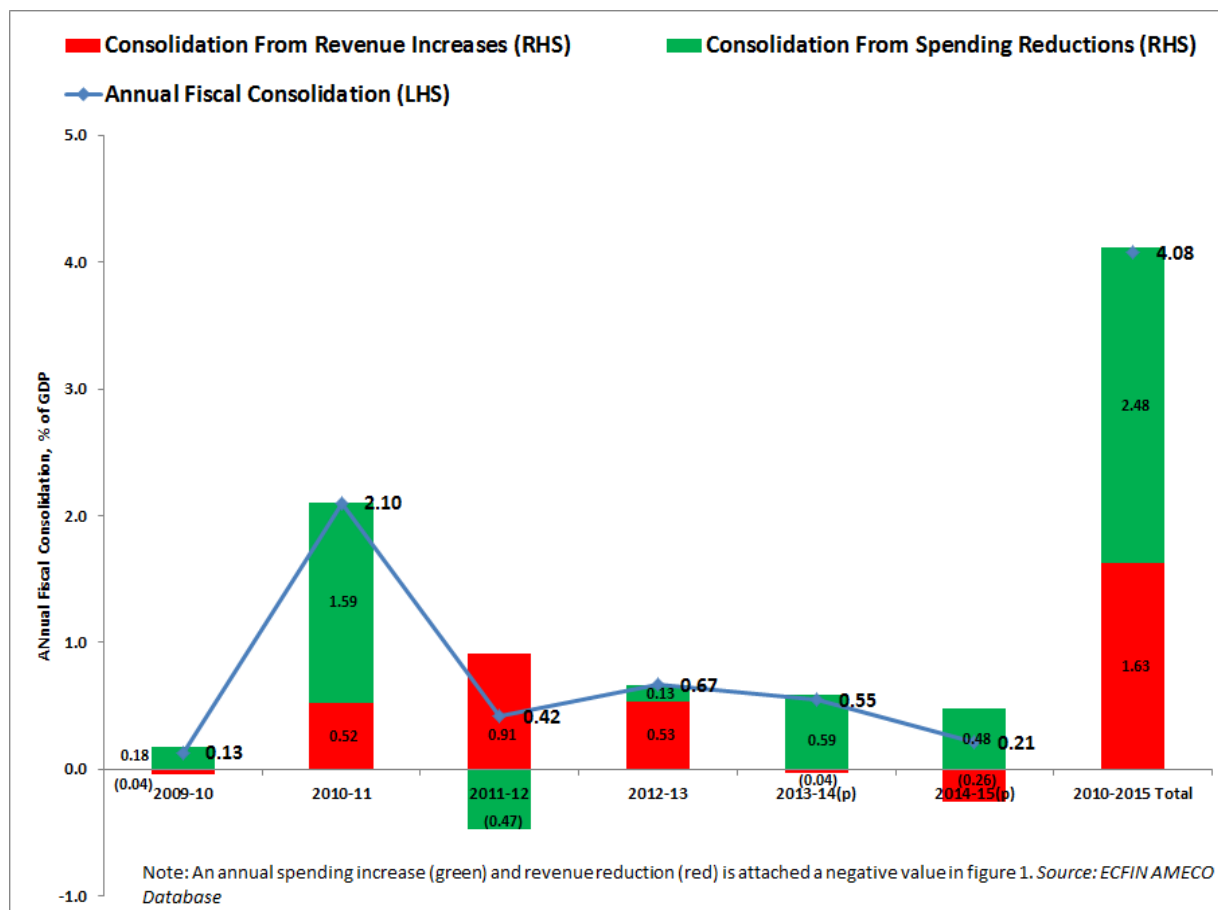


Figure 1 illustrates how only 60 percent (2.48 percentage points of period GDP) of total euro area fiscal consolidation from 2010-2015 is expected to come in the form of government spending cuts, while fully 40 percent will be achieved by raising general government revenues by 1.63 percentage points to a projected 46.5 percent of euro area GDP in 2015⁶. Figure 1 also makes it clear how government revenue increases dominated euro area fiscal consolidation during the last crisis years from 2011-2013, when recorded data ends.

⁴ The euro area deficit is projected to fall by 0.5 percent to 2.5 percent of GDP in 2014 and another 0.2 percent to 2.3 percent in 2015. EC (2014: Table 36).

⁵ The euro area cyclically adjusted deficit is projected to rise from 1.1 percent of GDP in 2014 to 1.3 percent in 2015. EC (2014: Table 39). EC (2014) does not project cyclically adjusted deficits beyond 2015, so whether this deterioration in 2014-2015 is a blip, or if additional underlying budgetary deterioration should be expected cannot be discerned yet.

⁶ Note though that the "negative" revenue reduction data for 2014 and 2015 in figure 1 illustrates how total euro area government revenue collection is expected to peak at 46.8 percent of GDP in 2013.

Only in the European Commission projections for 2014 and 2015 are spending reductions expected to again – as was the case in the early acute crisis years of 2010-2011 – outweigh what is anticipated to be limited revenue reductions (e.g. lower taxes) for euro area governments. For this projected outcome to materialize, euro area governments will therefore have to exhibit a degree of expenditure restraint that they failed to implement in prior years. Figure 1 thus illustrates how it is imperative that euro area governments and the relevant community fiscal surveillance institutions in the coming years focus on achieving fiscal consolidation overwhelmingly in the form of sound spending reductions.

The strengthened preventative arm of the SGP explicitly introduces national expenditure benchmarks to, along with structural balances, evaluate member states' adjustment path towards their medium-term budget objectives⁷. Newly introduced national budget frameworks are similarly intended to focus on implementing spending-based fiscal rules, and several 2014 CSRs also explicitly mention the need for expenditure-based government budget consolidation⁸. As such, this policy objective is at least included on paper in the 2014 Semester Cycle, including as figure 1 illustrates in the EC (2014) forecasts. However, as also shown in figure 1, in the years from 2011-2013, promised predominantly expenditure-based consolidation was not carried out, despite featuring quite prominently in the annual CSRs for many member states during the European Semester Cycles 2011, 2012, and 2013⁹. Additional political efforts to ensure a shift in government budget consolidation emphasis towards Member States' expenditure cuts in 2014 are therefore warranted.

However, simply shifting consolidation towards spending reductions will not suffice. Simply thoughtlessly cutting general government outlays in the euro area will not only generate excessively damaging short-term declines in economic growth through the negative fiscal multiplier effect of such cuts. It also may damage longer-term regional growth prospects. Even as euro area governments struggle to reduce the overall level of their spending, it remains crucial to safeguard the quality of this spending and to ensure that public investments in the future are not disproportionately sacrificed to consolidate current budgets. Among the most important and readily available public investment parameters is the level of general government gross fixed capital formation (GFCF) expenditures¹⁰. These are shown in table 1.

⁷ Expenditure benchmarks were part of the 2011 “six-pack” of reforms to the SGP.

⁸ 2014 CSRs for Estonia, France, Luxembourg, Latvia, Ireland, Italy, Portugal and Spain includes expenditure-based consolidation references.

⁹ See EGOV (2014) for an overview of the 2011-2014 Semester Cycle CSRs.

¹⁰ This spending category includes government expenditures on basic infrastructure, buildings and other tangible or intangible assets produced as outputs from processes of production that are themselves used repeatedly, or continuously, in processes of production for more than one year.

Table 1: General Government Gross Fixed Capital Formation, Percent of GDP

Country/Region	1999-2009 Average	2010	2011	2012	2013	2014(p)	2015(p)	1999-2009 Average to 2015(p) Change
EU-27	2.5	2.7	2.5	2.3	2.2	2.2	2.2	-0.3
EA-18	2.6	2.6	2.4	2.1	2.1	2.0	2.0	-0.6
Euro Area, Non-Crisis Economies								
Austria	1.3	1.1	1.0	1.0	1.0	1.0	1.0	-0.3
Germany	1.7	1.7	1.7	1.5	1.6	1.6	1.6	-0.1
Belgium	1.7	1.6	1.7	1.8	1.6	1.6	1.6	-0.1
Slovakia	2.5	2.6	2.7	2.2	2.1	1.9	1.8	-0.7
Malta	3.7	2.1	2.5	3.0	2.7	2.7	2.7	-0.9
Finland	2.6	2.5	2.5	2.6	2.8	2.9	2.8	0.3
France	3.1	3.1	3.1	3.2	3.2	3.0	2.9	-0.2
Luxembourg	4.1	4.1	3.8	3.5	3.1	3.1	3.2	-0.9
Netherlands	3.3	3.6	3.3	3.3	3.2	3.3	3.2	-0.2
Euro Area, Crisis Economies								
Spain	3.7	4.0	3.0	1.7	1.5	1.3	1.3	-2.4
Italy	2.3	2.2	2.0	1.9	1.7	1.6	1.5	-0.8
Ireland	3.9	3.4	2.4	1.9	1.7	1.6	1.5	-2.4
Portugal	3.6	3.8	2.6	1.7	1.4	1.8	1.7	-1.9
Cyprus	3.2	3.8	3.6	2.5	2.1	2.3	2.3	-0.9
Greece	3.4	2.3	1.7	1.8	1.9	2.6	2.5	-0.9
Recent Euro Area Entrants/High CapEx Countries								
Lithuania	3.5	4.6	4.4	3.7	3.4	3.4	3.3	-0.2
Latvia	3.0	3.7	4.2	4.2	3.9	3.7	3.4	0.4
Estonia	4.5	3.9	4.1	5.4	4.3	4.0	3.9	-0.6
Bulgaria	3.9	4.6	3.4	3.3	4.1	4.4	4.4	0.5
Croatia	3.6	2.4	2.3	2.0	2.2	2.5	2.8	-0.8
Czech Republic	4.2	4.2	3.6	3.2	2.8	3.2	3.6	-0.6
Hungary	3.6	3.4	3.1	3.5	3.9	4.4	3.8	0.2
Poland	3.7	5.6	5.7	4.6	3.9	3.8	3.9	0.2
Romania	4.1	5.7	5.5	4.7	4.5	4.3	4.4	0.3
Slovenia	3.6	4.5	3.5	3.3	3.7	4.2	3.9	0.3
Slovenia	3.6	4.5	3.5	3.3	3.7	4.2	3.9	0.3
Select Other Non-Euro Area Countries								
Denmark	1.8	2.2	2.2	2.6	2.3	2.3	2.1	0.3
Sweden	3.1	3.5	3.4	3.5	3.3	3.4	3.3	0.3
United Kingdom	1.7	2.5	2.2	2.2	2.0	2.0	2.0	0.3
Select Non-EU Countries								
Switzerland	2.3	2.3	2.3	2.2	2.2	2.2	2.2	-0.1
United States	3.8	4.1	3.8	3.6	3.6	3.6	3.5	-0.3
Japan	4.1	3.3	3.1	3.2	3.5	3.7	3.3	-0.8

Source: DG ECFIN AMECO Database

Table 1 highlights several important investment related issues in the euro area. Not only is it clear how aggregate euro area GFCF expenditures have declined substantially (over a fifth of total public investments to a projected just 2 percent of GDP in 2015) from pre-crisis levels in recent years. A remarkable difference in countries' GFCF investment levels is also visible. Germany, Austria and Belgium stand out as having had extremely low public investment levels even before the crisis began, and despite their relative crisis resilience have reduced them further after 2009. This finding is particularly striking for Germany's recently strong economy. It suggests that a sizable share of recent German fiscal consolidation has been of poor quality, and that Germany for the sake of its own future growth opportunities (as well as current euro area rebalancing) ought to increase its public investment levels.

It is further visible how most of the euro area crisis countries have witnessed very large declines in public investments since 2010 and now approach Germany's low levels. Yet strikingly, the similar public investment data for the Baltic countries make it clear that even in euro area members that have in recent years implemented very harsh reductions in total government expenditure levels¹¹, austerity need not have happened through long-term damaging reductions in GFCF. All the Baltic countries today retain public investment levels substantially above the euro area average, as does non-euro area member states like Poland and Sweden, as well as the United States and Japan. Astonishingly, essentially all non-euro area member states have in recent years managed to either increase their general government GFCF levels or maintain them substantially above the euro area average.

Given the longer-term importance of public investments in basic infrastructure and other essential items to sustain euro area growth prospects, the GFCF data in table 1 suggest that relevant EU and euro area fiscal surveillance frameworks (and in recent years Troika program designs) have in recent years failed to adequately protect this essential public expenditure category in some member states, as well as failed to coax long-term public investment laggards in the euro area to prioritize such expenditures. This implies that the SGP, the Macro-economic Imbalance Procedure (MIP) and other enhanced budgetary surveillance procedures have in recent years been short-termist in their implementation, and have neglected to protect the growth-enhancing quality of public expenditures in the euro area. Shifting scarce public expenditures towards higher levels of investments should consequently be a policy priority for the 2014 Semester Cycle.

The need to preserve growth enhancing investment expenditures is mentioned explicitly in just three of the 2014 euro area member state CSRs (Germany, Italy and the Netherlands)¹² and the 2014 euro area CSR unambiguously mentions the need to “[i]mprove the quality and sustainability of public finances by prioritising material and immaterial investment at national and EU levels”.

There has in recent months been extensive political discussions regarding the potential to reinterpret the SGP to exclude certain categories of public investment from deficit calculations. In this regard the EU Council Conclusions of 26/27 June 2014¹³ noted how “[t]he possibilities offered by the EU's existing fiscal framework to balance fiscal discipline with the need to support growth should be used.... Structural reforms that enhance growth and improve fiscal sustainability should be given particular attention, including through an appropriate assessment of fiscal measures and structural reforms, while making best use of the flexibility that is built into the existing Stability and Growth Pact Rules.” As such, member states seem to have the opportunity to increasingly prioritize growth-enhancing public investments, provided that such expenditures occur in tandem with structural economic reforms in the member state in question. This offers a potentially win-win situation, as short-term growth prospects are strengthened through timely sensible public investments, which simultaneously incentivizes national governments to implement longer-term structural reforms.

The MIP does not explicitly include parameters focusing on public investments, though among its 28 auxiliary indicators it includes economy-wide (e.g. both public and private) GFCF as a percent of GDP¹⁴. The 2014 In-Depth Review (IDR) for Germany further mentions the country's “relatively low public investments” as a contributing factor to its very large and persistent external surplus¹⁵.

¹¹ Estonia, Latvia and Lithuania reduced their total general government expenditures by 6.4, 7.6 and 10.4 percent of GDP respectively between 2009 and 2013.

¹² The issue is further mentioned in the 2014 CSRs for the non-euro area members Czech Republic and Poland.

¹³ Available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/143478.pdf.

¹⁴ See EC (2013).

¹⁵ See EC (2014b: 13f). Germany's external surplus could obviously also be reduced by lower savings in Germany (e.g. “reducing S”, rather than “increasing I”). However, domestic German policies to achieve such a reduction in savings will likely be very difficult to implement. German households have the historically most stable savings ratio in the OECD, while recent years' relatively high corporate savings levels is a global phenomenon found also in the corporate sectors in other OECD countries and noticeably in the United States. Lastly, the German government savings rate is regulated by both EU fiscal

In light of the dramatic long-standing differences among euro area members' public investment levels, it seems appropriate to include among the MIP's numerous auxiliary indicators the country level of government GFCF investments, as well as a medium-term target for this metric. To underline the importance for long-term growth of maintaining investment levels, especially now that the euro area as a whole has shifted towards a sizable external surplus (approximately 2.5 percent of EA-18 GDP in Q4 2013 and Q1 2014¹⁶), it may further be warranted to include the economy-wide GFCF number among the MIP Scoreboard's eleven headline indicators. This would ensure appropriate focus in all member states on the need to prevent a short-term widening of an external surplus though a long-term damaging collapse of domestic investments¹⁷.

1.2 Private Sector Debt Deleveraging, Financial Fragmentation and National Bankruptcy Reforms

The euro area's institutional structure remains predominantly focused on the need to constrain member states' public sector debts and deficits. This objective is critical for the long-term stability of the common currency, and overall fiscal policy space in the euro area consequently remains appropriately confined, making the pursuit of growth and investment friendly government budget consolidation policies imperative. Without powerful expansionary fiscal policy levers available, returning the euro area to sustainable higher growth rates must ipso facto be driven by an expansion of private sector activity. However, just as euro area public sector budgets are post-crisis weighted down by high debt levels, so are the euro area's private sectors' growth prospects hampered by a still large debt burden in many Member States. Facilitating an expeditious deleveraging, including in all probability restructuring at least a share of this private sector debt load and potentially renegotiating a limited part of outstanding residential mortgages is an urgent present day euro area policy objective.

One of the lasting legacies of the successful euro introduction in 1999 was the dramatic decline in interest rates towards low German levels, and an associated often spectacular increase in credit availability for both sovereign and private borrowers in many euro area members. As a result, in the region as a whole and in almost all Member States, both non-financial corporations and households became substantially more indebted during the first decade of the euro era (table 2).

surveillance institutions and the national German *Schuldenbremse*. See Kirkegaard (2014) for an in-depth discussion of the German sectoral savings and investment balance.

¹⁶ See Eurostat Press Release 114/2014 - 18 July 2014. Available at http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-18072014-AP/EN/2-18072014-AP-EN.PDF.

¹⁷ National income accounting stipulates that a country's national savings (S) subtracted its domestic investment demand (I) equals its external balance. Schematically, $S - I = CA$ balance.

Table 2: Private Sector Debt Levels, Select EU Countries 1999-2013 (or latest available), % of GDP

Non-Financial Corporate Sector Loan Liabilities, % of National GDP										
Country/Region	EA-17	Belgium	Germany	Estonia	Ireland	Greece	Spain	France	Italy	Netherlands
1999	51.5	64.3	49.2	42.5	N/A	39.5	50.8	45.5	51.3	85.5
2009	74.5	86.7	47.1	92.2	155	57.3	125.3	61.6	75.9	86
%-Point Change 1999-2009	23	22.4	-2.1	49.7	N/A	17.8	74.5	16.1	24.6	0.5
2013 (or latest available)	70.3	82.1	43.6	74.2	194.4	63.3	112.4	59.5	73.7	82.9
%-Point Change 2009-2013	-4.2	-4.6	-3.5	-18	39.4	6	-12.9	-2.1	-2.2	-3.1
Country/Region	Austria	Portugal	Finland	Cyprus	Latvia	Lithuania	Malta	Slovenia	Slovakia	
1999	64.3	80.4	52.4	73.6	25.7	29.6	N/A	N/A	52.9	
2009	76	107.6	76	132.7	90.9	51.7	97.2	84.7	45.9	
%-Point Change 1999-2009	11.7	27.2	23.6	59.1	65.2	22.1	N/A	N/A	-7.0	
2013 (or latest available)	72.4	104.5	73.7	161.6	56.7	38.4	81.5	71.9	44.1	
%-Point Change 2009-2013	-3.6	-3.1	-2.3	28.9	-34.2	-13.3	-15.7	-12.8	-1.8	

Households and Non-Profit Sector Loan Liabilities, % of National GDP										
Country/Region	EA-17	Belgium	Germany	Estonia	Ireland	Greece	Spain	France	Italy	Netherlands
1999	47.6	40.9	72.7	7	N/A	11.5	42.8	35.4	21.8	83.1
2009	65.5	51.6	63.9	57.7	121.8	53.3	86.6	54	44	127.9
%-Point Change 1999-2009	17.9	10.7	-8.8	50.7	N/A	41.8	43.8	18.6	22.2	44.8
2013 (or latest available)	63.9	56.5	58.2	43.1	105.1	64.5	81.3	56.7	45.3	127.9
%-Point Change 2009-2013	-1.6	4.9	-5.7	-14.6	-16.7	11.2	-5.3	2.7	1.3	0
Country/Region	Austria	Portugal	Finland	Cyprus	Latvia	Lithuania	Malta	Slovenia	Slovakia	
1999	45.9	54.7	32.4	83.5	3.5	1.8	N/A	N/A	3.8	
2009	56.1	95.4	61.9	124.6	51.1	33.0	61.3	29.1	24.3	
%-Point Change 1999-2009	10.2	40.7	29.5	41.1	47.6	31.2	N/A	N/A	20.5	
2013 (or latest available)	54.5	86.8	65.4	137.1	34.8	24.0	61.9	29.6	28.3	
%-Point Change 2009-2013	-1.6	-8.6	3.5	12.5	-16.3	-9.0	0.6	0.5	4.0	

Source: Eurostat

In the euro area, only German non-financial corporations and households reduced their leverage during the pre-crisis euro period until 2009¹⁸, whereas in other euro area members like Spain non-financial sector corporate debt more than doubled to well over 100 percent of GDP. Large increases in euro area household debts from 1999-2009 were even more widespread, driven by house price and mortgage lending booms. Since the crisis began in 2009, some reductions in debt levels have occurred among Spanish corporations, Irish households and in the Baltic countries, but overall euro area private sectors remain substantially more indebted today than they were during the early euro era economic expansion period.

The modest decline in overall euro area private sector debt since the crisis began stands in marked contrast to the almost one fifth reduction in U.S. household debt levels from 97 percent of GDP in 2009 to 81 percent in Q1 of 2014¹⁹. This decline in U.S. household debt has been facilitated by the existence of more legal avenues for debt restructuring in the United States.

The ECB's historically easy monetary policy since late 2008 has materially lowered the debt service burden of many euro area creditors, even as substantial financial market fragmentation has kept up interest rates in some euro members and prevented sound households and viable non-financial firms here from reaping the full financial advantage. The ECB's Outright Monetary Transactions (OMT) program and the introduction of the Banking Union are both (among other things) intended to alleviate aspects of

¹⁸ The euro introduction affected the German economy in the opposite manner of the rest of the euro area, as Germany saw virtually no change in real domestic interest rates, but a dramatic change in its external economic environment. In contrast, plunging domestic real interest rates in (most of) the rest of the euro area was the dominant economic effect of the euro introduction in these member states.

¹⁹ Over the same period, U.S. non-financial corporations had roughly unchanged levels of total liabilities at around 90 percent of GDP, as firms took full advantage of historically low interest rates. Data for total sector liabilities from the U.S. Flow of Funds Account in Federal Reserve (2014).

this financial fragmentation in the euro area²⁰. The goal is to fully restore equally low borrowing rates to all euro area members to once again enable monetary policy to function properly and the intended credit easing to fully benefit all euro area non-financial sector borrowers.

However, even as the ECB's OMT program has provided the euro area with a necessary politically conditional lender of last resort and when the Banking Union is fully implemented in the months ahead, it seems highly unlikely that borrowing costs for households and non-financial sector firms will return to be roughly the same across the entire euro area. In other words, even if all institutional reforms decided to date in the euro area are successfully implemented, financial fragmentation is unlikely to be fully eliminated. Indeed, in some ways if this were to occur, the euro area could be said to have returned to the unsound financial pre-crisis conditions, where financial markets offered credit at equally loose terms to borrowers across the euro area, irrespective of the structural fundamentals of individual member states.

Especially the Banking Union puts in place numerous crucial elements to ensure a sound and fully integrated euro area banking system. Yet other parts of the euro area financial sector infrastructure critical not only to achieve approximately similar borrowing rates for the non-financial sectors across the euro area²¹, but also to help facilitate the urgently needed private sector debt deleveraging remain both unreformed and unintegrated. First and foremost among these disparate parts are national member state private bankruptcy procedures, which remain highly divergent²², and requiring very different durations to reach a final legal settlement across member states²³.

Without fair access to and expeditious proceedings in bankruptcy, parts of the high private sector debt loads in the euro area cannot be restructured sufficiently fast to enable a return to faster growth. And banks will continue to charge a much higher interest rate for loans to a borrower in a euro area member where the expected time to work a potential bankruptcy is much longer, when compared to a similar borrower in another member with fast bankruptcy procedures and easy access to expedited out-of-court settlements. This difference in riskiness to the lending bank is structural and lies solely in the time it might take the bank to recover its money, and the related negatively correlated recovery rate (e.g. the longer a bankruptcy takes, the lower is the share of the loan that a lender can expect to recover).

Important progress in this area has recently been achieved in reforming and integrating cross-border EU insolvency rules by the political agreement of co-legislators to the Commission's recent proposal to modernize relevant European rules²⁴. However, to effectively assist euro area households and small and medium sized enterprises (SMEs) typically without cross-border activities, national laws and practices under whose jurisdiction these actors belong must be reformed. This will help ensure adequate and early out-of-court settlement opportunities, opportunities to renegotiate soured mortgages, expeditious bankruptcy processes, and a fair creditor-debtor balance in proceedings.

²⁰ The OMT program removed the risk of default from euro area sovereign borrowers and hence the "sovereign-level risk element" in euro area interest rate spreads, while the ECB's Comprehensive Review (e.g. especially the asset quality review and bank stress tests) of all large euro area banking institutions is intended to eliminate the "institution-level risk element" from the euro area banking system. Potential lenders (e.g. counter-parties) to euro area banks will therefore soon in principle not have to charge any "extra fee" for sovereign or institutional risks for a loan to a euro area bank, as financial credibility has been restored to both national governments and individual bank balance sheets.

²¹ A certain variance in the borrowing rates faced by non-financial sector actors in different euro area members, reflecting differing levels of banking sector competition in different Member States, is likely to persist in the medium-term. Only once a number of pan-euro area retail banks emerge to provide more equal levels of competitive pressures across Member States will such differences likely be competed away.

²² See INSOL Europe (2014) for a review.

²³ See CEPECJ (2013) for recent comparative data.

²⁴ See EC (2014c) and IP/12/1354, which was approved by the Justice Council in June 2014 and the European Parliament in February 2014. The European Parliament, the Council of Ministers and the Commission is expected to reach agreement on a final text by the end of 2014.

National bankruptcy proceeding reforms are, however, not appropriately reflected in the 2014 CSRs. Here they are generally mentioned as merely a part of overall administrative reforms to overcome obstacles to doing business and improve the judicial system²⁵. With a still very large private sector debt burden, hundreds of thousands of euro area firms and entrepreneurs currently trapped in often overly lengthy insolvency proceedings²⁶ and the need to complement the Banking Union with more uniform bankruptcy proceedings to fully overcome financial fragmentation, this is a crucial challenge of disproportionate importance to euro area households, SMEs and entrepreneurs. Reflecting national circumstances and credit cycles, the introduction of new national benchmarks and longer-term targets for share of early out-of-court settlements, distressed mortgage loan renegotiations, acceptable bankruptcy procedure durations and approximate creditor-debtor balance in settlements should be considered. Creating a supplementary and best practice pan-European bankruptcy code (and associated court system), which even solely national private actors could voluntarily agree to transact under, would be another longer-term reform opportunity to more expeditiously help overcome euro private sector debt problem.

2. AVENUES FOR THE PRESIDENT OF THE EURO GROUP (PEG) TO FACILITATE THE COLLECTIVE AND INDIVIDUAL ACTIONS BY MEMBER STATES TO ADDRESS THE POLICY CHALLENGES ABOVE AND TO INCREASE DEMOCRATIC ACCOUNTABILITY AT BOTH EU AND NATIONAL LEVELS

The policy challenges mentioned in Chapter II, and indeed by design most of those other challenges mentioned in national CSRs fall within areas of predominantly Member State jurisdiction. National political ownership of required national policy reforms is thus critical for potential success. The PEG should consequently seek to promote such national ownership by involving as many national stakeholders as possible in the process, preferably through direct meetings held in the respective Member States. Given the substantial increase in required travel time for the PEG to fulfil such requirements, and the political necessity of the PEG to unambiguously represent supra-national euro area interests when visiting member states, the PEG should logically be a full-time position. The current PEG arrangement with the position held part-time by a national policymaker is not constructive, and a full-time PEG should be appointed simultaneously with the other principal leadership positions in the European Commission, High Representative and EU Council President later in 2014.

Any PEG will within the next six months receive the policy priority of helping the ECB ensure that the new euro area Banking Union introduction proceeds smoothly. This will require the PEG to oversee the final political and institutional preparations for the publication of the ECB's asset quality review and bank stress tests in October 2014. Most important will be securing agreement among euro area governments for the details of how the new Single Resolution Fund (SRF) will be funded, both with respects to potential initially required government-provided bridge-financing²⁷ and the permanent distribution key for banking sector contributions. A particular political challenge in this regard for the PEG will be to manage the new "banking union area", which looks likely to include not only the euro area members, but also non-euro area Member States like Bulgaria and potentially Denmark.

Creating a full-time PEG position is invariably linked to the broader institutional reforms in the EU, and likely requires that the EU's variable institutional geometry be extended also the European Parliament. A promotion of the democratic accountability in the same manner as has recently occurred for the position of European Commission President is a natural complementing step for any future full-time PEG. A special session majority of 50 percent + 1 of the European Parliament members for the euro area countries could consequently be required for a new full-time PEG to assume office.

²⁵ Mentions of this nature are made in the CSRs for Bulgaria, Croatia, Latvia, Ireland, Italy, Spain, Slovakia and Slovenia.

²⁶ See Creditreform (2014).

²⁷ Until the SRF is fully funded at the target €55bn level by industry contributions after 8 years, the potential requirements for governments to step in remains a possibility in a new emergency.

Assuming that the European Parliament itself agrees to establish a special session of euro area-only MEPs, it seems possible that the entire European Parliament will have to threaten to refuse to accept the nominations for other EU leadership positions to secure the consent of the EU Council to its right to refuse a full-time nominee for PEG. It would further be natural for a future full-time PEG to appear regularly in front of euro area-only MEPs (e.g. that a euro area (sub-)Committee be formed in the European Parliament) to report on progress on euro area-only related issues.

To further boost the democratic legitimacy of the PEG, it could also be envisioned to see future full-time PEGs nominated on pan-euro area tickets by the political parties in the European Parliament to compete in the next electoral cycle in 2019. This would see the *spitzenkandidaten*-framework recently utilized to select the president of the European Commission extended to include also a full-time PEG. Creating an innovative new body consisting of both euro area MEPs and relevant numbers of euro area national parliamentarians to approve the appointment of a full-time PEG and conduct oversight relevant hearings could also be imagined. Such a hybrid parliamentary approach could on the one hand enhance the PEGs ability to secure national ownership of required policy reforms, while on the other hand it may blur national level and euro level competences.

The PEG should at all times strive to secure that the national ownership and legitimacy of CSRs are promoted through detailed commonly agreed policy targets for Member States. However, the crisis has clearly shown how the appropriate balance between Member States' legitimate right to exercise national sovereignty over policies under national jurisdiction, and the requirements to coordinate economic policies in the entire euro area has over time in the euro area shifted towards the latter. Recalling the explicit linkage between the flexibility of the euro area fiscal surveillance framework and member state structural reforms made in the European Council Conclusion on 26/27 June 2014 referenced above in chapter 1.1, the PEG should at all times strive to fully exploit this relationship.

The PEG should in country cases where the timely achievement of fiscal consolidation targets under the SGP and CSR reform implementation is coming under threat – in close collaboration with the European Commission – state the political quid pro quo of CSR commitment implementation in exchange for SGP target path flexibility explicitly and publicly. This could include that the PEG publicly presents a detailed list of required CSRs to be implemented, in return for additional flexibility to be granted towards achieving SGP fiscal goals. Failure by a member state government to achieve either CSR or fiscal target goals would with the public support of the PEG and the European Commission result in the immediate activation of the corrective elements of the SGP's excessive deficit procedure.

The PEG's role here amounts to working to ensure that the policy space granted to Member States to implement common agreed fiscal and CSR policy priorities is expeditiously restricted, so as to prevent that the common euro area economic policy goals comes under threat. The key to a constructive outcome in such a situation will be for the PEG to guarantee that the prescriptive list of CSRs required to be implemented by the Member States in question in return for potential easing of fiscal targets is material and in terms of the political obstacles of implementation at least commensurate with the difficulties of achieving the original fiscal target. This will require considerable political skill and judgment by the PEG to determine, but a scenario in which required CSRs to be implemented is "less politically painful" than achieving the original fiscal target must at all costs be avoided to safeguard the integrity of both the SGP and CSR frameworks.

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CAT QA-02-14-826-EN-11

Abstract

This paper focuses on the need for euro area policy makers to sustain their recent crisis-induced reform eagerness to pull the region away from the threat of economic stagnation. Important policy challenges in ensuring that fiscal consolidation protects public investment spending, and in overhauling national bankruptcy procedures to facilitate private debt deleveraging and complementing the Banking Union is presented.

The President of the Euro Group should be made a full-time position, and the post could have its democratic legitimacy enhanced through an expansion of the recent innovative Spitzenkandidat-framework to also include it. This would require that the European Parliament created a new euro area-only institutional setting. Proposals to enhance the working of the Euro Group and its President are also presented.

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PE 528.754

ISBN 978-92-823-5939-6

doi: 10.2861/67546