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# WORKING DOCUMENT

on the review of the economic governance framework: stocktaking and challenges

Committee on Economic and Monetary Affairs

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## Introduction - Legislative progress at the European level since the eruption of the crisis

The crisis that erupted in 2007 unveiled the flaws of the economic governance framework established for the eurozone in the 1990s. When the foundations for the single currency were agreed upon, it turned out to be impossible to push integration far enough, notably to ensure that the new currency area would be able to face adverse shocks. Instead it was hoped that belonging to the eurozone would be enough as an incentive for its members to coordinate their policies. This framework, with today's insight, was set up in a simplistic way, unable to take proper account of the complexity of macroeconomic policy challenges in a currency union.

Against this, the Maastricht Treaty and the Stability & Growth Pact (SGP) created a framework where monetary policy was centralized in an independent central bank, while fiscal policies were primarily decided at the national levels. A no-bail-out clause was meant to guarantee that fiscal problems in one eurozone Member State (MS) would not spill over.

In reality, community institutions lacked the legal instruments to combat the creation of macroeconomic imbalances inside the currency area like growing divergences of inflation rates, production costs and price of real estate and asymmetric developments in current-account positions. The reliance on the no-bail-out clause also implied that there was no planning for emergencies inside the currency area. After the outbreak of the sovereign debt crisis in 2010, this framework arrived at its limitations and ad-hoc solutions had to be devised in emergency to avoid even more dramatic events. The herd behaviour of financial markets turned around and drove the spreads and thereby the yields on these bonds to unsustainable levels.

In a short period of time, taking into account the political and institutional challenges at play, progress was made on economic governance: the adoption of the macroeconomic imbalance procedure has been an attempt to correct the limited focus of the SGP. Furthermore, the recognition of externalities of economic policies pursued by one MS on the eurozone as a whole has led to the creation of a complex system of coordination of economic policies through the 6-Pack and 2-Pack in 2011 and 2013, and thereby through the European Semester. Finally, the Treaty on Stability, Coordination and Governance was ratified with stringent rules on the required reduction in debt levels higher than the reference value.

## Impact of consolidation on growth and best possible policy-mix

The poor performance of the eurozone since 2011 has given rise to a debate on the policy-mix adopted in the wake of the sovereign debt crisis as the eurozone has been lagging behind its counterparts. An economic paper[1] by the Commission analysing the euro-area from 2011 to 2013 concludes that the simultaneous consolidations in eurozone countries - following the expansionary policies agreed by the G20 in the aftermath of the failure of Lehman Brothers - have had *'large negative output effects'* and *'significant negative spillovers'*.

For the paper, *'a temporary stimulus in AAA-rated countries would support growth in the core*

[1] 'Fiscal consolidations and spillovers in the euro area periphery and core', Jan in't Veld, Economic Papers 506, European Commission, October 2013, http://ec.europa.eu/economy_finance/publications/economic_paper/2013/pdf/ecp506_en.pdf.

*countries and spillovers to the periphery countries would ease their adjustment, although the impact on current accounts is shown to be modest and it clearly cannot be a substitute for reforms in deficit countries.'* This raises several questions.

- Has the current economic framework been able to ensure an efficient policy-mix?

- Is there a potential for counter-cyclical fiscal policies in the eurozone?

- While the new governance rules do not directly provide a mechanism for policy action at the level of the eurozone, what is the appropriate policy-mix in a currency area operating well below potential?

- While some MS have current-account surpluses above the threshold of the macroeconomic imbalances procedure, mostly due to historical developments that no longer apply, could there be a shift in growth models inside the eurozone where some would improve their competitiveness while others would focus on a re-balancing in favour of domestic demand?

**Flexibility of existing rules**

According to the IMF[1], the effect of a simultaneous fiscal policy contraction policy across Europe has been significantly underestimated until early 2013, notably since *'fiscal multipliers were substantially higher than implicitly assumed by forecasters'*. Against this background, the European Council in June 2014 stated that *'fiscal consolidation must continue in a growth-friendly and differentiated manner. Structural reform that enhance growth and improve fiscal sustainability should be given particular attention [...] while making best use of the flexibility that is built into the existing SGP'*.

In addition, the President of the European Central Bank declared on 28 August in Jackson Hole, USA, that *'it would be helpful for the overall stance of policy if fiscal policy could play a greater role alongside monetary policy and I believe there is scope for this, while taking into account our specific initial conditions and legal constraints […] A coherent strategy to reduce unemployment has to involve both demand and supply side policies, at both the euro area and the national levels. And only if the strategy is truly coherent can it be successful'*.

Furthermore, Mario Monti stated that *'Europe can no longer afford to stick with such a rudimentary instrument* [the SGP]' which, *'by failing to recognise the proper role of public investment, has pushed governments to stop building infrastructure just when they should have built more[2]'*.

In a context of low growth, low inflation and high unemployment rates inside the eurozone, these statements have induced a debate on the effectiveness of the new governance framework. Why has the current economic policy-mix been conducive to a situation of low growth and low investment? Has the economic governance framework allowed for reduction of imbalances among MS? Inside MS?

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[1] 'Growth Forecast Errors and Fiscal Multipliers', Olivier Blanchard and Daniel Leigh, IMF Working paper, January 2013, http://www.imf.org/external/pubs/ft/wp/2013/wp1301.pdf
[2] 'Europe's leaders need to back shift on rules on public investment', FT.com, 8 October 2014

The main avenues to be considered are the following:

- in its preventive arm, the SGP allows for deviation from the Medium Term Objective (MTO) to accommodate the transitory costs of adoption of structural reforms with an impact on the sustainability of public finances. The reference to a particular attention to be given to pension reforms leaves anyhow open the scope for the eligibility of a broad range for structural reforms. In the presence of this kind of structural reforms that improve the debt sustainability in the medium to long term, is there room for flexibility in the assessment of the adjustment path of the debt ratio?

- in both its preventive and its corrective arm, the rules now foresee that the Excessive Deficit Procedure (EDP) is not triggered when the breach of the deficit reference value is only exceptional and temporary and the ratio remains close to the reference value. 'Exceptional circumstances' are defined in two ways: first, as an event outside the control of the MS concerned, which has a major impact on its financial position. Second, as a 'severe economic downturn', defined as a decline in annual real GDP growth or an accumulated loss of output during a protracted period of very low annual real GDP growth relative to potential growth as measured by the output gap. In the same vein, a country under EDP can see its deadline for corrective actions be extended 'by one year as a rule' in the case of 'unexpected adverse economic events with major unfavourable consequences for government finances';

- the investment clause which according to the interpretation of then Vice President Rehn in his letter of 3 July 2013 would allow MS to temporarily deviate from the consolidated effort required under the preventive arm of the Pact but under strict conditions (negative growth or growth far below its potential, deficit below 3% of GDP and debt below 60% of GDP, maximum deviation directly linked to the amount of expenditures spent on co-financing EU projects, obligation to compensate for so that the time path towards the MTO is not affected).

These margins of evaluation also exist regarding the Pact's rules on the development of structural deficits. The 2005 reform of the SGP introduced the requirements of an annual adjustment in structural terms of 0.5% of GDP (more in good times and less in bad times) and of higher than 0.5% of GDP for those MS in an EDP procedure, with a debt level higher than the debt reference value or who are exposed to risks regarding the sustainability of their debt.

Furthermore, the reform of 2011 introduced an expenditure rule that prescribes that the growth of expenditures net of discretionary expenditure shall not exceed a reference medium-term rate of potential GDP growth. These rules create a margin of evaluation regarding the calculation of the potential growth rate of GDP and thereby of structural deficits. For example, labour market stance plays an important role in the definition of potential GDP. Empirical evidence[1] shows that the structural unemployment rate[2] tends to follow the short-term changes in the unemployment rate. Therefore, in the course of a crisis, characterised by sharp rise in unemployment, the structural unemployment increases more than what would be expected due to the impact of cyclical factors. The increase in this rate automatically determines a reduction in the level of potential output, and thus of the output gap.

[1]. 'New Estimate of Phillips Curves and Structural Unemployment in the Euro Area', Quarterly Report on the Euro Area, Volume 13(1), European Commission, April 2014

[2] Defined as Non-Accelerating Wage Rate of Unemployment (NAWRU).

In this context, the following questions should be raised:

- What are 'exceptional circumstances'?
- How to qualify a 'severe economic downturn'?
- What is an 'unexpected adverse economic event'?
- How to ensure that a structural reform proposal is adopted and implemented?
- How to ensure that the budgetary surveillance framework of the EU isolates factors outside the control of national governments?
- To what extent can Member States be held accountable for fiscal slippages, which are not due to cyclical developments?
- Should the Commission give even more emphasis on fiscal measures rather than fiscal outcomes when assessing whether a MS has taken 'effective action'?
- How can the compliance assessment procedure of Council recommendations, especially for MS under EDP, make systematic use of the 'adjusted fiscal effort' indicator (i.e. the fiscal effort corrected for ex-post revisions of potential growth and unexpected shortfalls in revenues)?
- What are the economic assumptions behind the calculation of the structural deficit, which is becoming a key concept to assess structural efforts in the SGP?
- Should the fiscal rules be made investment-friendly?
- Will a 'generous' application of these rules give enough short-term breathing space to MS that needs it?
- Will this flexibility - even when combined with some structural reforms and an expansionary monetary policy - be conducive to a clear improvement in the currently mediocre medium-to-long-term growth prospects for the eurozone as a whole?
- Do the rules of the economic governance framework as regards debt reduction have sufficient flexibility in a context of very low inflation?

**Democratic accountability**

Any framework for economic governance, however, cannot only be judged on outcomes ('output legitimacy'), but has also to be judged in terms of its democratic accountability. Does the economic governance framework allow for enough democratic accountability? Is it not to complex for proper ownership and appropriation by parliaments?

There is an increasing sense of a double democratic deficit in an enhanced economic governance framework of the Union at both the EU and at national levels. There is thus a need for both the European Parliament and National Parliaments to seek ways to increase their involvement, taking into account their respective roles.

Regarding the framework of adjustment programme, the 2-Pack clarifies somewhat the roles of the Commission and of the Council during such a programme and for the first time devolves some scrutiny rights to the EP. However, given not least the severity of the process, the importance of democratic accountability can hardly be overstated. The truth is that the succession of several 'memoranda of understanding', 'packs' and 'pacts' has created a political system based on 'blurred responsibilities'. A certain degree of complexity is somehow unavoidable to work together as 'united but diverse'. But is not it politically urgent, to clarify if the reforms of the EMU governance had not have a binding impact on democratic accountability?

It is against this background that the European Parliament has adopted a report (*'Enquiry report on the role and operations of the Troika (ECB, Commission and IMF) with regard to the eurozone programme countries'*) with a strong focus on necessary reforms to improve the democratic accountability of adjustment programmes in eurozone MS.

**Beyond the crisis**

Following the July 2012 announcement by the ECB President on Outright Monetary Transactions, progress on core issues regarding economic governance, beside the banking union, has slowed down or even come to a standstill. There has so far not been a follow-up to the Communication from the Commission *'A blueprint for a deep and genuine economic and monetary union - launching a European Debate'* (COM(2012) 777)[1]. In this document released in November 2012, the Commission provides a vision for a strong architecture in the financial fiscal, economic and political domains, involving incremental measures taken over the short, medium, and long run. The Commission has made no propositions on a dedicated fiscal capacity for the eurozone yet.

Likewise, the Presidents of the European Council, the European Commission, the European Central Bank and the Eurogroup *'Towards a genuine Economic and Monetary Union'* (2012/2151(INI))[2] presented on 5 December 2012 did not yet lead to any follow-up by the Commission. Nor did the European Parliament report with recommendations to the Commission on this four Presidents report (Thyssen report).

Moreover, the European Parliament CRIS report addressed the flaws in the EMU institutional setting and takes the view that *'deepening European economic integration is necessary in order to ensure the stability of the eurozone and of the Union as a whole, and that this will require notably further developments regarding the external representation of the eurozone, qualified majority voting on a corporate tax base, measures to combat tax evasion and tax avoidance, possible mutual issuance of sovereign debt and Eurobonds to stimulate fiscal discipline, the EU's borrowing capacity, a better balance between economic and social policies, own resources for the EU budget and a bigger roles of NPs and the EP[3].'*

The July 2014 declaration by the President-Elect of the Commission to follow up on the

[1] http://eur-lex.europa.eu/resource.html?uri=cellar:6ed5f706-fda6-492c-895b-4b5e8a25648a.0010.03/DOC_2&format=PDF
[2] http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2012-0430&language=EN&ring=A7-2012-0339
[3] Paragraph 102 – http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2011-0331&language=EN&ring=A7-2011-0228

report *'Towards a genuine economic and monetary union'* by the four Presidents and at least partially based on input delivered by the European Parliament, is therefore highly welcome and could mark the new beginning to an overdue debate.