BRIEFING

Experiences with the current EU Economic Governance Framework

Proceedings from a Workshop
The European Parliament on 10 December 2014

This briefing provides a summary of a workshop on the experiences with the current economic governance framework in the European Union (EU) held in European Parliament on the request of the Economic and Monetary Affairs Committee. The aim of the workshop was to provide expertise in the context of preparation of the INI report on stocktaking and future challenges in economic governance (Rapporteur Pervenche Bérès). The workshop focused on "stocktaking" as regards the current economic governance framework. The presentations given during the workshop are available on the homepage of the European Parliament (see details below).

BACKGROUND

The aim of the reinforced economic governance framework, introduced in 2011 by the so-called "Six-pack", was to improve the EU economic governance framework relying on several interlinked and coherent policies for sustainable growth and employment, in particular a Union strategy for growth and jobs, with a particular focus on developing and strengthening the internal market, fostering international trade and competitiveness, a European Semester for strengthened coordination of economic and budgetary policies, an effective framework for preventing and correcting excessive government deficits (the Stability and Growth Pact, SGP), a robust framework for preventing and correcting macroeconomic imbalances (the Macroeconomic Imbalance Procedure, MIP), minimum requirements for national budgetary frameworks, and enhanced financial market regulation and supervision, including macro-prudential supervision by the European Systemic Risk Board (ESRB). Since then, progress has also been made in introducing the main building blocks for an effective banking supervision and resolution at the EU-level.

The "Six-pack" together with the "Two-pack" (introduced in 2013 for Euro Area Member States) have established the building blocks of the present EU governance framework. According to legal provisions set out therein, the European Commission published in November 2014 a review on the application of seven regulations included in these two legislative packages.

In parallel, the European Parliament has started its own work on this review to provide input to the other EU institutions. In this regard, an own-initiative-report on "*The review of the economic governance framework: stocktaking and challenges*" (rapporteur Ms. Berès) has been launched and is expected to be adopted during spring 2015. In this context and upon the request of the Economic and Monetary Affairs Committee (ECON), Economic Governance Support Unit (EGOV) organised a workshop on the "Experiences with the current EU economic governance" on 10 December 2014. The workshop was divided into two sessions which focused on surveillance of macro-structural policies and surveillance of fiscal policies respectively.

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SESSION 1: SURVEILLANCE OF MACRO-STRUCTURAL POLICIES

Xavier Ragot (Observatoire Français des Conjonctures Économiques):

In his presentation, Mr Ragot argued that the EU governance framework has been changed for the better, evolving from dogmatic rules (as set out in the original SGP) to a system based more on economic analysis. However, this process of institutional learning has been too slow and therefore costly in terms of its credibility. In addition, it has entailed economic and social costs (too fast a consolidation in Southern Europe) as well as political costs (eroding support for the EU).

According to Mr Ragot, the euro area is faced with two main challenges at the current juncture, namely 1) in the short term, a lack of demand and deflation and the related lack of investment which is becoming a supply problem and 2) in the long-term, the need of policy actions to make Europe converge again. If these challenges are not properly managed, the ensuing debt deflation may plunge the euro area economy into a lost decade. To avoid this scenario, a two-pronged approach, consisting of internal nominal adjustment and investment demand/supply side policies, is needed. As regards internal devaluation (or revaluation depending on the Member State), it should be coordinated at the European level (for example via the introduction of minimum wage norms). This wage coordination is seen by Mr. Ragot as a substitute for the labour mobility (or the lack of thereof) within the euro area, which remains plagued by highly segmented labour markets among countries for deep institutional reasons. Furthermore, Mr. Ragot advocated for the extension of the Juncker investment plan as well as the exclusion of public investment when assessing Member States compliance with the SGP. Finally, he also advised that fiscal consolidation should be less strict and therefore be allowed to take place in a more generous timeframe (10-15 years).

Gilles Saint-Paul (Paris School of Economics):

Mr Saint-Paul began his presentation by stating that the MIP does not have a strong foundation and its existence is not beneficial for the European Union. According to him, the notion of imbalance is not properly defined and it is not clear why it should be corrected. In his opinion, in some cases, an economy can appear to be "balanced" even with highly inefficient policies and vice versa. Perceived imbalance, the professor explained, is often nothing else but a market response to a legitimate decision taken by sovereign government.

Mr Saint-Paul pointed out that detecting imbalances and assessing whether an imbalance is unsustainable are so difficult that it may be beyond the expertise of the EU and national institutions; therefore, the MIP can lead to large number of errors. He added that another reason why the MIP is flawed is that the European Commission imposes corrective measures upon Member States without taking into account the fact that markets provide self-correcting mechanisms.

In terms of the enforcement of the MIP, Mr Saint-Paul said that the Commission has a poor record, which is the result of a number of factors. Firstly, it is difficult to impose financial sanctions on those who are net contributors to the Union's budget. Secondly, sanctions can be blocked by Member States for political reasons and finally, the Commission gets scared of how markets react to its decisions. Saint-Paul believes that the latter was behind the decision to delay action regarding France's budget. He thinks that the Commission was afraid that a

tough position on France would scare the markets, which would lead to higher sovereign spreads and potentially to a new crisis. The professor stressed that not applying the rules causes a lot of damage and leads to uncertainty. Therefore, he added, it is better not to have rules at all than having rules, which are not enforced or properly applied.

Gunther Schnabl (Universität Leipzig):

Mr Schnabl began his presentation by putting the emergence of euro area imbalances into a global context characterised by benign global liquidity conditions and divergent monetary and fiscal stances across major world economies. In particular, he singled out loose monetary policy as one of the key drivers behind the recent boom and bust cycles as well as current account imbalances (the role of ample provision of low-cost liquidity had already been put forward by the Swedish and Austrian schools around a century ago - see Wicksell and Hayek). Consequently, the policy response has addressed today's problems at the expense of creating even larger problems tomorrow.

When discussing the origins of the European crisis, Mr Schnabl pointed out differences in the adjustment mechanism before and after the introduction of the euro. During the former period, the emergence of current account deficits had been constrained by limited foreign reserves, limited availability of credit, exchange rate depreciation and risk premiums on interest rates. These constraints have been to a large extent removed by the common currency. In addition loose monetary conditions and divergent fiscal policy paths have contributed since the year 2001 to diverging current account positions, which have been the origin of exuberance and crisis in several E(M)U Member States.

Having said that, Mr Schnabl acknowledged that since the emergence of the European debt crisis, intra-European expenditure patterns have widely converged (consolidation of current account imbalances within the euro area) following, among others, the introduction of the MIP. At the same time, the euro area current account surplus is growing and depending on the risks taken in foreign capital markets, a new crisis for Member States running large current account surpluses may emerge. In this context, his main policy prescriptions would be twofold: a tighter monetary policy stance (which would inevitably bring about short-term costs but yield long-run benefits) and expansionary fiscal policies in the surplus countries (and/or tighter control mechanisms in particular for capital outflows).

SESSION 2: SURVEILLANCE OF FISCAL POLICIES

Charles Wyplosz (Graduate Institute of Geneva):

In his presentation, Mr Wyplosz made the following key points. He thought that the original SGP was flawed, since the rules on deficit and debt were too rigid, leading to pro-cyclical fiscal policy. Also, the framework was too bureaucratic meaning that it was hard to ensure the political will to comply with the requirements, especially as fiscal policy still is considered by many to be a matter of national sovereignty and the SGP infringed on this.

When assessing the reforms of the framework he found both positive and negative elements. One key improvement was the introduction of deficit objectives in terms of structural balance rather than just headline figures. He also thought that the requirements to introduce safeguards for sound public finances into national legislation is a good initiative since this helps keeps fiscal policy at the national level and thus enhances the legitimacy of the process, although he thought the implementation has been patchy so far.

However, the reforms have also led to an increase of obligations making the framework more complex and too bureaucratic (including the European Semester); and with an increased number of obligations the pressure to comply with any individual requirement is lessened. He also criticized the use of sanctions to enforce EU rules, as the sanctions aren't credible anyway since actually applying them would be too costly politically.

Another consequence of the EU economic governance framework has been the weakening of the no-bailout rule, which in his view is the only truly credible mechanism to ensure sustainable fiscal policy. According to him the no-bailout rule should be the corner stone of the governance framework, and if needed, a Member State in distress could turn to the IMF for financial assistance. Hence he suggested looking at other fiscal models to use as blueprints, citing the US, Australia and Canada as good examples.

Daniel Gros (Centre for European Policy Studies):

Before beginning with his presentation, Mr Gros took up the suggestion by Mr Wyplosz to implement a strong no-bail out clause like in the US. While Mr Gros supported it in principle, he also raised the concern that financial markets can create more disorder in cases of defaults of euro area Member States than in cases of state defaults within the US. In the course of his presentation, Mr Gros said in this context that the Banking Union is important since it will mitigate the impact in case of state defaults in the euro area by reducing the cross border impact of bank bankruptcies. In his perception, it is not harmful that banks hold government bonds as far as the bank portfolios are diversified enough and not concentrated on government bonds of a specific country. He concluded the Banking Union topic by stating that the financial system should be made as resilient as possible.

As regards the fiscal policy framework tools in the EMU, Mr Gros considered that there is a huge difference between the letter of the law and the reality of its implementation; as an example national fiscal rules and institutions function in those countries which have such a tradition (and therefore do not need them), while in other countries, which would really need them, they are not effective. He also stressed that the SGP should not be implemented in a discretionary and flexible way, since it undermines the rule based system. Furthermore, he

expressed the view that the role of the chief economist in the Commission has not developed as originally foreseen.

Mr Gros showed on the basis of historical figures that debt levels can be reduced even when the nominal growth rate is lower than the interest rate. Thus debt reduction should be all the more possible in current times of interest rates close to zero and positive nominal growth. Mr Gros highlighted that the most important adjustment in the current situation should not primarily come from the fiscal policy, but mainly from reforms that would improve exports of countries with a negative current account balance. Such an adjustment can however not be decreed and decided by the government but should mainly be the consequence of market signals and flexible markets.

Costas Lapavitsas (School of Oriental and African Studies, University of London):

Mr Lapavitsas began his presentation with looking at the European policies pursued in order to end the debt crisis, listing the imposition of austerity, reinforcing the SGP, and coming up with new tools such as the MIP. Although he thought it too early to assess the effectiveness of the MIP he noted that the average fiscal deficit has shrunk in 2014; and in general thought this to be a better tool than previous attempts due to its wider scope, but remained sceptical of the credibility of the use of sanctions as a threat to ensure compliance with the thresholds.

However, his key point was that these measures are the wrong treatment of a problem that has been wrongly identified. In his view, deficits and rising public debt are the symptoms, whereas the fundamental cause of the crisis was diverging unit labour costs among eurozone countries, with Mr Lapavitsas in particular pointing out Germany and its "extraordinary" wage restraint. Rather than leading to improvements, he thinks that the SGP exacerbates the situation, resulting in poor growth prospects and fuelling anti-EU and anti-Euro sentiment.

In order to address the issues, the only viable solution he sees is for Germany to increase wages and boost domestic demand. At the same time a programme of public investment should be introduced, alongside with measures to better coordinate wage policy across the EMU in the future. The alternative to this is that the break-up of the EMU cannot be seen as impossible, and that both peripheral and core countries should begin planning for this eventuality.

ACCOMPANYING INFORMATION

The presentations are available on the European Parliament's Economic and Monetary Affairs Committee (ECON) website under Events – Workshops.
The full URL address is following:
http://www.europarl.europa.eu/committees/en/econ/events.html?id=workshops#menuzone

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