IIEA Economic Governance Group

Submission on Analytical Note *"Preparing for Next Steps on Better Economic Governance in the Euro Area"*

Edited by Group Chair, Michael G. Tutty

March 2015

IIEA

iiea.com
Sharing Ideas
Shaping Policy

IIEA Economic Governance Group

Submission on Analytical Note *"Preparing for Next Steps on Better Economic Governance in the Euro Area"*

Edited by Group Chair, Michael G. Tutty

Outlined in this submission is the response of the IIEA Economic Governance Group to the Analytical Note, "Preparing for Next Steps on Better Economic Governance in the Euro Area", published on 12 February, by the President of the European Commission Jean-Claude Juncker, in close cooperation with Presidents Tusk, Dijsselbloem and Draghi.

The Analytical Note underlines that "[t]he euro is more than a currency. It is also a political project". It says the single currency has created a "community of destiny" between its 19 members which "requires both solidarity in times of crisis and respect by all for commonly agreed rules". That emphasis on the political nature of the project is welcome – and necessary. However difficult it is for existing political leaderships, this logic asks whether Germany is willing to do transfers and mutualisation, whether France can contemplate the treaty change needed and whether the euro's leaders have yet got used to existing intrusive rules, much less taking on even more highly conditional ones. The eleven questions asked at the end of the Analytical Note raise such issues implicitly if not explicitly.

This submission answers those eleven questions and in doing so hopes to make a constructive contribution to the debate amongst stakeholders on Economic Governance in the Euro Area.

1. How can we ensure sound fiscal and economic positions in all euro area Member States?

Ensuring sound fiscal and economic positions in all euro area Member States is the objective of the Treaty on Stability, Coordination & Governance in the EMU (TOSCG) and the "Six-pack" and the "Two-pack". These new rules - in particular the expenditure benchmark constraints - need time to bed in before we start thinking of additional measures. Much depends on how the new rules will be implemented and how they will be received by politicians in various countries.

Experience has shown that the implementation and enforcement of the economic and fiscal governance framework (in both the EU and the euro area) are extremely difficult, particularly in circumstances in which Member States are experiencing fiscal difficulties. The rules of the Stability and Growth Pact were broken by Germany and France in circumstances of fiscal difficulty, when the governments of those Member States considered that strict application of the rules would have had undesirable deflationary effects. Guidance by the Commission based on an assessment of the implications of Irish fiscal policy for continued adherence to the SGP rules in 2001-2002 was dismissed by the Irish government of the day.

In the short term, it would be helpful to ensure that the annual budget procedure, especially the draft budget procedure, is progressed with full governmental transparency, parliamentary scrutiny and involvement of the Commission at Member State level. Engagement with the social partners/civil society as well as full press coverage would help public understanding/buy-in, which would minimize cynicism or disaffection and the politics of protest. The value of independent national verification bodies to scrutinize budgets should be further developed.

2. How could a better implementation and enforcement of the economic and fiscal governance framework be ensured?

While the threat of the application of penalties under the excessive deficit procedure and its successor may have had the effect of moderating the level of infringements, the idea of imposing substantial financial penalties on Member States already in fiscal difficulty is logically counter-intuitive and likely, in the current economic climate, to be politically provocative. Recent successive postponements of the date for achievement of the 3% budget deficit target in France indicate that this view is shared (however reluctantly) by the European Commission, the Eurogroup, ECOFIN and the European Council. The ECB has consistently taken a stronger position on adherence to the rules than the other institutions but it has no means of applying sanctions to lapses in fiscal policy.

Achieving better implementation and enforcement would therefore require that the governance rules stand up to scrutiny (see 3); that all Member States, especially large Member States, are subject to full implementation of the Stability and Growth Pact (SGP) and the Macroeconomic Imbalance Procedure (MIP), which has not always been the case; the European institutions and Member States must be seen to work together at national level and involve the social partners/civil society.

3. Is the current framework – if fully implemented – sufficient to make the euro area shock-resilient and prosperous in the long run?

No. The relatively poor performance of the EU and, in particular, the euro area in exiting the crisis suggests policy failure. Full implementation of the current framework would have resulted in more restrictive fiscal policy stances throughout the euro area and the EU generally in the years since the onset of the current crisis, with the exception of Germany, where fiscal policy should arguably have been more expansionary (and with the possible exception of Poland). Full implementation might also have seen the application of substantial financial penalties in Member States not participating in support programmes (France, Italy and Belgium under the terms of TOSG and, UK, Hungary Czech Republic and Slovakia under the terms of the Lisbon Treaty).

The problem and the complex nature of the European Semester stems from the partial nature of EMU: a single monetary policy but no European fiscal or economic policy beyond coordination of individual Member States' policies.

The consequences of lost competitiveness or gains in competitiveness resulting in macroeconomic imbalances that formerly would have been brought back to equilibrium by downward or upward currency adjustments, have not been fully recognized; in particular the now much more difficult measures which have to be taken by those Member States having to correct negative imbalances.

Within the EMU, the adverse consequences of inappropriate interest rates for some Member States in the EMU has not been recognized. In this regards, there will always tend to be a bias towards larger Member States because of their economic weight. For example, low interest rates and a weakening currency were beneficial to some Member States suffering weak growth in the early 2000s, but not for other Member States experiencing rapid growth. This is not to deny that Member States in some instances pursued highly inappropriate economic policies.

These imbalances cannot be addressed simply by urging, under pain of financial penalty, recommendations and reforms only on those adjudged to be uncompetitive. Surplus balances that have no corrective measures are also harmful. They may reflect lack of investment resulting in lower domestic demand; lack of progress in completing the internal market, especially in services; and excessive competitiveness gains via incomes policy to keep cost increases below the inflation norm of around 2% pursued by the ECB, could/should be viewed as not having due regard for the adverse economic impact on other Member States. This has been recognised in European Commission documents and recommendations have been made to Germany (which has a surplus balance) to invest more in this context, but no mechanisms exist to ensure that Germany follows these recommendations and in practice they are ignored. Steps must be taken to see that responsibilities are shared by all countries, not just those in deficit.

Under fiscal surveillance, the lack of a euro area fiscal stance hinders economic policy, which in this case is confined to the aggregation of all fiscal policies in the euro area. Under the SGP rules the use of the structural balance has the great deficiency that it is a non-observable metric based on theoretical and disputed calculations of potential output gaps, which is prone to substantial revisions. Efforts should be made to find a methodology suitable for all types of economies. Excessive emphasis is placed on debt reduction resulting from deficit reduction with insufficient focus on increasing growth in GDP as a more fruitful solution.

There is a need to develop a fiscal capacity in the euro area which will act as a shock absorber for asymmetric shocks, suchas a limited social insurance mechanism and an incentive instrument suchas the Convergence and Competitiveness Instrument first suggested in the Blueprint to direct funds on a contractual basis to Member States lacking fiscal capacity to carry out structural reforms that would have a common European interest.

Another clear weaknesses of the current framework is that it makes no explicit provision for consideration of external factors.

4. To what extent can the framework of EMU mainly rely on strong rules and to what extent are strong common institutions also required?

It is demonstrably the case that the present sharing of sovereignty is inadequate to meet the economic, financial and fiscal framework requirements of the common currency.

Strong institutions are essential to the EMU framework, which implies further pooling of sovereignty. The intergovernmental approach that has characterized recent years runs the risk of being driven by strong Member States interests rather than a more cohesive all-European approach guided by strong institutions.

"Strong rules" are clearly ineffective however, without political acceptance of the need for strong enforcement. The current institutions (European Commission, ECOFIN, Eurogroup and European Council) lack that political acceptance. In the absence of that acceptance, it is impossible to envisage the prospect that those current institutions would agree on the creation of a new institution with the necessary powers.

5. What instruments are needed in situations in which national policies continue – despite surveillance under the governance framework – to go harmfully astray?

The Excessive Deficit Procedure (EDP) and the MIP have the basis for direct intervention in guiding a Member States to take corrective action by making all structural funds and other supports contractual on the performance of agreed Country Specific Recommendations (CSRs) and on the performance of Partnership agreements. This may require the democratic election of a European Finance Minister to be acceptable.

6. Has the fiscal-financial nexus been sufficiently dealt with in order to prevent the repetition of negative feedback loops between banks and sovereign debt?

No. A full Banking Union is needed with a fully transparent banking resolution mechanism and a deposit guarantee fund. The lack of a speedy and well worked out resolution mechanism was a significant factor in prolonging and exacerbating the financial crisis.

Feedback loops between banks and sovereign debt are probably inevitable to some extent. A negative movement in the rating of a systemically important bank is likely to have a negative influence on the sovereign debt rating. A positive movement in a sovereign debt rating is likely to have a positive (or neutral) effect on the rating of a systemically important bank. The smaller the economy, the more likely it is that bank and sovereign debt ratings will have a connection in the context of market sentiment. The implementation of the Single Supervisory Mechanism and the Single Resolution Mechanism should moderate feedback loop effects.

7. How could private risk-sharing through financial markets in the euro area be enhanced to ensure a better absorption of asymmetric shocks?

A genuine European integrated financial market and a Capital Markets Union would result in Europe wide investment with bail-ins, which would spread the risk of asymmetric shocks.

8. To what extent is the present sharing of sovereignty adequate to meet the economic, financial and fiscal framework requirements of the common currency?

An enhanced fiscal capacity, either through a limited social insurance scheme, a convergence and competitiveness instrument or a greater EU budget will be needed to meet the requirements of a properly functioning EMU. Ultimately the raising of euro area bonds should be a natural development arising out of the trust that would come from the operation of a resolute fiscal governance process. Paramount in this is the confidence of the system to ensure fiscal solvency across the Union.

Another option would be the creation of a new fiscal policy institution. What might be the powers and functions of such an institution?

- It would need mandatory powers to fix overall budgetary parameters, borrowing levels and inflation targets for the euro area, taking account of both internal and external influences. These parameters would have to be articulated against the background of an agreed planning horizon.
- It would need mandatory powers to disaggregate these parameters and to express them as targets or requirements at the level of each Member State, over the same planning horizon.
- It would need mandatory powers to make adjustments to forecast outcomes at Member State level, at least at the margin, to take account of anticipated differential influences on these forecast outcomes over the agreed planning horizon. This would necessarily entail the development of a "transfer union" of some economic and fiscal magnitude.
- It would need a clear mandate to set out prescriptions for structural improvements across the euro area. A good starting point would be the creation of a single market for services.

While this specification would not necessarily require the total "communitarisation" of fiscal policy, it would necessarily entail a significantly greater central shaping of national-level fiscal and structural policies than is currently the case. It would be an extremely complex task: it should not, in theory, be beyond the capacity of resources available in the Member States. It would arguably give a more coherent shape to euro area fiscal and structural policy than the current result of inadequately-applied rules.

9. Is further risk-sharing in the fiscal realm desirable? What would be the preconditions?

Fiscal risk sharing need not go beyond some automatic sharing of asymmetric shocks via some kind of limited social insurance scheme and some enhanced resources devoted to bringing less developed regions, defined either as a Member State or cross border areas, closer to the EU average. This would help rectify harmful imbalances that cause much of the tension within the euro area.

10. Under which conditions and in which form could a stronger common governance over structural reforms be envisaged? How could it foster real convergence?

It is difficult to envisage a new fiscal policy institution (as mentioned in reply to question 8) gaining acceptance in the current fractious political climate. It is impossible to imagine, in that climate, that a new institution devolved from the current institutional structure without some new element of democratic involvement would be regarded as responding to popular concepts of accountability and legitimacy. If it did not conform to these popular concepts, it is impossible to imagine that it would have any real prospect of gaining general political acceptance.

Some progress is under way through the European Semester and the CSRs. Increased surveillance through the Alert Mechanism Report brings useful on-site missions by the Commission to Member States and should result in an improving working relationship between Commission staff and finance officials in Member States. The improved smoothing of the Semester process should continue with the involvement of the social partners and perhaps the independent verification bodies as a normal part of the annual Semester process. Real convergence would be improved by the awareness among all the stakeholders in each Member State of general wage developments, productivity improvements, and the issues of competitiveness that have been highlighted in Ireland by the Competitiveness Council for many years.

11. How can accountability and legitimacy be best achieved in a multilevel setup such as EMU?

The European Parliament ought to have deeper input into the objectives of the Annual Growth Survey and perform a surveillance role on the European Commission and Institutions in the surveillance and sanctions process. The crisis highlighted the diminished role of leadership from the European Institutions which has been filled by leadership from one or two strong Member States, which has sometimes reflected or is perceived to have reflected national rather than European interests. European Institutions have therefore become more remote but are seen at Member State level to interfere with national decision-making without a democratic mandate. The Commission should engage more publicly with national parliaments, the social partners and perhaps the independent verification bodies at national level to counter the democratic deficit. Member States entered the

EMU project without being fully aware of, or willing to agree to, the necessity of further pooling of sovereignty in the areas of economic and fiscal policy and a somewhat bigger EU budget to run the monetary union effectively. Until this mindset changes, it is unlikely that much progress will be made towards a genuine economic and monetary union beyond attempts to co-ordinate economic and fiscal policies, which is likely to result in sub optimal economic performance of the area as a whole.

iiea.com
Sharing Ideas
Shaping Policy

The Institute of International and European Affairs,
8 North Great Georges Street, Dublin 1, Ireland
T: +353-1-8746756 F: +353-1-8786880
E: reception@iiea.com W: www. iiea.com