

## ARTICLE

# THE REFORM OF ECONOMIC GOVERNANCE IN THE EURO AREA – ESSENTIAL ELEMENTS



*This article presents the key elements required for an enhanced economic governance framework for the euro area to ensure the smooth functioning and stability of Economic and Monetary Union. It highlights the deficiencies in the current framework and provides an overview and assessment of the proposed changes based on the European Commission's package of legislative proposals and the recommendations of the Van Rompuy Task Force.*

*The following are essential elements of an enhanced economic governance framework: i) more “automaticity” and less room for discretion in the operation of the preventive and corrective arms of the fiscal and macroeconomic surveillance framework; ii) strict deadlines to avoid lengthy procedures, and the elimination of “escape clauses”; iii) the creation of a macroeconomic surveillance framework with a clear focus on euro area countries that are less competitive, have sustained current account deficits or have high levels of public and private debt; iv) the introduction of additional political and reputational measures for compliance with the rules of the governance framework; v) the early and gradual application of financial sanctions under the proposed macroeconomic surveillance framework; vi) more ambitious benchmarks for establishing the existence of an excessive deficit; vii) more ambitious requirements as regards the adjustment path towards a country's medium-term budgetary objective; viii) guaranteed quality and independence of fiscal and economic analysis; ix) a commitment on the part of the euro area countries to swiftly enhance their national budgetary frameworks; x) improvements in the quality of annual and quarterly economic statistics, in terms of both their timeliness and their reliability; and xi) the creation of an effective crisis management framework, with any financial assistance being based on strong conditionality that avoids moral hazard.*

## I INTRODUCTION

The global financial crisis exposed weaknesses in the economic governance framework of the EU, and of the euro area in particular, and severe shortcomings in its implementation. Some Member States had already accumulated large fiscal imbalances in “good times”. However, the Stability and Growth Pact (SGP) – the fiscal surveillance mechanism in place to safeguard the stability of Europe's Economic and Monetary Union (EMU) – did not provide sufficient incentives for the correction of these fiscal imbalances, particularly after the reform of the SGP in 2005. The financial and economic crisis led to a further deterioration in fiscal positions, owing to the effects on budgets of automatic stabilisers in the tax and benefit systems, the fiscal stimulus packages introduced by governments to counter the economic downturn, and the support provided to the financial sector. Other macroeconomic imbalances and divergences across Member States in terms of competitiveness were also allowed to develop over a number of years and, in the absence of

more far-reaching economic reforms, they have left countries with relatively weak economic growth prospects after the crisis.

These severe fiscal and macroeconomic imbalances led financial markets to question the sustainability of public debt in some euro area countries. Owing to the high level of economic and financial integration in the euro area, risks of adverse spillovers from individual countries to the euro area as a whole emerged. In May 2010 ad hoc measures were thus necessary to assist vulnerable Member States. The European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) were set up. It was also decided to review the economic governance framework of the euro area.

At its meeting in March 2010 the European Council mandated its President, Herman Van Rompuy, to establish, in cooperation with the European Commission, a task force comprising representatives of the Member States, the rotating Council Presidency and the ECB. The Van Rompuy Task Force (VRTF) was asked to draft

proposals to strengthen the EU surveillance framework, in particular budgetary and macroeconomic surveillance, and to establish a crisis management framework.<sup>1</sup> The VRTF report, endorsed by the European Council at its meeting in October 2010, put forward proposals that included broader and deeper coordination of economic policies (see Box 1); enhanced fiscal surveillance and a new framework for the surveillance of macroeconomic imbalances and

competitiveness developments; and a stronger institutional framework. Moreover, the Heads of State or Government agreed in December 2010 on the need to establish a permanent crisis management framework.

<sup>1</sup> The ECB actively contributed to the work of the VRTF. On 15 June 2010 the President of the ECB submitted a note to the President of the European Council entitled “Reinforcing economic governance in the euro area” (see [www.ecb.europa.eu/pub/pdf/other/reinforcingeconomicgovernanceintheeuroareaen.pdf](http://www.ecb.europa.eu/pub/pdf/other/reinforcingeconomicgovernanceintheeuroareaen.pdf)).

## Box 1

### THE EUROPEAN SEMESTER

The European Council agreed on 17 June 2010 to implement one of the recommendations of the Van Rompuy Task Force on economic governance, namely to reinforce the ex ante dimension of economic policy coordination by introducing the “European semester” on 1 January 2011. The European semester comprises a timetable that applies to all elements of surveillance, including fiscal, macroeconomic and structural policies. The timing of the various surveillance processes will be aligned to ensure consistency, while they will remain legally and procedurally separate.

The European semester starts in January with the publication of a European Commission report, the Annual Growth Survey, which aims to identify the main policy challenges for the EU and the euro area as a whole (see the chart). An annual economic summit of the European Council in

#### The European semester of policy coordination

	Policy guidance for the EU and euro area as a whole				Country-specific guidance			Second half of the year
	January	February	March	April	May	June	July	
<b>European Commission</b>	Annual Growth Survey					Policy guidance & possible recommendations		
<b>Council of Ministers</b>		} Debate & orientations					Finalisation & adoption of guidance	
<b>European Parliament</b>								
<b>European Council</b>			Annual economic summit				Endorsement of guidance & possible recommendations	
<b>Member States</b>			Fiscal notifications	National reform programmes & stability and convergence programmes				Adoption of next year's budgets
<b>Continuous: surveillance and, if warranted, recommendations under the preventive and corrective arms of the Stability and Growth Pact</b>								

March then provides strategic guidance on policies to be taken into account by Member States in their stability and convergence programmes (SCPs), which are submitted in April. In parallel, and as part of the Europe 2020 strategy<sup>1</sup> to strengthen growth and employment, Member States identify their growth bottlenecks in their national reform programmes (NRPs) and devise an appropriate and detailed reform strategy to foster employment and sustainable, socially inclusive economic growth. Based on the SCPs and the NRPs, the Council issues policy recommendations focused on the following year, ahead of the finalisation of national budgets in the autumn.

In 2012 an enhanced macroeconomic surveillance framework aimed at preventing the emergence of major macroeconomic imbalances and correcting existing imbalances will be implemented. It comprises an alert mechanism based on a scoreboard of a set of macroeconomic indicators and the Commission's report on potential and existing excessive macroeconomic imbalances in the Member States. The results of the scoreboard and the Commission's report will both be published at the same time as the Annual Growth Survey. They will provide an initial indication of the existence or potential risk of macroeconomic imbalances and vulnerabilities in the Member States. If any are identified, the Commission will provide broad-based, in-depth reviews of economic, financial and public finance developments in the Member States concerned. These reviews will be published early in June, together with the Commission's assessments of SCPs and NRPs. On the basis of a Commission recommendation, and in parallel to other policy recommendations in the context of the Europe 2020 strategy, the Council can recommend economic policy measures, specifically aimed at reducing these imbalances and risks, to the countries in question.

Finally, the cycle ends with the publication of the Annual Growth Survey in the following year, in which the Commission assesses the extent to which Member States have taken EU recommendations into account.

1 The Europe 2020 strategy was adopted by the European Council in June 2010 as a follow-up to the Lisbon strategy for growth and jobs. The strategy aims at promoting sustainable economic growth and delivering high levels of employment, productivity and social cohesion. See [http://ec.europa.eu/europe2020/index\\_en.htm](http://ec.europa.eu/europe2020/index_en.htm).

In this context, the Commission issued six legislative proposals on 29 September 2010 relating to the reform and enforcement of the budgetary surveillance framework, the establishment and enforcement of a new surveillance framework to identify and correct emerging macroeconomic imbalances, and the harmonisation and strengthening of national budgetary frameworks.<sup>2</sup> This legislative package is currently being discussed by the Council and the European Parliament, with an agreement expected by June 2011.

Against the background of the proposals made by the VRTF and the legislative proposals of the Commission, this article assesses the proposed changes to the economic governance framework, as well as the potential features of a crisis management framework. Overall, the ECB views the proposals as a step in the right direction of

broadening and strengthening the existing framework for fiscal and macroeconomic surveillance in the EU. However, they are not ambitious enough, particularly regarding the changes needed for the euro area.<sup>3</sup> Experience since the global financial crisis erupted leads to the inescapable conclusion that a quantum leap in economic governance is required to appropriately consolidate and reinforce the functioning of EMU.

The high degree of integration among euro area countries clearly justifies deeper economic union. The global financial crisis has shown that unsound economic and budgetary policies pursued by

2 The Commission proposals are COM(2010) 522, COM(2010) 523, COM(2010) 524, COM(2010) 525, COM(2010) 526 and COM(2010) 527.

3 This position is reflected in the ECB opinion on the Commission's legislative package published on 17 February 2011 ([http://www.ecb.europa.eu/ecb/legal/pdf/en\\_con\\_2011\\_13.pdf](http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2011_13.pdf)).

individual euro area countries, whatever their size, and the resulting negative spillovers, can cause difficulties for other euro area countries and endanger financial stability in the euro area as a whole. Countries must recognise their joint responsibility for stability and prosperity in the euro area, which requires the setting-up of effective institutions and the exercise of peer pressure. Thus, the ECB has urged the EU legislators and the Member States to take the historic opportunity offered by the reform process to fully exploit the current Treaty framework to strengthen euro area economic governance. The ECB has also called for the reversal of those changes to the SGP introduced in 2005 that increased the leeway allowed to Member States in respect of their obligations under the SGP.

The next section of this article takes stock of the present economic governance framework in the euro area and shows why it did not suffice to prevent unsustainable fiscal policies and the emergence of excessive macroeconomic imbalances. The following three sections assess the current reform proposals. Section 3 discusses the proposed reforms to the fiscal surveillance framework, while Section 4 analyses the proposed macroeconomic surveillance framework. Section 5 briefly examines the envisaged crisis management framework, and conclusions are drawn in Section 6.

## **2 ECONOMIC GOVERNANCE IN THE EURO AREA – WHY A QUANTUM LEAP IS REQUIRED**

The Treaty on the Functioning of the European Union (TFEU) specifies a clear division of responsibilities between European and national policy-makers in EMU. Monetary policy is inherently indivisible in a monetary union, and in the euro area it is thus conducted at the supranational level. By contrast, economic policies, such as fiscal and structural policies, have remained largely the competence of national governments and reflect national political preferences. However, for EMU to function properly, a price and financial

stability-oriented monetary policy alone is insufficient. Sustainable fiscal policies, as well as other economic policies to promote financial stability, economic growth and social cohesion across the euro area, are also required.<sup>4</sup>

The TFEU specifies that Member States are required “to conduct their economic policies with a view to contributing to the achievement of the objectives of the Union” (Article 120 of the TFEU). They “shall regard their economic policies as a matter of common concern and shall coordinate them within the Council” (Article 121(1) of the TFEU). This implies that Member States’ economic policies cannot be conducted fully independently, but are subject to common rules and joint scrutiny. EMU requires the transfer of at least some national sovereignty in economic policy-making to the supranational level, particularly in the euro area.

### **THE LACK OF RIGOROUS IMPLEMENTATION OF THE SGP**

With the introduction of EMU, euro area countries agreed to conduct their fiscal policies in accordance with the rules of the TFEU and the SGP. Member States are under an obligation to avoid excessive government deficits (a limit of 3% of GDP is stipulated) and debt (which should not exceed 60% of GDP unless it is diminishing at a satisfactory pace). Additionally, the SGP establishes the details of a multilateral surveillance framework to prevent and, where necessary, correct fiscal policies that do not comply with this obligation. However, in 2005 the Member States agreed on a revision of the SGP, which, among other changes, introduced more discretion and flexibility into the surveillance procedures.<sup>5</sup> At that time, the ECB expressed serious concerns about the negative effect of these reforms on the functioning of the preventive and corrective arms of the SGP.<sup>6</sup>

<sup>4</sup> See the article entitled “The economic policy framework in EMU”, *Monthly Bulletin*, ECB, November 2001.

<sup>5</sup> Morris, R., Ongena, H. and Schuknecht, L., “The reform and implementation of the Stability and Growth Pact”, *Occasional Paper Series*, No 47, ECB, Frankfurt am Main, June 2006.

<sup>6</sup> See the article entitled “The reform of the Stability and Growth Pact”, *Monthly Bulletin*, ECB, August 2005.

The preventive arm of the SGP is based on regular monitoring of national public finances by the Commission and the Council on the basis of the stability and convergence programmes submitted by Member States on an annual basis. Each Member State is required to pursue its medium-term budgetary objective (MTO).<sup>7</sup> Member States that have not yet achieved their MTOs should undertake consolidation efforts to do so, and such efforts should be stronger in “good times”, but could be more limited in “bad times”. The purpose of the corrective arm of the SGP is to remedy policies which put fiscal sustainability at risk. When a country fails to comply with its obligations, the excessive deficit procedure (EDP) is triggered. The EDP foresees a series of steps ranging from Council recommendations to financial sanctions for euro area countries.

Some Member States used the years before the crisis, when output growth exceeded its potential level, to achieve sustainable budgetary positions. However, many others did not. According to the opinions issued by the Economic and Financial Affairs (ECOFIN) Council at the beginning of 2008, only eight of the 17 countries currently in the euro area strictly complied with their MTOs in 2007, and several others had backloaded the projected adjustment paths towards their MTOs.<sup>8</sup> While this issue was raised in the ECOFIN Council’s assessment of the stability and convergence programmes, it did not trigger the use of procedural tools available under the preventive arm of the SGP, such as early warnings or policy advice issued by the European Commission.<sup>9</sup> In fact, even before the onset of the crisis some countries – both large and small – had recorded excessive deficits in many years after the introduction of the single currency (this was not always evident owing to the misreporting of fiscal data). Moreover, the reduction in interest payments owing to narrowing spreads on government bonds was not consistently used to reduce debt levels.

The failure of the SGP to provide sufficient incentives to use good times to vigorously

pursue sustainable budgetary positions and to impose a swift correction of excessive deficits in all countries can be attributed to several shortcomings. Under the SGP’s preventive arm, a country’s adjustment path towards its MTO and the MTO itself are assessed on the basis of its cyclically adjusted budget balance (net of one-off and temporary measures) which, owing to technical factors, tends to be overestimated in good times. As a result, revenue windfalls allowed government expenditure to grow considerably faster than medium-term potential output in some countries before the crisis. Nevertheless, they were deemed to have complied with the adjustment path towards their MTOs.

In addition, although Article 126(2) of the TFEU assigns equal importance to the deficit and debt criteria, the debt criterion has largely been ignored in the surveillance procedures. The evolution of the debt ratio in some countries before the crisis was influenced substantially by stock-flow adjustments that are overlooked in deficit-based surveillance (see Chart 1). Nevertheless, no action has been taken under the corrective arm of the SGP in response to non-compliance with the debt criterion, in part because quantitative criteria for assessing the pace of debt reduction were lacking.

Another flaw was that stability and convergence programmes were based on national budgets that had already been approved by national parliaments, which hampered the incorporation of policy advice into national budgets. As a

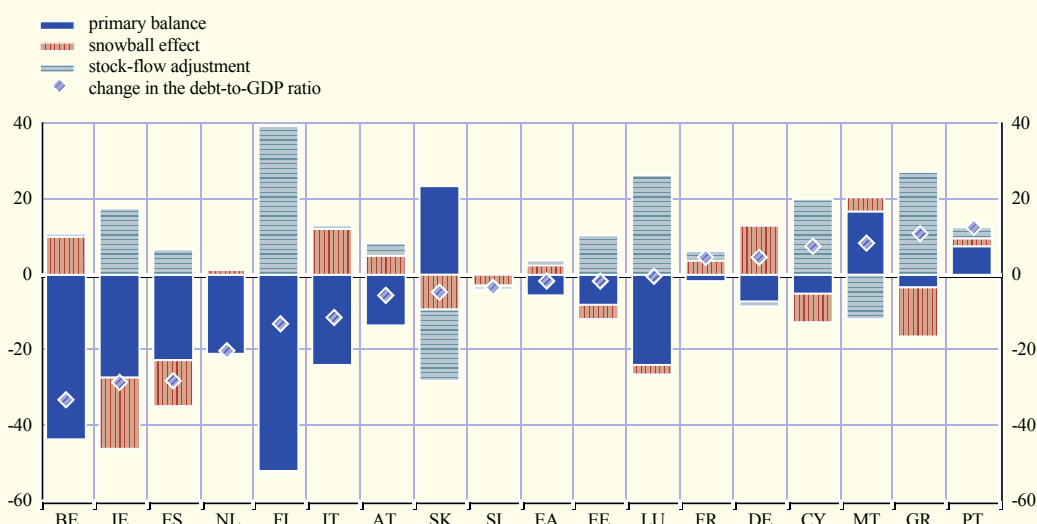
7 The MTO has a threefold aim: i) to preserve a safety margin with respect to the 3% of GDP reference value for the government deficit ratio; ii) to ensure rapid progress towards sustainable public finances and prudent debt levels; and iii) thus to allow room for budgetary manoeuvre, in particular so as to accommodate public investment needs.

8 Technical issues related to the calculation of structural balances also led to an overestimation of the progress achieved in 2007 towards the MTOs. The historical data reported in the Commission’s 2010 spring forecast revealed that in fact only five of the current euro area countries complied with their MTOs in 2007.

9 In the light of its 2008 spring forecast the Commission issued “economic and budgetary policy advice” only to France at the end of May 2008, since its general government deficit was projected to increase to 2.9% of GDP in 2008 and 3.0% of GDP in 2009.

Chart I Change in government debt ratios 1999-2007 and decomposition

(percentage points of GDP)



Source: European Commission.

Note: Countries are ordered by the change in their debt ratio. For Slovenia and the euro area aggregate, data start in 2001. The “snowball effect” represents the influence of the growth/interest rate differential on the evolution of the debt ratio.

result, the extent to which the fiscal rules of the SGP had been included in national budgetary frameworks differed greatly across countries.

Perhaps most importantly, the provisions of the SGP were only implemented half-heartedly. Peer pressure among the Member States – potentially a strong tool of mutual fiscal surveillance – was weak as countries did not attach sufficient importance to their joint responsibility for the stability of the euro area. The procedural tools for addressing instances of non-compliance lacked automaticity and left a great deal of room for discretion. Both the Commission and the Council were reluctant to use these tools and there was a lack of urgency in the follow-up measures requested from non-compliant countries. Sanctions, in the form of financial penalties imposed in the event of persistent failure to correct an excessive deficit, which were foreseen as the ultimate step in the long course of the EDP, were in fact never applied.

Finally, effective fiscal surveillance requires timely availability of reliable data and the impartial analysis of these data. However,

Eurostat, the Commission’s statistical service, did not have the necessary mandate to acquire reliable and comprehensive national fiscal statistics and to audit national statistical authorities.

#### THE LACK OF MACROECONOMIC SURVEILLANCE

The economic governance framework was also unable to prevent the emergence of excessive macroeconomic imbalances in the euro area.<sup>10</sup> Some countries experienced significant internal and external economic imbalances, and inflation rates persistently above the euro area average. Increases in labour compensation in some countries, driven in most cases by high public sector wage increases, exceeded productivity gains by a significant margin, leading to increases in unit labour costs in excess of those seen in other euro area countries and the euro area average, and a gradual erosion of competitiveness. At the same time, growth in

<sup>10</sup> However, under Articles 121(2), 121(3) and 121(4) of the TFEU it would have been possible to establish within the preventive arm of the SGP a relatively strong macroeconomic surveillance mechanism.

the unregulated financial sector and unsustainably strong domestic demand growth, coupled in some cases with excessive credit growth and large and sustained increases in real estate prices, resulted in large current account deficits (see Chart 2) and high levels of private and external debt.

Many factors contributed to these developments, including unrealistically optimistic expectations about future income developments and the underestimation of credit risks by financial institutions. However, the key factor was that wage and income policies were not sufficiently geared towards preserving competitiveness in a monetary union (see Chart 3). In addition to deficient fiscal, supervisory and regulatory policies, the necessary structural policies were not implemented. Governments failed to address structural rigidities in the euro area economies – relating inter alia to wage-setting institutions, including wage indexation, as well as labour and product market regulation.<sup>11</sup>

Excessively high credit growth led to the accumulation of severe financial risks in some countries. The extent of these risks was

uncovered in the context of the global financial crisis when governments intervened in order to stabilise the banking sector in their countries: euro area countries with a highly exposed private financial sector subsequently suffered from particularly severe deteriorations in their public finances. Such instabilities in the financial sector of one country can quickly spill over to other countries, given the euro area's highly integrated financial markets, implying risks to the stability of the euro area as a whole.

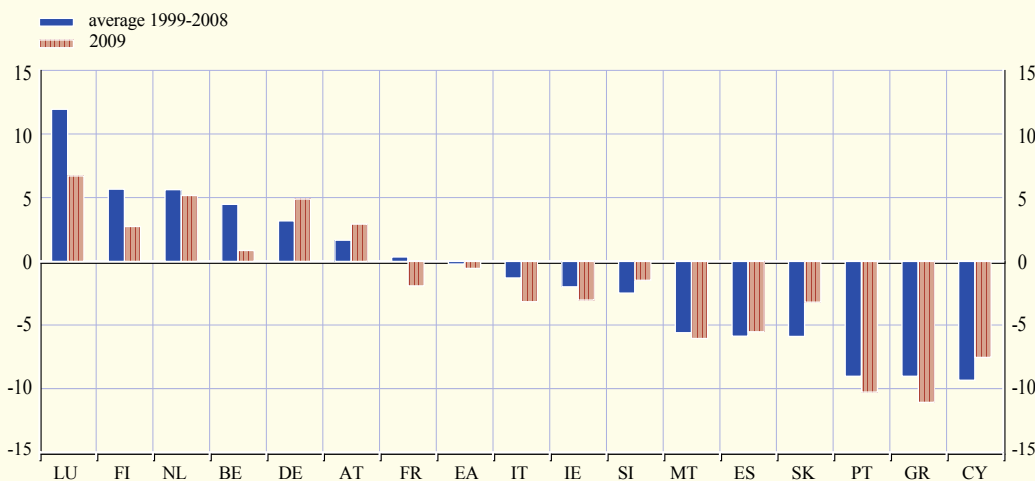
The euro area lacks appropriate mechanisms to identify and correct excessive macroeconomic imbalances. The coordination of economic policies in the EU is mainly conducted within the framework of the Broad Economic Policy Guidelines, the Employment Guidelines and the Europe 2020 strategy<sup>12</sup> (formerly the Lisbon

11 Holm-Hadulla, F., Kamath, K., Lamo, A., Pérez, J.J. and Schuknecht, L., "Public wages in the euro area – towards securing stability and competitiveness", *Occasional Paper Series*, No 112, ECB, Frankfurt am Main, June 2010.

12 The Europe 2020 strategy was adopted by the European Council in June 2010 as a follow-up to the Lisbon strategy for growth and jobs. The strategy aims at promoting sustainable economic growth and delivering high levels of employment, productivity and social cohesion. See [http://ec.europa.eu/europe2020/index\\_en.htm](http://ec.europa.eu/europe2020/index_en.htm).

Chart 2 Current account balances

(percentages of GDP)

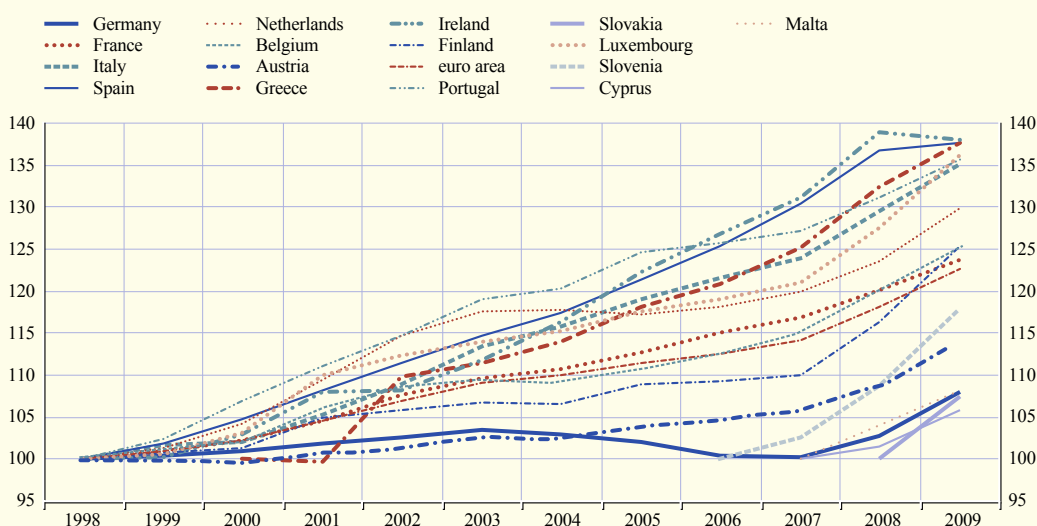


Source: ECB balance of payments statistics.

Note: Countries are ranked in descending order according to their average balance in the period 1999-2008.

**Chart 3 Indices of unit labour costs in nominal terms**

(indices based on annual data)



Source: Eurostat.

Note: The unit labour cost indices are set to 100 in the last year before the accession of the respective country to the euro area.

strategy), which set out policy recommendations to national policy-makers on macroeconomic, structural and labour market policies. The framework lacks sufficient surveillance instruments to monitor the implementation of policy recommendations, which are not binding and were thus all but ignored by Member States. While macroeconomic imbalances were frequently criticised in Council opinions on stability and convergence programmes, these opinions did not carry enough weight to persuade the Member States concerned to change their economic policies. Most importantly, however, this framework does not sufficiently focus on the risks associated with the build-up of significant macroeconomic imbalances and losses in competitiveness in the euro area and the potential for spillovers to other Member States.

#### THE LACK OF A CRISIS MANAGEMENT FRAMEWORK

The SGP was designed to safeguard the stability of EMU and effectively prevent a sovereign debt crisis from emerging in the euro area. In the run-up to EMU, hypothetical crisis scenarios for individual euro area countries were developed

and their consequences for public finances were simulated. The simulations showed that, under the assumption that the rules of the SGP were adhered to, only cases of deep recession would significantly weaken the fiscal position of euro area countries and the 3% deficit ceiling would be exceeded in only a very few situations.

Nonetheless, some euro area countries with high public debt levels lost access to market financing following the global financial crisis. On the one hand, none of the crisis scenarios were based on the assumption of a crisis of the magnitude experienced in 2007-08. No one was able to foresee a crisis of this severity and depth. On the other hand, and more importantly, however, many euro area countries did not adhere to the fiscal rules of EMU. The SGP was severely weakened in the 2005 reform and was not properly implemented. Thus, some euro area countries were already in a vulnerable fiscal position before the impact of the economic and financial crisis struck public finances.

In May 2010 the Council introduced support measures for individual, vulnerable euro



area countries on an ad hoc basis, acting in conjunction with the IMF, and subject to strict conditionality and non-concessional terms, with the objective of preserving financial stability and preventing spillovers to other countries. A permanent crisis management framework – designed to safeguard the stability of the euro area as a whole, while very significantly strengthening incentives for sound public finances – would enable such matters to be addressed in a systematic, rule-based manner.

In summary, this section has shown that the euro area requires, first, a stronger commitment on the part of countries to effectively prevent the pursuit of unsustainable fiscal policies and the emergence of other harmful macroeconomic developments. Second, if imbalances in public finances, significant losses in competitiveness or excessive macroeconomic imbalances nonetheless emerge, robust corrective mechanisms must come into force. There must be an appropriate degree of automaticity to ensure that these mechanisms are not open to wide interpretation or to undue political discretion. Third, in the unlikely event that the reinforced preventive and corrective arms of the proposed enhanced framework are unable to prevent a crisis in the future, the euro area would benefit from a well-designed permanent crisis management framework.

### 3 ENHANCED FISCAL SURVEILLANCE

In the wake of the financial crisis and the turmoil in sovereign debt markets, the European Council has agreed to overhaul the existing budgetary surveillance framework, as described in Section 2. The SGP will be enhanced and its application made more consistent and effective. To achieve this, the European Council has, among other changes, agreed to: i) strengthen the focus on government debt and fiscal sustainability; ii) reinforce compliance; and iii) ensure that national budgetary frameworks respect the European rules.

### PROPOSED REFORMS TO THE SGP AND NATIONAL BUDGETARY FRAMEWORKS

In order to strengthen the preventive arm of the SGP, the VRTF has recommended including expenditure developments (net of discretionary revenue changes) in the assessment of countries' compliance with their MTOs, which is based on changes in their structural deficits. According to the Commission's proposals, the growth rate of government expenditure should normally not exceed a prudent medium-term growth rate of GDP, unless matched by discretionary increases in government revenues.

Another new element is the option to issue policy recommendations if a Member State's adjustment path under the preventive arm is considered insufficient. According to the Commission's proposals, a recommendation would be issued if a significant deviation from the adjustment path towards a country's MTO persists or is particularly serious. A significant deviation would be defined as a divergence from the prudent rate of expenditure growth of at least 0.5% of GDP in one year or 0.25% on average over a period of two successive years.

To increase the focus on government debt and fiscal sustainability, in both the preventive and corrective arms, the VRTF has proposed that the debt criterion specified in the TFEU be better reflected in budgetary surveillance. Under the preventive arm of the SGP, Member States faced with a debt level exceeding 60% of GDP, or pronounced risks in terms of overall debt sustainability, would be required to make faster progress on their adjustment path towards their MTOs. Under the corrective arm, Member States with debt ratios in excess of the reference value of 60% of GDP would be subject to an EDP unless their debt was deemed to have declined at a satisfactory pace over a given period.

The Commission has proposed that a numerical benchmark be used to assess whether a country's government debt ratio is declining at a satisfactory pace – namely, in the three years

prior to the assessment the debt ratio should have declined by one-twentieth of the amount by which it differs from the 60% of GDP reference value per year on average (i.e. the government debt of a Member State with a 80% debt ratio would have to decline by 1% of GDP per year on average over three years for the pace of the decline to be considered satisfactory). When assessing the development of the debt ratio, it is proposed that an extensive list of relevant factors be taken into account, including developments in the country's medium-term debt position, as well as risk factors such as the maturity structure and currency denomination of the debt; stock-flow operations; accumulated reserves and other government assets; guarantees, notably linked to the financial sector; liabilities, both explicit and implicit, related to population ageing; and the level of private debt, to the extent that it may represent a contingent implicit liability for the government.

The VRTF has also recommended that compliance with the fiscal rules and recommendations be reinforced by introducing “new reputational and political measures”, including new reporting requirements for Member States; the option for a formal report to be issued by the Council and the Eurogroup to the European Council if a Member State does not implement a recommendation from the Council; and – for euro area countries and those participating in ERM II – on-site monitoring by a mission of the European Commission, in liaison with the ECB. These measures would complement new financial sanctions for euro area countries, such as interest-bearing and non-interest-bearing deposits, in addition to the existing fines. To the extent possible, the financial sanctions would be adopted by the Council via reverse qualified majority voting (see Table 1), thus increasing de facto automaticity in the decision-making process and acting as a “commitment device” for the Council.<sup>13</sup> The new financial sanctions and non-financial measures would be applied earlier and more gradually than the sanctions under the existing framework, which can be adopted by majority voting only at the end of the EDP.

Finally, the VRTF has recommended that national budgetary frameworks must meet a set of minimum requirements regarding: i) public accounting systems and statistics; ii) numerical rules; iii) forecasting systems; iv) effective medium-term budgetary objectives; and v) adequate coverage of general government finances. The Commission has included these elements in a draft directive on requirements for budgetary frameworks. Over and above these minimum requirements, a set of non-binding additional standards should be agreed upon, covering notably the use of top-down budgetary processes and fiscal rules, as well as the role of public bodies, such as fiscal councils, in providing independent analysis, assessments and forecasts related to domestic fiscal policy matters.

#### ASSESSMENT OF THE PROPOSED REFORMS

The ECB considers that the recommendations of the VRTF and the proposals of the Commission would broaden and strengthen the EU budgetary surveillance framework. However, they fall short of the effort needed to ensure appropriate fiscal policies in the euro area. The Commission and the Council would still have significant leeway in issuing recommendations and determining the level of sanctions. Excessive discretion could jeopardise the credibility of the proposed enhanced surveillance framework if rules and enforcement measures were not consistently applied. Therefore, more automaticity and less room for discretion are required in order to guarantee predictability, lend credibility to procedures and set the right incentives for governments. To strengthen the framework, the following elements would be necessary.

First, with regard to strengthening the preventive arm of the SGP, sufficient progress towards the medium-term objective should be evaluated on

<sup>13</sup> The new financial enforcement measures will be introduced on the basis of Article 136 of the TFEU for the euro area countries only, and it is envisaged that they will be complemented by conditionality rules based on compliance with the SGP requirements stipulated in the regulations on EU expenditure which apply to all Member States (except the United Kingdom).

Table I Summary of the proposed revised fiscal surveillance framework

	Key procedural steps	Financial sanctions
<b>Preventive arm</b>	<ol style="list-style-type: none"> <li>1 Member States submit stability and convergence programmes by April</li> <li>2 The Council issues opinions on stability and convergence programmes before the end of July and may invite a Member State to adjust its programme</li> <li>3 In the event of a significant deviation the Commission may issue a warning to a Member State</li> <li>4 The Council issues a recommendation to the Member State to take effective action</li> <li>5 The Member State reports to the Council on the action taken</li> <li>6 If the action is considered insufficient, the Council issues a recommendation to the Member State</li> </ol>	Interest-bearing deposit (0.2% of GDP) imposed by reverse qualified majority vote (proposed new sanction)
<b>Corrective arm</b>	<ol style="list-style-type: none"> <li>1 The Commission prepares a report on any Member State exceeding the reference value for debt and/or deficit, taking account of relevant factors</li> <li>2 The Council declares the existence of an excessive deficit and issues recommendations to the Member State</li> <li>3 Report on the effective action taken by the Member State concerned</li> <li>4 The Council assesses the effective action taken</li> <li>5 If the action is considered sufficient, the EDP is held in abeyance or the deadline is extended in the case of unexpected adverse economic events</li> <li>6 If the action is considered insufficient, the Council issues a decision on the lack of effective action</li> <li>7 The Council gives notice to the Member State to take measures to correct the excessive deficit</li> <li>8 The Member State may be subject to additional reporting and surveillance</li> <li>9 Report on the effective action taken by the Member State concerned</li> <li>10 If the action is considered sufficient, the EDP is held in abeyance or the deadline is extended in the case of unexpected adverse economic events</li> <li>11 If the action is considered insufficient, the Council can apply or intensify measures as long as the Member State fails to comply with the recommendation. Such measures include a requirement to publish additional information, an invitation to the European Investment Bank to reconsider its lending policy towards the Member State concerned or the imposition of a fine</li> </ol>	<p>Non-interest-bearing deposit (0.2% of GDP) imposed by reverse qualified majority vote (proposed new sanction)</p> <p>Fine (0.2% of GDP) imposed by reverse qualified majority vote (proposed new sanction)</p> <p>Fine (maximum of 0.5% of GDP) imposed by majority vote. This sanction is already an option under the existing framework</p>

the basis of an overall assessment using the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures.<sup>14</sup> This analysis should take into account the impact of the structure of economic growth on revenue growth in order to include revenue windfalls in the analysis. Member States with a debt ratio above 60% of

GDP should make more significant progress towards their MTO than the minimum requirement.

<sup>14</sup> The growth rate of government expenditure should normally not exceed a projected reference medium-term growth rate of potential GDP, which should be calculated according to the common methodology used by the Commission.

Second, with regard to the proposed benchmark for assessing the pace of debt reduction, the Commission proposal must be seen as the absolute minimum, as it may not constitute a sufficient incentive for fast debt reduction for countries with high debt and relatively robust nominal GDP growth. The recent crisis has shown that high levels of debt can become untenable within a short time span. Moreover, while some discretion in the assessment of a country's debt ratio is inevitable, since the evolution of debt is dependent on numerous factors over and above the budgetary policy pursued by the government, taking too lenient a view of such relevant factors, in particular mitigating ones, would undermine the agreement to adhere to a strict interpretation of the Treaty obligation to respect the reference value for government debt. With regard to the assessment of compliance with the debt criterion, relevant factors should only be considered when the government debt ratio will decline over a three-year horizon according to the Commission's forecasts.

Third, irrespective of whether the debt ratio is above or below the 60% of GDP reference value, when assessing whether the deficit is excessive, the relevant factors should only be taken into consideration if the deficit ratio, before taking into account such factors, is close to the 3% of GDP reference value and the excess over the reference value is temporary, in line with the current rules.

Fourth, the proposals for the introduction of new and graduated incentives and sanctions are a step in the right direction towards a rule-based quasi-automatic enforcement regime. A gradual build-up of pressure, starting well before a Member State is at risk of facing an unsustainable fiscal position, should make their application more credible. However, the Commission's proposals allow a lot of discretion in the application of the new sanctions, and this could be used to undermine their envisaged quasi-automatic application. The VRTF proposal is even weaker in this regard.<sup>15</sup> There should be no provisions enabling the Commission to propose to the Council that

financial sanctions be waived or reduced in exceptional economic circumstances or following a request by the Member State concerned.

Fifth, general exemption clauses, which are proposed under the preventive and corrective arms of the SGP, should not be implemented. The application of the SGP in past years lacked the discipline needed to achieve sustainable fiscal positions before the crisis. There was no lack of flexibility to respond to adverse economic circumstances. There is no need to include numerous provisions to allow procedures to be suspended or deadlines to be extended without limitation on broadly defined grounds.

Sixth, to give concrete meaning to the Treaty obligation to ensure that national budgetary procedures are in line with the objectives of the EU fiscal framework, Member States should enshrine these objectives in national law. Experience shows that independent forecasts help to prevent an optimistic bias in fiscal plans, and effective enforcement at the national level plays a key role in achieving sustainable fiscal policies. Member States should therefore provide a comparison between their forecasts and those of the Commission in their stability and convergence programmes. Such independent domestic fiscal surveillance could also strengthen the role of national parliaments in ensuring sound policies. For euro area countries, independent budget offices or fiscal monitoring institutions, such as fiscal councils, should be included in the minimum requirements for national budgetary frameworks.

Seventh, to underpin the reliability of a more rule-based framework, the independence and accountability of the underlying analysis has to be reinforced. It is important that the Commission services conducting macroeconomic and budgetary surveillance for the euro area have

<sup>15</sup> The VRTF report further weakens the Commission's proposed sanctions regime by stipulating that Council decisions on the new enforcement measures should be based on Commission recommendations instead of proposals, which require only a qualified majority of the Council instead of unanimity to overturn them.

the same independence as the Commission's competition services. This is necessary because the Commission's proposals to reduce the discretion available to the Council, although not as ambitious as they could be, put greater pressure on the Commission to live up to its pivotal role in proposing policy recommendations and sanctions. The Commission's intention to clearly distinguish the analysis and assessment carried out under the authority of the Commissioner for Economic and Monetary Affairs from decision-making by the full College of Commissioners regarding policy proposals to be submitted to the Council is therefore welcome, but should go further.

In addition, in order to ensure that economic and fiscal surveillance is conducted in an objective and independent manner, an independent advisory body made up of "wise persons" of recognised competence in economic and fiscal

matters should be established at EU level. Its task would be to publish an independent annual report on the compliance of the Commission and the Council with their obligations under Articles 121 and 126 of the TFEU and under the procedures presented in the Commission proposals. This body should also provide analysis on specific economic or budgetary issues on its own initiative or following a request by one of the European institutions to which it reports.

Eighth, to ensure the accuracy and timeliness of the data underlying the analysis, the European Statistics Code of Practice should be enshrined in a regulation, and weaknesses in data collection and reporting should be addressed immediately. To allow the Commission more time to assess reported fiscal statistics, the reporting deadlines for both annual and quarterly statistics should be brought forward (see Box 2).

## Box 2

### STATISTICAL GOVERNANCE FRAMEWORK

As highlighted recently in the conclusions of the November 2010 ECOFIN Council,<sup>1</sup> it is essential that the statistical indicators and underlying data used for the economic governance framework be firmly based on sound statistical methodologies and compiled in accordance with the principles laid out in the European Statistics Code of Practice (hereinafter referred to as the Code of Practice) and that the European Statistical System (ESS)<sup>2</sup> be involved in discussions concerning statistical aspects of the indicators.

Several steps have been taken to strengthen the overall governance of European statistics compiled by the ESS as a follow-up to the misreporting of Greek government deficit and debt data in 2004 and the subsequent call by the ECOFIN Council in November 2005 for the establishment of minimum standards to safeguard the independence, integrity and accountability of national statistical authorities.<sup>3</sup> Listed in the chronological order of their creation, the following three important elements have been introduced: i) the Code of Practice; ii) the European Statistical Governance Advisory Board (ESGAB); and iii) amendments to the legislation governing the collection, production and dissemination of European statistics by the ESS.

1 See the ECOFIN Council Conclusions on EU Statistics of 17 November 2010, available at [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/117762.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117762.pdf).

2 The ESS comprises the national statistical institutes of the EU Member States and Eurostat as laid down in Regulation (EC) No 23/2009 of the European Parliament and of the Council on European statistics. A number of measures have been taken that directly address methodological flaws in the compilation of excessive deficit procedure statistics.

3 See the ECOFIN Council Conclusions on EU Statistics of 8 November 2005, available at [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/86877.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/86877.pdf).



The Code of Practice was adopted in February 2005 by the Statistical Programme Committee<sup>4</sup> and presented by the Commission to the Member States in May 2005.<sup>5</sup> The Code has a dual purpose: i) to improve trust and confidence in statistical authorities by proposing certain institutional and organisational arrangements, and ii) to reinforce the quality of the statistics they produce. The Code of Practice contains 15 principles relating to the institutional environment of the ESS, its statistical processes and its statistical output, and aims to provide a general framework for enhancing the quality of European statistics. The principles go further than the statistical principles enshrined in the TFEU and are based on international and European quality standards, guidelines and good practice.<sup>6</sup>

The second initiative was the establishment of the ESGAB by the European Parliament and the Council in March 2008.<sup>7</sup> As early as November 2005 the Council had concluded that a new high-level advisory body would have enhanced the independence, integrity and accountability of the Commission (Eurostat) and of the ESS in the context of the peer review assessment that was conducted when the Code of Practice was implemented. The ESGAB is composed of independent statistical experts appointed on the basis of their competence for a limited period of time. Its mandate is to provide an independent overview of the ESS as regards the implementation of the Code of Practice. It can also advise the Commission (Eurostat) on i) appropriate measures to facilitate the implementation of the Code of Practice in the ESS as a whole; ii) on how to communicate the Code of Practice to users and data providers; iii) on the updating of the Code of Practice; and iv) on questions related to user confidence in European statistics. It reports once a year to the European Parliament and to the Council and is assisted by an independent secretariat provided by the Commission.

The third step, which was taken in 2009, was the updating of the legal basis for the collection, production and dissemination of European statistics compiled by the ESS. This was achieved through the adoption of a revised Regulation on European statistics.<sup>8</sup> This new legal framework represents a major step forward as it designates Eurostat as the “Community statistical authority [...] to develop, produce and disseminate European statistics”. It also enshrines the statistical principles of the Code of Practice.

Looking ahead, several other steps can be envisaged to further strengthen the foundations of the ESS. Ultimately, the ESS may be transformed into a European system of statistical institutes including a European statistical institution. This would be an independent body similar to the ESCB. However, such a comprehensive solution (in particular the creation of an independent European statistical institution) would require a Treaty change. Nevertheless, it may serve as a benchmark against which other measures to enhance the effectiveness of the ESS can be assessed.

4 The Statistical Programme Committee was the predecessor of the current ESS Committee.

5 See Recommendation of the Commission on the independence, integrity and accountability of the national and Community statistical authorities, COM(2005) 217 final, European Commission, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52005PC0217:EN:NOT>. Under Article 288 of the TFEU, recommendations and opinions have no binding force, so Member States are not bound to adhere to the Code of Practice.

6 Article 338(2) of the TFEU states that “The production of Union statistics shall conform to impartiality, reliability, objectivity, scientific independence, cost-effectiveness and statistical confidentiality: it shall not entail excessive burdens on economic operators.”

7 See Decision No 235/2008/EC, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:073:0017:0019:EN:PDF>.

8 See Regulation (EC) No 223/2009 on European statistics, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:087:0164:0173:en:PDF>.

Without amending the Treaty, there is limited scope for reforming the statistical governance framework under the principles of subsidiarity and proportionality. First, the professional independence of the ESS could be further strengthened. The provisions safeguarding the rules governing the nomination, the term of office and the dismissal of the Director General of Eurostat and the heads of the national statistical institutes could be reinforced in the Regulation on European statistics and in the Code of Practice. The latter could be made legally binding on the Commission and the Member States by incorporating it in a regulation. Second, full implementation of the Code of Practice could be accelerated to further enhance the quality of European statistics, in particular by reinforcing mandates for data collection and involving statisticians at an early stage in the design of requirements relating to administrative data. For this purpose, the competencies of the ESGAB could be extended to actively monitoring compliance of the ESS with the Code of Practice. It could be assisted in its task by courts of auditors, which would be in charge of reviewing the compliance of national statistical institutes with the Code of Practice. Finally, sanctions could be considered for repeated severe statistical misreporting in the absence of effective corrective action.

#### 4 MACROECONOMIC SURVEILLANCE

The new macroeconomic surveillance framework envisaged in the Commission proposals and the VRTF report aims to identify and address macroeconomic imbalances. It complements the macro-structural surveillance process foreseen under the Europe 2020 strategy, which focuses on fostering sustainable and socially inclusive growth and employment. As proposed, the new framework will apply to all Member States and will have preventive and corrective arms. The latter would include enforcement rules for euro area countries.

##### THE PROPOSED NEW MACROECONOMIC SURVEILLANCE FRAMEWORK

The first element of the preventive arm as proposed by the Commission is an alert mechanism which would provide an initial indication of the existence or potential risk of macroeconomic imbalances and vulnerabilities in Member States. The alert mechanism would comprise a scoreboard with a limited set of macroeconomic indicators to be supplemented by economic judgement. External imbalances would be covered by indicators of the external position (e.g. current account as a share of GDP, net foreign financial assets as a share of GDP), competitiveness (e.g. real effective exchange rates, unit labour costs, HICP inflation), and

internal imbalances by indicators on housing (e.g. construction value added, house prices) and indebtedness (e.g. public sector debt as a share of GDP, private sector debt as a share of GDP).

According to the Commission proposals, alert thresholds would be set and announced for each indicator to increase transparency and accountability. For competitiveness and current account indicators, thresholds would be symmetric: they would detect both excessively high levels and excessively low levels of the variable, implying that action would be required in both cases in Member States. The VRTF report adopted a more nuanced view on this issue by making a distinction between Member States with large current account surpluses and those showing persistently large current account deficits and large competitiveness losses, given that the need for policy action is particularly pressing for the latter.

Based on the results of the scoreboard, if significant macroeconomic imbalances or risks were identified, the Commission would carry out a broad-based, in-depth review of economic, financial and public finance developments in the Member States concerned. On the basis of its in-depth reviews, the Commission could recommend that the Council address a recommendation to the Member State concerned, setting out specific economic policy

measures aimed at reducing these imbalances and risks. These recommendations would be issued by the Council in parallel with other policy recommendations in the context of the Europe 2020 strategy and the SGP.

If the Commission were to identify severe macroeconomic imbalances, or imbalances that potentially endanger the proper functioning of EMU, it could recommend the triggering of the excessive imbalance procedure (EIP) under the corrective arm of the proposed macroeconomic surveillance framework, and the Member State concerned would be placed under stricter economic policy surveillance. Policy recommendations devised under the corrective arm would be more detailed and stricter than recommendations issued under the preventive arm and would specify the expected policy responses and set deadlines for taking corrective action. Member States under the EIP would be obliged to submit a corrective action plan (CAP) setting out their national policy response to the Council recommendations and deadlines, subject to Council endorsement. Member States subject to the EIP would be obliged to regularly report to the Council and to the Commission on the progress made towards the implementation of the Council recommendations. The Commission would assess their progress on the basis of these reports and possible country surveillance missions. The Member States would continue to be subject to stricter surveillance and reporting obligations until the Council, on the basis of a Commission recommendation, finds that the situation of an excessive imbalance has come to an end and closes the EIP.

The sanction mechanism of the EIP proposed by the Commission is foreseen to be broadly similar to the mechanism defined in the EDP for fiscal surveillance. For euro area countries, the Commission has put forward the possibility of applying financial sanctions in two situations. First, if the Council considers the measures or the timetable envisaged in the CAP to be insufficient to comply with its recommendations, it could ask the Member State concerned to revise the CAP. Sanctions could be applied to a euro area

country which repeatedly fails to provide a CAP which the Council deems appropriate. Second, if, on the basis of the Commission's assessment of a Member State's compliance with Council recommendations, the Council concludes that the Member State has repeatedly failed to deliver "appropriate action" under the EIP, it could implement financial sanctions, i.e. fines.

#### **ASSESSMENT OF THE PROPOSED MACROECONOMIC SURVEILLANCE FRAMEWORK**

The introduction of a macroeconomic surveillance framework is a potentially important step towards closer economic union. To ensure the smooth functioning of monetary union, the framework should be improved in several ways. First, the specific nature of membership of a monetary union should be reflected more explicitly. This requires a clear distinction between the policy needs of euro area countries, on the one hand, and those of the other Member States, on the other, in view of the fact that spillovers inside the euro area are larger and exchange rate adjustments are no longer possible for euro area countries. This should therefore be clearly reflected in differentiated indicators and thresholds in the scoreboard. Tighter thresholds for competitiveness indicators should be imposed for the euro area countries.

Second, the particular focus of the surveillance framework should be on those macroeconomic imbalances that threaten the smooth functioning of the monetary union, which are significant losses in competitiveness, persistent current account deficits, unsustainable increases in asset prices, including real estate prices, and high levels of external and internal indebtedness.<sup>16</sup> The framework proposed by the European Commission is symmetric with respect to detecting, preventing and correcting both

<sup>16</sup> The set of indicators should be limited and focus on the detection of macroeconomic imbalances, and should therefore comprise indicators of private and public internal indebtedness, external indebtedness and price competitiveness. Such variables have proved to be important indicators of internal and external macroeconomic imbalances and competitiveness developments. This differs from the much wider set of variables used to assess progress on reforms in the context of the Europe 2020 strategy.



Table 2 Summary of the proposed macroeconomic surveillance framework

	Key procedural steps	Financial Sanctions
<b>Detection of imbalances (preventive arm)</b>	<ol style="list-style-type: none"> <li>1 The Commission report assesses all 27 Member States vis-à-vis the thresholds defined in the scoreboard; the scoreboard is updated at least annually</li> <li>2 The Council discussion of the Commission report</li> <li>3 If Member States are considered to be affected by or at risk of imbalances, the Commission conducts an in-depth review</li> <li>4 The Commission formulates recommendations and informs the Council of Member States experiencing imbalances</li> <li>5 The Council issues recommendations to the Member States concerned</li> <li>6 The Council reviews compliance with recommendations annually and may amend recommendations as appropriate</li> </ol>	
<b>Excessive imbalance procedure (corrective arm)</b>	<ol style="list-style-type: none"> <li>1 The Commission formulates recommendations and informs the Council of Member States experiencing “excessive” imbalances based on the in-depth review</li> <li>2 The Council declares the existence of an excessive imbalance and issues recommendations to the Member State concerned, based on the Commission recommendations</li> <li>3 The submission of a corrective action plan by the Member State concerned</li> <li>4 Within two months after the submission of a corrective action plan, and on the basis of a Commission report, the Council shall assess the corrective action plan</li> <li>5 If the plan is considered sufficient, the Council shall adopt an opinion endorsing it If the plan is considered insufficient, the Council shall invite the Member State to amend its corrective action plan within a new deadline, taking into account the scale and urgency of imbalances and the capacity of policies to address the situation</li> <li>6 The Council will decide whether or not the Member State concerned has taken the recommended corrective action</li> <li>7 The Member State will be subject to regular reporting and surveillance</li> <li>8 Report on the action taken by the Member State concerned</li> <li>9 The EIP will be closed once the Council concludes, on the basis of a recommendation by the Commission, that the Member State is no longer experiencing excessive imbalances</li> </ol>	<p>Fine (0.1% of GDP) imposed by reverse qualified majority vote (proposed new sanction)</p>
	<p>If a Member State repeatedly fails to act on Council recommendations to address excessive imbalances, it will have to pay a yearly fine until the Council establishes that corrective action has been taken</p>	

excessive losses and excessive gains in competitiveness. This entails a risk that surveillance efforts would lack focus and could be distracted from the most serious challenges to monetary union. As noted above, the VRTF report addresses this issue and calls for differentiation in the treatment of over and underperforming countries within the proposed macroeconomic surveillance framework. In order not to make the procedure overly complex or introduce a misguided short-term focus on demand management in the surveillance process, cases in which Member States experience strong gains in competitiveness and large current account surpluses should only be dealt with in the context of the Europe 2020 strategy.

Third, a greater degree of automaticity should be introduced in the proposed macroeconomic surveillance framework. While macroeconomic developments may be affected by factors outside the control of governments, and the impact of policy measures on macroeconomic developments may be indirect and therefore difficult to identify, it has to be ensured that the macroeconomic surveillance procedure is effective and provides the right incentives. However, the Commission’s proposals give the Council substantial discretionary power over the issuance of policy recommendations and the size of sanctions. Too much scope for discretion could put the credibility of the macroeconomic surveillance framework at risk, since the rules

and enforcement measures may not be applied consistently. The possibility of reducing or waiving financial sanctions on the grounds of exceptional economic circumstances or at the request of a Member State should therefore be avoided. In addition, the reverse majority voting rule, whereby the Commission proposals and recommendations would be deemed adopted by the Council unless rejected by a qualified majority vote, should be used more widely throughout the procedure.

Fourth, as with the reforms introduced in the SGP, financial sanctions in the proposed macroeconomic surveillance framework need to be applied gradually and at an early stage in order to provide Member States with the right incentives to comply with policy recommendations. This implies that financial sanctions – such as the obligation to set up an interest-bearing deposit – should be imposed immediately after the first instance of non-compliance or non-cooperation by a Member State. Political and reputational measures – such as reports to the European Council in case of non-compliance as well as the possibility for the Commission to conduct missions to Member States, in liaison with the ECB for euro area and ERM II countries – should also be made available, under both the preventive and the corrective arm as envisaged in the VRTF report.

## **5 A PERMANENT CRISIS MANAGEMENT FRAMEWORK**

Broader and stronger preventive and corrective arms of the economic governance framework should go a long way towards minimising the risk of a fiscal crisis recurring in the euro area. Nonetheless, as the possibility of a future sovereign debt crisis cannot be completely ruled out, a permanent crisis management framework is required to deal with a sovereign liquidity or solvency crisis.

On 16 and 17 December 2010 the European Council agreed on a Treaty amendment to allow a permanent crisis management framework –

named the European Stability Mechanism (ESM) – to be established by the euro area countries. As proposed, Article 136(3) of the TFEU will stipulate that the crisis management mechanism will be activated if the financial stability in the euro area as a whole is endangered and that any financial assistance in the form of loans will be made subject to strict conditionality.<sup>17</sup> The EFSF and the EFSM, which were set up in May 2010, will remain in place until June 2013 and will then be replaced by the ESM. The European Council endorsed the general features of the mechanism as set out in the Eurogroup statement of 28 November 2010 and requested the Eurogroup and the Commission to finalise work on the intergovernmental arrangement for setting up the future mechanism by March 2011 in cooperation with the European Parliament.

According to the Eurogroup statement, the ESM will complement the new framework of reinforced economic governance from June 2013. It will be based broadly on the EFSF. More specifically, assistance provided to a euro area country will be based on a stringent programme of economic and fiscal adjustment and on a rigorous debt sustainability analysis conducted by the Commission and the IMF, in liaison with the ECB. For countries considered solvent, private sector creditors will be encouraged to maintain their exposure. Insolvent Member States will have to negotiate a way to regain debt sustainability with creditors as a precondition for any financial assistance. To facilitate the negotiations with private sector creditors, standardised and identical collective action clauses (CACs) will be included in all newly issued government bonds from June 2013. Any decision to grant financial assistance will require the unanimous agreement of the euro area countries.

<sup>17</sup> The Member States have agreed to amend Article 136 of the TFEU. Paragraph 3 of the Article will read as follows: “The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.”

The ECB has welcomed the creation of a permanent crisis management framework to safeguard the financial stability of the euro area as a whole as a complement to the enhanced fiscal rules and macroeconomic surveillance. Due to the close integration of financial markets, the ESM must ensure that a sovereign debt crisis in the euro area is resolved in a timely and orderly manner. Any risk of contagion across countries (spreading the fiscal crisis across the euro area) or from a sovereign to private agents (creating or exacerbating a financial crisis) should be addressed by quick and decisive intervention.

Most importantly, the assistance mechanism of the ESM should minimise moral hazard. It needs to be governed by rigorous and binding rules to impose discipline on fiscal policies and must not be an attractive option for Member States. Any financial assistance to a Member State should be subject to strict conditionality to ensure that the sustainability of public finances is restored in a timely and ambitious manner. At the same time the financial support should be granted on non-concessional terms and the permanent crisis management framework must allow for financial market discipline. The possibility for private sector involvement in the event of the insolvency of a euro area country will ensure that interest rates sufficiently reflect the risks associated with differences in fiscal positions across Member States.

## 6 CONCLUSIONS

The current economic governance framework was never fully implemented and has even been weakened since the start of EMU. It thus failed to prevent the crisis in the euro area. The economic surveillance framework in place for fiscal policies was not applied sufficiently rigorously and available sanctions were not implemented. At the same time it lacked suitable mechanisms for the surveillance of macroeconomic policies. The economic governance proposals of the VRTF endorsed by the European Council in October 2010 and the Commission proposals

still under discussion go some way towards remedying these problems. However, they are not the quantum leap required to ensure sound economic and budgetary policies in the euro area, guaranteeing long-run stability and prosperity.

This article has indicated more precisely the areas where the envisaged reforms to the economic governance framework need to be reinforced, as follows:

- i) **Greater automaticity is required in all surveillance procedures, including the new macroeconomic surveillance framework.** When Member States fail to comply with recommendations to adjust their policies, this should lead to the consequences provided for in the preventive and corrective procedures, and the Council should have less room for halting or suspending procedures against the Member States. A simple way of achieving this would be a formal declaration by the Council, or at least the Eurogroup, committing itself to voting, as a rule, in favour of the continuation of procedures where recommended or proposed by the Commission. Thus, the Council would voluntarily limit its discretion and would need to justify instances in which it did not follow its own rule. Also, broader use of reverse majority voting should be considered.
- ii) **Surveillance procedures require strict deadlines, to avoid lengthy procedures, and the elimination of “escape clauses”.** The Council or the Commission should not be allowed to extend the deadline for correcting an excessive deficit or accept any significant deviation from the adjustment path towards the MTO during a severe economic downturn of a general nature, or to reduce or cancel financial sanctions either on grounds of exceptional economic circumstances or following a request by the Member State concerned. This would enhance automaticity.

- iii) **The macroeconomic surveillance framework should have a clear focus.** In particular, it should focus on euro area countries with large current account deficits, significant competitiveness losses or high levels of public and private debt, as well as any other vulnerability threatening EMU.
- iv) **Political and reputational measures should foster early compliance with the surveillance framework.** This includes increased reporting obligations for Member States and the submission of reports by the Council to the European Council in the event of non-compliance with Council recommendations, as well as the possibility of the Commission conducting missions to Member States, in liaison with the ECB for euro area and ERM II countries if the ECB deems this appropriate.
- v) **Financial sanctions should be applied at an early stage and gradually within the macroeconomic surveillance framework to provide clear and credible incentives for countries to adopt appropriate macroeconomic policies.** The EIP should oblige Member States to lodge an interest-bearing deposit following the first instance of non-compliance and impose fines in cases of repeated non-compliance. The proceeds from any financial sanctions imposed on euro area countries as part of budgetary and macroeconomic surveillance should be assigned to the future ESM.
- vi) **Benchmarks for establishing the existence of an excessive deficit should be more ambitious.** The scope for taking into consideration any “relevant factors” when establishing the existence of an excessive deficit – whether on the basis of the deficit criterion or on the basis of the debt criterion – should be substantially reduced, particularly when these are factors that could be regarded as mitigating the Member State’s failure to comply with the criteria. As regards the deficit criterion, such factors should be taken into account only if the deficit ratio of the country concerned is close to the 3% of GDP reference value and exceeds this value only temporarily (irrespective of whether the country’s debt ratio is above or below the 60% reference value). As regards the debt criterion, such factors should be considered only if a government debt ratio in excess of 60% of GDP is projected to decline. Also, the backward-looking numerical benchmark used to assess whether a debt ratio above 60% of GDP is sufficiently diminishing should come into effect without delay.
- vii) **Requirements as regards the adjustment path towards a country’s MTO should be made more ambitious.** Under the revised budgetary surveillance procedure, the question of whether a country is making sufficient progress towards its MTO should be evaluated on the basis of an overall assessment using the structural balance as the point of reference, including analysis of expenditure net of discretionary revenue measures. In this context, the annual improvement in the structural balance should be significantly more than 0.5 percentage point of GDP where a country’s government debt exceeds the reference value of 60% of GDP or there are fiscal sustainability risks.
- viii) **The quality and independence of fiscal and economic analysis needs to be guaranteed.** This requires the establishment of an independent advisory body at EU level comprising persons of recognised competence. This body would provide an external ex post assessment of the conduct of budgetary and macroeconomic surveillance by the Council and the Commission.
- ix) **The commitment of the Member States to swiftly implement strong national budgetary frameworks in**

**order to facilitate compliance with their obligations under the SGP needs to be strengthened.** This would require that the proposed budgetary frameworks directive be transposed into national law as faithfully as possible and no later than by the end of 2012. The Eurogroup could issue a formal statement to that effect. Also, the directive has to establish clear consequences in the event that national authorities do not comply with their budgetary obligations. For euro area countries, a new chapter is required in the directive in order to make independent national fiscal monitoring institutions mandatory. The measures in the directive should not prevent Member States from developing stronger frameworks. The EU should consider obliging Member States to adopt clear borrowing frameworks with precise definitions and limits.

- x) **The quality of annual and quarterly statistics needs to be improved, both in terms of timeliness and reliability.** The European Statistics Code of Practice should be enshrined in a regulation, and weaknesses in data collection and reporting should be addressed immediately.
- xi) The enhancement of the SGP and effective macroeconomic surveillance are imperative. However, even if the rules are strictly applied, future crises cannot be excluded. **The new economic governance framework should include a crisis management framework that safeguards the financial stability of the euro area as a whole if one or more countries experience a sovereign debt crisis.** While the mechanism should effectively and appropriately address cases of illiquidity and insolvency, the avoidance of moral hazard is essential.