

Box 7

STRUCTURAL POLICY PRIORITIES FOR THE EURO AREA

In recent months, economic policies have focused on short-term measures to contain the impact of the financial market crisis on the real economy. National economic policies have been guided by the principles contained in the European Economic Recovery Plan (EERP).¹ For the longer term, the Lisbon Strategy for Growth and Jobs also provides guidelines for addressing long-term economic challenges with structural reforms. In this context, the European Council recently endorsed an update of the country-specific recommendations for economic policies.² This box presents an assessment of structural policy priorities in the current situation, as also reflected in the updated recommendations.³

The recommendations for euro area countries highlight five policy challenges that require an accelerated implementation of reforms:

1. Implementing EU financial services legislation and deepening cooperation in crisis prevention, management and resolution

The impact of the current financial crisis has called for a comprehensive review of the financial markets' regulatory and supervisory frameworks. In October 2007 the ECOFIN Council agreed on a list of actions to be undertaken by 2008 at the latest. These actions focused on (i) enhancing transparency; (ii) improving valuation processes, in particular for complex or illiquid financial instruments; (iii) strengthening market functioning, in particular by reviewing the role of credit rating agencies and the "originate and distribute" model; and (iv) improving the prudential framework and banks' risk management.

1 Communication from the European Commission to the European Council: A European Economic Recovery Plan, 26 November 2008.

2 Contribution of the Council (ECOFIN) to the Spring European Council 2009: Country-Specific Integrated Recommendations.

3 The recommendations are based on the priority areas identified in the Integrated Guidelines for Growth and Jobs for the period 2008-10 and on the principles of the EERP. For background information on the Integrated Guidelines and longer-term policy challenges, see the box entitled "The 2008 update of the integrated policy guidelines of the Lisbon strategy" in the April 2008 issue of the Monthly Bulletin. For policy priorities, see the box entitled "Structural policies in times of crisis" in the December 2008 issue of the Monthly Bulletin.

From a regulatory perspective, the main focus within the EU should be on the timely implementation of the amendments to the Capital Requirements Directive (CRD) that cover the large exposures regime, the establishment of supervisory colleges, the enhancement of the quality of banks' capital, the improvement of liquidity risk management and the treatment of securitisation exposures. Further changes to the CRD are already being discussed with regard to, inter alia, the capital requirements for the trading book, securitisation and the elimination of national options and discretions. Moreover, with a view to subjecting all institutions, markets and instruments that are systemically relevant or have a key role in market functioning to appropriate regulation and oversight, the European Commission has already presented proposals for tailored regulation concerning credit rating agencies and has announced additional initiatives addressing hedge funds and over-the-counter derivatives markets.

The current crisis has revealed that policy interventions need to be globally coherent in order to be effective. In this context, consistency should be ensured with the work being carried out under the aegis of the G20.

A report published by the de Larosière Group in February 2009 highlighted, inter alia, the need to strengthen the crisis prevention framework with adequate arrangements to monitor, signal and address at an early stage macro-prudential risks, as well as to address the failures in supervisory coordination evidenced by the crisis. More specifically, it is proposed that a new body, the European Systemic Risk Council, to be chaired by the President of the ECB, should be set up under the auspices and with the logistical support of the ECB. Furthermore, the report proposes the transformation of the Level 3 Committees into European Authorities. In its Communication of 4 March 2009, the European Commission endorsed the thrust of the proposals of the de Larosière Group and announced the presentation of a "European financial supervision package" before the end of May 2009, for decision at the June European Council.

2. Securing the sustainability of public finances and addressing macroeconomic imbalances

The economic downturn has led to a sharp and widespread deterioration in euro area countries' budget balances and to a rise in general government gross debt-to-GDP ratios, partly due to major bank recapitalisations. Furthermore, state guarantees to the banking sector represent sizeable contingent liabilities. On top of this, large implicit liabilities resulting from projected increases in total age-related spending constitute an additional risk to the long-term sustainability of public finances in many euro area countries.

To secure fiscal sustainability, it is essential that the provisions of the EU Treaty and the Stability and Growth Pact are applied in full, particularly with regard to excessive deficit procedures for countries with deficits above the 3% of GDP reference value. Countries subject to such procedures need to consolidate without delay and should make a credible commitment to quickly return to sound fiscal positions. The new formula for calculating EU Member States' medium-term objectives in the light of the ageing-related fiscal burden, which is to be applied for the first time in the 2009 stability and convergence programmes, should allow for an ambitious approach for taking into account implicit liabilities related to the cost of ageing. Finally, recent experience shows how macroeconomic imbalances contribute to countries' vulnerability to external shocks and highlights the need to contain such imbalances, inter alia, with the help of sufficiently tight fiscal policies.

3. Improving the quality of public finances

Available empirical evidence indicates that the quality of public finances differs significantly across countries, suggesting scope for efficiency gains.⁴ Therefore, in addition to maintaining an appropriate fiscal stance, fiscal policies can make an important contribution to economic growth and job creation by improving the quality of public expenditure and taxation. Indeed, given the scarcity of public resources, it is essential that expenditure programmes be pursued in an efficient and effective manner in order to improve productivity, long-term growth prospects and fiscal sustainability. Some of the recent fiscal measures adopted by governments to address the economic downturn (such as increases in public employment, transfer payments) run the risk of not contributing to a higher quality of public finances, particularly as they could be difficult to reverse and would then contribute to economic distortions that may inhibit long-term growth.

4. Implementing “principles of flexicurity”, promoting labour mobility and better aligning of wage growth with productivity, employment and competitiveness

From a longer-term perspective, and looking beyond the current weakness, past reforms have contributed to a structural improvement in the labour market situation. Several recent national measures on the labour market side, including cuts in labour taxes and social security contributions that lower tax wedges and therefore improve incentives to work, are also heading in the right direction. Recent measures to increase flexibility in hours worked and to support re-employment can also help to contain the rise in unemployment and to support the recovery.⁵

A firmer focus on policy measures that increase flexibility and wage differentiation would contribute to the recovery and improve the functioning of labour markets in the long term. While the guidelines ask for the implementation of “principles of flexicurity”, past reforms related to market flexibility have not been sufficiently comprehensive. As the economy recovers, lower dismissal costs, together with measures to support re-employment, would also increase incentives for firms to employ new workers. Wage bargaining should ensure that wages reflect firm-level productivity and take into account unemployment and competitiveness positions. Increasing cross-border mobility of labour would facilitate adjustment further. Given the limited fiscal room for manoeuvre, preference should now be given to regulatory reforms that do not have direct budgetary costs.

5. Increasing flexibility and competition in goods and services markets and deepening the internal market

Progress in policy areas promoting the internal market and competition has been limited over the past few years. Most national measures relating to the financial crisis are aimed at stimulating demand through support to businesses, mainly through facilitating access to financing for small and medium-sized enterprises, and through higher public investment.⁶ Some measures under discussion targeting specific industries include elements of industrial policy that risk hindering necessary economic restructuring, distorting competition and hampering the functioning of the Single Market. National orientation in policy measures leads to undesirable spillover effects across borders and detailed real-time surveillance of such measures is required.

4 See S. Deroose and C. Kastrop (eds.), “The Quality of Public Finances: Findings of the Economic Policy Committee Working Group (2004-2007)”, European Commission, Occasional Papers 37, 2008.

5 Annex to Commission Communication on Driving the European Recovery, 4 March 2009.

6 Annex to Commission Communication on Driving the European Recovery, 4 March 2009.

More emphasis should now be given to policy measures that enhance competition and innovation. The full implementation of the Services Directive is likely to improve competition in services. Further reforms aimed at lowering entry costs and increasing cross-border competition and market integration would strengthen incentives to eliminate inefficiencies, as well as enhance performance and innovation. The successful completion of the Doha round of international trade negotiations would make an important contribution to a more integrated and open world economy.

Past reform progress has been insufficient. While a number of recent economic policy measures are heading in the right direction, there is also some risk of measures hampering the functioning of the Single Market and some backtracking of past reforms based on the principles of an open and market-oriented economy. Particularly in the current situation, there is a clear need to focus on the implementation and delivery of agreed structural reforms, by fully aligning short-term measures with longer-term strategies. The opportunity provided by the financial crisis to accelerate reforms should be fully seized.