

STRONGER EU ECONOMIC GOVERNANCE FRAMEWORK COMES INTO FORCE

Following intense negotiations on the reform of the EU economic governance framework, an agreement was reached between the EU Council, the European Parliament and the European Commission in September 2011 and formally adopted in November. The reforms come into force in mid-December. This box summarises and briefly assesses the main elements of the new governance framework.

The governance reform package is aimed at strengthening fiscal and economic governance in the EU and in particular the euro area.¹

The *main new elements of the fiscal governance framework* to strengthen fiscal discipline are: i) an expenditure benchmark in the preventive arm of the Stability and Growth Pact (SGP) as part of an overall assessment of progress towards a country's medium-term objective with the structural balance as the reference, ii) a numerical benchmark for assessing compliance with the government debt criterion in the corrective arm of the SGP, iii) new financial sanctions and non-financial measures for non-compliant euro area countries which are applied at an earlier stage in the surveillance process and increase gradually in intensity, iv) a higher degree of automaticity in the fiscal surveillance procedures through the use of reverse qualified majority voting (i.e. in particular, Commission recommendations for imposing financial sanctions are deemed to be adopted unless the Council decides, by qualified majority, to reject them), v) minimum requirements for national budgetary frameworks of Member States, and (vi) minimum requirements for the independence of national statistical authorities and the possibility of financial sanctions in the case of falsification of budgetary statistics.

The *new macroeconomic surveillance framework* is aimed at identifying and addressing macroeconomic imbalances at an early stage. The new framework, which applies to all EU Member States, has a preventive and a corrective arm, with the following procedural elements: i) an early alert mechanism, comprising a scoreboard with a limited set of macroeconomic indicators and an annual qualitative economic and financial assessment provided by the European Commission; ii) broad-based in-depth reviews of economic developments in Member States for which the Commission has identified significant macroeconomic imbalances or risks thereof; iii) recommendations addressed to Member States for implementing specific economic policies to correct or prevent such macroeconomic imbalances; iv) Member States in which *severe* macroeconomic imbalances that potentially endanger the proper functioning of EMU have been identified can be made subject to the excessive imbalance procedure (EIP), which

¹ The governance reform package consists of six legal texts. For further details see also the article entitled "The reform of economic governance in the euro area – essential elements", *Monthly Bulletin*, ECB, March 2011.

entails more detailed and stronger policy recommendations and an obligation for the country to submit a corrective action plan setting out the policy responses to the recommendations and deadlines decided by the Council; v) financial sanctions can be imposed on euro area countries in the form of interest-bearing deposits if the Council establishes that the country concerned has failed twice to address the Council recommendation. In the case of continued non-compliance with the Council recommendation within the same EIP, such a deposit would be converted into an annual fine. Moreover, as a rule, a country that has failed twice to draw up a corrective action plan addressing the Council recommendation would be subject to a fine.

Other new elements incorporated in the legal texts are: i) provisions for an “economic dialogue” according to which the European Parliament may invite the President of the Council, the Commission and, where appropriate, the Presidents of the European Council or the Eurogroup to discuss multilateral surveillance, and ii) a regular review of the application of the legal acts and their amendment if appropriate.

While these governance reforms are an important step forward, the legislative package adopted falls short of the “quantum leap” that the ECB’s Governing Council had advocated.² In particular, the new framework still leaves considerable room for both the Commission and the Council to exercise discretion in executing fiscal and economic surveillance and enforcing compliance, which could seriously weaken the effectiveness of the reforms. The main shortcomings of the revised framework are as follows.

(i) Exceptions and many relevant factors to be taken into account

The envisaged strengthening of fiscal surveillance is considerably curtailed in several respects. In particular, the effectiveness of the numerical benchmark for net expenditure growth is constrained by the fact that a number of expenditure categories are excluded from the expenditure aggregate. Moreover, the deficit and debt criteria have been encumbered with an extended list of relevant factors that must be taken into account. Consequently, non-compliance with the deficit and debt criteria will not necessarily result in an excessive deficit procedure (EDP) being launched. With respect to economic surveillance, the new EIP can only be effective if it is sufficiently focused on correcting harmful macroeconomic imbalances threatening the smooth functioning of Monetary Union, such as excessive losses in competitiveness, persistent and excessive current account deficits, unsustainable increases in asset prices, including real estate prices, and high levels of external and internal indebtedness. However, the symmetric approach of the scoreboard, with respect to detecting and preventing excessive losses/gains in competitiveness as well as excessive current account deficits/surpluses, entails the risk that surveillance efforts will become diluted and will potentially be distracted from the most serious challenges to Monetary Union.

(ii) Insufficient automaticity of enforcement procedures

The introduction of earlier, more gradual and more differentiated sanctions is welcome, but greater automaticity is needed in decision-making through the use of reverse qualified majority voting to the maximum extent possible. In the preventive arm of the SGP, a somewhat

² See also the ECB’s legal opinion of 16 February 2011 on economic governance reform in the European Union in the “Legal framework” section of the ECB’s website (<http://www.ecb.europa.eu>).

stricter voting rule in the form of simple majority voting by the Council will only be applied after an additional step of normal qualified majority voting. Moreover, there is still considerable leeway as financial sanctions under both the EDP and the EIP can be reduced or cancelled either on grounds of exceptional economic circumstances or following a reasoned request by the Member State concerned to the Commission. Also, sanctions associated with a breach of the government debt criterion are subject to a transition period of three years starting from the correction of current excessive deficits.

(iii) Risks to implementation

The effectiveness of the revised fiscal rules will depend on them being fully implemented by the Commission and the Council. Compared with the old SGP, the Commission is expected to play a more important role in the procedures, also with respect to the stricter enforcement mechanisms in the case of non-compliance, as the Council's discretion to reject the Commission's recommendations has been reduced. A credible implementation of the fiscal and economic surveillance measures requires that the Commission take a strict approach and that the Council apply the full force of its peer pressure and impose sanctions on non-compliant euro area countries.

(iv) Higher complexity

The new fiscal governance framework is extremely complex compared with the old SGP. More information requirements will have to be met by the Member States. On the Commission's side, additional analyses and extensive technical capacity are required, and it might be difficult to obtain and verify all the necessary data on time. The increased complexity is expected to reduce transparency and thereby the accountability of the new fiscal governance framework and will, at the very least, present challenges as regards communication.

(v) Insufficient strengthening of national budgetary frameworks

The introduction of minimum standards for national budgetary frameworks is welcome. However, the agreed standards are not sufficient, and the strengthening of national budgetary frameworks will largely depend on the countries' political will. At the same time, some Member States have recently committed themselves in the Euro Plus Pact to transposing fiscal rules under the SGP into national legislation. Some countries have already taken initiatives in this respect; other countries should follow their example.

As the sovereign debt crisis has demonstrated, effective fiscal and economic surveillance and enforcement are crucially important to ensuring the smooth functioning of EMU. While the reform of the EU governance framework is a step in the right direction, more needs to be done and is under way.