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Call for Applications: Visiting Research Program

The Oesterreichische Nationalbank (OeNB) invites applications from external researchers for participation in a Visiting Research Program established by the OeNB's Economic Analysis and Research Department. The purpose of this program is to enhance cooperation with members of academic and research institutions (preferably post-doc) who work in the fields of macroeconomics, international economics or financial economics and/or with a regional focus on Central, Eastern and Southeastern Europe.

The OeNB offers a stimulating and professional research environment in close proximity to the policymaking process. Visiting researchers are expected to collaborate with the OeNB's research staff on a prespecified topic and to participate actively in the department's internal seminars and other research activities. They are provided with accommodation on demand and have, as a rule, access to the department's data and computer resources and to research assistance. Their research output will be published in one of the department's publication outlets or as an OeNB Working Paper. Research visits should ideally last between 3 and 6 months, but timing is flexible.

Applications (in English) should include

- a curriculum vitae,
- a research proposal that motivates and clearly describes the envisaged research project,
- an indication of the period envisaged for the research stay, and
- information on previous scientific work.

Applications for 2012/13 should be e-mailed to
eva.gehringer-wasserbauer@oenb.at
by May 1, 2012.

Applicants will be notified of the jury's decision by mid-June. The next round of applications will close on November 1, 2012.

Crisis of Confidence to Trigger Marked Slump in Growth in 2012

Economic Outlook for Austria from 2011 to 2013 (December 2011)

Gerhard Fenz,
Martin Schneider[1]

1 Summary

The Austrian economy expanded vigorously in 2011. In its December 2011 economic outlook, the Oesterreichische Nationalbank (OeNB) projects real GDP growth to reach 3.3% in 2011. In 2012, owing to a severe deterioration in external conditions and to a crisis of confidence, real GDP growth is expected to amount to just 0.7%. In line with both the assumed international economic recovery and abatement in the loss of confidence related to the sovereign debt crisis, 2013 will see growth accelerate to 1.6%. Compared with the OeNB economic outlook of June 2011, this means economic prospects look much more unfavorable, with the outlooks for 2012 and 2013 downgraded by 1.6 and 0.9 percentage points, respectively.

In 2011, owing to steeper price increases in the service, food and energy sectors, HICP inflation will reach 3.5%. In 2012 and 2013, inflation, on the back of falling commodity prices, will ease significantly to 2.2% and 1.6%, respectively. In 2011, primarily for cyclical reasons and due to the dissipation of one-off effects, the budget balance will markedly improve from –4.4% to –3.1% of GDP. In 2012 and 2013, it will fluctuate around the 3% target (2012: –2.9%, 2013: –3.2%).

The growth outlook for the world economy has deteriorated significantly

Chart 1

Real GDP Growth (Seasonally and Working-Day Adjusted)

Quarterly change in %

Source: Eurostat, OeNB.

JEL classification: C5, E17
Keywords: forecast, Austria
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since summer 2011. The intensification of the debt crisis is coinciding with a slowdown in (still buoyant) emerging market growth. The financial markets look skeptical about the progress made in combating the debt problem, which is resulting in a reappraisal of risk and an increase in government bond yields. Although the U.S.A. is not threatened by the dangers of recession, the still very tight situation in the U.S. housing market and high household debt levels are dampening short- to medium-term growth prospects.

Economic activity in the *euro area* slowed down considerably following a healthy first quarter in 2011. Around the turn of 2011/2012, economic output is expected to stagnate, or even decline slightly, before returning to modest growth. This forecast is based on the assumption that the financial and sovereign debt crisis will neither intensify further nor find a quick resolution. Of the countries receiving financial assistance from the EU, only Ireland is currently on track to a modest recovery. Portugal is in the middle of a very tough phase of consolidation while the situation in Greece is deteriorating visibly.

Despite healthy economic fundamentals, *Austria's* economy will be badly hit by the consequences of the debt crisis and the crisis of confidence. As an export-led economy, Austria cannot decouple itself from the deteriorating international economic outlook. Following a very healthy first quarter in 2011, export growth decelerated significantly and is likely to stagnate by year-end. Far more sluggish export growth (+2.9%) is expected in 2012 (2011: +7.3%). In 2013, export growth should bounce back in line with the assumed revival of the international economy.

In the wake of the incipient recovery, the investment cycle slowly picked up in 2010 but lost momentum as early as mid-2011. Excess capacity, which was still extant until mid-2011, suggests that present investment in equipment was aimed at primarily replacing old equipment and directed less at boosting production potential. In 2012, in the wake of the crisis of confidence and the expected economic downturn, companies will postpone their investment plans and reduce their investment in equipment (–0.4%). The investment cycle was therefore unusually short and sluggish. A modest recovery in building construction, which is signaled by a growing number of building permits and recently steep rises in house prices, is not expected until 2012. The civil engineering sector is likely to recover somewhat earlier than the building construction industry. However, clear signs of an upturn are absent, as no additional impetus is coming from the public sector.

In 2011, private consumption suffered from high inflation. Real disposable household income barely rose despite high employment growth. Although the results so far of the fall 2011 round of wage negotiations indicate high growth in collectively agreed wages in 2012, overtime payments and other overpayments, which decline in a downturn, will dampen wage growth. In conjunction with sluggish employment growth and a lack of stimuli from both mixed and investment income, purchasing power will therefore not rise appreciably in 2012 despite a drop in inflation. Projected consumption growth of 1.0% (2011) and 0.7% (2012) can therefore only be financed by a decline in the savings ratio.

The labor market was unexpectedly favorable in 2010 and has been so in 2011 to date. New jobs were created in almost all sectors of the economy. Since mid-2011, however, key leading indica-

tors have been signaling a trend reversal in the Austrian labor market. At 0.4%, employment growth will slacken appreciably in 2012 (2010: 1.5%). The complete liberalization of the Austrian labor market, which came into force in May 2011, generated an increase in labor supply by 20,000 persons according to current data. In 2011, the unemployment rate is expected to fall to 4.2%. In 2012, weak economic activity will mean unemployment will rise

Table 1

OeNB December 2011 Outlook for Austria – Key Results[1]

	2010	2011	2012	2013
Economic activity	*Annual change in % (real)*			
Gross domestic product	+2.3	+3.3	+0.7	+1.6
Private consumption	+2.1	+1.0	+0.7	+1.0
Government consumption	–0.2	+1.2	+0.6	+0.7
Gross fixed capital formation	+0.1	+3.9	+0.1	+2.0
Exports of goods and services	+8.4	+7.3	+2.9	+6.0
Imports of goods and services	+8.0	+7.2	+2.3	+6.1
	% of nominal GDP			
Current account balance	+3.0	+2.4	+2.9	+3.3
Contribution to real GDP growth	*Percentage points of GDP*			
Private consumption	+1.2	+0.5	+0.4	+0.6
Government consumption	+0.0	+0.2	+0.1	+0.1
Gross fixed capital formation	+0.0	+0.8	+0.0	+0.4
Domestic demand (excluding changes in inventories)	+1.1	+1.5	+0.5	+1.1
Net exports	+0.7	+0.5	+0.5	+0.4
Changes in inventories (including statistical discrepancy)	+0.4	+1.3	–0.3	+0.1
Prices	*Annual change in %*			
Harmonised Index of Consumer Prices (HICP)	+1.7	+3.5	+2.2	+1.6
Private consumption expenditure (PCE) deflator	+2.1	+3.0	+2.0	+1.6
GDP deflator	+1.8	+1.8	+2.3	+1.9
Unit labor costs in the total economy	+0.2	+0.5	+2.5	+1.0
Compensation per employee (at current prices)	+1.6	+2.3	+2.8	+2.0
Productivity (whole economy)	+1.4	+1.8	+0.3	+1.0
Compensation per employee (real)	–0.5	–0.7	+0.8	+0.4
Import prices	+4.9	+5.0	+1.1	+1.4
Export prices	+2.9	+3.6	+2.0	+1.7
Terms of trade	–1.8	–1.3	+0.8	+0.4
Income and savings				
Real disposable household income	–0.4	+0.3	+0.4	+1.6
	% of nominal disposable household income			
Saving ratio	8.4	7.6	7.3	7.7
Labor market	*Annual change in %*			
Payroll employment	+0.8	+1.7	+0.4	+0.6
	% of labor supply			
Unemployment rate (Eurostat definition)	4.4	4.2	4.5	4.5
Budget	*% of nominal GDP*			
Budget balance (Maastricht definition)	–4.4	–3.1	–2.9	–3.2
Government debt	71.8	71.7	72.8	73.8

Source: 2010: Eurostat. Statistics Austria; 2011 to 2013: OeNB December 2011 outlook.

[1] *The outlook was drawn up on the basis of seasonally adjusted and working-day adjusted national accounts data. Therefore. the historical values for 2010 may deviate from the nonadjusted data released by Statistics Austria.*

again to 4.5%, a level from which it will not budge in 2013. At these rates, unemployment in Austria is projected to be the lowest in the euro area in 2011, 2012 and 2013.

2 Technical Assumptions

This outlook is the OeNB's contribution to the December 2011 Eurosystem staff macroeconomic projections. The forecast horizon ranges from the fourth quarter of 2011 to the fourth quarter of 2013. All assumptions regarding the development of the global economy as well as the technical assumptions for interest rates, exchange rates and crude oil prices take into account developments up to and including November 18, 2011. The forecast was prepared with the OeNB's quarterly macroeconomic model and on the basis of seasonally and working-day adjusted national accounts data calculated by the Austrian Institute of Economic Research (WIFO), which were fully available up to the second quarter of 2011. Data for the third quarter of 2011 are based on GDP flash estimate, which covers only part of the aggregates in the national accounts, however. The short-term interest rates assumed for the forecast horizon are based on market expectations for the three-month EURIBOR, namely 1.4% in 2011, 1.3% in 2012 and 1.4% in 2013. Long-term interest rates reflect market expectations for government bonds with an agreed maturity of ten years, and have been set at 3.3% (2011), 3.8% (2012) and 4.1% (2013). The exchange rate of the euro vis-à-vis the U.S. dollar is assumed to remain at USD 1.36. The projected trend in crude oil prices is based on futures prices. The oil price assumed for 2011 is USD 111.5 per barrel (Brent), while assumed oil prices for 2012 and 2013 are set at USD 109.4 and USD 104.0, respectively. The prices of commodities excluding energy are also based on futures prices over the forecast horizon.

3 World Economy Hit by Financial and Sovereign Debt Crisis in Europe and the U.S.A. and by Slowing Momentum in Emerging Markets

3.1 Global Economic Recovery Loses Steam

The outlook for the world economy has deteriorated considerably since summer 2011. In addition to the intensifying European sovereign debt crisis, the debate about raising the U.S. debt ceiling helped trigger a loss of confidence. Financial market players do not see the measures implemented in Europe and the U.S.A. as sustainable solutions. Accordingly, many securities dropped sharply in price. Although emerging markets are still growing very rapidly compared with industrialized countries, they have also suffered from slowing economic momentum. In part, this cooling off is attributable to the restrictive monetary and fiscal policies being used to combat high inflation in emerging markets.

The *U.S.* economy grew very slowly in the first half of 2011. The third quarter of 2011, however, saw growth accelerate unexpectedly (+0.5% against the previous quarter). A contributory factor was the automotive industry, which boosted its production following interim product supply constraints induced by the Japanese earthquake. On the demand side, spending on consumer durables, exports and investment were growth drivers. Although the monetary policy of the Federal Reserve System (Fed) is very expansionary – with the federal funds target rate ranging between 0% and 0.25% – further monetary policy stimuli should not be expected. The still very tight situa-

tion in the U.S. housing market and high household debt levels are dampening the short- to medium-term growth outlooks. However, a slide into recession is not expected, since investment momentum is robust and residential construction investment is likely to have bottomed out. At 1.8%, U.S. growth in 2012 will be as high as in 2011.

After contracting as early as in the fourth quarter of 2010, the *Japanese* economy was badly hit by the earthquake disaster of March 2011. In the third quarter of 2011, however, direct production outages as a result of the earthquake were overcome, and GDP increased by 1.5% quarter on quarter. Japan's economic policy appears to be expansionary. In view of the earthquake, the Japanese government approved a comprehensive package of support measures. In addition, the Bank of Japan has acted to bolster the economy by purchasing government bonds and intervening in the foreign exchange market. For 2011 as a whole, however, negative growth is expected, with deflation continuing further.

China, notwithstanding moderately slowing growth in 2011, remains on track to extremely dynamic expansion. While the pace of export growth slowed markedly from almost 30% in 2010 to close to 12% in 2011, domestic demand is also playing an increasingly greater role. In addition to high investment momentum, private consumption is also becoming much more important thanks to considerable income growth. High inflation rates in China gave rise to a perceptible tightening in monetary policy. Against a background of easing inflation and the global economic downturn, no further tightening is expected, however.

Latin American countries are faced with slowing economic momentum as export growth declines. This phenomenon is attributable to industrialized countries' weak economic activity on the one hand and to a loss in price competitiveness due to currency appreciation on the other. By contrast, developments in domestic demand have been favorable. Nevertheless, growth in Latin America is expected to decelerate over the forecast horizon.

3.2 Euro Area Crisis Dampens Growth Outlook

Developments in Europe are currently very heterogeneous. EU Member States outside the euro area have higher average economic momentum than those within the euro area. Of the Central and Eastern European countries (CEECs), which have higher potential growth rates owing to their continuing catching-up process, Poland stands out, in particular. Given its robust domestic demand, the country was able to escape the impact of the financial crisis to a greater extent. Of the Scandinavian countries, Sweden best overcame the crisis. The combination of the Swedish krona's depreciation and an expansive monetary and fiscal policy has generated impressive growth following the crisis.

The *euro area* economy deteriorated significantly following a healthy first quarter in 2011. In both the second and third quarters of 2011, euro area economic growth came to no more than a mere 0.2%. In addition to the consolidation measures and loss of confidence related to the intensifying sovereign debt crisis, the cooling global economy and high energy price rises are responsible for this situation.

The situation in *Greece* has deteriorated dramatically in recent times. The savings measures which were agreed within the framework of the second support package and of which some have already been implemented did not

cause the fiscal situation to stabilize to the extent expected. Greece is also currently suffering from a huge loss of international competitiveness. This means that, even on the assumption underlying this forecast that Greece does not unilaterally declare itself insolvent, 2012 will be the fifth year in a row when economic output has been on the decline.

In addition to Greece, Ireland and Portugal are currently also receiving financial aid from the EU. Of these three countries, *Ireland* is the only one on track to a modest recovery. Despite dramatic consolidation measures necessitated by the comprehensive bank rescue packages, the recession was overcome thanks to growth in external trade. A critical contributory factor was improved price competitiveness thanks to falling unit labor costs. *Portugal*, by contrast, remains in a very difficult period of adjustment. The savings measures are giving rise to a sharp decline in disposable household income, as large groups of transfer recipients are affected in addition to public sector employees. Further drastic consolidation measures are anticipated for 2012. As a result, the decline in GDP will accelerate appreciably in 2012.

In view of its government debt ratio of 120% of GDP and its sluggish growth, *Italy* is also suffering from a loss of confidence on the part of financial market players. Italian government bond prices have fallen perceptibly in recent months. Currently (as at November 22, 2011), yield spreads between Italian and German government bonds amount to 487 basis points. In conjunction with the sluggish growth

Table 2

Underlying Global Economic Conditions

	2010	2011	2012	2013
Gross domestic product	*Annual change in % (real)*			
World GDP growth outside the euro area	+5.7	+4.1	+3.9	+4.5
U.S.A.	+3.0	+1.8	+1.8	+2.5
Japan	+4.1	–0.3	+1.9	+1.7
Asia excluding Japan	+9.4	+7.3	+6.7	+7.4
Latin America	+6.0	+4.4	+3.5	+4.1
United Kingdom	+1.8	+0.9	+1.0	+2.0
New EU Member States[1]	+1.9	+3.1	+2.2	+3.0
Switzerland	+2.7	+1.9	+0.9	+1.6
Euro area[2]	+1.9	+1.5 to +1.7	–0.4 to +1.0	+0.3 to +2.3
World trade (imports of goods and services)				
World economy	+12.4	+6.9	+5.6	+7.1
Non-euro area countries	+13.6	+7.2	+5.6	+7.6
Real growth of euro area export markets	+11.8	+6.4	+4.8	+6.9
Real growth of Austrian export markets	+11.4	+6.7	+4.4	+6.4
Prices				
Oil price in USD/barrel (Brent)	79.6	111.5	109.4	104.0
Three-month interest rate in %	0.8	1.4	1.2	1.4
Long-term interest rate in %	3.2	3.3	3.8	4.1
USD/EUR exchange rate	1.33	1.40	1.36	1.36
Nominal effective exchange rate (euro area index)	104.63	104.63	103.70	103.70

Source: Eurosystem.

[1] *Member States that joined the EU in 2004 and 2007 and have not yet introduced the euro: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania. Since 2011: excluding Estonia.*

[2] *2011 to 2013: Results of the Eurosystem's December 2011 projections. The ECB publisches the projections as ranges based on historical forecast errors.*

of potential output in 2012, increased financing costs for companies and households will spell a decline in economic output.

While *Spain's* government debt is relatively small compared with that of Greece and Italy, the private sector steadily increased its debt in the wake of the credit-financed housing boom. Furthermore, the required correction of the long accumulated current account deficit dampens growth prospects. Although the Spanish economy will grow in both 2011 and 2012 after stagnating in 2010 (–0.1%), the pace of expansion will remain very subdued.

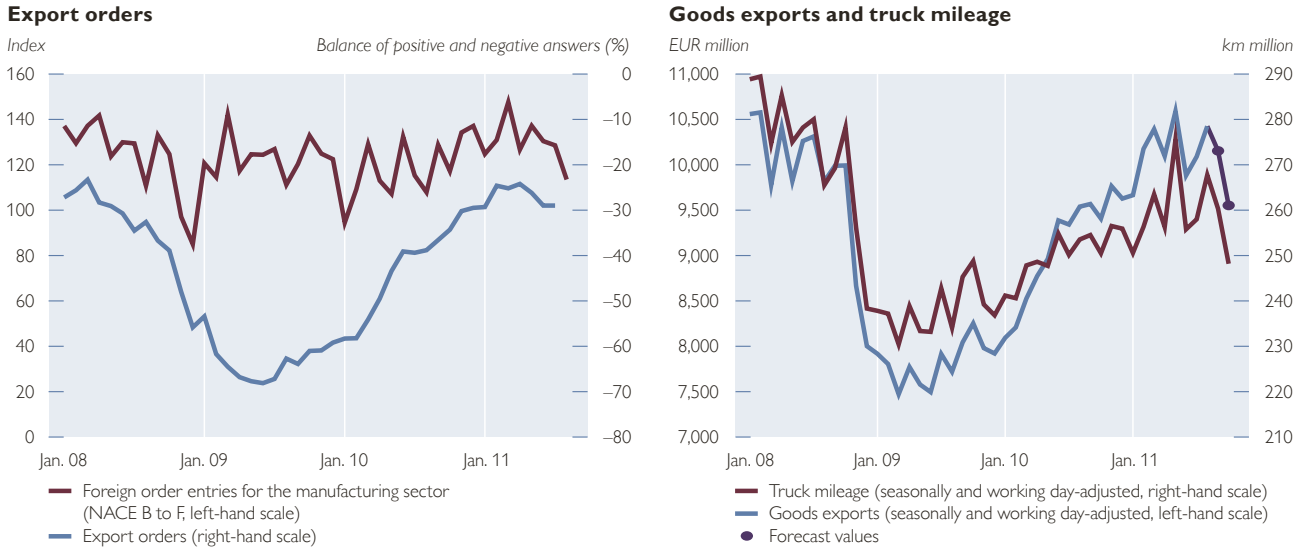
By contrast, *Germany*, the most important economy in the euro area, made an impressive recovery in 2010, which continued well into 2011. In the second quarter of 2011, exceptional factors (weather-induced decline in building investment and the shut-down of power stations after the earthquake disaster in Japan) triggered a significant downturn after a very strong first quarter. Nevertheless the underlying strong momentum was maintained into the third quarter of 2011. As an export-led economy, Germany is directly affected by its slackening export markets. Declining export order volumes indicate a significant dent in export growth by end-2011. As a direct consequence, hitherto very healthy investment activity will also cool, as companies will postpone planned increases in capital investment. The year 2012 will therefore see a significant slowdown in growth for Germany.

4 Austrian Exports Will Stall at End-2011

Austrian exports have still not completely recovered from their sharp slump during the economic and financial crisis of 2009, when the share of exports fell from 59% (2008) to 51% of GDP (2009). In 2010, Austrian companies succeeded in strongly boosting their exports, but, after a very healthy first quarter, export growth has slowed significantly in 2011. The results of the OeNB export indicator of November 2011 show a clear slump in goods exported in October 2011, suggesting a

Chart 2

Significant Slowdown in Exports Begins to Show



Source: OeNB, Statistics Austria.

Table 3

Growth and Price Developments in Austria's Foreign Trade

	2010	2011	2012	2013
	Annual change in %			
Exports				
Competitor prices in Austria's export markets	+5.2	+4.1	+1.3	+1.4
Export deflator	+2.9	+3.6	+2.0	+1.7
Changes in price competitiveness	+2.3	+0.4	–0.6	–0.3
Import demand in Austria's export markets (real)	+11.4	+6.7	+4.4	+6.4
Austrian exports of goods and services (real)	+8.4	+7.3	+2.9	+6.0
Market share	–3.0	+0.6	–1.5	–0.4
Imports				
International competitor prices in the Austrian market	+4.2	+3.9	+1.0	+1.4
Import deflator	+4.9	+5.0	+1.1	+1.4
Austrian imports of goods and services (real)	+8.0	+7.2	+2.3	+6.1
Terms of trade	–1.8	–1.3	+0.8	+0.4
	Percentage points of real GDP			
Contribution of net exports to GDP growth	+0.7	+0.5	+0.5	+0.4

Source: 2010: Eurostat; 2011 to 2013: OeNB December 2011 outlook, Eurosystem.

decline for the fourth quarter of 2011 as a whole. This picture is also supported by a slide in export orders. In the fourth quarter of 2011, however, total exports will stagnate owing to a rise in services exports.

For 2012 as a whole, owing to expected weaker export demand, export growth will decline sharply to 2.9%, with exports to the euro area growing far more sluggishly than exports to the rest of the world. In 2013, exports will bounce back strongly in line with the assumed global economic recovery. This means the exports-to-GDP ratio in 2013 will return to precrisis levels.

In 2011, owing to robust export growth and healthy investment activity, imports are expected to expand fairly vigorously (+7.2%). In 2012, both these import determinants will lose considerable steam, as a result of which import growth will slow markedly and not pick up until the expected recovery in 2013.

Austria's current account has steadily improved since the mid-1990s. After posting a record surplus of 4.9% of GDP in 2008, the current account balance deteriorated in 2009 owing to the sharp slump in exports. In 2011, the current account surplus will also

Table 4

Austria's Current Account

	2010	2011	2012	2013
	% of nominal GDP			
Balance of trade	3.5	3.3	4.0	4.3
Balance on goods	–1.1	–1.4	–0.8	–0.6
Balance on services	4.6	4.7	4.8	4.9
Balance on income	0.2	–0.1	–0.2	–0.2
Balance on current transfers	–0.7	–0.8	–0.8	–0.8
Current account	3.0	2.4	2.9	3.3

Source: 2010: Eurostat; 2011 to 2013: OeNB December 2011 outlook.

shrink on a year-on-year basis due to steep import price increases. For 2012, despite weak export growth, an improvement is expected, as import growth will lag behind export growth owing to the projected decline in investment.

5 Domestic Demand Remains Subdued

5.1 Investment Cycle Ends Prematurely

Austrian companies reduced their investment in equipment by 10% in the 2009 crisis year. At the same time, capacity utilization contracted sharply owing to the decline in demand. Investment activity slowly gathered momentum in the wake of the incipient recovery in 2010. Excess capacity, which was still extant until mid-2011, suggests however that this investment activity was aimed at primarily replacing old equipment and directed less at boosting production potential. Owing to their excellent profit situation, companies were able to finance a large part of this investment internally, which is why corporate lending growth significantly lagged behind precrisis levels. Lower sales expectations are prompting companies to postpone investment that is not absolutely necessary, which means investment in equipment will decline from the fourth quarter of 2011. As a result, the investment cycle was unusually short and sluggish. Recovery is not expected until the second half of 2012. However, equipment investment will decrease in 2012 (–0.4%) and not increase before 2013.

In 2011, building construction, despite growing robustly around mid-2011, will shrink for the third year in a row. Building permits and recently steep rises in housing prices nevertheless point to a slight recovery in building construction in 2012.

The civil engineering sector is likely to recover somewhat earlier than its building construction counterpart. However, clear signs of an upturn are absent, as no stimuli are expected from the public sector. According to their 2012 budget reports, the Austrian Rail-

Table 5

Investment Activity in Austria

	2010	2011	2012	2013
	Annual change in %			
Total gross fixed capital formation (real)	+0.1	+3.9	+0.1	+2.0
of which: Investment in plant and equipment	*+3.3*	*+4.5*	*–0.4*	*+3.3*
Residential construction investment	*–2.2*	*–0.3*	*+1.0*	*+0.5*
Nonresidential construction investment and other investment	*–2.7*	*+0.5*	*+0.2*	*+1.6*
Government investment	*–11.1*	*+2.4*	*+0.0*	*+0.0*
Private investment	*+0.8*	*+4.0*	*+0.1*	*+2.1*
	Contribution to real total gross fixed capital formation growth in percentage points			
Investment in plant and equipment	+1.2	+1.8	–0.2	+1.3
Residential construction investment	–0.5	–0.1	+0.2	+0.1
Nonresidential construction investment and other investment	–1.1	+0.2	+0.1	+0.6
Government investment	–0.6	+0.1	+0.0	+0.0
Private investment	+0.7	+3.8	+0.1	+2.0
	Contribution to real GDP growth in percentage points			
Inventory changes	+0.5	+0.2	–0.5	+0.1

Source: 2010: Eurostat; 2011 to 2013: OeNB December 2011 outlook.

ways (ÖBB), the ASFINAG road construction company and the federal real estate company BIG will cut their investments by EUR 400 million to EUR 3.6 billion. Local governments cannot act as pillars of the economy, either, owing to their often extremely tight budgetary situation.

5.2 Consumption Stabilizes at a Low Level

Owing to the still very favorable economic situation throughout the first six months of the year, total employment will rise steeply in 2011 (+1.5%). At 2.3%, wage growth, owing to modest wage settlements (+2.0%), was well below the inflation rate projected for 2011 despite a positive wage drift of 0.3%. This means private consumption will rise by a very modest 1.0%. However, even such modest growth is only attainable because of a recent decline in the savings ratio.

In 2012, high wage settlements (+3.3%) and low inflation will fuel household income. Owing to weak economic momentum, employment will, however, almost stagnate, and lower overpayments (overtime, bonuses, etc.) will dampen wage growth. Overall, real disposable household income will grow as strongly as in 2011. Even the weak consumption growth of 0.7% projected for 2012 is therefore only attainable because of a further decline in the savings ratio.

In 2013, given the anticipated economic recovery and further easing inflation, real household income should also climb somewhat more rapidly. Consumption growth, however, will not accelerate significantly, as households will attempt to adjust their savings ratio upward. The latter rose from less than 8% in 2002 to 11.5% before the outbreak of the crisis, only to fall back to roughly 2002 levels by 2011. Although this trend arises partly from households' desire to smoothen their consumption path, it was also determined by the composition of their household income. Along with investment and mixed income, income categories with a lower-than-average marginal propensity to consume grew disproportionately strongly in the pre-crisis years. Since the outbreak of the

Table 6

Determinants of Nominal Household Income in Austria

	2010	2011	2012	2013
	Annual change in %			
Employees	+0.8	+1.7	+0.4	+0.6
Wages per employee	+1.6	+2.3	+2.8	+2.0
Compensation of employees	+2.3	+4.1	+3.2	+2.7
Property income	–17.3	+3.3	–4.5	+3.4
Mixed income and operating surplus, net	+4.2	+3.9	+2.8	+4.0
	Contribution to disposable household income growth in percentage points			
Compensation of employees	+2.0	+3.4	+2.7	+2.3
Property income	–1.7	+0.3	–0.4	+0.3
Mixed income and operating surplus. net	+0.8	+0.8	+0.6	+0.8
Net transfers minus direct taxes[1]	+0.7	–1.2	–0.5	–0.2
Disposable household income (nominal)	+1.7	+3.2	+2.4	+3.2

Source: 2010: Eurostat; 2011 to 2013: OeNB December 2011 outlook.

[1] Negative values indicate an increase in (negative) net transfers minus direct taxes. positive values indicate a decrease.

Table 7

Private Consumption in Austria

	2010	2011	2012	2013
	Annual change in %			
Disposable household income (nominal)	+1.7	+3.2	+2.4	+3.2
Private consumption expenditure (PCE) deflator	+2.1	+3.0	+2.0	+1.6
Disposable household income (real)	–0.4	+0.3	+0.4	+1.6
Private consumption (real)	+2.1	+1.0	+0.7	+1.0
	% of nominal disposable household income			
Saving ratio	8.4	7.6	7.3	7.7

Source: 2010: Eurostat; 2011 to 2013: OeNB December 2011 outlook.

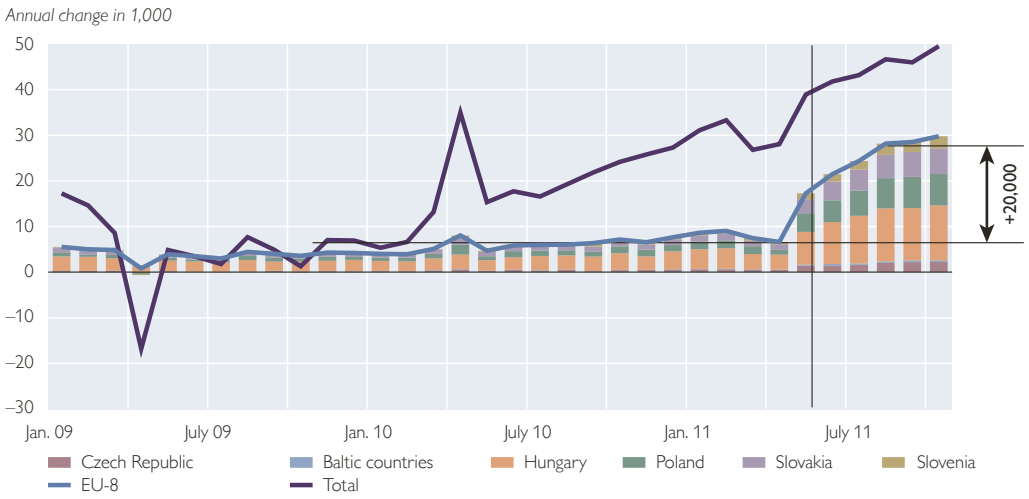
crisis, however, household income growth has been primarily fueled by the compensation of employees, the income category with the highest propensity to consume.

5.3 Robust Employment Growth Reduces the Unemployment Rate Only Slowly

In Austria, employment not only declined by a relatively small amount during the economic recession in 2009, it registered unexpectedly high growth in the ensuing upturn. This trend continued in 2011. New jobs were created in almost all sectors of the economy, with the goods, trade, employee leasing as well as health and social security sectors registering the strongest employment growth. To date (October 2011), employment momentum has remained unbroken. Among other factors, one of the reasons for this situation is likely to be the complete liberalization of the domestic labor market for persons from countries that joined the EU in 2004. About 20,000 additional workers from the new Member States have been registered since May 2011. How many of these new workers were active "unoffi-

Chart 3

Foreign Labor Supply by Country



Source: AMS (BALI data base).

Table 8

Labor Market Developments in Austria

	2010	2011	2012	2013
	Annual change in %			
Total employment	+0.9	+1.5	+0.4	+0.6
of which: Payroll employment	*+0.8*	*+1.7*	*+0.4*	*+0.6*
Self-employment	*+1.6*	*+0.3*	*+0.5*	*+0.5*
Public sector employment	*–0.2*	*–0.1*	*–0.1*	*–0.1*
Registered unemployment	–8.0	–0.1	+4.5	+2.3
Labor supply	+0.5	+1.5	+0.6	+0.7
	% of labor supply			
Unemployment rate (Eurostat definition)	4.4	4.2	4.5	4.5

Source: 2010: Eurostat; 2011 to 2013: OeNB December 2011 outlook.

cially" in the Austrian labor market prior to liberalization and have now been legalized and how many had really newly joined cannot be estimated precisely. Overall, however, the number of persons in payroll employment will rise by more than 60,000 in 2011 (+1.7%).

Since mid-2011, however, key leading indicators have been signaling a trend reversal in the Austrian labor market. For instance, the number of vacancies has been down since the third quarter of 2011 and the number of temporary employees registered as unemployed (in both cases, seasonally adjusted, on a quarterly basis) has been rising since the second quarter of 2011. For 2012 and 2013, therefore, much weaker employment growth of 0.3% and 0.6% is expected respectively, which also tallies with the projected cooling of the economy.

As in the past, labor supply will grow very procyclically over the forecast horizon, with the final opening-up of the labor market reinforcing this pattern in addition. Although almost 60,000 additional workers are expected in 2011, this number will more than halve in 2012 and 2013. From 2012, domestic demography will have a dampening effect on labor supply but will be more than offset by rising participation rates. The key factor for the growing labor supply remains the influx of foreign labor.

Austria continues to rank among those countries with the lowest unemployment rates in the euro area. In 2011, the unemployment rate (Eurostat definition) will stand at 4.2%. As a result of slowing growth, the unemployment rate will, however, climb from 4.1% in the second quarter of 2011 to 4.6% by end-2012, only to drop slightly thereafter. In 2012 and 2013, the rate will remain at 4.5%.

Box 1

Scenarios of Fiscal Development[1]

Scenario 1: Implications of the Debt Brake and the Stability and Growth Pact

In mid-November 2011 the Austrian federal government decided to constitutionally prescribe a debt brake for Austria, which is to take full effect from 2017 onward. According to the related government bill, a ceiling of 0.35% of GDP will be imposed on the structural deficit of Austria's central government (including social security institutions) from 2017, whereas regional and local governments' structural net lending/net borrowing will have to be at least balanced. Any deviations from this target will have to be booked to separate control accounts and corrected as directed by economic conditions. Unlike the nominal deficit targets laid down in the current Austrian Stability Pact, structural deficit targets should in particular counteract any incentives to pursue a procyclical fiscal policy.

According to the OeNB's economic outlook, Austria's structural deficit in 2012 will come to approximately 2.8% of GDP, a value that is still far above the 2017 target value of 0.35% of GDP. To be able to meet this target, the structural deficit would need to be reduced by an annual average of 0.5% of GDP. Further consolidation measures will also be necessary owing to the requirements Austria must fulfill according to the Stability and Growth Pact (annual improvement of the structural balance of at least ½% of GDP[2]) and under the excessive deficit procedure (by 2013 at the latest, the deficit-to-GDP ratio must be reduced to below 3%). Since the OeNB's economic outlook is based on a no-policy-change assumption, no additional measures have been assumed. The table below shows a scenario in which an austerity package of 0.5% of GDP (EUR 1.6 billion) is implemented in 2013.[3]

Effect of Fiscal Consolidation in 2013

	Volume	GDP	Budget balance
	% of GDP	*Annual change in %*	*% of GDP*
OeNB economic outlook		1.6	–3.2
Total effect	0.5	–0.3	0.4
Expenditure cuts	0.3	–0.2	0.2
Tax increases	0.2	–0.1	0.2
Forecast including fiscal consolidation		1.3	–2.8

Source: OeNB.

Scenario 2: Real Economy and Budget Effects of Higher Interest Rates

A major factor of uncertainty in the OeNB's present budget forecast is the expected development of Austrian government bond yields. Between early October and end-November 2011, Austrian government bond yields increased strongly and yield differentials against Germany, the Netherlands and Finland widened significantly. This increase has, for a large part, already been included in the forecast assumptions (table 2 in the main text). However, it cannot be excluded that market turmoil will further intensify. The table below shows the effects the public and the private sector would experience if short- and long-term interest rates were to increase steeply (i.e. by 100 basis points against the baseline scenario) in early January 2012.[4]

[1] *Compiled by the Economic Analysis Division, lukas.reiss@oenb.at.*

[2] *This annual adjustment by ½% of GDP is necessary to realize the medium-term objective of achieving a structural balance of zero.*

[3] *The underlying assumption is that 40% of fiscal consolidation will be achieved by cutting back government transfers and negotiating lower wage settlements in the public sector, 20% by reducing other government consumption, 20% by raising indirect taxes and another 20% by increasing direct taxes.*

[4] *This scenario only analyzes the effects of higher interest rates in Austria (assuming unchanged interest rates in the rest of the world).*

Simulations based on the OeNB's macroeconomic model illustrate the amount of macroeconomic costs associated with such a sudden interest rate increase. They also show that – in particular in the year 2013 – the indirect budgetary effects caused by the worse macroeconomic developments are significantly larger than the direct effects of higher interest payments, which can be explained by the relatively low volume of government bonds maturing in the years 2012 and 2013, among other factors.

Effect of a 100 Basis Point Interest Rate Increase on Austria

	GDP		Budget balance	
	2012	2013	2012	2013
	Annual change in %		*% of GDP*	
OeNB economic outlook	0.7	1.6	–2.9	–3.2
Total effect	–0.4	–0.5	–0.2	–0.4
Real economy effect	–0.4	–0.5	–0.1	–0.3
Increase in government financing costs	×	×	–0.1	–0.1
Forecast assuming higher interest rates	0.3	1.1	–3.1	–3.6

Source: OeNB.

6 Drop in Inflation in 2012 Determined Mainly by Energy

In 2011, average HICP inflation will amount to 3.5%. The steep rise in inflation in 2011 is primarily attributable to price increases in the service sector (particularly, hotel and restaurant services) and, to a lesser extent, to those in the food and energy sectors, with tax increases within the framework of the 2011 consolidation package contributing 0.4 percentage points to HICP inflation. In the food and energy sectors, above all, global commodity price rises were passed onto domestic consumer prices but some services (e.g. hotel and restaurant services) were also affected.

Inflation is expected to go down sharply to around 2.0% by the end of the first quarter of 2012 and should flatten to some extent by end-2012. Average HICP inflation of 2.2% is anticipated for 2012 as a whole.

The drop in inflation from 3.5% (2011) to 2.2% (2012) will be primarily attributable to developments in both the energy and service sectors and, to a lesser extent, to those in the food sector. This phenomenon will be primarily due to falling commodity prices and base effects (rise in service price inflation from fall 2010; 2011 consolidation package), which should now contribute significantly to the decline in HICP inflation. The relatively high collectively agreed wage settlements sealed in the 2011 fall round of wage negotiations should become apparent with core inflation (HICP inflation excluding unprocessed food and energy) rising only slightly in the course of 2012.

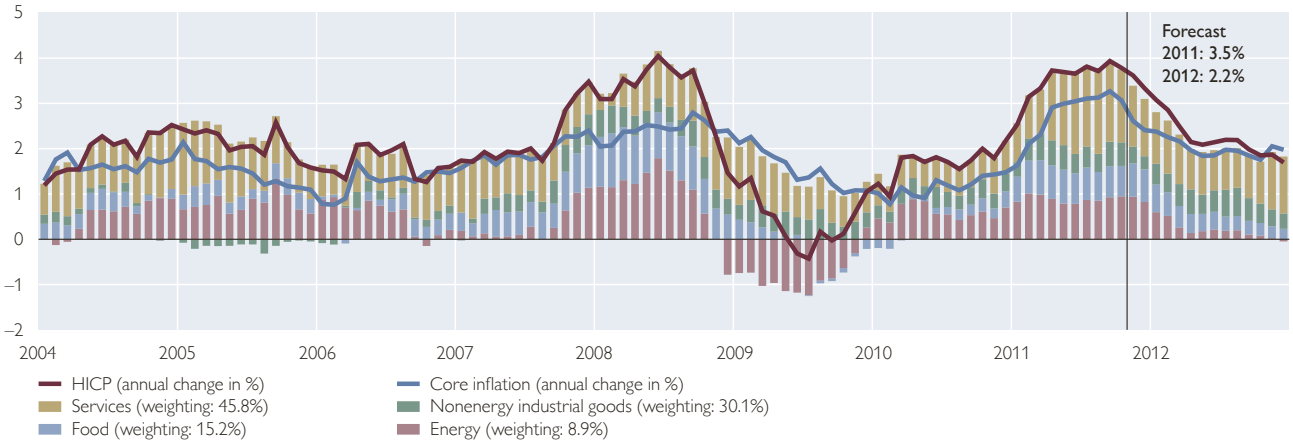
In 2011, changes in administered prices and those influenced by the public sector will contribute about 0.7 percentage points to HICP inflation, with 0.4 percentage points and 0.3 percentage points coming from tax increases and administered measures, respectively. In 2012, the public sector's contribution to HICP inflation will fall to 0.4 percentage points, according to current information available.

In 2011, buoyant economic activity meant both high overpayments and robust profit margin growth. In 2012,

Chart 4

HICP Inflation and Contributions by Subcomponents

Contributions to inflation in percentage points *Last observation: October 2011*



Source: OeNB, Statistik Austria.

these two components will decrease for economic reasons, as a result of which the price pressures stemming from the high wage settlements will be dampened. The wage settlements for 2013 should be lower owing to the weak economy expected in 2012, which means that production prices are not expected to come under pressure in either 2012 or 2013. Together with falling commodity prices, inflation should stand at well below 2%.

7 Forecast Risks Are High, but Not Only on the Downside

The current forecast was prepared in a period marked by an extremely high degree of uncertainty reflected in very high risks to the forecast, most of which are pointing to the downside. The largest

Table 9

Selected Price and Cost Indicators for Austria

	2010	2011	2012	2013
	Annual change in %			
Harmonised Index of Consumer Prices (HICP)	+1.7	+3.5	+2.2	+1.6
HICP energy	+7.6	+11.3	+2.6	+0.2
HICP excluding energy	+1.2	+2.8	+2.0	+1.7
Private consumption expenditure (PCE) deflator	+2.1	+3.0	+2.0	+1.6
Investment deflator	+2.9	+2.6	+1.8	+1.5
Import deflator	+4.9	+5.0	+1.1	+1.4
Export deflator	+2.9	+3.6	+2.0	+1.7
Terms of trade	–1.8	–1.3	+0.8	+0.4
GDP at factor cost deflator	+1.8	+2.0	+1.7	+1.8
Unit labor costs	+0.2	+0.5	+2.5	+1.0
Compensation per employee	+1.6	+2.3	+2.8	+2.0
Labor productivity	+1.4	+1.8	+0.3	+1.0
Collectively agreed wage settlements	+1.6	+2.0	+3.3	+2.2
Profit margins[1]	+1.6	+1.5	–0.8	+0.7

Source: 2010: Eurostat, Statistics Austria; 2011 to 2013: OeNB December 2011 outlook.

[1] *GDP deflator divided by unit labor costs.*

downside risk to growth undoubtedly consists in the further intensification of the financial and sovereign debt crisis. This forecast is based on the implicit assumption that the uncertainty associated with the sovereign debt crisis will gradually abate during the first half of 2012 and that the euro area will slowly resume its course of long-term growth. However, unforeseeable consequences may arise in the case of a disorderly Greek sovereign default. Although the direct impact seems manageable due to Greece's size, the risks of contagion for other countries cannot be easily estimated. The recently observed steep rise in yields for Italian and Spanish government bonds reflects an intensification of the crisis. A recession in the euro area, and therefore also in Austria, would be the most probable scenario in this case.

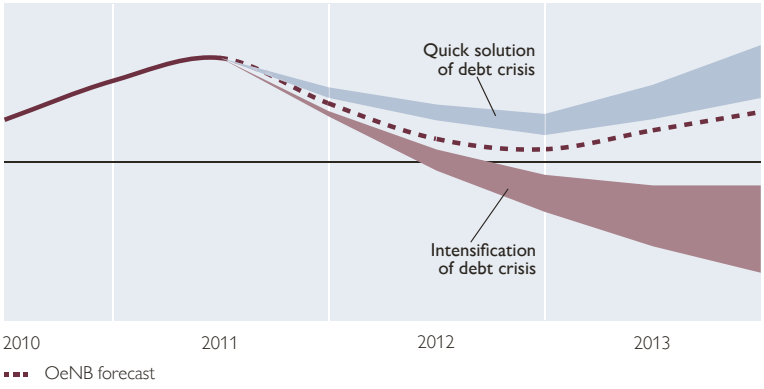
However, upside risks are also present. This forecast is based on both hard facts and sentiment indicators. Although signs of an economic downturn are visible in the real economy – for instance, export growth currently shows clear signs of cooling – the indicators available are not signaling a recession. If European economic policy quickly creates a credible and sustainable solution, growth could be even higher when the related uncertainties are resolved. Chart 5 illustrates the situation where the forecast ranges between two extreme scenarios, with each showing a non-negligible probability of event. This forecast assumes stagnation in the fourth quarter of 2011 and slightly positive growth in the first two quarters of 2012. The emergence of a technical recession (two successive quarters of declining economic output) cannot be ruled out even if the sovereign debt crisis does not escalate.

The inflationary risks look balanced over the forecast horizon. A depreciation of the euro might trigger higher inflation via increasing import prices. Likewise, the risk of faster rising commodity prices cannot be ruled out, but does not seem very likely owing to the sluggish growth of the world economy. In the event of a deeper-than-expected economic slump at both a European and global level, the inflationary risk from commodity prices would even point downward. In this case, a more strongly negative wage drift would be expected owing to the disappearance of overpayments.

Chart 5

Basic Forecast Scenario and Possible Alternative Scenarios

Annual real GDP change in %



Source: OeNB.

8 Weaker Export Market Growth and Loss of Confidence Trigger Downward Revision of Forecast

The international climate has deteriorated considerably since the OeNB's June 2011 economic outlook. Bleaker prospects for the global economy and downward revisions of the other euro area countries included in this forecast have generated a far more downbeat growth assessment of Austrian export markets. This effect is relevant to 2012 primarily. Lower interest rates, nevertheless, are providing positive stimuli for the economy. Changes in exchange rate and oil price assumptions, by con-

Table 10

Change in the External Economic Conditions since the OeNB June 2011 Outlook

	December 2011			June 2011			Difference		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
	Annual change in %								
Growth of Austria's export markets	+6.7	+4.4	+6.4	+7.5	+7.4	+7.2	–0.8	–3.0	–0.8
Competitor prices in Austria's export markets	+4.1	+1.3	+1.4	+3.7	+1.7	+1.6	+0.4	–0.4	–0.2
Competitor prices in Austria's import markets	+3.9	+1.0	+1.4	+3.8	+1.8	+1.6	+0.1	–0.8	–0.2
	USD per barrel (Brent)								
Oil price	111.5	109.4	104.0	111.1	108.0	103.7	+0.4	+1.4	+0.3
	Annual change in %								
Nominal effective exchange rate (exports)	+0.4	–0.1	+0.0	+0.2	–0.1	+0.0	+0.2	+0.0	+0.0
Nominal effective exchange rate (imports)	+0.7	–0.2	+0.0	+0.6	+0.0	+0.0	+0.1	–0.2	+0.0
	%								
Three-month interest rate	1.4	1.2	1.4	1.5	2.3	2.8	–0.1	–1.1	–1.4
Long-term interest rate	3.3	3.8	4.1	3.7	4.0	4.3	–0.4	–0.2	–0.2
	Annual change in %								
U.S. GDP (real)	+1.8	+1.8	+2.5	+2.6	+2.7	+2.8	–0.8	–0.9	–0.3
	USD/EUR								
USD/EUR exchange rate	1.40	1.36	1.36	1.42	1.43	1.43	–0.02	–0.07	–0.07

Source: Eurosystem.

trast, have no significant effect on forecast revisions.

The effects of these changed external assumptions were simulated using the OeNB macroeconomic model. Table 11 lists the reasons for revising the forecast in detail. Apart from the impact of changed external assumptions, they are attributable to the impact of new data and to a residual ("Other"). The influence of new data includes the effects of the revisions of both the historical data already available at the time of the OeNB's June 2011 economic outlook (i.e. data up to the first quarter of 2011) and the forecasting errors of the previous outlook for the periods for which data have now been published for the first time (i.e. data for the second and third quarter of 2011). The item "Other" includes new expert assessments regarding the development of domestic variables such as government consumption or wage settlements, as well as any changes to the model.

The slight upward revision of the outlook for 2011 by 0.1 percentage points is mainly caused by an upward revision of historical data. Since the forecast horizon commences in the fourth quarter of 2011, the more unfavorable international environment for 2011 as a whole is almost irrelevant. For 2012, however, almost half of the downward revision is determined by the external assumptions of the forecast. A major feature of the current situation is the marked loss of confidence on the part of the economic players. Since confidence effects are empirically difficult to record and model, they are not recorded technically and hence find themselves under the item "Other." For 2012 and 2013, this effect is about as strong as the impact of the external assumptions.

Table 11

Breakdown of Forecast Revisions

	GDP			HICP		
	2011	2012	2013	2011	2012	2013
	Annual change in %					
December 2011 outlook	+3.3	+0.7	+1.6	+3.5	+2.2	+1.6
June 2011 outlook	+3.2	+2.3	+2.4	+3.2	+2.1	+1.9
Difference	+0.1	–1.6	–0.8	+0.3	+0.1	–0.3
Due to:	*Percentage points*					
External assumptions	–0.1	–0.8	–0.4	+0.0	+0.0	–0.2
New data	+0.3	–0.1	+0.0	+0.1	+0.0	+0.0
of which: Revision of historical data until Q1 11	*+0.4*	*+0.0*	*+0.0*	*+0.0*	*x*	*x*
Projection errors for Q2 11 and Q3 11	*–0.1*	*–0.1*	*+0.0*	*+0.1*	*x*	*x*
Other[1]	–0.1	–0.7	–0.4	+0.2	+0.1	–0.1

Source: OeNB December 2011 and June 2011 outlooks.

[1] *Different assumptions about trends in domestic variables such as wages, government consumption, effects of tax measures, other changes in assessment and model changes.*

In 2011, inflation will rise more steeply than forecast in June. Only a small share (0.04 percentage points) of this increase is explicable by the new external assumptions. Most of it, however, stems from stronger domestic adjustments. Despite the downward growth revision, the inflation outlook for 2012 remains almost unchanged owing to high wage settlements. In 2013, the bleaker macroeconomic environment should have an impact on inflation.

Box 2

OeNB-BOFIT Outlook for Selected CESEE Countries: Growth Moderates Due to Worsening External Demand[1,2]

The recent projections indicate a slowdown in economic growth for selected Central, Eastern and Southeastern European (CESEE) economies as a result of the deteriorating external environment. Mainly for technical reasons, the baseline is based on a rather optimistic outlook for euro area GDP growth and points to moderate economic growth in the CESEE-7 region of 2.8% in 2011 and 2.5% in 2012 – a downward revision of the March 2011 projections. Therefore, we also calculated a more pessimistic alternative scenario. This scenario, for which we assume a potentially worse growth performance of euro area GDP in 2012 (1 percentage point lower), would push the 2012 GDP growth[3] rate of the CESEE-7[4] region down to 1.9%.

The contribution of external demand will decline over the projection horizon. Domestic demand will strengthen in all countries, but will remain negative in Hungary. Poland, the larg-

[1] *Compiled by the OeNB's Foreign Research Division, julia.woerz@oenb.at.*

[2] *The OeNB and the Bank of Finland Institute for Economies in Transition (BOFIT) compile semiannual forecasts of economic developments in selected Central, Eastern and Southeastern European (CESEE) countries. These forecasts are based on a broad range of available information, including country-specific time-series models for Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania (for technical details on the models used, see Crespo Cuaresma, J., M. Feldkircher, T. Slačík and J. Wörz. 2009. Simple but Effective: The OeNB's Forecasting Model for Selected CESEE Countries. In: OeNB. Focus on European Economic Integration Q4/09. 84–95). The projections for Russia, which were prepared by BOFIT, are based on a SVAR model. Cutoff date for all projections was September 29, 2011.*

[3] *The external assumptions are taken from the September 2011 macroeconomic projection exercise, prepared by the ECB. Annual real GDP growth of the euro area is thus assumed to range between 1.4% and 1.8% in 2011 and between 0.4% and 2.2% in 2012.*

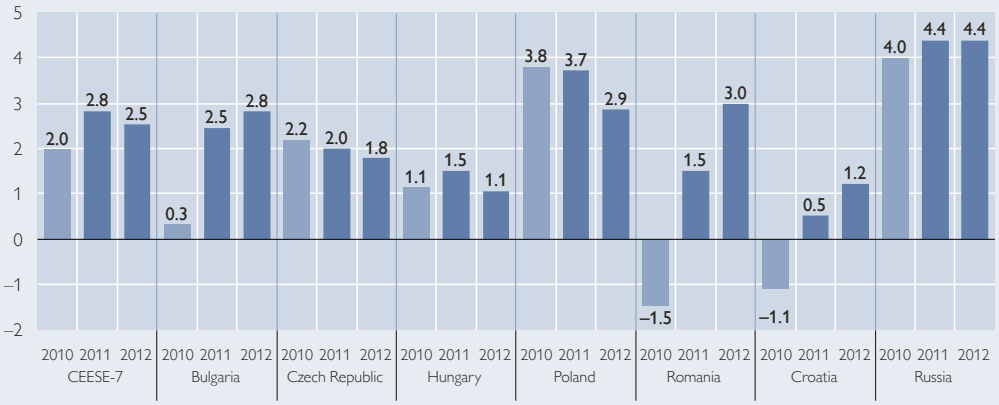
[4] *Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania.*

est economy in the region, continues to be an exception in terms of both growth rates and growth drivers. Russian economic growth in the first half of 2011 was weaker than forecast. Consequently, our GDP forecast was revised downward to 4.4% for 2011 and 2012. With a moderate economic recovery in the second half of the year, Croatian GDP is forecast to expand by a modest 0.4% in 2011 and to pick up slightly to 1.2% in 2012 on the back of strengthening domestic demand.

The risks to the current projections are clearly on the downside. A further and possibly substantial deterioration of external demand in the form of rising economic and financial tensions in the euro area has not been factored into the projections. Negative consequences for the CESEE-7 region could arise via trade and supply-chain links if economic growth in the euro area weakens or even stagnates. Additional possible contagion through the financial sector and the banking system imply further downside risks. Moreover, uncertainty prevails over the appropriate response to existing and possibly newly arising fiscal consolidation needs in the region. For Russia, the forecast risks are likewise on the downside, comprising lower oil prices, new bouts of risk aversion and related impairments of capital flows, uncertainties with respect to consumer confidence, a new food inflation wave, and heightened import growth in case of stronger real ruble appreciation.

CESEE-7: GDP Projections for the Period from 2010 to 2012

Annual growth rate in %, real



Source: OeNB-BOFIT September 2011 Projections, Eurostat.

How Would CESEE-7 Growth React to a More Pronounced Dip in Euro Area Growth? A Sensitivity Analysis

The current projections are based on rather optimistic external assumptions, which do not incorporate the consequences of the most recent developments in the euro area. Therefore, we illustrate here the sensitivity of our growth forecast for the CESEE-7 countries to a potentially worse growth performance in the euro area. More specifically, euro area GDP growth in 2012 is assumed to be 1 percentage point lower than the baseline.

Lower euro area GDP growth implies lower CESEE-7 GDP growth in the same year for various reasons. First of all, because the euro area represents the major trading partner for all countries in the region, slower euro area growth automatically reduces the CESEE-7 region's external demand for goods and services. Second, funding constraints for euro area banks active in the CESEE-7, consequent deleveraging in the region, increased uncertainty and negative wealth effects could also arise in the region with a negative impact on private consumption. Not all of these effects will necessarily materialize, and their growth impact would certainly vary from country to country, but the point is that there is an array of channels that may transmit lower growth in the euro area to the CESEE-7 countries.

In our models, the major influence of this change on CESEE-7 growth comes through the drop in external demand as compared to the baseline. Exchange rate developments are also

directly affected in the model, apart from indirect effects on all growth components feeding through the system. Our sensitivity analysis has to be interpreted as a conservative estimate of the effects, as financial transmission channels are not taken into account.[5]

In this scenario, GDP growth in the CESEE-7 region would be 0.6 percentage points lower in 2012 relative to the baseline under these weaker external growth assumptions. Individual countries would be affected differently: The GDP outlook for Poland, by far the largest economy in the region, would fall by 0.7 percentage points to only 2.2% year on year. Likewise, growth projections for Bulgaria would have to be revised downward by 0.8 percentage points. In Hungary, projected growth for 2012 would be more than halved to 0.5% year on year, down from 1.1%. Projected GDP in the Czech Republic would also 0.5 percentage points lower. By contrast, the impact on Romania would be smaller. The projected growth rate would only drop by 0.2 percentage points to 2.8%.

CESEE-7: GDP Projections for 2012 – Impact of Moderate Euro Area GDP Growth

	GDP growth 2012	
	According to projection (baseline)	In case of lower euro area GDP growth
	Annual growth in %	
CESEE-7	**2,5**	**1,9**
Bulgaria	2,8	2,0
Czech Republic	1,8	1,3
Hungary	1,1	0,5
Poland	2,9	2,2
Romania	3,0	2,8

Source: OeNB.

CESEE-7: External Demand to Fade as Growth Driver

The first quarter of 2011 brought about an acceleration of growth in the CESEE-7 region (+0.8% quarter on quarter in seasonally adjusted terms, up from 0.5% in the last quarter of 2010), while growth in the second quarter 2011 again moderated to 0.6% quarter on quarter. Uncertainties about economic developments in the CESEE-7 countries have risen in recent months. For 2011 as a whole, the CESEE-7 region is expected to expand by 2.8% and thus more moderately than projected in our March forecast. Growth in Poland, the largest economy in the region, will not expand further against 2010, but will remain the region's growth engine. This implies an acceleration of growth dynamics for all CESEE-7 countries apart from the Czech Republic and Poland. In the Czech Republic, the fiscal austerity package will restrict further growth, while in Poland investment growth will moderate after strong pre-election public investments. The deteriorating external environment and developments in the euro area imply that economic growth in the CESEE-7 region will remain well below its precrisis level and that catching-up will resume at a slow pace.

Based on the assumptions on euro area growth as put forward by the ECB in its September 2011 macroeconomic projection exercise, economic growth in 2012 will moderate to 2.5% in the CESEE-7 region. As described above, a more realistic assumption concerning economic growth in the euro area in 2012 would reduce CESEE-7 growth projections by 0.6 percentage points, to 1.9% per annum. The growth moderation will be led by the Central European countries, while the Southeastern European economies – Bulgaria and Romania – will continue to show a domestic demand-driven expansion that relies heavily on private consumption. In Hungary, domestic demand will be further hampered by the strength of the Swiss franc given the high ratio of private foreign currency loans. The contribution of net exports is falling in all countries except for Poland. At the same time, the growth contribution of domestic demand is rising in all countries apart from Poland, where it remains at a comparatively high level. In Hungary, domestic demand and, in particular, private consumption will remain subdued to the extent that their overall contribution to growth will remain slightly negative. For the region as a whole, several factors will weigh on economic activity in 2012 in addition to the weakening external environment, namely tight and uncertain financing conditions, hesitant investment activity and uncertainties about capital inflows.

[5] *In order to calculate the effect of the euro area dip on the CESEE-7 region as a whole, GDP growth in Latvia and Lithuania for 2012 was scaled down by the average growth reduction for the CESEE-5 aggregate.*

Russia: Growth Is Relatively Brisk, but Leveling Off

The speed of Russia's economic recovery went down to 3.7% year on year in the first half of 2011. Regarding the second half of 2011, growth is forecast to pick up from a slow second quarter, supported by easing inflation. The full-year 2011 GDP growth forecast of 4.4% is also supported by investment, which should gain momentum since the output gap is closing. Rebuilding inventories is likely to continue in 2011.

However, GDP growth is projected to slow down soon, assuming oil prices will level off, i.e. stop rising, during the forecast period. The annual GDP growth rate will remain at 4.4% in 2012, given the current year's partly low GDP level (another base effect), the partial winding-back of social security contributions in 2012 and government spending increases in the run-up to the presidential elections.

Private consumption is forecast to remain the crucial driver of growth and to increase briskly. Wages in the private sector are anticipated to rise swiftly as unemployment declines gradually from a relatively low level. Consumer loans are expected to rise further. Public consumption is anticipated to increase in 2012, since the authorities plan to augment total general government spending by around 6% in real terms in the run-up to the elections. Fixed investments are foreseen to recover in 2012, as pre-slump capacity utilization rates will be attained. Restocking is expected to subside in 2012.

Croatia: Protracted Recovery of Domestic Demand

With a moderate economic recovery in the second half of the year, the Croatian economy is forecast to grow by 0.4% in 2011 as a whole. The growth pattern seen in 2009 and 2010 will also prevail in 2011, implying a negative contribution of domestic demand and a positive contribution of net exports (albeit less pronounced than in previous years). Private and public consumption are expected to strengthen somewhat in the second half of the year in the wake of the upcoming parliamentary elections in December 2011. At the same time, restocking is expected to compensate slightly for weak investment activity. A fairly good summer tourism season is expected to underpin exports in the third quarter of 2011, but given the base effect-related slump in exports in the first quarter of 2011, export growth will turn out to be negative for 2011 as a whole. However, given the faster contraction of imports, the contribution of net exports to growth will remain positive.

GDP growth is expected to accelerate to 1.2% in 2012, driven mainly by a pickup in domestic demand. Consumption will remain weak, though. In particular, increasing fiscal consolidation needs following the 2011 election year will negatively affect public consumption. At the same time, private consumption is estimated to pick up slightly as the first signs of improving labor market conditions become apparent and the support measures of the government to support borrowers who have taken out loans in Swiss francs will help ease households' financial situation. After having contracted considerably for three consecutive years, gross fixed capital formation is forecast to recover in 2012, mainly driven by gradually increasing FDI inflows ahead of Croatia's EU entry in 2013. In a less supportive global environment, exports are expected to grow only marginally in 2012. At the same time, the investment-driven recovery of domestic demand will also contribute to a pickup in import growth, so that the positive contribution of net exports to GDP growth is likely to decrease further.

Annex: Detailed Result Tables

Table 12

Demand Components (Real Prices)

Chained volume data (reference year = 2005)

	2010	2011	2012	2013	2010	2011	2012	2013
	EUR million				*Annual change in %*			
Private consumption	142,223	143,621	144,695	146,203	+2.1	+1.0	+0.7	+1.0
Government consumption	49,436	50,036	50,339	50,710	–0.2	+1.2	+0.6	+0.7
Gross fixed capital formation	51,589	53,606	53,677	54,763	+0.1	+3.9	+0.1	+2.0
of which: Investment in plant and equipment	*20,367*	*21,290*	*21,204*	*21,896*	*+3.3*	*+4.5*	*–0.4*	*+3.3*
Residential construction investment	*10,288*	*10,258*	*10,365*	*10,419*	*–2.2*	*–0.3*	*+1.0*	*+0.5*
Investment in other construction	*20,838*	*20,949*	*21,000*	*21,339*	*–2.7*	*+0.5*	*+0.2*	*+1.6*
Changes in inventories (including statistical discrepancy)	2,046	5,412	4,539	4,761	×	×	×	×
Domestic demand	245,295	252,674	253,250	256,437	+1.7	+3.0	+0.2	+1.3
Exports of goods and services	145,758	156,405	160,960	170,633	+8.4	+7.3	+2.9	+6.0
Imports of goods and services	128,078	137,321	140,446	148,963	+8.0	+7.2	+2.3	+6.1
Net exports	17,680	19,084	20,514	21,670	×	×	×	×
Gross domestic product	262,975	271,759	273,764	278,107	+2.3	+3.3	+0.7	+1.6

Source: 2010: Eurostat; 2011 to 2013: OeNB December 2011 outlook.

Table 13

Demand Components (Current Prices)

	2010	2011	2012	2013	2010	2011	2012	2013
	EUR million				*Annual change in %*			
Private consumption	155,936	162,156	166,669	171,179	+4.2	+4.0	+2.8	+2.7
Government consumption	55,518	57,333	59,249	61,040	+1.9	+3.3	+3.3	+3.0
Gross fixed capital formation	58,521	62,379	63,554	65,804	+3.1	+6.6	+1.9	+3.5
Changes in inventories (including statistical discrepancy)	3,270	6,718	5,210	5,844	×	×	×	×
Domestic demand	273,245	288,586	294,682	303,868	+4.6	+5.6	+2.1	+3.1
Exports of goods and services	154,720	171,991	180,459	194,646	+11.6	+11.2	+4.9	+7.9
Imports of goods and services	141,978	159,708	165,203	177,618	+13.2	+12.5	+3.4	+7.5
Net exports	12,742	12,283	15,256	17,028	×	×	×	×
Gross domestic product	285,988	300,869	309,938	320,896	+4.2	+5.2	+3.0	+3.5

Source: 2010: Eurostat; 2011 to 2013: OeNB December 2011 outlook.

Table 14

Deflators of Demand Components

	2010	2011	2012	2013	2010	2011	2012	2013
	2005 = 100				*Annual change in %*			
Private consumption	109.6	112.9	115.2	117.1	+2.1	+3.0	+2.0	+1.6
Government consumption	112.3	114.6	117.7	120.4	+2.1	+2.0	+2.7	+2.3
Gross fixed capital formation	113.4	116.4	118.4	120.2	+2.9	+2.6	+1.8	+1.5
Domestic demand (excluding changes in inventories)	111.0	114.0	116.4	118.4	+2.3	+2.7	+2.1	+1.7
Exports of goods and services	106.1	110.0	112.1	114.1	+2.9	+3.6	+2.0	+1.7
Imports of goods and services	110.8	116.3	117.6	119.2	+4.9	+5.0	+1.1	+1.4
Terms of trade	95.8	94.5	95.3	95.7	–1.8	–1.3	+0.8	+0.4
Gross domestic product	108.7	110.7	113.2	115.4	+1.8	+1.8	+2.3	+1.9

Source: 2010: Eurostat; 2011 to 2013: OeNB December 2011 outlook.

Table 15

Labor Market

	2010	2011	2012	2013	2010	2011	2012	2013
	Thousands				*Annual change in %*			
Total employment	4,118.6	4,181.5	4,197.8	4,223.2	+0.9	+1.5	+0.4	+0.6
of which: Private sector employment	*3,587.1*	*3,650.8*	*3,667.8*	*3,693.9*	*+1.1*	*+1.8*	*+0.5*	*+0.7*
Payroll employment (national accounts definition)	3,527.7	3,588.8	3,601.9	3,624.2	+0.8	+1.7	+0.4	+0.6
	% of labor supply							
Unemployment rate (Eurostat definition)	4.4	4.2	4.5	4.5	×	×	×	×
	EUR per real output unit x 100							
Unit labor costs (whole economy)[1]	63.5	63.8	65.4	66.0	+0.2	+0.5	+2.5	+1.0
	EUR thousand per employee							
Labor productivity (whole economy)[2]	63.8	65.0	65.2	65.9	+1.4	+1.8	+0.3	+1.0
	EUR thousand							
Real compensation per employee[3]	37.0	36.7	37.0	37.1	–0.5	–0.7	+0.8	+0.4
	At current prices in EUR thousand							
Gross compensation per employee	40.5	41.5	42.6	43.5	+1.6	+2.3	+2.8	+2.0
	At current prices in EUR million							
Total gross compensation of employees	142,987	148,788	153,535	157,621	+2.3	+4.1	+3.2	+2.7

Source: 2010: Eurostat; 2011 to 2013: OeNB December 2011 outlook.

[1] *Gross wages divided by real GDP.*
[2] *Real GDP divided by total employment.*
[3] *Gross wages per employee divided by the private consumption expenditure (PCE) deflator.*

Table 16

Current Account

	2010	2011	2012	2013	2010	2011	2012	2013
	EUR million				*% of nominal GDP*			
Balance of trade	9,928.0	9,921.9	12,257.1	13,900.5	3.5	3.3	4.0	4.3
Balance on goods	–3,189.0	–4,119.2	–2,625.8	–1,819.6	–1.1	–1.4	–0.8	–0.6
Balance on services	13,117.0	14,041.1	14,882.9	15,720.0	4.6	4.7	4.8	4.9
Balance on income	538.0	–178.5	–736.1	–746.8	0.2	–0.1	–0.2	–0.2
Balance on transfers	–2,009.0	–2,387.0	–2,405.8	–2,430.4	–0.7	–0.8	–0.8	–0.8
Current account	8,457.0	7,356.3	9,115.2	10,723.2	3.0	2.4	2.9	3.3

Source: 2010, Eurostat; 2011 to 2013: OeNB December 2011 outlook.

Table 17

Quarterly Outlook Results

	2011	2012	2013	2011				2012				2013			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Prices, wages and costs	*Annual change in %*														
HICP	+3.5	+2.2	+1.6	+3.0	+3.7	+3.8	+3.6	+2.8	+2.1	+2.1	+1.8	+1.7	+1.7	+1.6	+1.5
HICP (excluding energy)	+2.8	+2.0	+1.7	+2.2	+3.1	+3.1	+2.7	+2.3	+1.9	+1.9	+1.9	+1.9	+1.8	+1.7	+1.6
Private consumption expenditure (PCE) deflator	+3.0	+2.0	+1.6	+3.1	+2.9	+3.1	+2.8	+2.4	+1.9	+2.0	+1.7	+1.7	+1.7	+1.6	+1.6
Gross fixed capital formation deflator	+2.6	+1.8	+1.5	+3.1	+2.8	+2.2	+2.3	+2.2	+1.6	+1.7	+1.6	+1.5	+1.5	+1.5	+1.4
GDP deflator	+1.8	+2.3	+1.9	+1.4	+1.5	+1.9	+2.4	+2.8	+2.6	+2.0	+1.7	+1.6	+1.8	+2.1	+2.2
Unit labor costs	+0.5	+2.5	+1.0	–1.1	+0.0	+1.3	+1.7	+3.2	+2.8	+2.4	+1.6	+0.4	+0.7	+1.2	+1.8
Nominal wages per employee	+2.3	+2.8	+2.0	+2.2	+2.3	+2.4	+2.2	+3.0	+2.8	+2.8	+2.7	+1.7	+1.9	+2.1	+2.4
Productivity	+1.8	+0.3	+1.0	+3.3	+2.3	+1.1	+0.5	–0.2	+0.0	+0.4	+1.1	+1.3	+1.2	+0.8	+0.6
Real wages per employee	–0.7	+0.8	+0.4	–0.8	–0.7	–0.7	–0.6	+0.5	+0.9	+0.8	+0.9	+0.1	+0.2	+0.5	+0.8
Import deflator	+5.0	+1.1	+1.4	+6.6	+5.5	+4.1	+3.8	+1.4	+0.4	+1.3	+1.4	+1.3	+1.3	+1.4	+1.4
Export deflator	+3.6	+2.0	+1.7	+4.2	+3.8	+3.6	+3.0	+2.6	+2.1	+1.6	+1.5	+1.6	+1.7	+1.8	+1.9
Terms of trade	–1.3	+0.8	+0.4	–2.3	–1.6	–0.5	–0.7	+1.2	+1.7	+0.3	+0.1	+0.3	+0.4	+0.4	+0.4
Economic activity	*Annual and/or quarterly changes in % (real)*														
GDP	+3.3	+0.7	+1.6	+1.1	+0.4	+0.3	+0.0	+0.1	+0.1	+0.3	+0.4	+0.4	+0.4	+0.5	+0.5
Private consumption	+1.0	+0.7	+1.0	–0.2	+0.3	+0.7	+0.3	+0.0	+0.0	+0.1	+0.2	+0.3	+0.3	+0.4	+0.4
Government consumption	+1.2	+0.6	+0.7	+1.3	+0.8	–1.0	–0.2	+0.5	+0.4	+0.4	+0.2	+0.1	+0.1	+0.1	+0.2
Gross fixed capital formation	+3.9	+0.1	+2.0	–1.1	+2.7	+0.9	+0.0	–0.8	–0.5	+0.0	+0.5	+0.8	+0.6	+0.7	+0.7
Exports	+7.3	+2.9	+6.0	+4.1	–0.2	+1.0	+0.0	+0.7	+1.0	+1.3	+1.4	+1.4	+1.6	+1.7	+1.7
Imports	+7.2	+2.3	+6.1	+4.7	–0.1	+0.6	–0.7	+0.2	+1.4	+1.6	+1.6	+1.3	+1.4	+1.5	+1.6
	Contribution to real GDP growth in percentage points														
Domestic demand	+1.5	+0.5	+1.1	–0.1	+0.8	+0.4	+0.1	–0.1	+0.0	+0.1	+0.2	+0.3	+0.3	+0.3	+0.3
Net exports	+0.5	+0.5	+0.4	+0.0	–0.1	+0.3	+0.3	+0.3	–0.1	–0.1	+0.0	+0.2	+0.2	+0.2	+0.2
Changes in inventories	+1.3	–0.3	+0.1	+1.2	–0.3	–0.3	–0.5	–0.1	+0.3	+0.3	+0.1	–0.1	–0.1	–0.1	+0.0
Labor market	*% of labor supply*														
Unemployment rate (Eurostat definition)	4.2	4.5	4.5	4.4	4.1	3.8	4.4	4.3	4.5	4.5	4.6	4.6	4.6	4.5	4.4
	Annual and/or quarterly changes in %														
Total employment	+1.5	+0.4	+0.6	+0.4	+0.4	+0.3	+0.2	+0.1	–0.1	–0.1	+0.0	+0.2	+0.3	+0.4	+0.4
of which: Private sector employment	*+1.8*	*+0.5*	*+0.7*	*+0.4*	*+0.5*	*+0.3*	*+0.3*	*+0.1*	*–0.1*	*–0.2*	*+0.0*	*+0.2*	*+0.3*	*+0.4*	*+0.5*
Payroll employment	+1.7	+0.4	+0.6	+0.5	+0.4	+0.4	+0.2	+0.1	–0.1	–0.2	+0.0	+0.2	+0.3	+0.4	+0.4
Additional variables	*Annual and/or quarterly changes in % (real)*														
Real disposable household income	+0.3	+0.4	+1.6	–1.5	–0.6	+1.0	–0.6	+0.3	+0.0	+0.1	+0.3	+0.3	+0.5	+0.7	+0.9
	% of real GDP														
Output gap	0.5	–0.3	–0.4	0.7	0.7	0.6	0.2	–0.1	–0.4	–0.4	–0.4	–0.4	–0.4	–0.4	–0.3

Source: OeNB December 2011 outlook (based on seasonally and working-day adjusted data).

Table 18

Comparison of Current Economic Forecasts for Austria

Indikator	OeNB			WIFO		IAS		OECD			IMF		European Commission		
	December 2011			September 2011		September 2011		November 2011			September 2011		November 2011		
	2011	2012	2013	2011	2012	2011	2012	2011	2012	2013	2011	2012	2011	2012	2013
Key results	*Annual change in %*														
GDP (real)	+3.3	+0.7	+1.6	+2.9	+0.8	+3.0	+1.3	+3.2	+0.6	+1.8	+3.3	+1.6	+2.9	+0.9	+1.9
Private consumption (real)	+1.0	+0.7	+1.0	+0.9	+0.8	+1.0	+0.8	+1.2	+0.9	+1.2	×	×	+0.6	+1.0	+1.4
Government consumption (real)	+1.2	+0.6	+0.7	+0.5	+0.5	+0.5	+0.5	+1.3	+0.7	+0.6	×	×	+1.0	+1.0	+1.2
Gross fixed capital formation (real)[1]	+3.9	+0.1	+2.0	+4.0	+1.1	+7.7	+1.1	+3.6	+1.2	+2.2	×	×	+4.7	+0.7	+3.0
Exports (real)	+7.3	+2.9	+6.0	+6.9	+3.6	+7.9	+3.5	+7.0	+3.1	+6.1	+8.2	+4.4	+6.8	+3.8	+6.4
Imports (real)	+7.2	+2.3	+6.1	+6.1	+3.8	+7.4	+3.0	+7.0	+3.1	+5.5	+6.7	+3.9	+6.4	+3.7	+6.4
GDP per employee	+1.8	+0.3	+1.0	+1.1	+0.4	+1.0	+0.8	×	×	×	×	×	+2.8	+1.9	+1.8
GDP deflator	+1.8	+2.3	+1.9	+2.0	+2.1	+2.1	+2.0	+1.8	+1.8	+1.7	×	×	+2.2	+2.1	+2.0
CPI	×	×	×	+3.1	+2.1	+3.2	+2.1	×	×	×	+3.2	+2.2	×	×	×
HICP	+3.5	+2.2	+1.6	+3.5	+2.3	×	×	+3.5	+1.9	+1.7	×	×	+3.4	+2.2	+2.1
Unit labor costs	+0.5	+2.5	+1.0	+1.6	+2.1	×	×	×	×	×	×	×	+1.2	+1.2	+0.7
Payroll employment	+1.5	+0.4	+0.6	+1.8	+1.4	+1.9	+0.5	×	×	×	×	×	+1.4	+0.2	+0.8
	% of labor supply														
Unemployment rate (Eurostat definition)	4.2	4.5	4.5	4.2	4.4	4.1	4.3	4.2	4.4	4.4	4.1	4.1	4.2	4.5	4.2
	% of nominal GDP														
Current account	2.4	2.9	3.3	2.8	2.8	×	×	3.0	3.4	3.8	2.8	2.7	2.7	2.8	2.9
Budget balance (Maastricht definition)	–3.1	–2.9	–3.2	–3.1	–3.1	–3.1	–2.8	–3.4	–3.2	–3.1	–3.5	–3.2	–3.4	–3.1	–2.9
External assumptions															
Oil price in USD/barrel (Brent)	111.5	109.4	104.0	110.0	100.0	112.0	115.0	111.0	110.0	110.0	103.2	100.0	111.0	104.0	100.0
Short-term interest rate in %	1.4	1.2	1.4	1.4	1.5	1.4	1.1	1.4	1.0	0.6	1.3	1.2	1.4	1.2	1.5
USD/EUR exchange rate	1.40	1.36	1.36	1.40	1.40	1.40	1.39	1.39	1.36	1.36	1.41	1.41	1.40	1.37	1.37
	Annual change in %														
Euro area GDP (real)	+1.5 to +1.7	–0.4 to +1.0	+0.3 to +2.3	+1.6	+0.5	+1.6	+1.0	+1.6	+0.2	+1.4	+1.6	+1.1	+1.5	+0.5	+1.3
U.S. GDP (real)	+1.8	+1.8	+2.5	+1.8	+1.0	+1.6	+2.0	+1.7	+2.0	+2.5	+1.5	+1.8	+1.6	+1.5	+1.3
World GDP (real)	+3.7	+3.6	+4.1	+3.8	+3.1	×	×	×	×	×	+4.0	+4.0	+3.7	+3.5	+3.6
World trade	+6.9	+5.6	+7.1	+6.0	+5.0	+7.0	+5.7	+6.7	+4.8	+7.1	+7.5	+5.8	+7.2	+5.3	+6.4

Source: OeNB, WIFO, IAS, OECD, IMF, European Commission.

[1] *For IAS: Gross investment.*

In Focus:
EU Governance Reformed

Editorial

Walpurga
Köhler-Töglhofer

The global financial and economic crisis and the subsequent public finance crises in some EU Member States have exposed weaknesses in the EU's economic and fiscal governance architecture. Despite the European fiscal framework, many EU and euro area members failed to achieve sufficiently sustainable fiscal positions in the years preceding the outbreak of the global crisis. This contributed to the fact that the financial and economic crisis turned into a sovereign debt crisis. Economic policymakers' attempts to promote the implementation of the EU's Lisbon strategy using the "open method of coordination" – a soft, nonbinding mechanism based on peer review and benchmarking – did not prove very effective either. Moreover, emerging macroeconomic imbalances that may affect the functioning of individual euro area economies, or the EU economy as a whole, were not given the appropriate attention prior to the onset of the crisis. Also, the Treaty of Lisbon did not make adequate institutional and economic policy provisions to prevent or cope with the banking and sovereign debt crisis in the EU.

In light of these realizations, a reform of the EU's economic governance framework consisting of several sets of measures was agreed. The introduction of the European semester, for one part, is supposed to better align the EU's economic policy and budgetary surveillance measures with national budgetary procedures, both in terms of timing and content. Both the preventive arm and the dissuasive arm of the Stability and Growth Pact (SWP) as well as the monitoring of national fiscal frameworks will be strengthened. Second, a new framework for the surveillance of macroeconomic imbalances has been introduced to complement fiscal surveillance. An alert mechanism based on specific indicators, together with a stringent surveillance mechanism, is supposed to facilitate the prevention and correction of such imbalances, in particular with regard to unsustainable debt positions in the private and public sectors, in the finance sector and vis-à-vis non-EU countries. Third, EU-wide monitoring of structural reforms in the Member States is to achieve actual progress toward the objectives laid down in the Europe 2020 strategy in the interest of smart, sustainable and inclusive growth. Moreover, the adoption of the European Stability Mechanism as a permanent crisis management mechanism designed to safeguard financial stability in the euro area as a whole represents an important step toward financial solidarity.

Given the complexity of the governance reform, the Oesterreichische Nationalbank (OeNB) has dedicated this issue of its quarterly publication "Monetary Policy & the Economy" to this intricate topic, aiming to provide the broad public with a comprehensive overview of the EU's new governance architecture, while at the same time explaining the intentions and objectives behind the new provisions. This special issue is the result of a cooperation between authors representing four different institutions, i.e. Austria's Federal Ministry of Finance, the Austrian Federal Chancellery, the Federal Ministry of Economy, Family and Youth, and the OeNB.
The cutoff date for this issue was December 9, 2011.

The first contribution, authored by *Gloggnitzer* and *Lindner,* analyzes the legal foundations of the economic governance reform and provides an overview of the financial and economic policy measures taken in response to the crisis from fall 2008 to early December 2011. The authors offer a preliminary

review of the reforms on the basis of the standard EU procedures as laid down in the Treaty of Lisbon and the initiatives taken by Member States and assess the perspective for future developments. The starting point of the discussion is the fact that the Treaty of Lisbon did not make adequate institutional or economic policy provisions to prevent or cope with banking and sovereign debt crises in the EU and that the institutional decision-making processes put in place by the Treaty proved too sluggish during the crisis. As a result, most of the measures taken to remedy the situation were agreed through intergovernmental decision-making rather than through standard EU procedures (the "Community Method"). The authors show that, by deepening a separate euro governance structure, the states in effect lent expression to the fact that the euro area required a more coherent and efficient economic governance structure.

The following article by *Köhler-Töglhofer* and *Part* addresses the EU's new coordination and surveillance structure, i.e. the European semester, which was first applied in early 2011. The authors explain the contents, objectives and procedures of the European semester, which aims to promote an improved ex ante coordination of EU Member States' economic and fiscal policies by harmonizing the different economic and fiscal policy coordination procedures. As a result, national fiscal and economic policies will be monitored in a coordinated and integrated manner rather than separately, and national policies will be aligned with integrated guidelines. This is to ensure that key economic policy priorities are jointly discussed at EU level and that the complementarity of national economic policy plans is ensured at EU level before related decisions are actually adopted at the national level.

The third contribution, authored by *Auböck, Burger* and *Mangler,* highlights the special features of the Europe 2020 strategy, which defines a new growth and employment policy framework for the EU. The Europe 2020 strategy has been shaped, on the one hand, by the weaknesses of its predecessor, the Lisbon strategy, and on the other hand by the major economic policy challenges brought on by the crisis. In the future, quantitative targets that have been defined early on as well as transparent surveillance are supposed to make it easier to monitor compliance. With its three priorities – smart growth, sustainable growth and inclusive growth – Europe 2020 builds on its predecessor strategy in programmatic terms; at the same time, the new strategy is based on a completely new governance concept: continuous process management, embedded in the coordination and surveillance framework of the European semester. This makes it possible to align the previously separate fiscal policy coordination processes within the SGP framework and the coordination processes relating to economic policy in terms of timing. While the Lisbon strategy was based on the "open method of coordination," the integration of the Europe 2020 strategy into the European semester represents a step toward comprehensive country-specific surveillance.

Four of the six EU legislative acts (the so-called "six-pack") through which the new EU economic governance framework was established relate to aspects of fiscal policy. In the fourth contribution, *Holler* and *Reiss* discuss the changes to the Stability and Growth Pact. The amendments to the SGP – the fiscal surveillance mechanism in place to safeguard the stability of Europe's Economic and Monetary Union (EMU) – are supposed to give more teeth to the SGP framework, which failed to provide

sufficient incentives for correcting fiscal imbalances even prior to the crisis. The core elements of the SGP reform are strengthening the preventive arm by introducing a spending rule, operationalizing the debt criterion in the dissuasive arm by amending Regulation (EC) 1466/97 and Regulation (EC) 1467/97, and tightening sanctions by adopting the new Regulation 1173/2011. The latter regulation provides for a new set of graduated financial sanctions. The changes to the SGP are complemented by new minimum requirements regarding national budgetary frameworks as laid down in Council Directive 2011/85/EU.

Two of the legal instruments constituting the "six-pack" are new regulations governing the procedure applicable in case of macroeconomic imbalances in the EU and euro area. These regulations are analyzed by *Essl* and *Stiglbauer* in the fifth paper published in this issue. Macroeconomic imbalances are viewed as one of the fundamental causes of the global financial and economic crisis. Owing to diverging competitiveness developments and a lack of adequate structural reforms, such imbalances also materialized among euro area countries. Consequently, the financial and economic crisis affected EMU member countries to varying degrees, leading to unexpected challenges for the single monetary policy and the coordinated fiscal policy. To prevent similar developments in the future, a procedure for preventing and correcting macroeconomic imbalances has been created – in analogy with the SGP – and integrated into the European semester. The preventive arm of the procedure provides for the detection and analysis of possible macroeconomic problems. If, in the course of the procedure, a Member State is found to be in an "excessive" imbalance position, the procedure's corrective arm enters into force. This usually means that the EU Council will issue recommendations, based on which the relevant Member State must present a corrective action plan. Failure to comply with Council recommendations may lead to sanctions. The new procedure comprehensively strengthens economic policy coordination in the EU and within EMU.

The last contribution in this special issue, compiled by *Nauschnigg* and *Schieder,* focuses on crisis financing in the EU. To facilitate the management of crises that threaten to spill over to the euro area, or the EU, as a whole, policymakers have established and reinforced stability mechanisms under which financial assistance may be granted to EU Member States and euro area countries. The introduced novelties most notably include mechanisms for the financing of Member States, which had not seemed a necessity for sustaining the monetary union project prior to the case of Greece. Since May 2010, the EU medium-term financial assistance (balance of payments) facility has been increased to EUR 50 billion. Additionally, Greece has been granted bilateral loans, and new financing institutions have been established: the European Financial Stability Facility (EFSF), the European Financial Stabilisation Mechanism (EFSM) and the planned European Stability Mechanism (ESM). These new financing measures complement the global funds of the IMF at the European level.

Next to implementing the reforms and crisis resolution mechanisms discussed in the six contributions, the euro area countries will aim to anchor the economic policy stance within EMU more firmly. Efforts to implement the "Euro Plus Pact" are already under way. On December 9, 2011, the Heads of State or Government of 26 EU Member

States agreed on several measures toward a fiscal stability union. It remains to be seen which effects these reform efforts will actually have on competitiveness, employment, long-term sustainability of public finances and financial stability in the EU and euro area. At this point it seems crucial, however, to safeguard not only the European Union's economic success but also its democratic legitimation.

Economic Governance Reform and Financial Stabilization in the EU and in the Eurosystem – Treaty-Based and Intergovernmental Decisions

Sylvia Gloggnitzer,
Isabella Lindner[1]

The institutional framework and the tools for economic governance provided by the Treaty of Lisbon were inadequate for preventing or resolving the recent banking and sovereign debt crisis in the EU. For instance, the Treaty did not provide any instruments for stabilizing euro area finances, and the existing economic governance instruments, such as the Stability and Growth Pact or the Broad Economic Policy Guidelines, were not applied adequately by the Member States. In addition, the institutional decision-making procedures foreseen by the Treaty proved too sluggish during the crisis. Therefore, most of the measures taken to remedy the situation were agreed through intergovernmental decision-making, with the European Council evolving as the key player in the governance process, rather than through standard EU procedures (with the "Community Method"). The deepening of euro governance, alongside the EU governance framework, resulted from the fact that the euro area required a coherent and efficient economic governance structure. The willingness to offer financial solidarity within the euro area correlates with the willingness of distressed Member States to implement sustainable national fiscal policies. To ensure the long-term success of the euro, the euro area will, however, have to adopt a common overall strategy that adds more value to its economic success as an entity.

JEL classification: G01, N14, O52
Keywords: EU economic governance reform, financial stabilisation, Treaty of Lisbon, intergovernmental decision

Overcoming the banking and sovereign debt crisis in the EU and in the euro area has put both the economic policy strategies of the EU and of its Member States as well as institutional decision-making to a severe test. The principal conditions governing the Economic and Monetary Union (EMU) framework laid down in the Maastricht Treaty have not been adapted. They thus remain the statutory framework on the basis of which measures may be taken at the EU level to combat the sovereign debt crisis. The economic policy framework in place certainly contains provisions whose expedient implementation could have mitigated or even prevented the current effects of the crisis (Wieser, 2011; Koll, 2011) – had all the Member States, especially the euro area countries, observed their self-imposed economic policy constraints.

Article 3 of the Treaty on European Union (TEU) lays down economic policy objectives for the EU, including "balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress." EMU is based on an independent monetary policy oriented toward stability, whose primary objective is to maintain the price stability of the euro under Article 127(1) of the Treaty on the Functioning of the European Union (TFEU). When founding EMU, the Member States entered into a binding agreement that fiscal and economic policy would remain a national responsibility. The fiscal policy framework laid down in the Treaty of Lisbon and compliance with the Stability and Growth Pact were designed to secure the stability-oriented single monetary policy. Article 125 TFEU –

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the "no bailout" clause – in combination with Article 123 TFEU – the prohibition of monetary financing of budget deficits – is considered the prerequisite for fiscal discipline in all Member States and for the functioning of monetary policy (Potacs and Mayer, 2011). Otherwise, the Member States could be tempted to pursue unsound fiscal policies because they would not have to bear the consequences of such policies alone – such as high risk premiums on their sovereign debt or the inaccessibility of market financing. The above-mentioned fiscal discipline rules should be applicable both to economic governance under normal circumstances and to crisis management.

Many critics have noted that the Treaty of Lisbon did not contain sufficient provisions for preventive crisis management (e.g. Breuss, 2011). Actual crisis management and considerations for long-term crisis prevention have indeed brought to light institutional and structural shortcomings that the EU and the euro area have begun to address. Among other things, the Treaty of Lisbon does not explicitly establish financial solidarity among the Member States; only in the event of a serious threat caused by natural disasters or exceptional circumstances can a Member State receive EU financial assistance under the provisions of Article 122(2) TFEU. To fill this gap, the euro area took the initiative to establish a stability mechanism under which financial assistance may be granted to distressed euro area countries. Burden-sharing during crisis between Member States with sound economic policies and those with unsound practices and between monetary policy and fiscal policy has revealed contradictory economic policy interests. To remedy this situation, the EU has since taken measures to enhance its economic governance framework. Moreover, the euro area has been criticized for its inefficient and slow crisis management and its sluggish crisis communication. The public and financial markets have decried the lack of clear solutions and have been confused by intransparent decision-making. The establishment of a separate euro governance structure shall rectify this situation.

This article provides an overview of the financial and economic policy measures taken from fall 2008 to fall 2011 in response to the sovereign debt crisis. A preliminary review of the reforms is made on the basis of the standard EU procedures as laid down in the Treaty of Lisbon and the initiatives taken by Member States. Perspectives for future developments are assessed.

1 The Treaty of Lisbon as the Point of Departure for Crisis Resolution and Reform

1.1 EMU Institutional Framework and Governance during the Crisis

On December 1, 2009, the new constitutional basis for the EU, the Treaty of Lisbon,[2] entered into force. The Lisbon Treaty applies to an enlarged EU of 27 Member States with 502.5 million EU citizens (Eurostat, 2011) and is intended to ensure a more efficient functioning of EU institutions. To what extent does the Treaty of Lisbon represent a suitable legal and institutional basis for efficient crisis resolution? Which EU bodies are involved in crisis management, and how do they interact?

[2] *The Treaty of Lisbon consists of the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU), including the annexed protocols and declarations (OJ C 83, 30. 3. 2010, p. 1).*

1.1.1 European Council and Euro Summits

The First European Council was held in Paris in 1961 at the behest of Charles de Gaulle, then President of France. The Treaty of Lisbon formalized the European Council and transformed it into an institution of the EU.[3] Meetings of the European Council are attended by the Heads of State or Government of the 27 EU Member States, its President, the President of the European Commission and the President of the European Central Bank (ECB). As a rule, decisions are taken by consensus. The European Council does not exercise a legislative function (Article 15(1) TEU). Electing a full-time president of the European Council for 2½ years is intended to enhance consistency and continuity in the political management of the EU, as the political guidelines and priorities for EU action are decided top-down by the European Council (European Policy Centre, 2011). In EMU, the coordination of economic policies and employment policy programs also follows policy orientation given by the European Council; the European Council moreover assesses the implementation of these programs. These functions indicate the key role the European Council plays in EU crisis management. While the Heads of State or Government used to come together four times a year, they met more often during the crisis, many times at short notice.

As the stability of the euro was considered to be under threat, it quickly became evident that the euro area would require a coherent approach to financial and economic crisis management. As early as October 12, 2008, Nicolas Sarkozy, then President of the EU Council, convened the historical first European Council of the Heads of State or Government of the euro area countries, the first Euro Summit (Schwarzer, 2009). The subsequent "Franco-German proposal"[4] for stronger economic and institutional governance of the euro area provided for regular meetings – at least two a year – of the Heads of State or Government of the euro area countries ("gouvernement économique").[5] The Euro Summit of October 26, 2011, expanded this proposal to improve the governance of the euro area (chart 1). The measures were aimed at strengthening economic policy coordination and surveillance within the euro area, improving the effectiveness of decision making, and ensuring more consistent communication. In the past, the authorities oftentimes sent mixed messages about complex decisions to financial markets and the public. The Euro Summit on October 26, 2011, therefore decided that its President together with the President of the European Commission would be in charge of communicating decisions. The President of the Eurogroup together with the Commissioner for Economic and Monetary Affairs will be responsible for communicating the decisions of the Eurogroup. To reinforce cohesion between the euro area and the EU, the President of the Euro

[3] *Article 15 TEU, Articles 235, 236 et seq. TFEU and the European Council Decision of 1 December 2009 adopting its Rules of Procedure L 315/51 (OJ 2009/882/EU) specify the functioning and competences of the European Council.*

[4] *As expressed in a communication by German Chancellor Angela Merkel and French President Nicolas Sarkozy (2011).*

[5] *Different EU Member States have their own understanding of what "gouvernement économique" means. France e.g. had already proposed an "economic government" when EMU was founded to establish a counterweight to the single monetary policy.*

Summit will inform the European Council of the preparation and outcome of the Euro Summits. The President of the Euro Summit will ensure the preparation of the Euro Summit, in close cooperation with the President of the Commission. The President of the Euro Summit will be designated and the President of the European Council[6] will be elected at the same time, and their terms of office will be 2½ years.

1.1.2 The Ecofin Council

The Council in the composition of the economics and finance ministers (Ecofin Council) has European legislative authority over economic and financial matters, in some cases in codecision with the European Parliament. The 27 EU ministers, together with the Commissioner for Economic and Monetary Affairs, meet under the presidency of the Member State that holds the rotating EU presidency. Moreover, the governors of the national central banks attend the informal Ecofin Council.

Like all other Council bodies, the Ecofin Council takes decisions by a qualified majority, as laid down in the Treaty of Nice. This system will apply until November 1, 2014, when the "double majority" principle will be introduced. Double majority means that decisions taken by the Council of Ministers will require a majority of 55% of the Member States representing at least 65% of the EU's population (Article 238 TFEU). To increase the EU's capacity for action, the qualified majority principle was extended to some EMU areas in the Treaty of Lisbon, e.g. to decisions on excessive deficits and to the appointment of the President, Vice-President and other members of the Executive Board of the ECB.

1.1.3 The Eurogroup

The Eurogroup, an informal gathering of the finance ministers of the 17 euro area countries, the Commissioner for Economic and Monetary Affairs and the President of the ECB, plays a pivotal role in euro area governance. This body was established already in 1998, as a "political counterweight" to the ECB, to meet the need for enhanced economic policy coordination among the euro area countries. The Eurogroup was later formalized in Article 137 TFEU and in a separate "Protocol on the Euro Group."[7] The president[8] of the Eurogroup is elected for a term of 2½ years. In the "provisions specific to Member States whose currency is the euro," the Treaty of Lisbon defines the areas in which the Eurogroup may take decisions autonomously. Euro area countries may adopt measures to set out economic policy guidelines and to strengthen the coordination and surveillance of budgetary discipline (Article 136 TFEU). The Eurogroup may, for example, issue special recommendations to its members about drawing up their stability programs and about the euro area entry of new members. When euro area countries' finance ministers take final decisions on Eurogroup-related issues in the Ecofin Council, the finance ministers of the non-euro area countries do not take part in the vote (Martens, 2009).

[6] *Herman Van Rompuy is currently President of the European Council; until the next election in June 2012 he will also preside over the Euro Summits.*

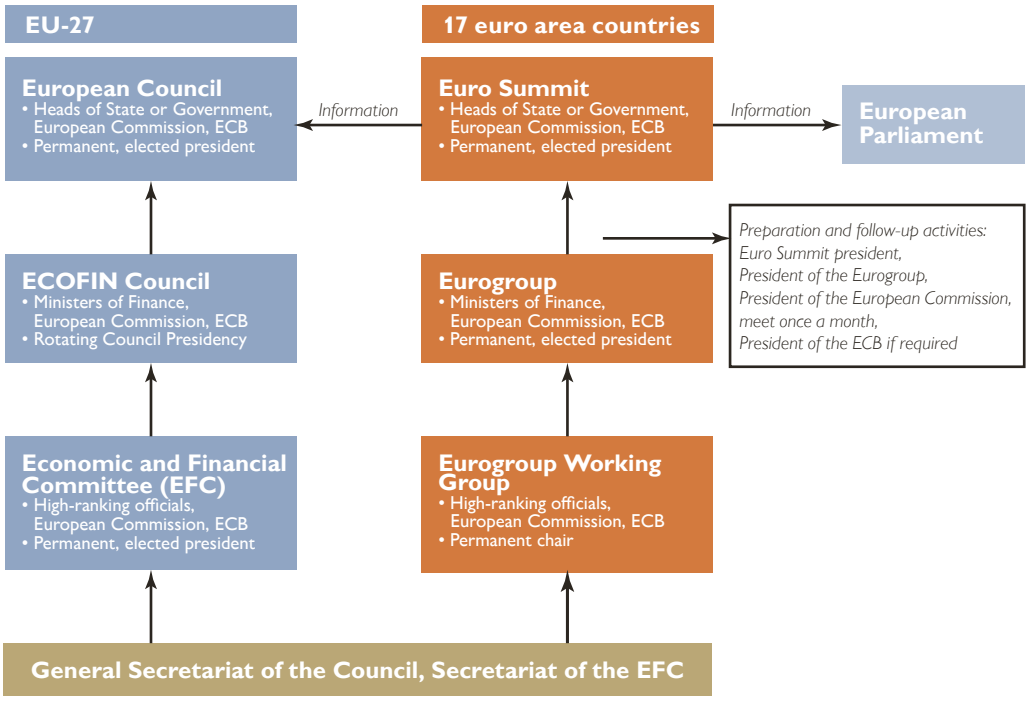
[7] *Protocol (No 14) on the Euro Group (OJ C 83, 30. 3. 2010) codifies the practice followed before the Treaty of Lisbon entered into force.*

[8] *The current president of the Eurogroup is Luxembourg's Prime Minister, Jean-Claude Juncker. His term ends in July 2012.*

Since the intensification of the sovereign debt crisis, euro area countries have been coordinating their actions much more closely. The pooled bilateral loans to Greece, the establishment of the European Financial Stability Facility (EFSF) and those areas of economic governance that concern only euro area countries may be cited as cases in point. To effectively overcome the current problems and to ensure closer integration, the Euro Summit agreed on a new economic governance on October 26, strengthening the governance framework for the euro area while preserving the integrity of the EU as a whole. Under this new framework, the Eurogroup will ensure greater fiscal coordination and will promote financial stability. The decision on whether the Eurogroup president should be elected from among Eurogroup members or whether the president should be a full-time official based in Brussels will be taken when the current incumbent's mandate expires. The Eurogroup will also be in charge of preparing, and following up on Euro Summits. The President of the Euro Summit, the President of the Commission and the President of the Eurogroup will meet regularly, at least once a month. The President of the ECB may be invited to participate. The presidents of the European supervisory agencies and the CEO of the EFSF or the Managing Director of the European Stability Mechanism (ESM) may be invited ad hoc. The Eurogroup Working Group (EWG) will be tasked with work at the preparatory level, drawing on expertise provided by the Commission. The EWG will be chaired by a full-time Brussels-based president, who will as a rule be chosen at the same time as the chair of the Economic and Financial Committee.

Chart 1

New Governance Structures in the Euro Area



Source: OeNB.

1.1.4 ECB

Article 13(1) TEU names the ECB as one of the EU's institutions. The provisions regarding the ECB in the Treaty of Lisbon (Articles 127 through 133 TFEU) and the ESCB/ECB Statute[9] call for personal, operational, financial and legal independence of the ECB. The ECB is consulted on any proposed EU act in its competence, such as the six legislative proposals of the European Commission to reform economic governance (the "six-pack"). The ECB is represented in all key decision-making bodies of the euro area, such as the Euro Summits or the Eurogroup, as well as in those of the EU. The Governing Council of the ECB, the main decision-making body of the ECB, consists of the six members of the Executive Board of the ECB and the 17 governors of the euro area NCBs. Votes are taken by a simple majority of the unweighted votes[10] of the Governing Council's members. Compared to the Eurogroup, the Governing Council of the ECB, with its streamlined decision-making and communication structure, is able to act very quickly during a crisis.

1.1.5 Role of the European Commission

The European Commission ensures the application of the Treaties, has the sole right to propose legislative acts, and oversees the application of EU laws (Article 17 TEU) (Schusterschitz, 2009). The European Commission has always been a driving force behind EU integration, proposing legislation by virtue of its status as a supranational institution independent of the individual Member States. The Commission exercises its right of initiative autonomously of the Member States' national interests, as was the case with economic governance reform. While the Task Force on Economic Governance was still negotiating, the European Commission already presented six legislative proposals frequently referred to as "the six-pack" (box 1).

However, many observers note that the European Commission has – to a certain extent – lost its role in crisis management. Proposals to resolve the crisis and initiatives for deepening integration, such as the Euro Plus Pact, were made by the Member States themselves, above all as a result of German-French cooperation. With a separate euro governance in place, the European Commission faces two particular challenges: The Commission will have to ensure coherence among the EU-27 while at the same time fulfilling special tasks for the euro area. The European Council already addressed this duality at its meeting of October 23, 2011, emphasizing that the European Commission was responsible for the efficient functioning of the EU by ensuring compliance of all 27 Member States with EU legislation. Any Treaty changes initiated by euro area countries have to be agreed by all 27 Member States. The European Council also took note that the Euro Summit intended to reflect on further strengthening economic convergence within the euro area. In this context, the Commission will prepare proposals and will strengthen the role of the Commissioner for Economic and Monetary Affairs in the Commission.

1.1.6 Strengthened Role of the European Parliament

With the establishment of the codecision procedure (Articles 294 et seq. TFEU) as the primary legislative pro-

[9] *Protocol No 4 of the Treaty of Lisbon: Statute of the ESCB/ECB.*

[10] *In precisely defined cases, voting is according to the capital key, e.g. for the distribution of profit.*

cedure in the EU, the European Parliament became a legislator on an equal footing with the Council. The outcome is a higher degree of control and democratic legitimacy, also in the field of economic and fiscal policy. In this vein, the European Parliament called for extensive amendments to the "six-pack" legislation on economic governance reform (box 1). The European Parliament only had to be consulted on the establishment of the European Stability Mechanism (ESM). The European Parliament was not called upon to act as a legislator for short-term crisis management in the euro area. However, it was agreed that the Euro Summit president would inform the European Parliament about the results of the meetings.

The expansion of the regular legislative procedure to include the European Parliament on an equal footing promotes decisions of a supranational nature at the EU level, but during the economic and financial crisis, the rapid action of the European Council and the Euro Summit were required. The upshot was that more and more decisions, such as the decision to establish EU-IMF financial assistance for EU/euro area countries, were agreed during intergovernmental negotiations. Therefore, decision makers will have to weigh the importance of acting rapidly against greater cohesion among the Member States and democratic legitimacy that a regular legislative procedure confers.

Box 1

Economic Governance Reform – EU Codecision Procedures Result in Complex Interinstitutional Cooperation

On March 25, 2010, the Heads of State or Government of the euro area countries agreed that economic governance needed to be improved. To this end, the Task Force established by the March 2010 European Council held its first meeting May 21, 2010. The European Council President Herman Van Rompuy chaired the meeting, which – in close cooperation with the European Commission – elaborated reform proposals on the basis of Treaty provisions. The European Commission adopted six legislative proposals to strengthen economic governance in the EU already on September 9, 2010, that is, even before the Task Force presented its report to the European Council on October 21, 2010. The substance of the legislation was, however, closely coordinated with the report.

At its meeting on March 15, 2011, the Ecofin Council reached agreement on the European Commission's package of six legislative proposals on economic governance. Before this breakthrough, the proposals applicable to the euro area had been debated within the Eurogroup.

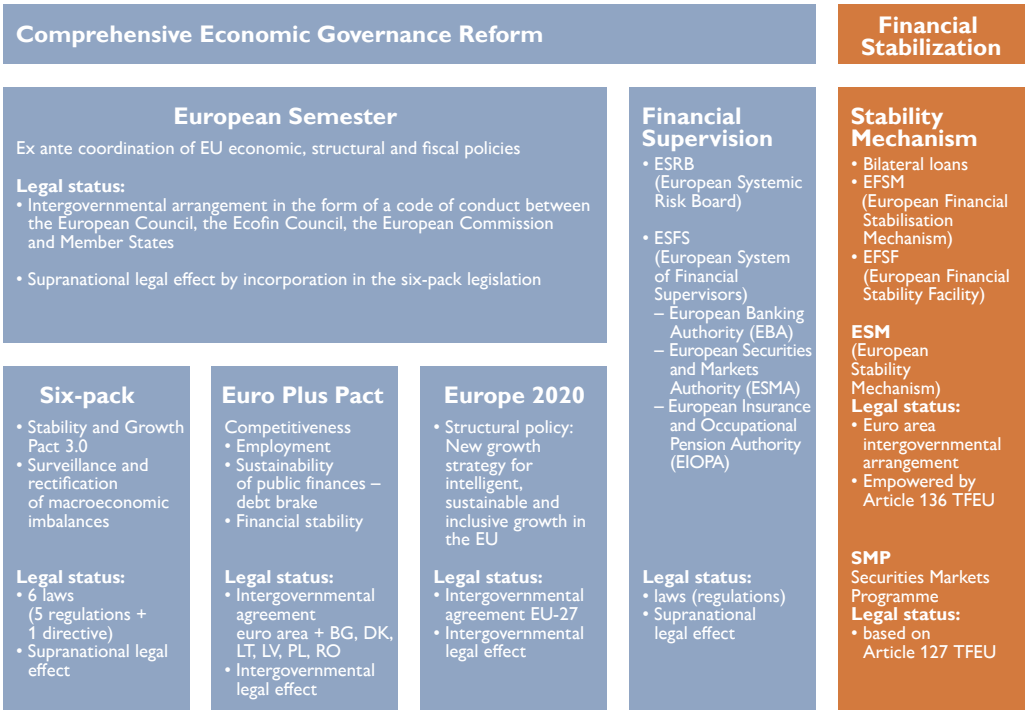
On September 28, 2011, the European Parliament adopted the legislation. The adoption of the laws was preceded by numerous tripartite negotiations between the European Parliament, the Ecofin Council and the European Commission to clarify contentious issues. To illustrate just how rocky the road was: the European Parliament had submitted some 2,000 amendments. On October 23, 2011, the European Council welcomed the agreement, and on November 8, 2011, the Ecofin Council formally adopted the six legislative proposals. The six laws entered into force on January 1, 2012, and will strengthen the economic policy pillar of EMU. It took nearly two years after the European Council had started its reform initiative before these laws went into effect. However, the measures are not to be seen as immediate crisis management tools.

1.2 Distribution of Competences and Cooperation between the EU Institutions on EMU-Related Issues

The distribution of powers between the Member States and the EU as well as among EU institutions is a key determinant of the overall economic and fiscal policy strategy of the EU and of the euro area (chart 2). On the basis of the Treaty of Lisbon, the Member States devolve powers to the EU for the purpose of realizing common economic and fiscal policy objectives. All of the powers that are not conferred upon the EU in the Treaties remain with the Member States. Hence, the principle of conferral (within the limits of the competences defined by the Treaties) while preserving the subsidiarity principle applies (Article 5 et seq. TEU, Protocol No 2). The Treaties distinguish between exclusive competences, shared competences (shared with the Member States) and competences to carry out action to support, coordinate or supplement the actions of the Member States (Title I, Articles 2 to 5 et seq. TFEU). The exclusive competences of the EU (Article 2(1), Article 3 TFEU) include monetary policy for the Member States whose currency is the euro. The Member States regard their economic policies as a matter of common concern (Article 121 TFEU). Consequently, Member States coordinate their economic and employment policies. For example, the Europe 2020 initiative uses the "open method of coordination" (OMC)[11] along the lines of

Chart 2

Economic Governance Architecture and Legal and Institutional Basis of EMU



Source: OeNB; Breuss, 2011; Obwexer, 2011.

[11] *The OMC uses instruments like common objectives, benchmarks, best practices and progress reports to attain objectives.*

Article 2(3) and Article 5 et seq. TFEU. By introducing the European semester in January 2011, the EU has fine-tuned economic governance and ex-ante coordination at the EU level (chart 2). Member States may be given fiscal and structural policy targets even before the respective parliaments have adopted the national budgets (Köhler-Töglhofer and Part in this issue). Another cooperation instrument is "enhanced cooperation" (Article 20 TEU and Articles 326 to 334 et seq. TFEU), which allows for a group of Member States to cooperate more closely in a particular area. Enhanced cooperation must take place within the framework of the EU's nonexclusive competences and is not suited to overcoming EMU design defects embodied in the Treaty (Fischer-Lescano and Kommer, 2011). On December 9, 2011, the euro area Heads of State or Government agreed to make more active use of enhanced cooperation without undermining the internal market.

The institutional reforms of the Treaty of Lisbon and the abolition of the three-pillar structure[12] of the EU have made it more difficult to strictly classify the EU's decisions as supranational or intergovernmental (Monar, 2010). Moreover, the Treaty of Lisbon did not sufficiently reinforce the economic and financial policy competences of EU institutions, i.e. of the European Commission and European Parliament. In practice, therefore, the crisis strengthened the role of the European Council, above all in its euro area configuration, because the crisis called for rapid economic policy decisions within the framework of more flexible intergovernmental agreements and outside the regular legislative process (Emmanouilidis and Janning, 2011). On December 9, 2011, 26 EU Member States agreed to establish a "fiscal stability union." A Treaty change with the intention of establishing this stability union within primary law and in secondary law is currently being blocked by a U.K. veto. Therefore, the 26 Member States have decided to conclude an intergovernmental treaty, or "fiscal compact" on stricter fiscal rules as a first step.

Given the large number of powerful decision makers involved in European Council meetings – among them the President of the European Council, the President of the European Commission, the German Chancellor, the French President, the Eurogroup President and the President of the ECB – the standard EU governance has increased in complexity, too. In order to improve working methods and enhance crisis management in the euro area the President of the European Council, in close consultation with the President of the Commission and the President of the Eurogroup, has therefore been charged with making concrete proposals (European Council, Conclusions, October 23, 2011).

2 Financial Stabilization and Economic Governance in the Euro Area – Deepening of the Economic Policy Strategy?

The constraints imposed by the fiscal and monetary governance framework of the Treaty and the discipline imposed by the financial markets had evidently failed to provide an adequate

[12] *Under the Treaty of Maastricht, the EU did not have legal personality in its own right, but provided the institutional framework for the EU's three "pillars": the European Communities (ECSC, EC, Euratom) with supranational decision-making powers, the Common Foreign and Security Policy (CFSP), and cooperation in the field of justice and home affairs based on intergovernmental decision-making.*

backstop (Bini-Smaghi, 2011). The architects of monetary union had not expected that countries would infringe established rules, that supervision by multilateral institutions would be inadequate, that unsustainable macroeconomic imbalances and high public debt would be built up, and that the financial markets would underestimate sovereign credit risk. The EU reacted to these infringements by taking far-reaching financial stabilization measures and by deepening coordination and economic governance without changing the economic policy objectives of the Treaty.

2.1 Financial Stabilization of the EU and the Euro Area

2.1.1 The First Measures to Counteract the Crisis and the Role of the IMF

When the crisis spilled over from the U.S.A., some Central and Eastern European countries were among the first to be hit. The EU was well equipped to provide financial support to these countries. For example, the European Commission is empowered to borrow funds on financial markets on behalf of the EU to assist countries threatened with balance of payments difficulties (Article 143 TFEU). To stabilize the region, the EU balance of payments support for non-euro area EU Member States was quadrupled from 2008 to mid-2009, rising from EUR 12 billion to EUR 50 billion.

From the outset of the crisis, the IMF played an important role in the financial stabilization of non-euro area EU Member States, later also in that of euro area Member States. Use of IMF financial support is in principle permitted under Article 219(4) TFEU (Deutscher Bundestag, 2010a) for euro area countries; they are exercising their sovereign rights as IMF members. Moreover, with its extensive technical expertise on economic and fiscal policy analysis and its clout in pushing through structural adjustment programs, the IMF is a key partner for the European Commission and the ECB. Cooperating with the IMF presented the two institutions with new challenges. One example is the need to agree on the economic policy conditions under which a country is eligible for funds. In a first step, the IMF Executive Board and the Ecofin Council/Eurogroup coordinate their decision on a country's qualification for an Economic Adjustment Programme. Then, the so-called troika – the IMF, the European Commission and the ECB – monitor countries' compliance with these conditions.

To ensure that the IMF would have adequate resources during the financial crisis, on December 9, 2011, the Euro Summit announced its intention, to provide the IMF with additional resources through bilateral loans of up to EUR 150 billion. The bilateral loans of the entire EU could amount to EUR 200 billion. Within the G-20, non-EU countries are also expected to contribute to boosting the IMF's lending resources.

At the beginning of 2010, there were no EU financial stabilization mechanisms in place for euro area countries. As already mentioned, all the experts assumed that euro area countries would always have sufficient access to market finance. But given the financial situation in Greece, as early as March 25, 2010, the euro area Heads of State or Government declared their willingness to take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole. At the same time, they determined that any financial support would be subject to strong conditionality. Article 125 TFEU ("no bailout" clause) does, indeed, not fully rule out

voluntary financial support among euro area Member States (Deutscher Bundestag, 2010b).

In May 2010, a joint financial support package for Greece was agreed, consisting of pooled bilateral loans by euro area Member States for a total amount of EUR 80 billion plus an additional EUR 30 billion of financing by the IMF under a Stand-By Arrangement. The European financial assistance is based on a contract concluded between Greece and its creditors, the other euro area Member States. Many authors note that, given Article 125 TFEU, such lending is not entirely unproblematic (Potacs and Mayer, 2011), as the loans are granted at a politically determined rate of interest rather than at market conditions. Furthermore, doubts had already been expressed about Greece's ability to repay the loans when the credits were extended. On the other hand, the loans to Greece are voluntary; Slovakia, for example, did not participate in the bilateral lending agreement. Prior to lending, the IMF and the European Commission performed a debt sustainability analysis of Greece in line with international standards.

As the authorities could not rule out contagion of other euro area countries, three key financial decisions were made in 2010 (Nauschnigg and Schieder in this issue) that had an impact on the fiscal policy of the euro area as well as on the single monetary policy:

1. The Ecofin Council/Eurogroup and the European Council adopted a three-year financial stabilization program encompassing the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF).
2. The EFSM and the EFSF were to be replaced by the European Stability Mechanism (ESM) in 2013.
3. The ECB adopted the Securities Markets Programme (SMP) for euro area countries' debt securities.

2.1.2 The European Crisis Mechanism: EFSM, EFSF and ESM

Under the EFSM, the European Commission is empowered by all 27 EU Member States to raise up to EUR 60 billion in the capital market and to lend these funds to distressed euro area countries. European Commission borrowing on behalf of the EU is backed implicitly by an EU-27 budget guarantee. The EFSM is based on Article 122(2) TFEU, under which the economic and financial crisis is interpreted as an exceptional circumstance beyond the control of Member States.

The EFSF set up as a Luxembourg-registered company, is backed by guarantee commitments from the euro area Member States for a total of EUR 780 billion and has a lending capacity of EUR 440 billion. EFSF bonds have been assigned a AAA rating. Further, the available resources are to be leveraged to as much as EUR 1,000 billion. To this end, the Eurogroup has already agreed on two options to leverage EFSF funds with the support of international investors.[13] Given the complexity of both instruments, it currently appears unlikely that leverage will raise lending capacity to up to EUR 1,000 billion.

As guarantors, euro area countries have a pro-rata liability in line with their ECB capital key. If a country steps

[13] *The two options consist of credit enhancement and/or the establishment of one or more Co-Investment Funds (CIFs) for public and private investors who wish to place funds in the EFSF.*

out ("stepping-out guarantor"),[14] its guarantee commitment is suspended and guarantees are allocated among the remaining countries.

EFSF lending is conditional on compliance with economic and fiscal requirements that the European Commission monitors. In the course of the crisis, the lending conditions were relaxed somewhat. To improve the borrowers' debt-servicing capacity, EFSM and EFSF interest rates were lowered to those of EU balance of payments assistance, i.e. about 3.5%, but not below the EFSF's own funding cost. Moreover, the EFSF instruments were made more flexible to meet the need for various funding purposes. The EFSF may now purchase government bonds in the secondary or primary markets, may recapitalize banks and may provide funds for precautionary programs.

The agreement on a permanent European Stability Mechanism (ESM) represents a decisive step toward financial solidarity among Member States. The ESM is an international financial institution that is based on Article 136(3) TFEU and is established by a treaty[15] among all euro area countries. The ESM has a capital stock of EUR 700 billion and a lending capacity of EUR 500 billion. The ESM's preferred creditor status implies priority repayment of financial assistance even in the event of sovereign insolvency. After assessing the debt-servicing capacity of a borrower the ESM might seek private sector involvement in line with IMF practice. In addition, starting in June 2013, the terms and conditions of all new government bonds must include standardized and identical collective action clauses (CACs) to allow for rapid debt restructuring, if necessary. As agreed by the European Council on December 9, 2011 the ESM should already become effective at the latest in mid-2012. Possibly, the EFSF and the ESM will work in parallel for a limited period of time.

2.1.3 ECB/Eurosystem: Securities Markets Programme (SMP)

Under the Securities Markets Programme (SMP), the ECB buys sovereign debt instruments issued by euro area governments to ensure depth and liquidity in dysfunctional sovereign bond market segments. Under Article 123 TFEU, overdraft or other credit facilities with the ECB or the NCBs are prohibited for central governments. However, the ECB may purchase government bonds in the secondary markets. From May 10, 2010, the ECB has bought Greek, Irish and Portuguese government bonds; from August 7, 2011, it has also purchased Spanish and Italian government bonds. The bond purchases total some EUR 211 billion.[16] In parallel, the ECB conducts weekly liquidity-absorbing operations to sterilize the liquidity provided through the SMP (ECB, July 2011) and to ultimately prevent risks to price stability.

Of course, this ECB measure attracted criticism. Belke (2010) argues that unlimited purchasing programs involving high risk could undermine long-term confidence in the political and financial independence of the ECB and the Eurosystem. In the whereas recitals of its decision to establish the SMP, which is based on Article 127(2) TFEU, the ECB explains that the SMP

[14] *One reason a country might not participate as a guarantor is that it has to implement an adjustment program itself, another reason is that the country's own financing costs are above those of the EFSF.*

[15] *The ESM was negotiated by all 27 EU Member States.*

[16] *Holdings as on December 23, 2011 (www.ecb.int).*

forms part of the Eurosystem's single monetary policy and will apply temporarily. This nonstandard measure would be phased out as soon as markets were working more normally again (Trichet, 2010). In a further recital, the ECB refers to a statement of the euro area governments that they would take all measures needed to meet their fiscal targets and would accelerate fiscal consolidation and ensure the sustainability of their public finances. The ECB explicitly referred to this framework because such secondary market purchases have an impact on the financing conditions for governments (Bini-Smaghi, 2011); in particular, they may lead to moral hazard problems with fiscal policy in the countries concerned. Therefore, in August 2011, ECB President Trichet and the respective NCB governor addressed a letter to the heads of government of Italy and Spain calling for sustainable economic and fiscal adjustment measures. The Euro Summit of October 26, 2011, called for particular reform efforts by Spain and Italy, as these countries were experiencing tensions in sovereign debt markets. In the case of Italy, the Euro Summit called on the European Commission to not just assess the measures taken by Italy, but also to monitor their implementation.[17]

2.1.4 Mutualization of Risk in the Euro Area

The comprehensive financial stabilization measures imply a risk transfer to those euro area countries providing assistance, and hence a large step toward the mutualization of risk (Deutsche Bundesbank, 2011a, b). Every credit given or every guarantee assumed is counted toward the debt ceiling under the Treaty of Maastricht. The conditions for financial assistance determine the degree of risk redistribution across euro area countries and hence increase the consolidation need – e.g. for the Austrian[18] budget. Reducing the interest rates for the EFSM, EFSF and ESM, and easing the conditions of some financing instruments has further intensified risk transfer. Furthermore, under Article 32.4 of the Statute of the ESCB and of the ECB, any risks from holdings of SMP securities, if they were to materialize, should be shared in full by the Eurosystem NCBs, in proportion to the prevailing ECB capital key.[19]

The willingness of euro area countries with sound economic policies to assume mutualized risk depends on two factors in particular – first, to what degree does mutualized risk affect the country's own creditworthiness; and second, how can adequate implementation of sound economic policies throughout the euro area be ensured? In this respect, the German Federal Constitutional Court of September 7, 2011, ruled that Germany was prohibited from agreeing on international measures that result in taking over responsibilities for other states' sovereign decisions. The court allows the German Bundestag a certain "margin of maneuver" in assuming such responsibilities as long as the stability orientation of EMU and German economic performance are taken into account.

[17] *At the G-20 summit on November 3 and 4, 2011, Italy agreed to let the IMF carry out a quarterly monitoring of its policy implementation and to have these surveillance reports be discussed by the IMF Executive Board.*

[18] *In Austria, the Zahlungsbilanzstabilisierungsgesetz (Balance of Payments Stabilization Act) represents the legal basis for financial assistance granted by Austria to other euro area countries.*

[19] *OeNB Annual Report 2010. Notes to the Balance Sheet. Asset item 7.1 Securities Held for Monetary Policy Purposes, p. 81–82.*

2.2 Economic Governance Reform

The sovereign debt crisis exposed glaring weaknesses in euro area economic governance: The countries did not comply with the provisions of the Stability and Growth Pact (SGP). Many countries neglected to establish sustainable public finances in the years before the crisis. Implementation of the Lisbon strategy was biased toward structural reform, although the program did include social policy objectives (Koll, 2011). Economic governance did not take account of growing external imbalances and the divergence of wage and price developments. Fiscal and structural policies were largely national, which made a consistent policy mix at the euro area level very difficult to achieve. Reacting to these deficiencies, "coercive elements", like requiring "reverse qualified majority voting"[20] for Ecofin decisions, were expanded. Economic governance has been extended to apply not just to fiscal policy, but also to macroeconomic imbalances. Finally, improved coordination of economic and budget policy over an annual cycle (the European semester) is designed to ensure more consistency in the economic policy mix at the EU and euro area level. Agreements between individual countries are also being sought to harmonize the revenue side of budgets; proposals include harmonizing the corporate tax base[21] or introducing a financial transaction tax. Overall, the agreed and planned measures are targeted at deepening Economic Union in the euro area.

2.2.1 Economic Governance Reform – The "Six-Pack"

In March 2010, the European Council installed a Task Force on Economic Governance. On January 1, 2012, six legislative proposals ("six-pack") came into force, as proposed by the European Commission, in close cooperation with the task force. The key elements of the "six-pack" are a reform of the SGP and the introduction of a new macroeconomic imbalances surveillance procedure:

- As countries' debt levels affect their market refinancing options, the excessive deficit procedure applicable to public debt higher than 60% of GDP was tightened.
- To reduce existing macroeconomic imbalances and prevent the occurrence of new ones, a new macroeconomic scoreboard will use indicators (such as the current account balance, the net external position, the real effective exchange rate based on unit labor costs, real house price increases and private sector debt) to identify imbalances.
- The respective national budget performance must fulfill comparable minimum quality standards.
- Early and gradual sanctions (adopted by reverse qualified majority voting) for euro area countries have been introduced to the SGP.
- Euro area countries are now subject to financial sanctions already under the preventive arm of the SGP and when experiencing excessive macroeconomic imbalances.

Regardless of the introduction of "coercive elements", the success of these re-

[20] *A reverse qualified majority voting procedure implies that unless the Council takes a qualified majority vote against a European Commission decision to impose financial sanctions within ten days of this decision, the decision will be adopted.*

[21] *When the program funds were allocated, Ireland was not formally forced to agree to a harmonization of corporate taxes (development of a common consolidated corporate tax base), but it committed itself to participating constructively in the discussion.*

forms continues to depend on countries' political commitment to implement the rules at the national level.

2.2.2 Economic Governance and Euro Plus Pact[22]

As the sovereign debt crisis progressed, the tightening of economic policy measures under the six-pack no longer appeared stringent enough. On the basis of a German-French initiative, the European Council adopted the Euro Plus Pact in March 2011 with the intention of further strengthening the economic pillar of EMU. Core objectives are enhancing competitiveness, fostering employment, contributing to the sustainability of public finances, reinforcing financial stability and preventing macroeconomic imbalances in the euro area. The measures taken by the participating countries under the Euro Plus Pact must be integrated into their national reform and stability programs.

In August 2011, German Chancellor Angela Merkel and French President Nicolas Sarkozy presented details of their Euro Plus Pact proposals calling for the following measures:

- Taking key policy decisions to counteract crises.
- Monitoring SGP implementation and enhancing competitiveness. The measures include e.g. the introduction of binding upper limits for the level that the structural deficit may reach annually ("debt brakes"). By the end of 2011, euro area Member States running an excessive deficit should submit adjustment programs for reducing their debt below the reference value. Payments from the structural and cohesion funds to countries that do not respect the EDP recommendations are to be suspended.
- Stepping up coordination of tax policies. Germany and France intend to harmonize their corporate taxes as early as 2013. Discussions on proposals for a financial transaction tax started in fall 2011.

The Pact is currently based on an intergovernmental agreement and is not enshrined in the Treaty. But the countries are trying to achieve conformity with the Treaty by seeking to implement EU legal acts with the simplified amendment procedure under Article 136 TFEU and within the framework of enhanced cooperation. Integration of the Euro Plus Pact into the European semester associates the Euro Plus Pact more closely with Community decision making.

2.2.3 Fiscal Stability Union

On December 9, 2011, 26 EU Member States (except for the U.K.) concluded an intergovernmental agreement to move toward a "fiscal stability union." This new "fiscal compact" represents a further step toward strengthening the economic pillar of EMU. In essence, it reinforces monitoring of national fiscal discipline and coordinating fiscal policies:

- The annual structural deficit in public finances must not exceed 0.5% of nominal GDP.
- This rule must be introduced in Member States' national legal systems at the constitutional level ("debt brake"), including an automatic correction mechanism, should the target be missed. The European Court of Justice will verify implementation of the rule at the national level.

[22] *In addition to the 17 euro area countries, Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania are participating in the Euro Plus Pact.*

– Member States in EDP must submit an economic partnership program detailing reforms to the European Commission and the European Council. The sustainable implementation of the program will be monitored by the European Commission and the European Council.
– Member States will publish a detailed debt issuance calendar up front.
– Measures and sanctions for Member States in EDP will be decided by a quasi-automatic procedure, mirroring the "reverse qualified majority voting" rule.

The European Commission has tabled two further legal proposals to tighten fiscal discipline. The proposals regard the monitoring and assessment of draft budgets in euro area Member States, and the strengthening of budgetary surveillance of euro area Member States[23] experiencing serious difficulties with respect to their financial stability.

3 Further Development of Economic Governance and Financial Assistance

At present, the implementation of proposals for further financial assistance is linked to the enforcement of sound economic and fiscal policies in euro area countries and with suitable and credible financial market involvement in crisis resolution. However, any proposal requiring a Treaty change must be seen as taking some time to implement.

3.1 Enhanced Financial Assistance to Stabilize Public Finances with Private Sector Bail-In

Bini-Smaghi (2011) and Buiter (2011) assume that the euro area countries could experience both liquidity and solvency problems, bearing in mind that the sovereign debt crisis and the banking crisis mutually reinforce each other. The type of financial assistance available should address both of these problems. Gros and Mayer (2011) propose to make the EFSF the main eligible counterparty of the Eurosystem to achieve leverage in EFSF lending. On this issue, the ECB (2011) notes that this would be an infraction of Article 123 TFEU, which prohibits monetary financing of fiscal deficits. However, the ESM could be transformed into a European Monetary Fund (EMF). The EMF should have access to ECB funding on the one hand, and on the other should be able to issue bonds for countries with solvency problems (Gros and Mayer, 2011). This proposal has, however, already been rejected at the political level. Buiter (2011) proposes expanding EFSF funding to EUR 2,000 billion to enable the ECB to discontinue its SMP. All of these proposals virtually disregard the ability of monetary policy and fiscal policy in sound euro area economies to bear the burden of crisis financing. Furthermore, the proposals do not provide a solution to moral hazard problems that generous financial aid might invoke for the fiscal policy of the country concerned and for the financial sector itself.

In EMU, the capital markets assume their function of imposing discipline on national fiscal policies only if there is a credible perspective of "bailing in" investors if a euro area country becomes insolvent (Deutsche Bundesbank, 2011a, b). However, the TFEU does not contain any rules for handling the insolvency of an EU Member State. On the contrary, with a stability imper-

[23] *Currently, Italy is such a country. Its budget is already subject to special monitoring by the European Commission and the Eurogroup.*

ative and fiscal discipline the TFEU lays down rules to prevent Member States' insolvency.[24]

Not only Germany, but also economic policy analysts (Kern, 2009; Pisani-Ferry, 2011) have recently called more strongly for private sector bail-in to be integrated into the EU legal framework in the form of an EU insolvency regime. Up to now, experience with sovereign debt default and restructuring relates largely to emerging markets (e.g. IMF, 2006). While this experience offers guidance that may be helpful to manage the current sovereign debt crisis, it cannot be applied directly to the situation in the euro area (Darvas, 2011). Kern (2009) developed a formal procedure to handle sovereign debt restructuring and the establishment of an EU sovereign debt agency. Pisani-Ferry (2011) proposes a procedure including the establishment of an administrative body that manages the legal settlement of sovereign default, an economic body (e.g. the European Commission, the ECB, the IMF) that assesses the degree of default and the ESM, which provides financial support to the sovereign in this phase.

The proposals to issue eurobonds or "stability bonds" go even further; such bonds would introduce joint financing of all euro area countries and differ in terms of the degree of common financing and with regard to the type of guarantee (European Commission, 2011a). Eurobonds – above all eurobonds issued with a joint and several guarantee – cannot be introduced without an amendment of the Treaty, as they are inconsistent with the "no bailout" clause of Article 125 TFEU. In addition, eurobonds are unsuitable for crisis financing: problem country debt has shot up to far more than 60% of GDP, so that the financial markets would demand high risk premia on all bonds other than the collectively guaranteed eurobonds. Eurobonds could give problem countries some breathing space, but do not provide national fiscal policymakers with incentives to consolidate and make public finances more sustainable. Moreover, collectively backed eurobonds are not suitable for Member States with solvency problems (Buiter, 2011).

3.2 Sovereignty Rights and Fiscal Policy

Former German Minister of Finance Peer Steinbrück[25] can envisage limited eurobond issues provided countries relinquish some sovereign fiscal policy rights. Countries would have to give up some of their fiscal powers to an independent institution, would have to gain approval already for budget drafts, and would be subjected to macroeconomic surveillance. A similar proposal by Dutch Prime Minister Mark Rutte provides for the establishment of an "independent fiscal institution" that would have the power to put noncompliant countries under guardianship and their fiscal decisions under the direct control of an EU Commissioner.[26] Former ECB President Trichet (2011) called for a European finance ministry with responsibilities in three areas, namely the surveillance of fiscal and competitiveness policies, above all of euro area countries, the supervision and regulation of the EU financial sector, and representation of the euro area in international financial institutions.

[24] *Only in the case of Greece, the granting of additional public funds was linked to a nonrecurring and voluntary private sector participation.*

[25] *Der Spiegel: Natürlich müssen die Deutschen zahlen. September 12, 2011.*

[26] *Frankfurter Allgemeine Zeitung. September 9, 2011.*

The Euro Summit of October 26, 2011, already vested the Ecofin Council and the European Commission with enhanced governance powers: they are authorized to examine national draft budgets and adopt an opinion before a national parliament passes the budget, they have the power to monitor budget execution, and they may, if necessary, suggest amendments. In the event of divergences, surveillance may be stepped up. The presidents of the European Council, the European Commission and the Eurogroup received a mandate to propose a further strengthening of the economic pillar of EMU, including the option of limited amendments to the Treaty (see "fiscal stability union").

3.3 Withdrawal or Expulsion from the Euro Area

German Chancellor Angela Merkel demanded that the Lisbon Treaty include a mechanism to expel individual countries from the euro area.[27] However, a general opt-out of the euro area would contradict the principle of the Maastricht Treaty and the Protocol on the transition to the third stage of economic and monetary union under which all Member States have declared the irreversible character of the move to Stage Three. Had EU law provided for exiting euro area, it never would have been possible to gain the trust of the markets and the public in the stability of the single currency.

Article 50 TEU provides for an exit clause for Member States to withdraw from the EU as a whole in a two-year process. During the course of these two years, a withdrawal agreement determining the political and economic relations between EU Member States and the exiting Member State must be drafted. The withdrawal option does not establish the right of expulsion; therefore, it is not a legitimate means to discipline difficult Member States. However, it is not possible for a country to exit a subset of the EU, like EMU, while retaining its membership in the remaining areas (Athanassiou, 2009). In such a case, a country would have to re-enter the EU, implying that it has to undergo the entire admission procedure under Article 49 TEU, including ratification by all Member States (Kumin, 2011).

4 Conclusions

When it was set up, the Treaty of Lisbon took account of the institutional needs of the EU-27 and provided them with sufficient capacity for action. The question raised earlier as to whether the Treaty of Lisbon provided an adequate legal and institutional basis for crisis resolution can be answered as follows: The Treaty of Lisbon failed to provide appropriately for preventing and combating crises. The complexity of decision making and the large number of economic policymakers slowed down the reaction, above all of the euro area, to the sovereign debt crisis. The European Council, primarily as a Euro Summit, and its president gradually emerged as the core of European economic governance (Schwarzer, 2009). With their centralized decision-making structures, the ECB and the Eurosystem were in a position to react more rapidly, as the Securities Markets Programme proved.

The euro area's method of operation must be improved to make crisis management coherent and to communicate to the public and financial markets with a single voice. Otherwise, confidence in crisis management and credibility of EU institutions will be

[27] *Financial Times Germany. Online issue of April 25, 2010.*

weakened. In this context it remains to be seen how the new framework of euro governance passes the test of practice. As an amendment to the Treaty is no longer completely out of the question, broader avenues of reform have opened up for the medium term. Such reforms could enshrine the new institutional processes for the euro area in the Treaty.

The crisis clearly exposed the defects in the design of EMU: Economic Union and the surveillance and enforcement of budget discipline at the national level is much too weak. Under these circumstances, implementing a comprehensive economic strategy for the euro area that represents more than the sum of its parts is nearly impossible. The EU bodies have meanwhile zeroed in on this flaw, because the only way to secure credibility among the general public and trust of the financial markets is to step up the economic and financial integration of the EU, and above all of the euro area.

Moreover, it would be crucial to create a European Crisis Resolution Mechanism (ECRM) to boost the efficiency of crisis resolution in the future. Cost-benefit considerations should be at the heart of such a concept to ensure that the mix of financial and economic policy measures addressing crises is well-balanced and to safeguard the credibility of EU institutions, especially the ECB. The willingness of countries with sound economic finances to fund a stability mechanism correlates with the willingness of those countries that have come under financial market pressure to implement sustainable economic and fiscal policies. It remains to be seen exactly what type of "coercive elements" and institutional structures will be laid down in law to ensure that euro area countries enforce sound fiscal and structural policies. The reformed Stability and Growth Pact, the surveillance of macroeconomic imbalances, the Euro Plus Pact, the European semester and the fiscal stability union point toward a better integration of economic and fiscal policies in the euro area. One outcome may well be that emerging EU market economies will not be able to "afford" euro area membership because it could cause them to lose competitive advantages.

The European Commission will have the difficult task of securing the cohesion of the EU-27 and at the same time of providing counsel and initiatives for the 17 euro area countries. By now, the anatomy of the EU has become even more complex – in the Euro Plus Pact, 17 plus an additional 6 countries have agreed on a common approach, while 26 of the 27 Member States endorse the "fiscal stability union." Basic reforms are increasingly being implemented by groups of Member States. This might lead to the euro area becoming increasingly separate from the other EU Member States. The Commission will therefore insist more rigorously on the use of the Community Method. Consequently, the reformed institutional and economic governance architecture of EMU must be laid down in the Treaty in the form of an amendment, to guarantee EU cohesion, the continued success of the EU economy and its democratic legitimacy.

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Macro Coordination under the European Semester

Walpurga Köhler-Töglhofer, Peter Part[1]

To reinforce ex ante coordination of EU Member States' economic and fiscal policies, a new monitoring cycle has been introduced: the "European semester" – a six-month period every year during which national budgetary and structural policies will be reviewed to detect any inconsistences and emerging imbalances while major budgetary decisions are still under preparation. Technically, the European semester brings together various procedures for economic policy coordination, based primarily on Article 121 (and to lesser degrees on Articles 126, 136 and 148) of the Treaty on the Functioning of the European Union. Specifically, the reform reinforces the preventive arm of the Stability and Growth Pact, introduces a new procedure for addressing macroeconomic imbalances, and places greater emphasis on monitoring the national fiscal frameworks, identifying macrostructural growth bottlenecks and detecting macrofinancial risks in the Member States. National fiscal and economic policies will be monitored in a coordinated and integrated manner rather than separately, and national policies will be aligned with integrated guidelines. The new approach is also intended to facilitate joint discussion of important economic policy priorities at EU level, thereby ensuring complementarity of national economic policy plans through policy guidance before Member States finalize their budgets for the following year. The results of such discussions and the definition of economic and fiscal policy priorities will then be effectively reflected in national policymaking, particularly in national budgets and structural reforms. The European semester thus follows an integrative approach that moves toward comprehensive, country-specific economic surveillance, in some cases with the possibility of imposing corresponding sanctions, which is in marked contrast to the "open method of coordination" used under the Lisbon agenda. Upon implementation of the "six-pack" of economic governance rules in January 2012, the already stringent monitoring requirements will be tightened even further.

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The global financial and economic crisis, along with the European debt crisis that followed in its wake, have prompted a rethinking of the existing economic policy surveillance mechanisms in the EU and the euro area. Since those approaches suffered from obvious shortcomings in economic policy coordination, governance reform became the top priority for the near term. The European Commission's legislative proposals of September 29, 2010, coupled with the results delivered by a task force[2] chaired by the President of the European Council, paved the way for a comprehensive redesign of the tools applied by the EU to reinforce the Stability and Growth Pact (SGP), i.e. to ensure sound fiscal policy and prevent macroeconomic imbalances.

The new strategy is centered on enhanced, integrated surveillance of fiscal policies, macroeconomic management and structural reforms, which marks a clear step away from the earlier "open method of coordination" as enshrined in the Lisbon strategy, in favor of comprehensive, country-specific monitoring. Integrated surveillance (which also comes with an extended range of sanctions) is to ensure the prevention or correction of macroeconomic imbalances that might jeopardize financial and price stability in

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[2] *See the task force report of March 2010.*

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the euro area and the EU, as well as the prevention or correction of insufficient competitiveness and growth bottlenecks. Technically, the new approach is a cornerstone of the recently implemented European semester – a six-month period every year during which Member States' budgetary and structural policies will be reviewed while major budgetary decisions are still under preparation. Notably, the SGP, which is the centerpiece of the European fiscal framework, will be strengthened progressively by focusing not only on public deficit but also on trends in public debt as well as the dimensions and dynamics of public spending. In addition, the euro area countries and several other EU Member States[3] adopted a complementary agenda of additional reforms – the Euro Plus Pact – in spring 2011 as a further means to improve competitiveness, employment, long-term sustainability of public finances and financial stability.

EU governance has been reformed on a number of levels. First, by introducing the European semester, the EU' economic and fiscal policy surveillance measures will be synchronized with national budget procedures, thereby facilitating a better integrated and more effective policy coordination at the European level. Specifically, the preventive and dissuasive arms of the SGP will be strengthened, and monitoring of national fiscal frameworks reinforced. Second, in addition to budgetary surveillance, procedures for monitoring macroeconomic imbalances will be introduced. An alert mechanism based on a scoreboard of specific indicators, coupled with a more stringent surveillance mechanism, will allow timely intervention to prevent or correct such imbalances, especially unsustainable debt positions in the private and public sectors, in the financial sector and vis-à-vis non-EU countries. Third, the EU-wide surveillance of structural reforms in the Member States aims at making tangible progress toward achieving the Europe 2020 strategy's objectives of smart, sustainable and inclusive growth (Auböck et al. in this issue). Finally, the temporary crisis management solutions are to be replaced by a permanent crisis management tool for safeguarding financial stability in the euro area as a whole: the European Stability Mechanism (ESM) (Nauschnigg and Schieder in this issue).

The reform was implemented, among other things, through six legal instruments (collectively known as the "six-pack"), four of which deal with fiscal issues, including an extensive reform of the SGP (Holler and Reiss in this issue), while two new regulations govern procedures aimed at identifying and effectively addressing macroeconomic imbalances emerging in the EU and the euro area (Essl and Stiglbauer in this issue). One primary motive behind the reform of economic and fiscal policy governance is to put "more teeth" into the regulatory mechanism by ensuring that deviations from fiscal rules will automatically trigger sanctions. For this reason, the implied changes to the SGP and implementation of the two new regulations dealing with macroeconomic imbalances will be accompanied by markedly stronger enforcement mechanisms.

This article describes the new coordination and governance structure under the European semester. The first section presents the pillars and principles of macro coordination in the EU and euro area established under the Treaty on the Functioning of the Euro-

[3] *Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania.*

pean Union. Section 2 examines the substantive and economic policy priorities that support the procedural framework of the European semester. Section 3 illustrates the actual timing of the European semester against the backdrop of the initial six-month cycle implemented from January to June 2011. The final section offers an initial assessment of the effectiveness of this new institutional process.

1 Principles of Macro Coordination under the Lisbon Treaty

The Economic and Monetary Union (EMU) has now been in effect for more than 12 years. Since the single currency was launched, the number of euro area Member States has increased from 11 to 17.[4] The Lisbon Treaty brought only slight changes in the basic concept of EMU. The fact that the achievement of economic and monetary union is one of the objectives laid down both in Article 3 of the Treaty on European Union (TEU) and Title VIII of the Treaty on the Functioning of the European Union (TFEU) shows the strong link between economic and monetary policy decisions. Regarding the concepts behind "economic union" and "monetary union," however, marked asymmetry exists with respect to the exercise of powers among the Member States. Monetary union is characterized by the single currency, free movement of capital and a common monetary policy aimed at maintaining price stability. Institutionally, it is evidenced by the independent European Central Bank (ECB) and the European System of Central Banks (ESCB). As defined by Articles 119 and 120 TFEU, economic union is based on economic policy coordination (which fundamentally has remained within the national jurisdiction), the internal market concept and the definition of common economic policy objectives for the European Union and its Member States (e.g. Häde, 2011). Articles 119 and 120 TFEU stipulate that the guiding principles of EMU are an open market economy with free competition, stable prices, sound public finances, stable monetary conditions and a sustainable balance of payments. In brief, those principles represent the macrofinancial prerequisites to, or restrictions on, the economic and fiscal policies of the Member States and the European Union to ensure that the monetary union remains focused on delivering (price) stability.

1.1 Salient Principles of Macro Coordination

– *Imposing "market" discipline on Member States' fiscal policies:* Article 123 TFEU bars the Member States' national central banks from directly financing public sector debt, public undertakings and other bodies governed by public law, with the exception of credit institutions. As a result, the purchase and sale of government securities by national central banks is possible only through the secondary market to ensure that such activities are subject to market valuation. Furthermore, Article 124 TFEU prohibits measures (e.g. preferential interest rates) providing the public sector with privileged access to financial institutions, while Article 125 also prevents the Union and Member States from assuming the public debt of another Member State ("no bailout" clause).

[4] *Belgium, Germany, Estonia, Finland, France, Greece, Ireland, Italy, Luxemburg, Malta, Netherlands, Austria, Portugal, Slovakia, Slovenia, Spain and Cyprus.*

– *Increased commitment of national budget policy to fiscal rules* to ensure adherence to sound fiscal policy and long-term sustainability of public finances by imposing quantitative restrictions in the form of ceilings on general government budget deficits and the Member States' gross public debt ratio. The preventive arm of the SGP (Regulation No 1466/97 as amended by Regulation No 1175/2011[5]) is intended to make Member States pursue a prudent fiscal policy aimed at building up the financial buffer necessary to ensure that automatic stabilizers can work to their full potential and preventive countermeasures can be adopted in the event of a severe economic crisis. The excessive deficit procedure (EDP) anchored in Article 126 TFEU and specified in further detail by Regulation No 1467/97 as amended by Regulation No 1177/2011[6] sets out the criteria for identifying the existence of an excess deficit, specifies the requisite measures and time limits for corrective action and stipulates the sanction mechanisms to be applied to euro area countries – and much less substantially to EU Cohesion Fund countries – in instances of nonadherence to the prescribed fiscal governance rules. For the future, said regulation also mandates stricter surveillance of debt levels and their development, which, according to the EDP, carries about the same weight as an excessive budget deficit. The changes to the preventive and dissuasive components of the SGP will be supplemented by a new set of gradual financial sanctions for euro area countries based on Article 136 TFEU and Regulation No 1173/2011.[7] To ensure enforcement, a "reverse voting procedure" is envisaged when imposing such sanctions: a sanction proposed by the European Commission will be deemed automatically adopted unless voted down by a (qualified) majority of the Council.
– *Stronger obligation of Member States to reduce excessive macroeconomic imbalances* by means of a new procedure based on Articles 121 and 136 TFEU (excessive imbalances procedure – EIP), which also provides a basis for imposing financial sanctions on euro area countries. As of 2012, the new surveillance mechanism specified by Regulations No 1174/2011[8] and 1176/2011[9] is intended to prevent the accumulation of excessive debt in the private sector, the financial sector or vis-à-vis foreign countries, a lack of competitiveness and excessive increases in the prices of real and financial assets throughout the euro area.
– *Implementing a permanent financial crisis resolution mechanism* for EU

[5] *Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.*

[6] *Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.*

[7] *Council Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area.*

[8] *Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic balances in the euro area.*

[9] *Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances.*

Member States and euro area countries. Based on Article 143 TFEU for non-euro area countries and Article 122 TFEU for cases of extraordinary situations, tools to counteract financial crises were created as debt crisis worsened in the peripheral countries of the EU and the euro area. Such tools include the EFSM[10], a temporary rescue fund which, although technically available to all EU Member States, focuses on the euro area. In addition, the members of the euro area, jointly with the IMF, implemented bilateral credit facilities for Greece and also created the EFSF[11] as a temporary vehicle for providing financial assistance to euro area countries facing liquidity problems. A permanent crisis management tool for the euro area – the ESM[12] – will be implemented as of June 2012 based on the new – yet to be ratified – Article 136(3) TFEU.

– *Strengthening the integrated economic policy surveillance of the Member States:* While under the Lisbon agenda, the key focus of economic policy governance used to be on the analysis of enforced/implemented measures and their impacts, the aim of the European semester is to reinforce coordination ex ante during the policymaking process.

2 Objectives and Content of the European Semester

2.1 Objectives

In March 2010, the European Council adopted the Europe 2020 strategy that replaced the Lisbon Agenda for Growth and Jobs.[13] The objective of Europe 2020 is to achieve smart, sustainable and inclusive growth by the year 2020. To realize that objective, ten integrated guidelines were adopted on the basis of the broad economic policy guidelines pursuant to Article 121(2) TFEU and the employment policy guidelines rooted in Article 148 TFEU, which also contain five EU-wide headline targets: employment, R&D, education, the environment and the fight against poverty.

The economic and debt crisis had also made it apparent that the Europe 2020 strategy would have to be based on a more effective framework than its predecessor – a challenge being addressed through implementation of the European semester. Thus, the instrument of *macroeconomic surveillance* has been reformed to ensure a stable macroeconomic environment conducive to growth. In line with the Europe 2020 integrated guidelines (guidelines 1 to 3), macroeconomic surveillance covers the economic policy areas under national jurisdiction that might influence macroeconomic imbalances, macrofinancial risks and the competitiveness of a national economy. As it is based on the synchronized assessment of Member States' structural policies, the respective macroeconomic surveillance addresses not only the direct impact of structural measures, but also their spillover effects on other Member States and the European Union as a whole. By extension, the *surveillance mechanism of the SGP* will be reinforced, primarily to support fiscal adjustment measures in the pre-

[10] *European Financial Stabilisation Mechanism.*

[11] *European Financial Stability Facility.*

[12] *European Stability Mechanism.*

[13] *See European Council (2010). Conclusions of the European Council of March 25/26. EUCO 7/10.*

ventive arm, thereby ensuring the long-term sustainability of public finances.[14]

The European semester aims at enhancing ex ante coordination of the economic and fiscal policies of the Member States and the Union by aligning the different strands of economic policy coordination. As a result, national fiscal and economic policies will be monitored in a coordinated and integrated manner rather than separately, and national policies will be aligned with integrated guidelines. This approach ensures that important economic policy priorities will be discussed jointly at EU level and that structural and fiscal policy reforms are compatible with the underlying policy stance. Similarly, complementarity of national economic policy plans will be ensured at European level through policy guidance before Member States finalize their budgets for the following year. The results of such discussions and fiscal and economic policy priorities will then be effectively reflected in national decision-making, particularly in national budgets and structural reforms, so that national and European efforts can be aligned in a manner designed to foster growth and stability and monitor progress over time. The European semester thus covers all the essential elements of economic policy coordination and surveillance, including strategies to ensure fiscal discipline and macroeconomic stability, and to promote growth in line with the Europe 2020 strategy. The first European semester was launched in January 2011.

Under the new macroeconomic policy framework, the governance and monitoring procedures established under the SGP and the Europe 2020 strategy will be synchronized and coordinated, while preserving their respective underlying legal principles. Assessment of the Member States' Stability and Convergence Programmes (SCPs) and their National Reform Programmes (NRPs), as well as adoption of the resulting Council recommendations will take place simultaneously and in a single instrument, leading to coherent and consistent integrated policy recommendations on cross-cutting issues. The benchmark for the assessments consists of the European Council's economic and fiscal policy orientations for implementing the Europe 2020 strategy and for establishing and ensuring sound public finances, which are provided in the European Commission's Annual Growth Survey.

The country-specific recommendations issued by the Council, which will be incorporated in the formulation of the national budgets for 2012 and provide ex ante guidance to Member States for configuring their employment and structural policies, are based on Articles 121 and 148 TFEU. Furthermore, in the context of correcting macroeconomic and budget imbalances as well as excessive spending patterns, the Council recommendations also provide a basis for further procedural steps.

2.2 Substantive Priorities of Macro Coordination

2.2.1 Enhancing the Preventive Arm of the SGP

The reform detailed in Regulation No 1466/97 as amended by Regulation No 1175/2011 does not affect the central elements of the preventive arm of the

[14] *For the euro area, a horizontal assessment of the members' fiscal stances is performed on the basis of their national stability programs and the forecasts of the European Commission. Special consideration to the aggregate stance should be given in cases where extensive fiscal policy measures of individual Member States are likely to produce spillover effects on other Member States.*

SGP since it does not change the medium-term objective (MTO) for the Member States' budgetary positions of "close to balance or in surplus," nor the requirement to submit annual SCPs. The minimum requirement for a structural adjustment of 0.5% of GDP (if the MTO has not been met or violated) likewise remains unchanged, as does the surveillance process itself. The Member States annually submit their SCPs to the Commission where they are assessed. On the basis of this assessment, the Commission then issues a recommendation on each SCP. The reform of Regulation No 1466/97 does introduce a new element, however: if a euro area country fails to comply with previous Council recommendations under the preventive arm, the (Ecofin) Council can impose financial sanctions on that country in the form of interest-bearing deposits. This measure would be utilized particularly in cases of non-compliance with the new expenditure rule or in instances where significant deviations from the adjustment path to reach the MTO are not countered with sufficient fiscal adjustment measures specified in a Council recommendation. Such financial sanctions are initiated through a two-stage process based on the reverse majority voting mechanism (a sanction proposed by the European Commission will be deemed automatically adopted unless the (Ecofin) Council, by qualified majority, decides to reject the proposal in a second step).

The Council recommendations thus have the main purpose of determining whether:

- *A corrective action plan is sufficient to eliminate an excessive deficit that has been identified;* in other words, whether the proposed reform measures are adequate and specified in sufficient detail or if further adjustment is required, for instance in cases where country-specific economic conditions and circumstances have changed. The procedure to be applied in cases of excessive deficit is specified in Regulation No 1467/97. If financial assistance has been granted, the procedure will follow the course prescribed by the structural adjustment program, which means that no specific recommendations will be issued. Finally, the Council recommendations also serve as a basis for financial sanctions to be imposed against euro area countries on the basis of Articles 126 and 136 TFEU.
- *A risk of excessive government deficit* pursuant to Article 126 TFEU exists because:
  1. *Excessive deviations from the required adjustment path* to reach the MTO or from the MTO itself (0.5% of GDP in one year or 0.25% of GDP in two consecutive years) have occurred. In this case, Regulation No 1173/2011 based on Article 136 TFEU authorizes the Council to impose sanctions on euro area countries in the form of interest-bearing deposits that equal 0.2% of GDP.
  2. The *new expenditure rule* is not followed. If public spending (not including interest and EU expenditure and unemployment benefits that depend on cyclical developments) exceeds the country's potential GDP growth rate by 0.5% in one year or 0.25% of GDP in two consecutive years, the new Regulation No 1173/2011 similarly enables the Council to sanction euro area countries by requiring them to pay 0.2% of their GDP into an interest-bearing deposit.

– The fiscal policy, given the effects of cyclical conditions on public spending, is sufficiently ambitious to ensure the *quality and sustainability of public finances*. Council recommendations made in that regard do not trigger any financial sanctions.

2.2.2 *Preventive Arm to Address Macroeconomic Imbalances*

The European semester also includes a preventive pillar embodied in a procedure to address macroeconomic imbalances, the details of which are specified in Regulation No 1176/2011. That feature is intended to reduce competitive deficiencies, asset price bubbles and debt positions in the private, public or financial sectors that might become unsustainable in the long term and could eventually lead to liquidity or solvency problems in the Member States, especially within the euro area. At the insistence of the European Parliament, real economic indicators, such as unemployment and productivity gains, will also be given greater weight in the analysis. The assessment of these factors by the European Commission and the Council (in its Ecofin and EPSCO configurations) will be based on information provided by the Member States in their NRPs and SCPs.

One purpose of the preventive arm is to facilitate the in-depth analysis of Member States' macroeconomic performance by the European Commission as part of its "alert mechanism." The cycle of analysis will be launched at the start of the European semester with the presentation of a scoreboard consisting of ten headline indicators intended to identify specific macroeconomic imbalances that might emerge in a national economy. The scoreboard, along with the findings for each Member State, will be published somewhat later than the European Commission's Annual Growth Survey (AGS), accompanied by a full economic reading of the results by the Commission. That initial analysis will then be comprehensively discussed within the Council so that subsequently (next in spring 2012), a more in-depth review followed by an exhaustive dialogue with the Member States will occur, which may include review missions conducted by the Commission to assess and verify the country-specific circumstances and requirements. At the conclusion of the European semester and during the assessments of the Member States' SCPs and NRPs, the European Commission will have the following options for its further course of action:

– No proposal for a Council recommendation since no material risks of macroeconomic imbalances were identified.
– Recommendation to the Council to adopt the necessary preventive recommendations to the Member State based on Article 121(2) TFEU in the context of the integrated country-specific surveillance protocols carried out annually.
– Recommendation based on Article 121(4) TFEU for the *opening of an excessive imbalances procedure* (EIP), which establishes the corresponding corrective action plan with specific deadlines or provides for sanctions based on Article 136 TFEU (as specified in Regulation No 1174/2011, in the form of an interest-bearing deposit which may be converted into an annual fine of up to 0.1% of GDP) if no adequate adjustment program is presented.

2.2.3 *Structural Reforms to Eliminate Growth Bottlenecks*

The Lisbon agenda was conceived to increase growth and employment in the EU and make the EU the world's

most dynamic economic region by 2010. However, that objective was not achieved, in part because of governance problems and a failure to implement structural policy reforms and initiatives both in the Member States and at the EU level itself. Concerns over shortcomings in economic policy governance prompted calls for a stronger national and EU-wide commitment to implementing the framework of structural reforms required under the new Europe 2020 Strategy.

As early as June 2010, the Ecofin Council specified a series of five growth bottlenecks for each Member State[15] and the euro area as a whole in the context of its broad economic policy guidelines. In May 2011, the Employment, Social Policy, Health and Consumer Affairs Council (EPSCO) followed by outlining a number of national bottlenecks to growth and jobs[16] in its guidelines for the Member States' employment policies, which ultimately provided the guiding principle behind the country-specific Council recommendations issued in June 2011. Overall, these recommendations provided for substantially streamlined regulatory arrangements and in some cases also included different focuses for different countries (section 3). However, contrary to the Council recommendations regarding fiscal policy or macroeconomic imbalances, no financial sanctions can be levied in the event of inadequate implementation. Success is to be ensured solely on the basis of national ownership, benchmarking and peer pressure as well as an exchange of best practices.

2.2.4 Monitoring of Macrofinancial Risks

Systemic risks in the financial sector are monitored primarily by the European Systemic Risk Board (ESRB), which acts independently from the European semester. The ESRB can issue recommendations to the (Ecofin) Council or individual Member States and demand corrective actions; however, such recommendations are not legally binding. In any case, the results of the ESRB's analyses may be incorporated into the framework of macroeconomic coordination by:

- Issuing a council recommendation based on Article 121(2) TFEU if insufficient financial market stability constitutes a growth bottleneck, or considerable macrofinancial risks lead to misallocations of capital in the financial sector.
- Identifying excessive macroeconomic imbalances in the financial sector in the context of a Council recommendation based on Article 121(4) TFEU if considerable macrofinancial risks have been revealed in the financial sector due to certain circumstances such as excessive bank indebtedness.

2.2.5 Strengthening National Fiscal Frameworks

In future, the EU will also pay significantly more attention to the national fiscal frameworks, thereby supplementing the framework of economic governance provided under the SGP. National fiscal rules and institutions, as well as efficient and effective budget surveillance are intended to prevent fiscal policy decisions from being based solely

[15] *For Austria: Budgetary consolidation, improvement of the fiscal equalisations system, more effective R&D and a better educational system, financial stability, higher rates of labor force participation among the elderly, unskilled and women, and structural reforms to increase internal demand.*

[16] *For Austria: Barriers to the job market for the elderly and unskilled, high taxes on labor, insufficient supply of education, disadvantages for women on the job market.*

on short-term considerations and to effectively incorporate medium- and long-term trends along with the associated fiscal and economic policy challenges into economic policymaking. This set of tools is aimed at preventing or correcting macroeconomic imbalances such as unsustainable debt dynamics, high levels of implicit financial liabilities or budget structures that are not conducive to growth.[17] Integration into the European semester occurs along two tracks, and the information underlying the assessment of national fiscal frameworks is generally contained in the countries' SCPs. Specifically, the recommendations relate to:

– Failure to meet the minimum standards stipulated by Directive 2011/85/EU[18], which will be applicable to all Member States as of 2013 and establishes minimum quality standards for the system of national accounts and fiscal statistics, a cautious approach to economic and budgetary forecasts, strong country-specific numerical fiscal rules and medium-term budget (expenditure) frameworks, transparency in public budget statistics and coverage of all subsectors of general government in the national fiscal frameworks.
– Moving in the direction of countries whose national fiscal frameworks serve as benchmarks. The procedure is based on changes effected through peer pressure, although any weaknesses that have been identified will, at a minimum, appear in reports submitted to the (Ecofin) Council and may lead to a Council recommendation based on Article 121 TFEU (pending the effective date of Directive 2011/85/EU).

The *Euro Plus Pact,* which was signed by the euro area Heads of State or Government on March 11, 2011, is also embedded in the European semester. Under this complementary agenda, the members of the euro area and six other non-euro area economies agreed on a set of concrete national actions which are to be achieved within the near future. The enforcement and implementation of these measures builds on the "open method of coordination" and thus relies on informal and independent procedures, but since the relevant actions are listed in the NRPs (as an annex in the Austrian case), they are also included in the individual country-specific surveillance programs.

3 Timetable and Governance Architecture of the European Semester

The first European semester was launched in January 2011 with the presentation of the European Commission's initial Annual Growth Survey (AGS), which assesses the main economic and social challenges to be addressed by the EU. In that survey, the European Commission specified the priority actions to be taken in three main areas: public finances, structural policy and growth-enhancing measures.[19] The European Council discussed the AGS at its meeting in March 2011 and essentially established or supplemented its policy orientations on the

[17] *See also Haberfellner and Part (2009).*

[18] *Council Directive 2011/85/EU of 8 November 2011 on requirements for budgeting frameworks of the Member States.*

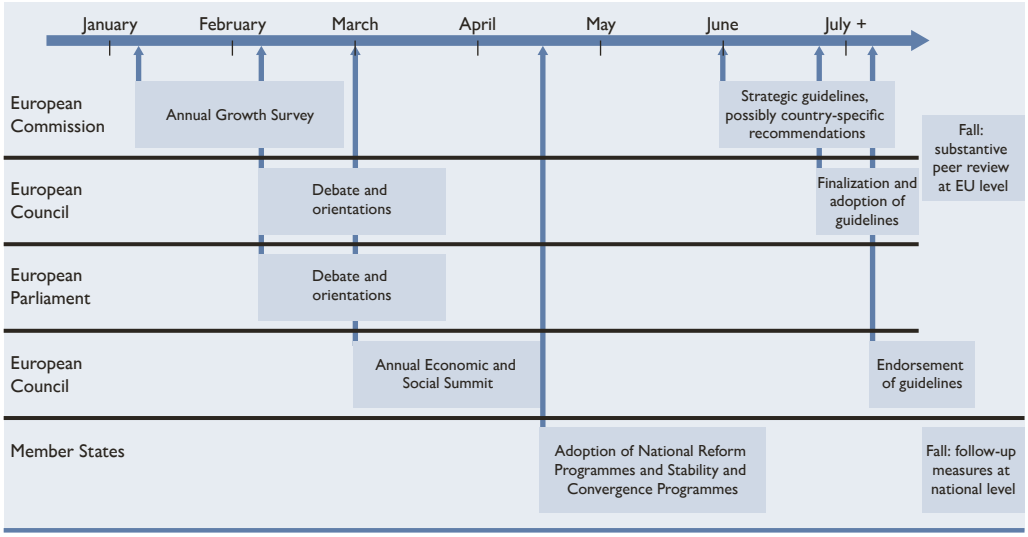
[19] *The AGS proposes ten priority actions that are pivotal to strengthening the EU's economic recovery, keeping pace with the EU's main competitors and preparing the EU to move toward its Europe 2020 objectives: (1) rigorous consolidation of public budgets; (2) correcting macroeconomic imbalances; (3) ensuring the stability of the financial sector; (4) making work more attractive; (5) reforming pension systems; (6) getting the unemployed back to work; (7) balancing security and flexibility; (8) tapping the potential of the single market; (9) attracting private capital to finance growth; and (10) creating cost-effective access to energy.*

basis of the proposals contained in the survey. Those orientations aim at the effective implementation of the Europe 2020 Strategy and ensuring a sustainable fiscal policy. Based on the findings of the AGS and the orientations derived therefrom, the Member States were given until the end of April 2011 to present their SCPs, reporting on their budgetary positions and medium-term budget objectives, and their NRPs, outlining actions to promote growth and employment and measures to achieve the objectives of the EU 2020 strategy.[20]

The European Commission assessed the programs submitted by the Member States based on the respective legal jurisdictions and presented an integrated set of recommendations for each Member State in early June 2011.[21] In total, the Commission issued 27 sets of "recommendations for a Council recommendation" to the Member States and one recommendation for the euro area as a whole. Those recommendations, which are concrete, targeted and measurable, concentrate on the key priorities to be addressed during the following 12 to 18 months. This reflects a deliberate choice to focus on the most pressing challenges and what can realistically be achieved in that time frame, taking into account the specific circumstances of each Member State.[22] Subsequently, based on the different areas of responsibility, the recommendations were discussed by the Alternates of the Economic and Financial Committee (EFC), in the Economic Policy Committee (EPC) and in the Employment Committee (EMCO). The drafts were then reviewed and finalized by either the EFC or the Committee of Permanent Representatives of the Member States (COREPER), depending on whether they referred to Article 121 or Article 148 TFEU. As a result, the recommendations cover a broad range of economic policy issues including public finance (budget consolidation, long-term sustainability, fiscal

Chart 1

Timeline of the European Semester



[20] *Greece and Portugal did not formally present any stability programs. Their fiscal policy priorities will be discussed on a regular basis during the follow-up to the assistance programs.*

[21] *The Council may direct only a single set of recommendations to each Member State.*

[22] *For Member States receiving financial aid, the European Commission has chosen to make only one recommendation: that they implement their commitments on schedule.*

framework, quality of structures), financial market stability, employment and labor market policy, wage policy, product markets, educational policy, research and development, and environmental and social affairs. In June 2011, the Council, via its configurations Ecofin and EPSCO, endorsed the final versions of the country-specific recommendations to be submitted to the European Council later that month. Following endorsement by the European Council, the country-specific recommendations were ultimately adopted by Ecofin and EPSCO in July 2011. By the second half of 2011, the recommendations, which are also intended as triggers for further growth-stimulating economic policy measures, had to be effectively reflected in Member States' national budget proposals, which are generally presented and adopted in the fall.[23]

4 Evaluation and Findings of the First Coordination Cycle

The requirement for Member States to submit their SCPs to the European Commission for assessment has not changed under the European semester, although the content of the SCPs has been streamlined and their timing has been adapted to fit the new cycle of the

Box 1

The Recommendations of the Council for Austria

The Council recommends that Austria take action to:

- *Accelerate the correction of the excessive deficit, which is planned mainly on the expenditure side, thus placing the high public debt ratio on a downward path, taking advantage of the ongoing economic recovery, in order to ensure an average annual fiscal effort of 0.75% of GDP from 2011 to 2013, in line with the Council recommendations under the excessive deficit procedure. To this end, adopt and implement the necessary measures, to include the subnational level.*
- *Specify measures as needed to ensure adequate progress towards the medium-term objective in line with the SGP after correction of the excessive deficit. Take steps to further strengthen the national budgetary framework by aligning legislative, administrative, revenue-raising and spending responsibilities across the different levels of government, particularly in the area of health care.*
- *In consultation with the social partners and according to national practices, take steps to further limit access to the current early retirement scheme for people with long insurance periods and take steps to reduce the transition period for harmonization of the statutory retirement age between men and women to ensure the sustainability and adequacy of the pension system. Apply stringently the conditions for access to the invalidity pension scheme.*
- *Take measures to enhance participation in the labor market, including the following: reduce, in a budgetary neutral way, the effective tax and social security burden on labor, especially for low- and medium-income earners; implement the National Action Plan on the equal treatment of women and men in the labor market, including improvements in the availability of care services and all-day schools to increase the options for women to work full-time and in the high gender pay gap; take steps to improve educational outcomes and prevent school dropout.*
- *Take further steps to foster competition, particularly in the services sectors, by relaxing barriers to market entry, removing unjustified restrictions on some professions and enhancing the powers of competition authorities; accelerate adoption of the outstanding "horizontal law" to implement the Services Directive.*

[23] *In the course of the European semester 2012, national progress will be evaluated based on the 2012 SCP and NRP assessments.*

European semester. This enables the Member States to take the Council's recommendations into account in their upcoming budget planning decisions for 2012, thereby adding an ex ante dimension to economic policy coordination and surveillance in the EU. Prior to implementation of the European semester, the focus was on ex post assessment of the measures proposed by the Member States in their SCPs and NRPs. By allowing for a synchronized and coordinated assessment, the new integrated approach has essentially paved the way for coherent and consistent recommendations on economic and fiscal policy to be issued to the Member States. This means that the EU dimension can be embedded in national policymaking *before* decisions are made, thereby allowing the EU to take stock of Member States' national efforts and decide on complementary actions to be taken at EU level, for instance in the context of the Europe 2020 flagship initiatives.

According to the European Commission's analysis (COM(2011) 400 final), the European semester 2011 was successful in that the national policy programs presented by many Member States are in line with the overall objectives of EU. The measures proposed in those programs provide a good "starting point for sustaining Europe's recovery, for addressing fiscal challenges and for driving more ambitious reforms at national level." The Commission also noted that Member States had largely sought to reflect the focal points of the AGS in their national efforts and further stated that the adoption of national targets would demonstrate that – with a few exceptions – there was a significant degree of commitment to the goals of the Europe 2020 strategy.

However, after assessing the Member States' programs, the Commission also found that the reform plans were often not sufficiently ambitious. Specifically, many of the commitments were formulated vaguely and abstractly (as had been the case previously in the SCPs and NRPs) and thus lacked the capacity to drive forward the necessary budget consolidations and structural reforms required to allow the EU to meet its headline targets by 2020.[24]

Clearly, the European semester is a highly complex and ambitious governance method that requires a great deal of time and coordination. Through comprehensive, transparent and timely support of policymaking in the EU and the Member States, the European semester is intended to facilitate more consistent and better coordinated economic and fiscal policymaking. However, those objectives can only be achieved if the Member States actually contribute to macro coordination by assuming ownership and deciding collectively on the key policy orientations to be implemented on the basis of the Council's recommendations. Since this would almost necessarily restrict national policymakers' freedom of action in favor of the interests of the European Union as a whole, the success of this course of action – as measured by the meta-objectives underlying the procedural reforms – seems questionable. The experiences with the initial "run-through" of the European semester have made it very obvious that procedures need to be streamlined and that cumbersome bureaucratic efforts must be reduced at both the EU and national levels. In addition, the first six-month cycle has shown that the time frames allotted to the coordination processes require rescheduling, and that the European

[24] *This indicates that some countries have not yet altered their past behavior despite introduction of the European semester.*

Commission must be given sufficient time to accomplish a thorough assessment of the reform programs presented by the Member States in order to make the coherent and consistent recommendations expected.[25] In sum, it will be impossible to conclusively evaluate whether the first European semester has achieved success until the measures adopted in the second half of 2011 have been analyzed. Furthermore, adoption of the "six-pack" set of legislative measures will likely change the entire dynamics of the European semester by adding financial sanctions to the preventive arm of the SGP and launching the new procedure to address macroeconomic imbalances in January 2012.

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Europe 2020 – A New Framework for New Growth

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The Europe 2020 strategy, as adopted by the European Council on June 17, 2010, provides the new framework for the EU's growth and employment policy. Under the new strategy, measures and reforms should be geared toward smart, sustainable and inclusive growth. The design of the new strategy was influenced heavily by the weaknesses of the Lisbon agenda (the predecessor to Europe 2020) and the compounded economic policy challenges arising from the crisis: The definition of quantitative targets at an early stage and transparent monitoring mechanisms will facilitate surveillance of implementation. For the first time, country-specific growth bottlenecks have been identified, in cooperation with the Member States, and these bottlenecks must be addressed with suitable measures. The strategy's focus on enhancing employment, the knowledge base, competitiveness, energy efficiency and social inclusion have concentrated efforts on the most important supply-side growth factors. The EU's new economic governance is designed to ensure the efficient coordination of national policies. All of these aspects will have a decisive impact on Austrian economic policy in the coming years.

JEL classification: 052, E61, E65
Keywords: Europe 2020, Lisbon strategy, European semester, structural reforms, financial crises

The European Council's final adoption of the Europe 2020 strategy on June 17, 2010, was preceded by a public consultation on the basis of initial considerations, an evaluation of the strategy's predecessor (the Lisbon agenda), and finally a proposal submitted by the European Commission. This intensive preparatory work gave rise to a new strategy designed to lead Europe onto a path of smart, sustainable and inclusive growth in the wake of the financial and economic crisis, with due attention to future challenges such as the aging population, climate change and ongoing globalization. With this focus, the Europe 2020 strategy dovetails neatly with the EU's new economic governance framework, which was completed with the adoption of the "six-pack" of legislative measures in late September 2011. In light of these developments, this article discusses the development, design and implications of the new framework on the basis of existing analyses and resolutions.

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1 Lessons Learned from the Lisbon Strategy and the Crisis as Key Influencing Factors

At the Spring European Council in Lisbon in the year 2000, the EU Heads of State or government agreed on the goal of making the EU *"the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion"* by 2010.

From the year 2000 onward, the Lisbon strategy therefore served as the EU's framework for economic policy coordination. The purpose of the strategy was to strengthen the EU economically, socially and ecologically with structural reform measures. The Lisbon strategy was not meant to create a new process, but to coordinate and simplify the Broad Economic Policy Guidelines, the Luxembourg process for employment, the Cardiff process to accelerate reforms on product and capital markets, and the Cologne process, also known as the "macroeconomic dia-

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log." The measures laid down in the Lisbon strategy were intended to be mutually reinforcing, and their effect was to be amplified by coordination among the Member States. The Lisbon strategy represented a change in the way EU policy was implemented, signaling a shift away from legislation and toward the "open method of coordination," a soft, nonbinding mechanism based on peer reviews and benchmarking among Member States. From the very outset, the Lisbon strategy was characterized by joint objectives set at the EU level but not broken down at the level of individual Member States. This turned out to be problematic for those Member States which had already surpassed the targets as well as those which were still far from reaching them.

Progress made under the Lisbon strategy lagged behind expectations in the first five years. According to the Kok Report (Kok et al., 2004) commissioned by the European Commission, the reasons behind this low rate of success were varied: the overloaded agenda, poor coordination, conflicting priorities, and above all a lack of political determination to enforce the agenda (see also European Commission, 2005; Breuss, 2005). Pisani-Ferry and Sapir (2006) also emphasize the fact that the Lisbon strategy had originally been designed, in 2000, for a relatively homogeneous group of high per-capita income Member States, whereas after the enlargement of the EU the strategy was applied to a far more heterogeneous group.

Therefore, in the course of the midterm review in 2005, efforts were made to simplify and re-orient the strategy by focusing on the objectives of growth and jobs, and a new approach was adopted as the central guiding principle: the partnership approach, which underscores the equal status of the European Commission and the Member States and calls for the participation of all stakeholders (i.e. parliaments, regional and local government agencies, social partners and civil society).

In order to implement the partnership approach, the Member States prepared National Reform Programmes (NRPs) in 2005 and 2008, on the basis of which each country was meant to respond to its specific national challenges with tailored structural reforms in order to contribute to strengthening European competitiveness. The framework for the preparation of NRPs was provided by the Integrated Guidelines for Growth and Jobs, which formally comprised the Broad Economic Policy Guidelines and the Employment Guidelines.

For the European Commission (2010a), one success of the Lisbon strategy was the fact that broad consensus was reached on the reforms necessary in the EU. Martens and Zuleeg (2009) and Cohen-Tanugi (2008) consider it an especially positive development that all EU Member States acknowledged the importance of structural reforms and that mechanisms were introduced to address these issues at the EU level. Breuss (2008) sees the main benefit in the fact that social policy no longer focuses exclusively on social security (passive social policy) but is now understood as active employment policy. The benefits for European citizens and businesses lie in higher employment rates, the more dynamic business environment with reduced bureaucracy, the broader set of choices open to the population, and the downward trend in energy intensity (European Commission, 2010a).

At the same time, social exclusion, poverty, poor access to education, and labor market segmentation are still

considered problematic. Another critical point (especially in light of the financial crisis) is that important aspects of necessary reforms – including issues related to financial market supervision (Lamfalussy committee structure), the monitoring of systemic risks on financial markets, and speculative bubbles – were "forgotten" or not integrated into the strategy. Moreover, too little attention was paid to macroeconomic imbalances and competitiveness problems in the Lisbon strategy as well as the Stability and Growth Pact (SGP). The unclear distribution of tasks and ownership, as well as weak governance structures have drawn especially heavy criticism. Finally, the European Commission (2010a) refers to the communication of the Lisbon strategy and its importance for the EU as the strategy's "Achilles' heel." According to Breuss (2008), the heterogeneity of the EU, especially after its enlargement to include transformation economies with relatively low income levels, was not sufficiently taken into account in the Lisbon strategy. Accordingly, the results diverge greatly among Member States (Cohen-Tanugi, 2008). Other important weaknesses included the administrative burden associated with the open method of coordination and the diversity of objectives – sustainability and globalization as well as employment and growth – pursued even after the relaunch of the strategy.

Ultimately, one of the essential objectives of the revamped Lisbon strategy – simplification and a sharper focus – gradually deteriorated as more and more quantified targets were added over the years (Breuss, 2008; Cohen-Tanugi, 2008).

Providing a conclusive assessment of the Lisbon strategy is difficult because its implementation was eclipsed by significant institutional factors such as the enlargement of the EU from 15 to 27 Member States as well as the launch of the single currency. Moreover, the crisis situation in recent years has overshadowed or even completely canceled out the long-term accomplishments of the strategy.

The financial crisis in 2008 disrupted the procedure under the Lisbon strategy: Instead of releasing a Progress Report in December 2008, the European Commission moved to present a European Economic Recovery Plan in November of that year (European Commission, 2008). The areas addressed in that program did not entirely coincide with the issues Member States were required to address in their NRPs. For example, the agenda included state aid and public procurement, neither of which had previously been covered by the Lisbon strategy. In general, one might say that the European Commission's recommendations tended to shift away from the supply side toward demand-side measures. However, Martens and Zuleeg (2009) also criticize the fact that the voices emphasizing the benefits of structural reforms grew fainter during the crisis. Breuss (2009) argues that the financial crisis severely hampered the attainment of the strategy's essential objectives, noting a clear trade-off between the massive economic stimulus package during the crisis and the targeted promotion of long-term growth and employment. However, Ederer et al. (2010) note, at least for Austria, *"that the Austrian efforts within the Lisbon strategy were successful at either reaching the targets or initiating positive trends towards meeting these European and national targets."*

2 Europe 2020: Design, Objectives and Priorities

Against the backdrop of the crisis, it has quickly become clear that there is a

need for closer economic policy coordination with a view to enhancing economic growth potential in the EU and its Member States. This is especially true within the euro area. In conceiving the Europe 2020 strategy (European Commission, 2010b), the European Commission therefore relied on continuous process management as the actual core of economic policy coordination. With regard to objectives, the Commission has linked the new strategy to its predecessor by way of the three priorities (smart, sustainable and inclusive growth); at the same time, however, the Commission has also designed a completely new governance structure.

2.1 Distribution of Tasks and Governance

Due to the extraordinary circumstances (i.e. the crisis) which accompanied the process of redesigning the Lisbon strategy, one of the conceptual challenges involved was to balance the need for economic stimulus with the need for forward-looking growth strategies. A clear distribution of tasks was derived from the three priority areas. According to this distribution, it is the responsibility of each individual Member State to present the economic policy measures with which it can boost its growth potential. These measures are described in the NRPs to be submitted in April each year. The reform efforts at the national level are complemented by measures at the European level, for which a framework was defined in the form of seven flagship initiatives. The European Council is responsible for steering the strategy, defining horizontal political guidelines and assessing overall progress on a yearly basis. For their part, the specific configurations of the Council of the EU discuss and review the reform program measures and progress in their respective areas of competence. The Economic and Financial Affairs Council (Ecofin) monitors the coherence of individual measures with due attention to macrofinancial constraints. The European Commission reviews overall progress, prepares the Annual Growth Survey, and issues country-specific recommendations. In addition to these institutions, which play a decisive role in steering the strategy, other European institutions also contribute to the process: The European Parliament was already involved in adopting the legislative package and may submit an assessment of the Europe 2020 strategy in the form of a resolution each year. The European Economic and Social Committee and the Committee of the Regions ensure the involvement of social partners, civil society as well as regional governments and local authorities at the EU level. However, this does not relieve the individual Member States of their duty to ensure the comprehensive involvement of social partners and civil society at the national level.

2.2 Elements of the New Strategy

The National Reform Programmes lie at the heart of the Europe 2020 strategy. At the top level, the three main priorities – smart, sustainable and inclusive growth – define the cornerstones of the strategy. In line with these focus areas, five headline targets valid throughout the EU were defined. At a meeting in March 2010, the EU's Heads of State or government agreed that each Member State is to define its own national target for each of the five headline targets (European Council, 2010). In addition to the five headline targets, the European Commission also launched seven flagship initiatives. The flagship initiatives refer to program focus areas which are each assigned to

one of the three priorities of the Europe 2020 strategy and make use of all instruments available at the EU level. These may include legislative initiatives, e.g. with regard to the single market, as well as financial funding, providing expertise or exchanging examples of best practices. Ultimately, the flagship initiatives are meant to work in concert with the Member States' policy measures and contribute to the achievement of the five headline targets.

The ten integrated guidelines serve as an additional steering mechanism (European Commission, 2010i and 2010j). In addition to the five headline targets and the flagship initiatives, these guidelines are applied to the design of national economic and employment policies. The integrated guidelines are laid down in the Treaty on the Functioning of the European Union (TFEU) and comprise the Broad Economic Policy Guidelines (Guidelines 1 to 6, Art. 121 TFEU) and the Employment Guidelines (Guidelines 7 to 10, Art. 148 TFEU). In order to ensure a maximum of stability in the framework, it was agreed that the guidelines should remain largely unchanged until the year 2014. The guidelines link the above-mentioned elements with one another and serve to structure surveillance as provided for in the Treaty.

2.3 Five Headline Targets, Seven Flagship Initiatives, Ten Integrated Guidelines, 27 National Reform Programmes

The five headline targets make it possible to measure and compare progress:

1. Employment: 75% of the population aged 20 to 64 should be employed
2. R&D and innovation: 3% of the EU's GDP to be invested in R&D and innovation (public and private investment combined)
3. Climate change and energy: (i) Reduction of greenhouse gas emissions by 20% compared to 1990, (ii) increase in the share of renewable energy sources in final consumption to at least 20%, and (iii) a 20% increase in energy efficiency
4. Education: Reduction of school drop-out rates below 10%; increase in the share of 30 to 34-year-olds having completed tertiary or equivalent education to at least 40%
5. Poverty and social exclusion: Lifting at least 20 million people out of the risk of poverty or social exclusion

The seven flagship initiatives give rise to seven European and seven national responsibilities:

Smart Growth

1. Innovation Union (European Commission, 2010c)
2. Digital Agenda for Europe (European Commission, 2010d)
3. Youth on the Move (European Commission, 2010e)

Sustainable Growth

4. A Resource-Efficient Europe (European Commission, 2011)
5. Industrial Policy for the Globalization Era (European Commission, 2010f)

Inclusive Growth

6. Agenda for New Skills and Jobs (European Commission, 2010g)
7. European Platform against Poverty (European Commission, 2010h)

The ten integrated guidelines are key to economic policy coordination and surveillance:

Guideline 1: Ensuring the quality and the sustainability of public finances

Guideline 2: Addressing macroeconomic imbalances

Guideline 3: Reducing imbalances within the euro area

Guideline 4: Optimizing support for research, development and innovation, strengthening the knowledge triangle and unleashing the potential of the digital economy

Guideline 5: Improving resource efficiency and reducing greenhouse gases

Guideline 6: Improving the business and consumer environment and modernizing the industrial base

Guideline 7: Increasing labor market participation and reducing structural unemployment

Guideline 8: Developing a skilled workforce responding to labor market needs, promoting job quality and lifelong learning

Guideline 9: Improving the performance of education and training systems at all levels and increasing participation in tertiary education

Guideline 10: Promoting social inclusion and combating poverty.

On the basis of the current challenges (growth bottlenecks) identified, the 27 National Reform Programmes are meant to include the appropriate reform concepts and focus on the targeted promotion of long-term growth and employment.

3 Alignment with the New Economic Governance Framework

In response to the weaknesses revealed by the global financial and economic crisis, a new basis was created for economic governance and surveillance in the EU. At the heart of these new measures is the package of six legislative proposals (the "six-pack") adopted in September 2011 in order to strengthen the SGP and to place greater emphasis on preventing and correcting macroeconomic imbalances (European Commission, 2010ka to 2010kf). The "European semester" has been in place as the new framework for coordination and surveillance since January 2011. This adapted schedule incorporates the Europe 2020 strategy into the integrated structure, with interconnections arising in particular through the newly defined macrostructural surveillance. The Euro Plus Pact – a voluntary obligation to strengthen competitiveness and convergence –, tightened rules and supervision structures for financial markets, as well as support mechanisms for Member States with financing problems round off the new economic governance framework.

3.1 The European Semester

With the introduction of the European semester in January 2011, the previously separate processes under the SGP and for economic policy coordination were synchronized more closely. The legal bases for these processes remained separate, but the European Commission now assesses the Member States' fiscal and structural policies simultaneously and in one consistent document. Another new feature is that the key challenges and the corresponding priorities for economic policy agendas are defined at the beginning of each year. This arrangement is meant to ensure that the European dimension is taken into account early in the budgetary negotiations for each coming year, and to ensure consistency with the measures under the Europe 2020 strategy (Köhler-Töglhofer and Part in this issue).

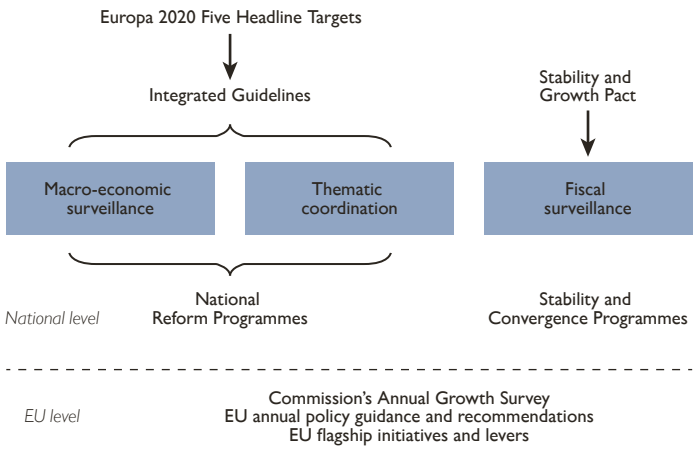
3.2 Interconnections

Besides the European semester as the overarching framework for policy coordination, there are other connections between the Europe 2020 strategy and the new economic governance scheme, in particular with regard to integrated surveillance itself as well as the identification and correction of macroeconomic imbalances.

The architecture of the Europe 2020 strategy consists of a macroeconomic surveillance component as well as thematic coordination (chart 1). The former focuses on macroeconomic imbalances, macrofinancial risks such as high foreign debt, and competitiveness. In this pillar of the strategy, Member States are specifically required to dismantle growth bottlenecks as identified in the process of developing the strategy. These tasks not only refer to "classic" structural policy areas such as education or productivity, but also include weaknesses in areas such as fiscal and financial policy (section 4). The analysis covered the general conditions for economic growth as well as the actual drivers of growth (European Commission, 2010m). Through this deliberately selected approach, duties under the reinforced economic governance must also be accounted for in the reform measures taken under the Europe 2020 strategy. The thematic coordination is geared toward growth-enhancing structural reforms based on the headline targets of the Europe 2020 strategy (European Commission, 2010l). In this regard, the interrelationships are clearly visible: Structural policies require the appropriate budgetary room for maneuver, while the growth-enhancing objective of the Europe 2020 strategy is intended to support the sustainability and quality of public finances.

Chart 1

Europa 2020 Governance Architecture



Source: European Commission, 2010l.

The legislative package for the EU's new economic governance includes two regulations on macroeconomic imbalances and defines a separate procedure for correcting such developments: the excessive imbalances procedure (EIP) (European Commission, 2010kd and 2010kf). Likewise, this issue is addressed in the revised guidelines (European Commission, 2010i and 2010j) and in the architecture of the Europe 2020 strategy as described above. In this respect, the medium to long-term orientation of the strategy with its objective of eliminating growth bottlenecks (which can arise in the form of internal and external imbalances) may overlap with the short and medium-term correction of imbalances within the framework of the EIP. Especially those aspects of the Europe 2020 strategy which aim to strengthen competitiveness and relate to e.g. incomes may play a key role in this context. The monitoring of macrofinancial risks under the Europe 2020 architecture will rely on the expertise of the European Systemic Risk Board (ESRB) established in 2010. In this area, there may also be overlaps with the EIP, especially in cases where imbalances are rooted in disproportionate lending developments, to name one example. Member States may thus receive recommendations for the correction of macroeconomic imbalances in the annual assessment of programs. Where an excessive imbalance is detected, specific recommendations will be issued, and for euro area members sanctions may be added. In addition to the suitable procedural integration of the EIP into the European semester, therefore, it will be nec-

essary to pay special attention to ensuring consistency in recommendations and minimizing trade-offs in the future.

4 Implications for Austrian Economic Policy

Although Austria will continue to determine its own policies, the architecture of the Europe 2020 strategy will have a decisive impact on Austrian economic policy in the coming years.

On the basis of an analysis by the Commission, the most important country-specific macrostructural growth bottlenecks were identified in joint discussions in the Economic Policy Committee (EPC) and the Economic and Financial Committee (EFC); these bottlenecks were then confirmed by the Ecofin Council in June 2010. The Employment Committee (EMCO) identified the most essential growth bottlenecks in employment policy. This procedure has created a certain coherence between macro- and microeconomic reforms as well as challenges in labor market policy at the national level up front. At the same time, the direction of reforms has been defined for all 27 Member States, and the necessary alignment of economic policy agendas has been ensured. In Austria's case, the following macrostructural growth bottlenecks were identified (European Commission, 2010m):

1. Consolidation of public budgets and simultaneous promotion of growth
2. Strengthening of the financial sector
3. Strengthening internal demand
4. Increasing labor participation, especially among older workers
5. Orienting educational systems toward the improvement of human capital and strengthening innovation capacity

Together with the national headline targets under the Europe 2020 strategy, overcoming these growth bottlenecks will constitute Austria's economic policy agenda for the next ten years. In order to reach the EU-wide headline objectives, the Austrian government has defined five national targets. These objectives call for an increase in R&D spending as a percentage of GDP; educational targets in tertiary education and school dropout rates; an increase in the employment rate with special attention to older workers, women, and people from migrant backgrounds; environmental and climate-related targets; and targets related to reducing the risk of poverty (Austrian Federal Chancellery, 2010):

1. Increasing R&D expenditure by 1 percentage point to 3.76% of GDP
2. Increasing the employment rate from its current level of 74.9% to 77–78%
3. Reducing greenhouse gas emissions by 16%, increasing the share of renewable energy usage to 34%, and stabilizing energy consumption at the level recorded in 2005
4. Reducing the school dropout rate to 9.5% and increasing the share of persons with tertiary academic degrees to 38%
5. Reducing the number of persons at risk of poverty by 235,000 on the basis of the three indicators defined at the EU level

The Austrian National Reform Programme, which was submitted to the European Commission in April 2011, discusses how these targets and obligations will be realized at the national level. Overall, the program represents an economic policy agenda compliant with the Europe 2020 strategy (Austrian Federal Chancellery, 2011).

Even the critics of the Europe 2020 strategy have noted that it accounts for many factors which are essential for competitiveness and growth. In addi-

tion to requiring supply-side factors such as infrastructure, education and research, growth also necessitates demand dynamics which can keep up with and stimulate supply (Ederer and Janger, 2011). As the Europe 2020 strategy is geared toward three priorities – smart, sustainable and inclusive growth – all of these factors are addressed. Ederer and Janger (2011) confirm that the essential points of the strategy exhibit elements of an innovation-oriented growth policy. This clearly supports Austria's current transition from imitation-based to innovation-based growth (Aiginger et al., 2009).

Despite the financial and economic crisis, the basis for reforms is strong in Austria. The conceptual framework is also fundamentally suitable for adding greater stringency to the reform agenda. In the coming years, therefore, it will be decisive to take advantage of this leeway and to advance Austria's fiscal consolidation process consistently, to implement structural reforms, to strengthen demand and to create stimuli for growth and employment.

5 Conclusions

An overall assessment of what the Europe 2020 strategy will do for Austria is characterized by considerable uncertainties. Macroeconomic estimates show that the simultaneous attainment of Austria's targets under the Europe 2020 strategy with regard to R&D intensity, tertiary educational attainment and the employment rate will increase Austria's GDP growth by 0.3 percentage points between 2010 and 2020; this accounts for nearly one-sixth of long-term GDP growth projections. As reaching those targets will have long-term effects, in 2050 Austria's GDP will be 5% higher than it would be if the Europe 2020 targets cannot be attained. The economic effects of reaching the environmental and climate-related targets are even more difficult to estimate; however, the induced investment effects and long-term savings in energy costs are likely to have considerable effects, as an investment of EUR 1 million in "green" measures is said to create 11 to 16 new jobs. Meeting the employment targets is likely to reduce the risk of poverty for some 20,000 people, which is already one-tenth of the poverty reduction target (Ederer et al., 2010).

The following economic policy insights can be derived from the development and architecture of the Europe 2020 strategy:

- Structural and fiscal policies are converging and require appropriate coordination.
- The significance of employment, the knowledge base, competitiveness, energy efficiency and social inclusion as elements of a supply-side economic policy is highlighted by the priorities defined in the strategy.
- The definition of quantitative targets at the EU level and at the level of Member States as well as the close surveillance process have increased the pressure for reforms.

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What to Expect from the Latest Reform of the Stability and Growth Pact

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Lukas Reiss[1]

Before the crisis hit, many euro area countries had failed to create sufficient fiscal room for times of economic difficulty, which made a new reform of the Stability and Growth Pact inevitable. Above all, this most recent reform introduces an expenditure rule in the preventive arm of the pact, operationalizes the debt criteron in the dissuasive arm and imposes stricter sanctions in case of noncompliance. The reform strengthens the preventive arm by making it easier to measure compliance and launch procedures as well as by introducing symbolic sanctions. While the introduction of the debt rule certainly tightened the conditions of the dissuasive arm for highly indebted countries, it remains to be seen by how much, given the large number of exceptions. Notwithstanding the new voting procedure (which is designed to make it more likely that sanctions are in fact applied), we doubt that economically significant penalties will be imposed in the foreseeable future.

JEL classification: E61, E62, H60
Keywords: Stability and Growth Pact, fiscal rules, fiscal policy

The reverberations from the global financial and economic crisis have highlighted the importance of fiscal policy coordination in EMU: Given the high degree of financial integration and the looming risks of sovereign default, there is the risk that the difficulties some member states face in sustaining their public finances may spill over to the entire monetary union. This increases the probability of bailouts of countries in distress, which in turn increases the moral hazard problem.[2]

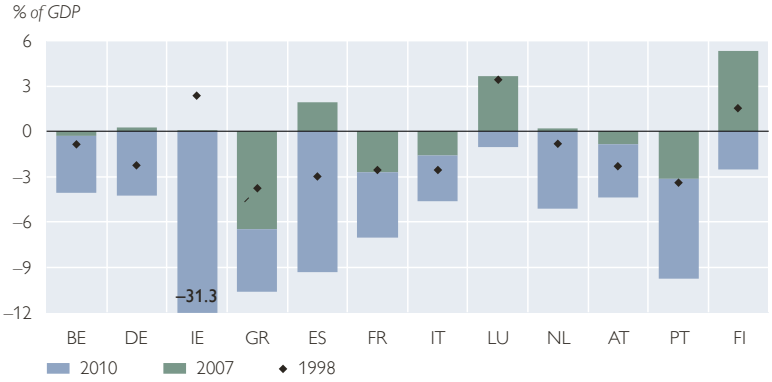
Against this background, this article addresses the most recent reform of the Stability and Growth Pact (SGP).[3] Section 1 discusses the shortcomings existing before the reform, while section 2 summarizes the most important changes made. Section 3 highlights the economic policy intentions behind these changes and provides an assessment of their implications, also taking into consideration the outlined shortcomings of the previous SGP. Section 4 summarizes our main findings.

1 Problems with the Previous SGP

Some of the problems encountered by Greece were of a statistical nature (massive ex post revisions of Maastricht deficit figures) and thus at least in part outside the scope of the SGP,[4] but many

Chart 1

Budget Balance (Maastricht)



Source: European Commission.

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[2] *The high level of financial integration in a monetary union increases the danger of individual member countries defaulting due to self-fulfilling prophecies (e.g. De Grauwe, 2011).*

[3] *The regulations in place for non-euro area countries are not analyzed.*

[4] *This aspect is increasingly taken into consideration as a result of the most recent reform, though (section 2.4).*

Refereed by:
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Austrian Federal
Ministry of Finance;
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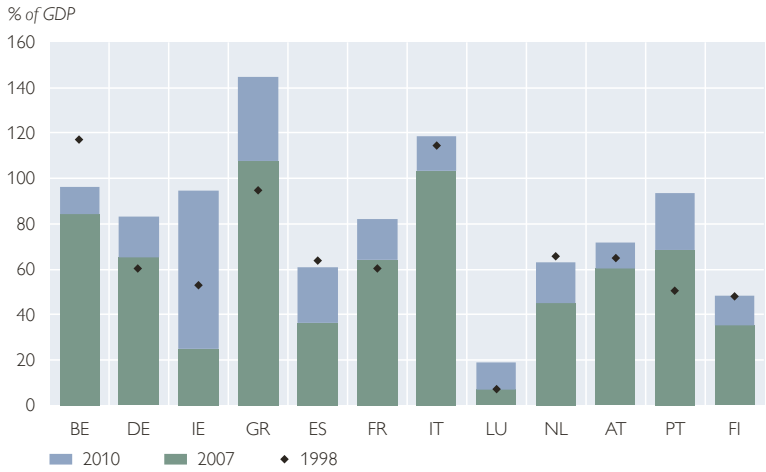
OeNB

Chart 2

Public Debt (Maastricht)



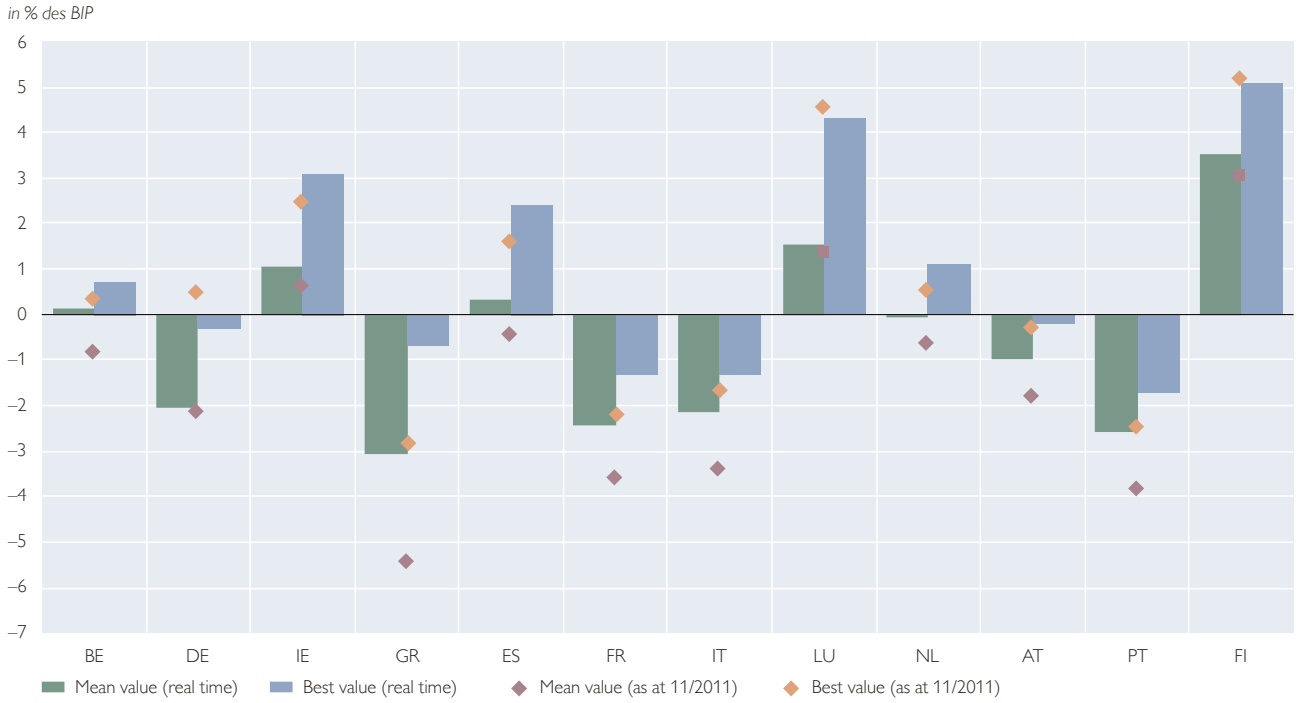
Source: European Commission.

other negative fiscal developments in the euro area can be traced directly to shortcomings of the SGP.

– While the requirement that the deficit ratio must not exceed 3% (chart 1) was broadly fulfilled in the precrisis years, most euro area countries failed to achieve the medium-term objective (MTO) for the structural balance[5] specified in the preventive part of the pact.[6] Austria, for instance, has never achieved its MTO of a balanced structural budget (chart 3). Therefore the fiscal positions of many euro area countries allowed very little leeway for discretionary anticyclical policy measures. This situation was further

Chart 3

Cyclically Adjusted Budget Balance (Maastricht) 1999–2007



Source: European Commission, spring forecasts (2000 to 2008), autumn forecast (2011).

[5] *The structural balance is calculated by adjusting the budget balance for cyclical factors (the result of this step is the cyclically adjusted balance) and certain one-off effects.*

[6] *In the first version of the SGP, the MTO was zero for all countries; the reform in the mid-2000s introduced country-specific MTOs, but specified that the structural deficit in euro area countries must be no higher than 1% of GDP. At present, Austria (like many other euro area countries) has an MTO of a balanced budget.*

exacerbated by measurement problems: For example, the structural budget balances of Spain and Ireland were significantly overstated in the precrisis years, as too little attention was paid to the fact that the growth of government revenues was driven by the real estate bubble and thus not sustainable in the long run.

– While the average debt ratio of the euro area countries declined until the onset of the crisis (chart 2), highly indebted countries like Greece and Italy failed to reduce their debt ratios even before the crisis hit.
– The fiscal difficulties can be traced above all to the incomplete enforcement of the SGP, that is, to the countries' lack of commitment to the SGP. No financial sanctions were imposed in the dissuasive arm of the pact (Diebalek et al., 2006), and only one early warning was issued (to France in January 2003[7]) despite repeated instances of noncompliance with the preventive arm in the euro area (European Commission, 2011b).

2 Main Changes to the SGP

The most important changes to the SGP are the implementation of an expenditure rule in the preventive arm, the introduction of an explicit debt rule in the dissuasive arm as well as additional and earlier sanctions in both parts.[8]

2.1 Implementation of an Expenditure Rule (Preventive Arm)

The preventive arm of the SGP (Article 121 of the Treaty on the Functioning of the European Union (TFEU) and Council Regulation No 1466/97) provides for requirements as to the structural budgetary position, i.e. the MTO, and – in case the objective was not met – as to the annual average adjustment path toward the objective. Since the first reform of the SGP in 2005, MTOs have been country-specific and have taken into account the expected cost of population aging and the debt ratio, among other things.

This set of rules is now complemented by an expenditure rule, which stipulates that the annual growth of primary government expenditure (= government expenditure excluding interest payments) must not exceed a certain benchmark. Discretionary measures on the revenue side are taken into consideration, so that the expenditure benchmark rises in case of tax increases and declines in case of tax cuts. By how much government expenditure is permitted to increase in real terms[9] depends on the fulfillment of the MTO at the starting point:

– If a country achieves its MTO, government expenditure may rise at the same rate as potential output.[10]
– If a country fails to achieve its MTO, expenditure growth has to be lower to an extent that ensures an "appropriate adjustment path" to the MTO. For Austria – like most other euro area countries – the benchmark will be roughly 1 percentage point below potential growth.[11] In countries with a small expenditure ratio, expenditure growth will have to be even lower so as to ensure an appropriate adjustment path.

[7] *This step was in fact irrelevant, though, as an excessive deficit procedure was initiated soon afterward.*

[8] *See Diebalek et al. (2006) for a detailed review of the SGP before the reform.*

[9] *Data are deflated using the GDP deflator.*

[10] *In our view, the legal text and the Code of Conduct are somewhat contradictory on this issue; we follow the interpretation given in European Commission (2011a).*

[11] *This corresponds to the value assumed in European Commission (2011a).*

– No ceiling on expenditure growth applies if a country overachieves its MTO – unless there is evidence that the MTO was achieved only thanks to significant revenue windfalls[12] and unless the plans outlined in the current stability programme are found to jeopardize future compliance with the MTO.

The country-specific growth rates will presumably correspond to the mean value of the European Commission's and the Economic Policy Committee's estimations of potential output growth for the past five years, the current year and the following four years.

The expenditure rule does not apply to the following types of expenditure: cyclical changes in unemployment benefits, expenditure offset by revenue from EU funds and expenditure in excess of the benchmark that is automatically offset by revenue increases. A smoothing period of four years is envisaged for government investment, given that its volatility is often very high.

2.2 Operationalization of the Debt Criterion (Dissuasive Arm)

The dissuasive arm of the SGP (Article 126 TFEU and Council Regulation No 1467/97) specifies deficit and debt thresholds in line with the Maastricht definition. While a deficit in excess of the 3% threshold automatically[13] will lead to the adoption of a report under Article 126(3) TFEU (and usually also to the launch of an excessive deficit procedure – EDP), noncompliance with the 60% debt threshold is tolerated as long as the debt ratio is considered to be "sufficiently diminishing."

How big the reduction must be to be considered sufficient has now been specified in the debt rule: When a country's debt in excess of the 60% reference value decreased at an average rate of one-twentieth per year over the previous three years,[14] the pace of debt reduction is deemed satisfactory and the debt criterion is considered to be fulfilled. Other factors that will prevent the preparation of a report under Article 126(3) TFEU and the launch of an EDP are compliance with the debt criterion according to the European Commission's forecast (assuming unchanged policies) or evidence that the benchmark was not met because of negative cyclical effects. In case these criteria are not fulfilled, the European Commission draws up a report under Article 126(3) TFEU, which addresses additional factors such as the composition of stock-flow adjustments[15] (e.g. the disbursement of bilateral financial assistance to euro area countries and the capitalization of financial institutions according to the Code of Conduct (2011); in addition, the accumulation of bonds and deposits is mentioned in European Commission (2011a)); these factors can still prevent the launch of an EDP.

A transitional period with lower requirements is foreseen for countries

[12] *This term is used to describe e.g. the upsurge in real estate tax revenues (above all taxes on transactions and on realized value increases) observed in Ireland and Spain until the mid-2000s. In contrast, revenue shortfalls are sharp decreases in tax revenues that cannot be explained by discretionary measures or cyclical developments.*

[13] *An exception is made in case of small and temporary breaches of the 3% limit due to exceptional circumstances (e.g. a severe economic downturn).*

[14] *The benchmark for a sufficient reduction of the debt ratio* b_t *will in all likelihood (according to the most recent version of the Code of Conduct) correspond to the suggestion made in European Commission (2011a). It is calculated as follows: benchmark for* $b_t = 60\%+0.95/3*(b_{t-1}-60\%)+0.95^2/3*(b_{t-2}-60\%)+0.95^3/3*(b_{t-3}-60\%)$.

[15] *Stock-flow adjustments (SFA) refer to the factors that lead to changes in Maastricht debt without influencing the Maastricht deficit. Typically, net purchases of financial assets are the biggest SFA item.*

that were subject to an EDP when the relevant Council Regulation was adopted.

2.3 Reform of Sanction Provisions

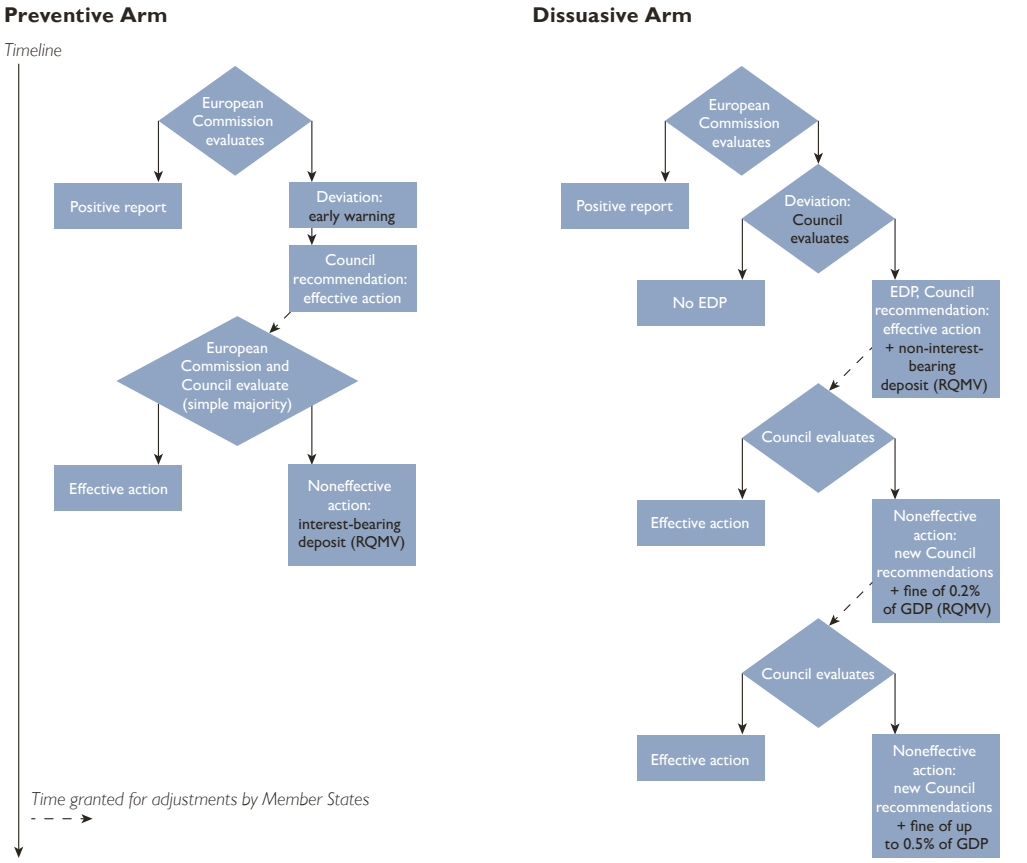
The introduction of new sanctions and the earlier application of existing ones, a strengthening of the European Commission's role in the preventive arm and a limit on the scope of discretion the Council of the European Union (hereinafter referred to as "the Council")[16] has in taking punitive action are the main changes made with regard to procedures and sanctions. Rather than describing the changes in detail, we chose to provide an overview of all regulations in place after the reform.

2.3.1 Stronger Role for the European Commission in the Preventive Arm

As part of the preventive arm of the pact, the European Commission issues an early warning to Member States where significant deviations[17] from the

Chart 4

Stylized Course of Events in the New SGP



Source: Council of the European Union.

[16] *In this contribution, "Council of the European Union" (which is colloquially also called "Council of Ministers") is used synonymously for the Ecofin Council, which is composed of the economics and finance ministers of the EU Member States.*

[17] *Deviations are considered significant when the structural budget balance deviates from the adjustment path by 0.5% of GDP in one year or by an average of 0.25% in two consecutive years. Divergences from the expenditure rule are significant when they have a negative impact on the budget balance of at least 0.5% in one year or of 0.5% cumulatively over two consecutive years. Deviations are not considered significant if they are caused by a severe economic downturn or by unusual events outside the control of the Member State concerned, on condition that the country's fiscal sustainability is not jeopardized in the medium term.*

adjustment path toward the MTO have been observed.[18] Within one month of the adoption of the early warning, the Council draws up a recommendation that includes a set of measures to address the deviation and a deadline (three to five months) for adopting these measures. The recommendation can be made public at the European Commission's proposal.

If a Member State fails to comply with the Council recommendation, the European Commission and the Council determine in a multi-step decision process whether effective action has been taken; the decision requires only a simple majority in the Council. Once a country is found to have taken no effective action, the European Commission issues a recommendation to the Council to impose a sanction that requires the country concerned to lodge an interest-bearing deposit in the amount of 0.2% of the previous year's GDP. The deposit is payable unless the Council decides to the contrary by qualified majority within ten days. This voting procedure is called reverse qualified majority voting (RQMV). At the reasoned request of the Member State concerned, the European Commission can reduce the deposit amount or suspend the sanction altogether.

2.3.2 Earlier Application of Financial Sanctions in the Dissuasive Arm

When a country's public finances do not fulfill the deficit criterion or the debt criterion (or both), the European Commission draws up a report under Article 126(3) TFEU, taking into account various "relevant factors" that could, under specific circumstances, still prevent the launch of an EDP (for instance, the composition of the stock-flow adjustment described in section 2.2 in case of a breach of the debt criterion). On the basis of this report, the Council can, by qualified majority, initiate an EDP under Article 126(6) TFEU.[19] The EDP contains recommendations for the Member State in question and sets a deadline (three to six months) for taking "effective action." Once the EDP has been launched, the European Commission recommends that the Council impose a sanction that requires the country concerned to lodge a non-interest-bearing deposit. Unless the Council, by qualified majority, decides to the contrary within ten days, an existing interest-bearing deposit is transformed into a non-interest-bearing deposit, or, in the absence of an interest-bearing deposit, the country concerned has to lodge a non-interest-bearing deposit in the amount of 0.2% of the previous year's GDP in the case of serious noncompliance. As in the case of interest-bearing deposits, the European Commission can reduce the deposit amount or suspend the sanction altogether in light of exceptional economic circumstances or at the reasoned request of the country concerned.

If the Council finds that insufficient effective action has been taken in response to its recommendations within the period laid down (Article 126(8) TFEU), the European Commission recommends the Council to impose a fine in the amount of 0.2% of the previous year's GDP (if the country already lodged a non-interest-bearing deposit,

[18] *The cost of structural reforms that have a positive impact on the long-term budgetary position can be taken into account in the assessment of deviations. Special consideration is given to the cost of significant healthcare, labor market and – most importantly – pension reforms.*

[19] *The Council decision also takes into account the cost of pension reforms.*

this deposit is converted into a fine). The Council can prevent fines only by RQMV within ten days. The European Commission can again reduce or suspend fines.

Additional fines can be imposed if the country still fails to comply with the Council's recommendations. These fines contain a fixed component (0.2% of GDP) and a variable component, which equals one-tenth of the difference between the country's deficit ratio of the previous year and the 3% deficit limit (breach of the deficit criterion) or one-tenth of the difference between the country's deficit ratio of the previous year and the deficit ratio specified in the Council's notice (breach of the debt criterion). A single fine cannot exceed 0.5% of the previous year's GDP. The Council decides in annual assessments whether additional fines should be imposed because the action taken has again been insufficient. Taken together, these fines may exceed 0.5% of GDP. The amount of additional fines is determined using the calculation method for the variable component. A direct Council decision is required for the imposition of such fines (no RQMV).

Fines and interest earned on non-interest-bearing deposits are assigned to the European Financial Stability Facility (EFSF) or its legal successor.

2.4 Other Changes

Council Regulation No 1173/2011 addresses the issue of data quality: In case of data manipulations that lead to a misrepresentation of deficit or debt figures (whether intentional or due to serious negligence), the Council can, on a proposal from the European Commission and by simple majority, impose a fine of 0.2% of GDP.

The SGP 3.0 also aims at increasing transparency in the European Commission's and the Council's decision-making processes, e.g. by allowing the competent committees of the European Parliament to invite an exchange of views in which the country concerned shall have the opportunity to participate.

The new rules for economic and fiscal surveillance in the EU consist of five regulations and one directive ("six-pack"): three regulations that reform the SGP, two regulations addressing macroeconomic imbalances as well as Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States. According to this directive, the Member States should implement numerical fiscal rules that promote compliance with the SGP as well as medium-term budgetary frameworks.

3 Assessment of the New SGP Provisions

The provisions of the preventive and dissuasive arms of the SGP work side by side. Therefore, we have to look at the interaction between them to assess the impact of individual provisions. Essentially, the preventive arm of the SGP aims at the early prevention of noncompliance with the debt and deficit criteria defined in the dissuasive arm. To be effective, though, the rules of the preventive arm must be binding before the provisions of the dissuasive arm are invoked. Adherence to the MTO would make it relatively unlikely that a country breaches the provisions of the dissuasive arm, as country-specific MTOs provide for a safety margin with respect to the 3% limit of the deficit ratio, and assessments of the debt position automatically consider stock-flow adjustments and cyclical effects. In the event of deviations from the MTO, the debt criterion (as well as the deficit criterion) can imply stricter (deficit) requirements in the first years of adjust-

ment than foreseen in the preventive arm of the pact. As mentioned in section 2.3, though, the sanctions for noncompliance with the dissuasive arm of the SGP are much higher.

3.1 Expenditure Rule Is Reasonable but Complex

The preventive arm of the SGP aims at balancing out the procyclical effect that materializes when a country merely fulfills the minimum requirements of the dissuasive arm. Its provisions have been largely ignored in the past, however (section 1).

The structural balance rules already existing and the expenditure rule newly introduced in the preventive part of the SGP work hand in hand but also compete with each other. For instance, if a country's expenditure growth benchmark is 1 percentage point below potential growth (because of noncompliance with the MTO), and assuming a revenue elasticity of 1, a constant interest expenditure ratio, a long-term multiplier of zero and an adjusted[20] primary expenditure ratio of 50%, the requirements regarding the adjustment path toward the MTO will exactly match the criteria of the expenditure rule (i.e., a structural improvement by 0.5% of GDP). Yet if the revenue elasticity is greater than 1 (e.g. owing to revenue windfalls in economically good times), the expenditure rule will require a faster adjustment to the MTO and thus becomes the binding criterion (the argument is derived in European Commission, 2011a).

Measurability is one great advantage the expenditure rule has over the structural balance rule: Both expenditure growth and the effects of revenue legislation can be measured with a relatively short lag, and the underlying potential output growth rate can be determined in advance. In contrast, making real-time estimates of the structual balance is difficult for various reasons, but above all because of difficulties in assessing a country's cyclical position and in identifying revenue windfalls or shortfalls.[21] Both would be necessary for estimating the cyclical component of the budget balance.

A look at Ireland and Spain – which seemed to have strong fiscal positions before the crisis – highlights the scope of the problem. Despite several tax cuts, Ireland had a relatively constant tax ratio from 1998 (O'Leary, 2010; Morris et al., 2009), which was attributable to a massive real estate boom that led to substantial revenue windfalls. Primary expenditure increased sharply in the same period. The windfall revenues partly masked a deterioration in the actual structural primary balance; at the same time, potential output growth was thought to be very high and – thanks to high output growth and low interest rates – Ireland's interest payments in percent of GDP declined sharply. Before the dramatic deterioration in the Irish economy from 2007, the country's fiscal position had thus been much weaker than the indicators of the previous SGP suggested. Rather similar developments were observed in Spain.

[20] *In this context, adjusted primary expenditure is defined as primary expenditure excluding unemployment benefits and expenditure items with a direct counterpart on the revenue side. For Austria, this ratio would be roughly 46% of GDP in 2010 (= total expenditure – interest payments – social transfers for unemployment – social security employer contributions for public sector employees – taxes paid by government – output produced for own final use – EU transfers to the Austrian public sector).*

[21] *Another problem is the discrepancy between results depending on the method of adjustment for cyclical effects (e.g. Bouthevillain et al., 2001).*

The expenditure rule does not completely solve the problem of measuring, in real time, a country's cyclical position and the scope of windfall revenues, as it is not applied to countries that overachieve their MTOs. According to the European Commission's assessment, Spain and Ireland overachieved their MTOs most of the time in the precrisis years (chart 3), even though they would have repeatedly failed to meet the expenditure rule (despite the assumed very high potential output growth). It is difficult to say in retrospect whether Spain and Ireland would have qualified for an exception from the exception for countries with substantial revenue windfalls described in section 2.1.

The necessary adjustment of expenditure data by discretionary revenue measures gives rise to another problem: It is as yet unclear what exactly constitutes a measure (does the nonindexation of income tax brackets or of nominal excise duties qualify as a measure?) and how implementation risks should be handled (are the measures adopted actually implemented?). Another issue in this context is the handling of substantial uncertainty regarding the size and timing of additional revenues, above all in connection with reforms of profit-related taxes and measures to prevent tax fraud.

Other matters of detail that still have to be resolved are the treatment of mandatory indexing[22] and substantial one-off effects (e.g. deficit-increasing capital injections for public enterprises or nationalized banks) in the adjustment of expenditure data and the handling of automatic revenue increases offsetting expenditure in excess of the benchmark (section 2.1).[23]

These details indicate that the lower procyclicality of the new expenditure rule (compared to other EU fiscal rules) comes at the price of high complexity.

3.2 Some Conceptual Weaknesses in the Debt Rule

In the past, EDPs were triggered, if at all, only by a breach of the 3% deficit threshold. Debt ratios in excess of the 60% threshold did not have any consequences, even though the debt ratios of some high-debt countries did not decline at all.

This is problematic in two respects: First, merely achieving the 3% deficit limit is not enough to reduce the debt ratio below the 60% reference value in the long run, given that most euro area countries post low nominal trend growth, as has been evidenced by the case of Italy, even before the crisis hit. Here, compliance with the new and stricter rules of the preventive arm would indeed reduce debt ratios significantly, but it remains to be seen whether these rules will actually be implemented given the low incentive levels and past experience (many countries that fulfilled the 3% deficit limit most of the time did not meet the requirements of their MTOs). Second, real-time debt developments can provide more meaningful information than deficit developments. The major revisions required in Greece, above all, tended to have a larger impact on the deficit ratio than on the debt ratio.

[22] *While past inflation is taken into account in the mandatory adjustment of pension benefits in Austria, current price developments (GDP deflator) are used for deflating expenditure.*

[23] *Adjusting by items that are completely offset by revenues – in particular taxes paid by government units (e.g. social security employer contributions for public sector employees) – seems an obvious choice. It is unclear, though, in how far the induced rise in wage tax revenues should be counted as offsetting a sharp rise in compensation for public employees or pension benefits. Our estimate of Austria's adjusted primary expenditure ratio was based on the assumption that only the first point will be considered.*

One reason why the debt criterion was never applied is the lack of a numerical benchmark for assessing whether the debt ratio was "sufficiently diminishing" (a requirement that was already stated in the dissuasive arm of the previous SGP). While the new debt rule addresses this weakness by operationalizing the debt criterion with exact reference values, it has some significant shortcomings.

Of all the relevant SGP indicators (debt ratio, deficit ratio, adjusted expenditure growth, structural balance), the debt ratio responds most to cyclical developments, which implies that the influence of policy measures is smallest in the short run. Economic developments impact not only the numerator of the debt ratio (as automatic stabilizers add to the deficit), but also the denominator (GDP).[24] Another problem lies in the fact that the Maastricht debt level is gross debt, i.e. financial assets of the general government are not considered[25] (even if they are liquid or relatively liquid, like cash or securities).

The most recent SGP reform addresses both problems: According to the new debt rule, a severe negative effect of the economic cycle or the buildup of substantial amounts of certain financial assets may remove the requirement for an EDP (section 2.2). These exceptions create strong asymmetry, however, as meeting the benchmark only by tapping into cash reserves or because of favorable economic conditions will avert an EDP. While there are also some exceptions to the existing deficit rule (sections 2.2 and 2.3), they come without such major asymmetries.

The debt criterion is weakened further by the fact that it also takes into account whether the benchmark is forecast to be breached in the future (section 2.2). Table 1 highlights the problem of this approach by looking at past debt ratio forecasts for Greece, one of the countries that have often been cited as a reason why it is necessary to introduce a debt rule (European Commission, 2011a). Judging from the first ex post data submitted during the EDP

Table 1

European Commission Forecasts of the Greek Debt Ratio

Forecast year	Budget balance	Public debt						Sufficiently diminishing	
	t–1	t–4	t–3	t–2	t–1	t	t+1	t–4 to t–1	t–2 to t+1
	% of GDP								
2000	–1.6	111.3	108.5	105.4	104.4	103.7	99.7	no	yes
2001	–0.9	108.3	105.5	104.6	103.9	99.9	98.0	no	yes
2002	0.1	105.0	103.8	102.8	99.7	97.9	95.2	no	yes
2003	–2.6	105.1	106.2	107.0	104.9	101.0	97.0	no	yes
2004	–3.0	106.2	106.9	104.7	103.0	102.8	101.7	no	no
2005	–4.4	114.8	112.2	109.3	110.5	110.5	108.9	no	no
2006	–4.5	107.8	108.5	107.5	104.6	100.9	97.6	no	yes
2007	–2.6	110.7	107.8	108.5	107.5	105.0	102.1	no	yes
2008	–2.8	98.6	98.0	95.3	94.5	92.4	90.2	no	yes

Source: European Commission spring forecasts (2000 to 2008).

[24] *While this effect can also be observed for the actual and structural budget balance as percentage of GDP, it is much smaller (as deficit ratios are much closer to zero than debt ratios).*

[25] *Government-held bonds and intra-governmental loans are important exceptions.*

Table 2

Budget Balance Required for a Sufficient Reduction of the Debt Ratio[1]

Nominal GDP growth in %	Previous year's public debt											
	% of GDP											
	70	80	90	100	110	120	130	140	150	160	170	180
0	0.5	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5	5.0	5.5	6.0
1	–0.2	0.2	0.6	1.0	1.4	1.8	2.2	2.6	3.0	3.4	3.8	4.2
2	–0.9	–0.6	–0.3	0.0	0.3	0.6	1.0	1.3	1.6	1.9	2.2	2.5
3	–1.5	–1.3	–1.1	–0.9	–0.7	–0.5	–0.3	–0.1	0.1	0.3	0.5	0.8
4	–2.2	–2.1	–2.0	–1.8	–1.7	–1.6	–1.5	–1.4	–1.3	–1.2	1.0	–0.9
5	–2.8	–2.8	–2.8	–2.8	–2.7	–2.7	–2.7	–2.7	–2.6	–2.6	–2.6	–2.6
6	–3.5	–3.5	–3.6	–3.7	–3.7	–3.8	–3.9	–3.9	–4.0	–4.1	–4.1	–4.2

Source: OeNB.

[1] Assuming zero stock-flow adjustment.

notification rounds, Greece would have breached the debt criterion every year since 1999 even before the onset of the crisis (table 1, column "Sufficiently diminishing, t–4 to t–1"). If we also use the European Commission's forecast,[26] as foreseen in the debt rule, the results are completely different. Based on these forecast data – which turned out to have been overly optimistic – the Greek debt ratio would actually have diminished sufficiently in most years under review, thus meeting the debt rule requirements (table 1, column "Sufficiently diminishing, t–2 to t+1"). The only exceptions are two years (2004 and 2005) in which Greece recorded a Maastricht deficit of 3% of GDP or higher even on the basis of the data available at that time.

Still, like in the case of the expenditure rule, past problems are not necessarily indicative of the future usefulness of the rule. At present, it seems highly unlikely that future forecasts of nominal economic growth in euro area countries would be as optimistic as they had been for Greece, Ireland or Spain before the onset of the crisis.

In light of significant asymmetries and the consideration of forecasts, it is impossible to say conclusively whether the debt rule will, as intended, impose stricter requirements on highly indebted countries than the deficit rule. Excluding the exceptions mentioned earlier, it would indeed be the case for countries with moderate growth rates (= nominal growth ≤ 5%) (table 2); in Greece, average nominal growth was much higher than that before the onset of the crisis.

Table 3 gives a somewhat exaggerated example of how the debt rule could be circumvented.[27] Let us assume that Austria pursues the strategy of keeping its debt ratio constant at 71.8% of GDP from end-2010. In this case, it would still be in compliance with the debt rule if it made temporary stock-flow adjustments (e.g. by accumulating cash reserves) equivalent to 4.1% of

[26] *This calculation is based on data from the respective European Commission spring forecasts (which should, as a rule, correspond to the data reported in the first ex post notification rounds). The benchmark for a sufficient reduction of the debt ratio* b_t *based on forecast values will probably be calculated as follows:* $b_{t+2} = 60\%+0.95/3*(b_{t+1}-60\%)+0.95^2/3*(b_t-60\%)+0.95^3/3*(b_{t-1}-60\%)$.

[27] *This scenario (and the study as a whole) does not consider the transitional provisions until the debt rule is fully applied.*

Table 3

Scenario for Circumventing the Debt Rule

Year	Debt ratio	Compliance with the debt rule[1]		
		t–3 to t	t–1 to t+2	Total
–2	71.8	x	x	x
–1	71.8	x	x	x
0	71.8	x	x	x
1	75.9	no	yes	yes
2	71.8	yes	yes	yes
3	71.8	yes	no	yes
4	71.8	yes	yes	yes
5	75.9	no	yes	yes
6	71.8	yes	yes	yes
7	71.8	yes	no	yes
8	71.8	yes	yes	yes
9	75.9	no	yes	yes

Source: OeNB.

[1] Compliance to be established in the following year.

GDP every four years.[28] Table 3 shows that – based on the formula given in European Commission (2011a) – the debt criterion would only be breached every four years. On the assumption that the European Commission's forecasts are exact, these breaches would not lead to the adoption of a report under Article 126(3) TFEU, as the rule would be fulfilled again in the near future according to the forecast.

3.3 Will the Application of Sanctions Become More Likely?

Under the previous SGP, the criteria set out in both arms were breached repeatedly and markedly. The response to noncompliance depended on whether it affected the preventive or the dissuasive part of the pact: While the Council in most cases rejected the issuance of an early warning as foreseen in the preventive arm, EDPs were usually launched in the case of breaches of the deficit threshold in the dissuasive arm.

The measurement problems outlined in section 2.1 cannot account for all instances of noncompliance with the preventive arm that were observed in almost all euro area countries before the most recent reform. Other major factors were the absence of financial sanctions, the Council's comprehensive powers and the Member States' lack of commitment to budgetary discipline as set out in the SGP as well as the fact that the national fiscal frameworks did not provide for sufficient budgetary discipline. The reform of the preventive arm addresses these problems by introducing numerical benchmarks (expenditure rule), strengthening the European Commission's role and introducing sanctions (the country concerned has to lodge an interest-bearing deposit in case of noncompliance with the adjustment path prescribed by the Council). The most recent reform makes it easier to issue early warnings, as they are now addressed by the European Commission and no longer require approval by the Council. However, the Council is still in charge of drawing up the recommendations for the necessary policy action following the issuance of an early warning. Given that the deposits are interest bearing, though, their effect on the country's net assets is rather negligible[29] and thus essentially limited to possible reputational costs. Moreover, they are not imposed automatically: The Council can prevent

[28] *4.1% of GDP roughly correspond to Austria's stock-flow adjustment in 2008 excluding the participation capital for Hypo Alpe-Adria-Bank AG. Alternatively, we could assume higher initial levels and/or a trend rise in debt ratios, but in that case, the stock-flow adjustment required every four years to ensure "compliance" with the debt rule would become very large.*

[29] *0.2% of GDP multiplied by the sovereign interest rate equals around 0.01% of GDP. In the case of Austria, this would be about EUR 30 million, which is less than the country's additional payments to the EU budget to offset the rebates granted to the United Kingdom, Sweden and the Netherlands.*

their imposition by simple majority. In addition, several exemptions apply (section 2.3). Also, it remains to be seen whether the European Commission (whose role has been strengthened in both the preventive and the dissuasive arm of the pact) will come under more pressure from the Member States.

As a result of the reform of the dissuasive arm, financial sanctions are now applied at an earlier stage. In situations when countries in EDP were formerly only required to make adjustments, they are now required to lodge non-interest-bearing deposits. Interest-bearing deposits in the previous SGP have been replaced by fines in the amount of 0.2% of GDP. The sanctions for repeated noncompliance with Council recommendations have remained unchanged, however. Even though recommendations by the European Commission regarding interest-bearing deposits or fines in the amount of 0.2% of GDP can only be rejected by qualified majority in the Council (RQMV), it is unclear whether financial sanctions will be imposed more often. In the dissuasive part, it is still the Council that decides, directly and by qualified majority, if an excessive deficit exists and if the country concerned has taken effective action. Unless the Council adopts these decisions, the above-mentioned sanctions cannot be imposed. Compared with the conditions for launching an EDP, the effectiveness of a country's corrective action in particular leaves ample room for interpretation. For instance, both Germany (2003 to 2005) and Greece (from 2010) failed to meet their Maastricht deficit targets, but both countries implemented comprehensive measures in this period.

4 Conclusions

The fact that the preventive arm of the SGP has been strengthened – by introducing numerical benchmarks, making it easier to launch EDPs and introducing (symbolic) sanctions – can be considered a remarkable step, especially because the preventive arm aims at balancing out the procyclical effect that materializes when a country merely fulfills the requirements of the dissuasive arm.

In light of the many exceptions, though, it remains highly questionable whether the debt rule will actually, as intended, impose stricter requirements on highly indebted countries.

Despite the new voting procedure which is designed to make sanctions more likely, we doubt that economically significant sanctions will be imposed in the foreseeable future. Still, we expect that the new and earlier sanctions (interest-bearing deposits in case of noncompliance with the provisions of the preventive arm and non-interest-bearing deposits in case of breaches of the deficit criterion or the debt rule) will be imposed.

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Prevention and Correction of Macroeconomic Imbalances: the Excessive Imbalances Procedure

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Macroeconomic imbalances can lead to economic crises. This is especially true in a monetary union due to the restrictions it imposes on the tools available to economic policymakers. The years leading up to the outbreak of the global economic crisis were characterized by divergent macroeconomic developments within the euro area, which meant that the impact of the crisis varied from Member State to Member State and that, subsequently, unexpected challenges have arisen for the single monetary policy and coordinated fiscal and economic policy. In order to prevent such developments in future, a procedure for preventing and correcting macroeconomic imbalances, analogous to the Stability and Growth Pact, was created within the framework of the European semester. The preventive arm of the procedure is designed to detect and analyze potential macroeconomic problems. If the procedure flags up "excessive" imbalances for a Member State, the corrective arm will come into effect, under which the relevant Member States will be required to submit plans for corrective measures. If Member States then fail to comply with the recommended corrective actions, sanctions may be imposed. The new procedure constitutes a considerable boost to economic policy coordination within the EU and the euro area. Nonetheless, it has yet to prove itself in practice.

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Macroeconomic imbalances, in particular the U.S. current account deficit and China's current account surplus, are considered to be one of the prime driving factors behind the emergence of the global financial and economic crisis (The Economist, 2009). They have therefore become more and more central to the analyses of international organizations such as the IMF and OECD (Padoan, 2010) and to economic policy coordination at global level: thus, in spring 2011 the finance ministers and central bank governors of the G-20 states agreed on guidelines for the measurement of potentially destabilizing global imbalances (IMF, 2011). Serious macroeconomic imbalances also built up between the euro area countries during the precrisis years, caused in part by divergent developments in their competitiveness position and an absence of adequate structural reforms; however, these attracted virtually no attention until the onset of the crisis.

A discussion of the causes behind these global macro imbalances would go far beyond the scope of the present study, which will address only the macroeconomic imbalances present at EU level, and in particular within the euro area. After this problem was highlighted due to the global economic crisis, the EU Member States agreed to implement a new framework – as a complement to the Stability and Growth Pact (SGP) – for the early identification and elimination of macroeconomic imbalances (the excessive imbalances procedure, or EIP), which will come into effect at the beginning of 2012. For the purposes of the EIP, "macroeconomic imbalances" shall mean "any trend giving rise to macroeconomic developments which are

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adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of economic and monetary union, or of the Union as a whole" (Council of the European Union, 2011a).

In principle, the EIP shall apply to all EU Member States. In a monetary union such as the euro area, the fact that both key decisions on economic and structural policy and responsibility for fiscal policy remain with the individual nations means that there is a greater need for economic policy coordination in order to prevent diverging economic developments which make it more difficult to conduct a single monetary policy. This article thus focuses exclusively on the euro area economies.

As the euro area countries no longer have the option of using exchange rate policy to address losses of competitiveness, wage policies need to be aligned across borders. Especially in the years leading up to the crisis, the euro area economies were shaped by increasingly divergent developments in the following respects: soaring public and private debt levels in Greece, real estate price bubbles in Spain and Ireland, an increasing loss of competitiveness in the Italian, Spanish, Portuguese, and Greek economies, etc. These problems were taken into account within the context of the governance reform carried out by the EU, which introduced a more effective macroeconomic coordination framework and tighter and more extensive surveillance – not only in the area of fiscal policy, but also with respect to the potential build-up of macroeconomic imbalances – to help prevent deeply divergent economic developments in future.

This article is structured as follows: section 1 describes the emergence of macroeconomic imbalances within the euro area and discusses some of the theoretical economic background aspects. Section 2 describes how the EIP will work. Section 3 offers a discussion of some of the issues involved, and section 4 concludes.

1 The Problem: Macroeconomic Imbalances in the Euro Area

1.1 Imbalances within a Monetary Union

In a monetary union, the Member States relinquish both their right to conduct an autonomous monetary policy and the option to use exchange rates as a policy tool. In the event that asymmetric shocks occur, the Member States must either fall back on fiscal policy, responsibility for which remains fundamentally with each nation state, or use flexible labor markets (wage flexibility, worker mobility) to bring about the necessary adjustment.[2] As free movement of labor in the EU is limited in comparison with other major currency areas (e.g. the U.S.A.), flexible wages are a key requisite for the functioning of the euro area. However, there is a limit to how much wage developments can be influenced by public policy measures.

Thus, essentially the only option left to individual Member States is that of fiscal policy measures. Having said that, however, fiscal policy options can also be limited if, for example, high levels of government debt have left no

[2] *This is the essence of the "theory of optimum currency areas" (De Grauwe, 2009). It should be stressed here that the scope of the discussion in this paper is of necessity limited to the "cost side" of a monetary union; in other words, to the restrictions it places on the use of economic policy instruments. However, it should not be forgotten that a monetary union also offers considerable benefits to its members (Beer, 2011, for an overview of the current literature).*

room for expansive fiscal policy measures, or – in the somewhat longer term – for dealing with the increasing burden on the budget caused by an ageing population. And indeed, if the occurrence of asymmetric shocks is attributable to differences in structural developments across the Member States of a monetary union, even fiscal policy measures (to stimulate the economy) will not be able to help.

In principle, there is another possible way to absorb asymmetric shocks; that is, via transfers within a (partially) centralized EU budget ("transfer union," De Grauwe, 2009). Politically, this is – at least for now – not a realistic option. In view of the limited scope for economic policy intervention, policymakers must therefore strive to identify macro imbalances as potential sources of asymmetric shocks *directly,* and to initiate countermeasures accordingly.

1.2 What Forms Do Macro Imbalances Take?

What do we mean by macroeconomic imbalances?[3] A definition given by Thomas Wieser, former President of the EU's Economic and Financial Committee (EFC) would seem to offer a sufficiently tangible explanation of the term (Wieser, 2011): "A macroeconomic imbalance is the (negative or positive) position of a domestic, external or financial variable… [which] may – if uncorrected over time – make the national savings/investment balance so untenable that it self-corrects abruptly, thereby causing significant adjustment shocks […]."

Thus, imbalances ultimately take the familiar guise whereby the current account balance of a country is equal to the domestic savings/investment balance.[4] Current account balances, in turn, have their counterpart in the balance of payments; i.e. current account deficits go hand in hand with capital inflows, current account surpluses with capital outflows.

It stands to reason, then, that to detect imbalances one should cast a comprehensive eye over both national (i.e. public and private) savings and investment balances and the balance of payments. However, as these represent purely book-keeping identities and thus do not permit any conclusions to be drawn on the causal connection, it is also advisable to look at factors with a direct influence on the above-mentioned aggregates; e.g. determining factors of the current account balance, such as indicators of price competitiveness[5]: real effective exchange rates and their determining factors, or unit labor costs (within a monetary union). One can also consider complementary indicators, such as the development of export market shares, and supplement flow values with stock values (e.g. using net international investment position data to supplement current account balance or debt figures). Finally, early warning indicators can be derived directly from the experience gained in past crises, for example through attempts to identify "unusual" financial sector developments (i.e. any developments which cannot be squared with empirical experiences and theoretical knowledge), such as extreme credit developments accompanied by strong gains in real estate or asset prices (speculative bubbles).

The academic literature has tried to identify suitable leading indicators for

[3] *See Ederer (2010) for an earlier overview study.*

[4] *See e.g. Blanchard and Illing (2009), chapter 19.*

[5] *See Ragacs and Vondra (2011) for a discussion of price and nonprice competitiveness.*

the crisis risk to countries by making ex post forecasts. In view of the different economic policy frameworks (e.g. exchange rate regimes) in place in different countries, and due to the idiosyncratic causes of crises in individual countries or groups of countries (e.g. the Asian crisis), a certain heterogeneity in the results of these studies is unavoidable.[6]

Imbalances and macroeconomic crises can easily change their form – as also became apparent during the most recent global crisis, which developed from a banking and financial crisis into a crisis in the real economy and, subsequently, a sovereign debt crisis in some countries. Accordingly, when assessing a country's vulnerability to crisis, a thorough scrutiny of economic indicators is indispensable.

1.3 Macroeconomic Developments in the Euro Area

Chart 1 shows the development of a number of macroeconomic variables for selected Member States. In order to maintain a certain level of clarity here, on the one hand the chart is limited to a group of countries which have been left comparatively unscathed by the financial, economic and sovereign debt crisis: Germany, the Netherlands, and Austria. Juxtaposed with these are those countries which have been particularly hard hit by the crisis and, subsequently, have required varying degrees of support from the other Member States, the IMF or the ECB: Greece, Ireland, Portugal, and – with a few qualifications – Spain and Italy.

In Greece and Italy, public debt levels were already well above the debt ceiling specified by the SGP even before the onset of the crisis (see chart 1(a)). The crisis then resulted in a rise in public debt levels in all euro area countries; however, this rise was most significant in relative terms in a few countries with low levels of debt (Ireland and Spain).[7] Both Spain and Ireland are examples of how strongly ultimately unsustainable developments in specific areas of the economy, such as the housing market or the banking sector, can impact upon public finances and result in financing problems for a government.

Chart 1(b) highlights differences in the development of nominal unit labor costs between individual euro area countries, with low growth in Germany and Austria standing in contrast to substantial increases in Ireland, Greece, Spain, Italy, and Portugal. These differences also showed up in persistent country-specific variations in inflation rates, and hence in divergent real interest rate levels (ECB, 2008). Chart 1(c) depicts developments in real effective exchange rates relative to 35 industrialized countries. The picture this provides is very similar to that for unit labor costs: Germany and Austria experienced a real depreciation, while price competitiveness in Ireland, Spain, Italy, and Portugal underwent a continuous deterioration in the run-up to the crisis. Finally, chart 1(d) highlights what is likely the most widely discussed uneven development within the euro area: persistent and (until the crisis) expanding current account surpluses in Germany, the Netherlands, and Austria side by side with consistently mounting deficits in the other countries.

[6] *Frankel and Saravelos (2011) offer a survey of this literature and conduct their own empirical analysis to provide a prognosis for the most recent economic crisis.*

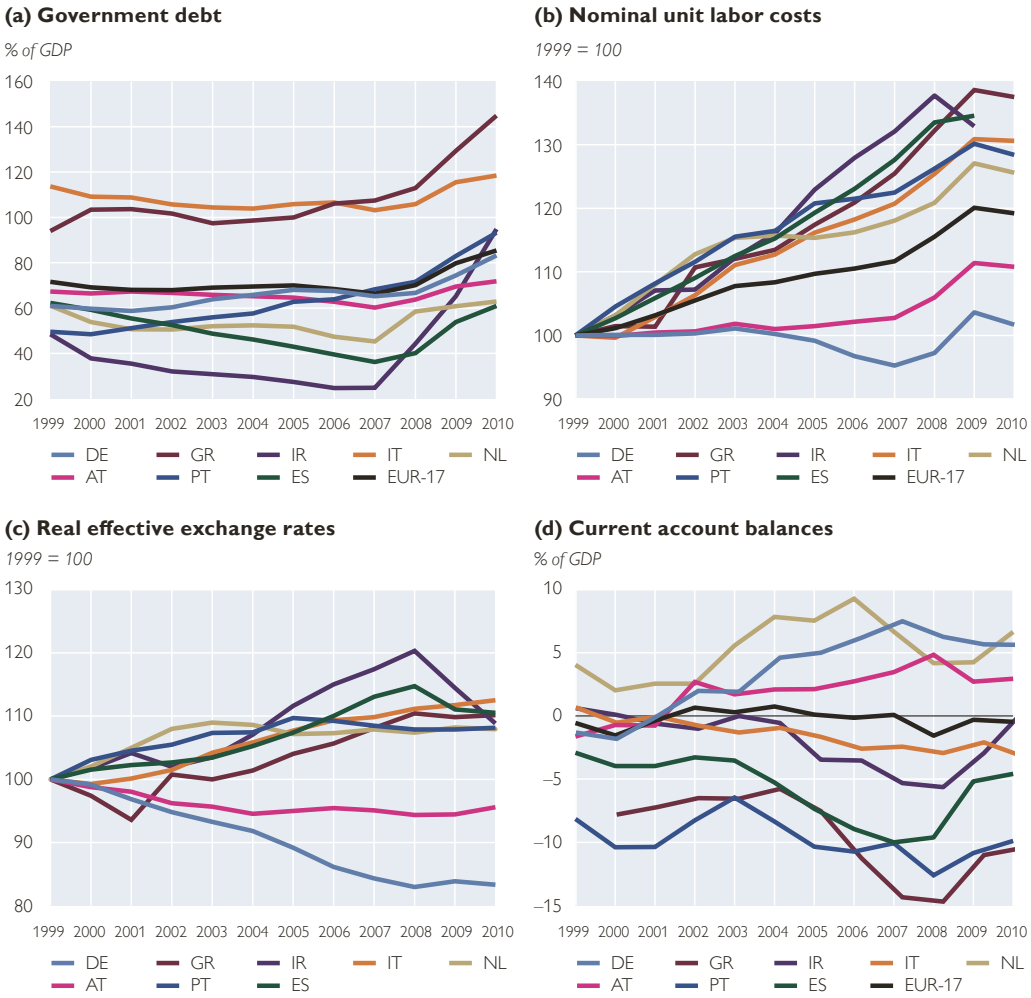
[7] *These two countries experienced the bursting of a real estate price bubble which had previously delivered high but ultimately unsustainable levels of economic growth and a temporary spike in public revenues.*

Persistent current account surpluses and deficits do not necessarily have to present a problem, as they can be a sign of different national preferences and stages of economic development: for example, countries with an aging population should plan ahead by seeking to build up current account surpluses; developing transition economies with a lack of national savings are dependent upon inflows of capital and investment. As long as the inflow of capital is not used for consumption purposes, this enhances the economy's long-term growth potential, providing the scope for later repayment of external liabilities. However, where persistent current account deficits are regarded as problematic, in the sense of being ultimately unsustainable,[8] this can lead to a reversal in capital flows and to economic crises (Aeppli, 2011).

Within a monetary union such as the euro area, the question also arises

Chart 1

Development of Macroeconomic Indicators in Selected Euro Area Member States



Source: OeNB, Statistics Austria, ECB, Eurostat.

[8] *This can be the case when capital inflows are channeled into a country's national (private and public) consumption and not invested, or because investor confidence is shaken as a result of political developments, etc.*

as to whether there is a causal connection between diverging current account balances; specifically, whether the export surpluses of Germany, the Netherlands, and Austria are *simultaneously* the import surpluses of the crisis countries. The trade linkages involved are, however, more complex than that: on the one hand, a substantial component of Germany's success as an exporter is attributable to markets outside of the EU and has to do with, inter alia, a concentration of its export base on high-growth markets in Asia. By the same token, the export weakness of the southern European countries likewise has structural causes – i.e. loss of price competitiveness and a productivity gap relative to the northern European countries. Moreover, Germany's exports go hand in hand with substantial imports of intermediate goods from the crisis countries (Belke, 2010; Bornhorst and Ivanova, 2011; and Moser, 2011, as well as the literature cited therein).

The ECB began issuing warnings on these types of divergent developments at an early stage (ECB, 2008). In a draft paper on the EIP, it addressed the problem of divergences in competitiveness and imbalances within the euro area and indicated that the tools used to deal with competitiveness issues in the past had been inadequate (ECB, 2010).

1.4 Potential Solutions

The developments of the last decade have shown that macro imbalances can lead to the development of crisis situations and that in the event of a crisis, countries may not have the necessary tools to deal with the situation effectively. For this reason, it is essential that such imbalances be reduced or eliminated. The EIP has been designed to make this intention a reality, by implementing a procedure which – like the SGP – seeks to adopt a comprehensive approach to anticipating and counteracting the build-up of imbalances, or rectifying imbalances rapidly and effectively once they have materialized.

Nevertheless, the question of who holds the primary responsibility for correcting the build-up of imbalances in specific cases, such as the emergence of current account surpluses in some Member States and current account deficits in others, has been the subject of some intense discussions. For example, in principle the surplus countries (most notably Germany) could make a contribution to bringing down deficits by improving the export prospects of the deficit countries through a program of fiscal expansion or higher wage growth. However, even a marked increase in Germany's imports (see above) would only slightly lower the current account deficits in the GIIPS countries (Greece, Ireland, Italy, Portugal and Spain). In other words, although Germany's current account surpluses would be reduced, the current account balances of the southern European countries would not necessarily see a commensurate improvement. Moreover, the potential for fiscal expansion in the surplus countries is limited due to the sharp rise in public debt levels over the last few years.[9]

Stronger wage growth would likely have a detrimental effect on Germany by lowering its competitiveness, since it would also run counter to Germany's efforts to boost its price competitiveness over the last decade (Moser, 2011).[10] Furthermore, allowing higher inflation in the euro area (Krugman, 2011) in order

[9] *Weber (2010).*

[10] *In the early 1990s, Germany – the "sick man of Europe" – was given the blame for the lack of growth in the EU, as it had suffered from significant problems with productivity and thus competitiveness after reunification.*

to enhance the relative competitiveness of the GIIPS nations without deflation would be inconsistent with the goal of price stability for the euro area. This leaves only internal deflation processes, coupled with structural reforms, as solutions to the problems of Greece, Ireland, Italy, Portugal and Spain.

In line with the intentions of the creators of the new macroeconomic governance architecture, the responsibility for preventing and correcting macro imbalances thus rests with the individual Member States themselves. The EIP provides a procedural framework for this process. Together with the reformed SGP and the European Systemic Risk Board (ESRB),[11] it constitutes the new toolkit for economic surveillance and the prevention of crisis developments in the euro area and EU.

2 Procedure for the Prevention and Correction of Macroeconomic Imbalances

The future mechanism for the early detection, prevention, and correction of macroeconomic imbalances consists of two regulations, the contents of which will be outlined below.[12] As with the SGP, the procedure can be divided into two components: a *preventive* arm, for the regular assessment of imbalance risks, and a *corrective* arm providing for remedial measures to deal with excessive macroeconomic imbalances.

2.1 Preventive Arm

The macroeconomic surveillance procedure starts with regular checks on Member States in the form of an alert mechanism for excessive imbalances. Alert mechanism reports are published in November of each year as part of the European Commission's annual growth report with a view to providing an initial overview of developments in key macroeconomic indicators. The alert mechanism consists of the so-called "scoreboard" – a set of macroeconomic indicators complemented by an accompanying qualitative analysis in the form of a report published by the European Commission.

The scoreboard consists of ten indicators of external and internal imbalances, complete with threshold values (box 1). If values above or below these thresholds are recorded, further analysis will be conducted. The threshold values are simply guidelines for the evaluation, as they are not meant to be interpreted mechanically, but rather only in conjunction with the accompanying qualitative analysis.

Based on the results obtained from the scoreboard and the qualitative analysis, the European Commission will draw up a list of those Member States at risk of being affected by excessive imbalances. After discussion in the Council of the European Union (subsequently referred to as "the Council") and the Eurogroup, a detailed, in-depth analysis of the affected Member States will be carried out. This will include an assessment of causes and potential effects of macroeconomic imbalances. The analysis will be carried out by the European Commission in collaboration with the affected Member State. The stability and convergence programs (SCPs) which countries submit to the European Commission in April of each year as part of the European Semester will be taken into account in the Commission's decision-making process. In addition, the ECB can also carry out surveillance missions in affected countries.

[11] *Pointner and Wolner-Rößlhuber (2011).*

[12] *Council of the European Union (2011a and b).*

The in-depth analysis can lead to three different outcomes: (1) The European Commission does not detect any macroeconomic imbalances and consequently does not take any further steps; (2) the European Commission detects macroeconomic imbalances and advises the Council to issue recommendations for preventive action to the affected Member State based on Article 121(2) of the Treaty on the Functioning of the European Union (TFEU); or (3) the European Commission detects excessive imbalances which could jeopardize the functioning of monetary union and advises the Council to issue recommendations for corrective action to the affected Member State based on Article 121(4) TFEU. Only in cases where the outcome of the in-depth analysis corresponds to (3) above will the EIP be initiated, thus bringing the mechanism's corrective arm into play. In cases where the outcome of the in-depth analysis corresponds to (2) above, the European Council will issue recommendations on the correction of the macroeconomic imbalances to the Member State as part of the country-specific recommendations issued in June; these recommendations will be solely preventive in nature. However, the procedure will be terminated at that point and the corrective arm will not be brought into play. Chart 2 provides a summarized overview of the timeline for the steps making up the preventive arm of the EIP.

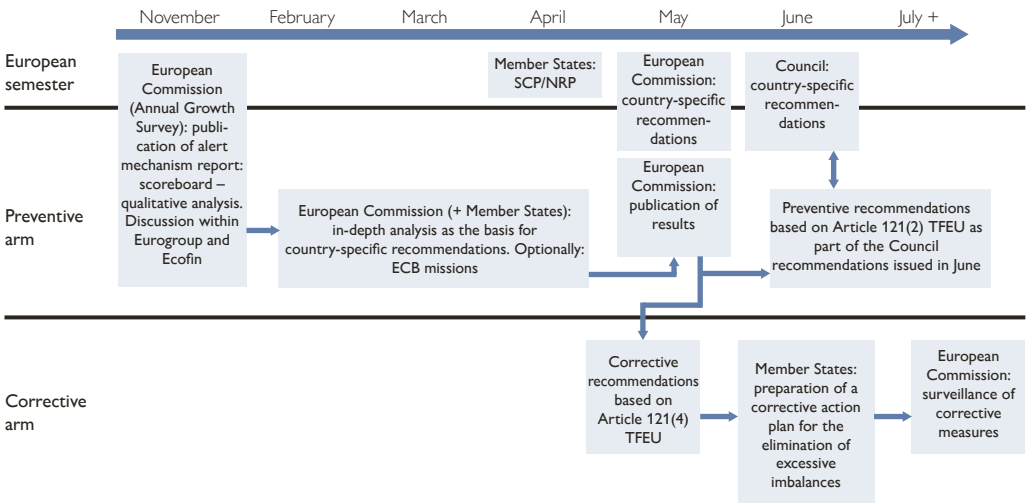
2.2 Corrective Arm

Once an excessive imbalances procedure has been launched, the Member State concerned must submit a corrective action plan, based on a Council recommendation in accordance with Article 121(4) TFEU, within a specified deadline. This plan must explicitly define measures for the correction of the imbalances detected. The Member State must also submit a timetable for the implementation of these measures.

The corrective action plan will be evaluated by the Council (based on a recommendation from the European Commission) within two months. If the plan is deemed inadequate, the Council will issue another recommendation in accordance with Article 121(4) TFEU

Chart 2

EIP Timeline



Source: Austrian Federal Ministry of Finance, European Commission.

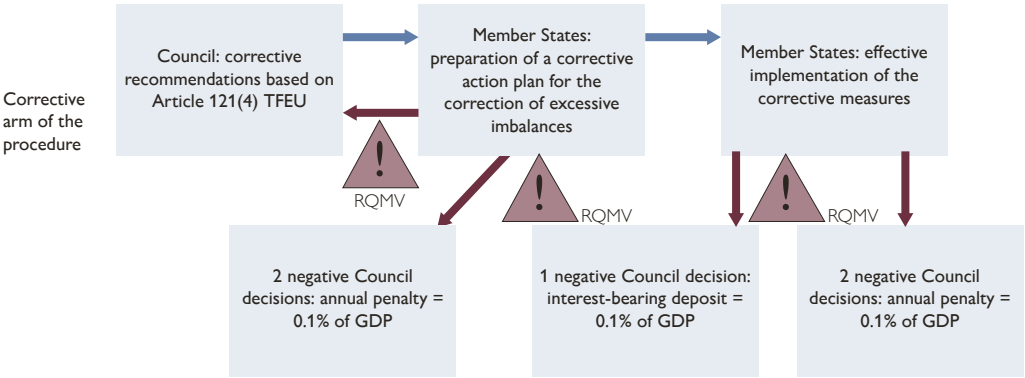
based on a proposal from the European Commission, inviting the Member State to submit a new corrective action plan. When a corrective action plan is adjudged adequate by the European Commission/Council, the Member State will be asked to implement the corrective actions defined in the plan in compliance with the submitted timetable. Actual implementation shall be assured via a reporting and surveillance procedure, including surveillance missions conducted by the European Commission and possibly also by the ECB. If a Member State fails to implement the corrective measures adequately, the Council will issue a recommendation setting new deadlines for implementation.

If a Member State is found to be in contravention of the EIP's corrective mechanism, "political sanctions" may be imposed. Alongside the obligations imposed on Member States through the surveillance and reporting procedure, a high level of transparency is also being explicitly targeted for the procedure. Thus, for example, in future the competent committee of the European Parliament will be able to summon representatives of the European Commission, the Council, and the Eurogroup for joint talks. The aim here is to bring decisions made in the context of the EIP closer to the public arena of politics. At the same time, it should also increase the pressure to act on the Member States experiencing excessive imbalances.

For euro area countries (but not, however, for the other EU Member States; this is in line with the SGP), the framework allows for financial sanctions in the event of contraventions of the EIP. For inadequate implementation of a corrective action plan after its acceptance, an interest-bearing deposit equal to 0.1% of the country's GDP will be imposed. This penalty is to be deposited with the European Commission. Two consecutive negative evaluations with regard to the corrective action plan or the implementation of corrective measures will entail an annual fine equal to 0.1% of the country's GDP. This yearly fine will continue to apply until the European Commission and Council have accepted a corrective action plan/have deemed the implementation of the corrective measures to be adequate. If a Member State has already lodged an interest-bearing deposit with the European Commission,

Chart 3

Sequence of Events for the Corrective Arm of the EIP



Source: Austrian Federal Ministry of Finance, European Commission.

the deposit will be transformed into an annual fine.

The mechanism specifies that decisions on the imposition of sanctions are to be taken via a reverse qualified majority voting (RQMV) procedure. Where a Council recommendation is in place regarding an inadequate corrective action plan or insufficient implementation of corrective measures, the European Commission will submit a recommendation for the imposition of the relevant financial sanctions. If the Council does not reject this recommendation by qualified majority within ten days, it shall be deemed to have been accepted. The penalties paid by the affected Member States, like those paid in the context of the SGP, will be used for the financing of the European Financial Stability Facility (EFSF) or, after its entry into force, the European Stability Mechanism (ESM). Chart 3 provides an overview of the sequence of events for the corrective arm of the EIP.

Affected Member States have the opportunity to object to the imposition of financial sanctions on the grounds of exceptional economic circumstances within ten days of the issuance of the European Commission's recommendation. The subsequent decision on whether or not to allow this objection is at the discretion of the European Commission. The EIP will be terminated once the Council, based on a recommendation from the European Commission, determines that the im-

Box 1

Scoreboard

The European Commission submitted an initial proposal for the scoreboard in mid-2010 (European Commission, 2010). This proposal was then further developed and refined over the course of several rounds of discussions between the European Commission and the Member States within the forum of the EU's Economic Policy Committee (EPC). This resulted in the development of a well-matched set of macroeconomic indicators. Four guiding principles were applied in the selection of the indicators (European Commission, 2011):

(1) The indicators should incorporate the most relevant elements of macroeconomic imbalances and losses of competitiveness.

(2) The early warning indicators should consist of an appropriate combination of flow and stock values and also threshold values. The threshold values are essentially based on percentiles from the individual indicator databases (e.g. first and third quartile in the case of an indicator which is to be interpreted symmetrically).

(3) The scoreboard represents an important communication tool.

(4) The statistical quality of the data should be high, and the data should be internationally comparable.

The indicators selected, ten in total, are divided into two groups. On the one hand, they are aimed at highlighting external imbalances and competitiveness issues; on the other, they focus on internal imbalances. Table 1 provides a detailed description of the indicators. The first group comprises the current account balance, the net international investment position, the change in the real effective exchange rate, the change in export market shares, and the change in nominal unit labor costs.

The second group contains the change in real house prices, private sector credit flow and debt, general government sector debt as a percentage of GDP, and the unemployment rate. The first nine values are plausible indicators of problems viewed against the backdrop of the discussion in section 1.2. The unemployment rate was proposed as an indicator within the context of the "trilogue" of the European Parliament, as a high level of unemployment is a key indicator for macroeconomic problems and indicates economic policy failures and/or structural problems within an economy.

Table 1

Scoreboard Indicators: Threshold Values and Data Base

Indicator	External Imbalances and Competitiveness					Internal Imbalances				
	Current account balance	Net international investment position	Real effecctive exchange rate	Export market shares	Nominal unit labor costs	Real housing prices	Private sector credit flow	Private sector debt	General government debt	Unemployment rate
Interpretation/transformation	% of GDP; average of the last three years	% of GDP	Relative to 35 industrial countries (HICP as deflator); three years percentage change	Five years percentage change	Three years percentage change	Year-on-year change in %	% of GDP	% of GDP	% of GDP; definition as per SGP	Average of the last three years
Data source	Eurostat	Eurostat	DG ECFIN	Eurostat	Eurostat	Eurostat, ECB, BIS	Eurostat, ECB	Eurostat, ECB	Eurostat	Eurostat (LFS)
Threshold values	+6% / –4% (lower bound: first quartile; upper bound: policy decision)	–35% (first quartile)	Euro area: +/–5% (first and third quartile) Other Member States: +/–11% (quartile + standard deviation for the euro area)	–6% (first quartile)	Euro area: 9% (third quartile) Other Member States: 12% (threshold value for the euro area + 3 percentage points)	6% (third quartile)	15% (third quartile)	160% (third quartile)	60% (SGP reference value)	10%
Data base	1970–2007	1970–2007	1995–2007	1995–2007	1995–2007	Up to 2007 (start year according to availability)	1995–2007	1994–2007	×	1994–2007

Source: European Commission (2011).

balances have been effectively eliminated.

3 Evaluation of the EIP

The problem that imbalances may trigger crises and endanger the stability of the euro area was identified years ago. As the euro area was not designed to be a transfer union, the prevention of macroeconomic imbalances is a key condition for it to be able to function (section 1). The necessity of the objectives targeted by the EIP is thus undisputed. Nonetheless, the effectiveness of the new procedure has been criticized and called into doubt.

3.1 Would the Scoreboard have Anticipated the Current Crisis?

The question is whether the scoreboard approach has been designed with sufficient scope to identify incipient im-

Table 2

Scoreboard Indicators, 2005 to 2007

		Current account balance	Net international investment position	Real effective exchange rate	Export share	Nominal unit labor costs	House prices	Private sector credit flow	Private sector debt	Government debt ratio	Unemployment rate
Threshold value		+6%/–4%	–35%	+/–5%	–6%	+/–9%	6%	15%	160%	60%	10%
AT	2005	1.9		2.7	12	1.4	2.5	12.2	132*	64	4.8
	2006	2.3	–21	–0.4	–0.2	1.1	1.8	11.6	144*	62	5
	2007	2.8	–18	–0.3	–0.6	2.8	1.5	24.8	152*	60	4.8
DE	2005	3.9	21	4.8	11	–0.5	–2.1	–0.9	128	68	9.9
	2006	5.4	28	0.2	3.3	–3.4	–0.8	0.9	125	68	10.1
	2007	6.6	27	0.6	2.1	–3.7	–0.4	3.6	123	65	9.6
NL	2005	6.8	–3	3.3	1.4	2.6	1.8	14.6	210	52	4.9
	2006	8	3	–1.1	–4.7	0.5	2.2	12.7	213	47	4.9
	2007	7.8	–6		–2.1	2	2.7	9.2	211	45	4.4
GR	2005	–6.6	–77	6.8	6	7.6	7.3	14.6	89	100	10
	2006	–8.2	–85	2.5	–5	7.9	9.3	16.7	96	106	9.8
	2007	–11.1	–94	1.9	3.9	9.3	1.7	15.4	104	105	9
IR	2005	–1.4	–25	12	6.4	13.9	5.7	24.3	192	27	4.5
	2006	–2.5	–5	3.4	–10.9	14.4	11.3	34.7	204	25	4.5
	2007	–4.1	–20	4.1	–15.7	14.6	4.1	20.9	214	25	4.5
IT	2005	–1.3	–16	7	–5.5	9.4	5	9.2	101	106	8
	2006	–1.7	–21	1.1	–12.7	7.1	3.1	9.5	107	107	7.5
	2007	–2.2	–22	0.7	–9.3	6.8	3.1	12	115	104	6.9
PT	2005	–8.4	–68	5.3	–4	8.6	–0.7	14.5	206	63	6.9
	2006	–9.8	–79	1.4	–5.6	5.5	–0.6	17.2	210	64	7.4
	2007	–10.4	–88	1.5	–5.4	2.8	–1.6	24.9	223	68	7.9
ES	2005	–5.4	–56	7.9	5.2	8.9	10.8	27.9	177	43	10.3
	2006	–7.2	–66	4.3	–3.4	9.3	7.7	37	201	40	9.4
	2007	–8.8	–78	4.2	–3.2	11	6.4	27	215	36	8.7

*Source: European Commission (2011). * Revised on December 7, 2011.*

balances at an early stage, and whether it would have allowed us to anticipate the current crisis. Table 2 provides sample scoreboard indicator values for selected euro area countries for 2005–2007.

As in chart 1, the table covers Germany, the Netherlands, and Austria as well as Greece, Ireland, Italy, Portugal, and Spain. The timeframe for the data was deliberately limited to the 2005–2007 period in order to evaluate the scoreboard's potential and its ability to anticipate the current crisis. The years for which the values exceeded or fell short of the threshold values are highlighted in red.

Particularly in Greece, Portugal, and Spain, the "current account" indicator came in well below the threshold value in the precrisis years. The stock values for the net international investment position obtained from the accumulated current account balance figures paint a similar picture. The indicators for the measurement of internal balances would also have exceeded the threshold values (above all in the case of private sector borrowing and debt levels). The only exception in the figures for the crisis countries is Italy, as only the export market share and debt indicators would have hinted at any problems. Then again, this does not seem odd, as Italy's core problem at the

moment is above all constituted by its significantly elevated public debt ratio.

Among the countries with a current account surplus only the government debt indicator would have argued for an in depth-analysis in the case of Germany and Austria, and only the public and private debt indicators would have done so in the case of the Netherlands. In sum, table 2 would thus suggest that the scoreboard indicators would indeed have been capable of predicting euro area countries' vulnerability to crises.

3.2 Topics of Discussion: Symmetrical Treatment of Current Account Balances and Criticisms from Trade Unions

During the development of the scoreboard and the associated threshold values, one hotly debated question was to what extent current account surpluses should also be viewed as an imbalance. Thus, representatives of the southern European states pressed for a "symmetrical treatment" of current account balances, while Germany in particular opposed this idea. Ultimately, a compromise was agreed: the scoreboard does now include a threshold value for current account surpluses; however, the (absolute) value is set considerably higher than that for deficits.

Trade unions have voiced frequent criticisms regarding what they see as the EIP's disproportionate focus on price competitiveness and low growth in unit labor costs (ÖGB, 2011; Rossmann, 2011). They maintain that this has resulted in a marked increase in income inequality, especially in Germany (OECD, 2011, table I).[13] Conversely, however, the high growth in unit labor costs in the GIIPS countries indicates a need for enhanced coordination between wage negotiators at the European level.

3.3 Open Questions Regarding the EIP

Particularly as regards the evaluation of the EIP's corrective elements, a number of important questions are yet to be resolved. For example, in cases where the Council issues corrective recommendations based on Article 121(4) TFEU, the affected Member State must adopt corrective measures. The goal of these measures is to bring the affected indicator values back below or above the relevant threshold values. However, the question which must first be addressed in this regard is that of the actual controllability of the indicators; in other words, whether a complex indicator such as the current account balance or wage developments can actually be directly regulated by policy.

A final question discussed was whether or not the scoreboard should include a financial market indicator as a complement/interface to the ESRB. However, no consensus could be reached as to which value should be used for this. Therefore, the first scoreboard (for the 2012 European semester) will not contain this type of indicator. However, the European Commission intends to submit another proposal in this regard before the end of 2012.

An additional question arising with regard to the inclusion of a financial market indicator has to do with the jurisdiction of the EIP considering the roles of other EU institutions, in particular the ESRB, which is responsible for the prevention/correction of imbalances in European financial sectors. On the one hand, questions of jurisdiction between the EIP and ESRB need a definite reso-

[13] *Moreover, Fitoussi and Stiglitz (2009) argue that an increase in income inequality was in itself a key factor in the onset of the economic crisis in the U.S.A.*

lution; on the other, the added value of including a financial market indicator in the scoreboard is unclear. At this point it seems important to note that the scoreboard is not "set in stone" and that the EU regulation provides the scope for both the indicators themselves and their threshold values to be changed (Council of the European Union, 2011a, Article 4).

Key to the effectiveness of the EIP, and in particular the corrective elements, is ownership, i.e. the question of whether the Member States will actually support the corrective measures recommended/preferred by the European Commission/Council.[14] The independence and, ultimately, the superordinate function of the European Commission and Council are fundamentally a good premise for the effectiveness of the EIP's corrective arm. Nonetheless, it involves a significant restriction of Member States' scope for action in favor of a more integrated approach. Individual Member States would see it as surrendering the job of interpreting developments in macroeconomic indicators to the European Commission and Council. The application of the RQMV method in certain steps of the procedure (for example, assessments by the Council that corrective measures have not been sufficiently implemented) could defuse this conflict of interest. It is likely that the imposition of financial sanctions using the RQMV rule will ensure a high level of effectiveness of the corrective arm of the EIP. However, as yet there are no practical examples of applications of the procedure from which to draw lessons.

4 Conclusions

The implementation of the EIP constitutes a major step in the direction of global economic policy coordination, especially within the euro area. Ex ante coordination within the context of the preventive arm of the EIP will significantly reinforce future efforts to prevent macroeconomic imbalances. The integration of the preventive arm into the European semester will improve the consistency of country-specific recommendations and take surveillance of macroeconomic imbalances to a new level. With the corrective element of the procedure, the EU has created a powerful, effective mechanism for correcting excessive imbalances. In particular, the application of the RQMV rule in various steps of the procedure and when imposing sanctions should enhance the effectiveness of the EIP. However, a few question marks remain. On the one hand there is the question of how much direct influence individual Member States can exert on individual indicators, and on the other, there is that of the potential conflicts of interest EIP protagonists may face.

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[14] *The ECB (2011) also fears that the EIP will be halted too frequently by the Council, and therefore advocates a self-imposed commitment on the part of the Council to comply, as a basic principle, with Commission recommendations on the continuation of the EIP, or to give specific reasons for any rejection of such recommendations.*

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Crisis Financing in the EU

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The European financial architecture in an environment of liberalized capital markets, and the European monetary union with the euro and an effective Eurosystem on the one hand and a less developed economic union on the other hand have needed to undergo reform to build resilience to crisis. As the Stability and Growth Pact (SGP) had failed to adequately ensure the budgetary surveillance required under the EU treaties, it was revised and reinforced again in 2010 and 2011, and in addition supplemented by a new procedure designed to prevent macroeconomic imbalances. Moreover, a number of "financial assistance facilities" were created or expanded for EU or euro area countries to support them in managing crises that might result in contagion effects. The emerging difficulties of Greece created a need to ensure previously nonexistent crisis financing for euro area countries. In March 2009, the funding capacity of the EU's balance of payments facility was raised to EUR 50 billion. Measures taken since May 2010 include the extension of bilateral loans to Greece and the creation of further financing mechanisms: the European Financial Stability Facility (EFSF: EUR 440 billion), the European Financial Stabilisation Mechanism (EFSM: EUR 60 billion) and the European Stability Mechanism (ESM: EUR 500 billion). With these mechanisms, the EU has built a framework for providing regional financial support alongside funding provided by the IMF at the global level.

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The recent experiences of European countries – Iceland in 2008, Central, Eastern and Southeastern European (CESEE) countries in 2008 and 2009, Greece in 2010, Ireland and Portugal in 2011 – have shown that financial crisis does not stop at the borders of developed economies.

Europe is characterized by liberalized financial markets and a relatively weak common financial infrastructure. The resulting international capital flows – first high inflows, then a sudden stop or even outflows – played an important role in the current crises in Europe. Amid the global financial and economic crisis and the ensuing sharp rise of general government debt ratios of many EU Member States, the economic policy framework of the EU and of the euro area in particular had come under critical scrutiny toward or in 2010. Hence, policymakers committed themselves to reinforce the coordination of budget policies through a reformed Stability and Growth Pact (SGP) and to prevent or, if necessary, correct emerging excessive macroeconomic imbalances through a newly implemented surveillance mechanism.

Moreover, the EU treaties foresee a facility to provide medium-term financial assistance for Member States' balances of payments (BOP). The ceiling of the EU's BOP facility has since been raised twice, most recently in March 2009. This facility had been designed to offer non-euro area EU Member States financial support in times of crisis and was previously without a counterpart for comparable assistance to members of the euro area. However, occasioned by the case of Greece, financial support mechanisms supplementing the assistance facilities of the IMF at the regional level have since been established for euro area countries as well. Following the phasing out of tem-

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porary solutions, the European Stability Mechanism (ESM) is to constitute a permanent crisis mechanism complementing the institutional framework of the euro area.

1 European Financial Architecture and Financial Crises

Since the Bretton Woods System collapsed in 1971, the number of financial crises has again risen worldwide and in Europe alike. According to the IMF (Laeven and Valencia, 2008), there were 208 currency crises, 124 banking crises and 63 sovereign debt crises from 1970 to 2007.

From the early 1970s to the establishment of the euro area in 1999, the EU, too, experienced currency crises and exchange rate volatilities again and again, e.g. the crisis of the European Monetary System in the first half of the 1990s. By creating a monetary union, the EU aimed at preventing such crises – resulting in high costs to the national economies – in the European internal market.

The global financial and economic crisis and the debt crisis of EU Member States that followed, however, also revealed shortcomings and deficiencies in the existing financial architecture and governance framework of the euro area as well as in the coordination of budget and economic policies at the EU level. For example, supervisory authorities had not been institutionalized at the EU level to prevent crises at banks and insurance companies or in the capital markets – they had to be created in response to the crisis. To provide for early warning of systemic risks that may be building up, the European Systemic Risk Board (ESRB) was set up, and financial market regulation was tightened. Furthermore, there was a lack of adequate financial assistance mechanisms to help Member States with liquidity difficulties – both at the EU level and in the euro area.

In addition to the instruments for BOP assistance which were already available under the EU treaties and within the framework of IMF assistance, a number of new mechanisms have been agreed since early 2009, driven by the acute financial and sovereign debt crisis in Greece and its impact on the euro area as a whole, in order to close existing gaps in the institutional infrastructure. These instruments have since been used to support the distressed economies of Greece, Ireland and Portugal as well as, since early 2010, to intensify economic governance in order to address problems arising from misaligned budgetary policies and emerging macroeconomic imbalances at the root.

The present paper discusses the establishment of financial assistance facilities for both euro area and non-euro area EU countries: the EU BOP facility with a ceiling of EUR 50 billion, bilateral loans for Greece, the European Financial Stability Facility (EFSF) with a capacity of EUR 440 billion, the European Financial Stabilisation Mechanism (EFSM) with a volume of EUR 60 billion and the European Stability Mechanism (ESM) with EUR 500 billion. These facilities will enable the crisis-ridden countries to finance an orderly adjustment process, while the Eurosystem's liquidity-providing measures will enable the banks of the crisis countries to compensate net capital outflows (ECB, 2011).

2 EU Balance of Payments Facility

When Lehman Brothers became insolvent in September 2008 and Iceland was hit by a severe financial crisis shortly afterwards, contagion effects arose in

Table 1

Crisis Financing in Europe since 2008[1] (as per November 11, 2011)

Country	Total loans	IMF loan	IMF facility	% of IMF quota	Amount disbursed by the IMF	Amount disbursed by the EU/ euro area	Further commitments and payments
	EUR billion				*EUR billion*		
Ireland	84.93	**22.43**	EFF	232,600	8.90	20.50	**EFSM:** 22.5 (disbursed: 13.9); **EFSF:** 17.7 (disbursed 6.6); IE: 17.5; UK: 3.8; SE: 0.6; DK: 0.4
Greece	110.40	**30.40**	SBA	3,212	17.96	47.10	**Bilateral loans[2]: 80 (disbursed:** 47.1)
Portugal	79.30	**27.30**	EFF	2,300	10.44	20.00	**EFSM:** 26 (disbursed: 14.1); **EFSF:** 26 (disbursed: 5.9)
Hungary	19.62	**12.12**	SBA[3]	1,015	8.79	5.50	**EU BOP facility:** 6.5; World Bank: 1
Latvia	7.65	**1.75**	SBA	1,223	1.13	2.90	**EU BOP facility:** 3.1; World Bank: 0.4, EBRD: 0.1; SW, DK, NO, FI: 1.9; CZ: 0.2, PL: 0.1, EE: 0.1
Poland	25.89	**22.05**	FCL	1,400	0.00		World Bank: 3.84
Romania	22.71	**15.71**	SBA[4]	1,326	12.16	5.00	**EU BOP facility:** 5 World Bank: 1 EBRD, EIB and IFC: 1
Iceland	3.92	**1.61**	SBA[5]	1,190	1.61		Scandinavia, NL and UK: 2.31
Bosnia and Herzegovina	1.43	**1.17**	SBA	600	0.39		**MFA:** 0.1; World Bank: 0.16
Serbia	3.36	**2.66**	SBA[6]	560	1.58		**MFA:** 0.2; World Bank: 0.5
Ukraine	20.16	**19.55**	SBA[7]	1,239	10.64		**MFA:** 0.61
Total	379.37	**156.75**			73.60	101.00	

Source: IMF; table prepared by OeNB. Exchange rates of Nov. 11, 2011: 1 SDR = 1.15 EUR; 1 SDR = 1.57 USD; 1 EUR = 1.37 USD. (The figures may differ from those shown in previous tables because of exchange rate fluctuations).

[1] The table is to illustrate all crisis programs offered in Europe since fall 2008, i.e. it also covers programs that have since expired, provided that funds were disbursed. For the sake of clarity, the overview only includes countries receiving more than EUR 1 billion under IMF programs.

[2] Loans granted to Greece by other euro area countries.

[3] Hungary's IMF program ended on October 5, 2010.

[4] One IMF program for Romania that disbursed EUR 12.26 billion ended on March 30, 2011. The current program totaling EUR 3.59 billion will end on March 30, 2013.

[5] Iceland's IMF program ended on August 31, 2011.

[6] One IMF program of Serbia that disbursed EUR 1.58 billion ended on April 15, 2011. The current program totaling EUR 1.08 billion will end on March 28, 2013.

[7] One IMF program of Ukraine that disbursed EUR 8.12 billion ended on July 27, 2010. The current program totaling EUR 11.6 billion will end on December 27, 2012.

Note: SDR = Special Drawing Right; SBA = Stand-By Arrangement; FCL = Flexible Credit Line; EFF = Extended Fund Facility; EFSM = European Financial Stabilisation Mechanism; EFSF = European Financial Stability Facility; MFA = Macrofinancial Assistance provided by the EU; EIB: European Investment Bank; IFC: International Finance Corporation

the CESEE economies. Hungary was affected directly after Iceland in October 2008 and had to be rescued by joint actions of the IMF, EU and other international financial institutions. As a result, the CESEE countries[2] faced speculative attacks in spring 2009. Austria, too, came under pressure because of the comparatively high exposure of its banks to this region.

In view of the financing problems of these countries, the European Council decided in March 2009 to increase the funding capacity of the "facility providing medium-term financial assistance for Member States' balances of payments" (EU Regulation (EC) No 332/2002; EU BOP facility) from EUR 25 billion to EUR 50 billion (following an initial increase from EUR 12 billion to EUR 25 billion). Additionally, the EU Member States agreed to contribute up to EUR 75 billion (approximately USD 100 billion) to support the IMF's lending capacity. Also Japan and the U.S.A. committed up to USD 100 billion each to increase the IMF's financial resources. Thus, the G-20 representatives were able to pledge tripling the IMF's lending capacity from USD

[2] *Apart from Latvia and Lithuania, in particular Hungary, Poland, the Czech Republic, Romania, Croatia and Serbia.*

Box 1

IMF Funding

The IMF is funded by its member countries – in the case of Austria through the Oesterreichische Nationalbank (OeNB). In 2009 and 2010, the OeNB's actual contributions (lending to the IMF) amounted to slightly more than SDR 440 million as a whole. In those years, the SDR interest rate stood at approximately 0.25%, thus being clearly below the main refinancing rate for Eurosystem monetary policy operations (1%) so that the OeNB suffered an annual loss of interest of roughly 0.75%, i.e. almost EUR 4 million in 2009 and 2010 each.

In the coming years, the OeNB's contributions will significantly rise because additional funds totaling up to SDR 3.6 billion will have to be provided to the IMF under the expanded New Arrangements to Borrow (NAB). However, the loss of interest could also turn into interest gains for the OeNB if the SDR interest rate should exceed the euro interest rate.

On December 9, 2011, the euro area Heads of State or Government agreed that the euro area countries and other EU Member States would consider, and confirm by December 19, the provision of additional resources for the IMF of up to EUR 200 billion, in the form of bilateral loans, to ensure that the IMF had sufficient resources for coping with the crisis. They added that they also looked forward to parallel contributions from the international community. On December 19, 2011, the EU finance ministers agreed that the euro area countries would provide EUR 150 billion to the IMF; the OeNB's share in this respect was slightly more than EUR 6 billion.

250 billion to USD 750 billion when meeting in London in early April 2009. To boost global liquidity, the IMF furthermore allocated special drawing rights (SDRs) equivalent to USD 250 billion to its member countries. Later on, the EU Member States agreed to raise their contributions to the IMF to EUR 125 billion, mainly by committing more funds under the New Arrangements to Borrow (NAB). Following the onset of the debt crisis in Greece in spring 2010, the IMF expressed its willingness to contribute up to EUR 250 billion to crisis financing in Europe.

The Vienna Initiative was successful in "bailing in" private sector creditors. Banks committed to maintaining their exposure to the CESEE region and, thus, to continuing to finance these countries. As a consequence, both credit default swap (CDS) spreads and risk premiums on government bonds decreased. Thanks to the joint financial support provided by the IMF and EU to individual Eastern European countries such as Hungary, Romania and Latvia, the situation in Eastern Europe stabilized (see overview in table 1). Austria also benefited from the stabilization of the CESEE economies since the risk premiums on domestic government bonds – which had strongly risen in comparison with Germany – declined again subsequently (see also Nauschnigg, 2011).

3 Greece

A number of new financing instruments were created for EU and euro area countries specifically in response to the budgetary imbalances that emerged above all in Greece. While in April 2009 the Ecofin Council had moved to launch an excessive deficit procedure for Greece, it did so under the (now inconceivable) assumption that, according to European Commission's forecasts, the general government deficit would reach 4.4% of GDP in 2009 and 4.2% of GDP in 2010 subject to a "no policy change" assumption. As a consequence, Greece was requested to take effective action within six months in order to bring the budget

deficit below 3% of GDP already in 2010. After the six-month period, however, the new Greek government reported considerable revisions of the deficit data (2008: 7.7% instead of 5% of GDP; 2009: 12.7% instead of 3.7% of GDP) in October 2009. These data were not validated by Eurostat, due to uncertainties over the figures notified by the Greek authorities, and subsequently had to be revised several times.

Against the backdrop of dramatically rising risk premiums on Greek government bonds and the increasing awareness that Greece would not be able to keep refinancing its debt at sustainable interest rates, or not at all, on the capital markets, the Heads of State or Government of the EU Member States already stated on February 11, 2010, that they "will take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole." At the end of April, Greece requested financial assistance whereupon the finance ministers of the euro area countries approved a support package at a special meeting held on May 2, 2010. This package provided funds totaling up to EUR 110 billion for a three-year joint adjustment program of the (then 16) euro area countries (up to EUR 80 billion) and the IMF (up to EUR 30 billion).

The mandate of the Heads of State or Government marked the start of a nearly two-year series of negotiations that had not ended by November 2011. Under the impression of persistent volatility in the financial markets, several summits were convened both at the level of finance ministers and Heads of State or Government of the euro area countries. Based on the solution tailored to Greece (bilateral loans pooled by the euro area countries), the decision was taken more or less in parallel to set up a temporary financial assistance mechanism until mid-2013: the EFSF, a guarantee-backed facility that had a considerably higher lending capacity of EUR 440 billion. Following a decision taken in October 2010, the EFSF will be replaced by the Permanent Stability Mechanism (ESM), which has been modeled on existing international financial institutions. In all cases, the disbursement of funds was linked to policy conditionality.[3]

Not surprisingly, the developments in Greece triggered critical debates on a series of fundamental economic and legal issues regarding the euro area which had never been resolved. At heart, these issues relate to the consequences of lacking budgetary discipline in individual euro area countries, the potential impact of such deficiencies on other euro area countries and the willingness or unwillingness to provide support in such cases. Specifically, this is reflected by the intensive discussions on the role of the "no bailout" clause enshrined in the Maastricht Treaty in 1992 (now Article 125 of the Treaty on the Functioning of the European Union – TFEU), the enforcement of the SGP as well as the role of the ECB. The views on these issues are highly varied, not only with regard to loan support to Greece, but also with regard to the establishment of the EFSF and the ESM, which have been identified as a necessary expansion of the institutional framework of the euro area as well as an inadequate treatment of symptoms raising the problem of negative incen-

[3] *Conditionality will not be discussed in this paper. It should be noted, however, that any conditionalities must comply with the existing rules of budgetary surveillance laid down in primary EU legislation and that the European Commission plays an important role in assessing the progress of the programs, in cooperation with the ECB.*

tives and continuing to undermine budgetary discipline. As the contagion risk for other euro area countries rises, the discussion becomes increasingly fundamental in nature and challenges the design of the euro area per se, having recourse to the argument that it lacks the characteristics of an optimal currency area. Therefore, concepts such as a European ministry of finance, a European monetary fund, a European debt agency or eurobonds frequently crop up in the political debate.

These fundamental issues that re-emerged with the debate about Greece are more important than the design of the bilateral loans pooled by the euro area countries, which are an interim solution, pending the creation of permanent institutions in the long run. Thus, the functioning of these loans need not be described in detail. What is important is that – unlike subsequent mechanisms – the first assistance package was based on bilateral loans pooled by euro area countries, with almost 80% of the monies provided by four countries: Germany (up to EUR 22.3 billion), France (up to EUR 16.7 billion), Italy (up to EUR 14.7 billion) and Spain (up to EUR 9.8 billion).

4 Temporary Financial Assistance Mechanisms: EFSF and EFSM

Immediately after the adoption of the first assistance package for Greece, the Ecofin Council announced more sweeping changes involving much higher amounts in a special meeting on May 9, 2010, which led to the creation of two new instruments: the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). Together with the IMF contribution, the financial stability package adopted by the Ecofin Council totaled EUR 750 billion – on top of the bilateral support to Greece. This was to demonstrate the political determination to combat the contagion risk for other Member States.

The EFSF was designed as a temporary mechanism, to be phased out after three years (mid-2013). To speed up the process, it was established as a public limited liability company in Luxembourg on June 7, 2010, with the shareholders being the euro area countries (Austria: 2.78%). The requirement to keep its structures lean is also reflected by its low capitalization of only around EUR 30 million.

The company purpose is to supply funds to distressed euro area countries, subject to strong conditionality, as was the case with the bilateral support to Greece, to be agreed in a memorandum of understanding with the European Commission. The idea is that the EFSF raises funds at favorable terms and conditions in the capital markets, and onlends these funds. The creditworthiness of the EFSF is ensured by pro-rata guarantees of the euro area countries. To ensure the AAA rating targeted for EFSF bonds given that just six euro area countries currently enjoyed such a rating when the EFSF was set up, various credit enhancements were put in place, including an "over-guarantee" of 120% on each issue; in other words, all Member States other than "program countries" – i.e. states receiving loans from the EFSF as well as Greece – are liable for 120% of their share in the bond issues.[4] Additionally, cash reserves were built up in summer 2010 to compensate for the low capitalization and offer higher security for investors. The

[4] *Irrespective of the over-guarantee for individual bonds, however, the liability of a Member State is limited to its shareholding. Austria's initial liability was around EUR 12.2 billion.*

EFSF made its debut on the capital markets in January 2011 to finance the first loan installment for Ireland through five-year bonds totaling EUR 5 billion.

The organizational structure of the EFSF, its terms and conditions for raising money in the capital markets (financing), the disbursement arrangements as well as the rights and obligations of the guarantors towards the company and among themselves are governed by a framework agreement between the EFSF and the euro area countries. Unlike the pooled bilateral loans for Greece, the EFSF is a guarantee-backed instrument and therefore does not require refinancing by the Member States. As a result, however, the EFSF also faces the risk of rating migrations[5] – which would, however, only materialize if a Member State with an AAA rating were to be downgraded.

The need to create a cash reserve to secure an AAA rating at the same time reduced the actual lending capacity of the EFSF; moreover, interest rate developments further decreased the originally assumed capacity of EUR 440 billion to an actual loan volume of EUR 220 billion to EUR 250 billion.

Therefore, the euro area Heads of State or Government decided on March 11, 2011, to raise the effective lending capacity to EUR 440 billion. In view of the persistent crisis and the perception that the financing instruments available (loans and primary market purchases) were insufficient, a special meeting of the euro area Heads of State or Government resolved to additionally enhance the flexibility of the EFSF on July 21, 2011. Specifically, the EFSF was enabled to use also precautionary instruments (similar to the IMF's flexible credit line and precautionary credit line[6]), to recapitalize financial institutions by means of loans and to buy government bonds on the secondary markets.

These changes were implemented in summer 2011 by adapting the EFSF framework agreement to include an increase of the total guarantee volume to around EUR 780 billion (EUR 726 billion excluding Greece, Ireland and Portugal) and a rise of the over-guarantee to up to 165% on the one hand and to include the new instruments on the other hand.[7] The significance of these changes is reflected by the intensive political debates in the Member States that, in the case of Slovakia, eventually even resulted in the collapse of the coalition government.

On October 26, 2011, the euro area Heads of State or Government took note of the entry into force of the new EFSF agreement and, at the same time, mandated that the resources available be used as efficiently as possible. Two leverage options were indicated: on the one hand the provision of credit enhancements to new debt issued by individual Member States to reduce the funding cost; on the other hand the establishment of one or more special purpose vehicles to combine existing public funds with private sector resources, which would accordingly augment the funds available for extending loans, for bank recapitalization and for buying bonds in the primary and secondary markets. As a result, the funds mobilized by the EFSF should

[5] *This means that a change in the rating of a guarantor may impact the rating of the EFSF.*

[6] *A detailed description of these two IMF instruments that mainly differ by their qualification requirements and conditionality is available at www.imf.org/external/np/exr/facts/eng/list.aspx (as retrieved on December 20, 2011).*

[7] *Hence, the share of Austria now amounts to around EUR 21.6 billion plus interest and cost.*

increase fourfold to fivefold. On November 29, 2011, the Eurogroup approved the terms and conditions of the leveraging options.[8]

Upon closer examination, it is striking that the EFSF has had to be modified several times already since June 2010: at first to ensure its creditworthiness, then to raise its effective lending capacity and finally to introduce new financial instruments. However, it would be overly simplistic to see the repeated adjustments as an outcome of structural deficiencies. In view of its extremely low capitalization, the strength of the EFSF unquestionably only relies on the quality of the underlying guarantees and therefore is affected by the different ratings of the guarantors and the related migration risk. Other challenges include the need to get investors to subscribe to bonds with different maturities, and the need to do so as a new market player in times of elevated volatility. At the same time, the EFSF must be credited for its ability to create a safety net in a very short time, which has already been used to support Ireland and Portugal in 2011. Within such a short period, it would simply not have been possible to create a more robust instrument that benefits from a higher rate of capitalization, like the ESM.

In contrast to the EFSF, the EFSM is a Community instrument, so that the relevant decisions need to be taken in line with EU-27 Community procedures. The EFSM is based on Article 122(2) TFEU, under which Member States which face difficulties caused by exceptional occurrences beyond their control may be granted financial support. The functioning of the EFSM is governed by a Council Regulation that was adopted at maximum speed and is modeled heavily on the existing instrument of EU BOP assistance.[9] Its funds are raised by the European Commission (on behalf of the EU) on the capital markets, and the guarantees are provided not directly by the Member States, but indirectly through the EU budget within the framework of its own resources ceiling. The lending capacity of the EFSM has been limited to EUR 60 billion. The underlying Regulation provides for a regular review on whether the exceptional circumstances still exist; in other words, the instrument was not designed to be a permanent mechanism. Most probably, the EFSM will have been phased out at the latest when the EFSF expires in mid-2013.

5 Permanent Crisis Mechanism for the Euro Area: ESM

Both the EFSF and the EFSM are to be replaced by the European Stability Mechanism (ESM) in the future. On October 28/29, 2010, the European Council already agreed on establishing a permanent crisis mechanism to safeguard the financial stability of the euro area. On November 28, 2010, the Eurogroup issued a statement defining the general characteristics of the ESM. It is to build on the existing rules and procedures of the EFSF: The ESM will provide financial assistance to euro area countries under strict conditionality. Unlike the EFSF, however, the rules will provide for ad hoc participation of private sector creditors. In order to facilitate the process, the countries of the euro area undertook to include collective action clauses (CACs) in the

[8] *www.efsf.europa.eu/attachments/efsf_terms_of_reference_maximising_the_capacity.pdf (as retrieved on December 20, 2011).*

[9] *Council Regulation (EU) No. 407/2010 of May 11, 2010 establishing a European financial stabilisation mechanism.*

terms and conditions for all new euro area government bonds to be issued after June 2013. Another new aspect is the fact that the ESM will claim a preferred creditor status without prejudice to the status traditionally accorded to the IMF.

The ESM is supported by the euro area countries. EU Member States acceding to the euro area in the future are explicitly expected to join the ESM, too.

Unlike the EFSF, the ESM has been set up as an international organization, i.e. by means of a treaty under international law (in Austria: state treaty under Article 50 paragraph 1 item 1 of the Bundes-Verfassungsgesetz – Federal Constitutional Law); therefore, its capital structure is in line with that of other international financial institutions, such as the International Bank for Reconstruction and Development (World Bank) and regional development banks. The authorized capital stock amounts to EUR 700 billion and, in analogy with other international financial institutions, is divided into paid-in and callable shares.[10] The nominal value of paid-in shares will total EUR 80 billion. Therefore, the ESM will operate in a way fundamentally different from the EFSF, whose low capital level had to be compensated by guarantees for individual bond issues. This mechanism is not required for the ESM; the high AAA credit rating needed is achieved on account of the high capital stock.

As in the case of the EFSF, the key decisions of the ESM (e.g. on the extension of loans) are to be taken by mutual agreement, i.e. unanimously. Access to financial assistance from the ESM is granted subject to strict policy conditionality and, on principle, under a macroeconomic adjustment program; beforehand, the European Commission, together with the IMF and in liaison with the ECB, is to perform a rigorous analysis of government debt sustainability. The beneficiary Member State is required to ensure adequate private sector involvement – taking account of the specific circumstances and fully in line with IMF practice. The ESM will have an effective lending capacity of EUR 500 billion.

In the case of the ESM, the European Commission and the ECB will again perform major tasks in monitoring program progress and ensuring coherence with EU budgetary surveillance. The expertise of the IMF will also be regularly used whenever possible.

The treaty establishing the ESM was signed on July 11, 2011, but again partly called into question by the decisions taken by the euro area Heads of State or Government on July 21, 2011. In particular, the creation of the new instruments mentioned above applies both to the EFSF and the ESM and, as a result, they also have to be introduced into the ESM treaty – thus, the ratification processes were postponed pending revision of the text.

In the past few months, political discussions especially focused on the question of how to adequately involve the private sector, given that the ESM is the first instrument for which private sector bail-in has been explicitly regulated. Some actors strongly criticize the approach adopted and consider it one of the causes of persistent uncertainty in the financial markets. This question was clarified in a statement of the euro area Heads of State or Government on December 9, 2011: "Concerning the involvement of the private sector, we will

[10] *The Austrian share is 2.7834% or almost EUR 19.5 billion, out of which approximately EUR 2.2 billion have to be paid in within five years of the ESM treaty's entry into force.*

strictly adhere to the well-established IMF principles and practices. This will be unambiguously reflected in the preamble of the treaty. We clearly reaffirm that the decisions taken on 21 July and 26/27 October concerning Greek debt are unique and exceptional."

The statement of December 9, 2011, also results in further changes, especially in the field of voting rules, which will also include an emergency procedure foreseeing decisions by a qualified majority of 85% in case the financial and economic sustainability of the euro area is threatened.

At the same time, an acceleration of the entry into force of the ESM was agreed (objective: July 2012).

Moreover, the issue of the external control of the ESM gains in importance. A key controversy was the fact that provisions are lacking on the involvement of national courts of auditors in addition to external and internal auditing. These requirements may be included in the revised ESM treaty. At any rate, this revision would also take account of the fact that, in view of the high budgetary expenditure, national parliaments should have broader information and control rights. Other controversies related to the relationship of the ESM to the EU treaties. Especially Germany demanded further specifications to be included in the TFEU – in the light of actions pending before the German Federal Constitutional Court. On March 25, 2011, the European Council adopted Decision 2011/199/EU amending Article 136 TFEU, thus added the following paragraph to Article 136: "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." According to the opinion of the Council Legal Service, this addition is not to be seen as the actual legal basis for the establishment of the ESM since it only acknowledges the right of the euro area countries to enter into a treaty under international law.

6 Conclusions

The developments outlined above show that, in the course of the debt crisis, a substantial deepening of European integration resulted from new crisis financing mechanisms, especially in the euro area.

Until recently, financial assistance mechanisms for euro area countries did not exist, and the idea of strengthening the European financial architecture was considered utopian, as can be seen from the fact that proposals put forth in 2009 to create a financial assistance facility in the amount of EUR 200 billion for the euro area countries as a lesson learnt from the Icelandic crisis and to prevent contagion effects (Nauschnigg, 2009) was considered unrealistic at that time. Yet the case of Greece put a process in motion in the course of which several mechanisms were established within an extremely short period to provide financial assistance to euro area countries in difficulty. These instruments will ultimately be replaced by a permanent crisis mechanism and a new addition to the institutional framework of the euro area: the ESM.

Financial support to Greece was still granted in the form of bilateral loans pooled by the euro area countries. Yet, these measures must be seen as an interim solution, pending the creation of permanent institutions in the long run. The EFSF that is available until mid-2013 is based on guarantees. Its swift establishment and configuration formed an important safety net that could be used for Ireland and Portugal

in 2011. But the guarantee concept involves deficiencies that have required several revisions since June 2010. The ESM will not be affected by this disadvantage because its capital structure is in analogy with that of other international financial institutions and in comparison with them, it has a high share of paid-in capital.

The financial assistance facilities that have been institutionalized permit orderly adjustments, reduce uncertainty among financial market actors and, as a result, reduce the vulnerability of European countries to financial crises. In the past, however, measures were very often taken only in the last moment and subject to domestic policy considerations, which significantly affected the impact of the actions in the financial markets. This gave the impression that policymakers were doing "too little, too late."

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Chronology of European Initiatives in Response to the Crisis[1,2]

Michaela Hajek-Rezaei[3]

Date	Institution or body	Action
Oct. 6/7, 2008	Ecofin/ Eurogroup	The EU finance ministers agree on a coordinated response to the financial crisis. The Ecofin Council endorses measures to support systemic financial institutions, strengthen the solvency and stability of the banking system, and protect savings deposits. These measures will be coordinated closely, public interventions will be determined jointly, and cross-border effects will be taken into account.
Oct. 8, 2008	European Commission	The President of the European Commission establishes a high-level group (de Larosière Group) to develop solutions for building a more effective European supervision for global financial institutions, currently supervised mainly at national level. The ultimate goal is to establish a European system of supervision and to enhance global cooperation.
Oct. 12, 2008	Euro Summit	At their emergency summit, the Heads of State or Government of the euro area countries reach agreement on further steps to restore confidence in, and proper functioning of the financial system. Their declaration on a concerted action plan establishes a list of measures to ensure liquidity for financial institutions and cooperation among European countries.
Oct. 13, 2008	European Commission	The European Commission releases a Communication giving guidance for Member States on how to support financial institutions in the current crisis without distorting competition and without violating EU state aid rules.
Oct. 15, 2008	European Commission	The European Commission proposes a revision to EU rules on deposit guarantee schemes. The new rules are designed to improve savings protection to maintain depositors' confidence in the financial safety net. The minimum level of compensation for deposits is to be increased within one year from EUR 20,000 to EUR 100,000. Member States can choose to apply higher minimum levels.
Oct. 15/16, 2008	European Council	The European Council welcomes the measures taken so far by the Member States, the ECB and the relevant central banks, and the fact that they have been coordinated well. The European Commission is invited to draft appropriate measures for an EU-wide economic recovery program by the end of 2008. The Ecofin Council is requested to define the modalities for establishing an informal crisis unit. The European Council expresses its resolution to seek further concerted and global action to protect taxpayers' interests, and strengthen European financial market rules and supervision.

[1] *For measures taken by the ECB in response to the crisis, see the Monthly Bulletins of the ECB (Chronology).*

[2] *To ensure a coherent response with regard to crisis financing measures and financial stability measures, some EU and euro area crisis measures were discussed also at the level of the G-20.*

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Date	Institution or body	Action
Oct. 29, 2008	European Commission	The European Commission sets out a coordinated action plan to tackle the crisis. This initiative calls for a new EU supervisory architecture for financial markets, efforts to create jobs and stimulate growth, as well as a globally coordinated response to the crisis.
Nov. 3, 2008	European Commission	The Commission Regulation adopting certain international accounting standards ensures that European banks can be as flexible as their American competitors in no longer having to take into consideration market fluctuations of certain assets in the balance sheet.
Nov. 4, 2008	Ecofin/ Eurogroup	The EU finance ministers discuss a comprehensive package of proposals for an international response to the financial crisis. The Ecofin Council adopts a decision to provide EUR 6.5 billion in financial assistance to Hungary. Together with the program money provided by the IMF (EUR 12.5 billion) and the World Bank (EUR 1 billion), the medium-term balance of payment assistance to Hungary totals EUR 20 billion.
Nov. 12, 2008	European Commission	The European Commission puts forward a proposal for a Regulation on credit rating agencies. The new rules are designed to ensure high quality credit ratings untainted by the conflicts of interest which are inherent to the rating business.
Nov. 26, 2008	European Commission	In a Communication, the European Commission proposes a comprehensive economic recovery plan with a number of initiatives to boost the economy in the short term, which are anchored in the Lisbon Strategy for Growth and Jobs and are partly based on the EU budget and partly on coordinated national measures.
Dec. 1/2, 2008	Ecofin/ Eurogroup	The EU finance ministers approve an economic stimulus package equivalent to 1.5% of EU GDP. The revised Stability and Growth Pact (SGP) with all the flexibility it offers provides an adequate framework for budgetary policies in Europe, consistent with the long-term sustainability of public finances. The Ecofin Council agrees on four key draft directives: Solvency II directive, capital requirements for banks, the rules governing undertakings for collective investments in transferable securities, and bank deposit guarantee systems. The Council approves of raising the lending ceiling to EUR 25 billion for EU balance of payments (BOP) assistance for Member States outside the euro area.
Dec. 8, 2008	European Commission	The European Commission publishes detailed guidance on how Member States can recapitalize banks to ensure adequate levels of lending to the real economy and stabilize financial markets whilst avoiding distortions of competition not in line with EU state aid rules.
Dec. 11/12, 2008	European Council	The European Council approves the European Economic Recovery Plan, equivalent to 1.5% of EU GDP (i.e. some EUR 200 billion). The plan provides a common framework for the efforts at EU level and the measures adopted by every single Member State and takes account of the respective national circumstances.

Date	Institution or body	Action
Jan. 20, 2009	Ecofin/ Eurogroup	The Ecofin Council adopts a decision to provide EUR 3.1 billion in financial assistance to Latvia. Together with the program money provided by the IMF (EUR 1.7 billion), the World Bank, the EBRD and several European countries, the medium-term BOP assistance to Latvia totals EUR 7.5 billion.
Jan. 26, 2009	European Commission	The European Commission adopts a set of decisions to strengthen the supervisory framework for EU financial markets, to improve supervisory cooperation and convergence between Member States, and to reinforce financial stability. Under the new rules, a clearer operational framework is established for the three supervisory authorities of the securities, banking and insurance sectors, and a more efficient decision-making processes is defined.
Feb. 25, 2009	European Commission	The de Larosière Group presents ambitious recommendations on cross-border financial supervision in the EU. Proposals include the Financial Stability Forum (FSF) to be put in charge of the coordination of international financial regulation, in close cooperation with the IMF. The Group also supports the swift establishment of global colleges of supervisors.
March 1, 2009	European Council	The EU Heads of State or Government agree on three lines of action: building confidence and promoting financial stability, getting the real economy back on track, and working together at the G-20 level. The European Council welcomes the support package for banks in Eastern Europe worth EUR 24.5 billion for 2009 and 2010, as adopted by the World Bank, the EBRD and the EIB.
March 10, 2009	Ecofin/ Eurogroup	The Ecofin Council adopts a decision to provide EUR 5 billion in financial assistance to Romania. Together with the program money provided by the IMF (EUR 13 billion), the World Bank, the EBRD and other countries, the medium-term BOP assistance to Romania totals EUR 18 billion.
March 19/20, 2009	European Council	The European Council expresses confidence in the ability of the EU to tackle the financial and economic crisis. Reviewing the fiscal stimulus package, it emphasizes that concerted action and coordination are essential to Europe's strategy for recovery. By acting together, the EU can put its financial sector on a sound footing, get credit flowing to the real economy, and protect its citizens from the worst impact of the crisis.
May 5, 2009	Ecofin/ Eurogroup	The lending ceiling for EU BOP assistance to non-euro area Member States is increased to EUR 50 billion.
May 27, 2009	European Commission	The European Commission presents a Communication on European financial supervision, proposing a set of ambitious reforms to the current architecture of financial services committees, which is based on recommendations of the de Larosière Group.
June 9, 2009	Ecofin	The Ecofin Council approves conclusions on the reform of the EU's supervisory framework for financial services. The reforms involve the creation of a European Systemic Risk Board (ESRB) tasked with assessing the stability of the financial system as a whole and of a European System of Financial Supervisors (ESFS), consisting of three European supervisory authorities that deal with the banking, insurance and securities industries and work together with national supervisors.

Date	Institution or body	Action
June 18/19, 2009	European Council	The Heads of State or Government support the establishment of the ESRB and the ESFS, as announced by the Ecofin Council on June 9, 2009.
July 3, 2009	European Commission	The European Commission adopts a Communication on the role played by derivatives in the financial crisis and on solutions for reducing risks that may arise in derivative markets.
July 13, 2009	European Commission	The European Commission adopts a proposal to further amend the Capital Requirements Directive for banks. The proposed amendments address capital requirements for the trading book and resecuritizations, disclosure of securitization exposures, and remuneration policies. The purpose of the amendment is to strengthen the regulatory framework in areas in which the financial crisis emerged and from which it spilled over.
Sep. 23, 2009	European Commission	The European Commission submits its legislative proposals for the creation of an EU-wide system of supervision: the ESRB and the ESFS.
October 20, 2009	Ecofin/ Eurogroup	The Ecofin Council reaches broad agreement on the contents of draft legislative proposals to establish the ESRB.
October 29/30, 2009	European Council	The European Council agrees on the need to prepare a coordinated strategy for exiting from broad-based stimulus policies when recovery is secured.
November 9/10, 2009	Ecofin/ Eurogroup	The Ecofin Council adopts the Solvency II Directive, setting new solvency rules for insurance companies. The EU finance ministers agree on a general approach on stricter capital requirements for banks and stricter remuneration policies in the banking sector. The Ecofin Council also adopts conclusions on the sustainability of public finances and specifies guidelines for exiting from economic stimulus programs.
Nov. 17, 2009	European Commission, Council, European Parliament	The Regulation on credit rating agencies is adopted to ensure that rating agencies act in accordance with the principles of integrity, transparency, responsibility and good governance, i.e. that they comply with high standards which will be monitored on an ongoing basis.
Jan. 18/19, 2010	Ecofin/ Eurogroup	The Ecofin Council adopts conclusions on government deficit and debt statistics in Greece, following a report from Eurostat. It calls on the European Commission to propose measures that will bring the Greek statistical system into line with EU requirements.
Feb. 11, 2010	European Council/ Euro Summit	Euro area members will take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole. The Greek government is called upon to implement the stability program for 2010 in a rigorous and determined manner.
Feb. 16, 2010	Ecofin/ Eurogroup	The Ecofin Council calls on Greece to correct its excessive deficit by 2012, and to bring down its deficit by at least 4% in 2010 (from a deficit of 12% in 2009). Greece is asked to submit quarterly reports for this process to be monitored.

Date	Institution or body	Action
March 25/26, 2010	European Council/ Euro Summit	The Heads of State or Government reaffirm that all euro area members must conduct sound national policies in line with the agreed rules and should be aware of their shared responsibility for economic and financial stability. They fully support the efforts of the Greek government and welcome the additional measures announced on March 3, 2010, to safeguard the 2010 budgetary targets. Euro area member states stand ready to contribute bilateral loans, on top of IMF funding, to support Greece in implementing its adjustment program. The European Council asks the President of the European Council to establish, in cooperation with the European Commission, a Task Force on Economic Governance, which is to work out recommendations for improving crisis management and budgetary discipline.
April 11, 2010	Eurogroup	Greece will receive bilateral loans of up to EUR 80 billion from euro area countries. Disbursements are subject to strong conditionality, need to be based on an assessment by the European Commission and the ECB, and must be agreed unanimously by the euro area member states. Participation shall be based on the ECB capital key.
May 8, 2010	European Council/ Euro Summit	The Heads of State or Government of the euro area countries agree on a three-year support package for Greece totaling EUR 110 billion (EUR 80 billion in pooled bilateral loans from the euro area countries, EUR 30 billion from the IMF). In response to the crisis, the Heads of State or Government reaffirm their commitment to accelerated consolidation and sustainability of public finances, strict enforcement of recommendations under the SGP, the creation of a European Stability Mechanism (ESM) and the strengthening of economic governance and financial market regulation.
May 9/10, 2010	Ecofin/ Eurogroup	The Ecofin Council adopts a resolution on launching a European Financial Stabilisation Mechanism (EFSM) with a funding volume of EUR 60 billion. Moreover, the euro area ministers decide on establishing the European Financial Stability Facility (EFSF), a special-purpose vehicle backed by guarantee commitments (with a lending capacity of up to EUR 440 billion) from the participating Member States on a pro-rata basis reflecting the ECB capital key. The EFSF will be a temporary facility to be dissolved after three years. A levy on banks or a financial transaction tax is considered. Plans for consolidating budgets and structural reforms are to be accelerated, and Spain's and Portugal's consolidation measures are welcomed.
May 17/18, 2010	Ecofin/ Eurogroup	The Ecofin Council agrees on a draft directive on alternative investment funds, such as hedge funds and private equity, and adopts conclusions on the unwinding of government guarantee schemes for banks.
May 21, 2010	Task Force on Economic Governance	First meeting of the Task Force on Economic Governance, which is composed of representatives of all Member States, the Commission and the ECB. The task force is to come up with proposals for achieving greater budgetary discipline through a strengthened SGP, creating an effective crisis mechanism and strengthening economic governance within the EU.

Date	Institution or body	Action
July 23, 2010	Committee of European Banking Supervisors (CEBS)	In cooperation with the ECB, the European Commission, national bank supervisors and central banks, CEBS conducts a first EU-wide stress testing exercises with banks, as mandated by Ecofin.
Sep. 7, 2010	Ecofin/ Eurogroup	The Ecofin Council endorses changes to the manner in which the SGP is implemented and introduces a "European semester" as from 2011. The European semester is a six-month period, starting each year in January, during which the European Council gives policy guidance to the individual EU countries.
Sep. 29, 2010	European Commission	The European Commission adopts a legislative package consisting of six proposals ("six-pack") for broadly reinforcing economic governance in the EU and the euro area. The proposals provide for broader and enhanced surveillance of fiscal, macroeconomic and structural reform policies, in the light of the shortcomings of the existing legislation. For noncompliant Member States, new enforcement mechanisms are foreseen. The proposals are also coordinated with the work of the Task Force on Economic Governance.
Oct. 21, 2010	European Council	The final report of the Task Force on Economic Governance is submitted to the European Council. Implementation of the recommendations will strengthen fiscal discipline, broaden economic surveillance, achieve deeper and broader coordination and create a robust framework for crisis management.
Oct. 28/29, 2010	Euro Summit	The Heads of State or Government of the euro area countries endorse the final report of the Task Force on Economic Governance. They also agree on establishing a permanent crisis mechanism and invite the European Commission to undertake consultations with the Ecofin Council to this end.
Nov. 24, 2010	European Commission, Council, European Parliament	Adoption of provisions amending financial services legislation to ensure effective operation of the European System of Financial Supervisors (ESFS).
Nov. 27/28, 2010	Ecofin/ Eurogroup	The EU and the IMF will provide financial assistance to Ireland worth some EUR 85 billion over 36 months (EFSM: EUR 22.5 billion; EFSF including bilateral loans from the U.K., Sweden and Denmark: EUR 22.5 billion; IMF: EUR 22.5 billion; Irish National Pension Reserve Fund: EUR 17.5 billion). The Ecofin Council approves the framework for the prospective permanent ESM. The ESM will provide liquidity assistance to euro area Member States in distress and allow for the participation of private creditors. This mechanism will replace the EFSF and the EFSM and come into force in mid-2013.
Dec. 16, 2010	European Systemic Risk Board (ESRB)	The ESRB, based in Frankfurt, comes into force. Its chair is the president of the ECB, its vice chair the governor of the Bank of England. The ESRB is an independent EU body responsible for the macroprudential oversight of the financial system within the EU. As an early warning system it will contribute to the early identification of systemic crises.

Date	Institution or body	Action
Dec. 16/17, 2010	European Council/ Euro Summit	The Heads of State or Government of the EU countries endorse the creation of the ESM.
Jan. 1, 2011	European Banking Authority (EBA)	The three European supervisory authorities take up their work: the London-based European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) based in Frankfurt, and the European Insurance and Occupational Pension Authority (EIOPA) based in Paris.
Jan. 17/18, 2011	Ecofin/ Eurogroup	The Ecofin starts implementation of the European semester 2011. It examines the Annual Growth Survey of the European Commission and draws lessons from the assessment of Member States' draft National Reform Programmes.
Feb. 3/4, 2011	European Council/ Euro Summit	The Heads of State or Government of the euro area countries reaffirm their strategy of maintaining financial stability and strengthening the euro area, which includes measures related to the reform of economic governance ("six-pack"), stress testing exercises for banks and financial sector repair. The Ecofin Council is urged to agree on a way forward regarding the European Commission's legislative proposals on economic governance in March while ensuring the strict enforcement of the recommendations made by the Task Force on Economic Governance. Germany and France present a "Pact for Competitiveness," now called "Euro Plus Pact," and are critiziced for their initiative being bilateral.
March 11, 2011	Euro Summit	The participants in the Euro Summit endorse the Euro Plus Pact, which establishes stronger economic policy coordination for competitiveness and convergence. The Euro Plus Pact builds on the European semester, the ESM as well as the reform of the SGP under the "six-pack" legislation. 17 euro area countries as well as Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania join the Euro Plus Pact.
March 14/15, 2011	Ecofin	The Ecofin Council reaches agreement on the "six-pack" legislation to improve EU economic governance.
March 24/25, 2011	European Council	The Heads of State or Government of the EU Member States adopt a comprehensive set of measures in response to the crisis: 1. The interim results of the European semester 2011 are assessed positively. All Member States will implement fiscal consolidation and structural reform through concrete measures as defined in their respective programs. 2. Agreement is reached on the "six-pack." 3. The Euro Plus Pact is confirmed. 4. The peer review process is very important on which the prospective banking stress tests are based in close cooperation with national supervisors, the ESRB, the European Commission and the ECB. 5. A Tax on financial transactions is to be investigated further. 6. Agreement exists on amending the Treaty of Lisbon to reflect the creation of the ESM.

Date	Institution or body	Action
May 16/17, 2011	Ecofin/ Eurogroup	The Ecofin Council adopts a decision on financial assistance to Portugal. The financial assistance package amounts to EUR 78 billion (EFSM: EUR 26 billion, EFSF: EUR 26 billion, IMF: EUR 26 billion). The aid will be provided on the basis of a three-year policy program, which stipulates the reduction of the general government deficit to below 3% of GDP by 2013. The Ecofin Council agrees on a draft regulation on short selling and credit default swaps, which is to introduce transparency requirements and harmonize the powers that regulators may use in exceptional situations. The Ecofin Council approves guiding principles on backstop measures to support financial institutions which prove vulnerable in the EU-wide stress testing exercise.
June 7, 2011	European Commission	The European Commission adopts 27 sets of recommendations to Member States in relation to their economic policies and their fiscal consolidation policies. Following the adoption of these recommendations, the June European Council may conclude the first European semester of economic policy coordination. It will now be up to the individual EU countries to act on the country-specific guidance and adjust their budgets for 2011 and 2012 accordingly.
June 19/20, 2011	Ecofin/ Eurogroup	The EU finance ministers approve the Commission's recommendations on Member States' 27 National Reform Programmes and fiscal policies, thus concluding the European semester.
June 24, 2011	European Council/ Euro Summit	The European Council delares its readiness to disburse the second tranche to meet Greece's financing needs in July 2011 and to set up a second financial support package for Greece financed through both official and private sources.
July 11, 2011	Eurogroup	The finance ministers of the euro area countries discuss the parameters of a multi-annual adjustment program for Greece. The finance ministers sign the ESM treaty. Following the ratification process, the ESM will become fully operational in 2013.
July 21, 2011	Euro Summit	The Heads of State or Government of the euro area countries reaffirm their commitment to the euro and their determination to do whatever is needed to ensure the financial stability of the euro area as a whole and its Member States. They agree to support a new program for Greece, together with the IMF, and voluntary contributions from the private sector. The second financial support package will amount to some EUR 109 billion. This program has been designed to decisively improve the debt sustainability and refinancing profile of Greece, notably through lower interest rates and extended maturities. The members of the Euro Summit call on the IMF to continue to contribute to fund the new program. Ireland and Portugal will receive EFSF assistance for the same interest rate and maturity conditions as Greece.

Date	Institution or body	Action
Aug. 16, 2011	Franco-German Summit	In a joint letter to European Council President Herman Van Rompuy, France and Germany demand closer economic policy coordination in the euro area as the prerequisite for further EU-wide financial support measures as well as the introduction, at the constitutional level, of binding upper limits for the level that the structural deficit may reach annually ("debt brake"). The heads of government of France and Germany also propose to establish a European Economic Council, which is to meet at least twice a year under the chairmanship of the President of the European Council. Both France and Germany are opposed to the introduction of eurobonds.
Oct. 3/4, 2011	Ecofin/ Eurogroup	The EU/euro area finance ministers agree on a draft regulation aimed at increasing transparency and reducing the risk in over-the-counter derivates markets.
Oct. 26, 2011	European Council/ Euro Summit	The Heads of State or Government of the EU agree on a comprehensive set of measures to restore confidence and to overcome the present tensions on financial markets. 1. A new multiannual EU/IMF program for Greece ensuring the provision of up to EUR 100 billion, subject to reinforced monitoring and implementation mechanisms. 2. Leveraging the resources of the EFSF to up to EUR 1,000 billion by providing risk insurance and a combination of resources from private and public financial institutions and investors through special purpose vehicles, without increasing the amount guaranteed by the Member States. 3. Increasing capital ratio requirements for banks to 9% of tier 1 capital by end-June 2012. 4. Ensuring budgetary discipline and accelerating structural reforms for growth and employment. 5. Significantly strengthening economic and fiscal policy coordination and surveillance. 6. Ten measures to improve governance in the euro area.
Nov. 7/8, 2011	Ecofin/ Eurogroup	The EU/euro area finance ministers adopt conclusions on the design of the scoreboard of economic indicators to detect macroeconomic imbalances. The Ecofin Council takes note of a proposal by the European Commission for a directive aimed at introducing a financial transaction tax in the EU.
Nov. 15, 2011	European Commission	The most recent developments in the sovereign debt crisis in the euro area have shown the inadequacy of the existing regulatory framework. The European Commission therefore presents two new proposals on economic governance ("two-pack") on monitoring and assessing the draft budgets of euro area countries and the fiscal supervision of those euro area countries whose financial stability is in jeopardy.
Nov. 30, 2011	Ecofin/ Eurogroup	The Ecofin opens the 2012 European semester. It examines the Annual Growth Survey of the European Commission and draws lessons from the assessment of Member States' draft National Reform Programmes.

Date	Institution or body	Action
Dec. 9, 2011	European Council	26 EU Member States (except the United Kingdom) agree to establish a "fiscal stability union" by means of an intergovernmental agreement. This is a first step towards reinforcing the economic pillar of the euro area, which essentially reinforces surveillance of national budgetary discipline and the coordination of fiscal policies. The annual structural deficit of national budgets should not exceed 0.5% of the respective nominal GDP. This "debt brake" rule, including an automatic correction mechanism, is to be incorporated into national constitutional law. Compliance is to be assessed by the European Court of Justice.
Dec. 19, 2011	Ecofin/ Eurogroup	The finance ministers of the euro area countries agree to provide EUR 150 billion in the form of bilateral loans to bolster the funding capacity of the IMF. In addition, the Czech Republic, Denmark, Poland and Sweden also pledge to increase their contributions.

Notes

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