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Reforming Fiscal Policy Rules for the Euro Area[1]

Fiscal policy rules have taken centre stage when discussing the origins and consequences of the crisis in the euro area. This is obvious for Greece and Portugal but quite a few other euro area Member States also suffer from a reckless fiscal policy in the past, i.e., before the economic crisis in 2009.

The introduction of the euro demolished barriers between European capital markets, freed from currency risks. In light of the increasing capital movements, especially from rich to poor countries, governments too often showed little fiscal discipline within the euro area in spite of the Stability and Growth Pact. In fact, the Pact has never been taken seriously but has been weakened in the midst of the past decade, not least due to the demands by France and Germany. As a reaction of the crisis in the euro area, the EU enacted several voluminous rescue plans in an ad hoc manner. Not until March 2011, a European Stability Mechanism (ESM) was put in place.

Therefore, two major questions arise:

– How should the Stability and Growth Pact be reformed in order to ensure sustainability of public finances?
– How should an ESM be designed in order to really safeguard the stability of the euro area as a whole?

In what follows, I shall deal with these questions in turn. As a basis of my considerations, I use the annual report 2010/11 of the German Council of Economic Experts (GCEE).

Reform of the Stability and Growth Pact (SGP)

The SGP needs to be tightened in such a way that timely and effective sanctions are imposed on countries pursuing an unsound fiscal policy. This will also necessitate strengthening the European Commission's position vis-à-vis the European Council. The failure of

the SGP to ensure fiscal discipline is the consequence of the dominant role of the Economic and Financial Affairs Council (EcoFin). Members of the EcoFin can block the imposition of sanctions for reasons of political suitability. In fact, until 2010 the records of the European Union show nearly hundred cases (countries and years) of deficits above 3%.[2] Only less than one third of these may be attributed to a large domestic recession and could therefore be justified on the basis of the SGP. To put it the other way around, in roughly two thirds of cases the SGP was violated. But sanctions have never been imposed due to several hideouts in the regulations of the SGP and due to

[1] *This contribution draws on the annual report 2010/11 of the German Council of Economic Experts. The opinions expressed here are not necessarily shared by all members of the Council.*

[2] *European Economic Advisory Group (2011), p. 79.*

the fact that potential sinners judged actual sinners.

In order to overcome this major deficiency, the most promising measure would be to reform the SGP by introducing sanctions which are automatically imposed on a country if certain thresholds regarding its public deficit and a deadline to sufficiently reduce it are exceeded. But this first best solution is anything but realistic if not naïve. Therefore, the GCEE has proposed a second best procedure hereby strengthening the role of the European Commission. More specifically, our suggestion rests on a reversed voting procedure: The European Commission proposes sanctions which can only be rejected by the Council with a qualified majority (within a given time period). It can be shown that such a reverse voting rule significantly increases the probability that sanctions are imposed.[3]

To what extent do the planned reforms of the SGP meet these requirements? In October 2010, the European Council endorsed the recommendations by the Van Rompuy Task Force. With respect to excessive deficits its suggested procedure is the following:

- In the preventive part of the SGP, if the state significantly deviates from the adjustment path foreseen in the SGP and also fails to take appropriate action within five months, the European Council will state this on the basis of a qualified majority. Then, by using a reversed majority rule, an interest-bearing deposit will be imposed.
- In the corrective part of the SGP, if the European Council decides by a qualified majority that the Member State has not taken effective action to correct the excessive deficit within a given deadline, a fine will be applied, if not ruled out by reverse majority rule.

The most important drawback is that in the first stage the European Council decides by qualified majority whether the state has undertaken effective action. Since Council members know the consequences of this first stage decision there is every reason to expect that they are very reluctant to vote against the state in question, to say the least. By and large, with respect to sanctions we would be back to the present SGP. In a draft report of January 2011, however, the European Parliament is in favour of much more convincing proposals made by the European Commission: The Commission asks for a sanction which can be rejected by the Council only by reverse voting.

This is not to say that the planned reform of the SGP does not have its merits. Most noteworthy is that more weight is put on the public debt ratio. More precisely, both the European Commission and the European Parliament suggest the following rule: An excessive ratio of government debt to gross domestic product is only to be considered sufficiently diminishing if the differential with respect to 60% has been reduced over the previous three years at an average rate of the order of one twentieth per year. What does that mean in practice? Take the Italian debt ratio of 120% as an example. It exceeds the reference value for 60%. Hence, Italy has to reduce its debt ratio at an annual average rate of 3 percentage points, i.e., if starting in 2011, Italy's debt ratio in 2014 would be 9 percentage points lower (111%). But again, the lack of automatic sanctions casts doubt on the effectiveness of this ambitious measure.

[3] *German Council of Economic Experts (2010), pp. 91 (box 8).*

Reforming the SGP in an efficient manner will, indeed, make a new European debt crisis much less likely, but the conclusions of the European Council cast doubt on whether a really tough SGP will be enacted. Moreover, we cannot be sure that neurotic financial markets will attack the euro anyway. Therefore, a crisis mechanism is warranted in addition to measures ensuring a stable private financial system (which is not my topic here). This leads me to my second question, namely how to design an efficient European crisis resolution mechanism.

European Crisis Mechanism

When the European Monetary Union was established, no institutional rules for crisis scenarios were agreed beyond the no-bail-out clause. The SGP was considered sufficient to guarantee stable public finances. This turned out to be a tremendous mistake. Hence, in May 2010 gigantic rescue shields were set up overnight without having been preceded by and based on detailed political and scientific debate. In order to obviate such abrupt and arbitrary operations in the future, it is vital to put in place a permanent European crisis mechanism to replace the temporary protective shields. This by no means is a request for simple bail-outs for countries with a reckless fiscal policy. Such a mechanism should only provide support to Member States if absolutely necessary to safeguard the euro area as a whole, to repeat: as a whole. Moreover, strong conditionality and burden sharing with the private sector are indispensable.

In March 2011, the European Council agreed upon a new permanent crisis mechanism, the European Stability Mechanism (ESM), assuming the European Financial Stability Facility (EFSF) in 2013. At the time of this writing (1 May, 2011), the European Parliament as well as national parliaments are deeply concerned with the conclusions of the European Council. Hence, those conclusions might be subject to changes. Indeed, serious improvements of the ESM are absolutely necessary. A very brief look at the details of the ESM serves as a prerequisite for an informed discussion.

According to the European Council, the ESM is to be activated if it is indispensable to safeguard the stability of the euro area as a whole. Some emphasis should be put on indispensable and euro area as a whole. While this phrasing is open to interpretation, reinterpretation, and redefining, the intention rightly aims at establishing a useful safety device.

The funding of the ESM amounts to EUR 700 billion with an effective lending capacity of EUR 500 billion. The capital base of EUR 700 billion consists of EUR 80 billion paid-in capital, being phased in between 2013 and 2017,

and of EUR 620 billion callable capital, i.e., the fund can ask shareholders to supply new capital if existing capital gets wiped out. The instruments of the ESM are twofold: Firstly, the ESM Stability Support (ESS) provides loans whose maturity depends on the nature of the imbalances and the prospects of

the beneficiary state regaining access to financial markets. Secondly, there is a primary market support facility to allow the fund to purchase government bonds directly from the state at stake rather than on the secondary market.

On request for financial support by a Member State, both the EU Commission and the International Monetary Fund (IMF) in liaison with the European Central Bank (ECB) assess the actual funding needs and negotiate a macro-economic adjustment programme. The result has to be adopted by the EU Council unanimously. This unanimity serves as a second safety device.

Private sector involvement is carried out only on a case by case basis, depending on the outcome of a debt sustainability analysis. Sustainability requires that the borrower is expected to continue serving their debt without an unrealistic large correction of their income and expenditure. If it is concluded, on the basis of a sustainability

analysis, that the macro-economic programme cannot realistically restore public debt to a sustainable path, the granting of financial assistance will then be contingent on the beneficiary state demonstrating sufficient commitment to ensure adequate and proportionate private sector involvement. Collective Action Clauses (CAC) will be included in all new euro area government securities.

Taken together, there is good news, bad news, and really bad news.

– Good news: A permanent crisis resolution after the EFSF is a good idea as long as the restrictions indispensable and euro area as a whole are taken seriously.
– Bad news: It is unclear how the problem is tackled if a Member State cannot honour its commitment due to excessive public debt, i.e., the “can’t pay, won’t pay”-case (Münchau, 2011).
– Really bad news: The regulations concerning private sector involvement are completely insufficient, in all practical cases burden sharing with the private sector is out of question. It is unacceptable to leave this to a case by case basis subject to interpretation due to the choice of words such as realistic, expected, and the like in the conclusion of the European Council.

Therefore, the ESM has to be renegotiated. Some guidance how to overcome the aforementioned deficiencies may be obtained from the German Council of Economic Experts’ proposal.

The GCEE sets up a precise framework which does not leave much room for interpretation. The mechanism suggested by the GCEE must provide support to Member States in the event of serious capital market disruptions without giving investors the impression that the Community will always bail out states. More precisely, the GCEE distinguishes three cases:

Case I: The state requesting support is not in an excessive deficit procedure. Financial support can be granted if endorsed by the European Council.

Case II: The state is in an excessive deficit procedure but not subject to sanc-

tions. Financial support can be granted if a majority of the European Council representing at least 90% of the population of the euro area agrees, and strict macro-economic conditions are imposed.

Involvement of the private sector is warranted but not conclusive.

Case III: The state was subject to sanctions during the past four years. In extension to the former case, involvement of the private sector is inevitably required, the magnitude of which depending on the sovereign debt ratio.

The challenge to the euro area is to establish a credible rescue strategy which, on the one hand, strictly binds private investors and, on the other hand, prevents the euro system from turbulences of a grand scale. Despite some progress, the ESM as it stands does not yet meet these requirements.

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