EU responses to the recent crises

Lecture 8

LIUC 2012

EU response

1) EU Economic Governance – reform (Six-Pack, Fiscal compact, Two-Pack)

- Stronger SGP
- Minimum requirement national fiscal framework
- Macroeconomic surveillance
- Fiscal Compact (Rules plus independent fiscal watchdog)

2) Repair and safeguard measures

- Financial sector repair

3) Stability mechanisms

- Temporary financial backstop mechanisms (EFSM, EFSF)
- European Stability Mechanism (ESM)
- Financial assistance

1 The Stability and Growth Pact (SGP)

- The SGP is a **rule-based** framework for the co-ordination of national fiscal policies in the economic and monetary union (EMU).
- It was established in 1997 as an instrument to **reinforce** the Treaty on Monetary Union. Revised in 2005 and also in 2011 (through the Six-Pack, i.e. 5 Regulations and a Directive).
- The Pact consists of a **preventive** and a **dissuasive** arm.
- The **medium-term budgetary objective** (MTO) is a crucial element of this framework.

- While the Treaty defines reference values for deficit (3%) and debt (60%), the SGP defines specific budget target for the medium-term.
- The MTO represents the budgetary position that **safeguards against the risk of breaching the 3%** of GDP threshold and ensures the long-term sustainability of public finances
- In the original SGP, all Member States were expected to pursue the attainment of a budgetary position **close-to-balance or in surplus (CTBOIS)** in the medium-term.
- The reform of the SGP in 2005 clarified that MTO should be interpreted in **structural terms (cyclically adj and net of one-off measures)** and **differentiated** to take into account country specificities: public debt, potential growth, and implicit government liabilities associated with rising expenditure due to ageing population.

- MSs must submit annual **Stability or Convergence programmes**, showing how they intend to achieve or safeguard sound fiscal positions in the medium term, taking into account the impending budgetary impact of aging population.
- The Commission assesses these programmes and the Council gives its **opinion** on them.

The SCP must contain the following information:

- The MTO adopted by the government (that cannot be less ambitious than the one calculated by EU Commission under the SGP legislation);
- the adjustment path towards the MTO and the expected path of the debt ratio;
- the underlying economic assumptions;
- policy measures to achieve the programme objectives;
- an analysis of how changes in the main assumptions would affect the budgetary and debt position (sensitivity analysis);
- the medium-term monetary policy objectives and their relationship to price and exchange rate stability (*for non-euro-area countries only*)

Stability and convergence programmes (cont.)

- The timeframe for the programmes has been revised with the institution of the **European semester**, for a true *ex-ante* policy co-ordination
- Under the new rules, the Council examines the MSs programmes in May and delivers **recommendations** based on assessments by the EU Commission and the Economic and Financial Committee (EFC).
- On the basis of this analysis, the Council opinion may suggest **policy action** to be taken by the country in question, while drafting the budget for the following year, or even **the revision** of the programme
- Before the establishment of the European Semester, the EU Council had **no impact** on the MSs budget preparation for the following year (poor and unsatisfactory *ex-post* policy co-ordination).

- **Stronger preventive action**: MSs are required to make significant progress towards medium-term budgetary objectives (MTO). Expenditure benchmarks will now be used alongside the structural budget balance to assess adjustments towards the MTO. An interest-bearing deposit of 0.2% of GDP will be imposed on non-compliant euro-area countries.

The Pact dissuasive arm – The EDP

- The **EDP (Excessive Deficit Procedure)** is established in the Treaty and specified in the SGP legislation.

- The EDP is triggered by the **deficit breaching** the 3% of GDP threshold of the Treaty, **or** by the **breaching of the requirement** for a satisfactory pace of debt reduction toward the reference threshold (60%) (after the 2011 revision).

- If it is decided that the deficit is excessive in the meaning of the Treaty, the Council issues **recommendations** to the Member States concerned to correct the excessive deficit and gives a timeframe for doing so.

- Non compliance with the recommendations triggers further steps in the procedures, including for euro area Member States the possibility of **sanctions**.

Stronger SGP: corrective arm

- **Stronger corrective action:** the EDP, **under the 2011 revision (Six-Pack),** can now result from government debt developments, as well as from government deficit.
- Member States with debt in excess of 60% of GDP should reduce their debt in line with a benchmark (at an average rate of one twentieth per year).
- Progressive financial sanctions kick in at an earlier stage of the EDP. A non-interest-bearing deposit of 0.2% of GDP may be requested from a euro-area country which is placed in EDP
- Failure of a euro-area country to comply with recommendations for corrective action will result in a fine.

Minimum requirement for national fiscal framework

- Member States should ensure that their fiscal frameworks are in line with **minimum quality standards** and cover all administrative levels (defined in the Six-Pack).
- National fiscal planning should adopt a **multi-annual perspective (MTBF)**, so as to attain the MTO.
- **Numerical fiscal rules** are to be in place to promote compliance with the Treaty reference values for deficit and debt.
- Independent national bodies (known as **fiscal councils**) shall monitor the effective and timely compliance with the numerical fiscal rules.

- MSs have made economic choices which have lead to competitiveness divergences and macroeconomic imbalances within the EU. A **new surveillance** mechanism will aim to prevent and correct such divergences. It will rely on an alert system that uses a **scoreboard** of indicators and in-depth country studies, strict rules in the form of a new Excessive Imbalance Procedure (EIP) and better enforcement in the form of financial sanctions for Member States which do not follow up on recommendations.

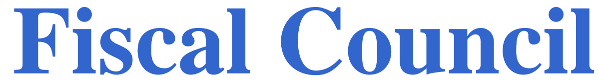
Treaty on Stability, Co-ordination, and Growth (or Fiscal Compact)

- It is an international Treaty, **not** a EU piece of legislation, signed in March 2012 by 25 EU MSs.
- It imposes **two fiscal rules to** Contracting Parties:
- The budgetary position of the general government of a Contracting Party shall be **balanced or in surplus**; the rule shall be deemed to be respected if the annual **structural balance** of the general government is at its country-specific medium-term objective (**MTO**), as defined in the revised Stability and Growth Pact. This rule shall take effect in the national law of the Contracting Parties at the latest one year after the entry into force of the Treaty through provisions of binding force and permanent character, **preferably constitutional**

- When the ratio of a Contracting Party's debt to GDP exceeds the 60% reference value, that Contracting Party shall reduce it at an average rate of one twentieth per year as a benchmark, as provided by Council Regulation (EU) No 1177/2011 (part of the Six-pack).
- An **independent institution** responsible at national level for monitoring compliance with the first rule is envisaged.
- The Treaty shall **enter into force on 1 January 2013**, provided that twelve Contracting Parties whose currency is the euro have ratified it (i.e. approved by Parliament).
- Why an international Treaty? The fastest way to introduce binding rules without waiting for the long procedure required to amend the European Monetary Union Treaties.
- The rules will be transposed into EU legislation in 5 years

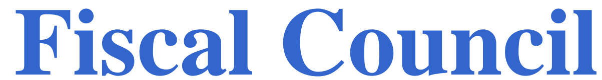
A model of fiscal discipline: fiscal rules and a national fiscal watchdog

- To prevent other crisis like the current one, triggered by external factors (US financial sector crisis), but exacerbated by budget imbalances in many MSs, the EU Union has adopted a strict fiscal discipline model, based on **numerical fiscal rules (including the balanced budget rule in structural terms)** plus **independent national fiscal watchdog!**
- These institutions are called fiscal councils



Fiscal Council

- Fiscal councils (FC) are nonpartisan bodies, publicly financed, established to actively inform the public debate on fiscal policy. Their tasks generally involve public assessments of fiscal policy, but can also include the preparation of macroeconomic and budgetary forecasts, and costing of specific policy initiatives.
- A FC's main purpose is to limit the "deficit bias" and pro-cyclicality that characterize the fiscal stance of many countries, by raising the reputational costs for policymakers in case of deviation from public commitments to sound fiscal policy.
- Therefore it does not punish the government in case of unsound policies: only electors, informed by the FC, can punish the government in the political elections.



- They are not involved in the design and/or management of national fiscal policy.
- They differ from audit offices (economic forward looking analysis versus legal backward looking analysis) and from think tanks (for their unlimited access to economic ministry's info and data)
- Their action is complementary to external surveillance carried out by international institutions, such as EU Commission.
- The establishment of a FC in each MS is envisaged by the Six Pack, the Fiscal Compact and also the Two-Pack.

Two-Pack provisions

- It consists of two new EU Regulations, not yet entered into force, with the aim at strengthening fiscal discipline in MSs.
- Main provisions:
  - The creation of a national fiscal watchdog, to be entrusted with fiscal surveillance tasks, is mandatory.
  - Macroeconomic projections for budget purposes must be produced or endorsed by the national fiscal council (empirical evidence shows that overly optimistic government's projections are source of deficit bias)
  - National medium-term fiscal plans and draft budgets of MSs must indicate whether budgetary projections have been produced or endorsed by the fiscal council
  - Draft budget law of MSs must be submitted to the Union's institutions before parliamentary discussion

2 Financial sector repair

- The EU established a new financial supervision architecture in January 2011. It includes:
  - A European Systemic Risk Board (ESRB) for macro-prudential oversight of the financial system
  - Three European supervisory authorities: the European Banking Authority, the European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority.
  - Rules have also been tightened on capital requirements for banks, investment firms and insurance companies, and new rules on remuneration and bonuses will reduce incentives for short-term risk-taking.

- To safeguard EU financial stability amid severe tensions in euro-area sovereign debt markets, in May 2010, the European Union and euro area Member States set up a stabilization mechanism that consists of:
  - **the European Financial Stabilization Mechanism (EFSM);**
  - **the European Financial Stability Facility (EFSF).**
- In addition, in October 2012 the **European Stability Mechanism (ESM)** was inaugurated.
- Note that financial assistance is linked to macroeconomic **conditionality**!
- Note that alongside the EFSM, EFSF and ESM, funding from the IMF and possible ECB purchases of sovereign debt on secondary markets are available, forming a viable safety-net, providing financial stability support.

European Financial Stabilisation Mechanism (EFSM)

- EFSM, established in May 2010, provides financial assistance to ALL EU MSs in financial difficulties.
- Under EFSM, the Commission is allowed to borrow up to a total of € 60 billion in financial markets on behalf of the Union under an implicit EU budget guarantee.
- The Commission then on-lends the proceeds to the beneficiary Member State. This particular lending arrangement implies that there is no debt-servicing cost for the Union. All interest and loan principal is repaid by the beneficiary Member State via the Commission.
- The EU budget guarantees the repayment of the bonds in case of default by the borrower.

- The EFSM can only be activated after a request for financial assistance has been made by the concerned Member State and a macroeconomic adjustment programme, incorporating strict conditionality, has been agreed with the Commission, in liaison with the ECB.
- The EFSM essentially reproduces for the **EU 27** the basic mechanics of the existing Balance of Payments Regulation for **non-euro area Member States** (established in 2002, activated for Hungary, Romania, and Latvia).
- The EFSM has currently been activated for Ireland and Portugal, for a total amount up to € 48.5 billion (up to € 22.5 billion for Ireland and up to € 26 billion for Portugal).

European Financial Stability Facility (EFSF)

- The EFSF was created in response to the unprecedented financial crisis that began in 2008.
- The objective of the EFSF is to preserve the financial stability of the EMU by providing temporary stability support to **euro area MSs**. It is a société anonyme set up under Luxembourgish law in June 2010, mandated to provide financial assistance on a temporary basis and thus able to enter into new programmes only until 30 June 2013; the EFSF will continue to service existing commitments thereafter.
- The European Stability Mechanism (ESM) will take over in providing stability support to euro area Member States.

EFSF

- The EFSF provides financial assistance to euro area MSs, linked to appropriate conditionality. It obtains financing by issuing bonds or other debt instruments on the financial markets backed by guarantees of the shareholder MSs. These guarantees total €780 billion (now as a result of the Greek, Irish and Portuguese programmes, the EFSF has effective guarantees totaling €726 billion that provide a lending capacity of €440 billion)
- EFSF is authorized to:
  - Provide loans to countries in financial difficulties
  - Intervene in the debt primary and secondary markets.
  - Act on the basis of a precautionary programme;
  - Finance recapitalizations of financial institutions through loans to governments

EFSF

- Each instrument is underpinned by a MoU that details the appropriate conditions a MSs has negotiated with the EU Commission, in liaison with the ECB, for financial support as well as the monitoring and surveillance procedures to ensure a MS is implementing said conditions and returned to normal functioning.
- In addition, to maximize the capacity of the EFSF two additional lending mechanisms were agreed on 26 October 2011:
  - ✓ Sovereign partial risk protection: the EFSF would provide a partial protection certificate to newly issued bonds of a MS.
  - ✓ Co-Investment Fund: it would allow a combination of public and private funding to purchase bonds on behalf of a beneficiary MS.

- The ESM is a **permanent** international financial institution that assists in preserving the financial stability of the EMU by providing temporary stability support to **euro area MSs**. The Treaty establishing the ESM was signed in February 2012; the ESM is as an intergovernmental organization under public international law and in October 2012 it entered into force.
- Its main features build on the EFSF. The ESM will be the primary support mechanism to euro-area MSs and complements the new framework for reinforced economic surveillance in the EU.
- This new framework, which includes a stronger focus on debt sustainability and more effective enforcement measures, focuses on **prevention** and will substantially reduce the probability of a crisis emerging in the future.

ESM

- The ESM will issue bonds or other debt instruments on the financial markets to raise capital to provide assistance to Member States.
- Unlike the EFSF, which was based upon euro area MSs guarantees, the ESM will have total subscribed capital of €700 billion provided by euro area MSs. €80 billion of this will be in the form of paid-in capital with the remaining €620 billion as callable capital. Lending capacity for the ESM is set at €500 billion.
- Financial assistance from the ESM will in all cases be activated upon a request from a MS and will be provided subject to conditionality appropriate to the instrument chosen.
- It will replace EFSF and EFSM.

ESM

- The instruments available to the ESM have been modeled upon those available to the EFSF:
  - Provide loans to a euro area Member State in financial difficulties;
  - Intervene in the debt primary and secondary markets;
  - Act on the basis of a precautionary programme;
  - Provide loans to governments for the purpose of recapitalization of financial institutions
- Each instrument will be linked to a MoU that details the appropriate conditions a MS has negotiated with the EU Commission, in liaison with the ECB, for financial support as well as the monitoring and surveillance procedures to ensure a MS is progressing towards financial stability.

Financial Assistance - Greece

- Since May 2010, the euro area MSs and the IMF have been providing financial support to Greece in the context of a sharp deterioration in its financing conditions. The aim is to support the Greek government's efforts to restore fiscal sustainability and to implement structural reforms in order to improve the competitiveness of the economy, thereby laying the foundations for sustainable economic growth.
- In May 2010, the Eurogroup agreed to provide bilateral loans pooled by the European Commission for a total amount of EUR 80 billion to be disbursed over the period May 2010 through June 2013. Under the Greek Loan Facility, the European Commission is not acting as a borrower but has been entrusted by the euro-area MSs with the coordination and administration of the pooled bilateral loans, including their disbursement to Greece.

- On 14 March 2012, euro area finance ministers approved financing of the Second Economic Adjustment Programme for Greece. The euro-area MSs and the IMF committed the undisbursed amounts of the first programme (Greek Loan Facility) plus an additional €130 billion for the years 2012-14. While the financing of the first programme was based on bilateral loans, it was agreed that - on the side of euro area MSs - the second programme would be financed by the European Financial Stability Facility (EFSF), which had been fully operational since August 2010.
- In total, the second programme foresees financial assistance of €164.5 billion until the end of 2014. Of this amount, the euro-area commitment amounts to €144.7 billion to be provided via the EFSF, while the IMF contributes €19.8 billion.

- The Economic Adjustment Programme for Portugal was agreed in May 2011 and covers the period 2011 to mid-2014. It includes a joint financing package of €78 billion (EU/EFSM – €26 billion, Euro area/EFSF – €26 billion, IMF – about €26 billion).
- Objectives:
  - structural reforms to boost potential growth, create jobs, and improve competitiveness;
  - a fiscal consolidation strategy, aimed at putting the public debt-to-GDP ratio on a firm downward path in the medium term and reducing the deficit below 3% of GDP by 2014;
  - a financial sector strategy based on recapitalization and deleveraging, with efforts to safeguard the financial sector against disorderly deleveraging.

Financial Assistance - Ireland

- The Economic Adjustment Programme for Ireland was agreed in November 2010 and covers the period 2010-2013.
- It includes a joint financing package of €85 billion with contributions from the EU/EFSM (€22.5 billion), euro area Member States/EFSF €17.7 billion, bilateral contributions from the United Kingdom (€3.8 billion), Sweden (€0.6 billion) and Denmark (€0.4 billion) as well as funding from the IMF (€22.5 billion).
- Objectives: immediate strengthening and comprehensive overhaul of the banking sector, ambitious fiscal adjustment to restore fiscal sustainability, correction of excessive deficit by 2015, growth-enhancing reforms, in particular on the labor market, to allow a return to a robust and sustainable growth.

- Spain requested financial assistance on 25 June 2012.
- It will receive financial assistance from euro area Member States via the European Financial Stability Facility (EFSF) of up to EUR 100 billion. This assistance is conditional on specific policy measures as regards the financial sector that the country has to implement, as foreseen by the Memorandum of Understanding (MoU). In addition, Spain needs to honor its commitments under the excessive deficit procedure and regarding structural reform, with a view to correcting macroeconomic imbalances in the framework of the European semester.