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Evolution of Economic Governance in the European Monetary Union

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Abstract

This note provides an account of the major milestones in the evolution of the economic governance in the European monetary union, assessing the reforms in governance frameworks of the EMU from 1997 up to mid-2013. It mainly focuses on the post-2010 reforms, where the financial crisis and the ensuing sovereign debt crisis exposed the weakness of the economic governance framework of EMU in Europe. It also highlights the on-going proposals for further coordination and cooperation that have been brought forward but still require agreement among Member States. The note suggests that while the commitment shown to introduce stricter fiscal rules and enhanced surveillance was a necessary step forward for sustaining the credibility of the single European currency, further reforms focusing on deepening European integration are still needed.

1. Introduction

The setting up of a monetary union among a number of sovereign states inevitably requires strict rules of economic governance in order to prevent moral hazard and free-riding by individual member states. The establishment of the Maastricht Treaty in 1992 was precisely meant to be the cornerstone of the economic governance structure of Economic and Monetary Union (EMU) in Europe to address this issue. Furthermore, incorporating such rules of economic governance within the EU's legal framework was to strengthen its enforceability to ensure the proper functioning of the EMU.

EMU in the European Union is characterised by a system where Member States are governed by a single supranational monetary authority, with fiscal policies and other economic matters remaining largely determined at a national level, though some policies are constrained by agreements reached at the European Council.

Although from an organisational perspective it may be simpler to transfer all the economic and fiscal decision-making process to a centralised supranational authority, such a proposition still remains unpalatable from a political perspective as Member States are all too often reluctant to surrender sovereignty in economic and fiscal matters (Verhelst, S. 2011).[2] Hence, a major challenge for such a set-up is that of ensuring that decision-making at the national level does not weaken the advantages of the common currency. This can be achieved through a well-defined framework of sustainable economic governance which aims to shape the evolution and progress of the entire European economy.[3]

The financial crisis and the ensuing sovereign debt crisis have exposed the weakness of the economic governance framework within the EMU. It was too narrow in scope, and enforceability, especially during the better times of the economic cycle, was somewhat weak. This brought about an urgent need for reform to economic governance in the euro area, particularly in respect of enhancing the process of cooperation and coordination of economic policies, and in improving enforceability. The crisis also highlighted the need for new tools to be embedded within its economic governance framework to enable the monetary area to cope with adverse circumstances.

This note aims to provide an account of the evolution of the economic governance framework of EMU in Europe. It begins by considering the basic structure of economic governance prior to the crisis period. Section 3 delves into the major recent reforms in the EMU's eco-

[2] See also: European Commission: Economic and Monetary Union, p.23 (1990), SEC (90) 1659
[3] Begg, I. (2008) defines economic governance as the combination of 'the philosophy and architecture of economic policy-making with the institutions, machinery and practices that shape the evolution of the economy.'

nomic governance framework, while Section 4 highlights the proposals for further coordination and cooperation that have been put on the table but still requires agreement among Member States. The conclusion sums up the major milestones in the evolution of Europe's economic governance framework, and highlights the major challenges ahead.

2. Economic governance in the pre-crisis period

At the design stage of the single currency project, European policy-makers recognised that for EMU to function properly it was important to set up a framework that coordinates national fiscal policies of Member States. Hence, in 1997, the Stability and Growth Pact (SGP) was approved as a rule-based framework to act as a fiscal surveillance mechanism to safeguard the stability of EMU.

The SGP aimed at strengthening the surveillance of budgetary positions and coordinate economic policies under its 'preventive arm', as well as clarifying the effective implementation of the excessive deficit procedure (EDP) under its 'corrective (or dissuasive) arm'. Through its preventive and corrective arms, the SGP aimed to prevent a situation where one Member State's budgetary policies penalises the rest of the monetary union through higher interest rates or weaker confidence in the stability of the euro. In other words, the SGP was intended to prevent governments from undertaking short-sighted policies and encourage them to focus on policies that bring longer-term stability. In this respect, the SGP incorporates a fiscal monitoring process of Member States by the European Commission, which reports to the Council of Ministers, whereby recommendations are issued, and ultimately, if non-fulfilment persists, sanctions against offending members could be also imposed. The SGP was also intended to be an instrument that reinforces the existing treaties of the European Union.

The Preventive Arm of the SGP

The preventive arm of the SGP states that all countries in the EU shall commit themselves to respect the medium-term objective (MTO) for their budgetary position to be close to balance or in surplus. Under the provisions of the preventive arm, Member States must submit annual stability or convergence programmes, showing how they intend to achieve or safeguard sound fiscal positions in the medium term.[4] These programmes are assessed by the Commission and at a later stage the Council gives its opinion and recommendations.

[4] European Commission - Economic and Financial Affairs, for further detail see : http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm

Two important tools which were embedded in the preventive arm relate to: (i) the possibility of an early warning by the Council (based on proposals by the Commission) to prevent the occurrence of an excessive deficit and that (ii) the Commission can issue policy advice to a Member State concerning the broad implications of its fiscal policies.

The Corrective Arm of the SGP

The corrective part of the SGP governs the excessive deficit procedure (EDP). The EDP is triggered when the fiscal deficit of a Member State breaches the 3% of GDP threshold established by the Maastricht Treaty. The European Commission carries out an assessment, and the Council of the European Union decides whether the deficit is indeed excessive as defined by the SGP. In its assessment the Commission prepares a report taking into account all relevant factors, including developments in potential growth, cyclical conditions, the implementation of policies aimed at boosting research and innovation, developments in the medium-term budgetary position, and reforms relating to retirement and pension schemes.

If the country's deficit is deemed to be excessive in terms of the Treaty, the Council will issue recommendations to the Member State to correct the situation within a stipulated time-frame. Non-compliance with the recommendations triggers further steps in the procedures, including the possibility of sanctions for euro area Member States.

The 2005 Reform of the SGP

The economic slowdown encountered in 2001, and the consequent deterioration in public finances, well beyond the 3% threshold in a number of euro area Member States, sparked a debate on the appropriateness of the SGP as a framework for fiscal policy in EMU. By 2002, Germany and France, the two largest EMU Members States were already unable to cut their budget deficit below 3% of GDP, as their cyclically adjusted budget deficit rose to 3.5% and 3.8% respectively. In such a situation, various policy-makers and observers intensified their criticism towards the SGP (Kostoris Padoa-Schioppa, F (2006). As a result, in 2005 the SGP was revised to respond to such criticisms of insufficient flexibility, and to make the Pact more enforceable.

With respect to the preventive arm, the revised SGP introduced differentiated country-specific MTOs. While maintaining a safety margin with respect to the 3% deficit limit, the MTOs were designed to take into account other characteristics of each country, in particular the debt-to-GDP ratio and potential growth. The reforms also introduced new specific provisions concerning the adjustment effort that should be made to reach the MTOs. As a benchmark, the adjustment should be equal to 0.5% of GDP per year, with more effort in good times, and possibly less in bad times.

Other revisions concerned the corrective arm of the pact. These included: (i) a less stringent definition of a “severe economic downturn”; (ii) within the context of the EDP, in the assessment of whether a deficit above 3% of GDP is considered excessive, the new Pact provided an explicit and relatively long list of “other relevant factors” that have to be taken into account when assessing fiscal developments; (iii) a significant change in the deadlines for correcting excessive deficits, where the initial deadline would be set such that a minimum fiscal adjustment of 0.5% of GDP per annum is required. [5]

The 2005 SGP reform led to mixed reactions, with many observers criticising it as such a reform had watered down its effectiveness. In particular, the Governing Council of the European Central Bank (ECB), while acknowledging that some of the reforms in the preventive arm were positive, expressed serious concerns about the changes to the corrective arm as it was effectively weakened. The ECB remarked on several occasions that for the preventive arm to become fully effective, the corrective arm needed to fulfil its deterrent role. Indeed, in 2006, on the back of persistent excessive deficits in a number of euro area countries, the ECB had demanded a more rigorous implementation of the new rules.[6]

Experience has shown that the reform of the SGP did not provide sufficient incentives for the correction of fiscal imbalances. The global economic and financial crisis had clearly exposed the shortcomings in the economic governance framework of the EMU that had been severely criticised in 2005. Although the SGP was intended to serve as a tool that enables the coordination of fiscal policies of Member States, in practice its enforcement has been problematic. Subsequently, the crisis led to a significant deterioration in fiscal positions, largely driven by the effects of automatic stabilisers on budgets, fiscal stimulus packages aimed at combatting the economic downturn, and the support provided to the financial sector.

In addition, other macroeconomic imbalances and heterogeneity across Member States in terms of competitiveness were also allowed to develop over a number of years, and in the absence of more far-reaching economic reforms, they have left some euro area countries with weak growth prospects.[7] Hence, it became all too clear that economic policies needed better co-ordination together with enhanced surveillance, although further improvement to

[5] Speech by José Manuel González-Páramo, Member of the Executive Board of the ECB, in a conference on “New Perspectives on Fiscal Sustainability” Frankfurt, 13 October 2005.
[6] Speech by José Manuel González-Páramo, Member of the Executive Board of the ECB: “The revised Stability and Growth Pact: is it working?” Frankfurt, 5 May 2006.
[7] “The reform of economic governance in the euro area – essential elements”, ECB March 2011.

the economic governance of the euro area would necessarily require a stronger and more binding political commitment.

3. Recent reforms in economic governance

Given the high degree of financial integration among Member States, with many banks holding a sizeable amount of debt securities issued by other euro area members, the unsustainability of fiscal policies in some countries have brought to the fore the risks of contagion and threat to the financial stability of the euro area. As a result, doubts about the debt-sustainability of certain countries were having an impact on the solvency of banks across the euro area.[8] This called for urgent action to introduce financing mechanisms to respond to risks of default by Member States of the euro area, apart from deeper reforms to the economic governance framework of EMU.

Introduction of financing mechanisms

When Greece formally requested financial support from the IMF and its euro area partners in 2010, it was immediately apparent that the single currency area lacked some kind of mechanism to provide support to Member States in financial distress. Indeed, the first financial package for Greece consisted of a bilateral loan agreement with other euro area Member States. However, euro area Finance Ministers and the European Commission worked on setting up a formal European Stabilisation Mechanism. The latter consisted of the temporary European Financial Stability Facility (EFSF), and the European Financial Stabilisation Mechanism (EFSM). Recourse to the latter was available to all EU member states, while the former is restricted to euro area Member States. These institutions were set up to safeguard EU financial stability amid severe tensions in euro-area sovereign debt markets.

In May 2012, in conjunction with the EFSM and the EFSF, funding from the International Monetary Fund (IMF) formed a safety-net of up to EUR750 billion to address such exceptional circumstances (see Diagram 1).[9] Besides, this support could be also supplemented by ECB purchases of sovereign debt on the secondary market.

[8] Eijffinger, S. and Hooduin, L (2012) p.3

[9] For further detail, see European Commission - Economic and Financial Affairs, http://ec.europa.eu/economy_finance/eu_borrower/european_stabilisation_actions/index_en.htm

Diagram 1: Framework for crisis management

€750 billion financial stability package

European Financial Stabilisation Mechanism	**European Financial Stability Facility**	**International Monetary Fund**
€60 billion (lending capacity)	€440 billion *(lending capacity)*	A maximum of €250 billion
Available to all 27 EU Member States	Available to euro area Member States	Up to half the amount drawn from EFSF and EFSM

Source: EFSF.

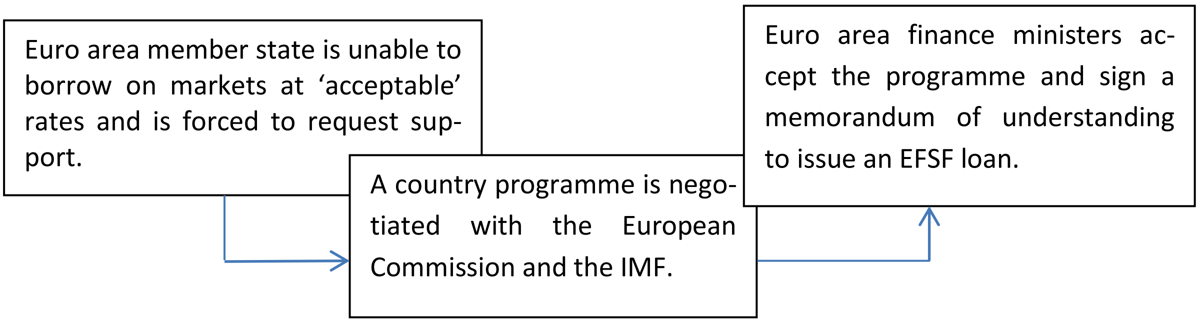
The EFSF is a Luxembourg registered company, owned by euro area Member States, and has the mandate to safeguard financial stability in Europe by providing financial assistance to euro area Member States. The EFSF is licenced to issue bonds or other debt instruments which are backed by 120% guarantees given by the euro area Member States, with a lending capacity of up to €440 billion. The contribution share of each Member State is calculated according to the relative size of its ECB's capital subscription. Once a country asks for EFSF support, it becomes a "stepping-out guarantor", meaning that it will no longer contribute to future loan guarantees, though agreements in place before it stepped out remain binding.

In exceptional circumstances the EFSF can also intervene in the primary market for government securities in the context of a programme with strict conditionality. Moreover, intervention in the secondary market can only be undertaken on the basis of an ECB analysis recognising the existence of exceptional financial market circumstances and risks to financial stability.

Initially the EFSF was used as a simple back-to-back funding strategy. However, in November 2011, a diversified funding strategy was adopted using a liquidity buffer as a key component. As part of this strategy, the EFSF introduced a short-term bill programme and since the end of 2011 has held several auctions of 3-month and 6-month bills.[10] This mechanism is currently rated AA+ by two of the major credit rating agencies.[11]

[10] For further detail on the EFSF strategies and lending operations see: http://www.efsf.europa.eu/about/operations/index.htm
[11] Funds are raised on the financial markets and are guaranteed by the European Commission using the budget of the European Union as collateral.

Diagram 2: Access to EFSF



Meanwhile, the EFSM is the other emergency funding programme that aims to preserve financial stability in Europe by providing financial assistance to any or all the Member States of the European Union.

The EFSF was designed to act as a temporary facility, with the intention to replace it by the permanent European Stability Mechanism (ESM) by July 2013. The ESM will manage a permanent rescue funding programme to support illiquid but solvent euro area countries. The ESM will assume the tasks currently fulfilled by the EFSF and the EFSM in providing, where needed, financial assistance to euro area Member States.[12]

The ESM is an intergovernmental organisation under public international law, and while its introduction was to be brought forward to July 2012 - a year earlier than anticipated – its launch had to be delayed because although the ESM Treaty was approved by the German Bundestag, such a decision was contested on constitutional grounds. However, in its judgement on 12 September 2012, the Constitutional Court rejected motions for temporary injunction, ruling that the laws that were being challenged do not violate the constitution.

The ESM has an effective lending capacity of €500 billion and a total authorised capital of €700 billion, though paid-in capital will be €80 billion, thus leaving a committed callable capital of €620 billion. The ESM will seek higher private sector involvement and will make investors shoulder more of the burden in a possible future bail-out. The new mechanism will analyse debt sustainability on a case-by-case basis, following established IMF policies. The ESM will claim preferred creditor status and standardized and Collective Action Clauses (CACs)[13] are to be included for all new euro area government bonds. For the ESM Treaty to be operational it has to be ratified by the parliaments of all euro zone countries.

[12] Treaty establishing the European Stability Mechanism, European Council (2012)

[13] A collective action clause (CAC) allows a majority of bondholders to agree to a debt restructuring that is legally binding on all holders of the bond, including those who vote against the restructuring.

The European Semester

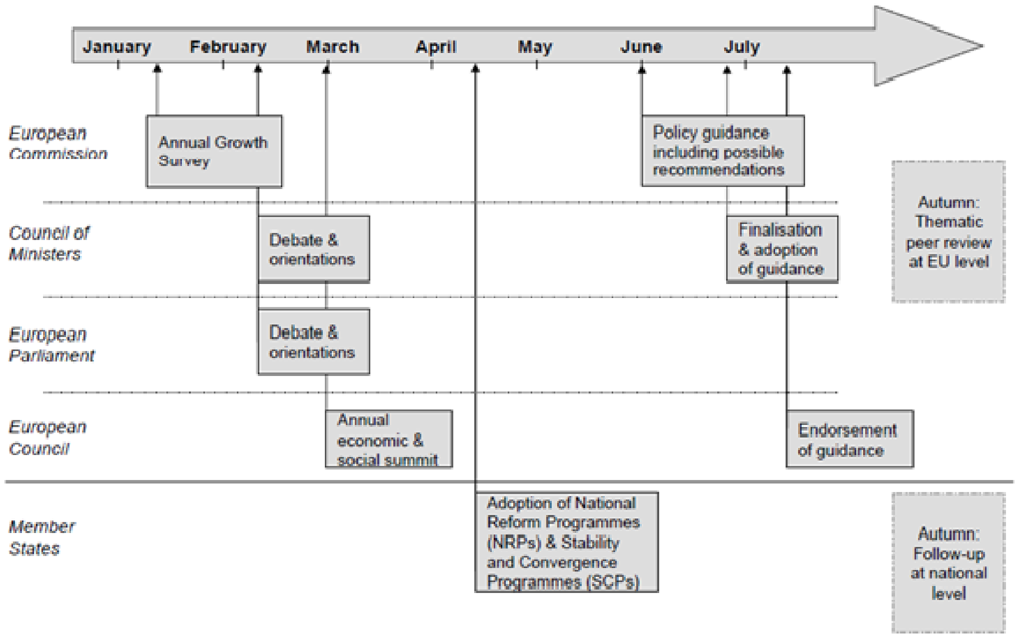
Apart from the introduction of financing mechanisms to address the urgent need for distressed euro area members, the European Commission proposed a set of tools to effectively strengthen both the preventive and the corrective arms of the SGP by extending surveillance to cover also other macroeconomic imbalances, and improve enforcement through appropriate sanctions and incentives.

By mid-2010, the Commission adopted a legislative package containing the most comprehensive reinforcement in economic governance of the euro area since the inception of EMU. At the same time, as part of the reform in EU provisions on the coordination of Member States' economic policies, the European Council modified the code of conduct on implementation of the EU's Stability and Growth Pact, enabling a 'European semester' to be introduced as from January 2011.[14]

The establishment of the European semester meant that EU Member States were to start coordinating ex-ante their budgetary and economic policies, in line with both the Stability and Growth Pact and the Europe 2020 strategy. The European semester works on a six-monthly cycle starting each year in January when the Commission publishes the Annual Growth Survey. The latter is followed by the identification of the main economic challenges by the European Council, which gives strategic advice on policies. On the basis of this advice, Member States will be asked to review their medium-term budgetary strategies when drawing up national reform programmes. In June and July, the European Council is to issue country-specific guidance, providing policy advice before Member States present their budgets in their respective national parliaments (see Diagram 3).

[14] The European semester was one of the first initiatives to emerge from a task force on economic governance set up at the request of the European Council in March 2010 and chaired by the President of the European Council, Herman Van Rompuy. More information can be retrieved from: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/14

Diagram 3: Policy coordination in the European Semester



Source: ECB (Monthly Bulletin March 2011).

The Six-Pack Legislation

However, it was clear that Europe still needed a mechanism that would not only concentrate on budgetary policies, but one that would also tackle macroeconomic imbalances and issues related to underlying problems of competitiveness. While for some countries, most notably Greece, fiscal policy was at the origin of the crisis, for other, particularly Ireland and Spain, the sovereign debt crisis was attributable to severe macroeconomic imbalances that had developed over time, which had eventually become transformed into a public finance problem. Besides, the crisis had shown that Member States had generally failed to adopt the recommendations of the Stability and Growth Pact during favourable economic periods and were consequently left with narrow scope of action to ease the prevailing economic recession.

In view of these unfolding developments, the European Commission submitted a package of six legislative proposals in September 2010, aimed at establishing the economic pillar of the Economic Monetary Union. In the ensuing months, the president of the European Council, Herman Van Rompuy, led a task force which also drew up its proposals. On 15 March 2011, following the alignment of the legislative proposals of the Commission, the task force, along with the European Parliament and the Economic and Finance Ministers of all the Member States, concluded a preliminary position on the six legislative proposals.

The six-legislative package, proposed by the European Commission, was approved by all 27 EU Member States and the European Parliament in October 2011. Subsequently, a few weeks later, on 13 December 2011 the reinforced Stability and Growth Pact entered into force with the new measures for economic and fiscal surveillance.

As a result, from December 2011 onwards financial sanctions began to apply to euro area countries that fail to take adequate actions. Member States which were in EDP, had to comply with the specific recommendations devised by the Council to correct their position, unless a qualified majority of Member States vote against it. The amended Stability and Growth Pact makes the debt criterion of the Treaty operational, where quantitative corrective measures to reduce public debt to the set numerical benchmark were defined. The provisions of the preventive arm of the reinforced Pact provide the main guidance for budgetary planning and execution for Member States that are not subject to an EDP.

The six elements of the legislative framework[15]

(i) Regulation of the European Parliament and the Council amending the legislative underpinning of the preventive part of the Stability and Growth Pact

The preventive part of the Stability and Growth Pact requires that Member States should achieve and maintain a medium-term budgetary objective and submit a stability and convergence programme to that effect. The amendments relate to the fiscal adjustment path determined by Member States, through which the Commission will evaluate this path from several different aspects and not only keeping track of the structural budgetary balance. Moreover, in terms of fiscal consolidation, all EU Member States (not only euro area countries) with a sovereign debt of over 60% of GDP would be required to take measures that go beyond the 0.5% annual adjustment in the fiscal balance.

(ii) A Regulation amending the legislative underpinning of the corrective part of the Stability and Growth Pact

An important amendment in the Stability and Growth Pact's corrective arm relates to the public debt criterion, whereby it will be given the same prominence as the fiscal deficit threshold. The amendments establish that when the annual pace of debt reduction is insufficient it will be possible to launch an Excessive Deficit Procedure (EDP) even if the budget deficit is less than 3% of GDP. The contraction in debt is to be considered sufficient if in the previous three years the amount of debt reduction amounts to at least 5%

[15] The agreement on the six legislative elements was reached during the Hungarian Presidency. More information can be retrieved from Hajdú, M. (2011) www.eu2011.hu/package-six-legislative-proposals.

of the debt in excess of the reference value of 60% of GDP. This means that countries should reduce the excess of the debt ratio over the reference value at an average of one-twentieth per year as a minimum.[16]

The amendments also change the rules concerning the consideration of the net costs of implementing pension reforms. The main concern focuses on whether these reforms can enhance the long-term sustainability of the overall pension system without increasing risks for the medium-term budgetary position. Moreover, a new set of financial and non-financial sanctions will be introduced at an early stage in both arms of the Pact.[17]

(iii) The introduction of a Council directive on the requirements for budgetary frameworks of Member States

The new directive was introduced with the aim of ensuring that all the EU countries commit themselves to sustainable and disciplined budgetary policies. It also ensures that the Stability and Growth Pact's objectives are transposed in the national budgetary framework. The directive contains minimum requirements for budgetary planning, transparency and implementation that need to appear in national fiscal procedural practices by the end of 2013. The requirements include the provision of statistical data, specific fiscal rules, publicly available macroeconomic projections (which form the basis of budgetary planning), and multi-annual budgetary planning.

(iv) A new regulation on the prevention and correction of macroeconomic imbalances

A new element of the EU's economic surveillance framework is the Excessive Imbalance Procedure which was established along the lines of the EDP. In order to detect early macroeconomic imbalances, the Commission proposed the set-up of a so-called scoreboard, with specific benchmark values varying between Member States, within and outside the euro area. If a Member State exceeds the threshold values this would not necessarily mean the occurrence of an imbalance. Nevertheless, if the qualitative assessment conducted by the Commission indicates a risk of imbalance, the affected country may be declared to be in a position of excessive imbalance.

In the course of the process, the Council would set forth recommendations for the Member State, which in turn would have to present a corrective action plan. This plan will be

[16] If for example a Member State has a debt-to-GDP ratio of 75% -- hence exceeding the 60% benchmark -- the country is required to reduce the excess by 1/20, that is by (75%-60%)/20, which is equal to 0.75% per year. For this to materialise the country is required to run a primary surplus. The amounts of the latter depend on the difference between the real interest rate and the real GDP growth rate.

[17] See amendment on Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure. For more information see: http://register.consilium.europa.eu/pdf/en/11/st07/st07848.en11.pdf

evaluated by the Council and a deadline is set for the implementation of corrective actions.

(v) A regulation on the effective enforcement of budgetary surveillance in the euro area

In implementing the economic governance framework, the Council can impose sanctions also during the preventive phase. If a country deviates from the expected adjustment path, the Council may issue a recommendation, and if the Member State fails to comply, this would result in the imposition on the Member State of an interest-bearing deposit. In the case of an excessive deficit, in the corrective arm, the interest-bearing deposit would be initially converted into a non-interest bearing deposit, amounting to 0.2% of GDP. If non-compliance with the Council's recommendation to correct the excessive deficit persists, the non-interest bearing deposit would be subsequently converted into a fine of up to 0.5% of GDP.

In order to ensure the effective enforcement of these sanctions, an important change to the governance framework has been the introduction of a 'reverse voting mechanism', whereby the Commission's proposal for imposing a deposit or fine would be considered as adopted, unless it is turned down by the Council, through a qualified majority. Any proceeds from interest earned on deposits or fines will be transferred to the European Financial Stability Facility, and subsequently to the European Stability.

(vi) A regulation on enforcement measures to correct excessive macroeconomic imbalances in the euro area

In the case of an Excessive Imbalance Procedure, the Eurogroup can impose a fine on a euro area Member State that has been subjected to the procedure only when it repeatedly fails to adopt corrective measures by the set deadlines. Moreover, the fine should be equal to 0.1% of the country's GDP, with the reverse voting mechanism applied when such decisions are to be taken.

Macro-economic Imbalance Procedure (MIP)

Before the global economic and financial crisis broke out in 2008, it was already evident that macroeconomic imbalances were building up in a number of euro area countries. Such imbalances were reflected in dwindling competitiveness indicators, unfavourable external positions in the balance of payments, and heterogeneous price developments, especially in respect of wages and property prices, that went well beyond the convergence process. While economic governance at the time strictly focussed on fiscal indicators, the reformed framework now enables the Commission and the Council to adopt preventive recommendations at an early stage, crucially before macroeconomic imbalances become too large, threatening a country's economic and financial stability. In cases where imbalances are viewed to be unsustainable and are not being corrected, an Excessive Imbalance Procedure, a feature of the corrective arm of the MIP, can be opened for Member States. The MIP is based on the last two regulations of the six-pack (1176/2011 and 1174/2011).

An early warning system for all EU countries was established based on the assessment of a scoreboard consisting of a set of ten indicators covering a wide spectrum of economic variables. The objective of the scoreboard is to monitor external imbalances, competitiveness and internal imbalances with the aim of identifying whether potential imbalances require immediate remedial action. The scoreboard basically includes ten indicators, which are listed below.

External imbalances and competitiveness

(i) Three-year backward moving average of the current account balance as a percentage of GDP, falling within a bracket of +6% and -4% of GDP;

(ii) Net international investment position as a percentage of GDP, with a threshold of -35% of GDP;

(iii) Five-year percentage change of export market shares measured in values, with a threshold of -6%;

(iv) Three-year percentage change in nominal unit labour costs, with thresholds of +9% for euro area countries and +12% for non-euro area countries;

(v) Three-year percentage change of the real effective exchange rates based on HICP deflators, with thresholds of -/+5% for euro area countries and -/+11% for non-euro area countries.

Internal imbalances

(vi) Private sector debt as a percentage of GDP, with a threshold of 160%;

(vii) Private sector credit flow as a percentage of GDP, with a threshold of 15%;

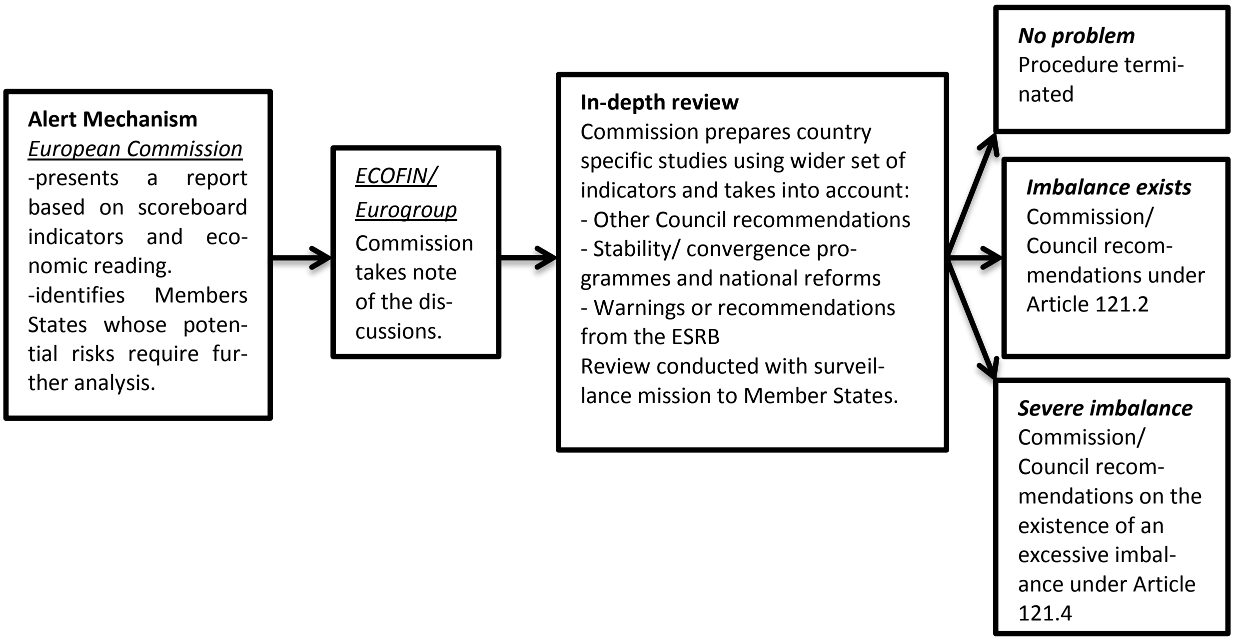
(viii) Annual changes in deflated house prices, with a threshold of 6%;

(ix) Public sector debt as a percentage of GDP with a threshold of 60%;

(x) Three-year backward moving average of unemployment rate, with a threshold of 10%.

On the basis of these indicators, the MIP gives the European Commission and the Council of Ministers the possibility to act on potentially harmful imbalances. The starting point of the new surveillance procedure is the Alert Mechanism report, prepared by the European Commission, which on a country-by-country basis identifies issues that necessitate a review. Although the Commission examines the economic indicators to identify imbalances, there is no automatic interpretation of the results and a qualitative evaluation is undertaken.

Diagram 4: Overview of the Macroeconomic Imbalance Procedure



Source: European Commission (Press Release IP/12/132)

The European Commission’s Alert Mechanism Report is published annually, although continuous monitoring of the macroeconomic situation in Member States remains mandatory as part of the European semester. The conclusions of the report are discussed in the Eurogroup and in the EU’s Council of Economic and Finance Ministers. The Commission takes their reactions into account and prepares country-specific in-depth reviews. As indicated in Diagram 4 the assessment of the country’s situation can lead to one of three outcomes: (i) the situation can be considered unproblematic and the Commission proposes no further steps under the MIP; (ii) the Commission considers that the country under review is experiencing, or is likely to experience, macroeconomic imbalances, in which case the Commission proposes recommendations (presented in the context of the European semester) to correct the imbalance or to prevent it from occurring; (iii) if macroeconomic imbalances are considered to be severe or that such a situation may jeopardise the functioning of the EMU, the

Commission can place the Member State under an EIP within the scope of the corrective arm of the MIP.

Treaty on Stability, Coordination and Governance (TSCG)

In 2007, Jean Claude Trichet, the then President of the ECB, proposed that the EU must ensure prudent fiscal policies across all Member States, and for this to be successful the EU needed to enhance its fiscal unity. Similar statements were made by other institutions, including the IMF, suggesting that the long-term sustainability of the EMU required a more uniform fiscal policy.

In December 2011, at the European Council meeting, all 17 members of the euro area agreed on a more comprehensive outline for a new intergovernmental treaty to put strict limits on government spending and borrowing, with penalties for those countries that violate the set thresholds. At the same time, all other EU non-euro area countries, except for the Czech Republic[18] and the United Kingdom, confirmed that they were also prepared to participate in such a framework, subject to approval by national parliaments.

This agreement, formally entitled the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)*, but commonly referred to as the *Fiscal Compact*[19], was signed on 2 March 2012 by all the Member States of the European Union, with the exception of the Czech Republic and the United Kingdom. The Treaty was subject to the ratification by at least 12 members of the euro area and entered into force in January 2013. The Maltese Parliament authorised the ratification of the TSCG in June 2013 and it became effective on 1 July. Since Malta has the euro as its currency, all provisions of the TSCG apply in full.[20]

The Treaty requires the 25 EU Member States to respect convergence toward the country-specific medium-term objective, as defined by the SGP, with a lower limit of the structural deficit[21] of 0.5% of GDP (1.0% of GDP is allowed for countries with a debt ratio substantially lower than 60% of GDP). The new deficit rule, also known as the 'golden rule', requires participating countries to split their budget into a balanced current account and a deficit financed capital account. The distinction between the two accounts is meant to foster a bias in favour of capital spending, hence shifting the emphasis away from a mere quantitative target to a criterion that also improves the quality of public finances. From an economic point of view,

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[18] The Czech Republic did not completely rule out its participation in such a framework. Indeed, after the Treaty was signed, the Czech Republic has kept the option of participating at a later stage.
[19] The Fiscal Compact is explained in Title III of the Treaty on Stability, Coordination and Governance.
[20] For an assessment on the implications for Maltese fiscal policy, see Schembri R., (2013).
[21] The structural deficit refers to the total government deficit excluding cyclical effects and one-off measures.

the golden rule stipulates that over the economic cycle governments will only be able to borrow in order to invest rather than to fund current expenditure, with the increase in public investment expected to contribute to higher potential growth, especially for less mature economies.

Additionally, corrective mechanisms within the framework should also ensure automatic action in case of deviations from the pre-set objectives. Therefore, the Treaty stipulates that the budgetary rules shall be placed in national law through binding provisions of a permanent nature, preferably constitutional.

In the occurrence where a signatory fails to properly implement the new budget rules, the European Court of Justice may impose financial sanctions of up to 0.1% of GDP. In the case of euro area Member States, the sanction proceeds would be channelled to the ESM, while in the case of a non-euro area member, the money would flow to the EU budget.

The Treaty includes other obligations aimed at reinforcing the implementation of the SGP with respect to the debt rule included in the six-pack. Furthermore, the Treaty reinforced surveillance and coordination of economic policies, with ex-ante coordination of debt issuance plans among signatories and economic partnership programmes which provide a roadmap for structural reforms for Member States in EDP. It also includes provisions on economic governance in the euro area, particularly in relation to more formalised bi-annual Euro summits.

The TSCG runs in parallel with the six-pack. There is substantial overlap between the two with regards to financial sanctions in cases of non-compliance, as well as definitions of medium-term objectives and exceptional circumstances under which normal rules would not apply. At the same time, in some areas the TSCG is more stringent than the six-legislative package. For example, if a euro area Member State breaches the deficit criterion, a reverse qualified majority voting applies at all stages of the EDP, even if this is not foreseen in the six-pack.

4. Outstanding proposals for further reforms

As the sovereign debt crisis in Europe persisted and spread to more countries, the momentum for further reform in EMU continues, gravitating towards deeper integration between Member States. As a result, European institutions continued to propose frameworks that should guarantee enhanced coordination and cooperation among Member States.

The two-pack initiative

As discussions on the Fiscal Compact were still on-going, on 23 November 2011 the Commission published two legislative proposals on the strengthening of fiscal discipline for euro area countries to complement the six-pack reform on economic governance. The two regulations of this legislative proposal are also commonly referred to as the two-pack. This initiative is applicable only to euro area Member States and aims at further consolidating the surveillance mechanism in EMU. The regulations introduce detailed procedures for persuading Member States to amend and align their national budgets with the Commission's recommendations.

The first regulation, emanating from the Gauzès report, prepared by MEP Jean Paul Gauzès, relates to euro area countries in financial distress, and focuses on "the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area".

The report suggested enhanced surveillance for countries experiencing market pressure, obliging their governments to provide quarterly reports to the EU on their banking sectors and overall economic prospects, and submit them to quarterly EU-ECB review missions. In addition, the proposed regulation allows a qualified majority of the Council to recommend a stressed Member State to seek a bailout, while extra monitoring will be imposed on those members under bailout programmes until at least 26% of their borrowing from EU financing mechanisms is repaid. Moreover, if a Member State is unable to implement tax, public sector or other structural reforms, it can request technical assistance.[22]

The second proposed regulation deals with budget discipline in EMU. This proposal includes a requirement of monitoring of draft budgetary plans of euro area Member States and other oversight. It follows on a report presented by MEP Elisa Ferreira whereby a common budget-making timeline for all 17 euro area countries is also suggested. This proposed regulation would require governments to submit three-year fiscal plans to the EU by 15 April, draft budgets for the following year by 15 October (along with the respective independent macro-economic forecasts), and the adoption of the following year's budget by 31 December. This regulation builds on and complements the preventive arm of the SGP, under which Member States present the main characteristics of their medium-term public finance plans to the Commission and the Council in spring. The additional proposed exercise in autumn allows for the monitoring and sharing of information on country-specific budgetary plans closer to

[22] Collins, S. (13 June 2012) 'Two-pack: MEPs plead for redemption fund to cut sovereign debt'. Retrieved on 13 July 2012 from http://www.europolitics.info/economic-a-monetary-affairs/two-pack-meps-plead-for-redemption-fund-to-cut-sovereign-debt-art336881-31.html

their adoption. The Commission analyses if the draft budget is in line with the SGP and the recommendations of the Council emanating from the European Semester. The regulation also includes a balanced budget rule mirroring that of the Fiscal Compact.

The Council adopted the recommendations of both the Gauzes and Ferreira reports on 21 February 2012, making only minor amendments, while on 13 June the European Parliament supported the two-pack in a plenary vote, but making more significant amendments to the European Commission's original proposals in response to issues raised by a number of Member States.

A notable amendment in the proposals includes a whole new chapter on the direct stimulation of growth and provisions for other measures aimed to resolve the euro area debt crisis. The main elements of this chapter are:

(i) the setting-up of a European Debt Redemption Fund, with the purpose of rolling over national debt of euro area Member States in excess of 60% of GDP (currently estimated at around €2.3 trillion) within a common redemption fund, where the repayment of this debt would then be carried out over a period of 25 years. This would provide countries with sufficient time to undertake structural reforms, and would also lower the average interest paid to refinance such debt.

(ii) one month after the legislation enters into force, the Commission would be required to present details on the introduction of Eurobonds.

(iii) the Commission would be also required to present a proposal for a growth mechanism, equal to 1% of GDP (approximately €100 billion) for investment in the infrastructure.

The proposed regulation, as amended, still required agreement among Member States, the European Parliament and the European Commission. The draft texts went back to the European Parliament's Committee on Economic Affairs, with the MEPs aiming to find an agreement with the Council. On 10 July 2012, the Economic Affairs Commissioner remarked that the amendments to the two-pack might be too-far-reaching to make it through negotiations with the Commission and the Council.[23]

On 20 February 2013, the European Union's Council of Ministers agreed on the importance of the 'two pack' fiscal rules. This reform package entered into force on 30 May 2013 in all

[23] For further detail see: http://www.europolitics.info/economy-monetary-affairs/two-pack-meps-warned-amendments-may-be-too-far-reaching-art339629-50.html

euro area Member States. The new measures will lead to increased transparency on budgetary decisions, stronger coordination in the euro area starting with the 2014 budgetary cycle, and the recognition of the special needs of euro area Member States under severe financial pressure.[24]

Integration in financial and banking sectors

During the European Council summit, held on the 28 and 29 June 2012, the President of the European Council, Herman Van Rompuy, presented the report *Towards a Genuine Economic and Monetary Union*. This report calls for a 'stronger EMU architecture, based on integrated framework for the financial sector, for budgetary matters and for economic policy'.[25] It aims to address the structural shortcomings in the institutional framework for financial stability by proposing two central elements: a single European banking supervision, and a common deposit insurance and resolution framework. The plan also foresees further mechanisms to prevent and correct unsustainable fiscal policies.

The report underlines that integrated financial supervision is essential to ensure the effective application of prudential rules, risk control and crisis prevention. It argues that a single European banking supervision system would guarantee that all European banks are supervised effectively; hence reducing the possibility of bank failures and preventing the need for intervention by jointly-provided deposit guarantees or resolution funds. The report suggested that the ECB could act as the single supervisory authority for all EU banks.

With the aim of mitigating the potential risks that may arise from a bank-run in any part of the euro area, the report discusses the possibility of a European-wide bank deposit insurance scheme as well as a common resolution scheme for the winding down of failed banks. This would be another major step towards the integration of the European financial and banking sectors, stimulating confidence and reduce risk aversion among market players. The deposit insurance scheme and the resolution fund would be expected to be set up under the control of a common resolution authority, which should reduce the likelihood for actual use of the guarantee scheme. As regards the euro area, the report suggests that the European Stability Mechanism could act as the fiscal backstop to the resolution and deposit guarantee authority.[26]

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[24] European Commission, MEMO/13/457.

[25] Van Rompuy, H., President of the European Council (26 June 2012): 'Towards a Genuine Economic and Monetary Union' (EUCO 120/12) p.1.

[26] During the 28-29 June Summit, the mechanism was modified to allow ESM funds to directly recapitalize banks and also using ESM funds to buy government bonds in order to lower borrowing costs for nations in difficulty.

Through the issue of three important documents on 12 September 2012, the European Commission presented its plans for further integration of the European financial and banking sectors. The Commission presented a communication titled *A Roadmap towards a Banking Union*; a proposal for a Council Regulation based on Article 127 (6) of the Treaty on the Functioning of the European Union, to create the Single Supervisory Mechanism (SSM) with a central role conferred on the ECB; and a proposal for a regulation of the European Parliament and the Council to amend the 2010 Regulation establishing the EBA, in order to adapt it to the creation of the SSM.

The European Commission's proposal for a SSM for banks in the euro area was considered a very important step in strengthening the EMU. The new single supervisory mechanism, with a central role conferred on the ECB, will have the ultimate responsibility of specific supervisory tasks to ensure financial stability for all the countries in euro area, as well as non-euro area countries that may wish to participate on a voluntary basis. At the same time, national supervisors will continue to play an important role in day-to-day supervision, supervision of smaller institutions in their respective countries, and to contribute to the preparation of ECB decisions and their implementation. The Commission also proposed that the European Banking Authority (EBA) develop a Single Supervisory Handbook to preserve the integrity of the single market and ensure coherence in banking supervision for all EU countries.

Subsequently, in March 2013, the European Parliament and the European Council of Ministers reached an agreement on the legislative package of the SSM, which is expected to be operational in 2014. The agreement also establishes rules on the governance and responsibility of the ECB to ensure a strict separation between its supervisory tasks and its monetary policy functions. In order to complement the SSM, on 10 July 2013 the European Commission proposed a Single Resolution Mechanism[27] (SRM) for the Banking Union. The SRM would ensure that in the context of strong supervision under the SSM, should a bank face serious difficulties, its resolution could be managed efficiently with minimal costs to taxpayers and the real economy.

In the meantime, on 28 November 2012, the European Commission adopted a *Blueprint for a deep and genuine EMU*, which provides a vision for a strong and stable architecture in the financial, fiscal, economic and political domains of the European Union[28]. This involves various gradual measures to be taken over the short, medium and longer term. Although many

[27] The Single Resolution Mechanism was announced by the Commission in the *Communication on A Roadmap Towards a Banking Union*, September 2012.
[28] Communication from the European Commission, 28 November 2012.

of the proposed measures can be accomplished through changes in the secondary legislation, some of the longer-term objectives will require a Treaty change (see Diagram 5).

Diagram 5: A blueprint for a deep a genuine EMU

A blueprint for a deep and genuine EMU
Launching a European debate

			Secondary law	Treaty change
ALL ALONG THE PROCESS – SHORT TERM	Within the next 18 months	1. Full implementation of **European Semester** and **six-pack** and quick agreement on and implementation of **two-pack**	✓	
		2. **Banking Union:** Financial regulation and supervision: quick agreement on proposals for a **Single Rulebook** and **Single Supervisory Mechanism**	✓	
		3. **Banking Union: Single Resolution Mechanism**	✓	
		4. Quick decision on the next **Multi-annual Financial Framework**	✓	
		5. **Ex-ante coordination of major reforms** and the creation of a **Convergence and Competitiveness Instrument (CCI)**	✓	
		6. Promoting **investment** in the **Euro Area** in line with the Stability and Growth Pact	✓	
		7. **External representation** of the **Euro Area**	✓	
MEDIUM TERM	18 months to 5 years	1. **Further reinforcement of budgetary and economic integration**	✓	✓
		2. **Proper fiscal capacity** for the **Euro Area** building on the CCI	✓	✓
		3. **Redemption fund**		✓
		4. **Eurobills**		✓
LONGER TERM	Beyond 5 years	1. **Full Banking Union**		✓
		2. **Full fiscal and economic union**		✓
		Political union: Commensurate progress on democratic legitimacy and accountability	✓	✓

Source: European Commission (Press Release IP/12/1272)

The work programme as set out in the Blueprint identifies short-term - stretching from November 2012 up to May 2014 - objectives which can be adopted through secondary legislation. During this period a strong commitment to concrete structural reforms backed by financial support, are to be set out in contractual arrangements between Member States and the Commission, including the SRM for banks.

For the medium-term, the collective conduct of budgetary policy and coordination of economic policies are to be strengthened. These objectives shall establish the fundamentals for the set-up of a debt redemption fund linked to strict conditionality, as well as the issuance of short-term eurobills. The latter objectives would require a new legal basis in the Treaties. The Blueprint also proposes longer-term goals which would lead to a full banking, fiscal and economic union prepared with a true stabilization and shock-absorbing function. Nevertheless, this would require a more comprehensive overhaul of the Treaties.

5. Conclusion

The onset of the global economic and financial crisis exposed the weaknesses of the economic governance framework of EMU in Europe, namely, but not solely, weak enforcement of budget discipline at the national level. While these weaknesses provided a major challenge for the integrity of the monetary union, they have also spurred European leaders to enhance integration among Member States. As a result, the crisis provided an opportunity for Europe to reform its economic governance framework to sustain the common currency project. While such reforms have pushed in the direction towards closer integration, at the same time they nevertheless continued to strike a fine balance between national sovereignty and supranational control.

The first reform process of the SGP in 2005 was met with criticism as it was perceived as less stringent in respect of fiscal discipline. Indeed, during the years of positive economic growth and low unemployment that preceded the crisis, strict enforcement of the SGP was clearly lacking. However, after 2009, EU institutions and Member States were compelled by the rapid evolution of the crisis to undertake substantial efforts to strengthen the governance of EMU to sustain the credibility of the single currency project. In this regard, during the past three years the major milestones of reform in EMU governance include the setting up of financing mechanisms, like the EFSF and the ESM; the establishment of the European Semester that strengthened surveillance and co-ordination of economic and budgetary policies; and the introduction of the six-pack legislation that broadened the scope of surveillance from fiscal to external and internal macroeconomic imbalances with the launch of the Macroeconomic Imbalance Procedure. Another important reform in the enforceability aspect of the governance framework was the enactment of the “golden fiscal rule” into national legislation, which incorporates fiscal expenditure and public debt limits, as well as the introduction of the concept of the reverse voting mechanism.

While the commitment shown to introduce stricter fiscal rules and enhanced surveillance was a necessary step forward for sustaining the credibility of the single European currency, further reforms focusing on deepening European integration are still required. The crisis can be turned into an opportunity to create a closer union among EMU Member States as national policies need to fully reflect the realities of being part of a monetary union. In particular, a major challenge ahead for the governance framework of EMU concerns the creation of a more integrated framework for the financial and banking sectors.

However, the success of reforms aimed at strengthening EMU also critically hinge on the ability and willingness of Member States to implement bold national reforms that contribute to improve competitiveness and promote sustainable economic growth.[29] In particular, policy reforms relating to labour markets, taxation, and strategies to tackle population ageing are critical for achieving fiscal sustainability and economic development. Many argue that this would call for a higher degree of pooling of sovereignty, and therefore further political integration, which perhaps remains as yet the strongest challenge for national policy makers and their citizens.

[29] Trichet, J-C.: 'Reforming EMU: time for bold decisions' (March 2011).

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