Will the Reform of the Institutional Framework Restore Fiscal Stability in the Eurozone?

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Introduction

The current European debt crisis has made it clear that the fiscal institutions of the eurozone need to be reformed. At the European summit on 24–25 March 2011, the governments of the EU member states have negotiated a reform package which changes the rules for fiscal policy coordination and supervision, extends the areas of policy coordination, and introduces the European Stability Mechanism (ESM) as a permanent institution which will assume the role of providing assistance to countries with financial difficulties.

This paper asks whether these reforms are sufficient to deal with the issue of fiscal stability in the eurozone. The answer given in this paper is that the reform package is insufficient although it does include steps into the right direction. More specifically, the main results of the analysis can be summarized as follows.

1. The reform package preserves the basic framework or fiscal policy making in the currency union: a high degree of fiscal policy coordination but ultimately decentralised fiscal responsibility. The focus of the reform is on making this work better. The idea of a fiscal union is rejected.
2. The introduction of the ESM is the most important element of the reform. It includes provisions for sovereign bankruptcies with an involvement of private sector creditors. This is an important step forward. But the key issue of credibility is neglected: as long as the financial sector is too fragile to absorb a sovereign bankruptcy and a financial meltdown looms, bankrupt countries will always be bailed out, even if their debt is unsustainable or they fail to comply with adjustment programmes. This can currently be observed in the case of Greece. Given this, governments as well as private investors have the wrong incentives. The bias towards lax fiscal policy and excessive lending by private investors will persist.
3. Therefore the current fiscal reform package will be ineffective unless it is complemented by reforms of the financial sector. This includes not just stricter capital requirements but also provisions to preserve access to ECB refinancing for the banking sector of countries undergoing debt restructuring.
4. Another weakness of the ESM setup is that there is too much discretionary political influence on its decisions, in particular the decision whether or not to involve the private sector in a debt restructuring. It would be desirable to limit the duration of financial assistance for any particular member country to two or three years. After that, an automatic debt restructuring with a compulsory involvement of the private sector should be carried out before more assistance is granted.
5. The reform package extends the scope of policy coordination and tightens the rules of the Stability and Growth Pact. But we should not expect too much from this. The reform fails to introduce automatic sanctions, so that enforcement is likely to remain weak. Moreover, the newly introduced rule for the reduction of debt levels is too ambitious. Highly indebted member countries like Belgium or Italy will almost certainly fail to comply with this rule. This will undermine the monitoring process as a whole.

The setup of the rest of the paper is as follows. The following section briefly summarizes the key elements of the reform package. The third section evaluates the reform package and relates it to a number of fundamental ideas about the institutional framework for fiscal policy in the eurozone. The final section concludes.

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The content of the reform package

The reform package includes three elements: firstly, a reform of the Stability and Growth Pact and secondly, an agreement on policy coordination to foster the competitiveness of eurozone member states and other EU countries called Euro Plus Pact (EPP). The third element is the creation of the European Stability Mechanism (ESM). Each of these elements will be explained in greater detail below.

Reform of the Stability and Growth Pact

The reform of the Stability and Growth Pact includes both a reformulation of the fiscal rules and a change in the process that may lead to sanctions. While the deficit limit of 3 percent of GDP and the limit for the debt level of 60 percent are preserved, more importance is attributed to achieving balanced budgets. Countries with a deficit below 3 percent will be obliged to reduce their deficit further to achieve balanced budgets in the medium term. If they do not make suitable efforts, they may face sanctions. In addition, the ceiling of 60 percent for the level of debt will be taken more seriously. Member countries with debt levels above 60 percent are required to reduce the excess of their debt ratio over this limit by five percent per year until the debt ratio falls below the 60 percent threshold.

In cases where rules are violated, the process that may eventually lead to sanctions has been accelerated and the hurdles for sanctions have been reduced. In particular, if the European Commission proposes sanctions against a country, the European Council can only prevent the sanction if a qualified majority votes against it. However, there are no automatic sanctions.

The Euro Plus Pact (EPP)

The EPP has been agreed by the governments of the euro area, not the entire EU. But all member states are invited to join the agreement, and Bulgaria, Denmark, Latvia, Lithuania, Poland, and Romania, have already done so. The objective of the EPP is to 'achieve a new quality of economic policy coordination, with the objective of improving competitiveness'.[1] It will 'cover priority policy areas that are essential for fostering competitiveness and convergence' and 'concentrate on actions where the competence lies with the Member States'.[2]

The list of policy areas and measures covered by this arrangement is long. It includes the design of wage setting institutions, public sector pay policies, labour market policies, the opening of sheltered sectors, efforts to improve education systems, research and development, innovation and infrastructure, measures to improve the business environment like reducing red tape, measures to improve the sustainability of public finance including reforms of the health and pension system, tax policy in general and measures to improve the stability of the financial sector.

Policy coordination under this pact will work as follows. In a first step, the participating governments will agree on a set of common objectives. Then each member state will develop a plan to pursue these objectives with its own policy mix. For each country there will be yearly commitments to implement a set of policy measures, and the implementation of these policies as well as progress towards the policy objectives will be monitored on the basis of a report by the European Commission. This monitoring is purely 'political', which means that no enforcement mechanisms have been developed for cases where countries do not comply.

The European Stability Mechanism (ESM)

The ESM will replace the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) in 2013. As its predecessors, the ESM may provide assistance to countries in financial difficulties. The ESM will have an effective lending capacity of 500 billion euros. As in the case of the EFSF and the EFSM, the ESM will seek to operate jointly with the IMF, so that the overall level of available financial assistance is higher.

The ESM may grant financial assistance in the form of loans to euro area member states which experience financial difficulties, provided that this is 'indispensable to safeguard the stability of the euro area as a whole'.[3] As in the cases of Greece, Ireland and Portugal, assistance is conditional on a macroeconomic adjustment programme. Next to granting direct loans, the ESM may also buy government

[1] Conclusions of the EU Summit of 24–25 March 2011, http://register.consilium.europa.eu/pdf/en/11/st00/st00010.en11.pdf, 5.

[2] *Ibid*, 14.
[3] *Ibid*, 24.

bonds in the primary debt market. Loans granted by the ESM will accept senior creditor status of IMF loans but will enjoy preferred creditor status relative to all other loans. It is unclear, though, whether this also applies to cases where the ESM purchases government bonds in the primary market.

A key novelty of the ESM is that it specifies a set of provision for the possible involvement of the private sector in cases where countries cannot fully repay their debt. These provisions include, firstly, the obligation for all member states, from July 2013, to include collective action clauses in newly issued securities with maturities above one year. Secondly, before financial assistance is granted, an assessment has to be made as to whether the public debt of the country seeking help is sustainable. If this assessment leads to the conclusion that, even with an adjustment programme, the country cannot realistically restore sustainability of its public debt, assistance will only be granted if the private sector creditors share the burden of reducing the debt to a sustainable level.

Are these reforms sufficient?

Are these reforms sufficient to address the issue of fiscal instability in the eurozone? The answer to this question depends on the assessment of what is wrong with the existing rules. Views about this differ widely. In order to evaluate the reform package it is helpful to relate it to a set of rather different fundamental approaches to solving the problem of fiscal instability in the eurozone. I distinguish four approaches which I call the 'no currency union without fiscal union' approach, the 'European Monetary Fund' approach, the 'coordination and supervision' approach and the 'no-bailout rule credibility' approach. Each of these approaches implies very different expectations as to what fiscal institutions in the eurozone can and should deliver.

The 'no currency union without fiscal union' approach

This approach is based on the view that the basic setup of the currency union – the combination of a common currency with decentralised fiscal policy – is flawed. According to this view the eurozone can only survive if the common currency is complemented by a fiscal union. It is not always clear what exactly the introduction of a fiscal union would mean. There is a wide range of proposals and concepts, which have in common that they include the introduction of some form of permanent fiscal transfer mechanism between the member states of the eurozone.

Clearly, the current institutions of the EU already include transfer mechanisms in the form of EU structural and regional policies. But these transfers are limited in size and mostly do not respond to macroeconomic conditions or fiscal crises of individual member states.

The most radical concept of a fiscal union would be an expansion of the EU budget, combined with a European tax, possibly combined with a horizontal fiscal equalisation mechanism. This would effectively transform Europe into something similar to a federation. In such a federation the central budget would act as an automatic stabiliser and cushion the financial impact of asymmetric shocks. This proposal raises many highly controversial issues. Clearly, political support for this type of fiscal union in either the EU or the eurozone is not in sight.

Then there are less radical proposals. One such proposal is the introduction of Eurobonds backed by all member states of the eurozone. The idea is that Eurobonds would allow highly indebted member states to get access to financing at lower interest rates, at least for intra-marginal borrowing. Of course, this reduction in interest rates for highly indebted member states comes at the cost of higher interest rates for the fiscally more solid countries. Again, political support for this option is limited. The current reform package does not follow the fiscal union approach.

The 'European Monetary Fund' approach

A more limited concept that nevertheless implies elements of transfers between member states is the introduction of a 'European Monetary Fund', an institution similar to the International Monetary Fund (IMF), which would provide loans to countries with financial difficulties. The economic idea underlying this approach is that member countries of a currency union are more vulnerable to fiscal crises than countries with their own currency and flexible exchange rates. Fiscal crises can happen even in cases where countries are not necessarily insolvent. This is because, in financial markets, multiple equilibria may occur. If investors believe a highly indebted country can repay its debt, it will enjoy access to credit at low interest rates, and the country is solvent. In contrast, if investors believe that a country will not repay its debt, maybe just because other investors will lose con-

fidence soon, interest rates will shoot up and the country's debt becomes unsustainable.

In countries with high debt levels, access to financing by private investors may thus depend on the stabilisation and coordination of expectations. Therefore a government institution that provides financial assistance can potentially play an efficiency enhancing role. Of course, this depends on whether or not this institution correctly assesses the potential of a macroeconomic adjustment programme to restore sustainability. In addition, the institution should be able to enforce policies necessary to overcome the liquidity crisis and it should be willing to deny help in cases where the situation suggests that a country is effectively insolvent or does not comply with the adjustment programme. In addition, this type of financial assistance has a cost in terms of moral hazard.

Clearly, the introduction of the ESM is largely based on the logic of this approach. However, there are some aspects of the ESM which question that it will operate according to the principles described above. Firstly, the assessment of whether or not a country can realistically restore sustainability of its debt after an adjustment programme will be exposed to massive political pressures. The ultimate decision of whether assistance will be provided, and whether or not the private sector will be involved will be a political one, even more so than in the case of the IMF. One way of addressing this would be to limit the duration of financial assistance for any particular member country to two or three years. This should also apply to the cases of Greece, Ireland and Portugal. After that, an automatic debt restructuring with a compulsory involvement of the private sector should be carried out before more assistance is granted. To the extent that financial sector regulation proceeds and the robustness of financial institutions is improved, financial assistance through the ESM can become more restrictive.

In addition, it is far from clear whether compliance with adjustment programmes can be enforced effectively. The terms of the ESM emphasize strict conditionality, but would financial assistance really be withdrawn in cases of non-compliance? It is one of the lessons of the current crisis that the expected costs of denying help – a financial market meltdown – may be too high. If that is the case, the threat of withdrawing help in cases of noncompliance is not credible, and conditionality simply does not work. The key weakness of the ESM is that it does not address this issue properly. We will return to the credibility issue below.

The 'coordination and supervision' approach

This approach is based on the view that a currency union with a decentralised fiscal policy can work if fiscal policy is coordinated effectively. From this perspective, the concept of the Stability and Growth Pact was the right idea, but its implementation was insufficient. According to this view, the areas covered by policy coordination have to be extended and enforcement of fiscal rules has to be improved.

There are, again, many proposals for ways in which the supervision of fiscal policy as well as other policy areas could be changed. It is one of the lessons of the current crisis that fiscal crises can be triggered not just by excessive government spending but also by economic downturns caused by bursting house price bubbles or by banking crises. Therefore some proposals suggest that policy coordination and supervision should not just look at fiscal indicators like deficits and public debt but also at housing markets, financial sector developments and more generally factors driving growth and competitiveness of individual member countries.

Another key issue is enforcement. Various proposals have been made to speed up the process leading to sanctions and to introduce automatic sanctions.

Clearly, the reform package places a lot of emphasis on the coordination and supervision approach. The reform of the Stability and Growth Pact introduces stricter rules and tries to make enforcement more effective. The Euro Plus Pact extends the area of policy coordination and supervision to almost everything, albeit without explicit enforcement mechanisms.

Will these measures be effective? Probably not. Firstly, the reform package should have done more to enforce compliance. In particular, the proposal to introduce automatic sanctions has been rejected although this is probably the only way to make sure that sanctions will ever happen.

Secondly, some of the rules seem to be so ambitious that they are unlikely to be respected. This applies, for instance, to the new rule for the reduction of debt levels. According to the spring forecast of the European Commission, Italy will have a government debt to

GDP ratio of approximately 120 percent at the end of 2011. This ratio will remain roughly constant in 2012. According to the new rules, however, Italy would be obliged to reduce the debt to GDP ratio in 2012 by 3 percent, to 117 percent. Interestingly, according to the spring forecast, all countries in the eurozone with the exceptions of Slovenia, Slovakia, Finland and Estonia will violate the new debt level rule in 2012. There clearly is the danger that noncompliance with this rule will undermine the credibility and the enforcement of other rules as well.

Thirdly and perhaps most importantly, even very effective policy supervision and control may not be enough to avoid that countries become insolvent. It is one of the lessons of the crisis that a country like Ireland, which did comply with the fiscal rules that were in force, can be hit by a strong macroeconomic shock which, combined with a banking crisis, has caused a fiscal crisis. In these situations the coordination and supervision approach does not have much to offer.

The 'no-bailout rule credibility' approach

Finally, there is a fourth approach which argues that a currency union with decentralised fiscal policy can work well provided that the no-bailout rule holds. According to this approach, the key issue is that the eurozone countries were not willing to let Greece and later Ireland and Portugal go bankrupt. The main reason was that there was the danger of a financial crisis with potentially huge costs for the eurozone as a whole and many other countries. According to this view, the flaw of the existing rules was that the no-bailout rule lacked credibility. Since the financial sector was not robust enough to absorb a shock like the bankruptcy of Greece or any other country in the eurozone, it was clear that the risk of lending money to highly indebted countries like Greece was limited – investors knew that they would be bailed out with high probability. Given this, capital markets failed to impose fiscal discipline.

From this perspective, reforms in the eurozone should focus on enhancing the credibility of the no-bailout rule. This requires that, in the event of a fiscal crisis, the costs to the eurozone of letting a member country go bankrupt are smaller than the costs of a bailout. This can only be achieved through a fundamental reform of the financial sector. The financial sector has to be sufficiently robust to absorb a sovereign bankruptcy. If this is not guaranteed the no bailout rule is not credible. If the rule is credible, capital markets should be much more effective in preventing excessive deficit financing. Countries with unsustainable fiscal policy would quickly face increasing interest rates and eventually lose access to credit.

According to this approach, the reform package is incomplete because it fails to take into account the key role played by the issue of financial sector stability. Clearly, the rather vague commitments to improve financial sector stability in the reform package are insufficient. This is also true for measures that have been taken in other contexts, in particular the Basel III process. This process will bring improvements in financial regulation, but these improvements will not even get close to making the financial sector robust enough to absorb a bankruptcy of a euro area member state. Next to much tighter financial sector regulation, it is of key importance to make sure that banks in countries undergoing a debt restructuring do not lose access to refinancing through the ECB.

Despite these shortcomings, there are some aspects of the reform package that will improve the credibility of the principle that private investors will be involved if governments face financial difficulties. In particular, the ESM procedures include the possibility of a private sector involvement and countries will be obliged to include collective action clauses in newly issued bonds. The ESM procedures do make it more likely that private creditors of insolvent governments will lose money, rather than being 'rescued' by the taxpayers of other countries.

Another benefit of the ESM is that the expected costs and risks of a debt restructuring which involves the private sector are reduced. In particular, the existence of the ESM reduces the likelihood that a restructuring in one country leads to contagion effects in other countries because other countries would have access to financial assistance through the ESM.

But the question is whether the likelihood of debt restructurings with private sector involvement under the ESM arrangements is large enough. Again, the process that may ultimately lead to the decision of private sector involvement will be under strong political influence, and there is a danger that there will be a bias towards too little private sector involvement.

Conclusions

The reform package proposed by the eurozone governments rejects the view that a currency union cannot survive without a fiscal union. Instead the reform package relies on the idea that, by reducing current budget deficits and the level of government debt and by increasing labour market flexibility and financial market robustness, individual countries in the eurozone can absorb macroeconomic shocks on their own. Given that the idea of a fiscal union with much more centralised fiscal policy responsibility in Europe raises a whole bunch of complex questions which go well beyond economic policy, and given that the idea lacks political support in most countries, it is perfectly reasonable that this project has not been pursued in the context of the current reforms.

The reform package does reflect the insight, however, that fiscal autonomy of the member states requires fundamental changes in national fiscal policies and other policy areas. The question is whether countries are willing and able to implement these changes. From a perspective of the eurozone as a whole, the decision to implement these changes could be left to the individual member countries if the benefits and costs of these reforms were fully internalised by the individual countries. The 'no-bailout rule credibility approach' explained in the preceding section proposes to establish a situation where this is the case. If countries can go bankrupt without triggering a financial crisis that affects other countries, because the financial sector is sufficiently robust to absorb the blow, there is no reason to worry about policy coordination or institutions providing financial assistance. Incentives for investors as well as governments would be undistorted.

It is unlikely, however, that the economic situation in the eurozone and beyond will be like this in the years to come. Implementing the required changes in financial regulation will take time. This suggests that improving financial sector stability is a key objective, but more than that is needed, at least for a transition period. One element is that, in the case of a sovereign bankruptcy, financial assistance by the ESM can offer some protection against contagion effects. But other aspects of financial sector vulnerability in such a scenario have to be addressed. Policy coordination and monitoring could also make a contribution, but stronger enforcement mechanisms are necessary. The current reform package has the merit of starting the process of improving the fiscal institutions of the eurozone. But much remains to be done.