ISPI Policy Brief

ISTITUTO PER GLI STUDI DI POLITICA INTERNAZIONALE

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No. 198 - OCTOBER 2010

Not only Public Debt: towards a new Pact on the Euro(*)

Abstract

"*Les hommes n'acceptant le changement que dans la nécessité et ils ne voient la nécessité que dans la crise*". Jean Monnet's teaching has always been successfully applied to the European Union. Once again, in the wake of a severe crisis, Europe is striving to enhance integration, both in the monetary and non-monetary field. The delusion that economic convergence would stem from the mere adoption of a single currency proved itself wrong. Time seems ripe for the European Commission to change the Stability and Growth Pact and, at the same time, to manage macro-economic imbalances and launch a new long-term growth Strategy ("Lisbon 2020").

Insights and proposals will be provided to better address these issues by also taking into account further governance improvements and socio-political sustainability.

The economic and financial crisis has exposed many imbalances of the world economy. In particular, as far as Europe is concerned, it has put under the spotlight the "original sin" of the Maastrich Treaty: the traditional view has had it that, within a single currency, persistent current account imbalances should not emerge; if they occurred, they would be transitory and of a benign nature, as they would signal the fact that, under capital mobility, savers can lend to international investors in the periphery of Europe to support catching-up processes. Hence, all it was needed to ensure a fair degree of macroeconomic stability was a control on public finances preventing the build-up of excessive public debt and deficit positions.

In reality, it is now clear that the current account imbalances which arose in the early stages of monetary unification are not transitory, but rather, in a context of deep, globalised financial markets, they can grow larger over time; moreover, these imbalances do not have a benign nature, as shown by the unsustainable credit positions developed by certain Member States, irrespectively of their absolute public debt levels (e.g. Spain).

Chart 1, in particular, describes the evolution of the current account as a proportion of GDP in Germany and in the group of the most indebted countries (Greece, Ireland, Italy, Portugal and Spain). All these countries have experienced, to different extents over time, a trade deficit leading in aggregate to diverging and persistent current account imbalances within the euro-zone; although the crisis has contributed to contain these differences in the last year, the latter effect is likely to be temporary, with the structural imbalances due to persist in the forthcoming periods[1].

[1] As clarified by the European Commission (2010), *Surveillance of Intra-Euro-Area Com-*

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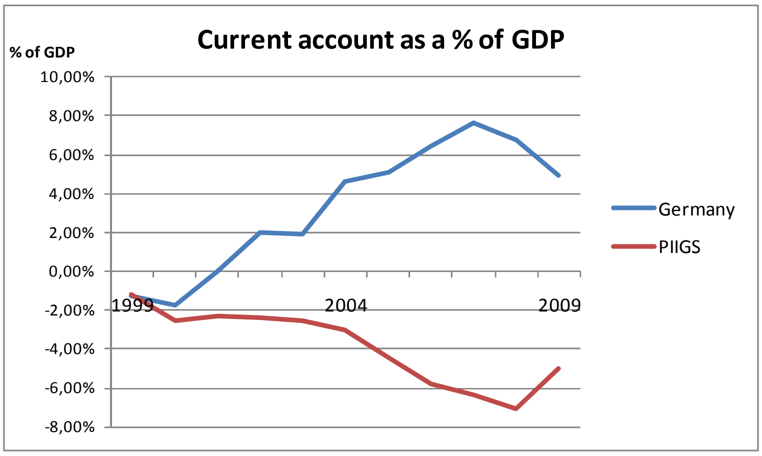
(*) The opinions expressed herein are strictly personal and do not necessarily reflect the position of ISPI.

The Authors wish to thank Simone Bondini for his help.

Building on the idea that in every crisis there is opportunity, once faced with this difficult situation, the EU institutions have however reacted with proposals on a renewed system of governance able to adequately tackle these imbalances. In particular, in the wake of the crisis, formal proposals have been made to step up powers and competences of the European Institutions with the aim of deepening the integration in the fiscal (or non-monetary in general) areas of governance, thus trying to rebalance the entire design of the Economic and Monetary Union (EMU) and correct its “original sin”. However, the latter attempt can be successful only if the underlying causes of the current imbalances are clearly identified and its consequences are mirrored by new, effective and sustainable measures.

Chart 1: Trade imbalances in EMU, 1999-2009



Source: Altomonte & Marzinotto

As far as causes are concerned, the crisis made it clear that a full understanding can only stem from the identification of the relationships among fiscal policies, macroeconomic imbalances and competitiveness developments[2]. In this regard, it is also noteworthy that the European crisis – and, in particular the so-called “PIGS crisis” – is not at all homogeneous; rather, it seems to be the result of different types of imbalances[3]. For instance, the Greek crisis is perfectly consistent with the original framework of the Maastricht Treaty: it is mostly fiscal in nature, stemming from public accounts out of control (if not plainly manipulated), it involves to a certain extent an inadequate preventive action by the EU Institutions, and it has been exacerbated by the lack of a clear-cut institutional roadmap for crisis management. Hence, it is quite straightforward that the Greek crisis has generated a call for a revision of the fiscal surveillance mechanism and the Stability and Growth Pact (SGP), as well as the setup of a crisis management strategy dealing with the possible default, or debt restructuring, of one of the EMU countries (an event completely ruled out under the original Maastricht design).

However, and quite more worrisome, the root of the Spanish crisis cannot be found in the fiscal field: even the most perfect implementation of the current or future rules on the SGP would have not prevented troubles to arise in Spain. More generally, the current account deficits (and thus the ensuing imbalances) of

petitiveness and Imbalances, EU Economy 1/2010, the recent convergence may be cyclical (due to the collapse in global demand in surplus countries and the substitution of imports in some deficit countries), with the pre-crisis divergence trend likely to resume once the recovery gains strength.

[2] See C. ALTOMONTE - B. MARZINOTTO, *Monitoring macroeconomic imbalances in Europe: Proposal for a refined analytical frame work*, Directorate General for Internal Policies, European Parliament, Note, 8 September 2010.

[3] See B. MARZINOTTO - J. PISANI-FERRY - A. SAPIR, *Two crises, two responses*, «Bruegel Policy Brief», March 2010.

Greece and Portugal can be re-conducted to negative public savings (i.e. public deficits), but the trade deficits of countries such as Spain and, to some extent, Ireland have certainly less to do with public finances and more with other economic distortions. These are related to decreasing real exchange rate competitiveness, coupled with a credit boom and a housing bubble, which has inflated the debt of the private sector, especially of banks. These situations oblige the EU institutions to think out of the box of the Maastricht Treaty, calling for a different governance strategy specifically aimed at tackling these imbalances.

Data show in particular that over the last decade some positive results in terms of nominal convergence (in interest rates and, to some extent, in inflation rates) have been obtained, especially when taking into account the Eurozone as a whole. But the same does not hold true when emphasis is placed on real convergence: in this case, a grim picture of diverging economic performances (in terms of price/wage trends, not compensated by adequate productivity rates) emerges. Consequently, competitiveness and growth rates have followed different paths inside the Eurozone, as shown in Chart 1: the stunning performance of Germany – its current account deficit in 2000 (35.2 billion euros) turned into an impressive surplus in 2008 (165.4 billion euros) – was contrasted with strong deficits and, ultimately, poor growth potentials in other Eurozone countries (e.g. Spain, Greece, Portugal)[4].

In this context, it was extremely difficult – if not impossible – to achieve the ambitious targets of the Lisbon Agenda in terms of research, innovation and, above all, growth and occupation, let alone the dream of making the EU the most competitive area of the world by 2010. Indeed, the latter had been a "mirage" well before an unprecedented economic crisis hit the world in 2008.

The European Commission and the newly appointed European President, Herman Von Rompuy, are now trying to take advantage of such a complex and heterogeneous context by launching new, ambitious initiatives. They include not only a new 10-year strategy ("Europe 2020") to prompt innovation, occupation and growth, while avoiding excessive macroeconomic imbalances, but also the revision of the Stability and Growth Pact (SGP) and, more generally, the introduction of a wider macroeconomic surveillance mechanism, thus *de facto* marking the biggest governance reform since the introduction of the Euro.

The proposal of new possible European sanctions – in particular the one related to the 60% debt/GDP ratio – have received wide media coverage. But, as already stated, the new measures go, with insight, well beyond the focus on the stock of national debts as they intend to set new objectives, rules and procedures. This Policy Brief considers the potential impact of the proposed changes with a view to assessing their ability to avoid future crises and creating new opportunities for stability and growth. Attention is also attached to their sustainability, especially in the Eurozone countries currently under heavy pressure.

Linking long-term targets with better surveillance

The new Strategy of the Commission for the next decade, "Europe 2020", foresees 5 headline targets (on employment, research and development, education, environment and poverty) and 7 flagship initiatives[5]. By acknowledging

[4] See A. VILLAFRANCA, *Piggybacking Pigs. The future of Euroland after the Greek crisis*, «Ispi Policy Brief», 179, March 2010.

[5] The flagship initiatives are: Innovation Union; Youth on the

the drawbacks of the previous Lisbon Strategy, the Commission wishes to avoid future failures. In particular, the rationale behind the failure of the former Strategy seems to be two-fold: on the one hand, governance was not consistent with the ambitious targets and, on the other, linkages between fiscal policies, macroeconomic imbalances and competitiveness were anything but clear. In order to overcome these limits, “Europe 2020”[6] acknowledges full ownership of the process to the European Council and tries to connect fiscal policies with macroeconomic stability. In this regard, member states will be required to jointly present the Rationalized Reform Programme and the Annual Stability and Convergence Programme in the last quarter of the year. These two documents will show, respectively, the results achieved by each country on the road to “Europe 2020” strategy and to medium-term budgetary objectives. In concrete terms, instruments and procedures of the two documents will be kept separate but reporting and evaluation will be done simultaneously in the framework of the new “European Semester”.

This link will be complemented by a completely new tool of economic surveillance in the hands of the Commission: the Excessive Imbalance Procedure (EIP)[7]. It is based on a “scoreboard” including a set of flexible indicators aiming at ensuring timely identification of significant imbalances in each country. The “scoreboard” will also consider indicators – such as external debt, house prices and real exchange rates – signaling possible external imbalances. The Commission will regularly release a Report including early warnings or recommendations (if any) from the European Systemic Risk Board (ESRB). The process may lead to peer-pressures on the member state concerned and, at the very end, to sanctions (equivalent to 0.1% of GDP).

These measures will probably enable “Europe 2020” to take a quantum leap from the Lisbon Agenda, but some other aspects could be taken into consideration to increase its chances:

- the competences of the EU Institutions on the wide-ranging issues covered by “Europe 2020” are often quite limited, if not negligible. As a result, more emphasis should be placed on what the EU can do by relying on its own strength. In this regard, it is striking that no reference is made to the necessary changes in the EU budget to make it more consistent with the targets of the Strategy. Besides, the ownership of the process in the hands of the European Council should be used to highlight the degree of commitment of member countries. In this regard, each meeting of the Council could focus on the progress made on a specific target of the Strategy, thus unveiling the real commitment of member countries. Finally, the role of the EU Parliament should be further strengthened in order to increase the democratic support of the targets and make them more acceptable (see below the paragraph on sustainability);
- no mention is made of the completion of the Single Market. The only measure foreseen by “Europe 2020” is the

move; A digital agenda for Europe; Resource Efficient Europe; An industrial policy for the globalisation era; An agenda for new skills and jobs; European platform against poverty.

[6] See *Europe 2020. A strategy for smart, sustainable and inclusive growth*, European Commission, COM(2010) 2020, 3 March 2010.

[7] See *Proposal for a Regulation of the European Parliament and of the Council on the prevention and correction of macroeconomic imbalances*, European Commission, COM(2010) 527 final, 29 September 2010.

flagship initiative on the digital agenda. Clearly, this is not sufficient and, therefore, it would be wise to consider all the possible linkages with the forthcoming "Internal Market Act"[8];

- as the "Europe 2020" Strategy and the reform of the SGP relate to a different system of governance within the Euro system, no sanction is foreseen for the countries which will not be willing to meet the targets of the Strategy, thus casting doubt on whether enforcement will be effective. Therefore, non-compliance with the Strategy should work as an aggravating factor when assessing possible sanctions under the new SGP and the EIP.

A new pact to stabilize the Euro

The PIGS crisis unveiled the drawbacks of the SGP, even in the reformed version of 2005. That reform – backed by non-compliant Germany and France – was meant to make the Pact euphemistically less "stupid" but, as it turned out, it only made it looser (especially in the context of the credit squeeze imposed by the crisis). The crisis changed it all. It is now crystal clear that both the *ex-ante* (i.e. the preventive part related to the Stability Programmes) and the *ex post* mechanisms (i.e. the corrective part of the Excessive Deficit Procedure, EDP) did not work well.

Building on preliminary proposals in the last months[9] and within the context of the strengthened macroeconomic surveillance mechanism, recently the Commission has outlined a wide-ranging reform of the SGP both in its preventive and corrective part[10]. In the first case a new principle has been introduced to enhance prudent fiscal policy-making. It makes operational – for the first time – the medium-term budgetary objectives (MTOs) and the 0.5% of GDP annual convergence requirement. In practical terms, a brake is applied to the growth of national expenditures, also in such a way as to prevent revenue windfalls from being spent and to make them available for debt reduction. In case of non-compliance with this principle, the member country concerned would be liable to a warning from the Commission which could also be followed, in extreme cases, by a Council recommendation. A completely new enforcement mechanism (for Eurozone countries only) is foreseen in the form of an interest-bearing deposit equal to 0.2% of GDP. Interestingly enough, a "reverse voting" mechanism is introduced: the deposit becomes due immediately after the proposal of the Commission, unless the Council decides not to back this decision by qualified majority[11].

In other words, enforcement mechanisms will be strengthened and new powers on surveillance will be handed over to the Commission.

The corrective part of the SGP is also enhanced by making the debt criterion of the EDP operational for the first time and introducing a new set of financial sanctions (again, a "reverse

[8] This document – based on the report by Mario Monti *A new Strategy for the Single Market* – will be released by Commission by the end of October. In addition, the implications of the Communication *Turning Europe into a true Innovation Union* (recently presented by Commissioners Antonio Tajani and Máire Geoghegan-Quinn) should also be explored.

[9] See the two Communications of the European Commission *Reinforcing economic policy coordination* (12 May 2010) and *Enhancing economic policy coordination for stability growth and jobs* (30 June 2010).

[10] See *Proposal for a Council Regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure*, European Commission, COM(2010) 522 final, 29 September 2010.

[11] A similar procedure is foreseen for the proposal of the maximum amount of the fine related to the EIP.

voting" is foreseen for them). In particular, the Debt/GDP ratio could be sanctioned if the part yearly exceeding the 60% has not been reduced by one-twentieth in each of the last 3 years. This new provision – strongly supported by Germany – has prompted negative reactions especially in countries with traditionally high debt levels. Indeed, in operationalising this rule, it would be wise to take into due account other factors, such as debt structure, private savings, spending in structural reforms, position of the country in the economic cycle etc. The importance of such variables seems to be clear to the Commission as it already promises to consider "all the relevant factors" and explicitly list some of them in its proposal. As a result, there is room for negotiation and for a flexible application of this criterion, thus making a compromise on its future introduction more likely.

In particular some aspects will probably require a more accurate evaluation, if not a re-thinking, during the political debate leading to their introduction:

- as already stated, the introduction of new rigid sanctions on debt in the reformed SGP risks being pointless since, in many cases, high levels of public debt were not the main cause of the crisis, but rather its consequence. Conversely, priority should be given to the expansion of the private debt, which ultimately fuelled the most critical aspects of the crisis. It is therefore necessary to place more emphasis on the responsibilities of the monetary authorities, in particular within the context of the new ESRB encharged of macro-prudential supervision, to avoid such expansion in the future[12];
- a stricter link with the supervision provided by the new European Authorities on micro-prudential supervision[13] would be necessary as banks have largely contributed to unsustainable lending in PIGS countries;
- quasi-automatic sanctions (thanks to the "reverse voting") risk to touch a raw nerve in many countries thus creating growing frictions with the Commission and among member states. As noted by Charles Wyplosz[14], the Commission could find itself in the uncomfortable position of increasing Euro-scepticism by imposing a fine or avoiding it by *de facto* undermining the credibility of the new Pact.

More generally, these points highlight two extremely relevant and sensitive issues which have not been sufficiently addressed so far: a more comprehensive revision of the European economic governance and the socio-political sustainability of targets and measures.

The governance and sustainability conundrum

The crisis has highlighted the importance of emerging macroeconomic imbalances within the EMU on top of rising fiscal deficits. As already stated, the EU Commission has proposed an enhanced macroeconomic surveillance framework that foresees the monitoring of a number of quantitative indicators, compounded by expert analyses, a strengthening of the SGP rules and a new long-term Strategy to relaunch growth.

As shown by the evidence discussed in this Policy Brief, such a broader approach to the non-monetary governance of the EMU is

[12] See P. DE GRAUWE, *What kind of governance for the Eurozone?*, «CEPS Policy Brief», 214, September 2010.

[13] European Banking Authority (EBA), European Insurance Authority (EIA), European Securities Authority (ESA).

[14] See C. WYPLOSZ, *Can the Eurozone's stability and growth Pact be made to work?*, http://wallstreetpit.com/46877-eurozone-reform-not-yet-fiscal-discipline-but-a-good-start.

welcome, but its implementation should entail a relatively high degree of flexibility and political judgment as most of the critical situations at national level cannot be mechanically associated to the outcome of one or another economic indicator.

Specifically, when looking at the broad picture of surveillance as stemming from the new Commission's proposals, we have identified three relevant issues which have been only marginally touched by the Commission's Communications, and thus should be further discussed throughout the legislative procedure leading to the set-up of the enhanced surveillance exercise:

1. The governance of the macroeconomic imbalances should be evaluated more thoroughly. The European Commission has proposed that the latter should follow a framework similar to the Stability and Growth Pact, the Excessive Imbalance Procedure, with a preventive arm based on a set of clearly defined indicators, leading to early warnings, and a corrective arm in which Member States are obliged to react to the emerging imbalances. While the preventive arm of is the EIP seems to be properly defined, with the already discussed *caveat* of avoiding a strict mechanical approach based only on quantitative indicators, the implementation of the corrective arm remains problematic.

In fact, provided that a clear set of measures can be identified, together with a viable roadmap, it remains to be seen:

- whether the competence of the suggested action falls within the scope of the EU-level of governance (e.g. in the case of a suggested reform of the wage formation mechanism);
- whether corrections to the existing imbalances can be effectively implemented by the national Governments in a defined time-span (e.g. in the case of a loss of competitiveness induced by a change in the global pattern of comparative advantages).

Given these constraints, it would be more appropriate on economic ground, and more effective on the policy one, to coordinate more explicitly the corrective arm of the enhanced surveillance mechanism with the commitments undertaken by the national Governments within the framework of the EU2020 exercise.

2. Surplus and deficit countries should not be treated symmetrically. As Figure 1 shows, one could in principle assume that, within the EMU, the deficit of a set of country is compensated by the surplus of others, in a symmetrical way (see also next point). As a result, since competitiveness is always defined in relative terms, if the symmetry hypothesis holds, one could suggest that, to reduce imbalances, either the countries in deficit become more competitive (reduce prices, increase productivity), or the countries in surplus "voluntarily" become a bit more inefficient (e.g. increasing wages more than their productivity levels, or reducing productivity altogether) to compensate for the imbalances of the laggards. In a closed economy the latter could be a possible experiment, because no effects would emerge with respect to the rest of the World. But in an increasingly globalised economy, of which the EMU is one of the key hubs, an adjustment "to the middle", apart from its very scant political feasibility, entails an overall loss of competitiveness for the entire area with potentially adverse welfare consequences for the entire EMU. If a principle of solidarity should apply in any case, in which both deficit and surplus country contribute to the redressing of the imbalances, then a viable solution is the setup of some enhanced forms of fiscal redistribution, thus strengthening the role of the EU budget.

3. Better data are needed on the study of the imbalances. Beyond the apparent symmetry reported in Figure 1, in which the trade surplus of Germany is as large as the sum of the deficits of the most problematic EMU countries, one should nevertheless explore whether the financing of the current account deficits (that is the capital counterpart of the balance of payments) has indeed remained mainly within the euro area or not. As a matter of fact, a geographical coverage of cross-border financial flows is not systematically available for the euro-area Member States, and is also complicated by the fact that bilateral flows from one country to another often transit via third countries. Preliminary and partial evidence available from the European Commission (2010) on the one hand seems to point to the fact that the financing of current account deficits has remained mainly intra euro area during the financial crisis. On the other hand, however, data show that the current account position of the major surplus country (Germany) has grown asymmetric over time, with the intra-euro area component of the trade surplus remaining by and large constant in the period 1999 - 2009, while most of the trade surplus has arisen from trade outside the Eurozone. A more thorough analysis of these dynamics through the availability of better data remains thus to be performed.

To conclude, it is noteworthy that most of the measures discussed in this Policy Brief will lead to additional costs[15], which risk being politically unsustainable. The only way out is to realize that the new global economic balance of power in the post-crisis context does not allow anymore a loose non-monetary economic integration in the Eurozone. The PIGS crisis indeed shows that the “original sin” of the EMU cannot be simply forgiven, it needs to be removed. But, at the same time, flexibility and political judgement must be at the core of the new European economic governance, otherwise a growing Euro-skepticism will inevitably undermine it.

[15] For instance, the proposal of the Commission to cut the debt (1/20 per year of the part exceeding the 60% Debt/GDP ratio) would imply an annual cost of 42 billion Euros for Italy.

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Le pubblicazioni online dell’ISPI sono realizzate anche grazie al sostegno della Fondazione Cariplo.

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