# EU economic governance

Stronger economic rules to manage the euro and Economic and Monetary Union

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*Economic and Financial Affairs*

# Responding to the sovereign debt crisis –

**important reforms of EU economic governance strengthen the future resilience of the Economic and Monetary Union**

The EU and the euro area have recently undertaken important reforms to ensure that the EMU truly becomes what the acronym stands for: an Economic and Monetary Union. The crisis that started in 2008 in some EU countries has clearly shown that more attention has to be paid to the "E" of the EMU, because economic coordination has not been strong enough to prevent the build-up of macroeconomic and fiscal imbalances within the euro area.

In order to overcome shortcomings in the architecture of the EMU, a comprehensive set of rules entered into force in December 2011 to strengthen fiscal and macroeconomic surveillance. These are being further reinforced in 2012 by additional rules for all euro area countries and new surveillance measures for countries receiving financial assistance, or whose financial stability is under pressure. Last but not least, in March 2012 all EU countries, except for the UK and the Czech Republic, signed a new international Treaty on stability, coordination and governance in the EMU. This reinforced discipline will rebuild confidence in the fundamentals of EMU that underpin the euro. Accompanied by structural reforms, of labour markets and the services sector among others, the new rules will lay the foundations for the future stability and enhanced competitiveness of the EU economies.

The strengthening of the economic governance rules coincided with the $10^{th}$ anniversary in January 2012 of the issuance of the euro notes and coins which are the legal tender of over 332 million European citizens. The euro played a vital role in preventing more severe consequences of the financial crisis for the euro area countries; supported by the new fiscal and budgetary discipline of all EU countries, the single currency will continue to provide benefits to citizens and companies.

# The economic and financial crisis

There were many causes of the debt crisis in Europe. Some of them were related to external factors: a global economic slowdown and growing risk aversion in the financial markets had direct impact on growth prospects in the EU. Other causes were related to the build-up in some EU countries of fiscal and macroeconomic imbalances, such as large government debt and trade deficits. The combination of high government debt, weakened competitiveness and poor economic growth led financial markets to increasingly question the fiscal sustainability of some euro area countries.

## The EU takes action…

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The objective of the Economic and Monetary Union (EMU) and of the euro is to increase the economic well-being of citizens and businesses in the EU, by boosting growth and creating more job opportunities. However, the euro does not bring economic stability and growth on its own. A single currency has to be underpinned by sound management of the euro area economies under common governance rules that are respected by all of them.

## … on the fiscal side

The central pillar of stability and fiscal discipline in the EMU is the Stability and Growth Pact (SGP). The challenges posed by the crisis called for a comprehensive and decisive strengthening of the application of the Pact. With this aim, new rules, set out in the legislative "six-pack", entered into force in December 2011. For example, greater emphasis is now placed on reducing high levels of government debt. The launch of an Excessive Deficit Procedure (EDP) can result not only because of an excessive government deficit but now also because of government debt developments. Moreover, the enforcement of the fiscal rules is given more bite and, for euro area countries, is backed up by a credible sanctions mechanism. This will ensure that all countries stick to the jointly agreed rules, in order to prevent a similar crisis from occurring again.

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## … on the macroeconomic side

In addition to strengthening the fiscal rules, the EU has introduced a new framework for the surveillance and timely correction of macroeconomic imbalances. The aim is to address risky developments, e. g. related to asset bubbles and weakening competitiveness, before they become a threat for the stability of an EU country, the euro area or the EU as a whole.

Therefore, indicators related to potential macroeconomic imbalances are regularly monitored in areas such as trade, international investment, labour cost, private and public debt, house prices and unemployment. EU countries that show potential worrying trends are analysed in-depth. If an imbalance is found to exist, the country concerned is asked to take action to prevent the situation worsening. If an excessive imbalance is identified, the country has to take action to correct the situation. For euro area countries enforcement of the rules is backed up by a sanctions mechanism.

## … on the growth side

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Europe 2020 is the EU's growth strategy for this decade to to become a smart, sustainable and inclusive economy. These three mutually reinforcing priorities should help the EU countries deliver high levels of employment, productivity and social cohesion.

To measure progress towards these goals the EU has set five ambitious targets - on employment, innovation, education, social inclusion and climate/energy - to be reached by 2020. Each country has adopted its own national targets in each of these areas. Actions at EU and national levels, as well as Structural Funds underpin the strategy.

## ... and on the institutional side

Our experience of the EMU has shown that having sound economic policies in the legislative rule book is not enough. Actions are what count. For that, structures have been created for decisions to be taken quickly, with more rigour, and on the basis of firm evidence and independent analysis. These innovations include regular euro area summits and strengthened support for the President of the Eurogroup (a meeting of the Finance Ministers of euro area countries) from a standing committee (the Eurogroup Working Group) chaired by a full-time President based in Brussels. This is complemented by a strengthened role for the European Parliament.

### The key elements of the new governance framework are

**The European Semester**: a period of policy coordination at EU level (the first half of the year), during which EU countries have the chance to review each other's economic and fiscal policies before they are implemented.

**Annual Growth Survey (AGS)**: a European Commission report, which launches the European Semester. In the AGS, the Commission provides a solid analysis of the progress towards Europe 2020 targets, a macro-economic report and the joint employment report. The AGS sets out an integrated approach to recovery and growth, concentrating on key measures. It applies to the EU as a whole and is then translated into country-specific recommendations in the second stage of the European Semester.

**Stricter monitoring of public debt levels**: countries saddled with high debt were more severely affected by the economic and financial crisis. Yet fiscal surveillance which focused more on deficits than on debt overlooked the build-up of vulnerabilities to long-term fiscal sustainability. To address this, the Commission proposed a binding benchmark for debt reduction for member states with debt ratios in excess of 60% of GDP. Non-compliance could result in financial sanctions for euro area countries.

**Macroeconomic surveillance**: during the crisis, large macroeconomic imbalances made certain euro area countries' finances more vulnerable to economic shocks. In the new economic governance framework, broader macroeconomic surveillance aims to provide an early warning of trouble ahead as well as helping in monitoring the correction of imbalances. The preventive arm of the surveillance includes an alert mechanism based on a scoreboard of economic indicators.

**Stricter enforcement**: euro area countries that fail to follow the agreed fiscal rules may face tougher and more automatic financial sanctions, ranging from interest bearing deposits to fines.

The new, reformed EU economic governance rules are composed of a broad range of elements and actors which make a relatively complex structure. However, the bottom line of these reforms is that steps have been taken to strengthen the economic union, in particular between the euro area countries, to avoid a crisis like the one that started in 2008 in the future. This implies new elements of coordination, such as ex-ante exposure of government budgets to peer scrutiny, joint agreement on economic targets, etc. The new economic architecture also ensures that commitments that EU countries make in Brussels are adequately followed up at national level, or to put it another way, that words are matched by deeds. All of this should contribute to a reinforced and more stable EMU, which can deliver on the final objectives of enhanced integration in the EU, more robust economic growth and more jobs for EU citizens.

## The 10th anniversary of the euro

1 January 2012 marked the 10th anniversary of the introduction of euro banknotes and coins.

The introduction of euro cash was the final step in an unprecedented example of monetary cooperation between EU countries. Since then, the euro has become one of the most important symbols of European integration, shared responsibility and solidarity among the members of the Union.

Notwithstanding the difficulties faced by some EU countries during the crisis, the euro area has benefited overall from low and stable inflation, and a strengthened internal market over the past decade. In addition, the more than 332 million people who use the euro no longer have to pay extra costs to exchange currencies. The euro also brings transparency in cross-border transactions, which enhances competition and promotes trade. Externally, the euro gives the EU a stronger voice in the global economy.

During the financial crisis of 2008, the euro protected the euro area countries from more severe consequences of the global meltdown. The EU's economic governance has now been considerably strengthened. The revised rules, which reinforce fiscal discipline and economic coordination, should allow the full benefits of the EMU to materialise.

## The crisis exposed several shortcomings in the EU's system of economic governance

- **Too much focus on deficits**: monitoring of countries' public finances had focused on annual budget deficits and not sufficiently on the level of government debt. Yet a number of countries that had kept to EU rules by running low annual deficits or even surpluses nevertheless found themselves in financial difficulties during the global financial crisis because of high levels of debt. Therefore, stricter monitoring of this indicator was needed.
- **Lack of surveillance of competitiveness and macroeconomic imbalances**: surveillance of EU economies failed to pay enough attention to unsustainable developments in competitiveness and credit growth leading to accumulated private sector debt, weakened financial institutions, and inflated housing markets.
- **Weak enforcement**: for euro area countries that did not play by the rules, enforcement was not strong enough; a firmer, more credible mechanism of sanctions was needed.
- **Slow decision-making capacity**: too often, institutional weaknesses meant that tough decisions on worrying macroeconomic developments were postponed. This also meant that insufficient account was taken of the economic situation from the perspective of the euro area as a whole.
- **Emergency financing**: when the crisis struck there was no mechanism to provide financial support to euro area countries that suddenly found themselves in financial difficulties. Financial support was needed not only to address country-specific problems but also to provide a "firewall" to prevent problems spreading to other countries that were at risk.

As a consequence, Greece, and subsequently Ireland and Portugal, were eventually unable to borrow on financial markets at reasonable interest rates. The EU was forced to step in, which resulted in the creation of a crisis resolution mechanism and financial backstops i.e. large funds on stand-by to be used in an emergency by euro area countries in financial difficulty.

## EU Financial assistance

- **European Financial Stability Facility (EFSF)**: provides financial assistance to euro area countries in difficulty by raising funds on financial markets. This is backed by guarantees of the countries of the euro area.
- **European Financial Stabilisation Mechanism (EFSM)**: provides financial assistance to EU countries in difficulty. The Commission is allowed to borrow in financial markets on behalf of the EU under an implicit EU budget guarantee.
- **European Stability Mechanism (ESM)**: a permanent financial assistance mechanism that will enter into force in July 2012 and eventually replace the EFSF and EFSM.

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## Economic governance in EMU: who does what?

Within EMU there is no single institution responsible for economic policy. Instead, the responsibility is shared. The main actors are:

**The European Council**: sets the main policy orientations.

**The Council of the EU (the 'Council')**: coordinates EU economic policy-making and takes decisions which can bind individual EU countries.

**The 'Eurogroup' (finance ministers of the euro area countries)**: coordinates policies of common interest for the euro area.

**The EU countries**: set their national budgets within agreed limits for deficit and debt, and determine their own structural policies involving labour, pensions and capital markets.

**The European Commission**: proposes orientations for the conduct of economic and fiscal policy to the Council, monitors performance and ensures compliance with Council decisions.

**The European Central Bank (ECB)**: sets monetary policy for the euro area, with price stability as the prime objective.

**The European Parliament**: shares the job of formulating legislation with the Council, and subjects economic governance to democratic scrutiny in particular through the new Economic Dialogue.

**Further info:**

The euro: www.ec.europa.eu/euro
The European Commission Directorate-General for Economic and Financial Affairs: www.ec.europa.eu/economy_finance
The European Commission: www.ec.europa.eu
The European Central Bank: www.ecb.eu

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