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# Macroeconomic Surveillance Within the EU

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The new European Union (EU) economic governance package released by the European Commission on September 29, 2010 includes two major components, i.e., changes and amendments to the Stability and Growth Pact (SGP) and new regulation on the prevention and correction of macroeconomic imbalances within the EU and European Monetary Union (EMU). While the first piece offers a certain improvement in the EU fiscal surveillance rules the second one looks deeply flawed and operationally unenforceable[1].

## Importance of EU-wide Fiscal Discipline

The fiscal crisis in Greece as well as other European economies confirmed the importance of fiscal discipline at both EU/EMU and national levels. It is difficult to overestimate the potential damage caused by the sovereign insolvency of any EU member state (regardless of whether this concerns EMU or non-EMU member countries) to the entire Union, other member states, or the entire global economy. The contagion channels may involve financial market panics, high exposure to public debt instruments (commercial banks and other financial institutions), and exchange rate volatility (among non-Euro zone countries).

Hence, a strong surveillance regime which could ensure fiscal discipline in EU member states and prevent their insolvency should be considered an important European (or even global) public policy goal. This regime should apply equally to Euro area and non-members because negative spillovers can originate from both groups of countries and may affect the entire EU, not only the Euro zone.

The component of the Commission's legislative package that intends to reinforce SGP (substantially diluted in 2005) appears to head in the right direction although one should not overestimate the scale and potential positive impact of the proposed changes. Instead of a radical overhaul, they offer a marginal improvement to the existing surveillance regime.

## EU Fiscal Rules: Preventive Measures

The so-called preventive arm of SGP, based on Article 121 of the Treaty on Functioning of the European Union (TFEU), is to be amended with the expenditure rule. The essence of this rule is to limit the annual rate of expenditure growth to "*…a prudent medium-term rate of growth of GDP*" (below this rate a country fails to comply with the medium term target of a close-to-balance fiscal position) unless the excess of expenditure growth is matched by discretionary measures on the revenue side. This rule attempts to curb excessive public spending, but it is not particularly demanding if one takes into consideration that the majority of EU member states face rapidly growing debt-to-GDP ratios.

Moreover, determining ex-ante *a prudent medium-term rate of growth of GDP* of any individual country in the current global macroeconomic environment as well as having limited knowledge of the supply-side damage caused by the recent global financial crisis appears almost impossible. In addition, it will become a subject of future political bargaining between respective EU member state governments and the Commission (similar difficulties have been experienced when determining a cyclically adjusted medium term fiscal position for the current SGP).

On September 7, 2010, the EU Economic and Financial Affairs Council (ECOFIN) introduced the European Semester, which brought together the coordination processes of both the SGP and the Broad Economic Guidelines under a single institutional framework. This initiative may help in strengthening ex-ante peer review mechanisms at the early stages of national budget planning.

## EU Fiscal Rules: Corrective Measures

Under the so-called corrective arm of the SGP (based on Article 126 of TFEU) the Commission proposes putting debt criterion on equal footing with the deficit. However, operationalization of this criterion in respect

[1] This E-Brief contains a modified version of the author's opinion on the EU Economic Governance Package prepared on request of the EU Economic and Financial Affairs and International Trade Sub-Committee (Sub-Committee A) of the UK House of Lords.



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to corrective actions raises some doubts. Countries which record debt levels above 60% of GDP should demonstrate an ability to converge towards this level with an annual rate of at least one-twentieth of the difference over the previous three years. Taking into consideration the strongly pro-cyclical character of debt-to-GDP ratios (as demonstrated by the recent crisis) this may be too simple and insufficient during boom times and too difficult (if not impossible) during recessions.

The Excessive Deficit Procedure (EDP) will be strengthened by the introduction of additional and more automatic financial sanctions against non-complying countries. They will begin working immediately upon launching the EDP (non-interest-bearing deposit equal to 0.2% of GDP) and will be stepped up in case of non-compliance with initial recommendations. The mechanism of "reverse voting" gives an opportunity to decrease political discretion in imposing sanctions, but it will not eliminate it completely. In the past this discretion made it impossible to impose any financial sanctions against non-complying member states, and generally, favored large countries against small ones. The most important shortcoming of both the existing and proposed financial sanction mechanisms is its limitation to Euro area countries while the contagion effects generated by sovereign insolvency in any non-Euro area member state (especially a large one) can be equally damaging.

## National Fiscal Rules and Crisis Resolution

The draft Council Directive on requirements for budgetary frameworks of the Member States, addresses a set of important issues intended to increase the level of fiscal transparency and predictability at the national level, increase quality and reliability of fiscal forecasting and planning, extend its time horizon to at least three years, ensure the coverage of all subsectors within general governments, set national numerical fiscal rules (compatible with the Treaty and SGP provisions) and set up independent budgetary offices or fiscal policy councils to provide external assessments of the medium-to-long-term fiscal consequences of government and parliamentary decisions. This is an important piece of legislation addressing institutional and methodological challenges related to fiscal discipline at the appropriate (i.e. national) level, where most fiscal decisions are actually taken. It can limit, to a certain extent, a risk of fiscal free riding in individual member states. However, this gives national authorities considerable discretionary opportunities to decide how effectively this directive will be embodied into national legislations and consequently how these legislations will be enforced.

In addition, the decision of the European Council of October 28-29, 2010 to initate a limited revision of Part Three, Title VII of TFEU ("Economic and Monetary Policy") provides a chance to build a permanent crisis resolution mechanism, after the current temporary solutions launched in May 2010 expire in 2013. A permanent mechanism could help to minimize market panics in case of fiscal difficulties in individual countries and would force financial markets to improve pricing of actual fiscal insolvency risks in advance.

## Fighting Macroeconomic Imbalances

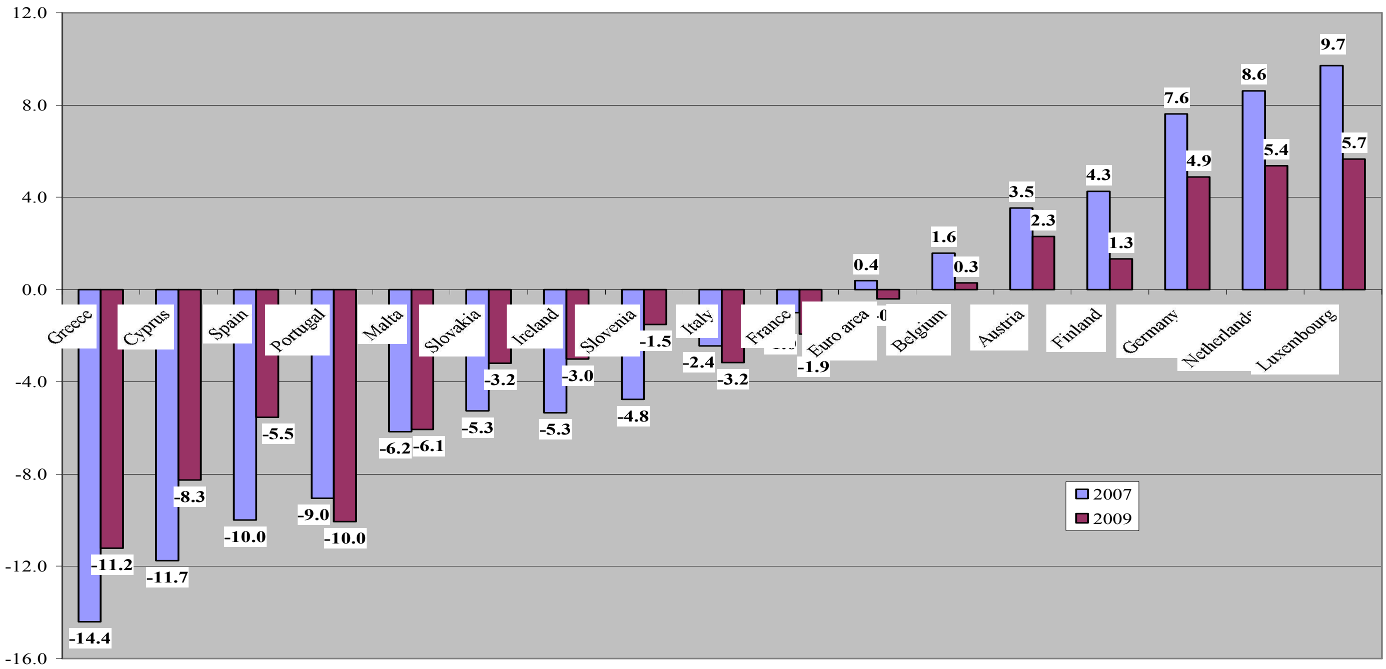
Apart from strengthening fiscal surveillance and fiscal discipline mechanisms at the EU-wide and national level, the Commission proposes the introduction of a completely new mechanism which prevents and corrects macroeconomic imbalances. They are elaborated in two draft regulations of the European Parliament and the Council: (1) on the prevention and correction of macroeconomic imbalances (which shall apply to all EU member states) and (2) on enforcement measures to correct excessive macroeconomic imbalances in the Euro area (which will apply only to EMU members). In case of "excessive imbalances", the Commission proposes to launch Excessive Imbalance Procedure (EIP), which is similar to EDP, but backed by financial sanctions in respect to Euro area countries.

Unlike the prospect of fiscal surveillance/discipline rules, the conceptual background of this legislation is very controversial if not completely wrong. First, the meaning of macroeconomic imbalance is not clearly defined in the draft legislation. Based on the Commission's comments and overall context of the proposed measures one can find a current account imbalance as the operational equivalent of macroeconomic imbalance. However, this means that the Commission intends to control the variable, which is, in a world of free capital movement, well beyond direct policy influence, especially within a single currency area (see Figure 1).

Furthermore, this approach seems to reflect a traditional balance-of-payment analytical framework with an implicit assumption of a fixed residence of capital owners, home country bias in capital movements, as well as a necessity to balance a country's net international investment position over a medium-to-long term horizon[2]. Such a conceptual approach is incompatible with the realities of a highly integrated monetary union such as the EMU. Moreover, if taken seriously it means stopping or limiting capital flows from higher-income countries and regions to less developed ones.

[2] These implicit assumptions have been challenged in M. Dabrowski "Rethinking balance-of-payments constraints in a globalized Word", CASE Network Studies and Analyses, No. 330 (2006), http://www.case-research.eu/upload/publikacja_plik/11517190_sa330.pdf

**FIGURE 1: CURRENT ACCOUNT IMBALANCES WITHIN THE EURO AREA, IN % OF GDP**

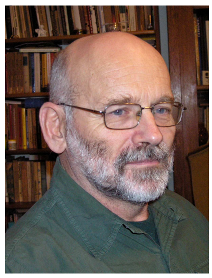



SOURCE: IMF, World Economic Outlook Database, October 2010

If "excessive" current account imbalances pose any real threat to EU-wide macroeconomic stability or the common market, it will most likely come from those countries remaining outside the Euro area rather than EMU members (such as excessive volatility of national currencies against the Euro). Ironically, under the proposed regulations non-Euro area members will be subject to a reduced level of monitoring and will avoid the threat of financial sanctions.

Finally, when one considers the available national policy options to correct this "excessive imbalance" the only obvious solution is the control of capital movements. The problem with this policy option is that it comes in direct violation of the Treaty as well as with one of the basic principles of the single market.

On an operational level, the proposed regulations not only fail to define macroeconomic imbalances but also the exact numeric criteria of "excessive imbalances", the speed of required adjustment, adjustment measures, etc. They give the Commission a mandate to establish *"…an indicative scorecard as a tool to facilitate early identification and monitoring of imbalances".* Most elements of the EIP leave great room for discretionary decisions and, therefore, for political bargaining. One can hardly believe that such a vaguely defined and highly discretionary framework can work effectively.



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