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Swedish Institute for European Policy Studies

European Policy Analysis
OCTOBER · ISSUE 2010:9epa

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Strengthening the Institutional Underpinnings of the Euro

Abstract
This European Policy Analysis discusses the need to strengthen the institutions underpinning the euro and makes several policy recommendations. The Stability and Growth Pact must be reinforced, have greater automaticity and entail graduated sanctions. Fiscal surveillance must be improved through the establishment of a European Fiscal Stability Agency. Finally, the European Financial Stability Facility must be made permanent.

Introduction
The fiscal turmoil in the euro area — in particular, the near-collapse of Greece in May 2010 and the worsening problems in Portugal and Ireland — has triggered an intense debate about how to strengthen the institutional underpinnings of the euro. While this process will take some time, some progress has already been made. In particular, on 10 May, 2010, the establishment of the European Financial Stabilisation Mechanism (EFSM) was announced and on 7 June, 2010, the European Financial Stability Facility (EFSF) followed.[1]

While these developments were important for preventing the financial tensions from spiralling out of control, measures need to be taken to strengthen the Stability and Growth Pact (SGP) which, to date, has been the main institutional mechanism for reducing the likelihood and severity of a public debt crisis in the euro area.[2] Furthermore, and more importantly, the possibility of introducing an explicit Crisis Management Framework, which has so far been lacking, must be explored. A specific issue in this context is whether the EFSM and the EFSF, which by agreement will only be operative for a three-year period (although they may take some time to close after that), should be made permanent.

This article discusses a number of issues that arise when considering how to strengthen the institutional fabric of the euro area. It is organized in four sections. Since the fiscal crisis has shown that the SGP was ineffectual, the first of these sections reviews some of the weaknesses of the Pact. Section 2 turns to the EFSM and the EFSF, and argues that the fact they are temporary is problematic since they may provide little incentive for government to change fiscal policy in a lasting way. Section 3 turns to the necessary features of a well-functioning regime for the resolution and management of sovereign debt crises. Section 4 makes some concrete suggestions for strengthening the institutional framework and Section 5 concludes.

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[1] For references, see Council Regulation (EU) n° 407/2010, 11 May, 2010:
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:118:0001:0004:EN:PDF;
Council Regulation (EU) n° 407/2010, 11 May, 2010:
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:118:0001:0004:EN:PDF;
Eurogroup (2010) 'Terms of reference of the Eurogroup: European Financial Stability Facility', 7 June, Luxembourg:
http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/misc/114977.pdf;
and the press release of the decision made by the Eurogroup:
http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/misc/114976.pdf.

[2] The European Central Bank's views are presented in the document on, 'Reinforcing economic governance in the euro area'. 10 June, 2010. See www.ecb.int.

1. Institutional weaknesses

The public debt problems faced by Greece and other euro area members indicate that the SGP was ineffective. It is useful to start by briefly reviewing some reasons why the SGP proved to be of little value in ensuring sound fiscal policies, and why it is necessary to have a clear framework for the management of crises.

The purpose of the SGP was to avoid the risk of a fiscal crisis by preventing euro area governments from accumulating excessively large public debts.[3] The historical record indicates that if the public debt is large and growing, bond holders will, at some stage, become concerned that the government might not be able to service and repay it. In turn, this may lead them to hesitate to roll over bonds when they mature, triggering a sovereign debt crisis.[4]

While the most recent experience provides plenty of evidence that the intentions behind the SGP were correct, why wasn't it adhered to? Several factors appear to have played a role.

The main reason was a lack of commitment to the SGP by euro area governments. The root of this problem is the fact that decisions regarding government spending and taxation impact on the distribution of income and wealth in the economy and are, therefore, intensely political. Governments do not wish to have their hands tied and, therefore, strive to avoid being seen as interfering in each other's fiscal policy decisions, in the hope of receiving reciprocal treatment. This hesitancy to comment on violations of the SGP, and to invoke the Excessive Deficit Procedur,e meant that the rules of the SGP were downplayed. Moreover, the fact that France and Germany were among the first countries that violated the pact without any adverse consequences strengthened the view that the Pact could be disregarded. Finally, since no European country had experienced a public debt crisis in recent decades, some governments no doubt remained unconvinced about the dangers of large public debts.

Furthermore, a number of design problems made it hard to apply the rules of the Pact. Several weaknesses are now readily apparent.

First, there was a lack of automaticity in the application of the excessive deficit procedure, and the SGP relied too much on peer pressure. In a small group of countries interacting on a range of issues that generate ample opportunity for trading off different objectives, it was difficult to forge agreement about the need to enforce the rules.

Second, the sanctions were too abrupt, procyclical and too punitive to be used. If economic activity, and therefore tax revenues, started to grow below trend, the budget deficit could quickly exceed the 3% limit. The SGP then required the country to tighten fiscal policy at a time of economic weakness, exacerbating swings in the economy.

Of course, the solution to this problem is to strengthen the government's fiscal position in good times so that a large recession would not push the deficit beyond the 3% limit. However, such long-term policies are unlikely to be adopted in a situation in which governments face short-term political pressures.

Third, there was a lack of clarity about whether excessive deficits were a result of bad policy or bad luck, which made countries hesitate to apply peer pressure.

Budget outcomes are volatile and largely determined by the state of the economy rather than changes in fiscal policy. Thus, business cycle contractions reduce tax collections and increase the pool eligible for unemployment benefits and income support. Governments could thus argue that budget deficits occurred despite their best efforts to adhere to the rules.

Furthermore, it is difficult to enforce the rules of the SGP since budget outcomes are only known with a delay. While this problem could be avoided by holding governments accountable by using deficit forecasts, these are sensitive to assumptions made about economic growth. Furthermore, the fact that recessions tend to be correlated across countries implied that when one country saw its deficit worsen, so did the others. This was not conducive to peer pressure.

A further weakness in the pre-crisis regime was the absence of a crisis management framework. This was arguably not accidental, but intended to support

[3] Calmfors (2005) contains an extensive discussion of the SGP. The report is available at http://www.sieps.se/publikationer/rapporter/what-remains-of-the-stability-pact-and-what-next-20058.html.

[4] For a discussion of confidence crises and large public debts, see Public debt management: theory and History, (in particular chapters by Alberto Alesina, Alessandro Prati and Guido Tabellini and by Francesco Giavazzi and Marco Pagano in) ed. by R. Dornbusch and M. Draghi, Cambridge University Press, 1990. Another useful reference is High public debt: the Italian experience, ed. by F. Giavazzi and L. Spaventa, Cambridge University Press 1988.

the functioning of the SGP by demonstrating, to governments and debt holders, that there would be no support for countries that broke the rules and found themselves in a fiscal crisis. However, it can be argued that the lack of such a framework had precisely the opposite effect, by leading borrowers and lenders to guess, correctly as it turns out, that a sovereign default in the euro area, and the likelihood that this would trigger a banking crisis, would force euro area members to launch a rescue. Paradoxically, the failure to prepare for a sovereign debt crisis in Europe made such a crisis more likely.

To improve fiscal discipline, it is therefore important to have a crisis-management framework that credibly promises a rescue, but also provides disincentives to governments and lenders. This requires the bail-out conditions to be unattractive to governments, both economically and politically, so that they provide firm incentives to avoid a crisis. In particular, any financial assistance must be subject to strict conditions and involve stringent reporting requirements.

Furthermore, and more importantly, they must be unattractive to creditors, so that financial institutions hesitate to lend to governments whose debts are large. For instance, financial assistance should involve automatic debt restructuring that entails a large reduction in the net present value of coupons and the principal.

2. The European Financial Stabilisation Mechanism and the European Financial Stability Facility

As noted above, the Greek public debt crisis led to the establishment of the EFSM and the EFSF. The former was intended as a stop-gap measure, without a formalized superstructure, in order to avoid an immediate fiscal collapse of Greece. The latter was given a stronger institutional basis — it was established as a special purpose vehicle under Luxembourg law and given staff — but was designed to operate only for a three-year period. The intention appears to have been to demonstrate that the support given to Greece is exceptional and limited to a period of three years, during which public finances must be sanitized. After that, no support would be available for countries that had disregarded the SGP.

However, while the temporary nature of the EFSF is intended to raise the effectiveness of the SGP, it does the opposite. By returning us to the pre-crisis situation without any crisis resolution mechanism, but with a widely shared feeling that a sovereign debt crisis would be a too terrible event for euro area countries to allow one to occur, it sends the signal that further bail-outs are possible. Instead of hoping that ambiguity about whether financial support will be available if needed will lead governments to adopt sounder fiscal policies, it seems much better to adopt a permanent crisis-management framework that specifies under what conditions any help would be made available.

While the adoption of such a framework might have been seen as introducing a moral hazard by holding out the prospect of financial support to governments that have borrowed imprudently, a properly designed framework is likely to deter and prevent governments from accumulating too much debt, so as to reduce the likelihood of a public debt crisis. As noted above, this crucially requires the bail-out conditions to be unattractive to governments and creditors alike.

3. Reducing the risk of a public debt crisis in the euro area

In order to reduce the likelihood of a repetition of the Greek crisis, a framework is needed that prevents government from borrowing excessively and that enables a crisis to be managed. For such a framework to be effective, it needs to be designed carefully. Before making some concrete suggestions for its institutional structure, this section asks what features it should have.

3.1 Less discretion and more automaticity

One problem with the SPG was that it relied on governments to take action to invoke the excessive deficits procedure against their peers. As discussed above, governments would naturally be hesitant to do so. While a fully automatic SGP would not be credible, since it would suggest that the system was out-of-

control and therefore lacked legitimacy, it would be highly desirable to introduce a presumption that the excessive deficits procedure will be invoked unless a qualified majority of the euro area governments take action to set it aside.

3.2 Improving fiscal surveillance

The role of short-term political influence in the surveillance of fiscal policy must be reduced. Decisions about whether countries are in compliance with the SGP should be made by a politically independent organ. In order for it to be able to do so, governments must make more information about their fiscal positions available publicly, and with shorter delay than is currently the case. They should also make available for review the assumptions (regarding growth, debt service costs, one-off items etc.) made when preparing annual budgets.

3.3 Progressive sanctions

Sanctions need to be progressive and of several types. Rather than have the excessive deficit procedure come into play discontinuously at a deficit of 3%, when, because of its procyclical effects, it cannot be enforced, interventions should start early and become gradually stronger. Initially, they should be primarily of a non-financial form and focus on ensuring that countries seek to abide with the SGP, not primarily on punishing transgressors. This is important for building political consensus behind the revised SGP, which will be crucial for ensuring that countries comply with it.

3.4 Greater emphasis on debt levels than on deficits

While the SGP introduced limits on both deficits and debt, measured as ratios to GDP, the latter provisions were not enforced because too many countries were in violation of them, in some cases egregiously. Since deficits are less important than levels of debt — the main reason deficits are important is that they signal higher future debt levels — this was unfortunate since it sent the signal that, as long as the deficit was not too large, the size of the debt was not a concern.

3.5 Greater focus on incentives and less on rules

Finally, the SGP should focus less on rules and more on incentives that promote better fiscal policy. Not surprisingly, few countries react positively to punishments for past sins, especially if they were committed by a previous government.

A particular concern is the limited effectiveness of market discipline. A common view before the crisis was that lenders would get nervous and demand higher interest rates if governments did not limit debts and deficits. However, this mechanism was inoperative because the interest rate demanded depends not only on the probability that a government will default, but also on the likelihood that it will receive financial support if it does. Unfortunately and correctly, investors did not believe that the no-bail-out rule of the SGP would be enforced, since a default would risk triggering a generalized banking crisis in Europe. Since there are good grounds to doubt the effectiveness of market discipline, a mechanism must be found to raise borrowing costs to provide incentives to limit debts and deficits.[5]

4. Strengthening the framework

In light of the analysis above, two questions are readily apparent. First, what institutional changes and what institutions are necessary to guard against a future fiscal crisis in the euro area? Second, what should follow after the EFSM and the EFSF? These questions are addressed in this section.

4.1 Redesigning the SGP

The SGP needs to be strengthened. Below, I propose a set of reforms that could be contemplated.

First, the SGP will need to come into play at much smaller deficits and at lower levels of debt than is presently the case. Countries experiencing deficits greater than 1.5% of GDP and/or a public debt of 60% of GDP should enter a 'surveillance regime'.[6] This regime would require them to provide the European

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[5] The idea here is that the cost of borrowing is currently too low since it does not capture the 'bail-out insurance' that membership of the euro area entails.

[6] The proposed thresholds for deficits and debts are only meant as illustrations.

Commission, the European Central Bank and a new European Fiscal Stability Agency (EFSA), which I describe below, with data on budget outcomes and budget plans for fiscal consolidation. However, there would be no presumption that any immediate policy action would need to follow.

If the budget deficit is greater than 3% or the public debt is greater than 90% of GDP, the country would enter an 'enhanced surveillance regime'. This would require governments to present plans to reduce deficits and debt. Moreover, national budgets would need to be presented to the European Commission, the ECB and the EFSA for public comment before adoption.

If the budget deficit exceeded 5% of GDP or the public debt is greater than 110% of GDP, the country would enter a 'strict surveillance regime'. Under this, the Commission and the EFSA could send resident representatives to follow public finance developments on-site and in real time.

To provide incentives to reduce debt, a new Fiscal Stability Charge should be introduced. The annual charge will equal 1% of the stock of public debt above 60% of GDP and will be paid by the national treasury.[7] The charge will be paid to the European Commission, which will return it to the euro area governments on a pro-rata basis. Thus, for the euro area governments as a group, the net cost will be zero.

Given the weak state of public finances currently, the rules would only apply to debt issued after 1 January, 2011. Since only a fraction of public debt is rolled over annually, it will take some time before the 60% limit is reached.[8]

4.2 Establishment of a European Fiscal Stability Agency

The objective of strengthening the SGP is to reduce the likelihood that a euro area member will suffer a public debt crisis by accumulating too large debts. But the recent experience has demonstrated that euro area governments are too hesitant to enforce the rules. The EFSA will be created as an independent organ to ensure proper surveillance of governments' fiscal accounts, and to trigger the different sanctions of the SGP if violations are detected.

The main objective of the EFSA is to review annually euro area governments' compliance with the SGP. It will do so by preparing annual reports on fiscal policy developments. Furthermore, it will determine what countries should enter the 'surveillance regime' and the 'enhanced surveillance regime' of the SGP, and it will be the main organ conducting that surveillance, including appointing resident fiscal policy experts to those countries for which this surveillance is required. It would also be useful for the EFSA to produce stress tests of fiscal policy. These tests would consider various scenarios for domestic and foreign GDP, inflation, unemployment and interest rates, and the likely repercussions of the government's ability to abide by the SGP would be assessed. It would be natural to make the findings of the stress test publicly available.

For such an institution to be effective, it must be small and not afraid to take controversial positions. In turn, this requires it to have operational independence from euro area governments and other EU organisations.[9] Since determining whether a country is in compliance with the SGP involves judgment and not a mechanical application of rules, it would be appropriate for that decision to be taken by a committee of experts of no more than nine members, rather than a single person, through majority voting. The committee members must be independent (that is, not be civil servants or politically active), and must not be permitted to seek or take external advice. Moreover, they must be recognised experts in the area of banking, fiscal policy or monetary policy. They would be appointed by the euro area governments for a non-renewable term of eight years. The appointments would be staggered.

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[7] Thus, a country with a stock of public debt equal to 100% GDP would pay 0.4% of GDP per year.

[8] As an illustration, consider a country that has a debt to GDP ratio of 100%, that the debt has a maturity of 10 years and that the maturity dates are evenly spaced. Thus, this country issues debt equal to 10% of GDP per year. By January 2017, it will have issued new debt equal to 60% of GDP and will, that year, pay a Fiscal Stability Charge of 0.1% of GDP. The next year, the charge will rise to 0.2% of GDP and so on, until it reaches 1% of GDP by 2021.

[9] In turn, that requires it to be financially independent.

4.3 The European Financial Stability Facility

However, even if a revised and strengthened SGP, coupled with stricter surveillance through the new EFSA, would reduce the likelihood of a public debt crisis in the euro area, there will always remain some risk that a new crisis will occur. Since the EFSF has been designed to be operational for only three years, it is essential to make this a permanent facility. While it would be possible to replace it with a similar institution, the EFSF already exists and already has a detailed set of rules regarding its operations.[10]

5. Conclusions

The near fiscal collapse of Greece, and the current pressures on Irish, Portuguese and Spanish bond yields have made it clear that a fundamental rethinking of the institutional fabric underlying the euro is crucial. The current problems arise largely for three reasons: the SGP was poorly designed and is, therefore, ineffectual; fiscal and budgetary policy is intensely political and peer pressure is, therefore, of little value in inducing countries to adopt sounder policies; and there is no credible crisis-management mechanism — indeed, the explicit lack of such a mechanism and the resulting ambiguity appear to be relied on as a disciplining device par excellence.

To reduce the likelihood and consequences of another fiscal crisis in the euro area, steps must be taken to limit public debts much more efficiently than has been the case to date. This must involve both carrots and sticks. The following steps seem crucial and should be taken promptly.

First, the SGP must be reinforced. It should involve more automaticity so as to avoid political obstacles being used to prevent it from operating as intended. Moreover, the sanctions must be various and graduated so that it becomes politically possible to let them function. Most importantly, the SGP must be seen as focusing on providing incentives for better policy and not on meting out punishment for infractions, in order to gain political legitimacy.

Second, fiscal surveillance and, in particular, adherence to the SGP must be strengthened by the establishment of the EFSA. This should be small and independent, but with considerable power to follow and analyse fiscal policy in the euro area economies. It must also have the power to comment publicly on countries' adherence to the SGP. Whether it should comment on broader macroeconomic imbalances, as recently suggested by the European Commission, is less clear.[11] Judging what constitutes such an imbalance is more difficult since their roots may be deep (such as in weaknesses in retirement systems). Furthermore, they can also be outside the direct control of policymakers.

Third and most importantly, the EFSF must be transformed into a permanent institution with credible and transparent rules for financial support. Countries must know that in an emergency they can obtain funds from the EFSF at a not excessive interest rate. But they may also understand that the political consequences of having to borrow are such that this should be avoided. Holders of sovereign debts must also know that if a country were to request financial assistance from the EFSF, an immediate consequence would be a restructuring of the public debt, entailing a reduction of its market value. Thus, they must also be provided with firm incentives not to lend to governments whose fiscal policy risks becoming unsustainable.

[10] See the *EFSF Framework Agreement*, dated 7 June, 2010, which is available at www.efsf.europa.eu.

[11] The European Commission's proposal is available as: MEMO/10/454 'Economic governance package (2): Preventing and correcting macroeconomic imbalances': *http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/454&format=HTML&aged=0&language=EN&guiLanguage=en.*

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