Opinion of the European Economic and Social Committee on 'The implications of the sovereign debt crisis for EU governance' (own-initiative opinion)

(2011/C 51/03)

Rapporteur: **Mr SMYTH**

On 29 April 2010 the European Economic and Social Committee, acting under Rule 29(2) of its Rules of Procedure, decided to draw up an own-initiative opinion on

The implications of the sovereign debt crisis for EU governance.

The Section for Economic and Monetary Union and Economic and Social Cohesion, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 7 September 2010.

In view of the renewal of the Committee's term of office, the Plenary Assembly has decided to vote on this opinion at its October plenary session and has appointed Mr SMYTH as rapporteur-general under Rule 20 of the Rules of Procedure.

At its 466th plenary session, held on 21 October 2010, the European Economic and Social Committee adopted the following opinion by 120 votes to seven with five abstentions.

1. Conclusions and recommendations

1.1 The sovereign debt crisis - triggered by financial and fiscal crises - threatens the very existence of EMU and requires effective financial, economic and political responses. It has highlighted the inadequacies of the Stability and Growth Pact as a mechanism for ensuring fiscal responsibility in member states.

1.2 The EESC supports the actions taken to date by the Council and ECOFIN to support member states in financial distress via the European Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). This is an interim solution but it may form the basis of a more permanent procedure and framework for conditional financial support through the establishment of a genuine European Monetary Fund. The case could also be considered for setting up a European sovereign debt agency that issues Eurobonds.

1.3 The EESC recommends that in order to avoid jeopardising the aims of the European Economic Recovery programme, debt reduction programmes should be set up in the euro area to ensure the area's economic and monetary stability. This should be done in a way that is compatible with the economic recovery and the employment objectives set out in the Commission's Communication 'Europe 2020: A strategy for smart, sustainable and inclusive growth', which have been seriously compromised by the crisis.

1.4 There are many lessons to be learned from the debt crisis for future EU governance. The initial proposals from the working group on economic policy in terms of surveillance and sanctions represent moves in the right direction. The EESC nevertheless believes that sanctions have to balanced with greater European solidarity in the management of sovereign debt but the EESC notes that as yet there is no formal mechanism for dealing with a sovereign debt default. This remains a structural weakness in the architecture of EMU that must be addressed by policymakers. The sanctions, however, should be both political and economic, to avoid further exacerbating the debt of the countries concerned.

1.5 Much of the blame for the sovereign debt crisis can be laid at the door of irresponsible fiscal policies pursued by some EU Member States. Some of the blame can be attributed to imprudent bank lending which fuelled construction and asset bubbles and some to the imprudent behaviour of credit rating agencies. The huge taxpayer-funded bail-outs of banks in some Member States and the subsequent fragility of the global financial system was also an important contributory factor to the crisis. For the future there must be effective reforms of global banking that prevents a recurrence of such behaviour.

1.6 The EESC hopes that the strengthening of European economic governance, to be launched in January 2011 with the European Semester, bringing closer economic policy coordination among the Member States [1], will aim to safeguard European jobs which are seriously threatened by the crisis.

1.7 The Committee believes, however, that economic policy coordination alone is not enough – at least for the euro area countries; rather, a genuine common economic policy is needed, as well as coordination of budgetary policy, at least in the first phase.

[1] COM(2010) 367: *Enhancing economic policy coordination for stability, growth and jobs – Tools for stronger EU economic governance.*

2. **Background to the crisis - fiscal policies underpinning Economic and Monetary Union**

2.1 Fiscal discipline is one of the key elements of macro-economic stability and this is particularly true in a monetary union, such as the euro area, which is made up of sovereign states that retain responsibility for their fiscal policies. In the euro area national monetary and exchange rate policies to respond to country-specific shocks are no longer available. Fiscal policies are therefore all-powerful but they can adjust better to such shocks if they start from a sound position.

2.2 Several mechanisms and arrangements were put in place to ensure sound fiscal policies and to limit the risks to price stability. These arrangements are enshrined in the Articles 121, 123, 124, 125 and 126 of the Treaty on the Functioning of the European Union (TFEU) and comprise the Stability and Growth Pact (based on Articles 121 and 126), the excessive deficit procedure (Article 126), the prohibition of monetary financing (Article 123), the prohibition of privileged access to financial institutions (Article 124) and a no-bail-out-clause (Article 125).

2.3 The basic rule of budgetary policy enshrined in the Treaty is that Member States shall avoid excessive government deficits. The basis of compliance with this is that Member States should observe an annual general government deficit limit of 3 % of GDP and keep gross national debt in relation to GDP at or below a limit of 60 %.

2.4 In exceptional circumstances a temporary excess of the deficit over the limit can be exempt from being considered excessive provided that it remains close to that limit. The decision as to whether a Member State is in a situation of excessive deficit lies with the ECOFIN Council, acting upon a recommendation from the European Commission. If the Council decides that a Member State is in a situation of excessive deficit, the excessive deficit procedure provides for the necessary steps to be taken. These could ultimately lead to imposing sanctions on the country concerned.

2.5 The rationale for the Stability and Growth Pact is to ensure that sound budgetary policies are adopted on a permanent basis. The Pact lays down the obligation for Member States to adhere to the medium term objectives for their budgetary positions of ‘close to balance or in surplus’, as defined under country-specific considerations. Adjusting to such positions is supposed to allow Member States to deal with normal cyclical fluctuations without breaching the 3 % of GDP reference value for the government deficit. In reality, the concept behind and the operation of the Stability and Growth Pact have been very far apart. As the European Central Bank (ECB) recently commented:

‘However, the compliance of individual Member States with the budgetary norms of the Maastricht Treaty and the Stability and Growth Pact has been uneven. Breaches of the 3 % of GDP reference value for the government deficit have been repeated and persistent in some countries, leading to the conclusion that at least in these cases the implementation of the Pact has lacked sufficient rigour and political will. To varying degrees across countries, deviations from fiscal plans have been caused by over-optimistic growth forecasts, ex post data revisions, larger than expected revenue fluctuations and persistent expenditure slippages.’ (Ten years of the Stability and Growth Pact, ECB Monthly Bulletin article, October 2008.)

2.6 The apparent breakdown in compliance with the fiscal rules underpinning EMU pre-dates the current global financial crisis but it could be argued that the risks of sovereign debt default within the monetary union represent a second phase of the crisis. After a decade or more of easy credit growth which led to housing and construction bubbles, the subsequent economic implosions in some Member States has left them with spiralling debt problems. It is somewhat ironic that the governments of Greece, Spain and Portugal did not have to undertake taxpayer funded rescues of their banking systems during the banking crisis but their sovereign debt difficulties now threaten to de-stabilise banks right across the EU. This illustrates the point that taxpayer-funded bail-outs of banks were not the main cause of the increase in public debt.

2.7 During the banking crisis it was often claimed that some banks were ‘too big to be allowed to fail’; now there is talk of Member States, struggling with mounting public debt, being ‘too important to be allowed to default’. Just as there was a painful acceptance by taxpayers of the need to bail out delinquent banks now, in turn, a potentially even more painful adjustment in public finances of some Member States is being demanded by international bond markets. The uncertainty which the sovereign debt default issue has created has also begun to undermine the euro itself and has prompted fears that it could engulf a number of euro Member States.

2.8 The sovereign debt crisis is a crisis of confidence for the EU in general and the euro zone in particular. It requires a political as well as a financial solution. It has brought into question the adequacy, or otherwise, of the fiscal arrangements outlined above to ensure the stability of the single currency. It could be argued with some justification that the Stability and Growth Pact has failed and that Europe now needs to create a new fiscal and monetary framework that could cope more effectively with seriously adverse economic outcomes or even the failure of a Member State. If this is correct, then what might such a framework look like?

3. **Alternative Fiscal and Monetary Frameworks**

3.1 There have been a number of developments at both the policy theory and policy implementation levels in recent months. One interesting proposal that has been put forward to address the sovereign debt crisis and the issue of sovereign default is the creation of a European Monetary Fund (EMF) ([2]). The idea behind this proposal is the argument that the International Monetary Fund (IMF) is not experienced in dealing with the threat of a sovereign debt default in a member of a monetary union and that the EU would have much stronger enforcement mechanisms if an EMF were in operation.

3.2 The notion of a European Monetary Fund should be seen as analogous to the kinds of policy responses to the recent financial meltdown when the objective of policy was to prevent the failure of large financial institutions. As the EU emerges from the banking crisis the policy debate has centred on reforms that would enable the orderly default of financial institutions and the self-financing of rescue funds for larger banks with solvency difficulties. In other words, having stabilised financial systems, European policy makers are now concentrating on ensuring that, in future, financial institutions and not taxpayers do the heavy lifting in times of crisis. Banking reform proposals include higher capital ratios, tighter supervision, capping bankers' bonuses and the drawing up of 'living wills'. In terms of EMU, to protect the single currency, the system must also be strengthened to cope with the instability caused by the default or failure of one of its members.

3.3 The proposers of EMF argued that it would be consistent with the notion of enhanced cooperation established in the Treaty and thus may not need an amendment to the Treaty. An EMF, properly constituted, addresses the weaknesses in the EMU architecture caused by the failure of the Stability Pact to date and the apparent lack of credibility of the no bail out clause.

3.4 How would such a fund be financed? In order to minimise the moral hazard problem now facing Germany and France in co-financing the emergency package for Greece, only those countries in breach of the Maastricht criteria would contribute to the EMF. Their contribution rates would be determined by two rules:

— 1 % annually of the stock of 'excess debt', which is defined as the difference between the actual level of public debt (at the end of the previous year) and the Maastricht limit of 60 % of GDP. For Greece, with a debt-to-GDP ratio of 115 %, this would imply a contribution to the EMF equal to 0.55 %.

— 1 % of the excessive deficit, i.e. the amount of the deficit for a given year that exceeds the Maastricht limit of 3 % of GDP. For Greece, the deficit of 13 % of GDP would give rise to a contribution to the EMF equal to 0.10 % of GDP.

For 2009, the total contribution for Greece would have been 0.65 % of GDP - considerably less than the levels of austerity now being demanded.

3.5 In addition the EMF would be able to borrow in the markets so that it would have sufficient resources on top of accumulated contributions to meet any requirements. The EMF could intervene to provide financial support by either liquidating part of its holdings or by guaranteeing a sovereign debt issue by a member state. To illustrate, and with the benefit of hindsight, using the suggested funding mechanism, the EMF would have been able to accumulate EUR 120 billion in reserves since the start of EMU. Combined with appropriate levels of market borrowings, this would provide enough to finance the rescue of any of the smaller euro area Member States.

3.6 With respect to enforcement, the EU has a number of options, ranging from cutting off structural funds, withdrawal of new funding guarantees or even cutting the country off from the euro area's money market. These penalties would be used progressively as individually they impose significant economic pressure on Member States that do not implement previously agreed reform programmes.

3.7 One of the claimed advantages of the proposed EMF is that it could manage an orderly default of a euro area member that does not comply with the terms of a reform programme. In comparison with the uncertainties of debt restructuring on international bond markets, the EMF could offer holders of the sovereign debt of the defaulting member state to exchange this debt at a standard discount against claims on the EMF. In this way the disruption caused by the default would be limited and the losses suffered by financial institutions would also be reduced.

3.8 Advocates of an EMF claim that it offers important advantages over simply calling in the IMF. The EMF could preside over an orderly sovereign default that would minimise disruptive spill over effects in bond and other financial markets. Just as with the lessons learned in the banking crisis, policy should now be geared up not just to prevent a future crisis but also to prepare for it. So too with the sovereign debt crisis. When and if the present crisis has passed, Europe must prepare for it to happen again.

([2]) This proposal is set out in full in D. Gros and T. Mayer, 'How to deal with sovereign debt default in Europe: Towards a Euro(pean) Monetary Fund.' Policy Brief No 202, Centre for European Policy Studies, May 2010. Many of the arguments in this document are drawn from this insightful paper.

3.9 Another interesting set of ideas centre on the tension between the need for European economic recovery and debt reduction. Research has shown that in the euro zone the fiscal disciplines of the Maastricht criteria and the Stability and Growth Pact have had a dampening effect on economic growth compared with the US and the UK ([3]). The irony is that the financial crisis started in the US and there the policy reaction has been an enormous fiscal and monetary counter cyclical boost. Euro area macroeconomic policy has suffered from inertia due to a policy bias towards monetary stability rather than growth. This is understandable in the context of establishing the credibility of the single currency and the ECB but it could now be viewed as potentially hindering economic recovery. Indeed there is a case for arguing that a relaxation of the limits of the Stability and Growth Pact might help to stimulate economic recovery and bring the debt crisis to an end.

3.10 It is argued that any policy or institutional response to the sovereign debt crisis should deal with the issues of debt reduction without endangering the aims of the European Economic Recovery Programme. One possible way of achieving this might be to combine a debt reduction process with an expansion of investments to counter the deflationary effects of the debt reduction. This proposal is based on the Delors 1993 White Paper on Growth, Competitiveness, and Employment and has a debt transfer option as its centrepiece. Thus a proportion of each member states' sovereign debt would be transferred to European Union bonds. The transfer would still oblige the member states to service their shares of their debt now in euro bonds. It would therefore not be a debt write-off nor would it increase the borrowing of member states faced with debt difficulties; rather it would lower the service costs of the portion transferred. Supporters of this proposal argue that it could be accommodated within existing Treaty guidelines. In tandem with the debt transfer, it is also proposed that European Investment Bank (EIB) and national financial institutions borrowing be expanded to finance the European Economic Recovery programme and to mitigate a contraction of employment income and trade resulting from aggressive debt reduction ([4]).

3.11 The official response to the debt crisis was set out following the Council extraordinary meeting on 9 May 2010. It involves the establishment of a European Financial Stabilisation Mechanism, based on Article 122.2 (exceptional occurrences) of the TFEU and an intergovernmental agreement of euro area Member States. The EFSM has 60 billion Euros at its disposal and it operates under conditionalities similar to those of the IMF. In addition a Special Purpose Vehicle (SPV), referred to subsequently as a European Financial Stabilisation Facility has been established. The SPV will last three years and it will have up to 690 billion Euros to support euro-area Member States facing exceptional financial difficulties. Furthermore the European Central Bank (ECB) has started to intervene in bond markets by purchasing the debt of governments in financial distress.

3.12 There are several important aspects of these new arrangements. First of all they are not a cheap finance option; all interest and loan principal will be repaid by the relevant Member State via the Commission. In this sense the EFSM is not a bail out and is therefore compatible with Article 125. Secondly, the EFSM and EFSF represent credit lines, not budget lines and therefore they stay within the 'own resources' decision. Thirdly, the EFSF will operate for a three year period but its effects could extend for several years beyond this if it issues bonds with longer term maturities. Fourthly, it is envisaged that the EFSF will issue bonds that will be guaranteed up to 120 % by all EU Member States; it is intended that these bonds will carry an AAA rating thereby minimising their servicing costs ([5]). Finally the EFSM represents tangible evidence that EU solidarity remains the ultimate underpinning of EMU.

3.13 The extent to which the EFSM proposals deal effectively with the present debt crisis will become clear in the months ahead and will depend upon the extent to which individual Member States undertake the fiscal adjustments required by the EU and IMF. The EU has reaffirmed its desire to strengthen fiscal discipline and to find a permanent crisis resolution framework. The latter has prompted speculation that the EFSM and EFSF could be made permanent but this might be difficult to achieve as it would require unanimous approval of all Member States. The lack of any substantive proposals that deal with the possibility of a sovereign debt default implies that policymakers will not permit such an eventuality. While this is entirely understandable it does not eliminate the potential for such defaults.

4. **Lessons to be learned**

4.1 It is becoming clear that the debt crisis could have been avoided if there had been better governance in member states and in the EU and it is imperative that the governance weaknesses of the past are not repeated. To this end the working group on coordinating economic policy has announced a series of measures to strengthen budgetary surveillance consistent with the Stability and Growth Pact. These measures deal with the

([3]) See Fitoussi, J.P. and F. Saraceno: 'Europe: How deep is a Crisis? Policy Responses and Structural Factors Behind Diverging Performances' Journal of Globalisation and Development. Volume 1 Issue 1 Berkeley Electronic Press. 2010.

([4]) For a full outline of these proposals see Holland, S.: 'A European Monetary Fund, Recovery and Cohesion' in Insight, http://www.insightweb.it/web/node/136 (accessed on 10.6.2010).

([5]) On 21 September each of the main Credit Rating Agencies declared that they would assign AAA ratings to debt issued by the EFSF.

peer scrutiny of member states' draft budgets, earlier application of sanctions in respect of the 3 % and 60 % debt thresholds, triggering of the excessive deficit procedure if debt reduction is not sufficiently timely, and greater independence for national statistical offices from the respective national governments.

4.2 The role and behaviour of the main ratings agencies throughout the financial and debt crises have been unsavoury to say the least ([6]). A new independent European rating agency has been proposed by Chancellor Merkel that would compete with the existing big three ([7]). It has also been suggested that Eurostat should be given the power to issue ratings of member states' public finances. If such powers had already been in place then Eurostat might have given earlier warnings of the Greek debt crisis ([8]).

4.3 The Commission has been criticised for lack of vigilance and proactivity in the quality assurance of national public finance data. This point relates to wider issues of surveillance, scrutiny and compliance which go to the heart of the failure of the mechanisms in the Stability and Growth Pact. Any longer term solution must address these issues effectively.

4.4 While there were no taxpayer-funded bail-outs for banks in Greece, Spain and Portugal, the scale of such bail-outs elsewhere in the EU and the US has contributed to an unprecedented level of pressure on sovereign bond markets and has precipitated this crisis. It is essential that effective reforms of global banking are implemented which would prevent the recurrence of such financial, economic and social instability.

Brussels, 21 October 2010.

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([6]) For a comprehensive discussion of ratings agency shortcomings see U.S. Securities and Exchange Commission: (SEC) 'Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies' http://www.sec.gov/news/studies/2008/craexamination070808.pdf (accessed on 10.6.2010).

([7]) Irish Times reports that the German Chancellor said that the new agency would 'naturally not be politically dependent' but would 'act in the spirit of sustainable economics that is not so oriented around the short term'. Irish Times from 21 May 2010.

([8]) During our visit to Eurostat we were informed that Eurostat had repeatedly given earlier warnings of the Greek high deficit and public debt crisis but nobody listened to them.