
The EU's Fiscal Crisis and Policy Response: reforming economic governance in the EU

**By Heliodoro Temprano Arroyo
Head of Unit**

**Neighbourhood Countries – Macro-Financial Assistance
Directorate General for Economic and Financial Affairs
EUROPEAN COMMISSION**



Outline

- I. Impact of the crisis on fiscal deficits/public debt**
- II. Medium-term and long-term challenges**
- III. Exit strategies**
- IV. What went wrong?**
- IV. The EU's response**
 - a) Filling the gaps in the EU's fiscal framework: towards a SGP III?**
 - b) Reinforcing economic governance**



- **The crisis has had a very negative impact on fiscal positions**
- **The EU-wide general government deficit has increased from 1% of GDP in 2007 to 6.8% of GDP in 2009, and 6 1/2% of GDP in 2010 (although it is expected to decline to 4.7% in 2011 and 3.8% in 2012)**
- **Both the operation of automatic fiscal stabilisers and the counter-cyclical fiscal measures adopted during the crisis explain this**



- **The EU's aggregate debt-to-GDP ratio has also deteriorated markedly, rising from 61.8% of GDP at end-2007 to a projected 82.3% in 2011.**
- **Commission long-term projections indicate that debt-to-GDP ratio could rise to around 110% by 2030 in the absence of fiscal consolidation.**
- **The public debt crisis in Greece, Ireland, Portugal and other euro area countries underline the fiscal risks, the need to act on the fiscal consolidation front**
- **Other advanced economies face similar fiscal challenges**



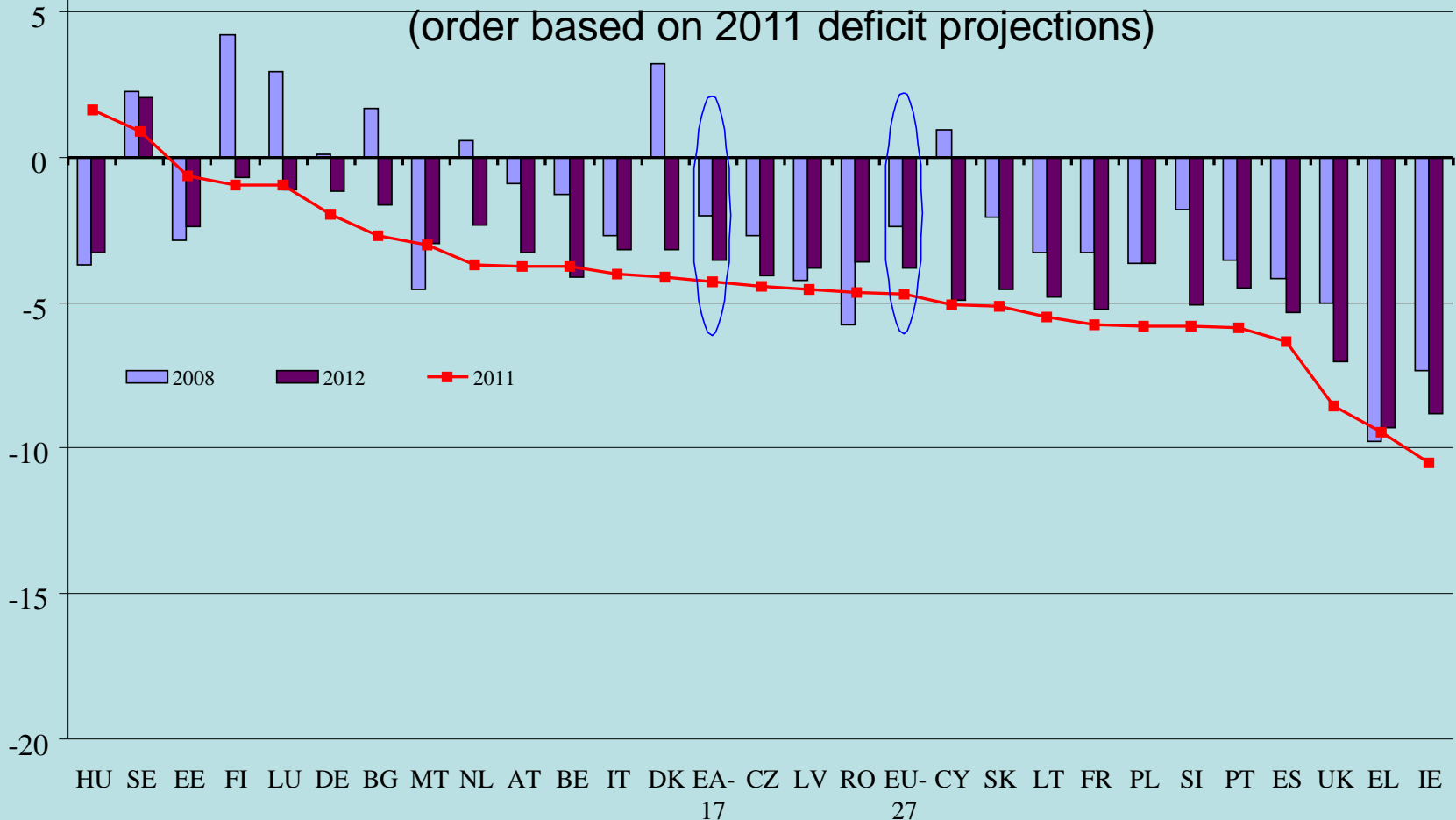
Impact of the Crisis on Fiscal Deficits and Public Debt
(in percent of GDP)

	2006	2007	2008	2009	2010	2011
General government balance						
EU	-1.4	-0.9	-2.4	-6.8	-6.4	-4.7
Euro area	-1.4	-0.6	-2.3	-6.8	-6.4	-4.7
USA	-2	-2.8	-6.2	-11.2	-11.2	-10
Japan	-1.6	-2.4	-2.2	-8.7	-9.3	-9.8
Gross public debt						
EU	61.5	58.8	62.3	74.4	80.2	82.3
Euro area	68.4	66	64.8	76.8	82.9	85.2

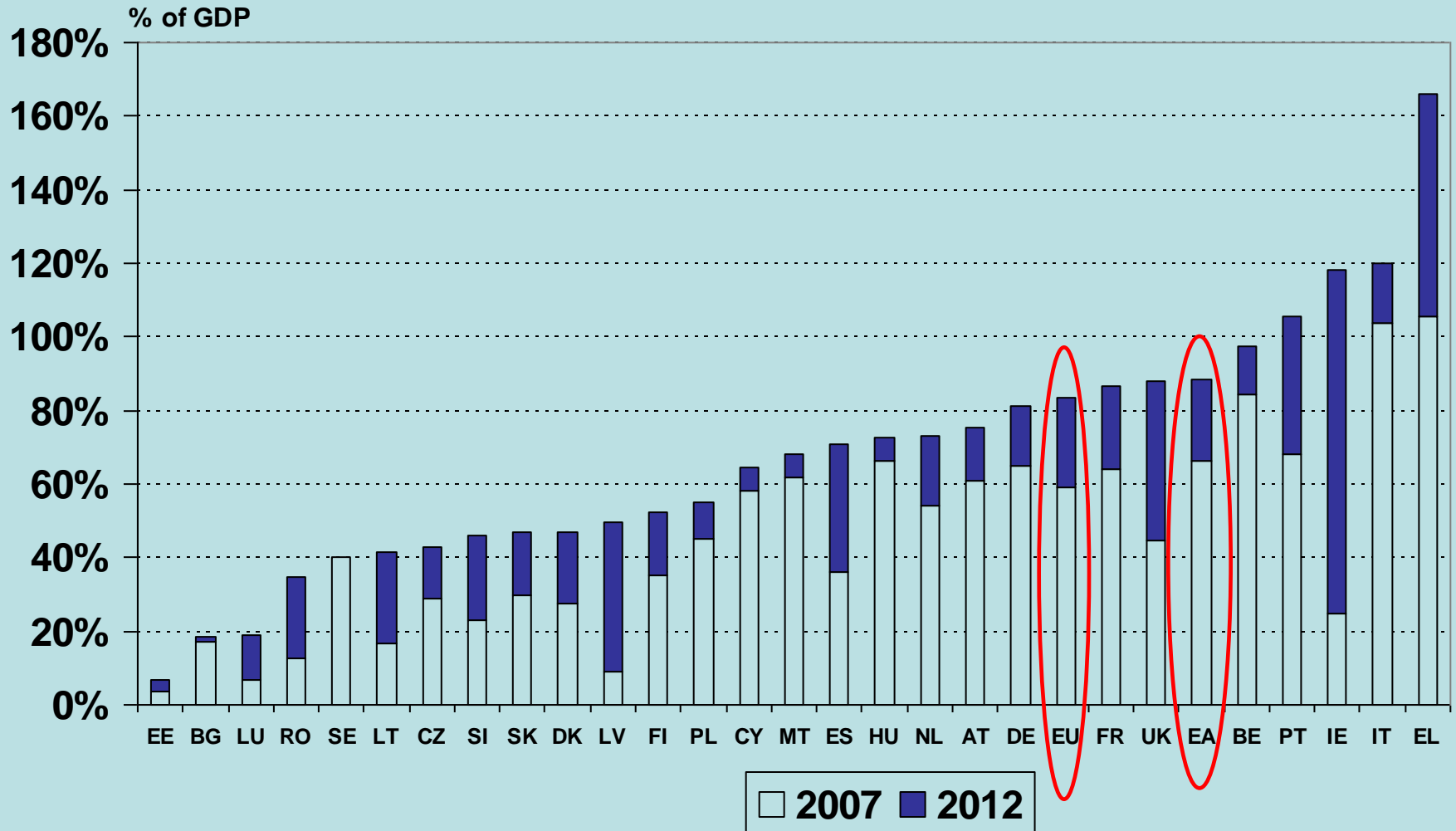
Source: European Commission's Spring 2011 Forecast

Daunting fiscal challenge: short-term fiscal impact of the crisis at country level - deficits Budgetary developments vary considerably across Member States

General government balance (%of GDP) in the Commission services Spring 2011 Forecast



Short-term fiscal impact of the crisis – general government debt



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- **The previous slide shows how easy it is to lose quickly previous achievements in fiscal consolidation**
 - **See in particular, the 2007-12 deteriorations projected for Ireland (over 110 pp of GDP!), Greece (60 pp), Latvia (40 pp), the UK (45 pp), Spain (35 pp)**
 - **Non-complacency and perseverance in fiscal discipline is the name of the game, particularly if countries want to build safety margins to respond to future shocks**

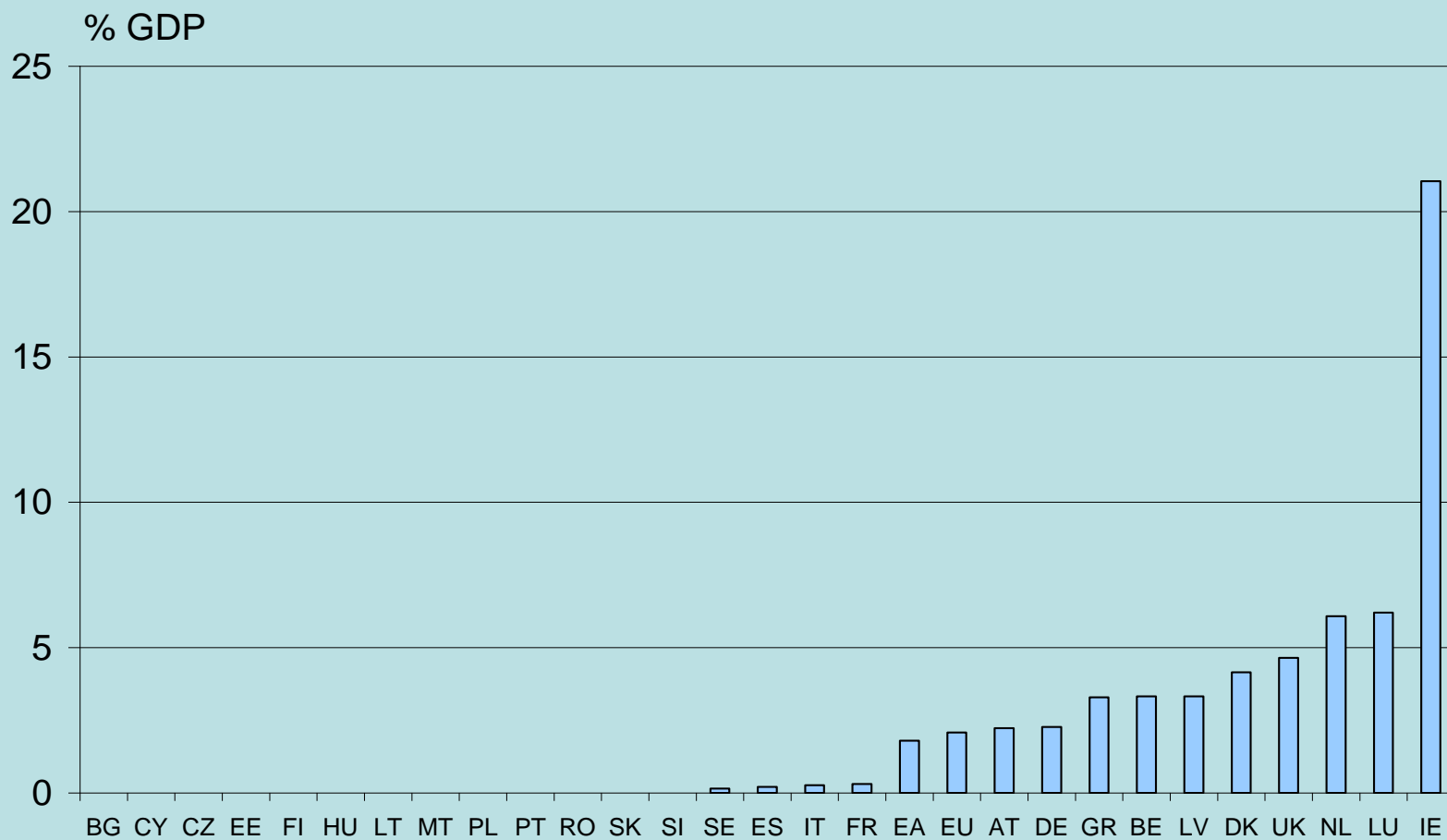


Part of the fiscal deterioration in the EU reflects an unprecedented policy stimulus to counter the crisis

- Fiscal stimulus overall roughly 5-6% of GDP in 2009 (half of this reflects automatic stabilisers which are large in EU)
- Measures to stabilise the financial system: resources potentially committed worth some 30% of GDP, of which 13% of GDP have been implemented, including recapitalisation measures (1.9%), guarantees (7.7%) and asset relief (2.8%).
- This is in addition to the monetary policy stimulus



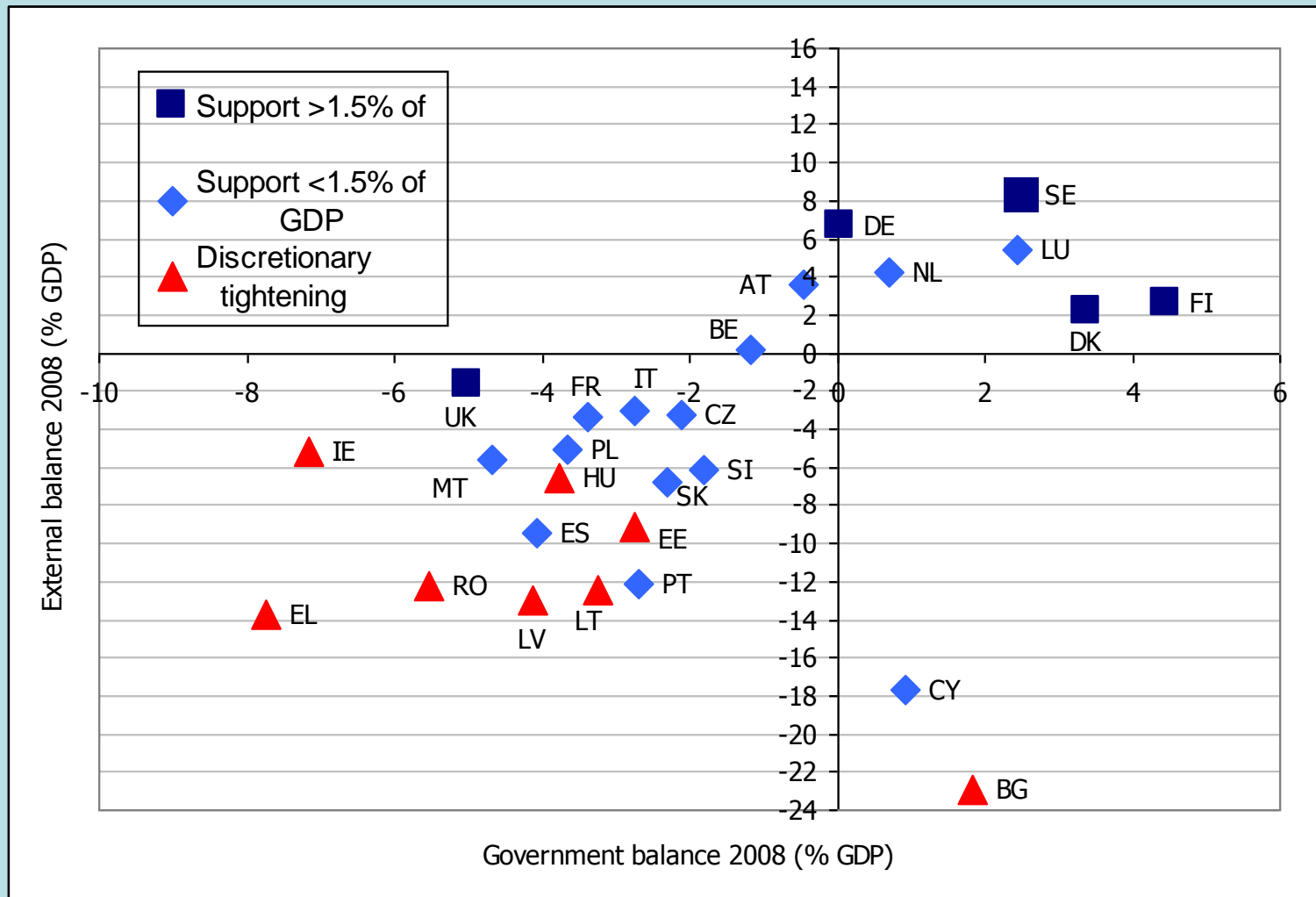
EU public interventions in the banking sector in the form of capital injections



Source: Commission; cut off date – October 2010.

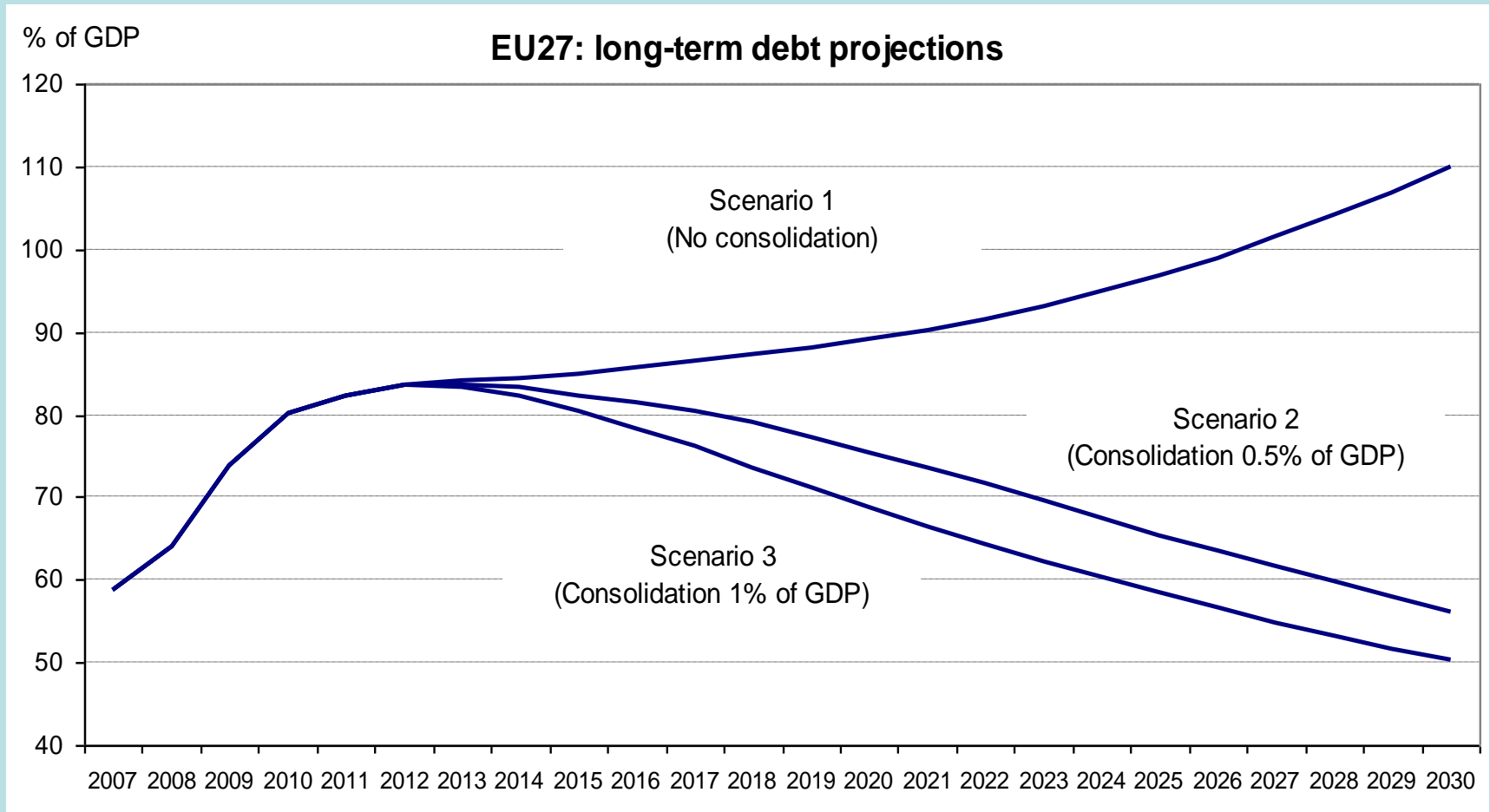
Discretionary measures in 2010 relative to 2008:

Government support was linked to starting position: larger in countries with comfortable external and budgetary positions



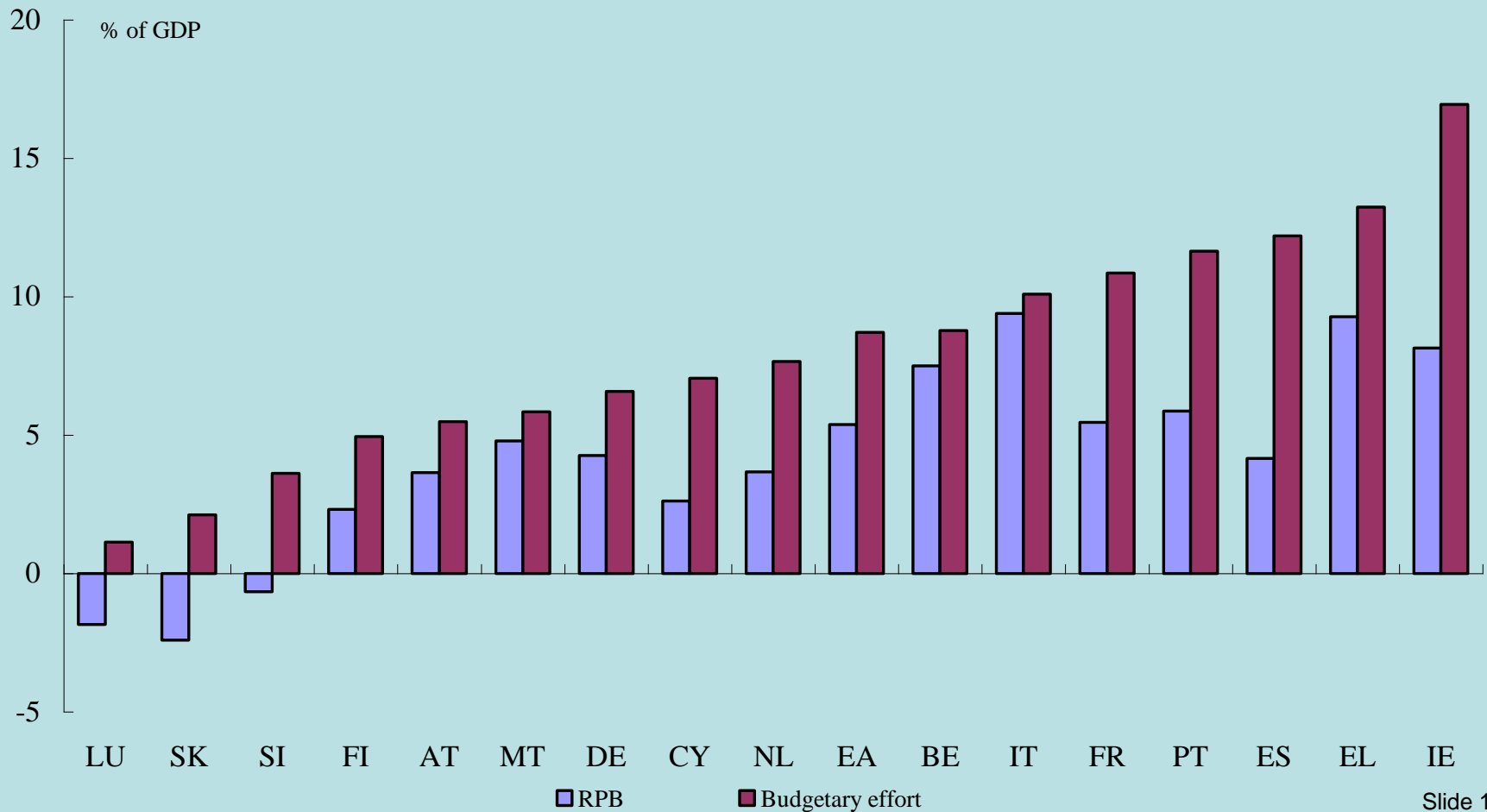
Daunting fiscal challenge: unsustainable debt trends

A recovery in economic growth and tax ratios is not sufficient to bring debt ratios on a declining path. Ageing adds to sustainability concerns



Effort (change in primary balance) required to bring the debt ratio below 60% of GDP by 2020

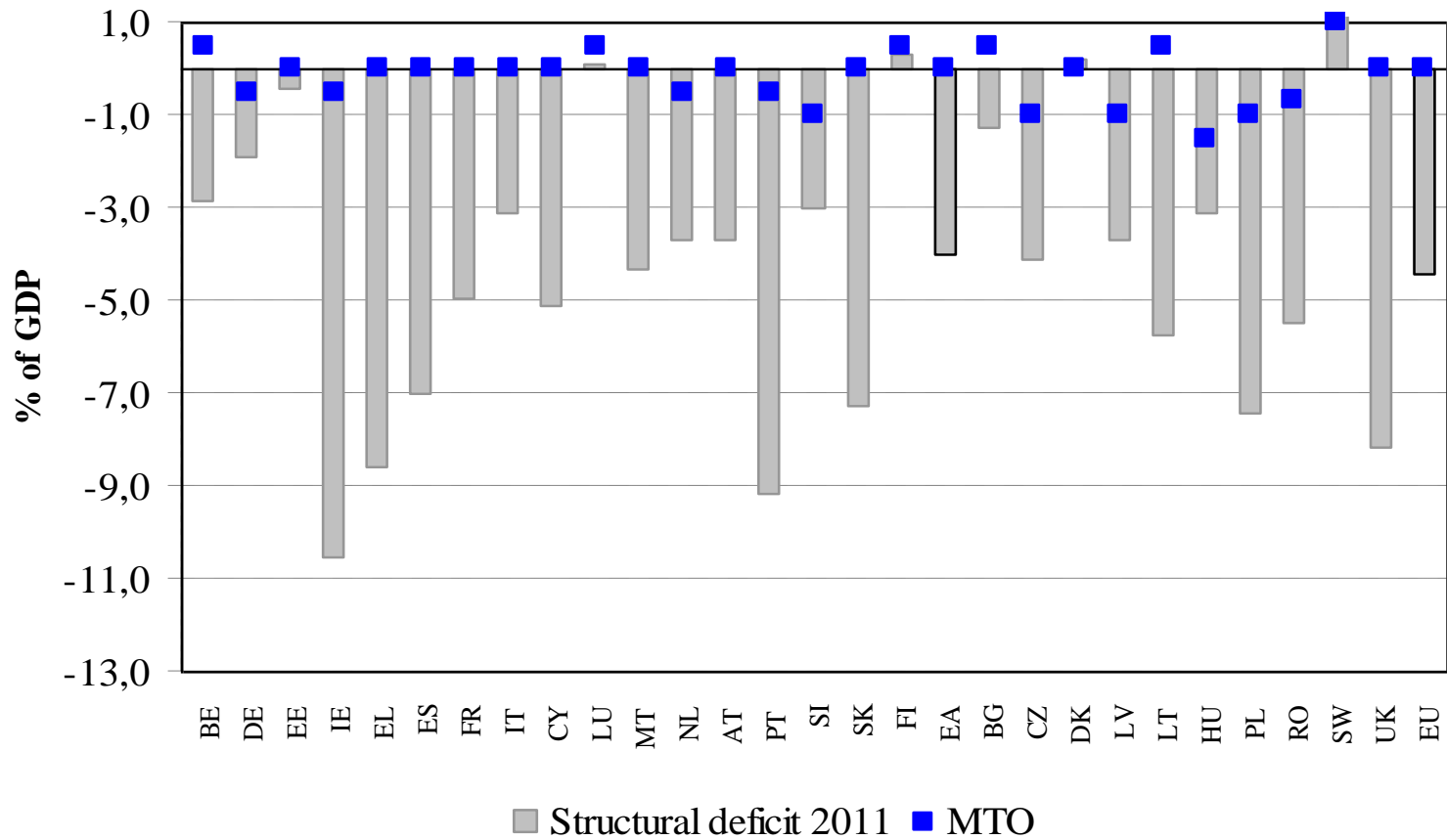
On average, EU countries would need a primary balance of 4½% of GDP in the medium term in order to reach the 60% threshold, which corresponds to a budgetary effort of almost 9 pp of GDP spread over the years 2011-15



Daunting fiscal challenge: unsustainable debt trends

Current structural fiscal position far from MTOs

Structural deficits (2011) and MTOs



MTOs presented by Member States in the 2009-2010 updates of the Stability and Convergence Programmes

Exiting from the fiscal stimulus: timing

- The G20-coordinated fiscal easing to arrest global recession worked but had its limits (risks to fiscal sustainability, public debt market crisis, risk of loss of confidence in the state's capacity to protect financial system)
- Fiscal exit strategies have begun to be implemented in most EU countries .
- The public debt crisis has forced an accelerated path of fiscal exit

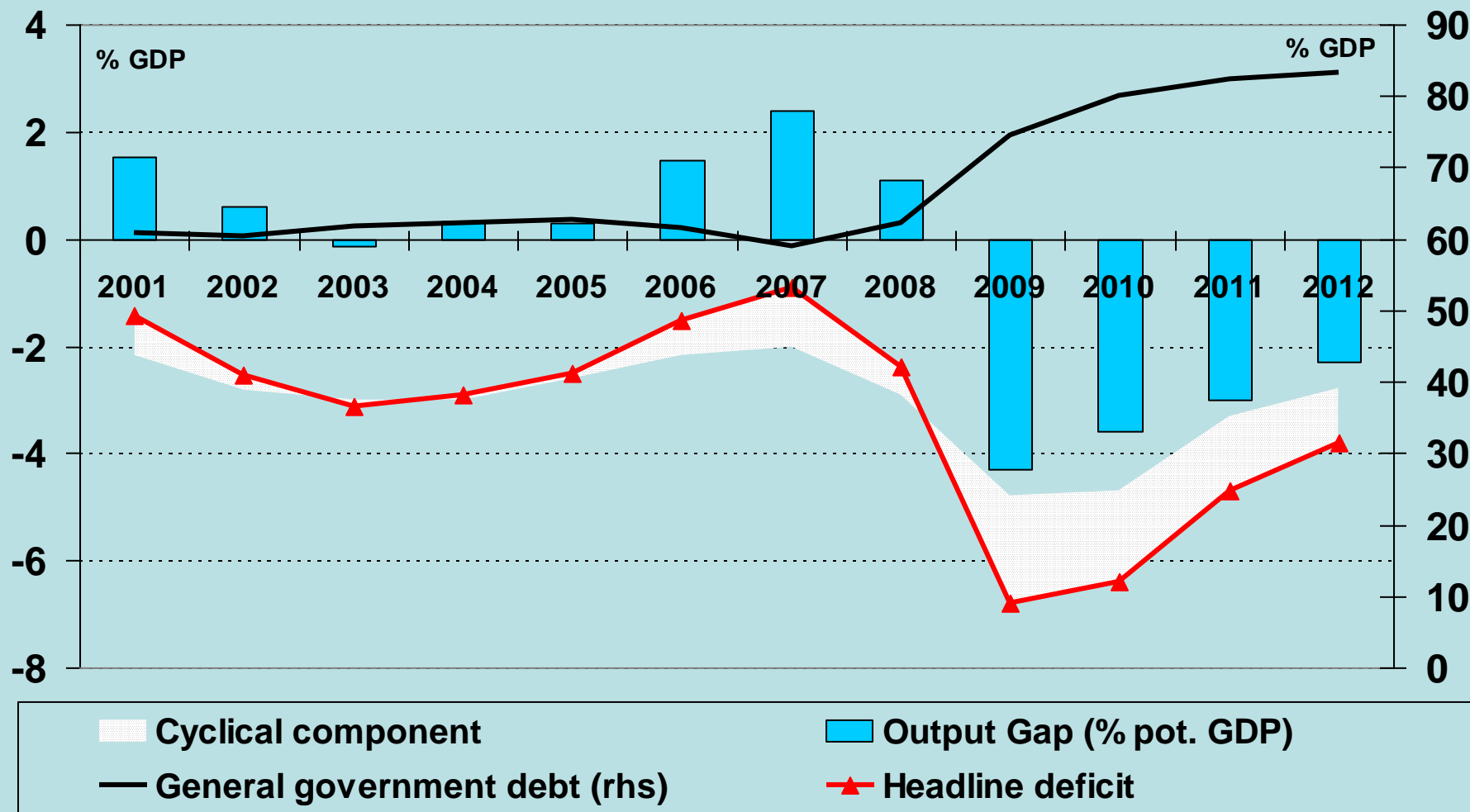


International coordination of fiscal exit: the G20

- In the G20 consensus on the pace of fiscal exit proved hard to reach: EU advocated earlier fiscal exit and US, Can and certain EMEs dragged feet, fearing to undermine global recovery
- However, sovereign debt crisis in EU helped to increase support for some form, if differentiated, of fiscal exit: at **G-20 Toronto Summit** in June 2010, advanced economies committed to fiscal plans that will at least halve deficits by 2013 and stabilise or reduce public debt/GDP ratios by 2016.
- Those with serious challenges to adopt more ambitious strategies
- For EMEs recovering well and experiencing capital inflow surges: fiscal tightening is optimal response



Short-term fiscal impact of the crisis – Fiscal stimulus and exit



Ambitious fiscal consolidation efforts announced by EU countries

- In the context of the public debt crisis, a number of EU countries have announced extraordinary fiscal adjustment packages:
 - Greece to cut deficit from 13.6% of GDP in 2009 to 3% of GDP in 2014 as part of bold programme agreed with EU and IMF.
 - Ireland to cut deficit from 12.2% of GDP (net of one-off banking support measures) to 3% of GDP by 2015 as part of EU/IMF programme
 - Portugal to cut deficit from 9.1% of GDP in 2010 to 3% of GDP by 2013 in context of IMF/EU programme
 - Spain is also implementing an ambitious fiscal consolidation programme. And Italy has just announced new measures forced by the deterioration in public debt market during the summer.
 - Other EU countries have also announced important budget cuts



A European strategy for fiscal exit

Initiated in October 2009, specified by the Council of 15/02/2011 in the context of the preparation of the European Semester and endorsed by European Council of 15/03/2011

- Ensuring government debt sustainability will require in most cases annual structural fiscal adjustments well above 0.5% of GDP benchmark, in addition to pension, health care and labour market reforms.
- In Member States facing very large structural budget deficits or very high or rapidly increasing levels of public debt, fiscal consolidation should be frontloaded. Particularly in Member States facing financial stress.
- Member States should keep the growth of expenditure net of discretionary revenue measures clearly below the medium-term rate of potential GDP growth until they have reached their MTO, while prioritising sustainable growth-friendly expenditure and promoting efficiency of public spending.
- Member States should present concrete multi-annual consolidation plans including specific deficit, revenue and expenditure targets and the strategy envisaged to reach these targets. Stability or Convergence Programmes should be based on cautious growth and revenue forecasts.

Consolidation under the excessive deficit procedure

Euro area - Differentiated fiscal effort and flanking policies

MS	EDP triggering deficit	Deadline	Deficit 2010 (% GDP)	Structural adjustment		Recommendations on:	
				Annual average (p.p. of GDP)	Starting year	Budgetary framework	Sustainability
AT	2009	2013	4.6	3/4	2011		
BE	2009	2012	4.1	3/4	2010		
CY	2009	2012	5.3	≥1½	2011	yes	yes
DE	2009	2013	3.3	≥0.5	2011		
EL*	2007	2014	10.5	>2	2010	specific measures	specific measures
ES	2008	2013	9.2	>1.5	2010		
FR	2008	2013	7.0	>1	2010		
IE	2008	2015	32.4**	2	2011	yes	yes
IT	2009	2012	4.6	≥0.5	2010		
MT	2008	2011	3.6	3/4	2011	yes	
NL	2009	2013	5.4	3/4	2011		
PT	2009	2013	9.1	1¼	2010	yes	
SI	2009	2013	5.6	3/4	2010		yes
SK	2009	2013	7.9	1	2010	yes	

Slide 21

* Notice under Article 126 (9)

** of which 19.8% of GDP one-off

Consolidation under the excessive deficit procedure

Non euro area - Differentiated fiscal effort and flanking policies

MS	EDP triggering deficit	Deadline	Deficit 2010 (% GDP)	Structural adjustment		Recommendations on:	
				Annual average (p.p. of GDP)	Starting year	Budgetary framework	Sustainability
BG	2009	2011	3.2	$\geq \frac{3}{4}$	2011	yes	
CZ	2009	2013	4.7	1	2010	yes	
DK	2010	2013	2.7	≥ 0.5	2011		
HU	2003	2011	4.7	\geq cumulative 0.5 over 2010-2011	2010		
LT	2008	2012	7.1	$2 \frac{1}{4}$	2010	yes	
LV	2008	2012	7.7	$\geq 2 \frac{3}{4}$	2010	yes	
PL	2008	2012	7.9	$\geq 1 \frac{1}{4}$	2010	yes	
RO	2008	2012	6.4	$1 \frac{3}{4}$	2010	yes	yes
UK	2008/09	2014/15	10.4	$1 \frac{3}{4}$	2010/11	yes	

What went wrong?

Four weaknesses have been exposed

- Despite improvements introduced by 2005 reform of SGP, the preventive arm of the SGP has failed to encourage the buildup of sufficient buffers in good times.
- Insufficient focus on debt levels and debt dynamics
- Weak governance/enforcement and narrow focus on procedural aspects and formal deficit limits in corrective arm
- Statistical misreporting crippled fiscal surveillance.
- Macroeconomic surveillance too narrowly focused on fiscal policy



The EU fiscal framework in a nutshell

- **The Treaty (Article 126)**

- deficit < 3% of GDP, unless it has declined and reached a level close to 3% or the excess is small, exceptional ('severe economic downturn') and temporary
- debt < 60% of GDP, or should be on a decreasing trend and approaching 60% at a satisfactory pace

- **The Stability and Growth Pact**

(Regulations 1466/97 and 1467/97, amended in 2005)

Preventive arm:

Pursuit of medium-term budgetary objectives (MTOs)
Stability and convergence programmes and annual updates. Early warning mechanism

Corrective arm:
(EDP)

Specifies the steps of the excessive deficit procedure

Sets up a timetable for the correction of excessive deficits and possible sanctions



What is being done? The EU's policy response to the public debt crisis

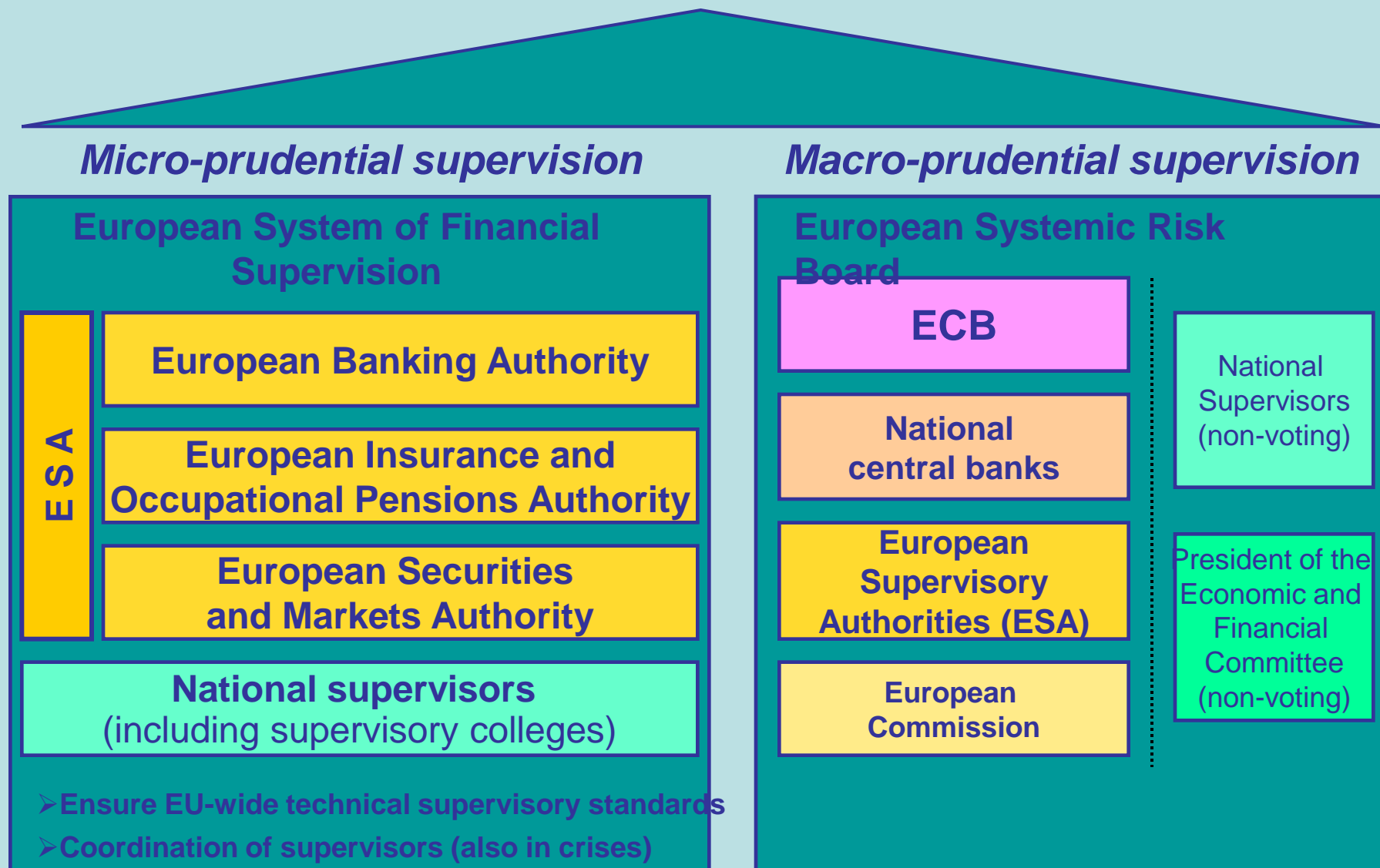
- The **EU/IMF packages for Greece (May 2010), Ireland (November 2010) and Portugal (May 2011)**: For Greece, €110 bn for 36 months. EA MS contribute €80 bn (bilateral loans pooled centrally by European Commission similarly to a syndicated loan) and IMF €30 bn. For Ireland, €85 bn. For Portugal €78 bn.
- The **European Financial Stabilisation Mechanism (EFSM)**: €60bn increase (from €50 bn to €110 bn) in BoP support facility and extension to euro area countries. Continuation subject to six-monthly reviews
- The **European Financial Stability Facility (EFSF)** of up to €440 bn (special purpose vehicle owned by all EA countries, which can issue bonds on the markets using MS guarantees; funds provided on same terms as those for Greece)
- **EFSF complemented with IMF funds** of up to €250 bn

What is being done? The EU's policy response to the public debt crisis

- Adjustment **packages for Hungary, Latvia and Romania**, approved during 2008-09, financed by the EU's BoP-support facility and IMF (total used: a bit less than 15 bn euros)
- Exceptional **fiscal adjustment packages** announced by many MS, as noted
- **Reinforcing the SGP and European economic governance:**
- **CEBS Stress Test Exercise:** successfully conducted
- **Reinforcement of EU's financial supervision system** (ESRB, 3 financial supervising agencies).



The new supervisory framework in the EU



What has been done?

European Financial Stability Facility (EFSF) agreed on 10 May 2010

- EFSF can issue bonds using EA Member States guarantees in order to raise funds for loans to individual EA countries in difficulty. The loans are subject to strict policy conditionality and in conjunction with the IMF. Bonds are guaranteed proportionally by all Euro area Member States (pro-rata according to their participation in the capital of ECB) up to a total of €440 billion.
- EFSF has been awarded AAA rating by S&P, Moody's and Fitch.
- Of a temporary nature: no new lending programmes after 30 June 2013, although it can continue to issue bonds and provide loans under existing programmes after that date



Integrated surveillance

- **SGP to be complemented by broader macroeconomic surveillance, notably competitiveness and structural reforms**

Recommendations and corrective measures for MS with serious imbalances, jeopardising functioning of EMU (« excessive imbalances positions »)

- **Introduction (starting in H1 2011) of a « European Semester »** (endorsed by ECOFIN Council of 7 September), integrating surveillance of fiscal, macroeconomic imbalances and structural reforms (stability and convergence programmes, BEPS...). But SGP and EU2020 strategy to remain formally separated

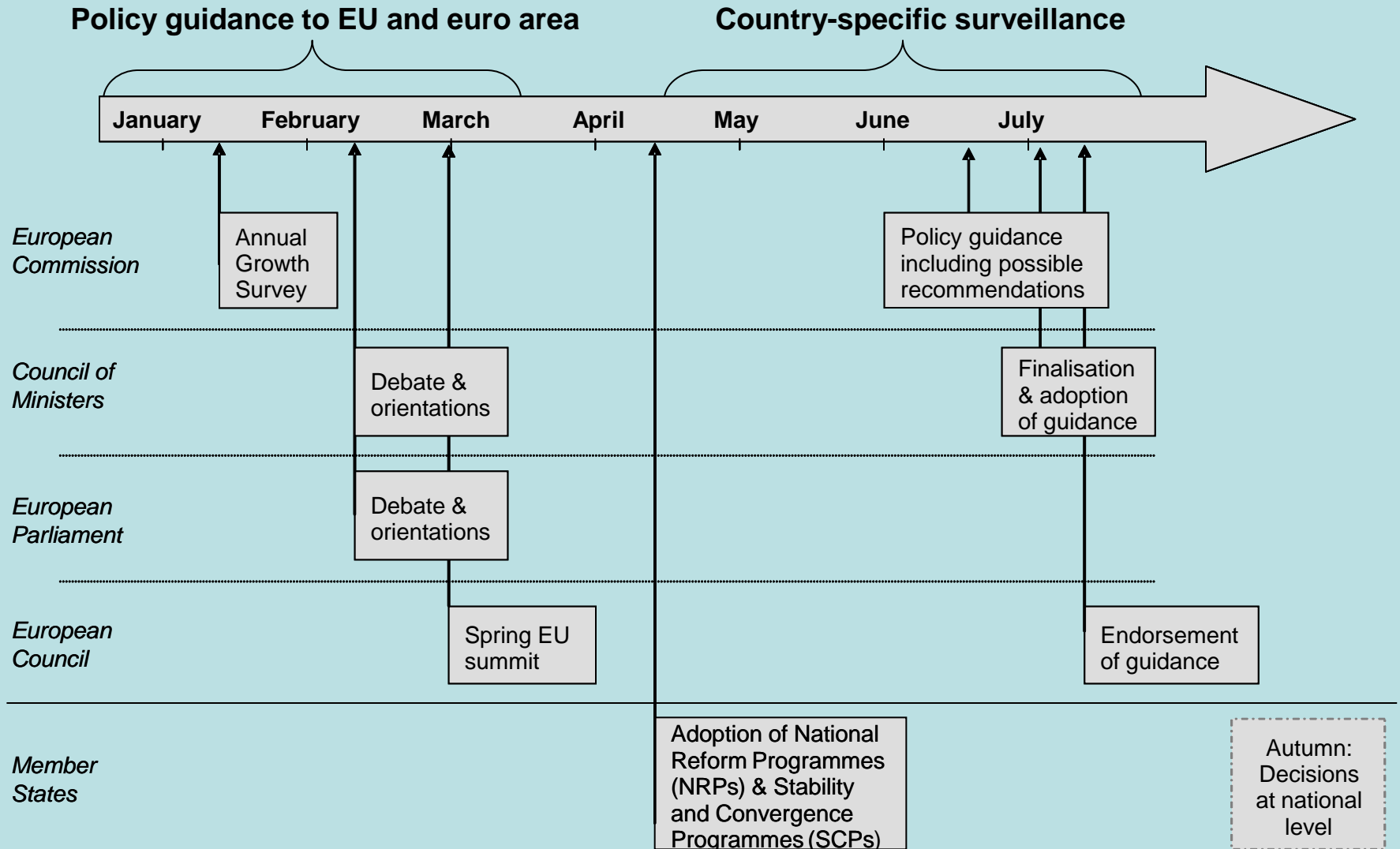
Fiscal surveillance

Macroeconomic
Surveillance

Europe 2020
Structural reform

Enforcement mechanisms

What has been done? The European Semester for integrated policy coordination



What has been done?

Improvement of governance and the surveillance framework

On 29 September 2010, the Commission presented legislative proposals for economic governance reforms:

- 1. Reinforcing the SGP** by strengthening preventive arm, increasing emphasis on debt criterion (corrective arm), strengthening EUROSTAT's role in ensuring high quality fiscal statistics and setting minimum requirements on national fiscal frameworks
- 2. Broadening surveillance** to intra-euro area (and intra-EU) macroeconomic and competitiveness developments
- 3. More effective enforcement** through appropriate incentives and early sanctions: automatic trigger unless Council decides otherwise

The legislative package (5 regulations and 1 directive) is expected to be adopted before end of 2011 and enter into force next year

What has been done?

Improvement of governance and the surveillance framework

The Commission's six legislative proposals:

1. **Reinforcing the preventive arm of the SGP (Regulation amending Regulation 1466/97) (co-dec)**
2. **Strengthening the corrective arm of the SGP (Regulation amending Regulation of 1467/97 on the EDP)**
3. **Directive on minimum requirements for budgetary frameworks**
4. **Regulation on the prevention and correction of macroeconomic imbalances (to broaden surveillance to intra-intra-EA CA and competitiveness developments) (co-dec)**
5. **Regulation on enforcement of budgetary surveillance in EA (co-dec)**
6. **Regulation on enforcement of measures to correct excessive imbalances in EA (co-dec)**



What has been done?

Improvement of governance and the surveillance framework

European Councils of December 2010 and March 2011:

- Agreed to establish a permanent European Stability Mechanism (ESM) for euro area countries to replace the EFSF and the EFSM, both of which will remain in force only until June 2013
- It will require a limited amendment of the Treaty (Article 136) to enable EA countries to « establish a stability mechanism...granting financial assistance...under strict conditionality ». This can be ratified through the simplified procedure provided for in Art. 48(6) of TEU
- Target date for entry into force is July 2013 (national approval procedures to be completed by end-2012)



What has been done?

The ESM:

- Will be set up as an IFI under international public law, will be located in Luxembourg
- One of world's largest IFIs
- Will have an effective lending capacity of €500 bn, including outstanding loans of the EFSF
- Its lending capacity will be ensured by a combination of paid-in capital (€80 mn), callable capital and guarantees (together amounting to €620 m): total financial base amounts to €700 mn
- Can provide loans and, in exceptional circumstances, intervene in primary and secondary debt markets. It will also be able to provide loans for bank recapitalisation



What has been done?

The ESM:

- ESM pricing will take into account debt sustainability of recipient country, while remaining above funding costs, with adequate mark-up for risk. Agreed pricing should effectively lower by approximately 100 bps current EFSF interest rates
- Non-euro area Member States may contribute on a voluntary basis
- ESM will enjoy preferred creditor status as IMF
- Goal is to have Treaty amendment signed by all participating EA MS by end-June 2011



What has been done?

At their 11 March 2011 summit, EU leaders agreed to:

Reinforce the EFSF

- by ensuring (through an increase in MS guarantees) that the EFSF's effective lending is increased to €440 mn, bringing the EFSF's and EFSM's combined effective lending capacity to €500 mn, the same as that of the future ESM.
- by lowering the EFSF lending rates by about 100 bps, thus approximately aligning them with those applied by IMF
- by allowing it to intervene in the primary debt market

Ease the conditions for loans to Greece

- by reducing by about 100 bps the interest rate applied to such loans
- by lengthening the maturity of those loans to 7.5 years on average



What has been done?

At their 21 July 2011 summit, EU leaders agreed to:

Further increase flexibility of EFSF and future ESM

- by allowing the EFSF/future ESM to finance the recapitalisation of financial institutions through loans to governments, including in non-programme countries
- by allowing the EFSF/future ESM to intervene in the secondary public debt markets on the basis of an ECB analysis (interventions in the primary market had already been allowed at March 2011 EA summit)
- by allowing to act on the basis of a precautionary programme
- by lengthening the maturity of future EFSF loans from the current 7.5 years to a minimum of 15 years and up to 30 years, with a grace period of 10 years
- To align EFSF lending rates with those of the BoP facility, i.e., with a margin at zero or close to zero but without going below the EFSF's funding costs



What has been done?

At their 21 July 2011 summit, EU leaders agreed to:

Greece

- Agreed on principle of a new EU/IMF programme for Greece to take into account larger than expected financing needs for current programme period (May 2010-June 2013), which are due to: unforeseen settlement of arrears and the fact that the assumed restoration of long-term market access in early 2012 is now unlikely
- Programme will amount to an estimated €109 bn, spanning the period between late 2011 and mid-2014
- It will be co-financed by the EFSF and the IMF
- to supports new reform and adjustment measures adopted by Greece during the summer, including substantial privatisation
- Agreed to Private Sector Participation through voluntary debt roll-overs and buy backs
- Also, the maturities of the existing Greek facility will be extended
- Credit enhancements to underpin quality of collateral so as to allow continued access to Eurosystem liquidity operations by Greek banks



Thank you for your attention!

