The Reform of European Economic Governance: Towards a Sustainable Monetary Union?

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THE REFORM OF EUROPEAN ECONOMIC GOVERNANCE: TOWARDS A SUSTAINABLE MONETARY UNION?

STIJN VERHELST

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Introduction

The euro is a rather unusual currency as it is shared by a union of largely independent states. This results in a single supranational monetary union, while most 'economic' matters are decided on a national level. A key challenge in such a system is to ensure that the different levels of decision-making do not undermine the advantages of the common currency. For this reason, the European monetary union has been buttressed by economic integration, resulting in the Economic and Monetary Union (EMU).

From a mere organizational perspective, one could argue that it would have been better to transfer economic decision-making to the level of the EU. However, this was politically unviable and deemed unnecessary, even by the European Commission[1]. Instead, policy-makers opted for a system in which national fiscal and economic policies would be supervised and coordinated at the EU level. This system is referred to as European economic governance[2].

Ever since the design of the single currency, there have been serious doubts on its sustainability. The question was raised whether quasi-autonomous fiscal and economic policies could be compatible with a single currency. The sovereign debt crisis that hit the eurozone in 2010 has indeed vividly demonstrated the insufficiency of existing European economic governance. Despite the provisions in place, several eurozone countries' public finances deteriorated to the point where markets began to question these countries' basic financial sustainability.

Faced with the shortcomings of European economic governance, the EU needed to respond. The EU chose not to pursue fundamental changes such as a closer political union or the break up of its monetary union. Instead, it opted to reform its economic governance framework. Up until June 2011, legislative negotiations took place. While a final agreement was not reached yet, the most important outlines of the reform of economic governance had become clear. This paper discusses this reform.

The paper begins by considering the need for economic governance (§ 1). Subsequently, economic governance before the sovereign debt crisis is discussed (§ 2). Economic governance, as it was, failed to avert the sovereign debt crisis

1. Commission of the European Communities, Economic and Monetary Union, 21 August 1990, SEC (90) 1659 final
2. While there is no common definition of the concept, European economic governance can be described as the European economic policy-making with the institutions, machinery and practices that aims to shape the evolution of the European economy. See: BEGG, I, Economic governance in an enlarged euro area, European Economy. European Commission Economic Papers, 311, 2008, p. 5.

(§ 3). This crisis proved to require a European response (§ 4) and laid bare several of Europe's economic governance shortcomings (§ 5). The subsequent reform of economic governance comprises two key components. On the one hand, legislative reforms aim at reforming existing economic governance (§ 6). On the other hand, crisis governance is being developed, which is to step in when a eurozone country faces severe financial difficulties (§ 7). Finally, a conclusion is provided.

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1. The Need for Economic Governance in a Monetary Union

A monetary union without proper economic coordination is doomed to fail. This has been clear from the onset of the European project. In 1970, the Werner report already called for the simultaneous creation of an economic and monetary union[4]. This message was frequently reiterated[5].

In the EU, technological progress and the single market had already integrated the Member States' economies to a great extent. The creation of a monetary union implied a subsequent, qualitative leap in the interdependence of eurozone countries. The monetary union fixes the countries' exchange rates and requires a unified monetary policy. Both of these crucial variables are then determined by the collective performance of the monetary union's members[6].

The members of the eurozone have thus become vitally dependent on each other's economic and fiscal performances. This mutual dependence implies that a policy in one eurozone country can easily influence the other members of the currency union. Such dependence has both positive and negative consequences. On the one hand, eurozone members reap the fruit of other members' successes. On the other hand, they have to share the burden of each other's downturns, as has occurred during the sovereign debt crisis.

A monetary union also makes it impossible for individual members to use monetary policies as a way to overcome their difficulties. Before the monetary union was established, loss of confidence in a country's economic or fiscal situation resulted in a depreciation of that country's currency. This implied an increase in competitiveness and a lessening of fiscal pressure. In case of severe problems, a devaluation of the currency could be applied. Both instruments have become unavailable to eurozone countries[7]. Therefore, a crisis in a eurozone country cannot be resolved as easily as in a country that is not a member of a monetary union. The crisis furthermore affects the other eurozone countries. This, again, calls for solid European economic governance.

4. Report on the realisation by stages of economic and monetary union. "Werner Report", 8 October 1970, In: Bulletin of the European Communities, No Supplement 11/70, 1970, pp. 5-29.
5. See for example: European Council, Presidency Conclusions, Hanover, 27-28 June 1988; Delors Committee, Report on economic and monetary union in the European Community, 17 April 1989 and Commission of the European Communities, Economic and Monetary Union, op. cit. footnote 1.
6. JAMET, J-F., Un gouvernement économique européen: du slogan à la réalité?, Questions d'Europa, nr. 167-168, Fondation Robert Schuman, 26 avril 2010.
7. DE GRAUWE, P., The Governance of A Fragile Eurozone, Discussion Paper, 2011, retrievable at: http://www.econ.kuleuven.be/ew/academic/intecon/Degrauwe/PDG-papers/Discussion_papers/Governance-fragile-eurozone_s.pdf

2. Economic Governance up to the Sovereign Debt Crisis

The interdependence between Member States and especially between eurozone countries had resulted in an economic governance framework, with a range of rules and coordination mechanisms. Yet, economic integration was rather limited, as decision-making was left at the level of the Member States.

In the first place, a set of European fiscal rules has been adopted (2.1). Secondly, a looser system of macro-economic policy surveillance and coordination was set up to achieve converging economic growth (2.1). As will become clear, the vast majority of pre-sovereign debt crisis governance applied to all EU Member States. Due to the continued difference in membership between the EU and the eurozone, as well as the need for closer eurozone cooperation, policy-makers nevertheless adopted a limited number instruments specific to the eurozone (2.3).

2.1. Fiscal Rules

Rules meant to ensure robust public finances were the cornerstone of the former economic governance set-up. The design of the economic arm of EMU reflects a deep-rooted fear that the problematic fiscal position of one Member State could deteriorate the economic, fiscal and monetary conditions of other Member States.

The EU level has not, however, been attributed major fiscal policy competences, as Member States largely remain in control of fiscal policies. A rule-based system has been adopted, which aims to ensure fiscal discipline and avoid negative spillover effects in case fiscal discipline is not achieved.

2.1.1. Rules to Ensure Fiscal Discipline

The Treaty's Excessive Deficit Procedure[8] and the Stability and Growth Pact[9], which complements and details the former, are the main legal instruments to

8. Article 126 of the Treaty on the Functioning of the European Union, OJ C 83, 30.3.2010, pp. 47-388, hereinafter TFEU.
9. The political basis for the Stability and Growth Pact was established by the Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997. The Pact was defined by Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 209, 2.8.1997, p. 1-5; Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L 209, 2.8.1997, p. 6-11. It was modified in 2005; see Council Regulation (EC) No 1055/2005 and Council Regulation (EC) No 1056/2005, both of 27 June 2005.

achieve EU-wide fiscal discipline. These legal instruments put in place a surveillance mechanism that can result in corrective measures if needed. After a failed attempt to use these corrective measures, the Stability and Growth Pact was revised in 2005. In the eyes of many, this led to less stringent rules[10].

The Treaty provides two main indicators to evaluate the budgetary situations of Member States. On the one hand, there is the public debt-to-GDP ratio. Debt is not to exceed 60%, or should diminish at a sufficient pace. On the other hand, the government deficit-to-GDP ratio is to be no more than 3%. A failure to meet these indicators can only be justified in case of exceptional circumstances[11].

The Stability and Growth Pact introduces medium-term budgetary objectives. The Pact stipulated in its original version that Member States' budgets need to be in balance or in surplus in the medium term. The 2005 revision somewhat diluted this requirement, by allowing differentiated Member State objectives, which can range from a budget deficit of 1% of GDP to a budget in surplus.

With the Stability and Growth Pact, attention shifts almost exclusively to the budgetary deficits. Public debt was sidelined, as it became one of the multiple medium-term evolutions to be taken into account, besides for example retirement costs and public investments.

In order to verify whether Member States adhere to the fiscal rules, a surveillance procedure has been put in place. Every year, eurozone countries have to submit a Stability Programme detailing their budget of that year[12]. These Programmes are subsequently evaluated by the Commission. Based on the Stability Programmes and its own surveillance, the Commission provides an assessment of the Member States' fiscal positions. If it believes that a Member State has an excessive deficit, it can address an opinion on the matter to the Council – after drawing up an initial report and obtaining the opinion of the Economic and Financial Committee. From that moment on, the Council holds the key to ensure the implementation of the fiscal discipline rules.

Subsequent to the opinion of the Commission on an excessive deficit in a Member State, the Council is to make an overall evaluation of that Member States' budgetary situation. The general nature of this evaluation gives the Council considerable leeway. Based on its evaluation, the Council is to decide whether or not the Member State has an excessive deficit. This decision is to be made by a qualified majority. The Lisbon Treaty brought about a minor change, as the

10. For example: MORRIS, R., ONGENA, H., SCHUKNECHT, L., The Reform and Implementation of the Stability and Growth Pact, Occasional Paper Series, European Central Bank, No. 47, June 2006.
11. Article 1 of Protocol No 12 on the Excessive Deficit Procedure, TFEU.
12. Non-eurozone Member States' programmes are referred to as Convergence Programmes.

Member State in question is no longer allowed to vote on whether or not it has an excessive deficit. If the Council finds a Member State to be in an excessive deficit, it is to recommend actions to correct this deficit.

As a very last resort, after giving additional notice and a deadline, the Council can impose sanctions if a Member States has not taken sufficient action to reduce its deficit. Such a decision needed to be made on the basis of a qualified majority. The Stability Pact provided that an initial sanction consists of a non-interest bearing deposit of between 0.2% and 0.5% of a Member State's GDP, depending on the severity of the excessive deficit. When the Member State in question returned to a healthy fiscal situation, the deposit would be reimbursed. If the excessive deficit remained uncorrected two years after the deposit was made, the deposit would be converted into a fine.

Originally, the procedure, from a Member States' first reporting to a first potential sanction was to take ten months. This was prolonged to 16 months in 2005[13]. The European Court of Justice, for its part, has indicated that the Council could prolong this procedure even further by not taking a decision[14].

2.1.2. *Avoidance of Negative Spillovers*

It seems as though Member States were aware from the start that the aforementioned fiscal discipline rules were all but foolproof. Therefore, the Treaty contains a set of rules that aim to prevent inadequate fiscal discipline in a Member State from producing spillover effects in other Member States.

A set of rules was put in place that needed to ensure that Member States' fiscal difficulties would not result in higher inflation or affect the common monetary policy. These rules prohibit central bank credit facilities for Member states[15], direct sovereign debt purchasing by central banks[16], as well as privileged access to financial institutions for the EU or Member States[17].

The Treaty equally provides that a Member State is solely responsible for its debt, so as to confine fiscal problems to that Member State. This is enshrined in the Treaty's no bailout clause[18]. The name of this clause can be somewhat mis-

13. See Recital 15 and Article 7 of Council Regulation No 1467/97, op. cit. footnote 7.
14. Case C-27/04, 13 July 2004, Commission of the European Communities v. Council of the European Union, European Court Reports, 2004, p. I-6649.
15. Article 123 TFEU.
16. Ibid.
17. Article 124 of ibid.
18. Article 125(2) of ibid.

leading, as it does not imply a complete ban on financial aid. Rather, it states that neither the Union, nor the Member States are to be liable for or assume the commitments of another Member State. Thus, debt of an EU Member State cannot be passed on to other Member States, nor can other Member States be held accountable for it.

This no bailout clause is meant to avoid moral hazard, i.e. the drive towards imprudent fiscal policies. The idea is that without such a clause, the eurozone would provide implicit insurance against fiscal difficulties in a eurozone country. Such insurance would imply that the eurozone would provide assistance to a Member State that faces a fiscal crisis. This, in turn, could lead to imprudent fiscal behaviour by eurozone countries and a lack of financial market vigilance. Less fiscal discipline would therefore be rewarded, with adverse effects for the monetary union as a whole[19].

2.2. Macro-economic Policy Coordination

Besides the fiscal rules, a range of economic policy coordination mechanisms has also been put in place – as required by the Treaty[20]. The goals of these instruments are to work towards converging economic policies and performances, as well as to foster economic growth in general. To achieve these goals, the Council is to monitor the economic developments of each Member State and coordinate national economic policies[21].

The Broad Economic Policy Guidelines (BEPGs) are designed as a main instrument for macro-economic policy coordination[22]. These Guidelines contain general macro-economic objectives, as well as policy recommendations to achieve these goals. The Council adopts the BEPGs, after a recommendation from the Commission and discussion by the Heads of State or Government. The Council subsequently monitors the consistency of national polices with these BEPGs, in addition to monitoring economic developments in general. On the basis of its work, the Council can issue recommendations when it believes that a country's policies are contrary to the common European interest. The Commission has the

19. See: BEETSMA, R. BOVENBERG, A, The Optimality of a Monetary Union Without a Fiscal Union, Journal of Money, Credit and Banking, Vol. 33, No. 2, May, 2001, pp. 179-204.
20. The need to coordinate economic policies has been enshrined in Article 5 TFEU.
21. Article 121(3) TFEU.
22. These Broad Economic Policy Guidelines were first published in 1993 and were followed by subsequent ones.

power to issue warnings[23]. The BEPGs, the Council recommendations and the Commission warnings are nevertheless not legally binding[24].

Besides the BEPGs, the European Employment Strategy plays a significant role in macro-economic policy coordination. This Strategy aims to coordinate the employment policies of the EU Member States. Similar to the BEPGs, the European Employment Strategy comprises a set of guidelines for Member States' employment policies. The Open Method of Coordination, which is a non-binding benchmarking and peer review instrument, was used to evaluate national policies. If required, the Council can make non-binding recommendations[25].

The Lisbon Strategy[26] supplemented and partly unified these two surveillance and coordination instruments. It also increased the political importance of economic coordination, as the European Council played a key role in the process. The Lisbon Strategy led to the integration of the BEPGs and the European Employment Strategy into so-called Integrated Guidelines for Growth and Jobs. Member States are to adopt multi-annual National Reform Programmes that aim to implement these Integrated Guidelines. Meanwhile, the Lisbon Strategy has been succeeded by the EU 2020 Strategy[27]. The EU 2020 Strategy differs in some aspects from the Lisbon Strategy, but it remains non-binding and continues to focus on structural reforms.

The BEPGs, the European Employment Strategy and the EU 2020 Strategy all focus mainly on obtaining stated 'positive' goals. In doing so, they paid less attention to divergence in Member States' macro-economic performance. Criticism of laggards has been rather soft[28]. Furthermore, the non-binding nature of the instruments clearly differentiated macro-economic policy coordination from the stricter fiscal rules. The EU's potential to influence macro-economic policies was more limited as a consequence[29].

23. Article 121 TFEU.
24. The Treaty on the Functioning of the European Union explicitly states that Recommendations do not have binding force (see Article 288 TFEU). Furthermore, Article 121(2) TFEU contains no provisions to make the Broad Economic Policy Guidelines, nor the Commission warnings legally binding.
25. Article 148 TFEU.
26. European Council, Presidency Conclusions, Lisbon, 23 and 24 March 2000.
27. European Commission, Europe 2020. A strategy for smart, sustainable and inclusive growth, 3 March 2010, COM(2010) 2020 final.
28. DEROOSE, S., HODSON, D., KUHLMANN, J., The Broad Economic Policy Guidelines: Before and after the Re-Launch of the Lisbon Strategy, Journal of Common Market Studies, Vol. 46, Issue 4, 2008, p. 838.
29. BEGG, I, Economic governance in an enlarged euro area, European Economy. European Commission Economic Papers, 311, 2008, pp. 8-12.

2.3. Limited Additional Eurozone Specific Governance

The aforementioned elements of European economic governance, i.e. fiscal rules and macro-economic policy coordination, concern all EU Member States. This is understandable if you take into account that – in theory – Member States have to adopt the euro once they adhere to the so-called convergence criteria[30]. However, due to EU enlargements, the opt-outs of the UK and Denmark[31] and the *de facto* opt-out of Sweden[32], many Member States continue to use a currency other than the euro[33]. Despite the fact that most of these countries will eventually join the eurozone, this asymmetry will persevere for some time.

In view of this asymmetry and their increased interdependence, eurozone countries decided to step-up economic governance inside the eurozone. An important step has been the creation of a eurozone-specific body: the Euro Group[34]. The Group normally consists of the eurozone's finance ministers, the ECB President and the Commissioner for Economic and Monetary Affairs[35]. It is not meant to replace Council meetings, but serves as an informal body. The Group's task is to perform surveillance of the eurozone, as well as discuss issues related to the zone's proper functioning. Eurozone ministers can also take measures regarding budgetary discipline and economic policy guidelines[36]. The Euro Group *de facto* decides on the initiation and continuation of the Excessive Deficit Procedure of eurozone countries, as well as their progress in meeting the policy guidelines.

Besides the Euro Group's role in economic governance, some additional economic governance instruments have been put in place for eurozone countries. These concern both fiscal discipline and macro-economic coordination. With regard to the fiscal discipline, eurozone countries must conduct mid-term budget reviews providing guidance for the coming year's budget exercise. As concerns macro-economic policy coordination, the BEPGs contain eurozone specific pol-

30. See Article 140 TFEU.
31. Protocol 15 on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland and Protocol 16 on certain provisions relating to Denmark, both annexed to TFEU.
32. Sweden has no official opt-out, but is not eager to join the eurozone. The country is not obliged to do so, as it isn't part of the ERM II (European Exchange Rate Mechanism II). Commission officials have indicated that it is up Sweden to decide whether it will join the euro. See: European Parliament, Verbatim of the hearing of Olli Rehn Commissioner-Designate Economic and Monetary Affairs, 11 January 2010.
33. As of 2011, 17 EU Member States have adopted the euro while 10 other Member States still use their own national currency.
34. Protocol No 14 on the Euro Group, TFEU.
35. Legal provisions do however not indicate which ministers shall be present at these meetings. This could thus be the Heads of State and Government. During the sovereign debt crisis, Heads of State and Government indeed held Euro Group summits.
36. Article 136 TFEU.

icy guidelines[37]. In addition, eurozone countries must conduct broad economic surveillance of the eurozone as such[38].

Despite the Euro Group and eurozone-specific instruments, it is clear that most of the economic governance of the monetary union concerned the EU as a whole. This is in contrast with the closer interdependence of the eurozone countries.

37. These have been introduced in 2000 and became a eurozone specific chapter in subsequent BEPGs.
38. Council of the European Union, The Eurogroup – Policies, retrievable on: http://consilium.europa.eu/showPage.aspx?id=1827&lang=en

3. The Eurozone Sovereign Debt Crisis

In the aftermath of the economic and financial crisis, the eurozone was confronted with a sovereign debt crisis from 2010 onwards. What first started out as a problem in one Member State, Greece, quickly developed into a crisis that affected important parts of the eurozone. The very future of the monetary union was put into question.

The crisis was for the most part due to the sharp deterioration of public finances (3.1). The result was increased market anxiety (3.2). This in turn led to a rise in public borrowing costs of some eurozone countries (3.3). As a consequence, these countries' public finances worsened even further, which in the end required assistance by the EU (see the next chapter). Notwithstanding these efforts, problems remain and a restructuring of public debt of one or more eurozone countries has become probable (3.4).

3.1. Deteriorating Public Finances

The economic and financial crisis that preceded the sovereign debt crisis led to a severe recession. Due to this economic downturn, tax revenue fell, while public spending increased. As a result, public deficit soared. From 2009 to 2012, eurozone countries are forecast to have annual budget deficits of over 5% of GDP on average[39]. As a consequence, average eurozone public debt will increase substantially, from 66% of GDP in 2007, to almost 88% of GDP in 2012. Such large and continual budget deficits and subsequent increasing debt have put pressure on the sustainability of public finances.

Greece's public finances, and its lack of credibility, proved the most worrying. At the end of 2009, Greece had to admit, once again, that its previous budgetary forecasts significantly underestimated the country's budget deficit. In January 2009, it had reported an envisaged 2009 budget deficit of 3.7% of GDP, while this figure was revised to 12.5% that same year[40]. As a result of the mistrust and aggravation of Greece's financial position, the world's three main credit rating agencies all downgraded Greece's rating[41].

Ireland proved to be another weak link. Ireland had been the first eurozone

39. The average eurozone deficit is forecasted to be 6.3% in 2009, 6.3% in 2010, 4.6% in 2011 and 3.9% in 2012. See European Commission, European Economic Forecast, autumn 2010.
40. European Commission, European Economic Forecast – autumn 2009, 2009, pp.93-94. The budget deficit was afterwards even revised upwards to 15.4%.
41. In December 2009 Fitch, Standard & Poor's and Moody's downgraded Greece's public debt rating.

country to substantially feel the consequence of the financial crisis. Its housing market and financial sector, both exceptionally large, contracted considerably. The result was a sharp deterioration of the countries' fiscal position. In September 2010, the Irish government announced a comprehensive package to support its financial institutions. The package is worth around 20% of GDP and increased public deficit to 32% of GDP[42].

The economic downturn has also put pressure on the other eurozone countries' finances. Especially countries like Portugal and Spain run high deficits and have weak economic growth prospects. As a consequence, their public finances have deteriorated tremendously.

3.2. Financial Market Anxiety

The continued deterioration of public finances and weak growth prospects in some eurozone countries have led analysts to doubt on these countries' basic financial health. Their ability to finance expenses in the long term, i.e. their solvency, has consequentially been put into question. The doubts made markets nervous. The nervousness was further compounded by other factors, related to the previous economic and financial crisis and to the eurozone's ability to cope with its internal difficulties.

The financial and economic crisis resulted in severe losses for investors. As a consequence, investors became averse to risk, avoiding any potential new losses. Investors tended to respond quickly and massively to signs of problems, including the state of public finances. The financial and economic crisis resulted in a highly fragile financial sector – and to make matters worse, financial institutions owned an important amount of public debt. Repayment problems in eurozone countries would therefore put the financial sector under great stress[43]. Consequently, investors began to mistrust banks that held large amounts of the public debt of countries with deteriorated public finances.

Another important reason for market anxiety was the low level of confidence in the ability of the eurozone to deal with its internal problems. Both the willing-

42. LENIHAN, B., Minister's Statement on Banking, Irish Department of Finance, 30 September 2010, ttp://www.finance.gov.ie/viewdoc.asp?DocID=6515&CatID=1&StartDate=1+January+2011&m=

43. Financial institutions in the eurozone own a large part of the debt of the euro area countries facing market pressures. At the end of 2009, eurozone banks' foreign exposure to Greece, Ireland, Portugal and Spain was USD 727 billion. The eurozone banks' foreign exposure to the public sector of these countries amounts to USD 254 billion. See: AVDJIEV, S., UPPER, C., VON KLEIST, K., Highlights of international banking and financial market activity, BIS Quarterly Review, Bank for International Settlements, June 2010, pp. 19-21.

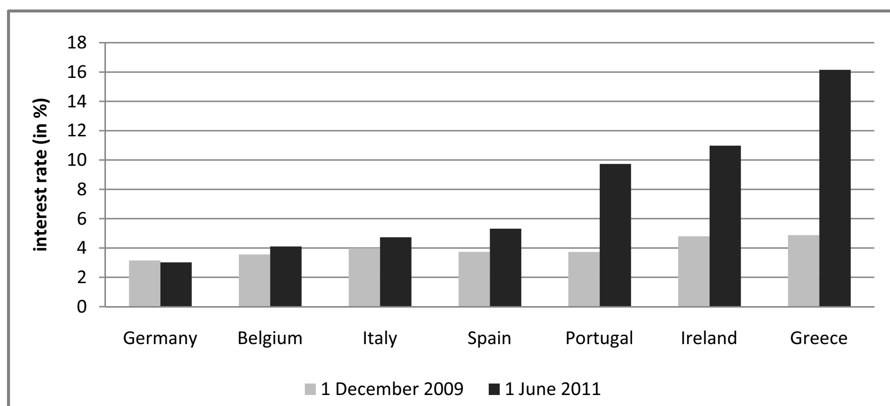
ness of the eurozone countries to deal with the problems of certain of its fellow members, as well as the basic soundness of the eurozone's set-up was questioned. Financial markets feared that the monetary union would render it exceptionally difficult for a Member State to overcome its difficulties.

3.3. A Surge in the Cost of Public Borrowing

The loss of confidence in Greece's ability to overcome its difficulties, as well as the general market anxiety, resulted in sharply increasing interest rates charged for the country's public debt. In May 2010, interest rates of 10-year Greek bonds had risen to well above 12%, which was more than 8 percentage points higher than 7 months before[44]. Afterwards, it further increased to more than 16% in June 2011.

The anxiety about the state of public finances subsequently spread to other eurozone countries. Countries whose fundamentals were judged weak, such as Ireland, Portugal and Spain saw the market interest rates of their public bonds increase considerably. Other countries with specific issues equally saw a rise in interest rates. The rising cost of borrowing for these countries only aggravated their already dire fiscal situations. For several eurozone countries it proved unfeasible to access the financial markets at affordable rates. The evolution of sovereign debt interest rates is illustrated in Figure 1.

Figure 1: Interest rates 10-year sovereign debt of selected eurozone countries[45]



44. The 10-year Greek government bond yields rose from 4.32% on 7 October 2009 to 12.63% on 7 May 2010. This implies an increase 831 basis points in 7 months (source: Thomson Reuters).
45. Source: Bloomberg.

Several eurozone countries thus feel the consequences of the eurozone sovereign debt crisis. Yet, the crisis does not appear to affect the eurozone as a whole in a major way. While the euro had initially seen a decrease in its exchange rate vis-à-vis the US dollar, it has since regained its strength[46]. This signals that a eurozone-wide crisis was avoided.

3.4. A Restructuring of Public Debt

As was mentioned above, the fiscal situation of some eurozone countries has become worrying. Many economists doubt whether fiscal consolidation is feasible for Greece and, to a lesser extent, for other troubled eurozone countries[47]. Several state that debt restructuring is necessary to alleviate Greece's debt burden.

Such debt restructuring would take place by means of one or more of the following measures: (1) lowering the interest rate received on public debt; (2) extending the maturity of the debt, i.e. spreading debt repayments over a longer period; or (3) reducing the nominal value of the bond, which is to be reimbursed to the bond holder at the final payment date.

Arguably more important is the nature of the debt restructuring. Restructuring can take place on a voluntary basis, or it can be unilaterally imposed by the country on its creditors. Voluntary debt restructuring implies that a country proposes bondholders a restructuring of their debt (in practice, such proposals would be made in consultation with major debt holders). On the basis of these proposals, debt holders can choose to agree to a restructuring of their debt. By agreeing to such debt restructuring, debt holders agree to receive less returns than originally foreseen. This represents a cost for investors. Yet, they simultaneously become more certain of receiving the remaining part of their investment[48].

In the case of unilateral debt restructuring, the country imposes a restructuring of its debt upon the government debt holders. In this case, the debt holders have no choice but to accept the conditions. The possibility of unilateral debt restruc-

46. In early December 2009, the euro-dollar exchange rate was close to 1.5. In June 2010, that rate had dropped to 1.2 (a decrease of 20%). Since, the euro has regained in strength compared to the US dollar. In June 2011, 1 euro valued approximately 1.45 US dollar.
47. See for example: DARVAS, Z., PISANI-FERRY, J., SAPIR, A., A Comprehensive Approach to the Euro-Area Debt Crisis, Bruegel Policy Brief, Issue 2011/02, February 2011, p. 4.
48. KOPF, C., Restoring financial stability in the euro area, CEPS Policy Brief, No. 237, 15 March 2011, pp. 16-20.

turing depends on the applicable law and the contractual provisions of the public debt. With regard to most Greek public bonds, neither the applicable Greek law, nor the bonds themselves contain provisions that seem to prevent unilateral debt restructuring[49].

This second way of restructuring is, of course, much more disruptive and would undermine investor confidence the most. Yet, it can result in a more profound reduction of the country's debt burden. In case of voluntary debt restructuring, the country cannot be sure that a large enough number of debt holders will agree to the proposed terms. Furthermore, a voluntary restructuring of debt would most likely result in a mild restructuring, such as a lengthening of maturities. Yet, it is doubtful whether this would be sufficient. Economists argue that in order for Greek debt to become sustainable, a restructuring would have to reduce the value of Greek debt (i.e. a haircut) by at least 20%, while figures of 30% to 50% are seen as more realistic[50].

Although debt restructuring can have a positive effect on Greece's fiscal sustainability, it also entails substantial risks. Debt restructuring would entail costs for investors and notably the financial sector in Greece and elsewhere, the EU and its Member States. The European Central Bank (ECB) would feel the consequences as well, as it owns considerable amounts of Greek debt. If badly managed, debt restructuring could therefore result in a new phase of the eurozone debt crisis. Nonetheless, it would be erroneous to simply disregard this option.

49. BUCHHEIT, L., GULATI, M., How to Restructure Greek Debt, Duke Law Working Papers. Paper 47, 2010, http://scholarship.law.duke.edu/working_papers/47

50. ROUBINI et al. calculate that a 20% haircut is needed to reduce Greek debt to 60% of GDP by 2030, based on optimistic figures. A 50% haircut would be needed based on more conservative macro-economic forecasts. According to Citi Investment Research & Analysis, a 29% haircut is needed to bring debt to 120% of GDP in 2013, while 52% is needed to bring debt to 90% of GDP by 2013. Finally, DARVAS et al. believe a 30% haircut is needed to bring Greece's debt to 60% of GDP by 2034. See respectively: ROUBINI, N., et al., A How-To Manual for Plan B: Options for Restructuring Greek Public Debt, Roubini Global Economics Analysis, 9 May 2011, p.5; NEDIALKOV, S., et al., Hellenic Banks. Fancy a Haircut?, Citi Investment Research & Analysis, 20 April 2011, p.11; DARVAS, Z. et al., op. cit. footnote 44, p. 4.

4. The EU's Response to the Sovereign Debt Crisis

While Greece's problems started in late 2009, it took considerable time before there was an EU response to the burgeoning sovereign debt crisis. The EU is generally slow in its decision-making, while disagreements within and between Member States caused additional delay. Furthermore, the EU was not prepared for a sovereign debt crisis in the eurozone since policy-makers had thought that preparing for such a response could lead to a self-fulfilling prophecy (see 2.1.2). Yet, as the crisis in Greece aggravated and spread to other eurozone countries, an EU reaction proved more and more inevitable.

The EU's eventual reaction essentially consisted of three parts. In the first place, it tried to calm the financial markets (4.1). When this reaction alone proved insufficient, the EU addressed the consequences of the crisis by providing financial assistance to the most troubled countries (4.2). Finally, in addition to these two short term reactions, the EU has started to address a major cause of the crisis: the flawed design of European economic governance (4.3).

4.1. Trying to Calm the Financial Markets

The increase in interest rates charged for sovereign debt was caused by doubts in the markets on the ability of some eurozone countries to reimburse their debt. The initial reaction by the EU and its Member States therefore consisted of trying to calm financial markets.

Policy-makers laboured to convince the financial markets that all eurozone countries would be able to meet their financial obligations. Greece and other Member States committed to comprehensive austerity measures in order to cut their budget deficits. EU declarations, for their part, stressed the significance of efforts that were undertaken by these countries.

The EU also downplayed possible cascade consequences of a eurozone country's inability to meet its financial obligations. To this purpose, a bank stress test was conducted and its results were published in the summer of 2010. The subsequent problems in the Irish financial sector have nonetheless shown that the stress test did not disclose the actual health of European banks[51].

51. Analysts found the stress test to be insufficient. The simulated stress was considered too weak, as it did not involve a sovereign default scenario. Furthermore, the stress test only focussed on the solvency of financial institutions. Their liquidity was not examined. Finally, the stress test only tested the resilience of 91 banks. See: Committee of European Banking Supervisors, Aggregate outcome of the 2010 EU wide stress test exercise coordinated by CEBS in cooperation with the ECB, 23 July 2010, http://stress-test.c-ebs.org/documents/Summaryreport.pdf

As a way to demonstrate their resolve to tackle the issue, EU leaders indicated that they were committed to deal with any threat to the monetary union. During the European Council of February 2010, the Heads of State or Government of the eurozone declared that they would "*take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole*". They failed, however, to provide any specifics as to what kind of actions they envisaged. As a consequence, investors were left with much uncertainty and the borrowing costs for Greece continued to increase. The lack of precision in future declarations often had a similar effect.

An alternative to calming financial markets was not to reduce anxiety in these markets, but to limit mechanisms that can lead to sharp, negative market evolutions. Speculators were the main target, as they are considered to unduly aggravate interest hikes. EU rules on the matter have been proposed[52], while Germany had unilaterally prohibited certain speculative strategies[53]. Actions to reduce the influence of the Anglo-Saxon credit rating agencies were equally considered[54].

4.2. Providing Financial Assistance

Efforts to appease the market were not very successful and it became very costly for Greece and, subsequently, other countries to finance themselves on the financial markets. After much discussion, eurozone leaders finally agreed to offer financial assistance to eurozone countries that required it. After an initial ad-hoc financial assistance package for Greece, a temporary lending mechanism applicable to the entire eurozone was put in place. Meanwhile, the ECB provided more discrete financial assistance to troubled eurozone countries.

While the financial assistance has aided troubled eurozone countries in the short run, some doubt whether it is beneficial in the long run. As financial assistance tries to solve the debt crisis by taking on more debt, it could result in a larger future crisis[55]. However, as the alternatives to not providing financial assistance

52. European Commission, Proposal for a Regulation on Short Selling and certain aspects of Credit Default Swaps, 15 September 2010, COM(2010) 482.
53. See: General Decrees of the Federal Financial Supervisory Authority (BaFin) of 18 May 2010. These Decrees were revoked on 27 July 2010.
54. The link between capital requirements for financial institutions and credit ratings was questioned and the idea of creating a European credit rating agency was floated; see: European Commission, Public Consultation on Credit Rating Agencies, 5 November 2010, retrievable on: http://ec.europa.eu/internal_market/consultations/docs/2010/cra/cpaper_en.pdf
55. DENNINGER, K., Solving a Sovereign Debt Crisis by Issuing More of the Same, Seeking Alpha, May 10, 2010, http://seekingalpha.com/article/204065-solving-a-sovereign-debt-crisis-by-issuing-more-of-the-same

seemed even more detrimental, such assistance seems a reasonable short term response.

4.2.1. Ad-hoc Assistance to Greece

In March 2010, eurozone leaders agreed on providing bilateral loans to Greece if market financing was insufficient. More concrete steps towards a rescue plan for Greece were agreed upon in April 2010, as Eurozone finance ministers agreed to offer a financial assistance programme for Greece.

The Greek rescue package was finally elaborated and implemented in May 2010, against a backdrop of soaring Greek government bond yields. Greece is provided with loans worth EUR 80 billion. The International Monetary Fund (IMF) provides an extra EUR 30 billion, resulting in a total rescue package of EUR 110 billion[56]. This package (as well other the subsequent packages, see infra) is provided in several tranches. The disbursement of each tranche depends on the progress of Greek reforms.

The ad-hoc financial assistance will most likely be replaced by a longer-term assistance package. This assistance package will be financed by the temporary financial assistance facility (see infra).

4.2.2. The Temporary Financial Assistance Facility

After the Greek ad-hoc lending, a temporary financial assistance facility stepped in. The facility will expire in 2013[57]. Its original goal was to dispel worries about eurozone countries' finances and was meant not to be used. It seems, however, that this rescue package was agreed upon too late. Financial markets remained worried over Greece's public finances and worries about the soundness of public finances spread to other peripheral eurozone countries and financial institutions.

a. Design

As a headline figure, the rescue mechanism is worth EUR 750 billion, although the actual financial assistance capacity had been much lower. The rescue mech-

56. Eurogroup, Statement by the Eurogroup, 2 May 2010.
57. The EFSF (see infra) will formally continue to operate beyond 2013 for as long as Member States reimburse the loans they received. The EFSF will, however, no longer be able to provide new financial assistance.

anism is massive, representing more than 8% of eurozone GDP[58]. It consists of three components, namely:

- Financial assistance provided by the Commission, dubbed the European Financial Stabilisation Mechanism (EFSM). This assistance is backed by the EU budget and, thus, all Member States. It has a lending power of EUR 60 billion.
- The European Financial Stability Facility (EFSF), backed by the eurozone members. The EFSF can borrow up to EUR 440 billion.
- IMF assistance. IMF financing is to add at least half of the amount provided by the Commission and eurozone assistance.

The EFSF is clearly the most important part of the rescue package. It is also the most complicated. The EFSF is a separate legal vehicle, set up as a private entity under Luxemburg law. Although the EFSF can borrow up to EUR 440 billion, its lending capacity is more limited.

The difference between the EFSF's borrowing and lending capacity is due to the eurozone countries' desire to obtain the best possible credit rating (a triple A-rating), despite the relatively weak nature of the eurozone countries' guarantees. Each eurozone country only guarantees a portion of EFSF's capital, so-called pro-rate guarantees. In contrast, the EFSM and other EU lending instruments are based on joint liability. The latter implies that all participating countries guarantee the reimbursement of loans to creditors[59].

Because of its weak guarantees, it is believed that the EFSF can only maintain the best credit rating if it does not lend out more than the sum of guarantees provided by the six eurozone countries holding a triple A-rating. This represents EUR 255 billion[60]. Eurozone countries have committed to increase the EFSF's guarantees to EUR 780 billion, which increases the triple-A countries' share of guarantees to more than EUR 440 billion. This should ensure an effective lending capacity of EUR 440 billion, while at the same time maintaining the EFSF's triple A-rating[61].

58. In 2009, eurozone GDP was EUR 9 194 billion, see: ECB, Monthly Bulletin, April 2011, http://www.ecb.int/pub/pdf/mobu/mb201104en.pdf
59. A holder of an EFSM debt obligation can require full compensation from any Member State in case a country would be unable to reimburse its loans to the EFSM. Whereas for the EFSF, a eurozone country is only obliged to provide the amount of its specific guarantee.
60. See: WATTRET, K., EFSF: Q&A Update, pp. 14-18 In: BNP PARISBAS, Market Mover, 87 p., 9 December 2010, http://bnpparibasinvestindia.com/files/1209_MM.pdf
61. Conclusions of the Heads of State or Government of the Euro Area, 11 March 2011, p. 3.

b. Financial Assistance by the Facility

The financial assistance facility can provide financial assistance in two ways: by providing loans and by the direct purchasing of government debt from Member States that requested European assistance. The latter was not part of the initial instruments of the assistance facility. It was only in March 2011 that the Heads of State or Government allowed the EFSF to carry out such operations. Up until June 2011, the instrument has not been used.

Financial assistance in the forms of loans has, on the on the other hand, been provided on several occasions. By the first half of 2011, two eurozone countries had requested assistance from this rescue package: Ireland and Portugal. In response to the Irish request for financial assistance, a financial assistance package worth EUR 85 billion was provided in December 2010[62]. The international part of the financial assistance package represents EUR 67.5 billion[63]. In April 2011, Portugal also requested financial assistance. It received an international financial assistance package of EUR 78 billion[64].

As mentioned above, Greece is to receive a new financial assistance package, financed by the temporary assistance facility and it is not impossible that Ireland or Portugal request more financial assistance. Other countries, such as Spain, might require financial assistance as well. The continuing need for financial assistance and the extension of existing programmes raises serious question with regard to the sufficiency and the sense of the financial assistance facility.

4.2.3. European Central Bank Assistance

The aforementioned initiatives were not the only actions undertaken at the European level. The ECB also changed its policies in light of the sovereign debt crisis. First, it has continued to accept Greek government bonds as collateral, despite the fact that its rating has been downgraded below the previously set minimum[65].

62. Of this sum, EUR 17.5 billion originates from Irish Treasury cash reserves and contributions from the Irish National Pensions Reserve Fund.
63. Contributions come from bilateral loans by Denmark, the UK and Sweden (EUR 4.8 billion in total), the eurozone's EFSF (EUR 17.7 billion), the Commission's EFSM (EUR 22.5 billion) and the IMF (EUR 22.5 billion). See: Recital 6 of Council of the European Union, Council implementing Decision on granting Union financial assistance to Ireland, 7 December 2010, 17211/1/10 REV 1.
64. The EFSF, the EFSM and the IMF are each to contribute EUR 26 billion. See: Statement by the Eurogroup and ECOFIN Ministers, 16 May 2011.
65. European Central Bank, ECB announces change in eligibility of debt instruments issued or guaranteed by the Greek government, Press Release, 3 May 2010, http://www.ecb.int/press/pr/date/2010/html/pr100503.en.html

Afterwards, the ECB started to buy government bonds in secondary markets, where investors sell bonds to other investors. These actions are referred to as the ECB's Securities Markets Programme[66]. As of May 2011, the ECB owned EUR 75 billion worth of government bonds[67], which is – by way of comparison – more than Portugal's financing needs for the period 2011-2013[68]. Buying bonds in secondary market provides only indirect aid to the troubled countries. This in contrast to the EFSF's competence to buy government bonds directly from eurozone countries. The combination of both instruments, the EFSF's direct purchasing of bonds and the ECB's Securities Markets Programme, stretches the Treaty to its limits[69].

Both the temporary lending facility and the ECB operations lead to extra liquidity in the financial system[70]. This can create additional inflation, which runs completely against the ECB's core objective: price stability[71]. The ECB would also be hit hard by a debt restructuring, making it a biased party. Some state that the ECB risks losing its independence and credibility as a consequence of its unconventional actions[72].

4.3. Working on a Long Term Response: Reforming European Economic Governance

Most of the EU's response to the sovereign debt crisis tackles short term liquidity problems. Neither the ECB's policy changes nor the rescue mechanism, however, are capable of resolving the high and ever-increasing public debt across the eurozone, nor did they deal with issues of competitiveness. Financial assistance, then, cannot be a long term solution.

66. European Central Bank, ECB decides on measures to address severe tensions in financial markets, Press Release, 10 May 2010, http://www.ecb.int/press/pr/date/2010/html/pr100510.en.html
67. See: ECB, Open Market Operations. Summary of ad hoc communication, 23 May 2011, retrievable on: http://www.ecb.int/mopo/implement/omo/html/communication.en.html
68. Portugal's financing need for the period 2011-2013 is EUR 72 billion, see: BUITER, W., GIANI, G., et al., The Debt of Nations, Global Economics View, Citi, 7 January 2011, p. 37.
69. As was mentioned above, the Treaty provides that the ECB cannot buy government debt directly from the Member States. As part of its crisis response, the EU has circumvented this restriction to its limits. The ECB can buy public debt, but only on the secondary market, while another body (the EFSF) does so on the primary market.
70. In principle, the ECB Securities Market Programme is to reabsorb an equivalent of the public debt it buys from financial markets. However, it has not always been able to do so, which creates small additional liquidity in the financial system.
71. Article 127(1) TFEU.
72. See for example: ANNUNZIATA, M., The ECB's Independence Is in Jeopardy, Opinion Europe, Wall Street Journal, 6 May 2010; WYPLOSZ, C., European Stabilisation Mechanism: Promises, realities and principles, 12 May 2010, voxEU, http://www.voxeu.org/index.php?q=node/5031 and BOSKIN, M., Time to Constrain Government, 25 May 2010, Project Syndicate, http://www.project-syndicate.org/commentary/boskin9/English

Faced with the failure of economic governance, policy-makers had, in a nutshell, three long term reform options. The first option was to end the monetary union and thus to break up the eurozone. This would result in the re-introduction of national currencies or in various monetary unions across the EU. A second option was to create a full-fledged economic and political union, which implies a major shift in decision-making from the national to the European level. The final option consisted of simply revising the current framework.

The first two options hardly seemed feasible, as there was no consensus on their benefits, nor any major political support[73]. Therefore, the course of action chosen by policy-makers consisted of revising the European economic governance provisions. While this response is, politically speaking, the most feasible, it is all but certain whether it will be successful. In order to have a better view of what the reforms should aim to achieve, it is therefore necessary to first discuss earlier shortcomings in economic governance.

73. A full-fledged political union is mainly contested from a perspective of subsidiarity, while a break-up of the eurozone risks leading to economic distress which deters policy-makers from considering the option, see: CLIFFE, M., et al., EMU Break-up. Quantifying the Unthinkable, Financial Markets Research, ING, 7 July 2010.

5. The Shortcomings of Economic Governance

Doubts on the viability of the Economic and Monetary Union are not new. Ever since the EMU was created there has been debate on this subject[74]. The 2010 sovereign debt crisis did, however, abruptly change the nature of the debate.

The sovereign debt crisis has made it clear that European economic governance did not offer enough leverage to deal with the increased interdependence caused by the monetary union[75]. Either rules failed to meet their objectives (see fiscal sustainability), or they were inadequate (see macro-economic convergence) or they were simply missing (see crisis governance). Besides failed rules, a major overarching problem was the Member States' general disregard for European economic governance provisions.

5.1. Inability to Impose Fiscal Sustainability

The most obvious shortcomings of economic governance lie in its fiscal rules. Rules meant to discipline Member States were simply not abided by, notwithstanding the sensed need for robust fiscal positions, and the envisaged sanctions.

5.1.1. Unsound Fiscal Evolutions

Even before the financial crisis (so before 2008), the EU rules had not been able to prevent unsound fiscal evolutions. The failure of the EU to impose its rules is evident when looking at Member States' budgets since the single currency was introduced. Each Member State was to keep its public deficit within the 3% of GDP limit[76]. Nonetheless, numerous countries have had deficits exceeding this threshold. Between 1999 and 2007, seven out of the twelve initial eurozone countries[77] had a deficit exceeding 3% of GDP at least once[78]. Several countries even had multiple budgets exceeding the 3% deficit limit. In France, one out of three annual budgets exceeded the limit, while for Germany, Italy and Portugal

74. See for example: BORDO, M., JONUNG, L., The Future Of EMU: What Does The History Of Monetary Unions Tell Us?, National Bureau Of Economic Research, Working Paper 7365, 1999 and CONNOLLY, B., WHITTAKER, J., What Will Happen to the Euro?, Economic Affairs, Volume 23, Issue 1, 2003, pp. 49-54.
75. See to this extent: IOANNOU, D., STRACCA, L., Have euro area and EU economic governance worked? Just the facts, ECB Working Paper Series, NO 1344, May 2011.
76. See Article 1 of Protocol No. 12 on the Excessive Deficit Procedure, TFEU.
77. I.e. the twelve countries that were member of the eurozone in 2001.
78. These countries are Austria, France, Germany, Greece, Italy, Portugal and the Netherlands.

this was the case for about half of their annual budgets[79]. More stunningly, Greece has never had a deficit of less than 3% of GDP since it joined the EU[80].

The goal of the EU's deficit rules, however, is not just to have deficits of less than 3%, but also to achieve medium term budgets close to balance or in surplus. In this respect as well, EU fiscal rules failed. In the period 1999-2007, the average budget deficit of the initial twelve eurozone countries was 1.8% of GDP. This is far from being close to balance, let alone surplus.

These assessments are based on ex-post figures, which sometimes differ considerably from the initial figures. This is especially the case for Greece. Its deficit figures have almost continuously been revised upwards. Due to this misrepresentation by Greece, the size of deficits was often not discovered until afterwards, when procedures had already finished[81]. To a lesser extent, these problems also occurred in other eurozone countries[82].

Deficit evolutions since the financial crisis highlight other shortcomings in the fiscal rules of the Union. Some eurozone countries have seen their deficits increase at an alarming speed. In 2009, Greece, Ireland, Portugal and Spain had deficits of more than 10% of GDP[83]. EU rules were not able to prevent the sharp deterioration of public finances.

Several reasons can explain the abnormally large budget deficits that followed the economic and financial crisis. A first, obvious reason is the dire straits budgets were in prior to the crisis. This was notably the case in Greece and Portugal, which had 2007 deficits of respectively 6.4% and 2.8% of GDP. Secondly, in some countries both public revenue and expenditure were tremendously affected by the crisis. Due to their weakened competitiveness and large current account deficits (see infra), these countries' entire economies suffered more than average from the crisis. Furthermore, some countries' public revenues heavily depended on a few sectors – such as the tourism, real estate and financial sectors – that suffered significantly from the crisis. On the expenditure side, the bailout of the financial sector in Ireland was worth 20% of GDP, vastly pushing up its budget deficit.

79. Source: European Commission, General Government data. General Government Revenue, Expenditure, Balances and Gross Debt, Part II: Tables by Series, Table 53B, p.154, autumn 2010 and own calculations.
80. Source: IMF World Economic Outlook Database April 2011.
81. European Commission, Report on Greek Government Deficit and Debt Statistics, 8 January 2010, COM(2010) 1 final.
82. See: GORDO MORA, L, NOGUEIRA MARTINS, J., How reliable are the statistics for the Stability and Growth Pact?, European Economy Economic Papers, no 273, February 2007.
83. Source: Eurostat database.

In contrast to the budget deficits, overall debt evolution was not particularly discouraging prior to the crisis. In the period 1999-2007, average debt-to-GDP in the twelve initial eurozone countries decreased by more than 5 percentage points (from 71.9% to 66.6% of GDP). However, some countries evolved against this trend, including countries with high debt levels (Greece; +11 percentage points) or low growth (Portugal; +13 percentage points). The performance of a country like Italy also appears inadequate: although Italy reduced its debt level by 10 percentage points during this period, it was not able to bring its debt level below 100% of GDP.

5.1.2. The Shortcomings of Fiscal Rules

In discussing the effects of EU fiscal rules, four major shortcomings can be identified. In the first place, the surveillance was based on too few and too rigid parameters. In evaluating fiscal positions, the focus was predominantly on the 3% deficit to GDP rule. Other considerations, notably the level of debt and the medium-term budget balance seem to have been largely overlooked by policymakers. The heavy dependence on certain sources of revenues was also taken into account insufficiently. Fiscal surveillance missed a long term approach.

A second shortcoming lies in the occasional lack of quality of the data provided to the EU. The Commission's statistical office Eurostat had to rely on data provided by the Member States and could do little to verify this data[84]. The result was an assessment based on incorrect figures.

Thirdly, the Excessive Deficit Procedure proved ineffective. It is a lengthy process, as several steps have to be taken before a warning can be issued. It takes even longer before recommendations or sanctions could be applied. The required cooperation between the Commission and the Council made the Procedure even more cumbersome. The Commission was in a weak position as its reports, opinions and recommendations were all non-binding. Political bargaining in the Council made it difficult to advance the Excessive Deficit Procedure[85].

Finally, the fiscal rules missed a functioning stick-and-carrot approach. The rules had no carrot, as no rewards for prudent fiscal policy were foreseen. The stick was there, but proved impracticable. In fact, the envisaged sanctions were never applied. Sanctions were not gradual enough and they could only be

84. A 2005 revision of Eurostat's powers has not proven sufficient to ensure trustworthy statistics, see: Council Regulation (EC) No 2103/2005 of 12 December 2005 amending Regulation (EC) No 3605/93 as regards the quality of statistical data in the context of the excessive deficit procedure.
85. For more detail, see: ZGAJEWSKI, T., HAJJAR, K., The stability and growth Pact has it a future?, Studia Diplomatica, Vol. LVII, n° 6, 2004 (published in Nov. 2005).

administered at the very end of the lengthy Excessive Deficit Procedure. The scope of sanctions was furthermore limited to those of a financial nature. This seems inappropriate, since – given the lengthy procedure – a country would already be facing financial difficulties when it was penalised. Politically speaking, sanctions have never been called upon since this would have required finance ministers to apply sanctions to their peers. They have been most reluctant to take such steps[86].

5.2. Insufficient Macro-economic Convergence

While the ineffectiveness of fiscal rules can be easily identified as a major cause of the sovereign debt crisis, fiscal discipline alone would most likely not have been able to prevent a eurozone crisis. Ireland and Spain, for instance, adhered to the rules of the Stability and Growth Pact. Nevertheless, both had to adopt harsh austerity measures and Ireland even had to request European financial assistance. An important part of their problems results from the unsound macro-economic evolutions they experienced since the start of the eurozone.

5.2.1. Unsound Macro-economic Evolutions

On the surface, Greece, Ireland, Portugal and Spain seemed to perform rather well, ever since joining the eurozone. In terms of economic growth, Greece, Ireland and Spain performed significantly better than the average eurozone country. This is in contrast to Germany, which experienced small economic growth. However, growth in Greece, Ireland, Portugal and Spain was largely driven by internal demand and the construction sector. Their export growths were below the eurozone average[87]. In contrast, Germany's exports grew significantly faster than the eurozone average, while its internal demand was relatively weak. The contrast in GDP and consumption growth versus exports figures resulted in increased macro-economic divergences, which is reflected in the evolution of competitiveness (see Table 1).

86. A parallel can be drawn with Article 259 TFEU, which allows a Member State to pursue legal actions against other Member States if it is of the opinion that they fail to fulfill an obligation under the Treaties. These provisions have hardly been used. Instead, the Commission brings such cases before the European Court of Justice.
87. With exception of Ireland, where export growth did not begin to deteriorate until 2005.

Table 1: Average annual change of key economic indicators in the period 1999-2007[88]

	GDP	Total Consumption	Investment in Construction[a]	Exports	inflation	Competitiveness[b]
Germany	1.6%	0.9%	-1.5%	7.9%	1.8%	1.2
Greece	4.1%	3.9%	3.8%	5.2%	3.3%	-0.8
Ireland	6.5%	6%	7.6%	8.4%	3.4%	-2.1
Spain	3.7%	4.2%	5.5%	5.3%	3.3%	-2
Portugal	1.8%	2.2%	1%	5.5%	2.9%	-0.7
Eurozone	2.2%	2%	2.1%	5.9%	2.3%	-0.1

a. Figures are for the period 1997-2007.
b. Average annual change in the harmonised competitiveness index based on GDP deflators (1999 =100)

The increasing macro-economic divergences led to large current account imbalances. A prime way of financing the economic growth in countries with large current account deficits was by taking on more private and/or public debt. The resulting high debt levels rendered them more vulnerable to an economic downturn. Germany on the other hand, developed a considerable current account surplus (see Table 2).

Table 2: Current Accounts and Debt (in percentage of GDP)

	Current Account Balance[a]	Debt[b]		
		Private[c]	*Public*[d]	Total
Germany	7.6%	129.1%	73.4%	202.5%
Greece	-14.4%	121.4%	126.8%	248.2%
Ireland	-5.3%	325%	65.5%	390.5%
Spain	-10%	206.4%	53.2%	259.6%
Portugal	-10.1%	236.6%	76.1%	312.7%

a. Figures are for 2007. Source: IMF World Economic Outlook Database April 2011.
b. Figures are for 2009.
c. Financial debt is calculated as the sum of loans and securities other than shares using consolidated amounts except for Ireland. Source: OECD Economic Surveys: Portugal 2010, p.30
d. Source: Ameco database.

88. Sources: GDP and Total Consumption: AMECO Database; Investment in Construction: European Economic Forecast – autumn 2010; Exports and Inflation: IMF World Economic Outlook Database April 2011; Competitiveness: ECB.

While weakened competitiveness and current account deficits seem more detrimental than increases thereof, in a monetary union both matter. The lack of convergence between Member States' economies makes the single monetary policy less appropriate, both for the stronger and the weaker economies. In relation to their economic performances, Ireland and Spain were faced with an overly loose monetary policy, which led to higher inflation and is likely to have stimulated their housing bubbles[89].

5.2.2. *The Shortcomings of Macro-economic Convergence Instruments*

The aforementioned evolutions took place despite the macro-economic surveillance and coordination mechanisms in place. The EU proved unable to detect or correct macro-economic divergences. Three main reasons can be given for the ineffectiveness of EU macro-economic convergence instruments.

A first reason is the shortfall of EU rules. EU macro-economic surveillance and coordination were focused on stimulating good policy practices and structural reforms. Such a focus led to reduced attention to unsound macro-economic evolutions and divergences. There was no formal EU supervision mechanism to monitor potentially unsound economic evolutions. Even when the EU would detect an imbalance, it lacked competences to require policy changes. EU macro-economic policy surveillance and coordination instruments were all non-binding. In essence, policy changes remain subject to the willingness of Member States.

The non-binding nature of EU macro-economic policy coordination is partly due to the uncertainty about what are considered correct macro-economic evolutions. This is a second reason why economic convergence instruments remained unused[90]. Evaluating macro-economic evolutions is more difficult than evaluating fiscal evolutions. While there is a large consensus on the need for fiscal sustainability, such a consensus is absent when it comes to the level of current account balances and other macro-economic variables.

Indeed, current account and competitiveness evolutions can be caused by benign and/or temporary evolutions, such as demographic evolutions or the catching up of lower-income countries. Distinguishing between benign and harmful evo-

89. SEYFRIED, W., Monetary policy and housing bubbles: a multinational perspective, Research in Business and Economics Journal, vol. 2, 2010.
90. MARZINOTTO, B., PISANI-FERRY, J., SAPIR, A., Two Crises, Two Responses, Bruegel Policy Brief, Issue 2010/01, March 2010.

lutions proves difficult and far from infallible. While in retrospect certain evolutions can be identified as harmful, it is hard to make such judgments on the basis of live data.[91]. In addition, while the concept of competitiveness is used very often, it remains rather vague and has been highly criticized. Competitiveness is a zero-sum variable, where one party's gains imply another party's losses. In this sense, it tends to overlook the overall beneficial effects of trade[92].

Finally, even if macro-economic imbalances are detected and there is a willingness to address them, it remains challenging to do so. The nature of macro-economic evolutions is such that Member States do not always have full control over them. Member States can only indirectly influence key macro-economic variables, such as private wage evolutions, asset prices and current accounts[93]. The limited role of governments in macro-economic evolutions should be underscored and could be important in further discussions on macro-economic coordination. However, it should not lead to neglecting the other reasons for failed macro-economic convergence.

5.3. Absence of Crisis Governance Provisions

In line with the no bailout clause and the avoidance of moral hazard (see 2.1.2), there were no crisis governance provisions with regard to eurozone countries. This is in contrast to provisions for non-eurozone countries, for which financial assistance in the case of balance of payment problems had been foreseen[94]. Such problems notably include difficulties to meet future international payment obligations, which was a major reason for aid to Greece[95].

In light of the sovereign debt crisis, the strategy not to foresee the possibility of financial assistance to eurozone countries proved erroneous. The strategy did not achieve its goals, as it has proven unable to prevent the eurozone sovereign debt crisis. Furthermore, the strategy's impact on fiscal prudency can be ques-

91. For instance, according to the competitiveness index used before, Luxemburg and Slovakia's competitiveness decreased much sharper than the competitiveness of Greece, Ireland, Portugal or Spain. Yet, as of mid 2011, these countries do not face sovereign debt issues.
92. KRUGMAN, P., Competitiveness: A Dangerous Obsession, Foreign Affairs, vol. 73, nr. 2, 1994.
93. GROS, D., Europe's Competitiveness Obsession, CEPS Commentaries, 5 June 2010.
94. Article 108 of the Treaty of Rome. Currently, Article 143 TFEU. This Article has been detailed in Council Regulation (EC) No 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments, OJ L 53, 23.2.2002, pp. 1-3.
95. The system of balance of payments assistance for non-eurozone countries has been used during the economic and financial crisis. Three non-eurozone countries have been provided with balance of payments assistance in the form of EU credit: Hungary, Latvia and Romania. The total amount of such aid amounts to EUR 14.6 billion. See the Memoranda of Understanding between the European Community and the Republic of Hungary (17 and 19 November 2008), the Republic of Latvia (26 and 28 January 2009) and the Republic of Romania (23 June 2009) respectively.

tioned. It was not able to stimulate pressure by the financial markets, as investors did not sufficiently discriminate between prudent and imprudent eurozone countries[96].

Besides the failure to induce fiscal prudence, the strategy has proven costly because of its lack of endgame provisions. This postponed the EU's response to the crisis, which aggravated problems in Greece and contributed to the spreading of the crisis to other eurozone countries. As problems aggravated to a point where intervention was necessary, EU leaders had to provide a eurozone answer to the crisis in the end. This ad-hoc crisis response had to be developed under considerable time constraints and increasing market pressure. The EU's response proved to contain some loose ends that resulted in more uncertainty, which undermined its effectiveness[97]. It also increased the EU's perceived indecisiveness, which worsened the crisis.

5.4. A Neglect of European Economic Governance by Member States

Regulatory shortcomings alone do not explain the failure of European economic governance. Member States' commitment to ensure a viable monetary union was clearly lacking as well. Too often, it was believed that the success of the single currency was the responsibility of the ECB alone[98].

The complexity of economic governance framework contributed to and reinforced this lack of ownership. The multitude of procedures and their varying degrees of alignment made it difficult for policy-makers (let alone the general public) to understand the functioning of economic governance. Furthermore, the complexity of governance instruments seems to have obscured the core purpose of economic governance, i.e. dealing with the ever-growing mutual interdependence.

Due to both general neglect and complexity, Member States failed to see the need for European economic governance. This lack of ownership ran through

96. European legislation even encourages equal treatment of prudent and imprudent eurozone countries, as the Capital Requirements Directive does not require any risk weighing for eurozone debt. This implies that financial institutions do not have to hold any additional capital to take into account risk associated with eurozone sovereign debt. See: Capital Requirement Directive 2006/48/EC and BISHOP, G., Market Discipline on Eurozone Public Debt, 26 April 2010, 7 p., retrievable on: http://www.grahambishop.com/DocumentStore/7c993f66-1a04-4625-b93c-802bb244dcba.pdf
97. An example is the EFSF's theoretic versus real lending capacities (see supra).
98. VAN DEN NOORD, P., et al., The Evolution of Economic Governance in EMU, European Commission Economic Papers, 328, 2008, pp. 63-64.

all parts of European economic governance. While there often were surveillance instruments and binding sanctions, they were left unused. Member States did not want to interfere with each other's policies, let alone punish each other. Yet, a single currency requires more coordination among its members, including control of each other's economic policies.

Achieving a shift in the mindset of Member States might prove to be more difficult than achieving regulatory reform. Stricter and better rules are one way to deal with a lack of ownership. In view of the European construction, ownership by Member States of European economic governance appears at least as crucial. Renewed neglect by the Member States of the European dimension of their policies is not an eminent threat, as the recent crisis experiences will surely have an impact on their behaviour. However, as time goes by and new political leaders emerge this effect is likely to fade away. Therefore, the reform of the economic governance framework should result in a clearer and more robust system, so as to ensure the monetary union's long term sustainability.

6. Reforming Economic Governance

The sovereign debt crisis and the shortcomings of economic governance that it revealed called for changes to the governance framework. These reforms were much needed, but will not solve the debt crisis in Greece, Ireland and Portugal. Its purpose is rather to prevent and mitigate future crises.

The reforms fall into two types. On the one hand, the EU is to reform existing economic governance. This governance concerns situations in which eurozone countries do not require external financial assistance, i.e. in the absence of acute stress. On the other hand, European “crisis governance” is being introduced. In future, crisis governance needs to do deal with situations in which eurozone countries are not able to finance themselves at affordable interest rates. This latter type of governance is discussed in the next chapter. Here, the focus is on the reform of existing economic governance.

In September 2010, The Commission proposed six legislative acts to reform existing economic governance. The European Council called for an agreement to be reached in June 2011[99]. Intense negotiations took place between the Parliament and the Council. These negotiations did, however, not result in a finalised agreement by the end of June 2011. The remaining bone of contention was the role of the Commission in advancing the fiscal surveillance procedure, a noteworthy element of the reform. Nonetheless, the lack of agreement on the matter does not prevent a general assessment of the economic governance reforms.

This chapter discusses the most significant reforms. These reforms aim to strengthen fiscal sustainability rules (6.1) and will put in place a procedure to avoid macro-economic divergences (6.2). In order to make economic governance less open-ended for eurozone countries, some measures have been taken with a focus on the eurozone. These notably concern strengthened sanctions, as well as the Euro Plus Pact (6.3).

The reforms add several new procedures to the economic governance framework. This risks making economic governance even more complex and could therefore undermine the general public and national administrations’ understanding even further. The European Semester is a partial answer to this problem, as it reinforces dialogue between the EU and the Member States and aims to better align fiscal and macro-economic surveillance instruments (6.4). However, economic governance will remain a complex matter.

99. Conclusions of the European Council of 16-17 December 2010, EUCO 30/1/10/ REV 1, 25 January 2011, p. 5.

6.1. Fiscal Sustainability

Up to the sovereign debt crisis, European fiscal surveillance concentrated almost exclusively on the current budget deficit. In reforming the fiscal rules, policy-makers seek to focus more on the longer term. Furthermore, the reforms aim to improve the quality of national fiscal planning.

6.1.1. Working Towards Long Term Fiscal Soundness

The EU Institutions seek to take more variables than the fiscal deficit into account when evaluating a Member States' budget. This should result in less short-termism. However, the problem before was not so much that the EU rules did not allow for other variables – such as the level of debt and pension costs – to be taken into account. Variables other than budget deficits missed concrete targets, which resulted in neglect of these variables. Therefore, the reforms aim to take more variables better into account, especially public expenditure increases and tax cuts, as well as public debt evolutions.

a. Taking Public Debt into Account

The Treaty already states that public debt should not exceed 60% of GDP, unless the debt ratio is "*sufficiently diminishing*[100]". This concept had been left undefined. In reforming economic governance, the concept is to be made operational.

A numerical rule that determines the required pace of debt reduction for countries whose debt exceeds 60% of GDP will be put in place[101]. The rule implies that each country will have to reduce the difference between its debt level and the 60% debt target by 1/20th per year on average. To take into account yearly fluctuations, debt reduction will be measured on a three-year basis[102].

Therefore, a country with a debt-to-GDP level of 70% would have to cut its debt (on average) by 0.5 percentage points by the next year. A country with a deficit of 100% of GDP would have to cut its debt by 2 percentage points. A debt-to-

100. Article 126(2)b TFEU.
101. See: Article 1(2)b of European Commission, Proposal for Proposal for a Council Regulation amending Regulation No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, COM(2010) 526, 29 September 2010.
102. The three-year average rule implies that a countries' debt-to-GDP that exceeds the 60% threshold needs to diminish by 14.26% (or $1 - {}^{19}/_{20}{}^{3}$) in three years' time. For the examples in Table 3, this implies that debt-to-GDP in year n+3 should be respectively 68.6%, 94.3%, 120%, and 145.7%. For the sake of clarity, this three-year average rule has not been included in the Table.

GDP level of a 160% of GDP would imply cutting debt by 5 percentage points (see Table 3). The latter is not a fictional example, as Greece's debt is set to reach such a level in 2012.

Table 3: Debt reduction rule

Debt-to-GDP level in year n	Difference with the 60% benchmark	Required annual debt reduction	Required debt level in year n+1
70%	10 p.p.	0.5 p.p.	69.5%
100%	40 p.p.	2 p.p.	98%
130%	70 p.p.	3.5 p.p.	126.5%
160%	100 p.p.	5 p.p.	155%

A breach of the numerical debt rule would, however, not automatically lead to an Excessive Deficit Procedure. Other economic variables, such as pension reforms and private debt are also to be taken into account.

The numerical debt rule will require an enormous and sustained effort from Member States with high public debt levels, notably Greece. Furthermore, the rule is rather complicated. For these reasons, some had pleaded for simpler rules. For example, an average yearly debt reduction of 0.5 percentage points per 10 percentage points of debt-to-GDP exceeding 60%, with a maximum required effort of 2 percentage points[103]. This could have resulted in more realistic efforts from highly indebted countries[104].

b. A Cap on Public Expenditure Increases and Tax Cuts

Some Member States with previously sound budgets proved to be hard hit by the financial and economic crisis. Their budgets deteriorated massively, as they were often dependent on the growth of a few sectors. In an attempt to render Member States' budget better prepared for such sudden shocks, a prudent fiscal policy-making rule was added to the Stability and Growth Pact[105].

103. This implies the following debt-to-GDP percentage points reduction targets:]60%-70%]: 0.5p.p.;]70%-80%]: 1p.p.;]80%-90%]: 1.5p.p.;]90%: 2p.p.
104. MAYSTADT, P., keynote speech at EGMONT-CCECRB expert seminar "The Financial and Economic Crisis: Overcoming the Shortcomings of the European Framework", 6 December 2010.
105. European Commission, Proposal for amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, COM(2010) 526 final, 29 September 2010.

The rule implies that a Member State's public expenditure increases and tax cuts cannot surpass the expected medium-term GDP growth rate. However, there are three exceptions to this rule. Firstly, when the expenditure increase or tax cut is counterbalanced by other fiscal changes (respectively a tax increase or expenditure decrease). Secondly, when the Member State's previously established budgetary trajectory (the medium-term budgetary objective) is met or overachieved. Finally, certain types of expenditure, such as automatic stabilisers (for example unemployment benefits), certain types of investment and interest expenditures can be excluded.

At any rate, in practice, the prudent fiscal policy-making rule is not so different from the existing budgetary objectives. If a country's expenditure grows out of line with its revenue, this evidently has a budgetary impact. Only when current GDP growth and expected future GDP growth differ, would the rule be relevant. Yet, a substantial problem in applying this rule is that it is difficult to determine a country's expected GDP growth. This uncertainty is likely to undermine the rule's relevance. Nonetheless, it does put a greater focus on expenditure. The rule can counteract, to a certain extent, the effects of one-off budgetary measures and unexpected revenue increases. However, it is doubtful that the principle would have prevented the problems in Ireland and Spain.

6.1.2. Improving National Fiscal Planning

As was mentioned earlier, there was a neglect of fiscal rules among Member States. The lack of ownership sometimes resulted in weak procedures, unreliable statistics and deficient fiscal planning in the Member States. To deal with these issues, Member States will have to adopt national budgetary rules that meet certain minimum requirements. The EU is aware that such rules are not foolproof. Therefore, it has also been made easier for the Commission to carry out inspections missions to verify national statistics.

a. National Budgetary Rules

A set of minimum requirements for Member States' budgetary frameworks are to increase both the attention to fiscal planning, as well as its quality[106]. They will concern, *inter alia*, minimum rules on accounting, reporting, statistics and numerical targets.

106. Council of the European Union, Draft Council Directive on requirements for budgetary frameworks of the Member States, 2010/0277 (NLE), 17 March 2011.

Member States would have to establish multi-annual budgetary frameworks. The figures on which Member States base their planning will need to meet certain requirements. Particularly, they will have to include negative scenarios, and their figures should be in line with the Commission's forecasts. Member States will have to point out any differences between their forecasts and those of the Commission.

Also, national numerical rules on debt and deficits will have to be adopted. However, sanctions for breaching these rules are not required. National numerical rules can undoubtedly be useful, but the benefit of just copying EU rules seems negligible, as these are already directly applicable in the Member States. It could furthermore be seen as undermining the legal principles of precedence and direct effect.

Each Member State will be required to have a functional autonomous body that monitors Member States' fiscal policies. Although this is an improvement, it stops short of requiring independent national fiscal councils, which are entities staffed by non-elected professionals that provide impartial oversight of fiscal performance. This is despite research showing the beneficial effects of such councils[107].

Finally, the Directive will have important consequences for the regional and local governments. They, too, will be subject to certain budgetary rules and reporting requirements. Any local government would have to be able to provide fiscal data at least on a three-monthly basis.

b. Increased European Surveillance of National Budgets

As national rules are no guarantees for success, the EU has endowed the Commission's statistical office Eurostat with surveillance powers to verify the quality of national statistics. In 2010, Eurostat's powers were expanded[108]. The new rules make it easier for Eurostat to conduct comprehensive visits[109] to Member States in order to verify their statistical data. Even with these new rules, comprehensive visits can only be conducted in exceptional cases, when specific problems

107. See for example: HAGEMANN, R., Improving Fiscal Performance Through Fiscal Councils, OECD Economics Department Working Papers, No. 829, 2010 and BOGAERT, H. et al., Fiscal councils, independent forecasts and the budgetary process: lessons from the Belgian case, Working Paper4-06, Belgian Federal Planning Bureau, 2006.
108. Council Regulation (EU) No 679/2010 of 26 July 2010 amending Regulation (EC) No 479/2009 as regards the quality of statistical data in the context of the excessive deficit procedure, OJ L 198, 30 July 2010, p. 1-4.
109. I.e. so-called methodological visits.

have been identified. Eurostat's auditing powers therefore remain limited[110].

The revision of fiscal surveillance procedures explicitly foresees the possibility for Eurostat to conduct surveillance missions in case specific goals in the fiscal surveillance procedure are not met. In some specific cases, the same goes for macro-economic surveillance (see infra). However, it is rather inconsistent that Eurostat's powers differ according to whether the statistical problems concern fiscal or macro-economic surveillance.

6.2. Macro-economic Convergence

Macro-economic evolutions were already monitored in the past, notably by means of the Broad Economic Policy Guidelines. Yet, the focus was predominantly on positive targets, rather than surveillance of negative evolutions. In addition, the monitoring did not enjoy much visibility or attention outside of the finance ministers' Council meetings. The EU hopes to overcome this problem by putting in place a more visible and effective macro-economic surveillance procedure.

6.2.1. Surveillance of Macro-economic Imbalances

The legislative package introduces a new macro-economic surveillance instrument[111]. This surveillance will be carried out on the basis of a scoreboard, which will contain a limited number of indicators that are to monitor macro-economic evolutions. Pre-determined thresholds need to signal macro-economic imbalance and could result in further actions.

While the scoreboard is at the centre of the new surveillance instrument, its content will be decided upon at a later stage. The Commission, in cooperation with the Council and the Parliament, will draw up the scoreboard. It goes without saying, though, that defining the exact indicators and their thresholds is of prime importance and is likely to be a highly contested matter. Although the content of the scoreboard has not yet been decided upon, its general outline is already clear. The variables of the scoreboard are to measure three types of imbalances:

110. The Commission has proposed to change anew the rules with regard to the control of statistics. See: European Commission, Towards robust quality management for European Statistics, COM(2011) 211 final, 15 April 2011.
111. European Commission, Proposal for a Regulation on the prevention and correction of macro-economic imbalances, COM(2010) 527 final, 29 September 2010.

- External imbalances, to be measured by the current account balance and net foreign asset positions;
- Competitiveness imbalances, to be measured by productivity gains, labour cost and GDP deflators;
- Internal imbalances, to be measured by private credit growth, public debt, added value in the construction sector and the evolution of house prices[112].

Surveillance will focus mainly on macro-economic weaknesses, such as current account deficits and labour cost increases that are not backed by productivity gains. More controversially, surveillance is also to monitor other types of imbalances, notably current account surpluses.

The Commission will monitor how the Member States perform on the scoreboard and whether thresholds are surpassed. This analysis is to be supplemented by additional economic analysis. Surpassing a threshold would therefore not immediately lead to further action. This non-automaticity is due to the controversial nature of macro-economic surveillance (see 5.2.2). Furthermore, an imbalance (for example a current account deficit or surplus) can be the consequence of several problems. Economic analysis should provide more clarity and potential remedies. The outcome of this scrutiny will remain controversial nonetheless.

6.2.2. Addressing Unsound Macro-economic Evolutions

Means to counteract macro-economic imbalances would differ considerably between members of the eurozone and other Member States. For both types of Member States, actions can be taken in a preventive phase and during a subsequent Excessive Imbalance Procedure. For eurozone countries, subsequent sanctions are envisaged (see infra).

During the preventive phase, the Commission can warn the Council of imbalances in a Member State. Subsequently, the Council can make recommendations to the Member State to counteract these imbalances. These recommendations are to be made public. During the preventive phase, no further follow-up is provided for.

If the preventive phase proves ineffective, an Excessive Imbalance Procedure can be initiated. The Council can declare such a Procedure upon recommendation by the Commission. In that case, the Council shall again make recommendations to the Member State to counteract the imbalance. The Member State in

112. European Commission, Economic governance: the EU gets tough, European Economy News N° 19, October 2010, p. 7.

question subsequently needs to adopt a corrective action plan based on these recommendations. The Commission is to monitor the country's progress, based on the country's efforts to implement both the recommendations and the corrective action plan. The Commission shall also draw up progress reports. Both the corrective action plan and the progress report are to be made public. If needed, the Commission may conduct surveillance missions.

The enforcement of the Excessive Imbalance Procedure does not stretch beyond the public nature of a part of the procedure and the possible surveillance missions. If these instruments fail to lead to the required results, sanctions can only be applied in the case of eurozone countries (see 6.3.1). For non-eurozone countries, such enforcement is completely absent. The lack of a sanctioning mechanism for non-eurozone countries risks making the procedure all the more noncommittal for them.

6.3. Measures Specific to the Eurozone

As was mentioned earlier, economic governance was neglected among Member States as they failed to see its necessity. It was clear that more ownership was needed. Yet, in several fields a step-up of commitments among all Member States proved unfeasible. Therefore, farther-reaching governance will be put in place for those to whom economic governance matters the most: the eurozone countries. Economic governance in the eurozone is to be made less open-ended both by lifting commitments and discussions to the level of the European Council via the Euro Plus Pact and by reinforcing sanctions.

6.3.1. Strengthened Sanctions

Sanctioning is perceived as the prime way of making governance more imperative. The reform of economic governance will increase the number of sanctions, as well as their automaticity. As will be discussed below, these changes increase the potential impact of the sanction toolbox. However, prime weaknesses of former sanctions have not been undone: political leeway remains and sanctions are of a pecuniary nature only. Arguably more important, positive incentives – such as Eurobonds[113] – remain absent.

113. Eurobonds are debt instruments that are issued collectively by the eurozone countries, or a different set of Member States. The Commission has been asked to report on the usefulness of such Eurobonds. See: DE GRAUWE, P., MOESEN, W., Gains for All: A proposal for a Common Eurobond, CEPS Commentary, 3 April 2009 and DELPLA, J., VON WEIZSÄCKER, J., The Blue Bond Proposal, Bruegel Policy Brief, issue 2010/03, May 2010.

a. More Sanctions

As regards the increase of sanctions, a distinction should be made between sanctions that relate to fiscal rules on the one hand and sanctions that relate to macro-economic surveillance on the other. In both cases, however, the proceeds of the sanctions will be used to fund the European Stability Mechanism (see 7).

With regard to fiscal rules, the prime goal was to introduce sanctions earlier on in the surveillance process[114]. To this extent, an interest-bearing deposit can be imposed before the Excessive Deficit Procedure is initiated if a eurozone country fails to meet its budgetary objectives. Once the Excessive Deficit Procedure is started, sanctions will also be applied sooner. A eurozone country could be required to make a non-interest bearing deposit from the moment the Council finds the country to have an excessive deficit[115]. An actual fine could be administered if the country fails to act sufficiently on the recommendations of the Council to reduce its deficit[116]. The previous last resort sanction[117] has equally been sharpened, as a larger fine can immediately be imposed at the end of the Excessive Deficit Procedure[118].

With regard to macro-economic imbalances, the situation is different. Here, pecuniary sanctions were non-existent and will now be introduced[119]. A eurozone country can be sanctioned in the case of an Excessive Imbalance Procedure (see supra) if it fails to adopt an adequate corrective action plan or if insufficient action is undertaken to meet this plan. In both cases, a fine could be administered. As these sanctions only come at the end of the procedure[120], macro-economic sanctions will be less gradual than fiscal surveillance sanctions.

In addition to the sanctions mentioned above, a fine in case a country deliberately falsifies its statistics is introduced. Taken together, these new sanctioning possibilities constitute a clear improvement. Yet, they are all of a pecuniary

114. European Commission, Proposal for a Regulation on the effective enforcement of budgetary surveillance in the euro area, COM(2010) 524, 29 September 2010.
115. Article 126(6) TFEU.
116. Article 126(8) TFEU.
117. Article 126(11) TFEU.
118. The non-interest-bearing deposit, the interest-bearing deposit and the fine related to Article 126(8) TFEU would normally all amount to 0.2% of the Member States' GDP. The amount of the final fine (Article 126(11) TFEU) is left unchanged and thus ranges between 0.2% and 0.5% of GDP.
119. European Commission, Proposal for a Regulation on enforcement measures to correct excessive macroeconomic imbalances in the euro area, COM(2010) 525, 29 September 2010.
120. An interest-bearing deposit can be imposed if the Member State does not take sufficient action after corrective recommendations have been made by the Council during the Excessive Imbalance Procedure. A fine can be administered during the Excessive Imbalance Procedure in case two successive deadlines for action by the Member State do not result in sufficient action. In both cases, sanctions can only be used in an ex-post manner.

nature. Substantial non-pecuniary sanctions did not find enough support and were thus not included. Notably the suspension of voting rights proved too controversial. Sanctions linked to EU expenditure have not been proposed either, although such rules could be introduced in the post-2013 EU budget.

b. Semi-automatic Sanctioning

Not only will new sanctions be introduced, sanctions will also become more automatic. Past experiences have indeed shown that the Council was reluctant to apply sanctions against peers. Sanctions would, however, not become fully automatic.

For most sanctions, the so-called reverse voting mechanism will be used[121]. In the past, the Council had to decide by qualified majority whether or not to apply a sanction proposed by the Commission. Under the new voting mechanism, a sanction proposed by the Commission will automatically be adopted, unless the Council opposes the sanction by a qualified majority within ten days of the Commission proposal. The tight timeframe and the majority requirement make it difficult for the Council to block a sanction and empower the Commission[122].

Even under the new voting procedure, effective sanctioning will remain easier said than done. On the one hand, it is likely that the Commission will be more careful in proposing sanctions. This could result in fewer proposals for sanctions. On the other hand, political bargaining in the Council is made more difficult, but remains possible. In sum, reverse voting undoubtedly increases the likelihood of sanctioning, but it will not be the miracle solution hoped for by some.

6.3.2. The Euro Plus Pact

At the European Council meeting of 24-25 March 2011, a so-called Euro Plus Pact was agreed upon[123]. It is a lighter version of a ‘Competitiveness Pact’ that had earlier been proposed by Germany. The Pact commits all eurozone countries and a number of other Member States that voluntarily agreed to adhere to the

121. Reverse voting does not apply to the final sanction in the Excessive Deficit Procedure (Article 126(11) TFEU), due to legal constraints.
122. The reverse voting mechanism will also be applied in some other parts of the surveillance procedures, which further empowers the Commission.
123. See: The Euro Plus Pact. Stronger Economic Policy Coordination for Competitiveness and Convergence, Annex I of the Conclusions of the European Council of 24-25 March 2011, EUCO 10/1/11, 20 April 2011, pp.13-20

Pact (hence the Plus in the Pact's name)[124]. While the Euro Plus Pact is focussed on the eurozone, it is not exclusively a eurozone instrument. Therefore, discussions on the implementation of the Pact will not result in exclusive Euro Group summits.

The Euro Plus Pact contains a set of goals in four policy areas: competitiveness, employment, public finances and financial stability[125]. These goals are far from new. The Pact proposes several policy actions to achieve the goals, such as reviewing indexation mechanisms, but Member States remain free to decide on their own course of action. Very few concrete policy commitments are made by the participating Member States. Two are worth mentioning. Firstly, the Pact requires Member States to adopt national legislation that needs to allow for an orderly resolution of banks. These rules would come in addition to future EU rules on the matter[126]. Secondly, the participating countries agree to adopt national budget rules (see 6.1.2) in a legal vehicle that is of a "*sufficiently strong binding and durable nature*[127]". With this wording, the Heads of State or Government refer to a legal vehicle that is superior to normal law. It can, however, be difficult for some Member States to agree on rules in a legal vehicle other than a normal law, as it typically requires a larger majority.

More important than these few new policy commitments is the fact that discussions on the four aforementioned policy areas will be lifted to the level of the Heads of State or Government. Every year, Member States are to formulate a number of commitments to achieve the set goals. The Heads of State or Government are to evaluate the ambition of these commitments as well as the actual results. These high-level evaluations will increase the importance of the discussions. However, no sanctions or incentives are provided for. The result risks being a talking shop with limited added value.

6.4. The European Semester: An Integrated Procedure?

European economic governance consists of a multitude of mechanisms, to which the economic governance reform even adds new ones. On the one hand, EU2020, the BEPGs and the Employment Strategy are to stimulate structural

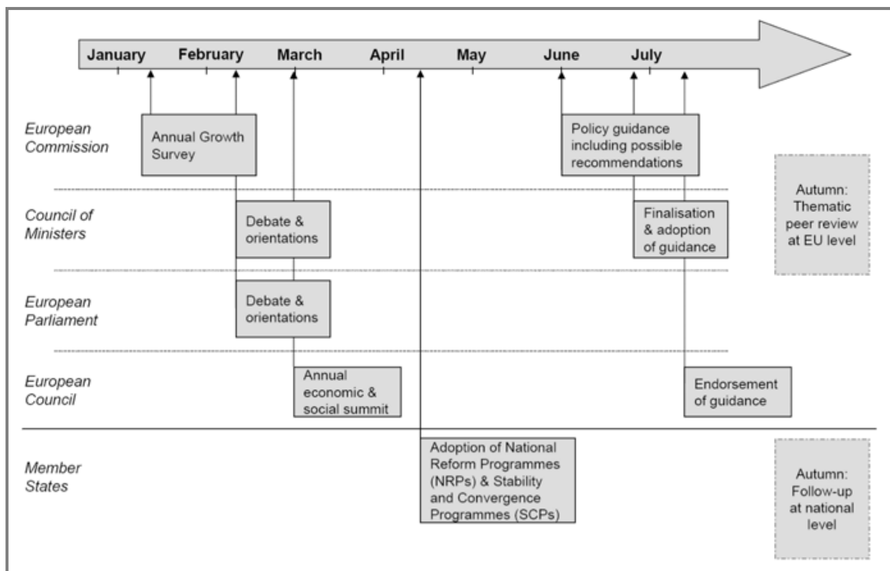
124. Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania agreed to the Pact. The Czech Republic, Hungary, Sweden and the United Kingdom do not participate in the Pact.
125. Besides the four policy areas, tax policy coordination is mentioned as a possible future domain of cooperation. The Pact does not go further than stating that Member States will engage in a dialogue on the matter.
126. For more information on the Commission's future Proposal, see: VERHELST, S., Addressing the financial crisis: the EU's incomplete regulatory response, Egmont Paper, nr. 39, December 2010.
127. Conclusions of the European Council of 24-25 March 2011, op. cit. footnote 129, p. 19.

reforms and economic growth. On the other hand, the Stability and Growth Pact and the Excessive Deficit and Imbalance Procedures have been put in place to prevent the derailing of fiscal and macro-economic evolutions. The Euro Plus Pact is a subsequent addition to these numerous governance mechanisms.

As was mentioned earlier, the complexity of economic governance contributed to a neglect of its instruments (see 5.4). Furthermore, the national policies and reform strategies were often elaborated in the Member States, without much interaction with the EU level. Only their implementation was monitored at the European level. This ex-post nature of economic governance limited the usefulness of the procedures.

The European Semester is an attempt to address these issues[128]. This Semester takes place from January to July of each year and its goal is to stimulate the discussion of Member States' economic governance programmes. Figure 2 provides an overview of the European Semester, as conceived by the Commission.

Figure 2: The European Semester of policy coordination[129]



128. The legal basis of the European Semester is a Code of Conduct endorsed by the Council; see: Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes. The Parliament has argued for incorporating the Semester into the legal provisions on economic governance.
129. Source: European Commission, European Semester of Policy Coordination, retrievable on http://ec.europa.eu/economy_finance/articles/euro/documents/com_367_european_semester_en.pdf

The 2011 European Semester was initiated by the Commission's Annual Growth Survey[130]. Although the publication of this document is not required by the European Semester's legal provisions, it is likely to kick off future European Semesters as well[131]. The input from the Commission and discussions in the Council are to provide input for the annual European Council spring meeting. At this meeting, the Heads of State or Government are to identify the general economic challenges and provide strategic guidance on Member States' future fiscal and economic policies. Input from the Parliament was originally not required, but the economic governance package will endow the Parliament with a formal role in the entire procedure.

The European Council's guidance is subsequently to be taken into account by the Member States in adopting their National Programmes. On the one hand, these Programmes include the National Reform Programmes, which are intended to achieve the EU2020 goals and avoid imbalances. On the other hand, the Stability and Convergence Programmes should achieve the EU's fiscal goals. A novelty of the European Semester is that these two Programmes are both to be adopted in April. The alignment of their timing is meant to ensure more coherence between the documents.

The National Programmes are subsequently evaluated again at EU level. Like the ex-ante guidance, the European Council carries out this ex-post evaluation, based on input by the Commission, the Council and the Parliament. This evaluation can lead to a modification of the Member States' Programmes.

The European Semester has clear advantages. Not only does it allow for better interaction between the EU and the national level, it can also improve the coordination between the different Council configurations. However, despite the European Semester, European economic governance will remain a complicated matter based on several mechanisms. Further streamlining and rationalising the procedures would be advisable. It is, for example, clear that the growth element in the Stability and Growth Pact is just window dressing. This is especially true as another EU instrument, the EU 2020 Strategy is meant to stimulate economic growth. Such inconsistencies make it all the more difficult for the general public to grasp economic governance. Yet, in the end, it is the public's support of European cooperation that will determine the success of the European project and its common currency.

130. European Commission, Annual Growth Survey: Advancing the EU's Comprehensive Response to the Crisis, 12 January 2011, COM(2011) 11 final

131. Legal provisions only require input by the Commission to the European Council meeting of March.

7. Developing Crisis Governance

A major conceptual innovation of the economic governance reform is the introduction of eurozone crisis governance. To this purpose, a permanent crisis governance framework will be put in place from July 2013 onwards. Such a permanent crisis governance framework alters the conception of the Economic and Monetary Union. Before the crisis, a crisis governance framework was taboo, as Member States did not want to commit to any far-reaching solidarity between them (see 3.1.2). Despite demanding conditions attached to any assistance, the future assistance framework signals the resolve of the eurozone to aid its weaker members. The no bailout rhetoric – no assistance to eurozone countries facing financial difficulties – therefore seems a thing of the past[132].

Future crisis governance will consist of two elements. In the first place, conditional financial assistance can be provided when a country faces temporary problems (7.1). If financial assistance cannot help overcome the crisis, more drastic crisis governance is to be envisaged. The possibility of debt restructuring is an important step in this direction (7.2), though it does not solve all remaining issues.

7.1. Financial assistance

The post-2013 financial assistance will replace the existing temporary assistance (see 4.2.2), with which it shares many characteristics. Like the existing temporary mechanism, this permanent assistance framework will provide financial assistance to Member States in financial difficulties. Due to its permanent nature, the framework will nonetheless result in some marked changes, notably a Treaty revision.

7.1.1. The Design of the Financial Assistance Framework

The future financial assistance framework will consist of financing provided by the IMF and a new, permanent EU body: the European Stability Mechanism (ESM). While the future financial assistance framework is yet to be created, its general outline has already been agreed upon by the European Council[133]. The setting up of the framework could, however, prove a rocky road.

132. The Treaty's no bailout clause (see 2.1.2) has, however, remained unaltered.
133. See Term Sheet on the ESM, Annex II of the Conclusions of the European Council of 24-25 March 2011.

a. The European Stability Mechanism

The future European Stability Mechanism (ESM) will replace the European arm of the existing temporary financial assistance facility. The ESM is to have an effective lending capacity of EUR 500 billion, i.e. the same as the European part of the temporary lending facility. The ESM's lending capacity is to be ensured by a combination of paid-in capital, callable capital and guarantees. These types of capital and guarantees are to represent EUR 700 billion in total. Member States' contribution to the ESM's capital is based on their share in the ECB's capital[134].

It is important to point out that the guarantees by the Member States are to be pro-rate guarantees, as is the case for the EFSF. This is different from the joint guarantees used in other EU lending instruments. As was mentioned earlier (see 4.2.2), pro-rate guarantees are a weaker form of guarantees. This explains why the ESM's lending capacity (EUR 500 billion) is smaller than its total capital base (EUR 700 billion). If this were not the case, the ESM would not be able to obtain the maximum triple A-rating.

Of the EUR 700 billion backing the ESM, EUR 80 billion will take the form of paid-in capital, the most solid form of financial backing. The eurozone countries will deposit this capital in five yearly tranches starting in July 2013. The rest of the ESM's financial backing, EUR 620 billion, takes the form of callable capital and guarantees. The former is capital that is pledged to be provided if needed. At any time, the Member States can decide to call upon this type of capital. Guarantees, on the other hand, would only be made use of to meet the ESM's obligations to its creditors. Thus, they serve as a last resort backing. Neither the callable capital nor the guarantees represent paid-in funds so they will not influence eurozone countries' budgets in normal times. The paid-in capital, however, will have an impact on the budgets of these countries.

In legal terms, a treaty among eurozone countries will set up the ESM. It is to be an international organisation located in Luxembourg[135]. The ESM will not formally be part of the EU. Important decisions regarding the ESM will be made by mutual agreement of the eurozone countries' finance ministers, i.e. no votes against a decision. This evidently includes decisions on the available types of financial assistance and their scope, as well as the actual provision of financial assistance and the conditions linked to it. As a consequence, a single eurozone

134. To meet the demand of new eurozone countries, a temporary exception is provided for countries with a GDP of less than 75% of the EU average during the first 12 years that they have joined the eurozone.
135. Term Sheet on the ESM, Annex II of the Conclusions of the European Council of 24-25 March 2011, p. 22.

country can block the provision of financial assistance by the ESM. This intergovernmental nature of the ESM runs contrary to the Commission's, Parliament's and the ECB's requests for a more supranational construction.

On German insistence, the ESM is to be based on a new paragraph in the EU Treaty[136]. The goal is to provide a clear legal basis specific to the eurozone, as well as to please the German constitutional court. The Treaty revision should be completed by 2013, using the simplified revision procedure[137]. The Treaty revision can be undermined in two ways. First, the revision might go beyond the simplified revision procedure, which can only be used when a revision does not "*increase the competences conferred on the Union*[138]". According to the European Council, this is not the case, but this does not mean that the European Court of Justice necessarily shares this view. As a second potential issue, the simplified revision procedure requires ratification by all EU Member States, which remains hazardous[139].

b. The Role of the International Monetary Fund

The IMF is to play a crucial role in financial assistance to a eurozone country, as the ESM will seek participation from the IMF for any financial assistance it provides. In contrast to the temporary financial assistance facility, the size of future IMF assistance has not been detailed. Nonetheless, it can be presumed that the IMF share in future assistance packages will be substantial, as is the case now.

Not only will the IMF provide part of the financial assistance, the international body will also be closely involved in the entire financial assistance process. Together with the Commission, the IMF will play a deciding role in the decision to grant financial assistance, the amount of assistance and the attached macro-

136. The following paragraph is to be added to Article 136 TFEU: "*The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality*". Its implications are discussed in what follows.
137. Article 48(6) of the Treaty on European Union, OJ C 83, 30 March 2010, pp. 13-45.
138. Ibid.
139. Problems could arise in several countries. Public protest, both in surplus and deficit countries, may block the permanent mechanism. In Ireland, Treaty revisions often imply a referendum. From a legal perspective, this does not seem strictly necessary as the revision doesn't alter "*the essential scope or objectives*" of the EU. Politically speaking, a referendum is not envisaged either. However, given the consequences of the austerity measures imposed by the EU, this might change in future. See the Irish case Crotty v. An Taoiseach, 9 April 1987 and the Statement by the Irish Prime Minister in the Irish Parliament, 22 March 2011, Retrievable on: http://www.taoiseach.gov.ie/eng/Government_Press_Office/Taoiseach's_Speeches_20111/Taoiseach's_Statement_in_the_Dáil_on_European_Council,_24_25_March_2011.html

economic reform package. It will also monitor, jointly with the Commission, the implementation of the macro-economic reforms[140].

The role of the IMF will undoubtedly have an impact on the financial assistance provided by the eurozone. The IMF is a long-standing body and has formalised procedures for providing financial assistance. In order to achieve IMF involvement, the eurozone arm of financial assistance will have to be in line with these procedures. This makes eurozone assistance less flexible and less autonomous. At the same time, this allows the eurozone to rely on IMF expertise. In case the IMF does not wish to provide financial assistance, the ESM can always provide assistance on its own. This would, however, be a rare exception.

7.1.2. Conditionality of Financial Assistance

Financial assistance undoubtedly entails an element of solidarity. However, the ESM is far from a simple solidarity mechanism. This is most clear when taking into account the conditionality tied to financial assistance by the ESM. The ESM will only provide assistance if three cumulative conditions are met. The eurozone countries have to agree on their fulfilment by consensus.

The first condition is that assistance must be indispensible to safeguard the stability of the eurozone as a whole. Financial assistance, then, will only be granted because the country's difficulties can result in problems for the rest of the eurozone, not simply to aid the troubled country. It will be much more difficult for a smaller eurozone country (like Malta or Cyprus) to obtain aid than it would be for other countries, regardless of its internal situation. This seems somewhat discriminatory.

A second, more traditional[141] condition implies that a Member State must commit to a macro-economic adjustment programme in order to obtain assistance. Such programmes aim to restore the soundness of public finances and traditionally result in expenditure cuts and tax increases.

Finally, a country that requests financial assistance must be able to return to financial health after receiving such assistance. To this purpose, a debt sustainability analysis is to be carried out by the EU and the IMF. If the financial aid

140. Term Sheet on the ESM, Annex II of the Conclusions of the European Council of 24-25 March 2011, p. 26.
141. This is also the case for the EU's balance of payment assistance to non-eurozone countries and has been a traditional requirement for IMF loans. The IMF does, however, abandon this requirement somewhat by creating credit facilities with little conditionality (the IMF's Flexible Credit Line).

and the macro-economic adjustment programme are not expected to restore financial health, the country has to work towards a debt restructuring (see 7.2).

These cumulative conditions are to deter eurozone countries from overly counting on financial assistance as a way out of potential problems (in addition to the interest surcharges, see infra). Indeed, without conditionality, appeals to financial assistance would be more probable. However, these conditions can also hold back the disbursement of financial assistance when it is truly needed, or make it less effective. No easy answer is available in the choice between crisis prevention and crisis resolution.

7.1.3. Types of Financial Assistance

Only if the eurozone countries agreed that all of the aforementioned conditions are met, can they decide on the type of financial assistance to be provided. Two types of ESM financial assistance have been foreseen: loans and direct government bond purchasing. Additional financial assistance instruments could be put in place in the future.

a. Loans

The key type of financial assistance by the ESM will consist of loans. The loans, or ESM Stability Support (ESS) as the European Council has phrased it, are to serve as short to medium-term stability support. This implies that the loans' time span should not exceed 7 years[142]. The interest rates charged to the borrowing country will contain a surcharge, which is both to make loans less attractive and to finance the functioning of the ESM. The surcharge, however, will be lower than the current lending facilities[143].

Bonds held by private investors will be subordinate to ESM loans[144]. This implies that in case a country would be unable to (fully) meet its debt obligations, ESM loans would be reimbursed before sovereign debt held by private investors. This is in contrast to the current financial assistance, which does not enjoy preferred creditor status vis-à-vis private investors. As a result, private

142. The maturities of the loans to Greece and Ireland.
143. A surcharge of 200 basis points will be required on all loans. In addition, loan amounts outstanding after three years will be charged an additional 100 basis points. For loans of more than 3 years, the weighted average between the surcharge for the first 3 years and the rest of the loan is used. For a six-year loan, this means that if the ESM borrows money at 2.5%, it will lend the money to the country at a rate of 5%. In mathematical terms, the total surcharge in basis points for loans of more than 3 years is 300-(300/X) with a X standing for the total maturity of the loan.
144. The ESM loans would for their part be subordinate to IMF loans.

investors' potential losses in the case of a country's insolvency increase. This can result in higher lending costs for some eurozone countries.

These provisions will apply from July 2013 onward, but they do already have an effect on investor behaviour. Most of the current eurozone debt has to be reimbursed in 2013 or later. If debt restructuring were to occur after July 2013, such current eurozone debt would be subordinate to any aid offered by the ESM. This increases potential losses on current public debt and pushes up the interest rates charged by investors. To counter this problem, Member States plan not to subordinate private debt to ESM loans for countries that received financial assistance from the temporary financial assistance facility (i.e. Greece, Ireland and Portugal). This exception would be maintained until these countries are able return to normality.

b. Direct Public Bond Purchasing

As a second type of financial assistance, the ESM will be able to buy sovereign debt directly from a eurozone country, i.e. buy it on the primary market. Such an operation would result in a higher demand for debt emitted by the Member State, given that the ESM's demand comes in addition to private demand. This reduces the interest rate charged for the debt emission. However, such an operation is likely to be controversial, as the ESM would acquire sovereign bonds with a certain risk attached. In case of debt restructuring, the ESM would have to bear the consequences, as it would not enjoy a preferential status on such debt.

There are two important limits to the ESM's means to buy government bonds. First of all, the ESM will not be allowed to buy sovereign debt that is traded by investors in the secondary market, which the ECB has been reluctantly been carrying out during the sovereign debt crisis (see 4.2.3). Secondly, the ESM may only buy debt from countries that have requested financial assistance and have committed to an adjustment programme. As a consequence, the debt purchasing cannot prevent financial difficulties, but can only try to limit their scope.

7.2. Debt Restructuring

Emergency financial assistance is a first important part of crisis governance. While such assistance can serve as a means to overcome some sovereign debt crises, it has its manifest limits. As past IMF lending operations have shown, a

country is not always able to restore financial health by mere financial assistance. A restructuring of public debt has sometimes proven necessary[145].

To take this risk into account, EU leaders have envisaged the possibility of debt restructuring for countries whose basic solvency is questionable. As was mentioned earlier, (see 7.1.2), a debt sustainability analysis is to show the potential need for restructuring a country's public debt. If the analysis concludes that a country is not expected to restore financial health, the country would have to initiate discussions with its creditors on the potential restructuring of its debt. If not, it cannot receive financial assistance.

To facilitate discussions on debt restructuring, all government bonds will have to include so-called Collective Action Clauses (CACs) from July 2013 onwards[146]. By means of such clauses, bondholders can agree – by a supermajority – on the restructuring of all of a country's debt. Such clauses are quite standard in certain Anglo-Saxon countries. In continental Europe, their use has been rare. The effects of CACs are unclear. World Bank research found that CACs reduce the borrowing costs for countries with high credit ratings, while costs for countries with low credit ratings rise[147]. The CACs might thus promote fiscal prudence in the long run, but can pose additional problems for eurozone countries currently facing difficulties.

It remains unclear what the lack of a debt restructuring agreement would imply for the countries' access to ESM aid. According to the European Council, the Member State has to "*negotiate in good faith*" and demonstrate "*sufficient commitment*" to achieve an agreement with private investors[148]. However, a voluntary agreement on debt restructuring is not guaranteed, as bondholders may refuse to restructure their debt on a voluntary basis. In that case, the Member State could apply unilateral debt restructuring. The European Council has not gone so far as to make such restructuring obligatory. It seems unlikely, however, that a normal loan would be granted if a country is probably incapable of returning to sustainable public finances. This issue has remained unaddressed by the EU.

145. STURZENEGGER, F., ZETTELMEYER, J., Haircuts: Estimating Investor Losses in Sovereign Debt Restructurings,1998-2005, IMF Working Paper, 2005, WP/05/137.
146. Term Sheet on the ESM, Annex II of the Conclusions of the European Council of 24-25 March 2011, p.31
147. EICHENGREEN, B., MODY, A., Would Collective Action Clauses Raise Borrowing Costs? An Update and Additional Results, World Bank Policy Research Working Paper No. 2363, May 2000
148. See Term Sheet on the ESM, Annex II of the Conclusions of the European Council of 24-25 March 2011, p.30

Conclusion

Ever since the Economic and Monetary Union was designed, it has been clear that its foundations are uneven. The economic governance that had been put in place was indeed unable to prevent the sovereign debt crisis. This crisis is the most significant test of the eurozone so far and requires both a short and a long term answer.

In the short term, it is imperative to restore the financial health of the weakened eurozone countries. The EU's financial assistance provided some breathing space, but might be insufficient to actually resolve the countries' difficulties. In that case, more unconventional instruments, such as debt restructuring, should be considered. In the longer term, the reform of economic governance is essential to ensure the sustainability of the monetary union. This reform is vital to prevent future crises, but cannot resolve short term issues.

As was demonstrated in this paper, the reform of economic governance consists of both revising existing economic governance and introducing crisis governance. Revising existing economic governance requires addressing the causes of the fiscal and macro-economic derailments that have occurred.

In terms of fiscal sustainability, the reforms seem to go in the right direction. The rules could, of course, be improved, notably by endowing the Commission with more powers to verify national statistics. However, if the current rules are properly applied and sufficiently aimed at the long term, they can succeed. The success of the rules regarding fiscal sustainability will therefore vitally depend on the willingness of the Member States to apply them.

With regard to macro-economic convergence, success seems more difficult. The new surveillance mechanism still needs to prove its validity. As has been argued, it is doubtful whether the EU will be able to correctly detect macro-economic imbalances or induce a sufficient policy response if needed. Political will to make the macro-economic convergence rules work is again much needed, but will not be sufficient.

Instruments focussed on the eurozone are to prevent a neglect of economic governance as experienced before the crisis. The Euro Plus Pact is to increase eurozone countries' efforts to obtain major policy objectives. Yet, the Pact contains very few innovations, which limits its added value. More important than the Pact are the strengthened, semi-automatic sanctions. These need to enforce the rules regarding economic governance. This can, indeed, constitute an improvement. It is regrettable, however, that sanctions in the macro-economic sphere

were not made more gradual, as was the case for fiscal rules. By not doing so, the EU is repeating previous mistakes. The crucial weakness of future enforcement, however, is its overdependence on pecuniary sanctions. Positive incentives, such as Eurobonds, have not been introduced, despite their potential added value.

The decisions on crisis governance have led to the abandonment of the pre-crisis no bailout rhetoric. Instead, conditional financial assistance and possible debt restructuring are to deal with future sovereign debt crises. On condition that the EU and the Member States are willing to effectively carry out the restructuring of a country's debt, crisis governance instruments should allow most crisis situations to be overcome.

Yet, the envisaged crisis governance instruments leave some issues unresolved. We are still left wondering what the EU would do when a country repeatedly requires EU assistance and remains unable to return to long term sustainability. In that case, more radical solutions are needed. The eurozone could then choose either to substantially upgrade its economic union, or to be more selective in its membership. This implies more conditions for entering the eurozone, or even ousting certain of its current members. Neither option is desired by the Member States. However, an ill-functioning eurozone would, in the long run, be at least as detrimental, both for the weaker and the stronger members.

Finally, the EU and its Member States must not forget that what ultimately matters most is the support and confidence of the EU citizens. The public opinions within the eurozone, including the stronger and weaker countries, need to be convinced of the benefits of the single currency and the common destiny it entails. If this is the case, a thriving monetary union is within reach. If not, future crises are unavoidable.