# INFORMATION AND ANALYSIS OF THE EURO CRISIS AND FISCAL COMPACT

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## EXECUTIVE SUMMARY – KEY POINTS

### Background to the Euro Crisis

- Stability and Growth Pact - intended to achieve fiscal coordination for currency union
- Limited criteria - 3% budget deficit and 60% Debt: GDP Ratio
- No measures of private sector debt, labour costs, export shares, employment
- Weakly implemented - 3% deficit target breached on many occasions
- 2008 Global financial crisis - Governments with large budget deficits / high levels of debt could no longer fund their borrowing at a sustainable cost

### Response to Crisis – Short Term Measures

- Establishment of Temporary Rescue Fund (EFSF) for countries (Greece, Ireland, Portugal) unable to service debt at a sustainable rate
- Limited ECB intervention in bond markets
- Financial Bailout Programmes – EU/ECB/IMF loans, implementation of austerity measures
- Major differences in opinion on cause and cure – increased fiscal discipline v. enhanced rescue fund, expansionary economic policies, increased intervention role for ECB

### Response to Crisis – Medium-Term Measures

### Economic Governance - The 'Six Pack' and Medium Term Objectives (MTOs)

- More rapid and effective financial sanctions for breaking debt and deficit rules
- Public Expenditure benchmarks – ensure sustainability of expenditure programmes
- Countries with excessive debt required to reduce this by 1/20$^{th}$ of gap
- Broad based early warning system or "Scoreboard" of economic and financial indicators, e.g. export performance, unemployment, private sector debt as % of GDP
- Structural deficit limits (0-1%) agreed for Member States

### Economic Governance - The Fiscal Compact

- Signed off on January 30 2012 by European Heads of State – not unanimous
- EU legislation on government deficits and debt incorporated into national legislation at a binding level – to be monitored by European Court of Justice (ECJ)
- Treaty will enter into force on 1 January 2013, if ratified by 12 Member States (individual Member States will not have a veto)
- Countries not signing up to Treaty will be excluded from permanent bailout fund (ESM)

### Overall Assessment

- Fiscal Compact is one element in response to crisis and not a comprehensive solution
- Most of requirements on budget deficits and government debt in Fiscal Compact already agreed and in place at EU level
- Agreement and adoption may facilitate action by member states on other measures – e.g. recent active policy by ECB of providing low-cost liquidity for banking system
- Ireland, under existing agreements, (Bailout programme and 'Six-Pack') required to reduce deficit and debt at same pace as set out in Fiscal Compact
- Proposed Fiscal Responsibility Bill – will introduce fiscal rules commensurate with 'Six Pack'/ Fiscal Compact
- Potential Implications of non-ratification – exclusion from ESM, diminished euro membership status

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# 1 Introduction

The proposed Fiscal Compact Treaty (Fiscal Compact), the text of which was signed-off by 25 of the 27 EU Heads of Government on 30 January, is a further element in the response by the EU, and by the euro states in particular, to the crisis in the euro system.

The full title of the Fiscal Compact is *"Treaty on Stability, Coordination and Governance in the Economic and Monetary Union".* While the Fiscal Compact is the most important and high-profile section, it contains two further sections; these deal with Economic Policy Coordination and Convergence, and with Implementation Issues.

With the UK opting out of the compact (and the Czech Republic, also not a Euro member), the proposed treaty could not be an EU treaty and instead will take the form of an International Agreement. The Agreement is expected to enter force on 1 January 2013, provided at least 12 euro Member States have ratified it.

In reality there is very little new in the Fiscal Compact apart from the key element, which is that EU legislation on the rules covering the member states' budgetary discipline is to be enacted also in the national legislation of the states *"through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes".*

This paper firstly sets out the background to the current euro crisis, in particular the fundamental weakness in the construction and implementation of the Economic and Monetary Union (EMU). It then sets out the response to-date at European level to the crisis. It focuses in detail on the Fiscal Compact, and in particular on its impact on Ireland as a country already subject to a Bailout Programme.

As a small open economy, Ireland benefits from membership of a stable currency regime. This prevents currency fluctuations and price uncertainty, improving access both to Eurozone and other markets. This is of particular importance for our export dependent sectors, such as agri-food, and is a key factor in attracting Foreign Direct Investment to Ireland.

# 2 Background to the Euro Crisis

## 2.1 Fundamental Weakness in the Construction and Implementation of EMU

European Economic and Monetary Union is a unique construction, reflecting the unique nature of the EU itself as a "Union" of separate member states who have agreed to share sovereignty in some policy areas but not in others.

Monetary union is provided by the single currency and by the independent European Central Bank (ECB) which controls the issuing of currency, sets interest rates, and acts as a 'lender of last resort' for the Euro banking system. However, because the ECB does not act as a "lender of last resort" for Euro Governments, the Eurozone could be more accurately described as a currency union.

Economic union is provided in the EMU system only to a quite limited extent. It does not have many of the normal characteristics of an economic and monetary union as seen elsewhere in the world. When the European system was established on 1 Jan 1999, member state governments could not accept a large central EU budget (which could potentially redistribute resources within the union). Neither could they accept loss of control over their national taxation or expenditure policies.

In the construction of EMU, a limited form of "economic union" was to be achieved through the coordination of Fiscal policy (government finances in the euro member states) at two stages:

1. To qualify for membership, a member state had to meet the "Maastricht convergence criteria" on government deficits and debt; and
2. On an ongoing basis, the "Stability and Growth Pact" (SGP) was intended to achieve fiscal coordination.

The key criteria in the SGP were and remain:

- An annual budget deficit no higher than 3% of GDP; and
- A national debt below 60% of GDP, or if above that figure it should be declining towards that level at a sufficient rate.

The SGP was weakly implemented. The 3% deficit target was breached on many occasions, including by the major states, Germany and France.

In addition, the criteria were too limited. Ireland's case illustrates this point, as prior to 2008 this country's annual budgets were within the 3% deficit target. However, account was not taken of the exceptional underlying factors which resulted in a cyclical increase in tax receipts. The short-term revenue buoyancy was used by Government to fund long-term expenditure commitments.

The euro system appeared largely stable until the emergence of the global financial crisis in 2008. Governments with large budget deficits or high levels of debt could no longer fund their borrowing at a sustainable cost. Also, following a number of years of rapid growth in bank lending in many EU countries, funded mainly from the wholesale inter-bank market, rather than bank deposits, bank liquidity collapsed. Many banks have since become dependent on the ECB to provide them with liquidity; this is very much the case in Ireland.

## 3 Response to the Euro Crisis – Short Term Measures

### 3.1 EFSF and ECB

The EU had no adequate mechanisms to deal with the crisis. The ECB is prohibited under the EU Treaty to be a lender of last resort to the governments of the member states (unlike the Federal Reserve in the US and the Bank of England in the UK). It should be noted that this restriction on the ECB is viewed as very important by many member states. As stated earlier, there was no possibility of automatic transfers from a central EU budget.

Greece, with an extremely high level of national debt and weak economy, was first affected and was bailed out by an agreed system of loans from other member states (May 2010).

A temporary rescue fund, the European Financial Stability Facility (EFSF), was established shortly afterwards, in summer 2010. This was required within months to bail out Ireland (November 2010) and Portugal (early 2011). The 'bailout' fund is tri-partite, involving funding from the EU Commission, the ECB and the IMF.

Italy and Spain (to a lesser extent) were affected by contagion during 2011 and their borrowing rates reached crisis levels. Italy was seen as too big to be bailed out by the limited EFSF; instead it was required to implement budget reforms before being supported in the market by the ECB. When the then Prime Minister failed to go ahead with these reforms, the government had to be replaced by a "technocratic" government, before receiving ECB support for Italian bonds.

### 3.2 Differences in approach on cause and cure

The political response to the euro crisis has been hampered by the quite different analysis of the crisis by the different member states.

The main focus by Germany (and some other northern countries) has been on the absence of adequate fiscal discipline in the member states. Germany sees the need for a binding agreement on a tight budgetary policy in all member states, with strict, enforceable limits on budget deficits and government debt, and an agreed correction programme where these thresholds are breached. Germany is also opposed to Eurobonds or other measures involving a common sharing of sovereign debt.

Other countries have put the focus on the need for an adequate rescue fund, and a financial "firewall" to protect countries coming under threat. On occasion, these countries express the desire that the ECB should be "a lender of last resort" in government debt markets. Given that this is explicitly prohibited in the EU Treaty, the achievement of this does not seem a realistic proposition in the short-term.

A further issue of contention is that countries who are required to implement austerity measures wish to see more expansionary economic policies being implemented in the stronger member states. Clearly, more expansionary policies by countries such as Germany would raise the overall EU growth rate, thereby enhancing GDP growth prospects in Ireland.

In broad terms, the response to the crisis at EU level has involved a "twin-track" action: (i) financial bailout programmes for the countries in difficulty, and (ii) reform of economic governance in the euro zone. These are summarised in the following sections.

### 3.3 Financial 'Bailout' Programmes

As outlined earlier, the EU Treaty prohibits the ECB from acting as a lender of last resort to support member states which are unable to borrow from market sources. However, the ECB has intervened to a limited degree in the market to support sovereign bonds of countries in difficulty. The ECB is also opposed to debt default by any euro country, presumably in fear of "contagion" to other euro members.

When the crisis in Greece emerged, there was no common financial rescue fund in place in the EU. The temporary EFSF was set up in summer 2010. It was decided during 2011 to replace this with a permanent fund, the ESM (European Stability Mechanism), and this is to apply from July 2012. The total size of this fund at €500b is viewed by critics as being too limited, and is far short of the original target of €1tr.

The EU Council has been opposed to default by euro countries on existing debt (with the particular exception of Greece). As regards Greece, such was the unsustainable level of government debt that the Council decided in June 2011 to support "voluntary" debt default by Greece. Under agreement reached on 21st February 2012, €107b of Greek debt is to be written off by the market lenders under what is called PSI (private sector involvement); this is voluntary in the sense that there was no realistic possibility of repayment. Greece was offered a second bailout loan of €130b as part of this agreement. The EU Council has ruled out all other debt default, and reversed an earlier decision on default of post-2013 new debt.

The funds provided under the EU/IMF bailout programmes are implemented as loans. The Programme countries are required to implement "austerity" measures, including reductions in public expenditure, increased taxation and structural reform of economies to achieve future stability.

### *3.3.1 Initiatives To-date to Support Ireland*

In September 2008, in response to a crisis in bank funding in Ireland, the Irish state guaranteed the liabilities of all six Irish banks. There is no external funding of this initial bank bailout, but it required retrospective clearance from the EU Commission. The source of the funding (mainly for Anglo Irish Bank) was a loan from the Irish Central Bank, and this has to be repaid over the next two decades in the form of "Promissory notes" from the exchequer.

In late 2010, due to continuing uncertainty on the further capitalisation costs of the Irish banks, the ability of Ireland to sustain the costs of its rising National Debt and with lower revised projections for growth, the Government applied for a joint EU/IMF Programme of Financial Support.

The EU/IMF Programme for Ireland amounts to €67.5b in loans and runs to the end of 2013. In its Memorandum of Understanding with the EU/IMF/ECB, Ireland has committed to restoring balance to its Public Finances by 2015, with a projected budget deficit in that year of 2.9%.

Ireland's stability programme has set the parameters for the 2011 and 2012 budgets and it requires further adjustments in public expenditure and taxation over the next three budgets. Approximately 65% of this will be through further expenditure cuts and 35% through taxation.

In July 2011, changes to the interest rate being charged for the EU component of the funding programme were agreed, and will result in a reduction in the overall loan repayment figure of the order of €1b annually. Further changes to the funding programme may emerge during ongoing and future discussions on the restructuring of the eurozone.

In particular, discussions between Ireland and EU are ongoing on the repayment arrangements for the "Promissory notes". As currently stands, the cost of these to the Irish Exchequer over the next decade is €3.1b annually.

As noted earlier, with continuing difficulties in obtaining deposit and non-deposit sources of funding, Irish banks remain heavily reliant on the ECB, with over €73b of borrowing by domestic credit institutions from the ECB at end November 2011[1].

# 4 Response to Crisis – Medium-term Measures

## 4.1 Reform of Economic Governance – the 'Six Pack'

During 2011 the EU Commission proposed a package of six measures to reform economic governance in the EU. Known as "the Six Pack", these have been implemented from 13th. Dec 2011. In effect, this involves a recasting of the SGP with a greater emphasis on two areas: (i) government debt reduction and (ii) enforcement. The main measures are as follows:

- Financial sanctions on member states who breach the budget and debt rules will be applied more rapidly and effectively than in the past. If the Commission recommends a sanction to the Council, this will be automatically adopted unless a qualified majority vote against it[2].
- New financial sanctions of up to 0.2% of GDP will apply.
- The excessive debt rule is given equal importance to the excessive deficit rule. Countries with persistent excessive debt are required to reduce this by 1/20th per year.
- A preventative system involving public expenditure benchmarks to seek to ensure that expenditure programmes are sustainable, and not just financed from cyclical or temporary increases in revenue.
- A broadly-based early warning system or "Scoreboard". For each country, the Commission will monitor a list of economic and financial indicators. These will include: International investment trends, export performance, unemployment levels, private sector debt as % of GDP, and house price trends[3].

## 4.2 Reform of Economic Governance - The Fiscal Compact Treaty

On 9th December 2011, following a meeting of the EU Heads of Government, agreement was reached on a proposed new fiscal compact for the eurozone.

Much of the detail that is contained in the Fiscal Compact is already agreed by the Eurozone members, whether as part of the original SGP, or the strengthened 'Six Pack'. The most important decision taken in December was that EU legislation on government deficits and debt would be incorporated into national legislation at a binding level.

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[1] Central Bank Quarterly Bulletin Q1 2012
[2] This is known as Reverse Quality Majority Voting (QMV)
[3] If this measure had been in place in the past it should have identified the property bubble in Ireland.

There has been some confusion in relation to the budgetary targets that will have to be achieved under the Fiscal Compact. There have been no further fiscal restrictions imposed in the draft Treaty.

The three main targets are:

1. Balanced budgets should be the norm, as defined by a limit of 0.5% on "structural" deficits (or a limit of 1.0% for countries with a low Debt: GDP ratio).
2. A limit of 3% on budget deficits in years of economic downturn or exceptional external event.
3. A 60% Debt: GDP ratio (or taking steps to approach this at a rate of 1/20th of the gap per year)[4].

Effectively, the structural deficit is a deficit (overspend) that remains after one-off or cyclical economic factors have been taken account of. It is designed to measure whether a country would balance its budget if external, short-term factors were taken out of the equation.

The Treaty will come into force at the beginning of 2013 if 12 or more Member States sign up to it; therefore, no Member State will have a veto on it. Other euro Member States may ratify it later, and it will enter force in these states on 1st of the month following ratification.

Where a Member State does not sign up to the Treaty, it will be prevented from accessing the permanent bailout mechanism, the European Stabilisation Mechanism.

Where the European Commission consider that the Member State has not made the legislative changes sufficiently binding at a national level, it can refer this to the European Court of Justice (ECJ). The ECJ judgment may require the Member State to take additional measures to ensure that the treaty is binding. In the event that the Member State fails to do this, the ECJ will have to authority to impose fines.

Following outline agreement on the Fiscal Compact proposal at the December 2011 Heads of Government meeting, the ECB took a major initiative in terms of provision of close to €500b in low-interest loans to support bank liquidity throughout the euro area. This extra liquidity also seems to be having a positive effect on sovereign bond rates, with banks now purchasing sovereign debt. The ECB are due to provide another €500b at end February.

#### *4.2.1 Impact of Fiscal Compact on Ireland*

For Ireland and other Programme countries the deficit and debt reduction targets do not apply during the duration of the programme. In addition, there is an exemption from application of the debt reduction provisions for three years after the programme ends.

For Ireland, the Programme target is that we have to reach the 3% deficit target by 2015. From 2018[5], Ireland will commence the steps to reduce the Debt: GDP ratio towards 60% at the rate of 1/20th of the gap per year.

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[4] See Annex for debt levels across EU 27 in 2011

[5] Countries in an Excessive Deficit Procedure (EDP) have three years after exiting this (Ireland, 2015) before they are required to adopt the numerical debt benchmark rules (moving towards 60% Debt: GDP ratio).

A further factor also shows how little will have changed by the introduction of the Fiscal Compact. Since 2005, as a refinement to the SGP, each country has been required to prepare and present to Brussels a "Medium-term Budget Objective", known as MTO's. These enabled a more country-specific approach to be taken to the implementation of the SGP, including an effective structural deficit limit. In 2008 and 2009 Ireland declared a medium-term budgetary objective as "*close to balance, i.e. in the range* of *0 to a deficit of 0.5% of GDP".*

### 4.3 Economic Policy Coordination

Another feature of the Fiscal Compact is the commitment towards Economic Policy Coordination and Governance.

Member States will work together on a common economic policy framework to ensure the smooth functioning of the EMU (euro) through enhanced convergence and competitiveness. Where any Member State plans to undertake any major policy reforms, these will be discussed in advance with the European Commission and other Member States, and where appropriate, coordinated among the Member States.

This type of coordination and consultation is already undertaken by Ireland with the EU/IMF/ECB as part of the Programme of Financial support.

## 5 Overall Assessment

The crisis in the euro system has its origin in the construction of the system, and in deficiencies in its operation.

The response of the euro countries to the crisis has, by necessity, included both the emergency situation of the bailed-out and threatened member states, and longer-term reform of the system to avoid repetition of the crisis. As a country operating an EU/IMF Stability Programme, Ireland has a strong interest in a successful outcome to both issues.

Most of the requirements on euro member states as regards limits on budget deficits and government debt which are contained in the Fiscal Compact are in fact already agreed at EU level and in place. The major new commitment is that the EU rules on government deficits and debt would be enacted in national legislation in each euro country at a binding level.

The Fiscal Compact should be viewed therefore as an important element in the response by the euro countries to the crisis, rather than a comprehensive solution. It is clear that a firm commitment to reform of the system by means of the Fiscal Compact measures was deemed necessary as a precursor to other actions.

There are indications that its agreement and adoption may facilitate action by the member states on other measures (such as a future role for Eurobonds/ other forms of risk sharing). Already, the initial decision on the Fiscal Compact by the EU Heads of Government in December seems to have resulted in a more active policy by the ECB in providing low-cost liquidity for the banking system.

Even if the Fiscal Treaty had not been agreed by the 25 Heads of Government, Ireland would be required under existing rules, including the "Six-Pack" measures which came into force on 13th December last, to reduce its deficit and debt at the same pace.

In addition, under the Government's proposed Fiscal Responsibility Bill (to be put before the Oireachtas in the coming months), it is expected that Ireland will introduce fiscal rules corresponding to those contained in the 'Six Pack' and Fiscal Compact.

Failure by Ireland to ratify the Fiscal Treaty will not prevent the treaty coming into force. It will come into force on or after 1st January next, as soon as 12 of the 17 euro countries have ratified it.

An immediate potential negative implication of not ratifying the treaty is that a country outside the Treaty will be prohibited from availing of the new permanent bailout fund, the European Stability Mechanism, which is coming into operation in July 2012.

In the longer-term, where a country did not ratify the Fiscal Compact, and thereby was not implementing all the rules of the euro system, it is suggested that its position within the euro system would, inevitably, be less certain.

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*27th February 2012*[6]

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## ANNEX I – EU 27 DEBT 2011[7]

| Member State | Currency | Millions of national currency | % of GDP |
|---|---|---|---|
| Belgium | euro | 361,378 | 98.5 |
| Bulgaria | BGN | 11,374 | 15.0 |
| Czech Republic | CZK | 1,519,612 | 39.8 |
| Denmark | DKK | 879,602 | 49.3 |
| Germany | euro | 2,089,756 | 81.8 |
| Estonia | euro | 951 | 6.1 |
| **Ireland** | **euro** | **162,200** | **104.9** |
| Greece | euro | 347,204 | 159.1 |
| Spain | euro | 706,340 | 66.0 |
| France | euro | 1,688,890 | 85.2 |
| Italy | euro | 1,883,738 | 119.6 |
| Cyprus | euro | 11,872 | 67.5 |
| Latvia | LVL | 6,110 | 44.6 |
| Lithuania | LTL | 38,707 | 37.6 |
| Luxembourg | euro | 7,826 | 18.5 |
| Hungary | HUF | 22,930,584 | 82.6 |
| Malta | euro | 4,473 | 70.3 |
| Netherlands | euro | 388,829 | 64.5 |
| Austria | euro | 214,115 | 71.6 |
| Poland | PLN | 839,044 | 56.3 |
| Portugal | euro | 189,700 | 110.1 |
| Romania | RON | 182,822 | 33.3 |
| Slovenia | euro | 15,884 | 44.4 |
| Slovakia | euro | 28,784 | 42.2 |
| Finland | euro | 89,354 | 47.2 |
| Sweden | SEK | 1,276,224 | 37.0 |
| United Kingdom | GBP | 1,278,240 | 85.2 |
| **Euro 17** | **euro** | **8,191,295** | **87.4** |
| **EU 27** | **euro** | **10,320,106** | **82.2** |

[7] Source: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-06022012-AP/EN/2-06022012-AP-EN.PDF