# THE NEW EU GOVERNANCE ARRANGEMENTS

**John FitzGerald**[1]
*The Economic and Social Research Institute*

Until the economic crisis hit in 2008, the euro area operated with a single set of fiscal rules – the Stability and Growth Pact (SGP). In the first decade of operation of EMU the rules were broken by Germany but this breach did not threaten the stability of the euro area. However, this set of rules did not prevent the crisis occurring in 2008 and it did not prove adequate to manage the subsequent fall-out for governments and EU institutions.

Since the crisis, a series of additional rules and directives have been implemented, both by national governments and by the euro area. These new rules have been developed in a period of crisis and they have been implemented relatively quickly to deal with specific aspects of the crisis. However, they were not subjected to an extensive evaluation process, nor were they based on a comprehensive analysis of the long-term needs of the euro area. Thus, while they address some current problems, they leave others unaddressed. It is also unclear how relevant these rules will be in guiding the day to day operation of policy in the euro area if, and when, it reaches calmer waters.

The current crisis in the EU has varied origins. Both Ireland and Spain complied with the Stability and Growth Pact rules up to the beginning of the crisis. The impending problems in these two countries were manifested in large and growing current account deficits, which were the counterpart to exceptional levels of

1. *email:* John.FitzGerald@esri.ie

investment in domestic property markets (EUROFRAME, 2006; Conefrey and FitzGerald, 2010). When these bubbles burst there were catastrophic effects on the banking system in the two countries. In turn, the resulting collapse in these two economies resulted in huge deficits appearing in the public finances, even though they had been in surplus prior to the crisis. With the benefit of hindsight, instead of merely observing the SGP rules, these two economies should have run increasing government surpluses in the middle years of the decade to keep actual output closer to potential and prevent a bubble occurring. Even more important, rigorous regulation of the domestic financial systems would have minimised the risks to these economies from a property bubble. Thus the SGP rules, which concentrated on the public finances, did not prevent the crisis in Ireland and Spain. It was only in the case of Greece that the origins of the crisis lay in a disguised contravention of the SGP rules.[2]

In the run up to the crisis the SGP rules themselves posed a different set of problems, especially in the case of Ireland and Spain. O'Leary (2010) looked at the advice proffered by the EU Commission and the IMF over the period to 2008. He found that the dangers inherent in the Irish situation were not adverted to by the international oversight teams. The fact that Ireland was obeying the "speed limit" of the SGP meant that they could not give Ireland a speeding ticket. In this case rules, which did not cover all sources of danger, were part of the problem rather than part of the solution; they restricted the scope of external oversight. This experience should be part of any analysis of the new set of policy rules that the EU has adopted. In the future, undue focus on a specific set of fiscal policy rules could obscure dangerous developments elsewhere in the economy.

The key elements of the additional set of rules put in place in the euro area over the last few years relate to the public finances of individual member states and the process whereby national budgetary policy is formulated and implemented. A number of changes have been made which make national budgetary processes more transparent. These changes also provide for enhanced powers

2. In the case of Portugal there was an earlier problem with government borrowing which was being addressed when the crisis in the world economy erupted.

for the Commission to oversee national fiscal adjustment programmes. The focus of these rules is primarily on limiting government borrowing and reducing current levels of indebtedness to return economies to a long-term sustainable level of debt.

While most of the attention is focussed on the fiscal rules, the new macro-economic imbalance procedure does focus on a range of indicators of problems other than the public finances, in particular on the current account. However, the breath of these indicators and the absence of a framework for prioritising may make the procedure relatively ineffective. If all member states are simultaneously in breach of one or more of the many indicators these breaches are not going to serve as an effective wake-up call to policy-makers.

The EU Commission has begun a procedure to consider the position of Germany, which has a large current account surplus. However, it remains to be seen how this turns out. Because the indicators of imbalances are backward looking, and because of the time that the procedure would take to implement, it may well be the case that the problems that this imbalance highlights could be over before any remedial action is taken.

What the new rules ignore is the desirability of taking counter-cyclical fiscal action where the euro area economy is operating significantly above or below its potential. While it is clear that counter-cyclical fiscal policy was neither appropriate nor possible for countries such as Portugal, Spain, Ireland or Greece in the current crisis, at the level of the euro area it would have been desirable in the period 2010-13 to implement a euro area fiscal stimulus (in 't Veld, 2013). Even if, as some would argue, the level of government indebtedness was too high in the euro area to allow this to happen in this crisis, in the future, when debt levels have fallen, the implementation of a euro area counter-cyclical fiscal policy would be appropriate. However, the new rules do not provide a mechanism to produce co-ordinated counter-cyclical fiscal policy action at the level of the euro area, should the euro area economy be operating well below or above potential.

A further significant problem with the current EU governance arrangements on fiscal policy is the defective nature of the methodology used to estimate potential output and the related structural deficit in individual countries, key concepts in assessing fiscal stance. These concepts have been enshrined in law but their definitions are subject to much debate.

The official EU methodology uses a production function, with a very simplistic model of the labour market, to derive the labour input into that production function. However, for potential output to be sustainable there should simultaneously be equilibrium in key markets – on the current account (the goods market), in the labour market (full employment consistent with stable inflation), households should have adjusted their consumption (and savings) so that their debt to income ratio is sustainable, companies should be operating at the minimum of their long run average cost curve and the housing market should also be in long-term equilibrium. The government accounts must then be on a sustainable path when the economy is in equilibrium – e.g. in balance or showing a small surplus. In the EU approach to modelling potential output these equilibrium conditions are not necessarily all guaranteed or imposed. In fact, in many cases the measure of potential output defined by the EU methodology would not be consistent with equilibrium in some or even most of these other markets.

In the approach currently used by the EU to estimate potential output a particular definition of labour market equilibrium is used which purports to estimate the level of unemployment consistent with an absence of inflationary pressures. In the EU methodology a Non-Accelerating Wage Rate of Unemployment (NAWRU) is derived using a filter process. This approach gives much more weight to recent observations so that, in times of high unemployment, it produces a NAWRU that is also high. The method for calculating the NAWRU leads to exceptional volatility in the number arrived at. The estimate of potential output for 2008 which is produced by this methodology today is dramatically different from that which it produced for 2008 when applied in the years 2007 or 2008. As such, it is not a good yardstick for deriving robust policy recommendations. In the standard EU approach no attempt is made to use a structural model of individual country labour markets and no attempt is made to derive the equilibrium labour input consistent with optimising behaviour by firms. This latter approach would be likely to provide a more stable benchmark for policy-making.

The result of using the filter process to derive the NAWRU is that today it suggests that the permanent level of unemployment in Ireland is well above 10 per cent of the labour force. When these estimates for the NAWRU are used in the production function to estimate potential output, they suggest that the Irish economy is today operating above potential.[3] On this basis the structural balance of the government sector is estimated using a fairly simple model relating potential output to government borrowing.

In the case of Ireland, if action were taken today to eliminate the structural deficit, defined in this way, the surplus on the current account of the balance of payments would rise to over 11 per cent of GDP (Bergin *et al.*, 2013). Such a rate of deleveraging by the private sector would not be a stable long-term equilibrium.[4]

If the structural balance is to play a significant role in guiding policy a more suitable methodology for estimating it will need to be developed. The methodology will need to take account of the specificities of individual countries. However, this would inevitably make oversight difficult for the EU Commission. The current situation involves a single simple model that is reasonably transparent. Once the idiosyncrasies of individual economies are modelled the process will be less transparent, even if it is more realistic. The problem would then be that much more reliance would have to be put on the expertise and judgement of those estimating the potential output and structural balance, something that will inevitably result in discussion and controversy. There would be no clear "right" answer. However, this would more appropriately reflect the challenges of developing appropriate fiscal policy responses to ever changing economic circumstances across many different economies.

3. In the *Irish Stability Programme Update*, April 2013, the Irish department of Finance refer to this result as counterintuitive. In the *Irish Stability Programme Update* published in the 2004 Budget they provide a detailed critique of the methodology highlighting the volatility in the EU Commission estimates of the NAWRU.
4. It would also trigger action by the EU Commission under the macro-economic imbalances procedure.

## Conclusion

We have learned to our cost that EMU has changed the environment for economic policy-making; the scope for inappropriate policy in one country to damage its EMU partners is much greater than was the case in the pre 1999 era. This has necessitated the development of new rules to guard against such negative externalities. These rules have now been developed to deal with what, we hope, are the exceptional circumstances of the last five years. However, many commentators believe that EMU will require a move towards a fuller fiscal union in the future if it is to survive.

It remains an open question how much of the recent crisis was attributable to EMU. The fact that countries such as Estonia and Latvia outside the euro area suffered from the crisis at least as severely as Ireland, Spain and Portugal inside EMU, suggests that the causes of the crisis were more complex than the mere existence of EMU. However, what EMU did was to enhance the dangers to all members of the EMU from a crisis in one or two member states.

If the new rules, and the advent of banking union, are successful in restoring the euro area economy to sustainable growth and if they prevent future economic and financial crises, then it is not clear to me that we need to go down the road of a full fiscal union. It seems possible that, in calmer times in the future, individual member states may be able to choose their own fiscal policy stance, provided it does not put the common good at risk. However, in times when output in the euro area economy is significantly below or above potential, the failure to implement a counter-cyclical fiscal policy at the level of the euro area would be a loss. A more decentralised approach would avoid the major political problems that fiscal union would involve and also avoid the problem of providing an appropriate level of democratic accountability for such a fiscal union.

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