

# SPECIAL REPORT

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### Fiscal Compact not yet home and dry

**Contrary to opinion polls, initial estimates of the outcome of the Irish referendum proclaimed a definite victory for the “yes”, with just over 60% of votes in favor of the Treaty on Stability, Coordination and Governance. However, this does not necessarily mean the Treaty will enter into force as scheduled on January 1, 2013. In fact, it could well be compromised since opinions are more divided than a few weeks ago in Eurozone countries where it still has to be ratified.**

#### Ireland votes for the Fiscal Compact

The outcome of Ireland's fiscal compact referendum was no reflection of opinion polls, which had predicted a large divide. The result, though, was clearly favorable to the Treaty on Stability, Coordination and Governance (TSCG) as part of Economic and Monetary Union, and initial estimates proclaimed a comfortable “yes” victory with just over 60% of the vote.

The outcome and the low turnout (50.4%) most likely point to the absence of any real choice in the matter, since Ireland is already operating a financial aid package and the TSCG is a condition for future assistance<sup>1</sup>.

The Treaty is divided into three sections - the fiscal compact, economic policy coordination and convergence, and governance of the euro area (see box below). It chiefly bolsters the anchoring of budget discipline, particularly through the application to Eurozone contracting countries of a clearly defined balanced budget rule, with an automatic mechanism to take corrective action and reinforcement of procedures for excessive deficits.

In terms of economic policy coordination and convergence, the commitments are more general and are really more recommendations rather than obligations for the contracting countries. The absence of specific employment and competitiveness targets, the absence of any recommendations as to the structural measures to be applied, and the absence of any timelines are in stark contrast to the stringency of the budgetary terms.

#### A compromise to the introduction of the fiscal compact?

The Irish vote does not necessarily mean the TSCG will enter into force, as scheduled on January 1, 2013 provided that 12

<sup>1</sup> *The Treaty in fact stipulates that “the granting of financial assistance in the framework of new programmes under the European Stability Mechanism will be conditional, as of 1 March 2013, on the ratification of this Treaty by the Contracting Party concerned.”*

Eurozone nations have deposited their instrument of ratification, or on the first day of the month following the deposit of the twelfth instrument of ratification by a Contracting Party whose currency is the euro, whichever is the earlier.

In the Eurozone to date, only Greece, Portugal (both receiving financial aid) and Slovenia have ratified the Treaty. Outside the Eurozone, Romania ratified it on May 21, while in Poland the lower chamber of parliament has now given the go-ahead, but the scheme still has to be approved by the Senate.

In Eurozone countries where the agreement is still pending ratification, there would appear to be more division than a few weeks ago, and this may make the approval process tougher.

In Germany, ratification initially scheduled for the end of May has been postponed, but should be in place before the summer break (July 6). Angela Merkel's conservative/liberal coalition, however, does not have the two-thirds parliamentary majority required to amend the German constitution, and will be compelled to call on the opposition. Statements by opposition parties that have no wish to make the vote on the fiscal compact an anti-Merkel vote would nevertheless seem to hint that ratification will not be so difficult.

In France, the election to the presidency of François Hollande, who is committed to renegotiating the TSCG either through amendments or by the addition of a growth component, has placed a question mark on ratification.

In Belgium, the Treaty must be ratified by the new parliaments (on a two-thirds majority), which puts the brakes on the process. Apart from these technical millstones, however, prime minister Elio Di Rupo clearly supports France's position, as does the new prime minister of Slovakia Robert Fico.

Ratification in Italy and Spain (where a budget balance rule has already been added to the constitution and adopted), which seemed a mere formality only a few weeks ago, is now

not quite so certain as both prime ministers call for a “growth compact”.

In Finland, opinions differ within the government itself, where the minister of foreign affairs has voiced opposition to the TSCG supported by the prime minister.

The Dutch government ran into difficulties in April during the vote on budget cuts. The political context is still tense (elections are due in September), and this could delay ratification of the Treaty.

With regard to the other Eurozone countries (Malta, Cyprus, Luxembourg and Austria), they will likely wait for the outcome of negotiations, particularly by Germany and France, before taking any decisions.

Opposition to the TSCG thus seems to be growing, and could be heightened by a certain amount of justification. Quite apart from the hierarchy of objectives set out in the TSCG, some issues cast doubt on its effectiveness. The possibility of non-ratification by Eurozone Member States (which would then be denied any financial aid) could lead to several levels of budgetary convergence within the Eurozone. The complexity of the budget scheme, moreover, may hinder the achievement of objectives (problem of transparency, application and verification). Finally, can a Treaty signed by EU Member States that is binding only on Eurozone countries solve the problems of the Eurozone?

### What is the future of the TSCG?

Although German Chancellor Angela Merkel stated there would be no renegotiation of the TSCG, its introduction would now appear to have been compromised. The informal European Council summit of May 23 has in fact demonstrated a power play change that appears to have come out in favor of the posture taken by the French president.

So what are the options?

Adding a growth component to the TSCG would appear to have been ruled out if we consider the German stance focusing on measures to support growth independently of the budget compact. This is not, however, impossible, even though the ratification process has begun.

Can the Germans take the risk of having the Treaty quashed? In 2005 the process to ratify the European Constitution was interrupted by a French “no”, followed by a Dutch “no”, and this set a precedent.

Will those supporting a “growth compact” be satisfied with independent measures (i.e., not as part of the TSCG)?

The compromise taking shape is based on the introduction of measures to boost growth which could take on a number of forms, now more or less feasible in due consideration of opposition from EU Member States.

Feedback from the informal dinner on May 23 indicates that six options were addressed:

- Project bonds: issues of EU bonds to finance the implementation of public-private partnerships towards priority investment (energy, transport, ICT).
- Increase in the capital of the European Investment Bank (around 10 billion euros, according to the Commission). In 2011, agreed loans came to 60 billion euros for a total of 395 billion euros in loans outstanding.

- Reallocation of structural funds and utilization of unspent funds. The Commission has estimated that 82 billion euros of structural funds were not spent in previous years, and these could be used for countries experiencing difficulties.
- A common deposit guarantee scheme for EU Member States, prudential surveillance and more integrated resolution criteria for bank failures (work and discussions are ongoing and the conclusions should be out in June).
- Granting the European Stability Mechanism (ESM) a banking license to secure funding directly from the ECB. This option is supported by France, Spain, Ireland and other countries, but Germany has already stated its opposition.
- Creation of Eurobonds: another bone of contention between the French and the Germans, since the latter feel this is the ultimate phase of European integration.

On the face of it, the June 28-29 summit is unlikely to produce any major declarations. The European Commission’s proposals concerning courses of action towards stability, growth and employment, published on May 30, demonstrate that in the first instance the measures should initially focus on bolstering existing means<sup>2</sup> or early introduction of project bonds (initially planned for the Commission’s multiannual 2014-2020 financial framework) with the launch of a “pilot phase” this summer, i.e. measures deployed in the European Union and not the Eurozone. Developments in the situation of Greece as parliamentary elections approach on June 17, however, and the issue of Spanish banks, could well force the issue.

<sup>2</sup> Concentration of structural funds on growth and convergence in 2012-2013: an average of 65 billion euros per year allocated to investment favoring growth and job creation. In addition to the annual amount earmarked, the EU also redeployed 17 billion euros, reallocating funds for research and innovation, assistance for SMEs and measures to improve the access of vulnerable groups to jobs, and also investment in infrastructures and energy efficiency. Investment in infrastructures is necessary in a number of countries to develop interconnections, boost supply, and introduce price competitiveness. Given the lack of room for budgetary maneuvering, it would be wiser to deploy innovative funding schemes such as European bond borrowing to finance projects (project bonds).

### Box

#### The main provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)

The main provisions of the TSCG are set out in Title III – Fiscal compact, Title IV – Economic policy coordination and convergence, and Title V – Governance of the euro area, in the Treaty signed on March 2 last by European Union Member States, with the exception of the United Kingdom and the Czech Republic.

The provisions of the TSCG apply only to Eurozone countries, though EU Member States can join the scheme<sup>3</sup>.

#### Fiscal compact

*Application to euro area Contracting Countries of a clearly defined balanced budget rule with an automatic mechanism to take corrective action and strengthening of the procedure concerning excessive deficits.*

The balanced budget rule

According to this rule, the budgetary position of the general government of a Contracting Party is balanced or is in surplus if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0.5% of the gross domestic product at market prices. A higher structural deficit is permitted if the ratio of general government debt to gross domestic product is considerably less than 60%.

The Contracting Parties shall ensure rapid convergence towards their respective medium-term objectives. The time-frame for such convergence will be proposed by the European Commission (EC) on the basis of an overall assessment.

The Contracting Parties may temporarily deviate from their respective medium-term objective only in exceptional circumstances<sup>4</sup>, and provided the deviation does not jeopardize the sustainability of the general government in the medium term.

This rule includes a correction mechanism triggered automatically if major deviations are observed with respect to the medium-term objective or the adjustment path towards it. The mechanism includes the obligation of the Contracting Party concerned to implement measures to correct the deviations over a defined period of time.

Bolstering of the procedure concerning excessive deficits

The TSCG goes beyond the provisions already adopted through the enhanced stability and growth pact (“Six Pack”) that came into force on December 13, 2011 – reinforcement of the automatic device for triggering the procedure concerning excessive deficits in the event of a breach of the deficit criterion through the introduction of the inverted qualified majority; triggering of the excessive deficit procedure if public debt rises above 60% of gross domestic product, even if the deficit is less than 3%, and the undertaking by the Contracting Parties concerned to reduce the deviation at an average rate of one twentieth per year as a benchmark.

A country subject to a budget deficit procedure, having failed to meet the deficit criterion, shall be obliged to put in place a budgetary and economic partnership program “including a detailed description of the structural reforms which must be put in place and implemented to ensure an effective and durable correction of its excessive deficit”, which shall be monitored by the Council of the European Union and by the European Commission.

It is also stipulated that, with a view to better coordinating the planning of their national debt issuance, the Contracting Parties shall report ex-ante on their public debt issuance plans to the Council of the European Union and to the European Commission.

#### Coordination of economic policies

Coordination of economic policies is based on three articles defining the undertakings of the Contracting Parties, as follows:

- to work jointly towards an economic policy that fosters the proper functioning of the Economic and Monetary Union (EMU) and economic growth through enhanced convergence and competitiveness, to that end taking the necessary actions and measures which are essential to the following objectives: fostering competitiveness, promoting employment, contributing further to the sustainability of public finances and reinforcing financial stability.

- to coordinate economic policies more closely:

- 1/ to make active use, whenever appropriate and necessary and stipulated in the measures provided for in Article 136 of the Treaty on the Functioning of the European Union<sup>5</sup>.

<sup>3</sup> Accession shall be effective upon depositing the instrument of accession with the Depositary, which shall notify the other Contracting Parties thereof. Following authentication by the Contracting Parties, the text of this Treaty in the official language of the acceding Member State that is also an official language and a working language in the institutions of the Union, shall be deposited in the archives of the Depositary as an authentic text of this Treaty.

<sup>4</sup> “Exceptional circumstances” refers to the case of an unusual event outside the control of the Contracting Party concerned which has a major impact on the financial position of the general government or to periods of severe economic downturn as set out in the revised Stability and Growth Pact.

2/ to benchmark best practices and work towards a more closely coordinated economic policy, the Contracting Parties ensure that all major economic policy reforms that they plan to undertake will be discussed ex-ante and, where appropriate, coordinated among themselves.

#### **Governance of the euro area**

Improving governance within the EMU entails arranging at least two “Euro Summit meetings” per year to discuss specific questions relating to the euro area (specific responsibilities, other issues concerning the governance of the euro area and the rules that apply to it, and strategic orientations for the conduct of economic policies to increase convergence in the euro area).

The summits must be convened, unless justified by exceptional circumstances, immediately after meetings of the European Council or meetings with the participation of all Contracting Parties having ratified the TSCG.

There are also new provisions concerning the organization and participation in the summits (the President of the ECB is invited to attend).

Contracting Parties other than those whose currency is the euro, which have ratified this Treaty, shall participate in Euro Summit meetings when discussions relate to competitiveness for the Contracting Parties, the modification of the global architecture of the euro area and the fundamental rules that will apply to it in the future, as well as, when appropriate and at least once a year, in discussions on specific issues of implementation of the TSCG in the Economic and Monetary Union.

#### **Ratification and entry into force**

The TSCG is ratified by the Contracting Parties in accordance with their respective constitutional requirements, and the instruments of ratification shall be deposited with the General Secretariat of the Council of the European Union. The introduction of key features of the fiscal compact into national law – budget rule and automatic correction mechanism – must be of a constitutional nature or at a higher level of legislation than that governing voting on national budgets.

The TSCG shall enter into force on January 1, 2013, provided that twelve Contracting Parties whose currency is the euro have deposited their instrument of ratification, or on the first day of the month following the deposit of the twelfth instrument of ratification by a Contracting Party whose currency is the euro, whichever is the earlier.

The other European Union Member States may accede to the TSCG. Accession shall enter into force on deposit of the instrument of ratification with the General Secretariat of the Council of the European Union.

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*5 To strengthen the coordination and surveillance of their budgetary discipline; to set out economic policy guidelines for them, while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance.*

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