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Commentary

Thinking beyond a fiscal union

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The EU and the euro countries in particular are gradually moving towards a fiscal union. The first draft of a new intergovernmental agreement is already on the table – published just a week after the 8-9 December EU Summit. The '*International agreement on a reinforced economic union'* was drafted as a separate agreement outside the EU Treaties. It is open to the EU 27, although its provisions will 'only' apply to euro countries. The objective is still to integrate these provisions into the existing treaty framework as soon as possible. But is the new 'fiscal compact' capable of managing and eventually overcoming the euro crisis?

Analysis of draft intergovernmental agreement

The draft agreement includes all the elements laid down in a statement issued by the Euro 17 at the last European Council meeting. Concretely, with respect to budgetary discipline, the draft includes provisions concerning (i) a "balanced budget rule" to be introduced at constitutional level or equivalent, the 'correct' transposition of which may be subject to the jurisdiction of the European Court of Justice (in accordance with Article 273 TFEU); (ii) a commitment to reduce debt at an average rate of one twentieth per year as a benchmark ('1/20 rule'); (iii) *ex ante* reports on national debt issuance plans; (iv) the application of 'reverse majority' in the excessive deficit procedure, which guarantees a higher level of automaticity and thus strengthens the role of the European Commission; and (v) binding "budgetary and economic partnership programmes," including detailed descriptions of the structural reforms necessary to correct excessive deficits.

Going even further than the statement of the Euro 17, the draft agreement states that contracting parties may temporarily incur deficits in the event of "exceptional economic circumstances" outside the control of governments or in periods of "severe economic downturn". These additional clarifications aim to mitigate the concerns of Paris and others that fiscal rules might become too rigid and fail to leave room for governments to adjust to shocks, and that 'excessive austerity' could throttle growth.

Aiming to enhance economic convergence, the draft agreement features commitments by contracting parties (i) to use whenever "appropriate and necessary" the instrument of enhanced cooperation on matters that are "essential for the smooth functioning of the Euro area" and (ii) to discuss and coordinate between themselves all major national economic policy reforms.

In addition to the Euro 17 statement, the draft foresees regular meetings between representatives of national parliamentary committees in charge of economic and financial affairs to discuss, in close association with representatives of the relevant European Parliament (EP) committee, the "conduct of economic and budgetary policies". This aims to appease national and European parliamentarians, who have been very critical of the conclusion of an intergovernmental agreement outside the EU treaty framework. In addition, it has already been agreed that the EP will send observers to help elaborate the agreement.

With respect to economic governance, the draft agreement does not foresee the establishment of new institutions or bodies, which would have undermined the current institutional setting. Instead, it merely reiterates a number of decisions related to Euro Summits, laying down the composition, frequency, preparation and follow-up of these meetings.

Negotiations will intensify in the coming weeks and EU leaders will return to the issue at an extraordinary EU summit at the end of January or early February 2012. The final agreement is due to be signed at the European Council in March 2012. Subsequently, the agreement will have to be ratified as quickly as possible in all member states. This is unlikely to trigger national referenda, as arguably the agreement does not lead to any further transfer of sovereignty and does not undermine national parliaments' final say on the budgetary process.

However, the agreement must be approved by national parliaments, which at the end of the day could prove difficult in some member states. But the ratification process as a whole is unlikely to be jeopardised, as the agreement will enter into force once nine euro countries have ratified it. This procedure follows the example of the ESM (European Stability Mechanism) treaty, which will also enter into force even without being ratified by every euro country.

EU leaders have been very keen to stress that the intergovernmental agreement will be open to all non-euro countries. Indeed, it seems very likely that the vast majority of 'outs' – with the clear exception of the UK – will do so. All this signals that the EU is not on the road to the 'division of Europe' predicted by some.

Instead, the picture is more complex. We already have different speeds, and yes, deepening cooperation among eurozone countries will create a higher level of differentiation. But this will not fundamentally widen the divide between the 'ins' and 'outs', as long as the EU institutions remain involved and both sides have a strategic interest in gradually enlarging the euro area – and this seems to be the case.

The fact that a first draft was presented within a week, as well as the fact that the entry into force of the agreement cannot be blocked by individual euro countries, sends a signal to 'the markets' that the EU and its members are ready and willing to tighten budgetary control as quickly and effectively as possible.

But will the new fiscal compact, which adds to an already complex crisis recipe, prove to be enough to overcome the crisis? The simple answer is 'no'. However, the intergovernmental agreement might still be a significant milestone. Steps towards establishing a 'fiscal union' may not only convince and enable the European Central Bank (ECB) to act as a temporary 'buyer of last resort', but also prepare the political ground for two major innovations: the need to balance austerity and growth, and the introduction of some form of debt collateralisation.

A 'New Deal' to balance austerity and growth

The crisis recipe needs to be reassessed by striking a more appropriate balance between austerity and growth, and between the undisputed necessity to reduce deficits/debt and the need to effectively counter growing economic divergences between EU countries – one of the basic structural causes of the current euro crisis.

The sovereign debt crisis has proven that greater budgetary discipline is necessary and the intergovernmental agreement, which has to be ratified and implemented by all euro countries, will push the euro area further in this direction. But the crisis has taught us more than that: growing disparities within the euro zone, loss of competitiveness in many countries on the EU's periphery, and increased competitiveness of core eurozone countries have significantly contributed to the current crisis.

Growing current account deficits in countries like Portugal, Greece, Spain and Italy have led these countries into the epicentre of the crisis. This is why these countries, unable to devalue their national currency, have to implement major reforms to boost their competitiveness, which is indispensable if they want to (eventually) grow their way out of difficulty.

But this will not be enough. In effect, the crisis recipe has to a large extent failed: it is not just that public finance discipline does not address the complex origins of the crisis – it is also unlikely to work should austerity continue to undermine growth perspectives in Europe's periphery, which will increase economic divergence within the euro zone even further. Ultimately, this damages confidence in the future of the common currency, as market players consider that the euro area will not be able to endure the political, financial and socio-economic costs of bridging the gap between a strong centre and a weak periphery. What is needed is a 'New Deal' for the euro, based on investment rather than transfers and linked to strict conditionality. The reduction of co-financing rates in order to speed up access to EU funds was a move in the right direction, but more needs to be done.

Separate treatment of productive investment in the excessive deficit procedure, austerity programmes and fiscal consolidation plans; the establishment of a temporary investment fund – a new Stability and Growth Fund (SGF) aiming to deliver the goals of Europe's growth strategy (Europe 2020) in countries unable to make the necessary investment themselves; increased use of new loan/private-public partnership instruments (including project bonds), requiring funding from the SGF, the European Investment Bank or the European Bank for Reconstruction and Development – all this would increase the feasibility of reform, boost growth and employment in weaker economies, reduce divergence and, in the end, calm markets. Private investors take long-term growth strongly into account.

A temporary collateralisation of debt

Second, the move towards a fiscal union could pave the way towards some kind of debt collateralisation. This would send a signal to private and institutional market players that euro countries are ready and willing to tie themselves together more closely than in the past, which in return could boost confidence in the future of the common currency.

The German government has strongly opposed any form of debt collateralisation, arguing that this would send the wrong signal to those euro countries that have to further reduce public spending and introduce structural reform. However, leading figures, including Finance Minister Wolfgang Schäuble and Chancellor Angela Merkel, have not totally closed the door to some form of debt collateralisation at a later stage, if and when the EU or the euro area reaches an adequate level of budgetary cooperation and control.

The intergovernmental agreement on securing fiscal discipline might bring the euro zone closer to that point; and the fact that both Mr Schäuble and Ms Merkel argue that the agreement is moving the euro zone towards fiscal union might indicate just that.

The vast majority of EU governments, the EP and the Commission either strongly support, or at least are open to, some form of collateralised debt. But the three options proposed in the Commission's Green Paper on the matter in late November might be asking for too much, too soon. This is why proposals by the German Council of Economic Experts *(Sachverständigenrat)* based on a debt reduction strategy that seeks the gradual but compulsory reduction of government debt to below 60% seem to be a very interesting alternative.

Their particular attractiveness stems from the fact that the common issuance of bonds would be temporary and used only for debt ratios over 60%. Debt exceeding this level of euro countries' individual GDP would be pooled in a "redemption fund". Every country would commit itself to autonomously redeeming the transferred debt over a period of 20-25 years, following a defined consolidation plan. In return, the fund would issue 'safe bonds', which would be used to cover pre-agreed financing needs for servicing outstanding debt and new borrowing. The 'redemption model' would be also more in line with the EU Treaties and national constitutional requirements, which prohibit permanent collateralisation of debt without precluding more permanent arrangements in the long term.

The end game?

So, maybe all the pain endured so far was necessary in order to bring us to this point, to effectively allow Germany to take the next step. A rethink is definitely necessary. Striking a new balance between austerity and growth and introducing collateralised debt point in the right direction. To achieve this, the current intergovernmental agreement may be a decisive stepping stone, but it is certainly still a long way from achieving the final goal, which at the end of the day will require a fully-functional, *sui generis* economic and political union.

Achieving this ultimate objective will require much more time and should not be secured behind closed doors or in the framework of limited treaty change – it will require a more profound adaptation of the Union's institutional and legal set-up in the framework of a European Convention. But let's take one step at a time, and let's hope that we'll have the time to do so.

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