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Summary of the report

Crisis Management in the EU: Strengthening Economic Governance and Financial Stability

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The global financial and economic crisis has revealed a number of weaknesses in the structures of the EU and EMU. The various measures taken in the EU since the onslaught of the crisis have served to strengthen the rules of economic governance and increase the stability of financial markets. However, the measures have been introduced at a rate that has sometimes made it difficult to keep up with developments. This report aims to fulfil a threefold purpose: first, to describe the different measures taken since the sovereign debt crisis erupted; second, to analyse these measures in terms of the problems and stumbling blocks ahead; and third, to analyse the direct and indirect effect on Sweden.

Measures that pertain to economic governance and financial stability: an overview

In order to strengthen economic governance in the EMU, a number of initiatives have been introduced so far: the European Semester; the so-called Six- and Two-packs; the Euro Plus Pact; and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (fiscal compact). Measures for stabilising the financial markets include the European Stability Mechanism (ESM) and work towards a banking union.

The European Semester is an annual six month long process that aims to coordinate the fiscal policy of the Member States more effectively. The subsequent initiatives, the Six-pack and the Euro Plus Pact, relate directly to the Semester in that they, together with the Two-pack, introduce more binding elements into the process for the euro countries.

The Six-pack aims to strengthen the Stability and Growth Pact (SGP). It has four purposes: 1. to strengthen the rules of the SGP; 2. to strengthen the euro countries' observance of these rules; 3. to introduce a new macroeconomic imbalance procedure; and 4. to strengthen the Member States' budgetary frameworks.

The strengthening of the SGP relates to the medium term budgetary target. It also elucidates the excessive deficit procedure. In terms of compliance, gradual sanctions have been introduced in the excessive deficit procedure and there is also a possibility of fining Member States for manipulation of statistics. The voting is carried out in the form of so-called reversed qualified majority voting, whereby a recommendation for a decision from the Commission is approved unless the Council rejects it by a qualified majority. The new macroeconomic imbalance procedure is based on an early warning mechanism, which in turn employs a scoreboard of macroeconomic indicators. The budgetary frameworks of Member States are enhanced by what is the only directive in the Six-pack, according to which national budgetary policies must be carried out according to certain provisions. Moreover, budgetary plans should include a multiannual perspective.

The Euro Plus Pact is an intergovernmental initiative that was signed by 23 out of 27 Member States (Sweden was not among the 23 signatories). The pact has four goals: 1. to increase the competitiveness of the Member States; 2. to increase employment; 3. to improve the sustainability of public finances; and 4. to strengthen financial stability. The Euro Plus Pact does not contain any supranational elements. However, the signatories take it upon themselves to introduce the rules of the SGP into their respective national legislatures. The Euro Plus Pact has since been incorporated into the European Semester.

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union is also an intergovernmental initiative. It implies that rules for the structural deficit should be introduced into national legislations. The structural deficit may not exceed 0.5 per cent of GDP. In cases of larger deficits, an automatic correction mechanism should kick in.

The Two-pack, which contains two regulations, introduces an early warning system for the budgets of the euro countries. It also introduces enhanced surveillance of public finances in eurozone Member States that have been affected by severe financial instability. The Two-pack aims to militate against the build-up of excessive deficits in the euro countries and to make sure that instability in one Member States does not spread to other Member States. In cases of support from the ESM, the Two-pack also purports to guide Member States back to borrowing in markets.

As regards measures needed to enhance financial stability, the EFSF and the EFSM were temporary measures and have now been succeeded by the ESM. The support given is in the form of loans and financial guarantees. Once the Single Supervisory Mechanism is in place, the ESM will be able to support both the public and private sectors.

The second initiative for improving financial stability is the work towards a banking union. Such a union should be able to provide four functions for banks in Europe: a common rule book, common supervision, a common deposit guarantee scheme (with common funding); and bank recovery and reconstruction. The first step towards a banking union was the introduction of a Single Supervisory Mechanism, which will be governed by the ECB. In the future the intention is to also introduce common funds for deposit guarantees and bank recovery and resolution.

Measures for economic governance and financial stability: analysis
Crisis management has tried to rectify the weaknesses that were built into the EMU from its very inception. However, it is not always sufficient to enact common laws. Different rules may be implemented differently in the respective Member States. There also a risk that the focus on austerity leads to such negative effects on the economy so as to threaten the entire system.

It is difficult at this stage to evaluate most reforms. However, as part of the European Semester, the Commission has produced three Annual Growth Strategies and two Alert Mechanism Reports. In the first Annual Growth Strategy, the Commission decided that further efforts were needed for budget consolidation, corrections of macroeconomic imbalances and stabilisation of financial markets. While the second report notes some remaining problem with regard to labour market reforms, the third report is more optimistic on the prospects for the EU economy. The first Alert Mechanism Report pointed out that twelve Member States were likely to suffer from harmful macroeconomic imbalances, while the second report pointed out that these had occurred in two additional Member States.

The combined effect of the Six-pack, the fiscal compact and the Two-pack is harder to assess. More automatic steps in fiscal monitoring would imply a higher degree of compliance. On the other hand, sanctions are still pecuniary, which might be problematic for a country already under financial stress. There is also the question of whether the system will cope with French or German breaches of the rules for the budget deficit.

In terms of the respective roles played by the ESM and the banking union, both initiatives have a strong rationale. The banking union in particular aim to provide a better supervision of banks. Financial market regulation may become more uniform, thus enabling further integration. Supervision may also become more independent and reduce the risk of corruption. The ESM can protect countries from instability spreading to their jurisdiction.

Since Sweden is not in the euro, the *direct* effect from the economic governance packages is very small. This is also true with regard to the ESM, which is reserved for euro countries only. Sweden is directly affected in the short term by the directives and regulations currently being negotiated on capital requirements, deposit guarantee schemes and bank recovery and resolution. However, it is very difficult to ascertain the extent to which Sweden will be affected in the longer term by the construction of a banking union.

The *indirect* effects on Sweden are also not clear. Judging by the results from the European Semester, the effects are likely to be positive if they imply a better functioning eurozone. However, the strong focus on austerity may hamper growth in the euro economies and this will naturally assert a negative influence on economic activity in Sweden through the export channel. To the extent that banking union and the ESM reduce uncertainty and improve financial stability, this is also positive for Sweden.

It is important to note that we are dealing with a moving target. Several of the regulations and directives have only recently been implemented or approved. The most important question is perhaps whether the eurozone countries can turn around the current of very dangerous development, lest the economic, political and social consequences become so grave that they not only threaten the euro but also the entire European integration process. Should the EU fail to deliver in terms of economic growth and low unemployment, the consequences may ultimately be severe.

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