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# Economic Intelligence


Up-to-the-Minute Analysis from
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# The European Council of 14-15 March 2013: Can It Deliver?

The upcoming European Council is the first to take place after the Italian elections on 24-25 February sent back a hung parliament – indeed, European Union leaders will gather on the eve of the inaugural sessions of the new senate and chamber of deputies in Rome, after which President Giorgio Napolitano will start his consultations for the formation of a new government. Mario Monti comes to Brussels for the last time as prime minister – solely in a caretaker capacity however, having first invited the main political leaders to provide input http://www.governo.it/backoffice/allegati/70518-8482.pdf.

The European Council also meets as the euro area faces the first back-to-back annual contraction in growth since European Monetary Union began in 1999.[1] And, while the news is not universally bad, with financial market tensions easing considerably since the summer of 2012, there is a persistent disconnect between the improvement in financial-market conditions and the downdraft in the real economy. Simply put, the improving market sentiment is not yet showing up in more jobs or higher incomes. As IMF Managing Director Christine Lagarde recently observed, "it might be helping markets, but it is not yet helping people" http://www.imf.org/external/np/speeches/2013/030813.htm. It is the European Council's task to establish the conditions for this shift to occur.

Specifically, there are four areas where this European Council needs to deliver:

- It must take steps to make the so-called European Semester a better instrument for generating growth and jobs in EU member states;

[1] For an interesting perspective on the way the European Council itself judges the progress achieved – and the challenges ahead – see **The 2013 Robert Schuman Lecture** given to the Lisbon Council by Enda Kenny, prime minister of Ireland, on the eve of the Spring European Council. Taoiseach Kenny is current chair of the Council of the European Union, the ministerial bodies that negotiate EU legislation on behalf of EU member states http://youtu.be/U6J87JbItrc.

- It must create conditions in which Ireland and Portugal can sustainably return to international capital markets;
- It must end the ambiguity over use of European Stability Mechanism (ESM) funds to directly capitalise banks so as to break the link between sovereign and banking debt;
- And it should recognise the urgent need for the ESM to clarify the conditionality that would be required of countries that apply for assistance under its precautionary facilities – a prerequisite for the European Central Bank to undertake purchases of a country's sovereign bonds under its Outright Monetary Transactions (OMT) programme.

The good news is that, after several years of crisis-fighting institution building, there are numerous levers and easy-to-reach instruments the European Council can use to help achieve these objectives. This note will focus on the key policy challenges facing this European Council, and propose a four-point programme – based on full leverage of instruments already in the European Union's toolbox – to address them.

## Seismic shifts, but a procedural agenda

Much has been written about the situation in Italy, and interpretations vary.[2] The precise nature of the vote will remain in the eye of the beholder, but the economic drivers of voters' discontent lie in hard and undeniable data. Indications of widespread public distress abound, with a recent study by the Bank of Italy on households' saving and wealth during the crisis providing perhaps the starkest evidence http://www.bancaditalia.it/pubblicazioni/econo/quest_ecofin_2/qef148. Already in 2010, even before the further sharp decline in incomes and output, as many as 65% of Italian households deemed their income as insufficient to cover their needs. This ratio stood at 40% in 1990.

Criticism that the European Union has focused excessively on fiscal adjustment at the expense of growth has become a growing chorus. Significantly, the criticism has for some time also included the IMF.[3] And political economists of all stripes have sounded the alarm regarding Europe's fraying social fabric. The upcoming European Council needs to show it has taken notice, and work toward making the required rebalancing process within the euro area both politically and socially sustainable.

Despite this formidable challenge, the annotated draft agenda for the 14-15 March European Council reads very much as business-as-usual. http://register.consilium.europa.eu/pdf/en/13/st05/st05639.en13.pdf . The summit's main goal will be to "conclude the first phase of the European Semester," a procedure from which much was expected when announced in 2010 but which, like its predecessor (the failed Broad Economic Policy Guidelines), has turned out to be too much of an

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[2] See Lorenzo Bini Smaghi "Reform Denial Poses Bigger Threat to Italy than Austerity," *Financial Times*, 05 March 2013; Paul Krugman "Austerity, Italian Style," *The New York Times,* 24 February 2013; and Joseph Stiglitz, "What is Italy Saying?" *Project Syndicate,* 04 March 2013.

[3] For a recent example, see Reza Moghadam, "A Missing Piece in Europe's Growth Puzzle," *IMF Direct-The IMF Blog,* 05 March 2013.

inward-looking, Brussels-centric exercise that remains unknown, and thus ineffective, at the national level.[4] The draft agenda has but a passing reference to other crucial issues: it notes, for example, that "if required (sic), the European Council will also take stock of progress of work on… the operational framework for the European Stability Mechanism to recapitalise banks directly." It is, of course, clearly required, as is a spur to action.

How should the upcoming European Council respond? The political instinct will likely be to point to progress in various areas and reaffirm a "stay-the-course" message. But to restore confidence and drive growth, both the rhetoric and action need to shift away from uncertainty about the future and toward a clear "will-do" attitude, with an emphasis on early delivery.[5] A successful European Council would be one that provides confidence-building, growth-friendly outcomes both on the items not officially on the agenda and on the one that is, the European Semester.[6]

## I. Ireland and Portugal: The return to markets

The Economic and Financial Affairs Council (Ecofin) of 05 March 2013 was disappointingly non-committal on the issue of providing further relief to Ireland and Portugal to facilitate their return to the markets. It stated simply that "ministers discussed… *whether to consider* [emphasis added] an adjustment of loan maturities in order to smooth the debt redemption profiles" of the two countries. Ministers agreed to ask the troika of international creditors to make a proposal for "the best possible option" in each case – which, *per se*, appears as a slight abdication of responsibilities, given that the European Financial Stabilisation Fund and European Financial Stabilisation Mechanism loans in question were granted by the eurogroup and Ecofin themselves. On the positive side, the IMF has suggested – without however providing details – that support could extend beyond a simple lengthening of maturities.[7]
http://www.irishtimes.com/newspaper/finance/2013/0307/1224330866528.html

The European Council could usefully bestow a broad political endorsement of the two countries' requests (dating from January), instructing ministers and representatives in the troika to give the issue urgent attention, and indicating that no options should be ruled out

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[4] For a critique and reform proposals of such "Brussels-talking-to-Brussels" exercises, see Alessandro Leipold, *Good Governance for the Euro Area: Proposals for Economic Stability* (Brussels: Lisbon Council, 2010) http://www.lisboncouncil.net/index.php?option=com_downloads&id=763.
[5] See José Manuel Barroso, "Europe 2020: A Blueprint for the Post-Crisis World," Keynote to the Europe 2020 Summit hosted by the Lisbon Council, Brussels, 07 March 2013 http://www.youtube.com/watch?v=2villprQlys&list=PL69C61E52A50F7DC5&index=2
[6] For an overview of the current economic situation, see *The Euro Plus Monitor Spring 2013 Update* published by the Lisbon Council and Berenberg Bank on the eve of the European Council meeting. http://www.lisboncouncil.net/publication/publication/91-the-euro-plus-monitor-spring-2013-update.html
[7] More generally, one is struck by the unusually harsh tone toward Europe used by the IMF in reporting on these two countries. While a divergence of views between two official institutions is traditionally expressed in hushed tones, the IMF's latest report on Ireland, for example, pulls no punches. It affirms that Ireland has largely done its part and that the prospects for a return to market borrowing in 2013 now depend crucially on a "forceful delivery of European pledges" to the country http://www.imf.org/external/pubs/ft/scr/2012/cr12336.pdf.

*a priori*. The sooner this matter is decided (i.e., by the April Ecofin in Dublin), the better, with rating agencies having already factored in a favourable outcome – and with predictably adverse consequences should it not materialize.

## II. End ambiguity about ESM direct bank recapitalisations

After apparently endorsing direct bank recapitalisations by the ESM in June 2012, when the eurogroup affirmed that it was "imperative to break the vicious circle between banks and sovereigns," there has been evident backtracking, both by key countries such as Germany but also by Klaus Regling, ESM managing director, who has raised doubts about its approval and concerns about the implied calls on the ESM's limited resources.[8] The latter concerns are justified, but the solution should not lie in abandoning a key instrument of crisis resolution, but rather in pressing the system to avail itself – should the need arise – of the possibility of capital calls afforded by Article 9 of the ESM Treaty http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf. At the same time, a murky distinction between "legacy" and "retrospective" assets has further muddied the waters of what might be contemplated.

While leaving the technicalities to their ministers, here too the European Council could provide reassurance that the commitment to direct bank recapitalisations by the ESM stands unambiguously, and commit to a decision by June 2013, when the Single Supervisory Mechanism will hopefully be in place.

## III. Clarify conditionality under ESM precautionary lending

While ECB President Mario Draghi's "whatever-it-takes" pledge of summer 2012 has been remarkably successful in calming market jitters, its effects appear to have shifted from what Mr. Draghi himself defined as "positive contagion" to, rather, a containment of negative contagion following Italy's inconclusive elections. This has coincided with growing questions about how the OMT programme would work in practice, and whether these central bank purchases would indeed ever be triggered.

There has, in this regard, been an evident reluctance on the part of the originally intended clients – Italy and Spain – to submit the request for ESM assistance which serves as a prerequisite to ECB support via OMTs.[9] A main obstacle to such a precautionary step, clearly advisable in a fragile and risky environment (with tail risks being particularly pronounced), has been the uncertainty surrounding the type of conditionality that would be attached to such operations. Apart from some rather general guidelines set out on the ESM website, the type of conditionality that would be attached to an ECCL (Enhanced

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[8] See Silke Wettach, "Mit großen Opfern verbunden," *Wirtschaftswoche*, 05 March 2013.

[9] In its note on the OMT's technical features, the ECB states that "a necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. Such programmes can take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases" http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html.

Conditions Credit Line) programme, and to the associated ECB purchases, remains largely undefined http://bit.ly/14NG1Ef. The oft-repeated official mantra is that conditionality must be "strict and effective" (as per the ECB's press release of 06 September 2012 http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html). But the interpretation of the phrase is far from uniform, with some providing reassurance that there would be no new conditions relative to existing commitments under EU surveillance, with only a prioritisation and a clear timetable, and others advocating full-fledged conditionality as under a traditional programme (which would, for example, make little sense for Ireland once it exits its present bail-out).

This uncertainty on conditionality thus compounds the long-standing stigma and sovereignty concerns, generating additional hesitancy in the face of the unknown and delaying recourse to facilities – until possibly too late. With OMTs remaining a phantom operation, the undoubted benefits that have stemmed from their announcement could over time evaporate.[10] Even now, despite the decline in long-term spreads, lending rates to households and corporates vary greatly among countries and the transmission of the ECB's easy monetary policy remains impaired, with a pronounced credit crunch in the periphery. As long as this remains the case, and the central bank's stance does not translate into easier lending rates, the recovery will remain elusive.

While it is clearly not for the European Council to enter into the details of this matter, here too it could usefully convey to its ministers (who, lest we forget, are also the ESM's Board of Governors) that the uncertainty on the conditionality of the ESM's precautionary facilities needs to be resolved, in a way that would facilitate their activation, largely by shifting emphasis from *ex post* to *ex ante* conditionality, i.e., one based on prequalification criteria. Though this would not necessarily help Italy in the present circumstances, it would certainly ease the way for Ireland, Portugal and Spain.

## IV. Making the European Semester truly 'growth-friendly'

Finally, as regards the main item on the official agenda, the European Semester, the European Council should strike a new tone and shift emphasis on three fronts.

First, the agenda states that the European Council will assess "progress made in implementing the 2012 country-specific recommendations." To be effective, this surveillance exercise should, as is often asked of the IMF, engage in as much "ruthless truth-telling" as can reasonably be expected from a gathering of peers. Failing this, the procedure will remain – as it is – without teeth. For each country, there should be an easily checkable report card, facilitating rankings. In preparation of the meeting, European Council President Herman Van Rompuy has sent a letter denouncing widespread non-observance of the end-2012 deadline for the implementation of 12 priority measures under the Single Market Act http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/135864.pdf. Who are the main offenders? They should be listed. Not delivering on the Single Market is

[10] See Luigi Zingales, "Pulling the OMT Trigger," *Project Syndicate*, 30 November 2012.

directly harmful to growth. Non-observance of a nominal fiscal target in a recession, on the contrary, is not.

Second, the European Council says it will provide "guidance to member states on the 2013 stability and convergence programmes and national reform programmes" – the two separate reporting procedures in which EU member states are required to set out 1) their medium-term budgetary or fiscal plans (the "stability programme") and 2) the steps they will take to correct on-going structural problems elsewhere in their economies (the national reform programmes, or NRPs). Until now, attention has focused largely on the stability programmes and related fiscal deficit targets. The NRPs have played second fiddle. Growth however hinges on effective structural reforms. A main difficulty here has been that both the NRPs and the Commission's own recommendations have been far too broad, trying to cover too many areas. This is partly a result of the fact that the framework document itself (the Annual Growth Survey, published in November and intended to chart the direction for Europe over the coming year, is very broad http://ec.europa.eu/europe2020/pdf/ags2013_en.pdf). This is understandable, as it needs to cover the requirements of a variety of countries, all exhibiting different roadblocks to growth. But five priority areas in one year, as identified by the AGS, imply too many different actions for any single country. The way forward should be to consider the AGS priorities as a broad menu, from which each EU member state should pick and commit to a few specific actionable reforms a year, chosen *à-la-carte* from this menu, according to their importance in unblocking domestic growth and to their national feasibility. This is a scope that would be both realistic and easily checked. The upcoming European Council should shift NRPs to the forefront of its surveillance – giving them at least equal standing to the stability programmes – and provide guidance that ensures that they are both focused and monitorable.

Third, with respect to stability programmes, the emphasis – often invoked in principle, but yet to be clearly applied in practice – must unambiguously be on structural (i.e., cyclically adjusted) balances as opposed to headline or nominal deficit targets (the holy grail of 3% of gross domestic product). The emphasis should be on long-term measures to improve the underlying fiscal position. From this angle, Italy is better placed than most, thanks to successive pension reforms that have, in the IMF's judgment, led to the most sustainable old-age spending position in the euro area. In short, pro-cyclicality – both in upswings and downswings – needs to be banned from EU countries' arsenals.

## A European Council 'will-do' list

In summary, a confidence-building European Council – one that takes due note of the message from Italy and elsewhere – needs to deliver on the following fronts:

- **Shift to a truly "growth-friendly" implementation of the European Semester**, with the main emphasis on a focused structural reform agenda for each country and an unambiguous primacy of structural over headline deficit targets in stability programmes. This means delaying the achievement of nominal targets where slippages are due to weaker-than-anticipated growth, granting the countries concerned the extra time.

- **Ensure a sustainable return to markets for Ireland and Portugal**, providing a broad political endorsement to the two countries' requests on the loan terms and instructing ministers and troika representatives to give the issue urgent attention, with all options on the table, and decisions by April 2013.

- **End ambiguity about ESM direct bank recapitalisations**, firmly reasserting the June 2012 imperative of breaking the vicious link between banks and sovereigns, and committing to a decision by June 2013, confirming that deadline for the Single Supervisory Mechanism as well.

- **Call on the ESM Board of Governors to clarify the conditionality to be used in precautionary lending facilities**, so as to overcome obstacles to a recourse to such facilities and, relatedly, to OMTs. Without these steps, OMTs stand to remain "phantoms" and the transmission of the ECB's easy monetary policy impaired – as it is at present. Fully translating easy monetary policy into easier lending rates is of great urgency and vital to any recovery.

Another, post-summit Economic Intelligence briefing will take stock – hopefully positively – of the European Council's work and conclusions.

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