NEW ECONOMY Section

THE FRAMEWORK OF MACROECONOMIC POLICIES IN THE EUROPEAN UNION AFTER THE CRISIS

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Abstract. *The way a government should intervene in a market economy is, and has always been, a most fierce debate addressing the core hypotheses of economics. Sometimes crisis emerge from lack of intervention from governments and other times they emerge from over intervention. Any economic crisis should be a strong indication for authorities that something went wrong with the regulating framework or with their economic decisions and operations that temporarily confused the markets and cripple their natural abilities to allocate resources in an optimum manner. In the last decade, many things have changed in EU and around the world because of the global economic and financial crisis that started in 2007 in US. This paper proposes a critical analysis of some of the main changes in the European Union macroeconomic framework driven by the recent crisis.*

Keywords: *economic crisis, macroeconomic theories, regulation, fiscal policy.*
JEL codes: *E44, Q54, E43.*

1. Introduction

Most modern economists agree to some extent that free market is a prerequisite for the wellbeing of a society. This is because the buying choices of individuals are directly linked with the success or failure of business and with the financial results of investors. The stronger is the link, the better. Such process of optimization has been exhaustively described by economists starting all the way from the workings of Adam Smith in the XVII century; author also known as the father of Economics.

Obviously, the government has a very important role in any society in the fact that it ensures a safe and proper environment in which the economic activity can develop. Other than this, the government has also a role in the redistribution of economic resources, the extent of which is usually debatable in the economic cycles.

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Economic crises are caused by factors that temporary disrupt the market forces in their role of enduring the optimal allocation of economic resources. The main culprit that has been found most of the times is government intervention, although economists have found other situations when markets tend to function incorrectly, an example being related with information asymmetries.

The economic crisis that started in 2007 originating in the US financial system, has quickly in all the aspect of economic life throughout the world and The European Union was no exception, being strongly affected due to the fact that, in Europe, the financial crisis overlapped to some major imbalances of fiscal and balance of payments.

The link between the US and EU economies is obviously very strong, but this is no reason to not have some basic filters for the risky financial instruments through which the financial crisis spread in EU and which were latter called “toxic assets”.

This paper is divided in four parts. After a short introduction, the second chapter is dedicated to the changes made in the EU financial regulation framework that are meant to prevent any similar external financial problems to spread in EU. The third chapter is dedicated to the fiscal measures that were addressed following the recent crisis and are meant to ensure economic and financial stability in the long run without negatively affecting the economic growth. The forth chapter is dedicated to conclusions.

2. Changes in EU financial regulation

Some of the most important changes implemented by governments around the world as a direct result to the economic crisis are related to the financial sector, the place where this crisis originated. Financial intermediation plays a very important role in the economic activity of any economy, ensuring the allocation of financial resources to the economic agents that can use them in the most efficient possible way. If financial intermediation is biased, then this will affect all other economic activities.

Other than its importance, another reason of which financial intermediation needs to be regulated and supervised by government authorities more than other activities is because it involves actions and decisions whose effects are felt strongly after a long term. An example of this would be in banking’s that tend to finance business or households on a long term, but attract financial resources with short maturities. The risk is a liquidity crisis in which customers would chose to withdraw their short-term assets without investing others to replace them. All banks should carefully monitor their balance sheet indicators and to try to limit or mitigate risks related with maturities or currency mismatches, or other mismatches related with the type of debtors and creditors (their residency or their main activity). It's true that the main responsibility for this should fall on the bank itself, however, as possible mistakes here can have negative effects throughout all economic activities, this responsibility must also be taken be public authorities.

Usually, in most countries, governments are responsible with all economic policy making decisions and financial regulation and supervision within the specific country. However, EU is a special case.

From the 28 states that make up the European Union, 19 have agreed to have a common monetary policy forming the Euro Area. Prior to the financial crisis, the fiscal policy and financial regulation and supervision were managed by each of these 19 countries in a different manner. The problem was that monetary policy and financial supervision work together, as monetary measures are implemented in financial markets and affect the results of other financial intermediaries. Also, although in the European Union, prior to the financial crisis, there were some common laws and regulations on financial supervision, most of these legislative acts were limited to some general guidelines and recommendations that remained in the responsibility of individual regulation authority to be implemented throughout Europe.

As expected, in the European Union, the crisis brought significant changes in the field of financial regulation and supervision. These changes relate mostly to the improvement of cooperation between EU member states and to the implementation of Basel III recommendations on capital requirements and liquidity ratios of credit institutions.

Basel Accords are a set of recommendations on banking regulation made by an international committee established in 1974 in Switzerland. The Basel Committee, the International Organization of Securities Commissions and the International Association of Insurance Supervisors make up the Joint Forum of International Financial Regulators, an international body that addresses the entire financial intermediation sector. After the financial crisis, in 2010-2011, the Basel Accords were revised leading to the so-called Basel III recommendations which must be implemented individually by countries around the world.

In the European Union, the Basel III Accord is implemented through the Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012, also known as “CRD IV”.

In line with Basel III, these new EU regulation addresses the minimum capital requirements that a bank should hold at a moment in time, measured by the solvency ratio. As compared with Basel II, this level was increased, but also, as a novelty, Basel III introduces the use of different thresholds for banks in different size. The idea is that large banks should be more capitalized, as their eventual problems would create more pressure authorities for possible bail out, and, more negative effects throughout the financial system. Basically, banks that are “too big to fail” need to be stronger and less vulnerable to financial risks.

Also, another novelty brought by Basel III is linked to the levels of liquidity that banks should hold. One of the lessons that the financial crisis taught us is that in short term, liquidity matters more that solvency. In troubled times, on a general background of mistrust in the financial system, temporary liquidity problems can lead to bankruptcies if not proper managed. Basel III Accords address this issue by introducing recommended levels for short term assets through 2 new indicators: The Liquidity Coverage Ratio (the banks’ ability to withstand a severe drop in liquidity supply in the next 30 days) and the Net Stable Funding Ratio (a measure of mismatches in maturities).

As an addition to the Basel III recommendations, the EU Regulation introduced also some new provisions on banking corporate governance, inspired by the OECD corresponding recommendations. These legal provisions address the remuneration framework of managers, by limiting and linking the bonuses also with the long-term risks that comes together with short term profits. Also, they address diversity in board composition and decision transparency.

Other than implementing the Basel III Accords, as a response to the financial, significant changes have been implemented in EU relating to the member states international cooperation. The Single Rulebook introduced by the European Banking Authority aims to provide a single set of harmonized prudential rules which institutions throughout the EU. The term Single Rulebook was coined in 2009 by the European Council in order to refer to the aim of a unified regulatory framework for the EU financial sector that would complete the single market in financial services. This will ensure uniform application of Basel III in all Member States. It will close regulatory loopholes and will thus contribute to a more effective functioning of the Single Market[1]. Prior to the Single Rulebook and before the financial crisis, most of the regulatory framework within the EU financial intermediation systems was established by member states individually, although some basic principles were also discussed at EU level. The need of a single regulatory framework resides from the degree of interconnects of financial systems in the European Union.

Another bold and very important initiative in this area consists of the creation of the Single Supervision Mechanism (SSM) and the Single Resolution Mechanism (SRM).

The SSM refers to the system of banking supervision in Europe and is comprised by the ECB and the national supervisory authorities of the participating countries[2].

Its main objectives are:

- ensuring the safety and soundness of the European banking system;
- increasing the financial integration and stability in EU;
- ensuring a consistent supervision of the European banks.

The SRM applies to banks covered by the single supervisory mechanism and is activated if and when a commercial bank, part of the SSM, faces bankruptcy for the situation to be handled properly and with minimum costs for the trust in the overall financial system as well as for taxpayers.

It’s important to mention that, while being mandatory for Euro Area Members, the SSM is in theory open for all EU member states outside EA that chose so. However, so far, no country outside EA formally informed the European Union on this intention. For now, the SSM seems to be restricted to the countries within the monetary union.

3. Changes in the fiscal policies

Other than financial regulation and corporate governance, one of the main reasons for which the financial crisis felt so strongly within the European Union, was that it overlapped to some major imbalances mostly related with the fiscal policies implemented by governments throughout the EU.

Table 1, bellow shows the evolution of fiscal policies in the EU before and after the crisis. Immediately after the financial crisis began, in 2009, both the Government deficit and Government debt in the EU 28

[1] http://www.eba.europa.eu/regulation-and-policy/single-rulebook
[2] https://www.bankingsupervision.europa.eu/about/thessm/html/index.en.html

increased. This evolution is due to the general decrease in GDP, but also to the measures adopted by some EU countries to mitigate the negative effects of the financial sector problems in the short run.

Table 1.
The evolution of the Government deficit and debt in EU28

%GDP

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Government deficit EU28	**2.5**	**1.6**	**0.9**	**2.4**	**6.6**	**6.4**	**4.6**	**4.3**	**3.3**	**3.0**	**2.4**	**1.7**
Standard deviation of MS Government deficit	*2.9*	*3.1*	*2.8*	*3.2*	*3.5*	*5.8*	*3.3*	*2.7*	*3.5*	*2.4*	*1.7*	*1.6*
Government debt EU28	**61.5**	**60.1**	**57.5**	**60.7**	**72.8**	**78.4**	**81.1**	**83.8**	**85.7**	**86.7**	**84.9**	**83.5**
Standard deviation of MS Government debt	*26.8*	*26.8*	*26.5*	*27.2*	*28.7*	*30.8*	*35.1*	*34.8*	*37.4*	*37.2*	*37.0*	*37.3*

Source: Eurostat

Although the Government deficit decreased somewhat in the recent years, the debt remained at similar higher levels and there are no perspectives of improving in the medium term. What is striking in the EU28 fiscal policies is the large discrepancies between member states main fiscal indicators. This is shown in the table 1 by the standard deviation of both Government deficit and Government debt, which reflects how far are the values of EU28 MS to the averages. In 2016, the EU Government debt was about 83.5% GDP, whereas the corresponding standard deviation stood at around 37.3%. This means that countries, on average, record a sovereign debt greater or lower than 83.5% level by 37.3%. Considering that the average of 83.5% is significant higher than the 1993 Maastricht mandatory provision of 60%, this really is a major issue that needs to be addressed soon. The top 5 countries in EU with the highest public debt in 2016 are Greece (179% GDP), Italy (133% GDP), Portugal (130% GDP), Cyprus (108% GDP) and Belgium (106% GDP), while the countries with the lowest public debt in EU are Estonia (9.5% GDP), Luxemburg (20% GDP) and Bulgaria (29.5% GDP).

High discrepancies make also hard to have a single common monetary policy to be applied to each and every member state.

Theoretically, before the financial crisis, EU institutions had a procedure to correct the fiscal imbalances called the Excessive Deficit

Procedure (EDP). In practice, however, this haven't function very well, being limited only to note the large imbalances.

The global character of the financial crisis brought into attention the importance of having a sound and predictable fiscal policy in all members states, particularly the ones that are part of Euro Area. Basically, the problems in one country can affect many others, a phenomenon that's been called the contagion effect. As a response, The Stability, and Growth Pact (SGP) have been amended by introducing automated procedures if a country exceeds the Maastricht thresholds of deficit and/or sovereign debt.

Another EU initiative meant to minimize the risk of contagion in EU countries is the so called Macroeconomic Imbalance Procedure (MIP) which aims to identify, prevent and address the emergence of potentially harmful macroeconomic imbalances that could adversely affect economic stability in a particular EU country, the euro area, or the EU as a whole[3]. MIP deals with a broader set of imbalances such as the current account deficit, the net international investment position, financial stability indicators, house prices, unemployment trends and so on.

The reality is that all these rules were known and understood by all member states before the financial crisis. However, they have been systematically broken by almost everyone under the idea that it would help the specific country to grow and it's only temporary anyway. So, the problem is not in understanding how financial policies should be implemented in theory, but rather to prevent politicians to take advantage from some economic measures that would have some advantages and benefits in the short run to gain some political capital. It's hard to say at this moment if these measures of improving the fiscal discipline implemented by EU institutions would really work, or they would only be limited to some bureaucratic procedures and reports with insignificant effects in the decisions of national authorities. This concern is especially strong considering the fact that EU seems to be weaker and weaker recently.

4. Conclusions

[3] https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/macroeconomic -imbalance-procedure/dealing-macroeconomic-imbalances_en

History thought us that economic crises emerges from time to time and that no 2 crises are the same. In economics, crises have a positive aspect in the sense that they correct excesses and restore the natural order of things. House prices cannot be increase indefinitely, financial intermediaries cannot grow continually and governments cannot increase their debt over and over. The major problem is that this restoration process affects many individuals in most negative ways.

One of the most important questions that the science of economics must respond is what the limit of government intervention is. How much should a government regulate and how much markets can solve on their own. This debate is most important for in establishing the reasons from which the crisis started and also in deciding what are the correct solutions to be implemented in order to prevent such crisis in the future.

The measures that were adopted in most countries around the world seem to indicate that the interventionism clearly won this debate. The regulation is stronger than ever in financial intermediation, covering aspects than seamed to many intangibles such as corporate governance, managers payment schemes etc.

Regulation has also a downside that most economists know about. The problem with a highly centralized system is that any mistake or bad decision made at this level affects all the system parts, while bad decisions within decentralized systems do not necessarily need to spread in all the system parts. However, this recent crisis showed us that in the case of financial intermediation, the negative effects spread very quickly in all parts due the high degree of interconnects and concentration into some few big players. At the least, this lesson should indicate to us all the importance and responsibility of regulation and supervision authorities.

While the European Union project brought many good things to all Europeans, it didn’t help when the financial crisis started. The particularities of its macroeconomic policy framework made it difficult to intervene decisively when the moment came. So, the crisis felt longer in EU with more negative effects than in US. Although the EU leaders tried to address all issues related with both financial intermediation and fiscal policy, some European countries seem to have lost their patience, with Great Britain being the most eloquent example.

It’s obvious that the European Union crosses its hardest test and it’s important to pass it quickly, a new crisis would certainly break EU. On the bright side, if the European Union passes this test it will be stronger than ever.

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[7] http://ec.europa.eu/eurostat.