Global Counsel

Not the treaty Europe needed

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Summary

- The new EU fiscal stability treaty focuses almost exclusively on imposing tighter fiscal disciplines on signatory states. Fear of difficult ratification debates and a big step into fiscal integration that would have divided the EU have ensured that the new treaty is narrow in scope and wide in application.
- The treaty is designed be reintegrated into the wider EU Treaty structure within five years, technically closing the rift between the UK and the other EU states.
- The treaty does not address the key questions for the future of the Eurozone such as collective debt liability for Eurozone states through Eurobonds, and as such will leave considerable uncertainty about the political future of the Eurozone.

The new EU treaty signed in Brussels yesterday is a narrow treaty that adds a layer of commitments on budget discipline for those who sign it, but little more. By imposing balanced budget policies on signatories, it has, as one commentator put it, tried to "make Keynesianism illegal" in the Eurozone.

It has ended up narrow for a number of reasons. First, because most EU states took fright at the reality of serious fiscal integration within the Eurozone with the UK and others outside this inner circle. Second, because a limited appetite for potentially difficult ratification debates in most member states has also pushed in favour of a narrow treaty over a deep one. In France Nicolas Sarkozy has already said that ratification will only take place after the Presidential elections in April and May; Socialist challenger Francois Hollande has stated that he will seek to renegotiate the Treaty if elected.

Both the Czechs and the UK have declined to sign the new treaty, but the limited scope of the treaty will allow it to be integrated into the full European Treaty Structure in a few years' time, technically closing the rift that opened between the UK and the other EU states in December. British Prime Minister David Cameron has been criticised by UK eurosceptics for conceding that the treaty signatories should have recourse to the European Institutions to help facilitate their new undertakings, but to insist otherwise would have been to elevate domestic politics over diplomacy and practicality to an absurd degree.

The new treaty may provide some reassurance to the ECB and to the markets with respect to the long term rectitude of EU governments, although it will also unnerve in its apparent insistence on pro-cyclical budget tightening. More importantly it does not address the fundamental problems facing the Eurozone and will leave markets unsure about if and when these will be fully addressed. One senior European official puts it this way: if the EU is a gothic cathedral, this treaty will be a flying buttress propping it up from the outside, not a chapel on the inside for the especially devoted.

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The Stability and Growth Pact redux

The new treaty (summarized in Table 1, below) is effectively a souped-up version of the European Union's much-derided Stability and Growth Pact,

both in its focus and in its approach. To the Stability and Growth Pact's existing rules on cyclical 3% deficit targets it will add a 0.5% structural deficit target and the obligation to implement fiscal discipline measures in national law, with automatic correction mechanisms attached. In theory, failure to implement these rules into national law or enforce them could see states brought before the European Court of Justice.

Sanctions will be semi-automatic, although they can be blocked by a qualified majority of European member states. France has fought off handing automatic power to enforce sanctions to the European institutions at every stage, and has successfully resisted a German proposal for Commission control over the Greek budget (or that of any similarly troubled state). Berlin may have no particular fondness for the European Commission, but it sees no alternative to an effective institutional player in the new system to prevent governments letting each other off the hook. The outcome is a system that makes it harder for member states to prevent action being taken against rule breakers, but not impossible.

The Commission's new powers are in fact embedded not in the treaty itself, but in the 'Six Pack' economic governance legislation passed last Autumn, something which a number of EU member states have quietly suggested means that a new treaty on the current model is not really needed at all. The European Commission, as now, will have the power to find states in breach of fiscal rules. The new system will add a power and to insist on sanctions in the form of interest-bearing deposits of 0.2% of GDP.

The Commission will also have a mandate for scrutiny of debt issuance plans and national budgets before they are adopted. This legislation also provides scope for the Commission to issue warnings and reports, and for the Council to require 'roadmaps' of corrective action for imbalances and asset bubbles within the Eurozone, which in theory can be followed by enforcement action if corrective actions are not taken. These however will also be subject to qualified majority blocking by member states.

3.1.(a), 3.1.(b)	Requires signatory governments to run balanced or surplus budgets, defined as not exceeding 0.5% structural budget deficit.
3.1.(c), 3.3.	In event of "an unusual event outside the control of the Contracting Party", or a "severe economic downturn", governments will be allowed to deviate from requirements of 3.1.(b)
3.1.(d)	Signatory governments' debt to GDP ratio to be capped at 60%. Where debt to GDP ratio is significantly below 60%, structural deficits may reach 1% GDP.
3.1.(e)	In event of a deviation from fiscal adjustment paths, a correction mechanism will be automatically triggered.
3.2.	Requires implementation of the rules in 3.1 in each signatory's national law, including automatic correction mechanism.
4.	Debt to GDP ratios which breach 60% shall be reduced at a benchmark average of 1/20th per year.
5.1., 5.2.	Excessive deficit procedures shall be submitted to, and monitored by, the European Commission and the Council in accordance with the Stability and Growth Pact.
6.	All signatories to report ex-ante on public debt issuance plans to the European Commission and the Council.
7.	Deficit reduction obligations may be waived at the behest of a qualified majority of Eurozone member states.
8.1., 8.2.	The European Commission will issue a report in due time on each signatory's compliance with the terms of the Treaty. Any signatory to the Treaty may bring the matter before the European Court of Justice, or ask the European Commission to issue a report, if they consider another signatory to be in breach of article 3.2.
11.	All major economic reform to be undertaken by the signatories shall be discussed ex-ante with all other signatories, and coordinated through the institutions of the European Union.
12.6.	Non-Eurozone member states who are signatories will be invited "when appropriate" and at least once a year to a meeting of all signatories to discuss implementation of the Treaty.
14.1., 14.2.	Subsequent to the ratification of the Treaty by 12 Eurozone member states, the Treaty will come into force on 1st January 2013, or on the first day of the month following the twelfth ratification.
16.	The Treaty is intended to be incorporated into the legal framework of the European Union within 5 years of its entry into force.

Table 1.Key draft articles of new European treaty
Source: European Treaty, 29th January 2012

So the new treaty is German in its exclusive focus on budget discipline, and French in its essentially intergovernmental structure. In this respect it reproduces the key weaknesses of the existing Stability and Growth pact. The Germans believe that qualified majority blocking requirements will

make it difficult for member states to avoid enforcing their own rules, but you do not have to be excessively cynical to imagine it happening. The ECB has already warned in uncharacteristically direct terms that some of the earlier draft treaty language allowed states too much latitude to suspend the pact in severe economic conditions. The new Article 3 tightens this language.

A buttress or a chapel?

The most common view of the new treaty in Brussels is simply that it misses the point. A new fiscal discipline pact would not have prevented this crisis and it will not prevent the next one. A collective bout of budgetary tightening is unlikely to do much for already feeble European growth, although most European governments are already tightening belts under pressure from the sovereign debt markets, so the treaty will simply underwrite this.

In the end, Europe has ended up with a buttress rather than a chapel because there is not yet enough genuine political appetite among European states to accept the two-tier Europe that serious action to secure the Eurozone would require. Berlin is in no hurry to invite German voters to endorse the idea of liability for Spanish and Italian debt and the relative robustness of the German economy does not help make the case that German prosperity is threatened by the current crisis. Merkel also believes she has already compromised enough. Her trip to the Bundestag to request a large slug of the next German budget to add to the cash reserves of the new ESM in 2012 is her third trip to the Parliament in half a year to ask for German concessions.

But Berlin is also reluctant to concede a two tier Europe, especially one in which the UK in particular remains outside a core group united around the management of the monetary union. For decades Berlin and the German system have seen British influence as a valuable counterbalance to France. However this has always required accepting a British tendency to nudge the Union into width (above all through enlargement to the East) over depth, often against French resistance. It is that political balance of power that the Eurozone crisis has now upset and which both Berlin and London are trying in their own way to revive.

However if the German desire to have maximum possible participation in the new treaty ensures wide participation, it also means the treaty has little scope for the kind of deepening and fiscal integration the Eurozone objectively requires to survive. Paris, which is probably the strongest heavyweight critic of this tendency, is nevertheless not in a position to resist this. Ironically this leaves Paris and the UK Eurosceptics pulling in the same direction: both insisting on the need for closer fiscal integration in the Eurozone, both agreed that London and Paris cannot both sign up to it.

The current Treaty solution will not square any of these circles. It may provide some reassurance to the markets and the ECB by reinforcing the fiscal rectitude of European states. But it will leave most of the long term questions on how to secure the Euro and the Eurozone – on Eurobonds, on the long term solution for bailing out states in crisis, on the challenge of convergence for the weaker Eurozone states with Germany - to be answered. At the point where the Eurozone probably needs some kind of chapel to survive, its gothic cathedral gets a flying buttress instead. Quite what will be left to prop up if (or when) the crisis deepens remains the key question for 2012.

Global Counsel

38 Wigmore Street
London
SW1U 2HA
info@global-counsel.co.uk
+44 (0)207 656 7600

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