

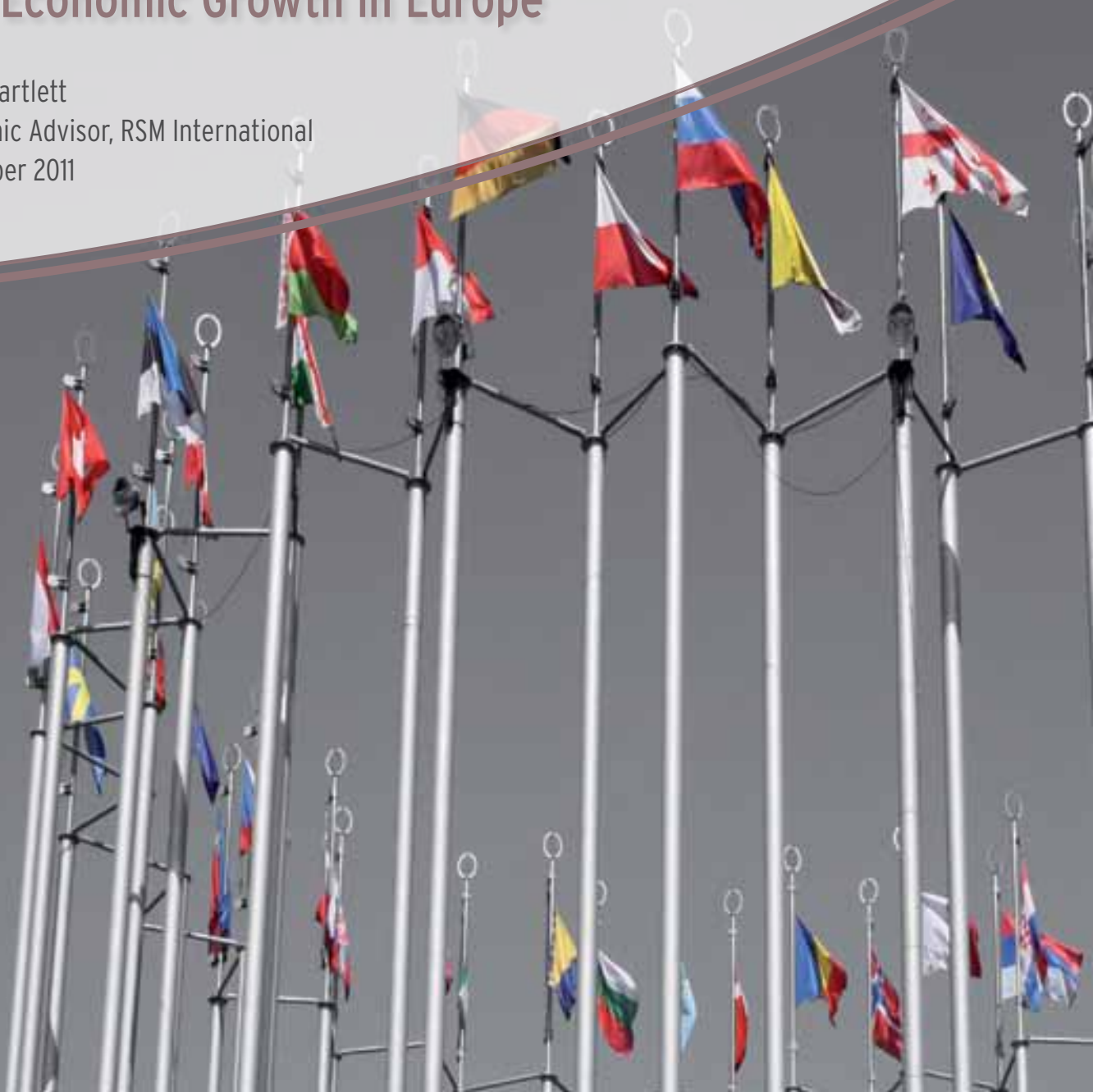
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Talking Points

The Brussels Agreement: Fiscal Adjustment and Economic Growth in Europe

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December 9 Accord in Brussels

On December 9, the European Council met in Brussels to devise a resolution of the Euro crisis that imperils the still fragile recovery from the global financial crisis. The Brussels Agreement includes a range of measures aimed at deepening fiscal integration in the Economic and Monetary Union (EMU) and disciplining Euro zone countries whose financial excesses precipitated the crisis.

The new fiscal rules reset the macroeconomic convergence criteria established under the 1992 Maastricht Treaty that launched the EMU. The national governments of the 17 Euro countries will be obliged to enact constitutional changes to move toward balanced budgets. They will be required to take corrective actions when their structural deficits exceed 0.5 percent of GDP, and will face automatic penalties if their overall budget deficits surpass 3.0 percent of GDP. A qualified majority of Euro members will be necessary to waive such sanctions. Reaffirming the Maastricht rules, the ceiling for the cumulative government debt will be set at 60 percent of GDP. Member countries presently exceeding that threshold (which includes such fiscal stalwarts as Germany) will be required to enact steps to meet the debt/GDP limit. Member governments will also be obliged to submit drafts of their national budgets to the European Commission, which will be empowered to request revisions.

In addition to these long-term institutional reforms, the Brussels Agreement includes short-term measures to strengthen the EMU's capacity to manage the debt crisis now enveloping Europe. EU leaders committed € 200 billion to the International Monetary Fund's bailout fund and agreed to speed the activation of their own € 440 billion European Financial Stability Facility (EFSF).

Yielding to German opposition, the European Council declined to authorise the European Central Bank to make unlimited purchases of sovereign bonds to ease pressure on Greece, Italy, and other countries that must refinance hundreds of billions of Euro debts in 2012. The Agreement thus represents a victory for

German Chancellor Angela Merkel, who regards increased fiscal discipline on imprudent Euro members as the necessary precursor to granting "lender of last resort" authority to the ECB, which under the Maastricht Treaty is prohibited from bailing out individual member states.

Fiscal Integration in Europe

EU leaders set a target of March 2012 to complete a draft treaty, envisaging formal ratification by the end of 2012. Chancellor Merkel cautioned that full implementation of the accord would take years, well beyond the tenure of her own and other member governments—underscoring the political logic of a treaty revision that would bind successor governments to domestically unpopular measures.

If enacted, the Brussels Agreement would constitute the biggest advance toward fiscal integration in the long history of the European project. Prospects for enactment are heightened by the palpable sense of urgency attending the December 9 summit, reflecting the gravity of a crisis that has quickly spread from troubled Southern European states to financially stable countries in Northern Europe. External support further raises hopes for enactment of the accord - The Obama Administration voiced its strong endorsement, while Russia's Medvedev government pledged \$20 billion to augment the IMF's newly expanded bailout facility for Europe.

But implementation of the Brussels Agreement encounters a number of obstacles:

1. The legal/institutional mechanisms needed to enforce the new fiscal rules remain unclear. The United Kingdom opted out of the accord, illustrating the financial interests of the City of London and Prime Minister David Cameron's unwillingness to commit to a new EU Treaty whose fiscal provisions would be enforceable by the European Commission and European Court of Justice. The U.K.'s exit left the remaining 26 EU countries (including 9 non-Euro states) to formulate a supranational pact that resides uneasily between an intergovernmental agreement and a full-fledged treaty.

2. The European Union's past record of enforcement of supranational rules does not engender confidence in the ability of current EU governments to undertake measures that may provoke domestic opposition. The enforcement record has been particularly poor when powerful member states have confronted politically inconvenient EU macroeconomic thresholds. In 1997 the EMU countries adopted the Stability and Growth Pact (SGP), which featured sanctions against states that violated the Maastricht convergence criteria. The German government spearheaded the launch of SGP, but subsequently joined France in securing waivers when both of those countries surpassed the 3.0 percent fiscal deficit ceiling. Franco/German efforts to water down SGP in the mid-2000s antagonised smaller, weaker countries in Central and Eastern Europe that were enacting politically risky austerity measures to join the Euro zone.
3. By prioritising short-term fiscal adjustment, the Brussels Agreement may prevent economically challenged Euro zone countries from realising the GDP growth needed to boost government revenues and achieve long-term fiscal stability. Even the weakened version of the Stability and Growth Pact discourages current and prospective Euro zone members from undertaking counter-cyclical stimulus measures. The loss of the exchange rate as a national-level economic tool of Euro countries further limits their capacity to enact pro-growth measures during economic hard times. The scale and depth of the global crisis (far surpassing previous economic downturns in the EU) heighten the tension between fiscal adjustment and economic growth in the 17 Euro zone countries.

Growth Prospects in the EU

On November 10, the European Commission issued an economic forecast that illustrated the challenges of reconciling fiscal adjustment and GDP growth in the European Union.



EXHIBIT 1 shows these EU growth projections through 2013.

1. Estonia is the economic growth champion of the Euro area, posting 8.0 percent real GDP growth in 2011. That small Baltic country's rebound follows the devastating economic contraction of 2008-09, when Estonian GDP shrank by 18.0 percent. Estonia's strong GDP growth also follows its entry into the Euro zone on January 1, 2011, which was facilitated by a rigorous macroeconomic policy that lowered the government debt/GDP ratio to 5.8 percent, the lowest in the European Union.
2. Slovakia, another new member of the Euro zone, also registers comparatively strong GDP growth numbers. Slovakia's government debt/GDP ratio (44.5 percent) is higher than Estonia's but well below those of the "PIIGS" (Portugal 97.2 percent, Ireland 108.1 percent, Italy 120.5 percent, Spain 69.6 percent) and smaller than those of large EU-15 countries (Germany 81.7 percent, United Kingdom 84.0 percent, France 85.4 percent).
3. The experiences of Estonia and Slovakia suggest that macroeconomic discipline and economic growth are not necessarily incompatible. The fiscal/monetary rigor

needed to secure membership in the Euro zone promotes financial stability in small CEE countries, strengthening their ability to weather the Euro crisis and enhancing their attractiveness to foreign investors. The Estonian and Slovak cases also demonstrate the continued value of Euro membership. Notwithstanding current anxieties over the future (and even survival) of the Euro, the common currency area still offers significant benefits to small trade-dependent economies.

4. But the Euro crisis is clearly impinging on the economic growth paths of other EU countries. Germany (whose export sector generated a stronger recovery from the 2008-09 downturn than any other G-7 country) is forecast to grow by just 0.8 percent in 2012, rising to 1.5 percent in 2013. France (0.6 and 1.4 percent) and Netherlands (0.5 and 1.3 percent) face similarly anemic growth prospects during the next two years. Other financially stable Euro countries enjoy only marginally better growth possibilities in 2012-13 (Austria 0.9 and 1.4 percent; Finland 1.4 and 1.7 percent).
5. Despite their customary lumping in the "PIIGS" group, the financially troubled countries of Southern Europe display important economic differences. Greece (by far the worst of the crisis

economies) is projected to shrink by 2.8 percent in 2012, its fifth consecutive year of economic contraction. While Greece is forecast to resume positive GDP growth in 2013, that country's medium/long-term growth prospects remain grim under even optimistic assumptions. Greece's departure from the Euro zone (still a possibility despite the Brussels Agreement) would likely provoke widespread bank runs and mass unemployment that would surely prolong that country's economic calamity.

6. Italy's new technocratic government has initiated austerity measures (including pension and labour market reforms) that bode favourably for a steady reduction of that country's debt/GDP ratio, which would alleviate concerns over Italy's creditworthiness and permit an orderly refinancing of its sovereign debt at tolerable interest rates. Italy hosts a number of leading multinational corporations (Enel, Fiat, Pirelli, et al) that continue to excel in the global business community. But Italy's GDP growth trajectory confronts a range of structural problems that long preceded the Euro crisis: Aging demographics; sagging productivity; weak governance.
7. Ireland exhibits a different dynamic than the other PIIGS. The punishing austerity programme imposed by the EU and IMF has lowered Ireland's budget deficit and reduced factor costs, generating an "internal devaluation" that promises to boost that economy's global competitiveness. In contrast to Greece, Ireland possesses an advanced manufacturing sector that offers hope for an export-led path out of the country's financial morass. But on December 16, the Dublin government announced that Ireland's GDP contracted 1.9 percent in the third quarter of 2011, the worst performance in the EU outside of Greece - demonstrating export-dependent Ireland's vulnerability to the global economic slowdown resulting from the Euro crisis.

Conclusion: Euro versus Non-Euro Countries

The launch of the Euro in 1999 prompted a debate over the merits/demerits of a common currency area. Euro advocates stressed the virtues of membership in the common currency, which lowers transaction costs and simplifies foreign exchange management - critical factors for small, open economies dependent on foreign trade and investment. Meanwhile, Euro skeptics emphasised the loss of monetary sovereignty and the macroeconomic strait jacket entailed in membership.

A comparison of the economic performance of Euro and non-Euro countries defies definitive conclusions about this debate. British authorities highlight the fact that the United Kingdom now enjoys lower borrowing costs than Germany, despite carrying a foreign debt three times the size of Germany's. But the U.K.'s economic growth prospects in coming

years are roughly in line with those of the major Euro zone countries. The other non-Euro EU-15 countries (Denmark and Sweden) register higher GDP growth rates and stronger macroeconomic fundamentals than the U.K.

For the non-Euro countries of Central and Eastern Europe, maintenance of the national currency permits use of the exchange rate as an export promotion instrument. But it also means continued exposure to currency speculation that raises the costs of foreign debt service. Poland, whose economy has largely weathered Europe's financial crisis, has signaled its intention to continue on a path to Euro membership by mid-decade. Poland and the other CEE countries joined Denmark and Sweden in their endorsement of the Brussels Agreement, leaving the U.K. as the lone dissenter. These developments indicate that Europe's common currency project remains intact despite present anxieties about a Euro breakup.

About David Bartlett

David Bartlett, Economic Consultant, has over ten years' experience of consulting, researching and teaching on international corporate strategy. He specialises in international growth, global manufacturing, foreign sourcing and distribution and corporate risk management.

David is Adjunct Professor of Strategic Management and Organization at the Carlson School of Management, University of Minnesota. He has also held faculty appointments at Vanderbilt University (USA), Yerevan State University (Armenia), and the University of World Economy and Diplomacy (Uzbekistan).

David has received a Fulbright Senior Scholarship, Salzburg Seminar Fellowship and other scholarly awards. He holds a PhD and BA from the University of California and an MA from the University of Chicago.

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