Contributions from the Sherpas of the Member States to the Five Presidents' Report

CROATIA

27 March 2015

"Preparing for Next Steps on Better Economic Governance in the Euro Area - Analytical Note"

Croatia

1. How can we ensure sound fiscal and economic positions in all euro area Member States?

The ambitious reform of economic governance that took place since the outbreak of the crisis expanded the toolkit that can be used in case of imprudent behaviour of national policymakers. The key role in ensuring sustainable growth should be played by the European semester. The benefits of the upgraded coordination framework will be especially noticeable in the future, when the economy finally reaches its firm recovery. However, the experience has shown us that the mere existence of coordination procedures does not necessarily imply better economic performance. Therefore, it is of utmost importance that the new economic governance framework is implemented in a consistent manner and widely respected by the national policymakers. An important feature of the overall EMU architecture that would provide for the needed consistent implementation is the strengthened ownership, at the national level, over the European Semester and its main elements.

2. How could a better implementation and enforcement of the economic and fiscal governance framework be ensured?

Regarding the options for further improvements in the current economic governance framework, we see some benefits of applying a more focused approach when adopting the country-specific recommendations (CSRs) as a part of the European semester. Currently, the CSRs consist of numerous recommendations targeting wide array of different structural policies, for which usually too ambitious implementation deadlines are set. We deem it beneficial if CSRs were based on fewer reforms that are assessed as the most significant and urgent ones for the particular Member State, but taking into account country specifics.

The positive effects of such an approach would be twofold: the most imminent vulnerabilities for the particular Member States would be addressed immediately, while the national governments would not be confronted with the excessive implementation burden stemming from numerous and widely defined CSRs. Additionally, having more focused CSRs would allow for more efficient monitoring of the progress in fulfilling the given recommendations.

In addition to having well targeted and prioritised CSRs, the substance of the set CSRs should be well discussed both at the national and EU level. Such a dialogue would provide for better understanding on what should be done and in what time horizons. An important feature of the overall EMU architecture that would provide for the needed consistent implementation is the strengthened ownership, at the national level, over the European Semester and its main elements.

3. Is the current governance framework – if fully implemented – sufficient to make the euro area shock-resilient and prosperous in the long run?

The ambitious and comprehensive reform of the economic governance framework might, assuming its consistent implementation, enhance the long-term resilience of the EMU. The benefits of the improved economic governance framework should be evident in terms of a more sustainable growth in the future. It would imply balanced growth, based on sound macroeconomic fundaments, where the emergence of potentially harmful macroeconomic imbalances and financial sector bubbles is prevented by the active application of economic, structural, and macro-prudential policies facilitated by the recently upgraded governance framework. Hence, the new framework should take the important role in preventing the risky dynamics in macroeconomic variables over the long run.

4. To what extent can the framework of EMU mainly rely on strong rules and to what extent are strong common institutions also required?

Regarding reliance of the EMU governance architecture on rules, we express our support to strong rules with, however, taking into account relevant specificities of the national economies. As already noted, this flexibility should be considered also when drafting the CSRs for a given Member State.

The reforms implemented over the last five years have enhanced both the tools and the mandates of the common institutions. Specifically, the European semester significantly expands the mandates of the EU institutions to monitor and to advise the economic policymaking in the Member States. However, whether the stronger institutions will contribute to better economic performance of national economies still depends on the level of Member States' compliance with the commonly agreed rules. In any case, it is quite sure that the continuous rigorous surveillance through the European semester will raise the awareness among the national authorities about the vulnerabilities in their national economies and the importance of prudent policymaking. This should in turn reduce the probability of excessive boom and bust episodes in the future.

6. Has the fiscal-financial nexus been sufficiently dealt with in order to prevent the repetition of negative feedback loops between banks and sovereign debt?

The recent experience of the debt crisis demonstrated that bank failures in times of financial crisis can seriously endanger the fiscal sustainability. A number of important steps have been taken in the EU in order to prevent such potentially detrimental feedback loop from materializing again in the future - primarily the establishment of the banking union. Here we have some significant changes and new mechanisms and institutions in place and they could certainly lead to a more effective and less expensive crisis management going forward.

However, the question is whether the system will, due to some of the new elements, become more prone to crisis. Given the lack of experience in their application, it remains to be seen how some of the new instruments will perform from the financial stability point of view. It relates primarily of the implementation of the bail-in tools that foresee creditors' participation in banks' recovery and resolution. Specifically, it is uncertain how the use of the bail-in tools will affect the broader financial system, as well as liquidity of financial institutions with unsecured exposures to the bank which is in the process of recovery.

8. To what extent is the present sharing of sovereignty adequate to meet the economic, financial and fiscal framework requirements of the common currency?

In the ideal case, the countries participating in a monetary union would, besides the common monetary policy, share all other important aspects of economic policy. Currently, the financial size of the annual EU budget that is equal to around 1% of GDP of the European Union is highly insufficient for it to serve as a mechanism for actively coping with asymmetric shocks.

10. Under which conditions and in which form could a stronger common governance over structural reforms be envisaged? How could it foster real convergence?

The implementation of structural reforms with large spillover effects should require stronger common governance.

It is important to point out the need to constantly enhance and adapt alert mechanisms in order to minimize the possibility for the member states to go harmfully astray. Preventive factor is crucial with the aim of stabilising the member states and diminishing the possible negative domino effect within and outside the euro-area.

11. How can accountability and legitimacy be best achieved in a multilevel setup such as EMU?

At EU-level, the European semester might be complemented by national procedures to monitor and, correct existing macroeconomic imbalances and to increase ownership at the national level. These procedures should be defined by EU legislation and their performance monitored by the European Commission.