BULGARIA

Open Questions based on the Analytical Note

[Introduction: The next few questions are practically asking whether the euro area need greater centralization of decision making (and new institutions) on fiscal and economic matters, which although necessary, will be rather difficult to sell politically, particularly in the hostile current environment (e.g. in France, Greece, UK, Spain, etc.).]

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

The global financial crisis prolonged reforms of the EU economic governance framework mainly due to the fact that governance was insufficient to ensure economic policies in the euro area countries that were commensurate with the requirements of a monetary union. The Stability and Growth Pact was not implemented to a degree that would have ensured sound fiscal positions in member states. There was also a lack of tools for preventing the emergence of large and persistent divergences among the euro area countries, and this led to large and unsustainable imbalances within the currency union. Therefore, the SGP was strengthened and the MIP was introduced. The key aim is to ensure sound fiscal position and to tackle macroeconomic imbalances, that will consequently increase the accountability and credibility of national fiscal policy-making, will boost competitiveness and as a result will underpin the economic growth and job creation over the longer term.

In that respect the sound fiscal and economic position in the euro area MS could be better ensured through increased ownership and strict adherence to the new economic governance framework within the European Semester. It is the loose implementation of the rules that is delaying the quick stabilization of public finances in the euro area MS.

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

The implementation of sound policies is best ensured if these are solidly anchored at the national level, which calls for strong institutions to underpin the quality of fiscal and economic policies. Moreover, the experience suggests that recommendations from the European Commission and the Council can only be fully effective if they match the preferences in the country itself – the so-called national ownership. In principal-agent terms when ownership is high, the agent will naturally prefer to act in a way that maximizes the welfare of the principal. When ownership is low, the principal must resort to ex-ante controls and ex-post measures to prevent the agent from shirking its responsibilities. The enforcement tools within the governance framework need to be more effective, leaving as little room for discretion as possible. Strict application of the rules and their sanctions would create discipline, while, on the other hand, concessions would create moral hazard and further unsatisfactory implementation. The practice has shown that Member States' efforts in implementation of the economic and fiscal governance framework are greatest when they face risks of sanctions or loss of market confidence and disruption in the access to market finance.

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

In fact, the current governance framework has some very solid elements, provided that it is implemented as it is designed. The framework would improve the confidence on the future financial stability if its options for fiscal loosening are reduced, while the existing flexibility is preserved but implemented in a more transparent and non-discretionary manner.

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

The framework of the EMU includes some solid rules, but their enforcement depends to a large extent on the strength of the common institutions and their actual independence from national/political influence. (*The practice so far has shown that due to the high political stakes involved in the matter, the common institutions do not remain entirely distant to the political issues and strict rules implementation is not always ensured.*

5. *What instruments are needed in situations in which national policies continue – despite surveillance under the governance framework – to go harmfully astray?*

In case national policies start to deviate from the recommendations of the governance framework, the rules envisage various forms of sanctions, which should be activated. The sanctions have not only economic, but also political weight, and that makes them a useful tool that should be used in the foreseen circumstances.

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 bank-sovereign feedback loop has been somewhat weakened due to the improved banks' balance sheets and governments' books. The effective policies to address the risks of adverse sovereign-bank feedback loops have to be targeted to two objectives: sound public finances and a stable banking system. Fiscal policy should be seen as a key component of the macroprudential policy apparatus, and a sound fiscal position as a prerequisite for the countercyclical use of fiscal policy. The stability of the banking sector requires high and countercyclical capital buffers, and reliable supervision, as well as an appropriate degree of transparency about banks' exposures to sovereign borrowers. To a big extent this is expected to be achieved with the BRRD enforcement and with the completion of the banking union. However, the fiscal-financial nexus cannot be entirely eliminated due to both sides' innate interdependence. (*The risk cannot be entirely eliminated; it can be merely shifted from one sovereign to (an) other.)* This would be only partially possible if there are limits to the amount of sovereign debt that the banks can hold (and to be risk-weighted[1]), which would, however, hamper the possibilities for sovereign financing.

[1] Daniel Gros (2013) - these proposals start from the observation that in most countries, banks' exposures to the domestic sovereign benefit from a preferential prudential treatment (they are typically assigned low or zero risk weights and are exempted from the rules limiting large exposures). Therefore, a tightening of this treatment would reduce banks' incentives to lend to their governments, contributing to loosen the sovereign-bank link. However, it should be noted that such a kind of option should be assessed against possible procyclicality!

7. *How could private risk-sharing through financial markets in the euro area be enhanced to ensure a better absorption of asymmetric shocks?*

Better absorption of shocks across the euro area could be achieved by taking measures to reduce financial fragmentation and to increase harmonization of Member States' financial systems. For example in the long run the forthcoming Capital Markets Union initiative could play a vital role through harmonizing corporate governance, insolvency legislation, mergers and acquisitions legislation, etc. In the short-run it could be helpful to reduce the barriers to capital flows, namely to ease the burden upon functioning of the capital markets like for example the so-called "Giovannini barriers" which are of a more technical and practical nature (e.g. national clearing and settlement restrictions, national differences in information technology and interfaces, national differences in operating hours/settlement deadlines and etc.).

All in all, the above-mentioned strategic directions will allow private financial institutions to operate in more similar national markets, which are increasingly becoming a single European financial market. The more the European financial market performs as a single one, the better shock absorption capacity it will have.

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

The current degree of sharing of sovereignty is somewhat less than the requirements of the common currency, but at the same time it is somewhat higher than the political constraints allow it. On the one hand, the common currency necessitates deeper integration, but on the other hand, the deeper political integration is at its limits. In short run, deepening economic, financial and fiscal integration increases the risk of disintegrative political fallout whose aim would be to undo it. In the long run, however, the euro area governance could be further improved.

9. *Is a further risk-sharing in the fiscal realm desirable? What would be the preconditions?*

Individual member states could first of all 'self-insure' against business cycle shocks by running a prudent fiscal policy and lower their debt level so that they have the freedom to run temporary deficits in case they face temporary shocks. The SGP and the 'Fiscal Compact' with its target of the budget balance in cyclically adjusted terms is implicitly based on this idea.

However, the euro crisis has shown that the really important shocks result not from normal business cycle fluctuations, but from financial boom-bust cycles which can put the entire financial system in jeopardy. Hence, in that regard, we have to keep in mind that there has been a substantial progress on risk-sharing in the recent years - *namely the establishment of the ESM and the SRM.* Therefore, there are no pressing needs for increasing that degree of risk-sharing.

In the political sense, even the progress reached so far has been difficult and not entirely completed (*i.e. the bridge financing options of the SRM during the transition period),* so any efforts to step it up (*via a euro area budget or common issuance of public debt*) contain risks.

In the longer term, however, a strategy for developing 'common fiscal space' for the EA could be considered.

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

Stronger common governance over structural reforms should be envisaged for those areas which potentially improve the flexibility and adjustment capacity of all Member States or where the national interests of a country may be in conflict with the overall interests at euro area/EU level.

Specifically speaking, the Convergence and Competitiveness Instrument proposed in the previous round of discussions on the topic, was in fact a sensible approach to strengthen common governance over structural reforms. Its most valuable benefit is that its activation is entirely voluntary by the Member State, which prevents eventual discussions on the ownership of the reform it is going to assist. On the other hand, surveillance on the implementation would be highly focused, so the creditors would be more reassured on the impact of the financing arrangement.

It has to be kept in mind that when deciding on enhancing common governance over policy areas, it is important to respect country specific characteristics, such as the economy's stage of development and the implications for the catching-up process. Harmonization of economic policies may entail implicit risks for the economic performance of countries at different stages of economic development.

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

The mechanism offering the highest degree of accountability and legitimacy that is available to policy makers is holding national referenda. They are particularly appropriate in cases when dramatic reforms are introduced to governance architectures.

The issue of democratic legitimacy and accountability in the EMU should be addressed within the wider context of the EU legitimacy and democratic oversight. There is growing skepticism across the board which we should address both at national and EU level.

Any steps should make full use of the existing EU legal instruments and institutional framework. The role of the national parliaments has been enhanced with the Treaty of Lisbon. An active political dialogue with the national parliaments has been established through the subsidiarity and proportionality checks. Potential to improve cooperation and coordination certainly exists, based on the existing treaty provisions.

The Treaty on stability, coordination and governance in the EMU provides for strengthening the inter-parliamentary cooperation. This should be based on the equal participation of all contracting parties.

We should avoid any possible fragmentation of the EU institutions and the creation of parallel structures. Such a move could deepen the problem of the democratic legitimacy.