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NO 18

Special Report

Financial assistance provided to countries in difficulties

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(pursuant to Article 287(4), second subparagraph, TFEU)

Audit team

02

The ECA's special reports set out the results of its performance and compliance audits of specific budgetary areas or management topics. The ECA selects and designs these audit tasks to be of maximum impact by considering the risks to performance or compliance, the level of income or spending involved, forthcoming developments and political and public interest.

This performance audit was produced by Audit Chamber IV — headed by ECA Member Milan Martin Cvikl — which specialises in auditing revenue, research and internal policies, and European Union's institutions and bodies. The audit was led by ECA Member Baudilio Tomé Muguruza, supported by the head of his private office, Daniel Costa de Magalhães and Ignacio García de Parada, attaché; Zacharias Kolias, director; Josef Jindra, team leader; Giuseppe Diana, Marco Fians, Daniela Hristova, Didier Lebrun, Ioanna Metaxopoulou, Adrian Savin, Kristian Sniter, auditors.

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Abbreviations

06

Council: Council of the European Union — the text uses this term as a shortcut for any Member State decision-making body

ECB: European Central Bank

EFC: Economic and Financial Committee

EFSF: European Financial Stability Facility

EFSM: European Financial Stabilisation Mechanism

EMTNs: Euro medium-term notes

ESA: European System of Accounts

EWG: Eurogroup Working Group

IMF: International Monetary Fund

MoU: Memorandum of understanding

SGP: Stability and Growth Pact

Executive summary

I

Seven years ago, Europe faced a financial crisis which turned into a sovereign debt crisis. The sovereign debt crisis was a consequence of various factors, including weak banking supervision, poor fiscal policies and the difficulties experienced by large financial institutions (and the consequent bailout costs borne by the general public). The crisis swept across EU Member States in two waves, first affecting the non-euro area countries in 2008-2009 and later spreading to the euro area itself. In total, eight EU Member States were forced to seek macrofinancial assistance.

II

But was this turmoil well resolved? We analyse the Commission's management of the financial assistance provided to five Member States (Hungary, Latvia, Romania, Ireland and Portugal).

Some warning signs went unnoticed

III

It is important to remember that before the crisis there was already a framework geared towards monitoring the Member States' budgets. Warning the Council about the mounting fiscal imbalances was the Commission's responsibility. The Commission was not prepared for the first requests for financial assistance.

IV

We found that the European Commission estimated the countries' public budgets to be stronger than they actually turned out to be. An important weakness of the Commission's assessments prior to 2009 was the lack of reporting on the build-up of contingent public-sector liabilities, which often became real liabilities during the crisis. Nor did the Commission pay sufficient attention to the link between large foreign financial flows, the health status of the banks and, ultimately, government finances.

V

Reforms to the Stability and Growth Pact in 2011, 2013 and 2014 sought to address the weaknesses of the pre-crisis period by introducing greater macroeconomic surveillance. However, back in 2008 the Commission found itself unprepared to manage the financial assistance when countries started presenting their requests.

Standing up to the challenge

Playing catch-up

VI

The Commission managed to take on its new programme management duties, which included holding talks with the national authorities, preparing programme forecasts, financing gap estimates and identifying the necessary reforms. Given the initial time constraints and limited relevant experience, this was an achievement.

VII

The Commission was mostly thorough in obtaining the information it needed. It has increasingly marshalled internal expertise and engaged with a wide range of stakeholders in the countries which appealed for help.

Complex tools

VIII

The production of macroeconomic and deficit forecasts was not a new activity. The Commission used an existing and rather cumbersome spreadsheet-based forecasting tool. Quality control was limited mainly to reconciling the various parts of the forecasts, with no enquiry by management into the reasoning behind the forecasting assumptions. It was very difficult to assess the plausibility of key assumptions such as fiscal multipliers, not only in any subsequent review but also, by management, during the actual production of forecasts.

Teething problems

IX

The assistance programmes were mostly soundly based, given the prevailing EU-level policies and the economic knowledge at that time. But a common weakness of the Commission process was the lack of documentation. It was not geared towards going back in time to evaluate the decisions taken. We could not validate some of the essential information that was forwarded to the Council, such as the initial estimates of the financing gap for some programmes.

X

This can be partly explained by the crisis context, the initial time pressure and the novelty of programme management to the Commission. The availability of records improved with time, but even for the most recent programmes some key documents were missing.

XI

The conditions in memoranda of understanding were mostly justified by specific reference to the Council decision. However, conditions were not always sufficiently focused on the general economic policy conditions set by the Council.

Different approaches

XII

We found several examples of countries not being treated in the same way in a comparable situation. The conditions for assistance were managed differently in each programme. In some programmes they were less stringent overall, which made compliance easier. When comparing countries with similar structural weaknesses, it was found that the required reforms were not always in proportion to the problems faced or that they pursued widely different paths. Some, but not all, countries' deficit targets were relaxed more than the economic situation would appear to justify.

Limited quality control

XIII

One of the reasons for these weaknesses was that the programme design and monitoring were largely in the hands of the Commission's programme teams. Before reaching the Council or the Commission, the key documents resulting from a team's work were subject to review, but this was insufficient in several respects. The underlying calculations were not reviewed by anyone outside the team, the work of the experts was not thoroughly scrutinised and the review process was not well documented.

Room for improvement

XIV

On the positive side, the programme documents, which provide the basis for the decisions that the Council or the Commission take, have improved significantly since the first request for financial assistance. This was due to the allocation of additional staff to programme management, more experience gained and better preparation. However, even the more recent programme documents lacked some essential information.

XV

For monitoring, the Commission used accrual-based deficit targets. This ensures consistency with the excessive deficit procedure, but it also means that, when a decision on programme continuation is to be taken, the Commission cannot report with certainty whether the beneficiary Member State has complied with the deficit target, as accrual-based deficits can only be observed after a certain time has elapsed. The manner of reporting on compliance with conditions was not systematic. Many different terms were used to convey non-compliance, leading to confusion. Some conditions were not reported on. A few conditions were reported to have been met when this was not in fact the case.

Programme met their objectives

XVI

The revised deficit targets were mostly met, with some exceptions. As economic activity declined in 2009, countries suffered losses in revenue, which wiped out any gains from new revenue measures. Tax-neutral or tax-offsetting reforms caused additional short-term fiscal costs and some countries took additional tax measures to offset the declining tax-to-GDP ratios. Structural deficits improved but at a varying pace. Part of the fiscal adjustment took place in a non-lasting way. Countries used one-off measures to meet the targets.

XVII

Member States complied with most conditions set out in their programmes, albeit with some delays. These were mostly incurred for reasons beyond the control of the Commission. Occasionally, however, the Commission set unrealistically tight deadlines for wide-ranging reforms. High compliance does not mean that all important conditions were complied with. In addition, we observed that Member States tended to leave compliance with the more important conditions until towards the end of the programme period.

XVIII

The programmes were successful in prompting reforms. Countries mostly continued with the reforms that were sparked by the programme conditions. Reversals of the reforms were rare at the time of our audit. They were offset by alternative reforms, which were often not equivalent in terms of potential impact.

XIX

In four of the five countries, the current account adjusted faster than expected. This is largely explained by the unexpected improvement in income balance, and to a lesser extent by the unexpected improvement in trade balance.

Our recommendations

(a) The Commission should establish an institution-wide framework allowing the rapid mobilisation of the Commission's staff and expertise if a financial assistance programme emerges. The Commission should also develop procedures in the context of the 'two-pack' regulations.

(b) The forecasting process should be subject to more systematic quality control.

(c) To ensure the factors underlying programme decisions are internally transparent, the Commission should enhance record-keeping and pay attention to it during quality reviews.

(d) The Commission should ensure that proper procedures are in place for the quality review of programme management and of the content of programme documents.

(e) For budget monitoring purposes, the Commission should include, in memoranda of understanding, variables that it can collect with short time lags.

(f) The Commission should distinguish conditions by importance and target the truly important reforms.

(g) For any future programmes, the Commission should attempt to formalise interinstitutional cooperation with other programme partners.

(h) The debt management process should be more transparent.

(i) The Commission should further analyse the key aspects of the countries' adjustment.

Introduction

The sovereign debt crisis in the EU Member States

01

The financial crisis that hit Europe in 2008 triggered the European sovereign debt crisis. The sovereign debt crisis had many causes, including weak banking supervision, poor fiscal policies and the difficulties experienced by large financial institutions (the bailout costs of which were borne by the general public). The effects of the crisis are still being felt as this report is published, and the resulting loan programmes have since run into the hundreds of billions, bringing onerous management responsibilities for all concerned.

02

The crisis affected the EU Member States in two waves. In the first instance, the contagion of the financial crisis spread through foreign credit and trade channels to a number of non-euro area Member States. The sharp increase in foreign capital outflows and decrease in exports revealed significant external imbalances for some countries, three of which (Hungary, Latvia and Romania) sought financial assistance from the EU's balance-of-payments mechanism[1], the International Monetary Fund (IMF)[2] and other sources[3].

03

The second wave of the crisis concerned euro area Member States. Although monetary union initially provided some liquidity cushioning, credit agencies started to downgrade several Member States' sovereign bond ratings in 2009. Sovereign debt market interest rates increased sharply in some countries[4] but decreased in others[5]. As a result of the decline in private funding and escalating borrowing costs, the governments of Ireland and Portugal, among others[6], applied for external financial assistance.

04

The purpose of this financial assistance was to help countries repay or finance their maturing debt and deficits. It provided a cushion to ease implementation of the adjustment programmes that were necessary in each country to correct underlying problems. In broad terms, the mechanisms addressed the need to safeguard the stability of the euro area or the EU as a whole, to limit the risk of contagion and to prevent a sudden shock to the economies of beneficiary Member States. The objectives of each programme differed in detail, but the overall aims of financial assistance were to return Member States to sound macroeconomic or financial health and restore their capacity to meet their public-sector (euro area) or balance-of-payments (non-euro area) obligations. ***Figure 1*** provides a timeline of the financial assistance provided to the five Member States covered in our audit.

1 Based on Article 143 of the Treaty on the Functioning of the European Union.

2 Poland received access to IMF resources in May 2009 through a flexible credit line, but it did not require EU support.

3 Depending on each programme, other sources of financing were to be provided by the World Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the Czech Republic, Denmark, Finland, Poland, Norway and Sweden.

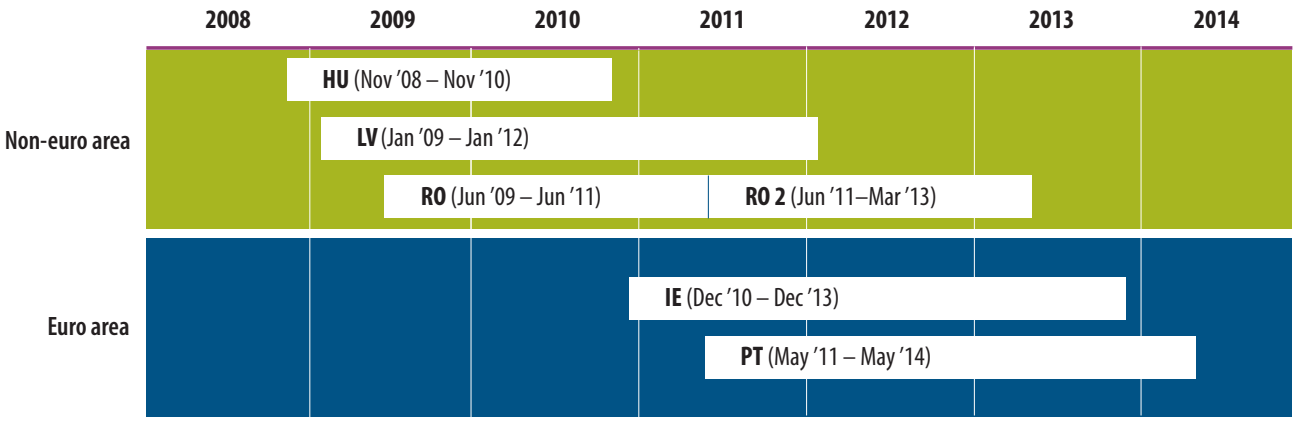
4 Ireland, Greece, Spain, Italy and Portugal.

5 Germany and France.

6 In the euro area, Greece, Spain and Cyprus also requested financial assistance.

Figure 1

Timeline of financial assistance



Note: The start date of each programme is the date on which the memorandum of understanding between the Member State and the Commission was signed.

Source: ECA.

05
As the crisis followed a different course in each country, assistance was requested for different reasons. ***Annex I*** provides an overview of those reasons.

06
A number of legal instruments were devised for providing financial assistance. Non-euro area Member States could take advantage of the existing balance-of-payments mechanism. Ireland and Portugal were helped by the newly created European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). Only the balance-of-payments mechanism and the EFSM were established as EU instruments on the basis of the Treaty on the Functioning of the European Union, as the EFSF is an intergovernmental vehicle outside the EU framework. ***Annex II*** provides an overview of the legal basis of the three instruments. The five countries also received financial assistance from the IMF.

07
Assistance to non-euro area countries was managed by the Commission and the IMF. The European Central Bank (ECB) — the third member of the troika of creditors — was involved in the management of financial assistance to Ireland and Portugal. This text refers to these institutions as 'the partners'.

Design and implementation

Programme design

08

Requests for financial assistance from the EU are initiated by Member State authorities. Requests must be submitted to the Commission and to the Economic and Financial Committee (EFC)[7] together with a draft economic adjustment programme[8]. Commission staff[9] prepare the macroeconomic forecasts underpinning each programme and conduct negotiations with the national authorities. The mandate for those negotiations is set out in advance in a policy brief[10]. The Commission will informally contact other stakeholders (the IMF, the EFC and, in the case of euro area countries, the ECB) to obtain a coordinated position on the programme conditions that will accompany the financial assistance (see paragraph 11).

09

The negotiation visit[11] to the country culminates in a set of key documents, listed below.

(a) A proposal for a Council decision on the financial assistance, setting out the general economic policy conditions attached to the assistance and the broad financial terms of the loan (financial envelope, instalment arrangements and maximum average maturity[12]).

(b) An explanatory note to the above proposal, presenting the Commission's assessment of the Member State's planned economic adjustment programme. The assessment is based on internal Commission forecasts, financial and macroeconomic models, Eurostat data and information obtained from the negotiation visit.

(c) A memorandum of understanding, which represents a more detailed commitment by the Member State and is typically signed by the Member State authorities and the Commission. The memorandum of understanding sets precise economic conditions for the disbursement of each instalment and establishes the Member State's reporting requirements.

(d) A loan agreement, containing the technical and legal details of the loan (such as the average maturity calculation, interest rates, disbursement and repayment arrangements[13]).

7 The EFC was set up to promote coordination in economic and financial policies among the Member States. The committee is composed of senior officials from national administrations and central banks, the ECB and the Commission.

8 Article 3(2) of Council Regulation (EC) No 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments (OJ L 53, 23.2.2002, p. 1) and Article 3(1) of Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European Financial Stabilisation Mechanism (OJ L 118, 12.5.2010, p. 1). The economic adjustment programme is a set of adjustment policies that the country aims to implement to correct underlying problems and re-establish its macroeconomic and financial standing.

9 The programme team, the head of the unit responsible for the programme country, the programme head and the director responsible for the programme country.

10 The policy brief analyses the financial and macroeconomic situation of the Member State and the potential impact of any proposed measures on its economy. It also sets out the framework for negotiations with the Member State. The policy brief is approved by the Commissioner responsible after having received the comments from the presidents of the EFC and Eurogroup Working Group (EWG).

11 The visits are conducted by senior staff from the Commission and the IMF, plus the ECB in the case of euro area countries. In general, these visits last between 2 and 3 weeks.

12 Each disbursement of the financial assistance can have a different maturity. The weighted average of these maturities must not exceed the maximum average maturity set in the Council decision.

10

As the IMF and the EU[14] remain responsible for their own lending decisions, two separate sets of programme documents are prepared, one by each of the two institutions. In the EU, the ultimate decision on granting financial assistance rests with the Council.

Conditions

11

Programme conditions explicitly link the approval or continuation of financing to the implementation of a range of measures, generally those which are important to programme objectives. The programme conditions may also include key data targets that will sound warning bells if policies veer off track (e.g. the inflation target)[15].

12

Conditions are either quantitative (e.g. a limit on fiscal deficit) or structural (e.g. greater enforcement of competition law). They also differ by intended function:

(a) to correct key imbalances (e.g. fiscal deficit reduction);

(b) to prevent imbalances from recurring in the future (e.g. adoption of fiscal responsibility laws); and

(c) to detect the scale of imbalances (e.g. a comprehensive assessment of public–private partnerships (PPPs)).

13

The conditions set effectively build on the Member State's economic adjustment programme and the partners' analysis. Thus, each programme will have a different set of conditions focusing on fiscal consolidation, structural reforms to promote economic growth and/or financial sector reforms or support (see ***Table 1***).

14

All the assistance programmes targeted fiscal consolidation through the adoption of fiscal policies to reduce government deficits and make debt sustainable. Apart from this primary objective, fiscal consolidation is important in the programme context because it can, inter alia:

(a) facilitate internal adjustment through various channels (such as a direct reduction in aggregate demand, or the impact of public-sector wages and employment on private-sector labour costs[16]);

(b) facilitate external adjustment by reducing an excessive current-account deficit;

(c) help tackle inflation by affecting prices through a range of channels (such as its impact on aggregate demand or on demand for money);

(d) free up resources for other sectors if the economy is financially constrained; and

(e) inspire confidence — under specific conditions — within the economy and thus have an expansionary effect[17].

13 A borrowing contract is also signed for each instalment.

14 EFSM funding to Ireland and Portugal was provided in conjunction with EFSF funding, and identical economic conditions applied to both lending sources.

15 Moon, S. and Bulíř, A., *Do IMF-supported programs help make fiscal adjustment more durable?*, IMF working paper, 2003.

16 Hernandéz de Cos, P. and Enrique Moral-Benito, *The role of public wages in fiscal consolidation process, workshop 'Government wage bill: determinants, interactions and effects' organised by Directorate-General for Economic and Financial Affairs*, 2014.

17 Daniel, J., Davis, J., Fouad, M. and Van Rijckeghem, C.,'Fiscal adjustment for stability and growth', *Pamphlet Series* No 55, 2006, International Monetary Fund, Washington, D.C.

Table 1

Focus of programme conditions

Programme	Fiscal consolidation	Structural reforms	Financial sector
Hungary	Yes	*No significant reforms*	— Strengthening of regulation and supervision
Latvia	Yes	— Business environment — Active labour market policies — Management of EU funds	— Strengthening of regulation and supervision — Bank resolution or consolidation plans
Romania I	Yes	— Business environment — Management of EU funds	— Strengthening of regulation and supervision
Romania II	Yes	— Labour market reforms — Competitiveness within the economy	*No significant reforms*
Ireland	Yes	— Labour market reforms — Competitiveness within the economy	— Deleveraging — Strengthening of regulation and supervision — Bank resolution or consolidation plans
Portugal	Yes	— Labour market reforms — Competitiveness within the economy and outside — Education — Health sector — Business environment — Judicial reforms — Housing market	— Deleveraging — Strengthening of regulation and supervision — Bank resolution or consolidation plans

Source: ECA based on relevant Council decisions and initial programme documents.

15
The role of structural conditions is mainly to implement structural reforms aimed at enhancing the long-term sustainability of macroeconomic adjustments. Financial sector conditions aim to stabilise the financial sector, which often plays a key role at the beginning of a programme, when bank restructuring typically takes place.

Implementation

16
The Commission must verify, at regular intervals, whether the economic policy of the beneficiary Member State complies with its adjustment programme and with the programme conditions. The programme conditions are monitored by the Commission[18] in coordination with the IMF. To that end, the beneficiary Member States report regularly on the progress of programme implementation[19], and the partners undertake monitoring visits. Both the Commission and the IMF prepare their own review reports after their visit.

18 In the case of the EFSM, the ECB is also involved in monitoring.

19 A memorandum of understanding generally includes an annex with the indicators and data that the country must provide on a regular basis.

17
On the basis of its review, the Commission, after consulting the EFC, decides on the release of further instalments and whether any programme conditions should be modified and/or appended to address unforeseen circumstances such as a change in the macroeconomic situation, significant data revisions or political or institutional factors in the Member State. The initial memorandum of understanding can be revised to account for these new circumstances and secure implementation of the adjustment programme.

18
If the review results in significant amendments to the conditions[20], the Council decision must be amended as well. The procedure for amending the Council decision is largely similar to the initial negotiation process (see paragraphs 8 to 10)[21].

Financial resources

Programme financing

19
The amount lent under each assistance programme covers the Member State's 'financing gap' — its financial needs until it is able to finance its government accounts (maturing debt and new deficits) or its external economic position (balance of payments) under normal conditions.

20
The external financing of euro area economies goes through the Eurosystem[22]. The financing gaps of euro area countries are therefore limited to the needs of their governments. Outside the euro area, the financing gap includes all external financing needs as presented in a country's balance of payments.

21
During programme negotiation, the partners estimate the financing gap using macroeconomic and fiscal projections and a set of assumptions, such as the rollover rates of debt[23]. The final level of programme financing is based on this estimate, but it is also subject to negotiation between the partners and the Member State. Each lender then takes a share in the programme financing[24]. The Member State's internal funding sources may also be considered.

22
For an overview of the key elements of programme financing, the relative share of each key lender and the amounts of financial assistance disbursed, see ***Figure 2***.

20 For example if deficit targets are changed.

21 The Commission carried out 36 formal reviews of the six audited programmes. In 16 cases, the review was followed by an amendment to the corresponding Council decision.

22 The Eurosystem is the central banking system of the euro area. It consists of the European Central Bank and national central banks.

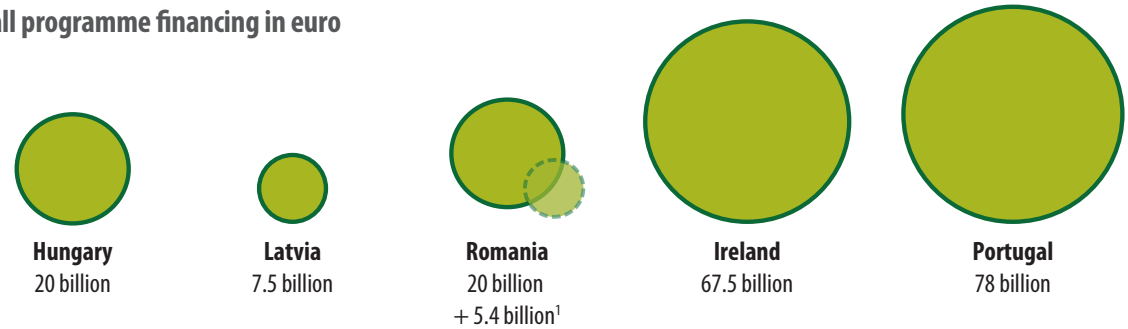
23 When a country's debt is about to mature it needs to be 'rolled over' into a new debt ,which will cover repayment of the old. Rollover brings the risk that the debt may be refinanced at a higher interest rate, thus increasing interest expenditure, or that the borrowing country will not raise enough funds to cover repayment of the old debt in full.

24 Although the legal framework allows for the provision of loans by the EU alone, in recent practice assistance has usually been granted in cooperation with the IMF and other international institutions or countries.

Figure 2

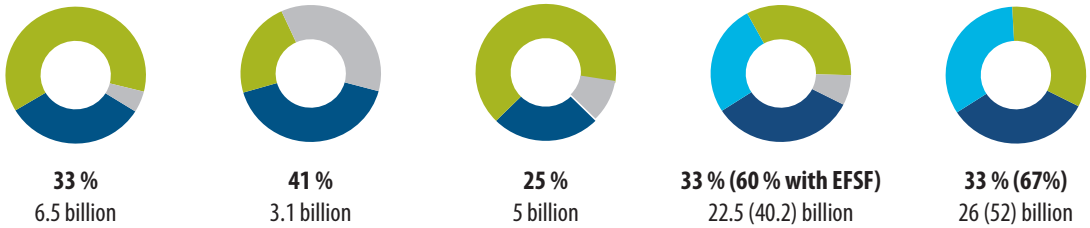
Programme financing

Overall programme financing in euro



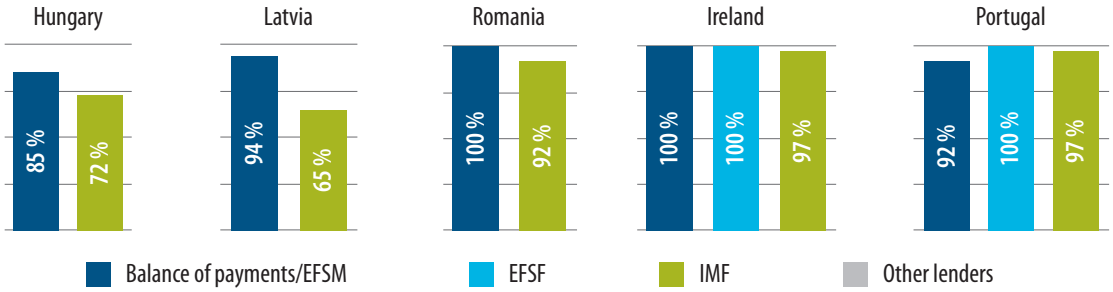
… as a percentage of each country's GDP

Financing committed by the European Union



Disbursements

as a percentage of committed financing



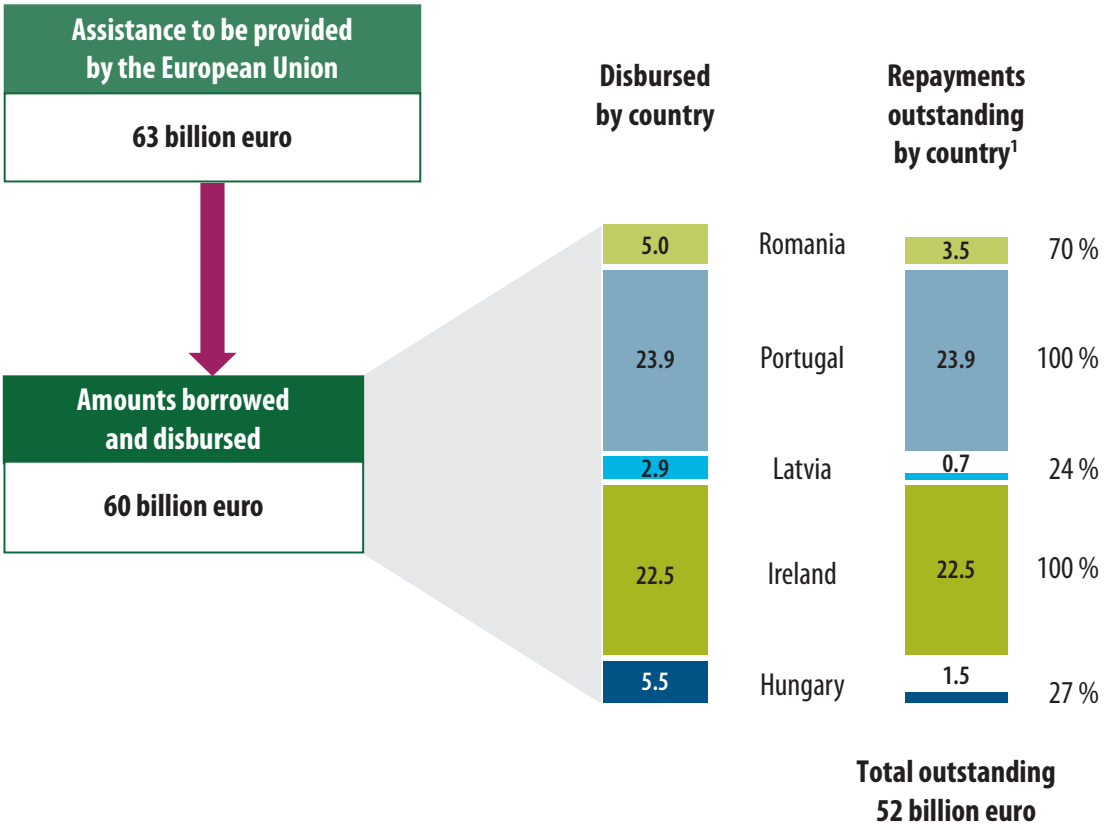
1 Precautionary assistance. Not included in the other charts.

Source: ECA, data provided by the European Commission and the IMF.

23
The five Member States used 95 % of the financing committed by the European Union, and 13 % of that amount had already been repaid by 31 March 2015 (see ***Figure 3***).

Figure 3

Financial assistance: amounts disbursed and repayments outstanding



1 Data as of 31 March 2015.

Source: ECA, data provided by the European Commission.

Borrowing on the markets

24
To provide its share of total financial assistance, the European Union borrowed on the capital markets and lent the money to the Member States in difficulty on the same terms, i.e. for the same amount and with the same coupon and maturity date. By the end of 2014, the EU had made a total of 22 bond issues with a nominal value of 60.1 billion euro. The Commission managed the borrowing on behalf of the EU.

25
Borrowing generally took the form of euro medium-term notes (EMTNs), which are issued on the capital markets and listed on the Luxembourg stock exchange. EMTNs are redeemable in full at maturity and bear fixed annual interest over the duration of their existence. European investors represent around 80 % of all investors in EMTNs.

26
The debt servicing of EMTNs remains an obligation of the European Union, which must ensure that all payments are made in a timely manner if the debtor Member State fails to reimburse the capital and/or interest due.

Audit approach

27

The audit examined whether the Commission's management of financial assistance programmes was appropriate. This was addressed by the following sub-questions.

(i) Were the growing fiscal risks detected on time?

(ii) Were processes sufficiently well designed to make a comprehensive input into programme decisions?

(iii) Did the Commission borrow at the best possible rates and in accordance with best debt issuance practices?

(iv) Did the financial assistance programmes meet their main objectives?

28

The audit covered the Commission's management of financial assistance provided under the balance-of-payments facility and the EFSM, for which the Commission borrowed on the capital markets using the EU budget as guarantee. The audit encompassed the financial assistance paid to Hungary, Latvia, Romania (the first two programmes), Ireland and Portugal, with an emphasis on the Commission's role in these programmes. We also examined the Commission's cooperation with its partners (the ECB and the IMF), but did not audit the partners.

29

We did not audit the decisions taken at the EU's political level and we limited the scope of the audit in several aspects. We did not consider the counterfactual scenario of no financial assistance or the feasibility of resolving the crises by other means (e.g. the mutualisation of sovereign debt). Nor did we assess debt sustainability or the likelihood that the loans will be repaid. We also did not evaluate if the Council had chosen the most appropriate deficit targets or structural conditions to resolve the crisis. When auditing the Commission's cooperation with other partners, we did not assess whether their involvement was justified.

30

The audit criteria were derived from the following sources:

(i) regulatory requirements (Council regulations, Council decisions, memoranda of understanding between the Commission and the Member States);

(ii) the Commission's internal rules and procedures (internal control standards and guidelines);

(iii) good management practices and evaluation criteria derived from evaluations of IMF programmes, *ex post* evaluations of the EU's balance-of-payments assistance to non-EU countries, previous Court reports on macrofinancial assistance, guidelines and other publications from independent institutes and think tanks, and academic research; and

(iv) best practices suggested in a number of guidelines on public debt management, investor relations and transparency in debt issuance.

31

Annex III provides further details of the audit methodology.

32

The audit evidence was collected on the basis of:

(i) a detailed review of documentation relating to the EU's financial assistance programmes (programme documents, internal Commission analyses, spreadsheet forecasts, evaluations and studies by other organisations);

(ii) interviews with the staff of the Commission's Directorate-General for Economic and Financial Affairs;

(iii) interviews with the staff of national authorities, such as ministries of finance, central banks, programme coordination units and sector ministries;

(iv) a scorecard analysis of programme conditions[25] to classify them by characteristics and compliance; and

(v) interviews with the staff of the IMF and the ECB.

25 The sample included 360 unique conditions.

Part I
The Commission was unprepared for the magnitude of the crisis that broke out

The Commission underestimated the extent of the fiscal imbalances in the run-up to the crisis

33
Warning the Council about mounting fiscal imbalances in the Member States is arguably one of the Commission's most important activities in the area of economic and financial affairs. Prior to the crisis, there was already a surveillance framework geared towards monitoring the fiscal situation in the Member States[26].

34
Although the financial assistance programmes' macroeconomic objectives went beyond fiscal adjustment, in all five programmes budget support[27] turned out to be a key part of how assistance was used. This raises a question as to whether the mounting fiscal risks were detected on time and flagged under the surveillance procedures.

The Commission estimated the public budgets to be stronger than they actually were

35
There are two key types of fiscal indicator. The first is the actual fiscal balance, or the difference between government revenue and expenditure. However, this balance is sensitive to temporary factors, such as economic growth, asset prices and one-off fiscal measures. The second is other fiscal indicators (e.g. cyclically adjusted balance, structural balance) which aim to correct these temporary factors and thus provide a more accurate view of a country's underlying fiscal position. These indicators cannot be directly observed but are the result of complex calculations.

36
During the pre-crisis period, actual fiscal balances were generally correctly estimated no later than at the end of the year in question. Nevertheless, the emergence of high budget deficits for 2008 in Ireland, Latvia, Portugal and Romania was poorly predicted in the Commission's deficit forecasts. For example, speaking of Ireland in March 2008, the Commission stated that 'the risks attached to the budgetary projections are broadly neutral for 2008'[28]. Yet at the end of 2008 the actual fiscal balance was 7.2 percentage points of GDP lower than forecast.

37
In its cyclically adjusted balance calculations during 2005-2008, the Commission systematically overestimated the strength of countries' public finances[29]. This error was mainly caused by changes in estimated potential GDP growth rates. All five countries were experiencing an economic boom, but the Commission initially estimated the scale of overheating to be more modest than, with hindsight, we know it to have been.

26 This was the 'preventive arm' of the Stability and Growth Pact established by Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 209, 2.8.1997, p. 1). The surveillance framework was last reformed in 2005 by Council Regulation (EC) No 1055/2005 amending Regulation (EC) No 1466/97 (OJ L 174, 7.7.2005, p. 1).

27 The financing of running fiscal deficits and the repayment of government debt.

28 European Commission, *Ireland — Macro fiscal assessment — an analysis of the December 2007 update of the stability programme*, p. 36.

29 Compare the first estimate made after the year's end (i.e. in spring forecast) with a recent estimate (i.e. October 2013).

Part I — The Commission was unprepared for the magnitude of the crisis that broke out

38
The estimate of the scale of overheating (the size of a positive output gap[30]) was in line with the strong increase in the indicators of the overall production capacity of the economy. However, this increase was generated by the housing booms, and investments in housing do not have the same effect on increasing the economy's potential as other more productive investments.

39
The Commission had focused on assessing the output gap in the real economy, without considering sector imbalances such as in the financial or construction sectors. However, it became clear during the crisis that inflation and output monitoring are not enough to guarantee macroeconomic stability and sustainable fiscal balances. The surveillance framework has since been significantly overhauled to take greater account of financial-sector and macroeconomic risks.

40
The Commission identified some sector booms after the event; for instance, a construction boom was noted in Ireland, Latvia and Romania and private credit booms in all five countries. However, the algorithm used to calculate the output gap did not make any allowance for such imbalances.

Assessments underestimated the potential fiscal risks

41
The Stability and Growth Pact requires Member States to report recent fiscal developments and forecasts in their stability and convergence programmes. These programmes are assessed by the Commission, which checks the plausibility of the trajectories forecast for GDP and the public budget.

42
One important drawback of the Commission's assessments prior to 2009 was the lack of reporting on the build-up of contingent public-sector liabilities[31]. Fiscal risks related to financial stability, state-owned enterprises or other public guarantees (e.g. PPPs) were not identified.

43
The Commission's surveillance did not adequately assess the implications of the large foreign financial inflows, especially in the form of debt, which were fuelling construction and demand booms and had the potential to disrupt the banking sector in a subsequent bust phase. The Commission did not note this link prior to its analysis of Member State requests for financial assistance.

30 A positive output gap is the amount by which the actual output of an economy exceeds its potential output.

31 For example, the long-term liabilities from public pensions or significant future fiscal expenditure resulting from the need to take measures in the event of a bailout. With the exception of the public pension liabilities, the Commission did not report on other contingent liabilities.

Part I — The Commission was unprepared for the magnitude of the crisis that broke out

44

Neither did the Commission's assessments examine the sensitivity of budget balances to a sudden hike in the interest rates applied to government debt, or to equally sudden shocks to economic growth or exchange rates. Yet these risks too had been recognised or warned against in various research papers published prior to the crisis[32].

As a result the Commission was not ready for the programme management

45

Prior to 2008, the balance-of-payments facility had last been used in 1993[33]. By 2008 any experience acquired in the first half of 1990s was lost. So, providing countries with financial assistance was in effect a new activity for the Commission.

46

Having underestimated the fiscal imbalances and their implications for the Member States, the Commission was unprepared for the task of programme management. The initial programmes in particular had to be set up under extreme time pressure. For instance, the proposal for the first programme (Hungary) had to be produced in just a few days. The Commission possessed very little in-house experience of designing and managing financial assistance programmes, and that experience could not be acquired at such short notice.

47

During the initial phase, IMF teams helped the Commission to prepare parts of the programme analysis. The practices used by the Commission were also developed on the basis of IMF practices (see paragraph 109).

32 See, for instance, 'Fiscal policies and financial markets' in ECB Monthly Bulletin 02/2006, p. 71.

33 Council Decision 93/67/EEC of 18 January 1993 concerning a Community loan in favour of the Italian Republic (OJ L 22, 30.1.1993, p. 121).

Part II
Processes were generally weak

48
The regulations entrust the European Commission with the operational management of financial assistance. A large part of this is about arriving at key programme decisions concerning the initial granting of assistance and (at each review) the continuation of the programme. Decision-making requires a sequence of steps and coordination with the Council and the other partners (see ***Figure 4***).

49
We divided the analysis of programme management processes into the following three parts.

(i) Processes within the Commission, in particular within the Directorate-General for Economic and Financial Affairs. Did the Commission keep control of the programme's development?

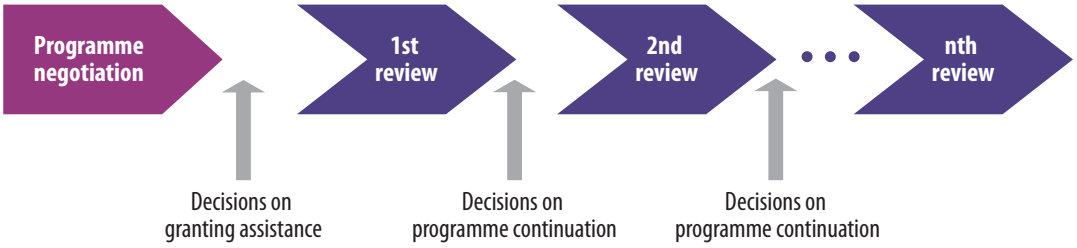
(ii) Process of providing information to the Council and the Commissioner in charge. Did the Council and the Commissioner in charge receive programme documents of good quality?

(iii) The process of interaction with other partners. Did the interaction with other partners work?

Figure 4

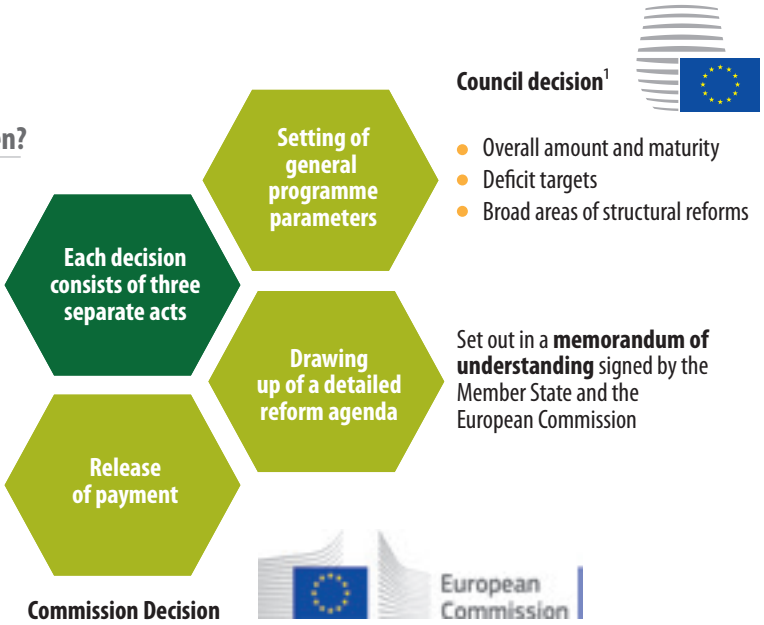
Programme decisions

A Programme timeline



B What decisions are taken?

Not all decisions are needed at each review. For instance if no changes are necessary to the general parameters of assistance, the Council decision does not have to be amended.

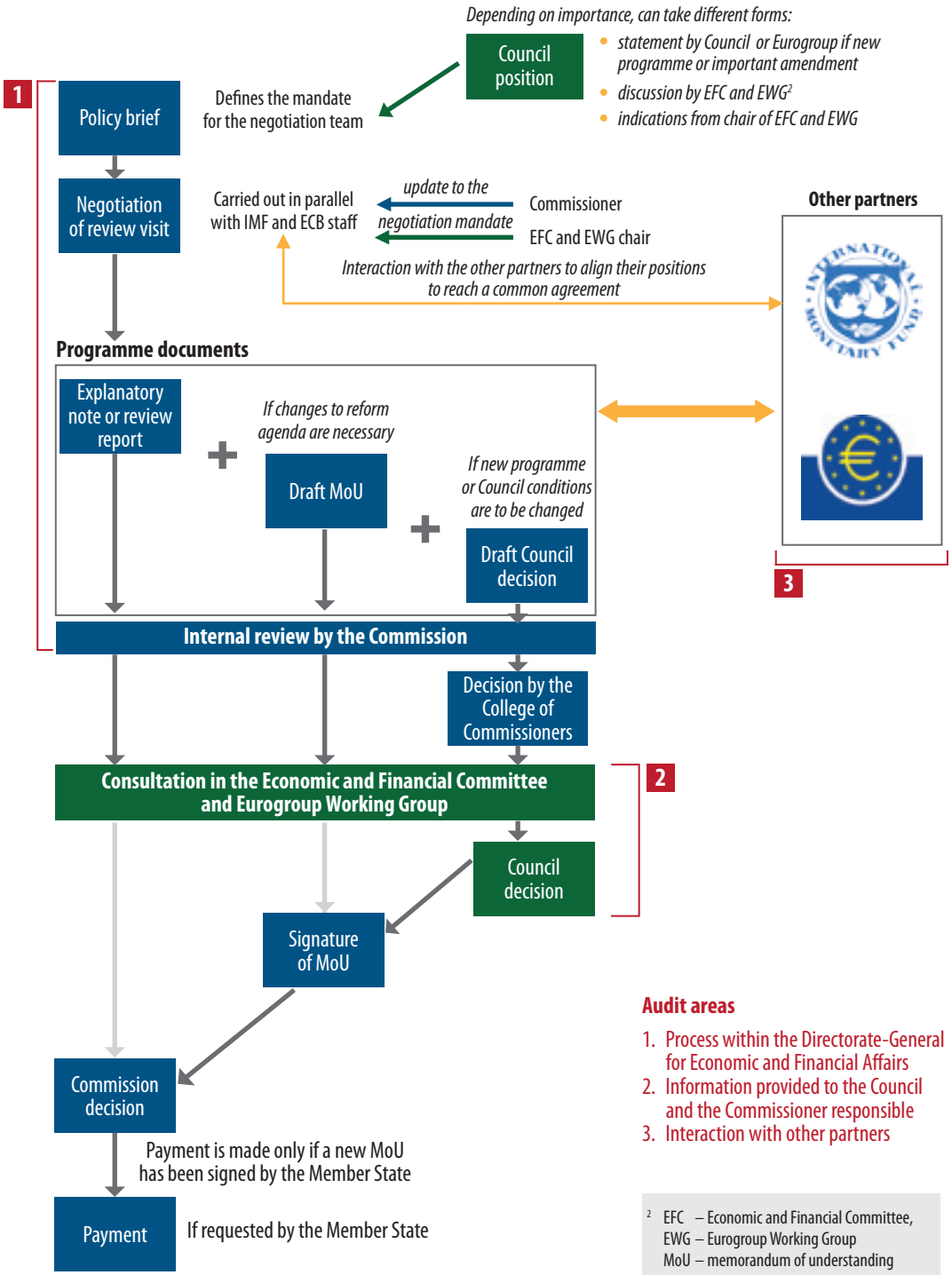


Typically taken by the Vice President on the Commission's behalf

1 In case of the Irish and Portuguese programmes, the general programme parameters were set both by the Council and the EFSF board of directors, i.e. the Eurogroup.
The EFSF decision-making process is separate from the EU decision-making procedure.

Figure 4

C Sequence of steps



[2] EFC – Economic and Financial Committee, EWG – Eurogroup Working Group MoU – memorandum of understanding

Source: ECA.

The Commission's processes did not always incorporate sufficient checks and balances

50

The Commission's processes should ensure — through sufficient checks and balances — that the initial programme design and any updates meet the following criteria:

(i) comprehensiveness — relevant information, both in relation to the Member State and from economic research, should be taken on board;

(ii) consistency — different elements of the programme should be mutually consistent, with a minimum of conflict between the different programme objectives;

(iii) documentation — due record should be kept of the reasoning behind the decisions made on various elements of the programme[34];

(iv) conformity — the memoranda of understanding should be in line with the Council decisions;

(v) even-handedness — as programme conditions are mostly drawn up by Commission's 'programme teams', countries should be treated consistently by the different teams, applying similar conditions in similar circumstances[35].

51

The work of programme teams should be checked and challenged to ensure that teams respect these criteria.

The Commission was mostly thorough in obtaining the necessary information for monitoring purposes

The Commission extensively relied on internal expertise as well as liaising with a number of actors in Member States

52

The Commission relied on the internal expertise available in the Directorate-General for Economic and Financial Affairs. Over time, it also increasingly consulted specialists from other directorates-general. These other experts provided limited input for the initial programmes, mainly through inter-departmental ('inter-service') consultation. They were more extensively involved in the two euro area programmes. The use of wider expertise allowed for a more thorough analysis of countries' problems, especially in the area of structural reforms. The Commission's human resources policy also did not allow greater use of external expertise for specific narrowly defined areas, a practice common in the IMF.

34 Commission internal control standards Nos 8 and 11.

35 Several studies confirm that this risk is real. For instance, an overview of relevant academic research can be found in Hakan Gunaydin, *Compliance with the IMF conditionality: Selection bias and conditions on social policy — Prepared for the PEIO Annual Meeting, 2014*. The Independent Evaluation Office of the IMF also provided an account of lack of even-handedness that it noted in its evaluations. For more details, see IEO, *Recurring issues from a decade of evaluation lessons for the IMF*, 2014.

53
The regular country visits made by the Commission and the other partners provided the main opportunity for obtaining the necessary information for monitoring. During its negotiation and review visits, the Commission consulted a number of ministries, other government departments and key independent institutions (such as central banks, fiscal councils and supreme audit institutions). It also held meetings with other bodies, including employers' associations, trade unions and opposition political parties. In three of the five countries[36] the Commission maintained a resident representative. All of this enabled the Commission to stay informed and to identify reforms for inclusion in the programme.

The Commission collected a wide range of information

54
In addition to the information gathered from country visits, each memorandum of understanding specified monitoring reports that the country in question was required to provide to the Commission. The information to be collected in these reports was very broad and touched on many areas. The Commission requested similar monitoring information in all programmes. However, in a few cases key information was not requested or only a limited amount of key information was collected.

Programme forecasts provide for broad checks of consistency in programme design, but with many caveats which are not verified

55
Good forecasting is essential for programme consistency. However, forecasts are unlikely to be 100 % accurate all the time, as they involve many imponderables which cannot be predicted with any precision. Instead of focusing on the accuracy of forecasts, we assessed the quality of the forecasting processes and tools applied by the Commission in the programme context. In practice, the Commission prepares two distinct but closely related forecasts (see ***Figure 5***):

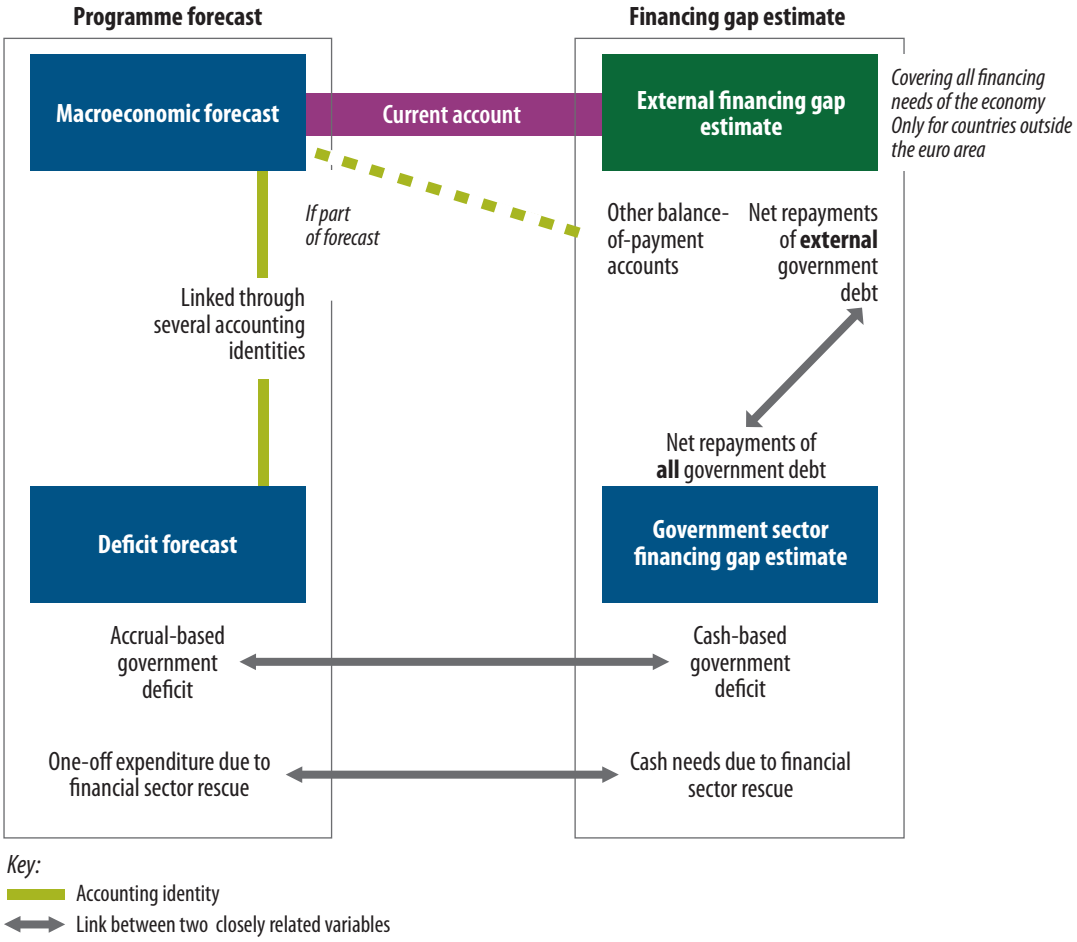
(i) a programme forecast (comprising macroeconomic and deficit forecasts); and

(ii) a financing gap estimate.

36 Latvia, Ireland and Portugal.

Figure 5

Links between the programme forecast and financing gap estimate



Note: Only the key links are depicted.

Source: ECA.

It is difficult to assess the production of programme forecasts

56

Forecasts can be produced using a variety of methods, ranging from pure judgement to large-scale calibrated or econometric estimation models comprising numerous behavioural equations and identities.

57

The Commission's tool for producing programme and deficit forecasts consists of a set of mainly accounting identities, the purpose of which is to ensure that forecasts of macroeconomic or budget aggregates are consistent with the forecasts of their components. The components are generated outside the forecasting tool using judgement or, at times, a mix of other quantitative tools. The Commission does not use a theoretical or empirical forecasting model.

Forecasting spreadsheets are a cumbersome tool which makes quality control problematic

58

The forecasts resulting from each review were typically prepared in multiple spreadsheet files. During the audit, difficulties were met in accessing all the relevant files. This was because the set of spreadsheets constitutes an overwhelmingly large and cumbersome body of data[37] which lacks transparency and traceability. Furthermore, as decisions were made under extreme pressure, storing all forecast material in a systematic and easily accessible form was not a priority.

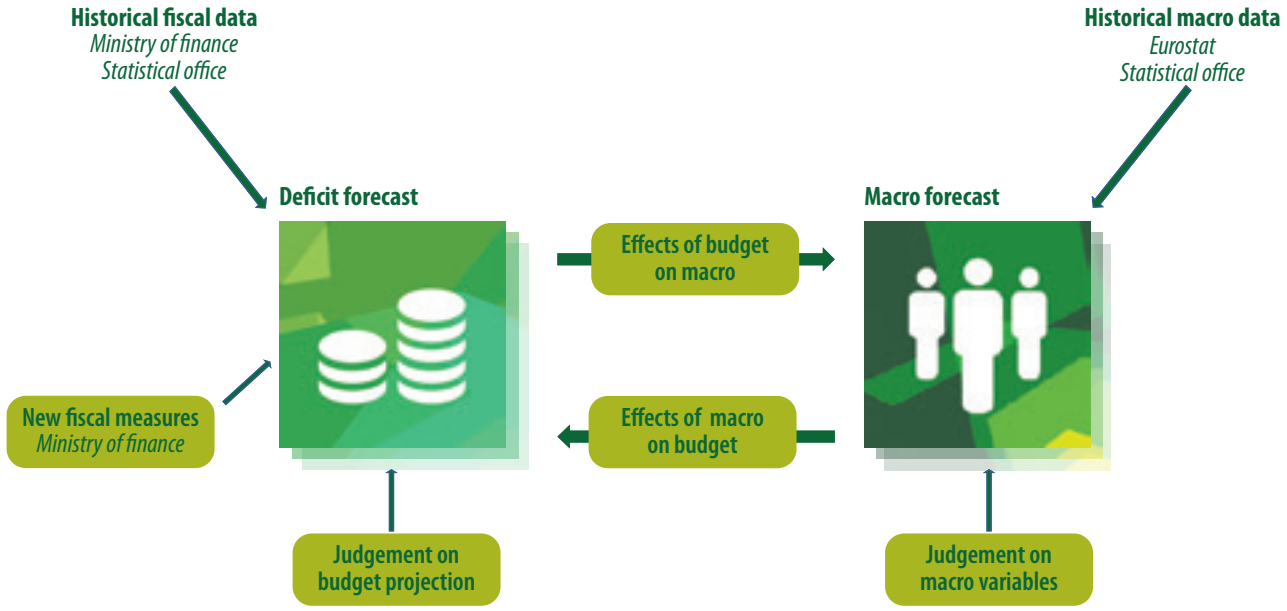
59

The spreadsheet files aggregated information generated outside the tool. Data typically came from several sources, and forecasts depended on judgements made by the various forecasters, both at the Commission and at the other partners and national authorities (see ***Figure 6***). Data heterogeneity and the use of a range of judgements are normal features of macroeconomic forecasting, and there are good reasons for considering diverse data and judgements in the forecasting process. However, there are some risks, including that the implications of any new assumption will not be properly reflected throughout all forecasts, or that new assumptions will not be well founded.

37 A forecast is prepared in two to four key files, which contain tens of spreadsheets. These key forecast files are interlinked with multiple formulas and draw data and projections from other files, which were not always saved in the same location. This greatly increases the risk that inconsistent projections or data are used when a forecast is updated, which in a programme context can happen on a daily basis. Assumptions are scattered throughout the spreadsheets in the key forecasting files and it takes considerable effort to obtain a clear picture of the judgement applied. Moreover, the staff use subsidiary models, which are stored outside the spreadsheets.

Figure 6

Macroeconomic and deficit forecasts at a glance



Source: ECA.

60

To manage these risks, quality control of the forecasting results was done at several stages during the forecasting process. Some consistency checks[38] are built into the spreadsheet. The forecasters responsible for, respectively, the fiscal and the macroeconomic sides of the forecast discussed their results among themselves and, when required, applied additional judgement in order to ensure consistency of the estimates[39].

61

Essentially, however, quality control of the forecasters' work took the form of reconciliations, with no inquiry into the forecasting process within the programme team. The spreadsheet approach and the scarcity of documentation made it hard to assess the plausibility of the assumptions and implicit parameters used in the forecasting. Discussion between partners was the only control stage at which the plausibility of the assumptions and implicit parameters was checked.

38 For instance, accounting identity or ratio-based plausibility checks.

39 In autumn 2013 the Commission introduced a new tool for the automatic detection of numerical and economic inconsistencies, but the tool was not used for the programme forecasts.

62
Analysis of the forecasting sheets also revealed examples of errors and inconsistencies that were present despite the consistency checks (see ***Box 1***).

Box 1

Examples of errors and inconsistencies in forecasts

(i) The amount of VAT levied on private consumption was not aligned between government revenue and private-sector payments, leading to a difference of 0.7 % in GDP in 1 year.

(ii) Owing to manual formula adjustments, the amount of direct taxes levied on labour was not aligned between the government and household sectors. The difference exceeded 0.5 % of GDP.

(iii) A tax measure applicable from the middle of the year was applied to the forecast on a full-year basis. The corresponding deficit projection was used in the programme document supporting the decision to release an instalment and communicated to the EFC in June 2009.

(iv) The impact of property prices was not factored consistently into projections of the same price index used in different forecasts for the same year.

Difficulties in assessing the plausibility of fiscal multipliers

63
Fiscal variables were recorded in the spreadsheets in the form of the expected volume of revenue or spending, which was increased or decreased by the net budgetary yield of any new fiscal measures during the year. The impact of new measures on the economy and the knock-on effect on the public budget were not explicitly stated or recorded in the spreadsheets. Instead, the forecast values of additional budgetary yield already took account of the knock-on effect.

64
The forecasts of net budgetary yield were taken from forecasts generated by the national authorities, which estimated them internally as part of their planning procedures. The national authorities discussed their estimates with the partners' staff, whereupon they might be revised before being formally accepted and included in the programme forecasts.

65
The impact of different fiscal measures on the real economy was accounted for implicitly and outside the spreadsheets by way of several heterogeneous procedures. The spreadsheets used did not allow the source of particular assumptions, or the reasons for them, to be traced. The country desks themselves had no real knowledge of the models applied by national authorities to estimate the parameters for assessing the impact of different fiscal measures on the economy. There was a lack of transparency and knowledge about the implicit value of the fiscal multipliers[40]. Only in 2013 did the Commission carry out an exercise to estimate the implicit multipliers.

66
The only checks made of net yields took the form of a judgemental plausibility assessment by the partners' staff. While this approach is highly likely to detect any substantial over- or underestimates, it is less amenable to identifying relatively small errors which may cumulatively still be of significant magnitude.

67
The programme teams kept records of some information, but to varying degrees because there was no formal requirement to do so. As a result, we were unable to identify and review the assumptions and parameter values that were used. If a forecast proved to be wrong, (for instance if it underestimated the negative effect on GDP growth of a reduction in public expenditure), it was impossible or extremely difficult to identify the source of the error.

Financing gap estimates were incomplete and inaccurate

68
The financing gap estimate is of paramount importance at the negotiation stage, because this is when the amount of financial assistance is set, typically to remain unchanged. If new funding needs emerge during the programme, they have to be accommodated within the overall financial envelope. Unlike the preparation of programme forecasts, estimating the financing gap was a new activity for the Commission.

69
For the euro area countries, the financing gap corresponds only to the needs of their governments. Outside the euro area, the financial assistance must cover all external financing needs as presented in a country's balance of payments. The Commission always justified its decisions to provide assistance by submitting the initial financing gap estimate to the Council. The underlying calculations were prepared in spreadsheets. However, the shortage of documentation greatly limited the possibility of review. When requested, the Commission was only able to provide provisional documents[41], which differed from the final versions submitted to the Council, could provide no information on important elements of the estimate[42] or could not provide any background files[43].

40 The fiscal multiplier measures the magnitude of impact of different fiscal consolidation measures on key macroeconomic (consumption, output) and fiscal (deficit) variables.

41 Latvian and Romanian programmes.

42 Irish programme.

43 Hungarian and Portuguese programmes.

70
Our review of the provisional documents revealed significant forecasting errors, such as double counting of some variables, use of incorrect amounts in foreign reserves or unrealistically high assumptions of debt rollover rates. The errors in the spreadsheets were sometimes substantial[44] and had not been detected by internal review. Discovery of the errors would not necessarily have led to an increase in the amount of financial assistance, as this also depends on the lender's willingness and ability to lend, but it could have resulted in a different set of policies to close the financing gap.

Programme features were generally soundly based, but important records were sometimes missing

Programme features were supported by analysis

71
In most cases, the Commission could point to a body of analysis, based on EU policy priorities and current data, that was used when setting programme conditions. In general, the depth of analysis had increased over time. This was mostly on account of improved expertise and a greater number of Commission staff assigned to programme management.

No trace of some key records

72
Record-keeping is an important part of any process. Several of the Commission's internal control standards refer to good practices in this regard[45]. Careful record-keeping can improve an organisation's internal control by helping to show why certain decisions were made. Records are central to monitoring and evaluation and a prerequisite for good accountability.

73
Because the assistance programmes were unexpected, procedures were still being fine-tuned and formalised after initial operations had begun. Operations were also complicated by time constraints, an uncertain macroeconomic environment and the complexity of programme management. Emphasis was therefore placed on sound operational procedures at the cost of good record-keeping.

74
In a number of instances, the information used to support decision-making had been lost by the time of the audit, or collecting it proved to be a mammoth task. Certain critical activities were not documented at all. Manuals of procedures, which typically anchor any process, were not well developed. ***Box 2*** illustrates the obstacles encountered during the audit[46].

44 In assessing the Romanian financing gap, the intra-group loans of corporates were counted under both foreign direct investments and new debt flows under other investments. This double counting led to a financing needs projection that was 1.8 billion euro too low. Furthermore, the initial amount of foreign reserves used in the initial projection differs by 0.7 billion euro from the figure reported now for the end of 2008 by the Romania's central bank. In the Latvian programme, the Commission projected that in the first year of the programme both the corporate and banking sectors would be able to obtain more long and medium-term financing than they needed to amortise. Such an assumption in the spreadsheet was not only unlikely given the severe financial pressures, but was also in contradiction to the information provided in the explanatory note.

45 For instance, internal control standard No 8 requires that 'the DG's main processes and procedures are adequately documented, particularly those associated with critical risks', and standard No 11 that 'appropriate processes and procedures are in place to ensure that the DG's document management is […] efficient (in particular as regards retrieving appropriate information)'.

46 The problem of obtaining the relevant information was not unique to this audit. The Portuguese Court of Auditors noted similar constraints in its report on the monitoring of the financial assistance to Portugal, *Relatório de auditoria n.º 28/2013-2.ª S., Acompanhamento dos mecanismos de assistência financeira a Portugal, Dezembro de 2013*.

Box 2

Examples of difficulties in obtaining key information

Emails were used to report upwards on the progress of a visit and to seek approval for any departure from the negotiation mandate. They were also an important means of communication among the partners and with national authorities. Generally, however, these key records were not available because emails had either been lost or could not be retrieved.

Documentation or data submitted by national authorities during the programme was not kept by the Commission or could not be consulted in its entirety because of the extensive resources required to reassemble it.

Some spreadsheets for Romania with macroeconomic programme projections were not made available to us during the audit.

The spreadsheets with final financing gap calculations had been lost or had not been collected from the IMF. The calculations underlying some key amounts were sometimes unobtainable.

Fiscal monitoring by Commission staff was not documented at all, or only very basic spreadsheets were provided in support of the Commission's analysis of budget implementation.

75

It is understandable that records should be lacking for the initial phase in 2008 and early 2009, which bore all the hallmarks of a crisis management situation. Over time, record-keeping clearly improved. Even so, some of the above examples of missing records relate to more recent years.

The Commission occasionally departed from Council decisions

Cases of non-compliance with the Council decisions

76

We examined the consistency between the memoranda of understanding and the corresponding Council decisions and found that most conditions were justified by reference to the decisions. However, in a few instances the conditions departed from the terms of the Council decision, or the memorandum of understanding had not been updated at the correct time (see ***Box 3***).

Box 3

Examples of non-compliance with the rules

An informal visit to Romania in August 2009 revealed the Member State's inability to meet the initial deficit targets. The Commission and the Romanian authorities consequently agreed to a substantial relaxation of the targets. This revision was communicated in a note to the EFC in August 2009. However, neither the Council decision nor the memorandum of understanding was modified accordingly. The targets were eventually updated in the memorandum of understanding in February 2010. The legal basis — the Council decision — was updated even later, in March 2010. However, the Commission postponed a release of a payment in November 2009 on account of the fact that Romania's budget did not comply with the updated target.

In Latvia, although the Council decisions did not refer to pension reforms, the memorandum of understanding included specific conditions in relation to the second pillar of the pension system.

In Ireland, although the Council decisions mentioned no specific conditions with regard to banking surveillance and sales of state assets and privatisation, these conditions appeared in the memorandum of understanding.

Conditions were not sufficiently focused

77
The purpose of the conditions in the memorandum of understanding is to establish an operational road map with a view to achieving satisfactory compliance with the general economic policy conditions set by the Council.

78
For most conditions, the link with general economic policy was relatively clear because they either required policy change or were a stepping stone to major reforms. However, the management[47] did not sufficiently challenge the proposals made to ascertain whether all the conditions were really necessary for the achievement of general economic policy goals.

79
Programmes included conditions which were either of minor importance, given the programme goals, or whose potential effects would be realised long after the programme period — conditions such as the implementation of specific IT systems, the allocation of budgetary funds to a small government entity, the training of public officials and research and development. However, here they had very remote links — if any — to the programme goals.

47 Senior management in the Commission and the vice-president signing the memorandum of understanding on behalf of the Commission.

Countries were not treated in the same way

80

Having analysed various aspects of the Commission's programme management, we found several examples of an inconsistent approach to different countries where it was difficult to justify this by specific national circumstances.

Differences in the Commission's management of conditions

81

The Commission managed the conditions for each financial assistance programme differently. In some programmes the conditions represented a relatively stable set of requirements, while in others they changed substantially with every review. For an overview see ***Table 2***.

Table 2

Various models employed by the Commission for managing conditions

	Hungary	Latvia	Romania I	Ireland	Portugal
How were conditions set?					
Distinction between different types of condition	None	None, but importance indicated in one of the review reports	Prior actions and other conditions	Permanent and other conditions	None
How were conditions monitored?					
How was compliance monitored?	Mixed[1]	Mostly by condition	By subject matter	By subject matter	By condition
How were conditions updated?					
How were conditions changed?	Existing conditions remained valid; addenda contained new conditions only	Each addendum replaced the previous version	Existing conditions remained valid; addenda contained new conditions only	Each addendum replaced the previous version	Each addendum replaced the previous version
Persistence of conditions[2]	Conditions partially stable over time Conditions generally unchanged	Frequent changes to conditions Conditions were changed even if not matured Difficult to trace conditions over time	Conditions always valid and unchanged unless made obsolete by new conditions	Mixed Some conditions stable, others subject to frequent change	Conditions stable over time Conditions valid and unchanged until fully complied with

1 In some reviews the Commission reported compliance for each condition, in others by subject matter only.

2 For additional explanation see ***Annex III***.

Source: ECA.

82

Some of these models had adverse implications for programme management. In particular, frequent changes to conditions in some programmes[48] made it much harder to track the country's performance. In some instances, reforms were gradually diluted as conditions were replaced by less demanding ones or completely disappeared from the memoranda before they were fully satisfied (see ***Box 4***).

83

Conditions also sought to bring about different structural effects. They might vary from the publication, or preparation, of a specific strategy or plan, to legislative changes to be adopted by the national parliament and affecting important parts of the economy[49]. While conditions of the first type would not bring about any meaningful economic changes by themselves, although they could serve as preparatory steps for more significant reforms. Condition of the latter type would probably mean long-lasting changes to the economy.

48 In particular Latvia, but also Ireland and specific areas in other programmes.

49 Other examples include significant changes to the institutional landscape, such as the establishment of a fiscal council, local government reorganisation or privatisation. See ***Annex III***.

Box 4

Examples of a reform diluted over time

The initial memorandum of understanding in the Latvian programme required the 'establishment of a single human resource planning and management system for public administration institutions.' This condition was not complied with and did not appear in the subsequent amendments. Instead, it was replaced by several other conditions, the general aim being 'the preparation of strategy on public administration' — a condition that is easier to comply with.

The Portuguese programme included a condition requiring — by the end of 2011 — the preparation of an action plan to reform the unemployment insurance system, notably by reducing the maximum duration of unemployment insurance benefits to no more than 18 months for newly unemployed persons. After the reform the maximum duration of unemployment benefits was reduced from 38 to 26 months and so exceeded the ceiling of 18 months that was initially agreed with the Portuguese authorities.

84
We found significant differences between conditions in terms of stringency. Balance-of-payment programme conditions typically required the enactment of certain legislative changes. In contrast, the euro area programmes often set only the first type of condition, and adoption by parliament was seldom required. As a result, decisions on instalments were based only on preparatory steps and not on the actual implementation of reform (see ***Box 5***).

85
Another difference lay in the number of conditions, which grew over time. Whereas Hungary was required to comply with fewer than 60 unique conditions, Portugal was faced with around 400. This large variation did not only reflect a need for more reforms in certain countries. We found instances where the opposite happened: countries that needed more reforms in a given field were asked to comply with fewer conditions than better-performing countries[0]. The conditions also targeted widely different reform paths despite countries being in similar circumstances[51].

Programme targets were not revised in a consistent manner

86
Revisions of deficit targets are a natural occurrence in assistance programmes. They do not automatically signal poor implementation on the part of the national authorities, as they may also be motivated by objective changes in the economic situation with an impact, negative or positive, on the public budget.

50 For example in the field of structural funds.

51 For example in the field of personal and corporate insolvency.

Box 5

Example of a condition linked to preparatory steps only

In the Irish programme, the government was required 'to introduce legislation for the enhancement of financial regulation, expanding the supervisory and enforcement powers of the Central Bank[52]'. The Irish authorities complied with this condition with a minor delay of 1 month when the Ministry of Finance published the draft law. However, the enactment took an additional 2 years. There was no condition linked to the enactment and thus the enactment was not necessary for the release of instalments.

52 Referred to as 'The Central Bank (Supervision and Enforcement) Bill' in later conditions.

87

Four of the six programmes had their deficit targets revised (see ***Table 3***). The Commission's records always explained downward revisions by a (significant) drop in economic activity, as was the case in Hungary, Romania, Latvia and Portugal.

88

Depending on the country, a change in economic outlook can have different consequences for the revision of deficit targets. As part of its fiscal surveillance, the Commission calculates cyclical budget balances[53]. When the economic outlook changes, the cyclical balance estimate is revised accordingly. Hence, real-time changes in the cyclical balance estimate should approximate to the changes in deficit targets made necessary by the changed economic context[54].

53 The budget balance can be broken down into a cyclical and a non-cyclical component. The cyclical component captures the effect of fluctuations in tax revenue and spending due to the economic cycle.

54 Assuming no significant errors in the forecasts of potential GDP, which is used as an input variable for calculating the cyclical balance.

Table 3

Revisions of the deficit targets in ESA terms

		2008	2009	2010	2011	2012	2013	2014
Hungary	MoU0 (Nov. 2008)	– 3.4 %	– 2.6 %					
	MoU1 (Mar. 2009)		– 2.9 %					
	MoU2 (Jun. 2009)		– 3.9 %	– 3.8 %	– 3.0 %			
Latvia	MoU0 (Jan. 2009)		– 5.3 %	– 5.0 %	– 3.0 %			
	MoU1 (Jul. 2009)		– 10.0 %	– 8.5 %	– 6.0 %	– 3.0 %		
	MoU5 (Dec. 2011)				– 4.5 %	– 2.5 %		
Romania I	MoU0 (Jun. 2009)		– 5.1 %	– 4.1 %	– 3.0 %			
	MoU1 (Feb. 2010)		– 7.8 %	– 6.4 %	N/A	– 3.0 %		
	MoU2 (Jul. 2010)			– 7.3 %	N/A	– 3.0 %		
	MoU3 (Jan. 2011)				– 5.0 %	– 3.0 %		
Romania II	MoU0 (Jun. 2011)				– 5.0 %	– 3.0 %		
Ireland	MoU0 (Dec. 2010)				– 10.6 %	– 8.6 %	– 7.5 %	
Portugal	MoU0 (May 2011)				– 5.9 %	– 4.5 %	– 3.0 %	
	MoU5 (Oct. 2012)					– 5.0 %	– 4.5 %	– 2.5 %
	MoU7 (Jun. 2013)						– 5.5 %	– 4.0 %

Note: N/A — not set.

Source: European Commission.

89
Where the cyclical budget balance was not significantly revised during the programme, there was no need to revise the deficit targets. This was the case for Ireland. However, we found that not all revisions of targets were consistent with a revision of the cyclical balance. For instance, while the 2009 deficit target for Hungary was relaxed less than suggested by the revision to the cyclical balance, the 2012 target for Portugal was relaxed even though the cyclical balance had improved and the economic outlook remained the same.

90
During the audit the Commission claimed that factors outside the government's control could have triggered a target revision, such as changed composition of growth or revenue shortfalls. However, neither the programme documents nor the Commission's internal methodology show a systematic approach to the assessment of these other factors when the Commission examined the feasibility of deficit targets at each review.

91
Another difference lay in the treatment of bank support measures with an impact on deficits. The deficit targets in the Portuguese and Irish programmes were defined as net of such measures, whereas they were included in the Latvian programme targets.

92
Programme documents also differed in the attention to the social dimension. For instance, in the Portuguese programme, 'tax increases (were) designed in a progressive way, with lowest-income groups retaining their levels of income […] minimum wages and lowest pensions remain untouched'[55]. This contrasts with the universal 25 % cut in civil servants' salaries in the Romanian programme, with no reference given in programme documents as to how this would affect lower pay grades. Similarly, the outcome of combining a decrease in flat-rate personal income tax and an increase in VAT — which was likely to shift the burden of fiscal consolidation to the less fortunate in society — was not considered in the initial programme documents for Latvia.

Programme management weaknesses due to weak controls

93
Even though, ultimately, decisions about a programme rest with the Council and/or the Commission, it is the Commission's representatives that negotiate with the national authorities and conduct programme reviews. The mandate for negotiation is set out in the policy brief. During a visit, the Commission's representatives update management on the talks, typically once a day, and seek approval for any departure from the mandate. After the visit, the Commission's representatives produce the programme documents (Council decision, memorandum of understanding and explanatory note). These are subject to review and furnish the basis for decisions by the Commission and the Council.

55 European Commission 'The economic adjustment programme for Portugal', *European Economy, Occasional Papers* 79, 2011, p. 16.

94
Preparation of the policy brief and programme documents is an expert-based process in which the judgement of forecasters and of a number of policy experts from several directorates-general plays a key role. The documents are reviewed by the deputy director-general and the heads of the horizontal units involved in their preparation. The former focuses on the documents' overall consistency, and the latter are responsible for ensuring consistency with EU policy of the contributions made in their respective fields.

95
Several weaknesses were found in the review process:

(i) no person outside the programme team reviews the underlying calculations and projections to check the consistency of the macroeconomic projection with the financing gap estimate or with the macroeconomic impact of the programme conditions;

(ii) in a number of respects, the work of the Commission's representatives was not sufficiently assessed, with too little questioning of the experts' forecasts (see paragraph 61), financing gap estimates (see paragraphs 69 and 70) and choice of programme conditions (see paragraph 79); and

(iii) internal quality control was generally not documented.

96
The IMF has also set up a process of internal review of the key features of programme design and updates. In some respects this is similar to the Commission's internal review process, but there are three main differences:

(i) the IMF has a dedicated review department which provides input to management;

(ii) more IMF officials are involved in the review process; and

(iii) the IMF process is documented.

Programme documents had improved with time but still displayed shortcomings

Improvements in the quality of programme documents

97
There were marked differences between programmes in terms of the analytical depth of programme documents. Many of these differences were due to the Commission's improved analytical capacity. In the first three programmes, the programme documents provided limited information on a number of aspects, including the composition of the fiscal adjustment, analysis of slippages if deficit targets were not met and social impacts. The analysis given in the two most recent sets of programme documents (Ireland and Portugal) had significantly improved (see ***Box 6***) and was, in many respects, very thorough.

Box 6

Example of improved analysis in programme documents

The initial programme documents for balance-of-payment programmes broadly characterised fiscal consolidation as mainly expenditure driven. However, details of the necessary budget measures were fragmentary (Hungary), no such measures were identified at all (Romania) or, if they were identified, there was no estimate of how much they would bring in (Latvia). For the same three countries, the Commission subsequently improved the level of detail in the programme documents by listing and quantifying which measures had been agreed to achieve the deficit targets. And in the remaining programmes (Ireland and Portugal) even more detail was the norm.

98

In some cases, we found that essential information had been omitted from the programme documents. For instance, the Commission did not always communicate key assumptions underlying the calculation of the financing gap.

(i) In the Hungarian programme, the Commission did not communicate details supporting the estimate of 20 billion euro to be provided to Hungary over the programme period.

(ii) In the Irish programme, the financing gap calculation used in the initial programme documents gave a cumulative accruals-based European System of Accounts (ESA) deficit of 44 billion euro over the programme period. However, the projected 'exchequer cash deficit, incl. promissory notes', which was used for the calculation of funding needs, stood at 58 billion euro. The main reasons for this significant difference of 14.1 billion euro (21 % of the initial financing gap) were not explained in the document.

99

The Commission carried out some basic sensitivity tests to assess the impact of a change in one or more parameters on overall funding needs. Although they could have provided valuable information about the risk of possible adverse outcomes, the results were not revealed in the programme documents.

Weaknesses in compliance monitoring and reporting

100

During each programme, the Commission should verify whether the Member State's economic policy is aligned with the conditions laid down by the Council. In practice this was done by verifying that the Member State was implementing the conditions in the memorandum of understanding.

The unreliability of using overall deficit targets to monitor fiscal implementation

101

Fiscal consolidation was a key feature of all five programmes, and fiscal performance was a key concern during talks with national authorities and when programme decisions were taken. Deficit targets were typically defined as a deficit expressed — in accordance with the ESA — as a percentage of GDP. The choice of the ESA deficit as the key anchor for fiscal policy was motivated by commitments made under the excessive deficit procedure[56].

102

The ESA deficit cannot be directly monitored during the year[57]. Instead, compliance with overall targets was monitored primarily by estimating the deficit. However, using these estimates entails a risk that the Commission will be unable to report with certainty to the Council that a country's fiscal policy complies with the adjustment programme. On several occasions, including those detailed below, the Commission estimates turned out to be wrong.

(i) It was reported in the spring 2009 notification that Hungary's deficit was within the programme's 2008 deficit target. However, the autumn 2009 notification revised the deficit to 3.8 % of GDP, i.e. above the deficit target[58].

(ii) In January 2010, Romania reported a 2009 cash deficit of 7.3 % of GDP, in line with the IMF target, while the Commission provisionally estimated an ESA deficit in line with the target and stated that the programme was 'on track'. However, in May 2010 the Commission revised the ESA deficit to 8.3 %. From autumn 2011, the revised deficit was 9 %.

(iii) In January 2013, the Commission provisionally calculated that Ireland's ESA deficit for 2012 was 8.2 %, only to revise it to 7.7 % in April and 8.2 % in autumn 2013. However, the last revision was mainly due to the reclassification of one-off revenue.

103

Another complication was the exclusion of bank support measures from the target definition in euro-area programmes. Fiscal targets defined in such a way should be, in principle, a much better anchor for fiscal policy, as bank support measures are sizeable one-off items which are beyond the direct control of the government. However, in the case of Ireland the Commission excluded only deficit-increasing capital transfers provided to the banks, but allowed the inclusion of revenues related to bank support measures. Such targets provide a less clear signal and measure of fiscal performance. For instance, had all banking related transactions been excluded, the 2012 budget deficit would have been higher by 1 percentage point.

56 The excessive deficit procedure is the EU's step-by-step procedure for correcting excessive deficit (above 3 % of GDP) or debt levels (above 60 % of GDP).

57 Member states' quarterly government accounts data based on ESA definitions are published with a time lag of 90 days. Furthermore, estimating ESA deficit requires assumptions to be taken on future decisions on the statistical treatment of some major transactions.

58 According to the Commission, the revision of the 2008 deficit reflected changes in relation to the absorption of EU funds, as some projects had not received the co-financing which had been expected to replace pre-financing from the budget.

Unsystematic reporting on compliance with conditions

104

Only for Portugal and, in part, for Hungary, Latvia and Ireland, did the Commission systematically report on the Member State's compliance with structural conditions.

105

Non-compliance was rarely reported. Only for a very small number of conditions (4% in the Portuguese programme) did the Commission clearly state 'not observed', although almost half of all conditions were not complied with on time. Many different terms were used to convey this[59], leading to confusion.

106

For around 30 conditions (8 % of the sample), either no compliance status was reported or the conditions were so vaguely written that compliance could not be effectively monitored (for examples see ***Box 7***)[60].

107

A few conditions were reported as complied with but could not be verified. For example:

(i) In the Irish programme (following the autumn 2012 review), the Commission was still engaging with the Irish authorities to ensure that elements of the multiannual budgetary framework were sufficiently binding and transparent to constitute a credible policy anchor[61] in the post-programme period. However, the condition was reported by the Commission to have been fully met.

(ii) In Portugal, the condition requiring the production of monthly reports on budget implementation by the national government was progressively enlarged to include all state-owned enterprises and public–private partnerships at national, regional and local government levels. The condition was deemed to have been satisfied after specific reporting was introduced at regional level, even though the requirement for consolidated budget reporting was not met.

59 For example largely met, broadly met, partially, ongoing, partly observed, not observed.

60 Conditions requiring permanent compliance at each review are excluded.

61 A fiscal policy anchor provides a structure for the government's decision-making on the appropriate size of the budget deficit given the state of the economy and some medium- or long-term objectives for government finances.

Box 7

Examples of conditions for which compliance was never reported

The number of public research and development priorities should be reduced to provide more resources to relevant research fields (Latvia).

Strengthen the capacity of the Structural Funds and Cohesion Fund managing authority to control and decide on EU spending (Romania).

The government is to adopt legislation to significantly reduce the number of taxes and payments similar to taxes (Romania).

By July 2012, the government will develop a consolidation plan to reorganise and significantly reduce the number of municipalities (308). The government will implement these plans and changes will come into effect by the beginning of the next local election cycle (Portugal).

Establishing special chambers within the tax tribunals (Portugal).

Cooperation with the other partners was informal only

108

EU financial assistance was provided together with IMF financial assistance in all programmes. Each institution took independent funding decisions in line with its own statutes and internal procedures. In the case of the Irish and Portuguese programmes, the ECB too was involved in programme management.

109

Working with the IMF helped the Commission in learning how to manage the programmes. We observed several examples of IMF practices that the Commission adopted after the programmes started, for example more detailed forecasting spreadsheets or the use of a resident representative in later programmes. Also, the Commission's programme teams were enlarged, matching the size of the IMF's teams.

110

The legal basis allowed the three institutions to decide how cooperation would be organised. In all programmes, the programme teams established informal cooperation arrangements. The variety of expertise and experience among the three institutions' staff made it possible to produce more thorough assessments, which reduced the risk of errors and omissions in programme design and updates.

111

The institutions did not make any formal arrangements concerning cooperation between them on such aspects as the following.

(i) Exchange of information. What information (e.g. negotiation mandates, other programme documents, underlying calculations[62], information collected from the Member State) should be exchanged with the other partners? How should information received after the cut-off date be treated?

(ii) Confidentiality. How should documents originally provided to another institution be treated? What should be done if an institution comes into possession of confidential information not available to the other partners[63] which could affect the overall programme design and internal analysis?

(iii) Ownership of common work. Some electronic documents were jointly produced by all three partners (e.g. macroeconomic projections, financing gap calculations), but were not fully shared between the institutions.

(iv) Mechanisms to resolve disagreements about financing decisions or other key programme parameters.

The ECB's advisory role was very broad

112

In the area of programme management, the EFSM regulation[64] establishes an advisory relationship between the ECB and the Commission:

(i) '(the general economic policy) conditions […] will be defined by the Commission, in consultation with the ECB'[65]; and

(ii) 'the Commission shall re-examine, in consultation with the ECB, the general economic policy conditions'[66].

113

ECB staff advised on issues relevant to financial stability and to ensuring that money markets functioned properly. This included topics such as debt sustainability and the pace of fiscal consolidation[67], which were seen by the ECB as important preconditions in both areas of its advisory role.

62 In the balance-of-payments programmes, the actual spreadsheets underlying financing gap estimates were prepared by the IMF and, according to the Commission, were not at the disposal of Commission staff.

63 For example financial market information in the IMF's financial sector assessments, information collected by the Directorate-General for Competition, ECB banking data.

64 Council Regulation (EU) No 407/2010.

65 Article 3(3)(b).

66 Article 3(6).

67 For instance, the ECB argued for maintaining deficit targets in the Portuguese programme.

114

Providing advice did not mean, however, that the ECB supplied the other partners with the analysis underlying its position in programme talks. For instance, the ECB did not provide the Commission with its internal deliberations on burden-sharing by senior debt holders in the restructuring of the Irish banks. Given that the amount of Eurosystem financing was close to 100 % of Ireland's GDP, continued Eurosystem financing[68] was essential for the success of the programme. The other Troika partners accepted no burden-sharing by senior debt holders. However, the IMF's *ex post* evaluation of the Irish programme suggests that alternative policy actions were available to contain the risks from higher burden-sharing[69], but were not pursued.

68 The provision of euro liquidity to its counterparties, or suspending or objecting to the provision of such liquidity, is part of the Eurosystem's Treaty role, according to which the Eurosystem is totally independent and outside the work of the other two institutions.

69 *IMF country report No 15/20 — Ireland — Ex-post evaluation of exceptional access under the 2010 extended arrangement,* January 2015, paragraphs 48-52.

Part III

Borrowing met financing needs even though circumstances initially made it difficult to always abide by best practice

115

The European Commission managed all borrowing on behalf of the EU in connection with the delivery of macrofinancial assistance. By the end of 2014, the EU had issued a total of 22 bonds with a total nominal value of 60.1 billion euro, of which 8 billion euro had already been repaid by 31 March 2015.

116

To assess the Commission's debt management:

(i) we analysed the outcome of issuance in terms of investor's subscription and cost of debt; and

(ii) we benchmarked the Commission's procedures to the best practices on public debt management, investor relations and transparency in debt issuance.

Bond issues were well subscribed

Cost of debt in line with peer levels

117

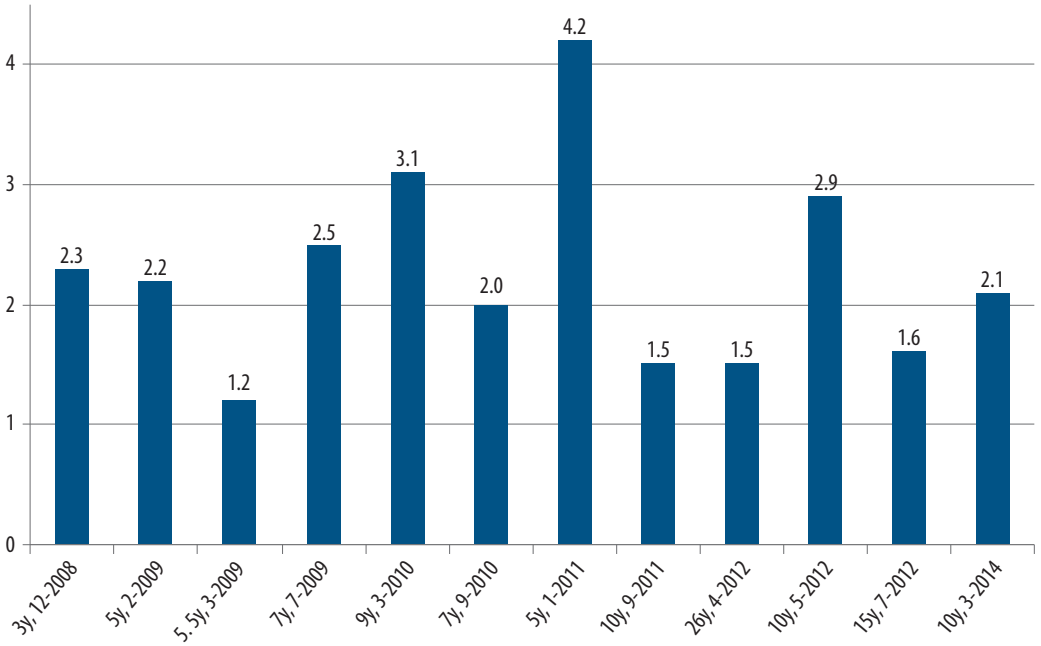
The price of an issue[70] depends both on the nature of the bond and on the market situation at the time it is sold. The Commission managed to acquire the necessary funding to finance the EU's contribution to financial assistance. All the bond issues attracted sufficient demand from the capital markets to be sold out. The bid-to-cover ratio (amount bid in relation to the total amount issued) ranged from 1.2 to over 4.2[71] (see ***Figure 7***).

70 The price defines the cost of debt.

71 Based on a sample of 12 bond issues.

Figure 7

Bid-to-cover ratio for EU bond issues



Source: European Commission.

Part III — Borrowing met financing needs even though circumstances initially made it difficult to always abide by best practice

118

From the very start the issues were made on time[72]. The final cost of debt was in line with the market and peer levels (see ***Figure 8***). Over time the spreads to prevailing risk-free interest rates decreased and, especially for the longer-term issues made in 2011 and 2012, the EU was often able to achieve a lower cost of debt than the European Financial Stability Facility, its only peer with similarly long-term issues.

Pricing levels at issuance sometimes higher than initial guidance from banks

119

The Commission used syndicated transactions to issue the bonds. It selected lead managers — internationally active banks — to underwrite each issue. The role of these lead banks was to contact investors directly and advise the Commission, as the bond issuer, on the timing and price of each issue. They would buy up each issue and sell it on to investors, having committed to buy any part of the issue which was not thus resold.

120

The benefit of syndication is that, via requests for proposals, it allows optimum pricing levels to be identified. The issuer can also capitalise on the banks' extensive client networks when issuing the bond. The issuer might provide details — typically 1 week in advance — of the upcoming issue's maturity and size, and usually asks for quantitative and qualitative information via a questionnaire. In response, banks give guidance as to how they believe the suggested instrument should be priced based on current market conditions.

121

Good practices[73] recommend that the back office maintains borrowing files containing correspondence with financial intermediaries, including the requests for proposals with the banks' pricing guidance. In most of the initial issues there were no requests for proposals, and none were produced before 2011.

122

We examined the files for three bonds issued in 2012[74]. For two issues the actual pricing level was higher than the consensus level indicated by the lead banks in their initial replies to requests for proposals. In one case the difference was 11 basis points (0.11 %), in the other 5 basis points (0.05 %)[75]. In both cases the demand from investors was high, with bid-to-cover ratios above 2 and 1.6 respectively.

72 For example, the first disbursement to Hungary was made 1 month after the Council's decision (Council Decision 2009/102/EC of 4 November 2008 providing Community medium-term financial assistance for Hungary (OJ L 37, 6.2.2009, p. 5)) to provide financial assistance.

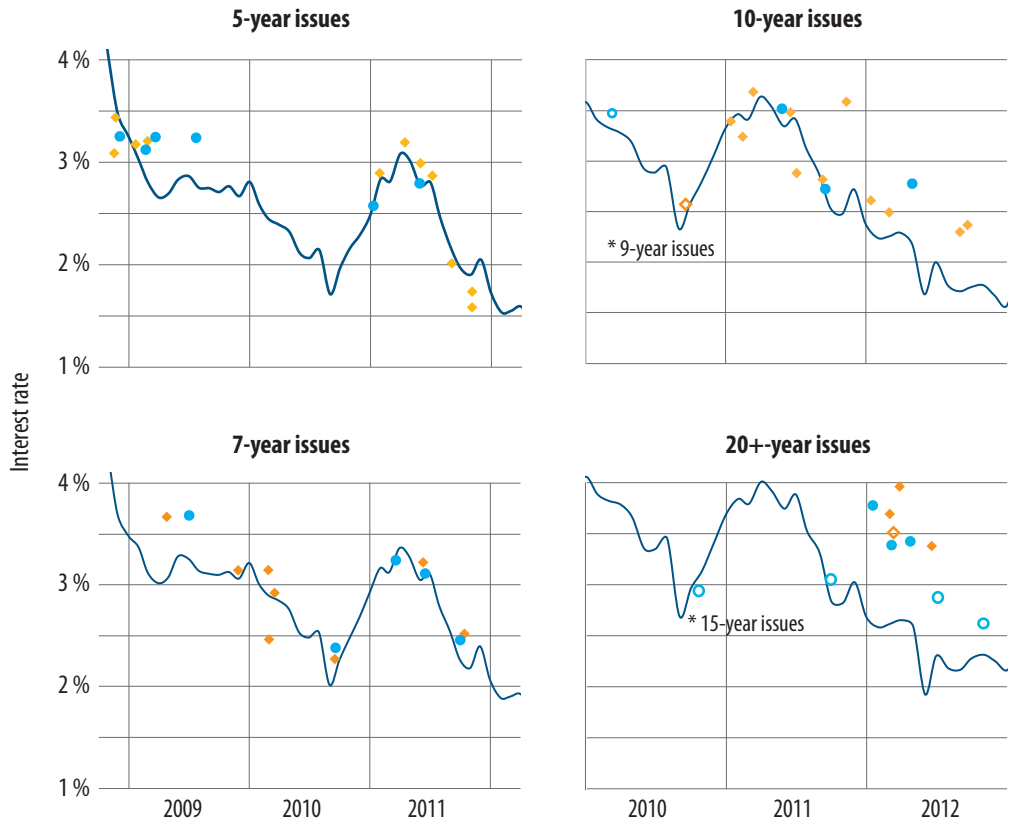
73 Commission internal procedure manual for borrowing activities, Commission internal control standards Nos 8 and 11.

74 The EU made six bond issues in 2012.

75 This translates into approximately 3 million and 1 million euro respectively of extra cost in debt per annum.

Figure 8

Final cost of debt similar to market and peer levels



Key:

- Issues made by the EU
- Issues made by the peer issuers
- Mid-swap rate for a given maturity
- *Issues made by the EU or peer issuers with a similar but different maturity than that of the swap rate curve

⇨ The distance of issue yields of EU bonds from the prevailing risk-free interest rate at a given maturity decreased over time.

⇨ The distance was also similar to the distance achieved by peer issuers.

Source: ECA, data provided by Bloomberg, see ***Annex III*** for methodology.

Part III — Borrowing met financing needs even though circumstances initially made it difficult to always abide by best practice

Circumstances initially made it difficult to always abide by best practices

123

We found a number of shortcomings in the debt management process in the initial years (see ***Figure 9***). Lack of documentation and other gaps did not have a demonstrable impact on the outcome of borrowing.

124

It is accepted practice[76] to issue written guidelines covering the organisation of the debt management office, the distribution of roles and responsibilities, the establishment of maximum debt thresholds, the type of debt to be issued and rules for documenting the issuance process.

125

'In many cases, the organisational structure of modern debt offices is patterned on private-sector financial institutions such as banks and finance departments of major corporations'[77]. On this principle, the office would be divided into at least two main units:

(i) a front office — typically responsible for executing transactions in financial markets, including managing auctions and other forms of borrowing, and all other funding operations; and

(ii) a back office — responsible for handling the settlement of transactions and maintaining financial records.

126

In addition, a number of key functions, particularly for risk management, could be situated in a separate middle office.

127

Limited human resources[78], combined with the urgency of raising funding[79] in stressed financial markets, made it very difficult in the initial years to abide by best debt management practices.

Pre-issuance

128

The manual of debt management procedures was drawn up at the time of the first issues, but was either unclear or lacked guidance on important elements of the process. It was progressively improved through multiple updates, the value of which was reflected in the quality of documentation for the bond issues since 2012.

129

From the end of 2008 to 2011, owing to time constraints, the Commission applied an exceptional procedure for the selection of lead banks. It mandated lead banks directly, which left a limited audit trail of documents on the selection process, such as requests for proposals or justification letters. Requests for proposals were not produced until 2011, when documentation of the selection process became more precise and comprehensive.

76 IMF, 2014, *Revised guidelines for public debt management'*, IMF-World Bank, p. 5-6.

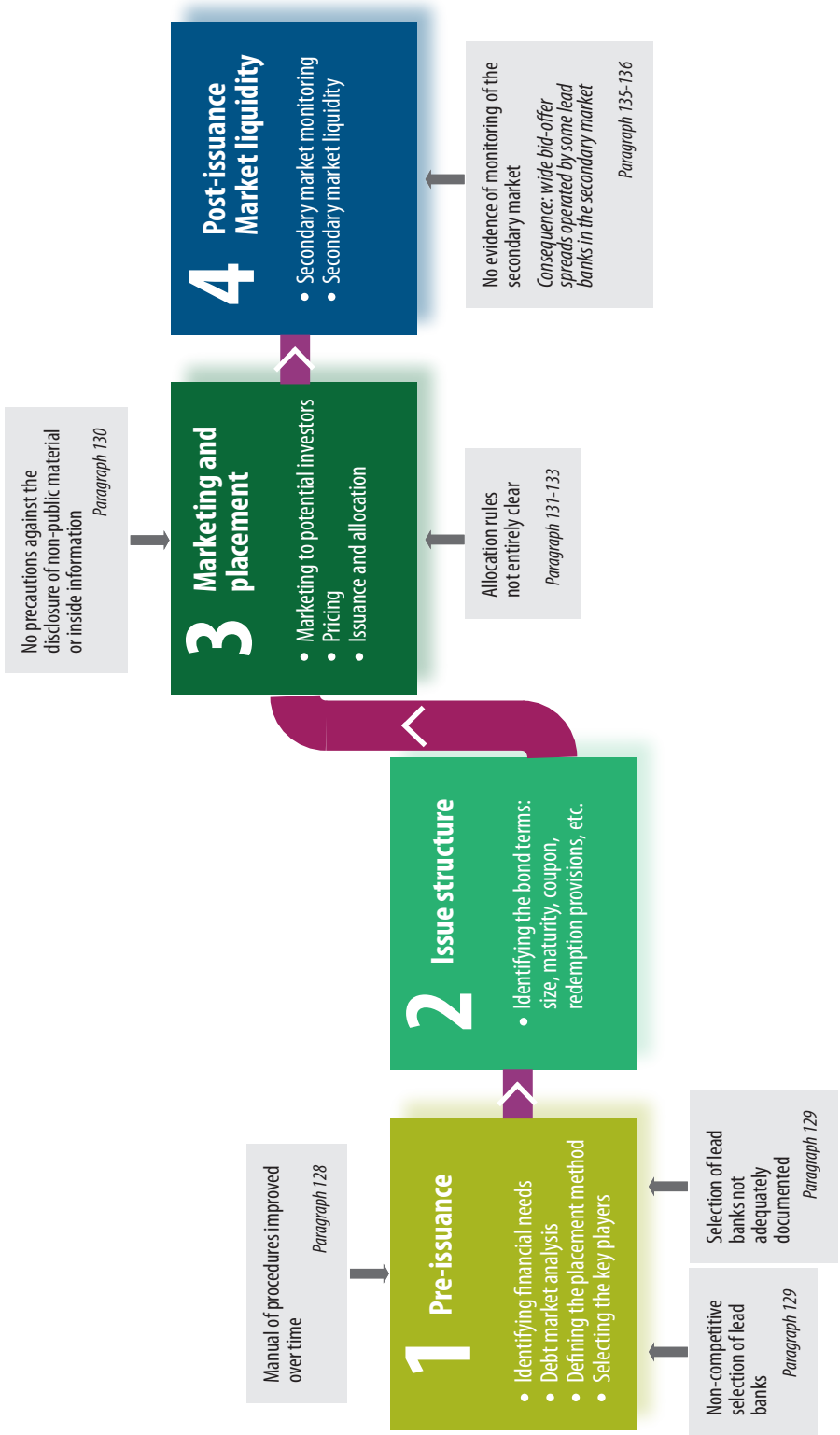
77 OECD, 2002, *Debt management and government securities markets in the 21st century.*

78 At the time of the first bond issue in December 2008, the unit responsible for both borrowing and lending was staffed by four people. At its peak, at the beginning of 2011, the unit still had no more than eight members of staff.

79 Recommendation for a Council decision granting mutual assistance for Hungary — Proposal for a Council decision providing Community medium-term financial assistance for Hungary COM(2008) 716 final of 30.10.2008, paragraph 6.

Figure 9

Shortcomings in debt management in the initial years



Source: ECA.

Part III — Borrowing met financing needs even though circumstances initially made it difficult to always abide by best practice

Placement

130

We did not detect any clauses in the agreements between the Commission and lead banks dealing with the sensitive issue of pre-sounding (see ***Box 8***). There was no evidence that the Commission took any precautions regarding the disclosure of non-public information, and no audit trail with which to determine whether lead banks wall-crossed certain investors during each issue, or whether they subsequently allowed them to trade or participate in the transaction.

131

An important part of any new bond issue is the way the bond is divided out among subscribing investors. One of the main benefits of syndication over auction is that the issuer has full control over the investor base, allowing it, for example, to choose how the securities are allocated. Best practice dictates that allocation rules should be clear and transparent, and always divulged beforehand. Fair and transparent allocation of an issue also helps in maintaining a diverse investor base.

Box 8

Pre-sounding and wall-crossing

Pre-sounding is a technique employed by primary debt capital market bankers to measure investor demand. It is quite a common business practice[80], especially in volatile markets, as it can help lead banks and issuers to seek initial feedback on an upcoming issue ahead of the public announcement. This feedback is often obtained by disclosing general information only. However, more specific information (potentially including non-public material or inside information) is likely to be imparted to market participants in other cases; therefore, the risk of market abuse remains.

When adding third parties to the information chain, best practice recommends an enhanced level of record-keeping and the use of formal written procedures. When non-public material or inside information is to be disclosed (a process known as wall-crossing[81]), lead banks must inform their clients about any applicable restrictions under the laws and regulations relating to the possession of such information.

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80 International Capital Market Association, *Primary market handbook*, 'XIII. Pre-sounding, bookbuilding and allocations', 2014. Also, European Securities and Markets Authority, *Discussion paper — ESMA's policy orientations on possible implementing measures under the market abuse regulation*, 2013.

81 Wall-crossing is the act of making a person an 'insider' by providing them with inside information.

Part III — Borrowing met financing needs even though circumstances initially made it difficult to always abide by best practice

132

The Commission stated that it played an active role in the allocation of each issue. According to the Commission, allocation was based on the following criteria:

(i) category of the investor as a measure of quality (investor type: 'real money' versus trading, etc.);

(ii) quality of the individual order (e.g. timeliness of the order, previous experience with the investor); and

(iii) geographical distribution.

133

An analysis of the allocation tables that were available[82] revealed that for very small amounts the allocation was 100 %, while there was little consistency in the degree to which larger orders were satisfied. Furthermore, the main orders were placed by specific financial entities (e.g. large investment houses) on behalf of investors. When the final allocation is made, the investment houses allocate the bonds to the investors. We did not find evidence that the Commission agreed with the final bond allocation.

Post-issuance

134

Defining a new bond as liquid in the secondary market means that it can be sold quickly. It is the responsibility of both the issuer and the lead bank to ensure that there is sufficient liquidity in the secondary market for any new issue. The Commission and lead banks should agree on secondary market commitments in the mandate letters signed for each issue. Furthermore, the participating lead banks are expected to maintain a similar low bid-offer spread (the difference between the buy and sell price) for at least the first few days of the secondary market.

135

During the audit, the Commission stated that it examined the liquidity of EU bonds on a quarterly basis, with a more formal examination procedure in place since 2012. However, we found no evidence in the borrowing files that it had checked liquidity in the secondary market before 2012.

136

An analysis of bid and offer prices showed that the closing daily bid-offer spread for the initial 30 days of each issue was relatively low. However, the bid-offer spread for each bond was found to vary widely between brokers. For instance, the bid-offer spread ranged from 7 to 30 basis points for one of the bond issues[83]. This variation was observed even with brokers that were participating as lead banks in multiple EU issues and were therefore obligated to respect certain secondary market commitments.

82 Information from the order books and final allocations were available for only 7 of the 12 bond issues sampled.

83 3.25 % coupon bond with a maturity date of 4 April 2018.

Part IV
Programmes met their objectives

137
The overall aims of financial assistance were to return Member States to sound macroeconomic or financial health and restore their capacity to meet their public-sector (euro area) or balance-of-payments (non-euro area) obligations. The financial assistance provided a cushion to ease implementation of the adjustment programmes that were necessary in each country to correct underlying problems. We structured our analysis of the programme achievements along four dimensions:

(i) analysis of how the overall funding was used and factors that made it sufficient;

(ii) compliance with deficit targets and implementation of fiscal adjustment;

(iii) compliance with the conditions and implementation of structural reforms; and

(iv) changes in countries' competitiveness.

No need to increase overall funding

Funding envelopes proved sufficient, if tight in two Member States

138
In no country did the financing gap evolve as envisaged. However, the programme set-up was sufficiently robust to allow significant discrepancies to be offset within a programme so that funding remained within the initial envelopes (see ***Figure 10***).

139
There were, nonetheless, some differences in the level of comfort provided by the financial assistance. The early programmes, designed in the wake of the Lehman collapse, included a substantial safety margin. Similarly, the Irish programme included a sizeable contingency reserve of 25 billion euro as part of the banking support scheme. On the whole, Ireland, Hungary and Latvia benefited from reduced funding needs, which allowed them to:

(i) reduce reliance on their own resources (Ireland);

(ii) exceed the initial foreign exchange reserve projections (Hungary);

(iii) reduce programme financing (Latvia, Hungary); and

(iv) repay (or consider repaying) the more expensive IMF loans before their due date (Hungary, Latvia, Ireland).

Figure 10

How was money used?

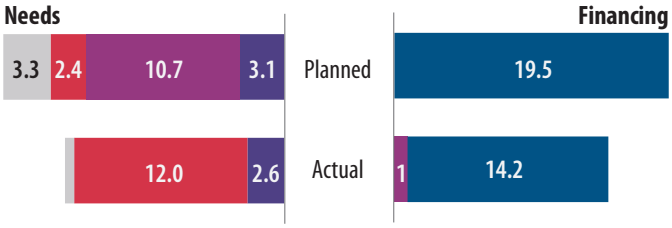
Balance-of-payment programmes

Key:

- Funding gap
- Current account
- Other
- Capital and financial account
- Increase in international reserves

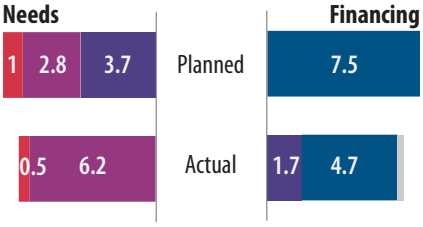
Hungary

- Contrary to the forecast, foreign banks increased exposure to their subsidiaries at the peak of the crisis and drains from foreign exchange derivatives did not materialise. Therefore no financing was required to cover the capital and financial account. Instead it became a financing source.



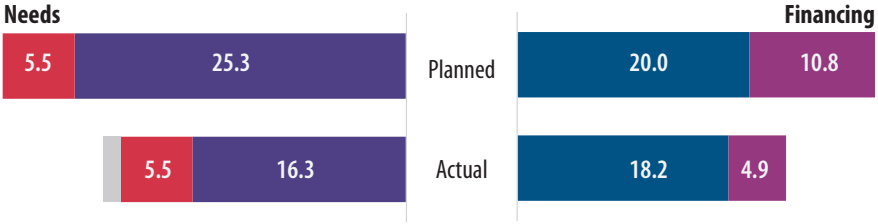
Latvia

- The current account corrected much faster than initially anticipated, becoming a financing source. This was partially offset by additional funding needs due to the capital and financial account.
- Of the 4.7 billion euro in financial assistance, 3.2 billion euro was used to finance ongoing government deficits and repayments of public debt. The financial sector rescue was less costly than anticipated.



Romania[1]

- The current account corrected faster than anticipated. This was partially offset by reduced financing through the capital and financial account.

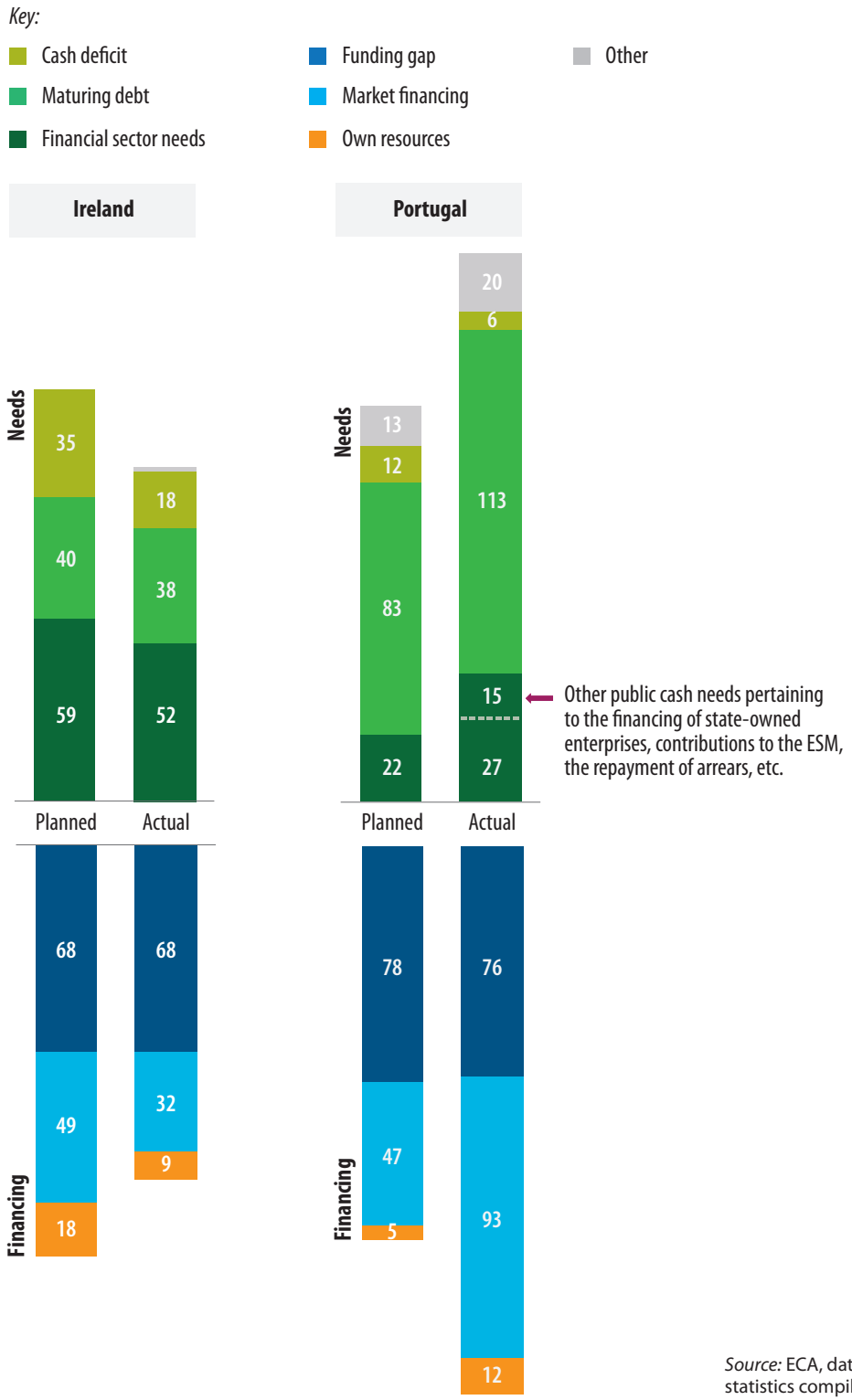


1 Data cover the first Romanian programme.

Figure 10

Euro area programmes

Comparison between planned and actual needs and financing in the government sector.



Source: ECA, data provided in programme documents, statistics compiled by national authorities.

140

In contrast, Portugal faced significantly higher financing requirements than initially estimated, and financing was tight during the Portuguese programme. To meet its additional requirements, Portugal had to rely on market financing. Monetary relaxation in the euro area in the second half of the programme helped Portugal to make a successful return to the financial markets[84].

141

The financial assistance to Romania was sufficient to cover the country's balance-of-payments needs, but financing of the Romanian public sector proved to be tight during the programme. The government's additional financing needs were covered in part by indirect support from the central bank.

Certain Member States received more advantageous financial terms than provided for the initial design

142

Portugal and Ireland benefited from reduced interest rates and longer maturities on the EU loans[85]. The primary aim was to enhance their long-term refinancing prospects[86]; however, the change also reduced the financial burden of meeting interest payments over the programme period. We estimate that Ireland and Portugal achieved, over the programme period, savings of 2.2 billion euro each.

143

Ireland and Romania benefited from the accommodating policies of their central banks.

(i) The Central Bank of Ireland agreed to swap non-marketable promissory notes issued to the Anglo Irish Bank for Irish government bonds with longer maturities[87]. This liberated Ireland from the need to seek market financing for 3.1 billion euro due in 2013. It will also reduce the country's financing requirements by a total of 30 billion euro over the 2014-2023 period and the deficit by an average of 0.7 % of GDP[88].

(ii) In November 2009, Romania's central bank decided to decrease the foreign exchange reserves requirement from 30 % to 25 % (following an earlier decrease from 35 % in August). This freed up around 1.3 billion euro in banking loans for government financing. The decision was publicly justified by the postponement of 2009 IMF/EU tranches[89].

84 Monetary relaxation also had a positive impact on financing for the Irish government.

85 EFSM loans were initially planned for an average duration of 7.5 years, with interest margins of 2.925 % for Ireland and 2.15 % for Portugal. In October 2011 these interest margins were suppressed, and the average maturity was increased to 19.5 years in June 2013. EFSF loans were also extended, and the interest margins of 2.47 % for Ireland and 2.08 % for Portugal were likewise suppressed.

86 This decreased also the expected revenue of the EU budget by 2.2 billion euro in total during in the programme period.

87 In its 2013 annual report, the ECB considered that 'The liquidation of the Irish Bank Resolution Corporation (IBRC) raises serious monetary financing concerns. These concerns could be somewhat mitigated by the disposal strategy of the Central Bank of Ireland.'

88 European Commission, 'Economic adjustment programme for Ireland — Winter 2012 review', *European Economy, Occasional Papers* No 131, 2013.

89 Press release of the Board of the National Bank of Romania of 16 November 2009.

Updated deficit targets mostly but not always sustainably met

With some exceptions, revised annual deficit targets were met

144

Compliance with the revised targets was generally good, with the exception of the Hungarian programme and some years of the Portuguese and Romanian programmes (see ***Table 4***).

145

However, missed targets did not necessarily mean failure of implementation. For example, the missed 2008 and 2009 targets in the Hungarian programme can be explained by statistical revisions to the budget deficit. Furthermore, all balance-of-payment programmes were successful in the sense that the Member States managed to exit the excessive deficit procedure in 2012.

Table 4

Compliance with updated targets

	% GDP	2008	2009	2010	2011	2012	2013
Hungary	target	– 3.4 %	– 3.9 %	– 3.8 %			
	actual[1]	**– 3.7 %**	**– 4.6 %**	**– 4.3 %**	4.3 %	– 2.1 %	– 2.2 %
Latvia	target		– 10.0 %	– 8.5 %	– 4,5 %		
	actual[1]	– 4.4 %	– 9.2 %	– 8.2 %	– 3.5 %	– 1.3 %	– 1.0 %
Romania I	target		– 7.8 %	– 7.3 %			
	actual[1]	– 5.7 %	**– 9.0 %**	– 6.8 %			
Romania II	target				– 5.0 %	– 3.0 %	
	actual[1]				**– 5.5 %**	– 3.0 %	– 2.3 %
Ireland	target				– 10.6 %	– 8.6 %	– 7.5 %
	actual[2]				– 8.9 %	– 8.2 %	– 7.2 %
	headline deficit[1]	– 7.4 %	– 13.7 %	– 30.6 %	– 13.1 %	– 8.2 %	– 7.2 %
Portugal	target				– 5.9 %	– 5.0 %	– 5.5 %
	actual[2]				– 4.4 %	**– 6.0 %**	– 4.5 %
	headline deficit[1]	– 3.6 %	– 10.2 %	– 9.8 %	– 4.3 %	– 6.4 %	– 4.9 %

Note: Non-compliance with a deficit target is shown in bold. Outside programme-period data are shown in grey.

Source: European Commission.

1 Net lending or borrowing of general government for excessive deficit procedure as of spring 2014.

2 Actual deficit as reported by the Commission and in line with the programme definition (see paragraph 91).

146
To achieve their deficit targets each programme envisaged a specific expenditure–revenue mix. Consolidation focused on the expenditure side in the balance-of-payment programmes, but was more uniformly distributed in the EFSM programmes. The realised compositions of revenue and expenditure broadly correspond to what was initially planned — with the exception of Hungary, which did not achieve the anticipated expenditure consolidation.

147
The erosion of tax bases, especially in 2009 in the wake of the sharp economic downturn, often wiped out the revenue gains from important new tax measures. For instance, in 2009 Latvia implemented indirect tax consolidation measures with an estimated impact of 2.5 % of GDP. In 2013 the Commission estimated that these measures had been entirely offset by falling short-term elasticity. Similarly, the tax-neutral reform implemented in Hungary in mid 2009 caused an estimated deficit slippage of 0.7 % of GDP in 2010.

148
With unchanged deficit targets, a declining tax-to-GDP ratio may create an incentive for tax authorities to counter falling tax revenue by introducing measures other than those agreed in the programme negotiations. In Romania, for instance, 97 changes were made to the tax code during 2009-2013, with 51 legislative acts enforcing those amendments. The frequency of change created an unstable economic climate for both businesses and individuals.

All countries improved their fiscal stance, but to varying degrees

149
Given that the programmes resulted from a loss of market access, the restoration of fiscal sustainability was arguably the most important aim. Improvement in a country's structural balance during the programme[90] would indicate progress towards more sustainable public budgets. The Commission calculated and published structural balance data[91].

150
The structural balance improved in all countries, at an average yearly rate of between 0.7 % of potential GDP in Hungary and 1.9 % in Portugal. Three factors could explain the different rates of change:

(i) the initial fiscal stance — the higher the initial structural deficit, the faster the pace of consolidation;

(ii) the initial level of public debt — the higher the initial debt, the faster the pace of consolidation;

(iii) differences in the recommendations made under the excessive deficit procedure concerning the need for a fiscal effort — the higher the recommended effort, the faster the pace of consolidation.

90 Accounting for the cut-off dates of government statistical data, the following programme periods were assumed: Hungary 2009-2010; Latvia 2009-2011; Romania 2009-2012; Ireland and Portugal 2011-2013.

91 Based on the spring 2014 forecast data, obtained in accordance with ESA95.

151

An initial structural deficit was indicative of the pace of fiscal consolidation in all the beneficiary Member States except Ireland. Hungary had the lowest structural deficit at the start of the programme and experienced the slowest consolidation; Portugal had the highest structural deficit and the fastest pace of consolidation. However, Ireland is an outlier in this analysis. From a similar starting point in 2010 to that of Portugal, its structural consolidation rate (net of banking and other one-off measures) was just under half as fast[92].

152

There was no relationship between the initial level of public debt and the average fiscal effort made. For instance, Romania's public debt was the lowest in the five Member States, but its average fiscal effort was relatively high. Ireland and Portugal registered very different average efforts despite a similar initial public debt.

Countries used one-off measures

153

Fiscal measures that are temporary do not lead to a lasting improvement in the underlying deficit. Temporary measures can be implemented on both the revenue and the expenditure sides. During the programmes several Member States had to resort to one-off revenue measures in order to meet their deficit targets.

(i) In 2010 and 2011 Portugal nationalised the private pension funds of both Portugal Telecom (improvement of deficit by 1.7 % of GDP) and the banking sector (4 % of GDP)[93].

(ii) The one-off tax and social security arrears recovery scheme put in place in Portugal in 2013 temporarily improved the deficit (0.8 % of GDP).

(iii) In 2012 Romania corrected its excessive deficit by reaching the 3 % ceiling. However, the one-off sale of telecommunications licences had brought in a total of 0.5 % of GDP.

(iv) In Ireland, banking measures brought a temporary increase in revenue (e.g. fees from the extended liability guarantee in favour of domestic banks, Central Bank dividends from one-off financing schemes).

154

According to the Commission, one-off measures were needed to handle short-term pressures, but for targets to be met sustainably temporary measures had to be replaced by permanent measures.

92 This is also not explained by the difference in changes of the structural balance prior to the programme. The Commission's estimates indicate that the fiscal consolidation started in both countries in 2010 with a similar consolidation effort.

93 As a result of this transaction, Portugal took over the future pension liabilities. Although these liabilities are not recognised as public debt according to the statistical framework, they negatively impact the sustainability of public debt. Therefore, the measure only appeared to improve the debt position of the country.

Compliance with the conditions was high

Member States eventually complied with at least 80 % of conditions

155
The Commission's monitoring reports show that the Member States met the deadlines set in the memoranda of understanding with varying degrees of success. While Portugal and Latvia complied with fewer than half of programme conditions on time, Hungary complied with almost three quarters. In Ireland and Portugal there were also significant differences in on-time compliance between the EU and IMF programmes. Although countries might not meet an original deadline, they did often comply after a certain lapse of time.

156
The Commission did not report on time on the compliance status of approximately 30 conditions (see paragraph 106).

157
Where compliance was delayed, this was mostly for reasons beyond the Commission's control: lengthy legislative procedures, national authorities' failure to implement the agreed upon reforms, legal issues not initially considered, social resistance, etc. However, occasionally the initial time frame was unrealistic given the scale of the reform (e.g. civil service reform), the need for intensive cooperation by local or regional governments or the requirement for complex new IT.

158
Conditions with a high structural content were as likely to be complied with by the original deadline as conditions where the structural content was lower[94]. We found that conditions with a high structural content tended to score most highly for end-of-programme compliance. Initially, the Commission's reviews did not 'push' countries to comply with the most important conditions on time; later, however, the focus partly shifted towards the most important reforms.

Programmes prompted reforms, but occasionally the desired effects did not materialise

159
To determine the performance of a policy, it is necessary to establish causality between the policy and the effects observed. For instance, the impact of reforms aimed at improving active labour market policies may be delayed in a weak labour market. Our analysis was further complicated by the fact that so little time has elapsed since the end of some of the programmes. Finally, the conditions often represented only a subset of the policy measures implemented during the programme period.

94 For the purpose of the audit, the importance of conditions was measured by their structural content: high, medium or low. See ***Annex III***.

160
We deemed a condition to have been effective if:

(i) the reforms were not reversed after the end of the programme but have been actively pursued by the Member State concerned;

(ii) the available policy indicators or evaluations point to a clear improvement in the relevant area; and

(iii) the desired effects were achieved.

161
The principal concern — that of reform reversal in the post-programme period — has proved unfounded. At the time of the audit, reversals were few and concerned mainly public-sector wage cuts (Hungary, Romania) and labour market reforms (Ireland and Portugal). However, this observation does not exclude further reversals in the future. Reversals were offset by alternative reforms, which were often not equivalent in terms of their potential impact. For instance, this was the case of compensatory measures for the return of the minimum wage to the initial level in Ireland, as well as compensatory measures for those declared unconstitutional in Portugal (see ***Box 9***).

162
The programme period was too short for some complex reforms to be fully implemented before closure. Apart from the reversals mentioned above, countries continued with complex reforms after the end of the programme.

Box 9

Gradual dilution and reversal of the labour market reforms in Portugal

The most significant labour market reforms were envisaged in Portugal. During the programme Portugal indeed carried out a number of reforms that reduced the level of employment protection. However, the improvement was not significant enough in international comparison. Already at the onset of the programme the reforms were not designed ambitiously enough when compared with the peer countries. For instance, Portugal was asked to prepare a proposal to align severance payments with the EU average instead of with the set of countries that represent Portugal's competitors in international trade. Then, during the programme, the less ambitious reforms were taken. For instance, the severance payments are now accumulated at 12 days per year of service, which was the higher end of the initial interval of 8-12 days per year of service.

The reform agenda was further diluted as some reforms of the dismissal rules were successfully challenged in the Constitutional Court. In response, Portugal enacted compensatory measures for those declared unconstitutional, but the Commission did not find that these measures could achieve similar effects to the original ones. The programme conditions did not include compensatory measures that would be equivalent in terms of their potential impact on flexibility of the labour market. After the end of the programme, some labour market reforms already implemented were easily reversed through administrative decisions of the government. These decisions were criticised by the Commission in post-programme surveillance reports.

163

We found[95] that there were tangible improvements when the programmes targeted reforms in the specific areas of active labour market policies, labour market reforms or the business environment. In some areas the programmes helped to encourage new reforms (e.g. fiscal responsibility), while in others they provided an incentive to accelerate the implementation of existing national plans (e.g. business environment).

164

Several conditions, while met, did not produce the desired effects. For instance, budgetary savings were not realised to the extent intended during the programme period, and the fiscal responsibility framework did not provide a sufficiently binding anchor for fiscal policy (see ***Box 10***).

95 We analysed the progress achieved by the five countries in three areas: labour market reforms, the business environment and fiscal responsibility. We relied on international regulatory indicators, input indicators and the assessments by the Commission, the IMF and other international institutions.

Box 10

When compliance did not deliver the desired effects

- In Hungary, the bank support package was largely unused because, in its final form, it was unattractive to banks.
- In line with the programme conditions, Hungary included cuts in local government expenditure in its budget law, but no substantial savings were achieved.
- Romania complied with the condition to adopt a public-sector wages framework law, but the compensation grids, which were one of key elements of this reform, were not applied owing to the lack of budget funds.
- Ireland and Romania adopted a new fiscal responsibility framework during the programme. However, in both cases the Commission reported several shortcomings in implementation. Most importantly, the framework was not effective in constraining the government's fiscal policy in line with the medium-term targets.
- Employment in the Portuguese public sector was decreased in line with the programme milestones; however, an unspecified part of this decrease was achieved through the early retirement of civil servants, and the budgetary impact was therefore contained.

How well did countries increase their competitiveness?

Competitiveness gains, but to varying degrees

165

One of the programmes' key underlying objectives was to restore external balances by enhancing economic competitiveness. The current-account and trade balances provide the broadest measures of that competitiveness[96].

166

All the programmes achieved a current-account adjustment. In four of the five countries covered this occurred faster than expected. Only the Irish adjustment was broadly in line with the programme forecast.

167

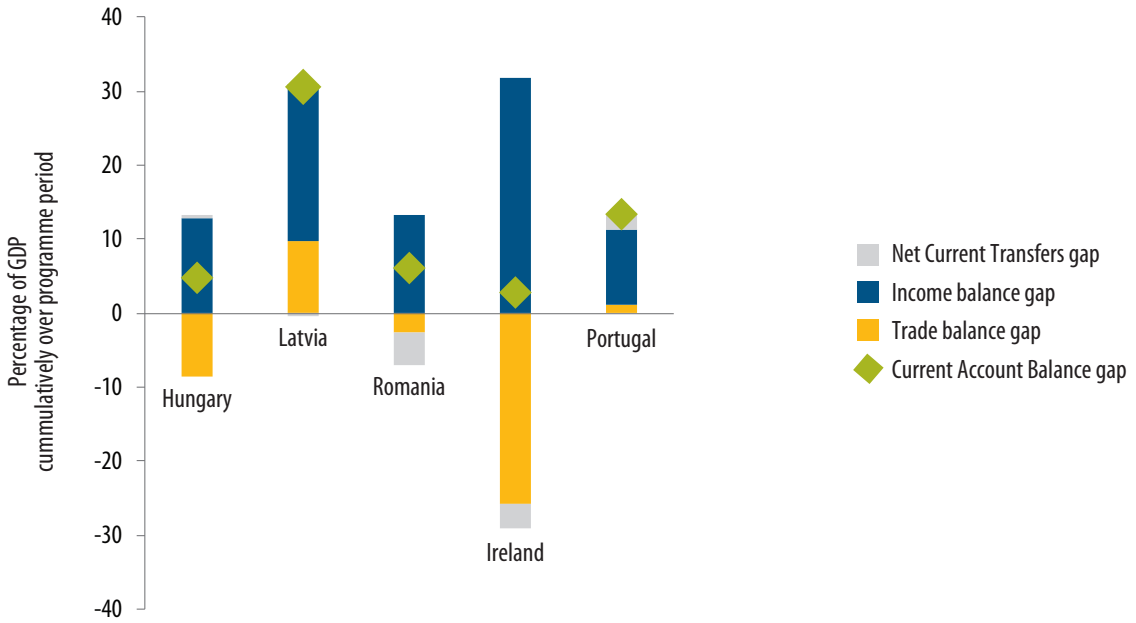
The common factor explaining the more rapid current-account adjustment was an unexpected improvement in the income balance[97]. Also in Ireland, the evolution of the current-account balance in line with the forecast can be attributed to an overperforming income balance, which compensated for major underperformance in the trade balance (see ***Figure 11***).

96 Countries' competitiveness is a multifaceted and complex concept. We chose to focus on these two indicators because they were part of the programme projection for all countries. This allowed us to assess the reasons why competitiveness sometimes did not evolve as expected.

97 The Income balance records financial flows between residents and non-residents related to income from labour, direct investments, and portfolio and other investments. It also includes payments between government and non-residents related to taxes and subsidies on products and production.

Figure 11

Possible reasons for the rapid adjustment of the current-account balance



Note: The graph shows the cumulative differences, in percentage points of GDP, between the outcome and the baseline, i.e. the initial programme projection. Calculated over the following programme periods: 2009-2011 for Hungary and Romania, 2009-2013 for Latvia and 2011-2015 for Ireland and Portugal.

Source: ECA, based on European Commission data.

168

The trade (export/import) balance captures more closely the effects of the changes in a country's competitiveness than the current account. The trade balance evolved in line with the programme forecasts in Portugal and Romania. It performed better than expected in Latvia (an average of 2 % per year). However, it was below forecast in Hungary (2.8 % per year) and Ireland (5.1 % per year).

169

A number of variables can account for fluctuations in the two components of the trade balance. These include external shocks (affecting exports), an unexpected trend in GDP (affecting imports) and unexpected swings in competitiveness (affecting both).

170

In Latvia and Romania, competitiveness gains[98] were significant and explain why the trade balance had been above initial forecasts since 2010. The gains are also illustrated by these two countries' increased share of global exports.

171

The other three countries had lower than expected competitiveness gains, and in all three the share of global exports had fallen since 2008. Hungary's and Portugal's exports were below the initial forecasts, but Irish exports exceeded what was forecast[99].

172

In Portugal and Hungary the trade balance adjustment was more or less in line with projections, but this was achieved only because both exports and imports were below the level initially expected. Around 80 % of this unexpected contraction in imports can be explained by GDP underperformance. Nevertheless, even for these two countries some competitiveness gains are apparent; for instance the ratio of exports to GDP increased compared with the pre-programme period.

Internal devaluation worked through the adjustment of the wages of the newly hired

173

Internal devaluation was a key element of macroeconomic strategy in three countries (Latvia, Ireland and Portugal). This is a set of policies designed to restore international competitiveness, mainly by reducing prices or labour costs[100]. Public-sector pay and job reductions are expected to be followed by private-sector pay cuts. This should occur because public-sector adjustments free up resources, thus increasing labour availability for the private sector and depressing pay levels in the economy at large. Reduced aggregate demand should contribute to the price and wage adjustment in the economy. In absence of national currencies, internal devaluation is a key strategy for adjustment of price levels within a currency union.

98 As indicated by various macroeconomic indicators of competitiveness, such as the real effective exchange rate, real unit labour costs and labour productivity, as well as composite indicators such as the global competitiveness ranking.

99 The main reason was that a large share of total Irish exports goes outside the euro area. Ireland therefore benefited from the euro's depreciation against the US dollar, which was not part of the initial programme forecast. The euro's depreciation also increased the value of imports to Ireland. The import content of Ireland's exports — the proportion of exports produced using imports of intermediate goods and services — is high, at around 50 %.

100 The Commission defines internal devaluation as policies aiming 'to reduce domestic prices either by affecting relative export-import prices or by lowering domestic production costs and thereby yielding a real exchange rate depreciation.' Source: European Commission: *Quarterly report on the euro area*, III/2011, Volume 10, p. 22.

174
In Latvia, internal devaluation worked mainly by affecting the pay of newly hired workers, while the salaries of incumbent workers in the private sector hardly declined at all. Part of the wage adjustment happened through the adjustment of undeclared wages, but the magnitude was limited (see ***Box 11***).

Box 11

The impact of internal devaluation on pay levels in Latvia

Internal devaluation was regarded as a key pillar of the Latvian adjustment. One reason why internal devaluation was expected to work was the belief that the labour market is particularly flexible. In practice the reduction observed in private-sector pay was relatively small[101]. While wage growth slowed quite rapidly in both the public and private sectors as the crisis developed during 2008, turning negative in 2009[102], both the depth and the duration of negative wage growth was much smaller in the private sector. The largest year-on-year decline in private-sector pay was 6.6 % (in October 2009), while the largest public-sector fall was just over 26 % (in November 2009). The aggregate wage dynamics do not capture the underlying process of the adjustment or allow for the possible explanation that it was partly located in the sphere of undeclared wage payments ('envelope wages').

The analysis of data on individuals pay[103] shows that the wages of workers hired during the recession were significantly lower than those enjoyed by incumbent workers, which hardly declined at all. This result is consistent with evidence found in the relevant literature suggesting that wages at recruitment are more cyclical than those of incumbents and offer a mechanism for reducing costs. Job cuts and an increase in the share of part-time work also played a part.

The retrospective survey of employers gives evidence that the 'true' wage-cost decline was between 6 % and 11 % in 2008-2009 and almost flat (below 2 %) in 2009-2010. Therefore, the decline was larger than suggested by official statistics (growth by 1.3 % in 2009 and decline by 2.9 % in 2010). This indicates that the private-sector pay did respond to the recession, but the response was not sufficient to prevent a large and prolonged fall in employment.

Source: ECA, based on a study by Andrejs Semjonovs, Alf Vanags and Anna Zasova, *What happened to wages in Latvia's 'internal devaluation'?*, Baltic International Centre for Economic Policy Studies.

101 It is the private sector, and in particular the tradable sector, where wage developments determine competitiveness.

102 March 2009 in the public sector and July in the private sector.

103 Anonymised records from the Latvian State Social Insurance Agency.

Foreign exchange loans remained a challenge

175
A common denominator in all three balance-of-payment countries was the high ratio of foreign currency loans to total outstanding loans.

176
During the crisis, central banks could not let the domestic currency depreciate to restore external competitiveness. The concern was that depreciation might curb the capacity of borrowers to service their debts in foreign currencies and hence affect the stability of the financial system, which would offset the economic benefits of the policy[104]. Owing to the high level of foreign currency lending, countries also tended to lose more international reserves during the crisis[105].

177
Although these issues extensively affected the available policy choices, the EU's financial assistance did not include any conditions for the national authorities to address the management of domestic lending in foreign currencies.

178
During the programmes, the total value of foreign currency loans remained a concern[106]. In Romania, foreign currency private-sector borrowing overtook borrowing in the domestic currency. The share of foreign currency borrowing started to decline in 2012 in Hungary, but not until 2014 in Romania.

104 This challenge was also recognised by the European Systemic Risk Board, in its Recommendation 2011/1, as the risk of 'hindered monetary policy transmission channels' stemming from high domestic lending in foreign currencies.

105 Recommendation 2011/1 of the European Systemic Risk Board.

106 For example, at the end of June 2013 the Hungarian central bank considered the exposure of households and small and medium-sized enterprises to foreign exchange rates to be very high.

Conclusions and recommendations

Pre-crisis surveillance

179

Before the crisis there was already an EU framework geared towards monitoring the public budgets in the Member States. Warning the Council about mounting fiscal imbalances was the Commission's responsibility. The Commission was not prepared for the first requests for financial assistance.

180

The Commission fell short in its task of assessing fiscal imbalances in the run-up to the crisis, when it estimated public budgets to be stronger that they actually turned out to be. One key weakness of the Commission's assessments prior to 2009 was the lack of reporting on the build-up of contingent public-sector liabilities, which often became real liabilities during the crisis. Nor did the Commission pay sufficient attention to the link between large foreign financial flows, the health status of banks and, ultimately, government finances. These surveillance failings meant that the Commission found itself unprepared for the task of programme management when requests for financial assistance started to arrive (see paragraphs 35 to 47).

Programme management processes

181

The Commission managed to take on its new programme management duties, which included holding talks with the national authorities, preparing programme forecasts and financing gap estimates and identifying the necessary reforms. Given the initial time constraints and lack of prior experience, this was an achievement (see paragraphs 45 to 50).

182

The Commission was thorough in obtaining the necessary information. It increasingly marshalled internal expertise and engaged with a wide range of stakeholders in the beneficiary countries. However, the Commission did not mobilise the same degree of expertise in 2008 and 2009 as it did later in connection with the euro area programmes, nor could it easily acquire external expertise. The Commission's human resources policy was not designed to deal with such a large and important European project as the resolution of the sovereign debt crisis clearly was (see paragraphs 52 to 54).

Recommendation 1

The Commission should establish an institution-wide framework allowing rapid mobilisation of appropriate human resources and expertise available in the different parts of the Commission or outside the Commission if a financial assistance programme emerges.

In relation to Regulation (EU) No 472/2013 of the European Parliament and of the Council, the Commission should develop procedures for the enhanced surveillance and management of possible new financial assistance programmes. The procedures should explicitly cover the scenario where these activities will be carried out by the EU institutions only.

Recommendation 2

Programme teams should be required to record systematically the key assumptions made and work done in preparing forecasts. The Commission should put in place tools to facilitate documentation. This can include the automatic logging of changes made by forecasters.

Quality control procedures should incorporate more checks on the key underlying assumptions and parameters chosen by country desks. For instance, a reference model-based forecast could be used in the quality review to flag areas where a judgement-based forecast significantly departs from the model-based forecast. This would allow for more targeted quality checks.

183

The production of macroeconomic and deficit forecasts was not a new activity. The Commission used an existing and rather cumbersome spreadsheet-based forecasting tool. Quality control was limited mainly to reconciling the various parts of the forecasts, with no inquiry by management into the reasoning behind the forecasting assumptions. It was very difficult to assess the plausibility of key assumptions such as fiscal multipliers, not only in any subsequent review but also, by management, during the actual production of forecasts (see paragraphs 55 to 70).

184

The programmes were mostly soundly rooted in EU policy priorities and current economic knowledge. However, the Commission's procedures were commonly affected by a lack of systematic record-keeping. Procedures were not geared towards the retrospective evaluation of decision-making. This can be partly explained by the crisis context, the initial time constraints and the novelty, for the Commission, of this type of programme management. The availability of records improved with time, but even for the most recent programmes some key documents were missing (see paragraphs 71 to 75).

Recommendation 3

To ensure the factors underlying programme decisions are internally transparent:

(a) staff involved in programme management should keep all necessary records in relation to the features of the programme design, the selection of conditions and the Commission's monitoring of programme implementation; and

(b) programme heads should be required to document key programme decisions in a decision log so that they are easily traceable.

185

The conditions in memoranda of understanding were mostly justified by specific reference to the Council decision. However, conditions were not sufficiently focused on the general economic policy conditions set by the Council (see paragraphs 76 to 79).

186

The conditions for assistance were managed differently in each programme. In some programmes they were less stringent overall, which made compliance easier. When comparing countries with similar structural weaknesses, it was found that the required reforms were not always in proportion to the problems faced or that they pursued widely different paths. Some, but not all, countries' deficit targets were relaxed more than the economic situation would appear to justify (see paragraphs 80 to 91).

187

The risk of treating different countries inconsistently or demanding unnecessary reforms remains a challenge to the process of programme management. The crisis nature of the programmes has made it difficult to develop detailed guidelines to restrict the room for manoeuvre of programme teams and national authorities when preparing and negotiating documents such as Council decisions or memoranda of understanding. Any solution must therefore be based on strengthening supervision of the work of Commission staff, and must go hand in hand with improvements to the review process.

188

The work of Commission staff culminates in a set of programme documents which provide the basis for decisions by the Commission (or the Commissioner on its behalf) and the Council. Both the programme documents and the underlying analysis have improved significantly since the end of 2008. However, even the more recent programme documents lacked some essential information (see paragraphs 97 to 99).

189
Common to all areas of programme management is a reliance on the judgement of experts in specific domains. The key documents resulting from expert analysis were subject to review, but this was insufficient in several respects. The underlying calculations were not reviewed by anyone outside the programme team, the work was not scrutinised and the quality control itself also suffered from the lack of documentation (see paragraphs 93 to 96).

Recommendation 4

The Commission should ensure that proper procedures are in place for the review of programme management and the content of programme documents, taking into account available resources. Horizontal review should function as a peer review of the work done by programme teams. It should pay particular attention to horizontal aspects, such as the similar treatment of countries, and report to management.

190
The Commission is responsible for monitoring programme implementation. The main shortcoming in this area relates to the monitoring of fiscal implementation. Each programme's deficit targets were set on the basis of the ESA deficit. While this ensures full consistency with the excessive deficit procedure, it also means that, when a decision on programme continuation is to be taken, the Commission's reporting concerning deficit target compliance is subject not only to measurement uncertainty, but also to forecast uncertainty (see paragraphs 100 to 103).

Recommendation 5

For budget monitoring purposes the Commission should include, in the memoranda of understanding, variables that it can collect with short time lags, such as a quarterly cash balance and/or an arrears target.

191

The manner of reporting on compliance with conditions was unsystematic. Many different terms were used to convey non-compliance, leading to confusion. Some conditions were not reported on. A few conditions were reported to have been met when this was not in fact the case (see paragraphs 104 to 107). An effective internal review (see recommendation 4) should reduce the risk of these errors. However, our work points to other weaknesses in how conditions were used. Instalments were released even though on-time compliance varied greatly between countries (see paragraph 200). Programmes included conditions, which were unable to guarantee the actual implementation of reforms or were not truly important for crisis resolution and repayment of the loans.

Recommendation 6

The Commission should clarify the role of programme conditions.

(a) Programme documents should set out the relative importance of conditions as prerequisites for the release of instalments.

(b) Conditions should focus on reforms with high and sustainable impacts. If instalments are made conditional upon preparatory steps, the memorandum of understanding should include conditions that guarantee the subsequent adoption of reforms.

(c) Conditions should be used sparingly, and should clearly relate to reforms that are essential to crisis resolution or the repayment of assistance. Programme teams should be obliged to justify the need for each and every condition. The selection of conditions should be a matter for internal review.

(d) Conditions should be defined so that compliance can be monitored with certainty. When conditions are set, programme teams should seek to identify data that may later be used to assess the results of the programme measures.

192

All programme teams established well-functioning informal cooperation with the IMF and the ECB. The lack of formal cooperation arrangements was due to the time frame, which was expected to be brief, and possibly to the preferences of the institutions (see paragraphs 108 to 114).

Recommendation 7

If the Commission has to cooperate with the other programme partners, it should aim to formalise interinstitutional cooperation. The terms of reference should specify mechanisms for sharing information, handling confidential information and resolving differences in opinion.

Borrowing operations

193

The Commission's issuance of debt was an accomplishment, as all bond issues attracted sufficient demand from the capital markets to be sold out. The Commission made the bond issues on time. The final cost of debt was in line with the market and peer levels. In terms of actual procedure, pricing levels were sometimes higher than the pricing level initially indicated by the lead banks (see paragraphs 115 to 122).

194

There were a number of gaps in the debt management process in the initial years. These omissions can be partly explained by the limited number of Commission staff assigned to this activity. The gaps did not have a demonstrable impact on the outcome of borrowing. The gaps were largely addressed in the later bond issues, so the recommendation concerns weaknesses identified as outstanding during the audit (see paragraphs 123 to 136).

Recommendation 8

In relation to the debt management process the Commission should:

(a) make more transparent how issues are allocated;

(b) keep systematic records of all its main issuance-related dealings with lead banks;

(c) insist on commitments by lead banks during the pre-issuance and post-issuance phases; and

(d) perform regular forward market analysis to determine the characteristics of each issue and assess the liquidity of the secondary market.

Programme achievements

195

The analysis of achievements should be the subject of further economic research to improve understanding of how countries tackled the need for adjustment and how its impact could be more evenly distributed in the future.

Use of financial assistance

196

In the five countries, the overall level of assistance funding remained as planned. However, there were some differences in comfort level. The early programmes and the Irish programme included a substantial safety margin. This allowed the countries concerned to repay more expensive IMF loans before their due date, to reduce programme financing or reliance on their own resources or to exceed their foreign exchange reserve targets (see paragraphs 138 to 139).

197
In contrast, Portugal faced significantly higher financing requirements than initially estimated, and financing was tight during the Portuguese programme. To meet its requirements, Portugal had to rely on market financing. The financial assistance to Romania was sufficient to cover the country's balance-of-payment needs, but financing of the Romanian public sector proved to be more problematic (see paragraphs 140 to 143).

Fiscal adjustment

198
With some exceptions, revised deficit targets were met. The actual composition of fiscal consolidation broadly corresponded to what was initially planned, but the erosion of tax bases wiped out the revenue gains from important new tax measures taken in 2009 (see paragraphs 144 to 148).

199
Each country's structural deficit improved, but the pace varied, largely because the starting points were different. Some fiscal consolidation had non-lasting results on the deficit because Member States used one-off measures to meet their targets (see paragraphs 149 to 154).

Structural conditions

200
The degree of Member State compliance with the deadlines set in the memoranda of understanding varied. Where compliance was delayed, this was mostly for reasons beyond the Commission's control. Occasionally the initial time frame was too ambitious given the scale of the reform. Although countries might not meet an original deadline, they did often comply after a certain amount of time had elapsed (see paragraphs 155 to 157).

201
Important conditions were as likely to be met by the original deadline as less important ones. At the end of a programme the compliance rate with more important conditions tended to be higher, which indicates that the Commission's focus partly shifted towards the most needed reforms as programmes neared closure (see paragraph 158).

202
The programme conditions successfully prompted reforms, and these mostly continued after the end of the programme, with reversals being rare as of the time of the audit. There were tangible improvements where the programmes targeted reforms in certain specific areas. In some cases the EU helped to encourage new reforms, while in others the assistance programmes provided an incentive to accelerate the implementation of existing national plans. However, compliance with a number of conditions still did not produce the effects in anticipation of which they were included in the programme (see paragraphs 159 to 164).

Macroeconomic achievements

203

As well as seeking to consolidate fiscal accounts and stabilise the financial sector, the programmes aimed at restoring external balance by enhancing economic competitiveness. In four of the five countries audited, the current-account adjustment was more rapid than expected. This can be ascribed, mainly, to an unexpected improvement in the income balance and, to a lesser extent, to a similarly unexpected improvement in the trade balance. Imports were lower than expected, mainly because of a fall in GDP. Where exports were also lower than expected, external factors (mainly a fall in the GDP of trading partners) were usually the cause (see paragraphs 165 to 172).

204

Internal devaluation was a key element of macroeconomic strategy in three countries, where a set of policies was devised to restore international competitiveness by focusing mainly on reduced labour costs. In practice, the pay adjustment applied to those newly hired during the recession, but the wages of incumbent workers hardly declined at all (see paragraphs 173 to 174).

Recommendation 9

The Commission should improve its understanding of how the countries adjusted so that greater attention can be paid to the lessons learnt from the programmes. Issues that could be further investigated include:

(a) impact of the measures to regain competitiveness, such as internal devaluation;

(b) social impacts and burden sharing of the adjustment programme; and

(c) sequencing of adjustment measures.

This Report was adopted by Chamber IV, headed by Mr Milan Martin CVIKL, Member of the Court of Auditors, in Luxembourg at its meeting of 11 November 2015.

For the Court of Auditors

Vítor Manuel da SILVA CALDEIRA
President

Reasons motivating the request for assistance

Each crisis situation was classified using the categories suggested in the academic literature[1].

Member State	Type of crisis	Key reasons motivating the government request for assistance
Hungary	**Balance-of-payment crisis**	The Lehman Brothers collapse generated a downward shift in investor sentiment in early October 2008. This led to a sell-off of government securities, a failed bond auction and sharp currency depreciation. The stress in foreign exchange markets prompted liquidity pressures within banks, which faced difficulties in rolling over foreign exchange swaps. Hungary requested financial assistance because of the concern that the evolving panic would upset market mechanisms to the extent a sudden disruption in Hungary's external financing capacity would occur. *Source:* Commission initial programme documents (2008); IMF ex post evaluation Hungary (2011).
Latvia	**Balance-of-payment crisis** **Banking crisis**	During the 3 months prior to the request for assistance, deposits had fallen by 10 %. This was led by a run on the Parex Bank, which encountered severe liquidity problems after it lost more than a quarter of its deposits. In the same period, official reserves fell by almost 20 % as the central bank sold foreign currency to defend the currency peg. In November the government decided to step in and nationalise the Parex Bank. In December, the government imposed restrictions on deposit withdrawals from Parex. According to the prime minister, Latvia was in need of financial assistance for three reasons: to manage the Parex Bank, to finance the budget deficit and to stabilise the financial market. Increasing concerns regarding Latvia's financial system and external debt resulted in the balance of payments and banking crises. *Source:* Latvia's IMF request (2009); Aslund, Anders and Valdis Dombrovskis (2011), *How Latvia came through the financial crisis*, Peterson Institute for International Economics; Blanchard, Griffiths and Gruss (2013), 'Boom, bust, recovery: forensics of the Latvia crisis', final conference draft to be presented at the Fall 2013 Brookings Panel on Economic Activity.
Romania	**Balance-of-payment crisis**	With the onset of the 2008 global financial crisis, domestic financial markets and the banking system came under severe stress. Access to external funding was limited, leading to a spike in interest rates. The slowdown in capital flows led to large exchange rate depreciation of over 15 %, deteriorating asset quality and the further weakening of bank balance sheets. The central bank intervened to stabilise the Romanian leu. Romania's credit rating was downgraded to below investment grade, which increased both the risk premium and borrowing costs. Sovereign yields jumped to 9 %. Against a background of strongly increased risk aversion, increased pressures on the exchange rate and increasingly restricted access to the bond market for public borrowing, the Romanian authorities made a request for financial assistance in March 2009. *Source:* IMF, *Romania: request for a stand-by arrangement* (2009); IMF ex post evaluation Romania (2012); European Commission, 'Overall assessment of the two balance-of-payments assistance programmes for Romania', *European Economy, Occasional Papers* 156 (2013).

Member State	Type of crisis	Key reasons motivating the government request for assistance
Ireland	**Banking crisis**	From late 2007, investor confidence in Ireland's property sector had evaporated amid concerns about over-supply and a price bubble. This left Ireland facing two problems: a sharp decline in cyclical construction-related revenues and the sudden emergence of large losses in the domestic banking system. In 2008-2010 Ireland had taken major measures to strengthen its banking sector. It provided government guarantees of domestic banks' liabilities. It injected capital amounting more to than 20 % of its GDP into the banking sector. The National Asset Management Agency took over banks' distressed land and property development assets. However, the government's obligations to the financial sector had pushed spreads on government bonds to historic highs and significantly reduced market access for the Member State. *Source:* Ireland: letter of intent (2010); IMF, *Ireland: request for an extended arrangement* (2010); European Commission (2011).
Portugal	**Sovereign debt crisis**	The period before the request for financial assistance was marked by unfavourable developments in public finances and a worsening economic outlook. This led to a deterioration of confidence and rising market pressures on Portuguese debt, accentuated by the negative developments in euro area sovereign bond markets. As market access tightened, the government had increasingly resorted to shorter-term security issuances and other types of financing (such as private placement, syndicated issue and substantial short-term financing from domestic banks). In early May 2011, Portuguese 10-year spreads over Bunds increased to 650 basis points. Amidst consecutive downgrading of its sovereign bonds by credit rating agencies, Portugal became unable to refinance itself at rates compatible with long-term fiscal sustainability. *Source:* European Commission, 'The economic adjustment programme for Portugal', *European Economy, Occasional Papers* 79, (2011); IMF, *Portugal: request for arrangement under the extended fund facility* (2011).

1 Claessens and Kose (2013); Laeven and Valencia (2012); Kaminsky and Reinhart (1999).

The lending facilities for the five countries

	Balance of payments assistance	European Financial Stabilisation Mechanism (EFSM)	European Financial Stability Facility (EFSF)
Institutional form	EU mechanism	EU mechanism	Private company owned by euro area countries
Capital structure	Guaranteed by the EU budget	Guaranteed by the EU budget	Guarantees from euro area countries
Lending capacity in euro	50 billion euro	60 billion euro	440 billion euro
Instruments	Loans, credit lines	Loans, credit lines	Loans, bond purchases on the primary and secondary markets
Duration	Permanent mechanism	Temporary mechanism	Temporary mechanism
Main decision-making bodies	Council, acting by qualified majority voting on proposal from European Commission		EFSF Board of Directors (i.e. members of the Eurogroup)
Legal basis of financing	Article 143 TFEU	Article 122 TFEU	Intergovernmental decision

Source: ECA.

The table does not include the other two facilities — intergovernmental loans to Greece and the European Stability Mechanism — which were put in place to provide financial assistance to euro area Member States.

Audit methodology

Identification of the audit criteria

1. We derived the good management practices and evaluation criteria from evaluations of IMF programmes, *ex post* evaluations of the EU's balance-of-payments assistance to non-EU countries, previous Court reports on macrofinancial assistance, guidelines and other publications from independent institutes and think tanks, and academic research. ***Table 1*** provides the most important source documents.

Table 1 — Key sources of audit criteria

IMF and Independent Evaluation Office of the IMF
International Monetary Fund guidelines on conditionality (2002); *Principles underlying the guidelines on conditionality* (2006); *2011 review of conditionality* (2012)
Fiscal adjustment in IMF-supported programs (2003)
Evaluation report: The IMF and recent capital account crises: Indonesia, Korea, Brazil (2003)
Evaluation report: Structural conditionality in IMF-supported programs (2007)
Structural conditionality in IMF-supported programs: background documents (2007)
Mauro, P., *Chipping away at public debt*, IMF, 2011
European Commission
Guidelines on the programming, design & management of general budget support (2007)
Final report: Meta-evaluation of macro-financial assistance operations (2004-2008) (2009)
Guidelines for the ex post *evaluation of macro-financial assistance and balance of payments operations* (2010)
Evaluation of Directorate-General for Economic and Financial Affairs' fiscal surveillance activities (2010)
European Court of Auditors
Special Report No 5/2001: Counterpart funds structural adjustment support earmarked for budget aid (seventh and eight EDFs)
Special Report No 2/2005: EDF budget aid to ACP countries: the Commission's management of the public finance reform aspects
Special Report No 11/2010 : The Commission's management of General Budget Support in ACP, Latin American and Asian countries

2. To identify the best practices in the area of public debt management, investor relations and transparency in debt issuance, we drew on the relevant work and guidelines of the following organisations:

   (a) the IMF and the World Bank, in particular the various versions of the guidelines on public debt management (2001, 2003, 2007 and 2014) and on the use of syndications (2010 and 2013);

   (b) the Organisation for Economic Cooperation and Development, in particular the cross-country analysis of government debt issuance procedures (2009);

   (c) the Bank for International Settlements; and

   (d) private-sector associations such as the International Capital Market Association, the Association for Financial Markets in Europe and the Institute of International Finance.

Analysis of structural conditions

3. The analysis of structural conditions was sample based (see ***Table 2***). The areas were selected after evaluating their relative importance for each programme.

Table 2 — Sample overview

	Hungary	Latvia	Romania	Ireland	Portugal
Number of analysed conditions	44	56	67	59	135
Approximate coverage (estimate by extrapolation from the sample)	73 %[1]	38 %	39 %	15 %	34 %
Thematic coverage					
Public financial management (e.g. fiscal responsibility, public procurement)	x	x	x	x	x
Public service reform and/or wage bill	x	x	x		x
Pension	x	x	x	x	
Structural funds	x	x	x		
State-owned enterprises, privatisation, public–private partnerships		x	x		x
Business environment		x	x		
Labour market (wage setting, active labour market policies, unemployment support)	x		x	x	x
Financial sector (capital adequacy ratios, banking surveillance)	x		x	x	

[1] 73 % of conditions represent all structural conditions. The remaining 27 % were only fiscal-related conditions.

Source: ECA.

4. Similar conditions in the different versions of the memoranda of understanding were grouped to avoid unnecessary repetitions. The share of the grouped conditions to the number of conditions in the different memoranda of understanding was used to measure the persistence of conditions.

5. The grouped conditions were classified in three categories of structural content:

   (i) Low structural content: this category covers conditions that would not bring about any meaningful economic changes by themselves. However, these conditions can serve as preparatory steps for more significant reforms. Examples include: (i) one-off discovery activities such as a single evaluation; (ii) preparation and publication of plans or strategies; and (iii) continuation of given activity.

   (ii) Medium structural content: this category covers conditions that can potentially have an immediate significant effect on the behaviour of some group of economic agents (e.g. public officials, enterprises, consumers, employees, and holders of licences). However, for these effects to be long lasting, additional follow-up measures would be required. This category includes four types of conditions. Firstly: conditions requiring that the executive branch of the government take actions that are likely to have an immediate effect. Such conditions can even have extremely significant macroeconomic effects (for instance, if the government decides to reduce the minimum wage), but such conditions are easily reversible. Secondly: conditions that require the government to repeatedly carry out some activity (e.g. regular budgetary monitoring). Thirdly: conditions requiring implementation of various administrative measures such as reorganisation within the central government, or measures leading to the implementation of existing legislation. Fourthly: all one-off actions.

   (iii) High structural content: this category covers conditions that would bring long-lasting changes in the economy by themselves. Such conditions can have very broad and significant effects, but the effects can also be concentrated on a few economic actors. Typical conditions in this category require legislative changes by the national Parliament. This category also includes significant changes in the institutional landscape, such as establishment of fiscal council or reorganisation of local government, and privatisation[1].

6. Compliance was assessed against the original deadline and against the implementation status at the time of the audit. The assessment was usually based on the available monitoring reports. The following types of conditions were not considered in the analysis of compliance:

   (i) vague conditions — i.e. conditions that did not allow for proper classification by the structural content;

   (ii) permanent conditions — i.e. conditions that require that certain activities be performed at each quarter; and

   (iii) conditions with no clear deadlines.

1 Nationalisation or banking support measures are not included in this category.

7. To account for situations of unobtainable compliance status, all statistical tests were always performed at least twice: (i) on the basis of data records without those where compliance status could not be obtained; and (ii) on the basis of all data records with missing values treated as non-compliance.

Cost of the debt

8. Concerning the pricing of the borrowings, the swap asset rates were used as the indicator of what markets considered as the prevailing risk-free yield of a given maturity at the time of issuance. The average of bid and ask swap rates (i.e. mid-swap level) was used as the benchmark for the issue yield achieved by the EU and peer issuers[2]. The data was obtained from Bloomberg or, if not available, calculated as the difference between the issue yield and the mid-swap level on the announcement date.

2 The EIB, the EFSF, Kreditanstalt für Wiederaufbau.

Reply of the Commission

Executive summary

I

The Commission welcomes this ECA performance audit of the programmes supported by balance-of-payments (BoP) and European Financial Stability Mechanism (EFSM) financial assistance. These programmes achieved their core economic objectives, which were for countries to return to financial markets, achieve sustainable public finances and return to growth leading to a fall in unemployment.

The impact and evolution of the crisis was unprecedented, both in Europe and globally. Predicting the full consequences of the rapid unwinding of imbalances in advance was very difficult. In such crisis conditions, standard economic reaction functions lose their ability to adequately describe the interrelationships between a number of economic variables. The Commission, and the EU, had to act quickly in the face of very high uncertainty and systemic sovereign and liquidity risks that challenged the stability of the whole financial system and the solvency of sovereigns.

At the onset of the crisis, a multilateral surveillance framework was already in place, but it did not prove fully adequate. Although the Commission had limited experience of the type and scale of intervention needed, it quickly developed a toolkit for crisis resolution. The BoP financial assistance programmes for EU Member States were put in place urgently and under difficult conditions. The EFSM programmes faced the same urgency due to the higher risk of spillovers to other euro area countries and the additional difficulty of being financed through financial instruments that had just been created. The Commission faced acute staff resource constraints, and had a steep learning curve. The programmes were complex instruments that addressed unpredictable crisis situations.

The input of the recipient countries in the programme design and evolution was critical. It reflects not just their different circumstances but also different political preferences, and is the most important factor in ensuring that they retain ownership over the reform programme. Without ownership, the probability of a programme succeeding is substantially reduced.

In comparing the programmes, it is also important to take into account recipient countries' different underlying circumstances and political, administrative and institutional constraints, and how they changed over time. Countries may have structural weaknesses that appear similar on the surface but that nevertheless are best addressed through different sets of policies. The flexibility to tailor and adjust the programmes to the needs and constraints of individual countries is critical to their success. The quality of a programme cannot be evaluated on the basis of benchmarking the number of structural conditions.

The Commission has already made substantial progress during the programmes under consideration in this audit and since they ended. This includes the mobilisation of additional expertise and financial resources, as well as the strengthening of EU economic governance and financial assistance mechanisms. The Commission intends to build on these changes and effect further improvements, as set out in its response to the audit recommendations.

III

A well-established fiscal surveillance framework was already in place in the pre-crisis period. The magnitude and nature of the 2007-2008 global financial crisis was unprecedented. This determined the abrupt and disorderly materialisation of imbalances in several EU countries.

The crisis showed that the pre-crisis surveillance framework was not fully adequate in identifying the risk in the underlying fiscal positions in times of unprecedented economic crisis. It also highlighted the extent of spillovers between countries and the need to take a wider approach to surveillance in the banking sector and wider macroeconomy. The reaction of financial markets — which was critical in the acceleration of the crisis — was, however, a new and particularly difficult effect to predict. At the point when countries applied for assistance, behind-the-scenes monitoring of a deteriorating situation had been under way and the Commission was in close contact with the national authorities.

It is for the recipient Member State, not the Commission, to make a request for a financial assistance programme. Also, the normal surveillance framework entails a more limited role for the Commission in terms of monitoring national economic and fiscal policy decisions and providing policy recommendations than under programme conditions.

The response to the crisis was immediate and comprehensive. It included the further strengthening of the EU's overall economic governance with an integrated system of European financial supervisory authorities (the European Systemic Risk Board (ESRB), the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA)) and regulatory architecture for financial institutions (i.e. banking union). The 'six-pack' and 'two-pack' were also introduced, addressing the surveillance weaknesses that the crisis unveiled. More specifically, the six-pack included the macroeconomic imbalances procedure, making the monitoring of macroeconomic and financial imbalances a key part of the EU's economic surveillance.

The fact that the actions of the Commission were not undertaken in a vacuum but are framed by complex institutional settings is not adequately taken into account in the assessment of the Commission's performance. The role of the International Monetary Fund (IMF) and — for the euro area countries — the European Central Bank (ECB) in the preparation and monitoring of the programmes is underplayed. Nor is the role of the Council as the primary decision-making body given due prominence.

IV

Macroeconomic and budgetary out-turns for 2008 have in general differed considerably from initial projections in the forecasts of a very large number of institutions, including the Commission. This is linked with the abrupt unwinding of imbalances and the unprecedented nature of the crisis, today generally accepted to have been a tail event, i.e. a very unlikely outcome in the distribution of possible outcomes. Furthermore, forecasts are always based on the information available at a certain point in time, therefore subsequent developments and data revisions naturally change the situation and outlook.

It must be recognised that forecasting is not an exact science. The Commission's forecasts have a good track record of accuracy.

The pre-crisis EU economic governance framework focussed primarily on fiscal policy, leaving the monitoring of financial risk, in particular, to central banks and national supervisory authorities. As a result of the absence of an integrated European supervisory and regulatory architecture for financial institutions, key risks were not flagged in a systematic way. Notable progress in addressing these institutional and governance shortcomings has been made since the crisis. The supervisory framework has been overhauled and closer contact has been established between the Commission and the newly established ESRB and the European supervisory authorities.

Nevertheless, the fact that, as a consequence of the unprecedented nature and magnitude of the financial crisis, governments took measures in support of the financial sector which had a sometimes substantial impact on public finances could not easily have been foreseen in advance.

V

The macroeconomic surveillance framework is a complementary process which does not form part of the Stability and Growth Pact (SGP). The SGP consists of a set of legal and political acts relating to fiscal surveillance. At the onset of the crisis the SGP was 10 years old, and had just been revised in 2005 in order to give a more prominent role to the underlying fiscal stance. The Commission is committed to learning from the shortcomings that became apparent, and revised it further in 2011, 2013 and 2014.

Making the link between the SGP and the Commission's preparedness to administer programmes does not take into account the point that both the reforms to the SGP and introduction of macroeconomic surveillance served to address the shortcomings in surveillance mechanisms. This allows imbalances to be identified in time to take the policy decisions needed to make countries better prepared to face a crisis. The management of financial assistance is a separate point from the identification of risks.

VIII

The report rightly points to the use of several spreadsheets and initial problems with documentation. The Commission's forecasting tools are not more complex than required.

Forecasting an economy is not an exercise that can be undertaken using a simple application. The Commission's forecasts have to cover a large set of variables. This necessarily leads to a large and rather complex set of data that country desk officers have to handle when preparing a forecast. Using the spreadsheets requires expertise and professional judgement. The Commission's forecasting method is in line with the practice of other organisations engaging in economic forecasts.

The Commission disagrees with the Court's statement related to the difficulty of assessing the assumptions in the forecast. The assumptions underlying the forecasts are described in the position paper that is produced at the beginning of each forecast round. The assumptions are then updated ahead of each subsequent forecast storage, and they are published in each forecast. Several meetings during the preparation of the Commission's regular forecasts bring together country desk officers, experts from horizontal units and top management. The discussion of the assumptions underlying the forecasts is a key part of these meetings. Moreover, horizontal units systematically check the mathematical and economic consistency of the forecasts prepared by the country desks.

In particular, the Commission has carefully explained its assessment of fiscal multipliers underlying the forecast (see for instance Box I.5 on page 41 of the 2012 autumn forecast). In 2013 DG Economic and Financial Affairs carried out an exercise to assess the implicit fiscal multiplier. The multipliers lie well within the range found in the empirical and theoretical literature.

IX

The Commission would like to underline the importance of properly distinguishing between providing the information needed to make a well-informed decision at the time and whether complete records could be retrieved at a later date.

In the early phase of the programmes the Commission was operating under severe time pressure and needed to put in place sound and effective crisis management procedures. The Commission accepts that there were weaknesses in document management in the early part of the programme processes, and that there was a process of 'learning by doing'.

The Commission provided the Court with a substantial amount of information, including spreadsheets, on the data and assumptions behind the initial calculations of the finance gap. Background documents were provided on all programme countries concerned.

X

The Commission does not agree that the most recent programme documents lacked essential information. The programme documents for Portugal and Ireland were very thorough.

XI

The Commission does not agree that there were conditions in the memoranda of understanding (MoUs) that were not focused on the general economic policy conditions set by the Council.

The general economic policy conditions set by the Council are 'general' and not intended to provide an exhaustive list of conditionality. Their attainment — particularly in relation to structural issues — often necessitates a broad range of measures in the MoU to strengthen the underlying position of an economy.

Furthermore, MoUs are the result of negotiations with the political authorities of the Member State concerned, whose input is crucial to the success of the programme.

Different approaches

In the Commission's view it was appropriate that each programme reflected country-specific economic conditions, institutional settings, circumstances and preferences.

XII

Though the Commission agrees that the risk of treating different countries inconsistently or requesting unnecessary reforms remains a challenge to the process of programme management, it is of the view that it was appropriate and necessary that the programmes were managed in a country-specific way. This flexibility was desirable given the diverse set of economic, political and administrative conditions in the different countries, and the important role of the recipient country in programme design and evolution. Countries may have structural weaknesses that appear similar on the surface but that nevertheless are best addressed through different sets of policies.

The input of the recipient countries in the programme design and evolution, which reflects not just their different circumstances but also their different political preferences, is the most important factor in ensuring that they retain ownership over the reform programme.

The Commission accepts that there is room for improvement in the consistency with which the conditions were categorised.

In the Commission's view the concept of 'structural content' used by the Court is not a meaningful metric for analysing policy measures and drawing conclusions about their importance. It is also the case that conditionality evolves through the lifetime of a programme. A structural reform that the Court would ultimately class as 'high content' may require several 'low content' preliminary steps in order to be assessed and prepared properly. The relaxation of some deficit targets was based on an overall view of whether the initial targets remained appropriate. This was done on the basis of a careful analysis, taking several country-specific developments into account and not only GDP growth.

XIII

Within the Commission, calculations underlying programme decisions are reviewed by officials outside the main programme team, including senior management and the heads of horizontal units. Review reports were subject to consultations procedures with relevant directorates-general.

In addition, the Commission worked in close cooperation with the IMF and ECB on EFSM programmes. Drafts of programme documents were consistently exchanged and cross-checked between partner institutions, all of whom were working actively with the domestic authorities.

Finally, negotiation outcomes were reported in detail to the Economic and Financial Committee (EFC) and Eurogroup Working Group (EWG), providing transparency on the outcome.

XIV

See Commission reply to paragraph X.

XV

The use of accrual-based deficit targets is supported by the legal framework underpinning EU economic surveillance and ensures cross-country consistency. All EU Member States, including those under an economic adjustment programme, are subject to the common EU fiscal rules. As per Protocol 12 of the Treaty on the Functioning of the European Union, which defines the reference values for the excessive deficit procedure, the deficit is measured according to the European System of Accounts (ESA), which is accrual based. Hence, the use of national accounts data to define the fiscal targets and for monitoring seems more than justified in a common European setting.

Conceptually, the principle of accrual accounting introduced with ESA95 was a key innovation, motivated at the time by the shortcomings of cash accounts. One of these shortcomings is that cash accounts are much more susceptible to manipulation and offer a less reliable economic picture.

However, the definition of the targets in line with the ESA does not preclude the Commission from using other available sources of information and data in its monitoring, where necessary. This may include fiscal cash-based data, especially given their faster availability compared to accrual data. Cash-based data must be interpreted with due consideration of their different conceptual underpinnings.

Overall, the proper use of more sources of data with different conceptual underpinnings and availability can only help to improve the monitoring of the programme targets and to support decision-making, where necessary.

XVI

The programmes set fiscal adjustment paths consistent with SGP requirements, taking into account country specific conditions and programme objectives. However, while the programmes take account of the appropriate factors in designing the pace of structural improvement, the eventual out-turn may be affected by a wider range of factors relating to the external environment. These include exceptional circumstances (e.g. deeper recessions than initially foreseen), inflation rates, the composition of growth and market sentiment affecting borrowing costs, as well as *ex post* data revisions.

Therefore, flexibility in adjusting to new conditions is necessary. This is also recognised under the EU's fiscal surveillance framework.

One-off measures may not be avoidable in some situations (Court decisions, bank rescue operations), but their classification as such ensures that they are recognised as temporary. They are not included in the structural balance precisely to avoid governments resorting excessively to such measures. Moreover, it is only natural that the structural balances of different countries change at different paces.

XVII

Tight deadlines to implement reforms could sometimes be characterised as unrealistic *ex post*, but they were set very ambitiously to encourage faster action.

The Commission does not agree that implementation of the most important conditions was left for the latter part of the programmes. The crisis conditions and political momentum for reform meant that important and difficult reforms were concentrated early on in the programme.

Recommendations

The Commission accepts recommendation (a).

The Commission improved its mobilisation of expertise over the years of the crisis. It was able to mobilise more expertise in the euro area programmes, which started later than the non-euro area programmes. The Structural Reform and Support Service (SRSS) has recently been set up within the Commission. The Commission will examine how some key principles for rapid mobilisation of the expertise needed could be further strengthened into an institution-wide framework where appropriate.

The Commission will take on board the need to develop procedures for the enhanced surveillance and management of possible new financial assistance programmes for euro area countries, in the context of the two-pack.

The Commission accepts recommendation (b), while highlighting the need to ensure that recording activity does not place a disproportionate burden on forecasters, particularly in a programme context.

The Commission has already improved procedures and document management since the first programmes were put into place. It will seek to further improve the implementation of its document-management and quality-control policy.

The Commission accepts recommendation (c).

The Commission has already improved record-keeping since the inception of the programmes. It will focus on ensuring that the new procedures are fully implemented, without undermining the ability of programme teams to meet tight timelines.

The Commission will examine how to further ensure the recording of key decisions without slowing down the decision-making process, in line with its document-management and quality-control policy.

The Commission accepts recommendation (d).

The Commission accepts recommendation (e). It will aim to include additional variables that it can collect with short time lags, such as a quarterly cash balance and/or an arrears target, in the MoUs, to assist in the monitoring of fiscal targets.

The Commission accepts recommendation (f). The Commission points out that what matters most is that there is a coherent and integrated set of reforms to address key economic challenges. Within that programme, there may often be choices to be made as to which reform package to choose. Hence, conditions should not be considered in isolation. The selection of conditions is a matter for negotiation with the recipient country. It should support countries' ability to set the agenda for their programmes. This is a prerequisite for them taking ownership of the reform process, which is an important determinant of programme success.

The Commission partially accepts recommendation (g). It has already set out guidelines for cooperation with the IMF and the ECB, and is taking other steps to facilitate interinstitutional cooperation during programmes. However, the Commission considers that clarifying this cooperation should avoid formalisation, making the decision-making process burdensome, especially given the time pressures involved. Flexibility should be kept in resolving differences of opinion as attempting to formally codify the dispute resolution process would be both difficult and of little value.

The Commission accepts recommendation (h). The Commission considers that the debt management process was always transparent and documentation has further improved over time.

The Commission accepts recommendation (i). It will seek to further improve its understanding of the adjustment process under the programmes through the current series of comprehensive *ex post* assessments and to draw lessons from them. The assessments cover all aspects of the economic adjustment under the programmes, including the three suggestions raised by the Court. An *ex post* assessment of the economic adjustment programme of Ireland has already been published.

Part I

34
As outlined in the Commission reply to paragraph III, the crisis showed that the existing surveillance framework was not fully adequate in identifying the underlying risks in some Member States' fiscal positions in times of unprecedented economic crisis.

The primary objective of financial assistance was to provide financing to the recipient countries to enable them to introduce the measures necessary to restore financial market confidence in a gradual manner. It is clear that for countries that required assistance due to being unable to fund their deficits on the financial markets, financial assistance would be used for budget support.

The Commission acknowledges that in the pre-crisis period it was difficult to fully detect the rising risk of fiscal imbalances, which were rapidly worsened by the unexpected materialisation of severe macrofinancial imbalances. However, there were concrete cases, such as Ireland and Spain, where the Commission indicated in its official documents that because of the macroeconomic and financial risks the countries concerned should run a budgetary surplus.

The need to activate the programmes for Member States was also determined by the unpredictable nature of the crisis, its unprecedented length and size.

35
While debt and deficit ratios are observable variables, the structural balance is not. By definition it relies on the calculation of the output gap, an unobservable variable. However, the calculation of potential output, from which the output gap derives, follows a methodology commonly agreed with the Council (hereafter 'the EU commonly agreed methodology'). This is rather complex but ensures a consistent framework across countries.

36
As discussed in more detail in the Commission reply to paragraph IV, the forecaster cannot anticipate country-specific policy decisions in advance. Actual outcomes can also be affected by *ex post* data revisions. Therefore this should be taken into account when comparing forecast and outcomes.

In the case of Ireland, the projected fiscal deficit was consistent with the central macroeconomic scenario, including for economic growth, contained in the Commission's spring 2008 forecast for Ireland. The discrepancy between the projected deficit and the out-turn is largely attributable to the revisions of the GDP forecast and other key macroeconomic variables that impact on the general government budget. The central scenario of the Commission's 2008 spring forecast did not anticipate the sharp economic slowdown that eventually materialised in the second half of the year. The Commission was not alone: domestic and international institutions, as well as private-sector forecasters, did not anticipate the severity of the downturn observed in Ireland in 2008.

37
The structural balance is a central indicator for policy surveillance since the 2005 reform of the SGP. While it is a fully relevant indicator for fiscal policy surveillance, the Commission accepts that it is not a fully accurate indicator and therefore interprets it with the necessary caution.

The estimation of the structural balance is conceptually affected by the same uncertainty that surrounds the forecast of other macroeconomic variables. This is an inherent characteristic, not due to the weakness of one method compared to another.

The calculation of the structural balance by definition depends on the calculation of the potential output, output gaps and headline balances and the impact of one-off measures. The calculation of potential output follows an EU commonly agreed methodology. It is regularly discussed and improved (when deemed necessary) within the Output Gap Working Group, a working group of the Economic Policy Committee (EPC). The method ensures cross-country consistency in terms of the quality and robustness of the estimation, as opposed to an à la carte method.

The commonly agreed approach used at the EU level to estimate the potential output and the output gap is not a pure statistical method. It relies on a large number of variables that determine a country's supply-side potential. Output gap estimates include as a crucial input forecasts of all relevant macroeconomic variables. Both output gaps and headline balances turned out to be more volatile than in previous periods, affecting the structural balance. This reflects the exceptionality of the situation and the nature of any forecast exercise.

Moreover, forecasts of small open economies (most programme Member States are such economies) are generally more volatile because they are exposed to a larger number of shocks and the impact of shocks is also stronger.

In several cases, in its assessments in the run-up to 2008, the Commission stressed risks related to the uncertainty regarding the cyclical position. For instance, the Commission recommendation for a Council opinion on the Irish stability programme 2006-2009 stated, 'In any case, it would be prudent to maintain room for manoeuvre against any reversal of the current growth pattern which has been led by strong housing sector developments.'

Therefore, the Commission is fully aware of the weaknesses of the structural balance indicator and factors these into its assessments. The fiscal surveillance framework has also been consistently improved, so that it now builds on a comprehensive set of tools, not only the structural balance.

For Member States in the excessive deficit procedure (EDP), since 2013 the structural balance has been corrected to control for forecast errors in potential output and windfalls/shortfalls of revenues. The methodology for assessing effective action under the EDP, endorsed by the Council in June 2014, also includes a second indicator of the fiscal effort based on the yield of the individual measures taken since the EDP recommendation. A careful qualitative analysis based on these two indicators is used to assess compliance.

For the SGP preventive arm, as part of the six-pack an expenditure benchmark was introduced at the end of 2011. This serves as a second indicator (alongside the structural balance) to assess compliance with the required adjustment towards the medium-term objective. An overall assessment of the two indicators is made to assess compliance with the rules.

These indicators are certainly complex and based on unobservable variables. However, when it comes to determining the fiscal effort implemented by a Member State and to give recommendations for the future, indicators like the structural balance are preferable to the simple deficit or debt ratios, as the latter are much more prone to being pro-cyclical.

See also Commission reply to paragraph IV.

38

The Commission acknowledges that the EU commonly agreed methodology did not fully correct for the impact of the housing booms which emerged over this period (see the cases of Romania and Ireland), which in turn resulted in very strong increases in the stock of capital. However, the stock of capital, which can be considered as an indicator of overall capacity in an economy, is not smoothed in the EU commonly agreed methodology. As a result it did not correct for these cyclical deviations (i.e. capital gaps) triggered by the asset bubble. In addition, investment in housing does not have the same effect on an economy's potential as gross fixed capital formation by firms. As a result, the housing boom overstated overall production capacity.

Work is ongoing to try to ensure that the EU commonly agreed methodology takes the influence of financial sector variables more into account in the future. In particular, a workshop organised by the Commission on September 28 2015 discussed the options for improving the EU commonly agreed methodology with the relevant stakeholders from the Member States and international institutions. This strand of work will be taken forward with the involvement of the Member States in the Economic Policy Committee. Specifically it will be under the auspices of the Output Growth Working Group, whose mandate is mainly to ensure technically robust and transparent potential output and output gap indicators, and cyclically adjusted budget balances in the context of the SGP.

In spite of the problems with the method that emerged in the pre-crisis period, it is generally recognised that the current methodology has done a very good job since 2009, relative to both the OECD's equivalent methodology and other methodologies such as the HP filter.

39
Sectoral imbalances have not been taken into account in the calculation of potential output. However, it is important to stress that: (i) currently there are no output gap calculations available at a sectoral level; and (ii) sectoral estimates would further complicate an already complicated calculation process.

As for real estate prices, the EU commonly agreed methodology did not fully correct for the impact of the housing booms which emerged over this period. See also the Commission reply to paragraph 38.

40
The existence of sectoral imbalances and risks associated with housing booms were not ignored in the Commission's assessments. For example, in the case of Ireland, risks related to the housing boom were already highlighted in the Commission assessment of the 2005 update of the stability programme.

42
The situation on the monitoring of contingent public-sector liabilities has significantly improved since 2009.

The supervisory framework has been overhauled and closer contact has been established between the Commission and the newly established ESRB and the European supervisory authorities.

The six-pack also introduced the macroeconomic imbalances procedure, making the monitoring of economic imbalances, including sectorial ones, a key part of EU economic surveillance.

In 2015, for the first time, the Commission produced series on contingent public-sector liabilities that are comparable across Member States.

43
In 2008 the Commission pointed out the need to broaden surveillance to address macroeconomic imbalances, beyond budgetary surveillance. (For details see pages 247-48 of the publication *EMU@10: successes and challenges after 10 years of economic and monetary union*).

The relevant institutional and legislative changes and significant improvements achieved since 2011 include the setting-up of the ESRB and the European supervisory authorities (EBA, EIOPIA and ESMA) and the adoption of the six-pack and the two-pack (see the Commission reply to paragraph 39 for further details).

More specifically, the six-pack introduced the macroeconomic imbalance procedure. This made inter alia the monitoring of financial imbalances (namely, the net international investment position private credit flow, private debt and financial sector liabilities) a key part of EU economic surveillance.

44
The sensitivity to various shocks was part of the surveillance activity of the Commission. The regular Commission forecasts provide specific exchange- and interest-rate assumptions, underpinning the economic and fiscal projections of each Member State and the EU as a whole. The main developments and impact channels on the economic and fiscal variables are explained in the horizontal chapters of the forecast publications, while such details might be omitted from the forecast commentaries for each Member State.

The Commission's assessment of the stability and convergence programmes (SCPs) for all countries usually included a specific section on risk assessment, the purpose of which was to discuss the plausibility of the programme's budgetary projections by analysing various risk factors. Similar content was also included in the SCP assessments prior to 2007 under the heading 'sensitivity analysis' or 'risk assessment'. For further information please see the SCP assessments:

http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/index_en.htm

46
Given the unprecedented characteristics of the crisis, there was a need to prepare an adequate and effective response as soon as possible. This meant, especially for the initial programmes such as Hungary, a need to work under very stringent time constraints.

The Commission had some in-house experience from the implementation of macrofinancial assistance to non-EU countries (including a number of western Balkan countries after the Kosovo crisis). It was familiar with negotiating and monitoring the implementation of MoUs that included structural reform conditions, as well as macro-conditionality for which the IMF was in the lead. It was also familiar with borrowing the necessary funds in the markets and lending them on to non-EU countries. This expertise enabled the Commission to make a proposal within a very short time period.

On some aspects, for example fiscal surveillance, the Commission had more in-depth knowledge of the country than the IMF. In other areas, for example banking supervision, the IMF initially had more experienced staff.

Part II

Programmes were mostly soundly based but there were weaknesses in record-keeping.

48
The Commission is mandated to analyse the economic and financial situation and help prepare programme decisions. For this purpose, the Commission coordinated closely with other programme partners and provided detailed programme documents to the relevant political decision-makers.

The Commission's processes did not always incorporate sufficient checks and balances

The Commission considers that its processes always incorporated sufficient checks and balances.

50 (v)
Programme countries should be treated consistently when targeting similar problems. This was a key concern throughout the programmes.

The input of the recipient countries in programme design and evolution is the most important factor in ensuring they retain ownership over the reform programme. This should be fully taken into account.

In addition, when assessing whether countries are in a similar (or comparable) situation in a given area, it is important not just to look at a static assessment of their performance in that policy area, but also to consider their capacity for effecting meaningful change. Equally a 'similar set of conditions' needs to be understood in terms of the overall content of the requirements, not the number of conditions.

52
The Commission collects a wide range of information coming from different sources (including outside the Commission). Therefore the assessments were informed by internal reports and surveillance material, by any relevant publicly available external publications (reports from academia, government, think tanks, stakeholders and other independent institutions) and by wide consultations with stakeholders.

54
The Commission requested key information when needed. Data was selected on the basis of its relevance for monitoring programme implementation, bearing in mind country and programme-specific needs, at the same time paying attention to not overburdening national administrations with reporting requirements.

57
The checks of the numerical consistency of forecasts include, for example, elaborate checks of the consistency of international trade forecasts. Moreover, the economic consistency of the forecasts is checked at several levels, including at the forecast meetings referred to in the Commission reply to paragraph VIII.

It is a conscious decision by the Commission to base the forecasts on the judgement of economists who are experts on the countries on which they produce forecasts. Other international institutions follow similar approaches. There is no evidence in the related literature that model-based forecasts perform consistently better than expert-based forecasts in general. Even in normal circumstances, structural relationships are not stable over time, and expert judgement is needed to adapt model relationships derived from econometric estimates to the specifics of the prevailing economic conditions. By contrast, judgmental forecasts surely perform better than forecast models during economic and financial crises.

Forecasting spreadsheets are a cumbersome tool which makes quality control problematic

Forecasting is by definition complex and the Commission has put in place a system to ensure adequate quality control.

58
Forecasting an economy is not an exercise that can be undertaken using a simple application. The Commission's forecasts have to cover a large set of variables. This necessarily leads to a large and rather complex set of data that country desk officers have to handle when preparing a forecast. Using the spreadsheets requires expertise and professional judgement. The Commission's forecasting method is in line with the practice of other organisations engaging in economic forecasts.

59
The forecast uses historical data compiled and validated by Eurostat whenever available. Only data not available internally in the Commission are taken from other sources (typically national central banks and statistical offices). For historical data, the forecaster's judgement is not involved. The single source of forecast data is by definition the forecaster (i.e. the country desk officer).

The Commission considers that the examples given by the Court do not provide evidence that there is a risk. On the contrary, the process for deriving the external assumptions to the forecast is clear and well documented (e.g. in the technical box contained in each forecast publication). These external assumptions are derived centrally and applied by all forecasters. There is also an extensive body of written guidance to the desk officers on how to identify and assess fiscal measures (in the context of applying the no-policy-change assumption).

Common Commission reply to paragraphs 60 and 61

The checks of the numerical and economic consistency of the forecasts go well beyond what is described in the report.

62

The Commission disagrees with the examples provided in Box 1 (see detailed comments). The Commission does not consider that these examples point to a general problem.

Box 1 (i)

The Commission disagrees with this assessment related to VAT in Romania. The forecast file provides the possibility to forecast in detail the other taxes on production by sector (households, corporations, government). The Commission did not project growth rates for these detailed variables and greyed out the relevant cells. As a result, the formulas still present in the greyed out cells kept the values for forecast years at a constant level. The discrepancy of 3.8 billion RON stems from a comparison of these unused cells with the desk forecast for government revenue from taxes on production and imports.

Box 1 (ii)

The Commission disagrees with this assessment. While 'civil servants' remuneration' was not a separate forecast line, a close proxy of this variable appeared as a separate item, which made the public-sector wage bill projection explicit in the file.

At the time under audit by the Court (2008-2010), the lack of timely data on household and corporate sectors (a 2-year lag) rendered it practically useless for the forecasting of such volatile, small, open economies. Accordingly, it was also not possible to use these data for projecting other sectors (on which more reliable and recent data was available) or for consistency checking with the whole economy data. Therefore, household and corporate sector projections were never published and appeared only as memo items in the forecast sheet, having no impact on other variables. In effect, the mathematical inaccuracy spotted by the auditors refers only to the breakdown of households and corporates that were intentionally excluded from the forecast exercise for Latvia due to the aforementioned data-quality issues.

In the Commission's view the decision to exclude untimely data from the analysis reflects a strength of the forecast process rather than a weakness.

Box 1 (iii)

The Commission disagrees with this assessment. The Court refers to an error in a document (June 2009 forecast) which was work in progress and not final. In the subsequent final forecast (September 2009) the measure was correctly incorporated.

Box 1 (iv)

The Commission disagrees with the Court's assessment concerning inconsistencies in the forecast of price indices for Latvia. The Court argues that the increase in value added tax in 2009 was not fully reflected in the forecast for consumer prices. This finding omits a multitude of other factors that also have a bearing on consumer prices. In 2009 and 2010 the consumer price index (CPI) turned out to be significantly lower than the Commission had forecast, suggesting the impact of the tax increase was not underestimated.

Data also show that the actual difference between the CPI and private consumption prices was larger than in the Commission's forecast. The items covered in the two indices are different. The major difference is the coverage of imputed rents in private consumption. The steep drop in house prices and rents during the crisis therefore had a much bigger impact on private consumption prices than on the CPI. This example underlines how economic relationships are different in times of severe crisis.

65

Country desk officers make their own assessment of the impact of fiscal measures. Whether country desk officers have detailed knowledge of the methods used in national authorities' assessment is therefore irrelevant.

The Commission also disagrees with the last sentence (on implicit fiscal multipliers). There is more knowledge of (implicit) fiscal multiplies than the report suggests. In 2013 DG Economic and Financial Affairs carried out an exercise to assess the implicit fiscal multiplier. The spring and autumn 2012 economic forecasts also included dedicated boxes which dealt with fiscal multipliers. The multipliers lie well within the range found in the empirical and theoretical literature.

QUEST model simulations were carried out at critical stages of some programmes (mostly the negotiation phase) to inform the definition of baseline and policy scenarios. For the Portuguese programme specific fiscal measures have been assessed on the basis of the country-specific version of the QUEST model. The relevant information, including the measure-specific multipliers, has been shared with the Court.

66

The Commission disagrees with this assessment. The conjecture that small errors could have gone undetected and might have led to significant cumulative errors is purely speculative.

67

The Commission acknowledges that there was a lack of comprehensive documentation, in particular in the early phase of programmes.

A partial forecast error decomposition exercise was carried out in 2013. A more comprehensive exercise is under preparation in the context of a reassessment of forecast accuracy. Also, during several forecast exercises country desks have decomposed the revision of the general government budget balance and real GDP growth compared to the previous forecast round. Decompositions of the changes in the forecast of the general government balance can be found in the programme review reports.

Financing gap estimates were incomplete and inaccurate

Some of the documentation with regard to financing gap estimates available at the time of the audit was incomplete. However, the heading does not adequately reflect the fact that the shortcomings primarily concern the documentation rather than the estimation.

69

The Commission disagrees with the Court's generalised statement on the availability of financing gap estimates.

The Commission provided the Court with a substantial amount of information, including spreadsheets, on the data and assumptions behind the initial calculations of the financing gap. Background documents were provided on all programme countries concerned.

The Commission accepts that there were weaknesses in document management in the early part of the programme processes. It is correct that for Hungary the relevant documentation for the initial financing gap is not available.

See also the Commission reply to paragraph IX.

70

The Commission considers that there were no significant errors in the financing gap calculations. In the case of Romania there was an error regarding the double-counting of intra-group loans of corporates.

The Commission disputes other claimed errors on which the Court has based its assessment. The Commission does not consider that these examples point to a general problem.

The Commission would like to stress that the estimation of financing needs over a programme horizon entails a range of calculations and assumptions which are subject to a large degree of uncertainty and can only be reliably quantified within a certain range. The lenders' willingness and capacity to provide funding also constrains the financial envelope, and the programme design needs to respect this constraint.

It is unrealistic to expect the estimates to be exactly right. What matters is that in practice any minor inaccuracies should not have negative consequences for the success of the programmes. In hindsight the projections proved accurate, since in no case under scrutiny did the financing envelope prove inadequate and have to be revised.

Alleged errors in the financing gap calculations did not affect the policy content of programmes.

No trace of some key records

Record-keeping clearly improved over time and some decisions are taken through non-written procedures.

Box 2 – Second indent

The Portuguese authorities created a web-based database of implemented programme measures, to which the Court has not been granted access. This is why it was difficult for the Commission to easily provide all the documents required.

In the case of Hungary, as the Commission explained to the Court that the adoption of decrees or laws has typically been monitored and verified based on the reliable web-based legal repository of the parliament and the *Hungarian Official Journal* (accessible free of charge). This is the main reason why paper copies of adopted legal acts were not archived systematically by the Commission.

Box 2 – Fifth indent

The forecasting process uses a standardised set of Excel files. It also relies on a clear process of documentation, quality checks and reviews by horizontal units, discussion with Member State experts and internal consultations. The standardised Excel files, which contain a fiscal sheet, are also used by country desks to monitor developments between forecast vintages. Country desks — in particular those working on programme countries — also use additional tools for the monitoring of fiscal variables. These depend on programme design, country-specifics and the granularity of the data available.

75

The Commission does not agree that the most recent programme documents lacked essential information. The programme documents for Portugal and Ireland were very thorough.

Box 3

The Commission does not agree that there were 'examples of non-compliance with the rules'. As set out in the Commission reply to paragraph XI the general economic policy conditions set by the Council are 'general' and are not intended to provide an exhaustive list of conditionality.

Box 3 – First indent

In case of Romania, the Commission pursued bi-annual formal reviews under the BoP programme whereas the IMF pursued quarterly reviews under the SBA. Under the joint EU/IMF programme, the Commission participated fully in all quarterly missions. However, the MoU/SMoU conditions can only be updated after a formal Commission review mission. During an informal review mission, only the LoI/MEFP is updated on the basis of agreement between Commission staff and the other programme partners.

Box 3 – Third indent

In the case of Ireland, the sale of assets and privatisation were not included in the Council implementing decision. The Irish programme never included formal conditions to privatise a given number of state-owned companies or a given amount of assets. In Ireland the number of state-owned enterprises is very limited. Nevertheless, over the course of the programme the authorities agreed to identify a number of assets that could be privatised. In addition they agreed that, in case the Irish authorities decided to privatise, half of the proceeds would be used for growth enhancing measures. During the course of the programme no privatisation proceeds were accrued.

Conditions were not sufficiently focused

The Commission considers that the conditions were sufficiently focused.

78

The Commission does not agree that the management did not sufficiently challenge the proposals to ascertain whether all the conditions were really necessary for the achievement of the general economic policy goals. The Commission reply to paragraph 79 addresses the link between the reform and economic policy objectives.

79

All reforms had close links with the programme objectives and need to be seen in the context of a broader set of policy reforms to improve the budgetary situation, the efficiency of public administration or the business environment. See also the Commission reply to paragraph XII.

80
Though the Commission agrees that the risk of treating different countries inconsistently or requesting unnecessary reforms remains a challenge to the process of programme management, it is of the view that it was appropriate and necessary that the programmes were managed in a country-specific way. This flexibility is desirable given the diverse set of economic, political and administrative conditions in the different countries. Countries may have structural weaknesses that appear similar on the surface, but that nevertheless are best addressed through different sets of policies.

See also the Commission reply to paragraph XII.

81
The revision or update of certain policy conditions should be viewed as a reasoned response to changing circumstances over the course of a programme. The initial MoU cannot be a complete contract that provides for all sorts of contingencies that may arise during programme implementation. The MoUs are living documents that need to be flexibly adapted to the new economic or implementation challenges.

82
It was appropriate and necessary that the programmes were managed in a country-specific way. This flexibility is desirable given the diverse set of economic, political and administrative conditions in the different countries. See also the Commission replies to paragraph XII and Box 4.

Box 4 – Second indent
The reduction of the duration of unemployment benefits aimed to reduce the risk of unemployment traps, and was a step in the right direction even if it fell short of what was required by programme conditionality. It was assessed in the context of being part of wider set of reforms. Keeping social dialogue open was seen as an important factor in delivering a strong reform package.

84
The Commission agrees that the definition of MoU conditions differed across programmes with respect to whether they included a requirement to 'draft' or 'adopt' legislation. This reflected the fact that, in some cases, national governments requesting financial assistance did not feel that it was appropriate to make commitments which bound their parliaments, given the principle of the separation of powers.

As noted in the Commission reply to paragraph XII, the input of the recipient countries in the design and evolution of programmes reflects their different circumstances as well as their different political preferences. Both are important factors in ensuring that they retain ownership over the reform programme.

Box 5
While this reform of the supervisory framework in Ireland was very important — given the failings in the run-up to the crisis — other reforms that were more critical to the success of the programme were addressed by the Oireachtas first, amid a very busy legislative agenda required by the financial sector component of the programme. It was also important to take the time to adequately calibrate the enhanced supervisory powers to be conferred on the Central Bank of Irland via the Central Bank Supervision and Enforcement Act. This act was enacted in 2013, providing extensive investigative powers to source information and conduct on-site inspections, issue regulations and take direct remedial and enforcement actions to address breaches of regulation, as well as to request independent auditor evaluations of banks' financial accounts.

85
In the case of Portugal, the number of conditions was commensurate with the structural problems the country was facing.

In addition, countries did not find themselves in similar circumstances with regard to structural problems. This justifies the variation in the structural component of the programmes.

The final number of conditions has little meaning. An ultimately 'high content' structural reform may require several 'low content' preliminary steps in order to be assessed and prepared properly.

Also, as set out in the Commission reply to paragraph 50, when assessing whether countries are in a similar situation in a given area, it is important to look not just at a static assessment of their performance in that policy area, but also to consider their capacity for effecting meaningful change. A 'similar set of conditions' needs to be understood in terms of the overall content of the requirements, not in terms of the numbers of conditions.

88

The Commission calculates and publishes the cyclically adjusted balance as well as the structural balance and other variables with every forecast vintage. If the economic conditions (or forecast thereof) have changed, this may affect the cyclical balance. However, there may be changes to the economic outlook with implications for the fiscal position without changes to the cyclical balance, for instance through changes in inflation projections.

On the other hand, when changes to the cyclical fiscal position (or forecast thereof) occur from one forecast vintage to another, this does not automatically imply a revision in the deficit targets under the EDP or under the programme. Revisions to the targets may be related to other factors besides the changed outlook for the economic cycle, such as a different composition of growth, revenue shortfalls/windfalls, changes in potential growth or other factors outside the control of the government. These different elements are duly considered by the Commission when deciding on revisions of targets.

89

Revisions in the cyclically adjusted balance do not — and should not — automatically translate into (similar) revisions of targets, as set out in the Commission reply to paragraph 88. Therefore no direct link should be established between changes in projected cyclical balances and the need to revise targets.

In the case of Hungary, the revision of the fiscal adjustment path agreed in May 2009, which extended the deadline for the correction of the excessive deficit by an exceptional 2 years from 2009 to 2011, was also partially justified by a sharper–than-expected downturn. Additional consolidation measures were also taken, which represented a clear shift towards improving the long-term sustainability of the public finances. The revision implied a less pro-cyclical fiscal policy stance for 2009, helping to avoid a vicious downward spiral in the economy.

For Portugal, the fiscal target was revised twice, at the fifth and seventh reviews. In both cases the targets were revised following a substantial unexpected deterioration in the economic outlook, as well as growth being less tax-rich than expected. This is discussed in the compliance reports of both reviews (Sections II and III). Moreover, both revisions were preceded by Constitutional Court rulings which triggered substantial gaps in the budget. These factors were not fully under the control of the government.

90

The SGP allows the fiscal adjustment path to be redesigned under certain circumstances. In accordance with Article 3(5) of Regulation (EC) No 1467/97, effective action has to be taken, but unexpected adverse economic events with major unfavourable consequences for government finances may occur.

While there is no pre-established algorithm for redesigning budget targets, the situation is assessed on a case-by-case basis. Where warranted the fiscal path may be redesigned, in line with the legislation and based on specific factors. Whenever various factors negatively affected the deficit targets, or when they were not met, this was duly explained in the country-specific programme documents such as programme reviews or notes to the EFC.

92

The absence of reference to particular issues in programme documents does not imply that they were not considered. For example, in the case of the Romanian programme, the particular structure of wages in the Romanian civil service was specifically considered when the wage cut was designed.

Programme management weaknesses due to weak controls

The Commission disagrees that controls were weak. The Commission considers that programme management was appropriate.

95 (i)

The Commission disagrees that no person outside the programme team reviews the underlying calculations and the projections. The discussions and facts were cross-checked with the IMF (and the ECB for EFSM programme countries) and the hierarchical line in DG Economic and Financial Affairs looked at the projections and overall consistency.

95 (ii)

The work of the Commission representatives was assessed by hierarchical superiors, though admittedly under intense time constraints. See also the Commission reply to paragraphs 61, 69, 70 and 79.

Financing gap estimates, and hence the size of the financial envelope of a programme, is an important issue which is heavily scrutinised by EU/euro area Member States.

95 (iii)

See Commission reply to paragraphs IX and X. The Commission agrees that there were weaknesses in document management in the early part of the programme processes. The Commission was operating under severe time pressure and needed to put in place sound and effective crisis management procedures. The crisis circumstances did not allow for thorough record keeping.

Box 6

The Commission disagrees that in the case of Romania no such measures were identified at all. The measures in the amended budget for 2009, adopted on 28 April 2009 by the Romanian parliament, were not included as conditions in the MoU due to the time lag between the mission and the signing of the MoU. The MoU, signed on 23 June 2009, stipulates for the further gradual deficit reduction in 2009-2010 that 'The adjustment will be mainly expenditure driven, by reducing the public-sector wage bill, cutting expenditure on goods and services, lowering subsidies to public entities and through reductions of capital spending on items like vehicles and office equipment. Priority will be given to investment projects co-financed by EU funds.' The Council Decision of 6 May 2009 providing Community medium-term financial assistance to Romania (2009/459/EC) includes these measures under Article 3 paragraph 5(c)-(g).

In the case of Hungary, all fiscal consolidation measures contained in the 2009 and 2010 budget bills with verifiable deficit-improving impacts were incorporated in the original MoU or subsequent revised MoUs.

98

The Commission provided several files containing underlying data used for constructing the financing gap tables that were published by the Commission. Sometimes assumptions underlying the financing gap calculation were presented in a rather succinct manner, so one cannot replicate the calculation based on this information only.

In one case (Hungary) the funding gap was calculated by the IMF only and the Commission acknowledges that it was not able to provide a copy of the underlying calculations. The Commission built up its capacity to calculate funding gaps as the crisis evolved.

98 (i)
The size of the Hungary programme was entirely based on IMF calculations. With the sudden eruption of the crisis in Hungary, which was the first country to ask for assistance, the ability of the programme team to rely on the expertise of the IMF was considered a key advantage. However, the numbers were scrutinised by the EU Member States before setting the financing envelope.

98 (ii)
For Ireland the Court makes the comparison between two different public finance indicators — the accruals-based ESA deficit and the cash-based Exchequer deficit. While they both reflect the state of the public finances there can be significant differences in their size and composition. The reconciliation between the two indicators requires detailed knowledge of the public finance accounts under both systems. It is usually done by the statistical authorities during the biannual EDP notification to the Eurostat.

For the forecast period, assumptions are applied for the major financial transactions that are expected to be recorded by the national authorities in the Exchequer balance, constituting a difference from the accruals-based ESA balance. Among such major transactions were repayments of the promissory notes, accounting for some 9.3 billion euro of the gap. Moreover, the National Treasury Management Agency used to include additional contingency buffers in addition to the baseline Exchequer financing needs calculations, thus increasing the financing needs, while such buffers were excluded from the ESA deficit and debt estimates. At a time of extreme market sensitivity, the absence of the specific details was motivated by unwillingness by the Irish authorities and the programme partners to disclose specific borrowing plans. Other elements of the difference are related to the fact that there were some divergences in the fiscal deficit estimates by different institutions. The most conservative estimate was included in the financing needs calculations.

The programme documents include the main elements of the fiscal projections and the financing needs calculations, and also mention in a footnote some differences between the two.

Projections for the aggregate Exchequer cash deficit have however been included in *The economic adjustment programme for Ireland* and subsequent programme documents.

There are always differences between cash- and accruals-based estimates. However, there was no need to explain deviations between cash- and accruals-based estimates as the latter were the most relevant indicators for the purposes of the programme, particularly as they are the indicators required by EU fiscal surveillance and the EDP.

99
The Commission partially agrees with the Court's assessment. The Commission carried out extensive sensitivity tests but kept them confidential in order not to trigger adverse scenarios. This information was highly sensitive and it may not have been appropriate to release it in a context of very volatile financial markets.

For Ireland specifically, the sensitivity to exchange and interest rates shocks has always been considered in the economic and fiscal projections. The 'pernicious feedback loops between the growth, fiscal and financial crises' were well understood when the financial assistance programme for Ireland was designed (see Occasional Paper No 76). The purpose of the EU-IMF programme was to break this feedback loop, including by removing the interest rate shock on public finances through external financial assistance and thus providing certainty for the private sector (reducing margins).

100
If 'conditions laid out by the Council' refers to the policy conditions agreed under the programme, then this was clearly done by the Commission. If 'conditions laid out by the Council' refers to policy guidance issued by the Council under the regular EU economic surveillance frameworks, the Commission also complied with the existing legal provisions.

101
Please see Commission reply to paragraph XV.

The choice of the ESA deficit is not only motivated by the EDP. It might be useful to complement the Court's observation with an explanation about the merits of national accounts and the ESA deficit versus cash data in the context of fiscal surveillance. Working with a cash balance only would increase uncertainty, rather than reducing it, as this would open the door for governments to play with the timing of payments for certain transactions in order to reach deficit targets.

102
The existence of the possibility of statistical revisions should not serve as an argument for switching to cash-flow budgetary targets. A cash-flow regime would imply other types of uncertainties with even larger adverse implications for the reliability of the fiscal conditionality.

Please see also Commission reply to paragraph XV.

102 (i)
The statement on Hungary is factually correct and refers to an *ex post* statistical revision (see Commission reply to paragraph 90).

102 (ii)
The statement on Romania is factually correct and refers to an *ex post* data revision validated by Eurostat, outside the control of the forecaster. In addition, the EFC note of 23 August 2010 reporting on the mission of 26 July-5 August contains a box on page 13 explaining the gap between the cash and ESA95 deficit in the case of Romania.

102 (iii)
The revision in Ireland was due to a reclassification (as validated by Eurostat) of revenues from the sale of mobile telephone licences from 2012 to 2013, which is not under the control of the forecaster.

103
Countries with programmes also had to comply with the rules of the EDP, which sets out a framework of fiscal targets. These fiscal targets have to be defined in line with the ESA definition.

Where bank rescue operations could have a considerable yet difficult-to-forecast impact on the budgetary outcomes, these operations were excluded from the programme fiscal targets.

In the case of Ireland, the Commission has been clear about the definition of the underlying deficit, which had to be — and was — consistent with the system of national accounts. The definition of the fiscal target therefore excluded the impact of the direct support for banks.

The Commission calculated the underlying deficit as: headline deficit minus deficit-increasing capital transfers provided to banks as a part of the financial sector rescue measures. The amount of financial sector support measures is included in the 'Supplementary table for the financial crisis' published by Eurostat, in the line 'Capital injections recorded as deficit-increasing (capital transfer)'. However, sometimes this line also includes capital transfers that are not treated as financial support measures for EDP purposes. In particular, receipts of the dividend payments from Anglo Irish Bank in the form of ordinary shares were treated as capital transfers.

104
In the case of Ireland, a 'Programme monitoring' table was provided as an annex to the MoU throughout the programme period. This detailed the compliance status of the various requirements. The detail contained within this table increased over the course of the programme.

In the case of Romania, progress on structural reforms was reported by topic, rather than condition by condition. The Commission agrees that this could make it difficult for the reader to fully assess the state of compliance.

105
The Commission disclosed how far conditions had been complied with. Typically, 'Not observed' was only used in circumstances where it became clear that the condition would not be respected soon. The deadlines were often set very ambitiously to encourage faster action. If reform action had advanced, an intermediate term between 'Observed' and 'Not observed' appeared more appropriate.

In the specific case of Ireland, a 'Programme monitoring' table was provided as an annex, which detailed the compliance status of the various requirements. These were described as 'Observed' or 'Non-observed'.

106
In many cases the detailed results of the monitoring were set out in the main text of the review report, rather than in the monitoring table itself. This was particularly the case for conditions that were 'ongoing' or 'delayed'. In addition, as the programmes progressed, some conditions and accompanying monitoring merged with other conditions or moved to different sections of the programmes.

Box 7 – Second indent
Progress in strengthening administrative capacity and other measures to increase the absorption of EU funds in Romania are reported upon in mission reports. See for example paragraph 37 on p. 17 of the EFC note of 23 August 2010, reporting on the 26 July-5 August mission.

Box 7 – Third indent
The Commission agrees that progress on this specific measure in Romania is not reported. This was because attention shifted to the improvement of tax collection and the reduction of tax evasion and fraud, with technical assistance provided by the IMF and missions by the Commission's DG Taxation and Customs Union (see paragraph 27 on p. 14 of the EFC note of 23 August 2010, reporting on the 26 July-5 August mission).

Box 7 – Fourth indent
The condition on reorganising local government in the Portuguese programme was not just about municipalities. The condition in the original MoU stated 'Reorganise local government administration. There are currently 308 municipalities and 4 259 parishes. By July 2012, the government will develop a consolidation plan to reorganise and significantly reduce the number of such entities.'

Compliance with this condition was reported in various programme review documents. Policy conditionality on this matter evolved over time, taking into account strong political opposition. The number of parishes (*freguesias*) was reduced to 2 882 after the local elections in September 2013. While there was no reduction in the number of municipalities, a new legal provision for creating intermunicipal communities was put in place.

107 (i)
The example provided for Ireland indicates that conditionality on multiannual budgetary framework was considered as fully complied with. The Commission has, however, repeatedly made clear in its quarterly reviews that it had concerns about specific elements regarding the framework. It again raised the issue in the context of the European emester 2014.

107 (ii)
In view of the high degree of autonomy of the two regions and the 308 municipalities in Portugal, the Commission had to accept that consolidated regular reporting on regional and local public-private partnerships and state-owned enterprises was not feasible and would require a disproportionate amount of administrative resources.

109
The Commission agrees that working with the IMF helped it to manage the programmes as it gained experience in crisis management. However, the Commission does not agree that the practices noted by the Court were only introduced in the course of the programmes. The Commission's forecasting spreadsheets were already more detailed than the IMF ones. The Commission teams for programme missions tended to be larger than those of the IMF from the start, due to the participation of DGs other than DG Economic and Financial Affairs.

111
Informal arrangements worked well. The exchange of information was very thorough and there is no evidence that the absence of more formal arrangements proved to be a problem.

111 (iv)
The institutions have different decision making procedures and it appears unrealistic to formalise *ex ante* a disagreement resolution that would actually facilitate the resolution of potential disagreements.

114
In Ireland the ECB, as an independent institution concerned with monetary policy, did not provide internal information to the Commission. This includes information on or related to its internal deliberations on the matter of burden sharing. As a result of the ECB's independent status, the Commission is not in a position to demand such information from the ECB. Given that the amount of ECB financing was close to annual Irish GDP, continued ECB financing was essential for the success of the programme. Hence the Commission, as well as the IMF, accepted such a condition. Developments since then have justified the choice not to bail in senior bond holders. Irish debt is clearly sustainable, credit default swap spreads are down to the levels of France, Belgium and Slovakia, Ireland's credit rating was upgraded and Irish banks repaid most of the ECB funding.

Moreover the decision to not bail in senior bond holders needs to be considered in its context. There existed a blanket guarantee for deposits which was devised by the Irish authorities. The benefits of such an action also had to be weighed against the costs in terms of the spillovers to other banks and the litigation risks.

Part III

Pricing levels at issuance sometimes higher than initial guidance from banks
These differences are inherent to the process of bond issuance.

121
While formal 'requests for presentations/proposals' were sent to banks as from 2011 (i.e. for all EFSM transactions), until 2010 proposals had been collected from banks via meetings and conference calls and documented in the 'bank selection notes'. These were produced as from the very first crisis-related BOP transaction in December 2008 and were made available to the Court.

122
The Court considered whether the level of pricing on the trade date was justified simply by comparing it to the initial price guidance given by banks in their proposals, without taking due account of the market developments in between these two dates. The two cases referred to by the Court refer to one single request for proposals. There was a time span of 14 and 23 days, respectively, between the initial price guidance and the trade dates. Deviations from the initial price guidance are inherent to the process in general, and in particular in case of such a long time span.

This observation should be seen in light of the Court's observation in paragraph 118 that 'The final cost of debt was in line with the market and peer levels'.

123
The Commission points out that the weaknesses identified referred to the period until 2010 only and were limited to documentation issues. They did not refer to the debt management process itself.

The Commission recognises that there were some shortcomings in the documentation of the borrowing process in the initial years, but the process was properly managed and did not impact the outcome.

The Commission considers that in the initial years the selection of lead banks was competitive, even though not fully documented. With regard to precautions against the disclosure of non-public material or insider information, the Commission complies with existing rules and regulations and with market practice when carrying out funding operations. Furthermore, the banks involved in funding transactions are subject to national securities regulations, including rules on the prevention of insider trading, which provides additional assurance to the Commission.

The allocation strategy is discussed with the lead managing banks beforehand and a standard approach is applied, in line with market practice. The allocation rules are therefore entirely clear to all parties involved. The final allocation is decided by the Commission.

The monitoring of the secondary market activities was formalised by the Commission in 2012.

The level of bid-offer spreads depends on a number of different parameters.

127
The Commission had to perform the borrowing operations under exceptionally difficult circumstances. Despite this, it successfully managed the debt issuances in accordance with market practices.

128
While the Commission acknowledges that the procedure manual was updated over time, the process was clearly documented from the start in separate notes. The Commission points out that the improved quality of documentation applies as from January 2011. At the time of drafting of the Court's report it had been in place for more than 4 years and was used for all EFSM transactions, which represent the majority of operations both in number and amount.

129
The Commission stresses that the selection of lead banks was at all times in line with the existing procedures and appropriately documented. Initially this was based on 'bank selection notes', and as from January 2011 the process was further formalised based on a 'request for proposal' procedure.

130
The Commission considers that it complied with existing rules and regulations and with market practice in this respect. Furthermore, banks are subject to national securities regulations, including rules on pre-sounding and prevention of insider trading, which provides additional assurance.

In addition, Article 6(2)(a) of Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (OJ L 173, 12.6.2014, p. 1), which will apply to issuers as from 3 July 2016, expressly exempts the transactions, orders or behaviour of the EU.

133
The allocation strategy is discussed with the lead managing banks beforehand and a standard approach is applied in line with market practice. The allocation is done in close cooperation with the syndicate and all orders are made transparent to the Commission, which has full control over the process and gives its agreement on the final allocation. All allocation tables are available at the Commission.

134
A formal 'secondary market commitment' was introduced as a standard feature of the EU's mandate letter for the EFSM, i.e. from January 2011 onwards.

135
While the Commission has been formally checking secondary market liquidity since 2012, it should be noted that it is not common practice that issuers generally check secondary market liquidity.

136
The fact that bid-offer spreads vary between banks is normal, especially considering the number of market participants.

138
The financing gap estimated at programme inception is not a plan. It represents an estimate of the financing needs to be met during the programme, with a buffer built in — in some cases explicitly — reflecting the inherent uncertainty in these estimates. The buffer serves to ensure that there is sufficient financing under worse than expected outcomes and to generate investor confidence and support the economic recovery process.

139
The safety margins included in early programmes, designed in the wake of the Lehman collapse, reflect the scale of the perceived uncertainty at the time and the need to ensure that the funding envelope would turn out to be sufficient. Banking sector needs are particularly difficult to predict, leading to a need for a substantial contingency reserve for countries like Ireland with significant banking sector difficulties. The financing envelope needed to be large enough to account for this uncertainty and to reassure markets that all needs were covered. It is therefore to be expected that, unless adverse developments materialise, funding needs should come in below the envelope.

139 (iv)
The repayment of the IMF loans before their due date relates to the success of the countries — and by extension the programmes — in being able to access the markets at cheap enough rates to make the early repayment politically and financially advantageous. Linking the early repayment to lower financing needs requires a number of assumptions which may or may not hold. Moreover, as indicated elsewhere, programme funding included safety margins as a signal to markets and were instrumental to the success of the programmes.

140
It should be noted that Portugal did not fully use all the financial assistance available under the programme, and that it ended the programme with a substantial Treasury buffer.

The easing of monetary conditions is also true for the Irish programme.

141
During the programme the IMF disbursements were normally made to the central bank to constitute foreign currency reserves, while the Commission disbursements were made to the Ministry of Finance to finance the budget. In 2010 some IMF disbursements were also made to the Ministry of Finance for the budget. The reason was that the budget deficit was higher than originally expected because of lower growth and policy slippages, while the reserves at the central bank were at an adequate level. From this, however, one cannot infer that the central bank indirectly covered some of the government's additional financing needs. The government managed to service and refinance all of its debt obligations during the programme. Monetary policy, which is an exclusive competence of the independent central bank, naturally also affects domestic financing conditions. This, however, should not be seen as indirect support.

146
The statement on Hungary does not take into account the increased absorption of EU funds.

147
It is important to separate out conceptually the revenue increasing impact of new measures from the reduction in revenues due to falls in economic activity. The actual impact of a tax reform cannot be judged by looking at the overall performance of revenues in an economy. Estimation of the counterfactual in the absence of the reform is needed.

148

Not all legislative acts referred to introduced changes which affect the tax-to-GDP ratio and not all of them relate to the BoP programme conditionality. The motivations for their introduction were complex.

Common Commission reply to paragraphs 150 and 151

The change in the structural balance is affected not just by the targets set and the policy choices made to meet these targets, but also by a wider range of factors outside the control of the government relating to the external environment. These include inflation rates, the composition of growth and market sentiment affecting borrowing costs, as well as *ex post* data revisions. In addition, in setting the targets, country-specific considerations going beyond the relationships set out below were taken into consideration. Therefore, the relationships between the variables mentioned in paragraphs 150 and 151 are of a complex nature. As a consequence, country benchmarking on the basis of these relationships may not be revealing in terms of challenges faced before the programme or outcomes afterward.

While in general a weaker initial fiscal position warrants a faster pace of consolidation, this factor should not be seen in isolation from other, sometimes country-specific, factors affecting the fiscal imbalances which needed to be corrected. It is also to be noted that the period of time granted by the Council for the correction of the excessive deficit (with the underlying recommended structural effort) may not coincide with the programme period.

152

The fiscal effort set out in the programmes was determined on the basis of a wide range of factors. The initial level of debt was taken into account, but other country-specific factors were also important.

As a middle-income non-euro area economy, Romania is more vulnerable to its public debt level than higher-income euro area countries. At the time of programme approval, interest rates on Romania's public debt had increased by 300 bps, suggesting doubts in international financial markets about the country's sovereign financing position.

153

While temporary fiscal measures do not represent a permanent change in the underlying fiscal balance, they can have a permanent impact on the level of the debt stock and thereby improve or deteriorate its long-run sustainability.

Not all temporary measures in the programme years were introduced to meet deficit targets. In some instances temporary or one-off measures were necessary (such as bank support measures), or were beyond the control of the government (such as Court decisions). Temporary measures eventually had to be replaced by structural measures to ensure that targets continue to be met.

The fiscal surveillance framework in the EU makes the important distinction between the headline fiscal balance (which includes one-off measures) and the structural balance, which measures the permanent fiscal effort (excluding one-off measures). This is the reason why countries with an excessive deficit are not only recommended to correct it in nominal terms (i.e. to bring the deficit below the treaty threshold of 3 % of GDP), but are also recommended a specific structural effort consistent with reaching the nominal target.

Therefore, the mere existence of one-off and temporary measures is not automatically contradictory to a sustainable correction of the excessive deficit.

153 (i)

It should be added that Portugal also faced one-off expenditure-increasing measures amounting to 2.8% of GDP in 2010 and to 0.6% of GDP in 2011.

153 (iii)
The excessive deficit procedure for Romania was abrogated in June 2013, based on 2012 out-turn data. An important condition for the abrogation of any excessive deficit procedure is the sustainability of the correction, meaning that the deficit has to remain credibly below the 3 % of GDP threshold during the forecast horizon of the relevant Commission forecast. In turn, the forecast is based on measures credibly announced by the government and specified in sufficient detail.

153 (iv)
The primary motivation for the liability guarantee in Ireland was not as a revenue-generating measure.

155
The Commission considers that it is not meaningful to compare IMF and Commission figures on compliance with conditions at the end of the programme, because the two institutions assess them against different benchmarks.

Some deadlines were initially set very ambitiously to encourage implementation, but were later adjusted to be as the programme evolved.

158
In the Commission's view the concept used by the Court of 'structural content' is not a meaningful metric for analysing policy measures and drawing conclusions about their importance. Conditions that require more intermediate steps (and are therefore classified by the Court as having 'low structural content') may be at least as important as conditions that are more straightforward to implement.

The classification used regarding the structural content of the conditions does not capture the essence and the importance of individual conditions. Many of the most critical structural reforms will require intermediate stages such as reviews or consultations (classed as 'low structural content') before the reform is finally put into law and implemented. The classification used by the Court of 'high structural content' is therefore not synonymous with 'important'.

160 (iii)
For certain reforms, the desired effect will only materialise in the longer run, after the end of the programme.

161
The reference to the Hungarian case for reform reversal (public-sector wage cut) seems to be inappropriate as the most significant savings measure in this field (abolition of the 13th month wage) remained intact. Explicit reversals were observable in the areas of child allowances and fiscal governance.

164
See Commission reply to Box 10.

Box 10 First alinea
In Hungary the low interest from the banking sector side was also explained by the eventual success of the coordination efforts with western European parent banks, which could not be known at the time of the launch of the programme and the design of the bank support package. Specifically, the largest foreign-owned commercial banks committed to maintain their overall exposure to Hungary, first on a bilateral basis with the central bank, and later in the multilateral framework of the European Banking Coordination Initiative. This combined action helped to improve financial stability and investor confidence, including in a broader regional perspective.

Box 10 Fifth alinea
Public-sector employment in Portugal decreased by close to 10 % between 2011 and 2014, more than the 2 % annual reduction required by the MoU. As civil servants cannot be laid off, a substantial part of the reduction had to be achieved by not replacing employees who left. Early retirement was a specified part of the personnel reduction. It turned out to be significant, but this does not mean the budgetary impact was limited. In addition, further measures were introduced by the government to reduce headcount, such as the mutual agreement redundancy scheme. As an overall result of reductions in staffing and wage levels, the public wage bill was reduced by close to 17 % between 2010 and 2014.

165

Euro area programmes focused on restoring fiscal and financial stability as well as enhancing competitiveness by addressing structural deficiencies. Restoring the external balance was an implicit part of conditionality for euro area programmes, but was not the immediate key concern.

The current-account and trade balances should not be used as competitiveness indicators in isolation, since external balances can be driven by both structural change and cyclical factors. This suggests that part of the improvement may unwind when cyclical conditions improve. By exclusively looking at the current-account/trade balance without analysing the underlying drivers it is not possible to identify improvements in competitiveness.

167

As a euro area Member State, Ireland was not in a balance of payment assistance programme. As such the external financing gap was not central to the programme as was the case in the non-euro area Member States. It should be noted that Ireland consistently ran a substantial trade surplus, with considerable volatility. In this context, the presentation of cumulative data on forecast errors may be misleading. Moreover, the trade balance improved slightly between 2011 and 2014, making a positive contribution to current-account adjustment. Forecasting the Irish external balance is complicated considerably by the activities of large multinational enterprises, which dominate Ireland's traded sector.

The Commission considers that no lessons can be drawn from Figure 11.

168

It is debatable whether 'The trade balance captures more closely the effects of changes in a country's competitiveness than the current account.'

Common Commission reply to paragraphs 176, 177 and 178

In Hungary, households' foreign exchange indebtedness (predominantly in Swiss francs) was not a particularly burning policy issue during the programme period (i.e. until Q1 2010).

Domestic lending in foreign currencies was not an issue in the euro area programmes or in Latvia, which had a programme policy objective of maintaining the peg with the euro.

In Romania, conditions were included to curb/limit lending in foreign currency through regulations addressed and closely monitored in the financial sector. A permanent dialogue was maintained with the National Bank. To address the vulnerabilities associated with foreign currency-denominated lending, the National Bank of Romania adopted measures aimed at further discouraging unhedged consumer borrowing in foreign exchange in 2011. Some of these measures were also extended later to unhedged small and medium-sized enterprises, in line with the ESRB's recommendations. Moreover, as part of the programme conditions, in the framework of 'First home — Prima casa', the Romanian government stopped providing state guarantees for mortgage loans denominated in foreign exchange in August 2013.

Conclusions and recommendations

179
See Commission reply to paragraph III.

180
See Commission reply to paragraph IV.

182
The Commission increased its ability to mobilise expertise after 2009 in connection with the euro area programmes, and was better able to acquire external expertise.

Recommendation 1
The Commission accepts recommendation 1.

The Commission improved its mobilisation of expertise over the years of the crisis, as evidenced by the fact that it was able to mobilise more expertise in the euro area programmes, which came after the non-euro area programmes. The SRSS has recently been set up within the Commission. The Commission will examine how some key principles for rapid mobilisation of the expertise needed could be further strengthened into an institution-wide framework where appropriate.

The Commission will take on board, where appropriate, the need to develop procedures for the enhanced surveillance and management of possible new financial assistance programmes for euro area Member States.

183
See Commission reply to paragraph VIII.

It was very difficult to assess *ex post* the plausibility of key assumptions in subsequent reviews.

Recommendation 2
The Commission accepts recommendation 2, while highlighting the need to ensure that recording activities do not place a disproportionate burden on forecasters, particularly in a programme context and given resource constraints.

The Commission has already improved procedures and document management since the first programmes were put into place. It will seek to further improve the implementation of its document-management and quality-control policy.

The Commission is developing a pilot forecast model, initially for the euro area as a whole with country-specific modules. The aim is not to replace the existing judgement-based forecast, but to examine how this can be used by the Commission to deliver quality checks that complement its judgement-based forecasts. However, the Commission notes that a model is unlikely to be particularly useful in times of unusual economic events.

184
See Commission reply to paragraphs IX and X.

Recommendation 3 (a)
The Commission accepts recommendation 3 (a).

The Commission has already improved record-keeping since the inception of the programmes. It will focus on ensuring that the new procedures are fully implemented in line with the Commission's document-management policy, without undermining the ability of programme teams to meet tight timelines.

Recommendation 3 (b)
The Commission accepts recommendation 3 (b) and will examine how to further improve the recording of key decisions in line with the Commission's document-management policy without slowing down the decision-making process.

185
See Commission reply to paragraph XI.

186
See Commission reply to paragraph XII.

187
See Commission reply to paragraph XII.

188
See Commission reply to paragraph XIV.

189
See Commission reply to paragraph XIII.

The key documents resulting from expert analysis were subject to review by officials outside the main programme team, including senior management and the heads of horizontal units. Review reports were subject to consultation procedures with relevant directorates-general. Draft documents were exchanged and cross-checked with partner institutions and the negotiation outcomes reported in detail to the EFC and EWG.

Recommendation 4
The Commission accepts recommendation 4. The Commission will enhance the procedures for the review of programme management and the content of programme documents, within the existing resource constraints and without causing undue delays.

190
The Commission reply to paragraph XV sets out the reasons why accruals-based data are used.

Recommendation 5
The Commission accepts recommendation 5. It will aim to include additional variables that it can collect with short time lags, such as a quarterly cash balance and/or an arrears target in the MoUs, to assist in the monitoring of fiscal targets.

191
See Commission reply to paragraphs XV and 104-107.

Instalments were released on the basis of an in-depth assessment of whether countries had complied with conditionality. Any delays in compliance were assessed on a case-by-case basis. Moreover, conditions that are 'not truly important for crisis resolution and repayment of the loans' may nonetheless be appropriate insofar as they support growth and reduce the risk of loans not being repaid under unexpected circumstances. The audit does not provide evidence that irrelevant reforms were included.

Recommendation 6 (a)
The Commission accepts recommendation 6 (a).

Recommendation 6 (b)
The Commission accepts recommendation 6 (b), but points out that in some cases guaranteeing the adoption of reforms would not make sense until the preparatory steps have identified the scale of the issue to be addressed or the possible responses.

Recommendation 6 (c)
The Commission partially accepts recommendation 6 (c). The Commission does not accept the obligation for programme teams to justify the need for each and every condition because of the crucial role of the recipient country in setting out its own vision for the reform programme.

The Commission points out that what matters most is that there is a coherent and integrated set of reforms to address key economic challenges. Within that programme there may often be choices to be made as to which reform package to choose. Hence, conditions should not be considered in isolation. The Commission also points out that reforms that increase medium-term growth are also important for improving the fiscal position and reducing the risk of non-repayment of financial assistance. EU assistance often has very long maturities, making strong growth an important factor in underpinning a country's ability to pay back its loans.

Finally, the selection of conditions is a matter for negotiation with the recipient country. It should support countries' ability to set the agenda for their programmes. This is a prerequisite for them taking ownership of the reform process, which is an important determinant of programme success. Conditionality is checked by management and also at the political level.

Recommendation 6 (d)

The Commission accepts recommendation 6 (d). For the conditions that are set it will seek to reply on measurable data to the largest extent possible. It emphasises, however, that the impact of conditions is not equally measurable, some results are of a qualitative rather than a quantitative nature and not all conditions have readily available data for assessment.

Recommendation 7

The Commission partially accepts recommendation 7. It has already set out guidelines for cooperation with the IMF and ECB and is taking other steps to facilitate interinstitutional cooperation during programmes. However, the Commission considers that clarifying this cooperation should avoid formalisation making the decision-making process burdensome, especially given the time pressures involved. Flexibility should be kept in resolving differences of opinion as attempting to formally codify a dispute resolution process would be both difficult and of little value.

193

The Court considered whether the level of pricing on the trade date was justified simply by comparing it to the initial price guidance given by banks in their proposals, without taking due account of the market developments in between the date of the initial pricing guidance and the actual issue date. Deviations from the initial price guidance are inherent to the process in general, and in particular in case of a long time span.

194

The Commission considers that there were no gaps in the debt management process but only some gaps in the documentation regarding the initial transactions.

Recommendation 8 (a)

The Commission accepts recommendation 8 (a).

The recommendation has already been implemented. The allocation is done in close cooperation with the syndicate and all orders are made transparent to the Commission, which has full control over the process.

Recommendation 8 (b)

The Commission accepts recommendation 8 (b).

The recommendation has already been implemented. Since January 2011, the processes for sending 'requests for proposals', for receiving banks' proposals and for mandating lead banks have been well documented.

Recommendation 8 (c)

The Commission accepts recommendation 8 (c).

The recommendation has already been implemented. Lead managers formally accept 'underwriting commitments' in case the order book does not reach the target size (pre-issuance), as well as 'secondary market commitments' to provide for an active secondary market trading (post-issuance).

Recommendation 8 (d)

The Commission accepts recommendation 8 (d).

The recommendation has already been implemented. A regular assessment of markets is documented in the Treasury Management Committee reports. A more specific assessment is carried out prior to each bond issue and is also documented *ex post* in a post-deal note. Moreover, the turnover of purchase and sale transactions of EU bonds is provided by banks on a quarterly basis and monitored by the Commission.

195

See Commission reply to recommendation 9.

196

See Commission reply to paragraph 139.

197

It should be noted that Portugal did not fully use all the financial assistance available under the programme and that it ended the programme with a substantial Treasury buffer.

198

This statement mixes the impact of new policy measures with the fiscal impact of economic conditions. See also the Commission reply to paragraph 147.

199

As set out in the Commission reply to paragraph 150 (i), the effect of the starting point on the pace of consolidation should not be seen in isolation from other, sometimes country-specific, factors affecting the fiscal imbalances which needed to be corrected. The Commission reply to paragraph 153 explains why one-off measures may be necessary and cannot be described as having unsustainable results.

200

See Commission reply to paragraph XVII.

201

The Commission reply to paragraph 158 sets out why the Commission does not consider the Court's metric for classifying the structural conditions as being representative of their importance.

202

The fact that conditions were included in the programme and did not yield observable results within the time frame of the programme does not mean that they failed, or that their effects were expected within the time frame of the programme. Structural reforms take time to materialise, and in most cases their impact can only be observed in the long-run.

203

See Commission reply to paragraph 165.

Recommendation 9

The Commission accepts recommendation 9. It will seek to further improve its understanding of the adjustment process under the programmes through the current series of comprehensive *ex post* assessments and to draw lessons from them. The assessments cover all aspects of the economic adjustment under the programmes, including the three suggestions raised by the Court. An *ex post* assessment of the economic adjustment programme of Ireland has already been published.

Recommendation 9 (a)

The Commission accepts recommendation 9 (a).

Recommendation 9 (b)

The Commission accepts recommendation 9 (b). In line with the political guidelines of President Juncker, the Commission has recently performed an *ex ante* assessment of the social impacts of the new adjustment for Greece. For any other new programme, such an assessment will be performed.

Recommendation 9 (c)

The Commission accepts recommendation 9 (c).

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When the 2008 financial crisis triggered a European sovereign debt crisis, some Member States were forced to seek macrofinancial assistance. This report examines how well the European Commission managed the assistance provided to five countries — Hungary, Latvia, Romania, Ireland and Portugal. We found that the Commission was unprepared for the magnitude of the crisis, which largely explains the significant initial weaknesses in its management processes. A number of the weaknesses we identified still persist, and the main message of the report is that the Commission has to strengthen its procedures for the management of financial assistance.

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