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Coming of age:

Report on the euro area

BY JEAN PISANI-FERRY, PHILIPPE AGHION, MAREK BELKA,
JÜRGEN VON HAGEN, LARS HEIKENSTEN AND ANDRÉ SAPIR

RAPPORTEUR: ALAN AHEARNE

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Jean Pisani-Ferry, Philippe Aghion, Marek Belka, Jürgen von Hagen, Lars Heikensten, and André Sapir
Rapporteur: Alan Ahearne

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This report is dedicated to the memory of Riccardo Faini, a great scholar and friend of ours. Riccardo was part of this group before passing away much too soon in January 2007. We miss his stimulating intellect and his amiable personality.

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Foreword

The euro marks its tenth year in 2008. It is unlikely to be the easiest one in its successful first decade. At the end of 2007, inflation in the euro area had jumped to above three percent, yet with economic growth slowing and unsteadiness in financial markets persisting, the European Central Bank is faced with a serious dilemma. The euro has appreciated recently to record levels against other major currencies but, at the same time, the global balance-of-payments adjustment is still far from complete and the risk of major exchange rate instability remains. With the entry of Cyprus and Malta, the euro area now counts 15 members, but the climate of uncertainty and mistrust generated by the rejection in 2006 of Lithuania's euro application lingers, and it is still unclear when the new EU member states of central and eastern Europe will join the euro.

The time is right, therefore, to look back and assess whether Economic and Monetary Union (EMU) is equipped to sail through less calm, perhaps even stormy, waters. This was Bruegel's intention when in 2006 it assembled a group of highly experienced policymakers and academics from countries within and outside the euro area. In this report, the group delivers a sobering assessment. It emphasises that the euro is a major achievement of European integration; that the European institutions deserve high marks for giving birth to a new entity out of what was initially a group of very different member economies; and, especially, that there is much to praise in the conduct of monetary policy by the ECB and in its handling of the 2007 liquidity crisis. Worryingly, however, the group also notes that, in spite of an exceptionally supportive international environment, the euro area's economic performance over the last nine years has been adequate at best; that governments have sometimes failed to realise that membership in a currency union requires a change in behaviour; and that almost twenty years after the start of the Maastricht negotiations, competing visions of future EMU continue to coexist.

The group makes a number of concrete proposals to improve euro area policy and governance. But the main message in this report is broader. When the EMU project was launched, it was often regarded as a step towards a fully-fledged federal union

in Europe. For many advocates of EMU, the goal was political – and money was a building block. After Maastricht, Amsterdam, Nice, the aborted EU Constitutional Treaty and Lisbon – five treaty changes or would-be treaty changes in less than twenty years – federal union is today a more remote prospect than it was in the late 1980s. For all practical purposes, the assumption must be that no federal government will emerge in the foreseeable future as a counterpart to the ECB, and that EMU will remain a *sui generis* policy system. Fortunately, however, EMU is also an evolving entity and only time will tell what the sharing of a currency will mean for the member economies and their mutual relationship. The euro's first decade has provided important insights, but ten years is a short time in the life of a monetary union. This is why the group emphasises that, if the euro is to be a lasting success, all participants must be more willing than they have been so far to draw lessons from their joint experience.

Jean Pisani-Ferry, Director, Bruegel
Brussels, January 2008

Executive summary

This report:

- Looks at the euro's record so far;
- Tests the performance of the euro area in key fields for the future success of the euro: monetary policy, fiscal policy, structural reform, financial stability, enlargement, the external dimension;
- Examines governance issues and the role of the Eurogroup;
- Makes concrete proposals for reform of both euro area policy and governance.

The report identifies three drivers of reform:

- The first is political. European projects can come adrift from political reality and discourse in member states. The euro is not immune to such a risk;
- The second is economic. The performance of the euro area since the launch of the euro has not been spectacular. The global environment, favourable since 1999, is unlikely to be as helpful in the coming years;
- The third is related to enlargement. The euro rules were not designed with the new member states in mind. If they are applied mechanically, there is a risk of incomprehension and real political or economic damage in new member states.

The report starts from the essential requirements of an appropriate policy system: stability, predictability, incentives for good policies, and adaptability. It identifies shortcomings in the current functioning of the euro area and singles out the Eurogroup as the essential institution potentially capable of fostering change. Its greatest weakness – absence of a clear mission – is also its greatest strength – ability to learn and base policy on evidence. Willingly or not, the Eurogroup embodies flexibility in an otherwise constrained system.

The report identifies three levels of reform:

- Changes in the behaviour of individual policy players. The ECB should enhance its

strategy and national governments should improve their policy performance;

- Changes in governance without treaty amendments. Better use should be made of the existing treaty framework, as was done in 2005 with the reform of the EU's Stability and Growth Pact;
- Changes to the rules. Most of the proposals made do not require EU Treaty changes. But overly strict interpretations of the Treaty that fail to consider economic reasoning undermine the very legitimacy of the common rule. As regards enlargement, there is a need to reinterpret - and possibly revisit - the treaty provisions in order to adopt a more sensible approach.

The report makes the following specific reform proposals:

Monetary Policy

- ECB to move to full inflation target regime
- ECB to publish forecasts that reflect the views of the Governing Council
- Eurogroup publicly to endorse ECB inflation targets

Fiscal Policy

- Focus more on comprehensive concept of debt sustainability
- More fiscal autonomy for countries with credible fiscal policy rules and institutions
- More differentiation in assessing national fiscal rules and institutions
- Eurogroup president to lead implementation of reforms and shaping of any common guidelines

Structural Reforms

- Eurogroup to push key EU-level reforms
- EU budget review 2008/2009 to switch funds towards helping national reforms
- More independent assessment, more Commission staff assessment of national reforms
- Eurogroup to consider formal recommendations if national policy threatens the euro
- Time-bound commitment to reach a specified debt-to-GDP ratio if reform leads to budget overrun

Financial Stability

- Euro area to push for European prudential and supervisory regime for pan-European banks

Enlargement

- Reference for price stability to be euro area inflation or the three euro area countries closest to two percent
- Relax the obligation to join ERM2 for two years before joining the euro
- More emphasis on prudent debt limit for the new member states
- Target of budget balance or surplus during periods of fast growth

External Dimension

- Verbal discipline on exchange rates by national policymakers
- Euro area to express views on exchange rate policies of key third countries
- Eurogroup president to represent the euro area externally and lead delegations in talks with third countries

Governance reform

- Formal Council recommendations to be reserved for serious threats to the euro
- Council meetings, including EU summits, to be possible in euro area format
- Create a single euro area chair at the IMF.

The report's overall message is that willingness to adapt the EMU policy framework in light of the experience gained is crucial to the long-term success of the euro. Over time, the return on the investment in the euro will depend on the participants' ability to learn and improve from experience.

Introduction

'We must, indeed, all hang together, or most assuredly we shall all hang separately.'
Benjamin Franklin, 1776

By many standards, economic and monetary union (EMU) is a major success. The transition to the new currency was remarkably smooth. The euro area has enjoyed remarkable price stability. After several years of disappointing economic performance between 2001 and 2005, growth picked up in 2006. Economic integration among the countries participating in the single currency has progressed. In spite of fashionable talk about a break-up of the euro area, the reality is that there are many countries wishing to join and none seeking to leave.

Yet there are also points of dissatisfaction with the way the euro area functions, even among European leaders. In July 2007, newly elected French president, Nicolas Sarkozy, instructed his finance minister to 'attain economic government for Europe and especially for the euro area' and encouraged her not to hesitate to 'propose institutional reforms to improve the economic functioning of the euro area that would allow it to harvest growth, employment and prosperity'[1]. French obsession with the governance of EMU may not be shared by other member countries, but statements by other euro area leaders also suggest a need for reforms. EU economic and monetary affairs commissioner Joaquín Almunia recently pointed out that 'the Eurogroup has yet to assume the critical role that it could play in piloting the economic policies of the euro zone', adding that 'at times, the collegiality necessary for common action has been missing and member states have not always succeeded in coordinating their actions effectively or in ensuring that common interests take priority'[2]. Luxembourg prime minister Jean-Claude Juncker, who chairs the Eurogroup, expressed a similar view when he said that 'construction work on the European single currency is not yet complete'. In his view, 'the political arm, the economic policy arm of European economic and monetary union needs to be

1. Nicolas Sarkozy, assignment letter to Christine Lagarde, 11 July 2007. Authors' translation.
2. Joaquin Almunia, 'Making EMU fit for the 21st century', speech at the Brussels Economic Forum, 31 May 2007.

strengthened. European economic and currency policies are not just about money'[3].

Nearly twenty years after the Delors Report provided the blueprint for EMU, fifteen years after the ratification of the Maastricht Treaty and almost ten years after the launch of the euro, EMU is still unfinished business. There is disagreement on which reforms are most desirable, the degree to which national economic policies should be coordinated, and the nature of the dialogue between ministers of finance and the monetary authority.

Those disagreements do not prevent EMU from working well. In spite of some declarations to the contrary, no European leader really disputes the independence of the European Central Bank (ECB), the importance of price stability, or the need for fiscal discipline in a monetary union. Participating countries, however, seem to hold different views about the still-unfulfilled promises of the euro, while their governments have to deal with disparate political environments and demands. Like partners in a couple, they live together but have their own lives to deal with, and sometimes also separate dreams.

Compromises have always been found between advocates of *bare bones EMU*, who regard central bank independence, fiscal discipline and market integration as EMU's three fundamental and sufficient tenets; advocates of *federal EMU*, who consider that the sustainability of monetary union requires some form of political union; and advocates of *coordinated EMU*, who regard a bare bones EMU as incomplete and unbalanced but support coordination instead of centralisation. However, our assessment is that clarity is now needed on what EMU is about and what it should become.

We see three reasons for this:

- The first is political. The rejection of the EU Constitutional Treaty by the French and Dutch voters in 2005 showed that dreams can clash with reality. While many reasons explain the voters' attitudes, the gap between the image of the EU cherished by political elites and reality on the ground was certainly one. For EMU to be robust, citizens and governments in all participating countries need to know what it can do, but also what it cannot do.
- The second is economic. Between 1999 and 2007 the economic performance of the euro area has been adequate, but not spectacular. This underperformance has occurred in spite of a very favourable global environment. The global environment

3. Jean-Claude Juncker, acceptance speech for the Charlemagne prize, Aix-la-Chapelle, May 2006.

is likely to be less auspicious in the years ahead because of adverse real and financial shocks. At the same time participating countries find themselves in differing situations. Hence, adjustment problems will become more pressing, which makes collective and individual agility essential and underscores the need for clarity about the rules of the game. So we are concerned that the environment will be more demanding on the governance of EMU than in the fair-weather conditions of recent years.

- The third is related to enlargement. The rules of EMU were devised to address the problems and circumstances of the incumbent EU member states in the 1990s. Some of the rules do not make sense for the new member states. If the principles are not well understood, or are perceived to be unreasonable, then there is a risk of an unnecessary political backlash in the new member states – not to speak of adverse market reactions that would endanger macroeconomic stability in the new member states.

A common thread throughout this report is the need for the policy framework of the euro area to be made clearer, more transparent and more accountable. We believe these reforms are essential for dealing with potential crises in the euro area.

In our analysis and proposals, we distinguish three levels of reform.

The first concerns individual policy players. Changes in the behaviour and strategies of the ECB and national governments can be introduced while leaving intact the overall rules, institutions and governance of EMU. We consider that much can be improved by acting at this level.

The second level concerns reforms of EMU governance that may require changes in legislation but no treaty amendments. In this category, we contemplate agreements to make better use of the existing legal framework or changes in secondary legislation – as was done in 2005 with the reform of the Stability and Growth Pact (SGP). Our assessment is that significant progress can also be made at this level. The focus here is specifically on the Eurogroup, because it is still a young institution whose role is not explicitly spelled out in the treaty.

The third level concerns treaty amendments. We would have wished to avoid altogether making proposals of this type because we do not expect that treaty revisions will be politically feasible in the near future. We have therefore exercised restraint and, in most instances, the proposals we are making do not require treaty changes, at least not in the coming years. However, while taking due account of political

constraints, we consider that the role of independent observers is to look beyond immediate obstacles and alert policymakers accordingly when there are strong reasons to do so. As developed in Chapter 7, our opinion is that overly legalistic interpretations of the treaty provisions that fail to consider economic reasoning and facts undermine the very legitimacy of the common rule. In particular, we feel that the strict application of the existing jurisprudence risks discouraging several new member states (those that joined the EU in 2004 and after) from joining the euro, and thereby contributing to the creation of a long-lasting divide within the EU. For these reasons, we think that there is a need to reinterpret – and even to revisit – the provisions of the treaty that stand in the way of a more sensible approach to the enlargement of the euro area.

While some readers will complain at the idea of revising the treaty, others may say that our agenda is too limited. Indeed, we deliberately refrain from proposing more ambitious reforms involving, for example, an additional transfer of competence to the EU, a significant increase in the size of the EU budget, or a redefinition of the mandate of the ECB. What we propose are, in fact, modest reforms. Even the amendments to the treaty that we consider would not change its architecture or alter the balance between institutions.

At this stage, we see no reason to envisage a radical overhaul of EMU. It has been reasonably successful so far and the focus for now should remain on learning and adjusting. But can a modest agenda change anything beyond rhetoric and bureaucratic procedures? Our view is that incremental changes can have significant effects if they are anchored in practical experience and send the right signals. We do not rule out the need for more radical moves in the future. But today's agenda is one of incrementalism, and we advocate giving it a chance to succeed.

The report consists of ten chapters. We start in Chapter 1 by laying out the analytical framework on which we will base our discussions. Chapter 2 surveys the economic performance of the euro area. In the chapters that follow we take up six policy challenges of major importance for the future:

- Chapter 3: Monetary policy
- Chapter 4: Fiscal policy
- Chapter 5: Structural reforms
- Chapter 6: Financial stability
- Chapter 7: The enlargement of the euro area
- Chapter 8: The external dimension

Chapter 9 looks at the governance of EMU and explores the extent to which changes in governance can help the euro area to face these policy challenges. The last chapter concludes and offers both policy-specific recommendations and proposals for reform of the governance of EU institutions. Our governance recommendations are primarily addressed to the Eurogroup.

With the euro approaching its tenth anniversary, it is time for an in-depth discussion on the common achievements and the way ahead. This report is designed to be a contribution to that discussion.

1. Analytical framework

When the EU's leaders agreed on the Maastricht Treaty in the early 1990s, they expected EMU to deliver stability, promote market integration, foster economic convergence and provide better opportunities for growth. But they also knew that introducing a common currency in Europe amounted to an investment and that EMU would require participating countries to make significant economic and policy adjustments. It was recognised that the benefits from EMU would depend on the design of the policy system and on the ability of the policy participants to play by its principles. It was acknowledged that asymmetric shocks, divergent responses to common shocks and idiosyncratic policy behaviour could all entail significant costs.

In other words, the treaty's signatories could not ignore that economic performance would in the medium term depend, on the one hand, on a wide-ranging redefinition of the assignment of macroeconomic policy instruments and, on the other hand, on accompanying reforms of labour, product and capital markets. While the treaty could set rules and establish institutions, the more in-depth transformation of micro- and macroeconomic behaviour that EMU called for could only take place over time and would necessarily require tailor-made national reforms[4]. However careful its institutional design, time, experience and a learning attitude were bound to be key ingredients of success.

Nine years is a short time span in the history of a policy regime. It is hardly enough to experience the various phases of an economic cycle, let alone the longer cycles of country-specific real appreciations and depreciations. Nor is it sufficient time to test the ability of the policy system to respond to political shocks. The learning is thus far from over. Experience in the first years of the single currency has, however, brought both confirmations and surprises, from which lessons can be drawn.

4. The broad agenda was outlined in the Delors report of 1989 and the European Commission's 'One market, One money' report of 1990. More in-depth analyses of the implications of membership in the monetary union were carried out at national level. Ironically, the most comprehensive studies were conducted in countries that in the end decided not to join EMU, such as Sweden and Britain. On this last point, see Calmfors *et al* (1997) and HM Treasury (2003).

To provide our assessment and propose reforms, we rely on a view of what is an appropriate policy framework, which needs to be spelt out in some detail. There are not many different ways to operate a monetary union: it needs a single currency managed by a single central bank. But there are many different ways to organise its policy framework, that is, the set of principles, rules and incentives that determine the behaviour of the policy players and of the private agents. As already alluded to in the introduction to this report, there can be different types of mandates for the central bank and different sorts of relationships between it and government. There can be different degrees of centralisation of fiscal and structural policies. And for a given degree of centralisation, there can be different sets of principles and rules for national policies and different incentives to conform to them.

So what is a good policy framework?

Stability

An essential property that is to be expected from a macroeconomic policy framework is naturally its ability to deliver stability. This means first of all price stability, an objective that has become uncontroversial. The benefits of price stability, the corresponding mandate given to the central bank, and the monetary institution's independence from political interference in the implementation of its mandate nowadays command wide support, both in academia and in the policy community. This also means sustainability of public finances, a necessary condition for price stability in the long run. Discussion on this issue has made much progress since the early days of EMU, when the focus was put narrowly on headline budget deficits and the broader issue of public debt sustainability was overlooked. It is now widely accepted that budgetary discipline is an essential feature of a monetary union and that its maintenance entails forward-looking behaviour. Nevertheless, the state of public finances indicates that not all governments have taken on board the lengthening of the time horizon that is inherent in renouncing the option of debt monetisation.

Stability does not end here, however, and there are three other newer, or less widely accepted, dimensions of stability that we wish to emphasise and include in our criteria for assessment of a good policy framework.

As already mentioned, financial stability is a dimension that has gained prominence in the context of liberalised capital markets. One of the aims of EMU was to spur increased integration of financial markets and a great deal of progress has been made in this direction. Flows of bonds and equities across borders have risen

significantly, while large pan-European banking groups have started to emerge. The counterpart to this advance is that financial stability has become a major challenge for European policy. But financial stability arrangements in Europe remain grounded at the national level. As a result, concerns have arisen about a system of banking oversight and supervision that seems ill-prepared for potential EU-wide systemic problems in the banking sector.

Macroeconomic stability, by which we mean the policy system's ability to respond to shocks and to undertake countercyclical stabilisation, is a standard objective of economic policy, yet one to which recent research has lent new support. This research suggests that macroeconomic volatility affects long-term economic growth through two channels. The first channel has to do with the functioning of labour markets and starts from the fact that workers who lose their jobs during a downturn quickly tend to become more difficult to reemploy. The second (and newer) argument is based on empirical evidence that, during recessions, credit-constrained firms tend to cut spending on research and development (R&D) and other long-term growth-enhancing investments. As a result, aggregate R&D expenditures become lower and more pro-cyclical; the larger the proportion of credit-constrained firms, the more this is the case. It is therefore particularly important to avoid excessive macroeconomic volatility in economies where a significant proportion of firms encounter credit constraints.

A final dimension of stability is the ability of the policy system to cope with crises – what could be termed its agility. A policy framework should not only be judged by its agility in fair-weather conditions, but also by its resilience in storm conditions – not only financial, but also economic and political storms. In bad times, the ability to convey relevant information to the ultimate decision-makers, to prevent conflicts of interest from obscuring choices, and to ensure swift decisions are key properties that depend on the system's design. In this respect, it should be recalled that in a global perspective the last eight years have been benign. The policy framework of the euro has thus not yet been tested under stress. It remains to be seen how well EMU is set up to deal with events like disruptive global shocks or internal crises. The system of responsibilities is in some respects well defined (eg the responsibility of the ECB for monetary policy.) But responsibilities are not entirely clear regarding the exchange rate, the role of the Eurogroup in shaping overall fiscal policy, the extent of coordination and responsibilities related to the handling of banking crises.

The enlargement of the euro area to higher-variance economies whose primary objective is to achieve real income convergence and that start from lower price levels and

lower levels of institutional and financial development adds to those concerns and calls for a more comprehensive approach to stability.

In what follows, we will take the above five dimensions of stability as a yardstick for assessing the EMU policy system and its evolution.

Predictability

Modern economic thinking emphasises the benefits of the predictability and transparency of a policy regime. This issue is of particular importance in the EMU context because economic agents within the euro area come from different traditions, speak different languages and belong to different communities. The explicit underlying models they rely on to make their own decisions and their ability to decipher the statements by the central bank or to interpret the signals emitted by the Eurogroup and the Commission vary widely from one country to another and from one market to another. This calls for clarity on the principles and rules upon which policies are based.

This especially applies to the ECB which, as the sole pan-European macroeconomic player, has a unique leadership role in the formation of common expectations. It even has a more important role vis-à-vis governments than in national contexts, because there is no central fiscal authority able to play a policy leadership role, at least in the absence of tight coordination of national fiscal policies. We therefore regard the formulation and communication of the ECB strategy as an issue of major importance, and this is the reason for devoting a chapter to it.

This also applies to governments. The recurrent gap between budgetary commitments and reality that characterised the first years of EMU is the symptom of a wider problem. It indicates that governments cannot be trusted and that they do not attach importance to doing what they have told their EMU partners they intended to do. The lack of trust which results from such behaviour necessarily permeates the entire policy system and the economic agents' perception of it. Obviously, there can be a need to depart from commitments when circumstances change. But the evidence is that economic shocks explain only a minor part of budgetary slippage. How to restore predictability and trust is therefore a major challenge for EMU.

Incentive properties

The macroeconomic policy framework is designed to deliver what it was built for –

stability – but it also indirectly affects other decisions by policymakers and private agents which are of major importance for Europe. We think it is useful to look at the framework both as a system of rules and as an *incentive framework* that implicitly or explicitly rewards certain types of behaviour and discourages other types. This especially applies to growth-enhancing policies. The EMU policy framework cannot be asked to *deliver* growth, because this is not what can be expected from a monetary union. But the framework can be expected to *encourage* pro-growth policies – or at least not to discourage them.

At the start of EMU, the hope was that the loss of the exchange rate instrument to respond to shocks would increase the incentive to carry out economic reforms and broaden their scope. The (economic) cost of not reforming would be much higher than the (political) cost of reforming. Instead, the euro so far seems to have insulated member economies from acute crises and the question has emerged whether monetary union may actually have slowed the pace of reform.

In principle, reforms should be the responsibility of national governments because countries themselves are the main beneficiaries of their own policies. This is undoubtedly true in the long run. There are, however, qualifications to this view. To start with, reforms are a purely national issue only if governments have long enough horizons. If they are to some degree myopic or politically motivated (as governments sometimes are), the need arises to look at the rewards and penalties stemming from the common policy system. In particular, a framework that would risk reinforcing the natural myopia of governments would act as a brake on reforms, even though responsibility for reform lies with governments.

Another qualification is that within monetary union, reforms at the national level generate positive spill-over effects to other member states. Reforms that boost the growth of potential GDP in a member state contribute to lower interest rates and faster growth at the aggregate euro-area level. Also, reforms can improve the overall functioning of the currency union, through faster adjustment to shocks, which reduces the risk of economies diverging from each other and departing from equilibrium for protracted periods. Without those reforms, divergence could affect the collective benefit of EMU membership.

There is thus a common interest in developing a framework that is conducive to pro-growth policies. So has EMU increased or reduced the incentives to reform? There is no single answer to that question. For governments with long-term horizons, membership in the euro area has increased the incentives to reform because the cost

of inaction has become higher. But for short-sighted governments, the opposite is true. EMU means less threat of immediate crises – especially those that are triggered by pressures in foreign exchange markets – which has dampened reform incentives. Furthermore, structural reforms typically involve initial sunk costs which may be alleviated by macroeconomic support. In the absence of such support, the short-term gains from reforms can be lowered, which reduces the incentive for national policymakers to implement them.

How to develop a framework that is conducive to national reforms without blurring policy responsibilities is a difficult question for EMU. This question has come to the forefront of discussions against the backdrop of disappointing economic performance and it remains an issue for the future.

Adaptability

EMU arrived as a *deus ex machina*. In order to make sure that it would be able to operate smoothly from day one and that controversies about its design would not hamper how it functioned, every single detail was laid down in the treaty and other legal texts. This was certainly necessary at the time. Yet Europe and the world have changed since 1991, and this raises the question of adaptability.

This is most evident in the case of enlargement. Until the mid-1990s, it was not expected that by 2007 the EU would encompass 27 diverse countries, that the euro area would become a subset of the EU, and that the criteria for, and the speed of, its enlargement would become a matter for controversy. EMU was initially conceived for advanced economies, most of them having had a long history of integration and cooperation on monetary and exchange rate matters. The question now is whether and how it should extend to countries undergoing rapid structural transformation.

This question should naturally be addressed from both sides. Extensive recent discussions about the choice of exchange rate regime for emerging economies have not invalidated the conclusion that 'no single currency regime is right for all countries or at all times'[5]. This provides guideposts for approaching enlargement from the point of view of the new member states (NMS), taking into account economic criteria such as their economic structures, the strength of their policy frameworks, and the development of their financial systems.

5. From Jeff Frankel (1998). Aghion, *et al* (2006) show that the most growth-enhancing exchange rate regime varies according to a country's degree of technological and financial development.

But the most difficult question concerns the current EMU members. It is sometimes claimed that the enlargement of EMU would not radically alter its functioning for the simple reason that the NMS are small compared to the current euro area. Nevertheless, if for no other than political reasons, it is important to assess membership from the point of view of the EU as a whole, taking into account the ability of the euro area to absorb new members and to manage the increased diversity associated with enlargement.

A new conversation therefore needs to develop, which will be very different from the current approach to EMU enlargement. Current discussions start from the premise that monetary union is right for all EU countries and that the Maastricht criteria provide the appropriate test for deciding when candidate countries will be allowed to join. This legalistic approach overlooks that it may not be in the interest of all NMS to join EMU in the short run, and that for those who have reasons to join, the Maastricht criteria, as currently implemented at least, may not be the appropriate yardsticks.

Adaptability is also relevant to the external dimension. At the time of the Maastricht negotiations, the only exchange rates that mattered globally were those of the G7 countries. Furthermore, those countries had implemented among themselves a type of soft target-zone system that was expected to last. This context had a significant effect on the exchange rate policy provisions of the treaty. However, this managed-float system lost its significance soon after the treaty was agreed, and the world economic landscape has subsequently undergone deep change. The current situation is one of almost unrestricted floating between the euro, sterling, and the dollar, while the global monetary landscape is being transformed by the rapidly growing importance of exchange rate relationships with emerging countries – especially China and other Asian countries – that remain in a fixed-rate system or on a *de facto* peg. The exchange rate policy and external representation of the euro area must be examined in that context.

On the issues of stability, predictability, incentives for good policies, and adaptability, the Eurogroup is the essential institution. Unlike the ECB, whose mandate is strictly defined, and the Commission, whose discretionary power is bound by the procedures it is in charge of, the Eurogroup has plenty of room for manoeuvre. Its greatest weakness – the absence of a clear mission – is also its greatest strength – an ability to learn and base policy on evidence. Willingly or not, the Eurogroup embodies flexibility in an otherwise constrained system. It should certainly exercise intellectual discipline to avoid abusing this freedom. But it should make use of its ability to assess and adapt. It may need it.

2. The record

Despite some predictions to the contrary, the launch of EMU on 1 January 1999 was remarkably smooth. There were no disruptive developments in foreign exchange markets, monetary aggregates and credit growth behaved normally, and TARGET – the euro area's real-time payments system – went live without any major problems. Further enlargements of EMU to include Greece, Slovenia, Cyprus and Malta also went very smoothly.

The overall economic performance of the euro area economy since the launch of the new currency has been mixed, however. Inflation has been low, but economic growth has been disappointing. Real GDP growth and productivity have staged a recovery in the past two years but the outlook is uncertain. This chapter briefly reviews the euro area's economic performance over the past decade. More specific indicators (for example, fiscal measures and indicators of market regulation) appear in later chapters on specific policy areas.

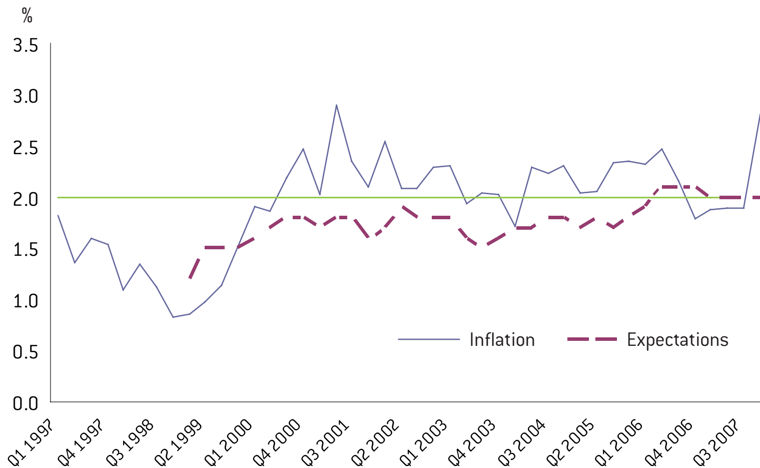
Inflation

A major achievement of the European Central Bank is that inflation in the euro area has been low and stable over most of the past nine years (Chart 2.1). Inflation moved up during the early years of EMU from very low levels, and until recently fluctuated within a narrow band of between 1.5 percent and 2.5 percent. In late 2007, however, inflation increased sharply, largely reflecting higher prices for food and energy. Inflation expectations have been well-contained, with expectations derived from surveys and financial markets generally in line with the ECB's objective of keeping inflation close to and below two percent per annum over the medium term.

The general public's perception of the effects that EMU has had on inflation are, however, somewhat different from the record in Chart 2.1. In *Eurobarometer* surveys, citizens in the euro area are virtually unanimous in recognising that the introduction of the euro has facilitated price comparisons and made travelling around Europe easier. The surveys also reveal that citizens even think that the single currency has made

the EU stronger in the world economy. But an astonishing 93 percent of those surveyed are convinced that the euro has provoked an increase in prices.

Chart 2.1: Inflation*



*Actual inflation is the four-quarter percentage change in the HICP. Expectations refer to the one-year-ahead expectations for inflation based on the ECB Survey of Professional Forecasters. Source: ECB.

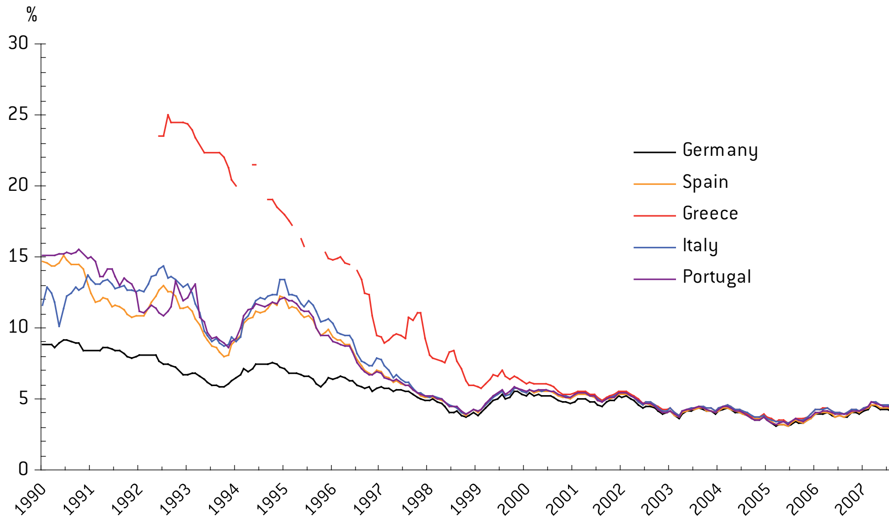
Support for the euro has declined steadily in recent years[6]. An explanation for the discrepancy between perception and the data can be found in the increase in services prices, particularly in those involving frequent transactions. In sectors where competition is limited, the changeover to the new currency temporarily clouded consumers' ability to process price information and provided an opportunity for increasing rents (Angeloni, Aucremanne and Cicarelli 2006). Memories of this event seem to linger, however.

Interest rates

The ECB's success in anchoring financial markets' expectations of inflation has helped to keep long-term interest rates at low levels. The corresponding steep decline in long-term interest rates in the run-up to monetary union (Chart 2.2) represented a significant windfall gain for public finances and borrowers in many member states. This was particularly true of those countries that were subject to large inflation and exchange rate risk premia in the past, such as Greece, Portugal, Spain and Italy.

6. Source: Eurobarometer surveys (http://ec.europa.eu/public_opinion/flash/fl193_en.pdf).

Chart 2.2: Long-term interest rates in selected member states*



* Yields on 10-year government bonds. Source: ECB.

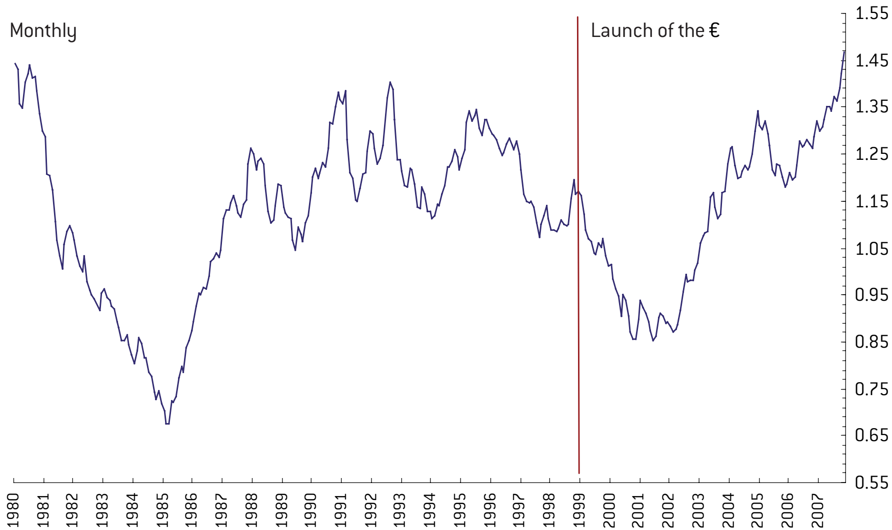
External developments

The euro has quickly become a major international currency, second only to the US dollar. A quarter of global foreign exchange reserves, about a third of international debt markets, and a sixth of international loan and deposit markets consist of euro-denominated claims. Roughly half of euro area exports and a third of its imports are invoiced in euros. The euro's share on most of these markets has stabilised in the past few years and there is no indication that it will increase further in the near future. At the regional level, evidence also suggests that the euro is widely used in many central and eastern European countries.

Following its launch, the euro initially weakened on foreign exchange markets, a development partially attributable to a diversification of the financial portfolios of euro-area residents, and to the appetite for US assets at the time of the dotcom bubble. Its subsequent appreciation remained within historical bounds and its volatility vis-à-vis the US dollar did not increase significantly. However, recent further appreciation of the euro vis-à-vis the US dollar (Chart 2.3) and other non-European currencies has brought the exchange rate to levels not observed since the early 1980s.

7. Comprehensive data are provided by the ECB's annual *Review of the international role of the euro*.

Chart 2.3: Euro-dollar nominal exchange rate



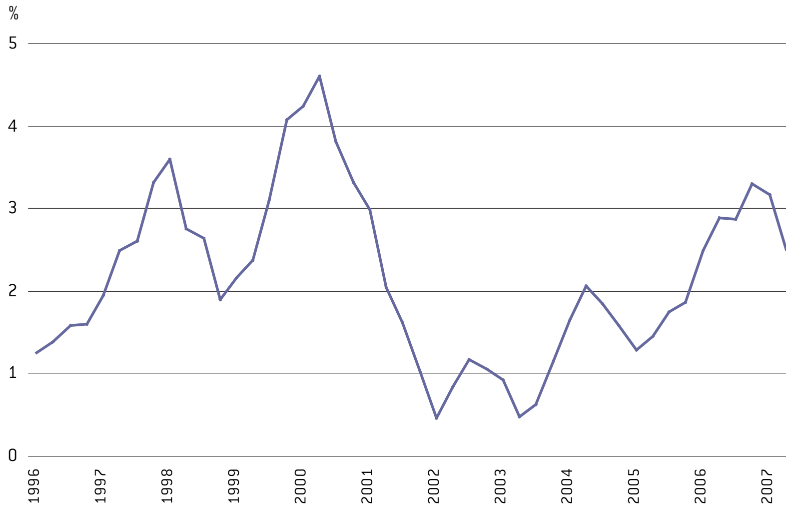
Source: ECB.

Integration

The euro has contributed to economic integration in Europe. This is especially true for financial markets, such as the money market (which has integrated fully) and to a somewhat lesser extent the markets for bonds and equities. Several studies (for example, Santos and Tsatsaronis 2003, and Lane 2006) have documented the large expansion in cross-border holdings of financial assets in the euro area. This expansion is a welcome development as portfolio diversification helps to offset the income and wealth effects of country-specific shocks. Also, Ahearne, Schmitz and von Hagen (2007) show that capital flows within the euro area have moved more into line with efficient patterns of capital allocation than capital flows between the euro area and the rest of the world.

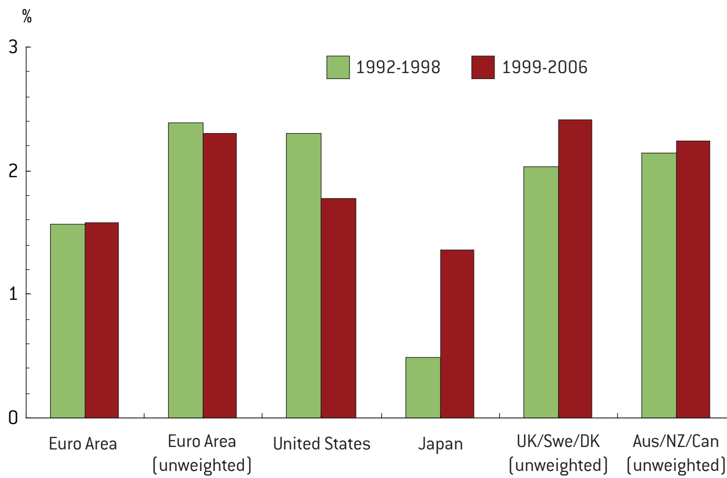
Arguably, the common currency has also boosted trade flows between member states. The effect, however, appears to have been small: between five and ten percent, according to a recent assessment by Baldwin (2006). Flam and Nordstrom (2003) also find an estimated effect in this range[8]. Frankel (2006) however suggests that the trade effects of the euro may still increase over time.

Chart 2.4: GDP growth*



* Four-quarter change in real GDP. Source: Eurostat

Chart 2.5: Average GDP growth per capita

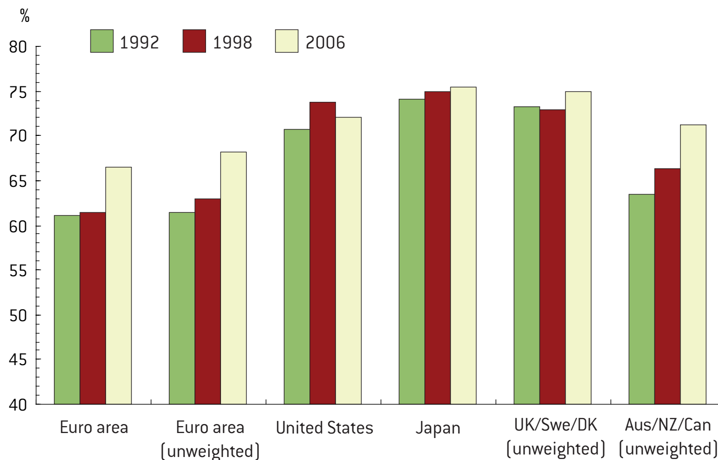


Source: Eurostat and OECD

Employment and productivity

The euro area scores poorly in terms of labour utilisation and productivity growth compared with other developed regions of the world. Employment in the euro area has begun to move up recently (Chart 2.6), but it still lags behind other advanced economies and this advance has been obtained at the expense of productivity growth (Chart 2.7). The euro area seems to be confronted with a trade-off whereby it only succeeds in increasing employment when productivity growth is slow, and *vice versa*. This is especially true for the larger member states that have dragged down growth in labour productivity.

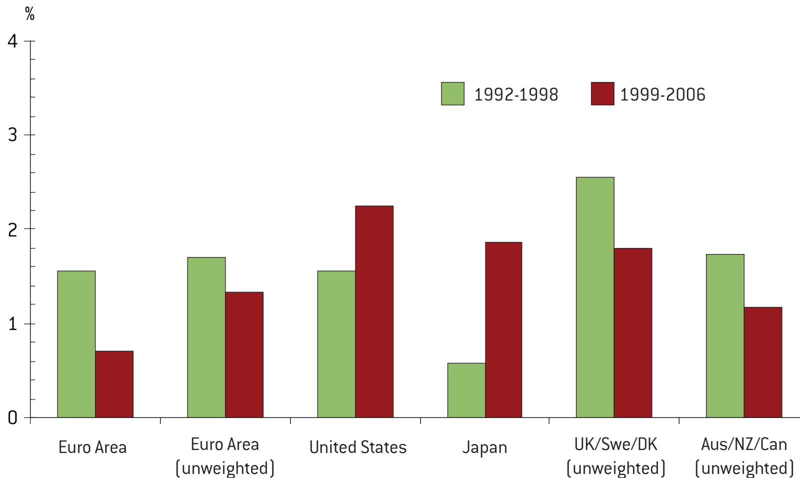
Chart 2.6: Employment rate



Source: Eurostat and OECD

Both the OECD and IMF estimate that the current rate of potential growth in the euro area is around two percent, a little below the average rate over the second half of the 1990s. Tellingly, when actual GDP growth was projected to be in the region of 2.5 to 3 percent in 2007, the ECB raised interest rates as it anticipated the build-up of inflationary pressures. For the time being, the euro area seems to be able to operate only in a low-pressure environment, though more promising data on productivity growth recently suggest that potential growth may be improving.

Chart 2.7: Average growth in labour productivity



Source: OECD

Divergence within the euro area

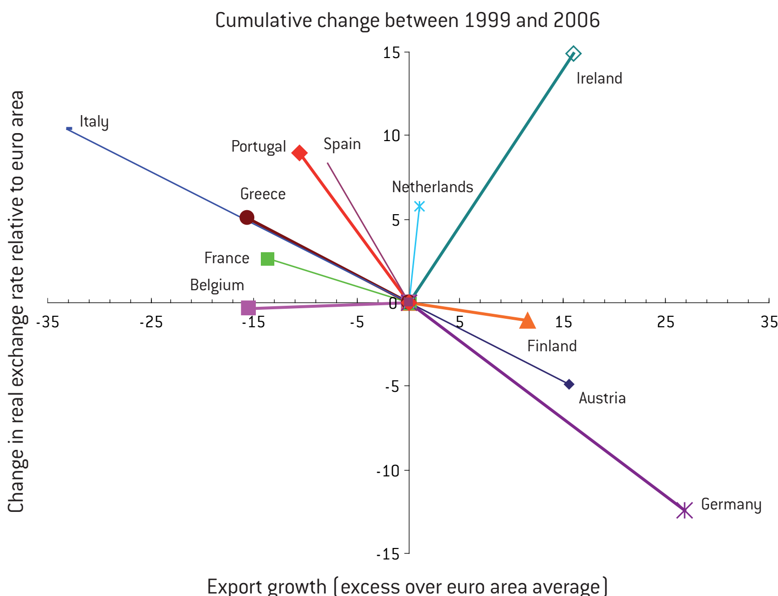
The distinction between standard euro area aggregates and unweighted aggregates highlights the uneven economic performance of member states under the common currency. At the start of EMU, a widely held (and somewhat naïve) view amongst policymakers was that the single currency would promote convergence in growth and inflation rates. While the potential for asymmetric shocks was known, it was expected that the threat of such shocks would recede over time.

The evidence points in a different direction. From a long-run perspective, this is to be expected as monetary union should promote the convergence of price and real income levels across the member states. Thus, to the extent that inflation and growth differentials reflect catching-up processes, they are in fact desirable. While high-frequency indicators such as economic sentiment show a remarkable convergence that provides evidence of common cyclical behaviour in the euro area, medium-term divergence in economic performance has increased and this has become a matter for policy discussion (European Commission 2006a). There is evidence in growth, wage-price developments and the current account of lasting country-specific boom-bust cycles originating in domestic shocks and policies. Some countries (for example, Portugal) have already entered the post-boom adjustment phase. Others, for example Spain, are at risk.

The most striking development in this respect is the persistence of inflation differentials within the euro area. While such differentials are necessary to bring real exchange rates into line with relative supply developments, the persistence of differentials in the rate of growth of prices and costs which are largely rooted in the non-traded sector and which are not related to relative export performance suggests that at least some of the real exchange rate changes do not correspond to shifts in economic fundamentals.

This is illustrated in Chart 2.8, which plots on the horizontal axis each country's export performance since the launch of the euro, and on the vertical axis each country's change in real exchange rate. Both indicators are expressed in relative terms; that is, they display the difference between the country in question and the euro area as a whole. The chart shows that real exchange rate appreciation resulting from higher inflation may correspond to improvements in the export performance and should therefore be regarded largely as an equilibrium phenomenon (this is the case for Ireland). But it also shows that some countries with higher-than-average inflation, such as Portugal, Greece and Italy have experienced inferior export performance. This indicates that the real exchange rate appreciation in these countries may have been driven by other factors and may have to be reversed.

Chart 2.8: Real exchange rate and relative export performance



Source: Authors' calculations based on Eurostat and DG ECFIN

Overall, therefore, the record is uneven. Inflation has been low, though recent movements in energy and food prices may pose a challenge for short-term price stability. Notwithstanding the pick-up in growth in the past two years, economic performance has been disappointing. Divergence in macroeconomic performance, and especially in real exchange rates, raises questions about future adjustments.

3. Monetary policy

There has been much to praise about the European Central Bank's conduct of monetary policy so far. In particular:

- The ECB has by and large fulfilled the price stability mandate given to it by the treaty. Expectations of inflation have been in line with the Bank's medium-term price stability objective for most of the past nine years (see Chart 2.1 in the previous chapter).
- The ECB has proved more pragmatic than many of its critics had feared (for example, in responding to oil shocks and the rise in monetary aggregates). In doing so, it has worked in the tradition of the German Bundesbank – tough in its rhetoric but rather pragmatic in implementing policy.
- The ECB responded quickly and aggressively to the challenges after the 9/11 attacks in the United States, as well as to the ongoing stress in credit markets by providing large amounts of liquidity to the banking system.
- The ECB has not made any major mistake and has had some success in anticipating cyclical upturns and downturns. However, this record has to be seen against the background of a stable international environment with low international price pressures. The recent substantial rise in inflation poses clear upside risks to price stability over the medium term. These inflation risks come at the same time as the ongoing credit squeeze threatens to depress economic growth.
- The ECB has demonstrated some willingness to reform important aspects of its policy, such as monetary strategy, in response to academic and public criticism.

Our concern regarding ECB policy relates to its contribution to the functioning of the policy system as a whole and specifically to the issue of transparency. Although monetary policy so far has been working well, our view is that the policy framework could be clearer and communications between the ECB and outside parties could be improved[9]. To increase transparency, we recommend changes to the ECB's monetary

9. See Bernanke (2007) for a discussion of recent changes to the US Federal Reserve communications strategy aimed at increasing transparency.

strategy that would bring it closer to what we consider best-practice 'flexible inflation targeting' (Svensson 2007).

But why alter a framework that has worked well? Both actual inflation and expectations for inflation have generally remained within a relatively narrow range between 1.5 percent and 2.5 percent over most of the past nine years. However, a key question arises: will inflation expectations remain anchored at around two percent now that actual inflation has jumped to three percent? Our view is that the improved transparency offered by an explicit inflation-targeting strategy provides the best anchor for inflation expectations. It also facilitates communication with governments and provides an undisputable basis for dialogue between them and the central bank.

3.1 The monetary policy framework

The arguments for greater transparency in monetary policy are well documented (Geraats 2002). More transparent monetary policy increases the credibility of the central bank, which helps alleviate the so-called 'time-inconsistency' problem in monetary policy (Kydland and Prescott, 1977). Greater credibility in turn improves the trade-off that economies face between inflation and unemployment. Increased transparency also makes policy interest rates more predictable, thereby reducing volatility in financial markets. The result is smaller risk premia and lower long-term interest rates. More openness and clarity in monetary policy also boosts the central bank's legitimacy. A central bank may struggle to meet its objectives in the long run if it does not have the support of national governments and wider society. Finally, greater transparency enhances efficiency in internal analyses and decision-making processes. When more of the internal documentation becomes publicly available, the incentive to improve the quality of that material is stronger.

A high level of transparency is particularly important for an institution like the ECB, which is relatively new, enjoys a high degree of independence, and acts within a policy framework that is complicated because it involves many actors and different cultures[10]. In recent academic studies the ECB scores reasonably well on transparency, though it is not among the top tier of central banks (Dincer and Eichengreen 2007)[11].

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10. Buiter (1999) discusses the link between transparency and independence.
11. The Reserve Bank of New Zealand, the Swedish Riksbank, the Bank of England, the Czech National Bank, and the Bank of Canada all score higher than the ECB on transparency in a recent study by Dincer and Eichengreen (2007).

An important reason why the ECB trails the leaders in terms of transparency is the Bank's choice of strategy. The ECB's primary goal is to maintain price stability over the medium term. Price stability is defined as a rate of inflation close to and below two percent. To achieve this goal, the ECB's monetary strategy relies on two pillars. The first pillar is essentially an inflation forecast based on a wide range of financial and non-financial data. The second pillar gives a prominent role to money, including a reference value of 4.5 percent for the annual growth of M3 (see ECB 2004)[12].

The lack of transparency of this strategy has triggered much criticism in the past. Regarding the inflation objective, it remains unclear at what specific rate of inflation the ECB is aiming. Although this is less of a problem today than it used to be some years ago before the ECB revised its definition of price stability, it is still difficult to see the intellectual argument for continuing to use an imprecise target. Regarding the pillars, it is unclear how conflicts between the two pillars will be reconciled. As long as the outlook for inflation derived from both pillars is the same, the two-pillar structure has no purpose. But if the two pillars give rise to different outlooks, one pointing to a rising inflation rate and the other to a falling inflation rate, it is unclear how the ECB will respond. Furthermore, monetary growth has been in excess of the reference value for most of the period since the start of EMU without triggering any obvious policy adjustment by the ECB.

The two-pillar strategy was originally justified by the need to build a bridge back to the Bundesbank. However, there is evidence that the Bundesbank had in fact behaved as other central banks, focusing on inflation and perhaps sometimes taking real developments into account, but in practice not relying much on developments in monetary aggregates[13]. It is not clear therefore that the real legacy of the Bundesbank is that of a central bank which accorded a prominent role to monetary aggregates in formulating monetary policy.

Even as far back as the mid-1990s, many countries with very poor inflation records had demonstrated that credible regimes could be created within only a few years using inflation targets[14]. It is not clear why a pure inflation target that does not give an explicit role to growth in money could not have worked for the ECB as well. Moreover, even if a bridge to the Bundesbank was important at the time, the

12. The strategy was adjusted in 2003, when the order of the pillars was reversed and the focus on money was reduced but not eliminated.
13. See, for example, von Hagen (1995, 1999).
14. For an overview of the international experience with inflation targeting, see Mishkin and Schmidt-Hebbel (2007) and Bernanke *et al* (2001).

argument hardly carries much weight today.

The argument for continuing to rely on the two pillars is that inflation and monetary developments act as a cross-check on each other. Of course, all relevant material should be used to forecast inflation. If a better forecast can be obtained by combining models based on real aspects and monetary aspects, then both should be incorporated. Also, if additional information signals risks to the outlook for inflation in the period beyond the forecast horizon, this too should be taken into account. But it is unclear why one factor should be singled out as particularly important for the inflation assessment and assigned a higher status. Nor is it obvious how the focus on monetary aggregates has improved forecasts or helped policymaking in any other sense.

Recently, another argument advanced in support of the second pillar is that it is supposed to help guard against dangerous developments in asset markets[15]. To be sure, central banks should pay attention to financial market indicators and assets prices, because developments in asset markets are likely to affect inflation as well as the real economy. Central banks should make it clear that they care about asset markets, and as far as possible describe both the reasons for this and how they might wish to act. However, it is doubtful that a central bank's concern over asset market developments is made any clearer by references primarily to measures of monetary growth.

3.2 Another step towards best practice inflation targeting

Against this background, we recommend that the ECB should give up its two-pillar strategy and replace it by an explicit framework of inflation targeting. We see two main reasons for this.

- First, a clear numerical target for annual inflation creates the best conditions for stabilising inflation expectations over time. Latest readings suggest that expectations appear to remain firmly anchored around two percent. However, inflation expectations are greatly influenced by the record on inflation, and the actual inflation performance has – as we noted previously – been very close to the target during most of the life of the ECB. This is a performance that cannot be

15. See, for example, several papers presented at the 4th ECB Central Banking Conference, 'The role of money: money and monetary policy in the twenty-first century', November 2006. In addition, Munchau (2007) argues that 'money is also useful as an early warning signal of financial instability, for example instability caused by bubbles. Since central banks cannot really be expected to price bubbles [...], it is much better for them to use a neutral intermittent indicator, such as money.'

taken for granted, as underscored by the recent jump in inflation. There can be no doubt that a clear target creates the best anchor for expectations and that the right time to introduce it is when expectations are where one wants them to be, as is the case today. There is no reason to try to reinvent the wheel in this area. A broad consensus has now emerged on how to operate an inflation target, though of course there are differences at the margin. Many inflation-targeting central banks use an inflation level of two percent as the target, which would seem to be the most natural target for the ECB as well, especially in light of the actual outcomes over the past nine years. The target should also be symmetric, making it clear that the ECB cares as much about deviations in one direction as in the other.

- Second, a precise numerical target also creates the best foundation for communication, not only with financial markets, but also with politicians and the public. Regarding financial markets, at first glance it might seem that there is no need for urgency. During recent years, markets appear to have been able to understand the intentions of the ECB. However, this is also an achievement that should not be taken for granted. The view of market participants can change quickly, especially in a situation like today when the central bank is faced simultaneously with rising inflation and significant downside risks to economic growth. It seems clear that communication could be even better if the target were more sharply defined. When it comes to communication with the political world, there have been more obvious difficulties. There is in our view a need to change the pattern whereby politicians in the euro area distance themselves from monetary policy. The main danger here is perhaps not undue pressure, but rather that the central bank might become isolated in the face of public dissatisfaction and end up being used as a scapegoat for perceived shortcomings in policy, with potential negative long-run effects on the legitimacy of the policy framework as a whole. Making the central bank's inflation target explicit would force politicians calling for lower interest rates to be explicit about their views on the inflation target as well.

An unambiguous and symmetric inflation target would provide a basis for introducing more intellectual discipline into the dialogue with euro area governments. Once it is specified, we suggest that the ECB should voluntarily inform the Eurogroup that it has adopted a reformed inflation target, and the Eurogroup should respond with an unequivocal endorsement (through an exchange of letters, perhaps) to show public support for the improved framework[16]. This would help to restrict future policy

16. Whether or not this should also apply to the European Parliament is a matter for discussion. In many countries that have adopted a numerical inflation objective, its definition is the responsibility of the central bank, the government, or both jointly, rather than of the parliament.

debates to the more technical question of what is the best way to reach the target. Thus, an inflation target would also improve the accountability of politicians in public debates over monetary policy.

To improve its own accountability, the ECB should also set a band around its inflation target and commit itself to commenting in public (to the European Parliament) in the event that the actual inflation rate were to move outside the band. This would be similar to what is now done by the Bank of England and some other central banks. The band would thus serve as a communication device, not a way to disguise an increase in what is regarded as an acceptable rate of inflation.

The inflation target should be combined with the message that importance is also attached to stabilising the real economy, as long as doing so does not pose risks to price stability. This accords with the treaty provision (Article 4), which states that the primary objective of monetary policy is 'to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Community'.

The targeting of inflation should thus be implemented in a 'flexible' manner, which in fact is broadly in line with the way the ECB has set policy so far. However, it is not sufficient for a modern central bank to stop there. Over time, the central bank should be more ambitious and explain publicly how the difficult 'calls' are made in squaring the inflation target with stabilising the economy. Obviously, these are difficult choices to make and no simple formula can be applied in all circumstances. What we expect, however, is that the ECB should be willing to explain its decision-making as clearly as possible. Similarly, the ECB should also elaborate on the role of asset prices in the setting of monetary policy under different circumstances.

Another important aspect of best-practice inflation targeting is the publication of forecasts for inflation and other relevant economic variables under particular growth scenarios. These forecasts are an essential tool for better communication with outside parties, including financial markets, national authorities, price-setting firms, and those involved in shaping wage settlements. This is true especially if forecasts reflect policymakers' views, rather than just being technical exercises produced by the central bank's staff, which is the case for the macroeconomic projections that the ECB currently publishes four times a year in its monthly bulletin.

There are three important benefits that derive from making forecasts public:

- First, they are useful in shaping expectations concerning future policy. Outside

parties can more easily see where policy is likely to go[17]. Over time, this will improve their understanding of how policy is shaped. A framework of this kind might be particularly important for the ECB because of the many communicators involved and the fact that there are several different political constituencies with varying attitudes towards monetary policy.

- Second, central bank forecasts have an important role in justifying monetary policy. By referring directly to what will happen under different circumstances – and how developments will affect inflation – it is possible to explain in a clearer way the different risks and policy options. When the markets and other interested parties are given information about the background of the forecasts, they can input new emerging information and make judgements about future policy (that is, they can identify the central bank's so-called 'reaction function'). This implies, among other things, that the need to guide markets and other outsiders using various forms of code – which tend to work only for a while and under stable conditions – will be lower.
- Finally, the forecasts are important for accountability. They demonstrate to the outside world how well substantiated the policy actions have been and they allow for more qualified *ex post* discussion in parliaments and other bodies.

The information provided about the forecasts (and, hence, about the reaction function) would also provide a better starting-point for concrete and serious dialogue with other authorities (for example, the Eurogroup). A politician wishing to argue against a decision on interest rates by the ECB would not be able simply to accuse the central bank of being unconcerned about growth but would need to take the discussion to a more sophisticated level. This would increase the quality of public debate on monetary policy and, again, increase politicians' accountability for their remarks.

With a clearer policy framework and published forecasts, a more qualified discussion is possible, especially between different economic policymakers but also with the public and with financial markets. But one point is worth underlining here. Although we have argued for more transparent monetary policy and we think that central banks should, in different ways, encourage public discussion of their actions, we also think that responsible politicians in the euro area should be careful to avoid getting involved themselves in public discussion of monetary policy. The reason for this is simple. Such involvement risks creating confusion and unnecessary conflict. This in turn threatens to discredit the policy framework. Moreover, the stronger the language

17. In particular, this is of course true if the central bank publishes the future policy rates underlying those projections (see Qvigstad 2006, and Svensson 2004).

used in such debate, the greater the risk that it will be counterproductive, limiting the central bank's room for manoeuvre[18].

3.3 Recommendations

- *The ECB should improve its policy framework by moving to a full inflation target regime.* The Bank should integrate its economic analysis and monetary analysis into a single analytical framework. We recommend that the ECB set a band around its *de facto* inflation target of two percent, make it explicitly symmetric and implement the targeting in a flexible manner.

- *The ECB should publish forecasts for inflation and GDP that reflect the views of the Governing Council.* An inflation target, together with forecasts, will provide a better foundation for communication. It would provide a good basis for dialogue with the Eurogroup. Being able to substantiate decisions in a rigorous way may also be important for the ECB because of the greater economic divergences within the euro area.

- *The ECB should voluntarily inform the Eurogroup that it has adopted a reformed inflation target, and the Eurogroup should respond with an unequivocal endorsement (through an exchange of letters, perhaps) to show public support for the improved framework.*

None of those proposals would imply changing the treaty. Nor would they imply any formal consultation between the ECB and the Eurogroup.

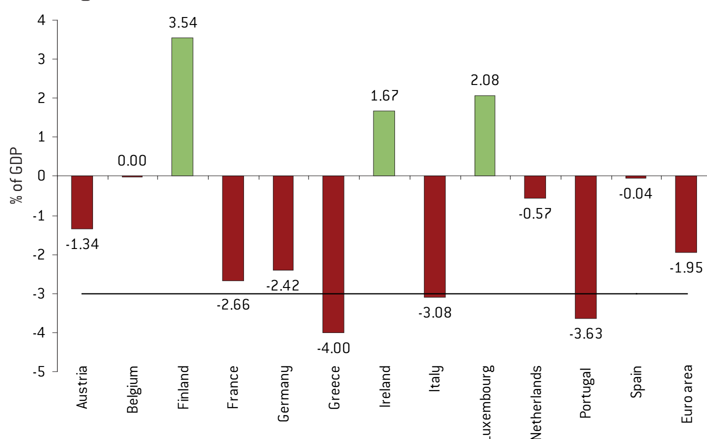
18. For an interesting account of this position in a US context, see Rubin (2004).

4. Fiscal Policy

In contrast to monetary policy, fiscal policy in the euro area has been much less appropriate for EMU.

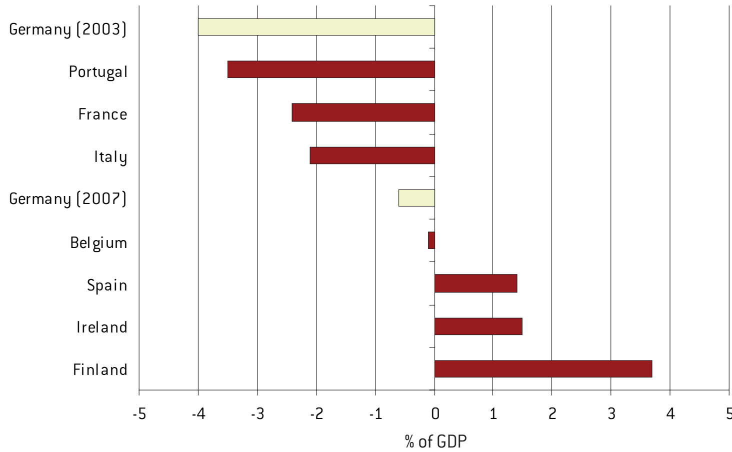
- Fiscal discipline has on average improved compared with the pre-EMU years, but has remained poor. Several countries have recorded persistently large fiscal deficits since 1999 (Chart 4.1). A significant factor behind this disappointing performance is that, among the large countries, only Spain reached the target of close-to-balance early in EMU. France and Italy continue to run large fiscal deficits, while Germany's fiscal performance was disappointing until its recent dramatic improvement (Chart 4.2).
- The aggregate budgetary policy of the euro area has been mildly pro-cyclical. Fiscal policy at the individual country level has, in general, not responded appropriately to country-specific shocks. In several member states, fiscal policy has exacerbated appreciations in the real exchange rate and, as a result, has contributed to a deterioration of competitiveness. This has also contributed to widening divergences in economic performance between the euro area countries.

Chart 4.1: Average fiscal balance, 1999-2006



Source: Authors' calculations using OECD data

Chart 4.2: Fiscal balance, 2007 estimates



Source: Eurostat and European Commission, 'Public Finances in EMU 2007'

In this chapter we first document the contrasting fiscal performance of the EMU member countries. We then discuss in what way the quality of fiscal adjustment programmes has affected outcomes. Next, we analyse the interplay between the EU fiscal rules and the member countries' domestic institutions. We then turn to the procyclicality issue, before concluding with policy proposals.

4.1 Experience with fiscal discipline

Fiscal consolidation was the most pressing problem of economic policy in the EU during the 1990s. In spite of improved overall macroeconomic conditions, discipline remains a concern for several countries.

In the late 1970s, average general government debt in EMU countries stood at 30 percent of GDP. At the time of the signing of the Maastricht Treaty in 1992, it had risen to nearly 60 percent. This rapid – and for peacetime unique – expansion of government debt raised concerns that the stability of the common currency might be undermined by weak fiscal discipline. As a result, the goal of regaining and preserving fiscal stability was deeply embedded in the Maastricht Treaty. This aim is reflected in the definition of 'sound public finances' as a guiding principle of economic policy in the EU, in the rule that countries with excessive deficits were not allowed to enter into the monetary union, and in the design of the excessive deficit procedure (EDP) and, later on, the stability and growth pact (SGP) as collective instruments to achieve fiscal stability. There were not only European but also national motives for this: monetary

union was seen as a chance to redress the tendency towards fiscal laxity.

Table 4.1: Change in government debt and spending (% of GDP)

Country	Change in general government debt ratio			Change in general government expenditures ratio*		
	1977-92	1992-99	1999-06	1977-92	1992-99	1999-06
Austria	27.3	10.7	-4.3	3.9	-0.8	-3.7
Belgium	69.5	-13.5	-25.7	-4.9	0.0	1.8
Denmark	52.9	-10.6	-27.5	7.6	-0.2	-2.2
Finland	32.8	5.5	-7.9	20.0	-11.7	-1.1
France	20	28.5	5.4	6.5	0.6	1.8
Germany	15.3	18.8	6.7	-1.4	1.1	-2.3
Greece**	67.9	24.5	-0.6	3.7	3.4	2.1
Ireland	31.4	-43.1	-23.7	0.3	-8.2	3.2
Italy	50.4	8.5	-8.7	8.2	-1.6	1.9
Luxembourg	-6.2	1.9	0.9	n.a.	-0.2	0.4
Netherlands	37.5	-18	-14.4	1.7	-7.9	2.8
Portugal	24.4	-0.3	10.4	7.7	4.4	3.9
Spain	33	15.6	-23.2	13.8	-3.4	0.7
Sweden	36.6	-1.1	-15.8	5.9	-7.0	-1.7
UK	-20.1	6.6	-1.6	1.7	-5.5	5.5
EMU12***	29.3	12.7	-3.6	1.6	-1.1	0.0

Source: Bruegel computations based on Eurostat data for debt ratios and OECD data for government spending ratios.
* General government expenditures = government consumption + social transfers + other transfers + subsidies + government investment.
** Greece: government investment excluded from government expenditures.
*** Includes only figures for countries where all data are available every year over the period.

The performance of European countries has been very diverse since then. When monetary union started in 1999, the average government debt ratio in the EMU stood at 72 percent. On average, therefore, the Maastricht programme for fiscal consolidation was not particularly successful. Yet this average hides vast differences in individual country performance (Table 4.1). France, Greece and Germany (where reunification represented a large and unexpected burden) experienced the largest increases in the debt ratio between 1992 and 1999, while Ireland, the Netherlands and Belgium experienced the largest declines. Outside the EMU group, debt ratios increased in the UK and fell in Denmark and Sweden. In the first eight years of EMU, the average debt ratio edged down, with individual countries performing differently. Outside the EMU, debt ratios fell, most markedly in Denmark and Sweden.

It is interesting to compare the increase in debt ratios with the evolution of government spending over the same period. Consistent data are not available for all countries, but some trends are identifiable. First, the countries experiencing the largest increases in the debt ratio also tended to experience significant increases in the expenditure ratio. Thus, the fiscal deficits that led to the rapidly rising debt ratios were typically caused by expenditure growing faster than GDP, not by declining revenue ratios. Second, countries experiencing the largest declines in the debt ratio also tended to experience significant falls in the government spending ratio. This suggests that both fiscal slippage and successful and lasting fiscal consolidations were largely determined by the relative growth of government spending and GDP[19].

4.2 Fiscal adjustments and quality of public finances

Fiscal policy focuses on target variables expressed as ratios of GDP (for example, the deficit ratio or the debt ratio). Since inflation is no longer under the control of domestic monetary policy for EMU governments, the only two ways they can affect such ratios are by slowing the growth of nominal debt or by implementing policies that boost the growth of real GDP[20].

Table 4.2 reports the averages of direct taxes (including social security contributions), transfers to private households, and public investment spending relative to GDP in three periods: before 1992 (which varies for different countries according to data availability), 1992-1999, and 1999-2006. These data are summarised for two groups: the group with the lowest and the highest growth rates in the EU between 1992 and 1999, and the group with the lowest and the highest growth rates in EMU between 1999 and 2006. The low-growth countries in the first period are Germany, Italy and France; in the second period, Germany, Italy and Portugal. The high-growth countries in the first period are Ireland, the Netherlands and the United Kingdom; in the second period, they are Ireland, Spain and Finland. What we see is that the average public debt ratio continued to grow in the low-growth countries during both periods. In contrast, the debt ratio fell in the high-growth countries during both periods. Econometric analysis suggests that most of that reduction was achieved by real growth rates exceeding the growth of nominal public debt (von Hagen 2003). In the low-growth countries, debt continued to rise faster than real GDP.

19. Based on broader samples of OECD countries since the 1960s, Alesina and Perrotti (1996) and Perrotti, Strauch, and von Hagen (1998) show that fiscal consolidations based on expenditure cuts are much more likely to achieve lasting deficit and debt reductions than consolidations based on revenue increases. The EMU experience confirms this point.

20. Surprisingly, this is a fact which is sometimes overlooked in member states.

Low-growth countries in the first period experienced an increase in the ratio of direct taxes to GDP and in both periods saw a rise in social transfers to GDP and a reduction in the ratio of public investment to GDP. They also recorded a sharp increase in transfer spending as a share of total public expenditure and a falling share of investment spending in total expenditures. High-growth countries, in contrast, experienced reductions in the ratio of direct taxes to GDP and transfer spending to GDP and a slight increase in the ratio of public investment to GDP in the second period. For these countries, the rise in investment spending as a share of total public spending is more visible in both periods. These observations underline the importance of choosing a growth-oriented strategy for fiscal consolidation.

The above evidence indicates flaws in the institutions governing fiscal policies in EMU. The first and most obvious flaw is that, despite the elaborate system of rules created by the SGP, fiscal discipline has not improved in several euro area countries. This suggests that the rules-based framework has not been adequate, at least not for all countries. One reason for that is that the framework remains entirely centred on deficits and, in the name of subsidiarity, overlooks what the Commission has called the quality of public finances. There are certainly very good reasons for preserving the national parliaments' ability to decide on the level of public spending, yet it must be recognised that this has contributed to ignoring some of the important factors behind fiscal slippages. Another factor has been long-term neglect of debt and the broader sustainability of public finances, taking into account off-balance-sheet liabilities (Coeuré and Pisani-Ferry 2005).

The second flaw is that, with its focus on aggregate budgetary targets such as debt and deficits, the EMU framework has not explicitly encouraged growth-enhancing policies. In fact, it might even in some cases have been counterproductive. There is no reason in principle why consolidation measures cannot be implemented in parallel with growth-enhancing policies. However, there have been cases where governments under pressure have used quick fixes for deficits, overlooking their medium-term impact on growth.

Pointing out the existence of flaws in the system should not blind us to the tendency in some countries to blame Brussels for problems caused by fiscal consolidation, although responsibility for strategies chosen and results achieved, in terms of growth and employment, has in reality remained with individual member states.

This discussion suggests that the distinction between good quality and poor quality fiscal strategies is crucial. Good quality strategies build on healthy trend growth and

do not harm the growth prospects of an economy. Poor quality strategies rely on short-run growth but harm the longer-term growth prospects by increasing the tax burden on factor incomes and reducing capital spending.

Good quality strategies require commitment to the policy goal of controlling public debt and the stamina to adhere to that goal for an extended period of time. Commitment is necessary, because good quality consolidations need to tackle politically sensitive spending items, such as social transfers and public sector wages. Stamina is required because good quality consolidations must be carried through fully in order to bear fruit. The problem in practice is that both commitment and stamina are rare in democratic societies, because governments face pressure from interest groups and the prospect of elections. The more uncertain a government's chances of winning the next election, the less likely it is to reap the benefits of good quality consolidation involving political pain today, and the more tempting it is to give in to pre-election spending pressures.

Table 4.2: Fiscal strategies in slow- and fast-growing EU countries

	1992-1999				1999-2006			
	Direct taxes	Social transfers	Public investment	Change in debt ratio	Direct taxes	Social transfers	Public investment	Change in debt ratio
Country group	Average of 3 slowest-growing economies Germany, France and Italy				Average of 3 slowest-growing economies Germany, Italy and Portugal			
% of GDP	1.7	1.3	-0.7	18.6	-0.6	1.3	-0.8	2.8
% total revenue/ expenditures	3.7	2.9	-1.5		-2.2	2.4	-2.1	
Country group	Average of 3 fastest-growing economies Ireland, Netherlands and United Kingdom				Average of 3 fastest-growing economies Ireland, Spain and Finland			
% of GDP	-0.8	-4.2	0.0	-18.2	-0.1	-0.9	0.4	-18.3
% total revenue/ expenditures	5.0	-4.6	1.3		-1.4	-2.9	0.8	

Source: Bruegel computations based on Eurostat data for debt ratios and OECD data for government spending ratios

4.3 Fiscal discipline and domestic institutions

So why have some countries succeeded while others have failed? There is now a rich and growing literature showing that fiscal institutions can help governments build the commitment and stamina necessary for good quality consolidations. This

literature starts by recognising that political fragmentation and instability undermine the government's ability to commit to a good quality consolidation and to adhere to it. Two models of fiscal institution are particularly relevant in this context: (1) fiscal contracts; and (2) the delegation of fiscal powers to a strong finance minister. They can, to varying degrees, be found in many EU countries.

Contracts

Fiscal contracts exist where governments design and adopt multiannual fiscal programmes based on numerical targets for the key budgetary parameters. Importantly, these targets are (re)negotiated among all relevant political actors at the outset of the annual budget process and considered to be binding throughout the remainder of that process. These targets must be based on reliable macroeconomic projections to ensure that they can be kept to with reasonable certainty. Furthermore, they must be specific enough to express the government's approach to spending cuts in politically sensitive areas. Making fiscal contracts work requires that the finance ministry can effectively monitor the spending ministries during the budget year. Often, fiscal targets come with rules spelling out what the government will do under unforeseen circumstances (that is, how unexpected revenue shortfalls will be handled or what will be done with unexpected revenue surpluses).

Fiscal contracts thus address the commitment problem of democratic governments by starting the budget process with negotiations in which a compromise agreeable to all relevant parties can be reached and by credibly threatening that deviations from the targets during the fiscal year will entail political sanction. They provide the stamina necessary for good quality consolidations by providing a medium-term framework against which fiscal actions can be measured and governments be held accountable. Fiscal contracts have worked best when these frameworks are more transparent and clear and the longer and more consistently they have been applied. Examples of successful fiscal contracts or frameworks in the EU are those in Ireland, the Netherlands, Sweden, Denmark and Finland.

Delegation

Delegating fiscal powers is based on the idea that the finance minister, who typically is not bound by particular spending interests, is in a particularly good position to decide on politically sensitive spending cuts. This model vests the finance minister with agenda-setting power over the spending ministers. That is, the finance minister can unilaterally – or jointly with the prime minister – set the main parameters of the

annual budget. Numerical targets typically play little role in this approach. To make it work, the finance minister needs the power to execute the budget to ensure that no deviation from the original budget occurs.

In the delegation model, the commitment power is provided by the relative independence of the finance minister from political spending interests. The stamina required for good quality consolidations is provided by the stability of the finance minister's position in the government. Successful examples of the delegation model in Europe are the UK, France, and Germany until the early 1990s.

The choice between these two models depends primarily on a country's political system (Box 4.1). Fiscal contracts or medium-term frameworks are common where the government is typically formed by coalition among relatively competitive partners. The reason is that contracts are ultimately enforced by the threat of one partner breaking up the coalition if another partner violates the targets in his or her spending area. This is underlined by the fact that the targets of the annual fiscal contract are often derived from a coalition agreement on multiannual fiscal targets, and that the party leadership is often involved in the negotiation of the annual targets. The more the threatening party can expect to find another partner to form a government with in case of a break-up of the ruling coalition, the more effective the threat is. Hence, the competitiveness of the political process promotes enforcement. Enforcement of fiscal contracts is also strengthened by informed national debates and legislatures with strong monitoring rights over the executive.

In contrast, delegation is not common in coalition settings. The reason is that delegation is a hierarchical model, resting on giving one individual special powers over others. Such power hierarchies typically exist within parties, but not between parties. Delegating strong fiscal powers to the finance minister in a coalition setting would create the suspicion that the finance minister would show favour to the his/her own party's spending interests.

Delegation works better in governments which are formed by a single party or two close allies. However, contracts do not work in such an environment, as a single-party government can simply decide to walk away from any pre-set targets, as it faces no penalty for doing so.

Box 4.1 Determinants of the political system

As shown in Hallerberg *et al* (2007), some parameters can be identified that determine the political system. The first is the electoral system – proportional representation versus majority rule – and district magnitude (that is, the number of seats in parliament coming from one electoral district). Proportional representation, especially with low minimum vote thresholds for obtaining a seat in parliament and large district magnitude, is conducive to political systems with many parties and coalition governments. Majority rule and proportional representation with low district magnitude and high minimum vote thresholds are conducive to political systems with one-party governments or coalitions of close allies such as in Germany until recently.

This reasoning is illustrated in Table 4.3, which reports the parameters of the electoral systems in the EU15 countries together with some indicators of the competitiveness of the government formation process and the type of coalitions prevailing. The last column predicts the type of institution chosen by the country. Hallerberg *et al* (2007) show that these predictions match the observed political patterns very closely.

Table 4.3: Electoral system, ideological distance, and type of fiscal governance, 1980-2000

	Electoral system	District magnitude	Average no. parties	Ideological distance small or large	Predicted type of budget process
Austria	2-tier PR	20/91	1.9	L 84-99, S 00-	C 84-99, D 00-
Belgium	PR	23	4.5	L	C
Denmark	2-tier PR	7/175	2.5	L	C
Finland	PR	13	3.9	L	C
France	Plurality	1	1.6	S	D
Germany	2-tier PR	1/603	1.9	S	D
United Kingdom	Plurality	1	1	S	D
Greece	Reinforced PR	6	1	S	D
Ireland	STV	4	1.8	L 85-97, S 98-	C 85-97, D 98-
Italy	2-tier PR	19/625	4.2	L 85-96, S 97-	C 85-96, D 97-
Luxembourg	PR	14	2	L	C
Netherlands	PR	150	2.4	L	C
Portugal	PR	12	1.7	S	D
Spain	PR	6	1	S	D
Sweden	2-tier PR	11/350	1.5	L	C

Source: Hallerberg *et al* (2007)

Explanation of terms: (1) Electoral systems: PR means proportional representation. A two-tier electoral system is one where an upper level of seats is used to top up the results at a lower level to make the overall distribution of seats more proportional. Plurality stands for plurality systems which elect only one representative per district. (2) District magnitude refers to the number of representatives elected from each electoral district. (3) Predicted types of budget process: C refers to Contract, D refers to Delegation.

It is interesting to take these predictions back to Table 4.2. There, we identified the three fastest- and the three slowest-growing countries in the EU in the 1990s and since the start of EMU. All countries in the slowest-growing group are from the group of delegation countries (that is, they have relatively strong finance ministers, while fiscal contracts play no role in their budget processes). Two of the three best-performing countries in each period are among the countries that adopted fiscal contracts. This is in line with more systematic evidence shown in von Hagen (2006) and Hughes Hallett *et al* (2001) that EU countries following the contract approach have achieved larger debt reductions than countries following the delegation approach in the 1990s.

Furthermore, the institutional framework of the EU's excessive deficit procedure and the SGP, with its emphasis on numerical medium-term targets, multiannual fiscal plans, and annual monitoring of progress made, closely resembles the institutional framework of the contracts approach at the national level. EU countries following the contracts approach were able to exploit this institutional similarity and use the European framework to strengthen their national fiscal institutions[21]. While delegation is not *per se* biased against growth and good quality consolidations, it does not share the same institutional resemblance with the EU framework and the latter did not appear to strengthen the national fiscal institutions in countries following the delegation approach.

The crucial point is that, for some countries, fiscal institutions compatible with the contracts approach would work best, while institutions compatible with delegation will suit others. The distinction depends on each country's electoral system. Whichever approach is adopted, high-levels of transparency are important. One step in the direction of greater transparency would be the setting-up in each country of an independent national body delivering to the public regular assessments of the budgetary situation and evaluations of the budgetary consequences of policy proposals presented to parliament.

4.3 Countercyclical fiscal policy

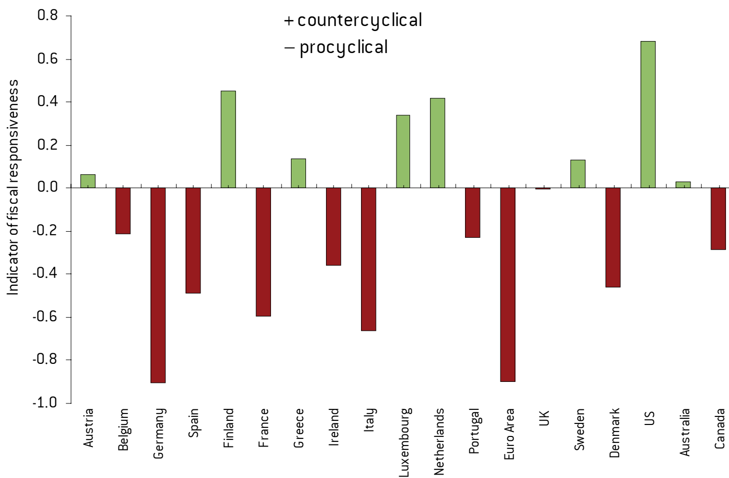
We have emphasised in Chapter 1 why stabilisation is important and why it may have consequences for long-term growth, particularly in economies where some firms face credit constraints. In a common currency area, the loss of the interest rate and

21. One example is Sweden, where the fiscal consolidation plans were closely linked with the convergence programmes applied in the run-up to EMU.

the exchange rate as stabilisation tools at the national level puts a premium on the proper use of fiscal policy for that purpose. As countries joined monetary union, governments could thus have been expected to increase the countercyclical behaviour of fiscal policy.

The record so far has been disappointing. Only a few member states have consistently run countercyclical fiscal policy since the start of EMU (Chart 4.3). Chart 4.4 illustrates this fact by showing the correlation between the change in the primary structural balance and the output gap as an indicator of the responsiveness of fiscal policy to the business cycle. The chart shows that the large member states in particular have had a tendency to run procyclical fiscal policies.

Chart 4.3: Fiscal policy stance, 1999-2006



Source: Authors' calculations based on OECD data

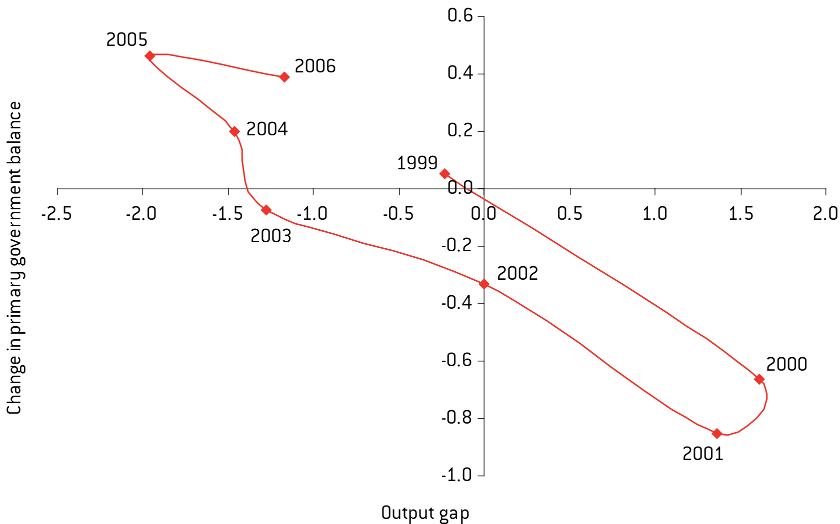
Box 4.2: Macroeconomic policy and long-term growth

Economic theory suggests a link between macroeconomic policy and long-term economic growth. The argument, first developed by Aghion, Angeletos, Banerjee and Manova (2006), henceforth AABM, is that credit-constrained firms have a borrowing capacity that typically depends on current earnings. (Note: the factor of proportionality between earning and debt capacity is called credit multiplier, with a higher multiplier reflecting a higher degree of financial development in the economy). In a recession, current earnings are reduced, and so is firms' ability to borrow in order to maintain growth-enhancing investments (eg in skills, structural capital, or R&D). To the extent that higher macroeconomic volatility translates into deeper recessions, it should affect firms' incentives to engage in such investments.

This prediction finds empirical support. Using cross-country panel regressions, AABM show that structural investments are more procyclical the lower the country's level of financial development. Berman *et al* (2007) use a French firm-level panel data set on R&D investments and on credit constraints, where more credit-constrained firms are shown to be those firms that are subject to 'payment incidents'. Namely, a firm that has not fully repaid its trade creditors is put on a 'payment incident' list to which all French commercial banks have access. The authors first show that firms currently on the payment incident list have more difficulties accessing bank loans. Then, using the payment incident dummy variable as a measure of credit constraint at the firm level, they show that: (i) the share of R&D investment over total investment is countercyclical without credit constraints; (ii) this share turns more procyclical when firms are credit constrained; (iii) this effect is only observed during down-cycle phases, ie in the presence of credit constraints, the R&D investment share plummets during recessions but does not increase proportionally during up-cycle periods. Thus evidence from French microdata confirms that, in firms that are more liquidity constrained, R&D suffers from output volatility.

But this in turn suggests a role for macroeconomic policy over the business cycle: namely, countercyclical macroeconomic policies, with higher government investment or lower nominal interest rates to help credit-constrained firms maintain their innovative investments during recessions. For example, the government may decide to stimulate the demand for private firms' products by increasing spending. This could further increase firm's liquidity holdings and thus make it easier for them to face idiosyncratic liquidity shocks without having to sacrifice R&D or other types of longer-term growth-enhancing investments. On the other hand, in a recession, more workers face unemployment, so that their earnings are reduced. Government spending could help them overcome credit constraints either directly (social programmes, etc.) or indirectly by fostering labour demand and thus employment. This relaxation of credit constraints would in turn allow workers to make growth-enhancing investments in human capital, re-location, etc. The tighter the credit constraints faced by firms and workers, the more growth-enhancing such countercyclical policies should be.

Chart 4.4: The output gap and fiscal stance



Source: OECD

The procyclical nature of fiscal policy since 1999 in part reflects the fact that political elections have had an effect on the stance of fiscal policy. Buti and van den Noord (2004) and von Hagen (2006) find that discretionary fiscal policies correspond strongly to electoral cycles, with expansions in electoral years. In addition, many European governments repeated in the early 2000s the mistakes made in the late 1980s, failing to reduce the structural deficit at the time the nominal deficit was shrinking as a consequence of favourable tax receipts. The policy frameworks and incentives set up at the European level have not been able to compensate for this. The focus on nominal, rather than cyclically-adjusted, outcomes in the early years of EMU may even have diverted attention away from countercyclical policies.

The reform of the SGP in 2005, the strengthening of its 'preventive arm' and the increased attention devoted to cyclically-adjusted measures have been steps designed to correct the procyclical bias of the early years. It is too early to assess whether those changes have contributed to improving the cyclical properties of fiscal policies in EMU.

Since there is no actor at the euro area level with a mandate to devise (and much less to implement) a proper fiscal strategy for the euro area, the fiscal stance of the euro area as a whole is simply the sum of the national fiscal policies of the member states. As Chart 4.4 shows, the aggregate stance of fiscal policy at the euro area level has

also been inappropriate most of the time, moving from a procyclical expansion in 2000 to a procyclical contraction in 2005. Such a pattern obviously makes it harder for monetary policy to stabilise the euro area business cycle. Thus, the experience so far shows that the present *laissez-faire* approach to aggregate fiscal policy does not automatically result in a policy which is appropriate for the euro area as a whole (nor, actually, for the member countries).

Determining whether there is a need to correct the aggregate fiscal stance of the euro area and, if so, which national policies should be corrected, is a classical collective-action problem. No individual government has an incentive to take into account the needs of, and the consequences for, the aggregate EMU economy when it sets national fiscal policy. Thus, each government will care only about its own economy, expecting others to do what is best for the performance of the euro area as a whole. To some extent, of course, the governments of the larger member states will internalise part of the effects of their policies on the euro area aggregates, but no member state is large enough to care for the common good. Consequently, one cannot expect fiscal policy spontaneously to identify appropriate and timely reactions to shocks at the euro area level.

The 'own house in order' approach which prevails in EMU should suffice to address this problem most of the time. In fact, adherence to fiscal discipline and the avoidance of procyclical national policies goes a long way towards ensuring an appropriate aggregate fiscal stance. But there could be circumstances in which incentives to conduct good policies at national level would not suffice and inability to devise a common response could be a serious issue. Consider, for example, a situation where aggregate saving results in a current account balance that contributes to an excessively strong or an excessively weak exchange rate. Under some circumstances changes of this kind could even be quite dramatic, demanding rapid policy responses. In such (admittedly rare) situations, there would be a case for being in a position to correct the aggregate fiscal stance.

The Eurogroup is a natural candidate for solving this collective-action problem. To do so, however, it requires a sufficiently strong presidency that can assess if there is a need for a common fiscal response, and, possibly, to develop a fiscal strategy for the euro area as a whole and encourage national governments to implement this strategy. This is not a plea for coordinated macroeconomic fine-tuning at the euro area level. But in the event of a large global economic shock, even avoiding major policy mistakes will require common action.

4.4 Implications for the policy system

We have emphasised in this chapter that the quality of national fiscal policies – that is, their ability to combine discipline over the medium term, cyclical stabilisation and growth-enhancing measures – does not depend solely on the quality of the EU numerical targets and commonly agreed rules. We have argued that it also depends on accompanying policies, especially as regards the quality of public finances and structural pro-growth measures, which are in the hands of national governments. Furthermore, we have provided evidence that the effect of common principles and rules depends on a country's domestic policy and even on its political institutions.

Because those dimensions were initially overlooked, the current EU fiscal framework does not seem to have delivered what was originally sought: continued consolidation in line with the pre-euro years, and improved cyclical behaviour.

Not enough priority has been given to the need to improve growth and the quality of public finances. This was especially true in the initial years of EMU. Fiscal sustainability and growth were dealt with through two separate processes: the stability programmes and the SGP on the one hand and the Lisbon agenda on the other. Very little attention was devoted to their consistency and to possible trade-offs between fiscal consolidation and growth-enhancing policies.

The twin reforms of the SGP and of the Lisbon agenda in 2005 have only partially resolved this issue. The SGP now explicitly takes into account the underlying factors behind a deficit, and the Lisbon guidelines include both macroeconomic and structural dimensions. Also, the 'Public finances in EMU' reports from the European Commission's Directorate General for Economic and Financial Affairs (DG ECFIN) address the quality of public finances (see for example European Commission 2006b). Yet the role of the Commission in the context of the corrective arm of the Pact is reduced to that of a mere scorekeeper with no room for informed judgment. While the reform of the SGP has increased the Commission's role in the preventive arm of the Pact by allowing it to issue early warnings without the approval of the EU Council of Ministers for Economic and Financial Affairs (ECOFIN), the Commission may face incentives to use this instrument timidly, if it fears that it will be blamed by governments for interfering with national policies, especially if ex post a government is fortunate and does not enter the procedures under the corrective arm of the Pact.

Despite the improvements in the Pact, there are still not enough incentives to improve the cyclical management of public finances. Governments are encouraged to

move into surplus in good years, but they are not sufficiently rewarded for such behaviour as they would be with a system of rainy-days funds (Box 4.3).

Box 4.3: Rainy-day funds

The lack of progress towards countercyclical fiscal policies points to two weaknesses of the EU's fiscal framework: the lack of incentives for fiscal discipline in good times, and the possibility that the three percent deficit threshold prevents countercyclical policies in bad times.

Drawing on the experience of the US states, Buti *et al* (2003) and Sapir *et al* (2003) suggested the introduction in Europe of 'rainy-day funds', which are spent in bad times and replenished in good times. These funds would increase the incentive for governments not to waste budgetary surpluses in good times and increase the room for manoeuvre during slowdowns. Setting aside in a fund the surplus generated by increasing revenues and falling expenditures to be used in bad times would strengthen the hand of the finance minister in resisting pressures to give away the automatic fruit of growth. To avoid moral hazard, it was suggested that there should be some rule to ensure that resources are withdrawn from the fund only in the case of protracted slowdowns. One possibility would be that the decision to set aside resources be made by a member state, but that the decision to draw on the fund would require a 'double key', ie approval of both the member state and the ECOFIN Council, based on a Commission recommendation.

Balassone *et al* (2006) argue that the decision to introduce rainy-day funds should be purely national rather than being centralised. To set up such a fund, however, a centralised decision by the Council would be required since, under ESA95 (European System of Accounts) accounting rules, deposits to and withdrawals from a rainy-day fund would be recorded as changes in financial assets, which only affect the composition of the deficit financing, not its level.

Without a change in the definition of the 'Maastricht deficit', which is based on ESA rules, governments would have little incentive to introduce rainy-day funds. Under current rules, the only benefit of accumulating assets in good times would be the possibility of avoiding an increase in gross debt in bad times, as rainy-day funds balances could be used to finance the deficit instead. However, there would be no change with respect to the three percent deficit ceiling.

A revised interpretation of ESA accounting rules by the Council (leading to a revision of the EDP protocol of the treaty) could allow withdrawals from a rainy-day fund in bad times to be considered as additional revenue and thus reduce the deficit.

A deeper issue, which has barely been addressed so far, is the interplay between the common rules and national fiscal institutions. Although Commission research (European Commission 2006) has acknowledged the issue, full conclusions have not been drawn from the fact that the rules and institutions that are conducive to fiscal discipline may not be the same everywhere. On the contrary, the adoption of a common EU framework has tended to blur responsibilities for fiscal policies. Although member states do in fact retain responsibility for fiscal policy and for its results, the impression has been created that the setting of fiscal policy objectives had been delegated to Brussels, at least in the countries that have underperformed.

The current framework for fiscal discipline continues to rely heavily on centralised rules. Admittedly, the reformed SGP has moved some way towards the use of constrained discretion and away from strict rules. But the system of fiscal discipline remains highly centralised. A better approach would be to put much more emphasis on incentives and on reforming domestic fiscal institutions. More leeway in fiscal policy could then be given to those countries that succeed in improving their domestic institutions. Countries that fail to reform their national institutions would remain under the centralised system. Of course, the criteria to be met in order to qualify for more fiscal autonomy, and the procedures governing such a process, would have to be agreed centrally.

4.5 Recommendations

Our analysis does not lead us to question the need for a policy system that ensures fiscal discipline. But it does lead us to question the system's current organisation, because we think that there is strong enough evidence that the effects of the common rules have not been the intended ones. The actual results obtained are not satisfactory and seem to depend more on the national political and policy institutions. We therefore recommend that the organisation of fiscal discipline in EMU be re-examined and a step taken towards a more decentralised, tailor-made approach:

- *The focus of EU surveillance should increasingly be put on a comprehensive concept of debt sustainability.* Initial focus on the deficit was justified, because this was the only variable governments could control in the short run. What matters most for EMU partners, however, is the sustainability of the budgetary position. Sustainability assessments should be enhanced by taking into account government assets and off-balance-sheet liabilities, which in turn entails developing a proper accounting framework for evaluating implicit age-related liabilities on the

basis of methods agreed on at EU level. Work done in recent years by the Commission and the EU's Economic Policy Committee can serve as a basis for moving in this direction[22].

- *The EU should recognise progress in home-grown fiscal discipline through granting increased national fiscal autonomy to countries that have put in place credible and appropriate national fiscal policy rules and institutions.* This should be done through defining minimum requirements for national fiscal frameworks and assessing the quality and the record of domestic fiscal rules and institutions. A country meeting those requirements could be given more leeway in the conduct of its policy over the cycle. This proposal does not require changes to the treaty, provided that the country remains within the (three percent, 60 percent) treaty limits.

- *In assessing national fiscal rules and institutions, the scope for differentiation should be recognised.* Depending on their electoral systems and political environments, some countries could be expected to adopt institutions compatible with the contracts approach while others are likely to adopt institutions compatible with delegation. Regardless of the approach chosen, minimum conditions should include the establishment of an independent national body delivering to the public regular assessments of the budgetary situation, and evaluations of the budgetary consequences of policy proposals presented to parliament[23]. The national frameworks should also include commitments to prepare and publish accounts, including for off-balance-sheet liabilities.

What we propose amounts to a change of philosophy – a move away from detailed European rules and day-to-day monitoring and towards underlining and making more transparent the role and responsibilities of the member states for national fiscal policies. At the same time, the EU level should retain responsibility for defining the common framework, for setting standards, and for assessing national rules and institutions. What we envision is a simplified SGP, focusing primarily on debt sustainability, and a framework to guide the judgements of fiscal institutions, on the basis of

22. We acknowledge that our proposal to focus EU surveillance on a comprehensive concept of debt sustainability is not compatible with the protocol on the Excessive Deficit Procedure (EDP), which includes the Maastricht definition of the debt. In the short term, we are not suggesting changes to the EDP, but rather an increasing focus on sustainability. It would be possible to do this while keeping the Maastricht definition of the debt. Only at some later stage would the procedure need to be changed.

23. An example of such a body already in operation is the newly instituted Swedish Fiscal Policy Council (see Calmfors 2007, for a brief discussion).

which more fiscal autonomy can be given to the member states. With this model, the responsibilities of member states would be clearer. At the same time it would allow the Eurogroup to concentrate on issues where it cannot be substituted: namely how to respond to serious violations of fiscal discipline, severe threats to the functioning of EMU and adverse internal or external economic conditions at the euro area level.

It goes without saying that these proposals are not a quick fix. They could only be put in place gradually, initially alongside the current system and without any change to the treaty. If successful, the approach suggested would probably lead at some point in the future to a replacement of the current numerical thresholds of three percent deficit and 60 percent debt by more elaborate targets. But this should only be contemplated on the basis of accumulated experience, and there is therefore no urgency to act.

While we argue in favour of more decentralisation in fiscal policy choices, we also see a case for joint strategic thinking and common decision-making in exceptional circumstances. To this end, the Eurogroup should be equipped with the ability to respond to stress. Urgent action might be needed in times of crisis and this should be recognised in the policy framework. Suitable instruments exist in the Lisbon Treaty, in Article 114, which allows the countries belonging to the euro area to adopt specific economic policy guidelines. We therefore suggest that:

- *The presidency of the Eurogroup should assume leadership in the implementation of the reforms we propose and, if required by exceptional circumstances, in devising common fiscal guidelines for the euro area.*

5. Structural Reforms

There is broad agreement that to promote growth the EU needs better functioning labour, product and financial markets[24]. This need is even greater for the members of the euro area since this enhances economic adjustment in the absence of the exchange rate instrument. Poorly functioning markets delay and hamper adjustments and contribute to potentially threatening situations of real overvaluation[25]. The euro area countries therefore have a particular stake in the design and implementation of adequate reform policies.

However, the evidence is that the euro area is not at the forefront of economic reforms. On the contrary, its member countries often lag behind other advanced economies. In particular, main problem with reforms lies with the large member countries. Comparisons based on OECD indicators confirm that the pace of reform in the euro area has at best matched the pace of reform outside the euro area and that it has not accelerated since the time of the introduction of the euro. There is even some evidence of reform slowdown in the euro area after 1999 (Duval and Elmeskov 2006).

We start in this chapter by reviewing the evidence. We then turn to discussing the pros and cons of reform coordination at the EU or euro area levels. We assess the current way of addressing the issue. Finally, we offer some conclusions for the Eurogroup.

5.1 The evidence

To provide a quantitative assessment, we rely on the same external benchmarks as in Chapter 2: those are the US, Japan, three advanced non-European countries (Canada, New Zealand and Australia) and three advanced European countries that do not belong to the euro area (the UK, Sweden and Denmark). We systematically use

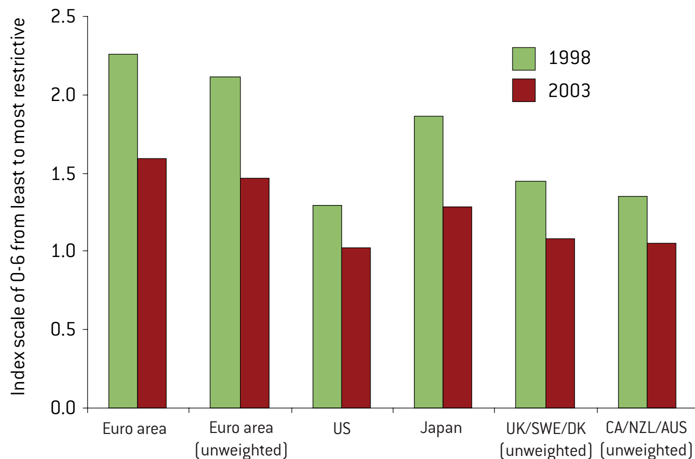
24. Aghion (2006) provides an overview of the arguments.

25. See, for example, the discussion in EC (2006).

unweighted averages for the comparators in order to eliminate the effect of relative country size. For the euro area, we use both a weighted average (that corresponds to the euro area entity) and an unweighted average (that give equal weight to participating countries irrespective of their size)[26].

Chart 5.1 first displays the level of product market regulation in 1998 and 2003, the latest year for which such indicators are available. It shows that product market deregulation has advanced significantly since the introduction of the euro and that there is a clear trend towards international convergence in the level of regulation.

Chart 5.1: Indicator of product market regulation

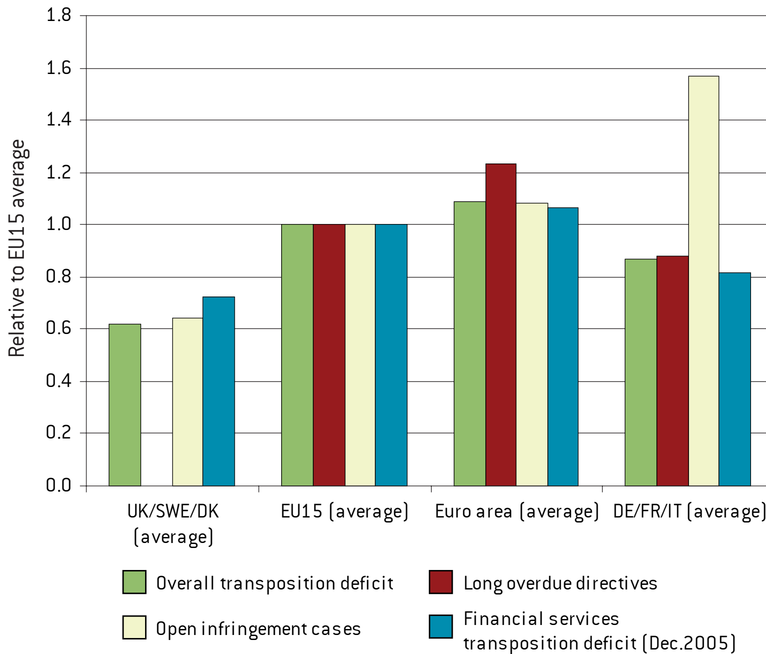


Source: OECD 'Going for Growth' 2007

Even though product market regulation is largely the responsibility of the EU, the situation in euro area countries differs substantially from that in non-euro area countries. However, more detailed indicators give an even grimmer picture. First, the euro area's record in transposing directives is inferior to that of non-euro countries, especially in the case of France, Germany and Italy, the euro area's 'big three' (Chart 5.2).

26. More precisely, we use data for the EMU12 as they allow better comparison over time than for EMU13 or EMU15.

Chart 5.2: Indicators of delays in implementing internal market legislation



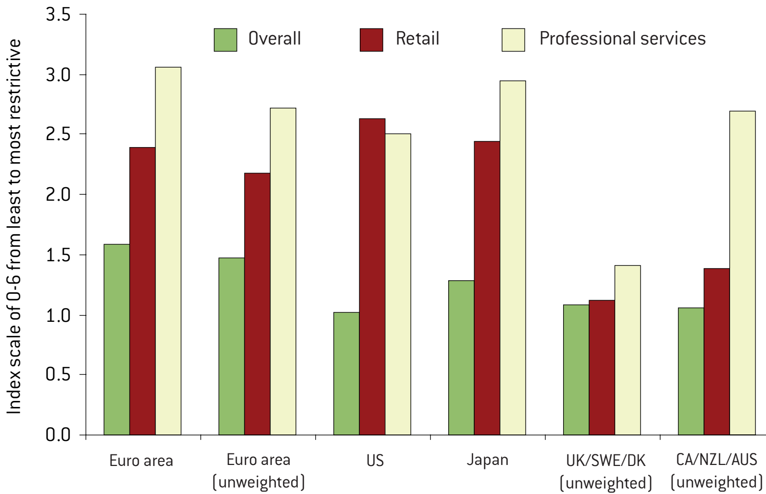
UK/SWE/DK: no long overdue directives. Source: Internal market scoreboard, July 2007

Second, the euro area countries' record is significantly less favourable in services sectors for which regulation depends more on national authorities. In those sheltered or semi-sheltered sectors, there is a clear difference between the euro and non-euro countries (Chart 5.3). The high level of regulation in those sectors has been identified as a significant factor of price inflation divergence among euro area countries (see Balázs 2007, European Commission 2006, and ECB 2003).

As regards labour markets (Chart 5.4), the level of employment protection legislation exhibits considerable inertia. The euro area remains characterized by a significantly higher degree of tenured jobs protection than in any other country except Japan. The image is less clear-cut for temporary contracts and for some other dimensions of labour market reforms such as working-time flexibility, but on the whole there is no evidence of a strong positive effect of EMU on reform intensity. Again, this contributes to making wages less responsive to labour market conditions and to slowing down national responses to competitiveness shocks[27].

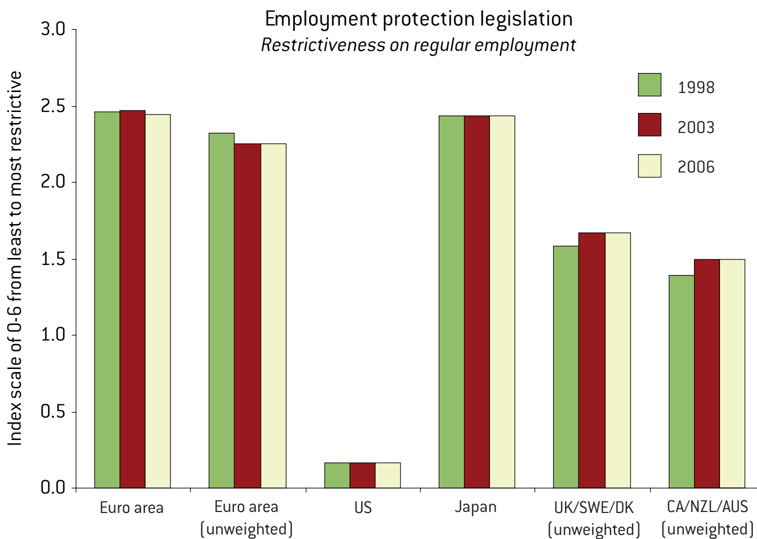
27. Holden, and Wulfsberg (2004), Linzert (2005), Nickell, Nunziata and Ochel (2005), Staiger, Stock, and Watson (1997), Den Haan, Haefke, and Ramey (2001).

Chart 5.3: Indicators of product market regulation in selected sectors (2003)



Source: OECD 'Going for Growth' 2007

Chart 5.4: Indicator of labour market regulation



Source: OECD 'Going for Growth' 2007

Empirical evidence thus broadly confirms the view that neither the commitment to the single currency nor its introduction have resulted in transforming the euro area economies into champions of structural reform. Its members thus seem to exhibit a

degree of inconsistency between the commitment to flexibility inherent in the participation in a monetary union and their domestic agendas. What is the reason for this inconsistency? And is it a policy issue for the EU, the euro area, or individual member states only?

5.2 Is there a rationale for a euro area dimension?

The basic EU doctrine is that responsibility for structural reforms is shared between the Union (which has responsibility for the single market, trade policy, etc) and member states (which have responsibility for labour markets, social policies and education), but that the latter are committed to coordinating their policies within the EU's Lisbon framework. However, the rationale for this coordination has never been properly articulated, and its euro area dimension has until recently been completely overlooked in the implementation of the Lisbon strategy (Pisani-Ferry and Sapir 2006).

In a nutshell, standard economic reasoning does not provide a *prima facie* case for centralising structural reforms. On the contrary, it suggests that structural reform is primarily beneficial to the country that undertakes it. Spillovers to neighbouring countries do exist, but they must be weighted against the complementarities across reforms that exist within a single country (Tabellini and Wyplosz 2004). Responsibility for reforms thus does not need to be allocated to a higher level of government or to be coordinated with neighbours.

Furthermore, the design of labour market, pension and education reforms depends intrinsically on existing rules and institutions. Reforms must therefore be tailor made. By the same token, the sequencing of reforms often depends on political economy considerations which necessarily vary from one country to another. There are in this respect many parallels with fiscal policy: the benefits of simultaneous EU-wide implementation of structural reforms must be weighed against the cost involved in attempting to coordinate what are by nature tailor-made, country-specific policies.

There are nevertheless reasons why some form of coordination might help:

- *Classic spill-overs.* Some national policies may significantly and directly affect neighbours, for example industrial policy measures implemented to support so-called national champions (negative effect) or spending on research and development (positive effect).
- *Learning.* Comparative assessments and the evaluation of national experiences

help sort out good from bad policies;

- *Vertical complementarities.* EU policies and national policies may complement each other (for example, product market reforms and labour market reforms are in most cases complementary because, beyond their effects on individual countries, they also jointly contribute to allocative efficiency and growth);
- *Political economies of scale.* Joint European action may help overcome the suspicion that governments are motivated by partisan agendas.

The above reasoning applies to the EU as a whole. In addition, there are two arguments of special relevance for the euro area (but not for the EU)[28]. First, a country that implements a reform the effect of which is to reduce inflationary pressures exerts an effect on its neighbours through the reaction of *common monetary policy*. This implies that countries contemplating reforms in isolation cannot expect their efforts to elicit a reaction from the central bank, in particular if they are small. This, in turn, may discourage short-sighted governments from undertaking reforms. Coordination between governments would open the door for monetary policy to accommodate an expected increase in the euro area's potential output. By the same token, a coordinated approach to reforms and the associated response of the ECB could alleviate the pressure on fiscal policies to be more supportive of reforms, which is important given the parlous state of public finances in many countries.

Second, reforms may be required to ensure a proper functioning of the euro area and prevent *political risks*. A country whose labour market institutions do not allow downward wage flexibility in response to a deterioration of competitiveness, or where domestic demand expansion combined with a lack of competition in the service sector results in an excessive rise in the relative price of non-tradables, may resort to behaviour that is harmful to its neighbours. For example, it can exercise undue pressure to depreciate the exchange rate of the euro, prevent further external trade competition or resort to economic nationalism. For those primarily political reasons, it may impair the functioning of monetary union as a whole and even represent a risk for its sustainability.

It should be noted that those two arguments are different in nature. The first emphasises the incentive dimension of the EMU framework and triggers reflection on ways to ensure that countries adopt policies that are in their own best interest. Coordination may foster the adoption of better policies, ie policies that favour growth and employment. The second argument is not about optimising how the system

28. This draws on Debrun and Pisani-Ferry (2006).

works but is concerned with *regime preservation*[29]. From this perspective, coordination is a way to ensure that no government embarks on a course that has the potential to threaten essential EMU public goods such as its viability or price stability. For example, it helps to correct policies that would lead to excessive real appreciations.

Summing up, we do not see a case for routinely coordinating structural policies at the EU or euro area levels. The arguments for decentralisation are compelling, while the arguments for centralisation, though respectable, lack general validity. We see a case for:

- Clearly differentiating between, on the one hand, fields in which the EU has authority for defining reform priorities with a view to improving the performance of the EU and the euro area as a whole and, on the other hand, fields that belong to the remit of national governments.
- Addressing situations where lack of reform in one or several countries is hampering the proper functioning of monetary union or possibly threatening its long-term sustainability.
- Discussing the lessons to be drawn from successful national reform experiences and assessing overall results.
- Improving the policy framework of the EU and EMU with a view to strengthening incentives for structural reforms that are conducive to higher output and more responsive markets.

5.3 Assessing the policy framework

How does the current policy framework measure up to our objectives?

In the domains of EU competence, reforms are frequently hampered by lengthy negotiations at the decision-making stage and by lack of momentum at the implementation phase. This applies, for example, to the regulation of many product and capital markets. Although we do not have evidence about the stance taken by euro area countries during negotiations, an indirect indication is provided by Chart 5.2 which shows that euro area countries – especially the larger ones – have lagged behind in the implementation of EU directives.

As regards mutual information and assessment, a positive aspect of the EU frame-

29. The distinction between policy optimisation and regime preservation was first introduced by Peter Kenen (1989) in the context of international finance.

work is that it provides opportunities for exchanging views on experiences and selecting policy priorities. The Lisbon process must be given credit for having created better awareness of neighbours' policies, as well as of their successes and failures. More can certainly be done in this respect, without any infringement of national policy autonomy, through systematic comparisons and independent assessments of national policies. Informed national debates with a clear analysis of the problems, in which concrete proposals are tabled, are likely to help reform efforts. The question here is: who should be in charge of preparing and publishing the assessments? Currently they suffer from being 'negotiated' within the Commission and with member state representatives. This weakens their authority in comparison with the findings of an independent report.

The main difficulty with the EU coordination framework is that it is still structured around processes such as the adoption of 'integrated guidelines', the submission of 'national reform programmes', and the assessment of those programmes by the Commission. Those processes offer each player an opportunity to have a say, and they allow the Commission to prepare detailed country assessments. But they have limited impact on actual national policies (Pisani-Ferry and Sapir 2006). Experience accumulated since the EU's first broad economic policy guidelines suggests that the problem does not stem from failures in the design of particular procedures but rather from the very principle of attempting to steer national policies through procedures which may remain cut off from the reality of policymaking at national level.

Here again, not enough thought has been given to the incentive dimension of the EU framework. Governments are told to engage in reforms, but there are not enough sticks or carrots. The sticks are markedly weaker than for the SGP. Unlike Article 104, which provides the legal basis for the SGP, Article 99 – on which reform coordination is based – does not allow for sanctions. The only possibility offered by Article 99 is for the Council to issue recommendations. Nor does the EU support efforts by national governments through its own funds. In fact, much of the EU budget is allocated towards preserving present structures rather than towards promoting structural change and economic growth (Sapir *et al* 2004).

Nor have the EU or the Eurogroup devised specific instruments for telling a country that it needs to change its policy course, and for organising joint action in crisis situations or other instances when cooperation is especially needed. They rely on exactly the same instruments – the broad economic policy guidelines and the evaluation of national reform programmes – that are used in routine cases, which does not appropriately signal the exceptional nature of the situation.

In sum, what is in place is a set of routine procedures for information-sharing and low-intensity economic policy coordination. While we recognise that this may help to improve the quality of national economic policies, we are worried by the combination of burdensome procedures and low effectiveness, which we regard as a recipe for irrelevance. Instead, we would prefer a focus on increasing the knowledge and understanding of the issues, on improved information exchange and on stronger incentives. We also see a case for tighter procedures for organising cooperation in exceptional circumstances, when structural deficiencies and a government's failure to address them represent a threat to the functioning of EMU.

5.4 Recommendations

Consistent with the approach we have outlined, the Eurogroup can play an important role at three levels.

The first level concerns present EU-wide policies, that is measures which should be adopted by the EU27, especially as regards trade policy and the single market. Here, *the Eurogroup could act as a catalyst and as a caucus for reforms which are of the competence of the EU but of particular importance for the functioning of the euro area* and for which there is a need to build support. To this end, the Eurogroup should hold a yearly discussion on the priorities for EU-wide reforms and take positions on this agenda. An important agenda in this respect is financial stability, as discussed in the next chapter, but the same philosophy applies to several dimensions of the single market, such as network industries integration or services liberalisation.

The second level concerns policies that ought to be adopted at the EU level as a matter of priority by those countries inside the euro area, even if they are not adopted at the EU level. Good candidates in this respect are measures to foster the cross-border movement of labour (for instance pension portability) where the euro area could serve as an vanguard. An important dimension here is that the *euro area should actively promote the removal of obstacles to cross-border labour mobility*. Some members – Ireland and Spain – are very open towards migration, and this has already transformed their pattern of macroeconomic adjustment to shocks, while others – Germany and France – remain relatively closed. In the long run, mobility of labour, while unlikely to become a major channel of macroeconomic adjustment as in the US, can be expected to play a stronger role in the functioning of EMU.

The third level concerns measures which are the responsibility of individual member states and should remain so, but which are of particular importance for the

functioning of the euro area because they have a bearing on the response of the economy to shocks. Prime candidates here are aspects of reform of labour and product markets that remain within the jurisdiction of individual member states, as well as banking regulations.

The desirability of a Eurogroup push at the first two levels is fairly uncontroversial, which does not mean that implementation is easy. It is the third level that is a matter for discussion. Our proposals are:

- To use the EU budget review of 2008/2009 and thereafter the preparation of the future EU financial perspectives as an opportunity to *direct EU spending towards promoting growth and providing incentives to reform* in member states.
- *To foster policy learning through resorting more systematically to independent assessment and benchmarking*, including through the preparation and publication of performance league tables.
- *To encourage the Commission to further enhance its surveillance role and issue under its own responsibility non-legally-binding assessments and recommendations* analogous to International Monetary Fund Article 4 staff reports and recommendations. Significant progress has been made in this direction recently and we only advocate going further.
- *To consider the adoption by the Eurogroup of formal recommendations to a country whose policy represents a significant threat to the proper functioning and the sustainability of EMU.*

The revised Article 99 in the new Lisbon Treaty provides instruments for enhancing the surveillance of policies that risk jeopardising the proper functioning of EMU. It allows the Commission to issue 'warnings' under its own authority. Moreover, Article 114 allows euro area countries (in practice the Eurogroup) to issue specific recommendations. To have 'teeth', such warnings or recommendations would first and foremost have to be based on a substantial economic analysis of the country's situation. The responsibility for such analyses should rest with the Commission services. Also, to give political significance to formal recommendations adopted by the Eurogroup by qualified majority, they would need to remain rare and be reserved to cases where a real danger to the functioning of EMU has been identified.

One question is whether the Eurogroup should acknowledge that trade-offs between structural reforms and budgetary adjustment, while not common, may arise in the short run in specific cases, especially when reform involves a direct budgetary cost. This should not serve as a justification for permanently relaxing the discipline of the

SGP, since successful reform and budgetary consolidation are complementary in the medium term. But there might be a case for addressing the short-term trade-off. If a country requests additional budgetary leeway, we recommend not giving a blank cheque in return for good reform intentions but rather spelling out which reforms justify delaying the adjustment in public finances and what their expected budgetary cost is to be. *Whenever the Eurogroup consider that a delay in the adjustment is justified, it should request and obtain from the country a time-bound commitment to reach a specified debt-to-GDP ratio.*

6. Financial Stability

The effect of EMU on financial markets has been dramatic. The elimination of exchange rate uncertainty and transaction costs, as well as increased price transparency, have greatly increased the efficiency of financial markets in the euro area and have torn down some of the walls that perpetuated segmentation. The money market has become completely integrated and yields on euro-denominated bonds and other assets of the same class have converged (ECB 2007a). The corporate bond market is regarded as being highly efficient[30]. Fixed-income investors tend to consider the euro area as a single entity (Hartmann *et al* 2003, Baele *et al* 2004, and Carletti *et al* 2007). Furthermore, the share of bonds and equities of other euro area countries in national portfolios has risen very significantly. Lane (2006) reports a rise of between 20-30 percentage points in fellow EMU members' share of cross-border bond portfolios for most countries, with more moderate increases in the weighting in equity portfolios.

A significant limitation, however, is that credit markets remain fragmented due to regulatory and tax differences across countries and the very limited extent of cross-border competition among banks. But things are changing fast in the banking system with the rapid emergence of pan-European banks (Decressin, Faruqee and Fonteyne 2007, Véron 2007). In addition, the links between financial systems in Europe and other parts of the world are rapidly becoming stronger. These are desirable developments from the perspective of efficiency, but the emergence of such institutions represents a challenge for stability.

A more integrated banking system may imply greater systemic risks that cannot be dealt with at the national level. We are worried that the system of banking oversight and supervision in Europe, which remains essentially national, is not equipped to deal with potential systemic problems in the banking sector[31]. As Italian finance

30. Biais *et al* (2006) provide a comprehensive study of European corporate bond markets. Dunne *et al* (2006) provide a corresponding study of the European government bond markets.

31. Similar concerns arise at an EU-wide level. However, the issues discussed in this chapter are probably more pressing for EMU since financial integration is deeper and banks are more closely linked within the euro area.

minister Tommaso Padoa Schioppa wrote in his letter to the ECOFIN of 26 November 2007, in the recent crisis 'supervision has been absent at the European level'. We also believe that it is important to develop a more coherent European approach to these issues in discussions with other countries.

Of course, concerns about stability are also relevant for other parts of the financial system. The most pressing challenges, however, appear to be in the area of bank supervision, where swift political initiatives are needed.

6.1 Cross-border banking in the euro area

Banks are important for economic activity. Notwithstanding the recent growth of capital markets in Europe, they remain instrumental in allocating capital and risks as well as in facilitating efficient payments. As shown in Chart 6.1, outstanding bank loans dwarf securities as a source of debt financing for non-financial corporations in the euro area. In fact, about 90 percent of debt financing for corporations is made up of bank loans, while the corresponding figure is less than 60 percent in the United States and about 75 percent in the United Kingdom (Issing 2006).

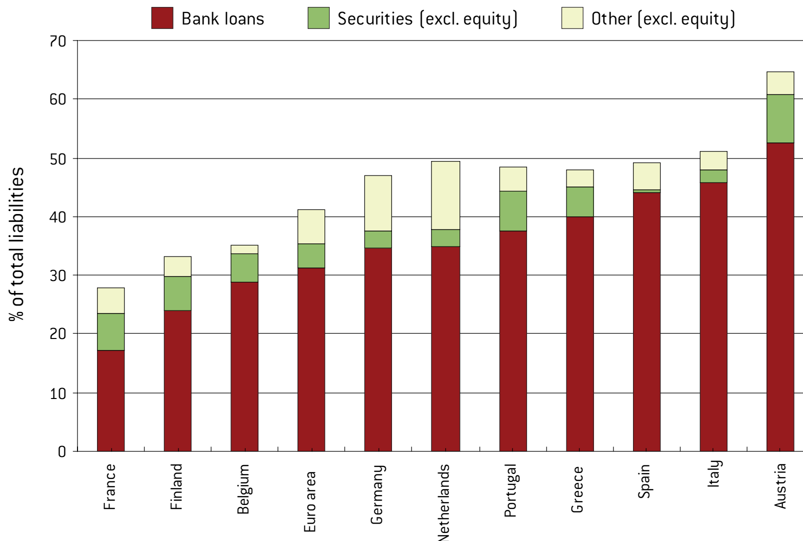
Banks are inherently prone to instability since their assets (mostly loans) are illiquid while their liabilities (deposits and short-term borrowings) are highly liquid. In addition, there are risks of contagion as problems in one bank can easily spread throughout the financial system. As illustrated previously in Finland, Sweden, and other European countries, banking crises tend to be extremely costly for an economy[32]. Together these considerations justify special financial stability arrangements for banks. As a result, banks are generally subject to special regulation and prudential supervision.

The 2007 turmoil in the global credit markets highlighted that 'bank-like' institutions (that is, non-bank institutions that borrow short and lend long) are also vulnerable to crises. In many ways, the 2007 credit crisis has had all the hallmarks of a traditional banking crisis, but one that has taken place among structured investments vehicles (SIVs) operating in the capital markets[33]. What the crisis has revealed is that SIVs accumulated large amounts of long-term, mortgage-backed or asset-backed securities, financed by short-term borrowing in the commercial bond market. Many SIVs were owned by banks, though their activities were off balance sheet. These conduits

32. Honohan and Klingebiel (2003) present estimates of the fiscal and output costs of past banking crisis.
33. Bundesbank President Axel Weber made this comparison between current problems in the non-bank financial system and an old-style bank run in comments at the recent Federal Reserve's Jackson Hole symposium.

were not regulated by the financial authorises, which appears inconsistent, as banks may at times be forced to take their SIVs' assets and liabilities back onto their own balance sheets.

Chart 6.1: Financial liabilities of non-financial corporations (2005)



Source: Eurostat

Traditionally, the responsibility for supervision has resided with the legal jurisdiction of the bank. However, the volume of cross-border banking has grown substantially during the last five years – at least partly spurred by the promotion of a single market for financial services in Europe[34]. Of course, banks have always been active in the international arena, but traditionally foreign banks have not targeted clients within the retail and small- and medium-sized company sectors. That is now changing. The number of cross-border banks with retail operations in several countries is increasing and some of these truly cross-border banks are large and active in many countries. According to the ECB, there were 33 major euro area cross-border banking groups in 2005 with consolidated group assets accounting for 53 percent of total euro area banking assets (ECB 2007a). This figure is up from 45 percent in 2001. Moreover, 16 of these 33 groups in 2005 were active in at least half of the euro area countries.

34. The ECB (2007a) notes that foreign subsidiaries and branches 'have gradually expanded their role in euro area countries in recent years, although they still only account for approximately 15 percent of total euro area banking assets.' It goes on to note that 'while the median market share of foreign branches has more or less stagnated during the period between 2001 and 2005, the median market share of foreign subsidiaries has been increasing.'

Recent years have seen a spate of major cross-border mergers and acquisitions among euro area banks (Table 6.1) and such activity is expected to continue to be important for driving the expansion of cross-border banking activities (see Véron 2007).

Table 6.1: Major cross-border M&As among euro area banks, 2000 - 2007

Date	Acquirer	Target	Value (€ billions)
2007	UniCredito (IT)	Capitalia (IT)	23
2007	Banca Intesa (IT)	SanPaolo IMI (IT)	29.6
2006	Credit Agricole (FR)	Emporiki (GR)	3.3
2006	BNP Paribas (FR)	Banca Nazionale del Lavoro (IT)	10
2005	Unicredito (IT)	HVB (DE)	13.3
2005	ABN Amro (NL)	Banca Antonveneta (IT)	6.1
2005	Unicredito (IT)	Bank Austria CA (AT)	2.1
2001	HVB (DE)	Bank Austria CA (AT)	7.8
2001	Dexia BIL (LU)	Kempen & Co. (NL)	1.1
2000	Fortis Bank (BE/NL)	BGL (LU)	1.6

Source: ECB, 'Financial Integration in Europe – March 2007' and Bruegel for updates from 2007 onwards.

6.2 Challenges for stability

Integration and cross-border M&A activity are likely to be positive for the European economy because they enhance competition and foster product development in different countries. The result should be better and cheaper access to finance for companies – especially smaller firms that do not have access to the corporate bonds market – and lower prices for banking services for customers. However, as banks increasingly extend their activities across borders, the financial systems of different countries are becoming increasingly intertwined and the risks of international contagion are multiplying. If a crisis were to emerge in a specific large bank, the resulting problems are unlikely to be confined to one country.

This, in turn, will require information-sharing and coordination of decision-making among supervisors, central banks, and ministries of finance[35]. For this reason, we have lately witnessed increased cross-border cooperation among supervisors and efforts to obtain some convergence in supervisory practices. These arrangements go

35. Finance ministries have a major interest in these issues as they are the ultimate guarantors for crisis resolution and deposit guarantee schemes in many countries.

some way towards improving the sharing of information and developing structures for coordinated decision-making. However, managing problems related to difficulties in a large cross-border bank may still be exceedingly complicated for several reasons[36].

First, there are practical issues. As the 2007 episodes involving the German *Industriekreditbank* (IKB) and the UK's *Northern Rock* have shown, it is difficult to coordinate two or more national authorities even in a domestic crisis. In a cross-border crisis, one must multiply the number of national authorities involved by the number of countries involved (there are no fewer than 60 members of the Committee of European Banking Supervision (CEBS)). A cross-border institution operating both branches and subsidiaries in a large number of EU countries would be subject to a great number of authorities, responsible for consolidating different aspects of supervision, crisis management and crisis resolution. There are also, in general, different legal structures and, in particular, different legal approaches to resolving problems in banks.

Second, the very notion of national responsibility is being undermined by the evolution of banking structures. While many of the cross-border banks retain a subsidiary structure, they increasingly organise themselves in an operational fashion. This means that some functions will be centralised into centres of excellence within the banking groups in order to reap the benefits from economies of scale and scope. As a consequence, many subsidiaries no longer operate as separate units. As a bank focuses all of its treasury management activities in a subsidiary in one country, all of its credit decisions in another country, and all of its auditing function in a third country, it may become very difficult for the subsidiaries to survive without the support of the other parts of the group. The distinction between subsidiaries and branches is becoming increasingly blurred.

Third, conflicts of national interest become accentuated when the social and economic consequences of a bank failure are different in the countries in which the bank operates. They become particularly apparent if the bank is important to the whole banking system in one country but not in another country. This is already the situation for several banking groups within the EU.

In the case of a bank with branches in other countries, the important question is how

36. Nieto and Schinasi (2007) use a theoretical approach to argue that the existing EU framework for fiscal burden sharing in the event of a failure of a cross-border bank is far from optimal.

far the taxpayers in the home country would be willing to go in order to bail out depositors in a host country. Judging from the budgetary cost of domestic banking crises (several percentage points of GDP, possibly close to one percentage point of GDP for a single bank), this could entail substantial cross-border transfers, which is something that most politicians tend to view with considerable scepticism. In the event of a large bank failure, it is difficult to imagine that authorities in the host country would simply refer depositors to the home country authorities, without taking any responsibility. The situation becomes particularly problematic if the operations in the host country are very large compared with the home country's economy.

Negotiations between authorities in the different countries involved are likely to take place at some point following the failure of a cross-border bank. Realising the stakes involved, the authorities are not likely to reveal their hand until the last minute. Such conflicts of interest would therefore have a negative effect on the incentives to share information and would impair the collective ability to diagnose at an early stage the full potential extent of a crisis.

More importantly, conflicts of interest may very well influence the effectiveness of crisis management. Some crucial measures may be delayed or not taken at all and an otherwise avoidable crisis may result. The result is that the ultimate costs become greater for all. In a single-country context, Ahearne and Shinada (2005) and Peek and Rosengren (2003) argue that delays in tackling problems in the Japanese banking system following the bursting of the asset bubble in the early 1990s contributed significantly to the fiscal costs of shoring up Japanese banks and to the country's 'lost decade' of economic stagnation. The problem would be compounded in a multi-country setting.

The situation is similar to the prisoners' dilemma. In order to avoid this prisoners' dilemma, some arrangements for burden-sharing – and other mechanisms for managing conflicts of interest – are needed. Naturally, finding an acceptable formula for such burden-sharing will not be an easy task. Goodhart and Schoenmaker (2006) suggest a number of criteria that could be used to create such a formula, including the size of GDP, the ECB capital ratio, and the amount of bank assets in each country.

It is vitally important that future arrangements for supervision, crisis management and crisis resolution of cross-border banks be dealt with jointly as a package and not in isolation. It is apparent that the solutions in any one of these areas will depend on the solutions in the other areas.

The ECOFIN Council in October 2007 agreed on common principles that will be the basis for co-operation among national authorities in preserving financial stability within the EU. Among these principles is that the 'objective of crisis management is to protect the stability of the financial system in all countries involved and in the EU as a whole and to minimise potential harmful economic impacts at the lowest overall collective cost'[37]. Therefore, national rules based on the principle of ring-fencing should clearly be avoided. Any steps towards limiting transferability of assets can be very harmful for crisis management – whether based on private or public solutions.

To summarise, as the number of cross-border banks increases, the authorities responsible for financial stability face greater challenges.

- First, information must be shared between a larger number of authorities. The question is how to arrange an efficient mechanism for information-sharing. Typically, in a national crisis the ministry of finance, the central bank and the supervisor are all involved. In a cross-border crisis, the number of authorities will multiply, making the sharing of relevant information cumbersome.
- Second, if the authorities in different countries come to different assessments about the crisis and the way to solve it, then a common solution may be difficult to find and the necessary coordinated action may not be taken. Therefore a mechanism for joint assessments would be beneficial.
- Third, there may be substantial conflicts of interest between the different countries. Typically most politicians are reluctant to commit themselves to any future cross-border transfer, especially if the amounts involved could be large. Of course, conflicts of interest are likely to affect the different countries' assessments and willingness to share accurate and relevant information in a crisis, rendering the handling of the crisis even more complicated.

6.3 Recommendations

Although the problems resulting from increased cross-border integration of banks have been under discussion for several years, it is only recently that concrete measures have been taken to enhance the arrangements for financial stability and crisis management in Europe. Legislative initiatives such as the EU capital requirements directive and the financial conglomerates directive have *inter alia* strengthened the requirements for information-sharing between the authorities involved in the

37. ECOFIN meeting, Luxembourg, 9 October 2007. Press release available at: http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/96375.pdf

management of cross-border crises. Cooperation among European authorities in the area of crisis management has also been strengthened through voluntary agreements in the form of memoranda of understanding (see ECB (2007b) for an overview of recent developments). The Lamfalussy process has led to the establishment of the Committee of European Banking Supervisors (CEBS), referred to earlier, which serves as an advisory body.

Notwithstanding recent efforts, Europe's current arrangements for banking supervision remain largely based on the principle of national authority and the supervision of cross-border banks continues to involve a huge number of different actors. Moreover, systems for bank supervision remain different across countries. Enlargement of the EU is likely to add to this diversity. Reforms are needed, and they require political initiative.

Although the financial stability properties of supervisory arrangements are an issue for the EU as a whole, the euro area has a particular stake in reforming them for two reasons. First, the euro area is in some respects at the forefront of financial integration in Europe. Second, central banks' emergency provision of liquidity to banks affects the Eurosystem as a whole. The very notion of ring-fencing turmoil in money markets is by its very nature alien to an integrated euro area.

- *We recommend that the euro area take the lead in promoting urgent reform of Europe's system of banking supervision.* The first priority should be the *creation of a European prudential and supervisory regime for pan-European banks*, along the lines of that suggested by Véron (2007). Banks operating mostly in one country should continue to be supervised by national agencies. The new pan-European supervisor's main tasks would be to monitor the major cross-border banking groups in Europe, including: (1) gathering information about the banking groups and their activities in different countries, including activities by off-balance-sheet conduits of these banks; (2) creating unified risk assessments of each cross-border banking group; (3) overseeing the activities and risks of these banking groups; and (4) reviewing and comparing the ways in which national supervisors carry out supervision.

Implementing this proposal would not imply amending the treaty but it would obviously require EU secondary legislation.

7. Enlargement

The enlargement of the euro area has become a divisive issue. Although Slovenia joined the single currency in 2007 and Malta and Cyprus in January 2008, the other new member states (NMS), except Slovakia, are a long way from fulfilling the Maastricht criteria, and some are openly lukewarm about joining. The European Commission's and the ECB's assessments of the candidate countries in 2006 were often perceived by the NMS as economically meaningless and politically biased and there is a risk that some of them will turn against membership of the euro area. The result would be a permanent split within the EU between those countries that have adopted the euro and those that have not.

The current official approach to EMU enlargement starts from the premise that all EU countries will adopt the euro, as the treaty requires, provided they fulfil the Maastricht criteria. This legalistic approach overlooks two facts of life. First, it may not be in the interest of all NMS (or of all member states) to join EMU, at least not in the short run. Second, the Maastricht criteria were devised for a different group of countries facing different problems in the 1990s. At the very least, the current approach overlooks the trade-offs that are more likely to be important for the NMS in the run-up to euro accession than they were for the member states at the time of Maastricht.

7.1 Formal status of the new member states

The requirement to join EMU is part of the treaty, subject to fulfilment of the Maastricht criteria. The treaty sets out five convergence criteria that each EU country must meet in order to adopt the euro (Box 7.1).

Only the UK and Denmark have negotiated EMU opt-out clauses, but the dates for ERM2 (and as a consequence EMU) accession are to be specified by the countries themselves. In practical terms, this is what has allowed Sweden to stay out of EMU – so far, the country has not sent in an application to join ERM2. This 'flexibility' does not in principle mean that a country is free to ignore its obligation to reduce its budget deficit according to the agreed convergence path, but sanctions only apply to

countries that have adopted the euro.

Box 7.1 EMU entry criteria

- Price stability: the rate of inflation must not exceed by more than 1.5 percentage points the average rates of inflation of the three best-performing member states (in price stability terms) of the EU. In addition, the inflation performance must be 'sustainable';
- Interest rates: long-term interest rates must not exceed by more than two percentage points that of, at most, the EU's three best-performing member states in price stability terms;
- Fiscal deficits: the general government budget deficit must not exceed three percent of GDP. If this is not the case, the ratio must have declined substantially and continuously and reached a level close to three percent;
- Public debt: gross government debt must not exceed 60 percent of GDP. If this is not the case, the ratio must have sufficiently diminished and must be approaching 60 percent at a satisfactory pace;
- Exchange rate stability: exchange rates must have remained within the authorised margin of fluctuation for the previous two years, without devaluing against the currency of any other member state.

The exchange rate criterion has in practice been interpreted to mean that, two years prior to the adoption of the common currency, an applicant country must officially join ERM2. The subsequent two-year period then serves as an observation period in which the stability of the applicant's currency is monitored. In addition to these economic performance criteria, there are several legal requirements such as a requirement that the central bank must be independent.

Apart from Slovakia, which seems to be well on track for EMU membership, the future date for the other NMS to join the euro is unclear. Below, we will discuss some of the aspects that are relevant for NMS in contemplating accession to EMU.

Table 7.1: 'Race' to the euro

Country	EU	ERM II	Euro
			Official date
Slovenia	2004	2004	2007
Cyprus	2004	2005	2008
Malta	2004	2005	2008
Slovakia	2004	2005	2009
Bulgaria	2007	n. a.	n. a.
Czech Republic	2004	2008*	2011*
Estonia	2004	2004	2010**
Hungary	2004	2011*	2014*
Latvia	2004	2005	2008**
Lithuania	2004	2004	2010***
Poland	2004	2009*	2012*
Romania	2007	n. a.	n. a.

* Official date not yet set; dates provided are forecasts by Fitch Ratings (August 2006)
** Under revision
*** In October 2006, the Lithuanian government decided that 'Lithuania will aim to join the euro area as soon as possible. The more favourable period for Lithuania to join the euro area starts from 2010.'

Source: Countries' convergence programmes, 'EMU Convergence Report – 2006', Fitch Ratings, 31 August 2006; 'Report on the state of practical preparations', October 2006, DG ECFIN: http://ec.europa.eu/economy_finance/euro/transition/preparations.pdf; Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank – Fourth report on the practical preparations for the future enlargement of the euro area, 10 November 2006, COM/2006/0671 final.

7.2 Economic arguments for and against the NMS joining EMU

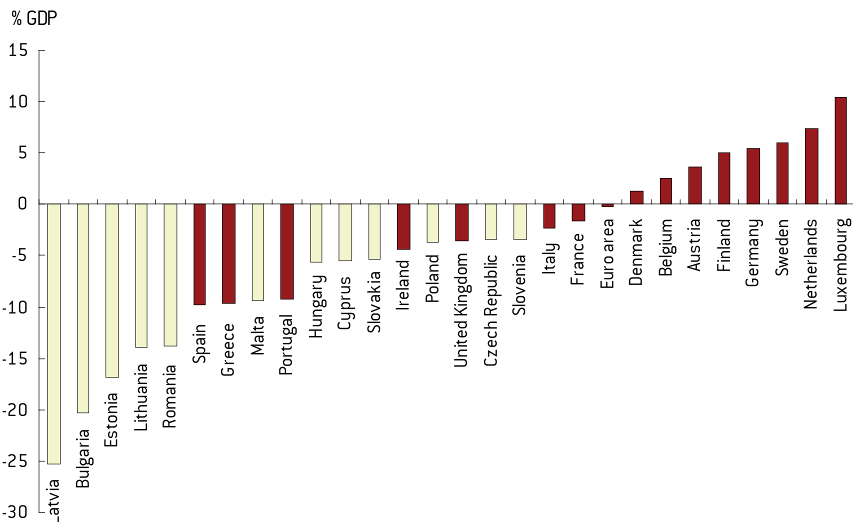
The main goal of economic policy for NMS is to catch up with the more advanced EU members in terms of economic development, that is, to achieve real convergence. This has strong macroeconomic implications. Domestic savings are insufficient to finance the rate of investment and growth needed to close the gap rapidly. Therefore the macroeconomic framework in NMS must be consistent with significant capital inflows. Many NMS already run sizable current account deficits (Chart 7.1). This section considers the economic arguments for and against joining EMU.

First, entry into EMU will mean lower exchange transaction costs, which should boost trade with other EMU member states. For the NMS, accession is likely to stimulate relocation, outsourcing and intra-industry integration with euro area partners. Admittedly, trade and FDI have developed considerably without the euro but, as documented by recent empirical analysis (Baldwin 2006), further expansion is likely

following EMU entry. More importantly, volatility of domestic currencies vis-à-vis the euro is a significant burden for small- and medium-size exporters from the NMS (and most domestic firms are small by European standards), except for foreign-owned firms[38]. For these exporters, hedging may not be available or may be too costly, as their currencies' markets lack depth. The trade-creation effects of entering EMU may therefore be significant for the NMS.

Second, EMU is not a necessary condition for running a high financial account surplus but it is likely to reduce the probability and the economic cost of 'sudden stops', that is, rapid reversals of capital inflows. It also has implications for the cost of borrowing abroad. Presumably, after joining EMU, the cost of foreign capital in the NMS will fall further, as the exchange rate risk premium disappears. More capital will be available and, assuming the financial sector is efficient in allocating these funds, economic growth should increase. An important consideration is thus the degree to which the financial system in these countries is able to support an efficient allocation of incoming funds. With this proviso, better access to foreign capital resulting from EMU accession seems to be a powerful argument for joining the euro for all NMS.

Chart 7.1: Current account balances in EU member states, 2007



Source: IMF World Economic Outlook, Oct 2007. NMS current accounts are plotted in yellow.

38. Mayer and Ottaviano (2007) show that Hungarian foreign trade relies disproportionately on foreign-owned firms.

Third, an argument against joining is that catching-up economies need more flexibility in exchange rate policy, something that they would give up on accession to EMU. Along the convergence path situations might arise where substantial real exchange rate depreciation is required to restore competitiveness. This could happen either because of economic shocks or policy mistakes – to which the NMS tend to be vulnerable as they are undergoing rapid transformation and many of their economic institutions are relatively new. In a monetary union, such adjustments might require deflation, which could exact a heavy toll from the economy.

This argument, of course, applies to all euro area members and concerns their overall ability to respond to shocks and pursue good fiscal and structural policies. The question is whether the NMS are 'agile' enough to join the EMU, a question that can equally be asked about current members (see Ahearne and Pisani-Ferry 2006). Here the differences are probably as large between the NMS as they are between the current members. On the whole, however, the NMS are more agile than the current members.

Fourth, an important issue is whether joining EMU provides protection against crises or whether in fact EMU membership might increase the risk and potential severity of crises. The economies of the NMS are relatively undeveloped, with shallow financial markets. As a result, they may be prone to a crisis in the event of a large shock. Prior to accession, a currency crisis may take place, for example, as a result of a massive reversal in capital inflows. After accession, it could still take the form of a banking crisis. It is an open question whether membership of the single currency would reduce the probability of financial crises or their magnitude. On the one hand, EMU membership rules out the threat of a financial crisis evolving into a currency crisis. On the other hand, EMU membership is likely to promote increased capital inflows and a rapid expansion of domestic credit. In addition, economies in EMU must cope with real exchange rate adjustment without changing the nominal exchange rate.

Fifth, experience shows that price recalculations accompanying the switch to the euro usually trigger a small one-time increase in inflation (resulting from rounding-up or menu effects). Although statistics consistently show that this effect is insignificant on average, it can be noticeable in sheltered sectors. Moreover, the argument is politically powerful and might be exploited to frighten the public at large away from euro adoption.

Sixth, a more fundamental argument (albeit not used by euro-sceptics in the NMS) is that EMU accession will bring about higher inflation in the longer term. Adoption of the euro will rule out any nominal appreciation and therefore any necessary real

appreciation must be achieved through higher inflation. Thus after accession, prices and wages are likely to rise faster and both the aggregate price level and relative prices will probably converge faster to the euro area average. For firms in the NMS, this means that instead of facing nominal exchange rate appreciation they will have to struggle with fast-rising input costs and engineer robust labour productivity growth in order to offset potential losses in competitiveness from real appreciation. More importantly, price level convergence within the context of monetary union will imply lower real interest rates. With inflation in NMS likely to exceed the euro area average by 2-3 percent per year, real interest rates in NMS are likely to be close to zero. In fast-growing economies, there is a risk that such a very large spread between the real growth rate and the real interest rate will result in capital misallocation (Bini Smaghi 2007b, Davras and Szapary 2008). This is a serious concern, especially in countries with an already weak financial system, and this can be a motive for preferring to remain in a fixed exchange rate system until price convergence effects have started to diminish.

An additional issue is the distributional effects of price convergence, as prices of non-tradable goods and services (where productivity growth will be slower) are likely to rise faster than those of tradable goods and services. Rapid increases in some prices (for example food) have the potential to lead to political tensions, so a close monitoring of this issue in the new EMU member states will be needed.

Seventh and finally, a rush towards EMU can entail short-run costs of meeting the Maastricht criteria. Fiscal adjustment to reduce a large budget deficit or monetary tightening to rein in inflation, even if economically sensible, is usually not very attractive for policymakers. However, in recent years growth in the NMS has been relatively rapid and NMS have either registered budgetary surpluses or at least have the potential (subject to political will) quickly to improve their fiscal position. Even the laggards are capable of taking the opportunity provided by the current economic boom to achieve the budget deficit target at reasonable costs. It may be much more difficult, however, to achieve the inflation target, especially in those economies growing at close to or above 10 percent annually. In these cases, a highly restrictive fiscal policy will be needed and this will involve not only sacrificing necessary social and infrastructure spending but also implies a growth rate which is lower than what could otherwise have been achieved. In addition, the restrictions are not consistent with the 2007-2013 EU budget under which the NMS become eligible for net financial support of nearly four percent of their GDP each year.

In sum, there are sound economic arguments both for and against the NMS quickly

joining EMU (Table 7.2). There is neither a compelling argument for rushing into EMU nor for keeping the NMS waiting indefinitely at the door. The bottom line is that the NMS that want to enter the EMU should be well prepared and assess the net benefits of EMU membership in the context of their expected growth and convergence trajectory. A serious discussion needs to be conducted on a case-by-case basis, taking into account the pace of economic development, the ability to respond to shocks, and the quality of policymaking institutions.

Table 7.2: Summary arguments for and against membership of EMU

Argument	For/against membership	Discussion
Trade effects of lower transaction costs	For	Unqualified benefit
Access to foreign capital	For	Benefit as EMU membership improves access to foreign capital, decreases likelihood of crises
Need for exchange rate flexibility to cope with shocks and real convergence	Neutral or against	Depends on current exchange rate regime and domestic structures. Unfavourable for floating exchange rate countries, neutral for fixers.
Probability and cost of crises within/ outside EMU	Ambiguous	Depends on current exchange rate regime and domestic structures
Budgetary discipline	Ambiguous	Depends on initial conditions

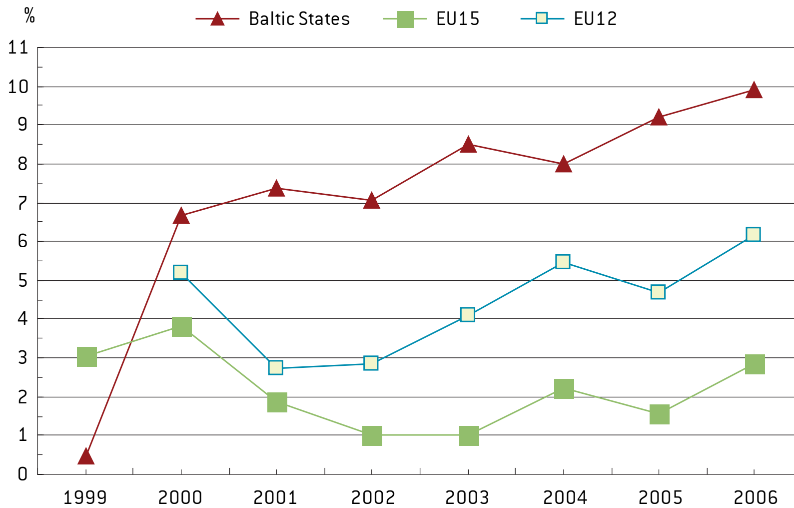
7.3 Structural features of NMS

Questions arise as to whether the structural features of NMS economies allow them to use alternative policies that could achieve needed economic adjustments in the absence of national monetary policies. Here, both flexible labour markets and fiscal systems are important. An additional issue is whether the NMS are sufficiently integrated with the euro area and whether mechanisms for transmitting monetary impulses from ECB policy can be expected to work in a way similar to that in the EMU incumbents.

We examine these issues by looking at four important variables: trade flows, financial systems, labour markets, and fiscal systems. In interpreting these data, it is important to recognise that the NMS are small economies. Their effect on euro area aggregates will be limited for the foreseeable future. In 2006 GDP at market prices of the twelve NMS (EU12) accounted for less than five percent of the EU27. At the same

time, the NMS are growing rapidly (see Chart 7.2) and will continue in the catching-up phase to grow at rates exceeding those of the EU27 and EMU for some time.

Chart 7.2: Real GDP growth rates*



*At 1995 market prices and exchange rates. Source: Authors' calculations based on Eurostat data.

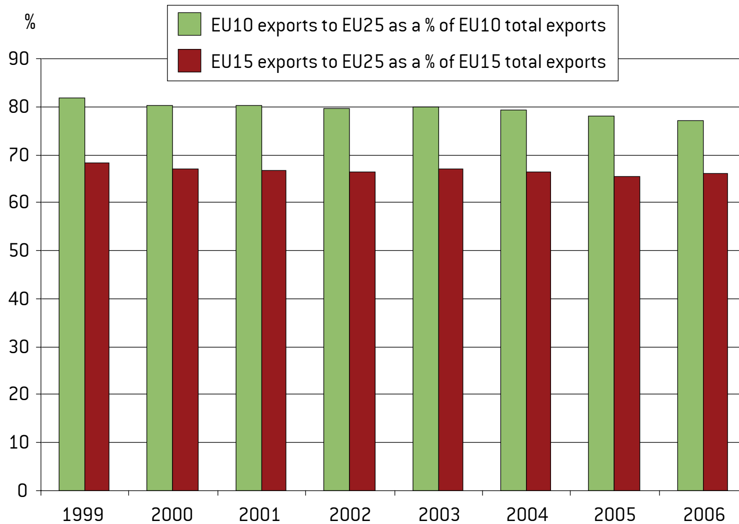
Continued fast growth can be expected for the years ahead as most NMS are (post-) transition economies that have undergone a period of deep structural reform in the run-up to EU membership. These reforms have provided, and should provide for some time to come, a significant supply-side stimulus. This, coupled with the catch-up and the boost to aggregate demand coming from EU structural funds, adds up to an extremely positive environment for growth for a number years.

Trade flows

As shown in Chart 7.3, exports to EU25 countries as a share of total NMS exports has been very high at nearly 80 percent over recent years. This share is markedly higher than that for the EU15 countries, which indicates that the NMS are highly integrated with the remainder of the EU. Such large trade flows are suggestive of a high level of business cycle synchronisation between old and new EU member states. Judging by this criterion, the NMS are no less well prepared to be part of monetary union than the incumbents[39].

39. The results of formal econometric analysis of business cycle synchronisation between new and old members are

Chart 7.3: Exports to EU25 countries as a share of total exports



Source: Authors' calculations based on Eurostat data.

Financial systems

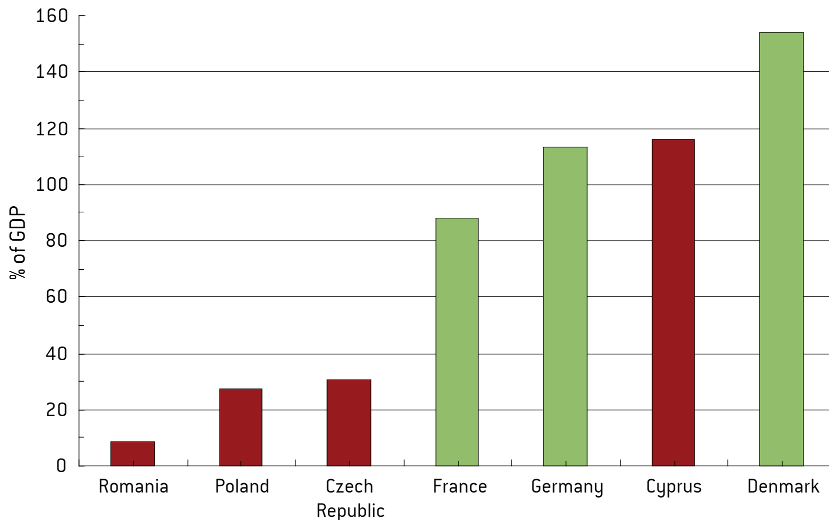
Financial systems are important for the efficient allocation of capital inflows. Such inflows are likely to be further stimulated by EMU accession. In addition, the transmission mechanisms of ECB monetary policy to NMS economies are likely to be more similar to that in present EMU member states if financial systems are comparable. That said, financial markets in most NMS are young and relatively shallow (Chart 7.4), which probably suggests a relatively weaker effect on economic activity of a given monetary impulse.

At the same time, the financial sector in most NMS is dominated by foreign institutions, usually from western Europe. This has promoted integration with global financial markets and has also accelerated technological and managerial progress in the financial sector[40].

mixed. In a meta-analysis of 35 identified publications, Fidrmuc and Korhonen (2006) find that many NMS already have comparably high correlation with the euro area business cycle. Artis *et al* (2004) find a low level of synchronisation. However, these results depend on historical trends that may no longer be particularly relevant. Moreover, as shown in Darvas and Szapáry (2007) EMU membership itself can be expected significantly to increase synchronisation.

40. Further discussion of banking systems in NMS can be found in ECB (2005).

Chart 7.4: Private credit outstanding, 2004



New member states' private credit outstanding is plotted in red. Source: Beck *et al* (2007)

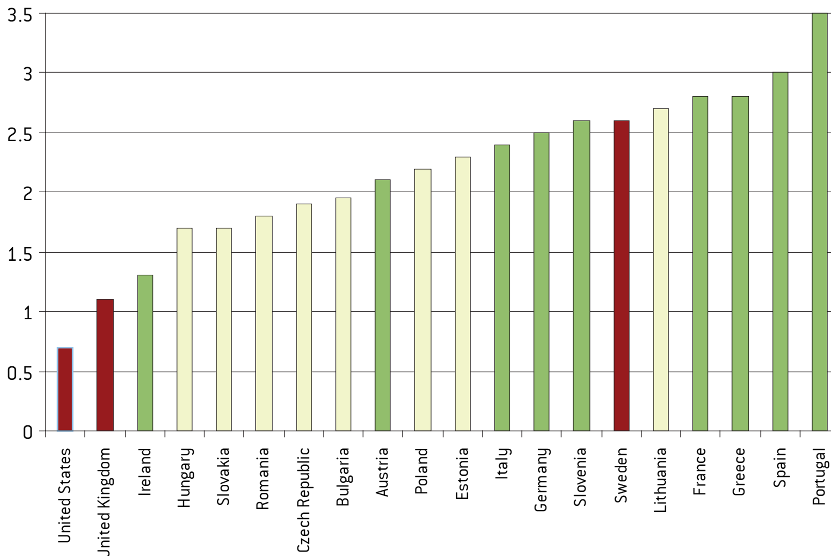
Labour markets

As discussed in Chapter 5, labour market flexibility is important in facilitating economic adjustment in a currency union. How do labour market regulations and institutions in NMS score compared with EMU in terms of wage flexibility and labour mobility? The OECD's employment protection legislation indicator (EPL), which compares labour markets across Europe, sheds some light on the question[41]. Chart 7.5 shows that most NMS rank better than current EMU members, resembling the more flexible labour markets of the US, UK and Ireland more than the inflexible markets of France, Spain and Portugal.

It appears that the NMS are no worse, and are in fact are probably better, than the incumbents in terms of their capacity to apply flexible labour policies (see Boeri 2006, for further discussion). Whether these flexible polices translate into more flexible wages in all cases is an open question.

41. The indicator is based on 22 aspects of employment regulation. See OECD (2004) for details.

Chart 7.5: Employment protection legislation indicator*



* The index varies from 0 to 6 with the higher number indicating stricter employment protection.
Legend: red – non-EMU; green – EMU; yellow – NMS
Source: Tonin (2006) and OECD

Another concern relates to the ability of the political systems in some of these new democracies to deal with significant adjustment in real wages. For example, if a downward adjustment in real wages is required in response to a negative shock, it is not clear how well the political system could tolerate the associated economic pain.

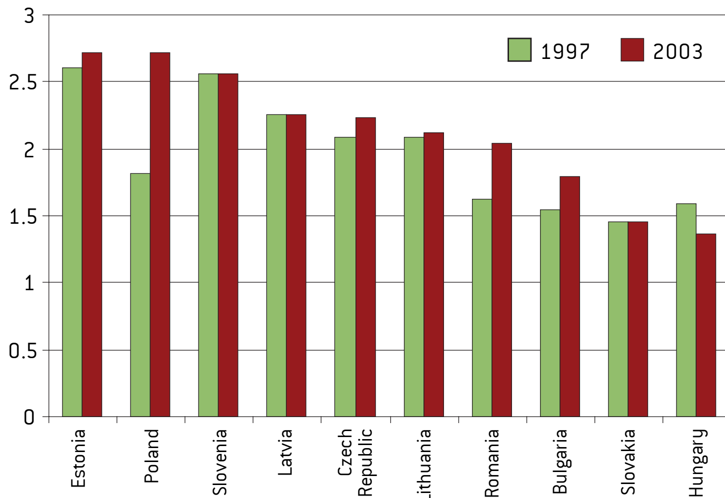
Fiscal systems

We argued in Chapter 4 that fiscal policy is a key instrument for dealing with inflationary (and other) shocks in the absence of a national monetary policy. Fiscal policy should be disciplined and flexible to allow for long-term stability (that is, a balanced budget over the business cycle) along with a reasonable degree of counter-cyclicality. As previously discussed, the quality of fiscal institutions and the political will to use fiscal policy properly are both important.

Fiscal systems vary from country to country both in the old and new EU member states, and it is difficult to make an overall assessment of their comparable quality. A starting point may be to compare how countries rank using the Fabrizio-Mody index of the quality of fiscal institutions (Fabrizio and Mody 2006), which is based on the

institutional framework of Hallerberg *et al*. (2007) discussed in Chapter 4. As discussed there, the index combines measures of the quality of the budget formation and execution process into an overall index of budgetary quality. Using this index, the NMS generally have weaker fiscal institutions than the old member states. However, several NMS have made significant progress since around the mid-1990s, with Poland and Romania having registered marked improvements in the quality of fiscal institutions. Estonia and Slovenia have consistently scored well in terms of the budgetary institutions. At the other end of the scale, Hungary, Slovakia and Bulgaria continue to score relatively poorly.

Chart 7.6: Quality of fiscal institutions



Source: Fabrizio and Mody (2006). Possible values range from 4 (highest quality) to 0 (lowest).

Overall, there is evidence to suggest that fiscal institutions in some NMS are either converging towards, or are already roughly comparable to, those in current EMU countries. However, other NMS are clearly lagging in terms of the quality of budgetary institutions and significant reforms are needed in these countries. Moreover, the prescriptions offered in Chapter 4 for current EMU members to improve fiscal performance and make public finances more resilient to shocks also apply to – and in many ways may be even more relevant for – the NMS.

Given the properties of their electoral systems, all NMS except Hungary would be likely to follow the contracts approach for the design of their budgetary institutions. Based on the experience of the current euro area members discussed in Chapter 4, it is to be expected, therefore, that the fiscal framework of EMU would help them

strengthen their budgetary institutions and achieve a satisfactory degree of fiscal discipline.

As in the case of handling potentially painful economic adjustment, questions arise as to the capacity of the political process in some NMS to deal with fiscal difficulties. The less mature political systems in NMS compared with current members underscores the importance of relatively strict criteria for fiscal discipline in NMS. Fiscal discipline might also benefit from a commitment in NMS to achieving a balanced budget over the business cycle.

7.4 'Floaters' versus 'fixers' and the Maastricht criteria

In 2006, the Lithuanian bid to join EMU was rejected because its inflation rate in 2006 proved to be marginally higher than allowed. More importantly, however, the rejection of the country's application to join EMU was justified by the unsustainable character of the low rate of inflation that Lithuania had achieved. It is true than inflation in Lithuania has risen in 2007. But does that necessarily mean that the decision to reject Lithuanian's application was correct? Our view is that the issue of the sustainability of low inflation needs to be looked at from a broader perspective.

Charts 7.7 and 7.8 compare the situation in countries that let their currencies float freely on foreign exchange markets (that is, the Czech Republic, Hungary, Romania, Poland and Slovakia) with those that adopted some form of currency board (that is, the Baltic states and Bulgaria)[42].

It is clear that a currency board, once considered the harshest currency regime, has turned out to be a looser currency regime in terms of inflation performance than the free-float regime. All three Baltic states and Bulgaria have inflation rates higher than the required Maastricht threshold and (except for Hungary) higher than free-floaters. However, they have a more favourable budget situation and have recorded faster growth.

There are two reasons for this situation. First, inflation is the only channel through which real appreciation vis-à-vis the euro can take place in countries with a fixed exchange rate regime. The faster the catching-up of prices, the higher inflation needs to be. According to Egert (2007), the ratio of the domestic price level to the euro area price level in 2005 was 36 percent in Bulgaria, about 50 percent in Latvia and

42. See Buiter and Grafe (2002) for a discussion of different exchange rate regimes in NMS.

Lithuania, and 57 percent in Estonia. Those ratios roughly correspond to relative GDP per capita levels, which means that prices should be expected to converge at the same pace as GDP per capita. Against this background, an inflation rate that exceeds the euro area average by two or three percentage points may correspond to a sustainable convergence path[43].

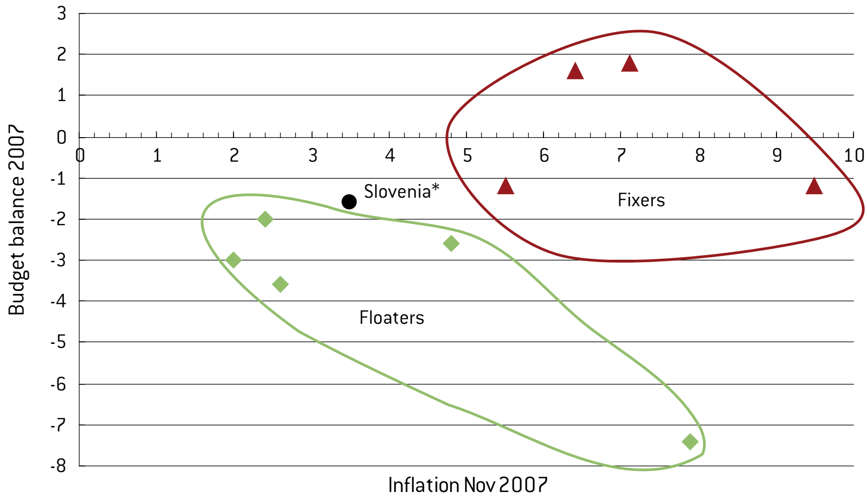
Owing to such structural factors upward pressure on prices will persist after the country joins EMU. This is, however, an equilibrium phenomenon, reflecting convergence in prices over time with those of the most advanced economies of Europe. For the same reason, inflation will increase in those NMS that have let their exchange rates float after they join EMU. In those countries, domestic inflation will replace nominal appreciation as the driver of real appreciation.

A second reason, however, may be that the euro area monetary policy is inappropriately loose for some countries with a hard-peg regime, because the combination of a moderate nominal interest rate and domestic inflation results in an excessively low real interest rate. In such circumstances, countries have to rely on fiscal policy to rein in the growth of domestic demand and perhaps the enhanced use of regulatory instruments to guard against the occurrence of speculative bubbles in asset prices.

Currency board countries have experienced limited (or no) nominal appreciation against the euro, whereas the free-floaters have followed a path of gradual, though sometimes erratic, nominal appreciation. Chart 7.9 shows that nominal appreciation, by absorbing inflationary pressures, has been the key to disinflation or achieving a lower inflation rate.

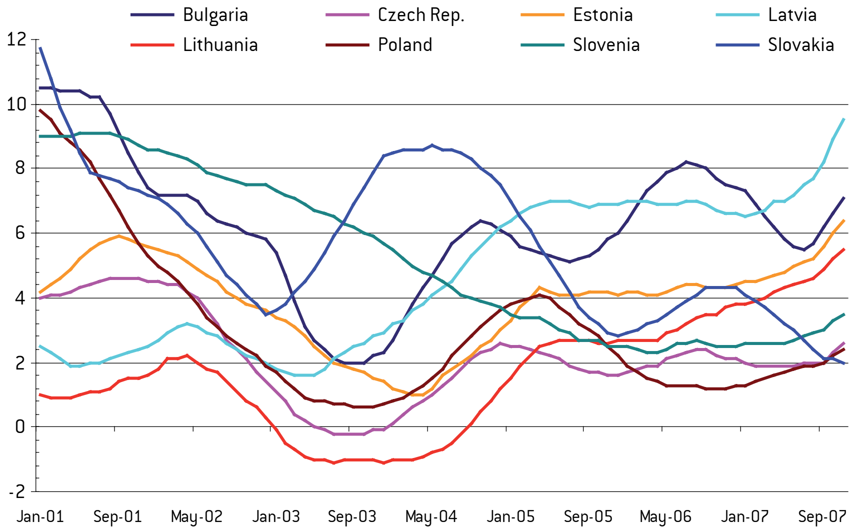
43. In developing and emerging countries, the Balassa-Samuelson effect results from productivity catching up faster in the traded-goods sector than in the non-traded goods sector and in services. This results in a rise in the relative price of non-traded goods and services and in a real appreciation. In a fixed exchange rate context, the Balassa-Samuelson effect implies that countries that are catching up have higher inflation. Egert (2007), Kovacs, (2003), and Mihajlek and Klau (2003) provide estimates of the size of the Balassa-Samuelson effect for NMS.

Chart 7.7: Inflation and fiscal balance in free-floating and currency-board countries



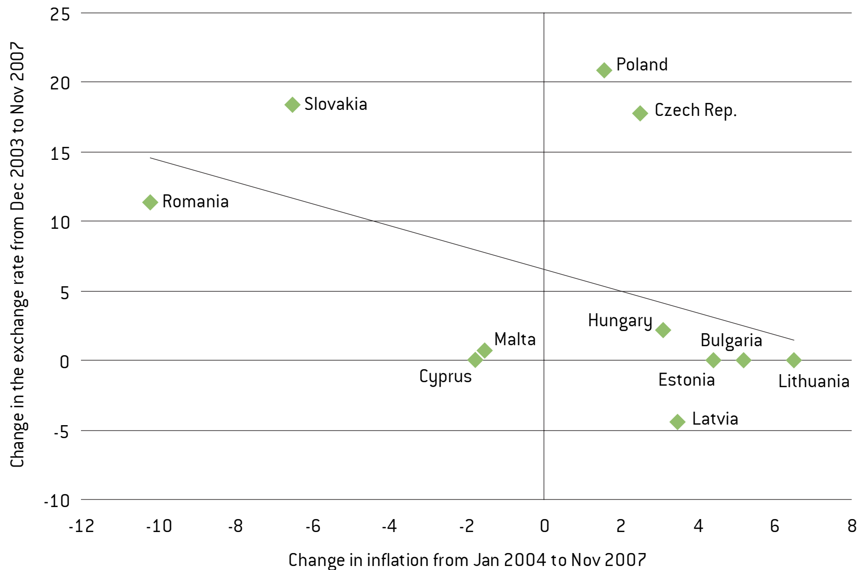
Source: Eurostat and DG ECFIN.
*Slovenia shown separately, because in November 2007 it was already a member of EMU, having had a currency board prior to entry.

Chart 7.8: Inflation*



*12-month percentage change of harmonised index of consumer prices.
Source: Eurostat

Chart 7.9: Nominal currency appreciation and disinflation



Source: Eurostat

This evidence thus suggests that the condition of 'sustainable low inflation', as applied to Lithuania, is not particularly meaningful. Comparison of the currency board and free-floating NMS suggests two points about the present rules of EMU accession:

- First, the currency board-type of exchange rate regime makes it very difficult, in fact unrealistic for these countries (barring price manipulation) to meet the inflation criterion in the foreseeable future;
- Second, if the free-floaters want to join under the present set of rules, they should, paradoxically, be ready to accept higher inflation than currently experienced outside EMU. There is a strong economic logic behind this reasoning, yet it should be recognised that it could be politically difficult to make this perspective consistent with EMU's aim of price stability.

7.5 Recommendations

The Maastricht criteria for EMU membership were conceived for different countries and different circumstances. On the basis of economic analysis alone, a case could be made to replace some of them altogether. However, given the traditional importance of continuity and equality of treatment across member states, we suggest

adaptation of the criteria that would preserve those principles while making better economic sense than the interpretation given to the treaty provisions so far.

The nominal criteria for inflation rates and interest rates are ill defined as they make reference to non-EMU countries and – at least when implemented in a rigid manner – are inappropriate yardsticks to apply to NMS seeking to enter EMU. Higher inflation in NMS is an expected consequence of rapid economic catch-up. Moreover, satisfying the inflation criterion in the run-up to EMU entry does not guarantee that inflation will remain low once membership has been achieved. In fact, judging both from what we have seen so far in the countries with currency boards and from standard economic analysis, an increase in inflation is more likely. In principle, we would favour criteria that are based on a deeper analysis of 'structural' and 'demand-led' inflation. But we recognise that, in the near term, radical change to the inflation criterion is not realistic. In light of the above, we make the following recommendation:

- *The criterion for price stability should be amended or reinterpreted. One possibility would be to require that the rate of inflation must not exceed by more than 1.5 percentage points the average inflation rate for the euro area, as opposed to the average rate of inflation of the three member states of the EU where inflation is the lowest. Another, somewhat stricter, option could be to take as a benchmark the average inflation rate for the three countries whose performance is the closest to the ECB objective. This would amount to reinterpreting the reference in Article121 of the treaty to the 'three best-performing member states in terms of price stability' and to considering that 'best performance' does not mean lowest possible inflation but inflation as close as possible to the objective*[44].

As regards the exchange rate criterion, the necessity to go through a two-year period of ERM2 seems unnecessary, as NMS have been through a long period of nominal appreciation or have currency board arrangements which, by definition, provide for nominal exchange rate stability (actually, as apparent in the text, the exchange rate criterion was meant to exclude countries entering EMU directly after having engineered a depreciation of their currency, which is not at all the situation in the NMS). Also, membership in ERM2 has drawbacks for the countries concerned. It risks leading to higher inflation rather than the other way around. In turn, high inflation rates may create concerns on the part of financial markets that the country will not in the end be able to join EMU. These concerns might lead to speculation and a risk of financial crisis.

44. We are indebted to Iain Begg for this suggestion.

- *A first-best solution would be to eliminate the obligation of membership in the ERM2 for two years for those countries that do not wish to join it. At any rate, the requirement should be interpreted flexibly, taking into account the country's previous exchange rate history.*

Fiscal criteria are generally appropriate for catch-up, post-transition countries such as most NMS because these countries require institutional maturity and the political ability to discipline the public finances. These could reasonably be thought of as necessary conditions for entry into EMU.

However, it should be noted that the Maastricht criteria lack consistency when applied to the NMS. The rationale underlying the combination of a 60 percent debt ratio and a three percent deficit ratio was that, assuming a long-run average nominal GDP growth rate of five percent annually, stabilising the debt ratio at 60 percent requires a deficit no larger than three percent of GDP. For the NMS, as for most emerging economies whose financial markets are less developed than in mature economies, a debt ratio of 60 percent is probably outside a reasonable safety margin for fiscal sustainability[45]. At the same time, even a lower debt ratio can be sustained with higher deficit ratios given NMS' much stronger growth prospects. For example, a debt ratio of 50 percent of GDP can be sustained with a deficit ratio of four percent for a country whose expected nominal growth rate is eight percent, and with a deficit ratio of 4.5 percent if the expected nominal growth rate is nine percent.

Since the NMS require much larger public sector investments to modernise education, health and public administration, and these investments should be partially debt financed for standard economic reasons, overly constraining deficits in the NMS can be counterproductive and become an impediment to long-term economic growth and, hence, convergence. There should therefore be more emphasis on the debt criterion for the NMS, combined with an assessment of the economic efficiency of how the governments spend the funds they borrow. This is consistent with our overall recommendations on fiscal policy.

- *There should be more emphasis on a prudent debt limit for the NMS*. Weighing the different arguments against each other we believe that a debt limit lower than 60 percent of GDP is more appropriate for NMS. With nominal growth significantly above five percent in most NMS, the 60 percent debt limit would allow deficits

45. See, for example, 'Assessing the Sustainability of Public Debt in Emerging Market Economies', World Economic Outlook IMF, Washington DC September 2003.

significantly larger than three percent of GDP during the convergence process, which would be inappropriate. We therefore advocate lower debt thresholds of the order of 40 percent or 50 percent of GDP.

Furthermore, there are reasons for fiscal restraint over and above the need to preserve public debt sustainability. As developed above, a restrictive fiscal stance is likely to be required to prevent a boom-bust cycle in the aftermath of accession. Furthermore, the experience of several current EMU member states has shown that the fiscal discipline displayed before EMU entry can easily disappear once in the euro area, especially if budgetary accounting tricks were used to satisfy the fiscal criteria. Therefore, we believe that there should be an emphasis on the quality of fiscal policy and institutions as well as on the quantities set out in the treaty. This mirrors the discussion in Chapter 4.

- *To help to promote fiscal sustainability, the NMS should strengthen their fiscal institutions and aim at reaching budgetary balance or surplus during the fast-growth years*. The quality of their fiscal institutions and behaviour should be taken into account when assessing whether they are fit for EMU.

In sum, what we are proposing amounts to a *quid pro quo* in which NMS face stricter debt and institutional criteria for entry into EMU in return for less strict inflation and exchange rate criteria. Our proposal is fully consistent with the spirit of Article 121 of the treaty, which sets out the entry criteria, as it still requires price stability, fiscal discipline and the avoidance of competitive depreciations as conditions for membership. However, it implies amendments to the treaty, or at least modification of protocol n°21 which spells out the numerical thresholds.

8. External Dimension

8.1 The state of play

Arrangements for exchange rate policy and the external representation of the euro area are notoriously complex. Above all, the division of responsibility between the ECB and the Council of Ministers is ambiguous (Box 8.1).

The reasons for this are well known. First, while the choice was clearly made to centralise monetary policy in the hands of the ECB, representation in international fora and institutions was not delegated to an EU institution but kept in the hands of member states (Ahearne and Eichengreen 2007). Second, Maastricht was a compromise between a 'German' view that regarded exchange rate policy as a by-product of monetary policy and a 'French' view that regarded it as an independent instrument (Henning 2007, Pisani-Ferry 2006). Consequently, external policy in EMU has suffered from ambiguities in both the vertical (between the EU and the member states) and the horizontal (between the ECB and the Council) distribution of competences.

The early years of EMU have thus been a period of learning and gradual clarification. This has led to a policy model that assigns prime responsibility for defining the exchange rate regime to the Eurogroup, supported by the European Commission, and prime responsibility for exchange rate management to the ECB. In between lies a grey area in which the Eurogroup and the ECB must cooperate. Positions for international meetings such as the Group of Seven (G7) and positions vis-à-vis particular countries are defined jointly. Both the Eurogroup and the ECB presidents participate in G7 meetings. Eurogroup and G7 ministers are involved in the preparation of concerted interventions in foreign exchange markets – there has in fact been only one such episode – and informed in advance of unilateral interventions (again, there has been only one). A line to be taken is agreed as regards opinions expressed publicly on exchange rate levels (but the line is not always adhered to)[46].

46. Bini Smaghi (2007a) provides a player's account of the current arrangements, which he assesses as efficient while pleading for more verbal discipline and a single voice in international fora.

The set-up is therefore closer to that of Germany pre-1999, where the Bundesbank had a prominent role in exchange rate policy, than to that of the US or Japan, where the treasury is responsible for it. However, the arrangements give the Eurogroup an important role as a forum for reaching consensus between the ministers and the ECB and assign particular responsibility for external representation to the president of the Eurogroup. The decision in late 2007 to send to China a trio composed of the president of the Eurogroup, the president of the ECB and the commissioner for economic and monetary affairs was a clear manifestation of this cooperative approach.

Box 8.1: Exchange rate policy and external representation: the legal provisions

Responsibility for exchange rate policy is defined by Article 111 of the Maastricht Treaty. Article 111-1 assigns to the Council (in practice to the Eurogroup) the prime responsibility for defining the exchange rate regime and for concluding formal agreements with third countries (this is almost everywhere a prerogative of the government in that such agreements have the character of an international treaty). Article 111-2 states that the Council may issue 'general orientations' for exchange rate policy and adds that those orientations 'shall be without prejudice to the primary objective of [...] price stability'. This provision was designed to allow the Council to enter into informal target zone arrangements and potentially gave it an indirect influence over monetary policy. However, clarification was provided as early as 1997, when the European Council agreed that 'general orientations for exchange rate policy' could be issued only in exceptional circumstances, for example in cases of clear exchange rate misalignment.

In 1999 and early 2000, ECOFIN and the Eurosystem clarified the matter further by agreeing to assign responsibility for exchange markets interventions to the ECB, being understood that interventions would follow an approach discussed with the Eurogroup and that the ECB would give notice to ministers.

Article 111 also includes provisions for external representation. Article 111-3 gives prime responsibility for external negotiations to the Council (not to the Commission as normally envisaged in the treaty, the Commission being only 'fully associated'). Article 111-4 gives the Council authority to decide on common positions at international level and on external representation.

Article III-196 of the aborted EU Constitution would have allowed the euro area countries to establish common positions on euro-related matters within international institutions and to ensure unified representation within those institutions. Article 138 of the Lisbon Treaty has retained the improvements in the governance of the euro originally proposed in the EU Constitution.

Against this background, the euro area has gradually gained recognition as an international player. In the meetings of the G7, national central bank governors have been replaced by the president of the ECB for discussions on macroeconomic, monetary and exchange rate issues. The appointment of a fixed president of the Eurogroup who participates in G7 meetings has given continuity to the representation of the euro area. Within the International Monetary Fund (where the euro area is not represented but where the ECB has observer status), coordination among representatives from euro area countries has improved somewhat and there is better prior consultation and discussion between finance ministries. A significant milestone in this respect was the involvement of the euro area as the single European representative in the multilateral consultations initiated by the IMF in 2006-2007, alongside the US, China, Japan and Saudi Arabia. Nevertheless, the system remains overly complex (Table 8.1).

Table 8.1: External representation of the euro area: an overview

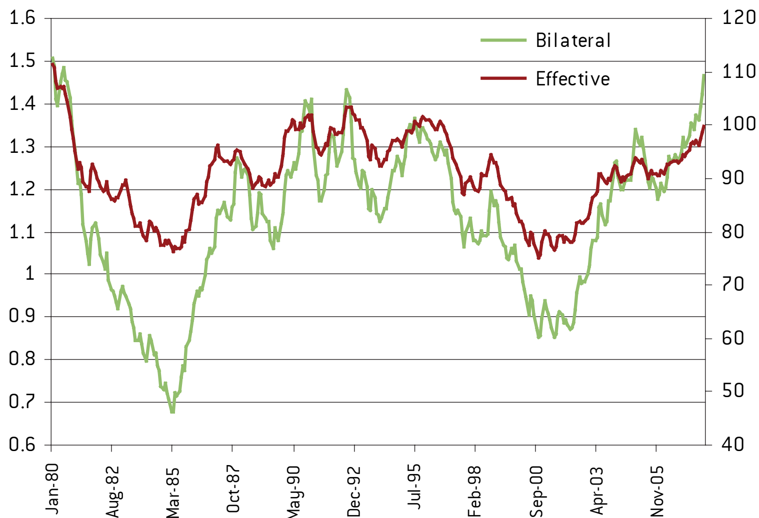
	European Central Bank	Eurogroup Presidency	EU Presidency	European Commission	EU member states
OECD	*Participates in Economic and Development Review Committee, Economic Policy Committee, and Committee on Financial Markets*	*Participates in Economic and Development Review Committee examination of the euro area*		*Quasi-membership (no voting rights and does not contribute to OECD budget but participates in all meetings)*	19
IMF Executive Board	*Observer status*		*Euro-area position represented by Executive Director holding EU/euro area Presidency*		27
Financial Stability Forum	*Full participation*				5
International Monetary and Financial Committee	*Observer status*		*Full participation depending on the constituency agreement*	*Observer status*	27
IMF Multilateral Consultations	*Full participation*	*Full participation*	*No*	*Full participation*	
G7 Finance Ministers	*Nearly full attendance*	*Nearly full attendance*		*Partial attendance (not involved in preparatory work)*	4
G20	*Full participation*		*Full participation*	*Attends meetings as part of the EU Presidency delegation*	5

Source: Regling (2007) and authors' sources

8.2 Assessment

How has the system performed? Critics complain that there has not been a proper exchange rate policy for the euro area but there is no evidence in the data of increased exchange rate instability or more pronounced misalignments after 1999, as illustrated by Chart 8.1 which plots both the effective and the bilateral dollar exchange rates of the euro.

Chart 8.1: Effective (R) and bilateral (L) dollar exchange rates of the euro



Source: Bank of England
Note: Prior to January 1999, the series corresponds to a synthetic euro area 12 currency.
Basis for effective exchange rate is 1990 average = 100.

What is true is that, contrary to the US dollar, the euro exchange rate has not behaved in a countercyclical way. The euro was weak in 2000 at the peak of the boom and started to strengthen when growth was faltering. In contrast, the dollar has served the US economy well: in 1998-2000 a strong currency prolonged a non-inflationary boom; it weakened in 2001 when the boom ended; and weakened further in 2007 as the expansion softened. However this can hardly be ascribed to an explicit US exchange rate policy.

Turning to policy, three main observations can be made:

First, markets continue to be puzzled by publicly expressed official disagreements over the exchange rate of the euro. Too often, ministers have expressed different

views or have jointly differed from the ECB. Former US Treasury Secretary Robert Rubin (2004) relates in his memoirs that whatever his views were about the dollar exchange rate, he was always cautious to say exactly the same thing because the slightest difference in language, such as switching from 'I believe a strong dollar is in our national interest' to 'I believe it's our national interest to maintain a strong dollar,' could have had an impact on the market. Even if this is not necessarily the benchmark, the European approach to exchange rate policy cannot be characterised as being appropriately disciplined.

Second, the vertical distribution of tasks between member states and the euro area institutions remains extremely complex as indicated by Table 8.1. The ECB is represented in all important fora but representation of the so-called economic side is divided between the president of the Eurogroup, the Council presidency, the Commission and the individual member states. This does not contribute to strengthening the voice of the euro area, especially in dealing with issues that are intrinsically political. It implies that there is at least a need for extensive and smooth-running coordination of policies and action if the euro area is to be influential.

Third, the horizontal allocation of responsibility between the president of the Eurogroup and the president of the ECB remains somewhat obscure. While they represent the financial and monetary arms of the same entity (in the same way that national ministers and central banks do), they often seem to compete for the title of 'Mr Euro', which again does not facilitate communication with markets and partners.

It therefore seems that the Maastricht provisions and the interpretation they have been given do not suffice to define policy roles and that the EU should further clarify responsibilities. Before entering into deeper discussion of the policy framework, we now consider some of the important changes that have taken place in the global environment.

8.3 Changing monetary landscape

In the world of Maastricht, and even more so in the years during which Maastricht was negotiated, the only thing that mattered was the relationship between the US dollar, the Japanese yen and the European currencies. There was also a strong belief that an appropriate way to organise international monetary cooperation was to keep real exchange rates between those currencies within certain bounds. Other currencies in Asia and more generally in the emerging world were largely irrelevant for all but the issuing country and its immediate neighbours. The intellectual background of Maastricht was therefore a three-currency world with soft target zones.

The world of 2007 is a very different one:

- Financial liberalisation has spread the world over. According to Lane and Milesi-Ferretti (2006), the ratio of the industrialised countries' foreign assets and liabilities to GDP has tripled since the early 1990s. Accordingly, larger and more lasting current account surpluses or deficits may be observed, the intertemporal dimension of economic policy has gained prominence, and valuation channels are of much greater importance in the transmission of the effects of exchange rate changes. Also, there is greater potential for upheaval as a result of abrupt change in market expectations or attitudes towards risk (Ahearne *et al* 2007c).

- In industrialised countries as well as in several emerging countries, the framework for monetary policy has evolved in the direction of what is generally called flexible inflation targeting (see Chapter 3). This strategy involves a focus on domestic variables (especially prices) at the expense of the exchange rate as a separate policy objective. It does not exclude departure from this focus in the case of foreign exchange market disruptions or exchange rate misalignments (in the same way that it allows central banks to take into account output developments in the setting of interest rates). But it does exclude the targeting of the nominal or real exchange rate vis-à-vis third currencies.

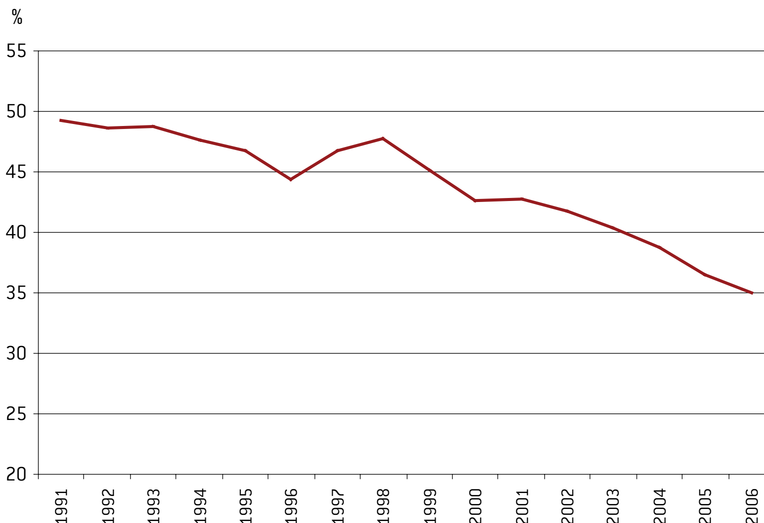
- Attempts at a permanent stabilisation of exchange rates between the US dollar, the yen and the European currencies have been abandoned. While Europe's own approach has played a role in this development, it has primarily been driven by the recognition that neither the US nor the Europeans were ready to subject their monetary policies to an external target. Intervention on foreign exchange markets has therefore become exceptional and 'oral interventions' by the G7 have become much less precise. Japan was until recently a different case, as indicated by the frequency and magnitude of Bank of Japan interventions, but this was in part due to the use of a depreciated exchange rate to combat domestic deflation. As normalisation proceeds in Japan, its exceptionalism has begun to recede.

- The US, Europe and to a diminishing extent Japan are still the unrivalled issuers of the world's key currencies but they represent a much smaller share of world GDP than at the time of Maastricht[47]. Almost all foreign exchange transactions still

47. The yen's share in foreign exchange transactions has fallen sharply, from 23.4 percent in 1992 and 22.7 percent in 2001 to 16.5 percent in 2007, on the basis of the 2007 BIS survey. The dollar's share (86.3 percent in 2007) has not changed much and the share of the euro (37% in 2007) has been stable since its introduction (note that the total of transaction shares is 200 percent as each transaction involves two currencies).

involve either the US dollar, the euro, the British pound or the Japanese yen and transactions between those four currencies still represent 56 percent of all foreign exchange transactions, although their share in world trade has declined dramatically (Chart 8.2). These countries therefore still retain a dominant role in exchange matters but the economic relationship between them has become less important in comparison to relations with third countries. It is no accident that US Treasury Secretary Henry Paulson has called the economic relationship with China the most important one for the US.

Chart 8.2: Share in world trade of the issuers of the major currencies



Combined share of US, Japan and EU15 in world exports. Source: Authors' calculations based on IMF DOTS

- Major new economic players such as China, other emerging Asian countries, and Middle Eastern oil producers remain on *de jure* or *de facto* exchange rate pegs (Dooley, Flokerts-Landau and Garber 2003, Reinhart and Rogoff 2004, Bénassy-Quéré *et al* 2006). In response to the Asian crisis, as well as in an attempt to stem the appreciation of their currencies, those countries have accumulated unprecedented quantities of foreign exchange reserves. These reserves, amounting to some $5,000 billion at end-2007 (Jen 2007), are still mostly invested in US dollars but diversification has started.

- In policy terms, the partial hollowing out of intermediate exchange rate regimes in favour of corner solutions means that there is both less scope for attempts at stabilising major exchange rates through flexible arrangements and more scope for

discussion with countries in pegged regimes. The intensity of controversy over the Chinese exchange rate regime highlights the point, but the issue is a more general one.

- The euro has become a regional hub for currencies in a formal or informal peg with it. In the same way that there is a *de facto* dollar zone (but at a smaller scale), there is a *de facto* euro zone that includes a large part of central and eastern Europe, the Mediterranean and Africa. According to Bénassy-Quéré *et al* (2007), in 1999-2004 about 15 countries in Europe and the Mediterranean (not counting Africa) were in a *de facto* euro peg or in a basket peg on a euro-dominated basket[48]. It is clear that a wider euro zone has developed in Europe and its neighbouring region. This zone includes countries at different stages in the development of their economic and financial institutions, some of which are vulnerable to crises.

All above changes mean that some of the implicit assumptions behind the Maastricht provisions on exchange rate policy have largely lost their relevance in today's world economy. These assumptions include the focus on the dollar and the yen, the G7-centred approach of international money, the notion that besides monetary policy there can be an exchange rate policy, and the (implicit at least) aversion to current account surpluses and deficits.

However, this does not mean that the euro area can afford to adopt a stance of benign neglect in international monetary affairs. As the issuer of the world's second international currency and as a monetary hub, the euro area has global and regional responsibilities that should not be eschewed. It is surprising that the exchange rate regime of the renminbi remained, for all practical purposes, a bilateral US-China issue until the Europeans went on a diplomatic offensive at the end of 2007, even though what happens to the Chinese currency is as important to Europe as to the US[49]. The same applies to other monetary issues that have been on the international agenda in recent years.

48. Papaioannou and Portes (2007) report results by Cobham, who also finds evidence of a euro zone.
49. According to the BIS, the share of China in the effective exchange rate is 13.7 percent for the US and 10.4 percent for the euro area, which is not materially different.

8.4 Recommendations

Based on our analysis, we make the following recommendations:

- *The current distribution of responsibility for exchange rate policy is broadly appropriate.* Suggestions that there has been a 'quiet hold-up' of the exchange rate policy by the ECB (Creel *et al* 2007) or milder complaints that, contrary to the treaty, the Eurogroup has conceded too much to the ECB simply ignore the fact that the world has changed and that the underlying model behind a different interpretation of the treaty is no longer valid. The idea that under normal circumstances there should be an exchange rate policy that is independent from monetary policy and assigned to a different institution does not correspond to reality.

- *Verbal discipline on the exchange rate is a prerequisite.* Even under favourable conditions, when the views of all concerned are well coordinated, exchange rate policy is a difficult matter and results cannot be guaranteed. If heads of state and government publicly disagree with each other and with the EU institutions, there is little chance that European policymakers will be able to influence exchange rates.

- *The euro area should express its views on the exchange rate policies of its main partners.* The present context of persistent global imbalances continues to involve a significant risk of a further *effective* appreciation of the euro beyond the level reached at end-2007, despite the fact that empirical evaluations show that it was valued at a level close to its equilibrium exchange rate (Ahearne *et al* 2007b). While a bilateral appreciation of the euro vis-à-vis the dollar is a necessary component of the global adjustment, there is no economic justification for an appreciation of the euro vis-à-vis currencies whose upward flexibility is voluntarily hampered. In this context there is a need for the Eurogroup and the ECB to reach common opinions, to communicate them to the markets and to express them to the economic partners, as was done in Beijing in November 2007.

- *Eurogroup involvement in foreign exchange market interventions remains necessary* whenever such interventions are concerted and it is highly desirable in the case of unilateral interventions, if only to avoid divergent public statements. In the case of significant misalignment, there could be a case for activating the provisions of Article 111-2 and formally adopting a Eurogroup view on exchange rate matters.

- *Even in normal times, the Eurogroup retains significant responsibilities.* First, it must be represented in multilateral policy fora that address other dimensions of economic policy than monetary policy. Whenever there is a need to discuss budgetary, tax, prudential or regulatory policy in such fora, it is clear that the ECB is not the natural representative. The Eurogroup should be represented in the G7 and multilateral consultations within the IMF[50]. Second, the euro area cannot be represented by the ECB in discussions with other countries on their exchange rate regime. The ECB speaks to the Chinese central bank but the People's Bank of China is not responsible for the choice of exchange rate regime, the level of the dollar parity or financial account liberalisation. As recognised in October 2007 in the decision to send a mission to Beijing, discussions on these topics must involve the president of the Eurogroup as ony he is able to talk to the Chinese government.

- *Arrangements for external representation need to be streamlined.* Europeans cannot continue to be represented at the same table by national authorities, the EU and the euro area. Proposals to consolidate Europe's representation into a 'high-representative' for all economic matters are probably too radical, because there are situations where different European players have legitimate claims to be represented directly. Discussions of budget-related matters at fora such as the G7 and IMF, for example, primarily concern national authorities. There are also macroeconomic issues where the ECB and the Eurogroup obviously have very important roles but where, given the national character of fiscal policies, member states can also claim to have a stake. The same is true for aspects related to financial stability. Besides, not all members of the EU are in the euro area. A useful starting point would be for euro area member states to agree to be represented to a greater extent than today by the Eurogroup president and the ECB in the G7 as well as in the relevant IMF discussions. Consideration should also be given to unified representation at the International Monetary Fund where the euro area chairs could be consolidated, as already developed in several Bruegel papers (Ahearne *et al* 2006, Ahearne and Eichengreen 2007).

- *Internal arrangements should allow the euro area to give a mandate to the president of the Eurogroup to represent it externally.* The trade template, where the European commissioner is given a negotiating mandate by the member states, is appropriate in this area too (Coeuré and Pisani-Ferry 2007). Having a clear

50. For example, the first multilateral consultations on global imbalances under the aegis of the IMF concluded in April 2007 that the euro area was planning to reform product, labour and financial markets. Only the last item on this agenda involves the ECB.

mandate which may include leeway to negotiate within certain bounds is likely to strengthen the authority of the Eurogroup president while preserving the prerogatives of member states.

- In line with what we have previously underlined when talking about fiscal policy, structural reforms and financial stability, the euro area should be better equipped to deal with monetary and financial crises. This implies *developing a delegation mechanism that gives the Eurogroup president authorisation to speak in the name of euro area countries and to represent them in emergency situations.*

These reforms could be based on Article 115a of the Lisbon Treaty, which stipulates that 'The Council, on a proposal from the Commission, may adopt appropriate measures to ensure unified representation [of the euro area] within the international financial institutions and conferences'.

9. Governance

9.1 Can governance reform help?

The previous six chapters have discussed the policy challenges of major importance for the future and offered specific recommendations. In this chapter, we turn to the overall governance of EMU and to the role of the various institutions involved.

Our view is that rather than additional guidelines and procedures, what EMU lacks is a sufficiently analytical approach to policy discussions, evidence-based decisions and mutual trust. So how can changes in governance help? Can behavioural weaknesses be remedied by institutional and procedural solutions?

EMU relies on two types of rules or, in other words, on two pillars: a 'hard' one (Article 104 and the SGP) and a 'soft' one (Article 99 and the various guidelines). As for institutions, there are two in addition to the ECB, which has a clearly defined role: the Eurogroup, a late and somewhat undefined addition to the policy system, and the Commission, whose role has also evolved. The question is: what can be expected from each of them?

The purpose of the hard pillar is essentially *regime preservation* – that is, the prevention of policies that have the potential to threaten the viability of monetary union or to endanger its basic tenets, such as price stability. Such risks justify taking action against governments whose behaviour represents a threat to the common good. This, in turn, requires principles and rules designed to sort out hazardous behaviour from acceptable behaviour, and to ensure predictable enforcement.

The purpose of the soft pillar is *policy improvement* through guidelines and other non-binding recommendations. Its role is to provide incentives for good policies and to steer policy action in a direction that will improve the overall functioning of EMU and the performance of its member countries. Rules are not really appropriate here as the emphasis is on incentives and persuasion.

The Eurogroup is an institution without a defined mission (it is actually not even an institution under the Nice Treaty, and will see its role formally recognised only with the ratification of the Lisbon Treaty – though it will not be given a defined mandate)[51]. Its role has developed in two complementary directions. First, it is the *de facto* enforcer of the rules since all important decisions pertaining to the implementation of EMU rules are discussed and agreed upon in the Eurogroup, leaving to ECOFIN the formal approval only. Second, it is the venue for addressing the collective action problem created by the sharing of the same currency and for learning from each other, building consensus and developing a dialogue with the ECB. So the Eurogroup both manages the apparatus of rules and guidelines and is in the end the institution in charge of solving the problems that cannot be solved by rules and procedures.

Furthermore, the Eurogroup is the place where ministers from participating countries have a voice. This is an important political function as it is well known that the chance to be heard reduces the temptation to leave the table. In this respect, the Eurogroup facilitate the continuing acceptance of the disciplines involved in participating in a monetary union.

Finally, the role of the Commission is best defined as one of a *moral authority*. Unlike in other fields where it implements policies or sets the agenda through its right of initiative, in the field of EMU it has been deprived of much power. It directly controls no policy instrument. The Commission is somewhat frustrated by this situation. Yet it retains the extremely important role of exercising surveillance and providing the analytical underpinnings of decisions. In this role, there is no substitute for the Commission.

We regard this distribution of roles as broadly appropriate, although with some important qualifications:

(a) The mapping of objectives into instruments is somewhat unclear, and it has been so since the first discussions on EMU (the Delors Report of 1989 is telling in this respect[52]). For example, the stability and growth pact seeks primarily to preserve the regime (through the prevention of unsustainable debt accumulation) but it is

51. Article 1 of the Protocol on the Eurogroup states that 'The Ministers of the Member States whose currency is the euro shall meet informally [..] to discuss questions related to the specific responsibilities they share with regard to the single currency' and that the ministers will elect a president. No decision-making competence is assigned to the Eurogroup.

52. The report indicated that economic and fiscal decisions 'would have to be placed within an agreed macroeconomic framework and be subject to binding procedures and rules'. This, the report added, 'would permit the determination of an overall policy stance for the Community as a whole, avoid unsustainable differences

often presented as a policy optimisation device (for example, when argued that it is necessary to avoid countries drawing excessively on common savings and thereby raising the long-term interest rate). Recommendations made to member states to modify their policies seldom indicate what the rationale for changing course is.

(b) The EU generally tends to believe that authority derives from reliance on a legal instrument. Hence, the multiplication of procedures (EDP, BEPGs, Integrated Guidelines, NRPs, and others). It is obviously correct that a referee's authority ultimately depends on having a red card in his pocket. But distributing frequent yellow cards does not confer authority, especially if one does not have any red card in reserve. By relying too much on weak legal instruments, the EU tends to undermine the authority of the Commission and the Council[53]. To borrow Max Weber's distinction between sources of authority, the EU institutions would gain from relying on legal authority only when justified by a risk to EMU. Ability to influence governments and to lead them to adopt good policies is a matter of incentives – and they are insufficiently aligned with the common EMU interest. It is also a matter of 'charismatic' authority – that is, the recognition by others of the value of one's leadership, analysis and advice. No legal provision can confer charismatic authority on an institution, but it can be acquired through experience and building up credibility.

(c) The scope for regime preservation is narrow. Only irresponsible fiscal behaviour is deemed a serious enough problem to justify possible sanctions. Other macroeconomic or financial developments (credit booms and busts, consumer or asset price inflation) are not regarded as potentially threatening enough to justify mandatory preventive action. Article 99 does recognise that a wider range of polices may 'risk jeopardising the proper functioning of economic and monetary union', but it only provides the Council with the possibility of making its recommendation public (no sanctions are possible). This dimension applies to all EMU members but could gain increased relevance with enlargement. In the new member states, macroeconomic stability can certainly not be regarded as synonymous with budgetary stability.

Summing up, we would prefer in normal times a more decentralised approach relying more on incentives and moral authority to influence policies, combined with a greater

between individual member countries in public-sector borrowing requirements and place binding constraints on the size and the financing of budget deficits.'

53. The 2001 decision to issue a recommendation to Ireland was a case in point.

capacity to centralise decision-making when required in response to crises or exceptional circumstances. A lighter touch for high-frequency interference with national decision-making and a stronger hand for low-frequency interventions would, in our view, avoid the drawbacks of procedure fatigue and prevent the risks of coordination failures.

9.2 Recommendations

We see four objectives behind amendments to the framework that the EU institutions can deliver. First, draw a clearer line between the responsibilities of the Eurogroup and those of ECOFIN. Second, clarify the use of instruments. Third, make the Eurogroup and its presidency more effective. Fourth, enhance the external representation of the euro area.

Institutional division of labour

Over time, the *de facto* role of the Eurogroup has developed at the expense of the formal ECOFIN Council. This situation is unsatisfactory.

The current division of labour between the ECOFIN and the Eurogroup is in theory that all decisions are made by ECOFIN, while the Eurogroup is only informal in character. In practice, however, all important decisions regarding the functioning of the euro area are taken in the Eurogroup and later formalised by the ECOFIN, where the Eurogroup commands a majority. This is frustrating both for the Eurogroup (because it is deprived of formal power) and for the ECOFIN (because it is deprived of real power). This was not a serious concern when a vast majority of ECOFIN members were also members of the Eurogroup, but has become a problem now that about half of EU members do not belong to EMU.

In the short run, the Protocol on the Eurogroup annexed to the Lisbon Treaty should, if the treaty is ratified, give the institution a clearer legal status and lay down essential provisions such as membership and chair. Articles 114 and 115, which broaden the scope for decisions to be taken by a vote of the euro area countries only and define the qualified majority threshold for those countries, go a long way towards giving formal decision-making power to the Eurogroup (the difference being that the vote is to be cast in the presence of the other EU members). But ambiguities and questions persist as to what will happen in the longer run.

There are two views here. One is that the Eurogroup should remain a sort of 'European

G7' where direct informal discussions are held among ministers, and leave all procedures to the ECOFIN. According to this view, the difference between the two bodies is not so much the fact that only the members of the euro area participate in the Eurogroup but the fact that membership is limited to two persons per delegation. The other view is that the Eurogroup should become an ECOFIN Council for the euro area, which means that it should be able to take formal decisions54.

Our view is that in the medium term, legal provisions should be reconciled with reality and that the Eurogroup's role in implementing EMU-specific provisions should be recognised – especially if membership of EMU continues to be significantly narrower than membership of the EU, which is likely.

A simple and clear solution would be to make ECOFIN responsible for all legislation while giving the Eurogroup the responsibility for implementing it. This would amount to giving formal status to the Eurogroup and assigning to it the policymaking competence of the Council for all issues pertaining to the euro area, including as regards implementation of the SGP and the excessive deficit procedure for euro area countries; coordination of economic policies within the euro area (and corresponding recommendations to member countries); and international economic policy. Such a move would require a revision of the treaty that is unlikely to be forthcoming in the short term but, if there is agreement to move in this direction a *de facto* division of labour can develop within the current legal framework – as has happened already.

The next question has to do with changes to the rules rather than their implementation. On the occasion of the 2005 reform of the stability and growth pact, negotiations took place within the Eurogroup and the results were eventually endorsed by the ECOFIN. Again, it might have been clearer to recognise that this was a matter for the euro area members – provided the rights of the non-members are preserved. With this in mind, it would be appropriate to give the Eurogroup the right to amend the euro-area specific rules (as regards, for example, the excessive deficit procedure) while giving some guarantee to the non-euro countries. A possible way could be to allow a Eurogroup decision to be submitted to a vote within the ECOFIN. The right to activate this call-back procedure could be assigned to the Commission. Again, this should be regarded as a medium-term initiative because it would require a change in the treaty. However, reaching political consensus on the matter would help to deal with the issue as it comes up in the current context.

54. There is even the compromise view that there should be a distinction between format and membership. Thus, there would be both a 'European G7' and a 'Euro ECOFIN'.

Clarification of the role of policy instruments

Moving to the Eurogroup's formal instruments, there is a need for a clearer distinction between, on the one hand, legally binding decisions that aim to preserve the proper functioning of EMU system and, on the other hand, proposals designed to improve the quality of economic policies or to exploit synergies within the euro area. As regards the former, regime preservation has primarily to do with--but cannot be reduced to--the avoidance of excessive public debt accumulation. There are other potential threats to the sustainability of EMU which deserve to be addressed, though this cannot be done within the framework of Article 104 on the prevention of excessive deficits. Barring a change in the treaty, Article 99 is the only possible basis for a strengthening of regime-preserving surveillance.

- *We propose to reserve formal Council recommendations under Article 99 and 104 to the prevention of risks regarding the proper functioning and the sustainability of EMU. Besides irresponsible public debt accumulation, potential risks covered by such provision should include threats to financial stability, unsustainable macroeconomic policies potentially resulting in severe real exchange rate misalignments within the euro area, and external threats to stability.* This would not require treaty change but a consensus to interpret Article 99 and give stronger political weight to recommendations based on it.

As regards the promotion of 'good policies', we are sceptical about the potential of formal procedures. Our reading of the Lisbon experience is that its effectiveness varies widely from country to country because the degree of ownership in the project varies considerably. We see more potential in accurate, human-capital-intensive analyses akin to the Article IV reports of the IMF. The Commission has moved in this direction and this is a welcome evolution. Further advances will require human resources and an ability to deliver accurate analyses without the interference of political considerations. Deepening the understanding of the issues concerned and making different actors aware of the relative progress made in various member states via scoreboards and the like can contribute to the reform efforts.

Another route would be to hold non-finance Council meetings in euro format, including at the level of the heads of state and government. This would have the advantage of reminding a wider and more senior circle of policymakers that interdependence amongst the participants in the euro area is both specific and more intense than with other EU member countries. Some of the policy reforms that are crucial to the functioning of the euro area are in fact not in the hands of the ministers of finance but

of the ministers of economy or labour. Also, strategic direction and important institutional decisions belong to the heads of state and government. We would therefore see benefits in holding such meetings, which would evidently only make sense if they go beyond mere political gestures.

- *We propose that it be possible to hold Council meetings in euro area format, including at the level of heads of state and government.*

A decision of this sort could be interpreted by the non-euro area members as a sign of exclusion. It should therefore be accompanied by counterbalancing gestures, for example by the convening of joint meetings of the Eurogroup and the ministers from the countries which have set a date for the adoption of the euro.

Effectiveness of the Eurogroup

The strengthening of the Eurogroup is high on our agenda because we see a danger in the current trends: in spite of common positions, contradictory statements by the member governments of the euro area regularly undermine the Eurogroup's legitimacy. The question is, therefore, how to raise the profile of the institution and of its president?

We have explored several solutions. One would be to make the appointment of the president a decision by the heads of states and governments. It can be argued that if the president of the Eurogroup is entrusted with responsibility for discussing policy priorities with national governments and for representing the euro area externally, the current election by peers for a fixed term of two and a half years may not be the most appropriate one because it does not confer legitimacy beyond that of finance ministers. A formal appointment by the heads of state and government of the euro area (that is, the European Council, but limited to the members countries of the euro area), together with the European Parliament, could confer a higher legitimacy to the president of the Eurogroup. The problem, however, is that such a procedure might weaken the president's recognition by the finance ministers. But the profile of the Eurogroup president could be strengthened by letting him or her attend *ex officio* European Council meetings[55].

A second possibility would be to make the Eurogroup president and the economic

55. This is evidently the case at present, but only because Jean-Claude Juncker is a member of the European Council in his capacity as prime minister of Luxembourg.

affairs commissioner into a single person. This is the solution envisaged for the high representative for foreign affairs, who will wear a such double hat. There are pros and cons to this solution. The pros are that this would be recognition of the intergovernmental character of EMU and of the fact that there is no room for two persons with executive responsibility. The cons are that it would deprive the system of an 'advocate of the common good' who is free to 'ruthlessly tell the truth', as Keynes said of the IMF. The current division of responsibilities between the Eurogroup president and the commissioner for eonomic and monetary affairs gives the latter the possibility of fulfilling this role. A merger of their roles would risk giving precedence to the search for political compromises over the aim of analytical clarity[56].

A third solution would be to strengthen the Eurogroup secretariat and equip it with analytical capabilities. This would undoubtedly raise the profile of the institution (which does not even have a website of its own) and of its president. But it would weaken the Commission and create perfect conditions for institutional rivalry. In the end, it is not clear that there would be anything to be gained from such a move.

Summing up, none of these solutions emerges strongly as having the clear potential to strengthen the Eurogroup, and all present some risks and adjustment costs. We have some sympathy for the appointment of the Eurogroup president by the heads and state and government but recognise that it has its drawbacks.

External representation

We discussed in Chapter 8 how to streamline and reform the external representation of the euro area. We wish only to restate here that this external dimension is of vital importance for the legitimacy of the Eurogroup and its president. A Eurogroup whose members constantly contradict each other in spite of having agreed on common positions is not only weak externally, it also demonstrates a lack of verbal discipline that can only undermine its ability to perform its internal role. Conversely, being authoritative in the external field would strengthen the Eurogroup internally.

We therefore regard the streamlining of external representation as a priority reform. A highly symbolic move with a potential for wider implications in the external field would be the consolidation of the euro-area member countries' representations at the International Monetary Fund into a single constituency. We therefore advocate

56. Also, there is the problem that the Commission is responsible vis-à-vis all members states while the Eurogroup is obviously a body only for the euro area countries.

considering it as a priority reform.

- *We recommend the creation of a single euro area chair at the IMF.* As indicated in Chapter 8, this would not require any change in the treaty as Article 115a explicitly envisages such possibilities. A merging of constituencies would, however, require amending the International Monetary Fund's Articles of Agreement.

10. Conclusions and recommendations

EMU is a learning process, but we are concerned that in some respects the process is excessively slow. Almost ten years into EMU, some of the basic tenets of participation in a currency union seem not to have permeated policymaking in some of the member countries. Too often, budgetary policies combine a disregard for long-term constraints with perversely procyclical short-run behaviour; economic reforms that have the potential to improve the functioning of the euro area are postponed; and contradictory statements undermine the credibility of the common exchange rate policy. The European Commission and the ECB deserve high marks for having consistently focused on the logical implications of forming a monetary union, but they too have sometimes been slow in drawing lessons from evidence. Devotion to the treaty – even to a narrow interpretation of it, as in the case of the enlargement criteria – and obedience to established practices have more than once hampered policy learning.

This situation is worrying in two respects. First, current behaviour does not allow the euro area to reap the full benefit of the single currency. Participants in the euro project have made an exceptionally large investment, but they seem reluctant to engage in the complementary—and in many ways much less significant—adaptations that would allow their investment to yield the expected return. They resemble builders of a high-speed rail link who, having made a multi-billion euro investment in the track and the trains, are reluctant to commit to a much smaller additional spend on the city stations.

Second, EMU can accommodate a certain degree of mutual mistrust, but at a cost: less resilience when coping with crises, less chance for economic agents to anticipate the policy response to shocks and less scope for market participants to decipher statements on exchange rates. At best, this results in poorer performance; at worst, in a less robust EMU system. More uncertain global economic conditions make this situation untenable.

The remainder of this chapter summarises both the policy-specific recommendations (Section 10.1) that were discussed in detail in earlier chapters and our recommendations for reforms in the governance of the Eurogroup (Section 10.2) that we proposed in Chapter 9.

10.1 Policy-specific recommendations

The EMU framework should fulfil four conditions. It should first deliver stability – taking into account that price stability is only one aspect of it. Second, it should ensure predictability—that is, provide clear and transparent rules on how the various policy players should behave in the common interest. Third, it should provide strong incentives for policies that are appropriate both from a national and from a European point of view. Fourth, it should be adaptable in order to evolve on the basis of experience and adjust to changes in the world environment.

Against these yardsticks, we consider that progress is desirable on all four fronts. We think that the concept of stability emphasised in the Maastricht Treaty was too narrow and that, although this has to an extent been taken on board in practice, a more comprehensive formulation of the objective is needed; that predictability has improved, at least for monetary policy, but that there would be value in going further, especially in view of the enlargement of the euro area; that the incentive dimension has been taken into account on the occasion of the reform of the stability and growth pact but that more is needed in order to spur action that is in the common interest; and that due deference to the treaty should not constitute an obstacle to learning and adapting (Box 10.1).

BOX 10.1: SUMMARY OF POLICY-SPECIFIC RECOMMENDATIONS

Monetary policy

The ECB should improve its policy framework by moving towards a full inflation target regime.

The ECB should publish forecasts for inflation and GDP that reflect the views of the Governing Council.

The ECB should voluntarily inform the Eurogroup that it has adopted a reformed inflation target, and the Eurogroup should respond with an unequivocal endorsement (through an exchange of letters, perhaps) to show public support for the improved framework.

Fiscal policy

The focus of EU surveillance should increasingly be a comprehensive concept of debt sustainability.

The EU should recognise progress in home-grown fiscal discipline through granting increased national fiscal autonomy to countries that have put in place credible and appropriate national fiscal policy rules and institutions.

In assessing national fiscal rules and institutions, the scope for differentiation should be recognised.

The presidency of the Eurogroup should assume leadership in the implementation of the reforms we propose and, if required by exceptional circumstances, in devising common fiscal guidelines for the euro area.

Structural reforms

The Eurogroup should act as a catalyst and a caucus for reforms which are of the competence of the EU but which are of particular importance for the functioning of the euro area. The euro area should promote cross-border labour mobility.

As regards policy fields for which member countries are responsible, the EU should use the budget review of 2008/2009 as an opportunity to direct EU spending towards promoting growth and reforms. The euro area could foster policy learning through resorting more systematically to independent assessment and benchmarking and encourage the Commission to enhance its surveillance role by issuing under its own responsibility non-legally-binding assessments and recommendations along the lines of IMF Article 4 staff reports.

The Eurogroup should consider issuing formal recommendations to a country whose policy represents a threat to the normal operation and sustainability of EMU.

In the rare case where trade-offs between structural reforms and budgetary adjustment arise, such trade-offs should be addressed by requesting from the country concerned a time-bound commitment to reach a specified debt-to-GDP ratio.

Financial stability

The euro area should take the lead in promoting a European prudential and supervisory regime for pan-European banks.

Enlargement

The criterion for price stability should be amended or reinterpreted. One possibility would be a requirement that the inflation rate must not exceed by more than 1.5 percentage points the average inflation rate for the euro area, as opposed to the average inflation rate of the three member states where inflation is lowest. Another, somewhat stricter possibility could be to take as a benchmark the average inflation rate for the three countries whose performance is the closest to the ECB objective. This would amount to reinterpreting the reference in Article 121 of the treaty to the 'three best performing member states in terms of price stability' and to considering that best performance does not mean lowest possible inflation but inflation as close as possible to the objective.

A first-best solution would be to scrap the obligation of two-year membership of the ERM2 for those countries that so wish. At any rate, the requirement should be interpreted flexibly, taking into account the country's previous exchange rate history.

There should be more emphasis on a prudent debt limit for the new member states, and the deficit limit chosen should be consistent with the debt limit and with medium-term growth prospects.

To help promote fiscal sustainability, the new member states should aim to reach budgetary balance or surplus during periods of rapid growth.

External dimension

The current distribution of responsibilities for exchange rate policy is broadly appropriate.

Verbal discipline is a prerequisite. There can be no effectiveness on exchange rate matters as long as ministers and even heads of state and government publicly disagree with each other and with the EU institutions.

The euro area should express its views on the exchange rate policies of its main partners.

The Eurogroup has significant responsibilities. Its involvement in foreign exchange market interventions remains necessary when such interventions are concerted, and is highly desirable for unilateral interventions. The Eurogroup president is the natural interlocutor of foreign governments on exchange rate and exchange regime matters.

Arrangements for external representation need to be streamlined. A delegation mechanism should be developed to allow the president of the Eurogroup to represent the Eurogroup externally and vis-à-vis neighbouring countries in the event of a crisis.

10.2 Recommendations for governance of the Eurogroup

Our recommendations for changes in the framework guiding the EU institutions have focused on reforms to governance of the Eurogroup. We believe that these reforms can achieve four objectives. First, they can help to draw a clearer line between the responsibilities of the Eurogroup and those of ECOFIN. Second, they can clarify which instruments are best suited to the job at hand. Third, the recommended changes aim to improve the effectiveness of the Eurogroup in general and the Eurogroup's presidency in particular. Fourth, our proposals can enhance the external representation of the euro area (Box 10.2).

BOX 10.2: SUMMARY OF RECOMMENDATIONS FOR GOVERNANCE OF THE EUROGROUP

We propose to reserve formal Council recommendations to the prevention of risks regarding the proper functioning and the sustainability of EMU. Besides irresponsible public debt accumulation, potential risks covered by such a provision should include threats to financial stability, unsustainable macroeconomic policies potentially resulting in severe real exchange rate misalignments within the euro area, and external threats to stability.

We propose that it be possible to hold Council meetings in euro area format, including at the level of heads of state and government.

We recommend the creation of a single euro area chair at the IMF.

10.3 Conclusion

As indicated in the introduction, the mandate we have set ourselves is one of substantial, but not radical, reform. We consider that the euro has made a good start, but that nine years is still a short period for experimenting with a new policy regime. Looking ahead, there are important challenges and perhaps significant risks on the horizon, not least the risks stemming from the combination of ongoing stress in global financial markets and rising inflation, and the euro area must continue to adapt. What we have therefore followed is an approach that only advocates changes in the procedures or the allocation of responsibilities where there are strong empirical or theoretical grounds for doing so.

Most of what we call for does not require treaty changes, at least not in the coming years. Adaptations can take place and improvements can be introduced within the current legal framework. Only with enlargement might a more radical approach be needed and, here also, improvements can be made without treaty changes.

We think that the experience gained so far demonstrates the need to make the policy framework for the euro area clearer and more transparent for all concerned. Only if the rules and the responsibilities of different actors are well understood can one expect that difficult decisions will be taken. Several of the proposals we have made reflect this rationale.

It seems to us that national policymakers are not always conscious of the magnitude of the challenge. Too often it is taken for granted that the euro is part of the landscape and does not require additional investment. The sense of collective ownership that characterised the years before, and immediately after, its introduction has tended to dissipate. Even though there are points of dissatisfaction with the way the euro area operates, this has not necessarily translated into a commitment to make corresponding adjustments in euro area and national policies.

Our main message is that the maintenance of a learning mindset and a willingness to adapt the policy framework in light of the experience gained is crucial to the long-term success of the euro. In the end, the return on the major investment made by the creators of the European currency will be determined by the ability of all participants to learn from experience and to improve.

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