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EURO-AREA GOVERNANCE: WHAT WENT WRONG? HOW TO REPAIR IT?

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Highlights

The European Union's heads of state and government have chosen euro-area governance reform as a topic for immediate discussion and swift decisions. Any serious discussion must start from an analysis of what went wrong. The superficial analysis has been that the crisis in Greece and elsewhere resulted from a failure to implement existing rules. There is some truth in this, but the crisis also reveals deeper governance flaws, which need to be recognised:

- Top-down government by statistics does not work (especially, but unfortunately not only, when they are wrong);
- Deterministic governance does not work in a stochastic world;
- Not all problems are fiscal;
- A commitment to no-assistance is not credible;
- Policy coherence is often lacking and ownership of the euro rules is tenuous.

If this view is correct, key choices for the euro area are:

- To reformulate the economic policy framework,
- To decide on the degree of decentralisation that is desirable, and
- To determine the reforms that are needed to ensure completeness of the policy regime.

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A FAILURE OF IMPLEMENTATION?

What went wrong in the euro area? A simple answer is that the rules are good but that implementation has been weak.

There is considerable truth in this: Greece in the last decade defied the most basic provisions of the European budgetary framework – and even a fundamental tenet of EU membership, namely trustworthiness. Several other member states, some of which find themselves in difficulty, have consistently flouted EU budgetary principles. In the Irish and Spanish cases, the EU had, but did not use, the legal means to tell them that the course these countries were on was endangering their own stability and the stability of the euro area. Finally, beyond formal rules, the Eurogroup had been given the mission to exercise vigilance, and it did not.

It is therefore tempting to conclude that the problem the Van Rompuy Task Force[1] should address is purely one of enforcement and strengthening the existing EMU provisions. President Van Rompuy has suggested that this is, at least in part, the direction taken by the discussions[2].

Enforcement is certainly an important part of the agenda. However we have learned much more from recent events and the lessons indicate that there are more fundamental problems than weak enforcement. It would thus be wrong to limit the discussion to the design of additional incentive or sanction procedures.

FIVE LESSONS LEARNED

Five lessons have been learned – starting with the most basic ones.

1 Top-down government by statistics does not work (especially, but unfortunately not only, when they are wrong)

The Greek crisis has shown that the system in place for monitoring public finances does not work. From 2000 to 2008, the budget deficit notified to the European Commission in spring of the following year was on average 2.9 percent of GDP. In fact, the true figure was 5.1 percent, as shown by revised data[3]. A monitoring system that provides such inaccurate estimates for so long is in need of fundamental repair.

There are several reasons for this failure. Two key ones are certainly that the Greek statistical office was under the control of the government, and that Eurostat was not given by the EU Council the mandate and the means to carry out on-site evaluations. But the problem runs deeper. In any organisation, a budget is a set of rules and procedures whereby spending is accounted for and monitored. For a government, it has a very different purpose than national accounts, the role of which is to record economic activity. Yet for reasons of comparability, the whole EU budget-monitoring system is based on the accounts prepared by national statistical offices. The relationship to the actual budgets of the various entities that compose general government is often loose; this

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1. The European Council in spring 2010 asked president Van Rompuy to chair a task force on euro-area governance. The task force is due to deliver a progress report to the June 2010 European Council.

2. See the remarks by Herman Van Rompuy following the second meeting of the task force on 7 June 2010.

3. See detailed data in Marzinotto, Pisani-Ferry and Sapir (2010).

'The implicit assumption in the EMU framework that threats to stability essentially arise from a lack of budgetary discipline has proven wrong. Spain and Ireland illustrate that budgetary discipline is not sufficient to avoid major threats to economic and financial stability.'

has created problems from the very beginning.

Furthermore the monitoring of budgetary situations within the framework of the Stability and Growth Pact (SGP) has gradually evolved in the direction of putting emphasis on the structural, or cyclically-adjusted, balance – a further statistical construct. This economically sensible move was intended to correct the pro-cyclical bias in the initial SGP, but measuring the output gap (which is necessary for cyclical adjustment) is fraught with considerable uncertainty, especially in times when potential output is affected by shocks. This puts the whole edifice of EU budgetary surveillance on shaky foundations[4].

Solving the contradiction between the economic aim of preserving the stabilisation role of budgetary policy and making the surveillance framework statistically robust is bound to remain a considerable challenge at EU level.

2 Deterministic governance does not work in a stochastic world

Spain moved between 2007 and 2009 from a two percent of GDP budget surplus to an 11 percent deficit, and Ireland from a balanced budget to a 14 percent deficit, while in the same period its debt jumped from 25 percent to 64 percent of GDP. Only a small part of these changes is accounted for by discretionary decisions. So what we have learned is that a country can move almost instantaneously from an apparently sound to an alarmingly weak situation. In other words a deterministic approach is of limited help in a stochastic environment where tail risks can deeply affect budgetary outcomes.

This observation has two implications. First, it raises a question mark over the very basis of budgetary surveillance, namely that the soundness of a country's budgetary situation can be assessed with current data and forecasts. In such a stochastic environment a 'value at risk' (which we should perhaps call 'policy at risk') approach is instead called for, which could, for example, result in requests for lower public debt ratios being made to countries that are more subject to such risks, especially but not exclusively because their financial sector is larger.

The second implication of the observed speed of change is that existing sanction procedures in the framework of the SGP are inappropriate: a country can be fined because its deficit has moved from 2.5 percent to 3.5 percent of GDP, but there would be no point in fining it when the deficit is already in double-digit territory.

The SGP is therefore facing more serious difficulties than European policymakers are willing to admit: on the one hand the preventive arm is made largely ineffective by the combination of uncertainties in estimating structural deficits and an overly deterministic approach. On the other hand, the corrective arm is made ineffective by the speed at which the budget balance can deteriorate.

3 Not all problems are fiscal

The implicit assumption in the EMU framework that threats to stability essentially arise from a lack of budgetary discipline has proven wrong. While the Greek case perfectly exemplifies how budgetary indiscipline in a small country can jeopardise financial stability in the euro area as a whole, Spain and Ireland illustrate that budgetary discipline, at least in the way it was assessed, is not sufficient to avoid major threats to economic and financial stability. The lessons to be drawn are that fiscal risks need to be prevented more effectively and that non-fiscal risks arising from credit booms, asset-price developments or a sustained appreciation of the real exchange rate need to be addressed. This has in fact already been pointed

4. For example the Commission estimate of the 2007 structural balance has changed from a 2.1 percent of GDP deficit in spring 2007 to a 3.7 percent deficit in spring 2010. For Ireland it has changed from a 1.8 percent surplus to a 1.6 percent deficit.

out by the Commission (European Commission, 2008).

To be fair, the 'it's all fiscal' assumption is nowhere explicit in the treaty. On the contrary Article 121 (ex-99) is entirely devoted to the coordination of economic policies beyond the mere enforcement of budgetary discipline. But this pillar of economic union has always been significantly less rigid than the fiscal one based on Article 126. Not only are the legal provisions weaker, but during the first ten years of the euro, they were not really used[5]. The Broad Economic Policy Guidelines that were supposed to be the backbone of coordination have been consistently ignored by national policymakers; the possibility of issuing a recommendation was used only once – without effect.

As indicated by the European Commission in its 2010 communication, the lesson from experience now calls for building a framework for surveillance over and above budgetary dimensions. The challenge here is however to define and put into place the foundations of such surveillance. The legal apparatus can only be made effective if a consensus is built on the economic underpinnings of the prevention of imbalances. All international experience – at European but also at global level – indicates that it will be a significant intellectual challenge to define benchmarks and thresholds for the surveillance of external imbalances and/or real exchange rate developments[6].

4 A commitment to no-assistance is not credible

There was never a 'no-assistance principle' in the treaty, only (and rightly so) a 'no-coresponsibility' principle for public debts (Article 125). Article 143, which limits the benefits of macro-financial assistance to EU countries outside the euro area, was not intended to prohibit assistance to those participating in the single currency. This article was only the result of the view that the members of the monetary union would no longer need balance-of-payments assistance (Marzinotto, Pisani-Ferry and Sapir 2010). But, until Greece, there was the belief that a member country would be allowed to default, rather than be provided with assistance.

No-assistance was furthermore not credible in any case because any EU country can request support from the IMF. The expectation that it would simply have to default and that this would serve as a deterrent to budgetary indiscipline (as can be the case for US states) was therefore unfounded.

Ambiguity has now been removed: it is clear, first, that euro-area countries are entitled to assistance and, second, that this assistance must be part of an IMF-led programme, with the usual conditions attached. But this does not entirely clarify the endgame. In fact one ambiguity has been replaced by another: what if a member government benefiting from EU assistance remains unable to regain access to the market? Will it remain dependent on an assistance lifeline? This question has been made even more relevant by the European Central Bank decision in May 2010 to embark on a government bond purchase programme, which creates a risk that the central bank will be trapped. As long as this ambiguity persists there will be uncertainty over how insolvency cases can be resolved. And there will therefore be room for speculation.

The availability of EU assistance does not necessarily weaken *ex ante* discipline. IMF conditions are harsh enough to serve as a deterrent and, furthermore, potential support from EU partners may strengthen calls for discipline because it gives undisputable legitimacy to surveillance. But the moves made in spring 2010 have exposed the incomplete character of the rules of the game in EMU and call for the treatment of insolvency to be clarified.

'There was never a 'no-assistance principle' in the treaty, only a 'no-coresponsibility' principle for public debts. But, until Greece, there was the belief that a member country would be allowed to default, rather than be provided with assistance.'

5. The exception was Ireland in 2001, but since the Council recommendation was (probably rightly) ignored by Ireland, this experience in fact contributed to weakening the instrument.

6. Marzinotto, Pisani-Ferry and Sapir (2010) elaborate on this point.

5 Policy coherence is often lacking and ownership of the euro rules is generally tenuous

Ultimately, the success of the euro depends on, first, an (implicit) commitment to have in place policies that are consistent with membership of the monetary union and, second, on ownership of the (explicit) principles and rules underpinning EMU. This primarily involves governments but also private agents.

Coherence has often been absent since the euro came into existence. Most governments after 1999 considered that euro-area management could be delegated to central bankers and ministers of finance but did not imply any significant change to most domestic policies. Very few countries (Finland was an exception) bothered discussing if participation in a monetary union also had implications for wage-setting. Several thought they could reject further integration of product markets, let alone labour markets[7].

Ownership of the rules has remained very uneven and generally tenuous. To take only one example, from 1997 (when the country qualified) to 2007, the government balance in France fluctuated between a 1.5 percent of GDP deficit and a 4.1 percent deficit whereas the SGP's stated target is that it should have been 'close to balance or in surplus'. This is *prima facie* evidence that this country – among several others – has had no ownership of the target it was committed to.

Ten years into the euro, it is time to realise that participation in a monetary union has significant implications for policy much beyond the observance of the explicit treaty rules.

THREE DIMENSIONS OF GOVERNANCE REFORM

These lessons suggest that the Van Rompuy Task Force should not limit itself to proposing the strengthening of existing provisions, but should address unresolved underlying tensions, and present strategic options for reform. The crisis has exposed fault lines in the governance of the euro area, and limiting reform ambitions to tinkering with the SGP would be widely seen as being symptomatic of a worrying inability to reform.

However, Europe's political situation is not favourable for fundamental reform. A few years after the failure of the constitutional project and the ensuing odyssey of the Lisbon treaty, and at a time when none of the EU's founding member states (except Luxembourg) show an appetite for further integration, the Monnet philosophy according to which *'l'Europe se fera dans les crises et elle sera la somme des solutions apportées à ces crises'*[8] applies partially at best. It is true that the Greek disaster of spring 2010 was an opportunity to invent a crisis-management regime that did not exist previously, but it is equally true that considerable resistance to such a move was demonstrated along the way. It is pure fantasy to imagine that the crisis provides an opportunity for making long-held federalist dreams into a reality.

A realistic reform agenda must therefore ditch long-held federalist dreams – such as a significant increase in the EU budget, significant horizontal transfers or a much tighter coordination of national economic policies – and attempt to reconcile the need for serious reform with the lack of political momentum.

On the basis of lessons learned, three dimensions of reform are worth highlighting.

1 What policy framework?

The crisis calls for a redefinition of the euro-area policy framework. As well as price stability, which is assigned to the European Central Bank, in its first ten years EMU has had budgetary discipline as its main objective. Another objective, the 'proper functioning of economic and monetary union', was mentioned in Article 121 (ex-99), but was ill-defined in the treaty and was not made operational through secondary legislation.

The European Commission has (rightly) indicated that macroeconomic surveillance should be expanded 'beyond the budgetary dimension to address other macroeconomic imbalances'

7. As observed by Mario Monti (2010), the twelve worse offenders as regards the delay for transposing directives are all members of the euro area.

8. Quote from Monnet's memoirs, quoted by Padoa-Schioppa (2010).

(European Commission, 2010). But this implies that EMU now has three economic objectives (in addition to the price stability objective):

- Budgetary discipline;
- Financial stability (which has emerged as paramount in the aftermath of the crisis); and
- The avoidance of macroeconomic imbalances.

This complicates significantly the policy framework for two reasons. First, these objectives are partially distinct and partially overlapping and are not defined with great precision. To take a concrete example, the EU in the 2000s could have told Spain that it needed to reel in its real estate credit boom because the boom involved budgetary risks, or because it was a threat to financial stability. But the EU could also have given Spain the green light on the budgetary front, considering that financial risks were sufficiently addressed by the Spanish supervisor, and focusing on the macroeconomic dimension.

Conceptually, it would be arguably sufficient to adopt financial stability as the overriding objective as both fiscal crises and crises stemming from macroeconomic imbalances ultimately result in financial instability. After all, the reason why the EU worries about budgetary or macroeconomic imbalances is because they represent a potential threat to financial stability.

This is however only true in the long run and experience – including in this crisis – shows that budgetary or macroeconomic imbalances can persist for a very long time before they ultimately lead to financial turmoil. Furthermore, defining financial stability as the overriding objective would not tell us much about how to proceed operationally. This is already an issue in defining the scope and instruments of the European Systemic Risk Board. Budgetary sustainability could arguably also be taken as the overriding objective. Indeed the emphasis on strengthening the SGP in the Task Force discussions suggests that this might be the road taken. However to be effective, such an approach would need to be very forward-looking and would need to encompass a variety of risks to the budgetary position – concretely to issue a warning even when the budgetary situation looks extremely sound. The experience with the implementation of a much cruder framework does not bode well for a one-objective approach of this sort. Operationally, therefore, it is preferable to retain three distinct objectives. But this implies a reformulation of the policy framework, so that assignments are clearly defined.

This leads to the second difficulty. If euro-area members are to meet three distinct objectives, they need three instruments. As argued above, and illustrated by the Spanish case (and also by the experience of countries with a currency board, such as Bulgaria), budgetary policy is clearly insufficient for the avoidance of macroeconomic imbalances. Supervisory instruments are also of limited effectiveness in a financial-integration context in which the responsibility for the stability of financial institutions belongs to the home country and the responsibility for the stability of the financial system belongs to the host country. This necessarily brings in another array of instruments which can be of a regulatory or a tax nature. Guidelines for wage formation may also be considered part of the required competitiveness monitoring tool kit.

These instruments however are currently considered by many, including member state governments, as being outside the EU scope and belonging at national level. Taking the reform of the policy framework seriously requires saying how wide the scope of coordination has to be and if it should involve the use of such instruments.

2 How much centralisation?

The attempt at enforcing budgetary discipline from the top in the first ten years of EMU has not been without impact but it has not been a great success either. Federal solutions implying a significant reallocation of budgetary responsibility to the EU level, or much tighter control from Brussels of national decisions, are politically unrealistic. In this situation the question arises of whether the EMU objectives, especially budgetary discipline, are more likely to be achieved in a more decentralised system.

President Van Rompuy[9] has indicated that priority will be given to strengthening top-down surveillance. The assessment of national budgetary plans by the European Commission and the Eurogroup before national parliamentary discussion starts, the introduction of sanctions that could start kicking in already before the three percent of GDP threshold is reached, and the increased emphasis on public debt in the excessive deficit procedure all go in this direction.

But it is perfectly possible to imagine an alternative scenario in which budgetary discipline would result from a combination of market forces and national-level institutional reforms. As Germany has now adopted a new budget rule and has started to act in accordance with it, and as markets benchmark the fiscal creditworthiness of each participating country against Germany, there is a new logic gaining momentum that could result in Germany again becoming the anchor, with other member states emulating its reforms. Several EU countries have introduced effective domestic budget rules; recent French announcements go in this direction. The UK also is overhauling its budgetary policy framework. Thus, in a way, policy competition has started to replace policy coordination as the engine for budgetary discipline.This is exactly what happened twenty years ago in the monetary field. The Exchange Rate Mechanism (ERM) of the then-European Monetary System was created in 1979 as a perfectly symmetric system with the ECU as its anchor. By the late 1980s it was increasingly evident that it had turned into an asymmetric system with the German mark at the centre. The question now is whether the SGP – today's anchor – will in the same way be superseded by a national anchor.

A move to a more asymmetric system can also be observed when considering the macroeconomic imbalances objective. In fact, as other euro-area members are bound to increasingly monitor their competitiveness relative to Germany, Germany could end up in the role of anchor for wage-setting.

It is a strategic choice for the EU if governance reforms should accompany and even encourage decentralisation by providing an umbrella framework for national rules and institutions, and by rewarding countries with better institutions or rules. There are strong economic and political-economy arguments in favour of such an approach, because decentralisation may be the best way to strengthen the ownership of policy rules.

Were this to happen, there would remain a significant but much-transformed role for the European institutions: the Commission and especially Eurostat would need to be equipped with enhanced capabilities for monitoring and evaluation, in order to ensure the comparability of national situations and to help disseminate good practices. They would also need to make the degree of intrusiveness of the monitoring dependent on the quality of national rules, procedures and institutions (thereby giving incentives to domestic reforms). These changes would admittedly represent a break with the past, and would require a long transition period.

3.Which reforms to ensure completeness of the policy regime?

A policy regime is a set of principles and rules the properties of which can be assessed from a logical standpoint. A particularly important property is completeness – ie how the policy regime behaves in different conditions and how *ex ante* incentives relate to *ex post* rules.

On public debts and deficits, the Maastricht regime

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9. See the remarks by Herman Van Rompuy following the second meeting of the task force on 7 June 2010.

was incomplete because it was entirely based on crisis prevention and had no room for crisis management and resolution. When the crisis hit, it was felt that to let a member country default was too risky, and there was no choice but to invent on the spot a crisis-management regime. With the creation of the European Financial Stability Facility (EFSF), the rules of the game of this crisis-management regime have been rather clearly spelled out, especially as they draw on the principles and procedures of the IMF. But this raises a new question, which is how to redefine the relationship between *ex ante* surveillance and *ex post* crisis resolution. On this, the IMF has no answer.

As regards debt crises, it is hardly imaginable to return to the previous regime. Therefore, a full crisis-resolution regime needs to be defined, which sets out in detail the principles and modalities of assistance, debt restructuring and possibly exit. If exit is (sensibly) ruled out because of its potential spillover effects, then this only strengthens the case, as proposed by Germany (Federal Ministry of Finance, 2010), for defining the debt-resolution regime. As the EU is a community of law, there is a strong case for establishing rules and procedures for a statutory European Debt Resolution Mechanism. Current reluctance to create expectations of an imminent default should not be an excuse for refusing to work out the principles on which EMU reform needs to be based. Half measures now would only perpetuate the incomplete character of the system.

The definition of a crisis-resolution regime would make room for innovative crisis-prevention solutions, such as the proposal of Jacques Delpla and Jakob von Weizsäcker (2010), who suggest creating a dual bond market, distinguishing for each country between 'blue debt' amounting to 60 percent of GDP at most, for which participant countries would have joint and several responsibility, and 'red debt' above the 60 percent threshold, for which each country would be individually responsible and on which partial default would be possible. Such a scheme would give markets a greater incentive to price default risk fully at the margin.

CONCLUSIONS

Discussions on euro-area governance have been going on at least since the first negotiations on the creation of the euro. They have not been settled because of ambiguities in the positions of the key participating countries, especially France and Germany, and because of ambiguities in the compromises they have reached (Pisani-Ferry, 2005). But something new has happened. As Keynes reportedly asked, 'When the facts change, I change my mind. What do you do?' This crisis is indeed an opportunity for clarification. In order not to waste it, the Van Rompuy Task Force and the European Council should resist the temptation to patch up divergences and tinker with the existing policy framework. Rather, they should take the opportunity to address fundamental questions about the operational principles upon which EMU is based.

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