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The van Rompuy reforms: Type 1 and type 2 errors and one small bright spot
Waltraud Schelkle (LSE) and Deborah Mabbett (Birkbeck, University of London)

In our contribution to the Intereconomics forum on 'Challenges Facing European Monetary Union' earlier this year, we argued that the euro area needed a stabilisation fund that would provide some positive incentives for sound macroeconomic management as well as some insurance against tides of adverse sentiment in the markets, which we saw as procyclical and likely to intensify problems of macroeconomic stabilisation. We were also critical of the ECB for relying on the ratings agencies to tell it which government bonds to accept on what terms. This, we argued, was an abdication of the ECB's responsibility to contribute to euro area stabilisation.

The van Rompuy Task Force has not addressed the issue of positive incentives at all, but instead has returned to the disciplinarian language of the original Stability and Growth Pact (SGP). In this contribution, we explain why we think its approach is flawed. Not only are the proposed sanctions likely to heighten political tensions, but also the assessments on which they are based are likely to convict some governments of crimes they have not committed, while allowing others to pursue policies that worsen the euro area's growth prospects. We then take another look at the curious politics of the ECB. The crisis has seen the boundaries between monetary and fiscal policy crossed in several member states: most strikingly in Ireland. As a result, the ECB has been dragged into country-specific measures. We suggest that this will be a permanent feature of its life from now on, and it needs to find ways to use its influence constructively. Finally, we turn to the debate over the crisis resolution mechanism (CRM) and argue for once in defence of the German position. Requiring creditors to take a haircut when a country has recourse to the CRM could actually mean that the markets finally come to provide timely signals to governments that are pursuing unsustainable policies.

The errors in the proposed SGP reforms

The Task Force solemnly proposes a return to the disciplinarian approach that prevailed before 2005. The Task Force wants more and earlier sanctions, namely for an excessive deficit, debt, and imbalances. The new decision mechanism in the Council also makes it more likely that such sanctions will be imposed, as it no longer requires a qualified majority to confirm the recommendation by the Commission but a qualified majority to reject it (a so-called reverse majority). In the future, sanctions may be extended to non-Euro area members although they will not have to pay a fine but may not receive certain funds from the EU budget (Task Force 2010: para 18). No doubt many small dramas will be enacted under these rules. They will do nothing to remedy the economic problems of the euro area and they will also harm the popular legitimacy of the Commission, which will be clearly responsible, as never before, for punitive actions towards member states.

For the drafters of the original SGP, irresponsible governments were the most important potential source of macroeconomic instability, and fiscal deficits and debt were the key data to be monitored if the euro area was to thrive. We now know that this led to what statisticians call Type 2 errors. Fiscal monitoring did not reveal the threats to macroeconomic stability that were bubbling up as the peripheral euro area countries enjoyed the effects of low interest rates. Spain, for example, performed

adequately on the fiscal criteria, whereas stresses might have been identified if macroeconomic monitoring had paid more attention to private debt and current account imbalances. Conversely, fiscal monitoring could lead to type 1 errors or finding a problem where there was not one. Belgium, a persistently poor fiscal performer, provides the leading example of that: it has a solid current account surplus and, before the crisis, managed to use lower euro interest rates to reduce its debt level slowly but surely.

Thus the Task Force is right to propose to monitor the 'excessive imbalances position' of member states (Task Force 2010: para 37). The list of indicators for such excessive imbalances has not been drawn up yet but the report mentions '[c]onsumption developments, housing bubbles[,] the accumulation of external and internal debt' and 'divergences in competitiveness' (Task Force 2010: para 32). So it seems that a lesson has been learned. But the disciplinarian fervour is yet again prone to rely on irrelevant evidence, thereby convicting governments of failures of macroeconomic management when they are not, in any meaningful sense, guilty.

The most striking source of potential type 1 errors is the suggestion that competitiveness should be monitored. Macroeconomic monitoring should be concerned with indicators that can be tackled with macroeconomic policies. Unit labour costs (the proposed measure of competitiveness) are a composite indicator of nominal wage developments and the evolution of employment (hours worked) relative to output. Governments could intervene to manipulate this measure but it is far from clear that they should and that they even can in any predictable way. In the capitalist market economies of the euro area, it is for firms and wage bargainers to determine these variables in the course of searching for profitable business and employment strategies, through their negotiations over wages and working time.

The Task Force proposes monitoring 'imbalances', but it is clear that it really means 'deficits'. Member states with large and persistent current-account surpluses are mentioned only once, in para 33, where it is suggested that their 'policies should aim to identify and implement the structural reforms that help strengthening their domestic demand and growth potential.' One cannot but wonder what these structural reforms might be: the demolition of the model of export-oriented growth and accompanying wage restraint that is apparently so deeply institutionalised in Germany, the Netherlands and Austria, perhaps? Seriously, structural reforms are an unreliable way to boost domestic demand and will actually make the problem of imbalances harder. The tax cuts that liberal-conservative governments in Germany and the Netherlands favour might do the trick, and perhaps more spending on social services would not go amiss. But of course this cannot be said, because the official EU line is to preach the doctrine of universal fiscal consolidation, for everybody to read in the Commission's assessments of stability and convergence programmes. This advice may be right for any one country looked at in isolation but it is not constructive advice against the background of large macroeconomic imbalances within the Euro area.

It would be much better to convince the governments of surplus countries that it is in their own interest to allow the debtors repay instead of competing them into the abyss. The surplus countries' banks and pension funds would then be on the line as well, since they hold a good share of the sovereign debt. To suppose that the surpluses of one group of countries are caused by good fiscal policy and the deficits of the other

group are due to bad fiscal policy is to commit both type 2 and type 1 errors at the same time. The surplus countries are deemed innocent of responsibility; the deficit countries found guilty. This is an achievement of sorts, as statisticians tell us that the occurrence of these errors normally varies inversely.

The ECB's role in the crisis saga

The monitoring of current account positions will reveal that fiscal authorities are not the only force behind unsustainable imbalances. Attention will shift to the growth of private debt and booms in bank lending on the back of housing bubbles. As economists noted long before the crisis, national governments in the Euro area have only fiscal instruments to deal with these problems. Tax policies can certainly have an impact on how attractive it is to incur mortgage debt; property taxes or windfall gains taxes on housing transactions could also help to restrain bubbles. But it is now clear that action should also be taken by monetary authorities. Macroeconomic stability is a monetary as well as a fiscal task. Paul De Grauwe (2010) has recently proposed that the ECB should accept its responsibility for asset market bubbles and impose, for instance, country-specific minimum reserve requirements on resident banks. Of course, the ECB will resist the use of country-specific assessments and instruments rather than general interest rate policy, as this will expose it to a much higher level of political debate.

One lesson of the financial crisis is that not just governments but also banks can pursue unsustainable strategies. The model of governance of the euro area, by contrast, was based on the assumption that member states' commercial banks were all equally sound institutions, managed according to common banking principles. We now know that national differences in banking regulation can have a profound impact on euro area stability. Regulators could monitor the strategies by which banks are increasing their leverage, restrain the erosion of loan-to-value ratios and control the spread of securitisation. They could also rein in loans to housing and construction that are based on overvalued collateral.

The ECB is already pursuing country-specific policies. This became apparent in a rather peculiar way when the ECB chose to settle unease about Greece's declining credit rating by announcing its continued willingness to purchase Greek bonds as part of its own version of quantitative easing. Now, the Irish crisis has revealed another role, as it has become clear that ECB loans are supporting the Irish banking system to a much greater extent than in any other country. So long as the imperative of maintaining liquidity reigned, this was just a small wrinkle on the ECB's generally expansionary stance. But with recovery now underway in the heart of Europe, the ECB will want to rein in its asset purchases and lending.

The deliberations of the van Rompuy Task Force, with its huffing and puffing about fiscal discipline, are strikingly orthogonal to the Irish problem. The Irish government cannot be accused of profligacy in regular government spending; if anything, the government has sent the economy into a downward spiral thanks to its pro-cyclical austerity programme. Until recently, markets praised the Irish government for doing all the things that the Greek government should do. The crucial step that Ireland took towards insolvency was to turn bank debts into sovereign debts, by promising to guarantee the position of bank creditors. While tough on public sector workers and

benefit recipients, the government has been lenient towards its political cronies in the banking and building sectors.

The crisis makes it clear now that the Irish government must make creditors share the losses of insolvent banks, or the resulting burden on Irish taxpayers will burden the economy for years. Such burden-sharing is arguably what the Commission has tried to do by forcing Ireland to turn to the European Financial Stabilisation Facility (EFSF) and the IMF. This intervention saw officials from outside Ireland trying to impose a solution in the interests of taxpayers rather than the political elite, which is naturally devoted to its 'sovereignty'.

A standby agreement would also end the present situation where the ECB is abused as a printing press to prop up the Irish banking system. It is a bitter irony and a damning verdict on the past strategy that this humiliation is inflicted upon the proudly independent central bank by a member state which accepts that its sovereignty is ceded to market forces rather than shared with the union of which it is a member. Like the ECB, the Irish government prefers to let its actions be dictated by the markets rather than take advice from other political authorities.

Crisis resolution

The one bright spot in these depressing stories is the possibility of a crisis resolution mechanism, not contained in the Task Force report but apparently under preparation on the request of the French and German governments. This mechanism provides an opportunity to correct the process whereby the financial markets create debt crises which member states can only calm by offering assurances of no default. The German vision is that the crisis resolution mechanism will see haircuts imposed on the national debt of member states that enter it. This should ensure that markets price in the risks of debt being discounted at a much earlier stage than they do now. If markets correctly assessed risk, countries pursuing irresponsible fiscal policies should find themselves facing an interest rate premium: a more salient and effective deterrent than any excessive deficit procedure.

The SGP as it stands prevents rather than supports this deterrent from operating. Intrusive fiscal surveillance inevitably declares budgetary policies to be a common responsibility and however much Commission and Council insist on the no-bailout clause, the markets see the common responsibility – why else would members accept the intrusion? At the same time, there is no fiscal substance behind this common responsibility, no central budget that could protect a government from being forced to austerity when the economy is already in the doldrums.

But it would be preferable and in our view even more effective if the markets would impose the haircuts on themselves. This calls for some innovation in public debt management. But then these unusual times are the right times for making the case for unorthodox measures, as monetary authorities have taught us. Robert Shiller (2005) has proposed to link returns on public debt to GDP growth. Bulgaria has already experimented with such bond issue. It would mean that if bond markets drive an economy into recession, the burden of servicing the public debt would fall as well. This would make for a smoother pricing in of evolving risks to which countries can adjust instead of being pushed into crisis and towards default. Such a mechanism is

not a silver bullet but would help to suppress the destabilizing dynamic of high interest rates and low growth.

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