

Euro Area Governance: What went wrong? How to repair it?¹

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The reform of euro area governance has been chosen by the heads of state and government in the EU as a topic for immediate discussion and swift decisions.²

Any serious discussion on it must start from an analysis of what went wrong. The superficial analysis is that rules is that the crisis in Greece and elsewhere resulted from a failure of implementation of the existing disciplines. There is undoubtedly truth in this analysis.

However the crisis also reveals deeper flaws in the governance regime, 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 generally shallow.

If this view is correct, key choices for the euro area are (a) to reformulate the economic policy framework, (b) to decide on the degree of decentralisation that is desirable, and (c) to determine which reforms are needed to ensure completeness of the policy regime.

¹ Earlier versions of this paper were presented at the Brussels Economic Forum, at an OBCE/Bank of Spain Madrid panel and at a Madariaga Brussels seminar. I thank my Bruegel colleagues for comments and criticisms.

² 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.

A. 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 view: Greece in the last decade defied the most basic provisions of the European budgetary framework – and even a fundamental tenet of membership in the EU - namely trustworthiness; several member states, some of which find themselves in difficulty, have constantly flouted EU budgetary principles; the EU had the legal means to tell Spain and Ireland that the course they were on was endangering their own stability and the stability of the euro area, but did not use them; 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 should address is purely one of enforcement and strengthening of the existing EMU provisions. Indeed indications given by President Van Rompuy suggest that this is, at least in part, the direction taken by the discussions.³

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

B. 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 indicated that the system in place for monitoring public finance developments does not work. From 2000 to 2008 the budget deficit notified to the EU in spring of the following year was on average 2.9% of GDP. In fact it has been revealed to be 5.1% on the basis of revised data⁴. A monitoring system that provides so inaccurate estimates for so long is in need for fundamental repair.

The reasons for this failure are several. Two key ones are certainly that the statistical office was under the control of the government and that Eurostat was not given by the 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 controlled. For a government, it has a very different purpose than national accounts whose role is to record economic activity. Yet for reasons of comparability the whole EU budget monitoring system is based on

³ See the Remarks by Herman Van Rompuy following the second meeting of the task force on 7 June 2010.

⁴ See detailed data in Marzinotto, Pisani-Ferry and Sapir (2010).

the accounts prepared by the statistical office. The relationship to the actual budgets for the various entities that compose general government is often loose and this has been creating problems from the very beginning.

Furthermore the monitoring of budgetary situations within the framework of the 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 EU budgetary surveillance on shaky foundations.⁵

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 2% of GDP budget surplus to an 11% deficit, and Ireland from a balanced budget to a 14% of GDP deficit, while in the same period its debt jumped from 25% to 64% of GDP. Only a minor 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 questions the very basis upon which budgetary surveillance was based, 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 requesting lower public debt ratios from 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% to 3.5% 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 the estimation of the structural deficit 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.

⁵ For example the Commission estimate of the 2007 structural balance has changed from a 2.1% of GDP deficit in spring 2007 to a 3.7% deficit in spring 2010. For Ireland it has changed from a 1.8% surplus to a 1.6% deficit.

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 may 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. So the lessons to be drawn are both 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 was actually already pointed out by the Commission in 2008 (European Commission, 2008).

To be fair, the ‘it’s all fiscal’ assumption is nowhere explicit in the treaty. On the contrary Art. 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 softer than the fiscal one based on Art. 126. Not only are the legal provisions weaker, but over the first ten years of the euro they have not really been used⁶. The Broad Economic Policy Guidelines that were supposed to be the backbone of coordination have been consistently ignored by national policymakers; and 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 operationalise 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 defining benchmarks and thresholds for the surveillance of external imbalances and/or real exchange rate developments is a significant intellectual challenge⁷.

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 (Art. 125). Art. 143 which limits the benefits of macro-financial assistance to EU countries not belonging to the euro area was not intended to prohibit assistance to those participating in the single currency, it was only the result of the view that the members of the monetary union would not need balance-of-payments assistance anymore (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.

⁶ An 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.

⁷ Marzinotto, Pisani-Ferry and Sapir (2010) elaborate on this point.

No-assistance was furthermore not credible in the first place 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 it has been replaced by another ambiguity: 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 ECB decision in May 2010 to embark on a government bond purchase programme, which creates a risk for the central bank to be trapped. As long as this ambiguity persists there will be room for speculation as regards the nature of the solution to insolvency cases.

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 as 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 clarifying the treatment of insolvency.

- 5. Policy coherence is often lacking and ownership of the euro rules is generally shallow.** At the end of the day the success of the euro depends on an (implicit) commitment to run policies that are consistent with membership in the monetary union and on ownership of the (explicit) principles and rules underpinning EMU. This primarily involves governments but also private agents.

Coherence has often been missing since the start of the euro. Most governments after 1999 considered that management of the euro area could be delegated to central bankers and ministers of finance but did not imply any significant change in most domestic policies. Very few countries (Finland was an exception) bothered discussing whether participation in a monetary union also had implications for wage-setting. Several thought they could reject further integration of product markets, let alone labour markets⁸.

Ownership of the rules has remained very uneven and generally shallow. To take only one example, from 1997 (when the country qualified) to 2007 the government balance in France fluctuated between a 1.5% of GDP deficit and a 4.1% deficit whereas the SGP's stated target is that it should have been 'close to balance or in

⁸ As observed by Mario Monti (2010), the twelve worse offenders as regards the delay for transposing directives are all members of the euro area.

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.

C. Three dimensions of governance reform

These lessons indicate that problems run deeper than an enforcement issue, which suggests that the Van Rompuy Task Force should not limit itself to proposing the strengthening of existing provisions, but address unresolved underlying tensions, and present strategic options for reform. As the crisis has exposed fault lines in the governance of the euro area, to limit reform ambitions to a tinkering with the SGP would be widely regarded as indicative of a worrying inability to reform.

However the political situation in Europe is not auspicious to fundamental reforms. A few years after the failure of the constitutional project and the ensuing odyssey of the Lisbon treaty, and at a time where none of the founding member states of the EU (but Luxembourg) shows 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*"⁹ applies partially at best. It is true that the Greek disaster of spring 2010 was the occasion to invent a crisis management regime that did not exist previously but it is equally true that considerable reluctance to such a move was demonstrated along the way. To imagine that the crisis provides an opportunity for making long-held federalist dreams a reality is pure fantasy.

A realistic reform agenda must therefore ditch long-held federalist dreams – such as a significant increase of the EU budget, significant horizontal transfers or a much tighter coordination of national economic policies – and attempt at reconciling the need for serious reforms and 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. Besides price stability, which is assigned to the ECB, 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 Art. 121 (ex-99) but it was ill-defined in the treaty and was not made operational through secondary legislation.

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

⁹ Quote from Monnet's memoirs, quoted by Padoa-Schioppa (2010).

imbalances' (European Commission, 2010). But this implies that there are now three economic objectives in EMU (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 the policy framework significantly, 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 tame its real estate credit boom because this boom involved budgetary risks; or because it was a threat to financial stability. But it could also have given it green light on the budgetary front, considered that financial risks were sufficiently addressed by the Spanish supervisor, and focus on the macroeconomic dimension.

Conceptually, it would arguably be 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 may worry 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 go on for a very long time before they ultimately result in a financial turmoil. Furthermore, defining financial stability as the overriding objective would not tell much on how to proceed operationally. This is in fact 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 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 of 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 member states in the euro area 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 in 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 where 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 toolkit.

These instruments however are currently considered by many as outside the scope of European belonging to the national remit. Taking the reform of the policy framework seriously requires saying how wide the scope of coordination has to be and whether 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 responsibilities to the EU level or a much tighter control of national decisions from Brussels are politically unrealistic. In this situation the question arises whether the EMU objectives, especially budgetary discipline, have a better probability of being achieved in a more decentralised system.

According to indications given by President Van Rompuy¹⁰, priority is currently given to strengthening surveillance from the top. The assessment of national budgetary plans by the European Commission and the Eurogroup before parliamentary discussion starts, the introduction of sanctions that could start kicking in already before the 3% 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 where budgetary discipline would result from a combination of institutional reforms at domestic level and market forces. 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 becoming the anchor again and the other member states emulating its institutional reforms. Several EU member states have introduced effective domestic budget rules and recent French announcements go in this direction. The UK also is overhauling its budgetary policy framework. In a way policy competition has started to replace policy coordination as the engine for budgetary discipline.

¹⁰ See the Remarks by Herman Van Rompuy following the second meeting of the task force on 7 June 2010.

Indeed this is exactly what happened twenty years ago in the monetary field. The EMS had been created in 1979 as a perfectly symmetric system with the ECU as a collective 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 collective anchor – will in the same way be superseded by a national anchor.

A move to a more asymmetric system could also be observed as regards the macroeconomic imbalances objective. In fact, as other euro area members are bound to increasingly monitor their relative competitiveness vis-à-vis Germany, this could result in giving Germany the role of an anchor for wage-setting.

Whether governance reforms should accompany and even encourage decentralisation through providing an umbrella framework for national rules and institutions and through rewarding countries with better institutions or rules is a strategic choice for the EU. 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.

If this were to happen, there would remain a significant role for the European institutions, but a much-transformed one: 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 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 require a long transition.

- 3. Which reforms to ensure completeness of the policy regime?** A policy regime is a set of principles and rules whose properties can be assessed from a logical standpoint. A particularly important property is completeness – i.e. how the regime behaves in various states of nature and how ex-ante incentives relate to ex-post rules.

As regards public debts and deficits the Maastricht regime was incomplete because it was entirely based on crisis prevention and made no room for crisis management and resolution. When the crisis hit it was felt that to let a member country default was too risky an option 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 are by now 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, whereby the principles and modalities of assistance, debt restructuring and possibly exit are set out in detail. If exit is (sensibly) ruled out because of its potential spillover effects, then this only strengthens the case for defining the debt resolution regime as proposed by Germany (Federal Ministry of Finance, 2010). As the EU is a community of law there is a strong case for establishing rules and *modus operandi* for a statutory European Debt Resolution Mechanism. Current reluctance to create expectations of an imminent default should not serve as an excuse for refusing to work out the whole set of principles upon which EMU reform needs to be based. Half measures now would only perpetuate the incomplete character of the system.

Having defined a crisis resolution regime would make room for innovative crisis prevention solutions such as the one proposed by Jacques Delpla and Jakob von Weizsäcker (2010), who suggest to create a dual bond market distinguishing for each country between a 'Blue Debt' amounting to 60% of GDP at most, on which participant countries would have joint and several responsibility, and a 'Red Debt' above the 60% threshold, for which each country would be individually responsible and on which partial default would be possible. Such a scheme would give markets a stronger incentive to price default risk fully at the margin.

D. 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 the ambiguities in the positions of the key participating countries, especially Germany and France, and the ambiguities in the compromises they had 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 limit ambitions to tinkering with the existing policy framework. Rather, they should take the opportunities offered to address fundamental questions about the operational principles upon which EMU is based.

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