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Eurozone Governance for the European People: Towards a path to sustained prosperity

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Nothing seems to beat the malaise surrounding euro area governance. For some, no amount of institutional engineering seems to be 'enough'. The question is how to produce *more* binding rules, how to make sure that hands are tied and discipline imposed. For others, there are 'too many' rules and institutions, far more complex than warranted and far more intrusive than shared sovereignty would require. The mixed economic landscape merely serves to invite subjective and inconsistent readings. Growth rates are picking up yet they remain below pre-crisis levels; worse, they are rather disappointing by international standards, particularly given the boost from cheap energy prices and the ECB's QE programme.

Why it is that Eurozone governance has not arrived at a state of acceptable equilibrium? 'Acceptable' in the sense of delivering the goods and of having the legitimating stamp of both centre and periphery. Is it a problem of vision? Eurozone elites appear to have made peace with the absence of vision. Muddling through, albeit of the process and rules-based kind has become the preferred modus operandi, endorsed by the problem-solving approach of German leadership. Leadership, by the way, requires an entity to lead and the reality of the matter is that the Eurozone is fragmented: it is fragmented financially, as companies in different regions pay different interest rates and operate under different tax frameworks; this affects their competitiveness, their reach in the European markets and beyond, the capacity of their economies to 'catch-up'. It is fragmented economically, as national institutional frameworks affect the rebalancing of many economies and as unemployment rates diverge along a clear core-periphery axis, effectively undermining the long-term survival of the Eurozone as a whole. It is fragmented politically. The typical elite approach, of wanting to deepen the process of integration while protecting and respecting national strategic interests, is almost no longer relevant. A process of delegitimisation has taken hold, closely associated with a growing disillusionment over the benefits of 'belonging'. This cuts across the left and right spectrum, across debtors and creditors, fuelling a generic anti-system sentiment against the 'establishment'. As piling up on rules and institutions produces the same skewed outcomes, unequally distributed across sectors and regions, governance is hit with even more delegitimisation and with increasing levels of falling trust.

Improving Euro area governance: the Five Presidents' Take

The recently published Five Presidents' Report, 'Completing Europe's Economic and Monetary Union' takes thinking about better economic governance to the next level. It shapes the big picture and offers a stage-based approach. More importantly, it abandons the naïve assumption, implicit in many analyses, that Eurozone governance should do *all the work*. It *is* a leap to faith, with its long-term plan of completing the EMU architecture via an Economic, Financial, and Fiscal Union; it is, nevertheless, a rationalized one. There is a sequence of steps, a timetable, a 'clear sense of direction' and measures for concrete action.

Rationality of this kind however does not necessarily pay off. An(other) opportunity has been missed. Take, for example, the concept of a 'fiscal stabilization function', central to the fiscal union envisaged and dependent on the convergence towards similarly resilient national economic structures. This shirks the main issue, the permanent cross-border transfers that would offer respite to countries in need, or those with limited capacity and even less time to improve their governance. Assuaging the moral hazard concerns of creditor countries will not take the proposed function far. It will just signal that in the fiscal union to be set up a member state would still be expected to go it alone.

Another 'condition' for tapping aid is compliance with fiscal rules and a common fiscal framework. This continues the charade that fiscal rules have become set in stone. In reality, "these rules are economically questionable and practically impossible to implement"[1]. Worse, as they are not applied even-handedly, an element of arbitrariness has become entrenched, and the results are questionable at best. Reinforcing the current direction is akin to perpetuating unequal outcomes and unequal opportunities- some are given fiscal space to match their needs and others are not.

The best bet for everyone involved is to complete the banking union. This would create a successful precedent and generate sufficient goodwill to overcome one of the main obstacles when thinking about eurozone governance: there are too many sticks and very few carrots. The proposal for a bridge financing mechanism, for example, in case a bank needs to be unwound prior to the Single Resolution Fund becoming operational (1 January 2016), 'answers' the recurring criticism that the Single Resolution Fund is too small and the process of building it up too drawn out, given the current state of many European banks. There is even the thought of establishing a credible common backstop to the SRF, to be implemented via a credit line from the European Stability Mechanism (ESM). Public assistance, however, is to be recouped by means of ex post levies on the financial industry. This does little to decouple banks from their sovereign, as financial markets have re-nationalised to a great extent. Eurozone elites appear to be 'blind' to the continuing disruptive presence of the loop. They choose to ignore the need to devise truly European, all-encompassing mechanisms. What seems to prevail is what has not

[1] Wolff, Guntram B. 'Euro Area Governance: an assessment of the "five presidents" report', Bruegel, 25 June 2015

worked: the all-pervasive logic of moral hazard, in the way it has been propagated by creditors and in the face of a significant reversal of financial integration (in the interbank market, in cross-border banking activity, and in the renationalisation of bond holdings).

'Fixing' Governance by Switching Framework

This 'path-dependent' thinking, gloriously re-affirmed in the Report, is highly unlikely to result in the kind of economic governance that strikes an acceptable balance between the need to make the single currency *work for all* and the imperative to respect the diversity of preferences in and among the electorates of Euro area member states. This is no easy task. There must be a switch of framework: the source of Eurozone's vulnerability has shifted, from markets to politics; 'fixing' it cannot take place in a political vacuum. The reform of economic governance can, therefore, no longer be framed in the context of 'supporting' this imperfect union. This will merely serve to render it a worse than imperfect union, while trumping national cultures and national democratic traditions, in the pursuit of a Don Quixotic kind of 'stability'.

To switch framework, or at least, integrate new modes of thinking when considering tools and rules, three conditions should apply:

a) Creating incentives. The logic of sanctions has failed. Firstly, sanctions have failed in their supposed prevention function. Secondly, sanctions have failed to deliver. Thirdly, they have failed the criterion of equality of treatment, which should be central to the operation of a union of equal members.
b) Sharing the costs of belonging. This is not an invitation for the weaker members to free-ride on the efforts of others. It is about recognizing differences in national economic models and creating national opportunities for growth. It is also about re-balancing. If some countries' imbalances go 'unpunished', while others countries have to undergo severe devaluations, then some members are more equals than others.
c) Bringing the people back in. The political legitimacy and long-term viability of the monetary union will not depend on its members being 'constrained' to emulate 'best practices' (i.e. Germany's export-led economic model) by adhering to 'new rules' and by being 'compensated' for their efforts by handsome investment packages. It will depend on whether economic governance can deliver growth, investment and employment for the European people while respecting national procedures for economic policy formation and without interfering with national ideals and values.

Eurozone elites have underestimated the extent to which many Europeans believe that their country's economic policies no longer reflect their national and personal priorities. This is a belief that goes much deeper than having an opinion on whether austerity is 'good or bad'. It is more of a fear of living in permanent insecurity, of surviving on ever-increasing cuts in nominal wages and pensions, of accepting ever-growing rates of unemployment. It will therefore not simply go away if austerity policies or fiscal orthodoxy policies are seen to be 'working', that is, if economic figures show some improvement. Equally, Eurozone elites have underestimated how this feeling is (and will be) systematically manipulated by extreme parties, across and within member states. Anti-European sentiment, including skepticism, is (and will be) on the rise wherever the sacrifices required to remain in the monetary union are experienced as too big and the adjustments as too heavy or unequally distributed, whenever this feeling of pervasive insecurity raises it head. What makes the current 'equilibrium' worse is that this is a union with no credible narrative on how to create a path for shared and sustainable prosperity.

If the single currency is to survive, however, economic governance should be about restoring a sense of security and about creating a path for prosperity. It should be about three things, flexibility, creativity, and innovation. It should aim at creating an 'open system' with its parts being allowed to 'breathe', rather than a claustrophobic set of constraints, leading to economic, political, and ideological stagnation. Common rules continue to have a central role to play. The difference is that they acquire an in-built capacity to adjust. In this way, participating members have a stake in making them work.

The approach should be piecemeal, yet systematic. The point is to create a virtuous circle, each cycle (of reforms) having a positive effect on the next, each cycle creating positive results to be 'exploited' for the creation of yet another cycle, generating a virtuous cycle at system level. This is an approach that takes into serious consideration two structural 'impediments': a) institution, rule, or governance building can no longer proceed independently of 'conditions on the ground'. Domestic politics and national economic performance rule governance perspectives, b) the political capital to pursue another round of institutional engineering that is incomprehensive, complex, and considered (or interpreted as) a burden on national sovereignty is scarce. It should therefore be used to maximum impact, going to great lengths to minimise collateral damage.

Banking Union

It is all about providing a real *European* backstop to the single resolution fund and a real *European* system of deposit insurance- most analysts concede that point and the Five Presidents appear eager to see its creation brought forward. There is, really, no other alternative if the doom loop between banks and sovereigns is to be broken. Why is it then that the political will is lacking? Is it merely about moral hazard or is it about maintaining a status quo, whereby parts of the European banking sector continue to be held back? If anything, the Greek case indicates that sovereign weakness will adversely affect the domestic banking system, even if the latter is under ECB supervision or supported by ELA funding. Some will rush to retort that Greece is a unique case. Sovereign debt held by banks in the periphery is on the rise however in the last couple of years, a fact which suggests that the contagion effect is ever-present, even if quietly lurking beneath the surface.

- There is more to consider. A credible commitment to create a European policy framework would go a long way towards reducing uncertainty, restoring 'normal' bank lending where most needed, and, particularly in the periphery, easing the process of deleveraging in both the public and private sectors and addressing the lack of affordable finance. Unequal access to finance for firms and households enables some in the euro area to thrive and others to wither and decline. This perpetuates divergences in economic growth and unemployment levels and, in the medium-term, it is not sustainable.

- Eurozone elites and creditor countries must shift their focus from moral hazard to system stability. This should involve the prompt and full implementation of the Single Resolution Mechanism, and a common deposit insurance scheme, well ahead of schedule. The funding should come directly from the ESM, following a "whatever it takes" logic. 'Unifying' bank supervision, bank resolution and single deposit insurance will rebuild Europeans' confidence in banks and restore the idea that banks are there to support their economic well-being and the growth of their national economies.

Fiscal Union

The idea of 'sanctions', inbuilt in institutions and rules created at Euro-wide level to wield national fiscal discipline and advance policy co-ordination, has produced meager results. It has also served to discredit, to an extent, the role that rules *can* play. Switching framework would mean introducing incentives: allowing national governments to recapture vital fiscal space, and 'reward' them with degrees of freedom to finance growth-enhancing investment and/or proceed with structural adjustment, without prejudicing the long-run sustainability of their country's fiscal position.

- End the variable application of fiscal rules. Introduce a rules-based flexibility, whereby governments retain their sovereign capacity to review the tax and spending regimes in the context of the economic and development interests of their country. The principle should be simple, 'this much degree of flexibility' for 'this type of reform'. This stops the silly game of de facto asking for extensions of previously granted extensions to 'comply' and lifts the poisonous suspicion of preferential treatment; it also makes the entire procedure far more transparent and credible, adding a modicum of legitimacy to the monitoring role of, for example, the Commission. There is an ex ante agreement that there are conditions attached, including the requirement that any expenditure increase or revenue loss must be offset, in the context of medium-term budgeting frameworks, by spending cuts or revenue increases. To prevent the risk of an erosion of the credibility of the EU fiscal framework (ironically, this has already been hit by the way participating members 'abide' by it), structural adjustment and growth-enhancing strategies must be well specified, duly communicated and implemented in a timely manner in order to maintain or enhance confidence in a country's long-term fiscal sustainability. It goes without saying that the more national parliaments become involved in national monitoring and national enforcement, the more European-level monitoring and auditing becomes democratically 'palatable'.

It is ludicrous to insist on fiscal constraints, to place participating members in a fiscal straightjacket, without offering an institutional counterweight, a deepening of fiscal integration. Structured with appropriate conditionality, a centralized budget/stabilization function could be built up to help countries adjust to economic shocks or to provide funds to tide them over as they proceed with politically costly overhauls.

- Introduce a mechanism of fiscal transfers to align national fiscal needs with having one currency and one interest rate. No amount of constraining and/or coordinating can fix that. Weaker economies cannot be expect to go it alone while addressing long-standing competitiveness problems (exacerbated by belonging in a union, where huge current account surpluses are left intact) or grappling with the negative impact that structural reforms have on nominal spending. Before anyone cries (yet again) 'moral hazard', it is perhaps best to consider the misery of sinking further in a debt trap, of having close to zero prospects for business investment to recover, of high unemployment becoming (more) entrenched and destroying future economic capacity.
- There are caveats of course: a) creating clear and transparent rules for the transfer of resources, agreed ex ante; b) raising funds for the fiscal capacity in the markets, via a diversified strategy, using a variety of instruments and maturities to ensure the efficiency of funding and continuous market access, c) linking transfers to quantifiable progress in economic performance and competitiveness within a jointly agreed time horizon. In this context, conditionality does not set punishing conditions in exchange for 'aid' but creates the incentives for macroeconomic stability, distributional equity, allocative efficiency and competitive public services delivery. Co-ordination and the creation of the 'appropriate' fiscal stance for the entire euro area will not materialise until all participating members of the union accept that their economies *remain* different and that competent procedures for public risk sharing must be put in place.

Economic Union

When thinking about convergence, jobs, and growth, too much attention has been paid to the Euro area level- with the proposed creation of Competitiveness Authorities to watch over national councils, a tougher implementation of the Macroeconomic Imbalance Procedure or a stronger co-ordination drive via a revamped European Semester. This is akin to turning a blind eye to the real problem: convergence or lack of begins at home, where the structural and institutional set-ups of participating countries play out.

- Productivity convergence holds one of the keys to real convergence, so a good starting point should be to come up with the country-specific structural determinants of productivity growth and then to formulate a national plan on how best to create or upgrade them. Eurozone institutions can play both a supportive -cash for reforms- and supervisory role, as national authorities proceed with the formulation of policies in three areas: improving the quality of labour, improving the quality of capital, improving the business environment.

- National ownership of real convergence means that political leaders understand the interdependence of structural and cyclical policies. ‘Structural adjustment’ may have become a catch-all, occasionally ‘empty’ policy term, but determined implementation can increase potential output and the resilience of the economy to shocks. A lot depends on the type of reforms promoted and whether they are perceived to be credible[2]- by agents who will have to adjust their behaviour, by firms and households who will have to adjust their expectations, and by the markets.
- Common governance of structural reforms can potentially offer a bird’s eye view and a checklist of whether the entire system moves to the ‘right’ direction. It still raises serious questions of legitimacy: who is to decide on the reforms, who is to determine the pace, who is to compare outcomes to targets? The best strategy is to begin with structural heterogeneity as a defining feature of the Union’s national economies and come up with the policies that will make them flexible. A critical mass of reforms at national level should constitute a prerequisite before any European-level discussion on how best to facilitate price and wage flexibility and the swift reallocation of resources within and across sectors.

Conclusion: Governance for the People

The Eurozone economy appears to be on a better footing *today*. Growth is picking up and the ECB’s accommodative monetary policy is making inroads in the real economy- at least, in some parts of the union. Inflation expectations have gotten back from their trough, in a sign that price pressures are returning to a recovering economy. This cyclical recovery however should not be used as ‘time off’, or for shirking shared responsibility. The union’s institutional set up is out of step: with the objectives of many of the participating economies, with the priorities of national democracies and, more importantly, the European people. Clearly, the current equilibrium involving a persistent debt overhang, high levels of structural unemployment, weak demand and rising nonperforming loans, requires a fundamental rethink.

There must be a switch of framework, a re-framing of what is at stake. The aim should not be to ‘complete’ the imperfect monetary union. Above and beyond current thinking, the aim should be to restore sustainability and prosperity, in a credible and all-inclusive way. The crossroad ahead is tricky: the time to disengage European integration from auto-pilot mode is fast approaching, yet the political capital to pursue grand designs is simply not there. At least, the people of Europe affirm and reaffirm that they are in favour of the single currency[3]. This is a good place to start, a decent road to take.

[2]Draghi, Mario, ‘Structural reforms, inflation and monetary policy: introductory speech’, Forum on Central Banking, Sintra, 22 May 2015

[3] See Standard Eurobarometer 83, Question QA18.1

What next?

- Institutionalise flexibility where the implementation of rules appears strained or is no longer deemed credible by policy actors and/or markets. Make this institutionalization principled; establish regular policy/strategy revisions and reassessment of policy objectives.
- Rethink co-ordination and place national sovereignty at the centre. The European Semester type of approach, of 'isolating' economic policy from the political environment, has very little legitimacy. This is probably one of the reasons why it has not taken root. Strengthen the participation of national parliaments and identify the most suitable level at which to cooperate/coordinate. Resolve issues which stick: insolvency, democratic control over excessive spending, legitimate means of fiscal stabilization by way of transfers[4]. For co-ordination to work, it is imperative to factor in the different initial conditions and the diverse cyclical positions of the member states.
- Democratic accountability and legitimacy will not be enhanced with the creation of new institutions, of a euro area Treasury or a euro Commissioner. It is unrealistic, at best, to conjure up new institutions and rules, under the circumstances. Europeans have yet to digest those already in place and, in all fairness, the excessive intergovernmentalism witnessed ever since the Eurozone entered crisis management mode (but also thereafter) has exacerbated a feeling that this is not a union of equal members. Other steps should take precedence[5]. First, each country has to determine the most suitable institutional arrangements for delivering stability and prosperity to its citizens within the constraints of the union. Beginning with current institutional structures, it should develop and implement a clear plan for overall governance improvement. Each country's political appetite for and pace of adjustment should be respected equally, subject to a strong ownership record and the implementation of annual performance goals commonly agreed in the context of shared responsibility. Second, based on the multilateral recognition of structural weaknesses and strengths, and provided that real convergence has progressed and a mechanism for public risk sharing set up, a central body with a mandate to pursue a common growth policy and decision-making powers to see it through could be set up.
- At whichever level you choose to strengthen institutions, you should match the transfer or import of competences with the transfer or import of resources. At bottom, no amount of institutional engineering will work unless participating economies do their homework. The first and last precondition for the viability of the

[4] Janning, Josef, 'Leadership lessons: The Greece fallout: Note from Berlin', ECFR, 23rd July 2015

[5] Panagiotarea, Eleni, 'The Greek Surge against Austerity: A Blessing or a Curse for the Eurozone?', http://eu.boell.org/en/2015/04/08/greek-surge-against-austerity-blessing-or-curse-eurozone, 8 April 2015

union is that of national ‘ownership’. Put simply, it is time for the national level to do “whatever it takes”.

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