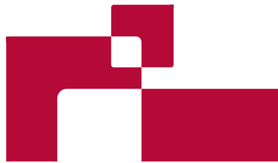

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EURO-AREA GOVERNANCE: WHAT TO REFORM AND HOW TO DO IT

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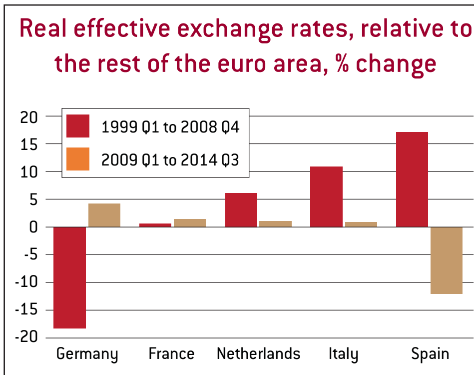
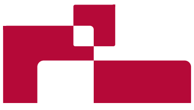
THE ISSUE Reform of the governance of the euro area is being held back by disagreement on what is at the root of the euro area's woes. Pre-crisis, the euro area suffered from the built-up of financial imbalances, price and wage divergence and an insufficient focus on debt sustainability. During the crisis, the main problems were slow resolution of banking problems, an inadequate fiscal policy stance in 2011-13 for the area as a whole, insufficient domestic demand in surplus countries and slow progress with structural reforms to overcome past divergences.

POLICY CHALLENGE

Euro-area governance needs to move beyond the improvements brought about by banking union and should establish institutions to prevent divergences of wages from productivity. We propose the creation of a European Competitiveness Council composed of national competitiveness councils, and the creation of a Eurosystem of Fiscal Policy (EFP) with two goals: fiscal debt sustainability and an adequate area-wide fiscal position. The EFP should have the right in exceptional circumstances to declare national deficits unlawful and to be able to force parliaments to borrow more so that the euro-area fiscal stance is appropriate. A euro-area chamber of the European Parliament would have to approve such decisions. No additional risk-sharing would be introduced. In the short term, domestic demand needs to be increased in surplus countries, while in deficit countries, structural reform needs to reduce past divergences.



Source: Bruegel. Selected euro-area countries.



JUST AS IT WAS CELEBRATING its tenth anniversary, the euro area was hit by a financial crisis that started in the United States but rapidly spread to Europe. Economic and Monetary Union (EMU) was ill prepared to deal with the immediate crisis and the large fiscal, financial and structural imbalances that had accumulated over the years. The financial crisis turned first, in 2010, into a Greek sovereign crisis and then, in 2011-12, into a full-blown bank-sovereign debt crisis that at one point threatened the very existence of the monetary union. The debt crisis has now abated but an economic crisis, with feeble growth and near-zero inflation, has replaced it. A lost decade beckons for the euro area, but its governments have been slow to respond[1].

The euro area has two features that have been particularly responsible for the crisis and for the difficulty of resolving it: major economic (and also political and social) differences between countries[2] resulting in some cases in failed policies, and the euro area's inadequate economic governance. Reform of this governance is needed in three major areas.

First, although fairly integrated, especially within the euro area, Europe's banking and finance system was left to operate without corresponding supervisory and resolution structures. Banking Union and various macro-prudential measures constitute a proper institutional response, though they will need to be improved in due course – a subject that is beyond the scope of this Policy Brief[3]. Second, in the absence of a nominal exchange rate and without a fully integrated labour market, the euro area needs a system to prevent large divergences between the unit labour cost (ULC) developments in its member countries. Third, the euro area needs a fiscal governance system to (1) ensure the fiscal sustainability of individual members, (2) to generate an appropriate area-wide fiscal stance, and (3) to quickly provide fiscal resources for prompt resolution in the event of banking and sovereign crises. We propose medium-term governance reforms to address the second and third of these issues, before concluding with the most pressing short-term challenges.

'The single currency resulted in imbalances and was ill-prepared to deal with them.'

THE RUN UP TO THE CRISIS: EMU'S SHORTCOMINGS

From the outset, the euro area comprised two groups of countries with substantially different socio-economic models and consequently different macroeconomic policies and outcomes: the core countries that belonged to (or shadowed) the Exchange Rate Mechanism (ERM) for more than a decade prior to the launch of the euro, and the peripheral countries that stayed mostly outside the ERM.

Different initial conditions in the core and the periphery, mainly in terms of interest rates, led to the credit boom in the periphery financed by capital flows from the core. This led to increasing competitiveness problems within the euro area, which were insufficiently monitored and difficult to counter in the absence of the exchange rate instrument. As a result, current-account balances and net foreign asset positions diverged to an unprecedented degree between the core (in surplus) and the periphery (in deficit). When the financial crisis hit in 2008-09, private capital flows from the core to the periphery suddenly stopped (Merler and Pisani-Ferry, 2012), leaving behind a mountain of external (private and public) debt in the periphery owed to creditors in the core countries. Italian and French price competitiveness diverged relative to Germany, but neither country ran significant current account deficits.

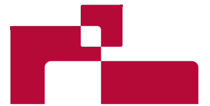
Instead of producing sustainable real convergence between the core and the periphery, the single currency had resulted in imbalances and was ill-prepared to deal with them. Insufficient attention was paid to the build-up of financial imbalances. This failure was not specific to the euro area, but the European monetary union was unique in that it lacked common supervision and resolution mechanisms to properly address financial crises within the integrated financial system.

This shortcoming, along with deeply entrenched opposition to bank resolution in a system characterised by major interdependencies between political systems and banks (Monnet *et al*, 2014), was a major hindrance in

1. See, for example, Carney (2015). Recent ECB measures are welcome but may prove insufficient to prevent a lost decade.

2. See Sapir (2005). General policy complacency and the great moderation were further factors leading to the build-up of imbalances.

3. In particular, the bank resolution framework, the deposit insurance system and capital markets union are important elements for further work.



getting to grips with a European financial-cum-sovereign-debt crisis of considerable magnitude, which evolved in 2011-12 from the global financial crisis.

Another weakness of the euro area's economic governance architecture was that it lacked a mechanism to monitor and correct macroeconomic imbalances, except in budgetary policy. Enforcement of the deficit rules was inadequate, public debt sustainability received relatively little attention and private debt no attention at all. Similarly, external debt (and current account imbalances) was all but ignored. Moreover, no attention was paid to long-term and persistent ULC divergences.

The lack of focus on public debt sustainability led to two types of situations: (1) Fiscal rules were insufficiently applied, partly because there was inadequate understanding of the debt sustainability risks. Stricter application of the rules would have reduced future debt problems in Italy (and other countries) and in Greece, where enough was known to justify more forceful demands for corrective action. (2) Countries like Ireland and Spain that, although they abided by the fiscal rules, proved not to be immune to debt problems once the financial crisis erupted, revealing the huge build-up of private debt that led to problems for their public finances.

Governance mechanisms to address macroeconomic imbalances such as wage divergences do not exist in true federations such as the United States. The euro area needs mechanisms to address both competitiveness divergence and coordination of fiscal policy, because labour mobility is limited and fiscal policy decentralised.

CRISIS MANAGEMENT: WHAT WORKED AND WHAT DID NOT?

When the global crisis triggered the European crisis, the European policy system was largely unprepared. Crisis management during 2008-14 consisted of:

- A timely coordinated macroeconomic response in 2009 consisting of monetary-policy easing, the European Central Bank playing the role of unlimited lender of last resort to banks and a substantial increase in fiscal deficits.
- Hesitant and delayed crisis management, with countries losing market access combined with the gradual establishment and reinforcement of institutions that can provide financial assistance and impose conditions for providing that assistance.
- A gradual process starting with the 'Van Rompuy task force' (European Council, 2010) to strengthen EU surveillance mechanisms, resulting in new rules and mechanisms[4].
- When the sovereign debt crisis became more widespread and yields increased substantially in Italy and Spain, quicker fiscal consolidation and ECB support was implemented through the Securities Markets Programme (SMP) and Outright Monetary Transactions (OMT) programme.
- As banking and sovereign stresses reinforced each other and bank resolution was delayed, the European Council decided to establish a banking union to de-link banks from their sovereigns and increasing financial stability. The banking union project is now officially finished.

The crisis response has not delivered economic results for the euro area. GDP has not grown since 2008, and unemployment has increased[5]. Inflation has fallen substantially and in December 2014, area-wide deflation (of -0.2 percent) was recorded for the first time since 2009. Internal adjustment has proceeded, with current-account deficits shrinking substantially[6]. However, current account surpluses have, if anything, increased in Germany and the Netherlands, reaching 7 percent of GDP or more in 2014. There was some wage and price adjustment in the crisis countries, but relative prices between the three biggest euro-area countries – Germany, France and Italy – have adjusted only marginally. The very low area-wide inflation rate has not helped: the lower it falls, the more difficult it becomes to achieve the necessary adjustment.

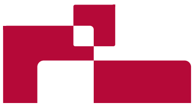
The euro area has not delivered. What went wrong in the last seven years, contributing to such a bad economic performance? Besides the severe macroeconomic imbalances at the beginning of the crisis, the following problems can be identified:

- From 2011 to 2013, fiscal policy in the euro area was pro-cyclical. In 2014, fiscal

4. The so-called six-pack, two-pack, Euro+ pact and the Fiscal Compact. See http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.

5. From 7.5 percent in 2007 to 12 percent in 2013 (11.6 percent in 2014).

6. Stressed countries including Cyprus, Greece, Ireland, Portugal and Spain reduced their current-account deficits on average by around 10 percentage points between 2007 and 2014.



policy was flat and did not counteract the continuing deterioration of the economy. Public investment and R&D expenditure have been cut during the crisis.

- Europe has taken a gradual approach to bank resolution; unresolved banking issues continue to plague credit provisioning in the euro area (European Systemic Risk Board, 2012). Banking problems were not addressed because of national political constraints and because of possible fiscal consequences.
- The ECB has been slow to respond to the deteriorating economic situation and has tried to avoid taking risk on board. It also misjudged the situation twice, resulting in erroneous rate increases.
- No serious and significant measures to address price divergence between Germany, France and Italy have been undertaken. Structural reforms progressed in all three countries largely in line with national political constraints, but were not commensurate with the need for adjustment in a monetary union where, by definition, adjustment cannot take place through exchange rate changes. Moreover, no euro-area wide demand management was undertaken to facilitate relative adjustment.

This analysis highlights the two central problems for euro-area governance:

a) **Fiscal policy**: no institution is responsible for the area-wide fiscal stance and for the distribution of fiscal policy across countries, and no fiscal resource (except the European Stability Mechanism) is available for risk sharing, including in banking.

b) **Only a very weak mechanism (the Macroeconomic Imbalances Procedure) exists to ensure that wage developments are in line with productivity**, which means that serious competitiveness problems can and do occur within the euro area. Wage setting remains mainly a national process with little or no regard for euro-area developments. Other national structural policies are implemented without consideration of potentially substantial cross-border effects.

'Preventing asset booms will not address all competitiveness problems in the euro area.'

Beyond these two governance problems, some euro-area countries suffer from very significant debt burdens and differences in social and employment performances and in the structural features of their economies. These legacy problems make governance reform significantly more complicated.

ON WHAT GOVERNANCE REFORMS SHOULD THE EU FOCUS?

The issue of sovereignty, or political legitimacy over policies, lies behind both governance problems we have highlighted.

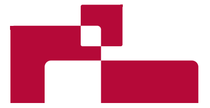
Wages and competitiveness

In many countries, persistent ULC increases were driven by unsustainable asset price booms resulting in overheating labour markets. The answer to such problems lies in better macro- and micro-prudential policies and better regulation of the financial system, which are beyond the scope of this Policy Brief.

Yet trying to prevent asset booms is not sufficient to address all competitiveness problems in the euro area, where countries often have labour markets and social systems that are incompatible with their membership of a monetary union. Other reforms that increase economic dynamism – for example the creation of a single and competitive market or the reduction of harmful regulation – are also essential.

The functioning of national labour markets must not lead to excessive competitiveness divergence. National wage formation and bargaining systems vary widely. As a result, the alignment of nominal wage growth with labour productivity growth at national level also tends to differ considerably in different countries. Such differences lead to inter-country changes in competitiveness, which are difficult to correct within the euro area because of the absence of the exchange rate instrument.

There are two basic solutions to this problem. The first would be to create a system comparable to a true federation with a single labour market. In the United States, citizens accept the model, in which they move regularly in



their lifetime from one state to another. The cost of such moves is limited because of the unified market and the absence of language barriers and barriers in the welfare system.

The alternative model starts from the assumption that it is neither desirable nor feasible to create a unified European labour market in which a unified welfare system would enable citizens to change their country of residence several times in their lifetimes. Some increased mobility is probably desirable and feasible, but we also strongly believe that the euro area will not for the foreseeable future create such a unified labour market in which regional shocks can be essentially fixed by large migration flows.

The euro area, therefore, needs mechanisms to prevent and correct substantial misalignments of competitiveness between its member countries. Since wage formation and bargaining systems are deeply rooted and difficult to change, deviations in competitiveness must be monitored and corrected before they become too significant and entrenched.

At EU-level, the Macroeconomic Imbalance Procedure (MIP) has the potential to be an important tool and should be applied symmetrically to correct excessive positive and negative imbalances. The MIP needs however to be complemented by national procedures to monitor and, if needed, correct competitiveness problems and to increase ownership at the national level. These procedures should be required by EU legislation and their performance monitored by the European Commission.

All euro-area countries should put in place a competitiveness-monitoring framework involving regular assessments and the definition of instruments to prevent problems. An interesting example is the Belgian framework, introduced in 1996 to preserve the country's competitiveness in EMU by keeping the evolution of wages in line with wage developments in the main trading partners. A national body regularly reports on the evolution of Belgian competitiveness relative to its three main trading partners (Germany, France and the Netherlands). These reports are used by social partners to fix a wage norm for the next round of wage negotiations. Although the norm amounts only to a non-binding guideline, it has generally been respected by the private sector (to which the system applies). In case social partners fail to agree a wage norm compatible with the evolution of competitiveness, the government can step in and make the norm legally binding. The system has worked fairly well: it kept untouched the wage formation and bargaining system that existed prior to the euro, but made the behaviour of social partners compatible with membership of the euro area. The result has been that ULCs in Belgium have evolved more-or-less in line with those in its main trading partners, thus avoiding major competitiveness problems.

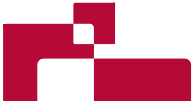
'All euro-area countries should put in place a competitiveness-monitoring framework'

The Belgian system could be improved, and anyway cannot be exactly copied by other euro-area countries since they typically have different wage formation and bargaining systems. What is important is that all euro-area countries put in place a mechanism to ensure that, although operating within their own system, the behaviour of social partners and the outcome of their wage negotiations is compatible with membership of the euro area in terms of competitiveness and employment. These national mechanisms would constitute national competitiveness councils.

We would recommend therefore the creation of a Eurosystem Competitiveness Council (ECC) consisting of both national competitiveness councils and the European Commission. The ECC's primary task would be to coordinate the actions of national competitiveness councils to ensure that no euro-area country fixes a wage norm that implies significant competitiveness problems for itself and/or others. In case this fails, the Commission should have the power to require the relevant competitiveness councils to take corrective action using the MIP and the European Semester instruments.

Fiscal policy

The euro area faces the choice of either significantly moving ahead with fiscal integration while accepting that national parliaments lose some power (eg Marzinotto *et al*, 2011), or imple-



menting a fully decentralised solution in which fiscal decisions are taken completely at the national level (eg Mody, 2013). For the latter, it is essential to have a credible no-bail-out regime so that national decisions have primarily national consequences.

The fully decentralised solution – accepting defaults without mechanisms to safeguard financial stability – would be politically, socially and financially unstable[7]. More worryingly, a decentralised solution would not provide adequate euro-area wide stabilisation, thereby forcing monetary policy to do more than it can achieve[8].

The euro area therefore needs to have a fiscal mechanism to reduce the pernicious effects of recessions, increase financial stability, reduce cross-border contagion and manage the fallout from debt restructuring should it become necessary, while government default should remain a last-resort option. There should be (a) the ability to steer a euro-area wide fiscal stance, (b) a fiscal capacity to manage sovereign debt and banking crises, and (c) a different regulatory framework for sovereign debt[9]. Since this amounts to a limited insurance system, mechanisms would have to be in place to manage the risk of moral hazard.

'The ECB would be overburdened if it had to manage alone the euro area business cycle.'

The current system of fiscal rules aims to establish smart, rules-based fiscal governance. However it fails in its aim because of faulty rules and ill-defined national fiscal discretionary space[10]. There is a need to adjust the current EU fiscal governance framework through several interconnected steps:

a) **A reform of the fiscal framework addressing moral hazard.** This could involve fiscal federalism by exception[11], with the focus of fiscal surveillance on debt sustainability. The closer a country moves to unsustainability, the stronger the intervention would be, with ultimately the complete removal of the ability to borrow. This enhanced governance would come on top of the ultimate possibility of debt restructuring.

b) **The fiscal framework should not only be given debt sustainability goals.** It should also ensure that the sum of deficits in the euro area achieves a reasonable area-wide fiscal stance[12]. The new framework would thus not only have the right to prohibit borrowing, overruling national parliaments, but it would also have the right to force member states to run higher deficits, overruling national parliament decisions in substantial euro-area recessions. In other words, the notion of 'fiscal federalism by exception' should be symmetric. It should apply to countries with both dangerously excessive deficits and insufficient borrowing from a euro-area perspective.

c) **The governance of fiscal surveillance could be organised in a Eurosystem of Fiscal Policy** (EFP), composed of a Governing Council (GC) that would be comparable to the Eurosystem of central banks. At its centre would be a euro-area finance minister[13]. This person would prepare the meetings of the GC together with five budget directors that have joint responsibility over the ESM. All euro-area finance ministers would also sit on the GC. The GC would take fiscal policy decisions based on qualified majority with the six central representatives having a substantial vote. These decisions would become binding at the national level in case of substantial danger to debt sustainability or a substantial euro-area recession. In normal times, the size of fiscal deficits would still be managed by the national level and the recommendations of the EFP would not be fully binding.

d) **The EFP would also have the power to activate fiscal resources of a fund,** such as the ESM, for special purposes. This would include providing support to individual member states in the context of an ESM programme, and backing-up banks in cases of severe systemic stress[14].

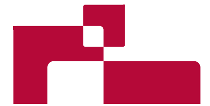
e) Such a system would raise substantial questions about its legitimacy and the role of national parliaments and the European Parliament. The ESM currently requires unanimity among the finance ministers, and prior parliamentary approval in several countries. This has proven to be complex. At the same time, unanimity is justified because the

7. Technocratic solutions such as indexing bonds to GDP are unlikely to be practical and would require a totally different regulatory framework. At the minimum, a European sovereign debt restructuring mechanism would be required; see Gianviti *et al* (2010).

8. See, for example Coeuré (2015) for a recent discussion of the argument originally made by Lamfalussy. In situations like the current one, monetary policy alone is insufficient to provide adequate stabilisation.

9. In Sapir and Wolff (2013), we argue for the introduction of limits or risk exposure limits or risk weights on sovereign debt.

10. It establishes a number of criteria that try to take account of the business cycle situation as well as debt sustainability in a rules-based framework. However, the rules fail to achieve what they promise because of the technical impossibility of computing output gaps, as has been amply documented. The discretion that is applied as a result is awkward and based on



resources needed to back up the fund are national taxpayers' resources. This system is ultimately unsustainable because it regularly puts national parliaments and decision makers in a position of having to vote on matters that could benefit banks elsewhere or even other countries.

f) We would therefore imagine a system, in which political legitimacy would be allocated to the European level together with European tax-raising power. The European or euro-area parliament would be allowed to raise a certain amount of taxes to fund the commitments of the common fund in case the fund needs to borrow for extraordinary circumstances. In other words, the European fund would draw on European resources requiring European legitimacy. A 'euro-area parliament' would thus provide legitimacy to decisions on the ESM fund and would also approve decisions by the EFP-GC when they are become binding on national parliaments[15].

'We propose a symmetric fiscal federalism by exception with appropriate legitimacy.'

g) This system would be a huge change from the current system, in which legitimacy of fiscal policy – despite a treaty-based framework of coordination – derives from national processes. In the Eurosystem of Fiscal Policy, the majority decision would be binding on national parliaments in the sense that in certain circumstances, their ability to borrow would be removed or they would be forced to borrow. Such a system would only be credible if the European Treaty and certain national constitutions were to change. It is also possible to conceive such a system without change to the European Treaty and instead with the establishment of a new intergovernmental treaty[16].

h) To increase the new institution's objectivity, we also recommend the creation of an independent euro-area fiscal council that issues opinions on the decisions taken and in particular confirms whether there are exceptional circumstances.

It is important to note that we do not propose the creation of a 'federal budget'. As essentially all government spending would remain at the national level, the creation of a federal capacity would imply either shifting substantial fiscal expenditures to the federal level or increasing overall government spending by creating new federal spending categories. The former option is unfeasible at this stage while the latter is probably undesirable given the already large size of the government sector in many euro-area countries.

It is also important to note that our proposal does not foresee risk sharing beyond the current ESM capacities. Our system is essentially a stepped-up framework for fiscal policy coordination. A much more far-reaching step would be to establish a fiscal mechanism for proper risk sharing between countries, such as a European unemployment insurance mechanism to complement national systems. This would introduce real risk-sharing. However, this would arguably only be possible if labour market conditions are harmonised significantly so that the mechanism only insures against truly exogenous events rather than policy-induced ones (Claeys *et al*, 2014). More risk sharing is desirable because debt levels are high in many countries and national-level borrowing might become constrained and financial markets might not be able to provide adequate funding for stabilisation. But these differences in starting positions will make it very difficult to move ahead with a risk sharing option.

An important question is whether the treaty changes that would be required to underpin these proposed fiscal mechanisms, and the additional sovereignty pooling that would go with them, would still be necessary for the euro area's functioning if competitiveness and debt-overhang problems had been tackled. Our view is that they would. A well-functioning monetary union requires fiscal mechanisms to ensure that shocks are met by the union as a whole. Problem solving in a monetary union cannot only be about putting one's house in order; it must also be about putting the common house in order. But this necessary change of philosophy compared to the current (Maastricht-based) approach will require a treaty change that can only be envisaged once trust between the

complicated political and technocratic compromises.

11. As proposed by Jean-Claude Trichet (2011).

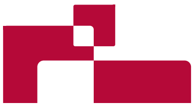
12. To achieve this, there needs to be first and foremost an agreement that this is actually a desirable policy goal. We believe that our analysis and the declining inflation rates clearly demonstrate the weak fiscal dominance and the substantial macroeconomic problem that the euro area has.

13. A European budget commissioner who can reject national budgets if they fail to respect the rules, as Wolfgang Schäuble put it in a speech in Bruges in March 2014 (Schäuble, 2014).

14. We thus envisage a further development of the ESM into a system in which decisions are taken based on majority voting in the EFP instead of unanimity of the ESM finance ministers, as is currently the case.

15. This was recently advocated by German finance minister Wolfgang Schäuble; see footnote 13.

16. The EU Court of Justice's 2012 Pringle



countries and citizens of the monetary union has been regained by implementing measures that require no treaty change but can go a long way towards solving the current situation.

TRANSITION TOWARDS THE NEW GOVERNANCE SYSTEM

There is a pressing need to address two central problems in the euro area immediately. First, it is imperative to increase inflation and demand. Second, it is imperative to address the substantial divergences in ULC, in particular between France, Germany and Italy. This requires political consensus between governments because the ECB cannot continue to act alone to achieve these objectives. A reformed European Semester with better timing and a greater focus on euro-area recommendations could lead to a change in philosophy.

Correction of imbalances in both surplus and deficit countries is essential as is dealing with the stock of debt through a combination of more aggressive macroeconomic policies and messy debt restructuring where necessary.

In the next few years, it will be challenging to manage acute problems such as high debt, high unemployment and weak growth. Leaders should keep in mind a sense of direction towards a new governance model that cannot be achieved overnight. Yet, without a process starting now that will eventually lead to the necessary treaty changes, the daily management of the various crises may become impossible.

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