

Making the European Union work

Issues for Economic Governance Reform

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Synthesis of round-table discussions
of the Expert Group on European Economic Governance

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Introduction

Between February and December 2010 the Bertelsmann Stiftung in Gütersloh, Germany organized a total of four expert round-table meetings under the title "European Economic Government – Managing Heterogeneity" in Frankfurt and Berlin. The immediate reason for the establishment of the working group was the rapidly developing sovereign debt crisis in Greece and the manner in which the European Union, the European Central Bank (ECB) and later on the International Monetary Fund (IMF) were seeking to identify solutions to the unprecedented challenge brought about by the events in Athens. As this report was being prepared, events became more and more unpredictable, with Ireland becoming the second euro zone member to seek a multi-billion financial rescue arrangement from the EU and the IMF, thus putting even more pressure on decision-makers to act. The recent Franco-German proposal for a **Pact for Competitiveness** has not been included in the deliberations of this group.

The urgency of events has given rise to a broader discussion about the nature and future of economic governance in Europe. Increasingly, the need for a thorough reform debate about economic governance structures inside the European Union was seen by the Commission, the ECB and national governments as essential for the future of the integration process.

The members of the working group were invited according to their expertise in the field. In consequence, a highly heterogeneous set of experts came together to discuss:

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The debates during the four meetings were often controversial and sometimes heated, thus reflecting the general political and public debate on the topic. Yet all members of the group were strongly and continuously committed to the cause and to finding agreement. In many areas, this turned out to be difficult if not impossible.

Therefore, this paper is to be considered a synthesis of the issues discussed and diverse ideas put forward during the four meetings and in written contributions by all members of the group. It should neither be considered a joint proposal by the working group nor a position by any of the experts individually nor the Bertelsmann Stiftung as a whole. However, our working group sought to participate in the public debate on these issues and to feed into the deliberations in Brussels and beyond.

This synthesis would not have come into being without the continuous commitment of the members of this group, to whom we owe our sincerest gratitude. We would, in particular, like to thank Jens Bastian and Iain Begg for their unwavering support in drafting this report, as well as David Gow, who did an exceptional job of editing the text despite the challenge of not having heard the debates around the meeting table. Not least would we like to thank our colleagues Céline Diebold, Thomas Fischer, Isabell Hoffman and Stefani Weiss for their substantial contributions as well as Gabriele Schöler for bringing this group together and organising the workflow.

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An urgent EU priority: economic governance reform

A crisis waiting to happen

The rapid transformation of the economic crisis into a sovereign debt crisis took Europe's leaders by surprise in late 2009. The true extent of the Greek fiscal deficit previously hidden by misleading statistics and the fear of contagion soon became alarmingly clear. And, indeed, a year later, Europe faced a fully-fledged crisis of the euro zone that called into question the medium-term stability of the 11-year-old currency. It still does.

This crisis has exposed blatant shortcomings in economic governance within the 17 member euro zone in specific and the entire EU 27. As we show below, these are now being addressed. In particular the absence of a crisis resolution mechanism within the euro zone was a yawning gap.

Procedures for surveillance of macro-economic policy were ineffective and inadequate. Fiscal discipline was poor. The constraints of the Stability and Growth Pact (SGP) imposing a 3% budget deficit ceiling and setting maximum government debt at 60% of GDP were regularly flouted – and hardly any Member State respected the Pact's medium-term objective of keeping budgets "close to balance or in surplus". Persistent offenders, including Germany and France, escaped any of the financial sanctions provided for in the SGP. Yet fiscal rectitude was shown not to be sufficient. Two former star pupils, Ireland, bailed out in December 2010, and Spain, had been credited with sound fiscal positions until mid-2010. Today they face severe adjustment problems because of asset bubbles in the housing and property markets that disguised their unsustainable budgetary stance.

Macroeconomic imbalances within the euro area, already extant long before the deep recession of 2008-09 but ignored, have been exacerbated by the 2010 sovereign debt crisis. Despite enduring efforts to ensure convergence before and after the advent of the common currency, underlying differences within and between national economies persisted and they remain today – in heightened form.

The European Central Bank, monetary guardian of the euro zone, uses as its main policy instrument (to control inflation) the "one-size-fits-all" short-term interest (repo) rate. But nominal long-term interest rates – those on euro-denominated government bonds – have arguably contributed to the emergence of imbalances because of national differences in inflation rates. In real terms, long-term interest rates were persistently lower in high inflation countries (Greece, Ireland, Portugal, Spain) than in low inflation countries (Germany, France, the Netherlands).

Cheap money in the more inflation prone member states contributed to substantial differences in real economic growth rates in the pre-crisis decade. But it also fuelled credit booms and house-price bubbles and led to growing current account deficits, while countries gaining in competitiveness, such as Germany and the Netherlands, accumulated growing surpluses.

During the first ten years of the euro unit labour costs in Germany were almost flat but they rose by over a quarter in Greece, Italy and Spain. These disparities were not especially visible in the good times, but as the gap continued to increase year by year, it suddenly became clear that it represented a major challenge for economic governance.

A failure of political leadership

...in Germany but elsewhere too

In addition to these difficulties, the crisis also exposed worrying political flaws. The delayed reaction of euro zone – and EU – leaders to the sovereign debt crisis and unseemly disputes over how to handle it cost huge sums of money. They appeared, moreover, incapable of understanding bond market dynamics and knowing how to communicate with capital markets during an unfolding crisis.

This was laid starkly bare in November 2010 when the Irish rescue package was finally adopted – not least because of ill-chosen remarks from Chancellor Angela Merkel of Germany and President Nicolas Sarkozy of France at their Deauville summit about bondholders taking their share of the financial burden. (We discuss this further below).

Clearly, so acute a crisis called for exceptional political measures and decisiveness. Instead, in 2010, we witnessed finger pointing: first and foremost at Greece but, later, at Ireland, Portugal and Spain and, even, France and the UK, a non-member of the euro zone. But, as the risks of contagion deepened and spread, everyone looked, above all, to Germany and Chancellor Merkel for the leadership that was obviously wanting.

But today's generation of political elites in Germany is quite unlike that during earlier phases of EU integration. It has been trapped between domestic pressures and growing self-assertiveness on the international stage; as a result, Germany's relations with the EU have become tricky and prickly. This partly reflects sensitivities over its export performance and the manner in which it is achieved.

Germany has been, probably unfairly, blamed repeatedly for its trade surplus. But the origin of the problem lies not in Germany but in the unfinished design of Economic & Monetary Union (EMU). From the very start of the euro, it was evident that countries at lower stages of economic development and with different technological and productive structures would have to restrain labour costs if they were not to squander the favourable terms on which they joined the single currency. Immediately after the launch of the euro, the consensus was that Germany had entered at a relatively uncompetitive exchange rate and would need to contain wage increases to improve its competitive position. This it did with great success.

Politically, however, its "attitude problem" caused untold and necessary damage to the image of EU – and itself. Its decision to hold back on radical deepening of the euro area, including reform of European economic governance on the lines favoured by France, swiftly annoyed its long-standing partner. And it provoked raised eyebrows by issuing an early public warning about the limits to what Germany could bear – notably its people's willingness to foot the EU bill indefinitely.

No country has, in fact, benefited more from EU membership, both politically and economically, than Germany. So, it was surprising that it chose not to promote a truly constructive European strategy that would instil confidence among both citizens and financial markets. Nor did it nip in the bud the still lively debate on quitting the euro zone and reintroducing the Deutsche Mark, with the potentially negative consequences this would bring.

But there are now signs of a change of political heart in Berlin (see below) – and in Brussels where the European Council, at its February 2011 meeting, agreed to press on with reformed governance and conclude further steps at its traditional March "spring" summit.

Action stations

The Greek sovereign debt crisis did, eventually, prompt extensive action – not least because of urgent market pressures. A rescue package was cobbled together as the unthinkable swiftly became the unavoidable. Barely 72 hours went by in Brussels, Berlin and Paris between agreeing a €110 billion international rescue package for Athens and a €750 billion emergency facility to stabilise the euro – the former adopted partly under the Lisbon Treaty's Article 122 allowing

emergency aid for a member state affected by "exceptional occurrences beyond its control."¹ In both cases, at German insistence, the IMF was also called upon to contribute a sizeable proportion of the money.

In the latter case, two huge contingency funds were set up in May 2010 to act as a bulwark against risk contagion: the European Financial Stability Facility or EFSF (worth €440bn and agreed by the EU-27 but only funded by the euro zone's 16 members - without Estonia which joined in January 2011) and the European Financial Stability Mechanism or EFSM (worth €60bn via the EU budget and backed by all EU-27 members). Taken together with the €250bn EFSF commitment from the IMF, they amount to €750bn.

Both instruments are temporary and are due to be replaced by a €500bn European Stabilisation Mechanism (ESM) from 2013 under an agreement reached at the December 2010 European Council meeting on a two-sentence amendment to Article 136 of the Lisbon Treaty. This will establish the permanent crisis resolution mechanism for the euro zone that was glaringly absent as the crisis unfolded.

The ESM – expected to be worth €750bn in total with the IMF's extra facility - is designed as an exclusively euro zone fund though other EU member states may contribute voluntarily. A key feature at its core is **conditionality** – agreement to meet onerous loan conditions such as interest levels, debt restructuring and strict external monitoring of progress towards set goals. This remains highly contentious – notably over any "haircuts" to be incurred by bondholders and the potential issuance of "Eurobonds" backed by the ECB. Germany favours the former but not the latter.

At the time of writing, the working group was unable to fully consider the latest Franco-German proposition for a "pact on competitiveness" which would see the 17 euro area members commit to a degree of co-ordination in corporate tax, pension and debt laws – including imposing "debt brakes" to control public spending and raising the official retirement age.

...As Captain Herman Van Rompuy steps in to steady the ship

Meanwhile, the European Commission had been working on proposals for closer economic co-ordination, initially securing agreement on splitting the fiscal year into a European semester during which the broad lines of national budgets would be scrutinised, leaving the national semester to settle the detail. The Commission then came forward with a far-reaching legislative package in late September 2010. Previously, the first permanent president of the European Council had been asked (end March 2010) to lead a task force on economic governance reforms: formulating new budgetary rules and regulations to prevent another Greek-style sovereign debt crisis. Essentially, it focused on fiscal surveillance and economic governance in the EU.

The task force – comprising 27 finance ministers, Commissioner Olli Rehn, Eurogroup chairman Jean-Claude Juncker and ECB president Jean-Claude Trichet – reported on October 21, 2010.² Its recommendations to reform economic governance were endorsed by the European Council at its meeting in Brussels a week later.

In all, six pieces of legislation – on reforming the SGP, introducing a new procedure for surveillance of macroeconomic imbalances and for improving domestic fiscal framework were approved following the conclusions of the task force and are now going through the legislative process.³ The (ambitious) aim is to agree upon these by June 2011 but stresses and strains among participants were acute in the run-up to crucial meetings in March 2011.

¹ A provision intended to provide support in dealing with natural, not financial, disasters but with enough elastic properties to become the most important tool in the box!

² "Strengthening Economic Governance in the EU". Report of the Task Force to the European Council, Brussels, 21 October 2010.

³ Regulation amending the legislative underpinning of the preventive arm of the SGP; regulation amending the legislative underpinning of the corrective arm of the SGP; regulation on effective enforcement of budget surveillance in euro area; directive on requirements for budgetary framework of member states; regulation on prevention and correction of macroeconomic imbalances; regulation on enforcement measures to correct excessive macroeconomic imbalances in the euro area.

The SWOT state of play

Strengths: The proposed new framework of economic governance can be expected to provide for significantly better prevention, making sovereign debt problems less likely and establishing a refined toolbox of dealing with them should they arise.

The reforms should strengthen macroeconomic management in the euro area. Given the severity of current shortcomings in surveillance aimed at preventing the emergence of excessive deficits or imbalances, the mix of new and revamped measures is a big step forward. The proposed range of sanctions under the SGP is much more comprehensive and coherent.

Adding an operational debt criterion to the SGP is long overdue as the risks to fiscal sustainability are clearly much greater for heavily indebted countries. Similarly, the proposed excessive imbalances procedure (EIP) should make it easier to highlight macroeconomic risks that could be systemic but do not show up in fiscal indicators alone. Our group welcomes the drive to buttress national fiscal frameworks, which will, over time, lead to more disciplined public finances.

A permanent crisis resolution mechanism was an absolute necessity so the fact that one is now accepted is to be heartily applauded. However:

Weaknesses: Serious reservations emerge about the effectiveness of the proposed changes to the way sanctions are implemented under the SGP and the new Excessive Imbalances Procedure (EIP). These sanctions range from peer pressure via interest-bearing deposits to, ultimately, fines for breaches of both provisions. It is, however, completely open to question whether the changes will make compliance by member states more likely.

The (controversial) reverse majority rule, under which sanctions proposed by the Commission are adopted unless explicitly rejected by the Council, is meant to increase their "automaticity."

The ECB had suggested automatic sanctions within the preventive arm of the SGP: up to and including the loss or suspension of voting rights. This notion was ruled out as it would require extensive treaty changes and also poses problems of legitimacy and democratic rights. The EU may be suffering from constitutional change fatigue after Lisbon but this question remains open.

There are no explicit procedures for the possible default of a member state (a position subsequently endorsed by the European Council). The Van Rompuy task force argues in favour of a *crisis resolution mechanism* only for countries in serious difficulties while Germany insists that such a mechanism can no longer be an orderly insolvency process. This, too, remains an unresolved issue.

The working group is unconvinced that the links between the Van Rompuy package, the new crisis resolution mechanism and the reforms of financial supervision – both the macro-prudential tasks assigned to the European Systemic Risk Board (ESRB) which monitors risks to the entire financial system and the micro-prudential ones overseen by the ESFS – have been sufficiently worked out.

Opportunities: The very fact that change is on the way opens up the prospect of more substantial reforms. The EU now has no role in fiscal stabilisation whether through its budget or similar instruments. But the crisis has underlined that the EU will have to move towards a greater degree of **fiscal union**: anathema to some, manna from heaven for others.

This could, in our view, mean one of three things. First, "more Brussels (and Frankfurt)" in the oversight of national fiscal policies is an option. The Van Rompuy package points heavily in this direction (a rules-based union). Second, it could entail mutual responsibilities or support for liquidity risks as in, albeit ad hoc, the Greek and Irish rescue packages (a liquidity union). The proposed new crisis resolution mechanism effectively extends the safety net. Third, it could mean a system of transfers from fiscally-well endowed to fiscally-strapped parts of the EU – to directly fund public services. This is normal practice within nation states but ruled out hitherto in the EU and between member states.

The proposed new ESM could lead to the creation of a **European Monetary Fund** – an idea we discuss, favourably, in more detail below. The **EU Budget** could also be more closely aligned to

the aims and ambitions of the Europe 2020 strategy which may prove to be no more attainable than those of the Lisbon strategy (which aimed to make the EU the world's most competitive economy by 2010 [sic]). The latter, a loose co-ordination of supply-side policies, has had uneven results to put it mildly. One could think of a substantial reform of the EU Budget from 2013, including the establishment of a ***pan-European unemployment insurance scheme***.

Threats: The crisis has been marked by hesitant and inconsistent political leadership. The proposed reforms so far give no clear guidelines on where the political lead will come from in European economic governance. The latter is provided, in the euro area, by the Eurogroup but its inter-action with the ECB, on the one hand, and with EU-27 bodies such as Ecofin and the Commission has not been recalibrated in the reform packages. The European Parliament, moreover, has been marginalised and is not included in the Franco-German competitiveness pact – just when the Lisbon Treaty has given it greater co-decision powers.

A lot of the political drive for taking the plans forward has come from the traditional Franco-German tandem. But, arguably, the negative short-term repercussions of the Merkel-Sarkozy "Deauville deal" (see above) militate in favour of a powerful figure for pan-European – EU or euro zone – economic policy formulation on the lines of the High Representative for Common Foreign and Security Policy (Catherine Ashton) created by the Lisbon Treaty. But that in itself is politically fraught by demanding further and more substantial Treaty changes that would be unacceptable in several countries, not just the UK.

There remains, also, the serious issue of ***democratic legitimacy***. The public in the shape of the EU's 500m citizens is profoundly alienated by the technocratic nature of EU decision-making processes. But the process of reforming European economic governance is already under way – however without engaging their active participation. Further co-ordination of economic and fiscal policies – which most of us endorse – will be a significant step towards political union but its acceptance and eventual success depend in no small measure upon reinforcing its popular legitimacy.

This requires, at the very least, a three-stage – short-, medium- and long-term – strategy of engaging with stakeholders. Initially, this must involve the media but journalists alone cannot be held responsible for political information and communication. Political parties and other relevant civil society bodies, notably social partners, must be involved more directly in the decision-making process. There is no longer a natural social and political consensus in favour of common European policies. Ultimately, then, new methods of ***citizen participation*** – via the Internet or deliberative democracy – need to be explored more intensively.

...a reality spot-check

The economic outlook for most countries in the EU may be less alarming than it was in 2009-2010 and the prospects for monitoring and preventing fiscal and other imbalances may be more robust today. But the period up to 2013 when the new ESM is due to replace the emergency measures adopted to contain the Greek and Irish crises risks being fraught. So far, the ad hoc nature of any agreements, the lack of definitive arrangements and the reaction to market trends rather than pre-emptive responses are a combustible mix. By itself, this could be a strong incentive for market players to test the instruments being adopted and the resolve of their advocates.

Countries still have protracted hangovers from previous excesses. Greece's lack of competitiveness may lead to deflationary cuts in labour costs that will prove politically impossible to sustain over the medium-term. Spain and, especially, Portugal face similar, albeit less acute, challenges. Italy, the leading "Club Med" player, has been relatively unaffected so far by contagion risks but is acutely vulnerable on the supply side. Ireland, politically unstable, has a real economy with sound foundations but faces two or three years of severe challenges in restructuring its banking sector and as the recently concluded elections demonstrated, deep-seated antagonism to the political class, let alone the bankers, and, ultimately, to "Brussels". In all cases, there is a rocky road to travel ahead in grappling with the political acceptability of austerity programmes and ensuring their legitimacy.

The German response?

Germany will, as ever, be pivotal. The renewed and extraordinary dynamism of its economy is vital for the rest of the EU but it is being accompanied by a growing assertiveness around German national interest. This impinges, inevitably, on its readiness to take on financial obligations and other burdens. Certainly, however, German political leaders have reasserted their commitment to the euro and our group welcomes that discussions to exclude countries from the euro zone have abated in Berlin.

There remain, nevertheless, critical questions. One issue is the apparently ultra-technical issue of symmetry in macroeconomic adjustment – and this starkly affects Germany's position and role within the euro area. Put simply: a symmetrical solution to the problem of imbalances could mean that the uncompetitive economies raise their game while the competitive, notably Germany, find ways of spending more. Equally, there could be excessive burdens on deficit countries to counter-act imbalances by adopting austerity policies that simply depress demand even further.

This could be destabilising by itself. If, under the proposed EIP, Germany (or the Netherlands) is expected to "correct" its persistent current account surplus – or face financial sanctions for promoting imbalances – it's hard to envisage any circumstances under which a German (or Dutch) finance minister simply sits down and writes a cheque to Brussels. But Europe needs to lead a debate on both deficit countries and surplus economies.

...and the crunch question

More generally, the great imponderable about the governance proposals is whether the new enforcement (sanctions) regime will be robust enough to ensure compliance. There is and will be a battle of national political wills and some say it is only when a financial penalty (the first!) is imposed on – and, critically, accepted by – a member state that we will know the answer. On this outcome, we remain deeply sceptical.

European economic governance – issues for further consideration

Many overdue reforms are already in the pipeline. But the more they will work towards automatic and binding surveillance of and sanctions for all Eurogroup and EU-27 members, the more the lack of **democratic accountability and legitimacy** will become evident.

European Council president Herman Van Rompuy and German Chancellor Angela Merkel are thus already speaking of far-reaching Treaty changes, while not necessarily meaning the same thing. The experts' group endorses these moves towards a more **federal Political Union** but specific proposals to reach this goal are beyond our present remit. The group favours, meanwhile, implementing the provisions of the Lisbon Treaty that allow partial devolution of governance powers.

Our group concluded that the following issues deserve further consideration by decision-makers, yet here reservations of different members of the group against different issues remain. This list should, therefore, not be considered a list of recommendations but rather "food for thought and decision-making".

Implementation of the provisions of the Lisbon Treaty embraces **national debt brakes** – which oblige governments to eliminate structural deficits over a defined period - to buttress the commitment of member states to sound fiscal policies. These should be controlled by national parliaments and overseen by European institutions, i.e. the Commission, the Council, the European Parliament, the European Central Bank and Eurostat, the EU statistical agency. The flip side is that this would result in six national and European-level institutions to oversee those debt brakes. The **European Semester** or six-monthly review process of national budgets should be conceived both as an early warning mechanism to prevent future crises and as driving forward structural reforms to improve the competitiveness of national economies.

A **scoreboard** of macroeconomic imbalances would better enhance the prudential capabilities of national fiscal policies. But this should be accompanied by a wider scoreboard of defined progress towards the objectives of the Europe 2020 strategy, the new 10-year strategy for revitalising the EU economy.

Despite some obvious shortcomings, our group notes the recent Franco-German proposal for a **Pact for Competitiveness**, but has reservations about its narrow focus and the risk that it puts too much emphasis on stability and not enough on growth. Under the European Semester this could inform the European Council's political guidelines set out in early March 2011. National parliaments and governments would then draw up and submit structural reform and stability and convergence programmes in April. This decentralised approach would help secure democratic legitimacy at home and at EU level.

Naming and shaming would be built into any scoreboard. Automatic sanctions within a reformed Stability and Growth Pact (SGP) should be complemented by incentives. These would reward sound economic governance by increasing the EU's funding of regional development projects. The European Systemic Risk Board would be empowered to send its alarm signals to all national legislatures and the European Parliament, not just the Council. Radical reform of the EU budget would embrace both the spending side (all investment would be linked to sound economic governance) and the revenue side by enshrining **EU taxes**. These twin innovations could be supplemented by a pan-European **unemployment insurance scheme**.

In the case of insolvency, the EU needs a sovereign debt restructuring mechanism, which fully involves the private sector ("haircuts"). The transition from the proposed European Stabilisation Mechanism (ESM) and the European Financial Stability Facility (EFSF), to a **European Monetary Fund** may be an answer. Aid from the EMF would be under the control of Euro zone members (and their parliaments!) and strictly conditional.

Reconnecting financial markets to the real economy is, above all, urgent. A strict application of stress tests and (varying) minimum reserve requirements for banks under the Basel III agreement and a single regulatory framework for the financial sector under the new "European System of Financial Supervision" are essentials.

On effective decision-making

The sovereign debt crisis has laid bare fault lines in EU fiscal policy coordination under Economic & Monetary Union (EMU) during the past decade. The system operated ineffectively and there was no in-built capacity to anticipate crises. The EU's *Stability and Growth Pact* (SGP) proved inadequate in the euro's first 11 years. The main characteristics of this original framework are well-known (see footnotes):

In theory and on paper a combination of general guidelines, multilateral surveillance, potential sanctions up to and including fines and the "no-bailout rule" was supposed to produce effective fiscal policy-making in EMU. However, in the current economic crisis an exogenous shock to demand has hit the euro area countries. With interest rates converging to zero, this shock has had significant external effects which should ideally be internalized via a coordinated effort of national fiscal policies.

If one adheres to the view that no member state can be allowed to default, this logically implies that a *political union* or, at the minimum, some degree of *fiscal union* - implying central control over tax and spend policies, possibly including greater transfers of tax receipts - must complement the euro even though there is a lack of consensus on what fiscal union could mean in practice.

- Fiscal union could mean "more Brussels" (or Brussels *and* Frankfurt) in the oversight of national fiscal policies. The Van Rompuy package pushes quite a long way in this direction [rule-based union].
- Or it could entail mutual responsibilities or support for liquidity risks. This has happened in an ad hoc way with the Greek and Irish rescue packages. The proposed new crisis resolution mechanism effectively extends the safety net but is a mechanism designed for crisis and crisis alone, and not for more routine times when preventive funding might make better sense than reactive bailouts.

In the common interest, for example, the euro bond proposal could be a justifiable step and potentially lower borrowing costs for all euro area members [liquidity or funding union].

- A third form of fiscal union would mean a system of transfers from fiscally well-endowed to fiscally constrained parts of the EU, to provide direct funding of public services. Such flows of resources are normal in nation states, but have hitherto been unacceptable in the EU [transfer union].

This is the dilemma which European political leaders and the European Parliament must now confront: either a dramatic step towards more political and fiscal integration or a bullet-proof framework to cope with the effects of a member country's failure to comply with the fundamental rules of EMU.

After the recent Greek experience, it is crucial that independent national and European statistical authorities (Eurostat) assure the quality of data. In the agreements on *stricter macroeconomic surveillance* the application of a scoreboard on trends in competitiveness and macroeconomic imbalances which enable the timely identification of negative developments is set out.

On effective prevention and surveillance

Was Greece ever subjected to fines from the European Commission despite the decade-long practice of fiscal deception and public finances fiasco? To what degree could the Irish problems and Spanish troubles, namely private sector debt and asset bubbles in the property sector, have been avoided through the EU's Stability and Growth Pact?

The obvious answer is that the system of surveillance was found wanting and therefore must be improved. Consequently, any new mechanism and/or institutional arrangements should contain clear rules on decision-making procedures and on sanctions. There also has to be clarity on funding facilities, conditionality for loans, monitoring of resource allocation, as well as a political mandate to facilitate an orderly resolution of sovereign debt liabilities.

Prevention and surveillance in European economic governance

With most levers of economic policy in the hands of national governments, coordination is at the heart of European economic governance, starting with prevention. In some respects, the existing system achieves this. Budgetary discipline is covered by the SGP, while prudential supervision has addressed the microeconomic dimensions of financial stability. But one of the principal conclusions from the troubles of the spring of 2010 is that broader imbalances (both within and between countries) and divergences in competitiveness have not been given proper attention.

The new Lisbon Treaty provisions governing economic and monetary policies offer additional powers of co-ordination. Euro area members may adopt stronger co-ordination and surveillance measures than apply to the EU as a whole, albeit with the caveat that they have to be compatible with the latter. This can open the way for wide-ranging innovations, since only a qualified majority of "participating" member states is required to take action.

The obstacles to effective prevention are largely political; they remain formidable and pose acute legitimacy and accountability challenges. In addition, there will be legal constraints because of subsidiarity (the devolved power principle) and the assignment of competences in the Treaty. Moreover, the spectre of the German Federal Constitutional Court, with its vigilant stance on transfers of sovereignty, can further inhibit change. Finally, for many countries outside the euro zone, including the UK, the dilemma is that they see the merits of effective surveillance, but bridle at being subject to it.

Focusing on imbalances

Imbalances can arise between countries bilaterally or multilaterally, in the structure of an economy, or between short and long term imperatives. There can often be two sides to imbalances and one of the most enduring challenges in economic policy co-ordination has been how to reduce existing asymmetries and introduce effective burden sharing. A possible taxonomy (classification) of imbalances is shown in box 1 and can be thought of as a template for approaches to prevention.

Box 1: Imbalances and indicators for monitoring them

LEVEL	NATURE OF IMBALANCE	INDICATORS
Global	Savings/consumption	Current account of BoP
	Dependency on few key industries (e.g. oil)	Volatility in GDP
Intra EU	Savings/consumption	Intra-EU trade balance
	Competitiveness	Trends in unit labour costs
	Attractiveness to investment	Inward FDI, standardised
Intra Member State	Sustainable public finances	Excessive deficit – short term
		Rising debt – long term
		Un-funded obligations (age)
	Private indebtedness	Level and growth by main sectors of economy
	Asset bubbles	House prices or similar index
	Industrial concentration or growth of activity	Share of GDP in branch relative to benchmark
	Spatial	Regional disparities in GDP per head
	Inequality	Gini coefficient

There are undeniable obstacles to effective burden-sharing, aggravated by the fact that deficits are associated in public perception with recklessness and surpluses with virtue. If prevention focuses excessively on curbing deficits while leaving the causes of surpluses untouched, the collective effect will be to dampen demand. German surpluses and Greek deficits cannot be seen in isolation from each other.

Governance in the euro zone

European policy makers sought to signal last year that they were capable of agreeing on dramatic new steps in order to save the euro zone from disintegrating. However, after an initially positive reaction, many capital and bond market participants questioned the unprecedented stabilization funds for weaker euro zone members and, particularly, the ECB's direct purchase of sovereign bonds on secondary markets.

An equally important objective is to restore fiscal discipline and improve fiscal coordination among existing euro zone members. The inherent problem appears to be as simple as it is severe in its consequences: the *Stability and Growth Pact* (SGP) has been found to be time-inconsistent and unenforceable, providing no mechanism to override national sovereignty.

With the benefit of hindsight the central flaws in the euro area's institutional setup are obvious: first, a currency union will be under pressure without sufficient fiscal convergence. Secondly, the euro area has not been capable of creating credible incentives for fiscal discipline over time. On the contrary, the creation of EMU has weakened such incentives, notably by eliminating exchange rate risk at the individual country level.

At the same time, a perceived "implicit bailout" insurance scheme induced lower credit risk premia and converging sovereign bond yield spreads. This kind of interest rate convergence based on soft budget constraints is clearly the opposite of what the founding fathers of the euro area had in mind.

The irony is that for ten and a half years capital and bond markets behaved exactly how the ECB expected they should: they looked at the euro area *as a whole* rather *than at individual* countries – and this specific focus represented an important part of the problem.

An improved institutional setting for macroeconomic surveillance should also include a framework for collective agreement on the longer-term economic objectives of the EU. Incentives included in the surveillance and discipline package should be aligned with medium- to long-term strategic goals, including of course the 2020 objectives. This is on its way to being achieved via a better coordination of national fiscal policies, focusing on the budgets' orientations, during the "European semester": the six-month cycle of reviewing budgetary and structural policies within member states. Thresholds and sanctions in the surveillance mechanisms should be conceived in such a way as to induce national governments to direct their budgets towards jointly defined goals, such as reducing carbon intensity and other sustainable development targets.

As regards economic policy, the differentiation between proposals for euro area and non-euro area countries made by the Commission and the task force is likely to become an issue. Potential sanctions and conditionality will play a lesser role with non-euro area countries. Scoreboard thresholds may also be different between euro area and non-euro area countries.

The looming question is whether and by how much an economic "core Europe" could decouple itself from the non-euro area countries and, in doing so, indirectly make it less probable the latter will enter the euro area in future. It is thus overall right to take into consideration the very close interconnections with non-euro-area economies, especially those that are expected to join the euro area, as part of the new multilateral surveillance.

It should also be carefully assessed whether non-euro area member states could possibly join the European financial stabilisation mechanism on a case-by-case basis and after fulfilling pre-defined criteria.

Is a scoreboard approach suitable?

It is often argued that a "scorecard approach", as envisaged for the new excessive imbalances procedure, will allow a transparent and easily accessible picture of the state of each euro area economy relative to the rest of the region. The key elements of the scorecard would include:

- Indicators on domestic real interest rates;
- Indicators on current account and trade positions;
- Indicators on the fiscal position (structural and cyclical);
- Indicators on the net household position (savings rate, household debt);
- Indicators on unit labour costs developments.

For each indicator, the distance between the individual country's position and the euro area average would be the main measure. The added advantage of this approach is that it would not be limited to the fiscal stance of a country.

But a rigid and mechanical application of such a large range of different indicators may simply be ambiguous and confusing. This, in turn, would damage the effectiveness of monitoring and potential sanctions. For instance, how should one react if some indicators point one way and a couple of others another? How to aggregate the evidence? If aggregation is agreed upon, what are the weights? In any case, the real issue is inadequate governance of an array of imbalances prevalent within a country. The answer proposed in the EIP is for there to be complementary qualitative analysis and political judgement. The danger with this approach is precisely that which bedevilled the original SGP, namely that when it becomes uncomfortable, the politics overrides the rules and the system falls into disrepute.

On automatic fiscal stabilization

The countries within the euro area suffered differently and asynchronously from the deep recession of 2008-2009. Discretionary fiscal stimuli were adopted in all countries, but with very different magnitudes, structures and timing. One common feature was the deterioration of public finances. However, an unresolved issue is how extensive coordination of national fiscal policies should be, whether for the euro area or the EU in its entirety.

Fiscal policy centralization and coordination - a controversial issue

View 1: On the (lack of) benefits of fiscal policy coordination in EMU

Around two years ago, policymakers in the EU-27 started drawing up rescue packages to prevent the financial crisis hitting their economies with unmitigated force. Each government responded with a country-specific set of measures. Given the global nature of the crisis, would coordinated action at the European level be a better approach? Or can national governments deal more adequately with economic problems?

It is widely assumed that a common currency makes it desirable to have a common fiscal policy (or even a political union).⁴ However, this is not a foregone conclusion if one accepts that fiscal policy can also deliver shocks. Fiscal policy might be destabilizing in the current crisis because: policy makers do not have full control over outcomes; the effect of a given measure (e.g. a tax reform) may be quite different from what is anticipated; or, as in the current situation, the economic forecasts underlying fiscal policy may turn out to be wrong. Finally, if fiscal policy measures are to be effective, it is crucial that those presented as temporary are not seen by private agents as liable to become permanent.

Looking at the case of the current economic crisis, it is reasonable to assume that an exogenous shock to demand has hit the euro area countries. With interest rates converging to zero, this negative shock has significant external effects *which should ideally be internalized by a coordinated effort of national fiscal policies*. This proved to be a point of convergence within the working group.

View 2: The availability of automatic fiscal stabilisation mechanisms

When the global crisis hit the real economies of EU member states in 2008-2009, the debate on counter-cyclical budgetary policies was revived, concentrating on *discretionary fiscal stabilisation*. National governments put together huge stimulus packages and the European Commission mobilised €5bn from its own budget for measures at the EU level – an historic first even if tiny in scale.

However, individual member states' stimulus measures were said by critics to lack any pan-European coordination. Economically, it might make sense to take a euro zone view (e.g. on the question of fiscal stimulus), some of us argued, but this was not in line with domestic policy makers' incentive systems.

In the absence of automatic stabilisers at EU level, fiscal stabilisation has mainly been implemented through national budgets since the Euro's launch. Some of us therefore argue that the consequences of the global economic crisis and the lessons learned from the European sovereign debt crisis necessitate a re-think about the establishment of mechanisms for automatic stabilisation inside EMU.⁵

⁴ For a survey on the first issue see, for instance, De Grauwe, P. (2005), *Economics of Monetary Union*, 6th ed. (Oxford University Press, Oxford), and Gandolfo, G. (2001), *International Finance and Open-economy Macroeconomics*, Springer, Berlin-Heidelberg. For an introduction into the second aspect see Gros, D., Thygesen, N. (1998), *European Monetary Integration*, Addison Wesley Longman, New York.

⁵ These suggestions have been presented in greater detail by Sebastian Dullien/Daniela Schwarzer: *Bringing Macroeconomics into the EU Budget Debate: Why and How?*, in: *Journal of Common Market Studies*, Vol. 47 (1), 2009, S. 153-174.

- The public debate on the composition and volume of the next multi-annual EU budget post-2013 has been fuelled by the proposal to introduce an EU tax. Our group argues that this EU budget debate cannot be conducted in isolation from the discussion on the future of EMU governance.
- Depending on its nature, a European tax would be a more suitable instrument to take into account the wealth of certain regions or member states than the current funding system behind the EU budget. This holds true for a European corporate tax and - from an economic point of view - even more so a European income tax.
- A second avenue concerns the expenditure side and how to equip the EU budget with resources earmarked for stabilization functions. To date no expenditure is devoted to stabilisation purposes. For some countries, transfers from Brussels reach important volumes in terms of GDP ratios. But the resources are often spent without any consideration for the state of the national business cycle: in Spain, structural funds amplified the construction boom.
 - Several measures could be taken to solve these problems. Firstly, the disbursement for investment-spending should more closely match the business cycle by extending or speeding up the funding period. Structural funds could thus acquire a secondary purpose of stabilising national or regional business cycles. The same principle could be applied to spending redirected towards R&D, vocational training initiatives and life-long learning.
 - Furthermore, in order to facilitate the stabilisation of the business cycle across regions and over time, the EU should receive a mandate to build up reserves in an economic upswing and spend then in a down-turn. This can be achieved without allowing the EU to accumulate debt if the system is introduced in a cyclical upswing. Such reserves could have complemented the €5bn of discretionary spending by the Commission during the severe economic recession in 2008-2009.
- Thirdly, we propose the introduction of an explicit pillar of automatic stabilization, namely a European unemployment insurance scheme to supplement the member states' national systems. Each country would still operate its own scheme, reflecting national preferences and traditions. It is important to emphasize that such a European scheme would not raise the overall contributions for employers and employees.
 - Such a scheme would only compensate for cyclical unemployment (and not for structural unemployment) as only those who have been regularly employed for a certain period prior to unemployment can receive payments.

All three proposed measures require financial resources which would initially be rather low. Under this approach, the instruments in question could provide partial stabilisation without jeopardising their primary purpose, i.e. bringing the economy closer to balance. Even if problems resulting from cyclical divergence in the EMU would not all be immediately solved, a systematic change in the way the EU budget works could be kick-started by giving it an unprecedented parallel stabilising function.

On a dual mandate for the European Central Bank

One of the key lessons from the first decade of EMU is the primacy of the pro-cyclical real interest rate effect over the counter-cyclical real exchange rate effect. If inflation rates vary across countries, the single nominal interest rate set by the ECB will translate into country specific real interest rates. Member states with higher inflation will face lower real interest rates while those with lower inflation rates will face higher real interest rates. The real interest rate effect thus operates in a pro-cyclical manner. However, the CPI rate also affects the real exchange rate, and thus exports and imports to other euro area countries. High inflation countries will face declining external demand whereas low inflation countries will improve their competitiveness. The real exchange rate effect thus operates in a counter-cyclical manner.

What kind of a dual mandate for the ECB?

The ECB takes into account economic developments in the euro zone as a whole. So its "one-size fits all" monetary policy potentially threatens to destabilize those domestic cycles whose economic fundamentals are/were not in line with the euro area average. However, blaming the ECB for such outcomes would be putting the cart before the horse. From the perspective of the euro zone as a whole, the ECB ran a wholly appropriate monetary policy during the first decade of EMU. Its performance in the crisis was much better than that of fiscal policy in terms of timeliness and scale of impact. Looking at each Member State individually, however, the destabilizing effects become clearer.

The Federal Reserve (Fed) has a dual mandate from the US Congress regarding economic growth and consumer price inflation. Unlike the ECB or other central banks which directly target inflation an explicit numerical goal is not part of the Fed's mandate.⁶ Unlike the Fed's, the ECB's official mandate, however, covers inflation but not employment.

The idea of introducing such a dual mandate for the ECB has been controversial within the working group, not least because it is hard to square it with the bank's existing statutory mandate; it risks locking monetary policy into quasi-fiscal activities. The latter becomes immediately obvious with an eye on the Fed's current policies of quantitative easing (QE) which spill over onto other regions of the world via the global liquidity channel and/or other central banks copying it.

However, this is a difficult balancing act since expected inflation also raises the nominal interest rate. Some of us expressed doubts that the ECB disposes of such kind of fine-tuning knowledge. The US example clearly demonstrates that expansionary monetary policy targeted at high unemployment is inadequate because US unemployment has become more and more structural and monetary policy is not a suitable instrument to fight structural weaknesses.

Quasi-quantitative easing by the ECB – following an implicit dual mandate

The European Council agreed to tighten the SGP and set up a system aimed at reducing macroeconomic imbalances within the euro area. It obviously took the view that the main source of the euro area debt crisis was the "misconduct" of national governments which permitted their budget deficits and debt levels to explode and implemented too few measures to avoid economic divergences. While this view is partially true, it clearly neglects the fact that unsustainable increases in private debt (of households and financial institutions) forced many governments to bail out the private sector (and, in the end, forced the ECB to pick up the pieces). Excessive bank credit enabled the emergence of these bubbles. In the long run, only the central bank but not governments can control bank credit volumes, the conditions for lending and the development of unsustainable private debt.

Reforms of euro zone economic governance should therefore not only focus on the serious responsibilities of national governments but also on those of the European monetary authorities, particularly those of the ECB. After Lehman's collapse, European policy followed the principle that

⁶ The most influential regional Fed president, William Dudley, the president of the Federal Reserve Bank of New York and a vice-chairman of the federal open market committee with a permanent seat on the Fed's rate-setting body floated the option to adopt an explicit inflation target like that of the UK in October 2010.

the insolvency of governments and banks had to be prevented under all circumstances and at any cost. The sustained bond market turbulences exposed this as a fantasy. The welcome compromise agreed upon at the European Council meeting of 28-29 October 2010 clearly diverges from this principle. The links between the current European rescue packages, the proposed new permanent crisis resolution mechanism and ECB monetary policy need to be better understood. The ECB main refinancing (repo) interest rate shields Ireland and Greece from insolvency. This important aspect is neither taken into account nor explicitly tackled within the package of governance reforms.

All the discussions about a potential "bail-out" of countries within the current rescue package neglect the fact that a much larger bail-out can be read off the ECB balance sheet in, say, the form of purchases of "toxic" government bonds. This *must* effectively lead to a redistribution of risk among member states but it will also lead to the deterioration in the asset quality of the ECB's balance sheet.

However, an even more alarming aspect that may have escaped public attention is that the ECB supports member countries within its ordinary monetary policy operations. The ECB enables troubled and distressed commercial banks to refinance hundreds of billions of euros, i.e. 40 to 50 percent of GDP for Ireland and Greece respectively, at a one percent interest rate but with a discount on the value of collateral accepted. Without this transfer of nearly free money, both countries would almost certainly have gone bankrupt some time ago. ECB lending to Greece amounts to a subsidy worth more than the transfer from the EU Structural Funds⁷.

The ECB is now the buyer of only resort for Irish bonds, possibly the only policy institution able to prevent the collapse in Irish and Portuguese bonds from further spreading.

A European Monetary Fund, on the model designed by Daniel Gros and Thomas Mayer, may well represent the blueprint of an orderly sovereign default mechanism which truly deserves its name⁸. It would contribute decisively to release the ECB from its role as turning into a bad bank and let debtor countries and creditors share the costs of sovereign default according to the costs-by-cause principle. Otherwise the reputation of the ECB would be damaged too much and one would slip deeper and deeper into a transfer union.

⁷ Gros, D., Is financial failure an option in the EU?, CEPS Commentary, Centre for European Policy Studies, Brussels, May 27.

⁸ Gros, D. And Mayer, T. (2010): 'How to deal with sovereign default in Europe: create the European Monetary Fund now!' CEPS Policy Brief, Centre for European Policy Studies, Brussels, 17 May 2010.

On a European Monetary Fund

The financial rescue framework used to bail out Greece proved politically cumbersome, took too long to agree with huge financial consequences,⁹ and was devised in an ad hoc manner. Both transparency of procedure and predictability of policy action were hardly visible in the run-up to the three-year, €110 billion financial rescue package.

The *European Financial Stability Facility* and limited to three years with a nominal volume of €440 billion is an AAA-rated facility set up outside EU treaty rules. Largely at German insistence its successor mechanism (the new ESM) is being implemented through a change of the Lisbon treaty and includes the key provision that private creditors will have to share the burden, via collective action clauses, of any sovereign debt rescheduling.

Making a bail-out system – or "crisis resolution mechanism" – permanent must be embedded in the treaty to be "legally unchallengeable".¹⁰ This precondition reflects domestic considerations, especially the need to satisfy Germany's federal constitutional court of the EFSF's legitimacy. France argues that, in order to make the current EFSF facility permanent, each euro zone member would have to agree to provide capital resources as collateral for a bond offering to assist a country in crisis.

The lessons learned from the Greek-style sovereign debt implosion in May 2010 have given rise to a plethora of proposals regarding the establishment of a European Monetary Fund (EMF), aka a European Stability Fund. In spring 2010, Germany's finance minister Wolfgang Schäuble temporarily supported the idea of an EMF publicly but has since failed to reiterate that support.

The experts' group argues that setting up an EMF to deal with euro area member countries in financial difficulties is superior to the option of either calling in the IMF or muddling through on the basis of continuous ad hoc decision-making procedures and institutions. Such a fund would include an orderly default mechanism, operate as an insurance scheme and be based on the compliance of euro zone countries with the Maastricht fiscal deficit and public debt criteria.¹¹ However, the risks of moral hazard should be taken into account while drafting. It is not yet clear whether the new ESM will go far enough achieve this range of goals.

The European Monetary Fund

Our deliberations about the need for and mandate of an EMF are much in line with current proposals presented by Gros/Mayer (2010) and a recent presentation by the ECB. This discusses ways to reinforce economic governance in the euro area without – however – referring explicitly to the possibility of an EMF.¹²

The majority view in the working group is that an EMF would be a common EU institution under the formal supervision of Ecofin. In terms of its governance, there is no need for a president, but rather a collective – and independent - leadership structure similar to that pertaining at the IMF.

In order to avoid political controversy over whether the EMF would complement or take the place of the IMF our group suggests that it represents the euro zone area inside the governance structures of the IMF. This meets concerns that an EMF could duplicate activities and responsibilities of other international financial institutions.

An EMF creates a regional system similar to other IMF-like regional funds outside the euro zone. Regional insurance funds are being set up elsewhere, notably among members of the *Association of Southeast Asian Nations*, plus China, Japan and South Korea. This Fund would hold USD120 billion (€90 billion) in the event of major liquidity issues for subscribers. Latin American countries also want to create a regional alternative to the IMF through their *Bancosur* lender, launched in

⁹ Within the time period of March to end-May 2010 the volume of financial assistance discussed inside *Ecofin*, the *Eurogroup* and the Commission for Greece moved from initially €30 billion to €110 billion!

¹⁰ German Chancellor Angela Merkel in the Bundestag, 27 October 2010, quoted according to the FT, 28 October 2010: 'Treaty Change Forced on to Brussels' Agenda', p. 9.

¹¹ Gros, D. And Mayer, T. (2010): 'How to deal with sovereign default in Europe: create the European Monetary Fund now!' CEPS Policy Brief, Centre for European Policy Studies, Brussels, 17 May 2010.

¹² European Central Bank (2010), Reinforcing economic governance in the euro area, Frankfurt/Main, June 10.

2007. An African fund is likewise under consideration. The EMF would be designed for the euro bloc only.¹³

This leaves open the question how an EMF would be institutionally integrated into the permanent crisis resolution mechanism agreed at the December 2010 EU summit. There is also no consensus among us over whether the proposed mechanism should embrace the IMF or not.

In terms of efficacy, the EMF would improve EU fiscal federalism while limiting moral hazard. More importantly, the setting up of an EMF would, at the same time, come with defined orderly sovereign default procedures for euro zone members. The EMF could also enhance the transparency of public finances because its intervention mechanism in the event of failure would penalize derivatives trading and other unregistered transactions. This would be a strong deterrent against governments using this type of transaction to try to massage their public finances.

Even more important from a strategic point of view, an EMF does not systematically discriminate against smaller countries and takes away any appearance of Franco-German dominance from the mechanism. An EMF mitigates the increasing tensions between larger and smaller member countries, the latter feeling patronized by the former. This is because every member country would, according to the envisaged financing mechanism, be called to account proportionally to its GDP if it breaches the Maastricht fiscal criteria. The prospects for setting it up would improve if it could lose the image of a potential IMF rival internationally, especially in the US.

In terms of the critical question of where the financial resources for the EMF would be coming from, the working group proposes a variety of sources:

- (i) Eurobonds could constitute the funding basis. Furthermore, the transfer of available resources from the ESM into an EMF would be an additional option.
- (ii) Contributions that are calculated on a country's sovereign debt/budget deficit ratio. The less disciplined a country is in budgetary matters, the more it would have to pay in. The EMF would maintain a conditional solidarity, i.e. countries in financing difficulties are entitled to financial support, according to their previous payments and agreement to tailor-made adjustment programmes supervised by the Commission and the Euro Group.
- (iii) The incentive structure for member states to make use of EMF resources should be low. Only those countries in breach of set limits on governments' debt stocks and annual fiscal deficits would have to contribute, giving them an incentive to keep their public finances in order. This is precisely why it cannot be claimed that an EMF would encourage fiscal irresponsibility.

The argument in favour of establishing an EMF cannot ignore existing cons. One potential drawback might be that if the EMF is stricter in terms of its economic and financial conditions, European countries may opt to go to the IMF in Washington instead.

Without the installation of a sovereign default mechanism complementing an EMF, the ECB has to bear the burden. But it then risks degenerating into the "*Bad Bank of the euro area*" as private and institutional investors offload their sovereign bond holdings with uncertain repayment values onto the ECB's balance sheet. An EMF on the model designed by Gros and Mayer, 2010¹⁴ might well represent the blueprint of an orderly sovereign default mechanism which really deserves its name. It would contribute decisively to release the ECB from its current role as a "bad bank" for sovereign debt from distressed euro zone member states.

But this proposal can work only if and when there is a credible threat to member states that failure to comply with the requirements set out by the Commission can also result in a country defaulting on its sovereign debt. In other words, the political choice between activating the EMF mechanism and proceeding towards an orderly default procedure must remain available to policy makers.

What remains unclear to date is if the establishment of such a Fund should take place inside or outside the EU Treaty framework. Is it politically feasible to separate the establishment of an EMF

¹³ See "European Monetary Fund debate: the main points." EU Business. 11 March 2010

¹⁴ See Gros, D. And Mayer, T. (2010): 'How to deal with sovereign default in Europe: create the European Monetary Fund now!' CEPS Policy Brief, Centre for European Policy Studies, Brussels, 17 May 2010.

from the Treaty? It is a subject of considerable debate whether one would need Treaty change to create an EMF or not. In the ECB's view this appears to be necessary. By contrast, the current Franco-German position supports a limited treaty change, but no advocacy of an EMF.

The positive answer to the question whether the EMF can be set up without a new Treaty argues that such a procedure would ensure that the existing no-bailout clause – Article 103 saying the EU may not be liable for the commitments of national governments - is not abolished or irrevocably called into question. The flip side of this view holds that non-EU countries would be involved in any restructuring negotiations and/or financial assistance deliberations.¹⁵

¹⁵ Unclear is the involvement of the Paris Club of public creditors and the London Club of private creditors.

On the role of capital markets

In Athens, Dublin or Lisbon bond markets are now frequently portrayed as barbarians at the gate. With countries inside the euro zone competing to be the fastest to impose belt tightening, the events of the past months beg the question whether fiscal discipline is best administered by the sheer presence of markets?

This suggests that market valuation of sovereign risk remains a valid mechanism for punishing fiscal profligacy, especially in a financial crisis. The adjustments being implemented today would have been much easier to deliver when budget revenues were flush and the political as well as economic conditions more favourable. But a puzzling question remains unanswered: why did markets not exercise this power sooner?

This debate proved controversial within our group. The question arose concerning how much market pressure can force governments of widely different political colours to deal with long-term overspending and structural fiscal deficits. In other words, is there a tipping point where bitter fiscal medicine can turn into an overdose because markets are not exercising disciplinary pressure but simply overreacting and mispricing potential risks?

This herd mentality in financial markets cannot be underestimated. The ongoing euro area debt crisis underlined blatant evidence of state failure – in particular the failure of the EU's disciplinary devices – but also a significant dimension of market failure. As an example: until mid-2009 the spread difference between 10-year Greek bonds and German benchmark *Bunds* was only 30 basis points. The subsequent correction that followed was rapid, but can also be seen as an overreaction to previous market passivity and/or indifference.

It therefore remains to be seen if the proposed new governance mechanisms that are the outcome of the Van Rompuy task force will establish new rules of the game or if some of the participants continue playing by their own rules. But there is a strong corrective element already at work. Any evidence that countries are not committed to establishing greater fiscal discipline will quickly be registered by bond market participants and credit rating agencies and the cost of their borrowing needs will rise in international capital markets.

Equally, we have to bear in mind that any ambiguity in policy-making or recommendations at the EU level will swiftly be noted by "bond vigilantes". This was evident when European leaders decided at their summit meeting end-October 2010 to reopen the EU's treaties to create a new permanent rescue mechanism.

But markets immediately interpreted the summit agreement as signalling that current (junior) bondholders would be forced to take "haircuts" if Greece were to restructure or Ireland and Portugal needed to be rescued. Irish bond prices subsequently surged to record levels. It took the intervention of finance ministers from Britain, Germany, Spain, Italy and France at the G20 meeting in Seoul, South Korea to state publicly that such a new system would not be in place until 2013 and that it would not be retrospective.

The definition of this private-sector role in a future permanent rescue mechanism has yet to be fully clarified in terms of legal procedure and administrative execution. French proposals suggest that private investors would be dealt with on a case-by-case basis when a country defaults or has to restructure. By contrast, the German position appears to be more focused on an insolvency procedure with automatic "haircuts" for private creditors. Whatever the outcome of these highly charged deliberations, it appears that in certain circumstances private sector involvement will become necessary. On November 12th, 2010 Mrs. Merkel was quoted in the FT as follows:

"Let me put it quite simply: in this regard there may be a contradiction between the interests of the financial world and the interests of the political world. ... We cannot keep constantly explaining to our voters and our citizens why the taxpayer should bear the cost of certain risks and not those people who have earned a lot of money from taking those risks."

Credit rating agencies

In early November 2010 the EU Commission published a consultation note addressing the further procedure with respect to rating agencies.¹⁶

- Competition: Only a handful of big firms make up the CRA sector. There are high barriers to entry. Concerns have been expressed that the rating of large multinationals and structured finance products is concentrated in the hands of only a few CRAs. This lack of competition could damage the quality of credit ratings. The Commission asks what options exist to increase diversity in this sector;
- The rules on whether and under what conditions civil liability claims by investors against CRAs are possible vary greatly between member states. These differences could result in CRAs or issuers shopping around, choosing jurisdictions where civil liability is less likely. The Commission asks whether one should consider introducing a civil liability regime in the EU regulatory framework for CRAs;
- Conflicts of interest: The "issuer-pays" model raises questions of conflict of interest. Under this model, issuers solicit and pay for the ratings of their own debt instruments. This model is the prevailing model among CRAs. As they have a financial interest in generating business from issuers seeking the rating, this could lead to assigning higher ratings than warranted in order to encourage the issuer to do more business with them in future. It may also lead to practices of "rating shopping", which is when an issuer chooses a CRA on the basis of its likely rating. The Commission asks what evidence there is for such practices and whether alternative models would be possible.

In our view the Commission's consultation points in the right direction and expedient action in this regulatory field is necessary.

¹⁶ 'Financial services: The European Commission consults on further policy in the field of credit rating agencies', 5th November 2010, IP/10/1471.

On enforcement

We have seen that surveillance of budgetary balances alone, as reported by national governments, even if reinforced by paying attention to debt, is not enough.

No country has ever been fined in the euro's 11-year history for overstepping the EU's deficit limit. This means that soft law devices (such as peer pressure or naming and shaming) are all that is available. A legally robust means of triggering sanctions has yet to be identified and agreed upon.

The Centre for European Reform has suggested turning the "Europe 2020" process "into a proper benchmarking exercise, with naming and shaming"¹⁷. The Gonzalez Reflection Group proposed strengthening the link between common guidelines at EU level and their implementation at national level "through an effective 'name and shame' peer pressure mechanism process".¹⁸

The oversight of national budgetary positions exercised by various EU agencies (Ecofin, Eurogroup, Eurostat, the Economic and Financial Committee and the Commission) has manifestly failed to maintain macroeconomic stability because of their inability to force member states to implement necessary changes. Table 1 presents a simple count of the number of years for which different fiscal outcomes were achieved for the EU-15 (1999-2003) and the EU-25 (2004-2007) in the years leading up to the crisis.

Table 1: Overview of budgetary discipline in EU, 1999-2007

	Surplus	Deficit 0-3%	Excessive deficit	% excessive
EU-15, 1999-2003 (75 observations)	29	32	14	18.7
EU-15, 2004-2007 (60 observations)	26	18	16	26.7
Sub-total EU-15 (135 observations)	55	50	30	22.2
EU-10 2004-2007 (40 observations)	6	23	11	27.5
Total EU-25 (175 observations)	61	73	41	
% of cases	34.9	41.7	23.4	

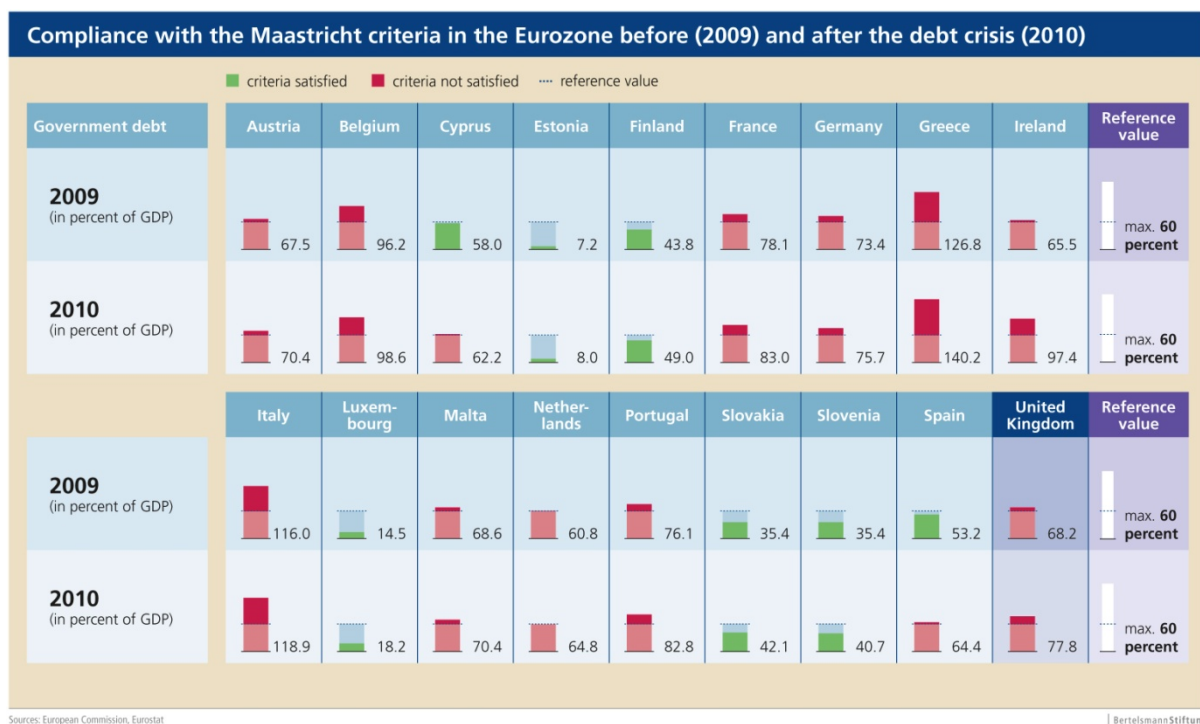
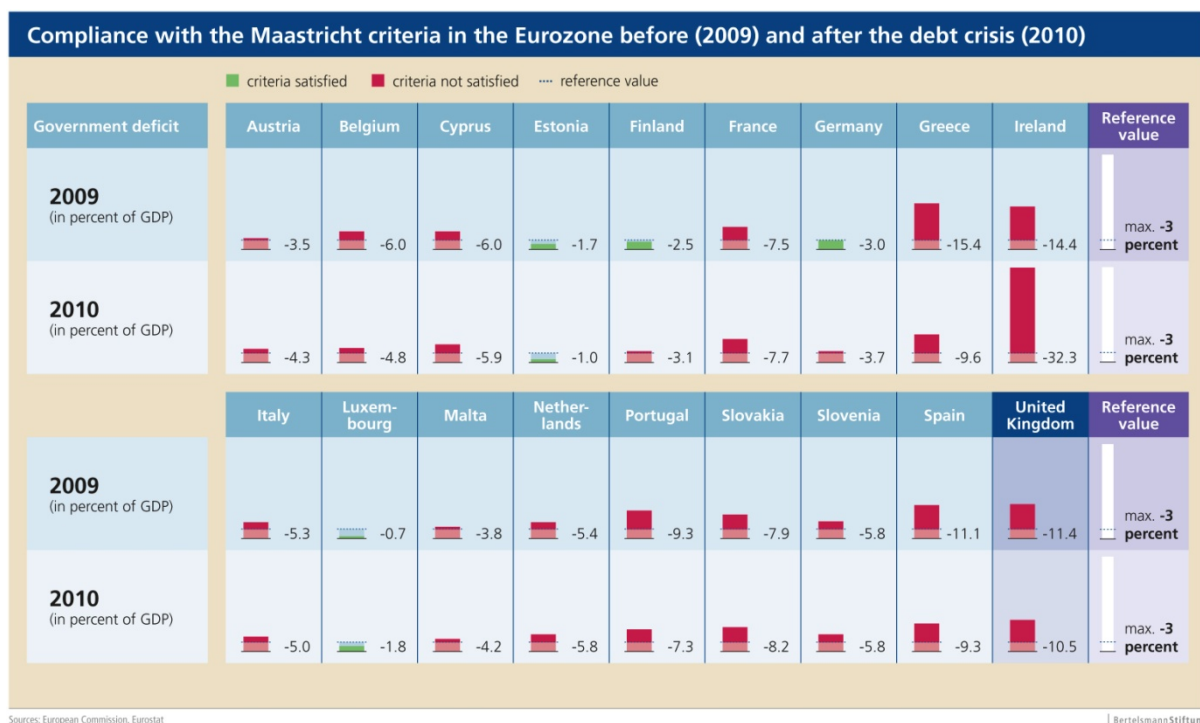
Source: elaborated by Iain Begg using data from AMECO database

¹⁷ Tilford, S., Whyte, P.: The Lisbon Scorecard X: The road to 2020, London: Centre for European Reform, Press Release, March 15th 2010.

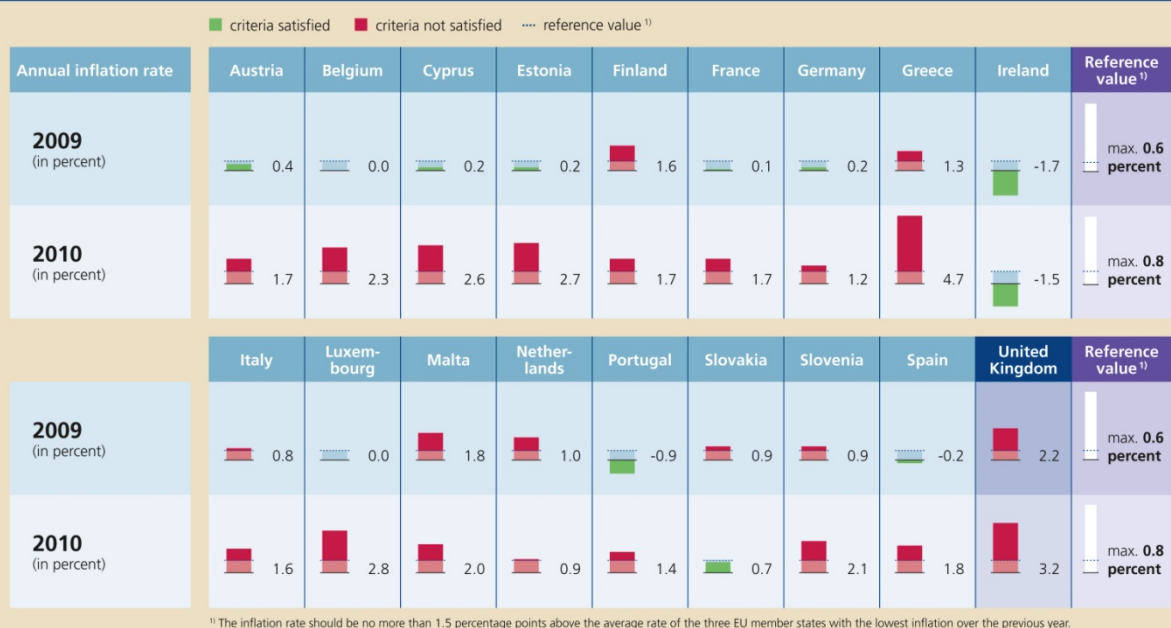
¹⁸ Project Europe 2030. Challenges and Opportunities. A Report to the European Council by the Reflection Group on the Future of the EU 2030, May 2010.

Appendix:

Compliance with the Maastricht criteria in the Euro zone before (2009) and after the debt crisis (2010):



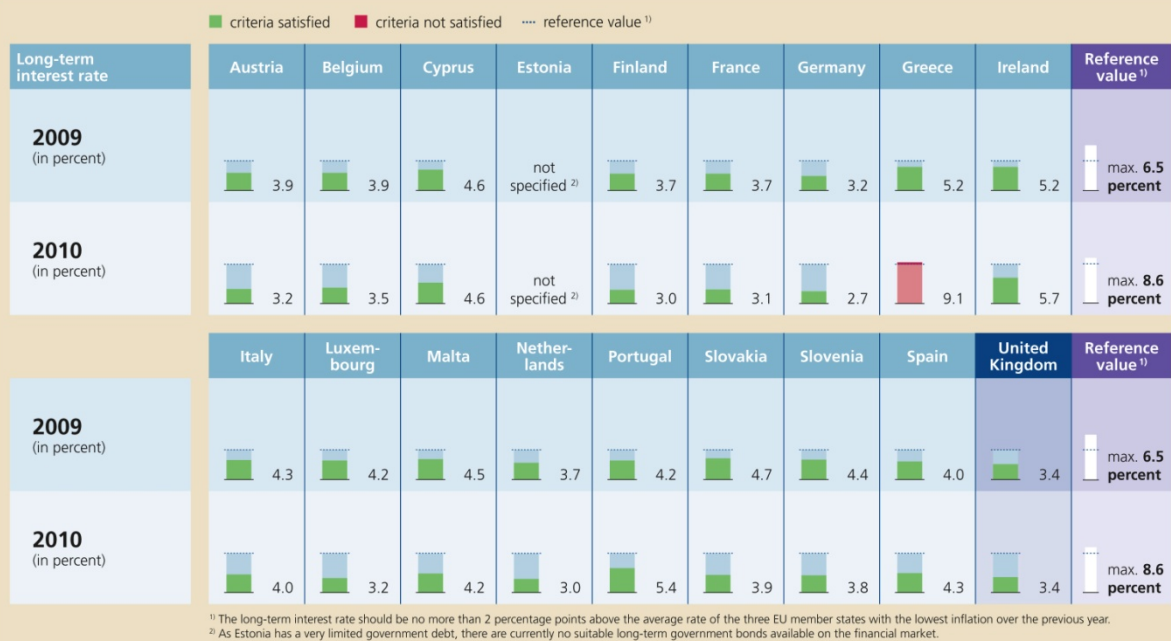
Compliance with the Maastricht criteria in the Eurozone before (2009) and after the debt crisis (2010)



Sources: European Commission, Eurostat

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Compliance with the Maastricht criteria in the Eurozone before (2009) and after the debt crisis (2010)



Sources: European Commission, Eurostat

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